

Jon Cunliffe: The Bank of England's Monetary and Financial Policy Committees – guiding the economy towards a sustainable and safe recovery

Speech by Sir Jon Cunliffe, Deputy Governor for Financial Stability of the Bank of England, at the International Festival for Business conference, Liverpool, 3 July 2014.

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When my friends and relations discovered I was going to join the Bank of England I was inundated with the same request. From politicians and senior Whitehall mandarins to family and young children, after wishing me congratulations and good luck, the first question was: “can I please come and see the Bank's gold?”

I of course promised excursions to see the Bank's gold to all and sundry. On arrival at the Bank, however, I was made aware of the sober reality. The Bank only owns two bars of gold. And they are in the Bank Museum for all to see.

Of course, the Bank looks after a great deal of other people's gold – over 5000 tonnes including the UK Government's reserves and some of the reserves of other countries. Visits to the vaults in which it lies – as I also found out on arrival – are politely but very heavily discouraged. But apart from the two bars in the museum, the Bank of England itself no longer owns any gold.

I am pretty sure that most of those who wanted to see the Bank's gold would not really be surprised by that. Gold plays virtually no part in our or other modern economies. But I do not think it was an accident that so many associated gold with the Bank. Gold remains for many a powerful symbol of stability. And stability is what the Bank of England is for.

There have been major changes to the Bank over the last year or so. With the passing of the Financial Services Act in April last year, Parliament gave us very significant new responsibilities and wide ranging powers. More than ever now, stability remains at the heart of what we do. As we set it out in our new objective, the Bank's core purpose is:

“to promote the good of the people of the United Kingdom by maintaining monetary and financial stability”.

I want to focus today on the financial stability part of that purpose: what are we trying to achieve and how do we go about it? And how does it fit in with the other main part of that core purpose, maintaining monetary stability – or to put it simply, controlling inflation?

A little bit of history might help to provide some context.

The Bank's current arrangements for the setting of monetary policy date back to 1997. At that time, I was involved, at the Treasury, with the implementation of the reforms that gave the Bank of England operational independence on monetary policy. Our thinking in those days was very much dominated by the need for simplicity and clarity – “one instrument for one target”.

The instrument was monetary policy; the target was price stability. So the Bank was given a statutory objective of maintaining price stability by hitting an inflation target. It was given new machinery, the Monetary Policy Committee (MPC), with the power to set interest rates to achieve the target.

Over the MPC's first ten years, the UK economy enjoyed a remarkable period of macroeconomic stability. There was only one month – March 2007 – where inflation was more than 1 percentage point away from the Bank's target. The annual rate of economic growth ran on average at around 3%, with fluctuations little more than 1.5pp either side of that. There was not a single quarter where economic activity contracted.

But though the macroeconomic environment was stable, huge risks were building up in the financial system. There was an explosion in risk taking in the global financial system, much of which had an impact on the UK because of our internationally active banks and our position as international financial centre. Over the ten years to 2007, the balance sheet of the UK banking sector nearly doubled relative to the size of the economy. By the time the crisis broke, the balance sheet of the UK resident banking sector approached 6.5 times annual GDP.

But though much of the risk came from abroad, there was also a substantial rise in domestic lending and domestic debt. House prices increased faster than people's incomes – from five times earnings in 2000 to over eight times earnings by 2007. As most people borrow to buy houses, this drove up outstanding household mortgage debt from 50% of GDP to around 85%. Household debt as a whole went from around 110% of household income to over 165%. Commercial property prices doubled and lending to support commercial property investment trebled.

Should the Bank have tried to rein this in? The MPC's objectives made no mention of financial stability. Much of the international thinking at the time was that central banks should not try to use monetary policy tools like interest rates to address asset bubbles and financial stability risks. Rather they should deal with the consequences of such risks if they crystallised. Or, in the jargon of the day, not to “pop bubbles”, but to “mop up” the mess if and when they burst.

Responsibility for financial stability at the time was shared jointly the Bank, HM Treasury and the Financial Services Authority, the latter body responsible at the time for regulating banks and building societies. True, the Bank as whole did have an objective to contribute to the maintenance of the stability of the financial system as a whole. But it had no formal powers with which to do this. The FSA had powers but its focus was on individual institutions rather than vulnerabilities building across the system as a whole. It is fair to say that the task of addressing risks to financial stability fell between the cracks.

The rapid expansion of debt and accumulation of risks in the financial sector ended, as we all know, in a damaging and painful crash – for the financial sector and for the economy as a whole. There is a substantial body of international evidence that recessions are deeper and more painful when they follow a sharp run-up of debt and a banking bust. The UK recession in 2008–9 was a case in point.

The costs of mopping up afterwards are still very clear today. Despite interest rates being effectively at zero for over five years now, the economy is only just now back to its pre-crisis level. There are still over half a million more people unemployed in the UK than before the crisis. The amount of net public sector debt has pretty much doubled relative to GDP. On current plans, the OBR expect it will take a further five years until the public sector deficit is eliminated.

I think, knowing what we now know, we would be more prepared to use monetary policy to address financial stability risks. Indeed the MPC's latest remit letter from the Chancellor notes the MPC might wish to allow inflation to deviate from the target temporarily to avoid the development of imbalances that pose a potential risk to financial stability.

But it is not without cost. Monetary policy, may, as Jeremy Stein said when he was at the Federal Reserve, be effective in tempering financial stability risks because when we change interest rates it “gets in all the cracks”. But because it gets in all of the cracks across all of the economy, using interest rates to deal with financial stability risks can carry a high cost. It is a very blunt instrument that affects the economy as a whole.

So although it is an effective line of defence, it should be seen as one of the last lines of defence. The question then becomes how do we ensure that it does not – because we lack other instruments – have to be used as a first line of defence? Here the financial crisis and recession has led to the development of what is now called “macroprudential policy”.

In essence, macroprudential policy means using the regulatory “stance”, the underlying settings of the regulation of the financial sector, first to reduce the probability and impact of systemic crisis and then, by varying those settings, to counter emerging threats to financial stability.

The Bank now has a sister committee to the Monetary Policy Committee, the Financial Policy Committee (FPC), with extensive powers to set and change the regulatory stance for the financial system as a whole in order to safeguard financial stability. Like the MPC, it has external members, drawn from outside the Bank’s executive team, a published record of its meetings and a regular Financial Stability Report to explain how it is using its powers to achieve its statutory objectives. There is substantial cross-membership between these two Committees to ensure effective policy co-ordination.

But though the institutional set up for the Financial Policy Committee mirrors that of the Monetary Policy Committee, the nature of its task is different. The Monetary Policy Committee is, in the main, engaged with guiding the economy towards the best achievable path for output consistent with keeping inflation at target – or with bringing it back to target. In the jargon – which some of you in the logistics field, for example, may be familiar with – the problem is one of “optimal control” or “dynamic programming”. What setting for interest rates is consistent, looking forward, with the best central outlook for the economy?

The Financial Policy Committee’s job is really about identifying risks and preventing them from crystallising.

This is not just about the most likely and visible risks. What we learned in the financial crisis was that the financial system, has a myriad of connections and actors and a phenomenal ability to change and adapt. It needs to be thought of as a complex “ecosystem”. At times of stress, it can behave in very extreme ways – or break down altogether.

In such a world, it is not enough to know that every individual part is managing its own risk. You have to know that when the parts come together and act upon each other, the system as a whole is resilient. One part of the system may well think it has a good plan for offloading some of its risk in a period of stress. But the impact of that on other parts of the system may turn a stress into a crisis.

And, given the cost when things go badly wrong, it is not only important to ensure the financial system can manage the known, likely risks it faces – the ones you can see and the ones that you think may well materialize. The system needs to be resilient to the risks of events that are improbable but possible. And, life being what it is, it must also have resilience to risks that simply cannot be foreseen – the “unknown unknowns”.

To use a familiar but imperfect metaphor, the Monetary Policy Committee is like a driver steering a car down a winding road. It can dimly see the road behind but can only forecast what the road ahead looks like. The instruments usually give unclear or contradictory readings. For all that, the MPC tries to keep the car at the highest speed that can be achieved without risking having to jam on the brakes at the next bend or having to floor the accelerator to prevent stopping.

But to push this further – and perhaps too far – for the Financial Policy Committee’s role in relation to the financial system we need a rather different metaphor. The FPC is more like the safety authority for a race track. Its job is to see that the safety standards for the track and for the cars are high enough. That there are sufficient buffers on the bends if one of the cars comes off the track. And that, if there is a crash, the wreckage can be got off the road and does not cause a multiple pile up.

But the track authority’s job is not just about ensuring the track is safe. If, when the race is running it starts to pour with rain and conditions become riskier, the track authority brings the “safety car” onto the track to slow the other cars down. Sometimes a race has to be interrupted because it has become too risky. The FPC sometimes has to do the same.

The safest approach of course might be to shut the track altogether. But the economy needs a healthy, thriving financial sector. It needs credit so that it can grow. Savers need to be able to invest. So the FPC needs to consider the impact of its actions on the economy. Adding more safety features or slowing the speed down can have an impact on the economy that has to be factored in to decisions. Likewise, bringing the safety car in when the danger is passed will also have an impact. These can be difficult judgments to make. They need to be coordinated with the Monetary Policy Committee so that the latter can take them into account in steering demand in the economy as a whole. But the focus of the FPC is financial stability risk: ensuring the system is robust to stress and taking steps to make periods of stress less likely and less severe. That is its comparative advantage.

I want to finish by setting out two recent examples of how the Committee approaches this task: first, the stress test of the major UK banks which is currently in train, and second, the action the FPC announced last week on the housing market.

In April, the Bank of England launched a stress test of the 8 major UK lenders, as part of an EU wide exercise. Stress testing is one of the tools developed in the aftermath of the financial crisis to test the resilience of the financial system. In essence, a stress test sets out a so called "adverse scenario" in which the economy gets into trouble and financial risks materialize. Together with the banks, we can then look to see how they would cope with a scenario like this.

Of course, supervisors in the UK have regularly stress-tested individual banks. But this is the first time that we will test all the major lenders at the same time. The objective is to see not just how each individual bank copes, but also how, when you put together all their responses to the stress, the system performs as whole.

And the scenario we have developed is deliberately not what we think is likely to happen.

In the stress scenario the UK suffers a severe recession: a drop of 4% in GDP and a rise in unemployment of over 5 percentage points. Due to the current account position, interest rates have to increase. House prices drop by 35%.

This stress is a severe one; a chain of events and challenges that is very unlikely. But it is one that could plausibly happen. Many of these things have happened in the UK before: in the last recession, GDP dropped by 7%, in the early 90s recession, the unemployment rate rose by almost 4 percentage points and interest rates had to rise to nearly 15%.

To repeat, this is not a combination of events that we expect to happen or think likely. But we do want our banks to be resilient to this level of stress, to such an unlikely but plausible scenario. We do want the financial system as a whole to be able to withstand such a shock without a breakdown in the essential functions on which the economy depends. And if we find that individual banks or the system as a whole are not resilient we will need to consider how stability should be reinforced.

To go back to my earlier imperfect metaphor, we want to test whether the track and the cars can cope with an unlikely but plausible combination of adverse circumstances.

And you will note that a major part of the adverse scenario is a rise in unemployment and a crash in house prices. We want particularly to test this because housing mortgage debt is around two-thirds of UK banks' domestic lending.

And this brings me onto my second example. Last week, the Financial Policy Committee announced two important measures to address the risk that continued momentum in the housing market could pose to household indebtedness and thence to the economy and to financial stability.

I think it is important to understand why the FPC is concerned about the housing market: what we are and are not responsible for and what we can and cannot do. We cannot address

the imbalance between the supply and demand for houses in the UK. The Bank cannot build a single house. Nor should we take responsibility for house prices. It is the risks to financial stability and to the economy we must focus on.

The main risk we see arising from the housing market is the risk that house prices continue to grow strongly and faster than earnings and – and this is an important “and” – this increase in prices leads to higher and more concentrated household indebtedness. In short, the risk that more people take on higher debt relative to their income as they have to stretch further to buy homes.

In the UK, household debt as a whole is already equal to 135% of household earnings. It was around 110% in 2000 and was driven up to 165% in the years leading up to the crisis. It fell back sharply after the crisis. Not surprisingly, the crisis and recession made households realize that their housing assets were worth less and that their debt made them more vulnerable than they previously expected. So they increased their savings and paid down their debt.

And the more indebted they were, the more they were likely to cut back sharply on their consumption. There is good reason to believe that this cut-back in consumption in the face of high debt is one of the main reasons why recessions are more painful when they follow a period in which household debt goes up quickly.

At around 135% UK household indebtedness is high. It is at 2004 levels. It is markedly higher than many European countries. It is on par with the US. True, there are a few countries with even higher levels. But starting from this elevated level, the risk that the FPC is concerned about is that with limited housing supply, the demand for housing in the UK continues to push prices up; that lenders are ever more willing to finance high loan-to-income mortgages as house prices rise, and that as a result household indebtedness climbs sharply, making the economy and financial system more vulnerable. This risk is greater at a time of exceptionally low interest rates which may well mask the likely true cost of a mortgage over time.

So at its recent meeting the Financial Policy Committee agreed two measures. First, that when lenders are assessing applications for mortgages they test whether the mortgage would be affordable if interest rates were to be 3% higher. And second, that no more than 15% of a lender's flow of new mortgages should be more than four-and-a-half times the borrower's income.

These measures do not bite now on the market as a whole. Most lenders are already testing whether borrowers could afford mortgages if interest rates were to rise by around 3%. The FPC's first recommendation is intended to stop that from slipping.

And though the proportion of new mortgages worth more than four and a half times the borrower's income has been increasing sharply, it is currently around 10%, below the 15% limit the FPC has set in its second recommendation.

These measures should be thought of as insurance. The MPC's central forecast of the economy is for housing transactions to rise and for house prices to continue to grow faster than incomes in the near term, but then to fall back to grow in line with incomes. If that forecast came to pass, the upward pressure on household debt from the housing market would ease and the flow of new mortgages worth four-and-a-half times the borrower's income would likely remain under the 15% limit.

But an outcome in which house prices grow more rapidly relative to income and do so for longer is also quite plausible. It has certainly happened before in the UK. We know the pressure from demand for homes is great and that the supply of new homes is quite weak.

If such an outcome came to pass, the proportion of mortgages at high multiples of the borrower's income could rise substantially. Debt would grow and become more concentrated. Financial stability and the economy would be more exposed to a shock and one which, if it

crystallised, could derail a sustained and durable expansion. The FPC's recommendation should be seen as insurance against that risk crystallising.

Consistent with its role as risk manager, the FPC has acted in advance to identify and to protect against a very major risk to the financial system and the economy.

To return to where I started. The Bank of England is for stability. Monetary and financial stability. We do not achieve that, any more, by holding gold. We aim to address that through the actions of the MPC and the FPC.

The first aims to balance supply and demand and so steer the economy to keep control of inflation. The second aims to preserve financial stability by ensuring the underlying financial system is resilient by identifying risks and taking action to prevent them crystallising.

The stress test of the major UK banks towards the end of the year will assess the resilience of the system to a major crash. The steps taken last week are insurance against the possibility of a sustained boom in the housing market leading a substantial increase and concentration in household debt that could make a crash more likely and more severe.

And finally, just in case despite this speech, I am deluged with requests to visit the Bank's gold vaults, I am afraid there are very good security and safety reasons why we cannot offer this. But I can recommend that on your next trip to London you visit the outstanding Bank of England museum just off Threadneedle Street. It is free. And you will be able to try to pick up one of our two bars of gold. Most important of all, there is an excellent game that will allow you to try your hand at maintaining monetary and financial stability. Because stability is what the Bank of England is for.