David Clementi: The Bank of England
- a central bank post-independence

Speech by Mr David Clementi, Deputy Governor of the Bank of England, at the Annual Leonard Sainer Lecture, 14 November 2000.

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Introduction

It's a great pleasure to be asked to give this lecture, the occasion being in honour of Leonard Sainer. One of my first experiences as a young investment banker in the City was working in the mid-1970s with Dick Russell and Michael Smith, then the young Turks of Leonard Sainer's firm, on the financial reconstruction of a Property Company. We have remained in touch ever since. At the time we were working on the reconstruction of the Property Company, the Bank of England kept a fatherly eye on how the matter was progressing, concerned as it then was, and still is, with systemic risk running from the property sector into the banking sector which funded it. I have to say that it never occurred to me, with my roots firmly based in the private sector, that I would one day be part of the Bank of England. Indeed one or two of my friends, Dick Russell and Michael Smith among them, occasionally express surprise that I have moved from the commercial world of Investment Banking to Central Banking. They like to ask the question: "Does the Investment Banker know the difference between right and wrong?" To which the answer is: "Of course he does, provided he's allowed two guesses!"

Having arrived at the Bank over three years ago, I am often asked what I actually do there. And the answer is that I have three main roles. First, I am one of the nine members of the MPC; secondly, I have responsibility for the Bank's work in financial stability; and thirdly, I have day-to-day responsibility for the management of the Bank. One way or another, wearing these three hats involves me in most of what the new Bank of England does - new in the sense that the 1997 changes, incorporated in the Bank of England 1998 Act, were fundamental to the Bank's activities. Without providing a personalised "this is how I spend my day" account we occasionally read in the newspapers, perhaps I could say a little about each of these roles.

Monetary Policy Committee

Being a member of the Monetary Policy Committee is a hugely rewarding experience.

The process we go through has been quite well documented elsewhere so let me be brief in my description. We are required by the 1998 Bank of England Act to meet at least monthly, although we have the right to meet as often as we wish. On the Friday before the monthly MPC meeting we meet with the Economics and Markets staff of the Bank, in what is known as pre-MPC, to go through the latest data; and this process takes a whole morning. Doing it on a Friday allows us a few days to commission any additional work we need ahead of the MPC meeting itself. This is held in our main committee room under the watchful eye of Augustus John's portrait of Montagu Norman (Governor of the Bank between 1920 and 1944) and starts on a Wednesday afternoon. This meeting is given over to a discussion of the key issues raised by the data presented at the pre-MPC; and of any tactical considerations. The following day, Thursday morning, we meet and after a brief resume of the previous day's discussion from the Governor, proceed to go around the table with each member indicating the factors he or she considers relevant and his or her vote. The policy decision (ie interest rates up, down or constant) is released to the market at 12 noon on the Thursday. The minutes of the meeting, including the individual votes of members, are released two weeks later.

Much has been written about the MPC's constitution and operation, but perhaps I might make a few observations. In the first place, whilst there is a good deal of talk about the Bank of England's independence, it is important to put this in context. The objective of our Monetary Policy deliberations

- the inflation target - is set annually by the Chancellor, not the Committee, and it is specified fairly precisely. Thus the decision on the policy objective rests with the elected government, its execution in the form of the technical decision-making rests with the MPC; and in this sense we tend to talk about our system as one of "operational independence".

Secondly, as is well known, the Chancellor has set the inflation target objective at 2.5% for each of the first three years of operation. Such an explicit target aids accountablility; and plays an important role in anchoring private sector expectations. Our remit is to aim for this target at all times. We are required to regard deviations above and below the target in the same light and the target is thus a symmetrical one. We are obliged to write an open letter to the Chancellor if we deviate by 1% either above or below. The importance of the symmetry of the target is not well understood, but in the working of the committee it is hugely important. As central bankers, we would obviously like to do "the prudent thing". And if the 2.5% target had been set as a ceiling, then it would be clearer, at times of doubt, or when the decision was finely balanced, what the right action to take on interest rates would be. But since the target is set at 2.5% on a symmetrical basis, the concept of "prudence" cannot be applied in the same way. The result is that we worry as much about being below the target as we do about being above it. And I believe this makes good economic sense: the problems of severe deflation are at least as great as severe inflation.

The particular indexed measure of inflation the Chancellor has chosen is RPIX, that is the headline RPI number after excluding - this is the X bit - mortgage interest payments. Some believe that we should move to the Harmonised Index of Consumer Prices (HICP), widely used in Europe and, accordingly, making comparison with Euroland inflation easier. HICP inflation in this country has been running consistently below RPIX by about 1%. This reflects differences in the construction of the index, in particular the treatment of depreciation of property costs. Some have argued - most recently the Engineering Employers' Federation - that if we moved to HICP, then interest rates could immediately be lowered. But this does not follow. If we moved to a different calculation of inflation, it would seem natural to revise the target at the same time. A 2.5% target for HICP would mean that we are targeting a higher level of inflation than we are at present. In any event, my view is that, as we seek to disseminate the benefits of low and stable inflation to as wide an audience as possible, consistency of the existing index and level is an advantage.

Critics of the process often argue that the MPC should have a second target; most commonly industrialists argue that this should be an exchange rate target, seeking stability for sterling against our major trading partners. I well understand the difficulties that, in particular, exporters face given the volatile movements in exchange rates; and the frustration is compounded by the difficulty in explaining such movements purely in terms of economic fundamentals. Nevertheless it should be recognised that the recent historical experience of the UK in operating monetary policy geared to exchange rate stability has been that a conflict sooner or later emerges between the exchange rate objective and other policy considerations, so that the exchange rate objective has to be abandoned. The most recent experience was our membership of the Exchange Rate Mechanism between 1990 and 1992. Fundamentally, there is a problem in operating monetary policy so as to achieve two targets - which one has primacy? How would the trade-offs be made? My view remains that a single inflation target objective is a better, as well as much clearer, framework for monetary policy.

My next point relates to the transparency of our process. In almost all committees I have served on in the past, the process has been one of trying to achieve consensus on the way forward. The MPC process, however, involves no pressure to reach agreement. We are each accountable for our views; full minutes are taken and published; our individual vote is publicly recorded. This is counter-intuitive for anyone from a PLC background. It is impossible to believe that a split in the Board of a major corporation, certainly a split that was aired in the press, could exist for any length of time. Either the split would need to heal rapidly, or more likely some high-profile departures from the Board would ensue.

But in the MPC a system which permits different views to surface publicly is both refreshing and appropriate. Since economic analysis involves a great deal of peering into the future, it is not surprising that there should be disagreement. There is, of course, the old joke of putting nine

Economists into one room and getting ten views. But it is better to be open about the disagreements than try to forge a false sense of consensus. Of course, alongside this transparency and open voting system goes a degree of personalisation within the Press. An industry has grown up geared to guessing our personal habits, psychoanalysing our personalities and classifying us into different species of the aviary. And alongside this has gone a demand for even greater transparency which falls only a little short of having TV cameras in the Committee Room. All this has resembled at times an economics version of Big Brother; indeed I expect the viewing economics community will ask next for the right, through a telephone poll, to vote members off the Committee!

Occasionally the differences of view that surface in the Committee arise from different views about the workings of some economic relationship; on other occasions they represent a difference in tactical views. There is more than one interest rate path which would give an inflation profile consistent with the target. And so there can be differences between those who might at any moment prefer to wait and see - recognising that this might require a sharper movement in interest rates later on - and those who might prefer a more pre-emptive activist approach to setting rates, what might be termed the Macbeth School of Economics: “If it were done when ‘tis done, then ‘t’were well it were done quickly”. The fact that there are different paths to achieve the 2.5% target is one reason why there is no automatic link between our inflation forecast, which we publish on a quarterly basis, and that month’s interest rate decision.

I mentioned that the setting of interest rates requires one to peer into the future. Unfortunately it is more difficult than that. It also requires policy makers to have a view about what is happening currently. There is often considerable uncertainty about what the current situation is - a particular problem relating to Q3 as we try to assess the impact of the petrol price crisis in September. Even the past is uncertain and we regularly receive from the ONS revisions to past data about growth of different parts of the economy. As I look at the data each month, knowing that some of the dials are misreading, I am reminded of the saying: that the intelligent man knows that half the data he is looking at is false; the brilliant man knows which half! More seriously we need to have in our mind a view about which data series are reliable and which are particularly erratic. Happily the RPIX data, our goal, is easily observable. But, by way of example, wages, which are a key piece of data, are much less easy to observe. And as we look at the average earnings data, we need to recognise that, not only is it difficult to measure and calculate, it will also occasionally exhibit “noisy” features that may obscure what is going on in the real economy. Indeed, over the Millennium period, as special Y2K bonuses were being paid, it was very difficult to determine what represented real “news” about the economy, and what was mere “noise”.

Sitting at the controls of the aircraft, trying to pilot a sensible middle course between the extremes of unsustainable take-off and hard landing, we need “eyes and ears” on the ground. Our network of Bank of England Agents is extremely important in this area. Around the country we have twelve Agencies, in general staffed by long-serving Bank of England people, constantly collecting information at the grass-roots level from their many business contacts. And the information, which they provide direct to the MPC on a monthly basis, can often prove helpful: either in helping us unravel inconsistencies in the data; or, as was the case in the Summer and Autumn of 1998, alerting us to problems in the economy before they show up in the official data.

Notwithstanding the help of the Agents, problems with interpretation of the data abound. Some of these will be discussed in our Quarterly Inflation Report, due to be published on Thursday this week. I hope you will have the opportunity to read it.

Financial stability

Perhaps I could now turn from monetary policy matters to financial stability; and to the second part of my job as the Deputy Governor responsible for this part of the Bank’s work.

Go back a little over three years and the Bank had a large department with four hundred and fifty staff supervising banks. Hard on the heels of the decision to grant the Bank independence, the Government decided in May 1997 to establish the Financial Services Authority bringing together existing UK financial regulators and supervisors under one roof. The decision was intended to streamline the UK regulatory framework and, recognising that the distinction between different types of financial firms had begun to blur, to bring together financial regulation in a single organisation and under a single piece of legislation, the Financial Services and Markets Act. In a world crowded with acronyms, this gave an opportunity for something of a cull, consigning the numerous self-regulatory organisations - or SROs - like SFA, IMRO and PIA to history!

However, while you may be able to take financial supervisors (quite literally) out of a central bank, you cannot remove all responsibility from a central bank for the safe-running of the financial 7 system. The Bank stands at the heart of the financial system not only in the implementation of monetary policy, monitoring the financial intermediaries that make up the transmission mechanism for policy changes, but also operationally, as a market participant: on a daily basis carrying out open market operations or providing final settlement for payment systems across accounts at the Bank; or, in more extreme circumstances, intervening in the market to support the currency or to provide liquidity to a bank in difficulty.

Thus, while responsibility for supervision of individual banks has moved to Canary Wharf, the Bank has retained responsibility for maintaining the stability of the financial system as a whole. The Bank's role is recognised in the Memorandum of Understanding agreed between the Bank, the Treasury and FSA and published in the Autumn of 1997, which sets out how the three organisations are to cooperate in monitoring the UK financial system. To this end, the MOU established a tripartite Standing Committee which meets monthly to discuss issues of current concern; and cooperation is further enhanced by the fact that I sit on the FSA Board and Howard Davies is a Member of Court.

Coordination is also important internationally. The Asian Crisis in 1998 demonstrated how quickly shocks could pass between markets. One response from the international financial community was the establishment of the Financial Stability Forum, a body similar in purpose to the Standing Committee. The Forum meets semi-annually, bringing together central banks, regulators and finance ministries from developed and developing countries, to discuss the threats to financial stability. The Bank is an active participant in the FSF, along with HMT and FSA.

Having described the organisational structure, I want to turn now to the four broad areas where the Bank is involved in financial stability.

The first is the analysis of developments in G10 and emerging market economies and financial markets and the potential impact on financial stability. Macro-prudential surveillance is at the core of the Bank's financial stability effort, bringing together detailed knowledge of the macroeconomic environment and financial markets to identify potential vulnerabilities in financial systems in aggregate. Recent examples include the volatility of technology stocks, the growing size of telecom debt or the problems of the Japanese insurance industry. Much of the work is published in the Bank's Financial Stability Review which is intended to promote public understanding of financial stability. The most important part of the FSR is an assessment of the global conjuncture and potential risks to the UK financial system.

Emerging market economies have attracted particular attention in recent years. Not only were these countries the source of the most recent shock to the international financial system in 1998 but, since that time, they have been a major focus in international groups such as the FSF. The work to strengthen the financial system has centred as much on crisis prevention as crisis resolution. Under crisis prevention, the accent has been on improved disclosure, establishing new international standards for transparency for governments and private sector firms in the publication of economic and financial data. In terms of crisis resolution, discussion has turned to the role of the official sector, and the IMF and World Bank more particularly, in helping countries that get into difficulty. Many of the crises in emerging market economies have been marked by a sudden withdrawal of private sector capital, including outflows to private sector creditors of official funds intended to stabilise the position and reverse this capital flight. The Bank of England has taken a leading role in discussion with other governments and central banks, and with the private sector market participants, to find a more orderly approach to crisis situations and to avoid the kind of damaging scramble to withdraw funds from emerging market economies that marked the Asian Crisis.

The second area of Bank involvement is market infrastructure, the payments and settlements systems that underpin financial markets. Given the size of payment flows, domestic and cross border, the importance of robust and reliable systems is paramount. Any failure in payment systems would result in gridlock and widespread disruption. The Bank has an operational interest, closer to home, in that payment systems, especially in the wholesale market, often rely on the transfer of payments across central bank accounts. Because of this, under the MOU the Bank is explicitly given responsibility for the systemic oversight of payment systems. In carrying out this responsibility, we take a close interest in the interaction of these systems with other parts of the infrastructure - settlement systems and clearing houses. This interest extends to exchanges and the dizzying process of alliances, mergers and failed bids that has marked the attempt to consolidate global equities markets, especially in Europe where, despite EMU, trading is still widely split between markets.

The third area of Bank involvement is regulatory policy. Although responsibility for supervision of the bank has passed to the FSA, the Bank retains an interest in the design of the regulatory structure and the impact that this has on the stability of the system as a whole. The Bank is represented on the Basel Supervisors Committee and has been closely involved in discussions on the new Basel Accord and the capital requirements to be applied to banks. Clearly ensuring that individual banks are adequately capitalised has a direct bearing on the ability of the system as a whole to withstand shocks. However it is only really in a crisis or an economic downturn that it is possible to tell what the full story is. As one of my colleagues colourfully puts it, it is only when the tide rolls out that you find out who is not wearing swimming trunks!

The final area I would like to mention is the Bank's role in reviewing financing for business in the UK. This is more focused on efficiency and competitiveness than financial stability but, over several years, the Bank has built up a leading role in looking at financing conditions for small firms and high-technology companies. More recently the Bank has also become involved in the government's initiatives under the Social Exclusion unit to look at financial exclusion and the provision of banking services to deprived areas. On occasion, the Bank also takes a role in corporate restructuring, holding the ring between large debtors and their bank lenders. The Bank in this way provides a kind of ACAS for syndicated lenders, known as the London Approach. Like ACAS, the London Approach is voluntary, informal and by mutual agreement. It is also less active now than previously, certainly since my own first encounter with the Bank in the mid-1970s, hopefully a good sign for Financial Stability.

Management of the Bank

Having dealt with the policy implications of the changes announced by the Government in May 1997 - the advent of the Monetary Policy Committee and the transfer of line supervision for banks to the FSA - I would now like to turn to the profound impact that the changes have had on the Bank as an institution and to the third part of my job, responsibility for day-to-day management of the Bank.

With the new responsibilities for monetary and financial stability came a recognition of the need for less generalist and more specialist analytical skills, and in particular for highly trained economists. At the same time, in our banking and other operations, as in other financial organisations, the introduction of new technology brought increasing demands for staff with emphasis on IT and not purely clerical skills. These have presented huge challenges for the management of the Bank and its staff. Looking back over the last three years, we have made changes in many areas, but I would like to pick out four in particular.

Increased efficiency

First has been the move towards greater efficiency and a reduction in overheads. At the time of the transfer to the FSA, the Supervision division was, as I have already mentioned, the largest in the 10 Bank with 450 people. However, while the frontline supervisors all moved out, none of the associated central services and overhead costs moved with them. We committed to remove these excess overheads, setting ourselves the target of taking £20 mn off costs - 10% of total costs - over a five-year period. We are consolidating our property portfolio, shrinking the buildings we use from five down to one, our main office in Threadneedle Street, in order to deliver substantial savings in accommodation and maintenance costs. At the same time we have sought to improve the efficiency of our central services; and this has required substantial reductions in numbers in some parts of the Bank.

Our objective has been, as a public sector organisation, to deliver value for money, to ensure that the Bank is cost effective in its operations and comparable to best practice elsewhere. Finding suitable benchmarks for the Bank, however, is not easy. The Bank employs 2,500 staff which compares with over 15,000 at the Banque de France and also at the Bundesbank. But direct comparison with other central banks is made difficult by differences in functions. For example, the Banque de France retains a network of 211 branches for distribution of banknotes whereas the Bank has closed all but one of its regional cash centres, moving to a system using commercial banks for note distribution. Where possible, individual functions - personnel, finance, property services - are benchmarked against equivalent functions in private sector firms. However the Bank's cost effectiveness in all functions, even those where benchmarks are hard to identify, is monitored closely by management and is subject also to the scrutiny of the Court of the Bank of England.

Corporate governance

The role of Court and changes to the Bank's corporate governance arrangements is the second area I would like to address. The powers of Court to oversee the operations of the Bank were substantially enhanced by the 1998 Act. In particular the Act:

(a) requires the Court of the Bank to determine our Objectives and Strategy for the year; and

(b) sets up a non-Executive Committee to review the Executive's performance against the Objectives. This is chaired by our Senior Non-Executive, a position formally designated under the Act.

So our latest Annual Report for the year to February 2000 sets out the Bank's ten key Objectives for the year, includes a long description by the Executive of the Bank's performance against the Objectives; and finally a section, written by the Non-Executives, commenting on our performance.

The aim of the Act was quite plainly to increase the level of transparency of our operations; and to raise the accountability of the Executive to Court as a whole, and in particular to the Non-Executive Directors appointed to review our performance.

Risk control

Thirdly, I would like to comment on the enhancements we have made to our risk controls. This is an area where the private sector has made enormous advances in recent years, much of it strongly encouraged by the banking supervisors. Risk management has become more sophisticated with more differentiation between risks: the separation of credit and market risk; the recognition of operational risk as a distinct category; and the importance of reputational risk. Notwithstanding that the nature and size of our operations are different and smaller than many private sector institutions, the Bank is exposed to many of these same risks.

In managing these risks, we have wanted to ensure that our practices are consistent with best practice in the private sector, to the extent that this is applicable to a central bank. We have invested heavily in technology to allow management of the risks on a consolidated basis and where appropriate in real time. We have also instituted a number of organisational changes, setting up an Assets and Liabilities Committee which I chair and which reviews at senior level the management of our balance sheet; and a Risk Monitoring Department (based in part on the Middle Office model of the private sector), independent from our banking line management. Above this, like public companies, we have a number of Board sub-committees, and in particular an Audit Committee, taking reports from the Internal and External Audit, looking carefully at our internal systems and controls and our policies and processes for management of the main financial, operational and reputational risks. Like public companies, and no doubt many of you here who are directors of public companies, we are working hard to ensure full compliance with the Turnbull report.

Personnel policies

Finally I would like to mention the changes we have made to our personnel policies.

I have already indicated that the changes imposed by the 1997 proposals, together with the changes brought about by a changing environment, placed a heavy demand on the flexibility of our workforce. We have needed to increase the analytical capacity of the Bank, in part by additional recruitment of economists. Indeed we are among the largest employers of professional economists in the country. We have also substantially upgraded our programmes under which individuals are able to go back to full-time education supported by the Bank to obtain the Masters, and in some cases Doctorate degrees, that we need to keep us at the forefront of thinking on economic and financial issues.

We have reorganised the rank structure within the Bank. For some time, we had two broad categories of staff: officers and officials. Counter-intuitively, the officials were senior to the officers, rather like the Civil Service of many years ago when Administrative Grades were senior to the Executive Grades. We have merged the officers and officials grading into one structure, taking out several layers while we were at it - although I would have to admit that the Bank remains a formidable hierarchy!

Along with the flatter rank structure, we have introduced a more discretionary and merit-based pay system, removing some of the barriers to rapid advancement of the very best people. At the same time, we reformed our benefits arrangements, removing a system that geared benefits in part to length of service and replacing it with one geared to contribution to the organisation. In particular we removed subsidised mortgages, arguing that the Central Bank, now responsible for interest rates, should not insulate its staff against the effects, for example, of rising interest rates which might affect the rest of the country. The approach to the new flexible benefits is modern, offering staff a menu of benefits up to a percentage of their salary; if none of the choices appeal, they can take cash instead.

Many of these management issues are dealt with in our Annual Report - and I hope this gives comfort that the Bank of England is not hiding behind its unique role to limit disclosure. Rather we recognise that we should play our part in being open and accountable.

In aiming to achieve a high degree of efficiency we must recognise that we will never reach any absolute goal - but we do want to stand up well in comparison to other organisations in the public sector. We have set ourselves the goal of seeking excellence as one of the leading central banks in the world; and at home to stand out as one of the leading UK public sector institutions.

Perhaps I could close at this point by thanking you for coming. I have got a few points “off my chest” - and I hope for your part I have made a few points which have been of interest.