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News release

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Bank of England Publishes Latest Financial Stability Review

The Bank of England is today publishing its latest Financial Stability Review. It contains six articles (summarised in the attached 'Themes and Issues' editorial), and also the Bank's regular half-yearly assessment of risks to stability.

Commenting on the Bank's assessment, David Clementi, Deputy Governor for Financial Stability, said:

"Risks in the financial environment have probably increased somewhat in recent months, reflecting weaker growth and tighter credit conditions in the US, renewed pressure on some emerging market economies and a substantial build-up of debt in the telecoms sector. In the face of this, financial systems in the industrial countries nevertheless remain generally robust, so that the risks of instability should not be exaggerated. I hope that the Bank can contribute to achieving an objective assessment of vulnerabilities by making its own analysis transparent in this Review."

Some of the key points in the Bank's assessment – which deliberately focuses on potential threats to financial stability rather than the most likely prospect n are as follows (see the Conjuncture and Outlook Overview, pages 9-16):

- The central question – for financial firms and for the authorities – is what would be the effect of a sharper-than-expected slowdown in the US economy, if that were to happen, given the build-up of private sector and external debt and the uncertainty about returns in the 'new economy'. The Bank discussed this in the November 1999 and June 2000 Reviews.
- One particular issue is whether a cyclical slowdown in measured productivity growth in the US might lead to a downward revision of expected potential growth and so of expected growth in corporate earnings, potentially prompting changes in asset prices, saving behaviour, and possibly exchange rates.
- Liquidity conditions have not tightened sharply in the way they did in late 1998 and equity markets have corrected further, without damaging spillovers to other financial markets. Equity market valuations may now be more realistic, assuming that the 'new economy' has indeed brought about sustainable productivity improvements which will flow through to corporate earnings. The rates of

expected dividend growth implied by current equity prices nevertheless continue to look high compared with the past.

- As the Bank highlighted in the June Review (pages 10 and 48), there is a risk arising from the substantial increase in exposures to the telecoms sector, reflecting especially the scale of its recent and prospective debt issuance. On balance, these risks may have increased somewhat since June. Regulators, central banks and financial authorities more generally need to share information on developments in this area.
- The prospects for emerging market economies (EMEs) vary, but will be sensitive to developments in US growth and the dollar. The continuing fragility of some countries has recently been apparent from the problems experienced by Argentina and Turkey. Some EMEs have not made full use of the period since the 1997-1998 crises to repair national balance sheets and to restructure corporate and financial sectors, leaving them more vulnerable to shocks.
- The prospective slowing of the world economy somewhat reduces the risk of a further oil price shock, but uncertainty about future oil prices remains considerably higher than six months ago.
- The capital ratios of G10 banks, including UK banks, increased on average during the 1990s. The Japanese financial sector remains convalescent, notwithstanding the modest recovery in output growth during this year, and the public sector debt burden is large.
- In the UK, corporate and household sector debt has been rising and the weakest parts of the corporate sector seem to have deteriorated further during 1999. But on most measures, in aggregate, sectoral balance sheets remain considerably stronger than in the late 1980s/early 1990s, offering reassurance as long as the economy grows broadly in line with current expectations.
- Competitive conditions in UK retail banking have intensified. Lending to households by smaller banks and by new entrants has been growing rapidly, as has lending to companies by smaller banks and those previously concentrating on mortgage lending.
- The development of the credit derivatives market, and the involvement of onshore and offshore insurance companies and vehicles, is making it more difficult to assess the distribution of risk in the system. This area (see pages 45-47) merits continued monitoring and exploration.

Notes to Editors

(1) The FSR is the Bank of England’s twice-yearly publication covering the Bank’s financial stability mandate, which is macroprudential rather than related to the regulation of individual firms.

(2) The Bank’s assessment focuses on downside risks, rather than on the central expectation, since one purpose of the FSR is to identify potential threats to systemic stability.

(3) As well as the Bank’s assessment and the articles, this Review contains the Bank’s paper on its oversight of payment systems, published on 30 November.

Key Resources

Financial Stability Review, December 2000

http://www.bankofengland.co.uk/archive/Pages/digitalcontent/historicpubs/fsr/fsr09.aspx