



BANK OF ENGLAND

Speech

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Speech given by

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Ladies and gentlemen it is a great pleasure to be here this morning.

My announced theme today - the role of the Bank of England and of London as we enter the new millennium - is, on the face of it, a pretty broad one. The explanation for that is not so much high ambition, but that I had to choose a title some time ago, and did not at that point know that I would stand before you today in the wake of some significant policy announcements about the UK's gold reserves.

Nevertheless, I will stick, more or less, to my original theme, although I will obviously have to focus on just a few aspects of it. So my plan of campaign is as follows. First, I will say something about the recent decision to sell some of the UK's gold reserves. My main point there is that the decision was driven entirely on portfolio management grounds, and that the government, and the Bank as its agent, plans to retain a major presence in the gold market. Returning to my announced theme I then want to go on to outline the range of other markets in which the Bank retains an operational presence. The point is that, since monetary independence, the Bank's monetary policy work has - quite rightly - been scarcely out of the news. But the Bank has other major policy responsibilities as well - most importantly the pursuit of financial stability - and a keen interest, and involvement in, a whole range of financial markets in order to pursue them. So I then want to talk in more detail about the Bank's financial stability role: what it consists of, and how we go about it. Finally I will end by saying a few words about the role technological advance is playing in changing the shape of all financial markets - an area of interest, though also of irreducible uncertainty, for policy makers, issuers, investors and intermediaries everywhere.

I would like first to take a few minutes to explain the rationale behind the decision, announced on 7 May, to sell around 60% of the UK's gold reserves. There were in fact three key elements of the announcement. First, that 125 tonnes of gold would be sold in this financial year. Second, that this gold would be sold by single price auctions; there will in fact be five auctions between now and next March, the first of which is on 6 July. Third that, though further disposals are planned for future years, the government has stated that around 300 tonnes of gold will be retained in the reserves.

Now there has been a certain amount of speculation as to the rationale for these decisions. I should say first of all that it would be quite wrong to suppose that the decision to sell gold arose because the authorities had concluded that the gold price was going to fall further; or that gold had no role in our reserve management strategy; or that it pre-empted a decision on EMU entry. Instead, the decision reflected a view as to what the right combination of risk and return was for the UK's reserves. Gold currently represents just over two fifths of our net reserves - those reserves which are, effectively, financed by sterling liabilities rather than by matched foreign currency borrowing - and for a country which emphasises diversification as a means of reducing risk that was too high. But, that said, the risk-return characteristics of gold mean that it does have a continuing role to play in the UK's reserve management strategy. Even when the sales are complete, gold will still make up around one fifth of the UK's net foreign exchange reserves.

Now I know that some analysts have questioned whether this kind of portfolio decision should be taken with a view to the net reserves, as we have done, or the gross reserves - which are just the total stock of foreign currency assets, regardless of how they are financed. For some countries the distinction may not have great significance; many countries' reserves are financed mainly or wholly in the domestic currency or are managed completely separately from their liabilities. But in the UK the official foreign currency assets and liabilities are managed together, with the latter hedging a substantial proportion of the former, and so in taking a decision on portfolio diversification grounds it is clearly the net reserves which are the relevant benchmark.

Of course, the Treasury and we at the Bank were never under any illusion that this would be a popular decision with gold producers or investors. But I can assure you that the whole process - announcing in advance the overall scale of the portfolio adjustment, and the decision to proceed by single price auction - has been designed to provide maximum transparency, and full information about the scale and timing of supply. Furthermore, we have consulted the market about the detailed structure of the auctions, and have chosen the single price format - where all successful bidders buy the gold at the lowest successful price - so as to increase the confidence of all those bidding. And more generally we hope that the auction process will foster and focus interest in gold as an investment. Our whole approach is designed to minimise uncertainty about our intentions in the market; and as far as the gold price is concerned we obviously have as much interest as anyone (except those who are short!) in seeing some recovery from current levels. On Friday we published an Information Memorandum setting out the details of the auction programme, and we look forward to working with the market in making this process a success.

Turning now to other issues, I would like to talk about the 'new' Bank's role in financial markets more generally. The Bank is involved in financial markets issues for several reasons. At one level, it is because the Bank is just that - a bank. Although, with the changes to our responsibilities following the last election, the Bank is no longer responsible for domestic debt management, we still have an operational capacity in a wide range of markets. As the manager of the government's foreign exchange assets and liabilities we obviously trade in a range of major foreign currency bond and money markets, as well as in the foreign exchange markets themselves and as a lender of gold. In the sterling markets, as banker to the banking system as a whole - perhaps the core central banking function - the Bank stands at the heart of the sterling money markets, and the sterling payment systems. Also, the Bank retains an operational presence in the gilt market, partly in order to offer investment services to various central banks, and other, customers.

Now this operational presence in these markets is not an accidental thing. Aside from meeting the requirements of our customers - of which the most important is the government itself - our presence, actual or potential, in a wide range of financial markets is fundamental to our work as a central bank in two other ways. First, information derived from financial markets - both relating to a wide range of financial asset prices, but also more subtle material relating to market conditions - is of considerable importance to our analysis of monetary policy and financial stability. And second, although regular monetary policy operations

are more or less confined to the core short-term sterling markets, our financial stability role could potentially require us to operate in a whole range of financial markets.

But just what is this financial stability role? It is not new, but it is now explicitly set out in the 1997 Memorandum of Understanding between the Bank, the Treasury and the FSA. That says that the Bank is responsible for the overall stability of the UK financial system. What stability means in this context is that the financial system is able to perform three key functions effectively. The first of these is to provide a secure means of holding financial assets of all kinds (including money itself). The second is to provide for the safe and efficient payment and settlement of financial and other claims. And the third is to allocate savings amongst competing investments.

The emphasis in all this is on the stability of the system, not the liquidity or solvency of particular financial institutions; systemic stability does not mean that no individual firm should ever fail. But of course the failure of some firms could be systemic, and that is one reason why the Bank works closely with the FSA, to which our former responsibility for banking regulation has passed.

In practice, the Bank's financial stability work has essentially three aspects. First, we are working to promote structures and policies which enhance the robustness of the financial system. This encompasses a broad range of issues. It includes for example analysing the impact of developments in the regulatory regime where, for instance, the Bank is closely involved in the work going on internationally to revise the Basel Accord. Another example is our work to promote further steps to reduce risks in market infrastructure - by which I mean exchanges, clearing houses and payment and settlement systems.

The latter area is indeed one aspect of the Bank's financial stability work which is specifically singled out in the MOU. Over the last few years the Bank has promoted vigorously real time gross settlement (RTGS) in high value payment systems; we think it is the most effective means of minimising the risks arising from intra day exposures amongst the main settlement banks, which in any modern economy is a key area of systemic vulnerability. The sterling CHAPS system has incorporated RTGS since April 1996. More recently CHAPS euro went live on 4 January, and the Bank worked hard in co-operation with other EU central banks to make sure that the EU-wide TARGET system was launched successfully. More broadly, John Trundle of the Bank is chairing a group under the aegis of the G10 central banks - but consisting also of representatives of other central banks and international financial institutions - seeking to devise a set of payment system core principles. These would be applicable to all countries, and cover the design, operation and oversight of systemically important payment systems. The overall aim is that such systems should be both safe and efficient. Other items in our extensive forward agenda in this area includes pushing for full Delivery-versus-Payment in securities settlement; taking a close interest in the design and management of central counterparty clearing houses; monitoring moves towards the consolidation of securities trading, clearing and settlement in Europe and beyond; and promoting further steps to reduce risk in the settlement of foreign exchange transactions.

In contrast to this structural work, the second aspect of our financial stability work is conjunctural: the surveillance of current financial stability conditions, including actual or potential shocks, and the extent to which the financial system has the capacity to absorb them. This work has a lot of different angles. But to take a few examples, we have recently spent a great deal of time analysing the problems in the various emerging market economies - in Asia, Russia, Latin America and elsewhere - and in particular looking at their implications for the UK financial sector. And the Bank is also heavily involved in the debates relating to the international financial architecture which have been going on in the G7, at the IMF, in the new Financial Stability Forum and elsewhere, largely in response to these emerging market difficulties. In making our contribution, the Bank is focusing particularly on methods to involve the private sector constructively and systematically in crisis prevention and resolution, and on ways to improve debt and liquidity management (especially of foreign currency exposures) in emerging market economies.

In a similar spirit we have a team looking at events in the major G10 economies and markets which could threaten UK financial stability. And closer to home, we look very closely at macro - as opposed to firm-specific - developments in key sectors of UK financial services - securities firms, insurance companies, and especially banks - as well as in the corporate and personal sectors.

Some of this sort of analysis is inevitably sensitive, and the same degree of transparency as we now have in relation to monetary policy is not appropriate. But our aim is to put as much of our work as is feasible into the public domain. And the next edition of the Bank's Financial Stability Review - to be published this Thursday - will include for the first time a survey of our current view of financial stability conditions.

The final aspect of our financial stability role is that the Bank will, in exceptional circumstances, undertake official financial operations to limit the risk of problems in particular institutions spreading to other parts of the financial system - the classic central banking Lender of Last Resort function. Obviously, we hope that such operations will be needed only very rarely. And, in any crisis, we would liaise very closely with the Treasury and the FSA (as set out in the Memorandum of Understanding).

Finally, no discussion of current financial stability issues would be complete without covering millennium risk. However since I, and others from the Bank, have addressed this issue extensively elsewhere I will try to be brief.

As with other businesses, all financial market participants - investors, intermediaries, and infrastructure providers - need to work hard to make sure they are ready for the millennium date change. This is an issue to which the Bank has devoted a great deal of attention - both because of our policy responsibilities and because we have extensive computer systems of our own. I am satisfied that our own critical systems are Y2K compliant; and, more broadly, I am confident that the key systems on which the financial system's stability depends will work. So I think the main risks in financial markets may actually arise from the effects of

individual firms altering their behaviour in anticipation of problems elsewhere - which, in aggregate, could create market problems that rebounded on all firms.

The Bank's focus is now on these so-called "shadow effects" . This is to some extent partly an issue of confidence. And to that extent it can be addressed by financial sector players being as open as possible with each other about their preparations. To that end, and to spread the message that the financial sector as a whole is well prepared, a few weeks ago the Bank and the FSA hosted a symposium on Year 2000 issues. The overall message was a reassuring one. But that does not mean our work is done. I hope that all financial sector participants will continue to review critically the work they have already completed on their systems, as well as their contingency planning.

For the Bank's part we are continuing to review our preparations, and finalise our contingency planning, to make sure that our key operations are proof against any foreseeable difficulties. We are working with the banks to make sure that sufficient notes will be available to the public, and are in the right place at the right time. And we are talking to market participants, the FSA and other central banks, to make sure that our liquidity provision arrangements work satisfactorily in the run up to the millennium weekend.

Ladies and Gentlemen, I want to end by saying just a few words about one more general aspect of the future of London and its markets as we enter the next millennium.

All financial markets, in Europe and everywhere else in the world, are being transformed by continuing rapid technological change. Electronic trading systems have been, or are being, introduced in a wide range of financial markets. Initiatives are also well advanced to introduce electronic straight through-processing in a range of markets, allowing the transaction process to be automated from the initial trade right through to its eventual settlement. And on top of all this there is the, as yet, unknown potential of the internet.

The precise implications of this technological change are, of course, uncertain. But there are several general trends emerging. First, the distinctions between OTC and exchange traded markets are becoming more blurred. Some OTC markets are moving away from decentralised bilateral trading to establish some common market infrastructure; for instance foreign exchange is often now traded over an electronic platform provided by Reuters or EBS, and the London Clearing House will later this year launch a central counterparty clearing service for the swaps market. Second, access to markets is being widened, which should enhance liquidity and in turn widen interest still further - in many markets remote access is becoming a reality, making the markets more international in scope. Third, competition between the various exchanges and trading platforms is likely to become more intense. And fourth, the clearing, settlement and payment infrastructure will have to respond to these changing needs; in Europe there are now at least three proposals for the consolidation and integration of securities settlement.

No policy making institution can ignore the potential impact of continuing technological change; and the Bank is looking at these issues closely, from its financial stability and monetary stand points, as well as because we have as our third core purpose the promotion of the efficiency of the UK financial services sector. But no private sector market participant can afford to ignore them either - and that is as true in the gold market, one of the oldest of all financial markets, as in the more exotic derivative markets which new technology has itself made possible.