Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, to the CBI Dinner, Nottingham, 20 January 2009.

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Certain truths are self-evident. One is that financial markets and the economic outlook can change quickly and in surprising ways. You in the Nottingham business community know that only too well. In line with businesses across the United Kingdom, your economic fortunes have changed markedly over four months.

Before last September, the world economy was slowing and at home the Monetary Policy Committee published a central projection of falling output in the United Kingdom in the third quarter. Inflation, though, was still rising. But after the failure of the American investment bank Lehman Brothers, there was a widespread collapse of confidence in the banking systems of the industrialised world. That led to an unprecedented and synchronised downturn in business and consumer confidence around the world. Our business contacts at home and abroad, and my international counterparts, started to report that orders and confidence had, in the same telling phrase, "fallen off a cliff".

Global equity prices fell more in the month following the failure of Lehman Brothers than in any but a handful of months in the Bank of England's 300 year history. Chinese electricity production, having risen steadily at 15% a year, fell in November to a level 8% lower than a year earlier – the steepest fall on record. Car sales in Brazil contracted by a quarter compared to a year earlier. In Japan, industrial production fell by 8.5% in just one month in November, and in Germany, the value of exports declined by over 10%. In the United States, over a million jobs were lost in the final two months of last year – the fastest rate of job losses in over 60 years. And in the United Kingdom, manufacturing output contracted at its fastest rate since 1980. Trade was badly affected – the Baltic Dry Index, an indicator of demand to ship materials around the world – fell at the fastest pace on record in October. For the world economy as a whole, consensus forecasts of growth in 2009 have been revised down from 3% to just 1% since September.[1]

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[1] See charts below.

Sources:

Chart 1: Composite indices from Global Financial Database, comprising of: East Indies share for 1693; Bank of England and East Indies shares from 1694 to August 1711; Bank of England, East Indies and South Sea shares from September 1711 to January 1811; Rostow's Total Index of Share Prices from 1811 to 1867; the London and Cambridge Economic Service Index from 1867 to 1906; The Banker's Magazine Index from 1907 to May 1933; the Actuaries General Index from June 1933 to April 1962; and the FTSE All-Share from April 1962 onwards. Data are monthly until 1965, then weekly until 1968, and daily afterwards.

Chart 2: National Bureau of Statistics, China

Chart 3: Associação Nacional dos Fabricantes de Veículos Automotores, Brazil

Chart 4: Ministry of Economy, Trade and Industry, Japan

Chart 5: Bundesbank, Germany

Chart 6: Bureau of Labor Statistics, US

Chart 7: ONS

Chart 8: Baltic Exchange

Chart 9: Consensus Economics and Bank calculations

Governments and central banks around the world responded decisively and boldly with large fiscal injections and cuts in interest rates, and the provision of hundreds of billions of pounds in capital and funding to support banks. The scale and urgency of their actions embodied an audacity born out of pessimism.

Tonight I want to ask: what went wrong? How can we limit the impact of the banking crisis on the wider economy? And can we design a better approach to the management of our economy and financial system in the future?

So what went wrong? The origins of the crisis lie in the imbalances in the world economy which built up over a decade or more. The entry of the rapidly growing economies in Asia into the world trading and financial systems provided a huge new pool of savings. But their development and exchange rate strategies meant that they were running large current account surpluses. In other words, their domestic saving was more than enough to finance investment at home. Significant amounts were channelled into foreign financial assets. Equally, the policies of the industrialised countries were aimed at ensuring a sufficient level of total demand to maintain stable inflation, and so desired levels of output and employment. That required policies to stimulate domestic demand and current account deficits to offset the surpluses elsewhere. The perverse result was huge flows of capital from the poorer developing economies to the richer mature economies.

Large amounts of savings flowing into global financial markets would by themselves have pushed down **real** interest rates. That, together with the success of central banks in the industrialised world in maintaining low and stable inflation – something that they had not been able to do in the preceding three decades – meant that **nominal** interest rates fell even further. As a result, nominal risk free returns fell to levels not seen in a generation.

The combination of a fall in risk-free returns, and large amounts of capital looking for a home in western capital markets, created a demand for assets offering higher returns – the so-called search for yield. Investors, including banks, overlooked the fact that higher returns could be generated only by taking higher risks. As a result, money was lent on easier terms. That helped to push up further asset prices that had already risen as real interest rates were falling.

It also led to an explosion in the size of the financial sector as new instruments were created to satisfy the search for yield. As well as lending to households and businesses, banks lent to other banks which bought ever more exotic instruments created by the financial system itself. The effect was to replicate the original risky loans many times over. Over the past five years, the balance sheets of many of the world's largest banks more than doubled.

From the early 1990s to the start of the financial turmoil in 2007, total debt in the UK relative to GDP almost doubled. Around two-thirds of the increase in total debt was accounted for by lending to the financial sector. A marked expansion in debt of the financial sector also occurred in the United States and the euro area.

The Bank did not stand idly by during this period. The Monetary Policy Committee set Bank Rate to achieve the inflation target. Monetary policy – here and in our major partners – was successful in controlling inflation and maintaining economic stability. From the early 1990s until the onset of financial turmoil in 2007, output growth, both here and in the industrialised world in general, was close to its long-run average. Moreover, through our regular publications and speeches on financial stability the Bank highlighted the dangers posed by the growth in the size and complexity of the financial sector. Nevertheless, it is clear that policy did not succeed in preventing the development of an unsustainable position.

Some have suggested as a result that Bank Rate be directed not only at meeting the inflation target but also at preventing excessive increases in debt and asset prices. Leaving to one side the feasibility of targeting the latter, the obvious question is how one can meet two objectives with one instrument. The answer of course is by accepting a trade-off between the two objectives. But why should we accept unemployment or high inflation in order to reduce financial imbalances? It would be more sensible to use Bank Rate for its traditional task of targeting inflation to maintain a balance between demand and supply in the economy, and to create a new instrument to limit the build up of debt.

What is required is an additional policy instrument to stabilise the growth of the financial sector balance sheet. There is an active international debate as to the optimal design of such an instrument, but one way or another it must provide incentives for banks to reduce the volatility of their balance sheet.

It is also clear that at the heart of the crisis was the problem identified but not solved at Bretton Woods – the need to impose symmetric obligations on countries that run persistent current account surpluses and not just on countries that run deficits. From that failure stemmed a chain of events, no one of which alone appeared to threaten stability, but which taken together led to the worst financial crisis any of us can recall. For several years the Bank of England and other UK participants in the international fora argued for a major reform of the international monetary system and the IMF in order to address this issue.

The gravity of the present crisis demonstrates the urgency of rectifying both of these deficiencies.

In the past year the true scale of the risks taken by financial institutions has become painfully apparent. As losses mount it has become obvious that banks did not have sufficient capital to support their inflated balance sheets. Questions about the adequacy of liquidity have turned into questions about solvency. In response, banks have been trying to raise new capital and shrink their balance sheets. The banking system is in the throes of a difficult and prolonged adjustment to much smaller balance sheets relative to their equity capital – or leverage, as it is known. Leverage ratios of large banks remain at remarkably high levels, and the required adjustment will not happen quickly.

I know that bankers around the world realise this. The incentives they face to adjust, in whatever way they can, are now overwhelming. With fresh capital from the private sector difficult to obtain, banks have opted to reduce their lending and that is why the flow of credit to all parts of the economy, here and abroad, has been heavily disrupted. And the credit that is still flowing is available only on materially tighter terms and conditions. But the fact that much of the increase in debt occurred within the financial sector means that the necessary unwinding of balance sheets could and should take place primarily within the financial sector. That is why the Bank of England has been monitoring carefully the lending by banks to the non-financial sector – businesses and households – and why the lending agreements announced yesterday which will be negotiated between Government and individual banks will focus on lending to those sectors. There is scope for a reduction in the leverage of banks without restricting lending to the "real" economy. But to bring that about much of the necessary "netting" of exposures would be cross-border, demonstrating that almost every aspect of the present crisis has an international dimension.

What is the appropriate policy response in present circumstances? Some say that because the massive increase in indebtedness contributed to the crisis the right response is to save and repay debt. Others argue that the only way out of our present difficulties is to borrow and spend more. Who is right?

Both are – up to a point. We cannot avoid the necessary long-term adjustment. To pretend otherwise would only store up problems for the future. But we can try to slow the pace of the adjustment to domestic demand in order to limit its impact on output and employment. So we need to take actions now that will dampen the adjustment in the short term while recognising that the adjustment will ultimately need to be made. This is the paradox of policy at present – almost any policy measure that is desirable now appears diametrically opposite to the direction in which we need to go in the long term. Spending now supports the economy, but in the long run we need to save more and borrow less. Public borrowing sustains spending, but in the long run needs to fall. Banks are encouraged to run down their capital to enable them to absorb losses while continuing to lend, but in the long run they will need more capital. Interest rates have fallen to unprecedented levels, but in the long run will need to rise to more normal levels.

In each area of policy it is important that there is a clear framework which guides both the short-term response to the current downturn and the exit strategy when normal conditions return. For monetary policy, the inflation target is that framework. Bank Rate is set to meet our target of 2% for the twelve-month rate of consumer price inflation.

For a decade inflation and Bank Rate were remarkably stable. But in only four months, the MPC has cut Bank Rate by 3½ percentage points to its lowest ever level of 1½%. Does this mean we have changed our target? No. We have taken those actions precisely because the sudden downturn in the world and UK economies created a significant risk that inflation would fall below the 2% target.

Despite those big cuts, there remains a risk that inflation will fall below 2%. The disruption to the banking system has impaired the effectiveness of our conventional interest rate instrument. And with Bank Rate already at its lowest level in the Bank's history, it is sensible for the MPC to prepare for the possibility – and I stress that we are not there yet – that it may need to move beyond the conventional instrument of Bank Rate and consider a range of unconventional measures. They would take the form of purchases by the Bank of England of a range of financial assets in order to expand the amount of reserves held by commercial banks and to increase the availability of credit to companies. That should encourage the banking system to expand the supply of broad money by lending to the private sector and also help companies to raise finance from capital markets.

The conventional approach to such unconventional measures is to buy assets, such as government securities or gilts, which are traded in liquid markets to boost the supply of money. Provided the additional reserves are not simply hoarded by banks, as happened to some extent in Japan earlier in this decade, such asset purchases can increase the supply of broad money and credit and the liquidity of private sector portfolios, raising spending. The effectiveness of this approach is likely to be enhanced by the clear commitment by the MPC to take the measures necessary to meet the inflation target in the medium term.

In addition to these conventional unconventional measures there are also unconventional unconventional measures. When credit markets are dysfunctional, as some are at present, targeted purchases by the Bank of England of assets may improve liquidity in markets for those credit instruments. The objective of such purchases would be not only to boost the supply of broad money but also to increase liquidity and trading activity in the markets for those assets. A reduction in the illiquidity premium for a particular credit instrument might help to stimulate issuance by corporate borrowers and the resumption of capital market flows, thus reducing reliance on bank lending. It could also raise the values of assets that are currently under-priced because of high illiquidity premia, helping to strengthen the balance sheets of banks and other financial institutions.

Yesterday the Government authorised the Bank of England to conduct such operations, financed by the issue of Treasury Bills, in order to improve the flow of credit to companies. But at some point the Monetary Policy Committee might wish to adopt these unconventional measures as an instrument of monetary policy.

In conducting such operations, it is important to choose the markets in which to intervene extremely carefully. There is a fine dividing line between helping to oil the wheels in markets which are temporarily impaired, and artificially supporting markets in which there is no underlying demand. That is why, as Federal Reserve Chairman Bernanke said in London last week, central banks will look to intervene only in markets that "normally play major roles" in the functioning of the financial system. Therefore, the Bank will need to be satisfied that there is a genuine private demand for an asset in normal conditions before it would be eligible for the asset purchase facility. We are aiming to complement and stimulate private demand, not substitute for it.

The Bank is actively considering in which markets targeted purchases might stimulate new issuance. One example is the corporate bond market. Spreads on high quality corporate bonds have more than doubled since early September to an average of over 5 percentage points. Despite innovation in financial markets this is the highest spread since the mid-1970s. The Bank estimates that a significant element of this spread represents an illiquidity premium which could be reduced somewhat by increasing activity and liquidity in the market. Commercial paper is another case where purchases might help, although that market is considerably smaller in the United Kingdom than in the United States. In each case the Bank will keep the market fully informed, and more details will be published at the end of the month. It will be a matter of weeks not days before a programme of purchases can begin, but it will be weeks not months.

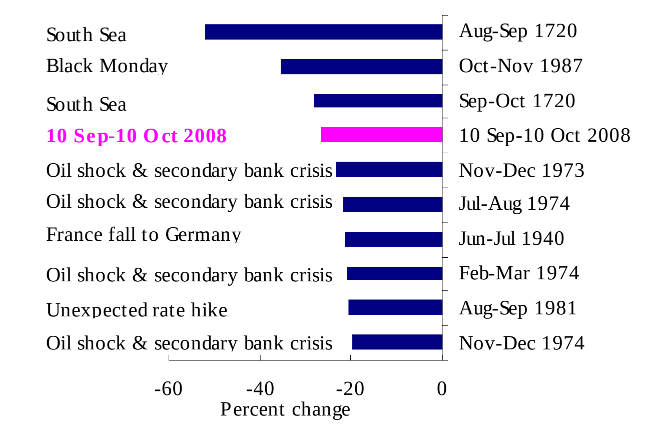
There is another reason to tread carefully. Such asset purchases involve taking more credit risk onto the public sector balance sheet. That is why the Bank will consider purchasing only high quality assets.

Despite the existence of a range of unconventional instruments, monetary policy is likely to be more effective when the banking system is working normally. So the first priority for policy is to fix the banking system so that it can resume its normal lending function. The contraction of lending to ordinary viable businesses – your businesses – is threatening to drive the economy further into recession. The package of measures announced yesterday by the Chancellor are not designed to protect the banks as such. They are designed to protect the economy from the banks. In particular, the Asset Protection Scheme aims to remove a degree of uncertainty about the future losses banks will make. It also has the effect of reducing the amount of capital banks need to hold against their risky assets. Both effects will serve to strengthen and underpin banks' balance sheets and so support their lending to the real economy. To be clear, the scheme does not mean that the taxpayer will bear the full brunt of past lending mistakes by banks. Rather, there is sharing of losses between shareholders and the government – or coinsurance – with the government providing, at a price, insurance against only extreme outcomes for the banks. That can be to the advantage of all of us if banks help to underwrite the economy through the agreed lending targets and government underwrites the balance sheet of the banks. The insurance policy will be most cost-effective for taxpayers if all the major lenders sign up to lending targets.

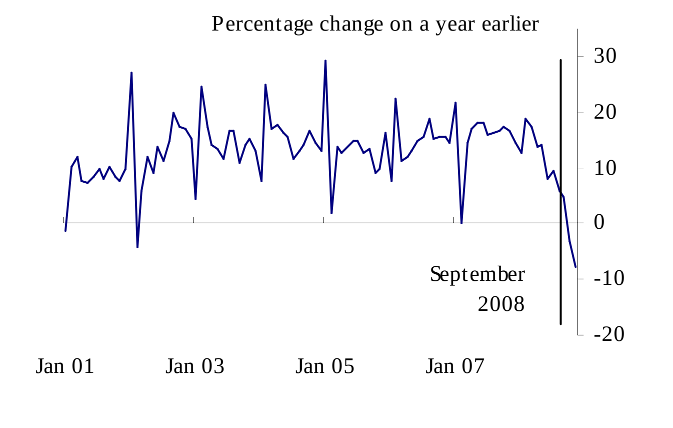
Nevertheless, the problems in the financial sector mean that 2009 will be a difficult year for all of us. A pronounced contraction in spending and output is underway. As expected, output in the UK economy fell in the third quarter of 2008, but the downward momentum intensified in the fourth quarter. Manufacturing output is falling, and the key service sector surveys have reached record low levels in recent months. Total output in the fourth quarter is expected to have fallen sharply. In the first half of this year, the rate of contraction is likely to continue to be marked, and our trading partners are experiencing similar problems.

But the very significant policy actions taken in recent months will eventually stimulate a recovery in demand, output and employment. Bank Rate has fallen from 5% to 1½%. And, as I have explained, the Monetary Policy Committee has a range of options to stimulate the economy further if required. Fiscal policy has been eased. The banking system is receiving massive support to cope with the need to restructure its balance sheet. That will take time, but time is a great healer, even of banks. Since the summer, the exchange rate has fallen by almost 20%; and oil prices have fallen by around two-thirds, both of which will boost demand. No one can know at what point the impact of all this stimulus will have a visible effect on activity; the lags in economic policy are notoriously long and unpredictable. But well-designed policies implemented within a consistent policy framework will eventually work.

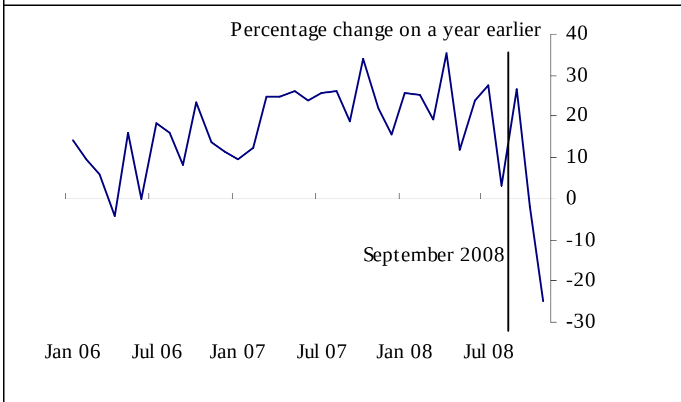
1. Ten largest monthly falls in UK equity prices



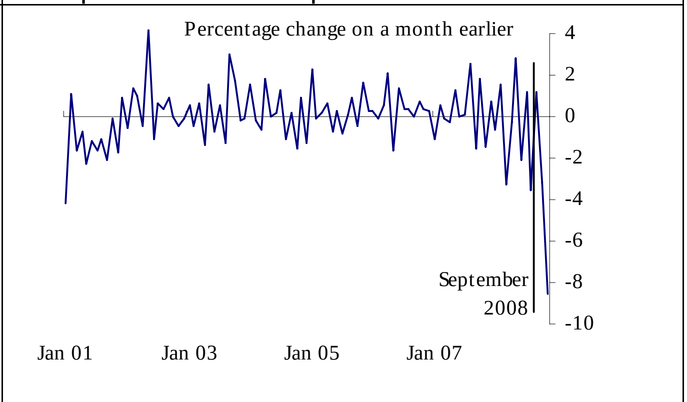
2. Chinese electricity production



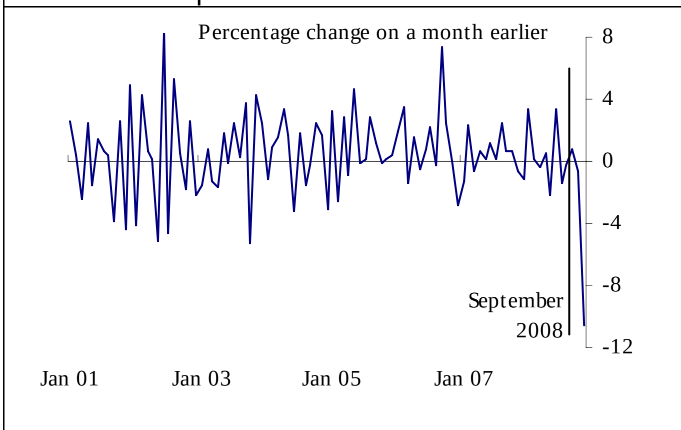
3. Brazilian car sales



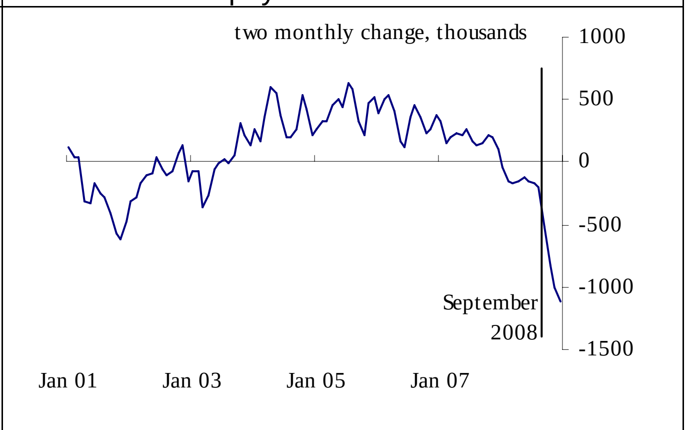
4. Japanese industrial production



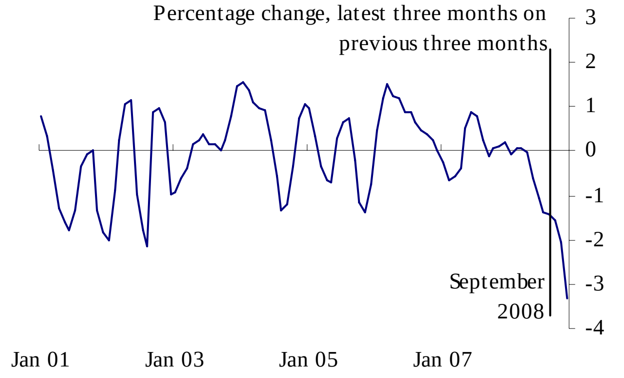
5. German export values



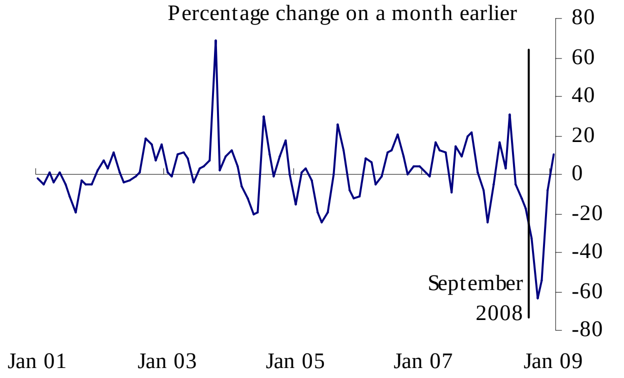
6. US Non-farm payrolls



7. UK manufacturing output



8. Baltic dry index (monthly averages)



9. Consensus forecast for world growth