Mervyn King: Address by Mervyn King to Trades Union Congress

Address by Mr Mervyn King, Governor of the Bank of England, to the 2010 Trades Union Congress, Manchester, 15 September 2010.

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President and Congress

I want first to thank you for inviting me to address Congress. Members of your General Council have made a huge contribution to the Bank of England by serving on our board – the Bank's Court. Carrying on that tradition today is Brendan Barber. By bringing a distinct and important perspective to our discussions, Brendan has helped us through some extremely turbulent times. I am grateful to him.

Recent times have indeed been turbulent. After a decade and a half of stability, with rising employment and living standards, came the crisis and recession – the biggest economic upheaval since the Great Depression. Before the crisis, steady growth with low inflation and high employment was in our grasp. We let it slip – we, that is, in the financial sector and as policy-makers – not your members nor the many businesses and organisations around the country which employ them. And although the causes of the crisis may have been rooted in the financial sector, the consequences are affecting everyone, and will continue to do so for years to come.

Thankfully, the costs of the crisis have been smaller than those of the Great Depression. But only because we learnt from that experience. An unprecedented degree of policy stimulus, here and abroad, prevented another world slump. Even so, around a million more people in Britain are out of work than before the crisis. Many, especially the young unemployed, have had their futures blighted. So we cannot just carry on as we are. Unless we reform our economy – rebalance demand, restructure banking, and restore the sustainability of our public finances – we shall not only jeopardise recovery, but also fail the next generation.

To my mind, a market economy and its disciplines offer the best way of raising living standards. But a market economy cannot survive on incentives alone. It must align those incentives to the common good. It must command support among the vast majority who do not receive the large rewards that accrue to the successful and the lucky. And it must show a sense of fairness if its efficiency is to yield fruit.

There was nothing fair about the financial crisis. It was caused not by problems in the real economy; it came out of the financial sector. But it was the real economy that suffered and the banks that were bailed out. Your members, and indeed the businesses which employ them, are entitled to be angry. But however legitimate, anger will not produce change unless its energy is harnessed to a cool analysis of what happened and why. So I want to discuss the fundamental causes of the crisis before turning to current policy.

The fall of the Berlin Wall in 1989 changed both politics and economics. Within a few years, the former Soviet empire, China and other Asian economies, with their combined workforce of over a billion people, entered the world trading system as market economies. Their focus on export-led growth allowed consumers in the West to enjoy rising living standards as the prices of traded goods fell. But the trade surpluses in emerging economies implied an outflow of capital. Relatively poor countries were lending money to richer western ones – the reverse of the traditional model of development. In the process, countries like China built up huge holdings of foreign assets – running into trillions of dollars – matched by equally huge debts in the deficit countries. Such massive imbalances were never likely to be sustainable, and so it proved.

If the first fundamental cause of the crisis was the scale of imbalances in the world economy, the second was the inability of our banking system to absorb such large inflows of capital without taking excessive risk. In the five years leading up to the crisis, the balance sheets of the West's largest banks doubled – mainly because banks lent more to other firms within the financial sector than to the wider economy. And the proportion of capital held by banks shrank so that their leverage – the ratio of total liabilities to equity capital – rose to unprecedented levels. Immediately prior to the crisis, the leverage ratios of some UK banks approached 50. To say that was risky is an understatement: at such levels, a 2% fall in the value of a bank's assets is sufficient to wipe out its capital and render it insolvent.

Remuneration, especially the structure of financial sector bonuses, encouraged excessive risk-taking, and distorted the aspirations and career choices of too many talented young people. Investors, banks and regulators had been swept up by the apparent success of modern finance. When investors realised that many of the assets that banks held on their balance sheets were opaque and hard to value, there was immediate and justifiable concern about the solvency of many of those banks.

At the end of 2008, these two fundamental factors culminated in the worst financial crisis in history. In the six months after Lehman Brothers collapsed world trade fell by nearly 20% – a faster decline than in the Great Depression. Around the world, the same telling phrase was repeated: economic activity was "falling off a cliff". In its statement to the London G20 summit in April 2009, the international trade union movement argued that "The first priority for G20 leaders must be to restore confidence by halting the freefall in world growth". That has been achieved. World output grew by 4% over the past year. And in the United Kingdom, growth has been somewhat faster than anticipated a year ago. Nevertheless, total UK output remains around 10% below where it would have been had the crisis not occurred.

So how do we prevent this happening again? If we are to prevent another crisis, action is required on both of the fundamental causes. First, we need to resolve the problems caused by massive capital flows from poor to rich countries. Yet the imbalances are growing again. This problem can be tackled only by international cooperation – most obviously through the G20 – and I hope that the trade union movement will continue to engage with that process.

Second, our financial system needs radical reform. Slowly but surely, we must move towards a banking system that does not put both the economy and your members' livelihoods at risk. In the long run, banks will have to hold much more capital and be much less highly leveraged. Part of the answer is improving the way we regulate banks, and devising policy tools to control the risks taken by the financial system as a whole. The aim should not be to prevent all bank failures. Just as with every other company in the economy, banks that get it wrong must be allowed to fail, without risk to ordinary depositors or taxpayers. In 2008, banks were bailed out not to protect them but to protect the rest of the economy from the banks. That may not seem fair – and it isn't – when other companies, such as Jaguar, had to stand on their own feet or go to the wall. So banks too must face market discipline.

But we need to do more than reform our banking system. If the world economy needs rebalancing, so does our own. The substantial trade deficit over a number of years means that national spending exceeded production. We need a higher national saving rate, a shift in spending and production away from consumption and towards exports. And a key part of that is a reduction in our budget deficit.

There is a perfectly reasonable debate about the precise speed at which to reduce the deficit. Indeed, I supported the extra fiscal stimulus to the economy provided in the immediate wake of the crisis. And there is a further question about how the deficit should be reduced – the balance between raising taxes and cutting spending. That is not for me to say; that is for you and the politicians to debate. But it is indisputable that, because of the crisis, national income is 10% lower than was expected with a damaging impact on tax revenues. As a result, this country has the largest peacetime budget deficit in its history – over 11% of GDP in the fiscal year to 2010. Although a large budget deficit is inevitable for a period after a crisis, it is also clearly unsustainable – our national debt, even relative to GDP, is rising sharply and will continue to do so for several years. It is vital for any government to set out and commit to a clear and credible plan for reducing the deficit. I would be shirking my responsibilities if I did not explain to you the risks of failing to do so.

Vague promises would not have been enough. Market reaction to rising sovereign debt can turn quickly from benign to malign, as we saw in the euro area earlier this year. It is not sensible to risk a damaging rise in long-term interest rates that would make investment and the cost of mortgages more expensive. The current plan is to reduce the deficit steadily over five years – a more gradual fiscal tightening than in some other countries. As a result of a failure to put such a plan in place sooner, some euro-area countries have found – to their cost – a much more rapid adjustment being forced upon them.

Of course, no one can forecast the gusts – or indeed storms – the economy may face looking ahead. But if the recovery is slower than expected then the automatic fiscal stabilisers – the lower tax receipts and higher spending that result from weaker growth – will act to stimulate demand. And monetary policy can react too, especially when there is a credible plan to reduce the deficit.

In the wake of the worst financial crisis ever, the amount of money in our economy – broad money – is now barely growing at all. It was the failure in the 1930s to halt a marked contraction in the money supply that led to the Great Depression. So the Bank of England has taken extraordinary measures – described as "quantitative easing" – to boost the supply of money in order to support a recovery in the economy and keep inflation on track to meet our target. And because monetary policy is a flexible instrument that can be changed in either direction each month, it is the best tool for managing the economy in the short run.

Nevertheless, the road ahead is unlikely to be straight. There is considerable uncertainty about the prospects for both the United States and the euro area – our most important export markets. Business and consumer confidence at home has weakened recently, and it will be some time before our banking sector is able to finance a recovery on the usual terms. The transition to a better balanced economy will be difficult. But we are already seeing encouraging signs of expansion in manufacturing and UK exports.

This morning's figures show a small rise in the claimant count and a small fall in the Labour Force Survey measures of unemployment. But the big picture is that unemployment is higher than before the crisis but lower than many had feared a year ago. In July, on one of my regular visits to different parts of the country, I met with the Scottish TUC in Glasgow to learn more about the labour market there. Our contacts with experienced union officials in touch with a range of companies and sectors are the best source of intelligence on labour markets. With your help, we are determined to understand what is happening in every region and country of our economy so that we can set the right monetary policy. I want to assure you that the Bank of England is there to serve the whole economy, right across the length and breadth of this country.

The costs of this crisis will be with us for a generation. And we owe it to the next generation to seize this opportunity to put in place the reforms that will make another crisis much less likely and much less damaging. We at the Bank of England and you in the trade union movement should work together. That is why I am pleased to be with you today. It will require patience and determination on all our parts, including your members. But the prize of restoring and maintaining economic stability – and a return to sustained rises in employment and living standards – will be worth the effort.