

## Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, to the South Wales Chamber of Commerce, Cardiff, 23 October 2012.

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Of the many memorable moments in an eventful summer, recall that balmy night in late July when attention was diverted from the economy by the Opening Ceremony of the Olympic Games. The sound of Welsh children singing Cwm Rhondda on that beautiful beach in Rhossili filled the Olympic stadium. Inside the stadium, we saw not manna descending from heaven, but thousands of athletes and volunteers rising to their challenge.

If the Olympics aimed to inspire a generation, the challenge for economic policymakers is to give that same generation the opportunities to make the best possible use of their talents in a vibrant economy. After a period of lopsided expansion, with growing trade deficits and debt levels, and a collapse of their banking systems, advanced economies across the world are facing a huge adjustment. Such is the scale of the global adjustment required that the generation we hope to inspire may live under its shadow for a long time to come.

During the course of this year, the challenge has grown as the economic sky has darkened. The storm clouds coming from the Euro area have not yet lifted, and in other parts of the sky new clouds have drifted over. China, India and Brazil, the three largest emerging market economies, are all slowing. According to the latest IMF projections output will fall this year in no fewer than 10 European economies. And the IMF recently lowered its forecast for growth in the advanced economies next year.

Ours may be a sceptred isle, with its own currency and control of monetary policy, but we cannot insulate ourselves from these events. So this precious stone set in the silver sea seems more like a storm-tossed vessel. Despite the probable rise in output in the third quarter, the big picture is that GDP is barely higher than two years ago, and remains some 15% below where steady growth since 2007 would have taken us. Total exports have risen sharply in the wake of sterling's depreciation, but manufactured exports to Europe are falling. Recovery and rebalancing of our economy remain the main challenges for economic policy.

Here in Wales, despite impressive improvements to the infrastructure – not least the remarkable regeneration of Cardiff Bay and the magnificent monument to Welsh culture in this Millennium Centre – your economy too is suffering with total production well below its peak in 2007.

In combating the downturn, monetary policy has played its part. Bank Rate has been cut to its lowest level ever and the Bank has purchased £375 billion of assets in order to inject money into the economy. Although this unprecedented degree of monetary loosening has prevented a depression, it has caused pain to those dependent on interest income. And we have not been able to avoid a sharp rise in youth unemployment.

In the long run, we will need to rebalance our economy away from domestic spending and towards exports, to reduce our trade deficit, to repay our debts, and to raise the rate of national saving and investment. So you are probably puzzled by the fact that we seem to be doing exactly the opposite of that today. Almost four years ago now, I called this the “paradox of policy” – policy measures that are desirable in the short term appear diametrically opposite to those needed in the long term. Although we cannot avoid the long-term adjustment to our economy, we can try to slow the pace of the adjustment in order to limit the immediate damage to output and employment. Loose monetary policy today will eventually give way to a tighter stance of policy as the economy recovers. In confronting the paradox of policy, the Bank has had to show some of the same fleetness of foot and ability to feint as my Cambridge contemporary, Gerald Davies. So let me try to explain this evening what monetary policy can do and what it can't.

In doing this I am not going to pretend that I shall be entertaining. But these are serious times and you deserve a serious explanation of what we at the Bank can do and what we can't, or shouldn't.

Let me start with what monetary policy can do. When banks extend loans to their customers, they create money by crediting their customers' accounts. The usual role of a central bank is to limit this rate of money creation, so that an excessive expansion of money spending does not lead to inflation. But a damaged banking system means that today banks aren't creating enough money. We have to do it for them. And as private sector balance sheets contract, public sector (government and central bank) balance sheets have to take the strain. The way in which the Bank of England expands the money supply is to purchase government gilts from the non-bank private sector and credit the bank accounts of people from whom the gilts are purchased. Please note that we are not giving money away.

What is the effect of these purchases? They push up the price of gilts thus lowering yields. As the sellers of gilts use the proceeds to buy other assets, the price of those assets also tends to rise. Increases in asset prices boost wealth, and at the same time reduce the cost of borrowing for companies and households, which helps to stimulate spending and hence output. The size of these effects is of course uncertain. But there can be no doubt that our economy would have followed an even more painful path over the past few years in the absence of asset purchases.

Some question the scope for further purchases, or their likely effectiveness. I do not have any concerns on the first point. The quantity of gilts in private hands is higher now than when we began our asset purchases, and the government continues to issue new gilts at a rapid rate. As far as the effectiveness of gilt purchases is concerned, it is of course true that as gilt yields have declined the room for further falls is reduced. But it is not the sole objective of asset purchases to push down on government bond yields. Raising the price and reducing the risk premium on a much wider class of assets is equally important.

Although monetary policy can play a crucial role in supporting the economy in these difficult times, there are limits to its ability to stimulate private sector spending. Those limits are inherent in any form of monetary easing, not only asset purchases. Two limits are important.

First, monetary policy supports demand and output by encouraging households and businesses to switch demand from tomorrow to today. But when tomorrow becomes today, an even larger stimulus is required to bring forward more spending from the future. Since the paradox of policy has been evident for almost four years, tomorrow has become not just today but yesterday. When the factors leading to a downturn are long – lasting, only continual injections of stimulus will suffice to sustain the level of real activity. Obviously, this cannot continue indefinitely. Policy can only smooth, not prevent, the ultimate adjustment. At some point the paradox of policy must be resolved.

Second, the scale of the underlying adjustment is large, and monetary policy cannot put off for long the necessary change in the pattern of demand and output. A downward correction of expectations about future incomes and wealth has rendered unprofitable some of the investments made before the crisis. A good example is the investment made in shopping centres which is now either proving less valuable than anticipated, or making redundant some of the other pre-existing stock of retail space. Almost 1,000 high street chain stores closed in the first half of the year. Lower asset values have left debt levels looking too high. Households, businesses and, especially, banks are all deleveraging.

Nowhere is the overhang of debt more obvious than in the banking sector where deleveraging is holding back the flow of new lending. During the crisis central banks have provided liquidity to banks on a truly extraordinary scale, so much so that there were no takers for additional liquidity in our latest auction. It is still useful to keep that auction facility as an insurance policy. But banks are now overflowing with liquid assets. Their problem remains insufficient capital. Just as in 2008, there is a deep reluctance to admit the extent of the undercapitalisation of the banking system in many parts of the industrialised world. The

verdict of the market is clear – without central bank support banks still find it expensive to borrow.

So the Bank of England, together with the Government, has set up the Funding for Lending Scheme (FLS) which provides banks with access to finance for up to four years at below prevailing market rates for term funding. Crucially, the more banks lend to UK households and businesses, the more they can borrow from the Scheme and the cheaper is that funding. That provides a powerful financial incentive for banks to supply more credit.

More than 20 banking groups, including the five largest lenders to the UK real economy and covering nearly 80% of all such lending, have so far signed up. Since the Scheme was announced bank funding costs have fallen by around 100 basis points (see Chart 1). Not all of this is attributable to the FLS – the announcement by the ECB of Outright Monetary Transactions has also played an important role. But it is noteworthy that UK bank funding costs have fallen by more since June than have European bank funding costs (see Chart 2). The effect of the FLS will be seen in the lending data only after some months because of the time it takes for banks to change their lending strategies and for data to be collected and published.

The FLS can be only a temporary scheme. The window of opportunity which it provides must be used to restore the capital position of the UK banking system. I am not sure that advanced economies in general will find it easy to get out of their current predicament without creditors acknowledging further likely losses, a significant writing down of asset values and recapitalisation of their financial systems. Only then will it be possible to return to a more normal provision of the vital banking services so crucial to an economic recovery. In the 1930s, faced with problems of sovereign and other debt similar to those of today, the pretence that debts could be repaid was maintained for far too long. We must not repeat that mistake.

Over the past three years, the Bank of England has bought £375 billion of government bonds – gilts – from the private sector to create a lot of new money. Many – perhaps some of you – are understandably concerned about the use of such an unusual and unfamiliar policy. Some people talk about the dangers of money creation. I want to explain why it is important to distinguish between “good” and “bad” money creation. In essence, the argument is very simple. “Good” money creation is where an independent central bank creates enough money in the economy to achieve price stability. “Bad” money creation is where the government chooses the amount of money that is created in order to finance its expenditure. Insufficient money creation can lead to a contraction of the money supply and a depression. We saw that in the United States during the Great Depression and we see it today in Greece. Excessive money creation leads to accelerating inflation and ultimately the collapse of the currency.

The role of the Bank of England is to create the right amount of money, neither too much, nor too little, to support sustainable growth at the target rate of inflation. We are not doing it at the behest of the Government to help finance its spending. It is the independence of the Bank that allows us to create money without raising doubts about our motives. But just as it is crucial that governments do not control the printing of money, so too the unelected central bank must not determine the levels of taxes and public spending. Fiscal policy is a matter for elected governments.

There has been some talk about the possibility that money created by the Bank could be used directly to finance additional government spending, or even that money could be given away. Abstracting from the colourful metaphor of “helicopter money”, such operations would combine monetary and fiscal policies.

There is no need to combine them because, as now, once the Bank has decided how much money should be created to meet the inflation target, the case for the Government to increase spending or cut taxes to counter a downturn stands or falls on its own merits. What determines the interest rate at which the government can borrow, however, is the path for the

amount of government debt held by the private sector, rather than the total amount of gilts in issue. That is true when the Bank purchases gilts and will be true later when the Bank comes to sell the gilts.

Not only is combining monetary and fiscal policies unnecessary, it is also dangerous. Either the government controls the process – which is “bad” money creation – or the Bank controls it and enters the forbidden territory of fiscal policy. It is peculiar, to say the least, that some of the same people who believe that the Governor of the Bank is too powerful also believe that he should stand on the steps of Threadneedle Street distributing £50 notes – a policy which you will appreciate is rather hard to reverse. For the same reason, the Bank could not countenance any suggestion that we cancel our holdings of gilts. The Bank must have the ability to reverse its policy – to sell gilts and withdraw money from the economy – when that becomes necessary. Otherwise, we run the risk of losing control over monetary conditions.

Giving money either to the government or to households directly, or indeed cancelling our holding of gilts, means that the Bank of England has no assets to sell when the time comes to tighten monetary policy. And when Bank Rate eventually starts to return to a more normal level, as one day it will, the Bank would then have no income, in the form of coupon payments on gilts, to cover the payments of interest on reserves at the Bank of England that we had created. The Bank would become insolvent unless it created even more money to finance those interest payments, and that would lead ultimately to uncontrolled inflation. That is a road down which the Bank will not go, and does not need to go. I suspect that the advocates of “helicopter money” and related ideas are really talking about a relaxation of fiscal policy. It would be better to be open about that.

Enough of what the Bank of England should not be doing. So what should we be doing? Since the Monetary Policy Committee last published an assessment of the economic outlook, other central banks have been active. The European Central Bank announced its plans for Outright Monetary Transactions, the Bank of Japan expanded the scale of its asset purchases, and the Federal Reserve committed to continue with its asset purchases until the outlook for the labour market improves substantially. Our current programme of asset purchases will be complete by next month. What happens after that will depend upon the outlook, beginning with an appraisal of where we are today.

Judging the present state of the UK economy is far from easy. On the one hand, over the past two years total output, or GDP, has been much weaker than expected. In fact, output has been broadly flat over that period. And the zig-zag pattern of quarterly growth rates of GDP that we have seen this year is likely to continue, as we may see on Thursday when figures for the third quarter are released.

On the other hand, there are other more encouraging signs. First, the labour market gives a very different picture to that conveyed by the output data. In the private sector, more new jobs have been created than over any other two-year period since the mid-1990s. And in the past year, unemployment has been falling, and falling faster in Wales than in the United Kingdom as a whole. Second, inflation has now fallen back to 2.2%, close to our 2% target. Although recent increases in domestic energy and food prices are likely to leave it a little above target well into next year, the fall in inflation means that the squeeze on real take-home pay, which accounted for much of the weakness in consumer spending over the past two years, has eased somewhat. And retail sales figures are consistent with a pickup in consumer spending.

The disparity between weak output growth and a buoyant labour market is not easy to explain. It is not the product of a switch from full-time to part-time jobs because total hours worked have risen at the same rate as employment. Productivity per head is 4% below its level of five years ago. No-one really understands why. Perhaps the output data are understating the true picture. Perhaps the black cloud of uncertainty moving towards us from the euro area means that businesses are choosing to meet demand by expanding employment, which can if necessary be adjusted downwards relatively easily, rather than

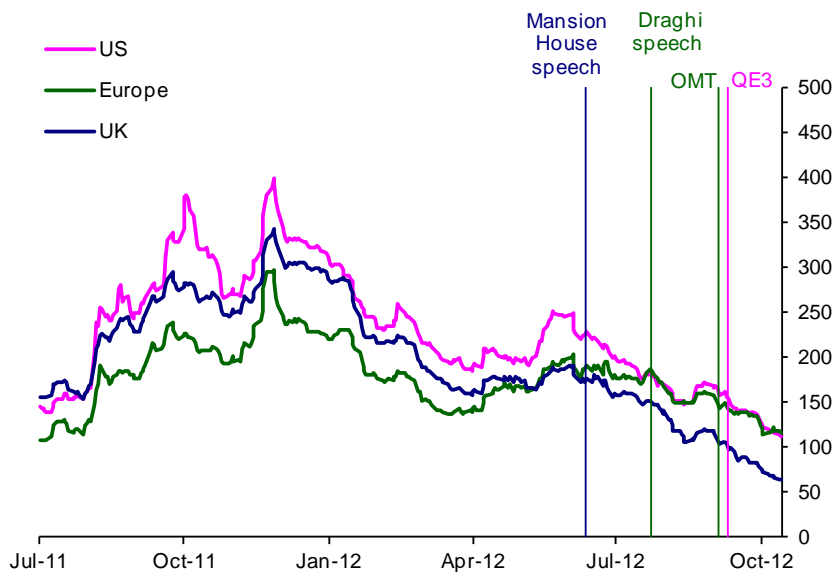
investing in new capital equipment which cannot. Perhaps flexible wages have encouraged employers to hold on to labour. Or perhaps forbearance by banks has allowed inefficient firms that might otherwise have had to contract to continue with more labour than can be employed in the long run.

One thing we can see clearly is that the recovery and rebalancing of the UK economy are proceeding at a slow and uncertain pace. At this stage, it is difficult to know whether some of the recent more positive signs will persist. The Monetary Policy Committee will think long and hard before it decides whether or not to make further asset purchases. But should those signs fade, the MPC does stand ready to inject more money into the economy.

Printing money is not, however, simply manna from heaven. There are no shortcuts to the necessary adjustment in our economy. The problems in the world economy mean that we shall have to be patient. Over the past twenty years, during regular visits to Wales, I have seen several waves of restructuring of the Welsh economy. And the rebalancing of the UK, towards manufacturing, offers opportunities for Wales.

As for the MPC, you can be sure we shall be looking for as much guidance as we can find, divine or otherwise. What better inspiration than the memory of those children on Rhossili beach singing Cwm Rhondda.

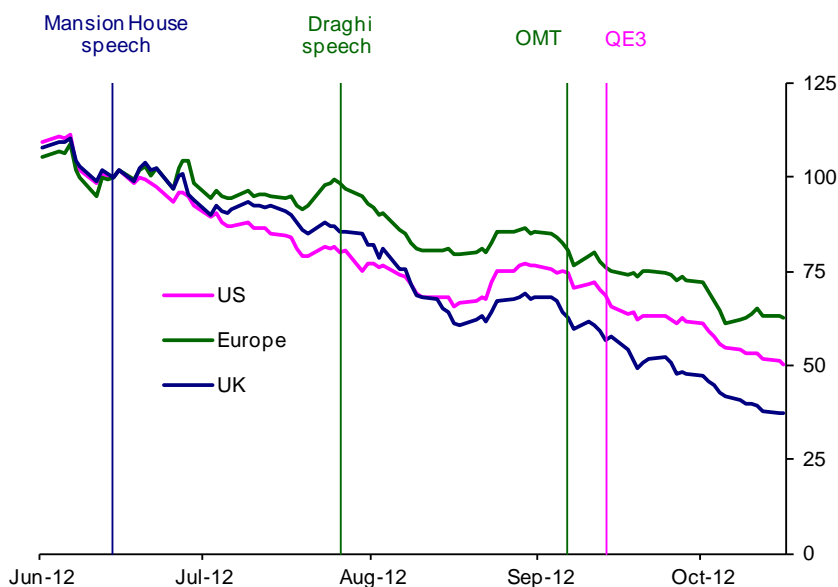
**Chart 1: Major banks' indicative senior unsecured bond spreads<sup>(a)</sup>  
(basis points)**



(a) Each line is an unweighted average of the spread between euro-denominated senior unsecured bonds and equivalent maturity swap rates for a selected bond issued by each of a selection of major banks in the region. The selected bonds have residual maturities of between two and six years.

Source: Bloomberg and Bank of England calculations.

**Chart 2: Major banks' indicative senior unsecured bond spreads since announcement of FLS<sup>(a)</sup>  
(index, equal to 100 on 14/06/2012)**



(a) See footnote to chart 1.

Source: Bloomberg and Bank of England calculations.