International economic stability and co-operation

The ***Governor***[1] *considers the consequences of the enormous changes in the international financial environment over the past decade. He argues that the changes have reinforced the need for co-operation among policy authorities, both in the area of prudential supervision and macroeconomic management. The* ***Governor*** *draws a number of practical lessons about co-operation.*

Looking back on almost ten years as Governor of the Bank of England, I am struck by the enormous changes that have taken place in the international financial environment. Most strikingly, the sheer volume of financial transactions has grown exponentially and the world's capital markets have become increasingly integrated. These developments have been reflected in the changing pressures facing international financial institutions (especially banks). They have also required monetary authorities to co-operate ever more closely, both to protect the stability of the financial system and to promote a healthy macroeconomic environment.

In my remarks this evening, I would like to examine more closely some of these trends that have so profoundly affected the world in which we make our professional lives. I want to explore how the growing integration of goods and capital markets has reinforced the need for co-operation among policy authorities, both in the area of prudential supervision and macroeconomic management. And I want to ask the question where this process of change is leading us. For although my own term of office will shortly come to an end, I will continue to have the greatest interest in the challenges facing the banking community.

Allow me to begin by trying to summarise some of the major developments that have shaped the evolution of financial markets in the last two decades or so.

First, of course, has been the continued growth of international trade and investment flows. This, and the global reach of major multinational corporations, has called for a comparable growth in the provision of financial services.

Second, and even more important, has been the tide of liberalisation that has affected the financial services industry. In particular, controls over cross-border transactions among industrial countries have been almost completely eliminated.

Third, the revolution in information technology has dramatically reduced the cost of financial transactions and made possible the development of markets in sophisticated derivative instruments.

A *fourth* development with far-reaching implications has been securitisation. As the range of financial instruments has grown, so has the share that are marketable as securities.

These developments have led to profound changes in the size and structure of the financial sectors of the industrialised countries, although not always in identical ways. The distinction between the three main areas of financial activity—banking, securities business and insurance—has become harder to define. New forms of maturity transformation, and the desire for liquidity on both the liability and asset sides of balance sheets, have created new orders of risk management that cross traditional boundaries between financial institutions.

In one way or another these trends have dominated my term as Governor of the Bank of England over the past ten years. No central banker could ignore them—least of all in London, the world's most international and, I like to think, most innovative financial centre.

Any central bank's basic concern is with stability. This has two aspects. First, of course, to provide the stable macroeconomic framework that is necessary for the long-run growth of output and employment. But second, and more specifically, any central banker will want to ensure that the network of financial institutions and markets for which he or she is responsible is sound and resilient. That will be the case whether or not the central banker is formally responsible for the supervision of individual banks. It is a systemic concern, growing from the central banker's prime function of ensuring stability in monetary and financial conditions.

Both of these aspects of stability have an international dimension that has grown in importance over the years. Stability of the financial system in any one country depends significantly on the strength of financial institutions and markets throughout the world. All of us, therefore, have to be confident that other participants in financial markets are soundly capitalised and effectively supervised, wherever they may be located and wherever their business may be done.

The same applies in the macroeconomic sphere. Instability in one country, or a sudden change in policy mix, can create serious problems of economic management for its partners. Even more damaging, in the long run, inconsistent macroeconomic policies can undermine the consensus for the open trading system. Conversely, effective international co-operation can underpin national economic stability and strengthen non-inflationary growth.

(1) In a speech to the Institute of International Bankers at the Waldorf Astoria, New York, on 5 May.

Although we have a natural concern with financial stability the preservation of *competition* is also important. Any constraints that we place on financial institutions in the name of systemic stability must be carefully designed. I have always been clear that my task is not to stifle competition and innovation, but to provide an environment in which they can flourish. I have also been clear that anything that is done to make the banking system safer must be done internationally, in a spirit of co-operation.

In the field of banking supervision, it was plain as early as 1974 that an international approach was needed. Following the failure of Bankhaus Herstatt in that year the Group of Ten countries established a committee of banking supervisors—the 'Basle Committee'—to consider how to strengthen the international banking system. The current Chairman of the committee is, as you know, Gerry Corrigan and I am happy to take this opportunity to pay tribute to the enormous contribution he and his predecessors have made to this effort.

The original objective of the Basle Committee was to improve 'early warning' systems. But this was only a beginning. A major goal has been to ensure the adequate supervision of cross-border banking activity. Two principles are involved: to ensure that no international banking establishment can escape supervision; and to ensure that supervision is adequate. In other words '*who supervises?*' and '*how do they supervise?*'.

The question of who supervises was addressed in a document that came to be known as the 'Basle Concordat', which sets out principles for sharing supervisory responsibilities for banks' foreign operations, as between host and parent authorities. As a result, no banking office within the G10 countries can escape the supervisory net. More recently we have taken steps to ensure, in addition, that all internationally active banks are subject to comprehensive consolidated supervision by their home supervisor.

The issue of *how* to supervise is inherently more complex. Given differences in national situations, traditions and financial structures, it is obviously neither feasible nor desirable to harmonise supervisory practices precisely. Nevertheless, a measure of agreement is clearly necessary. By the mid-1980s the need for action on this front was greater than ever. Many of the new banking and securities market products being introduced into international markets were creating new categories of exposure. Like our counterparts in other central banks, we in the Bank of England were becoming increasingly anxious to find ways of setting capital requirements against the various types of risk being accepted by our banks. It was in the summer of 1986 that Paul Volcker and I decided, in effect, to kick-start the process of international co-operation by achieving, bilaterally, a joint UK/US approach to the measurement of capital. Agreement was reached in 1988 on the weightings that would apply to different classes of assets and on a minimum risk asset ratio. This system has now been applied not only in all G10 countries, but in most countries with banks with a significant international presence.

I do not want to go into here the debate which these decisions have spawned in the banking industry. I am quite well aware that specified elements of these agreements can be challenged, though I am not persuaded that any better alternatives have been put forward. For now, I simply want to make two points. *First*, in a highly competitive and international banking environment, close co-operation among bank supervisors is essential to achieve the goals of systemic stability and a level competitive playing field. *Second*, those responsible for international co-operation in this area can never afford to rest on their laurels. Looking ahead, there are two tasks that must be high on our agenda. One is to reach agreement on other categories of risk (such as market and interest rate risk) that are inherent in financial activity. The other is to ensure the security of payments and settlement systems.

In my time as a central bank Governor this latter issue has become more and more important. With the growth of the volume of payments has come a greater interdependence among institutions, both geographically and across market segments. In 1970, for example, it is estimated that payments through the main funds transfer systems in the United States were about 10 times underlying GNP. By 1990, they were 75 times GNP. The scope for accidents has grown, and so have their potential systemic implications.

Much good work has been done at the BIS to strengthen payments systems, both by proposing improvements in netting arrangements, and assigning responsibilities among the various central banks involved. I believe, however, that a more complete solution lies in a move towards the immediate final settlement of large-value transactions. Developments in technology now make it feasible for large-value transactions to be settled instantaneously through debits and credits over the books of central banks (what we call 'real time gross settlement'). We are close to implementing such systems. When we do, we will have succeeded in virtually eliminating payments risk as a systemic danger. And we will have built the necessary foundation on which we can construct systems to bring similar certainty to the settlement of other financial transactions, for example in the foreign exchange, money and capital markets.

I have dwelt at some length on the involvement of central banks in banking risks, because I wanted to show the essentially international character of central banking in the last decade of the twentieth century. Capital markets have become global, and finance is an international business. Therefore those whose responsibility is for the health of financial systems must be international in outlook also. I am happy to report, as I approach the end of my own term of office, that personal and professional relations among central banks have never been better. That does not mean that all problems have been solved, nor that we do not have important differences of view. But I am confident that the will and determination are there to find mutually agreed solutions.

The health of the financial system is, of course, only one of the areas in which co-operation among national monetary authorities has become increasingly important. When I look back on my ten years in office, I am forcibly reminded of the importance of international financial co-operation across a wide range of other issues—from the resolution of the LDC debt problem at the beginning of my term to the financial situation of the former Soviet Union at present. In addition, a constant theme throughout that period has been how to strengthen the co-ordination of economic policies in order to reinforce stability, both in the context of our efforts to promote economic integration in Europe, and in the wider international context.

It is sometimes argued that co-ordination is unnecessary or, worse, counterproductive. Those who hold this view believe that each country should pursue its own domestic economic agenda and allow exchange rates between countries to be determined by market forces. Each country would have an obligation not to 'manipulate' its exchange rate to gain unfair advantage, or to impose trade restrictions. Beyond this, exchange rate relationships would be determined by market forces.

There is much in this view with which I can agree. It is certainly true that the primary international responsibility of each country is to set its own house in order. The worst outcome is when we seek to shelter our own mistakes (on inflation, for example) by persuading others to err in the same direction. It is also true that market forces have to be allowed to play their proper role. Once appropriate domestic policies are in place, market forces can help reinforce the maintenance of balance at the international level.

None of this means, to my mind, that policy co-operation does not have an important role to play. Indeed, in an interdependent world, it is impossible to ignore the 'spillover effects' of economic developments in one country to its trading and investment partners. The task of economic policy-makers is to make the most of positive spillover effects (through greater trade and capital flows) while trying to avoid the negative effects of inconsistent national policies. I have always been a strong internationalist, though I hope a realistic one. For a country like the United Kingdom, our economic interdependence has both a European and a global dimension. Within Europe, we are co-operating with our EC partners to deepen the economic linkages among our countries and strengthen our policy co-operation. These efforts, I believe, need to respect certain key principles. *First*, they must be based on free market principles. To achieve its potential, any move toward economic and monetary union in Europe must aim to remove unnecessary regulations, open markets to competition, and eliminate barriers to trade and the movement of factors of production. This is the essence of our support of the single market legislation. *Second*, macroeconomic policies must be based on the pursuit of stability: in other words, the lasting defeat of inflation and the durable consolidation of national budgetary positions. This in turn will provide the most secure basis for the pursuit of exchange rate stability. My *third* principle is that of respect for the national democratic traditions of member countries. Co-operation does not mean the elimination of national differences. Each European country has its own customs, traditions and legal systems, which enrich our common heritage. Forging closer economic co-operation need not conflict with the preservation of national practice across a broad range of economic activities.

Many of the same principles can be applied at the global level. However, the issues that arise in economic co-operation in the larger world economy are not the same as those inside a single region, such as Europe. In particular, the question arises of how to manage macroeconomic interactions in the absence of a framework such as the European Monetary System.

As we have learned from experiences, changes in macroeconomic policy mix can have major effects on exchange rate relationships among the three major currency regions. These swings in exchange rates, in turn, can have adverse consequences of three types. *First*, they act as an impediment to the wealth-enhancing growth of international trade and investment. *Second*, they interfere with the task of national authorities in achieving stable non-inflationary growth. *Third*, and perhaps most seriously, they tend to inflame protectionist sentiment. Protectionism is not only an ugly form of nationalism; if allowed to grow unchecked, it could undermine our collective prosperity.

It was a recognition of these dangers, and particularly the last, that gave rise to the Plaza agreement in 1985, and the subsequent intensification of what is now rather grandly called 'The G7 process'. The combination in the United States of an expansionary fiscal policy and continued monetary restraint led to a sustained appreciation of the dollar in the early 1980s, and a sharp widening of the US payments deficit. The extent of the dollar's appreciation was welcome to no country. It undermined the competitiveness of America's export industries, and it complicated the task of restoring price stability in Europe. The protectionist pressures it unleashed caused grave concerns in Japan. Moreover, because the widening of the US payments deficit could hardly be sustained indefinitely, there was considerable alarm about the possibility of a 'hard landing' when markets eventually forced an adjustment.

The Plaza accord, and the subsequent Louvre agreement were, I believe, remarkably successful in correcting a potentially dangerous exchange rate misalignment. More than that, they confirmed the Group of Seven as an 'anti-inflationary club', whose goal was to underpin exchange rate stability through the common pursuit of sound macroeconomic policies.

Of late, the G7 has not had such striking successes in the field of economic policy co-ordination. There are both substantive and procedural reasons for this. Substantively, the objectives of countries differ, as they find themselves at different stages of the economic and electoral cycle, and as beliefs about the nature of underlying economic processes diverge. Procedurally, our regular meetings have sometimes been handicapped by the publicity that surrounds them, and the expectations that are aroused by newsworthy communiqués.

I have now attended every meeting of the Ministers and Governors of the G5 or G7 in the past ten years. Indeed, I believe I am the only person to have done so, whatever such a record can be taken to signify! So I feel I have some standing to reflect on the lessons that can be learned. Let me identify just four lessons, two involving the *process* of policy co-ordination and two involving the *substance*.

First, meetings among financial officials are most effective if they are kept small and informal. Large set-piece meetings are in my experience not a good environment in which to reach understandings on policy co-ordination. *Second*, the aim of our regular G7 meetings should be to understand each other's objectives, and the political and economic constraints we face. We also need to understand the 'spillover' effects from one country's policies onto others. From this process of understanding, we can often discover policy options that lead to a better outcome for all. But if, on the other hand, we begin from an attempt to pressure our partners into adopting policies they are reluctant to pursue, the exercise can degenerate into confrontation.

Third, on substance, policies should be aimed at medium-term sustainability not short-term fine tuning. It is always tempting to try to respond to the political pressures created by the latest economic statistics. But we follow a more reliable compass if we keep our attention focused clearly on the medium-term goals of price stability and budgetary consolidation.

Fourth, exchange rate stability is the result of convergence in underlying economic policies and performance. It cannot be achieved by actions in the exchange markets alone. Attempts to move exchange markets in directions that are not consistent with underlying policies nearly always end in disappointment.

These may strike you as rather self-evident conclusions. And so they are. But what is surprising is how strong the temptation is to ignore them when political pressures mount This is perhaps one of the central reasons why regular meetings among finance minsters and central bank governors can be an important force for good. We all face similar pressures, and are forcefully aware of the constraints imposed by the fact of international interdependence. We can provide each other with an invaluable sounding board for ideas—and a mutual support society against the slings and arrows of outrageous political fortune.