Mervyn King: A Governor looks back – and forward

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, 19 June 2013.

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My Lord Mayor, Ladies and Gentlemen:

Chancellor: thank you for those generous words. It has been a privilege to work with you over the past three years, a period of great change both at home and abroad. Your support for the Bank has been much appreciated at this end of town, and you have changed for the better the regulatory framework that oversees the City. But we both know that the past few years would have been much more difficult without the continual support of two people. And I am so pleased that both Frances and Barbara are with us tonight. And I'm particularly happy, George, that neither you nor I have to speak after either of them because experience suggests that we would suffer from the comparison.

Lord Mayor: let me thank you too for presiding over my final Mansion House Dinner. We have enjoyed many musical evenings together, and Barbara and I look forward to sharing many more with you and Clare after you shed the chains of office later this year. The City has been extremely fortunate to benefit from your energy, drive and can-do attitude as Lord Mayor.

I shall not detain you this evening with a retrospective examination of my time as Governor. Suffice it to say that it was a game of two halves. And, far from a boring goalless draw, it turned out to be a rather exciting and dramatic game, full of incident, with a red card or two and a passionate and at times justifiably angry crowd. We shall have to wait for the historians of tomorrow to file the full match report.

Instead, tonight I want to focus on the twin challenges of engineering a recovery and reforming the financial system. I want to look back on the huge amount that has been done, and look forward to the unfinished business on both fronts, much of it for the Bank of England. I shall also tell you a story about the Governor of the Bank of England, the Governor of the Bank of Canada and a certain Mr Osborne. But that comes later.

Since 2008, the Bank's Monetary Policy Committee has gone to extraordinary lengths to stabilise the economy and support growth and employment. In fact, we have pursued what I have called the "paradox of policy": doing in the short run, by encouraging spending through an unprecedentedly loose monetary policy, the opposite of what we need to do in the long run, which is to raise national saving. But that has been necessary to prevent an even worse recession, and without similar action from other central banks the world might have experienced a major depression.

Now there are clear signs that a recovery in the UK, albeit modest, is underway. From the beginning of this year, business surveys have improved, broad money growth has stabilised at around 5% a year, and the housing market is picking up. Despite this encouraging picture, growth is not yet strong enough to reduce the considerable margin of spare capacity in the economy. Nor is recovery at an adequate rate fully assured. The weakness of the euro area and the problems of the UK banking system continue to act as a drag on growth. So the need to support the recovery remains.

Of course we must be mindful of the risks from injecting more money into the economy. We cannot afford to return to the inflationary episodes of the past. In the two decades before inflation targeting was introduced in 1992, inflation averaged almost 10% a year. The purpose of inflation targeting was to change the way in which interest rate decisions were made and to build credibility in the UK's commitment to price stability. Over the following two decades, CPI inflation averaged only a fraction above 2%. Today, inflation is above the 2% target – as it has been for most of the past five years. But our economy has had to absorb an oil price shock on a par with that of the 1970s, as well as a sharp depreciation of sterling. And yet there are few signs of domestically generated inflation, which has remained close to 2%.[1] Pay rises and underlying inflationary pressure are low, and the medium-term outlook is for inflation to fall back to the target. Inflation targeting achieved its objective.

The greater risk at present is that, over the next few years, unemployment remains unnecessarily high. We must not forget that one million more people are out of work than in the five years before the crisis. It is too soon to say the job of securing recovery is complete. There is a powerful case for more stimulus in the short run.

The present extraordinary monetary policies cannot, however, continue indefinitely. Both nominal and real interest rates are at unsustainably low levels. There is an understandable yearning for a return to normality. And in recent weeks bond yields have risen – up around 45 basis points since the start of May. But such market moves should not be confused with a return to normality.

A rapid return to higher interest rates would do great damage to the balance sheets of highly indebted households, companies and, especially, financial institutions. The challenge in returning to normality is not so much managing market expectations when that eventually happens, important though that is, but in creating the economic conditions in which it is sensible to return to more normal levels of interest rates. The real challenge – on a global scale – is to rebalance the world economy so that very low interest rates are not required to exhort deficit countries to spend in order to absorb the surpluses elsewhere.

Monetary policy cannot provide the answer. It can only buy time to bring about the necessary structural changes in investment, trade and capital flows. Whether they involve changes in currency values or restructuring of debt is a political choice, but a failure to deal with global imbalances will not only retard the recovery in the world as a whole, but worsen the scale of the adjustment ultimately needed. It will inevitably be a bumpy ride.

The other obstacle to a return to normality is our banking system where, despite the generous provision of liquidity and funding from the State, lending remains lacklustre, and risk premia high. Although the combined balance sheet of our largest banks has shrunk since the height of the crisis in 2008, it is still 400% of annual GDP. Leverage ratios have fallen, but all our major banks remain highly leveraged. And of course the two biggest lenders to the domestic economy remain largely in state ownership. It is difficult to imagine a banking sector like that making a real contribution to any economic recovery. It must be time for decisive action.

Chancellor, you have made clear tonight that you embrace that view. Britain needs a thriving banking system to serve households and businesses, and Lloyds and RBS will be able to play that role to the full only when back in the private sector. I welcome your announcement that Lloyds Banking Group will be returned to private hands soon. And I very much support your plans for a full review of the future structure of RBS.

The return of banking supervision to the Bank of England has also seen decisive actions. The Financial Policy Committee (FPC) and the new Prudential Regulation Authority (PRA) have acted quickly to make our banking system more resilient. In March, the FPC recommended that banks' capital should be assessed using more prudent estimates of expected losses and risk weights. Since April, the Board of the PRA has been making those assessments and asking banks to take action to deal with any shortfall of capital. That work is now complete, the banks know the results, and tomorrow we will publish them for each of the major banks. In total, the eight largest banks have a capital shortfall of around £25bn relative to the standard recommended by the FPC. After this exercise, our major banks all now have plans for actions to fill that shortfall. The first evidence is the announcement on

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1 As measured by the rate of increase in the GDP deflator.

Monday by the Co-operative Bank. Others will follow. By taking firm pre-emptive action, we have shown what the new judgement-led approach to supervision means in practice. It substitutes substance for process and judgement for box-ticking. We need not more but better regulation and, just as with monetary policy, we have changed the way regulatory decisions are made.

The PRA announcement tomorrow is another step in dealing with the legacy of the past. It will make our banking system more resilient and better able to support recovery. But it is too soon to say that the job is done. Many of our major lenders will still be highly levered. The levels of capital required by the Vickers reforms, on the one hand, and the Basel standards for large international banks, on the other, mean that there is clearly some way to go before we can claim to have a really well-capitalised banking system.

In future, the FPC and the PRA will work together to conduct regular stress tests of our banks, starting in 2014. Those stress tests will I am sure be made public, and banks will be expected to set out their plans for making up any identified shortfall in capital. Managing this process, and the transition to a higher level of capital, will be key tasks for the FPC and PRA in the coming years.

Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending. That is why some of our weaker banks are shrinking their balance sheets. Capital supports lending and provides resilience. And, without a resilient banking system, it will be difficult to sustain a recovery.

Although higher capital does not restrict lending, requirements to hold more liquid assets do. Every pound of additional holdings of liquid assets is a pound that could otherwise be lent to the real economy. That is why the Bank has stood ready, through the Special Liquidity Scheme, its new Discount Window Facility, through its market operations (including the ECTR) and through its Funding for Lending Scheme, to provide a backstop for the liquidity needs of the banking system – against adequate collateral and at an appropriate interest rate. Given that backstop, the FPC has over the past year been recommending that regulatory requirements to hold liquid assets should be loosened.

The Bank's provision of liquidity to the banking system has been transformed out of all recognition in the past six years. But here too there is unfinished business. We asked Bill Winters to review our system and make recommendations for further changes. We have reviewed his proposals and will soon be taking steps to expand our regular auctions to a wider pool of collateral and to make our Discount Window Facility both cheaper and more easily accessible.

All these policy actions have and will put our economy in position for a recovery.

But we must also ensure that our financial system is truly reformed in a way that reflects the lessons of the financial crisis. At this Dinner six years ago, before the crisis began, I said, "Excessive leverage is the common theme of many financial crises of the past. Are we really so much cleverer than the financiers of the past?" We are all much wiser now. And this country can claim to have been in the vanguard in learning lessons. Much has been done. But we cannot be complacent. As the memories of the crisis fade, and those who saw it at first hand retire, it is vital that the 'audacity of pessimism' is not lost.

We must deal once and for all with the problem of financial institutions that are too big, or too important, to fail. Some progress has been made. When the crisis hit, we in the UK had neither an effective deposit insurance scheme nor a resolution framework to deal with failing banks. Now we have both. But there is unfinished business. Although the UK is leading the way in the development of agreements among regulators worldwide as to how the largest banks could be resolved, managing cross-border resolutions is still fraught with difficulty. We also need to implement the proposals of the Independent Commission on Banking as soon as possible, including the 'ring-fence' to separate commercial from investment banking, and the leverage ratio. A situation in which taxpayers again bear the burden when banks fail is unacceptable. That implicit guarantee is costly and distorts competition. The United Kingdom simply cannot afford to have an international banking centre if taxpayers have to underwrite a balance sheet that is many multiples of GDP. Too important to fail is too important to ignore.

The economics of banking is changing, and the City has an opportunity to adapt and lead the new forms of banking that will emerge. The strength of the City of London has always been based on two qualities: its ability to adapt to new circumstances, and its truly global perspective. That will stand us in good stead now. But the future of banking will depend not only on changes to leverage but also on a greater degree of responsibility by all involved: the leaders of our banks, regulators and consumers. We must restore trust in our banking system.

Today's substantial and authoritative *Report* from the Parliamentary Commission on Banking Standards is an important landmark in mapping the path to that goal. Changing the ethics and culture of banking is a precondition of restoring trust. As the Commission's *Report* shows, the sheer size and complexity of global banks have led to failures of governance. Governments, regulators, prosecutors and non-executive directors have all struggled to come to terms with firms that pose a risk to taxpayers, cannot be prosecuted because of their systemic importance, and are difficult to manage because of their size and complexity. It is not in our national interest to have banks that are too big to fail, too big to jail, or simply too big.

Solving these problems is the work of a generation, and I hope that the financial community will rise to this challenge and not shrink from it. The City as a whole does merit trust. And, when the historians look back on this period many years from now, they will conclude that although we were not wiser than the financiers of the past, we did learn and we reformed, and the country benefitted and prospered as a result.

As I leave the scene, there is undoubtedly much unfinished business for my successor. I am delighted that Mark Carney will be the next Governor. He brings a new generation of leadership to the Bank, as well as enormous experience from his time as a central bank governor and his role in steering the Financial Stability Board. He has my wholehearted best wishes for his term as Governor.

Mark is, however, not the first Canadian to have been in the frame for the Governorship of the Bank of England. The very first Governor of the Bank of Canada, Graham Towers, was put forward by Keynes as a successor to Montagu Norman. The proposed transfer fell through – apparently the Directors of the Bank viewed the Canadian as 'too Keynesian'. What that tells us about his views on monetary activism I do not know. But it is perhaps worth noting that Towers' first Deputy Governor was a Mr. Osborne, who agreed to move to Canada from the Bank of England for a spell of 'up to 5 years'. Sadly, the partnership between the Canadian Governor and Mr. Osborne lasted only three years, before the latter departed. But, Chancellor, remember that history doesn't always repeat itself.

In Britain, and especially in the City, we have always welcomed talent from around the world in academic, business, artistic and sporting life. Why should central banking be different? George, you are to be congratulated on Mark's appointment.

I shall of course be sad to leave. But Governors come and Governors go – it is institutions, and the ideas they embody, that matter more. I leave behind a strong, independent, much-changed Bank now focused on its two main responsibilities. The lessons of recent years have been learnt and it is up to us all to remember them. The test of our monetary arrangements is to see them work successfully under new leadership, none of whom were present at the creation. No doubt some things will change. No doubt some things need to change. After all one does not change an institution in order to set it in concrete. A successful institution, just like the City as a whole, always adapts to new circumstances. I know the Bank will continue to do just that under Mark's leadership. Mark inherits a wealth of young talent in the Bank, led by three outstanding Deputy Governors: Charlie Bean, Andrew

Bailey and, of course, Paul Tucker, who has made an enormous contribution to the Bank over three decades.

The Bank of England is in safe hands, and the country will be the better for it.

Lord Mayor, the wheel may have come off your carriage at last year's installation, but then we saw your characteristic ability to turn every situation to advantage as you returned in triumph to Mansion House in a Land Rover. As the City too faces the challenge of turning disaster into triumph, it would do well to follow your example of how to "treat those two imposters just the same".

Roger, your commitment to the promotion of the creative industries – crucial to this, the most exciting city in the world – as well as opportunities for children, aspiring musicians, even trees and bicycles, is well known. And all of us here tonight would like to pay tribute to you Lord Mayor, and to thank the Lady Mayoress, Clare, and yourself, Roger, for the splendid hospitality which you've 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, Roger and Clare Gifford".