Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London, London, 20 June 2007.

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My Lord Mayor, Mr Chancellor, My Lords, Ministers, Aldermen, Mr Recorder, Sheriffs,
Ladies and Gentlemen:

Chancellor, this will be your last Mansion House Dinner with the Merchants and Bankers. And I want to start by warmly congratulating you on your record-breaking period in office, and on the imminent assumption of the leadership of your party and country. It has been a remarkable decade for the British economy.

Your decision to grant independence to the Bank of England ten years ago is widely and rightly regarded as a fundamental improvement to the conduct of economic policy in this country, and we in the Bank are grateful to you for giving us the opportunity to demonstrate the benefits of an independent central bank. Your reform illustrates the key principle that institutions matter. Individuals, however talented, cannot consistently perform well if the institutional structure in which they operate is badly designed.

For too long the UK economy lurched between success and failure rather in the way that the national cricket team has recently. Getting the institutions right was a crucial part of the 1997 reforms. Perhaps there is a lesson here for the ECB – the England and Wales Cricket Board. And I welcome the changes that you announced last week to make appointments to the Monetary Policy Committee subject to a more transparent process with a more systematic timetable.

Behind the design of our monetary institutions is a simple principle. I described it last October in a lecture at Kirkcaldy. It is that the value of paper money depends on trust. Trust that it will hold its value. Trust that others will accept it as a means of payment.

In particular, our banknotes must be trusted by the public – cash still accounts for over 60% of the number of transactions. In March the Bank launched a new series of bank notes with enhanced security features. As an economist, I was pleased that a pioneer of the dismal science should appear on our bank notes. Adam Smith, who appears on new £20 notes, was a thinker who recognised the importance of institutions.

Imagine my concern, therefore, when, after 3 ½ years as Governor, I read the following report from the Wolverhampton Crown Court. "A judge demanded to know why police failed for three and a half years to arrest a wanted Birmingham man – when all the time he was living at home. Adam Smith, suspected of passing forged £20 notes, had a fixed address in Edgbaston and was picking up benefits". So I hope the introduction of one Adam Smith will hinder the activities of the other.

I am proud of the new £20 notes, but I cannot say the same of our £5 notes. There has been much, and in my view justified, criticism of their availability and condition. Over the past ten years, the value of Bank of England notes in circulation has doubled, from around £20 billion to around £40 billion. But none of that is accounted for by the £5 note for which the value in circulation has remained constant for fifteen years at some £1 billion. And the average lifetime of the note has doubled. As a result, many more notes are noticeably soiled and scruffy.

ATMs account for over 60% of all cash obtained by the public. Few issue £5 notes. It is more economical for banks to stock ATMs with £10 and £20 notes. The problem is not at the production end – we have an ample supply of new £5 notes waiting to be used. We want to see them in circulation. There is a need for an adequate supply of low denomination notes that can be used for small transactions where cash is the predominant means of payment. Such mutual convenience is a public good, and may not correspond to the private interest of commercial banks.

That is why we must not let this situation continue any longer. The public need £5 notes. The solution may involve some alteration in the incentives for banks to obtain different denomination notes from the Bank of England, new arrangements to increase the availability of notes to retailers, and an improvement in the durability of the notes that we print. So the Bank will be initiating discussions to see what methods might ensure greater access by the public to new £5 notes.

Your reforms, Chancellor, encompassed not just monetary policy – through the Bank of England Act – but also financial regulation – through the creation of the FSA and the 1997 Memorandum of Understanding between the Bank, FSA and Treasury. There was, however, some unfinished business in that Memorandum. The Bank of England was given responsibility for the oversight of payment systems. But it was given no formal powers to discharge that responsibility. Instead it relies heavily on the influence afforded by its operational role at the centre of the high-value payment system. But that influence extends only so far.

The time has come to deal with the imbalance between responsibilities and powers. The "plumbing" of the financial system represented by payment and settlement systems may not be as glamorous as the trading activity which attracts so many bright young people to work in the financial sector, but it is absolutely crucial to maintaining stability. To have responsibility without power is the misfortune of the bureaucrat. The solution, in my view, does not mean more powers for the Bank, but narrower responsibilities. Proposals are under active discussion among the tripartite partners, and they give me confidence that the imbalance will soon be resolved.

Financial stability more generally is a topical concern in financial markets. More than one banker and merchant in the City has said to me recently, "I cannot recall a time when credit was more easily available". How worried should we be? Let me begin with the implications for the stability of markets and institutions before turning to monetary policy.

Securitisation is transforming banking from the traditional model in which banks originate and retain credit risk on their balance sheets into a new model in which credit risk is distributed around a much wider range of investors. As a result, risks are no longer so concentrated in a small number of regulated institutions but are spread across the financial system. That is a positive development because it has reduced the market failure associated with traditional banking – the mismatch between illiquid assets and liquid liabilities – that led Henry Thornton and, later, Walter Bagehot to promote the role of the Bank of England as the "lender of last resort" in a financial crisis.

But the historical model is only a partial description of banking today. New and ever more complex financial instruments create different risks. Exotic instruments are now issued for which the distribution of returns is considerably more complicated than that on the basic loans underlying them. A standard collateralised debt obligation divides the risk and return of a portfolio of bonds, or credit default swaps, into tranches. But what is known as a CDO-squared instrument invests in tranches of CDOs. It has a distribution of returns which is highly sensitive to small changes in the correlations of underlying returns which we do not understand with any great precision. The risk of the entire return being wiped out can be much greater than on simpler instruments. Higher returns come at the expense of higher risk.

Whether in banking, reinsurance or portfolio management, risk assessment is a matter of judgement as much as quantitative analysis. Ever more complex instruments are designed almost every day. Some of the important risks that could affect all instruments – from terrorist attacks, invasion of computer systems, or even the consequences of a flu pandemic – are almost impossible to quantify, and past experience offers little guide.

Be cautious about how much you borrow is not a bad maxim for each and every one of us here tonight. Ignore the unsolicited emails that rain down on us offering unwanted credit. I received one last week that began, "We have the solution, Mervyn, for your bankruptcy".

The development of complex financial instruments and the spate of loan arrangements without traditional covenants suggest another maxim: be cautious about how much you lend, especially when you know rather little about the activities of the borrower. It may say champagne – AAA – on the label of an increasing number of structured credit instruments. But by the time investors get to what's left in the bottle, it could taste rather flat. Assessing the effective degree of leverage in an ever-changing financial system is far from straightforward, and the liquidity of the markets in complex instruments, especially in conditions when many players would be trying to reduce the leverage of their portfolios at the same time, is unpredictable. Excessive leverage is the common theme of many financial crises of the past. Are we really so much cleverer than the financiers of the past?

Concerns about the rate at which credit is being created extend to monetary policy. As I said last week in Cardiff, it would be optimistic in the extreme to suppose that the rapid growth of money and credit could be dismissed solely as a positive shock to the demand for money. The spread between interest rates paid by households and businesses and interest rates available in the money market has fallen. This has been one of the factors behind the strength of demand in the UK economy over the past year. Despite greater availability of labour, businesses have not expanded employment sufficiently to prevent stronger demand from increasing capacity pressures. Such pressures encourage businesses to raise prices. And that is exactly what the business surveys suggest has been happening. That underlying upward pressure on inflation has in part been hidden by the volatility of domestic energy prices. But it is why we have raised interest rates four times and by 1 percentage point in all over the past year.

Our central view remains that inflation will fall back this year as the rises in domestic gas and electricity prices last year drop out of the annual comparison, and the recent cuts in prices feed through to household bills. But it is important to look through those temporary effects to the outlook further ahead. The discussion within the Monetary Policy Committee is explained in the minutes of our June meeting which were published this morning. As ever, there is room for differences of judgement as to the appropriate level of Bank Rate – as shown by the differing views within the MPC. But every member of the Committee is determined to bring inflation back to target and keep it there – or as close to the target as possible – indefinitely.

In the long run, it is of the utmost importance that the right institutions to secure both monetary and financial stability are in place. I believe they are. Chancellor, you are now moving on. Our country continues to benefit from the institutional arrangements you introduced in 1997. As that great political commentator Niccolo Machiavelli noted, “nothing brings a man greater honour than the new laws and new institutions he establishes”. I encourage you to be equally bold in your next job.

Institutions outlast us all. Over time, they are adapted as we learn the lessons of the past in the light of a changing present to meet our future needs. Lord Mayor, you know the importance of learning, and the Chancellor has emphasised again this evening the role of education in shaping Britain’s place in the world economy. Both the Chancellor and I have been enthusiastic about the theme of your mayoralty: “City of London – City of Learning”. And all of us here tonight would like to pay tribute to your work since you became Lord Mayor, and to thank both the Lady Mayoress and yourself for the splendid hospitality which you have extended to us all this evening.

So I invite you all to rise and join me in the traditional toast of good health and prosperity to "The Lord Mayor and the Lady Mayoress".