Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward at the Royal Armouries, Leeds, 21 October 2008.

* * *

My first memories of Leeds are from a wet summer in 1958. I was ten years old, we lived on the moors above Hebden Bridge, and my father took me to my first Test Match –England against New Zealand at Headingley. It rained all day on both Thursday and Friday, and, when play started in mid-afternoon on Saturday, on a drying wicket New Zealand were bowled out by Laker and Lock for 67. So I became a slow bowler. I was taught to bowl – slow left arm – at Old Town primary school by the headmaster, Alfred Stephenson. During the morning break he would mark the wickets in chalk in the playground, and draw a small circle exactly on a length. If we could pitch the ball within that circle he would give us a farthing. As we improved, and the payout of farthings increased, the morning break became shorter and shorter – my first lesson in economic incentives, or what is known in the trade as “moral hazard”.

So let me move forward 50 years to the events of 2008, and describe the nature of the financial crisis, the steps that governments and central banks have taken to deal with it, and, most important, the implications of recent events for the UK and world economies.

Since August 2007, the industrialised world has been engulfed by financial turmoil. And, following the failure of Lehman Brothers on 15 September, an extraordinary, almost unimaginable, sequence of events began which culminated a week or so ago in the announcements around the world of a recapitalisation of the banking system. It is difficult to exaggerate the severity and importance of those events. Not since the beginning of the First World War has our banking system been so close to collapse. In the second half of September, companies and non-bank financial institutions accelerated their withdrawal from even short-term funding of banks, and banks increasingly lost confidence in the safety of lending to each other. Funding costs rose sharply and for many institutions it was possible to borrow only overnight. Credit to the real economy almost stopped flowing. In financial markets, confidence in others fell to a point where investors sought refuge in government instruments such as US Treasury Bills, which at one point yielded a negative return. Central banks around the world were providing enormous amounts of liquidity to some institutions while at the same time taking large deposits from others. Eventually, on 6 and 7 October even overnight funding started to dry up. Radical action was necessary to ensure the survival of the banking system. And on the morning of 8 October that action was taken when the Prime Minister and Chancellor unveiled a UK plan for recapitalising the banking system on which the Bank, FSA and Treasury had been working for a while.

Why was radical action necessary? When the financial turmoil began in August 2007, markets for a number of financial instruments, including mortgage-backed securities, dried up. Most observers expected this closure to be short-lived, and the predominant view was that the crisis was one of (a lack of) liquidity. But, as time passed and markets did not re-open, it became clear that the problem was deeper seated, and concerned the solvency of the banking system and the sustainability of its funding model. Attempts to deal with the problem by injections of liquidity from central banks led to temporary alleviations of the symptoms, but, after an initial improvement, conditions would deteriorate again.

The scale of central bank liquidity support during the crisis has been unprecedented, and all central banks have increased the scale of their lending in broadly similar ways. The UK taxpayer now has a larger claim on the assets of banks (in the form of collateral held by the Bank of England) than the total equity value of UK banks. Massive injections of central bank liquidity have played a vital role in staving off an imminent collapse of the banking system. Such lending can tide a bank over while it is taking steps to remove the cause of the concerns that generated a run or lack of confidence. But it can also serve to conceal the severity of the underlying problems, and put off the inevitable day of reckoning.

I hope it is now understood that the provision of central bank liquidity, while essential to buy time, is not, and never could be, the solution to the banking crisis, nor to the problems of individual banks. Central bank liquidity is sticking plaster, useful and important, but not a substitute for proper treatment.

Just as a fever is itself only a symptom of an underlying condition, so the freezing of interbank and money markets was the symptom of deeper structural problems in the banking sector. So let me explain why a major recapitalisation of the banking system was necessary, was the centrepiece of the UK plan (alongside a temporary guarantee of some wholesale funding instruments and provision of central bank liquidity), and was in turn followed by other European countries and the United States.

Securitised mortgages – that is collections of mortgages bundled together and sold as securities, including the now infamous US sub-prime mortgages – had been marketed during a period of rising house prices and low interest rates which had masked the riskiness of the underlying loans. By securitising mortgages on such a scale, banks transformed the liquidity of their lending book. They also financed it by short-term wholesale borrowing. But in the light of rising defaults and falling house prices – first in the United States and then elsewhere – investors reassessed the risks inherent in these securities. Perceived as riskier, their values fell and demand for securitisations dwindled. For the same reason, the value of banks' mortgage books declined. Banks saw the value of their assets fall while their liabilities remained unchanged. The effect was magnified by the very high levels of borrowing relative to capital (or leverage) with which many banks were operating, and the fact that banks had purchased significant quantities of securitised and more complex financial instruments from each other. Not only were these assets difficult to value, but the distribution of losses across the financial system was uncertain. Banks' share prices fell. Capital was squeezed.

Markets were sending a clear message to banks around the world: they did not have enough capital. At the Annual Meetings of the IMF and World Bank in Washington ten days ago, the message was reinforced by our colleagues from Japan, Sweden and Finland, who, with eloquence and not a little passion, reminded those present of their experience in dealing with a systemic banking failure in the 1990s. Recapitalise and do it now was the lesson. Recapitalisation requires a fiscal response, and that can be done only by governments.

Confidence in the banking system had eroded as the weakness of the capital position became more widely appreciated. But it took a crisis caused by the failure of Lehman Brothers to trigger the coordinated government plan to recapitalise the system. It would be a mistake, however, to think that had Lehman Brothers not failed, a crisis would have been averted. The underlying cause of inadequate capital would eventually have provoked a crisis of one kind or another somewhere else.

So where does this leave us? The recapitalisation plan is having a major impact on the restoration of market confidence in banks. Perhaps the single most important diagnostic statistic is the credit default swap premium – an indicator of market concerns about solvency of banks. These premia have fallen markedly since the announcement of the UK plan. From the close of business on 7 October to now the premia on the UK's five largest banks have more than halved. We are far from the end of the road back to stability, but the plan to recapitalise our banking system, both here and abroad, will I believe come to be seen as the moment in the banking crisis of the past year when we turned the corner.

As concerns about the viability of our banks recede, banks should regain the confidence of the market as recipients of funding. There are already some signs of greater activity. But the age of innocence – when banks lent to each other unsecured for three months or longer at only a small premium to expected policy rates – will not quickly, if ever, return. In itself that does not affect the ability of banks to fund lending, but confidence has been badly shaken after the traumatic events of the past few weeks. New sources of funding will develop only slowly, although the temporary government guarantees of new lending to banks will help. So it will take time before the recapitalisation leads to a resumption of normal levels of lending by the banking system to the real economy. And we cannot assume that there will not be problems in other parts of the financial system and in some emerging market economies to be overcome before the crisis can truly be described as over.

With the plan for recapitalisation in place, the focus of attention has moved to the outlook for the UK and world economies. Over the past month, the economic news has probably been the worst in such a short period for a very considerable time. The most recent activity indicators for the second of half of the year have fallen sharply. In the UK, unemployment continues to rise and, over the past three months, has risen at the fastest rate for seventeen years, albeit from a relatively low level. House prices declined by about 5% in the third quarter and are 13% lower than a year ago. The recent weakness of the housing market is likely to continue. And if the news on the domestic front were not sufficiently discouraging, the rest of the world economy also appears to be slowing rapidly.

Why has the outlook deteriorated so quickly? The banking crisis dealt a severe blow to the availability of credit. Growth in secured lending to households fell to an annualised rate of 1.9% in the three months to August, its lowest level in more than a decade. The Bank of England's survey of credit conditions suggests that the terms on which banks provide credit to companies have tightened even further. And, on some estimates, the supply of finance to the UK corporate sector has ground to a halt. This credit shock has come on top of a fall in real disposable incomes resulting from the rise in energy and food prices earlier in the year. So, taken together, the combination of a squeeze on real take-home pay and a decline in the availability of credit poses the risk of a sharp and prolonged slowdown in domestic demand. Indeed, it now seems likely that the UK economy is entering a recession.

At the same time, consumer price inflation, our target measure, has risen from around the 2% target at the beginning of the year to a worryingly high rate of 5.2% in September. Oil and other commodity and food prices have all been rising very rapidly. In those circumstances, it was sensible to allow those price changes to be absorbed by movements in consumer prices. The alternative would have been an even sharper slowdown in the economy. Central banks in other countries also find themselves in a similar position. Over the past year or so, CPI inflation rose from 2.0% to 5.6% in the United States and from 1.7% to 4.0% in the euro-area.

It is surely probable that the drama of the banking crisis, which is unprecedented in the lifetime of almost all of us, will damage business and consumer confidence more generally. But two pieces of good news should temper the gloom. First, the banking system will be recapitalised and, in due course, the banking system will resume more normal lending, although by normal I do not mean the conditions that prevailed prior to August 2007. Second, oil prices have now fallen from a peak of $147 a barrel only three months ago to around $70 today. And wholesale gas prices have now also started to follow oil prices down. That will help to support the growth of real incomes as well as bringing down inflation.

So, what should the Monetary Policy Committee do now? It must continue to set Bank Rate in order to meet the 2% inflation target, not next month or the month after, but further ahead when the impact of recent developments in both credit supply and world commodity prices will have worked their way through the economy. This is the time not to abandon but to reinforce our commitment to stability. The slowdown in demand, and the recent falls in energy prices, will bring inflation back towards the target. The Committee must balance the risk that a prolonged slowdown in domestic demand pulls inflation materially below the target against the risk that today's high inflation rate becomes embedded in inflation expectations. During the past month, the balance of risks to inflation in the medium term shifted decisively to the downside. And the MPC – in an action co-ordinated with six other major central banks – cut Bank Rate by half a percentage point to 4.5%.

Looking ahead, the outlook is obviously very uncertain – both for the world as well as our own economy. The MPC cannot simply extrapolate the past into the future. The prospects for oil and other commodity prices are difficult to assess. So too are the period over which bank lending will return to normal and the extent of the damage to business and consumer confidence. Moreover, the credit crunch affects not just demand but also the supply potential of the economy, complicating the assessment of the inflationary impact of changes in the level of demand. The associated shift of resources away from those parts of the economy that have flourished in recent years towards other areas of economic activity will moderate the increase in potential output while that adjustment is taking place. The MPC must monitor carefully all the available evidence about fast-changing patterns of spending, supply and prices. It will act promptly to ensure that inflation remains on track to meet our target.

The downturn in the economy will affect not just monetary policy but fiscal policy too. That subject is for another occasion, but there is one point I do want to make tonight. The cost of supporting the banking system will inevitably raise the level of national debt. Managed properly, however, such a rise in national debt need not prove inflationary. Indeed, within a reasonable period it should be possible for the Government to reduce its stake in the banking system, for example by selling units in a Bank Reconstruction Fund, and repay the additional debt that had been issued. That is one difference between past increases in national debt in times of war and the increase now to pay for recapitalisation of the banking system which involves the acquisition of an asset.

Let me take you back again to 1958. In the very first television interview given by a Governor of the Bank of England, Cameron Cobbold explained national debt to Robin Day on "Tell the People", the highlight of ITN's Sunday evening schedule fifty years ago. Here is the exchange:

Cobbold: The National Debt represents the sums of money which the Government have over the years borrowed from the public, mainly in this country and, to some extent, abroad. That is really the amount of expenditure which they have failed over the period to cover by revenue.

Day: Have we paid for World War II?

Cobbold: No.

Day: Have we paid for World War I?

Cobbold: No.

Day: Have we paid for the Battle of Waterloo?

Cobbold: I don't think you can exactly say that.

On this occasion, we should have little difficulty in evaluating when we have paid for the recapitalisation. There are, though, questions about the source of the funding and the level of borrowing by the country as a whole from overseas. For several years, the UK banking sector has been relying extensively on external capital flows, principally short-term wholesale funding, to finance its lending activities. Those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s. Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run.

With the bank recapitalisation plan in place, we now face a long, slow haul to restore lending to the real economy, and hence growth of our economy, to more normal conditions. The past few weeks have been somewhat too exciting. The actions that were taken were not designed to save the banks as such, but to protect the rest of the economy from the banks. I hope banks will come to appreciate, just as the New Zealanders at Headingley in 1958, the Yorkshire virtues of patience and sound defence when batting on a sticky wicket. I have said many times that successful monetary policy would appear rather boring. So let me extend an invitation to the banking industry to join me in promoting the idea that a little more boredom would be no bad thing. The long march back to boredom and stability starts tonight in Leeds.