

John Gieve: Learning from the financial crisis

Speech by Sir John Gieve, Deputy Governor of the Bank of England, 2008 Europe in the World Lecture Panel Discussion, at the European Business School, London, 19 November 2008.

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The years after sterling left the ERM were the most successful and stable in my lifetime. In early 2007, for example, inflation had not moved by more than a single percentage point away from target in the previous 10 years, the output of the economy had grown in every quarter since 1992 Q3 (**Chart 1**), unemployment had fallen by 5 percentage points from its peak in the early 1990s and living standards had steadily increased. Interest rates had been low and stable.

However as we know now, that was the end of “the Great Stability”. The summer ushered in a period of extraordinary turmoil in Western financial markets which we are still trying to calm. And this year has seen the onset of recession not just in Europe but throughout the advanced economies. Despite the dramatic policy measures of the last months, the outlook for 2009 is bleak and the prospects beyond are uncertain.

That move – in the space of only 12 months – from the policy maker’s dream of steady non-inflationary growth to the biggest banking crisis since the outbreak of World War I and the onset of recession sets the questions for this evening.

First, how did we get into this position?
Second, what are the immediate challenges for policy?
And finally, what lessons should we draw for the future?

How did we get here?

The path that led from losses in the US sub prime housing market to a collapse of confidence in the Western banking system and a savage credit squeeze has been described many times, most recently in the Bank’s *Financial Stability* and *Inflation Reports*. I don’t need to repeat that here but I would highlight two features: first this is a global story; second, the nature of the crisis has changed over the past 15 months and has called for a changing policy response.

A global crisis

You cannot explain recent developments on a national basis, even in the US. The roots of the crisis lay in global imbalances in trade and capital flows between advanced and emerging economies. The rapid growth of exports from Asia, and latterly the Gulf, was reflected in a substantial build up of savings. In China the national saving rate peaked in exceeded 50% of GDP. Those funds flowed back to the developed world and to the US in particular. That kept interest rates low and allowed a rapid growth of credit. Following the dotcom bubble, there was a particular appetite for fixed income investments which led to an increasingly risky search for yield. That was the platform for the excesses of lending to the sub-prime housing market in the US and a sharp rise in house prices more generally.

The impact was not confined to the US. The flow of funds into the US was re-exported to the advanced economies, especially through the growing securitisation markets, and helped finance the rapid increases in house prices in the UK (**Chart 2**) and many other countries. And that internationalisation of markets was reflected also in the build up in our banks of portfolios of AAA-rated securities which offered a slightly better yield than traditional bonds and many of which were based on sub-prime assets.

So when losses emerged in sub-prime market, they not only hit US banks but ricocheted through the international financial system. Much of the commentary has focused on the structured credit losses in banks' trading books and treasuries and they have certainly been large.

But equally as important was the impact on the liability side of balance sheets. Banks had not only expanded their balance sheets too far, they had in the process become reliant on wholesale funding markets which had not been tested in a downturn. In the UK, the gap between customer lending and deposits moved from zero at the turn of the century to over £700 billion in 2008 H1 (**Chart 3**). That proved a structural weakness when investors realised that the AAA label concealed substantial and uncertain risks and withdrew from the securitisation markets.

Just as the origins of the crisis lay in global imbalances its effects are also global. Initially, the impact of the crisis seemed to be concentrated in the US and a handful of European banks in Germany, the UK and Switzerland which had pursued particularly risky strategies. The euro area as a whole did not see a marked reduction in credit growth. Meanwhile the emerging economies of Asia continued to boom. With wages and prices rising, many of the people I met in India and China at the start of the year rather welcomed the prospect of a fall in Western demand as a means of taking a little of the heat out of their own economies.

But despite different starting points and policies, we have now seen bank failures in many countries in Europe and acute pressures develop everywhere. And the US, Japan, the euro area and the UK have all entered recession. This summer has also brought a slowdown in growth in the Far East and other emerging economies which is likely to test political as well as economic regimes.

The challenge for policy

It was clear last autumn that the financial crisis was leading to a squeeze on credit and lowering the prospects for growth and inflation in the UK. That was why the MPC, which had been raising rates as late as July, cut Bank Rate in December last year and followed with two more reductions in February and April. While the euro area started with lower rates and initially seemed less affected than the UK by a credit crunch, expected increases in rates were delayed.

However, these downside pressures were not the only challenge to policy. Oil prices which had been pushed up by the rapid growth in emerging markets took another dramatic jump and food prices began rising more quickly too. Between 2007 and mid-2008 oil more than doubled in price, while food prices rose by around 80%. At the same time sterling which had climbed to \$2.10 in November 2007, fell back. The result was that consumer price inflation in the UK rose well above target to 3% in April and over 5% in September, its highest rate since 1992 (while RPI inflation has been over 4% for all but 4 months out of the past two years).

Not surprisingly expectations of inflation also rose sharply (**Chart 4**), raising the risk that higher inflation would become embedded in decisions on the prices for other goods and services and on pay. Of course commodity prices and inflation more generally have now begun to come down but I believe the risk of dislodging expectations was a real one, not a mirage. Certainly I felt that to reduce rates during months when inflation was not only rising rapidly, but was rising faster than we had forecast, would be confusing and might weaken confidence in our resolution and the credibility of the inflation target. On similar grounds, despite the appreciation of the euro, the ECB raised rates in July this year.

In the spring and early summer, the financial crisis also was showing some signs of stabilising in the US and in Europe, particularly after the takeover of Bear Stearns in March signalled that the "state safety net" in the US had been extended to cover investment as well as commercial banks. The introduction of the Special Liquidity Scheme in April here and extensive liquidity measures in the US led to a period in which funding pressures eased and

Libor spreads and CDS premia softened. Our August forecast was for a pronounced but limited deterioration in growth. The threat of a strengthening feedback loop from a contracting banking sector to a severe downturn in the real economy had not disappeared but did not seem the central case.

But the risks and the challenges changed dramatically in the autumn.

First, the losses incurred by investors in the rescues of Fannie and Freddie combined with the decision to allow Lehman Brothers to go into administration, led to a dramatic loss of confidence in financial markets (**Chart 5**) threatening a savage further twist in the squeeze on credit for households and companies.

Second, we saw a sharp weakening in oil prices (**Chart 6**), with the odds implied by options of such a fall less than 1%. Other commodity prices also fell. And, even before that was reflected in consumer prices, the public's inflation expectations turned down decisively.

In short, the balance of risks between inflation being above or below target in the medium term shifted decisively to the downside.

That was the background to the internationally coordinated reductions in interest rates in early October and the aggressive cut of 150 basis points in Bank Rate in November, the largest reduction in official interest rates since 1992 (indeed I believe it was only the third time Bank rate had been cut by 150bp since the Bank was founded over 300 years ago).

Even so, our latest medium term projections for inflation show inflation remaining below target in the medium term and suggest further reductions may be necessary (**Chart 7**). Of course, there are large uncertainties around that projection; more so than usual. In particular, they take no account of any fiscal measures that the Government may announce next week.

Just as we had to change gears on monetary policy, so we needed to change our approach to the banking sector. The tripartite authorities – the Bank, FSA and Treasury – were criticised for the handling of Northern Rock and for being slow off the mark when the crisis started in 2007. But we learned from that experience. We have established new ways of providing the market with the liquidity that it needs. And, as the crisis has widened, we have dealt with vulnerable and failing banks, such as Bradford and Bingley, more speedily and cleanly.

But as the crisis deepened in late September, it became clear that we needed more than a case by case approach here to tackle the continuing loss of confidence in the banking system in the UK, in euro area and in the US. On 8 October therefore we announced a comprehensive package of measures including support for recapitalisation, guaranteed funding and enhanced liquidity. That very quickly became the template for action in other advanced and some emerging countries.

The central plank of the package was the offer to underwrite capital issuance of at least £50 billion and it is important to be clear what that was intended to do. It was not to establish new regulatory minimum ratios. It was intended to underpin confidence in the banks and to ensure that each institution would have a sufficient capital buffer both to absorb losses that are likely to arise during a recession and to continue lending on normal commercial criteria. Under the new Basel II rules the ratio of capital to risk weighted assets is almost bound to fall as arrears and losses mount. The aim of the package was to create the headroom for that to happen and to remove the capital pressure on banks to deleverage quickly by refusing even good credit requests.

The capital raising is not complete of course but the process is underway. Banks and building societies have already secured around £50 billion of guaranteed funding in the market and has facilitated new bank debt issuance without the need of a guarantee. Overall there has been some easing in the money markets and some repair in confidence. The complete seizure that was looming has been averted.

However, we are clearly not out of the woods yet. Financial markets across the world are still badly impaired; spreads have not yet returned to their summer levels; and, while banks look more secure, many hedge funds for example are under increased pressure. In the wider economy, we are only in the early stages of a recession in the advanced economies and of the slowdown in emerging markets. So we must be ready to take further action if required whether monetary, fiscal, or directly in the financial sector.

Lessons for the medium-term

That is the immediate prospect. I want to finish by drawing out some lessons for the medium term.

1. *Closer international co-ordination of macroeconomic policy*

The first lesson is the vital importance of international cooperation in a global economy.

For several years we worried about the growing imbalances between the US in particular and emerging Asia. We can now see how painful the rebalancing is proving. No doubt we could do better in national policy making but we also need to recognise that the sum of policies which make sense at the national level may well not be optimal at the global level. To give one example, for most economies individually a change in the oil price is an external event – something beyond the reach of policy. But clearly that is not true of the global economy as whole.

Of course we have a great deal of experience in the EU of establishing common rules and policies. We know it is a painstaking process among 27 countries. But on finance and the economy we need to go wider than the EU and wider than the G7 to engage the new economies which account for so much of world growth. That is why it was so important and welcome that the recent meeting in Washington was of the G20 rather than the G7. Alongside the IMF it is going to play a key role in global macroeconomic coordination.

2. *Better ground rules for cross-border financial crises*

The failure of Lehman Brothers has confirmed that cross-border failures of large and complex firms are just as damaging and difficult to manage as we had feared. We need to ensure that proper contingency plans are prepared between the authorities most concerned for failures not just within the EU, where a lot of work is in hand, but on a global basis.

As a start I hope we can establish a robust and predictable framework of rules and conventions that ensure that home authorities will co-ordinate a cross-border response better. The Financial Stability Forum is working on these urgently.

This is not easy. In particular emergencies there are often different national interests at stake and the sheer pressure of events can limit cross-border consultation. However, if we do not tackle this we will see the growth of national restrictions on the terms on which cross-border operations are permitted – in terms of capital, liquidity and legal structure – and that could have great economic costs.

3. *Strengthening banks' resilience*

The financial crisis has revealed a number of gaps and flaws in the regulatory and accounting conventions especially for banks. We need to put those right quickly and on an international basis. The G20 Summit has asked the Financial Stability Forum to take that forward.

For example the events have shown up the lack of any agreement on liquidity requirements on banks. The FSA is developing proposals for UK which will deliver tougher standards. But

we are pressing also for international agreement in the Basel Committee. Events also brought home the need for a fundamental review of both the amount and the definition of capital requirements.

4. *And developing macro-prudential tools*

The last lesson I have drawn is that we need to bridge the gap between macroeconomic policy and the regulation of individual firms. We need a third club in our bag which can directly dampen the financial cycle. This is needed both for financial stability and for wider economic management.

As we have been reminded over the past 15 months, it is primarily in the “bad times” that banks need to demonstrate that they have adequate financial resources. We need to ensure that banks build up resources in good times to a greater extent, which can then cushion the shock in bad times. I think of this as “protecting banks from the economic cycle”.

But we have seen also how the financial sector can drive the wider business cycle, by becoming over-confident in the upswing and over-constrained (by lack of financial resources – capital and liquidity) in the downswing. It seems to me that mechanisms which oblige banks to build up resources in good times can serve a second useful purpose of dampening the economic cycle. I think of this as “protecting the cycle from banks”.

We need two-way protection and I would like to describe three ways you might go about providing it.

The first is the Spanish system of dynamic provisions, which requires banks to build a general reserve that can be drawn on in downturns. Each period, banks are required to make general provisions equal to the difference between the “inherent” losses (based on the growth of loans and a long-term average of incurred losses) and the specific provisions on impaired assets for the period. The difference, if positive, is treated as an expense in the profit and loss account. If negative, it is treated as income – provided that the general reserve has been previously built up to the required level.

The specific provisions made by Spanish banks fluctuate substantially through the business cycle, as one would expect, falling during upswings and increasing in downturns. But the flow of general provisions moves in the opposite direction, acting as a countercyclical mechanism. In the last boom, the accumulated stock of total provisions grew steadily between 2005 and 2008, to a level which at the start of this year was twice as large as their non-performing loans. That figure has fallen sharply in recent quarters, in the face of fast-growing credit losses, but it did ensure that Spanish banks were better placed than their counterparts in other countries to absorb such losses without immediately eating into their core capital. The Bank of Spain estimates the current level of general provisions could absorb losses associated with a doubtful assets ratio of 9% (the current level is 1.5%). The general reserve is also substantial in comparison with the tier 1 capital ratios, representing 1.3% of the risk-weighted assets.

I know that general provisions fall foul of modern accounting practice and can be unpopular with tax authorities. But the Spanish example demonstrates that – despite all the technical arguments there might be about the details – a mechanism with broadly the right features is practicable and can generate worthwhile additional reserves against the losses which crystallise in cyclical downturns. It does not require precise estimates of the length of the cycle, or predictions of when the cycle will turn; and it can be capped, so that the reserve does not continue to grow inexorably in an extended upswing. I think it merits serious consideration for more widespread adoption, irrespective of the accounting and tax treatment such reserves might attract.

One key feature of such reserves is that they should be useable. That is, the markets and analysts need to accept that using such reserves to absorb write-offs when losses are high is the natural counterpart of building them up when losses are cyclically low. It is not a sign of

weakness or of inadequate capitalisation, but of prudent management of the cyclical pattern of losses. From the point of view of market acceptability, separating cyclical reserves from more structural capital requirements seems a valuable idea.

The second scheme I want to promote is growth-related capital requirements.

Losses tend to be lower in the early stages of a loan's life than when it is fully seasoned because borrowers are more certain of their own and the economy's near-term prospects. A loan book which is growing more rapidly than average will be weighted towards such unseasoned loans, and so will appear to be performing better than a balanced portfolio of loans of different vintages. In addition, rapid growth of lending tends itself to be associated with taking on poor business – even if that is not obvious at the time it is written. Typically, rapid growth can only be achieved by drawing in marginal borrowers to the market. That is true of the banking sector as a whole. And when such growth is achieved by an individual bank, over and above that achieved by its peers, adverse selection – attracting weaker borrowers, who are unable to raise funds from other lenders – is an additional factor depressing the quality of the loan book. The simple fact is that rapid absolute and relative growth is strongly associated with poorer average loan quality and, sooner or later, sharply higher non-performing loans.

The proposal is that, the risk weighting (and so, the capital requirement) of bank loans should include a growth-based component. This could be linked either to the economy-wide growth rate of a particular type of business, or to the growth rate of an individual bank's lending relative to the market as a whole; or some combination of the two. This would make it more expensive for banks to expand their balance sheets faster than normal when confidence is high and could be a useful means of dampening banks' contribution to the business cycle.

The third, less direct, mechanism to discourage over-rapid expansion would be on the liabilities side. Rapid balance sheet expansion tends to be fuelled by access to less stable sources of funding, attracted perhaps by higher interest rates as the bank seeks to meet its balance sheet aspirations (and feels able to pay, because – as already explained – loan loss experience is good). Such funding could be treated as an added risk factor in assessing a bank's liquidity needs and those needs should be reflected in a requirement to hold high quality liquid assets. So banks which are funding their expansion in this way will need to match that expansion with an increasing stock of safer and lower-yielding assets. This will tend to reduce their profit margins and so discourage rapid growth which is funded from less stable sources.

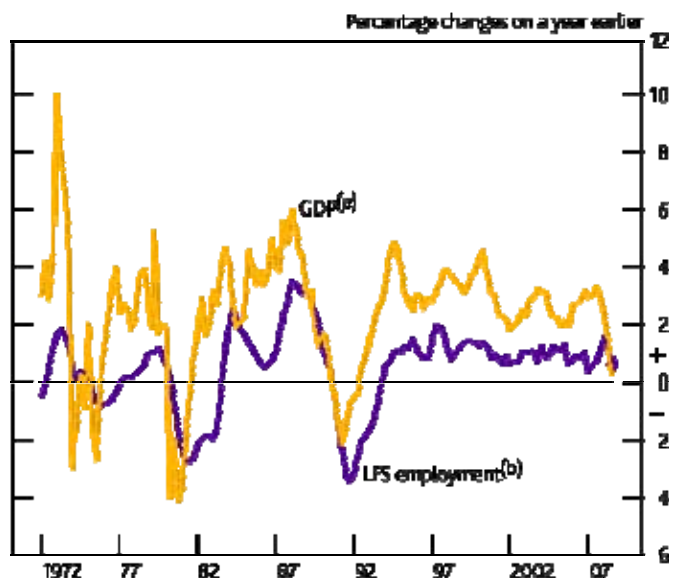
Of course these outline proposals need a lot more work. Striking an appropriate balance between the prudential objective of protecting the banks against the cycle and the macroeconomic objective of dampening lending in the upswing will not be easy. And they are never going to be the whole answer. The more we raise the cost of increasing lending by banks, the greater the incentive we will create for the growth of intermediation outside the regulated banking sector or to foreign banks not subject to such counter-cyclical requirements. Even if such unregulated competition had no consequences for banks themselves, it could certainly undermine the desired counter-cyclical effects. And the secondary banking crisis of the early 1970s is a reminder that we cannot anyway be relaxed about changes in the scale of lending taking place outside the regulated sector.

Conclusion

To sum up, the last 15 months have brought home the costs of unbalanced growth in the world economy. Although the correction started with a bursting property bubble in the US, it has expanded into a global financial crisis and brought on recession throughout the advanced economies and a sharp deceleration of growth elsewhere. The immediate priority is to deal with this downswing. The extraordinary measures we have taken in this country and others are having a positive impact but we may need to do more. We must also learn

some lessons for policy in the medium term including the need for far better coordination of policy internationally and the need for some new policy instruments alongside interest rates to dampen the financial cycle.

Chart 1: GDP and employment



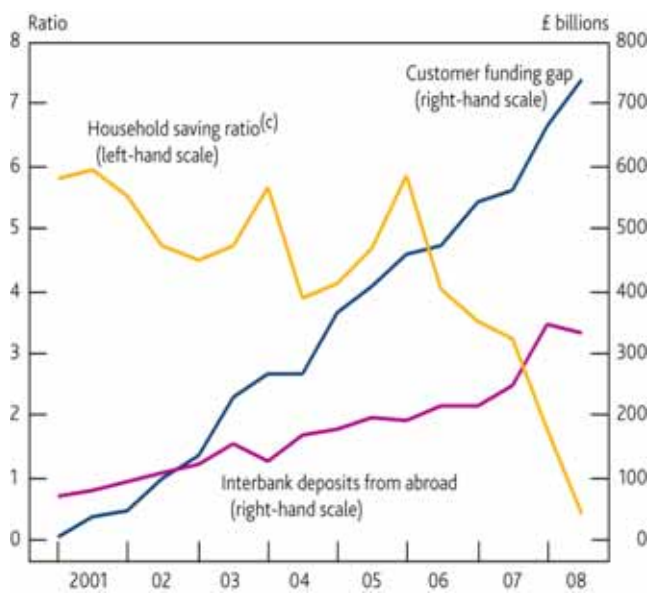
Source: ONS (including Labour Force Survey)

Chart 2: House prices and earnings



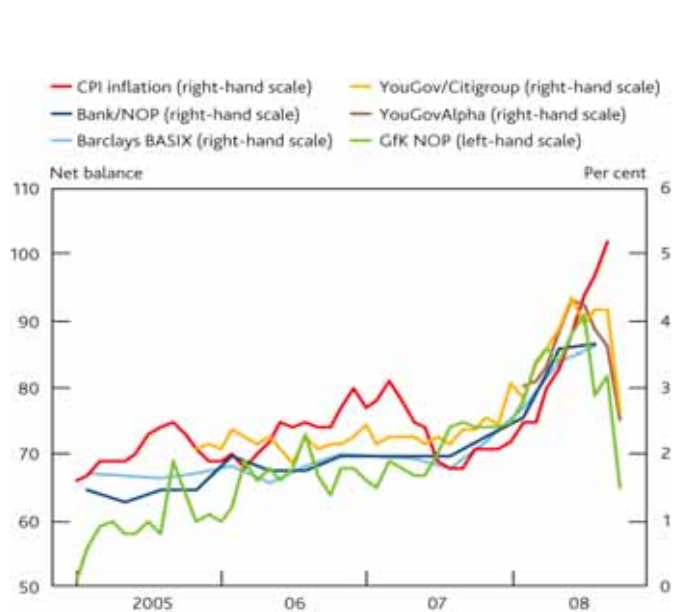
Source: Halifax, Nationwide, ONS and Bank calculations

Chart 3: Major UK banks' customer funding gap, household saving ratio and foreign interbank deposits



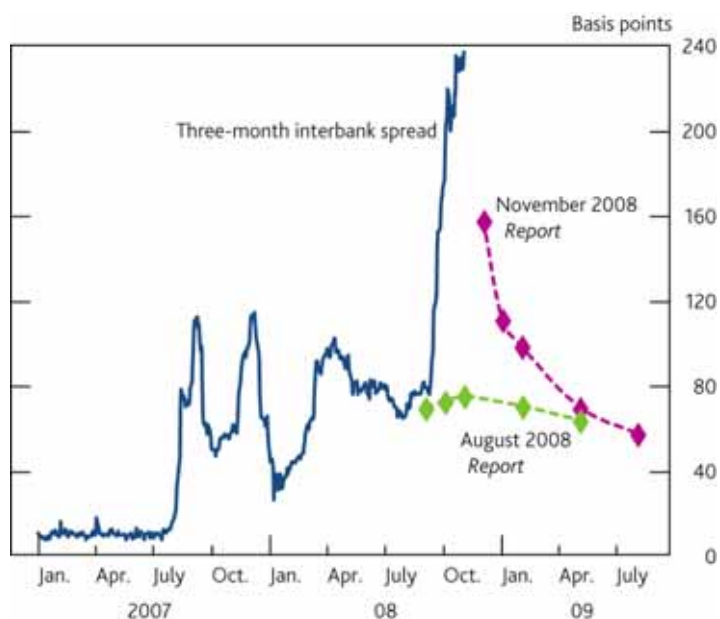
Source: Bank of England, Dealogic, ONS, published accounts and Bank calculations.

Chart 4: CPI and households' inflation expectations for the year ahead (scaled to match CPI on average)



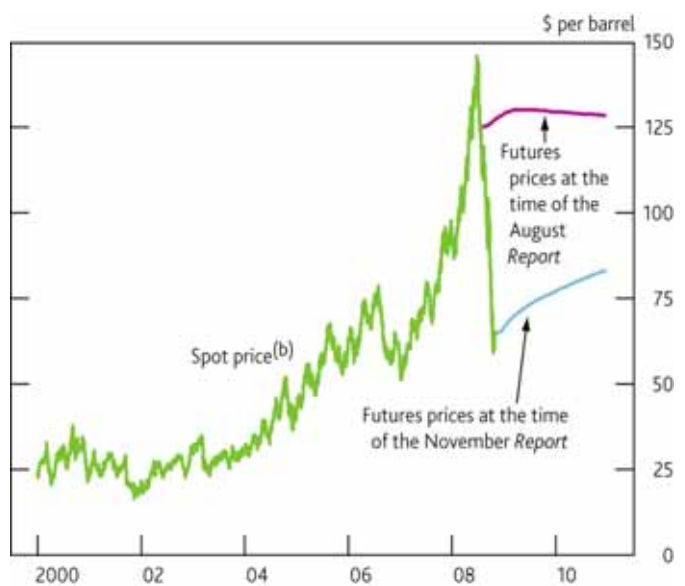
Sources: The AlphaMonitor: consumer, YouGovAlpha, Bank of England, Barclays Capital, Citigroup, GfK NOP, research carried out by GfK NOP on behalf of the European Commission and YouGov.

Chart 5: Sterling three-month interbank rates relative to future expected policy rates



Sources: Bloomberg and Bank Calculations

Chart 6: Oil prices



Sources: Bloomberg and Thomson Datastream

Chart 7: CPI inflation projection based on market interest rate expectations

