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 at the Mansion House, London, 17 June 2009.

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

It has been quite a year. A year to remember, but not to repeat. Since we last met, a financial panic swept through markets in September, several major financial institutions failed, and a remarkable collapse of confidence around the world led to unprecedented declines in industrial production and national output. World trade fell by almost 15% in six months, a faster rate of decline than in the Great Depression.

Faced with this crisis, the Bank of England took extraordinary actions. Bank Rate was cut virtually to zero, and the Monetary Policy Committee embarked on a programme of £125 billion of asset purchases. And in your own businesses you too have had to deal with what some have called a once-in-a-century event.

Since the panic last autumn, overall output has fallen by around 3% in the United States and the United Kingdom, 6% in Germany, and 7% in Japan. The collapse of spending in these economies is having painful consequences. In less than a year, over 5 million jobs have been lost in the United States, almost 2 million in the euro area, and almost half a million here in the United Kingdom.

Despite those unprecedented falls in activity, there are some signs that the British economy is beginning to stabilise, and financial markets have improved markedly. There are three solid reasons for thinking that a recovery in activity was likely to occur at some point this year.

The first I call the "Honda effect" – many firms, as Honda did last year at its plant in Swindon, cut back production and met demand from stock, resuming production this year once inventories had been reduced.

The second factor is the level of sterling which, despite its recent rally, is still some 20% lower than in the summer of 2007. That will encourage a switch in spending, at home and abroad, towards goods and services produced in the UK.

Finally, and perhaps most important, is the enormous policy stimulus that has been injected into the economy. Bank Rate was cut by four percentage points in four months. But the Monetary Policy Committee judged that even that was insufficient to prevent inflation falling below our 2% target, and so it embarked on a programme of asset purchases designed to increase the money supply and improve conditions in non-bank corporate credit markets. The programme will shortly be extended to working capital finance, which should be of particular help to smaller companies. But the Bank must not become the arbiter of the allocation of public credit to individual companies or sectors – such decisions are rightly and necessarily the province of government. So there is a limit to the scope of the Bank's activities in this area.

The success of the policy is not to be judged by the increase in bank lending. Its aim is to increase the money supply. There are already tentative signs that the programme is beginning to have beneficial effects with the growth rate of broad money picking up.

So there are certainly grounds for believing that the rapid falls in activity are coming to an end. But there are some equally solid reasons for believing that the path to full recovery could be protracted. The most obvious is that the supply of bank lending to companies and households remains constrained. The stock of bank lending to non-financial companies has been falling in recent months, and household lending has been flat. Part of this undoubtedly reflects weak demand in the face of the recession. But the evidence from prospective borrowers, and the terms on which lenders are willing to extend credit, suggest that banks' ability to finance a sustained recovery remains impaired by low levels of equity capital. Stress tests designed to assess the viability of banks are very different from tests of the capacity of the banking system to finance a recovery.

Investors continue to demand high returns to finance banks. Put bluntly, market data on credit spreads imply that some banks are viewed as a worse credit risk than some of their customers. As a result, companies that can bypass the banks to access capital markets directly are doing so. Indeed, in the first four months of this year, more finance was raised in debt and equity markets than is normally the case in an entire year. Most companies, however, especially smaller and medium-sized enterprises, rely heavily on bank finance. And with current market sentiment it may take further additions to equity capital before the banking system will be able to supply credit at a price and on a scale to finance a sustained recovery. That is likely to take time.

It is too soon to reverse the extraordinary policy stimulus that has been injected into the UK economy through monetary policy, the provision of liquidity support to banks, guarantees of bank funding, and fiscal policy. Nevertheless, it is not too early to prepare such "exit strategies" and to explain how they would work.

The challenge facing the Monetary Policy Committee is straightforward in principle but difficult in practice. As activity returns to more normal levels, the outlook for inflation will pick up. And it is the outlook for inflation that will guide decisions on the pace and timing of a withdrawal of monetary stimulus. Reaching judgements on the outlook for inflation is never easy, and assessing their implications for policy will always be a matter of balancing risks. In contrast, the choice of instruments is simple. When appropriate the MPC will raise Bank Rate and gradually run down its portfolio of assets in a manner consistent with maintaining orderly markets.

Just as no one should plan on the present degree of monetary stimulus persisting indefinitely, so too no bank should expect that the current extraordinary liquidity support will continue for ever. In due course, a strategy will be needed to exit from that temporary support, and from the extensive bank guarantees, to the permanent regime for liquidity insurance that the Bank announced last year. The Bank of England will talk with the banks about how to manage the transition.

As we emerge from recession, fiscal policy too will have to change. In taking the extraordinary measures to stabilise banks and the wider economy, some of the past build-up of debt has been transferred from the private to the public sector. And it was right to use a temporary fiscal stimulus to counter the depth of the downturn experienced last year. But five years from now national debt, as a proportion of national income, is expected to be more than double its level before the crisis. So it is also necessary to produce a clear plan to show how prospective deficits will be reduced during the next Parliament, so returning to a gradually declining path for the ratio of national debt to national income.

We must learn lessons from the events of the past two years. They cannot be final conclusions because the present crisis has some way to run. But two stand out. First, price stability does not guarantee stability of the economy as a whole. Second, the instruments used to pursue financial stability are in need of sharpening and refining.

Setting Bank Rate to maintain price stability was successful in itself, but did not prevent a recession induced by a financial crisis. But let's not throw out the baby with the bathwater. The period prior to the crisis was the most stable economic environment for generations. And, unlike most previous recessions, this crisis wasn't preceded by an unsustainable boom in output. In the five years leading up to the crisis, overall GDP growth remained close to its long-run average and inflation differed from the 2% target on average by only 0.2 percentage points. Diverting monetary policy from its goal of price stability risks making the economy less stable and the financial system no more so. To argue that monetary policy should be directed to counter inadequately priced risk is to argue that unemployment is a price worth paying to tame the banking system.

Inflation targeting is a necessary but not sufficient condition for stability in the economy as a whole. When a policy is necessary but not sufficient, the answer is not to abandon, but to augment, it. Indeed, the overarching lesson from this crisis is that the authorities lacked sufficient policy instruments to take effective actions. Nowhere was this more evident than in dealing with Northern Rock in the absence of proper resolution powers. For domestic institutions that particular issue was settled by the Banking Act 2009, and the new resolution powers were successfully deployed by the Bank to deal with the Dunfermline Building Society in March.

What other powers are required? There is a broad consensus that our traditional policy instruments need to be augmented by a "macro-prudential" toolkit. But what are such "macro-prudential" instruments for? Are they to increase the resilience of individual banks, or are they to protect the economy from the banks? The former implies a sensible extension of the current regime of capital requirements for individual institutions. The latter goes to the heart of the problems caused by the financial sector as a whole for the rest of the economy.

We need to reflect more deeply on the nature of the failures before designing a regulatory response – after all many financial markets continued to function well. But banks entered the crisis with historically low levels of liquid assets, and inadequate levels of capital with which to absorb losses. Moreover, in the United Kingdom, the financial sector became too big and too highly leveraged. First, the size of our banking system was, as a proportion of GDP, five times that in the United States, and the risks to the UK taxpayer correspondingly greater. Second, the process of reducing very high leverage is doing great damage to the rest of the economy. And the required adjustment still has a long way to run – few of the largest banks in the United Kingdom managed to reduce their leverage ratios through 2008, which remain at historically high levels. Third, interconnections between institutions create potential fragilities across the system, as we saw last September. Fourth, the risks associated with large-scale proprietary trading are probably harder to control in limited liability companies. So we need instruments to prevent the size, leverage, fragility and risk of the financial system from becoming too great. The resulting "macro-prudential" toolkit will contain a number of instruments to reduce risk, both across the system and over time. It must not be put together in a hurry. And I share the concerns of many of you that we are a long way from identifying precise regulatory interventions that would improve the functioning of markets.

As far as individual banks are concerned, we face some uncomfortable choices about the structure and regulation of our banking sector. If some banks are thought to be too big to fail, then, in the words of a distinguished American economist, they are too big. It is not sensible to allow large banks to combine high street retail banking with risky investment banking or funding strategies, and then provide an implicit state guarantee against failure. Something must give. Either those guarantees to retail depositors should be limited to banks that make a narrower range of investments, or banks which pose greater risks to taxpayers and the economy in the event of failure should face higher capital requirements, or we must develop resolution powers such that large and complex financial institutions can be wound down in an orderly manner. Or, perhaps, an element of all three. Privately owned and managed institutions that are too big to fail sit oddly with a market economy.

One important practical step would be to require any regulated bank itself to produce a plan for an orderly wind down of its activities. That would provide the information to the authorities the absence of which made past decisions about the future of institutions difficult. Making a will should be as much a part of good housekeeping for banks as it is for the rest of us. And it would be sensible for the various authorities to work across national boundaries to identify detailed plans for how each large cross-border financial institution could be wound down.

The Bank of England has a new statutory responsibility for financial stability. Bank Rate is the instrument we deploy to achieve monetary stability, and should be used exclusively for that purpose. To achieve financial stability the powers of the Bank are limited to those of voice and the new resolution powers. The Bank finds itself in a position rather like that of a church whose congregation attends weddings and burials but ignores the sermons in between. Like the church, we cannot promise that bad things won't happen to our flock – the prevention of all financial crises is in neither our nor anyone else's power, as a study of history or human nature would reveal. And experience suggests that attempts to encourage a better life through the power of voice is not enough. Warnings are unlikely to be effective when people are being asked to change behaviour which seems to them highly profitable. So it is not entirely clear how the Bank will be able to discharge its new statutory responsibility if we can do no more than issue sermons or organise burials.

Whatever the ultimate shape of the structure and regulation of the banking system – and, as many of you have said, we need to think carefully to get this right – change will be necessary. The costs of this crisis are not to be measured simply in terms of its impact on public finances, the destruction of wealth, and the number of jobs lost. They are also to be seen in the lost trust in the financial sector among other parts of our economy. For a generation or more, businesses and families up and down the country were told, not least by the City, that the disciplines of the market economy were essential, even if painful in the short run, for greater prosperity in the longer term. That belief in the merits of a market economy was embraced and for many years was not misplaced. But out of the blue – in this case the financial sector – came a crisis that did not stem from weaknesses in the real economy. It has wreaked havoc on those same businesses and families. Unemployment, as we saw in today's figures, is rising sharply. And yet it is the banking system that has received financial support on an almost unimaginable scale. We who work in the financial sector have much to do to regain the trust of those who work outside it. "My word is my bond" are old words, but they were important. "My word is my CDO-squared" will never catch on.

There is no support in this country, and no case, for excessively bureaucratic regulation. But change to the structure, regulation and indeed culture of our banking system is necessary. Blaming individuals is no substitute for acknowledging the failure of a system, of a certain type of banking. We have a real opportunity now to put that right, and regain the trust that has been lost.

Lord Mayor, as we prepare to toast the Bankers and Merchants of the City of London, we remember that the City is more than banking and that banking is much more than the trading of complex securities. So all of us here tonight would like to pay tribute to your work since you became Lord Mayor, to support your efforts to promote financial literacy, 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", Ian and Lin Luder.