Mark Carney: Crossing the threshold to recovery

Speech by Mr Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at a business lunch hosted by the CBI East Midlands, Derbyshire and Nottinghamshire Chamber of Commerce and the Institute of Directors, Nottingham, 28 August 2013.

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Introduction

I'm delighted to be in the East Midlands today to deliver my first speech as Governor of the Bank of England. With leaders in retail, manufacturing, engineering, logistics, information services, biosciences and education, Nottingham and the East Midlands are integral to the success of the UK economy. The businesses here will make good on the promise of recovery in our economy. So I'm very pleased to have the opportunity to listen to business people in this region. In my years in central banking, I have found that there is no substitute for hearing directly from those who deliver economic growth.

What I hear from businesses here and elsewhere is that a renewed recovery is taking hold amid a rising tide of optimism. The signs are that this recovery is broad based and set to continue. This is welcome and should be encouraged.

Over the past five years, a pervasive sense of uncertainty has held the economy back. The British people have been through the virtual collapse of the financial system, the worst recession in living memory, large job losses, falls in real wages and a, at times harrowing, crisis in the euro area, our most important trading partner.

Households have been worried about their savings, jobs, earning power and their homes; companies have been concerned about the availability of credit, the health of their suppliers, the viability of their markets and the prospects for their investments. Uncertainty has reduced confidence, dampened spending, and slowed growth.

As a result the UK has endured its weakest recovery on record. Comparisons with other countries throw that fact into sharper relief. Over the past five years Germany has grown by 2%, the US by 5%, Australia by 13% and China by more than 50%. Meanwhile the UK economy still produces 3% *less* than it did five years ago.

The real cost of this poor performance is that around a million more people are unemployed than before the recession. Capacity has lain idle in firms and opportunities have gone wanting for lack of finance and confidence. It will take a period of robust growth to begin to reduce meaningfully this spare capacity in the labour market and in companies.

The Bank of England's task now is to secure the fledgling recovery, to allow it to develop into a period of sustained and robust growth. We aim to get there in part by reducing the uncertainty that has held back growth. And we are using our full suite of policy tools to help rebuild confidence so that we all can move forward in a sustainable manner.

First, we are giving confidence that interest rates won't go up until jobs, incomes and spending are recovering at a sustainable pace. In particular, we will have to see the rate of unemployment, currently 7.8%, fall at least to a threshold of 7% before even beginning to consider whether to raise Bank Rate.

Second, we are building confidence in banks so they can serve the needs of the real economy by providing credit to those who can put it to work. In particular, we have required banks to repair their balance sheets so that their capital ratios at least reach a threshold of 7% by the turn of the year.

Crossing these two 7% thresholds is necessary to ensure that our economy can withstand the inevitable bumps along the road to full recovery.

We must meet the thresholds in a disciplined way. We will ensure that we bring inflation down as the recovery progresses. And we will use our considerable policy tools to prevent new vulnerabilities, whether in the housing sector or financial sector, from arising during this critical transition period.

Today I want to say more about how the Bank will help bring the British economy over the threshold into a sustainable recovery and what that means for you.

Guidance about monetary policy

Three weeks ago the Monetary Policy Committee (MPC) did something it has never done before: we gave clear, quantitative guidance about the future path of monetary policy. Specifically, we announced that we do not intend to raise Bank Rate at least until the unemployment rate falls to 7%, provided there are no material threats to either price or financial stability.[1] All nine MPC members agreed to set monetary policy in future according to this framework of forward guidance.

That does not mean Bank Rate will automatically rise when unemployment falls to 7%. Nor is 7% a target for the unemployment rate – it should ultimately fall well below that level. Before the Great Recession, the UK's unemployment rate stood at just over 5%. The 7% threshold is instead a staging post along the road to recovery. When unemployment reaches 7% the MPC will reassess the state of the economy and the appropriate stance of monetary policy.

Our forward guidance provides you with certainty that interest rates will not rise too soon. Exactly how long they stay low will depend on the progress of the recovery and in particular how quickly unemployment comes down. What matters is that rates won't go up until jobs and incomes are really growing. The knowledge that interest rates will stay low until the recovery is well established should give greater confidence to households to spend responsibly and businesses to invest wisely.

It may seem that unemployment doesn't have far to fall, from the current 7.8% to the 7% threshold. The MPC's central view, though, is that this could take some time – for three reasons.

First, while the outlook for growth has improved considerably in recent months, growth prospects over the next three years are solid not stellar. The MPC's current forecast is for growth to average around 2½% per year over the next three years, just below its historical average rate of 2¾%. That suggests spare capacity will be used up only gradually.

Second, a great many jobs need to be created to bring unemployment down. A fall in unemployment from its current level to 7% over three years would mean well over three quarters of a million new jobs created – and given the shrinkage in the public sector, over a million new jobs in the private sector.

Third, a recovery in growth does not necessarily mean faster job creation and lower unemployment.

More than half of the increase in employment since the recession has been in part-time jobs. Many part-timers would prefer to work full time. If the recovery were fuelled by involuntary part-time jobs becoming full time, nearly half a million fewer new jobs would be created.[2]

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[1] Until the unemployment threshold is reached, the MPC also intends not to reduce the stock of asset purchases financed by the issuance of central bank reserves and, consistent with that, intends to reinvest the cashflows associated with all maturing gilts held in the Asset Purchase Facility.

[2] 1.4 million part-time workers would prefer to be working full time, three quarters of a million more than before the financial crisis. If those additional involuntary part-time workers switched to full time working, the extra hours worked would be equivalent to over 400,000 new jobs.

Moreover, there is certainly scope for the economy to grow through an increase in output per hour worked rather than new job creation. Productivity growth has been anaemic and – remarkably – the UK is no more productive than it was back in 2005 – before Jake Bugg got his first guitar. The critical questions are how much and how quickly productivity improves.

The MPC's central view is that productivity growth is likely to pick up only slowly in the early phase of recovery, but that there is potential for growth to accelerate as the recovery takes hold. The slow pickup in productivity means unemployment could initially fall quite rapidly, but fall short of 7%.

Over the next three years productivity is expected to grow at around 1.8% per year, below its pre-crisis trend[3] of 2.2%. While even that modest productivity recovery is not assured, it is hardly an aggressive forecast. It implies that productivity reaches its 2008 level only in 2015. And it means that productivity doesn't catch up any of its current 15% shortfall relative to its pre-crisis trend.

Were any productivity catch-up to happen, unemployment could take even longer than three years to reach the threshold.

A rebound in productivity, if accompanied by higher output growth, would be no bad thing. It would boost the incomes of those in employment and is an essential part of improving the UK's competitiveness.

Moreover, in such a scenario, you would know to expect interest rates to stay lower for longer, encouraging household spending and business investment. Our forward guidance is a stabiliser – securing the scale and duration of recovery that is needed to bring unemployment down.

The prospect that interest rates might stay at their low level for longer will not be welcome for savers. I have tremendous sympathy for them – after all they have done the right thing, set money aside, and now they are earning returns that are substantially below what they would have expected. But raising interest rates now is not the answer – instead what savers need is a stronger economy. That will mean higher asset prices, and will allow interest rates to return to normal levels in a sustainable way. A strong economy is in all of our interests, as it will deliver better job prospects for our friends, neighbours, children and grandchildren.

The last thing savers want is for the UK to follow Japan by raising interest rates before recovery is secured, only to find that we are condemned to decades more of low interest rates and lost opportunities.

Our forward guidance is about setting the path of inflation to return to target

Let me reassure you that our mandate to deliver price stability has not changed. Our inflation target of 2% was reconfirmed in our remit from the Chancellor in March. The MPC's guidance is fully consistent with price stability. I can also assure you of my personal commitment to price stability. I certainly have no hesitation in raising interest rates when required – when I was Governor of the Bank of Canada, we raised interest rates as the recovery there gathered pace.

But that was the appropriate policy for Canada at that time. The challenges in the UK today are different, and policy must be tailored accordingly.

The Bank of England's remit recognises that, at times, it is appropriate to bring inflation back to target more slowly in order to avoid unnecessary volatility in output. With a depressed level of output and inflation above target due to temporary factors rather than demand

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[3] The trend is adjusted for the secular decline in North Sea oil and gas production.

pressures, this is such a time. The MPC is charting the right path back to its 2% inflation target.

CPI inflation is currently being pushed up by rises in utility prices and tuition fees that do not reflect the underlying pressure of demand on supply, along with the effect of past increases in import prices. Underlying domestic inflationary pressure is subdued, with wages growing at only around 1% per year. Although there will be bumps in the road, inflation is set to fall back over the next two years. In these circumstances it would not make sense to choke off the recovery by raising interest rates prematurely. Given that 'administered and regulated' price increases will continue to push up on inflation over the next two years, the MPC is prepared to bring inflation back to the target over two years or a little longer.

Rest assured, however, that we *will* bring inflation back to target – and at each point we will ensure that risks to price stability are contained. Our forward guidance builds in important safeguards of price stability. If there are any signs of underlying inflation pressures building such that it seems inflation 18–24 months ahead will be 2.5% or more, or if medium term inflation expectations are no longer sufficiently well anchored, then the guidance on interest rates no longer applies. These safeguards give ample flexibility to bring inflation back to target at the appropriate pace, while ensuring that risks to price stability are contained.

Market reaction to forward guidance

Much has been made of the upward movements in market interest rates since our announcement of forward guidance. Let me give you my perspective.

There has been a generalised upward move in long-term yields in advanced economies, including the UK, over the past month. The main common driver is speculation that the US Federal Reserve will soon reduce the pace of its asset purchases. That has – not surprisingly – affected yields in other countries because safe, liquid sovereign bonds of the world's largest economies are close substitutes for each other.

In the UK, these movements have been reinforced by growing expectations of recovery. As we explained at the time of the forward guidance announcement, a rise in the yields on long term bonds is consistent with our commitment to price stability and supporting the recovery.

Market interest rates at terms of 2–5 years have also risen recently. The date at which the markets expect the first increase in Bank Rate has moved in from the end of 2015 to mid-2015. One possible explanation is that markets think that unemployment will come down to 7% more quickly than we do. Since the aim of our policy is to secure recovery as quickly as possible, that would be welcome. But policy is built not on hope, but on expectation. And we estimate there is only a 1 in 3 chance of unemployment coming down that quickly (Chart 1).[4]

Furthermore, thinking unemployment will come down faster than we expect isn't enough to believe interest rates will rise soon. As I said earlier, the 7% threshold is a staging post to assess the economy. Nobody should assume that it is a trigger for raising rates.

Another possible explanation is that the increase in shorter-term yields, like the move in long yields, reflects changing expectations of US monetary policy. But the US recovery is much further advanced than that in the UK.

While much has been made of the special relationship between the US and UK, it is not so special that the possibility of a reduction in the pace of additional stimulus in the US warrants a current reduction in the degree of monetary stimulus in the UK.

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[4] We are not alone in that belief – other major independent forecasters such as the OBR and NIESR share our view that unemployment will be above 7% in 3 years' time. The MPC's assessment of the outlook for unemployment and likelihood of hitting the threshold is described in the August *Inflation Report*, available on the Bank's website at http://www.bankofengland.co.uk/publications/Pages/inflationreport/2013/ir1303.aspx.

Movements in longer-term market interest rates are certainly relevant, but what matters most to you is what actually happens to Bank Rate, now and in the future. That is because the interest rates on 70% of loans to households and more than 50% of loans to businesses are linked to Bank Rate.[5]

And it is the Bank of England that controls that rate. We do not intend even to consider raising it before unemployment falls to 7%. When it does reach that point, we will control whether a rise is warranted, taking into account the strength of the recovery and the outlook for inflation.

The upward move in market expectations of where Bank Rate will head in future could, at the margin, feed into the effective financial conditions facing the real economy. The MPC will be watching those conditions closely. If they tighten, and the recovery seems to be falling short of the strong growth we need, we will consider carefully whether, and how best, to stimulate the recovery further. Our forward guidance was clear that, although we would not reduce the stimulus until the recovery is secure, we would if necessary provide more.

Crossing the threshold to a healthy banking system

Confidence that interest rates will stay low is a necessary step to securing the recovery, but it is not sufficient. The UK also needs a fit and healthy financial sector. It plays a vital role in generating services output in the UK, creating jobs and in exporting to the rest of the world.

To serve the needs of the wider economy by extending credit to where it is needed, banks must command the confidence of their customers and investors. That is why a second element of the Bank of England's strategy is to ensure that banks reach a clear threshold of good health.

Some argue that the repair of banks' balance sheets holds back economic recovery because it causes banks to cut back their lending. The reality is the opposite: where capital has been rebuilt and balance sheets repaired, banking systems and economies have prospered.

US banks have added more to their capital base since the crisis and, as a result, have been able to provide more credit to their economy than UK banks have to ours. In the past two years, UK banks have reduced their lending to the real economy by 1%. In those same two years, US banks have increased their lending by more than 8% (Chart 2).

Within Europe, the correlation between the market's assessment of a bank's capital base at the end of 2011 and that bank's lending over the subsequent year is striking (Chart 3).

Without an adequate capital base, banks will be wary of lending and, if they do, will find themselves needing to turn off the lending taps when the unexpected happens, as it inevitably does. Investors will lack the confidence to fund banks cheaply, raising the cost of credit to the real economy, and most importantly, you will lack the confidence that credit will be available if you need it.

That is why the Bank of England has established a threshold for the capital base of the major banks and building societies after taking account of likely future losses, fines for past misconduct and prudent calculations of risk. That threshold, a capital base of 7% of their risk-weighted assets and at least 3% of their total assets, must be crossed if the system is to be able to support and sustain the recovery. Some of the UK's major banks had already crossed it, and over the summer we have made sure that the others put in place plans to reach it. The plans do not involve cutting back lending to the real economy.

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[5] 53% of the stock of bank loans to non-financial businesses pay a floating interest rate, and for an additional one third the interest rate is fixed for one year or less.

As a result of the Bank of England's actions, we can relax other requirements to help with the flow of credit. Balance sheet repair will give confidence to depositors and investors who provide funding to banks. With that market funding assured, banks can safely hold fewer liquid assets, such as government bonds, that act as a cushion to be sold in the event that investors withdraw their funding.

Accordingly, I can confirm today that, for major banks and building societies meeting the minimum 7% capital threshold, the Bank of England will reduce the level of required liquid asset holdings. The effect will be to lower total required holdings by £90 billion, once all eight major banks and building societies meet the capital threshold.[6] That will help to underpin the supply of credit, since every pound currently held in liquid assets is a pound that could be lent to the real economy.

Taken together, our actions create not just a more resilient system, but also one more able to support and sustain a recovery by serving the real economy.

Crossing the threshold of balance sheet repair is not the end-point. The 7% capital threshold, like the 7% unemployment threshold, is only a staging post at which we assess our next steps. Beyond that our major banks will need to strengthen their capital base further. For example, large international banks will be

subject to new internationally-agreed requirements for systemically-important firms. Other UK-focussed retail banks will need to meet the requirements set by the Vickers commission for "ringfenced" banks. Our task will be to manage the transition from the threshold to the end point in a gradual way that supports continued confidence in growth.

Using all the Bank of England's tools to secure a sustainable recovery

A recovering banking sector, coupled with persistently low interest rates and new government programmes, may lead to concern that the seeds are being sown for a new cycle in the housing market. The number of mortgage approvals for house purchase is up by 20% on a year ago, while house prices have risen by 5% over the same period – and by more than that in some parts of the country.

That must be kept in perspective, however. Mortgage approvals are currently running at only a little more than half, and transactions a little more than two-thirds, of pre-crisis levels. Households' debt servicing costs relative to income are below their 20-year average, and houses cost the same relative to earnings as they did in 2003.

Nevertheless, the Bank of England is acutely aware of the risk of unsustainable credit and house price growth and will be monitoring it closely.

The important thing to recognise is that we now have tools other than interest rates that can be used to contain risks in the property and financial sectors. These so-called macroprudential tools were not available to us before the crisis and we are now fully prepared to deploy them if that were needed. The Bank of England is now in a position, for example, to supervise lending to specific sectors more intensively, to make recommendations to banks and building societies to restrict the terms on which new credit is provided, or even to raise capital requirements on mortgage or other types of lending.

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[6] In June 2013 the Financial Policy Committee concluded that there was scope for banks to reduce their holdings of liquid assets in the near term, and recommended a relaxation in liquidity requirements in order to strike the appropriate balance between achieving resilience and reducing possible impediments to the supply of credit to the economy. That relaxation was subject both to banks meeting the minimum capital threshold, and to additional firm-specific considerations. Today the Prudential Regulation Authority (PRA) has agreed with that recommendation, and is announcing how it will be implemented. The PRA will be making a more detailed statement today and writing to individual firms in due course.

Having these in our toolkit – and if necessary using them – will help us to keep interest rates low to secure recovery without creating risks that make that recovery ultimately unsustainable. If that is not enough, a final safeguard is built into our new forward guidance framework. The Bank's independent Financial Policy Committee has the task of warning publicly if persistently low interest rates are leading to vulnerabilities that cannot be contained by other means.

In short, we are providing the stimulus the economy needs, but in a disciplined way to secure price and financial stability.

Conclusion

Let me finish by drawing the pieces of the jigsaw together.

Developments at home and abroad suggest that conditions are in place for growth to be sustained into the medium-term – though at a pace that is likely to be measured rather than rapid.

Households have reduced their debt levels and are now spending out of income. The outlook for the world economy and our major export markets is a bit better. The extreme risks in the euro area have been substantially reduced. The global financial system is being repaired.

There will still be bumps in the road ahead. A few can be foreseen, others will surprise. Emerging market economies – the engine of global growth in recent years – are under strain as capital flows back to recovering advanced economies. A few less well-managed financial institutions still have a long journey ahead to rebuild their balance sheets and are vulnerable to shocks until they do so. Progress in Europe will remain uneven.

We cannot control all these events. Instead we are focussed on doing what we can to reduce uncertainty and build resilience so that the recovery can be sustained despite the inevitable shocks ahead.

We are removing uncertainty with our guidance that interest rates will stay low at least until unemployment has fallen. That will boost demand.

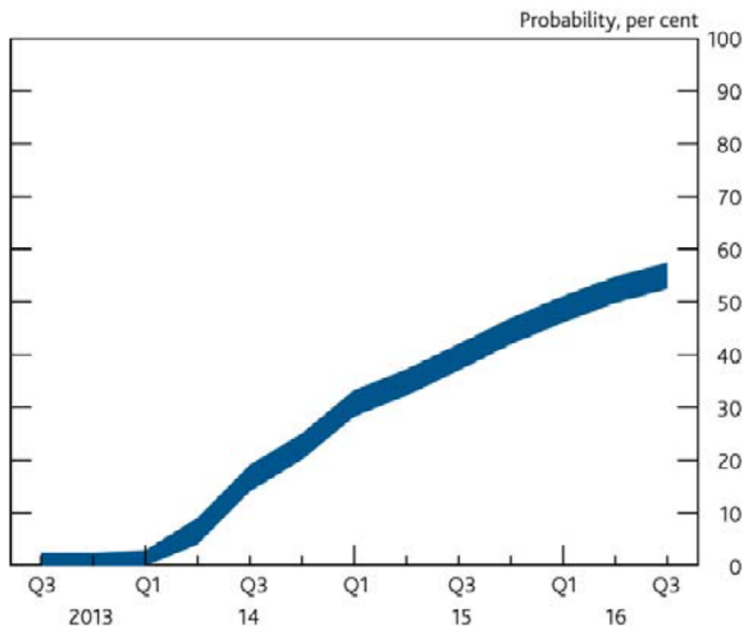
By repairing the balance sheets of banks we are putting them in a position to support the real economy. That will promote investment.

And by standing ready to use the range of other tools at our disposal, we can help to avoid sowing the seeds of the next crisis.

In these ways, the Bank of England is helping the British economy over the threshold and into strong, sustainable and balanced recovery.

Thank you.

Chart 1: Cumulative probability of unemployment having fallen below the 7% threshold [(a)]



[(a)] The swathe shows the probability that the unemployment rate has fallen below 7% in each quarter, according to the MPC's August 2013 *Inflation Report* forecast. The 5 percentage points width of the swathe reflects the fact that there is uncertainty about the precise probability in any given quarter, but it should not be interpreted as a confidence interval.

Chart 2: Bank lending to households and non-financial businesses

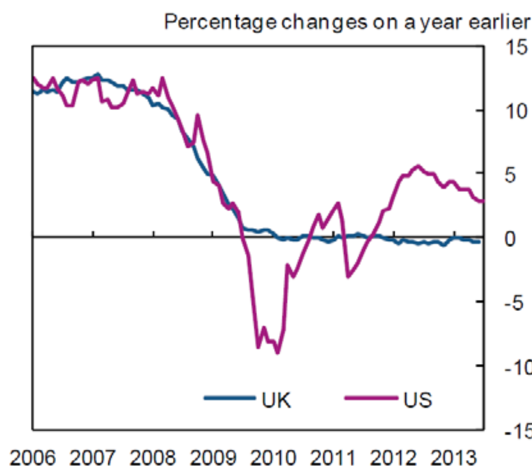
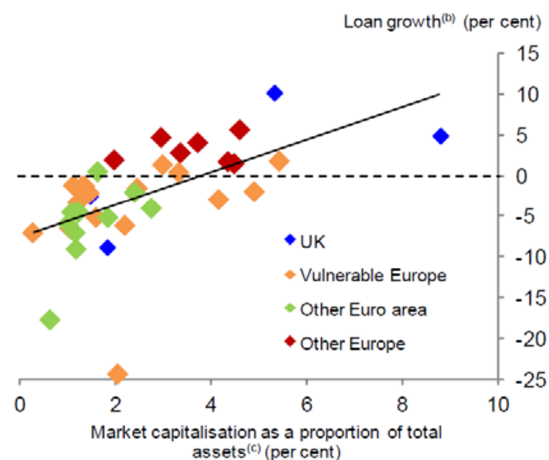


Chart 3: Bank loan growth versus market capitalisation as a percentage of book value[(a)]



Sources: Bank of England, SNL Financial, Thomson Reuters Datastream, individual bank reports and Bank calculations.
(a) Sample comprises the largest 45 banks in developed Europe. Excludes Credit Suisse, Allied Irish and Dexia and those banks that merged with another during the period. Consolidated data. Solid line is line of best fit.
(b) Growth in the stock of gross loans to customers Dec-11 to Dec-12.
(c) As of December 2011.