Lords Economic Affairs Committee

Opening Statement by the Governor

19 April 2016

I would like to begin by thanking their Lordships for their debate, scrutiny and improvements to the Bank of England and Financial Services Bill. This Bill, which is continuing its passage through the Commons, will reinforce the transformation of the Bank begun by the Financial Services Act 2012.

By placing the Bank's three major policy committees on the same statutory footing, by streamlining the MPC's meeting schedule, and by further enhancing the transparency and governance of the Bank's operations, this legislation will ensure the institution can operate more effectively as One Bank to promote the monetary and financial stability of the United Kingdom.

This is crucial because, in a challenging global environment, it is more important than ever that the Bank coordinates its microprudential, macroprudential and monetary policies. This afternoon I would like to expand briefly on this general point by giving three specific examples where the Bank's policy functions are acting in a complementary fashion to achieve our objectives, namely:

- addressing vulnerabilities in the buy-to-let market;
- setting the Counter-Cyclical Capital Buffer; and
- managing risks associated with the Referendum on the UK's membership of the European Union.

Buy-to-let

The FPC is mindful that there is a long history of rapid credit growth becoming associated with deteriorating underwriting standards and rising systemic threats.
Growth in mortgage lending is now being driven solely by the buy-to-let sector.
Buy-to-let mortgages increased by 11.5% last year and now account for 17% of the stock of total secured lending, twice the proportion of a decade ago.

The PRA has just reviewed the plans of the 31 top lenders in the industry, representing over 90% of total buy-to-let lending. The Review revealed that some banks were applying weaker standards and highlighted the risk that more might do so to meet aggressive growth plans.[1]

In response, the PRA has clarified its expectations for buy-to-let underwriting standards and introduced new guidelines for minimum stressed interest rates to be used when lenders test affordability.

[1] In anticipation of planned changes to stamp duty, the number of buy-to-let mortgages increased by 6% in January alone.

Given the combination of this prudent reinforcement of underwriting standards and major tax changes now coming into force, the FPC has decided to take no further action at this stage but will continue to monitor potential threats to financial stability from buy-to-let.

The Counter-Cyclical Capital Buffer

The second example of the synergies within One Bank is the setting of the Counter-Cyclical Capital Buffer (or CCyB).

Over the past few years, the FPC has assessed the capital needs of the banking system and clarified:

- the amount of capital our banking system requires given the risks it faces; and
- how that capital should be allocated across different types of firms and risks.

In reaching these judgements, the FPC carefully considered the costs of the crisis, the benefits of the reforms made in response, and the results of two years of severe-but-plausible stress tests.[2]

The FPC has made clear that the UK capital framework will involve the active use of macroprudential tools, including the CCyB. Buffers make the capital framework more efficient, lower borrowing costs for households and businesses, and create the right incentives for banks to increase resilience.

The countercyclical buffer will be built up as risks increase and released in order to ensure the banking system can withstand stress without restricting the supply of credit to the real economy.

With UK financial conditions shifting out of the post-crisis repair phase, the FPC has indicated its preference to raise gradually the CCyB to the region of 1%.

To that end, the FPC raised the CCyB rate to ½% of risk-weighted assets in March.[3] The FPC's decision was informed by discussions with the Bank's other committees. The FPC worked closely with the PRA Board to avoid duplication between the risks captured by current supervisory capital buffers and the CCyB. Joint meetings with the MPC considered the impact on monetary policy. The FPC's approach balances the desirability of a higher capital buffer with the likelihood that gradual increases will reduce the costs to the economy and maintain appropriate monetary flexibility.

[2] See Bank of England *Financial Stability Report*, December 2015; and "Supplement to the December 2015 *Financial Stability Report*: The framework of capital requirements for UK banks".
[3] This new setting will become binding at the end of March 2017.

The Referendum

The Bank of England has not made, and will not make, any overall assessment of the economics of UK's membership of the European Union. At the same time, the Bank must assess the implications of the UK's EU membership for our ability to achieve our core objectives of maintaining monetary and financial stability.

The Bank has a duty to report our evidence-based judgments to Parliament and to the public. That is the fundamental standard of an open and transparent central bank. Assessing and reporting major risks does not mean becoming involved in politics; rather it would be political to suppress important judgments which relate directly to the Bank's remits and *which influence our policy actions*.

These policy actions include developing, and if necessary implementing, contingency plans. As with the Scottish Referendum, we will communicate as much as is prudent about those plans in advance of any risk materialising and as comprehensively as possible once risks have dissipated.

The Bank published a detailed, comprehensive report last year which reviewed the how EU membership affects the Bank of England's ability to achieve its objectives.[4]
A core conclusion was that, to the extent to which it has increased economic and financial openness, EU membership has reinforced the dynamism of the UK economy, making it more resilient to shocks and able to grow rapidly without generating inflationary pressures or financial stability risks.[5]

This judgment is grounded in extensive evidence including:

- The fact that the UK's trade intensity accelerated on both upon joining the European Community and following the creation of the single market, [6] and that EU countries have seen the largest increase in trade intensity amongst advanced economies over the past 15 years;[7]

[4] See Bank of England (2015), *EU Membership and the Bank of England*, October.
[5] The Report stresses that the UK's economic dynamism is the product of a variety of drivers including economic openness, flexible labour and product markets, deep human capital, well-developed physical infrastructure, a competitive fiscal regime, as well as the clarity and integrity of the rule of law.
[6] See chart on page 18 of Bank of England (*ibid*.). The UK's trade intensity, in volume terms, rose by 0.32pp per year on average between 1953-72; by 0.62pp on average between 1973-92; and by 1.11pp on average between 1993-2012. The equivalent data in values terms are -0.43pp; 0.24pp; and 0.85pp for these three periods, respectively.
[7] This is especially true for the newer EU member states for goods, and for older member states for services. In contrast, the level of trade intensity of NAFTA members has been largely unchanged over the past fifteen years. The increase in trade intensity for EU member states has also coincided with a decline in both goods and services trade costs in the past twenty years. Services trade costs have tended to fall in EU countries but have increased for the US. In part, this reflects the EU's initiatives to deepen the integration in services over the past fifteen years (Miroudot, Sauvage & Shepherd, 2013). See Bank of England (*ibid*.), page 19; and Miroudot, S, Sauvage, J and Shepard, B (2013), 'Measuring the cost of international trade in services', World Trade Review, Volume 12, Issue 4, pp. 719-735. This rise in trade intensity matters disproportionately for the UK: today, UK exports to the EU represent 12% of UK GDP (44% of total UK exports), whereas exports from the rest of the EU to the UK represent only around 3% of rest-of-EU GDP.

- Gravity model analysis that shows that EU membership contributes positively to trade flows between member states *after controlling for the size of these countries and the distances between them*;[8 9]
- The reality that since the establishment of the Single Market, FDI inflows have increased faster in both the UK and the rest of the EU, as a percentage of GDP, than in the US and the rest of the world, with the UK being the largest recipient in the EU.[10]
- Survey evidence that indicates that, as a result of FDI, UK firms report the greatest extent of positive technology spillovers in the G7;[11]
- And extensive evidence that whilst being a member of the EU, the UK has retained among the most flexible product and labour markets in the G7.[12]

The Report's second major conclusion is also grounded in evidence and derives from the more general reality that greater economic and financial openness means the UK economy is more exposed to shocks from overseas. In recent years, as a result of closer integration with the euro area, this may have increased the challenges to UK economic and financial stability.

The euro-area crisis likely had a material impact on UK GDP growth through a number of channels, including lower demand for our exports, weaker domestic activity because of greater uncertainty and lower asset prices as well as higher financing costs for our banks. Overall, by mid-2012, the level of UK GDP was materially lower than expected at the time of the Bank of England's May 2010 *Inflation Report*, with the euro-area crisis likely to account for much of this demand shortfall.[13] For example, around two thirds of the unexpected weakness in UK-weighted world trade between 2010 and mid-2013 can be directly accounted for by developments in the euro area.[14]

[8] Head and Mayer (2014) summarise the conclusions from over 150 papers using these models. Of the 2500 estimates used in their paper, around 300 estimates are EU-specific. On average, membership of the EU is found to have contributed positively to trade flows between member states after controlling for the size of these countries and the distances between them. See Head, K and Mayer, T (2014), 'Gravity Equations: Workhorse, Toolkit, and Cookbook', Handbook of International Economics, Volume 4, Chapter 3, pages 131-195.

[9] In principle, any boost to intra-EU trade ('trade creation') could have come at the expense of trade diverted ('trade diversion') from other non-EU countries. However, studies including Eicher et al (2008) and Allen et al (1998) find that the trade creation effects associated with EU membership and the single market more than offset the trade diversion effects. Looking specifically at the UK, some papers suggest that the UK's trade with EU members is higher than might be expected, given the size of these countries and the distances between them (HMT (2005), CER (2014)).

[10] By 2013, the EU accounted for around 50% of the stock of UK inward FDI, compared with 27% from the US and 7% from Asia. The EU is also a significant beneficiary of outward FDI from the UK, with a share of 43%. However, care needs to be taken over the interpretation of both the source and destination of FDI given the measurement issues explored in Annex 4 of the Bank of England's Report (*ibid*.).

[11] See Bank of England (*ibid*.), page37, which cites the World Economic Forum Global Competitiveness Report 2014 and, in particular, the answer to the question: "To what extent does FDI bring new technology into your country? (1 = not at all; 7 = to a great extent—FDI is a key source of new technology)" in the World Economic Forum Executive Opinion Survey.

[12] See Bank of England (*ibid*.), page 35-6, which draws on the OECD product market regulation database, OECD employment protection legislation, and the World Economic Forum Global Competitiveness Report 2014.

[13] See Bank of England (*ibid*.), pages 64-5; and the box on page 47 of the November 2013 *Inflation Report*, which examines forecast errors between the August 2010 *Report* and the November 2013 *Report*.

[14] The expected rise in UK-weighted world trade between 2010Q1 and 2013Q2 in the MPC's August 2010 *Report* was 24.1%. As of the November 2013 Report, the rise that actually materialised was 14.6%.

With this broad context, the FPC concluded at its most recent policy meeting that the threats stemming from the forthcoming Referendum are "the most significant near-term domestic risks to financial stability."[15]

In particular, the Committee noted that pressures associated with the Referendum have the potential to reinforce existing vulnerabilities in relation to financial stability, including risks emanating from the very high current account deficit, property markets, market liquidity, and possible negative spillovers to the rest of the EU.

Some elements of these risks may be beginning to manifest.

Since November, the trade-weighted value of sterling has fallen 10%, with more than half of that occurring since the MPC's last forecast in February.

The cost of buying protection against a marked depreciation of sterling has risen notably, with sterling risk reversals falling to their lowest level in over a decade.

UK short-term interest rates have fallen by around 60bps since November.
The equity prices of UK-focussed firms have underperformed by around 10% those with a more global orientation since the middle of February.

The Bank's indicator of uncertainty has increased by 1.5 standard deviations, which on past relationships would be associated with a marked reduction of the rate of GDP growth.[16]

Commercial real estate transactions have fallen by around 40% in the first quarter across the country and by around 60% in London.[17]

Such developments reflect a growing uncertainty about the UK's macroeconomic outlook. As the MPC has observed, there might be some softening in growth during the first half of 2016 as a result, but, given Referendum effects, "the Committee is likely to react more cautiously to data news over this period than would normally be the case."[18]

A vote to leave the EU might result in an extended period of uncertainty about the economic outlook, including about the prospects for export growth. This uncertainty would be likely to push down on demand in the short run.

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[15] See the Record of the meeting of the Financial Policy Committee held on 23rd March, 2016, paragraph 28.
[16] See Haddow, A, Hare, C Hooley, J and Shakir, T (2013), "Macroeconomic uncertainty: what is it, how can we measure it and why does it matter?", *Bank of England Quarterly Bulletin*, Q2.
[17] The data source is Property Archive.
[18] See Monetary Policy Summary and Minutes of the Monetary Policy Committee meeting ending on 13 April 2016.

Uncertainty regarding the supply side of the economy might also increase, reflecting any alterations to product or labour market regulation, adjustments in labour flows or changes in the rate of technology adoption as a result of different arrangements governing foreign trade and capital flows.

A vote to leave could also have significant implications for asset prices. In addition to affecting the exchange rate, a rise in uncertainty could weigh on other asset prices, tightening financial conditions. Rising risk premia, all else being equal, would depress activity.

Any positive impact of a depreciation on activity would need to be set against any net negative impacts (whether on investment, consumption, exports or potential supply) stemming from its underlying cause. There is a range of plausible scenarios including ones where the combined effects of the exchange rate move and its drivers on aggregate demand, aggregate supply and exchange rate pass through lead to a lower path for growth and a higher path for inflation.

The MPC would have to make careful judgements about the net effects of these potential influences on demand, supply and inflation. Ultimately, monetary policy would be set in order to meet the inflation target, while also ensuring that inflation expectations remained anchored.

Whatever the outcome of the Referendum, the MPC would use its tools to achieve its inflation remit, and, more broadly, the Bank's policy committees will work in concert, as One Bank, to promote monetary and financial stability.