The Roles of the Bank of England - with particular reference to Monetary Policy

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Introduction

It is a pleasure to have the opportunity to speak to this conference. In the course of my work I call on several of your members, and this hotel is just outside Coventry, which is one of the biggest industrial centres in the West Midlands and where I spend a good deal of time talking to the many important businesses established here.

I shall say more about my job and its relation to monetary policy in a few moments. But I would first like to talk a little about the other roles of the Bank of England. As a publicly-owned institution, and incidentally one of some antiquity, it is important that what we do is widely known. Some of our functions are very much in the public eye - eg setting interest rates and printing banknotes, for instance - but others are less visible.

You will be relieved to know that I won't attempt to give you even a potted history of the Bank over its 308 years of existence. I think that it is enough to make two points: that in common with most other institutions of that age, we have changed quite a bit and that the speed of change has accelerated in the last decade; and also that we were founded as a bank and indeed we remain a bank, even if not quite in the sense that most of you would recognise in your day-to-day business or professional lives.

The Bank has three core purposes. (Incidentally, you will note that I say 'the Bank' and I would write it with a capital B. That may sound somewhat arrogant, but that it is not the intention: in the City of London at least, we are certainly regarded as the Bank, and having worked there for more than thirty years it's difficult to get out of the habit.)

So back to our core purposes. The first is to maintain the integrity and value of the currency. We do this in a number of ways, including setting short-term interest rates, operating in financial markets, and through printing and issuing bank notes.

The second core purpose is to promote the stability of the financial system, both domestic and international. And the third is to promote the effectiveness of the UK's financial system. I shall say a little about each of these, but I will devote most of the time available to our work in the field of monetary policy.

The Bank as a bank

As a central bank, we differ from other banks in a number of ways, but most notably in the number of accounts that we hold (very few), the average value of transactions (very large) and the nature of our customers (very select).

Two of our most important roles as a bank are to act as banker to the Government and to provide the ultimate settlement facilities for the various payment systems. I don't need to say more about our Government banking role, other to note that ultimately most payments to and from central government cross accounts at the Bank of England. But our role in acting as the fulcrum for payments systems is not widely understood, yet is of critical importance to the efficient functioning of the economy.

In essence, when a customer of one commercial bank transfers funds to a customer of another bank, that payment is made across the respective banks' accounts at the Bank of England. Very large numbers of such payments are made each day- some 12mn cheques, nearly 10mn direct debits and standing

orders, and over 100,000 payments by Chaps.
You will all be familiar with cheques, direct debits and standing orders, but may know less about Chaps. Chaps is a real-time settlement system, which transfers payments almost instantaneously from the payer to the recipient. As such, it needs to be exceptionally reliable and robust and together with the other banks that operate in Chaps, the Bank of England plays a critical role in ensuring that reliability. As individuals, most of us only use Chaps when buying or selling houses, but as businesses it can be an attractive option when larger time-critical payments need to be made.
We also operate at the other end of the scale, in that staff and pensioners of the Bank are entitled to operate accounts if they wish. I have an account myself, but the days when I waited expectantly for recipients of my cheques to gaze at them in awe have long passed. And the value of such an account has to be tempered by the knowledge that the nearest ATMs are some 100 miles away, in London.
Also in its capacity as a bank, the Bank of England operates in financial markets, such as the money and foreign exchange markets.
Banknotes
Virtually everyone knows that the Bank of England issues banknotes - after all, our name is at the top of every note. It is less widely known that we print them as well- at a dedicated factory in Essex. We do not mint coins - that is the responsibility of the Royal Mint.
Designing and printing bank notes are highly skilled operations. In design, we seek to maintain a balance between making our notes attractive and incorporating adequate security features. I hope you will agree that on the whole we do manage to achieve that balance.
From time to time, like other central banks, we redesign our notes and you will know that in recent years we have produced new variants of the £20, £10 and £5. Among other enhancements, these have larger numerals to help the partially sighted, and enhanced security features, such as a hologram.
You might be interested in some statistics on bank notes. We print around 1 billion notes each year, at an average unit cost of 3 pence, which is highly cost- effective by international standards. By far the most popular note is the £20, which accounts for more than half the £30 billion of notes in circulation. The value of bank notes in circulation continues to rise by around 6% each year, despite the increase in use of alternative means of payments, such as debit and credit cards.
And the printing and issuing of banknotes is a profitable business! This is because the amount that we are paid for the notes is their face value, while the cost, as I have just said, is only a few pence each. We invest the money that we receive for the notes and the interest earned allows the Bank to make an annual profit on this business of around £1.5bn. Happily for you - and the rest of the British public - we are required by law to pay all of the profits to the Treasury and thus into the public purse.
That might be an appropriate point to mention that even in its other business streams, the Bank is a profitable institution. Last year we turned in a profit of just over £1 OOmn, and again the public purse benefits from this through payments of tax and a dividend. We are definitely not a drain on the taxpayer!
Financial stability
Our second core purpose, as you may recall, is to promote financial stability.

This is a fairly recondite subject for an after lunch session and I won't dwell on it for long. The important point is that when you have financial stability most people are uninterested in the subject, but when you don't, it can threaten to affect all our lives in uncomfortable ways.

We no longer have the responsibility for supervising individual banks - which is now the responsibility of the Financial Supervision Authority - but we do devote considerable resources to assessing actual and potential risks in the UK and international financial systems. Some of the topics that my colleagues have been looking at over the past year are: the disruption to markets caused by the events of 11 September; large company bankruptcies, the financial problems in Argentina, and market issues raised by Enron and World Com, among others.

The UK Financial System

The third core purpose is to do with the effectiveness of the UK financial system. Financial services, often rather loosely and to some extent inaccurately described as just 'the City', make a very significant contribution to the UK's economy and to its balance of trade. Accordingly, we have an interest in ensuring, as far as possible, that the system is functioning well. But in order to demonstrate that the Bank is not solely concerned with what might be called matters of high finance, I will just highlight one important field of work in this area.

This concerns the financing of small businesses, where we have long taken an interest, dating back to times when it was clear that a considerable gulf existed between banks and many of their smaller business customers. Partly as a result of our work, that gulf has narrowed and small firms now see banks as much less of an obstacle than they once did. Our work in this area continues, nevertheless, and now also encompasses work on the finance of ethnic minority firms and on technology businesses.

Monetary Policy

I now turn to my principal topic - and the one that occupies most of my working life these days - which is the Bank of England's role in the operation of monetary policy.

Since 1997, we have had an explicit role in delivering price stability by setting short-term interest rates. This has brought the Bank into much greater public prominence, and we have responded by being open and transparent about how we go about the business of setting interest rates.

It is important to stress that the elected Government decides on the appropriate target for inflation (which is currently 2 Y2 %) and then delegates to the Bank the power to set short-term interest rates in order to meet that target. In other words, we have no discretion to aim for a different level of inflation, unless the Government chooses to change the target.

Why do we have an inflation target when the principal concerns of most people are with matters such as economic growth and employment - ie living standards? The answer is really quite simple: history shows that it is simply not possible to have a steadily growing economy and steadily rising standards of living without stable, low inflation. That fact has become increasingly recognised around the world in recent years, and many countries now have a target for inflation as the basis of monetary policy. Of course, that does not mean that governments do not have other economic levers at their disposal; of course they do, and notably fiscal policy - ie government spending and taxation. But low inflation is essential and it is the Bank's job to secure that.

As you probably know, decisions on interest rates within the Bank of England are the responsibility of the Monetary Policy Committee. This body, usually known as the MPC, has nine members and is chaired by the Governor of the Bank. The Bank's two Deputy Governors are also members, and four members are appointed by the Chancellor of the Exchequer. The remaining two members hold senior positions within the Bank, with directorial responsibility for financial markets and for economics respectively.

The Committee meets monthly, with the meeting dates published well in advance. It announces its decision as soon as its meeting is over and you can read full minutes of the meeting - together with details of individual votes - just two weeks later. If you have never looked at these minutes, I would encourage you to do so. They - together with much other useful material - can be found on

the Bank of England web site - www.bankofengland.co.uk

How does the Committee reach its decision each month? The short answer is by analysing information on the UK and world economies that has become available over the preceding month.

And this is where I come in, because as well as examining the numbers, the Committee pays close attention to the information that I, and my colleagues around the country, feed in to them from our discussions with business contacts. Together with a colleague, I visit some 650 companies each year throughout the West Midlands and Oxfordshire for face-to-face discussions about business trends and pressures, and each month we report to the MPC on our assessment of the local economy based on these and other discussions. However, I should stress that we always protect the confidentiality of our individual meetings.

In fact, members of the MPC also spend time away from the office, visiting the regions and talking to businesses at first hand. I myself host four or five such visits each year - and in my area so far in 2002, there have been MPC visits to, among other places, Ludlow, Shrewsbury, Birmingham, Wolverhampton, Leamington, Banbury, Oxford and Worcester. And similar visits take place regularly around the rest of the UK as well. I have not yet myself organised an MPC visit to a bakery, but I hope that this might be possible on a future occasion.

Why does the MPC use short-term interest rates as the mechanism to control inflation? The answer is that it seems to work, and no better instrument has yet been found. Since the MPC was established in 1997, inflation - as measured by the Retail Prices Index excluding mortgage interest payments - has never moved outside the narrow band of 1 Y2 % to 3 Y2 %. In essence, what the Committee seeks to do is to control demand in the economy, by raising interest rates if demand is too high and threatens to exceed the supply capacity of the economy (which would push up prices), and by reducing rates if demand is falling short of capacity (which would threaten deflation).

It is important to note that the Committee has been given a symmetrical target. inflation is more that 1 % above or below the target, then the Governor is required to write an open letter to the Chancellor, explaining why the target has been missed and what the Committee plans to do to bring it back within the required range. This symmetry is a protection against the Committee taking an overcautious attitude, which might be the case if they had simply

been given a ceiling for inflation.
If one of the Bank's key objectives is to widen understanding of the need for low inflation, and opinion polls suggest that we are having some success in achieving this. Inflation has now been below 3% for around ten years, which is in sharp contrast to the experience of the two decades before that - as I am sure that many of you will remember all too vividly.
Businesses ask for stability, and we are delivering that. We know that there are many other pressures on your firms, and other speakers at this conference are highlighting some of those. The Bank of England can't solve all of your problems and wouldn't pretend to be able to do so. But we do work hard at laying the foundations for a steadily growing economy with low inflation, which we hope will give you one less concern to worry about.
Q. David Marsh, Brackley
Does the UK economy meet the 5 economic tests for entering into the euro?

A. The five tests are a set of tests that the Chancellor has set down. The Treasury will do an analysis and advise on the extent to which these tests have been met. The Bank of England does not comment on those 5 tests. They are complex tests. If those tests had been in place when the euro came into being we would not have passed the test. It is a matter for the Treasury and the Bank of England who will comment when the time comes.
Q.
Why does it take so long to transfer money from one account to another?
A. For a CHAPS payment - once your bank has your instruction, it should be in the recipients' hands, certainly within the hour. Internet banking is done by BACS which is a batch system, it is updated each night. It is not economic for the transfer of small amounts.