Mark Carney: Winning the economic marathon

Speech by Mr Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at the Commonwealth Games Business Conference, Glasgow, 23 July 2014.

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Accompanying charts can be found at the end of the speech.

It is a pleasure to be in Glasgow for the opening of the 20th Commonwealth Games.

For the athletes, the games represent the culmination of years of training. For fans they are a chance to witness great sporting achievements.

I remember attending the 1978 games in my hometown of Edmonton and being mesmerised by one of its stars: Scotland's Allan Wells. At just 26, Wells burst onto the scene, winning silver in the 100 metres, beating the reigning Olympic champion in the process. He spurred Scotland to gold in the 4x100 metres, won the 200 metres outright and set the stage to become the fastest man in the world two years later at the Olympics.

The UK economy has also had some sprint success of late and is the current holder of the "fastest growing advanced economy in the world" title. That is welcome after some difficult years, but what really matters is what comes next. The bigger prize is winning the economic marathon by achieving a durable expansion.

We must replicate the sprint success of Wells over longer distances, taking our lead from Scotland's Liz McColgan, who memorably won gold in the 10,000 metres last time the Games were held in Scotland, before going on to win the New York, Tokyo and London marathons.

To understand how we – and by "we" I mean the UK, the Commonwealth and the world – can win the economic marathon, I want to draw on three less athletic, but nevertheless great, Scots, each of whom points us to an essential ingredient of economic success: the right policy framework; an open trading system; and fair and effective financial markets. In all these respects, the UK is leading the way.

The right policy framework

The UK's current policy framework has its origins in the work of William Paterson of Skipmyre, Dumfriesshire. More than three centuries ago Paterson proposed the establishment of the Bank of England to "promote the publick Good and Benefit of our People…"[1] At that time the public good meant financing a war with France. Over the ensuing centuries, as objectives evolved, Paterson's bank would have many guises including government banker, lender of last resort, bank supervisor and monetary authority.

Today, having learned the lessons of the crisis, we understand that the Bank of England can best serve the public good by maintaining monetary and financial stability. Let me briefly explain how we are pursuing those objectives which are building blocks of a balanced and sustainable expansion.

As I mentioned earlier, the UK economy has been growing rapidly. Over the past year, job creation has been the quickest on record, pushing unemployment down to 6.5 per cent. The economy is finally producing as much as it did on the eve of the crisis in 2008, and inflation is back near its 2 per cent target.

In short, the UK economy is starting to head back to normal.

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[1] Bank of England founding charter, 1694.

As the economy normalises, Bank Rate will need to start to rise in order to achieve the inflation target. But the MPC has no pre-set course and the timing of any increases in interest rates will be determined by the data.

In this regard, the Monetary Policy Committee (MPC) is balancing the implications for inflation of hard evidence of sustained economic momentum against conflicting signals over the degree of slack in the labour market.

While some indicators such as wages suggest that there was more labour supply than we had previously thought, it is also true that spare capacity is being used up a bit more rapidly than we had expected. A key judgment for the MPC is when and to what extent these developments will translate into real wage growth, and in turn that wage growth into price pressures. Next month's *Inflation Report* provides the next opportunity to update our thinking on these important questions.

A durable expansion rests ultimately on moving from anaemic to strong productivity growth. Only that can improve export competitiveness and underpin consistent increases, rather than falls, in real wages.

To generate needed productivity growth will require recent strong business investment growth –10% over the past year – to be sustained.

The MPC is supporting investment through clear guidance that it expects increases in Bank Rate, once they begin, to be gradual and limited. From my own experience visiting businesses up and down the country, including some in Glasgow earlier today, I know that businesses understand this message. This guidance puts all the short-term noise about when the first rate rise will be into its proper context and it encourages firms to hire and invest with an eye to the medium term.

Why does the MPC expect Bank Rate increases, once they begin, to be gradual and limited? This is in part because the headwinds facing the economy are likely to take some time to die down. These headwinds include public balance sheet repair, a highly indebted private sector likely to be particularly sensitive to interest rates, as well as the drag from a 12% appreciation of sterling over the past year and the persistent muted demand from our main export markets.

Over the medium term, several dynamics are likely to keep rates lower than in the past. UK rates could be restrained by continued imbalances between global saving and investment, together with potentially lower rates of global productivity growth. The MPC can also be expected to accommodate with lower risk-free rates the higher spreads that are likely to result from new regulatory requirements.

All of these factors likely mean that, even when spare capacity is used up, Bank Rate will need to be materially lower than in the past in order to keep the economy operating at its potential and inflation at its target.

The Bank is well aware that a prolonged period of historically low interest rates could encourage other risks to develop. In the UK, the biggest risks are associated with the housing market, which is why last month the Bank's Financial Policy Committee (FPC) took graduated and proportionate actions.

The Bank's role is not to control house prices. Nor can the Bank do anything to address the severe structural problems across the UK caused by a chronic lack of new housing supply. Our job is to mitigate the risks to the broader economy that arise from these underlying challenges.

It is the prospects for household indebtedness that concern us. UK households start from a vulnerable position, with debt at 140% of disposable income and the share of riskier mortgage lending rising markedly over the past year. Housing debt can represent a major risk because mortgages are both the largest asset of UK banks and the largest liability of UK households.

The FPC does not believe that household indebtedness poses an imminent threat to stability. Underwriting standards are more responsible than in the past. But we have seen time and again how quickly responsible can turn to reckless, creating risks that ultimately derail the economy.

Allow me to explain why this matters to everyone from Land's End to John O'Groats, even those who do not own homes.

History shows that the British people do everything they can to pay their mortgages. That means cutting back deeply on expenditures when the unexpected happens. If a lot of people are highly indebted, that could tip the economy into recession. Recessions that follow periods of rapid credit growth tend to be deeper and longer lasting. Since we start from a vulnerable position, we need to be especially careful.

To insure today against such risks in the future, the Bank has introduced both new affordability tests for borrowers and a cap on the proportion of any lender's new residential mortgages at high multiples of borrowers' incomes.

By acting early, the Bank can reduce the need for more drastic action later on. And by acting as we have, we can encourage a broadening of the housing market recovery. We recognise that there are large differences in housing markets across the UK. Around one in five new London mortgages are extended at or above 4.5 times borrower income, compared to one in ten across the UK as a whole, and one in twenty in Scotland. Capping the riskiest borrowing means that for every high ratio mortgage six must be extended at lower ratios. This helps spread lending capacity across the country, further contributing to balanced growth and a sustained economic expansion.

Trade

Good domestic policy cannot, on its own, guarantee balanced growth in an open economy like the UK's. Our fortunes are also tied to those of our trading partners.

In recent years those fortunes have been modest. Demand from the UK's traditional markets, such as Europe, is a staggering 25% below a continuation of its pre-crisis trend. This is because the UK relies heavily on the slow-growing advanced economies (***Chart 1***).

In contrast, the Commonwealth countries, which account for only a tenth of UK exports, have grown over three percentage points faster on average each year than our major trading partners between 2008–13.

The need to diversify trade to faster-growing economies in the Commonwealth and emerging markets is clear. This will require both the continued initiative of UK businesses and a determined trade strategy.

In short, we all need to be inspired by another great Scottish figure, David Hume.

Hume brilliantly showed that free trade was beneficial to all; that it acquainted nations "with the pleasures of luxury, and the profits of commerce", spurring them on "to further improvements in every branch of domestic and foreign trade."[2]

His ideas helped usher in the first great era of globalisation during the 19th century. In this wave, the British economy grew twice as fast as during the preceding century (***Table 1***).

Almost exactly a century ago, the outbreak of the First World War brought this incredible period of prosperity to an end. It would take almost half a century for it to start to be rebuilt and another 30 years before it fully gathered steam.

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[2] David Hume, "Of Commerce", *Selected Essays*, Oxford University Press, 1993.

Now globalisation is again under threat with the financial crisis raising the spectre of protectionism. G20 leadership has thus far prevented this from happening, but the G20's commitment to resisting protectionism is ultimately a defensive agenda.

The UK can help lead a more positive one by spurring on new deals such as the Transatlantic Trade and Investment Partnership between the EU and the US. And trade diversification can be promoted through the pursuit of more bilateral initiatives such as those underway with India and China.

Likewise the rich diversity of economies across the Commonwealth provides opportunities for all parties to gain from greater international trade.

Fair and effective financial markets

Open trade requires open finance. To secure the latter requires nothing less than the re-founding of the global financial system.

Since the crisis, globalised finance has been under siege. Cross-border capital flows have fallen sharply. There are constant pressures to Balkanise financial systems – myopic attempts to protect one country that weaken us all. As the leading global financial system, the UK will be central to completing the job of financial reforms that support an open and integrated system.

To do so, we must make global finance more resilient and fair.

To make the system more resilient, funding and derivatives markets are being overhauled. Formerly risky areas of shadow banking, such as securitisation, are being transformed into sustainable market-based sources of finance. Financial institutions are being made stronger, with a seven-fold increase in the minimum capital requirements for the world's largest banks. In the UK alone, major banks have raised over £140 billion in new capital over the past few years and the Bank of England is now regularly testing their resilience to severe shocks.

To make the system fairer, we should look to the insights of a third great Scottish figure, Adam Smith.

Smith was a great advocate of competition. Its frequent absence in financial services has been corrosive.

The most prominent examples are large, complex banks which privatise gains but socialise losses. The G20 summit later this year in Brisbane will be decisive in determining whether we can end too-big-to-fail.

A more pernicious development has been the widespread rigging of some financial markets for personal gain. This has both diminished the effectiveness of markets and undermined trust in markets themselves.

Adam Smith emphasised the importance of conduct, or what he referred to as "the established rules of behaviour," by which "many men behave very decently, and through the whole of their lives avoid any considerable degree of blame."[3] Those established rules of behaviour – social capital – underpin the functioning of the free market.

In short, to be effective, markets must also be fair. And we need to invest in social capital just as we invest in economic capital.

That is why the Bank, Treasury and Financial Conduct Authority are undertaking a major review to secure true markets. Markets:

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3 Adam Smith (1789), *The Theory of Moral Sentiments*.

- that are open and transparent;
- where access extends beyond a privileged few;
- where all who wish to trade have common information and commonly accessible prices; and
- where the informational integrity of key benchmarks is beyond question.

Some of this will require changes to the way markets work.

Some can be delivered by bringing more activities within the scope of regulation.

And some may require new codes of conduct.

We need a simple approach that recognises that the actions of a few to manipulate, game or profit from unfair access weakens the effectiveness of markets for all. Such actions hold back prosperity. They should therefore have clear consequences.

Our approach should deliver true markets which are the greatest source of dynamism, prosperity and progress.

Completing this agenda will reinforce the G20's efforts to rebuild an open and resilient financial system, and in doing so it will support underpin global trade and investment to the benefit of all.

Conclusion

The UK, the Commonwealth and the world have always drawn inspiration from great Scots. We must continue to do so if we want to win our economic marathon.

Paterson showed us the need for a central bank. Its modern variant is a leading macroprudential institution, well equipped to face the challenges of promoting a balanced expansion.

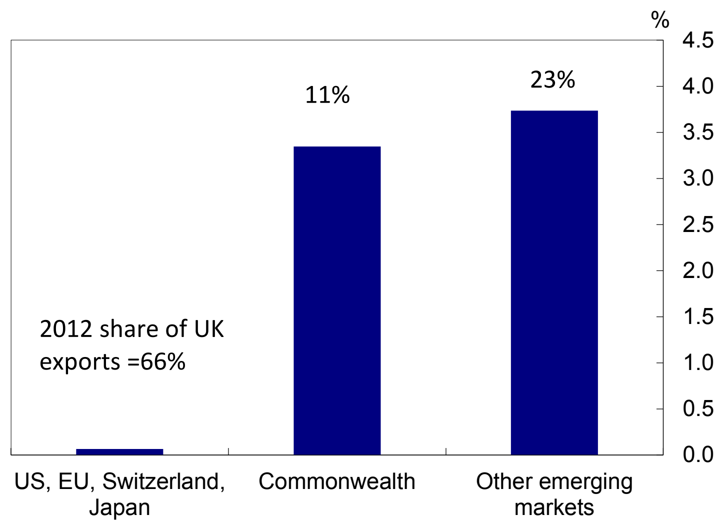
Hume demonstrated the virtues of free trade. The UK, already one of the most open economies, can help lead the development of new EU trade deals as our businesses diversify their markets.

Smith showed us the importance of social capital. With a financial system that is a global good and a national asset, the UK is leading financial reforms to build a resilient global financial system with fair and effective markets at its core.

And finally Wells and McColgan showed us the enormous pay-offs for hard work, dedication and perseverance.

Winning the economic marathon will take similar determination. But the prize of a durable expansion is great and, if inspired by some of Scotland's many heroes, we should not fail.

Chart 1: Average GDP growth (2008–2013) of UK export destinations[a][b]



(a) Bars show the mean calendar-year GDP growth rate between 2008 and 2013 for all countries included in the groupings.

(b) UK export share data is not available for all countries. For regions where country-level data is not available, chart assumes that UK exports are distributed between Commonwealth and "Other" countries in proportion to the number of those types of countries in each region.

Table 1: Annual average growth rates of trade and GDP (per cent)

United Kingdom[(a)]

	Exports	Imports	GDP
1701–1830			1.1
1830–70	5.0	4.4	2.0
1870–1913	2.9	3.1	1.9
1913–50	1.3	0.7	1.5
1950–73	4.4	4.4	2.6
1973–2001	4.8	5.1	2.4

World[(b)]

	Trade volume	GDP
1500–1820	1.0	0.3
1820–70	4.2	0.9
1870–1913	3.4	2.1
1913–50	0.9	1.8
1950–73	7.9	4.9
1973–2001	5.2	3.1
1820–2001	3.9	2.2

(a) Bank calculations and Hills, Thomas and Dimsdale (2010), "The UK recession in context – what do three centuries of data tell us?", *Bank of England Quarterly Bulletin*, Q4.
(b) Table 6 in Angus Maddison (2005), *Growth and interaction in the world economy: the roots of modernity*, The AEI Press, Washington.