BANK OF ENGLAND

Speech

A changing world; is global still good?

Speech given by

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Introduction – the role of macroprudential policy

It is a great pleasure to be back in Edinburgh today. I have been coming here for both business and pleasure for more than 30 years. My husband is half Scots, so my 'Reel of the 51st' is definitely ok, my 'Mairi's Wedding' is passable and I do like the family trews! More seriously, I learnt in my early City days as a gilt futures broker, that the Edinburgh based asset management community was essential to the good health of the UK gilt market. Later on, as Chief Executive of the London Stock Exchange, I found myself with a welcome raft of Scottish institutions as shareholders. A select few stood by the Exchange through thick and thin, and, let me tell you, there was an awful lot of 'thin'! This required more than a little bit of grit, so I stand here with some rather special memories.

I speak to you today as an independent member of the Bank of England's Financial Policy Committee (FPC), which has been in place on a statutory basis for almost three years. The FPC was set up in the aftermath of the last financial crisis, and our job is to identify, monitor and take action to remove or reduce systemic risks to UK financial stability.

We do this in a number of ways: we have powers of direction to adjust bank capital and leverage requirements at a system-wide level, and to ensure that lending to households and businesses remains prudent.[1] We can also issue recommendations to regulators or anyone else, even government, where we think action is needed to protect and enhance the resilience of the UK financial system. And we regularly publish our views of the risks to, and the resilience of, the financial system, in our biannual *Financial Stability Report*. All of these activities make up our 'macroprudential' policy, reflecting our perspective on the system as a whole. This is what distinguishes it from 'microprudential' policy which is aimed at the safety and soundness of individual institutions and is the responsibility of the Prudential Regulation Authority (PRA).

Obviously, a prerequisite for macroprudential policymaking is being clear on what 'financial stability' means. Unlike our counterparts on the Monetary Policy Committee, we do not have a precise numerical target in mind, and one person's 'financial stability' may be another person's dangerous complacency. One approach would be to define our target negatively: financial stability as the absence of financial crisis. But while avoiding crises is undoubtedly a key goal, it's not enough. Enfeebling the banks might well reduce the probability of a financial crisis (or at least a banking crisis) to zero, but it would self-evidently defeat the purpose of macroprudential policy! In fact, protecting banks and market participants is not an end in itself: the underlying goal is to ensure that the real economy has access to the financial services it needs, in both normal times and stressed conditions. This is what makes us *macro* prudential.

Our mandate reflects this. As set out in the Bank of England Act, we have a primary objective to maintain financial stability. In achieving this, we should not take any action 'likely to have a significant adverse effect

[1] For the full set of FPC powers of direction, see http://www.bankofengland.co.uk/financialstability/Pages/fpc/policystatements.aspx.

on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term'.[2] We need to be both prudent and pragmatic, and our approach to policymaking should reflect this.

The FPC also has an important secondary objective – subject to our primary objective, we must support the Government's economic policy, including its objectives for growth and employment. The Chancellor of the Exchequer sets out the Government's economic policy through his regular remit letters to the FPC. The most recent one, delivered alongside the Summer Budget last year, clarified the new Government's vision for the UK financial services sector, including that 'the City of London will remain the world's leading international financial market'.[3]

This speech will consider the UK's position as host to a global financial centre, in light of both of the FPC's objectives. I will draw some lessons from the fortunes of financial centres throughout history, and conclude with some implications for policy today.

The UK as a global financial centre

The United Kingdom has long been a global centre of finance. The British Bankers' Association estimates that of the UK's £6 trillion in banking assets, some £4.5 trillion are international.[4] This distinctly outward-looking character led us to finance US railways in the 19th century, coordinate the international gold standard in the decades before the First World War[5] and develop London as home to the Eurodollar market in the 1950s and '60s. Today, the UK is a leader in foreign exchange trading, emerging markets finance, insurance, asset management, and much else besides. In the September 2015 Global Financial Centres Index, published by Z/Yen, London was ranked as the world's leading financial centre, a whisker ahead of New York, followed by Hong Kong and Singapore.[6]

And while the City of London plays a key role, the UK financial sector is very clearly not just a London story. Here in Scotland, for instance, the financial services industry employs nearly 100,000 people, and manages more than £800 billion of assets, mediating between investors and borrowers from across the world.[7] Quite literally, a huge asset to UK financial services!

The asset management industry plays a fundamental role in promoting and reaping the benefits of financial integration. Global asset managers invest across borders, building portfolios that reflect the diverse growth opportunities a global economy can provide. From a financial stability perspective, markets are more stable when they are more diverse: if everyone in a market has the same reaction function, highly correlated trading can encourage asset bubbles and damaging illiquidity spirals can follow when markets turn.

[2] This and other Bank of England legislation is available at: www.bankofengland.co.uk/about/pages/legislation/default.aspx
[3] This and previous remit and recommendation letters is available at: www.bankofengland.co.uk/financialstability/Pages/fpc/remit.aspx
[4] BBA and Oliver Wyman (2015), 'Winning the Global Race: the competitiveness of the UK as a centre for international banking', page 3. 'International banking' is defined as foreign-owned banks operating in the UK and the wholesale arms of UK-owned banks.
[5] Barry Eichengreen (1996), *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939,* Oxford University Press.
[6] Z/Yen (2015), 'The Global Financial Centres Index 18', page 4.
[7] http://www.sfe.org.uk/facts.aspx.

A vibrant asset management community will play a key stabilising role in global markets. Of course, asset management has its own set of risks, and in the December *Financial Stability Report* the FPC reviewed these.

My question today is whether playing host to a global financial centre is still a good thing. In the current context of financial 'de-globalization', with falling cross-border capital flows driven by contractions in international banking (highlighted by my Bank colleague Kristin Forbes in a 2014 speech[8]), it seems a good time to consider the benefits of global markets and financial centres. Kristin noted that 'international capital flows are now only 1.6% of global GDP, ten times less than the peak of 16% in 2007', and that this was driven by a 'major contraction in the global banking network', with a 'particularly striking' contraction for the UK. Even though no sane person would wish us back to 2007 (and this is certainly not what was implied by using the peak as a comparator), this is a sobering statistic.

Integrated markets, global centres

Historically, the development of global financial centres went hand-in-hand with the integration of international capital markets. Financial 'globalisation' of this kind brings well-known benefits: the wider and more diverse the pool of investors and borrowers that make a market, the more likely it is that characteristics like maturity and duration, risk profile and liquidity requirements will be well-matched. In other words, a more complete market can allocate capital with much greater efficiency. At its best, a global financial centre can ensure that the savings of a Canadian pension fund can be channelled to building a dam in China, or the spark of a Scottish entrepreneur can be lit in a new factory in Australia. In a previous speech I discussed the huge benefits of market-based finance to the real economy.[9]

Global financial markets can also promote stability.

A 2015 IMF Staff Discussion Note examines the stability-growth trade-off that financial development entails for emerging markets in light of the damaging risks thrown up by the financial crisis and its aftermath.
As they put it:

'Financial development increases a country's resilience and boosts economic growth. It mobilizes savings, promotes information sharing, improves resource allocation, and facilitates diversification and management of risk. It also promotes financial stability to the extent that deep and liquid financial systems with diverse instruments help dampen the impact of shocks.'[10]

[8] Kristin Forbes (2014), 'Financial "deglobalization"?: capital flows, banks, and the Beatles', available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech777.pdf.
[9] Dame Clara Furse (2014), 'Taking the long view: how market-based finance can benefit how market-based finance can support stability', available at www.bankofengland.co.uk/publications/Documents/speeches/2014/speech718.pdf.
[10] Ratna Sahay et al (2015), 'Rethinking Financial Deepening: Stability and Growth in Emerging Markets', IMF Staff Discussion Note.

They then examine the trade-off. As we see now, financial deepening and connected markets can transmit shocks as well dispersing and absorbing risk, and driving growth.[11] Overall, however, with the right policy framework, choices and institutions, it seems clear that the benefits of financial globalisation are compelling.

So, global markets and financial development should be a force for good. But why have global centres? In principle, one can imagine an integrated but decentralised world, where counterparties in different jurisdictions do business remotely. Advances in communications technology – themselves a major driver of globalisation – have made this technically feasible. And there has clearly been some fragmentation as global banks reduce their footprint, cut back their risk appetite and manage the significantly increased cost of post-crisis resilience.

But global financial centres do yield particular benefits for the wider financial system.

One reason why it's good to be global is that a specialised financial centre can yield 'agglomeration benefits'. In economic terms, these are the economies of scale arising from having an industry cluster in a particular location. In concrete terms, this means having a highly qualified workforce, with a vast and deep expertise in banking, asset management and insurance. It means playing host to a raft of quality professional services – legal, accountancy, advisory and specialised IT; these are needed to facilitate the effective provision of financial services. You won't be surprised to hear that London is regarded as the global centre for international arbitration, resolving disputes the world over.

And it means having an institutional structure that's second to none: transparent, consistent and fair, and populated by policy makers and regulators who understand both the risks and the opportunities that finance creates. As these economies of scale are unlocked, the marginal effect is to improve the real economy's access to finance.

Another benefit of centralisation is that it allows the authorities to see more. The global financial system is a notoriously complicated, and highly interconnected organism. This is natural, given the complexity of the underlying economic activity in a global economy. But complexity also brings opacity, particularly where financial activity taking place across multiple jurisdictions carries risks that no single regulator can identify. The more that activity clusters in a small number of centres, the more that regulators and policymakers can take a holistic, systemic view of threats to financial stability – a real benefit to the system as a whole. That said, international coordination is essential, as many of these risks, from market fragilities to cyber attack, inevitably and continuously cross borders.

In the UK context, there is an additional reason to support a continued role for the UK as a global financial centre. Financial services are an important national industry, estimated to employ over a million people

[11] Governor Carney recently discussed some of these issues in a European context, in his speech 'The European Union, monetary and financial stability, and the Bank of England', available at: www.bankofengland.co.uk/publications/Pages/speeches/2015/852.aspx

across the UK, and providing £21.4 billion in income and corporate tax receipts in 2013/14.[12] While the primary objective of financial stability is paramount for the FPC, the UK clearly has an interest in maintaining its strong position as a provider of these services, and as I have already noted, this has been recognised explicitly in the Chancellor's remit letter to the FPC. Provided the financial sector remains resilient – and our new regulatory framework seeks to ensure that it does – this is central to the FPC's secondary objective.

Lessons from history

Given the importance of financial centres, we should consider the conditions for their success or failure. One approach is to look at economic models, which seek to explain the existence of global financial centres as the equilibrium outcome from the interplay of rational agents seeking to maximise their utility. The 'agglomeration benefits' model, which I have already mentioned, is one way of thinking about why finance might cluster in a particular place. A related idea is 'comparative advantage': if the UK has a lower opportunity cost for providing financial services, it may be economically efficient for these services to cluster here.[13]

Economic models like these can be very useful, but they only take us so far. The location of financial centres is the product of unique historical circumstances – in economists' terms, they are 'path dependent'. As policy makers, we need a detailed contextual understanding of the economies in which our policies operate – and that means considering their history in order to draw lessons for today.

When the first European financial centres developed, finance was not an industry. Rather, it was an outgrowth of trade. As Kindleberger noted in his seminal comparative history of financial centres, 'the bulk of bankers started as merchants'.[14] Following the 'commercial revolution' of the thirteenth century, international trade and commercial activity gradually became more complex and large-scale, and merchants invented a set of systems to make their own lives easier: shipping insurance to pool the risk of long and dangerous voyages, equity finance to support major projects like mining or shipbuilding, and bills of exchange to make it easier to trade goods.[15] It was over many centuries that finance, and professional services more generally, took on a life of their own as specialised activities. Their relative prominence as industries in developed countries is, in historical terms, a recent phenomenon. Even in the City of London, 'physical trade in merchandise ranked top among… commercial activities' until the 1870s.[16]

[12] House of Commons Library (2015), 'Financial Services: contribution to the UK economy'.
[13] These issues are explored in more detail in Bush, O, Knott, S and Peacock, C (2014), 'Why is the UK banking system so big and is that a problem?', *Bank of England Quarterly Bulletin*, Volume 54, No. 4, pages 385-395.
[14] Charles Kindleberger (1974), 'The formation of financial centers: a study in comparative economic history', *Princeton Studies in International Economics* No. 36.
[15] Peter Spufford (2006), 'From Antwerp and Amsterdam to London: the decline of financial centres in Europe', *De Economist* 154, pages 143-175.
[16] Youssef Cassis (2005), *Capitals of capital: the rise and fall of international financial centres 1780–2009*, Cambridge University Press.

It should come as no surprise, then, that **financial centres have tended to cluster around centres of economic power**. We see this throughout history.[17] Venice was Europe's financial centre in the 15th century, as a result of its trade with Alexandria, its proximity to the industries of Lombardy, and its own manufacturing strength in silk, glass and sugar-refining. As the centre of European commercial power shifted over the centuries, other cities – Bruges, Antwerp, Amsterdam, London – took advantage as hubs of global trade, backed by industrial prowess and supported by favourable politics, to position themselves as international financial centres. Thinking about the UK specifically, this historical prominence cannot be separated from Britain's economic rise following the industrial revolution. In the nineteenth century the UK was the world's greatest trading nation, accounting for as much as a quarter of world trade and producing around a tenth of global GDP.[18]

Modern history tells a similar story. New York's increasingly important financial role tracks the US's emergence as an economic and political superpower; although New York's financial business remains largely domestic, a function of the country's very rapid and impressive growth. And centres like Hong Kong and Singapore are gaining traction, reflecting the globalisation of trade and the economic rise of Asia.

But while financial centres usually start life in countries or cities that provide particular economic value and relative political stability, a financial centre can prosper even after economic power has shifted elsewhere. In other words, **financial centres have proved themselves pretty 'sticky' so far**. The explanation for this probably lies in some of the agglomeration benefits discussed above – once a particular country has the infrastructure, people and institutions required, the costs of moving and losing these benefits may outweigh the gains from being closer to power. This will only be true, of course, if the old centre of finance is well-positioned to provide services to the new centres of commerce. Again, we can look to history for instruction. Antwerp remained an international financial centre for decades after regional power and trade had shifted, primarily to Amsterdam. And the UK has maintained its position right into this century, even though the days in which Britain was the dominant superpower are long gone.

But while financial centres tend to be sticky, international finance is increasingly mobile. While the balance of international power is the product of long-term demographic, economic and technological trends, **the decline of a financial centre is often precipitated by a 'shock' –** an adverse event that either makes the continued provision of financial services impossible, uneconomic or simply destroys confidence in it. In the past, many of these shocks were the result of what macroprudential policymakers might call 'the crystallisation of heightened geopolitical risk' – at the time, they were simply called 'wars'. Examples abound. The Netherlands' financial and commercial ambitions were dealt a 'fatal blow' by a war with Great Britain in 1780-84.[19] Paris was destined to play a secondary role to the UK following French defeat in the Franco-Prussian war of 1870-71. And the UK's central position in the international financial system was

[17] Much of my account of the development of finance before the 19th Century is drawn from Spufford (2006).
[18] Mark Carney (2013), 'The UK at the heart of a renewed globalisation', available at www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf.
[19] Cassis (2005), page 17.

seriously undermined in the decades after the First World War, only to be revived later in the 20th Century. Of course, the shock doesn't need to be a war: Spufford (2006) attributes the collapse of the Antwerp money market to a sovereign default by Spain in 1596, which triggered 'a wave of bankruptcies in Spain itself and in Antwerp', setting in motion a longer-term decline.

One lesson I draw from history is that **policy choices and institutions matter**. When finance was a lucrative side-line for merchants, the main policy choices required for a successful financial centre were openness to trade and political stability. But as finance became more complex, so too did the policy framework required for a global financial centre. The Bank of England, originally founded to fund a war with France, grew into its role as lender of last resort in the 19th century, starting down the path that would lead it to macroprudential policy. Accounts of our rise as a financial centre highlight the UK's regulatory approach as well as a US policy error as key factors in our dominance of the Eurodollar market in the second half of the last century.

Looking forward

Do these lessons from history still hold true today? Yes and no. **Proximity to power may be less important for financial centres in the modern world**, where improvements in communications technology mean the UK can continue to provide financial services to the world even as economic and political power shifts. This is an important opportunity; hubs provide value because they reduce frictional cost through easy access to product and expertise, highlighting the reality that efficiency drives productivity.

Because moving is easier than before. The same factors that mean the UK can serve the world also allow for a wide range of alternative centres – or the possibility, even, of a decentralisation of the financial system; with activity coordinated electronically, and counterparties separated by national borders and nervous regulators. A new world? Finance would still flow, but not from a global centre. We would lose the benefits of agglomeration and there must be a risk that decentralisation would induce a destructive trend to deep fragmentation. This would undermine the efficiency of global capital markets, and harm global growth.
To avoid this, **authorities need to remain alert to shocks**, including those arising from the geopolitical and wider macrofinancial environment, as well as the more 'bread and butter' risks that are visible on banks' balance sheets. This is where the FPC can play an important role. We receive briefings on a whole spectrum of risks – from commercial real estate to cyber attack. As I said earlier, we report our conclusions in the *Financial Stability Report*. Alongside our colleagues in the PRA, we conduct regular 'stress tests', in which we explore the ability of the financial system to weather severe scenarios: most recently, we considered the effects of a global macroeconomic shock so severe that it included a fall in annual Chinese GDP growth to 1.7%. Our conclusion was that the banking system would have the capacity to maintain its core functions in such a scenario.

And in an environment where geography and sheer economic scale matter less, **institutions may matter even more**. We need a clear, prudent and proportionate system of regulation, which is sensitive to the different risks and opportunities posed by different kinds of activity. Britain's post-crisis regulatory framework is designed to achieve just that, with responsibilities clearly assigned to macroprudential and microprudential regulators, with mandates that take into account both financial stability and other goals, like economic growth, employment and competition.

On the FPC, we recently set out in detail our views on the appropriate design and calibration of the capital framework for UK banks. In our judgement, the appropriate Tier 1 equity requirement for the banking system, in aggregate, is 11% of risk-weighted assets, properly measured. This was based on a cost-benefit analysis by Bank staff, which assessed the impact of equity finance on resilience, against the broader effects on credit provision of tighter capital requirements. By publishing our views, we aim to provide clarity on this momentous shift to a new framework for banks. This framework is intended to be both prudent and proportionate: for example, by using our power to set the countercyclical capital buffer for UK risks, we can vary capital requirements over time, improving resilience in an up-swing without incurring the social costs of permanently higher, precautionary capital funding for banks.

At the European level, the Commission's proposed Capital Markets Union (CMU) has the potential to realise the vast benefits of financial integration across Europe. In its response to the Commission's consultation, the Bank stated that 'CMU should improve the matching of savers and borrowers and private-sector risk sharing, and thereby increase financial diversification and deepened financial integration while ensuring economic stability is not put at risk, delivering genuine benefits to the whole of the EU'.[20]

If the proposed CMU can overcome some of the impediments noted by the Bank in its consultation response – such as 'fragmented market and infrastructures', 'information asymmetries' and 'lack of harmonisation' – then it will undoubtedly reduce the cost of finance to the real economy. In an environment where the marginal cost of finance will have been increased, as a result of much-needed reforms to secure the resilience of our banks, this would be particularly welcome.

To conclude: international and global financial centres have historically played a crucial role in promoting both growth and stability. But policy makers cannot take their existence for granted. In a world where institutions and policy choices matter more than ever, a prudent and proportionate regulatory framework is essential to sustainable growth. That is what we on the FPC are seeking to achieve.

[20] Bank of England (2015), 'The Bank of England's Response to the European Commission Green Paper: *Building a Capital Markets Union*', available at http://www.bankofengland.co.uk/financialstability/documents/cmu/greenpaperesponse.pdf.