BANK OF ENGLAND

Speech

21st Century Markets

Speech given by

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I am delighted to have this opportunity to contribute to the 15th Annual European Finance Convention. The event is a valuable feature in the international calendar and the agenda is as wide-ranging and stimulating as ever. But this occasion is special because it is the last time we shall meet in this forum before the euro moves from book entry to tangible notes and coins - from virtual reality to actual currency. It is for all of us a historic time to be meeting.

As my contribution, I want to offer some thoughts tied to the theme of the growing and pervasive importance of financial markets in the economic policy process. I want to point out the important role that financial markets now play in the pursuit of economic growth and development and in the conduct of stable macro-economic policies. I want to try to show what this means at the global level, at the level of national economies, at the level of individual business enterprises and at the level of the individual citizen. I want to suggest that this enhanced role for markets has the potential to be enormously beneficial. But I also want to argue that, if markets are to help us manage our economies, we need to take a continuing interest in both the safety and soundness of the markets and their efficiency and effectiveness. How we do this needs careful thought: we need to work with the grain of the markets, co-operating closely with market participants and drawing on their expertise. Only in this way, with market structures that are sound and efficient, can we hope to capitalise fully on the potential the financial markets offer to promote growth in output and employment and rising living standards - the economic aims that we are all ultimately pursuing.

At the global level, the growing size and interconnectedness of financial markets is not a new phenomenon, but the pace of growth and the degree of global interconnection has arguably intensified in recent years. To take just one measure of growth, global issuance of bonds and equities has risen from $700 bn in 1995 to $2,000 bn in 2001 so far. In sterling, that increase has been almost four-fold: from $33 bn to $120 bn. The high degree of interconnection among markets is illustrated by the increased tendency for major money, bond and equity markets to move, if not in tandem, at any rate in broadly the same pattern. Local developments, relevant to local conditions, can still be an important influence on movements in markets in the local area. But just as often movements in the major internationally-traded markets tend to occur together, as all of them react simultaneously to events in the global economy. In this way, markets moving together can transmit developments across the world economy faster than direct linkages through, for example, trade and investment. We indeed these days all live and work in one world.

At the national level, too, it has never been truer that no man is an island. Private capital flows, moving across economic boundaries more freely than ever in modern times, have long since overtaken official financing as the major source of funds for development. This is true of both direct and portfolio investment. One result is that exchange rates seem, in recent years, to have become less influenced by differences in short-term interest rates and more responsive to longer-term capital flows, and hence more influenced by relative growth prospects and by the rates of return available on longer-term investment in soundly-growing economies.

Another consequence has been to increase the importance for economic policy-makers of putting in place, and maintaining, a stable medium-term framework for macroeconomic policy, as a demonstration to financial markets of the country's commitment to sound economic policies. Hence the value attached to setting clear monetary objectives, directed at maintaining low inflation, with the conduct of monetary policy then delegated to an independent, but accountable, central bank. Hence too the focus on setting a sustainable medium-term framework for fiscal policy, and on developing a coherent programme of structural reform to improve the supply side of the economy. The discipline that markets can exert in the macro-economic sphere is an important reason why transparency in the policy process is for many countries now an important design feature in their policy framework.

An important consequence of this heightened role of the markets in encouraging stable economic policies is the increased focus now given to financial stability - that is, to ensuring that financial markets operate on the basis of sound trading systems and operational infrastructure. I shall say more about this in a moment, but it is plainly critical to ensure that we develop financial systems that are sound enough to carry the role that financial markets now play in the economic process.

At the level of the individual business enterprise, it is the task of the financial markets to supply the range of facilities that firms need to conduct their business, and firms similarly need to equip themselves to tap the range of services they require. Alongside a continuing role for financial intermediaries, disintermediated markets play a critical role in mobilising savings and channelling them to productive investment and in enabling market participants to manage actively the portfolio of return and risk exposures that best meets their investment and business needs. The constant flow of new instruments and new trading techniques are testimony to the role that the markets can play. A sound structure of financial markets, just as much as a successful national sports team, has become the mark of a modern advanced economy.

The same is true at the level of the individual citizen, even if (happily) he or she still probably shows more emotional attachment to the national sports team. The progressive increase in personal wealth and the heightened emphasis on personal financial provision has greatly increased the focus on active management of personal finances. Individuals and households need a range of saving outlets and competitive choices among mortgages and pension plans tailored to their individual circumstances. Financial intermediaries can most effectively provide these retail facilities by managing their own exposures in the wholesale financial markets. And, of course, as personal wealth is increasingly invested in market-related forms, such as housing and equity-related products, movements in market prices may through the wealth effect have a progressively greater or speedier impact on personal consumption spending across the economy as a whole.

In all these ways, financial markets are playing an increased role in the economic process, all of the way from the global economy to that of the individual citizen. I have no doubt that it is a process that can offer enormous benefits, because markets, if soundly based and trading freely, offer the best mechanism we have yet devised for optimal allocation of resources. But the proviso is important: it is only if markets are soundly based and trade freely that we can hope to reap the benefits.

For that reason, we have a continuing and live interest in promoting the soundness and efficiency of financial markets, so that they can reliably undertake the role we have assigned them in promoting economic growth. The range of exercises being pursued with this general purpose in view is legion. Here in Europe, the rapid integration of financial markets within the European Union and the euro area is a significant case in point. So too is the progressive process in many emerging market economies of modernising their market structures to facilitate greater international participation in their markets. Other initiatives that work in the same direction are the standards that are being developed by international institutions for good practice in a wide range of economic and regulatory policy areas, the work on developing a new Basel Accord, and the attention being given to the respective roles of official funds and private financing in crisis management. A more recent example is the heightened attention now being given to contingency planning in the light of the tragic events of 11 September.

11 Out of this array, I want to draw your attention to one particular initiative, purely because it represents the culmination of a long programme of work in my own country and, as it happens, has come to successful fruition this very week. This is the introduction of real-time payments with immediate finality in central bank money into CREST, the UK's main securities settlement system. The UK, along with many other countries, introduced real time gross settlement (RTGS) for our sterling high-value payment system several years ago, and since 1999 we have been offering the same capability in euro, both for domestic and, through TARGET, for cross-border high-value payments. In parallel, we have long had electronic book-entry settlement facilities for securities, operated in London by CREST. But the securities settlement system, while offering finality of securities settlement in real-time, has until now depended upon end-of-day net settlement of the associated payment obligations. This very week we have linked the payments and settlements systems to provide full delivery versus payment (DvP), so that securities transactions are now settled in real-time in CREST versus a simultaneous real-time payment in the high value payment system, with the Bank of England operating the central system that links the two. This is a major advance in reducing risk in the financial system and in increasing its efficiency. It was a big step for the UK financial markets when we inaugurated the system on Monday of this week, 26 November, and we are all delighted that it is operating so smoothly and so successfully.

12 Central banks have a critical interest in the work of promoting the efficiency and effectiveness of markets and strengthening their soundness and safety, and indeed are involved in many of the exercises, precisely because the soundness and efficiency of markets is a key adjunct to the macroeconomic responsibility central banks have for the conduct of monetary policy. Monetary policy, however well conceived and conducted, is unlikely to be able to deliver effective results in terms of maintaining low inflation as a basis for sustainable growth if policy has to be conducted in a flawed financial system. For that reason, central banks have increasingly in recent years developed a closer focus on financial stability - the safety and soundness of the financial system as a whole - and on the efficiency of the financial system in serving the needs of the economy, as integral adjuncts to a central bank's responsibility for monetary stability. That work has made great progress but, given the continued growth of activity in the financial markets, there is plenty still to do that will keep us all fully occupied for years to come.