Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, on the 2012 BBC Today Programme Lecture, London, 2 May 2012.

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Fifty years of rising living standards came to an end with the financial crisis. As a nation, we are now significantly worse off than we were four years ago. The crisis has cast a long shadow. Of course, the immediate challenge is to get our economy growing again. But fifty years from now will our grandchildren ask why we lacked the courage to put in place reforms to stop a crisis happening again? I hope not – and that's why I want to speak to you tonight about the changes we need to make.

Believe it or not, it's more than seventy years since the Governor of the Bank of England last gave a talk on radio in peacetime. In March 1939, Montagu Norman spoke to the BBC in the wake of the economic slump that we now call the Great Depression. Just listen for a moment to the 1930s version of Evan Davis introducing the broadcast:

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> *"The Rt Honourable Montagu Norman, Governor of the Bank of England, speaking in the Empire Series on the City of London."*

More the presenter of "yesterday" than "today"!

In those days, the Bank of England, known affectionately as the "Old Lady of Threadneedle Street", was a private bank performing the role of a central bank only by custom and practice. Here is how Norman described the relationship between the Bank of England and the Government in the 1930s:

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> *"The Bank of England has always been constitutionally a private body... but what matters is not the position on paper but the position in practice. In monetary as in other matters the Government of the day must have the final word and this is fully recognised."*

Today, the position on paper and the position in practice are the same. Our job is given to us by the Government and by Parliament.

But for me, the story of the modern independent Bank of England began exactly fifteen years ago in early May 1997. It was a Bank Holiday Monday, immediately following the general election. After an early morning tennis match, I returned home to find a message from the Governor, Eddie George. He wanted to meet me in the Bank as soon as possible. An hour later we met in his office, alone in the imposing building known to most of you only by the facade shown on television. Eddie told me of his meeting that morning with the Chancellor, Gordon Brown, who had explained the proposal for Bank independence. It was something for which Eddie and I had worked for five years since Britain's departure from the Exchange Rate Mechanism in 1992. Now we had a chance to show what an independent central bank could do. Although far from clear at the time, the later decision to remove from the Bank of England the power to regulate banks would return to haunt us.

Over the next decade, the new Monetary Policy Committee established a track record of low and remarkably stable inflation. In my first speech as Governor in 2003, I warned that this stability was unlikely to continue. And it didn't. Within a few years, and despite low inflation, the advanced economies of the world were plunged into a financial crisis which led to the sharpest decline in world trade since the 1930s, recessions across the world, rising unemployment and the near collapse of our banking system.

So tonight I want to try to answer three questions. ***First***, what went wrong? ***Second***, what are the lessons? ***Third***, what needs to change?

Let me start by pointing out what did ***not*** go wrong. In the five years before the onset of the crisis, across the industrialised world growth was steady and both unemployment and inflation were low and stable. Whether in this country, the United States or Europe, there was no unsustainable boom like that seen in the 1980s; this was a bust without a boom.

So what was the problem? In a nutshell, our banking and financial system overextended itself. That left it fragile and vulnerable to a sudden loss of confidence.

The most obvious symptom was that banks were lending too much. Strikingly, most of that increase in lending wasn't to families or businesses, but to other parts of the financial system. To finance this, banks were borrowing large amounts themselves. And this was their Achilles' heel. By the end of 2006, some banks had borrowed as much as £50 for every pound provided by their own shareholders. So even a small piece of bad news about the value of its assets would wipe out much of a bank's capital, and leave depositors scurrying for the door. What made the situation worse was that the fortunes of banks had become closely tied together through transactions in complex and obscure financial instruments. So it was difficult to know which banks were safe and which weren't. The result was an increasingly fragile banking system.

So how did banks find themselves in such a precarious position? Banks are a vital part of our economy. They run the payment system, allowing us to pay our bills and receive our wages. They finance businesses investing in new ventures and families buying a new home. Without a banking system our economy would grind to a halt. Because of that, markets correctly believed that no government could let a bank fail since that would cause immense disruption to the economy. This meant that large banks in particular benefited from an implicit taxpayer guarantee, enabling them to borrow cheaply to finance their lending. In good times, banks took the benefits for their employees and shareholders, while in bad times the taxpayer bore the costs. For the banks, it was a case of heads I win, tails you – the taxpayer – lose.

This cheap funding fuelled lending. Banks got bigger. In the UK, their balance sheets rose from around one-half to more than five times our national income in a generation. As the banks got bigger, so did the implicit subsidy – by the time of the crisis it reached many billions of pounds a year. The bigger banks became, the more they were seen as too important to fail, and the surer markets became that the taxpayer would bail them out. But there are only so many good loans and investments to be made. In order to expand, banks made increasingly risky investments. To make matters worse, they started making huge bets with each other on whether loans that had already been made would be repaid. The seeds of the eventual downfall of the financial system had been sown. As loans and investments went bad, those seeds started to sprout.

In August 2007 came the moment when financial markets began to realise that the emperor had no clothes. The announcement by the French bank BNP Paribas that it would suspend repayments from two of its investment funds triggered a loss of confidence and a freezing of some capital markets. A month later, the crisis claimed its first victim when Northern Rock failed. In the months that followed, there was a steady procession of banking failures culminating in the collapse of the American bank Lehman Brothers in September 2008. Financial waters, already extremely chilly, then froze solid. Banks found it almost impossible to finance themselves because no-one knew which banks were safe and which weren't.

From the start of the crisis, central banks provided emergency loans but these amounted to little more than holding a sheet in front of the emperor to conceal the nakedness of the banks. They didn't solve the underlying problem – banks needed not loans but injections of shareholders' capital in order to be able to absorb losses from the risky investments they had made. From the beginning of 2008, we at the Bank of England began to argue that UK banks needed extra capital – a lot of extra capital, possibly £100 billion or more. It wasn't a popular message. But nine months later, market pressure forced banks to raise new capital or accept it from the state. UK tax payers ended up owning large portions of two of our four biggest banks, Royal Bank of Scotland and Lloyds TSB, but almost all banks would have failed had not taxpayer support been extended. That bold action in October 2008 could have happened sooner. But the most important thing is that it was done. And the policy of recapitalising the banks was soon copied by other countries.

Bailing out the banks came too late though to prevent the financial crisis from spilling over into the world economy. The realisation of the true state of the banking system led to a collapse of confidence around the world and a deep global recession. Over 25 million jobs disappeared worldwide. And unemployment in Britain rose by over a million. To many of you this will seem deeply unfair, and it is. I can understand why so many people are angry.

It's vital that we learn from the crisis. A good place to start is to ask, as the Queen famously did, "Why did no-one see this coming?" The answer is extremely simple: no-one believed it could happen. Recessions were supposed to follow booms and high inflation, not periods of steady and sustainable growth with low inflation. There seemed to be no reason to expect the worst recession since the 1930s. After the ravages of inflation in the 1970s – younger listeners might need to be reminded that inflation hit 27% in 1975 – it was I think understandable that we focussed on the need to bring inflation down. But conquering inflation was not enough to ensure stability. Although inflation was under control, fragilities were building in the banking system. On all sides there was a failure of imagination to appreciate the scale of the fragilities and their potential consequences. No-one could quite bring themselves to believe that in our modern financial system the biggest banks in the world could fall over. But they did.

That isn't to say we were blind to what was going on. For several years, central banks, including the Bank of England, had warned that financial markets were underestimating risks. So why, you might ask, did the Bank of England not do more to prevent the disaster? We should have. But the power to regulate banks had been taken away from us in 1997. Our power was limited to that of publishing reports and preaching sermons. And we did preach sermons about the risks. But we didn't imagine the scale of the disaster that would occur when the risks crystallised. With the benefit of hindsight, we should have shouted from the rooftops that a system had been built in which banks were too important to fail, that banks had grown too quickly and borrowed too much, and that so-called "light-touch" regulation hadn't prevented any of this. And in the crisis, we tried, but should have tried harder, to persuade everyone of the need to recapitalise the banks sooner and by more. We should have preached that the lessons of history were being forgotten – because banking crises have happened before.

In the 1930s, the Great Depression saw a collapse of the banking system in the United States. So severe was it that President Franklin Roosevelt, only a week after his inauguration in March 1933, announced a bank holiday shutting the banks to provide a breathing space so that confidence could be restored. Here he is, in his first fireside chat, explaining banking to the American people:

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> *"My friends I want to talk for a few minutes with the people of the United States about banking… We have had a bad banking situation. Some of our bankers have shown themselves either incompetent or dishonest in their handling of the people's funds. They had used some money entrusted to them in speculation and unwise loans. This was of course not true in the vast majority of our banks but it was true in enough of them to shock the people of the United States for a time into a sense of insecurity and to put them in a frame of mind where they did not differentiate but seemed to assume that an act of a comparative few had tainted them all. And so it became the government's job to straighten out this situation and to do it as quickly as possible and that job is being performed."*

We too have had a “bad banking situation”. Roosevelt showed bold and decisive political leadership in explaining to his listeners the reasons why they should not fear banks but trust their Government to ensure that the economy could be saved from the bank failures that had led to the Great Depression.

For the sake of future generations, we too must be bold and decisive and, while the memory is fresh, learn the lessons from this crisis. Reform is essential.

Three reforms top my list. The first concerns ***regulation*** of banks. Next year, the responsibility for regulating banks will return to the Bank of England.

Next time we find ourselves with steady growth and low inflation, but with risks building in the financial sector, we shall be able to do something about it. The Bank’s new Financial Policy Committee will have the power to step in and prevent a hangover by taking away the punchbowl just as the party in the financial system is getting going.

We believe that successful regulation means understanding and guarding against the big risks, not compliance with ever more detailed rules. That means focussing on the wood not the trees, looking not just at individual banks but also at how their fortunes are tied together with other banks and with the rest of the economy. For example, the biggest risk to banks at present stems from the troubles in the euro area. These are far from over. That’s why we’ve been pushing banks to pay out less to their shareholders and employees and instead retain profits as a cushion against possible losses.

In future, to protect the rest of the economy from failures in the banking system, we need to ensure that more of banks’ shareholders’ own money is on the line, and banks rely correspondingly less on debt. If banks and their shareholders have more to lose, they will be more careful in choosing to whom they lend. And, when banks make losses, there is more of a cushion before the bank fails, and less chance that the taxpayer will have to foot the bill.

Nevertheless, bank failures will happen from time to time – indeed failure is part and parcel of a prosperous market economy. So the second reform on my list aims to make sure badly run banks can fail safely – that is, without causing damage to ordinary depositors and the rest of the economy, and without billing the taxpayer. That requires a special legal framework to allow a failing bank to continue to provide its essential services while its finances are being sorted out. Such a framework is called a ***resolution*** mechanism. It’s precisely what was lacking when Northern Rock failed in 2007, leaving nationalisation as the only alternative. That painful lesson has been learnt, and the 2009 Banking Act introduced a resolution mechanism in Britain for the first time. But that won’t work for big global banks with operations around the world. So there is much more to do.

The third reform is to ***restructure*** the banking system. In so doing we must recognise the crucial distinction between essential banking services to people like you and me, on the one hand, and complex and potentially risky trading activities, on the other. We don’t build nuclear power stations in densely populated areas; nor should we allow essential banking services and risky investment banking activities to be carried out in the same “too important to fail” bank. Last autumn, the Independent Commission on Banking, chaired by Sir John Vickers and comprising some of our most brilliant bankers and economists, published recommendations on how to do this. It’s vital that Parliament legislates to enact these proposals sooner rather than later.

Regulation, resolution and restructuring of the banks are the three Rs of a new approach to make banking, and so our economy, safer.

The three Rs will be central to the work of the Bank of England. And all of that will come on top of our responsibility for monetary policy to reduce inflation while supporting a gradual recovery of our battered economy. It’s the biggest challenge the Bank has faced for decades.

We are up to the task. Already we see vested interests rise up to defend their bonuses and profits. But, as an independent central bank with over three centuries of history, we can resist those short-term pressures and take the longer view needed to prevent another crisis.

Independence is, however, not the discretion to do as you wish, but the exercise of specific powers delegated to us by Parliament to meet a remit set by Parliament. So with independence come the responsibilities of transparency and accountability. Back in 1997, with independence to set interest rates, we revolutionised the openness of monetary policy. Our decisions, deliberations and even the disagreements within the Monetary Policy Committee are open to public scrutiny. I want to build on that track record to do the same for our new tasks because in everything the Bank does, I and my colleagues are conscious that we are accountable to you.

The Bank of England has changed radically since that Bank Holiday Monday in 1997 when Eddie George and I sat in the Bank contemplating our new role, unaware of the roller coaster ride on which we were about to embark. The Bank will change again next year with its new responsibilities. But some things don't change. Here again is Mr. Montagu Norman:

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> *"I would sum up the vital characteristics of the Bank as experience in affairs, cooperation on all sides, independence of judgement. But you know these three things – experience, cooperation, independence – are no good unless people have confidence in you. I like to believe that the Bank, with its long history and tradition, stands high in public esteem. But only by service to the community can that esteem be maintained through times good and bad.*"

That's true not just for Montagu Norman's day, but for today too.

The present crisis is far from over, as events in the euro area illustrate weekly. Our own economy is still not back to health. Although inflation has fallen back in recent months, it is still too high. And despite efforts to stimulate the economy, the recovery is proving slower than we had hoped. It will come. But dealing with the consequences of our "bad banking situation" is likely to be a long, slow process.

Just as, if not more, important, in my view, is to look further to the future, to the economic possibilities for our grandchildren. To give them the prospect of economic stability, we must reform the three Rs of our financial system. We have an historic opportunity, and a duty, to do that.

The day-to-day tasks of controlling inflation and curbing the excesses of the financial system will fall to the Bank of England. When, as it will, the economy returns to normal, our role will be to take away the punchbowl just as the next party is getting going. That won't make us popular among bankers, politicians and even at times some of you, and it's not supposed to. But it will, I hope, reflect the trust and confidence that the citizens of this country can place in the Old Lady of Threadneedle Street.