John Gieve: The credit crunch and the UK economy

Speech by Sir John Gieve, Deputy Governor of the Bank of England, to the Family Office Leadership Summit, London, 22 September 2008.

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Introduction

In recent days we have seen extraordinary developments in US financial markets. At the start of last week we saw the collapse of Lehman Brothers and the merger of Merrill Lynch and Bank of America; by Friday the US Treasury had rescued AIG, issued a guarantee of Money Market Funds and an outline plan for a Resolution Trust that is now in Congress. And this morning the Federal Reserve announced that Goldman Sachs and Morgan Stanley would become regulated bank holding companies.

But I want today to concentrate on the broader economic impact of the crisis in credit markets, which began over a year ago with the downturn in the US sub-prime housing market. While the epicentre has remained in the US, it has already had a major impact on the structure of our banking sector. Northern Rock was among the first casualties. And this year we are seeing a significant consolidation within the UK banking sector, with Santander purchasing Alliance & Leicester, Nationwide absorbing two smaller building societies, and most recently the merger of HBOS and Lloyds TSB.

The turmoil has also affected all of the Bank’s work; from the setting of interest rates, to the scale and structure of our market operations, and to our joint work with the FSA and Treasury to deal with institutions under stress and to help design an effective international response to the crisis.

For example, like other central banks, we have adapted our money market operations to provide the liquidity the banking system as a whole has required. First, we have allowed banks to increase their reserve balances at the Bank, increasing the size of our overall provision of central bank money; second, within that larger total, we have shifted the balance towards longer-term lending as the terms of market finance have shortened; third, we have widened the collateral we accept for longer-term repos. And in April, we introduced a special scheme to provide banks with up to three years’ finance for legacy assets which have become illiquid.

Last week we offered extra sterling liquidity through our usual Open Market Operations and provided US dollar liquidity as part of co-ordinated action with the Federal Reserve, ECB, Bank of Japan and Swiss National Bank. We also extended the window in which banks can swap their legacy assets under the Special Liquidity Scheme until January next year. Even once the window closes, the Scheme’s asset swap will provide liquidity for a period of up to three years, something many people have not fully appreciated.

Events are still moving quickly, so I hope you will understand why I am not going to attempt a live commentary on events. I hope that the massive and far-reaching measures the US Government has now announced will restore greater calm and confidence in their banking system. Stabilisation of US markets and banks should have a beneficial knock-on effect on wider international markets too. But we will continue to monitor the situation closely, in consultation with our counterparts in the US and elsewhere, in order to judge whether any further measures are needed.

Inflation outlook

This morning I want to take a wider perspective and discuss how the credit crunch is affecting the wider UK economy and draw some medium-term lessons for economic policy.

And the first point to make is that the turmoil in financial markets has not been the only shock to our economy in the last 12 months. In any other week more attention would have been given to the fact that for the second successive quarter the Governor had to write an open letter to the Chancellor on behalf of the Monetary Policy Committee to explain why inflation was more than a percentage point away from the target of 2%. In fact inflation has risen from 2.1% in December to 4.7% in August and it seems set to peak above 5% soon.

The immediate driver of that increase has been the international commodity cycle (Chart 1). The rapid growth across most large emerging market economies (EMEs) in particular has fuelled global demand for raw materials, which in the short term are in relatively fixed supply, pulling their prices upwards. In August, oil prices were up 60% higher than a year earlier, wholesale gas prices were up 90%, and food prices 40%.

These sharp increases in costs have fed into food and petrol prices and passed along the supply chain, driving up the prices of other goods including in particular household gas and electricity bills (Chart 2). But so long as the prices of wholesale energy and foodstuffs on global markets stabilise at their new higher levels, their direct impact on inflation should wash out after a year. In other words, by late 2009 these items would not be making any contribution to the rate of consumer price inflation: whereas, at present, they are contributing almost 3 percentage points.

Moreover there are some signs that the commodity cycle may have turned down. Since the peak in July, the price of food has fallen by 10% and the price of crude oil has fallen by over a quarter, and that is consistent with other indicators that point to a slowing in growth in both emerging and advanced economies.

That good news on commodity prices has been offset somewhat in the UK by a falling exchange rate. Sterling has been trading at around 1.8 against the US dollar – a year ago it was 2.0. But the same arithmetic applies: such price level shocks need have no long-term impact on the inflation rate.

In the medium term the real upside risks to inflation lie at home – in whether we see “second round” rises in wages and prices in the domestic economy. It is to counter those pressures that the MPC have judged it necessary over the last year for growth to slow and create a margin of spare capacity in our economy. That makes it more difficult for companies to raise prices and puts more pressure on them to restrain their costs.

It also re-emphasises our determination to get inflation back to the 2% target and thus influences the expectations of financial markets, price setters, wage negotiators and households generally. And expectations themselves have an important impact on inflation. Broadly, the higher households’ expect inflation to be, the less they are likely to save today. Inflation expectations also shape workers’ wage demands as they try to protect their standard of living. And companies’ expectations will shape the prices they set as well as their willingness to concede cost increases.

We know from the inflations of the 70s, 80s, and early 90s that raising interest rates will in time bring inflation down, even when expectations of future inflation are high. But we also know how painful that process is. It works through the increased threat of bankruptcy and unemployment. That forces a change in peoples’ behaviour and their hearts and minds and expectations follow. Conversely, the more confident people are that inflation will fall back the less we have to rely on slowing the economy to force them to hold prices and wages down.

That is why the risk of inflation expectations drifting up has been such a central concern of the MPC over the last year. In my view it has been particularly important through recent months, when each forecast has been higher than the one before and each inflation figure has exceeded the earlier forecast, not to confuse the central message that we will set policy to bring inflation back down to target.

We have seen households’ near-term expectations of inflation rise this year, but that was inevitable given experience and our own forecasts (Chart 3). What matters more are expectations of inflation over the medium-term, and whether they are consistent with the target, and here the surveys are less alarming: according to the YouGov/Citigroup survey, those expectations have fallen back a little and a gap has opened up between people's perceptions of current inflation and their expectations of a year or more ahead.

We can use other economic data as a cross-check on what is happening to inflation expectations. If households' expectations had become detached, we should expect to see households spending more, and saving less, and pushing for larger nominal wage increases. If companies' expectations had become detached, we should expect to see a broad-based pickup in cost and price inflation. But consumer spending appears to be weak, nominal wage growth remains relatively muted and once we strip out the impact of rising commodity prices, output price inflation has been steady. To paraphrase Sherlock Holmes, if expectations have become detached, it is curious that those dogs haven't barked. So in my view the news on that front has been encouraging.

The impact of the credit crunch

And of course, we have been balancing that upside risk to inflation from the commodity price shock against a downside risk that the credit crisis would drive down activity too far and push inflation below target in the medium term. And the news on that front remains worrying.

The headlines are about the drama on Wall Street but the failure or rescue of even big and well known financial firms matters mainly because of their knock on impact on the wider economy. The last year has brought home once again why central banks have to be concerned with financial stability as well as monetary stability and inflation. For the biggest risk to the financial sector is also the biggest downside risk to the economy: namely that damage to bank balance sheets would lead to tighter credit conditions, lower asset prices, lower consumption and investment and to a severe feedback loop into more losses for banks and so on down a spiral.

That feedback is already working to some degree not just in the US but in the UK too. Our investment banks have suffered losses in their trading books and a wider group of banks have lost money on their treasury books because of the fall in the values of structured credit of all sorts. At the same time they have found that some of their major sources of finance, notably securitisation and medium term unsecured lending, have dried up and others, notably shorter term lending in money markets, have become much more expensive (Chart 4).

What is more, all these effects have lasted longer than expected and seem set to continue for some time. Banks have responded by hoarding liquidity and trying to reduce their leverage by raising new capital (not without difficulty in some cases) and by constraining the growth of lending. One direct effect has been a marked tightening of credit conditions over the past year (Chart 5), which seems still to be underway. That in turn is pushing down asset prices and demand.

Our forecasts and our policy decisions have reflected our best assessment of the likely impact of this feedback. We brought down interest rates earlier in the year to cushion the impact of the change in bank behaviour. In effect we have relied on the credit squeeze in large measure to produce the slowdown we consider necessary. But we are fully aware of the risk that the squeeze on banks and the feedback to the economy could prove more powerful than expected.

That risk does not just arise from the drama of the last week or two. We will continue to work for the return of calmer financial markets. But we should not rely on that to reverse quickly the broader macroeconomic slowdown that is underway. Indeed there are still risks to the downside and I thought it might be useful to spell out how they feed through the economy and therefore make plain what indicators I will be focusing on in the next few months.

Any contraction in lending to the real economy can amplify the slowdown in demand (Chart 6). Increases in retail lending rates for those who can still get access to credit discourage spending. Increases in credit rationing can have a more dramatic impact. If those households and companies are unable to tap other sources of finance, then their spending will have to fall back in line with income.

Spending on high cost durable goods – such as purchases of cars and white goods by households and machines by companies – are likely to be particularly affected. And the contraction in mortgage lending pushes down house prices, further eroding the value of the collateral against which banks' loans are secured.

Tighter credit conditions raise income gearing, forcing households and companies to devote a larger share of their income to servicing debt. And as the impact of those tighter credit conditions bite on the economy, income is likely to be squeezed and that at the same time as real incomes are being affected by higher food and energy prices. The slowdown in demand will fall disproportionately on certain industries, starting with the house-building sector and related services and lead to falls in employment. Some households and companies are likely to be driven over the default threshold.

Tighter credit conditions could also affect the potential output of the economy – reducing the capacity of the economy to produce goods and services. The economy's supply capacity reflects not only the number of people who work and the number of machines at their disposal, but also how productive our companies are at using that labour and capital to produce output. And the innovations in new products and new processes which drive productivity growth are financed in part by bank lending.

In short, the process of deleveraging that was designed to alleviate pressure on banks' capital position can lead to an additional wave of credit losses, coupled with higher write-off rates, given the lower level of property prices (Chart 7). And, welcome though the reforms of Basel II and accounting rules are in many respects, they can accentuate the squeeze on capital because the requirements are based on risk weights which rise when arrears are increasing and collateral values are falling.

House prices and consumption

One important feedback is through the housing market which is continuing to weaken. The number of loan approvals for house purchases is at a record low, the ratio of sales to stocks is approaching the levels of the early 1990s, and prices are now down 12% on their peak of late last year.

Of course falls in house prices tend to coincide with a slowdown in the wider economy because they are affected by the same factors – notably falls in real income and employment. But they can also feed back into activity. First they slow housing investment and transaction flow which hits builders and related services like estate agents and conveyancers. The purchases of white goods and furniture tend to go hand in hand with transactions in the housing market. So the slowdown in the number of people moving home is likely to impact on spending on those goods.

Falling house prices limit how much households and small businesses can borrow today and that pulls down consumption and investment. Also by reducing their expectations of what they will be able to borrow tomorrow either to compensate for a reduction in income or a need to spend, some households and firms may increase their precautionary savings.

Finally, falling house prices redistribute wealth. Those who already own houses and expect to trade down in future and realise a capital gain, are worse off. On the other side, those hoping to trade up or who are not yet on the housing ladder are better off (although the tighter constraints on lending may mean they have to save a bigger deposit to enter the market). The former will tend to reduce their consumption; the latter will tend to do the opposite. In a perfect market these two effects might balance out. But given that some of the beneficiaries of house price falls do not yet have independent incomes, and others have a longer period ahead to consume their additional wealth, on balance I would expect the net effect on consumption to be negative. More widely I would expect some impact from the end of a wide perception that in housing you can have your cake and eat it – that the return on your house as an investment will in time substantially offset the cost of housing as a service.

All these feedback channels are at work and economics is better at identifying their nature than in forecasting their scale. There is no alternative there to reviewing all the indicators I have mentioned month by month and then making an informed judgment.

Some policy lessons for the medium term

We identified the mispricing of risk, particularly in credit markets in our Financial *Stability Reports* over the last two years. But the reckoning has been more severe and destabilising than anyone anticipated. Risk premia had become compressed and leverage throughout the financial markets had risen too high. The pendulum has now swung back with a vengeance. As the *FSR* noted earlier this year, risk premia now appear to have overshot in some markets and that is contributing to the slowdown in the real economy.

Could policymakers have taken earlier action to correct those imbalances? Of course we took the decisions we did on the basis of the available data at the time. But with hindsight, seen across the world as a whole, there was a case for somewhat tighter monetary policy to prevent the demand for resources outstripping supply (although I would note that our interest rates have been consistently higher in recent years than those elsewhere in the advanced economies). The rise in oil and food prices has appeared as an external pressure on each country on its own but it is not external to us all collectively. A particular problem here – that has yet to be resolved – is the expansion of the dollar bloc. The emerging economies were importing loose monetary policy, which scarcely seemed appropriate to their domestic conditions.

However it is hard to believe that a somewhat tighter monetary policy would have been guaranteed to head off the credit boom and subsequent crunch altogether. Put another way, monetary policy is a blunt instrument. To prevent excesses in financial markets, we might have had to generate an unnecessary slowdown in the real economy. I share the view therefore that we have to look for new regulatory measures to complement interest rates.

There are a number of specific lessons on regulation which have already been identified. The FSA, for example, is already strengthening its prudential supervision. And internationally, we need to fill gaps in the current framework – for example on mortgage origination in the US, increasing the capital requirements for some credit products and loan commitments, and ensuring that investors and rating agencies assess new products more diligently. In the UK we have also set out proposals to reform the legal framework for dealing with failing banks. Through the Financial Stability Forum we also need to strengthened supervisory colleges and cross-border crisis management arrangements.

One more general lesson is that we have to recognise the difference between what is good risk management in a single company and what is good for the system as a whole. For a company the ideal risk management system is one which enables them to take risks, reap the rewards but get out first when the music stops. And the right capital and liquidity is one which is just enough to see you through the subsequent downturn in asset prices and transactions. But there is always someone at the end of the queue and it is impossible to be sure who they will be. Moreover in a global market the problems of one institution are bound to spread quickly to others along a complex web of interconnections in many markets. For the authorities what matters is whether the losses to the slower players damage the system as a whole. One lesson of recent events is that the capital and liquidity buffers need to be higher for everyone. The long decline in holdings of liquid assets (Chart 8) by banks for example has to be reversed a bit and the increase in leverage likewise (Chart 9).

In the Financial Stability Forum, which is leading the international regulatory response to the crisis, we are also looking at the scope for “macro prudential” instruments to dampen the destabilising procyclicality in financial markets. To do this we need to do more than simply raise the minimum levels of capital and liquidity that regulators, rating agencies, or the markets require. We need to create reserves based on macroeconomic factors, which can be drawn down as the cycle turns down and have to be replenished on the upswing when profits are high. The system of dynamic provisioning in Spain seems to work effectively in that respect and may well offer a guide for the way forward.

Conclusion

To conclude, on monetary policy, we have one instrument, and one goal – ensuring that inflation stabilises at target in the medium-term. While we must remain vigilant for any signs of inflation expectations drifting upwards, the news on that front is encouraging. On the other side, the risk we must be careful not to underestimate is the deflationary consequences of the credit crisis.

At the moment we are focused on the risk that the slowdown in the real economy will be amplified through a contraction in banks’ balance sheets. But we should also set in place longer term measures to prevent such financial imbalances from building up again in the next upswing. In my view the case for macro-prudential policies alongside monetary policy is compelling.

Chart 1: Commodity Prices

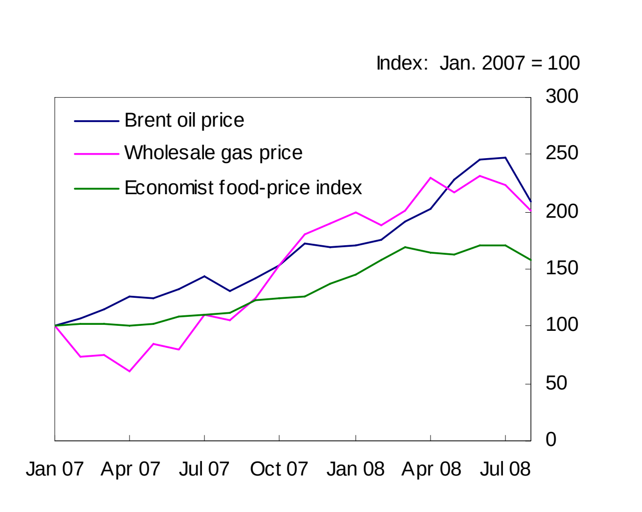


Chart 2: CPI Inflation

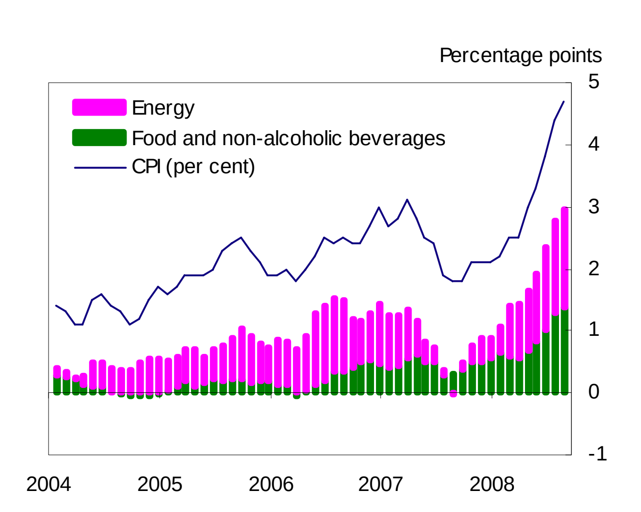


Chart 3: Inflation expectations

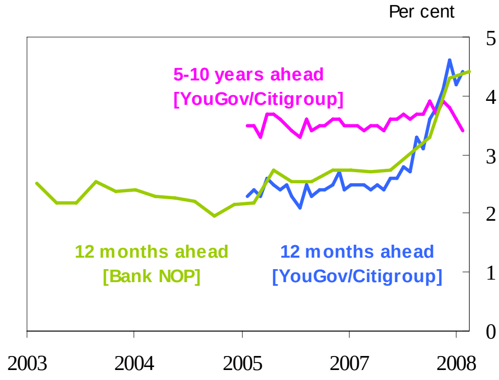


Chart 4: Three month Libor spreads

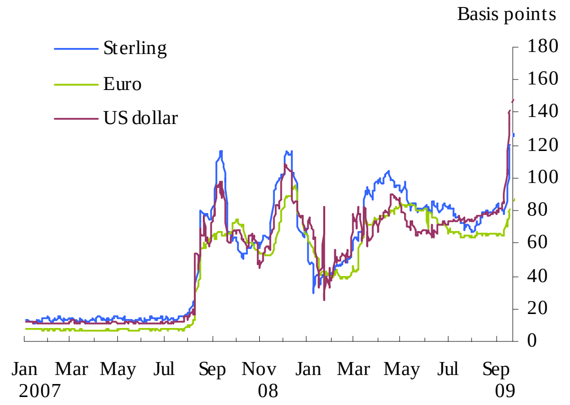


Chart 5: Credit conditions on mortgage lending

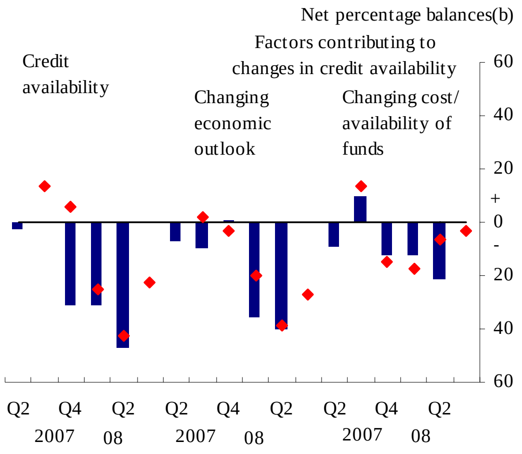


Chart 6: Feedback effects (I)

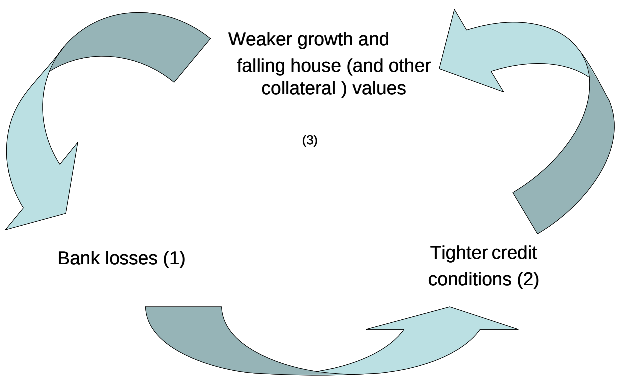


Chart 7: Feedback effects (II)

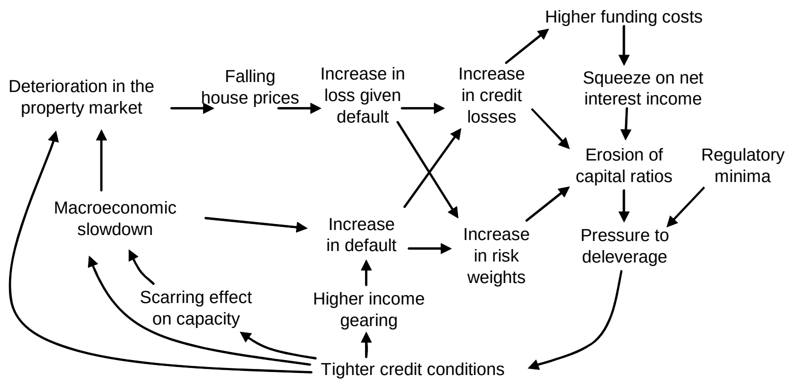
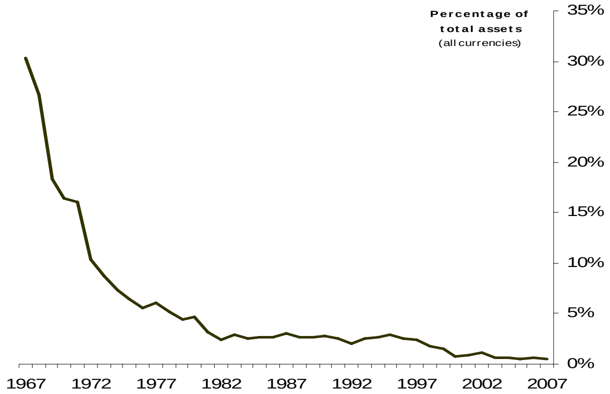


Chart 8: Liquid assets ratio



Liquid asset sinclues: Cash, BoE balances, money at call, eligible bills and UK gilts.

Chart 9: Leverage ratios of major UK banks