

Mr. Plenderleith considers what is new in the financial markets in the United Kingdom Speech by Mr. Ian Plenderleith, an Executive Director of the Bank of England, at the 6th Central Banking Conference, in London on 18/11/97.

1. This has been a year marked by important developments in the UK financial markets and I am delighted to have this opportunity to take you through some of the highlights.

The UK's new monetary framework

2. Perhaps the single most momentous change in the financial landscape in the UK has been the new government's decision, in May, to give operational responsibility for interest rates to the Bank of England -- essentially, to establish operational independence for the central bank. This significant reform, which took effect immediately, and is to be the subject of legislation recently introduced in the UK Parliament, represented an immediate concrete demonstration of the new government's commitment to monetary stability. It ensures that monetary policy will continue to be directed to the pursuit of low inflation, recognising that that is an essential pre-condition for achieving the sustained growth in output and employment that we all seek to achieve. The step was warmly welcomed by the markets, as was evidenced by the immediate fall of around 50 basis points in long bond yields.

3. The framework put in place with that announcement has been carefully constructed and I would like to point to four features of it that I believe will be important to its long-run effectiveness.

4. First, the target the Bank of England is to pursue -- a low inflation target of 2½% -- is set by the government. In an open market economy, the conduct of an effective monetary policy is helped enormously if the authorities can be clear and open about the price stability objective they are pursuing; and in a democratic system, it is absolutely right that the elected government should set this critical strategic objective for the central bank to pursue.

5. Secondly, it is then the responsibility of the Bank of England to achieve this low inflation target, principally through management of interest rates. But this responsibility is to be conducted within a structured framework. Decisions on interest rates are taken by a Monetary Policy Committee in the Bank, consisting of nine members: five of these come from within the Bank -- the Governor, the two Deputy Governors and the two Executive Directors responsible for monetary policy; the other four are appointed by the Chancellor of the Exchequer and are recognised experts in their field -- in fact, four economists of outstanding reputation. A representative of the Treasury attends the meetings and can contribute to the discussion, but has no vote. The Monetary Policy Committee meets monthly. It announces its decision each month as soon as its meeting concludes, and the minutes of its meetings are published within six weeks, including details of how each member voted.

6. A third important feature is that monetary policy is conducted with a high degree of transparency. I have indicated that the Monetary Policy Committee's decisions on interest rates are announced immediately; and that the minutes of its meetings are published. In addition, the Bank of England publishes a quarterly Inflation Report, which gives a full account of its monetary actions, and their effect, over the past quarter, and a detailed assessment of the forward outlook for inflation, including a projection looking two years or so ahead and an assessment of the relevant upside or downside risks. This degree of transparency is, we believe, important in generating greater public understanding of the stance of monetary policy, as well as better-informed public debate and greater public confidence in the process.

7. Closely related is a fourth key feature of the arrangements -- a high degree of accountability by the central bank for its actions. We are accountable in the first instance to our own Court of non-executive Directors, who are specially charged with monitoring the process by which the Monetary Policy Committee discharges its responsibilities. We are accountable also to the government, for which purpose we are required to write an open letter to the Chancellor of the Exchequer if inflation deviates by more than 1% either side of the 2½% target, explaining the divergence and the action taken to bring it back on course -- an open letter, and hence a further element of transparency. We are accountable also to Parliament, which will entail members of the Monetary Policy Committee giving evidence to the House of Commons Treasury Select Committee, most probably on the basis of our quarterly Inflation Report, as well as the Bank's Annual Report being debated in the full House. And we are accountable to the public through the framework of transparency.

8. Put together, these elements provide for greater transparency and accountability of the monetary policy process than in any other country in the world. None of this, of course, guarantees success. But I believe that this new, and carefully-constructed, framework provides the best prospect we have had for years of delivering price stability as a steady foundation for the sustained growth of output and employment that the UK is capable of achieving. This framework for monetary stability, combined with the parallel commitment the government has demonstrated to fiscal responsibility and to promoting a flexible and competitive supply-side structure for the economy, provides a basis for the UK economy to continue to grow on a sustainable basis in the years ahead.

Preparations for EMU

9. These changes in the monetary framework have been a major focus of interest of the UK financial markets over the past summer. But in parallel there has also been close focus on the continuing progress being made within the European Union towards Economic and Monetary Union (EMU).

10. The UK government's statement on EMU last month provided a clear account of UK policy in relation to the monetary union. That statement indicated that, in principle, a successful single currency within a single European market would be of benefit to Europe and to Britain. But, in order for EMU to be right for Britain, the economic benefit should be clear and unambiguous. If, in the end, a single currency is successful, and the economic case is clear and unambiguous, then the government believes Britain should be part of it. The statement identified five economic tests that define whether a clear and unambiguous case can be made for the UK to join EMU. These are: whether there can be sustainable convergence between Britain and the economies of a single currency; whether there is sufficient flexibility to cope with economic change; the effect on investment; the impact on the UK's financial services industry; and whether it is good for employment.

11. Applying these five economic tests has led the government to the conclusion that British membership of a single currency in 1999 could not meet the tests, so that joining at the start of EMU is not in the country's economic interests. The government will therefore be notifying our European partners, in accordance with the Maastricht Treaty, that we will not seek membership of the single currency on 1 January 1999; and, barring some fundamental and unforeseen change in economic circumstances, making a decision during this Parliament to join is not seen as realistic. The statement therefore indicates that it is therefore sensible for business and the country to plan on the basis that, in this Parliament, the government does not propose to enter a single currency. However, the government has said that if a single currency works and is successful, Britain should join it. The

government believes that we should therefore begin now to prepare ourselves so that, should the economic tests be met, a decision to join a successful single currency can be made early in the next Parliament. To help with the essential preparations, the Chancellor has invited the Governor of the Bank of England and the heads of the two main bodies representing industry and commerce, and two other Ministers, to join him on a Standing Committee to lead the preparations for EMU.

12. In the UK wholesale financial markets, practical preparations are accordingly proceeding apace.

13. We at the Bank of England have been taking an active role in helping the UK financial markets to prepare for the euro. We do this because, even though the UK will not be in at the start, it is plain that banks and financial institutions in the UK, in their wholesale business for their corporate and institutional customers, in the UK and overseas, will want to be able to offer the full range of financial facilities in the euro from the outset. They will want to be able to offer their customers deposits and foreign exchange facilities in the euro, lending and borrowing in the euro, hedging and collateral in the euro and financing and settlement facilities. The London markets will need to be able to operate in euro from the outset across the full range of their wholesale activities, and practical preparations are now well advanced to achieve that by January 1999.

14. The Bank of England's part in this extensive process of market-wide preparation, besides equipping ourselves internally for operations in the euro, is a co-ordinating one, in three main ways:

- first, our job is to ensure that the necessary infrastructure is developed in the UK to allow anyone who wishes to do so to use the euro in wholesale payments and across the financial markets from the first day of EMU.
- second, we aim to promote discussion between the EMI, national central banks and market participants across Europe about practical issues on which the market is seeking a degree of coordination.
- and third, we provide information: for example, through a quarterly publication on Practical Issues Arising from the Introduction of the Euro, which is distributed to around 32,000 recipients, including 4,000 directly overseas. The next edition will appear shortly, neatly timed for people's Christmas reading, and I confidently expect it to be on the best sellers' list for the festive season. And following the successful symposium we held early this year, we are planning to hold a further symposium, next January at the Bank, on London as the international financial centre for the euro.

15. This exercise -- to prepare the UK markets for wholesale activity in the euro by January 1999 -- has now gathered substantial momentum. Let me touch on a few of the main priorities being pursued:

16. First, market participants agree on the need to be able to trade in London the full range of euro-denominated instruments.

17. Secondly, they also agree on the need for appropriate payments mechanisms in London to carry out transactions in euro both between parties within the UK and cross-border to and from the UK.

18. Thirdly, efficient, cost-effective mechanisms for settling transactions in euro-denominated securities also need to be made available in London.

19. Fourthly, there is agreement on the desirability of harmonised market conventions for the issuing and trading of euro-denominated instruments.

20. Fifthly, there is agreement on the need for as sound a legal basis as possible for euro transactions, to provide legal certainty and to ensure continuity of contract.

21. Sixthly, there are tax and accounting issues to be addressed, related to the introduction of the euro.

22. There is work going on in each of these areas, and good progress on many of them. Let me give you one example -- the payments system, which lies at the heart of the UK's preparations for the euro. The UK's sterling Real-Time Gross Settlement (RTGS) system is being developed to accommodate the euro, so that from the beginning of 1999 euro wholesale payments may be made in a safe, efficient and cost-effective way as sterling payments can now, even though the UK will not be a participant in the monetary union at the outset. That development remains on schedule, and it is encouraging that the UK system (CHAPS) has had expressions of interest recently from a number of overseas banks wishing to join.

23. The UK euro system -- CHAPS euro -- will allow payments to be made both between parties within the UK and cross-border from and to the UK through its link to TARGET. Using the knowledge and expertise we have acquired through developing and operating by far the largest RTGS system in Europe -- with average daily volumes of some 70,000 payments, worth some £150 bn -- we are contributing a great deal to the technical development of TARGET. Because it extends the benefits of RTGS systems, in reducing the risk in payments, for the first time cross-border, it is a project we wholeheartedly support.

24. But we also want to see TARGET as efficient and effective as possible, so that it becomes the payment system of first choice for banks, in order to maximise its benefits in reducing systemic risk. We have to recognise that TARGET will be competing with alternative euro payments mechanisms, including correspondent banking and the European Banking Association's net end-of-day settlement systems. Consistently with this view, we believe that it is essential that payments be able to flow freely throughout the TARGET system.

25. Why do we devote this effort for preparing for the euro? The reason is very straightforward. London's pre-eminent position as an international financial centre rests on the fact that it provides broad and liquid markets for the full range of internationally-traded currencies and for the vast array of different instruments and facilities denominated in them. The euro will undoubtedly become a major internationally-traded currency, and it is therefore certain that it will be traded extensively in the London markets. The euro thus represents an opportunity, rather than a threat, for the London markets, and it is important that the London markets prepare in good time the systems and infrastructure needed to take advantage of this opportunity.

London as a financial centre after EMU

26. The reason why we are convinced that the euro represents a major opportunity for the London markets relates essentially to the strengths that the London markets have displayed over the years:

- London is a global financial centre rather than just a European centre, with much of its business generated around the world, not just within Europe.

- London has always thrived on financial innovation, and has a strong track record of capitalising on new opportunities.
- The euro may very well bring greater financial activity to the main Continental financial markets. But expansion in these markets is not, on past experience, a zero sum game: it is likely to lead to more, not less, activity in London since London is the major interface with the rest of the world in the European time zone.
- The economics of financial market activity point to concentration, to gain economies of scale and facilitate better management control. That is why many firms have been moving their operations, and even headquarters, to London as the preferred financial centre. Uncertainty about UK participation in the single currency has been with us for some time. But undeterred by that uncertainty, firms have continued to concentrate their trading activities in London.
- London has an unrivalled range of markets and ancillary services; and an associated deep skill base; and an unbureaucratic approach to financial regulation, which has been developed working with the grain of the market.

27. All these advantages and more help to explain why there are more people working in financial services in the City of London -- over 600,000 -- than there are in the entire population of Frankfurt and its surrounding region!

28. None of this gives any grounds for complacency: the financial services industry is an intensely competitive business. But importantly, if we can harness the strengths of the London markets to the opportunity presented by the euro, I believe that will be an important contribution to the success of the single currency. Of course, London will benefit. But London is not just a UK financial centre. It is a European financial centre, and by providing competitive trading facilities in the euro London can help provide better facilities for business and industry across the whole single market and bring more business into Europe from the rest of the world.

Opportunities in euro for market participants

29. I have talked so far principally about the steps the authorities are taking to help prepare the London markets for the euro. But of course, at the end of the day, the authorities can only facilitate: the real challenge in seizing the opportunities presented by the single currency has to be met by market participants themselves. Let me touch on three areas where the advent of the euro is likely to usher in significant changes -- but, I believe, positive changes, offering new business opportunities -- for financial market participants.

30. First, in the bond markets, monetary union will serve to unify the various national government bond markets of the EMU participants, and the already substantial ECU bond market, into a single market in a single currency with multiple national government issuers. Currency risk will be removed, at a stroke. This does not, of course, mean that all government bonds of the different national issuers will trade at the same price: differences will still remain in trading structures and liquidity, in perceptions of sovereign risk and the scale of supply by different governments, and in investors' basic preferences. But the different national government bonds will tend to trade on essentially the same yield curve, with the focus of the market being concentrated, even more so than at present, on spread relationships.

31. This of course raises the interesting question -- spread over what? Who will provide the benchmark issues? Moreover, the intensified focus on spread may produce two further results. First, there will be even greater incentives than at present for national governments, who will

remain responsible for their own debt management, to converge in their techniques for issuing and marketing their debt. It will be interesting to see whether this will generate greater co-ordination amongst debt management authorities in managing their debt programmes, including, for example, their auction timetables.

32. A second effect in this area flowing from the concentration on spreads may be greater interest in developing a diversified, deeper corporate bond market in euro, as has long been present in the United States, but much less so in other countries. If this happens, it could be a considerable boon to corporate borrowers as a whole because it would extend the range of financing opportunities open to them.

33. A second area where financial market activity in the euro is likely to generate new opportunities is in the short-dated money markets. Foreign exchange traders do clearly face some contraction in their activity, as an inevitable consequence of currency unification. But I do not expect to see too many destitute foreign exchange traders miserably wandering the streets in search of charity or menial employment because of course, as trading amongst the EMU currencies disappears, new international trading is developing in a range of currencies of leading emerging market economies. But more importantly, the advent of the euro will usher in potentially much deeper markets than exist in the individual national centres at present in a range of different money market instruments -- short-dated government and/or central bank paper, commercial bills, CDs, inter-bank deposits, commercial paper, repos, interest-rate futures, swaps, FRAs, options and a miscellany of tailor-made variants on these basic products. Markets in these products are of very varying depth and liquidity, where they exist at all, in the individual local-currency markets of the countries likely to participate in EMU. But all of these instruments are, as it happens, traded in London in the main international currencies; and with the advent of the euro, all of them will also, for the first time, be traded in the major European currency. This represents a tremendous business opportunity for banks and financial institutions with the capacity to trade these instruments and to harness them to the needs of their customers.

34. But there is a third impact on financial markets from the euro that is essentially a necessary prerequisite that must be fulfilled if the benefits from integration of the bond and money markets that I have identified are to be achieved. This is that the new single-currency, euro, markets develop trading practices and standards of conduct, and the necessary infrastructure, that will genuinely facilitate integration. In terms of infrastructure, for example, real-time, same-day wholesale payments are essential to tie together money market activity conducted in different centres in the same instrument in the single currency; and similarly, linkages may also need to be considered between different settlement systems. Common trading practices, and market conventions, will also need to be developed. The lead here lies in many cases with market participants themselves, and with the systems they have developed to serve their trading needs. But it is a process we are very familiar with in London, where we have sought when necessary to encourage just such common initiatives in order to enhance the effectiveness of international trading activity in London. And with an eye on EMU, we have encouraged trading activity in the ECU, particularly in the money markets: hence, for example, the regular programme of monthly auctions for UK government ECU treasury bills, and the quarterly auctions of UK government three-year ECU notes, which have been running for some years. Because of the international flavour of our markets, and because we are conscious that these markets will want to trade the full range of euro instruments in London, we will continue to support initiatives aimed at achieving the necessary market structure where we feel we can make a contribution.

Reforms in the London markets

35. In parallel, we have been pressing ahead with reform in the structure of the UK sterling financial markets, and the pace of progress has notably quickened in 1997. Last year saw two notable events -- the start of the gilt repo market and the completion of the Stock Exchange's Sequence project, to provide it with a new and modern integrated electronic platform for its trading and information services. This year we have already doubled up on last year, with four major initiatives -- reform of the structure of the Bank of England's money market operations; the completion of migration to electronic settlement of equities on CREST; the successful launch of SETS, the Stock Exchange electronic order book for equity trading; and a major upgrade of the CGO electronic settlement system for gilts. We have a fifth advance to come next month, with the start of a strips facility for gilts. But for the fact that a central banker is not supposed to reveal that he knows how to play poker, I would call that a "full house"!

36. I believe these are major steps forward to improve trading market facilities, and the essential market infrastructure, in London. And the fact that the London markets have been able to bring so many major projects to a successful conclusion in so short a space of time speaks highly of the resources in depth available in the London markets and the ancillary services. But I would draw attention to one particular feature, which I think is of wider significance. The upgrade of CGO has been effected utilising CREST software -- deliberately, in order to align those two electronic settlement systems -- CGO for gilts, CREST for equities -- more closely. This was a considerable technical achievement, because the operating processes in the two markets are different -- equities settle on T+5, gilts on T+1 (and in some cases T+0); the equity market comprises a large number of relatively moderate-value deals, the gilt market a smaller number of much higher-value deals; hence delay in settlement in gilts is much more disruptive, and needs to be much less frequent, than in equities. Overcoming these differences has been a considerable challenge to the Bank team and I would like to pay tribute to their dedication and expertise and to their achievement in bringing the CGO upgrade to a successful and so far smooth launch just last week. I say this without immodesty because, though I was closely involved in overseeing the project, it was their technical proficiency that delivered the goods.

37. But this achievement has a wider significance. By utilising CREST software in CGO, we have now achieved for the market much of the benefit sought by those who favour a merger of the two systems. In particular, both utilise the same hardware, and the same software application; they operate on the same networks; and users can access both systems via a single terminal using a common gateway. The Bank is, as already announced, planning to seek the views of market participants on what the relative priorities should be in developing payments and settlement systems in London in the year ahead. This will include the possibility of full merger between CGO and CREST, but recognises that merger is only one of a number of IT projects UK financial markets may have to contemplate over the next few years, all of which represent potential claims on scarce IT resources. What is important in the meantime is that a big step towards integration of systems has been achieved, to the benefit of all market users.

Conclusion

38. I have tried in these remarks to explain major developments in UK financial markets over the past year. Looking ahead, there is more to do, and I believe EMU will open up new opportunities for the financial markets. I believe this will be particularly so for the international markets in London. We intend to be ready to take full advantage of these opportunities, right from the outset in January 1999, even though the UK will not participate in EMU at that stage. The reason for this is very simple: London is the major European financial market, and we think that extending its activity to include financial services in euro is a significant contribution we in the UK can make from the outset to the success of the monetary union and of the single European market as a whole.