

Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London, London, 21 June 2006.

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My Lord Mayor, Mr Chancellor, My Lords, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen:

Chancellor, I know how much store you put on education. So, in the modern spirit of audience participation, let's see how our City audience matches up to the standards of the past. One hundred years ago, candidates for employment in the Bank of England were required to take an examination. The arithmetic paper contained 16 questions to be completed in three hours. I'm going to give you just two questions and you will have either 15 minutes or the length of my speech, whichever is the shorter and I am in no doubt as to your preference on that, to find the answers.

Qu.1: Simplify the expression;

$$\frac{\frac{2}{9} \times 4\frac{1}{2}}{\frac{1}{3} + 1\frac{5}{6}} \div \frac{1 - \frac{1}{3} \text{ of } 1\frac{1}{13}}{\frac{5}{8} - \frac{7}{12}}$$

Qu.2: A person invested £2,205 in a 3% Stock at 90. He afterwards sold out at 93 1/2, and invested the proceeds in a 4 1/2 percent Stock at 98. What change was thereby made in his income?

Answers can be sent to the Financial Services Authority. No compensation is available if you are incorrectly advised by your neighbour or any other person from the financial sector.

Twenty years ago, the City was anxiously awaiting its revolution - Big Bang. If ever there was an example of structural change in response to global competition, Big Bang was it. None of the leading broking and jobbing firms of the time now survives. Yet the City, and the people who work here, are more successful today than at any time in its history. Few in 1986 could have imagined how much the City would change and how far its domain would extend - from Canary Wharf to the West End, no longer a **single** Square Mile but a banker's dozen.

A key ingredient of the City's success has been, as the Lord Mayor remarked, a stable set of rules within which to play up and play the game. Simple, clear rules of the game are essential for a market economy to function. But excessive regulation makes life difficult for us all. In March of this year I received a letter from a certain government department which read as follows:

"Dear Mr. King; I am writing to inform you about how the changes to Crown immunity ... in relation to planning legislation, will affect flying national flags Flags are defined as advertisements under the Town and Country Planning (Control of Advertisements) Regulations 1992. Under these regulations you are allowed to fly the national flag of any country ... from a single vertical flagpole without requiring the prior express consent of the local planning authority. The European Union flag is not classified as a national Flag under the current regulations. ... the Office of the Deputy Prime Minister is proposing to change the Regulations". Until then, however, consent is required. The letter continued: "I have been advised that consent usually takes six to eight weeks to obtain and costs £75. You need to send the completed advertisement consent form plus fee with a covering letter explaining when and where you wish to fly the flag providing details of the size of the flag and photos of the flagpole in relation to the building."

Chancellor, you can be sure that the Bank of England will abide by the rules - although we may not fly many flags, both literally and metaphorically. The Bank now has a very clear focus on maintaining monetary and financial stability - the former defined by the inflation target and the latter by the revised Memorandum of Understanding between Bank, FSA and Treasury published in March.

The great strength of the 1997 reforms to the monetary policy process is that they establish clear rules of the game for making decisions on interest rates. The Monetary Policy Committee sets interest rates each month to meet the inflation target. But how do we implement those decisions in the market? Our objective is to ensure that the policy rate set at the monthly meetings of the MPC is the rate in the money markets until the following meeting. For many years, the Bank operated several times a day in

the money markets, but that hyperactive approach did not succeed in stabilising the overnight interest rate which remained more volatile than in most other advanced countries. It was important to move to a simpler system in order to reduce that volatility, and the new system of money market operations, which was introduced last month, has done precisely that. The Bank now deals in the markets only once a week. Almost all banks and building societies now have access to the Bank. And they no longer have to balance their books with us at the close of business every day, but instead must achieve a target balance with us on average over the month running between MPC meetings. For the first time in its history, the Bank pays interest on reserve balances held by the commercial banks with us. The rate paid by the Bank on those reserve balances is the rate set by the MPC - Bank Rate is back.

Great credit is due to the teams led by Andrew Bailey and Paul Tucker who together managed the introduction of the new system, proving that, as Cameron Cobbold remarked in 1958, "the Bank is a bank, not a study group".

The 1997 reforms also changed the rules of the game for communication between the Bank and financial markets, and I would like to say a word about what they are. Markets need to form a view on the probabilities of different paths of future interest rates in order to price a wide range of financial instruments. So they are interested in what central banks say. In recent months both the Federal Reserve and the European Central Bank have found it far from straightforward to convey the likely trajectory of future interest rates. And the Fed announced three weeks ago that Chairman Bernanke had established a subcommittee of the FOMC to examine a number of "communication issues". There is now a lively debate about how, and to what extent, central banks should try to communicate their intentions with respect to future official interest rates to financial markets and the wider public.

At the Bank of England, our approach is to keep it as simple as possible. We don't say where interest rates will go next for the simple reason that we don't know. And it would be quite misleading to pretend otherwise. The MPC reaches a new judgment each month, made afresh in the light of all the new information about the prospects for inflation. We don't decide in advance. So trying to give direct hints on the path of interest rates over the next few months risks deceiving financial markets into believing there are definite plans for the next few months when no such plans exist.

But in order to form judgements about the likely path of interest rates over somewhat longer time horizons, markets do require some information from the central bank. To be precise, two key pieces of information - our **objective**, and our **analysis** of the economy.

Our objective is the 2% inflation target given to us by the Chancellor and plain for all to see. And our analysis of the economy is published in the minutes of our monthly meetings, in more detail in our quarterly *Inflation Report*, and in speeches by members of the MPC.

Knowledge of our objective and our analysis is all that markets need from us to form judgements about the future path of interest rates. Changes in our analysis, and the range of views within the Committee, may well affect the conclusions that financial markets draw about the likely path of interest rates. Markets appear to have been rather successful in drawing conclusions because our decisions on interest rates have not, by and large, surprised them. But there is a big difference between setting out our analysis of the UK economy and dropping hints about decisions we have yet to make.

So all those listening to the speeches of MPC members - including this one - for a hint as to the decisions we shall take in the coming months will be disappointed repeatedly. We make up our minds one month at a time. Those, however, who read our Minutes, *Inflation Reports* and speeches to understand our thinking will mine a richer seam. Knowing our thinking, they will be in a better position to evaluate the implications of developments in the economy for the future path of interest rates.

There is one other arena where clearer rules of the game would be of great value - the Commercial Court. After 13 years, we have at last drawn a line under the BCCI case, the most expensive fishing expedition in history. It ended as a comprehensive victory for the Bank, both on the substance of the case and on costs. The trial set new records - the longest opening speech in English legal history, an even longer reply, and almost certainly the most expensive commercial litigation ever.

It is for others to comment on the behaviour of those who brought a case that even they described as a blood sport. I can presume only that they were allowed to play within the rules of the game. In which case, it is the rules of the game that should be questioned.

A legal framework for enforcing contracts and resolving disputes is not just an arcane process which allows professionals to earn vast fees, but an integral part of the infrastructure of a successful market

economy. It matters that there are simple, clear and timely ways of resolving disputes. What the BCCI case revealed was a legal system incapable of guaranteeing that. How can a case described by the trial judge himself as built “not even on sand but on air” take thirteen years and over £100 million in costs to come to a conclusion?

The Bingham Report was produced in only a year and contains all that is worth saying about the supervision of BCCI. It was not comfortable reading for the Bank, but the Bank accepted and acted on its findings. The subsequent legal proceedings over thirteen years have benefited only one group at the expense, in the end, largely of the creditors.

As Mr Justice Lightman argued in his 2003 Edward Bramley Memorial Lecture, the adversarial system imposes huge costs on litigants and defendants alike. As he put it, “to the great majority of the public the perception (if not the reality) is that the legal system is a profitable monopoly of the lawyers”. BCCI showed that perception was indeed reality.

A system that is powerless to prevent a case so hopelessly misconceived continuing for thirteen years requires examination. I very much hope that the Government will look carefully at this case, learn the lessons, and take steps to ensure that such an outcome can never occur again.

Finally, who managed to obtain the correct answers to the two questions I gave you at the beginning? Chancellor, you can see that mental arithmetic in the City is not what it was. In fact the answer to the first question is 3/100 or 3%, and to the second question is £31 13s. 9d. - before tax.

Lord Mayor, over the past year you have brought the global economy to Mansion House, you have opened its doors to many who would not otherwise have thought of entering, especially from the Asian community, and you have gone out of your way to meet young people from our financial firms. You have raised money for disabled children and you have promoted Cornwall - next Tuesday is “Cornwall Day in the City” with, I hope, free pasties for everyone.

And tonight all of us here would like to pay tribute to your work since you became Lord Mayor, and to thank both the Lady Mayoress and you for the splendid hospitality - Cornish produce in fact - which you have extended to us all this evening.

So I invite you all to rise and join me in the traditional toast of good health and prosperity to “The Lord Mayor and the Lady Mayoress”, David and Tessa Brewer.