

## Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at the University of Exeter, Exeter, 19 January 2010.

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Some dates are easier to remember than others. 1789 and the French Revolution, 1989 and the fall of the Berlin Wall, 1929 and the Wall Street Crash are easily recalled. How will 2009 be remembered: as the year when the world economy fell off a cliff but was rescued by government and central bank intervention around the world? Or the year when we finally recognised that genuine reform to the international monetary and banking system was essential to restore prosperity? Time will tell.

The world economy is now coming out of recession. But the cost of the banking crisis has been high. After an unprecedented period of sustained growth, total output in the United Kingdom has now fallen for six consecutive quarters. It contracted last year by around 5%, the largest fall in output since 1931. National income is around 10% below the level it would have reached in the absence of the financial crisis.

Around the world, governments and central banks put a massive sticking plaster on the wounds in the form of an extraordinary degree of monetary and fiscal stimulus. As a result, business confidence, orders and output, which all collapsed at the end of 2008, are gradually recovering.

But there is a long period of healing ahead. Although quarterly growth rates of GDP may soon turn positive in the United Kingdom, unemployment is likely to remain high. Fortunately, it has not increased to the 10% rate now experienced in both the United States and the euro area. But at just under 8%, it is markedly above the level to which we had become accustomed during the period known as the "Great Stability".

The sharp monetary squeeze resulting from the efforts by banks to contract their balance sheets is still casting a shadow over the future path of output and employment. Over the past year, broad money growth has slowed sharply to a virtual standstill in the United States, and it turned slightly negative in the euro area. In normal circumstances, we might expect annual rates of increase of between 5% and 10%. At home, annual broad money growth has slowed somewhat less sharply, and remains positive. The unprecedented actions of the Monetary Policy Committee to inject £200 billion directly into the economy – described by some as "quantitative easing" – have averted a potentially disastrous monetary squeeze.

The headline in the *Racing Post* of 29 December said it all: "Quantitative easing Maintains Perfect Record". Its Newbury correspondent reported that "Quantitative easing started as a red-hot favourite and had little trouble maintaining his unbeaten record. Ridden with plenty of confidence his task was made easier when Tail of the Bank came to grief at the second last. His trainer said 'I was delighted with the way he went through that testing ground'". Rather like the MPC, the owners of Quantitative easing, winner of all three of his races in 2009, have yet to decide how many outings he will have in 2010. They are waiting for race conditions to become clearer.

The bold action, taken both at home and abroad, helped to end the collapse in confidence and spending last year. But equally bold action will be needed to prevent a similar crisis from recurring. The origins of the crisis lay in our inability to cope with the consequences of the entry into the world trading system of countries such as China, India, and the former Soviet empire – in a word, globalisation. The benefits in terms of trade were visible; the costs of the implied capital flows were not.

The new entrants adopted a strategy of expanding manufactured exports to create employment. High rates of saving depressed domestic demand. So substantial trade

surpluses were required to keep total demand in line with supply. Equally, the countries importing those manufactured goods ran trade deficits and required low saving rates to maintain balance in their economies. Everyone seemed to gain. High-saving countries created employment, and low-saving countries enjoyed faster consumption growth as cheap imports meant that living standards rose by more than the increase in production – worth around half a percentage point a year in the United Kingdom. These were the benefits of greater trade.

But the pattern of poor countries saving a lot and rich countries borrowing was not sustainable. The consequences of our inability to cope with these capital flows did not show up in the usual macroeconomic indicators such as growth, unemployment and inflation. Overall balance in each of the major economies was maintained. Rather, the massive flows of capital from the new entrants into western financial markets pushed down interest rates and encouraged risk-taking on an extraordinary scale. Banks expanded their balance sheets and new instruments were created to satisfy the search for yield. In the five years up to 2007, the balance sheets of the largest UK banks nearly trebled. The build up of risk came to threaten the stability of the entire financial system. Capital flows provided the fuel which the developed world's inadequately designed and regulated financial system then ignited to produce a firestorm that engulfed us all.

To prevent another crisis will require reform to both the regulation and structure of banking and the international monetary system. I have spoken about the former on earlier occasions. Tonight I want to focus on the question of how we can reduce the imbalances in the world economy.

Although overall growth in both high and low saving countries was sustainable, the composition of that growth was not. And the composition of growth reflects the interaction between countries' economic policy choices. No individual country faced strong incentives to alter its own choices, but the collective outcome was costly to everyone.

The interdependencies between countries can be illustrated by a simple three by three table which I call "Sudoku for economists", showing the composition of demand in, and the trade flows between, the high- and low-saving groups of countries.

**"Sudoku for Economists": 2008 data**

	<i>Domestic Demand</i>	<i>Net trade</i>	<i>GDP</i>
<i>High-saving countries</i>	18,000	1,000	19,000
<i>Low-saving countries</i>	28,500	-1,000	27,500
<i>Total</i>	46,500	0	46,500

Source: IMF.

Data for G20 countries, rounded to the nearest \$500 billion.

The key point is that the entries in the table – corresponding to economic policy choices – are interdependent reflecting economic constraints. Total demand or GDP is the sum of domestic demand and net trade. And, assuming for simplicity that the world can be divided

into high- and low-saving countries, the trade surplus of one group is the deficit of the other. Just as in a sudoku puzzle, the nine numbers in the table cannot be chosen independently. Sudoku for economists is simpler than ordinary sudoku because the economic adding-up constraints mean that of the nine numbers in the table, only three can be chosen independently. So, for example, if both groups of countries want to achieve full employment levels of GDP, and the high-saving group targets a trade surplus, the low-saving group cannot target a reduction in its trade deficit. Either trade deficits must remain high, which is not likely to prove sustainable, or something else must give. That might involve a recession in the deficit countries, or an acceptance by the surplus countries that, one way or another, trade imbalances must be reduced. Sudoku for economists shows that countries cannot pursue for long incompatible economic policy frameworks.

The reason why continuing large deficits are not sustainable indefinitely is that for every current account deficit there is an equal net capital flow in the opposite direction. Even if those flows remain constant in size, they imply an ever increasing stock of international asset and liability positions. Today China alone has reserves of over two trillion dollars, and Japan another trillion dollars. Adding inexorably to the stock of international assets and liabilities is like adding one brick on top of another to form a tower. With skill, it can be done for a surprisingly long time. But eventually the moment comes when adding one more causes the tower to fall down. If countries do not work together to reduce the “too high to last” imbalances, a crisis of one sort or another in financial markets is only too likely. We saw that following the first oil crisis in the 1970s when the attempt to “recycle petrodollars”, as they were called, led to defaults by a number of emerging market economies and a crisis in western banks. And sudden shifts in capital flows have led to periods of remarkable volatility in exchange rates between the world’s major currencies, the dollar, yen and euro (and, before 1999, the deutschmark).

So the problem of global imbalances is hardly new. It was behind many of the currency crises in the post-war period and exercised the participants at the Bretton Woods conference in 1944. And for the past decade it was a regular item on the agenda of international meetings of finance officials at the IMF, G7 and elsewhere. But the incompatibility of different countries’ policy frameworks has proved difficult to resolve.

At the Bretton Woods Conference, the British economist John Maynard Keynes identified the asymmetry of the obligations placed on surplus and deficit countries as the main source of the problem. He had argued that,

*“the process of adjustment is **compulsory** for the debtor and **voluntary** for the creditor. If the creditor does not choose to make, or allow, his share of the adjustment, he suffers no inconvenience. For whilst a country’s reserve cannot fall below zero, there is no ceiling which sets an upper limit.”*

Both the British and the Americans put forward proposals for a system with more symmetric obligations – but without success. For most of the post-war period, the obligations on debtor countries, asymmetric though they may have been, prevented the imbalances from becoming too big. More recently, the fact that the largest deficit country, the United States, was the issuer of the world’s reserve currency allowed the imbalances to continue for a long period, inducing a sense of complacency and threatening the stability of the global economy.

So the challenge of designing an international monetary system that could prevent the emergence of “too high to last” imbalances remains. The financial crisis has reminded us all of the importance of solving this problem. Sudoku for economists shows that it is essentially a political and not a technical problem: how can we ensure that the economic policy frameworks of countries are consistent with each other?

At present there is no political mechanism for achieving that consistency. Finding such a mechanism is urgent. Having narrowed somewhat at the height of the crisis, the imbalances are now widening again. There is a risk that countries will, out of frustration, impose unilateral

and ultimately self-defeating protectionist responses. Because the number of countries involved in the international trading system is now so large, and the countries so diverse, the idea of another Bretton Woods conference is wholly impractical. The IMF, despite the legitimacy bestowed by its membership of 186 countries, is too unwieldy without reform. The G7 omits some of the key players, such as China. Of more immediate promise is the G20 group of countries, which produces almost 90% of world GDP. Last year, under the UK Presidency, the G20 agreed to a new policy coordination framework which commits member countries to a process, using the expertise of the IMF, of assessing the consistency of their national policies. G20 Heads of Government will meet twice this year, in June and November, to discuss progress.

So far the only specific agreement is to talk to each other. Concrete steps to reduce the scale of global imbalances have, to date, been notable by their absence. Smiling family photographs marking the attendance at international gatherings are no substitute for specific actions. Still, the G20 has laid its reputation on the line. It will be damaged if the framework comes to nought.

Looking further ahead, the legitimacy and leadership of the G20 would be enhanced if it were seen as representing views of other countries too. That could be achieved if the G20 were to metamorphose into a Governing Council for the IMF, and at the same time acquire a procedure for voting on decisions.

The economic message from the crisis is clear: low-saving countries will reduce their net borrowing from abroad and so will no longer be able to play the role of consumer of last resort. To maintain levels of economic activity, high-saving countries must expand domestic demand and allow their trade surpluses to shrink. This is easier said than done. It will require changes in prices and most obviously in real exchange rates – via either nominal exchange rates or domestic price levels. In themselves, proposals such as the creation of a new reserve currency do not solve the inconsistency puzzle unless they alter the desire of high-saving countries to run imbalances that are too high to last. But the reason for hope, even if it has not yet triumphed over experience, is that, despite the short-term political considerations that have prevented adjustment so far, the lesson of Sudoku for economists is that cooperation is better than conflict. There are potential gains for all in the longer term. That is why the UK Government put so much effort into the G20 process. It is, as they say, the only game in town.

Working with our international partners will be important if we are to achieve reforms to the international monetary system. But, as one of the low-saving group of countries, we must not neglect the need for domestic policy actions. The need for a rebalancing of our economy has been apparent for some time; I spoke about it in a speech just along the coast in Plymouth ten years ago. The proportion of our domestic output that we save has fallen by around a third over the past decade, as the share of consumption, especially public consumption, has risen sharply. Looking ahead, monetary and fiscal policy together must help to bring about a switch of demand from private and public consumption to net exports and business investment as the recovery takes hold.

A key element in raising the national saving rate is the elimination over time of the structural deficit in the public finances. Of course, there is a perfectly sensible debate about the appropriate timing of the withdrawal of the temporary fiscal stimulus as the economy recovers. Some has in fact already been withdrawn with the return of the standard rate of VAT to 17.5% at the beginning of the month. But uncertainty about how and when fiscal policy will respond has a direct bearing on monetary policy. And markets can be unforgiving. As Federal Reserve Chairman Bernanke said recently about the similar fiscal position in the United States, “near-term challenges must not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy

economic growth". The Chancellor has made clear that the Spring Budget provides the opportunity to do precisely that.

Over the past year, the UK economy has battled against the headwinds of an intense monetary squeeze and a sharp fall in world trade, supported by the tailwinds of a huge policy stimulus and a lower exchange rate. At this very early stage of the recovery, it is particularly difficult to judge the medium-term prospects for the economy. Ten years ago, I described how movements in macroeconomic data can sometimes bear a "resemblance to old-fashioned disco dancing – sharp movements in unpredictable directions creating much excitement, accompanied by a good deal of noise". Over the next few months, the data are likely to be dancing particularly vigorously under the influence of the reversal of the VAT cut, a turnaround in the stock cycle and even the effects of the recent cold weather. Added to that, the MPC is acutely aware that initial data releases are often later heavily revised, and there is uncertainty over the timing of fiscal consolidation.

The patience of UK households is likely to be sorely tried over the next couple of years. There is little scope for growth in real take-home pay, which may remain weak even as output recovers. It is clear that inflation is likely to pick up markedly in the first half of this year, a message reinforced by this morning's news that CPI inflation reached 2.9% in December. The continuing pass-through of the earlier significant depreciation of sterling, while part of the necessary rebalancing of our economy, is offsetting to some extent the downward pressure on inflation from the large amount of spare capacity. And the rise in VAT back to 17.5% means that CPI inflation is likely to rise to over 3% for a while, or even higher for even longer were energy prices or indirect taxes to increase further. Although such price level effects do not constitute a continuing source of inflation, and hence should be temporary, they remain in the official measure of inflation for a full year. Provided monetary growth remains well under control – and remember that at present it is undesirably low – inflation should return to target in the medium term. I hope you will all remember that in both of the past two years inflation picked up as a result of temporary price level factors and then fell back, as the MPC had predicted.

So how will 2009 be remembered? As I said at the outset, it is too early to tell. The full impact of the financial crisis has yet to be seen. And the national statisticians will take another two years or so before providing their best estimates of spending and output in the UK economy. More importantly, the question of whether basic reforms to the structure of banking and the international monetary system will be made before another crisis engulfs the world economy remains unanswered.