Eddie George: Financial stability and the City - the evolving role of the Bank of England

Speech by The Rt Hon Eddie George, Governor of the Bank of England, at the London Chamber of Commerce Conference, held in London, on 13 June 2000.

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Thank you, Chairman. I'm pleased to take part in this Conference, and to share the platform this morning with Gavin, but also with Howard Davies my long-standing partner in crime - or perhaps I should say in crime prevention.

You ask me to talk about the evolving role of the Bank of England, in relation to financial stability in particular, which I'm happy to do. In fact it is rather easier to talk confidently about our role these days since it is now more clearly defined.

A remarkable thing about the earlier legislation - the 1946 Bank of England Act - was that it made no mention of the Bank's essential "raisons d'être" - what we were there to do. It seems to have been taken for granted that everyone knew what our role was. But about a decade ago we decided to define our core purposes more precisely for ourselves, primarily for internal management reasons. We identified three core purposes.

The first two:

– the maintenance of monetary stability; and

– the maintenance of the stability of the financial system are key objectives of central banks pretty well everywhere.

Our third core purpose - the promotion of the efficiency and effectiveness of the financial system in serving the interests of the wider economy - was more unusual for a central bank, but arose from a long-standing tradition of catalytic involvement in the development of our financial system, including, in its international dimension in particular, encouragement of the role of the City.

These three core purposes have been essentially carried over into the new statutory framework introduced through the Bank of England Act of 1998. There are certainly some very important changes in the more precise nature of the Bank's role. In relation to monetary stability, the Bank, through its new Monetary Policy Committee, now has independent responsibility for the operation of monetary policy and for achieving consistently low inflation as defined by the Chancellor. And in relation to financial stability, responsibility for banking supervision has passed from the Bank to Howard at the FSA - which helps to explain why I have retained more of my hair ... than ... I might otherwise have done!

But, notwithstanding these important changes, our core purposes remain.

The Memorandum of Understanding between the Treasury, the Bank and the FSA, in particular defines our respective responsibilities in relation to financial stability and provides a structure for the necessary close cooperation between us.

In the terms of the MOU the Bank is responsible for the overall stability of the financial system as a whole. The MOU implicitly recognises the inter-relationship between monetary and broader financial stability, which is fundamentally important: just as we could not hope to deliver monetary stability if the financial system was crashing around our ears, so, too, monetary stability is a very necessary - though in itself still insufficient - condition for stability of the financial system. Specifically the MOU recognises the Bank's role - as the bankers' bank - at the heart of the payments system; and it recognises our capacity, in exceptional situations and subject to override by the Chancellor, to act as lender of last resort in order to limit systemic damage. The MOU acknowledges more broadly the Bank's oversight role which enables us to advise on the financial stability implications of developments in domestic and international markets and payments systems; and it acknowledges finally also our role in promoting the efficiency and effectiveness of the financial sector, with particular regard to international competitiveness, but which can also contribute to the robustness of the financial system.

In the context of the UK's highly developed and increasingly integrated financial services industry, in which distinctions between banks, building societies, investment intermediaries, insurance companies and so on have been becoming increasingly blurred, the argument for moving away from a fragmented supervisory and regulatory structure, in which banks were separately regulated, was compelling - and Howard and his team have done a tremendous job in bringing all the different strands of financial services regulation together under the FSA umbrella seamlessly and in a relatively short space of time.

A potential downside from the Bank of England's perspective was the possible loss of information from, or contact with, the banking sector which might reduce our capacity to exercise our responsibility for the stability of the financial system as a whole.

Now of course it is early days to begin to assess the new arrangements from this perspective. It is true that we have not had any serious threats to financial stability in this country over the past three years, but I suppose that putting that down to the new structure would be a bit like the man who claimed that the absence of pink elephants in Hyde Park was the direct result of his clicking his fingers there on his regular morning walks. We really haven't been tested.

All I can say is that I am encouraged by the close cooperation between the Bank and the FSA which I am confident we can build upon, enabling us to withstand the strain when the first pink elephant is sighted!

The Standing Committee of the Treasury, Bank and FSA has met each month over the past couple of years. Cross-membership of our respective Bank and FSA boards is firmly established. Howard and I meet regularly together. And most fundamentally our respective staff are in more or less continuous contact at working level - it is a culture that we must continue to work together to maintain. To be honest I have felt as closely in touch with significant developments, even in the banking sector, as I did before and perhaps better informed about developments in the financial system more widely. In part this is because, without day by day responsibility for banking supervision, particularly its consumer protection dimension, the Bank has been able to refocus on and develop its wider oversight role, focusing particularly on strengthening the market infrastructure, intensifying our surveillance and crisis management, both nationally and internationally.

I think perhaps you can get the flavour of our broader focus if you look at our half-yearly publication - the Financial Stability Review. The next edition is due out in a fortnight or so, and I'm sure that my office would be happy to make it available to you for a small commission - or you can download it free from our website.

So, Chairman, although Howard took with him responsibility for banking supervision, and some 20% of our staff, to the FSA, the Bank's essential concern with, and responsibility for, the stability of the financial system as a whole - and its role in promoting the efficiency and effectiveness of the financial sector, including the promotion of the City - remain much as they were. What has more clearly changed over the past few years is the external environment within which we pursue these tasks. And in my remaining remarks I should like to comment on three particular developments - the introduction of the euro, the impact of information technology, and continuing broader financial globalisation - which have increasingly preoccupied the Bank in our work in these areas.

First, the euro. Whether the UK is in or out of the euro, the Bank has a keen interest in its success as a widely used trading and investment currency - for the contribution that can make to financial stability, to financial sector efficiency, and to financial activity here in the City.

Well before its introduction, the Bank played an active role in coordinating the City's technical preparation for the euro, and in encouraging the City's professional institutions to work with the European Commission and the ECB in developing the necessary legal and technical framework. The City's contribution to the successful introduction of the euro is widely acknowledged on the

Continent. And the City has continued to play a very active part in developing market activity in the new currency ever since. In many respects the City is already an integral part of the Eurozone.

There were those who argued that the City would suffer if the UK failed to join from the outset. That clearly has not so far happened - quite the reverse. The argument now is that we will suffer if we don't join reasonably soon. That's not something you can actually prove either way. It's not a general point about the City's competitiveness. It's euro-specific, with the implication that somehow or other obstacles will be put in our way. That possibility cannot be altogether excluded, but it would be illogical. Most of the people that I talk with recognise the positive contribution the City is making to the development of euro financial markets - it is in fact the most positive contribution that we can make from the outside. Of course it represents competition with other European financial centres, but at the macro-economic level such competition is a positive - not a zero - sum game from which borrowers and lenders and market intermediaries collectively all stand to gain. Certainly the City has benefited from the euro's introduction, but not at the expense of other centres, rather alongside them. Against that background the Bank is continuing to work constructively with the ECB though its membership of the General Council, while at the same time we are working with the Government and the financial sector to ensure that we are technically prepared for transition to the euro if and when that is what the Government, Parliament and the people of this country decide.

The build-up to the euro roughly coincided with the accelerating advance of information and communications technology that is sweeping across the global economy.

This development, too, can give rise to technical concerns - the Bank and FSA cooperated, for example, in helping to ensure that the financial sector was properly prepared to combat the Millennium bug. But its ramifications go very much wider.

We are having to monitor very closely the potential impact of the "new economy" on productivity growth and what that may mean for monetary stability; and we are having to keep a very close eye on financial market volatility as investors struggle to assess its impact on relative stock values for its effect on financial stability.

In the financial sector in particular the new technology is perhaps the main driver of innovation and change. It makes possible the introduction of new services and products, and is radically altering the way in which existing services are delivered - often at a fraction of the initial cost and, potentially, at lower risk. In wholesale markets it has the capacity to change fundamentally the relationships between end-users, intermediaries and organised exchanges by affecting the whole spectrum of activity from trading through clearing to payment and settlement, across the whole range of financial instruments and across national boundaries - not just within Europe which was until recently the immediate focus of attention, but much more widely internationally.

Beyond a general evolution towards international consolidation of trading activity and parallel, though not necessarily coincident, consolidation of clearing and settlement, it is not at all clear precisely where all this is taking us - just where the end point is or what the stepping stones are that will get us there. But it is clear that standing aside is not an option. That's why we are seeing such a proliferation of initiatives as the various market participants feel their way ahead. It is in that context that I welcome the iX initiative which Gavin has described to us this morning. The process of integration will involve a huge cooperative effort on the part of market participants, but it will also involve active cross-border cooperation between the relevant financial regulators and central banks. Our role is not to determine the way ahead, but to facilitate the steps that the markets themselves decide upon, consistently with our public policy concerns. The prize - of greater market efficiency and liquidity and of more effective international allocation of financial resources - is immense. I have no doubt at all that the City has the professional and technical capacity, and the self-confidence, to make a major contribution to this process.

Let me touch, finally, Chairman, on financial globalisation more generally. As we have seen, the increasingly free flow of capital internationally has the capacity to contribute massively to the expansion of the world economy; but it can become distorted, with the risk of destructive volatility, which in turn can pose a significant threat to financial stability on a world-wide basis. Since the sudden onset of the Asia crisis some three years ago with its global repercussions there has been a huge international effort to reduce the risk of volatility. This has involved drawing up codes of best practice - covering everything from fiscal and monetary prudence, external balance sheet and liquidity management and greater transparency, to increased financial regulation as well as higher legal, accounting and corporate governance standards - which national governments particularly in capital importing countries, are being encouraged to apply. It has involved extensive and ongoing reviews of the financial infrastructure and regulatory practice also in creditor countries. And it has involved a continuing review of the role of the international financial institutions in preventing and managing international debt crises. The Bank has been very intensively engaged in much of this work - with the Treasury in the G7, the G10, the new G20 and the IMF, with both the Treasury and the FSA in the new Financial Stability Forum; with the FSA also in the Basel Committee; and with our central bank counterparts in both the BIS and the ECB.

All of this, too, points to the critical importance of coordination and cooperation, nationally between the Treasury, the Bank and the FSA, but also to an ever increasing degree with our various interested counterparts abroad. And in this context, given the international importance of the City, we, together with the FSA, have a particular role to play in engaging the private sector financial community in the consultation process: we have a common interest in the outcome.

All of these developments, Chairman, pose major challenges both for market participants and for the authorities. But, for the markets at least, with major challenges come major opportunities. Our job is to help the markets take advantage of those opportunities by providing a stable and orderly financial environment within which markets can function more effectively. It is very much in the interests of the City that we should succeed. We - like you - have plenty to do.