The Foreign exchange market and the economy today

*The **Governor** [1] discusses a number of issues surrounding today's foreign exchange market. He stresses that new clearing and settlement systems, currently under discussion, are more likely to reduce counterparty risk (which has become an important concern of the banking sector) if these new systems are based on the standards set by the Basle Group of G10 central banks. He goes on to discuss the links between the exchange rate and monetary policy; and the importance of maintaining the credibility of policy in the eyes of the market. Western Europe has sought to achieve this through the ERM, whose success has relied on the commitment of each member to price stability. The **Governor** suggests that, in looking for a credible and necessary anchor for their own counterinflationary policies, the countries of Eastern Europe might consider pegging their currencies to the Ecu. Turning to economic and monetary union, the **Governor** argues that the future European Monetary Institute's natural location would be in London, given that the effectiveness of the Institute will benefit greatly from a deep understanding of financial markets.*

Ladies and Gentlemen, I am very conscious of being in a unique position in delivering this annual Roy Bridge Memorial Lecture. I am the first person to deliver the address on more than one occasion—I was privileged to speak to you in this same fine hall in 1986 and, as those of you with long memories may recall, in my previous incarnation as a Clearing Bank Chairman, I was unable at the last moment to give the lecture three years earlier than that. It is also, interestingly enough, the third occasion in the thirteen year history of these lectures that the speaker has been the Governor of the Bank of England—my predecessor, Gordon Richardson, initiated the series in 1980—and I think this is testimony, if any were needed, of the high regard we in the Bank of England have for the London Forex Association and for its work on behalf of the foreign exchange market in London. I hasten to add that these sentiments are not in any way prompted by the presence here this evening of Eddie George; but I would like to say how delighted I am that he has become your President.

Unlike Mr George, I did not have the opportunity to work with Roy Bridge when he was at the Bank of England, but his career was remarkable and his contribution to the establishment of the Forex asssociation as an international organisation was considerable, culminating in his election as the second President of the Association in 1962. Roy Bridge was of course very closely involved in the policy issues of his day and he would, I suspect, find the current re-establishment of fixed exchange rates within Europe somewhat closer to the situation he knew in the 1960s than the intervening years of floating.

One thing that has certainly not changed since the 1960s is the importance accorded to the exchange rate and to the exchange market in policy-making, and that is the subject of my remarks this evening.

Changes in the banking industry

If the exchange market has changed since Roy Bridge's day, so has the general environment in which the market's major participants—the banks—have to operate. For the banking system at large, the last decade has perhaps been the toughest and most demanding for half a century. It is nearly ten years now since the banks were first affected by international debt problems. And already by then—and rather more fundamentally—they were increasingly exposed to deregulation and to an unprecedented degree of competition, including with non-bank institutions.

This has been a fundamental change, prompting equally profound changes in the way banks manage their business. As you will all know from personal experience, banks are more ready to enter new areas of activity in which they see opportunities for profit, but they are equally ready to abandon areas of activity in which the returns have disappointed their expectations. And, critically, banks now pay much more attention to the accurate measurement and careful control of costs and risks; and to the identification and accurate measurement of returns.

This is, I think, more than just a phase. The changes of the past decade are largely irreversible; the more restless atmosphere created in the world of banking is, I believe, here to stay. In the course of the next year, the Single Market reforms will further stimulate cross-border competition, not only within the European Community, but in a wider area including those EFTA countries which decide to participate in the Single Market programme. And,

(1) In the RAO Bridge Memorial Lecture to the Forex Association on 3 March 1992.

looking further ahead, Monetary Union would have the potential to transform completely the domestic operating environment for European banks and other financial institutions—a theme to which I shall return a little later on.

Structural developments and policy issues in the foreign exchange market

Foreign exchange activities have not been immune from the trends I have been describing. Indeed the market has been affected by structural change, competition and the business cycle in much the same way as the other parts of the banking system. One notable development has been the way in which banks have become far more conscious of counterparty credit risk and, encouraged by their supervisors, are now generally measuring and controlling it much more carefully than they used to.

This has had wider effects on the market, and it is a commonplace that liquidity has diminished over the past few years. There is no doubt that a better appreciation of credit risk has been a major influence here, particularly in forward and derivative markets where the credit risks are longer-lasting and require sophisticated analysis. And I am bound to say that I think any improvement in the appreciation of risks is to be welcomed. Market liquidity is of course a very good thing in itself, but it is something which has its price, and insufficient attention to risk is not a price worth paying.

Another influence on market liquidity may have been that market-makers, who quote dealing prices actively and continuously and thereby provide liquidity to the market, have increasingly found the rewards insufficient to compensate for the market risks involved. If this is a major problem, it is one which the market must solve itself. The solution might involve a reduction in the volume of human and financial resources devoted to market-making; it would also involve an increase in the rewards of market makers, giving them the necessary incentive to sustain liquidity.

I realise of course that liquidity and turnover are not the same thing, but I think it nevertheless likely that some statistical light will be thrown on the liquidity debate by the survey of turnover in foreign exchange markets worldwide, which as you know is to be conducted by central banks with your help next month. I should, incidentally, take this opportunity to say how glad I am that *all* the major financial centres will be taking part in the survey this year. And I am sure that, when the results are available in the autumn, we will gain a much better understanding of the spread of business worldwide.

I mentioned perceptions of counterparty risk as playing a part in the market's recent development. One aspect of counterparty risk—discussed not only actively but also constructively—is the settlement exposure which is bound to arise when one side of a foreign exchange deal has to be completed before the other, typically in another jurisdiction. As I say, this has been explored extensively over the past few years, and a number of very active banks are already employing the technique of bilateral netting, which, if backed by suitable legal agreements, has the capacity substantially to reduce their settlement flows and the size of the associated exposures.

Reduction of settlement flows can in principle be taken further, and made available for less active banks, by multilateral netting. And since this is currently under discussion in a number of groups now, I should perhaps spend a few moments on the general outline of such schemes. They basically involve the establishment of a clearing house for foreign exchange transactions, with a role not dissimilar from the clearing houses in futures markets. Any transaction between two members of the clearing house—let us call them A and B—would be transformed immediately into a pair of matching transactions, one between A and the clearing house and the other between B and the clearing house. All contracts between each member and the clearing house would be netted so as to reduce the risk exposure of the clearing members and of the clearing house. The clearing house would therefore be running a completely 'matched book', and its credit risk exposure would be confined to its net unsettled positions with its members.

This type of structure raises some important issues and central banks naturally have a very close interest in them. Through work in Basle, the G10 central banks have collectively identified a set of standards which such clearing and settlement systems must meet if they are to be regarded as genuinely reducing risks rather than just obscuring them—or even, as could perhaps happen, actually increasing them. I believe that these standards are widely recognised as being based on a sound analysis of the risks involved in settlements and in netting; and I trust that they provide a means for progress. In fact, I personally believe that the Basle netting standards could over time prove as fundamental for clearing systems as the Basle capital standard has proved for banks generally.

It is natural that the market should be anxious that central banks should arrive at a common view on particular proposals as quickly as possible. Nevertheless the analysis of individual schemes is invariably difficult and complicated. As I have suggested, the proposed clearing houses would be absolutely critical to the proper functioning of the foreign exchange market. Their central positions in the market would mean that their financial health would be of great interest to both commercial and central banks. And it is therefore hardly surprising that their design has been—and still is—a matter of extensive debate among the prospective participants. I hope you can therefore appreciate that this is an issue on which central banks feel very strongly that they have to work with the proponents and prospective users of these schemes to arrive at a common assessment of all the possibilities. It is very important that this should be done thoroughly.

Foreign exchange markets and economic policy

Central banks are concerned about the functioning of foreign exchange markets not only because of the mind-boggling amounts of money transacted in them but also because of their vital role in the functioning of market economies. The classic function of foreign exchange markets is facilitating international trade, and this is as important as it ever was. But, as you all know, turnover has in recent years grown many times more rapidly than international trade, on account of the use of foreign exchange markets for international investment—or, to use an expression which perhaps conveys more accurately what has been happening, for balance sheet management, which has now become hugely more sophisticated. Both this and the more traditional trade element in the market's activities are obviously enormously important for economic policy, and especially monetary policy.

The overriding objective of monetary policy is directed at the domestic price level, or the internal value of the currency. In an open economy this is closely related to the external value of the currency—or the exchange rate. For one thing the exchange rate directly affects the price of imports; but—and this is critical—in the slightly longer run it also affects the prices of all domestically-produced goods and services which compete either in domestic or foreign markets with goods and services produced in other countries; and indeed ultimately it affects even goods and services which are not exposed to foreign competition but which nevertheless have to compete for productive resources with those sectors of the economy which are so exposed.

Equally significant is the fact that exchange rate behaviour is heavily influenced by market analysis of monetary and economic developments. Accordingly, the monetary authorities have to take seriously the private sector's conclusions, which are encapsulated in market behaviour and the discipline it imposes on monetary policy. The key here is to maintain the credibility of policy in the eyes of the market.

For the economies of Western Europe, the route to this has increasingly been seen to lie in the fixing of exchange rates within a pre-announced band, not only within the ERM but also, for example, in Norway, Sweden and Finland, which have pegged their currencies to the Ecu. The purpose of fixing exchange rates in this way is by no means to suppress market forces: indeed movements of exchange rates within the fluctuation bands yield extremely valuable information for policy makers. Rather it is to make clear that the instruments of monetary policy will be directed at monetary stability; in the long run, domestic price stability and exchange rate stability within the ERM should become mutually self-reinforcing *provided* that all the countries whose exchange rates are fixed together share and can achieve the common aim of price stability. This requires at least the large economies of Europe to direct their monetary policies towards establishing and maintaining price stability; the fact that the Bundesbank has done this with such success over a long period in Germany is of course precisely why the deutschmark has effectively functioned as the anchor of the ERM.

We in the United Kingdom took a large step when we joined the Exchange Rate Mechanism of the European Monetary System in October 1990. Our objective in doing so was to reinforce our anti-inflationary policy by making a public commitment to keeping sterling's exchange rate against other member currencies within the ERM bands by whatever means are necessary. Our experience thus far has been encouraging. As our inflation rate has fallen—and, it has to be said, as Germany's has risen—we have been able to narrow the short-term interest differential between the United Kingdom and Germany from 7% before we joined the ERM to about 1% now. Sterling has fluctuated within the wide band, but it has been noticeable and reassuring that demand for sterling has strengthened whenever we have moved down within the band, and so has helped to contain the downward movement. We realise of course that, for the market to act in this stabilising way, our monetary policy and our commitment to the ERM must remain credible.

Of course over the last few months there have been latent tensions in the ERM arising fundamentally from the fact that business cycles in European countries have been unsynchronised, with Germany experiencing a unification boom, now apparently ended. It is an eloquent testimony to the value put on the ERM that even in these circumstances, none of those countries has seriously contemplated realignment, for readily understandable reasons. Happily, the market has recognised what an unattractive policy option devaluation in the ERM would be, and the latent tensions in the ERM have remained latent. In the long run, it is on episodes like this that the credibility of the ERM is built.

Monetary stability is very clearly one of the most attractive features of the European Community to neighbouring countries which are not—perhaps I should say are not *yet*—members. It is, for example, extremely significant in my view that Norway, Sweden and Finland have all chosen to peg their currencies to the Ecu; I think that the ERM members should be pleased that they have done so. It demonstrates the confidence of those other countries in the commitment of the ERM members to stability; and it expands potentially the area of stability more widely in Europe. I hope that the newly-liberated countries of Eastern Europe, when reviewing their currency policies, will seriously consider the Ecu as a possible anchor for their exchange rates.

This issue is certainly relevant to the central bankers of Eastern Europe and the former Soviet Union, facing the daunting challenge of establishing monetary stability in their countries. Their first task is to establish a public perception of their domestic currencies as objects of value which are worth saving as well as spending. But after that, one of the questions which they have to address is the relationship between their currencies and other currencies. It is extremely difficult in any circumstances to decide at what level to fix an exchange rate: it calls for judgments above all

about competitiveness and the flexibility of costs and prices. And in Eastern Europe these difficulties are compounded because the relevant evidence is basically absent on account of the legacy of command control of the economy. In practice, however, these countries have no developed financial markets which can be reliably expected to take anything but a very short-term view when dealing in the foreign exchange market, and they have had no real option but to fix their exchange rates—perhaps to an adjustable peg—even though they have very little evidence on which to base the choice of level. Inevitably this will be followed by periodic exchange rate adjustments as the relationship between internal and external prices gradually becomes clearer. But it is really very important that these adjustments should take place within a credible counterinflationary framework. History is littered with examples of exchange rates being set free without the anchor of domestic monetary discipline—often with disastrous consequences.

Economic and Monetary Union

In Western Europe, the debate has moved on from pegged exchange rate regimes to something rather more ambitious: the possibility of Economic and Monetary Union, and this has been a preoccupation for me and my fellow EC Central Bank Governors since the Delors Committee was established in June 1988. The debate took a significant step forward last December in Maastricht, when the Heads of Government agreed a Treaty which provides that Monetary Union should take place by the beginning of 1999 at the latest for those countries which meet what are generally known as the four convergence criteria. Briefly, this requires the achievement of a high degree of price stability and a sustainable government financial position, and for countries to have kept their currencies within the narrow band of the ERM for at least two years without devaluing on their own initiative against any other currency. These are highly desirable tests, and I also welcome the fact that the final criterion introduces an element of market judgment by requiring the durability of each country's convergence to be reflected in long-term interest rate levels.

The criteria are elaborated in numerical terms and are fairly demanding. In my view it is a good thing that they are demanding. There is an obvious danger of allowing our hearts to rule our heads, and to allow countries to join a monetary union without having properly converged. To succumb to this temptation would be false generosity, and it must be resisted. For any country the consequences of joining a monetary union prematurely are likely to be far worse than the consequences of not joining at the outset but waiting until the conditions are right.

Moves towards a single currency in Europe do of course have important consequences for foreign exchange markets; not least because, in a monetary union, banks would lose what must be a steady and reliable source of income from intra-European foreign exchange transactions. There is no escape from this; though I can say that the effect on London would be less than on other European centres because London specialises more in trading in non-European currencies—mainly of course the dollar and the yen—and it is these markets which would be of prime importance after any move to a single Community currency. So there is no need for traders, brokers and other participants in the London market to look forward with trepidation, especially as trading in the currencies of Eastern Europe and the former Soviet Union is bound to increase as they become more freely convertible and as the economies and financial systems of those countries develop.

In the shorter term, the next step planned on the road to monetary union is the establishment of the European Monetary Institute, which is due to take place on 1 January 1994. Perhaps I might remind you of the objectives of the EMI. The Treaty says that

'the EMI shall contribute to the realisation of the conditions necessary for the transition to the third stage of EMU, in particular by:

> first—strengthening the co-ordination of monetary policies with a view to ensuring price stability;
>
> second—making the preparations required for the conduct of a single monetary policy in the third stage of EMU and for the establishment of the European System of Central Banks and the creation of a single currency;
>
> and third—overseeing the development of the Ecu.'

During Stage 2 itself, monetary policy will remain unambiguously the responsibility of national authorities. But, looking ahead, the EMI's functions will be extremely important, and I am accordingly very pleased that the EC Central Bank Governors' Committee has taken on the role of setting up the EMI.

As I have already said, our experience is that market developments provide valuable input into monetary policy decision making—or, to put it another way, monetary policy ignores markets at its peril; and I need hardly say here that this applies particularly to the foreign exchange market. In my judgment it is absolutely vital that this precept becomes deeply embedded in the culture of the EMI, and later, of the European Central Bank. This means that the EMI will need—at the very least—to have very good contacts in London, where Europe's largest financial markets, and particularly exchange markets, are located—and indeed it would most naturally be located in London.

The most important of the preparations required for the conduct of a single monetary policy in the third stage of EMU will be hard thinking about what range of influences is going to be brought to bear on monetary policy decisions and in particular what the relationship will be between economic and market developments and monetary policy decisions. Of course it will not be possible to make any very precise preparations, because all monetary policy decisions are unique in that each is made in the light of a unique set of

circumstances. This does not, however, absolve the EMI from the responsibility for establishing a set of presumptions which can guide policy-makers once Stage 3 begins.

If the EMI is to be able to discharge this onerous responsibility adequately, its staff will need experience of the relationship between central banks and financial markets. It would be a great pity if the EMI became an ivory tower generating ideas galore but not subject to the sometimes harsh discipline of reality and therefore not ultimately effective. Certainly ideas will be essential, but so will be practical and deep market experience. In practice, the EMI is likely to have some direct involvement with financial markets, because it will be entitled to hold and manage foreign exchange reserves as an agent for and at the request of national central banks. As you may know, one of the functions of the Bank of England is to manage the United Kingdom's external reserves, and our reserve managers have a reputation for expertise among central banks of which we are proud. What we gain from this activity, besides a useful return on our reserves, is a close, first-hand and up-to-date understanding of market practices and market sentiment. This is part and parcel of monetary policy-makers being sensitive to markets, and in any event there is no escaping the fact that the European monetary policy of the future will have to live with financial markets. This means that European monetary authorities and financial markets will need to get to know each other as well as they can in advance—recognising of course that, as in all relationships, there are bound to be surprises, both pleasant and unpleasant. It will be the EMI's responsibility to ensure that this process of familiarisation leads to a cohabitation which is as harmonious and understanding as it can be.

I have ranged rather widely this evening over the issues preoccupying the market and policy-makers. Perhaps the only certain thing is that there is reason to expect the foreign exchange market to experience as much change in the coming years as over the past decade. Roy Bridge would no doubt have pointed out that it was ever thus.