Mr Clementi elucidates the core purposes of the Bank of England and gives his thoughts on the UK economy

Speech by Mr David Clementi, Deputy Governor of the Bank of England, to the Cardiff Business Club Dinner, Cardiff, on 28 February 2000.

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Ladies and Gentlemen, it is a pleasure to be here in Cardiff. I last visited the city in November for the final of the Rugby World Cup. I admired the new stadium, loved the atmosphere and enjoyed the game. Of course the big match is coming up this Saturday, where the men in white will be seeking revenge for the damage done to them last year in the unlikely setting of Wembley Stadium. We can safely leave the debate on the match to the newspapers, sure in the knowledge that they will cover huge amounts of column inches on the likely outcome by the time we get to kick-off. Instead this evening I would like to outline the changes in the Bank since independence in 1997.

The Bank may trace its origins back to 1694; but it has been through a period of profound change since 1997 when the Labour Government was elected: the arrival of monetary independence and with it the Monetary Policy Committee; the transfer of debt management to the new Debt Management Office; and the merger of the Bank's banking supervision department into the Financial Services Authority.

On the face of it, these add up to a substantial change to the Bank's responsibilities; and to our operations and staffing needs. But in fact our underlying objectives as a central bank - what we term our three core purposes - have remained remarkably unchanged. These are, first, maintaining the integrity and value of the currency; secondly, maintaining the stability of the financial system; and, thirdly, seeking to ensure the effectiveness of the UK's financial services. I would like to say something about each of the three core purposes in turn.

Core purpose: monetary policy

As regards monetary stability, as you all know, the Bank was given monetary independence in May 1997 when the Monetary Policy Committee was established to set interest rates. The structure of the Committee was later set out in the Bank of England Act 1998 and the Bank's independence in pursuit of monetary policy is enshrined there. To quote directly, our objective is "to maintain price stability and, subject to that, to support the economic policy of HM Government including its objectives for growth and employment". The balance implied in this objective is important. First,although the Bank has operational independence, the inflation target - RPIX (that is, retail prices excluding mortgage interest payments) of 2.5% - is set by the Government and confirmed in the Budget each year. And this target is symmetrical. We on the MPC are as concerned about inflation being below 2.5% as we are about it being above 2.5%. Indeed, if inflation is more than 1% above or below target, the Governor is required to write an open letter to the Chancellor to explain why. But the accountability of the MPC is much wider than this. It has to answer to Court (the Bank's board made up largely of non-executive directors) and to the Treasury Select Committee. But of equal importance, through publication of the Inflation Report and the minutes of its monthly meetings, the MPC answers to the public, setting out in some detail the decisions it has made.

And this accountability is personal. The votes of each of the nine individual members are recorded in the minutes. As you might imagine, knowing that one's voting record will be subject to public scrutiny helps wonderfully to concentrate the mind. But we think it is important that differences of view are properly reflected; and nor is it altogether surprising that differences of view exist given the uncertainties in economic forecasting.

Transparency is another key ingredient of the new framework. Holding MPC meetings on a regular monthly cycle, with minutes published within two weeks, contrasts with the more ad hoc approach of the past, Chancellors announcing changes with little or no notice and with limited explanation.

The minutes not only record the discussion within the MPC and explain the decision reached but also list the data that the Committee has considered. The Committee relies primarily on official statistics but these are often produced on aggregate basis and with a lag. The Bank, therefore, relies to a considerable extent on its established network of twelve Regional Agents who have the role of finding out from local businesses and firms their views on the state of the economy. The Agents maintain direct contact with around 7,000 businesses across the UK and provide a monthly report for each region to the MPC. Where there are particular concerns, the MPC also commissions the Agents to carry out inquiries on specific issues.

Because of the time it takes for changes in interest rates to impact on inflation, it is perhaps too early to judge the success of these new arrangements. We could argue that we have made a reasonable start, given the period of sustained growth with low inflation and falling unemployment the UK has enjoyed since the new monetary framework was put in place. But a fairer measure of the MPC's success is perhaps the fall in inflation expectations since May 1997 (which can be derived from prices of government bonds) which has brought the cost of long-term borrowing down to historically low rates. I think that this provides some measure of the growing credibility of the monetary policy framework; and the expectation that we have moved into an era where we can expect low and stable price conditions.

Core purpose: financial stability

I will say more later about the current position of the UK economy, but first I would like to say something about the other functions of the Bank which are perhaps less familiar than the MPC. The Bank's second core purpose is maintaining the stability of the financial system.

The Bank is no longer responsible for the supervision of individual firms but has a clear interest in ensuring the financial system functions smoothly. As the Asian Crisis in 1998 and the problems in Japan show, dislocation of the financial system can impose significant economic costs and it is the Bank's role, looking at the system as a whole, to identify potential threats and vulnerabilities.

In some respects this interest is integral to the Bank as a central bank. For example, secure and efficient payment and settlement systems are an essential condition for economic growth, providing the means for money to flow between individuals, businesses and government. Like other essential services - electricity, water - it is easy to take payment systems for granted. But the amounts involved are huge: 30mn transactions are processed every day in the UK clearing system, the value of which totals over £800bn every week. These payments ultimately result in transfers between settlement banks across accounts which they maintain at the Bank of England.

A failure in the payment system could have an immediate impact on the economy and the Bank has worked with clearing banks to reduce the risk to the financial system, first by the introduction of Real-Time Gross Settlement and now by moving towards delivery versus payment in securities markets.

Less esoteric, perhaps, is our interest in the financial stability of individual firms and the structure of the financial system as a whole. While responsibility for individual firms lies with the FSA, the Bank takes a close interest in the impact on the wider economy of the regulatory structure and the links between individual institutions and markets.

The Bank also has a direct role as lender of last resort. In the event that a bank has liquidity difficulties that might undermine confidence in banks more generally, the Bank has the power to step in to provide support on a temporary basis. But in exercise of this power and in other aspects of financial stability, the Bank works closely with the FSA and HMT; and this common interest is governed by a Memorandum of Understanding. The three parties also meet monthly in a Standing Committee to discuss any issues of current concern; and relations with the FSA are further cemented by the fact that I sit on the FSA Board and Howard Davies is a Member of Court.

One of the major driving forces in financial markets currently is technology. The face of banking is changing rapidly, with barriers to entry in particular markets and between markets falling as first telephone banking and now internet banking and e-commerce impact on more traditional banking services.

Technological innovation creates opportunities for integration of services and wider access to markets that previously did not exist. This can be seen clearly in the movement towards integration of stock exchanges and clearing houses. But more technology brings with it more operational risk. One example is the work involved with preparation for the Millennium date change, in which the Bank was heavily involved in ensuring that the UK financial system was ready; this work certainly brought home to me the reliance on IT and the huge variety of interconnections between different systems.

While IT networks and improvements in communications have allowed provision of financial services more cheaply and efficiently, they have also brought financial markets around the world closer together.

This trend to globalisation has been beneficial to the UK. Net investment income and profits from overseas make an increasingly large contribution to the UK balance of payments, going some way to offset the deficit on traded goods. However, with global markets, shocks in one part of the world are transmitted more quickly to other financial systems. The most recent example was the Asian crisis, starting in the summer of 1997 in Thailand; and spreading to Korea which had to seek outside support in December of that year. As turmoil spread through financial markets in the region, within a year equity markets had halved in value with a similar depreciation in exchange rates. Conditions were further exacerbated in August 1998 by the default on Russian government debt, fuelling further fears about emerging market debt. The flight to quality this prompted contributed in turn to the collapse of one of the large US hedge funds, Long-Term Capital Management.

The events of 1997 and 1998 brought home the complex linkages between financial markets in a global economy. The international community has been active since in putting in place arrangements for more advance warning of risks to the financial system. The accent has been on improved disclosure, establishing new international standards for transparency in monetary and financial policies and for publication of economic and reserves data forcountries to follow; and for firms (in particular, banks) in developing countries improving standards for corporate financial disclosure. The Bank has been actively involved in these initiatives. For example, to watch over the financial system, in order to permit either early warning of an impending crisis or to permit the coordination of a speedy response to problems, a new body was established, the Financial Stability Forum; and this body brings together representatives from central banks, governments and regulators from most of the major world economies.

All this may seem a long way from South Wales but the stability of different parts of the financial system, here and overseas, can have a significant impact on what is happening in our back yard, not least because of the importance of foreign direct investment from countries such as Korea into the United Kingdom, and particularly here in Wales.

Core purpose: effectiveness of financial services

There is a connection here to the Bank’s third core purpose - promoting the efficiency and competitiveness of UK financial services.

The Bank has been active in particular in promoting financing for small business. This role dates back to 1993 in the aftermath of the last recession. At the time there was evidence of a breakdown in communication and trust between small firms and their finance providers which threatened the effectiveness of the provision of finance to this sector of the economy. Since that time, the situation has improved, in part against a background of economic growth but also with a change in the structure of small business finance with a move away from overdrafts towards some element of fixed-term lending. A particular interest has been financing for high technology companies, focusing attention on the access that technology-based firms have to the equity they need in their early stages. The Bank produced its first report in this area in 1996 and has since held an annual forum with regular meetings with small business groups, venture capitalists and fund managers. Small business investment is especially relevant for Wales given the ongoing need to attract more knowledge-based industries to replace more traditional sources of investment.

One final area where the Bank has taken an active role is worth mentioning; and that is in assisting the UK financial sector in its practical preparations for EMU. This was concentrated in the run-up to the introduction of the euro at the end of 1998 but the UK's readiness at that time has meant that a large part of cross-border business in euro, whether in bonds or equities, is transacted with the UK, particularly in London. The Bank continues to promote London's merits as a financial centre and, despite EMU, London remains the primary financial centre in Europe.

The UK economy

Let me conclude with some thoughts on the UK economy. With inflation below target and sterling so strong, whilst the MPC's recent decision earlier this month to raise rates was expected by the market, it also attracted some criticism. But if the inflation target is to be met, the MPC cannot afford to ignore evidence of inflationary pressure emerging in the economy. Domestic demand is strong and the economy as a whole is growing above trend (at around 3%); a rate that is unsustainable unless, that is, UK productive capacity and the trend rate of growth have increased, such that the UK can enjoy a period of rapid non-inflationary growth similar to the US. The labour market is clearly tight with average earnings rising at close to 5%, even before the large jump in December's data which we think may have been influenced by bonuses and Y2K payments. Increases through last year in the price of oil and other commodities are beginning to feed through the supply chain to producer prices. At the same time, increases in asset prices - share prices and housing - are fuelling consumption further, not least through the pick-up in mortgage equity withdrawal. Given the time it takes for interest rate changes to feed through to inflation, it is important for the MPC to be forward-looking and proactive in dealing with these threats.

Set against this, sterling's strength, essentially against the euro since the dollar rate has remained fairly constant for some time, continues to bear down on some sectors and some regions. Within the MPC we are very conscious of the resulting sectoral imbalances in the economy and you may have seen from the latest minutes that we have discussed the issue at length. One of the standard policy responses in these circumstances would be a fiscal tightening, but active use of fiscal policy in this way is by no means straightforward.

In the circumstances, it is not clear how monetary policy in the short run can help in bringing sterling down to what we might regard as a more appropriate level. A decision not to have raised rates would not necessarily have resulted in a fall in sterling. In the context of buoyant domestic demand and a tight labour market pointing to strong underlying domestically-generated inflation,the market might have been left with the expectation that tighter policy had simply been deferred, and this might have had the perverse effect of putting further upward pressure on sterling. Another possibility that the Committee considered was foreign exchange intervention; but there is no indication that market support for sterling at these levels is fragile and any intervention operation that failed would be damaging to the credibility of the Committee and thus of the new UK monetary policy framework.

These were the factors behind the MPC's decision at the last meeting to raise rates: but it may well be that there is now an opportunity to wait and see for a period how the economy develops; and this need not damage our prospects of meeting the inflation target; and it might improve the chances of continued sustainable growth in output and employment, and, perhaps, of a return of sterling to a more realistic level.

I would like to finish by thanking the Cardiff Business Club and Sue Camper for providing me with the opportunity to speak to you tonight. I believe most of you know Sue and the work she does as the Bank's Agent in Wales. The Agents play a vital role as a channel of communication not only for the

Bank to explain more widely the monetary policy framework and the reasoning behind MPC decisions; but also to hear the views of others on the economic conditions they are facing. And I am grateful, on behalf of the MPC, for the support you give her.