Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, to the Institute of Directors, St George's Hall, Liverpool, 18 October 2011.

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Mr Chairman, Ladies and Gentlemen,

Surrounded by the magnificent architecture of St George's Hall, we are reminded of the benefits and the costs of exposure to the world economy. Built at the peak of Liverpool's mercantile fortunes, the Hall, and the other magnificent buildings of the cultural quarter, exhibit the prosperity derived from openness to trade. Indeed, tonight is the anniversary of a grand banquet held here on 18th October 1860 to celebrate the opening of the public library and museum building that stands opposite. Its construction had been financed by the guest of honour at the banquet that evening, William Brown, whose statue stands in the Hall today. Brown had profited from transatlantic trade both as a merchant and by establishing a bank which financed trade – at the time a risky business. In those days, finance and trade supported each other, and the city prospered. But the subsequent history of St George's Hall, which fell into neglect in the last century, illustrates Liverpool's vulnerability to changes in the rest of the world.

The British economy too has enjoyed the benefits of globalisation. Now we are seeing some of the costs, as they play out in a global financial crisis. As a country, we are trying to rebalance our economy at a time when a global slowdown, and concerns about the solvency of European banks and sovereigns, threaten recovery here in the United Kingdom.

Two weeks ago, the Monetary Policy Committee (MPC) decided to resume its asset purchase programme and create new money. Before I set out the reasons for that decision, I want to explain why the global nature of the crisis means that monetary and fiscal policy in the United Kingdom can only do so much. Our fate rests to a considerable extent on the policies pursued by our trading partners. That is why the Chancellor and I put such weight on this interdependence among the major economies at last weekend's G20 Meetings in Paris. Countries have responsibilities to each other, and we need to work with our partners overseas to find a solution to present problems.

Four years into the crisis it is surely time to accept that the underlying problem is one of solvency not liquidity – solvency of banks and solvency of countries. Of course, the provision of additional liquidity support to countries or institutions in trouble can buy valuable time. But that time will prove valuable only if it is used to tackle the underlying problem.

After the crisis began, it took a year before governments in Europe and the United States were persuaded that the problems of their banking sectors resulted not from a shortage of liquidity – that was merely the symptom – but from massively over-leveraged balance sheets. Eventually, in October 2008, banks were recapitalised, albeit, especially on the Continent, inadequately so. But the underlying problems of excessive debt have not gone away. As a result, markets are now posing new questions about the solvency of banks, and indeed of governments themselves.

What were the causes of the unsustainable build-up of debt in Europe and elsewhere? They lay in the continuing imbalance between those economies running large current account surpluses and those running large current account deficits. Persistent trade surpluses in some countries and deficits in others did not reflect a flow of capital to countries with profitable investment opportunities, but to countries that borrowed to finance consumption or had lost competitiveness. The result was unsustainably high levels of consumption (whether public or private) in the United States, United Kingdom and a range of other advanced economies, and unsustainably low levels of consumption in China and other economies in Asia, and some advanced economies with persistent trade surpluses, such as Germany and

Japan. The burden of debt will go on rising in the former group of countries until these spending patterns adjust and the latter group will find their loans eventually repaid in depreciated currencies, if at all. Surplus countries, a group which includes three of the world's largest four economies, share a major responsibility to respond to our present dilemma by expanding domestic demand. By importing more they would provide deficit countries with the wherewithal to export and service debt repayments.

When the crisis hit, the starting point was the need for a substantial rebalancing of demand and a repayment of debt. In the deficit economies, there was an inevitable tension between the short run need to stimulate demand to prevent rising unemployment and falling inflation, and the long run need to rebalance demand and reduce indebtedness. In January 2009, I described this as "the paradox of policy … almost any policy measure that is desirable now appears diametrically opposite to the direction in which we need to go in the long term". The almost intractable challenge facing policy-makers is how to balance those short-run and long-run considerations. There is a long journey ahead before the world economy returns to a sustainable equilibrium, involving rebalancing and a reduction of debt burdens. For the time being, a significant degree of policy stimulus is appropriate to support demand. But that will delay and exacerbate the size of the adjustment ultimately required.

It is hard to imagine a solution that does not involve actions in more than one country. In 2008–09, it was easy to coordinate international action in the G20 economies. In the face of a collapse in world trade even faster than that in the 1930s, countries needed no persuasion of the necessity of policy stimulus. But it has proved much harder to form a consensus on how to tackle the underlying problems. So, three years later, the imbalances in demand remain. Around the world, short-run stimulus packages of various kinds, and unsustainably low interest rates, have bought time. So far that time has not been used to deal with the underlying imbalances, or the weaknesses in bank and sovereign balance sheets. Four years after the financial crisis began, the foreign exchange reserve holdings of China are substantially larger than at the onset of the crisis. Markets now realise that before the crisis banks were seriously undercapitalised and so react in a volatile way to any news about the health of the banking system. And the indebtedness of governments around the world is certainly greater. Time is running out.

So what is to be done? One way or another, domestic spending must be raised in the surplus countries and lowered in the deficit countries, relative to current trends. In the past, market-determined exchange rates have played an important role in rebalancing world demand and trade. Exchange rates are the natural safety valve, which can limit the extent of imbalances in demand across countries. Governments in the G7 agreed that intervention in the currency markets should be undertaken only when there was a collective view that exchange rates had become out of line with their longer run fundamental values. That reticence served us well. But over the past two decades, some governments, particularly in Asia and the euro area, have tried to fix exchange rates without putting in place mechanisms to ensure that competitiveness could be rebalanced by other means. That has contributed significantly to the problems facing us.

It is crucial to the health of the world economy that we find ways of allowing competitiveness to adjust so that trade imbalances, and hence the present scale of indebtedness, can be reduced. Neither liquidity nor austerity are answers to the question of how to restore a loss of competitiveness.

Dealing with these structural issues will take time. Meanwhile, how do we resolve the immediate crisis of confidence in some banks and sovereigns? Since the summer, there have been renewed concerns about the adequacy of the capital of banks in the euro area to absorb likely future losses, thus jeopardising their ability to raise funds. Wholesale funding dried up for many banks over the summer, and share prices of European banks are around 35% lower today than at the start of July. A transparent recognition of losses and a substantial injection of additional capital are necessary to restore market confidence. On its own, however, such a policy will raise difficult political questions about the capacity of the weaker sovereigns to pay for any recapitalisation of their banks. Bank and sovereign solvency concerns are inextricably intertwined. In the end, the underlying solvency concerns require countries to adopt compatible policies so that they can credibly service their internal and external debts.

What does this mean for our own economy? Our objective must be to steer the UK economy slowly back to a position of more normal interest rates and lower budget deficits. With a lower level of sterling and a credible plan to reduce the fiscal deficit over the medium term, we were on track. But the problems in the euro area and the marked slowing in the world economy have lengthened the period over which a return to normality is likely.

2011 has been the year of the reluctant recovery. Growth has disappointed, both here and abroad. Business and consumer confidence have fallen sharply, not only at home but also elsewhere in Europe and the United States. And the level of world trade in goods has stagnated.

A slowing of the world economy, especially in the euro area, is a threat to our strategy of rebalancing and recovery of the UK economy. Despite the more competitive level of sterling, the recovery in our trade position is at risk of stalling. It is not surprising, therefore, that although unemployment has been broadly stable over the past two years at around 2½ million, a rate of about 8%, it has risen in recent months, especially among young people. And total output remains around 4½% below its peak three years ago.

Despite depressed levels of activity, inflation has been well above our 2% target. This morning's confirmation that CPI inflation rose to 5.2% in September was in line with the expectations of the MPC at the time of our August *Inflation Report*. That is likely to be at, or close to, the peak, and we expect inflation now to start to fall back, as it did in the months following the peak in inflation in September 2008. Nevertheless, it will seem odd to many that at a time of high and rising inflation, the MPC has eased policy further. So let me explain why the Committee considered it necessary two weeks ago to resume its programme of asset purchases.

In contrast to headline inflation, domestically generated inflation remains subdued – and on some measures barely above zero. Increases in energy prices, import prices and VAT account for the current high level of inflation. Once the effect of these temporary factors begins to dissipate, inflation should fall back sharply early next year. A persistent margin of spare capacity in the economy, and the recent deterioration in demand prospects linked to the crisis in financial markets, will add to the downward pressure on inflation in the medium term. So it is the outlook for inflation, rather than its current rate, which explains the MPC's decision to resume asset purchases.

Asset purchases work by increasing the amount of money in the economy. When the Bank buys assets, the people who sell the assets to us receive money which can then be used to buy other assets. In turn, the sellers become buyers of other assets, and so on indefinitely as the money is transferred from one account to another. The prices of assets that investors choose to buy go up, raising wealth and pushing down on yields. Those yields are the opposite side of the coin to the borrowing costs of companies. In these ways, the Bank's purchases of assets increase demand in the economy.

Some of you have asked why the MPC has focused largely on purchases of gilts, rather than securities issued by companies. The answer is three-fold. First, gilts are the only asset available in sufficient quantity such that the Bank can rapidly inject large amounts of money into the economy – £75 billion in the present case. Second, we have bought, and continue to buy, corporate securities, but this was designed to ensure that the corporate bond market functioned normally with the Bank acting as a temporary market-maker in a dysfunctional but previously liquid market. We were able to achieve that objective without the expenditure of large sums of money – unnecessary given the size of the market. Third, the Bank should not take decisions that discriminate between different companies and sectors. There may well be good reasons for discriminating in some circumstances but that is a decision properly reserved to elected politicians. By buying gilts we leave the private sector to decide in which directions the money we create should percolate through the economy.

Any positive impact of asset purchases will benefit all companies, large and small, through its impact on overall demand. Our programme of gilt purchases has helped large companies to reduce their reliance on the banking system and obtain finance directly from equity and corporate bond markets. In fact, the majority of Britain's largest companies can borrow more cheaply in capital markets than the average of the largest six banks.

Smaller and medium-sized companies (SMEs), however, are constrained to borrow through the banking system. And there is special concern about their ability to obtain credit – I share that concern based on my experience of meeting many such firms during visits to all parts of the United Kingdom and hearing reports from the Bank's regional agents. We have made this point repeatedly at hearings of the Treasury Committee in Parliament. Over the past year the stock of SME borrowing has shrunk by around £5 billion or 5%. By far the most effective way of helping SMEs quickly would be to provide incentives for lending by existing banks because they can assess credit risk in a way that no other institution could do in the immediate future. Bank and Treasury officials are working together on such ideas. In the end, however, the shape and parameters of any scheme will be, and properly so, determined by the Government.

Let me sum up. From the very beginning of the global crisis there has been a reluctance by governments to face up to the underlying solvency problems generated by apparently unending trade deficits with no mechanism, whether flexible exchange rates or some other means, for correcting these disequilibria. Those solvency problems have shown up on country and bank balance sheets. The initial reaction has always been to provide liquidity: through central banks or an extension of official lending by governments. Providing liquidity to buy time to devise and put in place a coherent response to the underlying problem can be not only valuable but necessary. But liquidity can never be the answer in itself. And if the time bought is not used then the size of the debt problem becomes larger and its cost is gradually transferred from private sector creditors to taxpayers.

The main impediment to the strategy of rebalancing our economy is markedly slower growth in our major export markets, especially in the rest of Europe. That is why we are treading a fine line between stimulus to demand in the short run, and a rebalancing away from private and public consumption towards exports and import substitution in the longer run. Without monetary stimulus – low interest rates and large asset purchases – there is a risk that growth will stall and inflation fall below our symmetric 2% target. But easy monetary policy, by bringing forward spending from the future to the present, means that the ultimate adjustment of borrowing and spending will be even greater. That is our dilemma, and that of other deficit countries. The best way to escape this dilemma would be higher spending by the surplus countries – to make possible rebalancing by the deficit countries – and supply-side reforms in the deficit countries – to raise expected future incomes and ease the burden of debt repayments. Each country can put itself in a position to rebalance, as we have done in the UK. But in the absence of rebalancing, globally and especially in the euro area, we could be facing a recovery that is not merely reluctant but recalcitrant.

Just as St. George's Hall was reconstructed to meet the needs of Liverpool in the twenty-first century, so the international financial system must be reconstructed to ensure a return to prosperity. We can be optimistic – the fundamentals of the UK economy are strong. But without a rebalancing of spending in the world economy, a struggle between debtor and creditor countries will inflict economic pain on everyone. We must use the gravity of the global crisis to provoke a bold response. We acted together in 2009; we can do so again.