BANK OF ENGLAND

Speech

Speech by the Governor at the Euromoney International Bond Congress

Speech given by

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Thank you, Padraic. I wasn't quite sure what you had in mind when you asked me to wind up this Congress once again this year. I couldn't remember what I'd done to wind you all up last year! But I am happy to join you anyway at what has become – in five short years – an unmissable event in the calendar for anyone with an interest in the international bond markets.

And what an extraordinary year it's been since we all last met here. Despite all the upsets – beginning in Asia, then Russia and most recently Brazil – which had everyone scrambling for liquidity and desperate to reduce risk, it proved, on IFR's figures, to be a record year for international bond issues, with total issuance rising by some 17% to over a trillion dollars equivalent. That can't have been bad for fees! And altogether it suggests you had a pretty good year – apart from those of you who chose to go on holiday in August leaving someone else to look after your long positions in Russian bonds.

Inevitably issuance by emerging market economies fell away, but issuance by supranational and sovereign borrowers in aggregate still accounted for some 30% of total issuance.

At the same time, higher rated corporate borrowers took advantage of lower yields to strengthen their balance sheets, accounting for 45% of total issuance. This was despite a general widening of credit spreads – which though they have come back some way from the peak levels of the autumn are – and are likely to remain – substantially wider than before the emerging markets crisis, reflecting a more sober assessment of relative credit risk. Against that, the bond markets generally benefited substantially from continuing low inflation and a further decline in inflationary expectations, so that yields have declined in virtually all the main currency sectors. In terms of government bonds they have come down by 100 basis points in the US, by 150 basis points in bunds, by close to 200 basis points in the sterling gilt market, and even by over 100 basis points in Japan before yields there began to back up late last year. Borrowers have been attracted by lower nominal borrowing costs; and investors in the market have been attracted by the prospect of rising values as yields have declined. Significantly, the decline in yields in the underlying government bond markets has typically more than offset the widening in spreads faced by lesser credits. In the US corporate bond market, for example, BBB spreads widened over the year from around 75 basis points to around 140 basis points, but because of the underlying fall in yields, yields paid by BBB borrowers actually fell from around 6½% to 6%. Similarly, in the sterling market here, lower grade spreads widened from around 80 basis points to over 150 basis points but yields paid fell from just over 7% to around 6%. The result has been a notably effective contribution by the bond market to meeting the financing needs of the corporate sector.

The past year has, also, in a real sense been the year of Europe. In any event, the prospect then advent of the euro was undoubtedly a major factor driving the increase in bond market activity. Issues by European borrowers accounted for some 25% of the total, and issues in European currencies rose to nearly 30%. Many issuers took the opportunity to issue tributary or parallel bonds which were fungible with the launch of the euro. Others offered large benchmark issues with provision for re-denomination into the euro. In parallel, 1998 saw a further rapid expansion in the volume of equity issuance by European names, fed partly by

privatisation sales, but reflecting also increased corporate use of the equity market to finance expansion and acquisitions. Even more remarkably, merger and acquisition transactions in Europe rose nearly 50% in 1998, continuing a trend which has seen this area of activity increase by around 35% a year over the past five years.

Moreover, January 1999 has by all accounts started the New Year in an even more active vein, with a very high volume of bonds issued, and with the euro accounting for over a third of the total. In part, this no doubt reflects the fact that the euro is, for the moment, the new kid on the block which everyone wants to meet. But more fundamentally it is a clear vote of confidence in the new currency that such international interest should already be apparent in borrowing and investing in the euro, and in adapting and re-balancing portfolios to take account of this major change in the structure of the capital markets.

A hugely important contribution to this process has, of course, been the vast exercise to prepare conventions, processes and systems for the euro, both within firms and in the shared market infrastructure. The scale of work undertaken in all centres – but notably in London, because of London's pre-eminent position as the international centre for the bond markets – has been immense and I want to pay tribute to the high professionalism with which the preparations and the conversion itself were conducted. People commented on how empty the bars and restaurants were in the City of London over conversion weekend – which is remarkable in itself; but inside and indoors, 30,000 or more people achieved a remarkable feat of engineering, all within the space of a three-day holiday weekend. It may not have been everyone's preferred way of spending New Year's Eve, but it was certainly a very productive one. The good news is that everyone can come back and do it again this year for Y2K!

So there is a lot you can feel positive about in the past year's achievements and in the start you have made to 1999. But looking ahead, the world prospect remains uncertain. Notably, the emerging markets crisis has had an immense impact on international financial flows, and the economic adjustments that those shifts will bring in their wake must be likely to have important impacts on the bond markets and on your business activity.

As a measure of the impact of the emerging markets turbulence, the Institute of International Finance recently published data which show that total net private capital flows to the emerging markets (broadly defined) fell from some $325 bn in 1996 to around $150 bn last year. Within this, non-bank lending and portfolio equity inflows also fell back by around $60 bn (to around $50 bn). Although direct investment in the emerging market countries held up pretty well (at around $100 bn), and despite a big increase of nearly $50 bn in official lending, there was a sudden huge decline in the overall availability of finance to the emerging market economies. And that left many of them with sharply weakening exchange rates, and little choice but to contract their domestic economies.

The immediate international priority last year was to contain the financial contagion – and there was some progress in this direction following the initial shocks in Asia. But after the series of new shocks during last summer – Russia, LTCM, the deepening recession in Japan and the worsening position in Brazil – the prospects, at around the time of the IMF meetings in Washington last autumn, were looking pretty bleak.

Now I would completely destroy my reputation as a central banker if I were to suggest that we are out of the woods. But the darkest financial storm clouds have lifted a little since the Fund meetings. The US Congress finally approved more resources for the IMF, the threat of a credit crunch extending to the industrial economies in the wake of LTCM receded, helped also by an easing of monetary policy in Europe as well as in the United States. In Asia, Japan took more determined policy action to address the fragility of the banking system and to stimulate domestic demand; the yen strengthened; China and Hong Kong both remained admirably resolute; and there have even been some encouraging signs of renewed capital inflows to some of the Asian countries. The floating of the exchange rate in Brazil last month inevitably increased concerns about emerging market instability, but it is encouraging that adverse effects on other markets have so far been limited.

There may be further particular setbacks, as far as the overall financial situation is concerned, but I think I can confidently say that if it doesn't get any worse it is likely to get better. Risk aversion is all very well for a time, but it doesn't pay the rent!

What we are now having to cope with are the economic consequences of the earlier financial disturbances. The inevitable counterpart of recession in much of the rest of the world is a sharp slowdown of net external demand – particularly for manufactures – in the industrial world. That has been reflected in growing weakness and falling business confidence in large parts of the manufacturing sector in both the United States and Europe. The prospective growth in world economic activity has already roughly halved – from its trend rate of about 4%. Unless this fall in net external demand is offset by sustained domestic demand growth in the industrial countries – unless, in other words, the industrial economies collectively accommodate the necessary improvement in the external current account position of the emerging countries, through a deterioration in their own current account positions – the prospects for world economic activity would be dismal.

Happily, we start from a position of relatively low inflation throughout the industrial world and, faced with weakening external demand, we can afford to see higher offsetting domestic demand growth without jeopardising price stability. Indeed we need to see higher domestic demand growth than we would otherwise if overall demand is not to fall short of underlying supply-capacity, and we need it, too, to offset the effects of weak world prices and of lower exchange rates in many emerging market producers on our own domestic price level.

These considerations largely explain the easing of monetary policy in the US and in Europe since last autumn. The fact that we reduced interest rates by different amounts, and that they remain at different levels, is explained by differing assessments of the prospective impact on the pressure of overall demand, taking account of our own particular starting points. But the general nature of the response was driven by essentially similar considerations.

Managing this global imbalance will be a considerable challenge for policy makers over the next few years; and helping to finance it – including helping to finance re-emerging markets - will be a considerable challenge for international bond markets. The fact that you are all here – and in evidently good form – after the past remarkable year suggests that you have strong nerves. You may well need them again in the period ahead. But think of it this way. By the time we meet again for this great Congress next year, Y2K will be behind you – and if you have survived that, you can survive anything! I wish you all all possible success.