Three weeks ago, thousands of depositors queued on the streets outside branches of Northern Rock to take their money out. Those scenes, broadcast around the world, were shocking. How did they come about and how can we prevent them in future?

My focus tonight will be on why the incentives facing banks, investors, and depositors led them to behave as they did. Most of what happened can be understood in terms of those incentives. And, if we are to create a structure for our banking system so that such scenes are not repeated, we must ensure that the temporary measures put in place in recent weeks evolve into permanent reforms in the coming months.

But I want to start with the story of how these events came about. It begins in the international capital markets. One of the most remarkable changes in the world economy over the past decade has been the fall in interest rates. Some of that stems from the fall in inflation as central banks have regained control after the Great Inflation of the 1970s and 1980s. But even adjusting for inflation, low-risk borrowers have been able to borrow on world capital markets at very low rates. In the UK, the yields on 10-year inflation-protected government bonds have, in the past year, been close to 1%. At the turn of the millennium, they were 2%. Back in 1990, they were 4%.

Why have these real interest rates fallen so much? The primary explanation is the high rates of saving in other parts of the world. Japan has been a net saver for more than a quarter of a century. Following the Asian crisis in the mid-1990s, many of Japan's neighbours also raised their national saving rates. That group includes the country which is now the world's biggest saver – China. And more recently, after the tripling of oil prices, they have all been joined by the oil-producing nations from Saudi Arabia to Norway.

The savings of these countries, evident in their trade surpluses, have flooded into world capital markets. Faced with what Ben Bernanke has called a "glut" of savings, borrowers in the rest of the world have been able to attract long-term loans at remarkably low interest rates. Those rates of interest have, in the developed world, encouraged borrowing and spending, and reduced saving. From the United States to Australia, and also here at home, we have increasingly spent more than we earn, resulting in large and expanding trade deficits. Our own trade deficit is more than 3% of GDP, but that is dwarfed by the United States, with a trade deficit of more than 6% of GDP.

The response of central banks in the developed world to these changes was predictable. To keep overall demand growing – and inflation stable – in the face of trade deficits, they needed to keep short-term interest rates low and domestic spending strong. In the United Kingdom, Bank Rate has averaged just 4 ½% in the past 5 years. In 2003, it was as low as 3 ½%. But even then, the UK had the highest interest rate in the G7. In the United States, the Federal Reserve cut its interest rate to just 1%, and in Japan, experiencing deflation, interest rates were just 0.1%.

Those developments were inevitable if the world economy was to continue to grow. But the price was unusually low interest rates – both short and long-term – which were considerably below the levels to which most investors had become accustomed in their working lives. Dissatisfaction with these rates gave birth to the "search for yield". This desire for higher yields could not be met by traditional investment opportunities. So it led to a demand for innovative, and inevitably riskier, financial instruments and for greater leverage. And the financial sector responded to the challenge by providing ever more sophisticated ways of increasing yields by taking more risk. But some of those new instruments were so opaque
and complex that investors lost sight of the risks involved. Until, that is, they were brought down to earth with a bump on August 9.

Occasional tremors in financial markets had been evident over the past year or so, and again in July this year. It was impossible to tell whether they constituted a gradual release of pressure on risk premia that had become overly compressed, or whether they signalled a more disruptive movement to come. On August 9 the question was answered.

As if to highlight the global nature of the crisis, the unexpected revelation by a French bank that its investment funds could no longer value their exposures to US sub-prime mortgage loans produced a sharp reappraisal of the risks they were taking by investors around the globe. The returns demanded by investors on all risky assets rose – from packages of bank loans to plain vanilla company shares – so the prices of those assets fell. And in some markets for complex financial instruments, investors realised that perhaps they did not understand as much about the nature of the risks involved as they should. So not only did asset prices fall, but the markets in some of these instruments virtually closed. There were no buyers.

This freezing of capital markets led to a chill in banking systems around the developed world. Banks that had relied on selling packages of loans in securitised form found that they couldn’t sell them. Investment vehicles that held securitised loans have found it difficult to finance their holdings by borrowing. Faced with the possibility that they would have to finance these vehicles themselves, banks with spare cash have hoarded it and have become reluctant to lend to other banks beyond very short maturities. That has been evident in the spreads between interbank lending rates and central bank interest rates in the UK and equally in the euro area and United States. The bottom line is that banks that had financed themselves by borrowing from their peers, or by securitising and selling their loan assets, found that their funding dried up. In the United Kingdom, Northern Rock was particularly exposed. It was able to borrow only at shorter and shorter maturities.

The present financial crisis is of a most unusual nature in that it comes against a background of five years of strong growth of the world economy and a decade and more of remarkable economic stability at home. Moreover, most banking and financial crises in the past – from the failure of Overend and Gurney in 1866, to the collapse of BCCI in more recent times – were associated with bad loans and significant losses on assets. The remarkable fact about this crisis has been the relatively small size of the bad loans compared with the total assets of banks. The crisis has arisen instead from the way banks have managed their liabilities.

What did the Bank of England – as the central bank – do for the banking system?

First, we did our routine work in the money markets of lending to the banking system against high quality collateral, such as government debt, and at Bank Rate set each month by the Monetary Policy Committee. After some initial volatility, we achieved our primary objective in the money markets of bringing interest rates on overnight borrowing into line with Bank Rate. And over the past two months as a whole, overnight interest rates have, on average, been as close to Bank Rate in the UK as in the euro area and closer than in the US.

We were, however, pressed to do more than our routine job and to lend in exchange for other collateral, including the financial assets for which the markets had virtually closed. Banks, in particular, said they wanted us to help them turn illiquid assets into cash.

As I told the House of Commons Treasury Committee on 20 September, we were cautious about doing this. The case for caution is, in the jargon, moral hazard. Put simply, such action by us encourages the very risk-taking that caused the present problems. It is crucial that, in making their lending and borrowing decisions, banks face the right incentives. That is why we did offer to lend in exchange for illiquid assets but only at a penalty rate of interest.

Support on the scale required by Northern Rock would have been difficult to undertake without it becoming “stigmatised” – regardless of the method adopted. The only way to avoid that would have been to offer to lend to all banks at a rate that many others – in addition to
Northern Rock – found attractive to pay. And to do that without drawing attention to Northern Rock’s take-up would have required a truly massive injection of cash into the banking system. That could happen only if there were no penalty rate or if conditions in money markets generally were difficult enough to make the penalty rate attractive to many banks over a prolonged period.

Nothing would have been easier than for the Bank of England to lend freely without a penalty rate. Almost every actor in this drama saw advantage in cheap money and plenty of it. The role of the central bank is to ensure that the appropriate incentives are in place to discourage excessive risk-taking and the under-pricing of risk, and in so doing to avoid sowing the seeds of an even greater crisis in future. That we have done in each action we have taken – by maintaining the principle of the penalty rate.

Some commentators have taken issue with these concerns about moral hazard, arguing, by analogy, that fire departments put out fires started by people who smoke in bed. I agree that we have fire services to do precisely that. And if a fire starts in the financial system, the central bank will put it out if it threatens to spread. But fire services do not offer free insurance for people who smoke in bed or set fire to their own house, thereby encouraging them to take risks that endanger others.

When it became clear that Northern Rock could not find funding elsewhere, it came to the tripartite authorities (FSA, Treasury and Bank) to seek financial support from the Bank of England. Rather than stabilise the situation, the actions of the authorities seemed, at least initially, to fan the flames. There are lessons for us to learn. And I will come to those in a minute. But let me return to the queues of depositors. Here is an extract from a local newspaper:

“By noon on Friday, more than 40 … customers … were waiting in line at the branch … waiting upward of an hour and a half to withdraw money from their accounts.”

“Anxious depositors clutching withdrawal slips filled the offices for a second straight day. … The company placed extra chairs in a waiting area and asked customers to write their names on a sign-in sheet.”

This wasn’t Newcastle or London. It was Los Angeles on August 17 and 18. The bank experiencing the run was not Northern Rock but Countrywide, a US mortgage bank. It is a Tale of Two Banks – banks of similar sizes and facing similar difficulties with funding – just a few weeks apart. Like Northern Rock, Countrywide took risks and relied on short-term funding from investors. But the similarity ends there. There were two significant differences.

First, Countrywide had paid millions of dollars each year to big banks as a liquidity insurance policy so that, in the event of difficulty, they would provide it with long-term loans. So on August 17 Countrywide was able to claim on that insurance and draw down $11.5bn of committed credit lines. Northern Rock had not taken out anything like that level of liquidity insurance. So when it came to the Bank of England for support, it was important that liquidity was not provided free.

Second, even though Countrywide had insurance, its depositors were still worried. On hearing that it had claimed on its insurance, queues formed. But those queues were short and soon dissipated. The depositors simply did not face the same incentives to withdraw their money. The United States has a well-developed insurance scheme for depositors. If a bank is forced into administration, there are mechanisms in place to repay depositors in full, up to $100,000 per account. And most importantly, the depositors are paid within just a few days. Without such a scheme in the UK, once the queues started to form at Northern Rock, other depositors faced every incentive to join them. The only way to stop the run was for the Chancellor to announce a government guarantee of the deposits of Northern Rock, which today was extended to new depositors as part of the continuing stabilisation plan for the business.
So what are the main lessons for us from the recent episode? Time will provide an opportunity for deeper reflection, and it is important that careful thought does come before action. But I would identify three lessons.

First, liquidity should be central to the regulation of banks. Regulation worldwide has paid insufficient attention to liquidity, focussing instead on capital. Northern Rock did not face a problem of inadequate capital. But it was vulnerable to a shock that reduced the liquidity in markets for securitised mortgages. Banks need to face the right incentives to manage their funding positions. Smaller banks with reliance on wholesale funding should be encouraged to put in place insurance. We should not, however, expect regulation alone to solve this problem. That is why I think it is so important to create the right incentives.

Second, the single largest impediment to dealing with Northern Rock was the absence of a mechanism for intervening pre-emptively in a bank in trouble to separate the retail deposit book – the insured deposits – from the rest of the bank’s balance sheet. The ability to do this is central to the way the US and other systems operate, where the authorities are obliged to step in early – “prompt corrective action” – to protect depositors. One tool at their disposal, currently unavailable in the UK, is a special insolvency law for banks. Legislation to create the powers to deal with a bank in this way seems to me to be the single most important necessary reform. Deposit insurance is another area that requires change. To pretend that retail depositors can be treated in the same way as unsecured creditors in a business as complex and opaque as some of today’s banks is wholly unrealistic. The upper limit on deposits that qualify for 100% insurance has sensibly been raised, and the Government has made clear that a longer term reform of deposit insurance is also under review.

Third, central banks operate as lenders of last resort. We need to be able to lend against good, albeit illiquid, collateral, and at a penalty rate, without destabilising further any bank to which we lend. Reform of deposit insurance will go a long way to achieving this. But in an age of instant communications, where the news of a facility for Northern Rock was leaked even before it was officially announced, it may be difficult to adopt the quiet methods used by central banks in the past. We will, however, explore ways to restore the use of discretion in central bank operations.

Finally, it is worth remembering that, unlike the cases of BCCI and Barings a decade or more ago, or the problems with pensions and life insurance more recently, not a single depositor has lost a penny. I hope, however, that the three lessons I have identified will be incorporated in future legislation.

It is equally important that the Bank is not distracted from the job of setting interest rates to meet the 2% target for CPI inflation. In March this year, inflation rose to 3.1% and I wrote an open letter to the then Chancellor explaining why and what we were doing about it. Over the past 12 months, we have raised Bank Rate by one percentage point. And, notwithstanding some claims at the time of the open letter, inflation has since fallen back quite sharply, mainly as retail gas and electricity prices have stopped rising and, more recently, fallen. CPI inflation was, in August, a fraction below the 2% target. The challenge now for the Monetary Policy Committee is to keep it there.

The current turmoil in financial markets is not over. Conditions have eased a little – share prices have recovered and interbank interest rates have fallen back. Indeed, spreads between interbank rates and anticipated central bank interest rates are now lower in the UK than in the euro area or United States. But for the moment, some markets remain virtually closed. And even as they re-open, there will not be a return, I hope, to the excessive risk-taking – and associated rapid expansion of credit – of the past few years. With investors more wary of risks, banks will find it harder to raise funds. So credit will not be so readily or cheaply available to businesses and households.

As we said in August, pressures on capacity mean that output growth needs to slow moderately over the next year or so if we are to continue to meet the inflation target. We will be monitoring closely the impact of tighter credit conditions on demand and output over the
coming months. Even though inflation is close to the target and pay pressures are muted, we will continue to look ahead and monitor the risks to inflation that we identified in August: the signs from surveys and financial markets that people expect inflation to pick up; the strength of company pricing intentions, and the recent increases in world commodity prices.

Keeping inflation close to the 2% target is the biggest contribution the Bank of England can make to economic stability generally. Changes in Bank Rate could not prevent the profound change in the world economy that pushed down yields on low-risk financial assets and led investors to take on more risk. They cannot now prevent the re-pricing of that risk. And just as Bank Rate was not set to insulate the manufacturing sector from the trade deficit that resulted from the earlier change in the world economy, it will not be set now to insulate the banking system from the re-pricing of risk. But you can be sure that we will do whatever is necessary to keep inflation close to the 2% target.

Tonight is the first time that the Court of the Bank of England, and the Monetary Policy Committee, have gathered in Northern Ireland. So much has changed in the Province since the troubles started and I first came to Belfast to speak at Queen’s University. Given that we are the Bank of England, it would be understandable if many in Northern Ireland were suspicious of our role. But I can assure you that we are most definitely the central bank of the whole of the United Kingdom, including Northern Ireland. We pay great attention to events here, and, along with other members of the Monetary Policy Committee, I visit regularly. We have a full time Agency with a team who live and work in Northern Ireland and report back every month on what is happening in the local economy.

At this momentous time in the history of Northern Ireland, I can assure you that the Bank will continue to place great importance on its presence here. During my visits, I have discovered some extraordinarily successful companies, many set up during the troubles. As you continue to build the political success and economic prosperity of the new Northern Ireland, the Bank of England will support you wholeheartedly through our efforts to provide a platform of economic stability.