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, 16 June 2010.

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My Lord Mayor, Mr Chancellor, My Lords, Ladies and Gentlemen,

May I join the Lord Mayor in welcoming you, Chancellor, to your first Mansion House Dinner? You have set a rapid pace in your first month in office, not least in your announcements this evening.

In previous years I have sometimes set this gathering a quiz question. Tonight I want to reverse the process by providing the answer and asking you for the question. The answer is 23, and later I shall ask you – to what question is 23 the answer?

Over the past year, there has been no slackening in the pace of economic and political upheaval. The financial crisis that began in 2007 is not yet over. Much of the recent market volatility reflects concerns about the ability of governments to service their own debt and provide assistance where necessary to weakened banking systems, especially in the euro area. Such risks have the potential to derail recovery and we cannot ignore them.

At home we face the challenge of ensuring recovery while rebalancing the economy, reducing the fiscal deficit, and reshaping the structure and regulation of our banking system.

In playing its part to meet this challenge, the Bank of England has two priorities. Our first priority must be to maintain low and stable inflation. Of late there have been those who doubt our ability or willingness to meet the inflation target. In May, CPI inflation was 3.4%, and for much of the past three years has been above the 2% target. Over that period the rise in prices in excess of that implied by the target was around 3%. That can be accounted for by the direct impact on the price level of the fall in sterling's effective exchange rate, of about 25%, which is supporting the rebalancing of the UK economy.

Inflation has not only been higher than in the previous decade; it has also been more volatile. Our ability to keep measured inflation close to the target has been hindered by movements in world oil and commodity prices, as well as the temporary reduction in VAT. Oil prices, for example, have gyrated between $40 and $150 a barrel.

Although such price changes clearly lead to higher or lower CPI inflation for a period, by themselves they do not generate the continuous rise in prices to which monetary policy should respond. A continuous rise in prices would ordinarily be associated with strong money growth, wage inflation, rapid increases in money spending and an excess of demand over the supply capacity of the economy. The UK economy exhibits none of these traits – annual broad money growth is around 1%, growth in regular pay is close to 2% and money spending growth is around 3%; all of which are significantly lower than the average growth rates recorded before the crisis. And a range of indicators point to spare capacity in the economy rather than excess demand. Perhaps most obviously, unemployment is around 8%, three percentage points above the average levels before the crisis – a million fewer people in work. The Monetary Policy Committee judges that it is likely, though not certain, that this spare capacity will press down on inflation. That seems to be happening in both the United States and the euro area where underlying inflation is falling.

No one should take this as a sign of complacency. The MPC is conscious that there are always risks to the upside, and the apparent rise in inflation expectations is one that concerns us. We have always explicitly recognised that there is a significant chance that inflation may turn out to be above target. A forecast is not a single number; it is an assessment of risks. In our May forecast, the MPC judged that, under prevailing market interest rates, the odds were in favour of inflation remaining above target over the next year, whereas, looking two to three years ahead, the odds were on inflation being below the target. There are always risks to the outlook – on both sides – and to ignore them in either direction would be foolish. What the MPC must do is continually update its assessment of those risks, and set policy in order that, on balance, inflation remains on track to meet the target in the medium term.

No one should doubt our determination to meet the target. The inflation target introduced in 1992, and the new regime for monetary policy decision-making introduced in 1997, have shown beyond doubt that monetary policy in the United Kingdom is dedicated to maintaining low and stable inflation. Indeed, for ten years, I was, to my frustration, regularly described as a hawk. But I am neither hawk nor dove. Everyone on the Committee votes according to his or her judgement of the outlook for the economy. I have not changed. The Committee has not changed. Circumstances have changed. When confidence, output and trade around the world collapsed in the autumn of 2008, the balance of threats to the inflation outlook shifted rapidly to the downside. So the Bank of England and central banks in other industrialised countries responded by reducing official interest rates nearly to zero and injecting money directly into the economy.

There will come a time when our task will be to manage the exit from such an abnormal degree of monetary stimulus. The MPC will not hesitate to begin to withdraw the current degree of stimulus when we judge that is necessary. When it comes, that is most likely to be through a rise in Bank Rate with asset sales being conducted later in an orderly programme over a period of time, leaving Bank Rate as the active instrument.

But monetary policy must be set in the light of the fiscal tightening over the coming years, the continuing fragility in financial markets and the state of the banking system. I know there are those who worry that too rapid a fiscal consolidation will endanger recovery. But the steady reduction in the very large structural deficit over a period of a parliament cannot credibly be postponed indefinitely. If prospects for growth were to weaken, the outlook for inflation would probably be lower and monetary policy could then respond. I do, therefore, Chancellor welcome your commitment to put the UK's public finances on a sound footing. It is important that, in the medium term, national debt as a proportion of GDP returns to a declining path.

At the same time, it is important, however, that we work with our partners overseas to reduce the global imbalances and promote an adequate level of world growth. Countries with large current account and budget deficits will need to pursue both fiscal consolidation and policies to improve their competitiveness. And countries with current account surpluses, while understandably wanting to avoid unsustainable fiscal paths of their own, have a responsibility to expand domestic demand so that the imbalances can be reduced. Only if the two sets of policies work in tandem will growth prove sustainable.

Our second priority is to accept the challenge of the new responsibilities that you, Chancellor, have asked the Bank to take on in respect of micro prudential regulation and macro prudential control of the balance sheets of the financial system as a whole. I welcome those new responsibilities. Monetary stability and financial stability are two sides of the same coin. During the crisis the former was threatened by the failure to secure the latter.

The experience of the financial crisis taught us two important lessons. The first is that, whatever its theoretical attractions – and there certainly are some – putting prudential regulation into the same organisation as the oversight of consumer protection and market conduct didn't work in practice. The two types of regulation require different skills and a different approach. Separating them – the so-called "twin peaks" model of financial regulation – is the right direction of reform. That conclusion is not a reflection on the people who work at FSA. They are an able group and have worked hard to improve prudential regulation over the past three years. I look forward to working with them in the future. Nor does it follow from this first lesson that prudential regulation should necessarily go to the central bank.

But a second lesson is that when banks hit trouble the central bank needs to be fully involved in resolving those problems. The Bank of England cannot effectively perform its role as lender of last resort without first-hand knowledge of the health of the banks to which it might provide support. In peacetime, regulation can be conducted outside the central bank. But in a crisis, decisions must be made quickly and decisively and the central bank, working with government which is always responsible for any use of public money, needs to be in charge. That was one of our painful lessons.

In approaching our new responsibilities we shall build on the real improvements to its regime of prudential regulation made over the past three years by FSA. But the Bank will bring its own central banking culture. The focus of regulation needs to be on maintaining stability of the banking system as a whole. We shall be looking not just at those aspects of a bank that make it look unsafe in comparison with other institutions, but even more so at whether there are common features that threaten the stability of the system, such as the dangerously high leverage prior to 2007.

We shall aim to avoid an overly legalistic culture with its associated compliance-driven style of regulation. That is an important reason for the separation of consumer protection and market conduct from prudential regulation. We will need to exercise discretion when setting capital and liquidity ratios for individual banks. And to do that properly will require changes to the current legislation and rule book. We must reverse the seemingly inexorable trend towards more regulation and more regulators. That did not work in the past and is not the right response now.

I am absolutely delighted that Hector Sants has agreed to remain at FSA and then move to the Bank to become the first chief executive of the new prudential regulator. In difficult circumstances, Hector has engineered major improvements to FSA's prudential regulation. Andrew Bailey will head the Bank's transition team and will be the first deputy chief executive of the prudential authority. Together, Hector and Andrew form the perfect partnership to make the transition work and create the new organisation.

In the new regime, regulation will reflect two different, though complementary, perspectives. The first, as now, is a bottom-up perspective, focused on setting institution-specific capital requirements. Those would be fixed requirements that banks could not breach. The second is an overall perspective with a set of system-wide capital requirements that vary over the economic cycle. Judgements on the level of these capital buffers will be part of the remit of the new Financial Policy Committee. The prudential regulator, with its micro prudential responsibilities, and the Financial Policy Committee, with its macro prudential responsibilities, will need to work closely together, and that is one reason why it is sensible that they are both in the central bank.

It is not difficult to see what role such a macro prudential regime might have played in the run-up to the crisis. A progressive tightening of capital standards, for example, would have helped rein in the near-tripling of UK bank balance sheets between 2002 and 2007. The Bank's sermons on the storms ahead would have had more influence if at the same time a collection plate was passed round the congregation so that money was available in the event that the church roof had to be replaced.

But a macro prudential regime also has a key role to play in the downswing phase of the cycle. Since 2008, credit conditions have tightened, jeopardising the recovery and, in turn, threatening renewed losses for banks. By allowing banks to draw on their macro prudential capital buffers, while credit conditions remain tight, the system is counter-cyclical. In other words, a credible macro prudential regime could help forestall both excessive exuberance and unnecessary caution. By altering the pressure on the financial brakes according to circumstances, regulation, far from being an inflexible foe, would become a flexible friend.

This type of regulatory regime, and its objectives and tools, are largely untried and untested. But that is not a reason for not trying and not testing. The Financial Policy Committee will be a first. Over the next few years we will put in place a framework for financial stability to parallel that for monetary stability. We need both. As we have seen, one without the other is not enough. Just as the role of a central bank in monetary policy is to take the punch bowl away just as the party gets going, its role in financial stability should be to turn down the music when the dancing gets a little too wild.

Still, we should not put all our faith in regulation. It has limits. If the structure of banking creates incentives to take excessive risk then regulators will be overwhelmed by the avarice so vividly captured by Michael Lewis in his book *The Big Short*. Incentives must be right. One misalignment of incentives today is the implicit guarantee to banks that are "too important to fail", so that creditors have little incentive to monitor the behaviour of banks because they believe they will be bailed out. This problem is too important to ignore. There is no one simple solution. But we should not shy away from radical reform just because of the opposition of vested interests. So I welcome the setting up of the Banking Commission, with its talented commissioners and a wise and forensic chairman in Sir John Vickers.

Let me now return to the quiz question I posed earlier – to what question is 23 the answer? Several plausible answers come to mind. First, 23 is the number of players in England's World Cup squad in South Africa. Second, it is of course 23 years since England last won the Ashes "down under". But neither of these are the right answer which is that 23 years is the age difference between the Chancellor of the Exchequer and the Governor of the Bank of England. In case there is any doubt, George is the younger. This age difference is highly desirable because the appropriate incentives are to allocate the responsibility of determining monetary policy to the older generation, which has a real interest in preserving the value of money, and the responsibility for fiscal policy to the younger generation, on whom falls the burden of excessive debt. If we are tempted to leave a large burden of debt for the next generation to pay back, what better incentive mechanism than to have as Chancellor someone who has a longer life expectancy than any previous Chancellor on record? Given those incentives, Chancellor, I look forward to a harmonious coordination of monetary and fiscal policy.

Lord Mayor, as we prepare to toast the Bankers and Merchants of the City of London, all of us here tonight would like to pay tribute to your charitable work since you became Lord Mayor. This year the Lord Mayor's charity "Pitch Perfect" is focussed on two educational charities in which I have a special personal interest – the educational work of the London Symphony Orchestra and *Chance to shine*, the campaign to regenerate cricket in state schools which, in five years, has already brought the opportunity to play competitive matches to more than one million children, over 40% of whom are girls. Your personal commitment Nick to support these causes in times of great financial difficulty is a tribute to you and also to the charitable instincts of the City of London. We thank you for that work, and I am sure that everyone here tonight thanks both you and the Lady Mayoress 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", Nick and Claire Anstee.