BANK OF ENGLAND

Our brief is simple, but critical: keep the system strong and stable

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Credit crunches leave scars. Three years on, the damage from the 2008 crisis remains deep and painful. In the UK we are around 10% poorer as a nation and 800,000 people have been made unemployed.

House prices are about 15%, and commercial property prices about 35%, below pre-crisis peaks. Some half a million homes face negative equity, as do a significant number of commercial property firms. Growth in bank credit to households and corporates remains weak. In the US, unemployment stays high and house prices continue to fall; in parts of Europe, the crisis in confidence is acute.

These crises have a common cause – credit. or, more accurately, the boom and bust in credit. In the run-up to the crisis, credit rose faster than incomes in many advanced economies. Banks' balance sheets became bloated with debt. Credit growth became a juggernaut which, having picked up pace, then ran out of control. When the juggernaut crashed, credit feast turned to famine, starving the real economy of growth.

That has been the story of this time's crisis. But it is an old story. For credit booms have sown the seeds of almost all historical financial crises. As pride comes before a fall, excess credit comes before a crisis.

This boom-bust cycle in credit is as regular as the cycle in output – and is, if anything, more virulent. The typical peak-to-trough cycle in real incomes is 5-10%; for credit, it is double that, and for asset prices double that again. It has been that way, in the UK and internationally, for well over a century.

So is history condemned to keep on repeating itself, not as farce but as tragedy, and, if not, who is to break the cycle? In the past, the answer was nobody. Keeping credit in check and the financial system sound was in no one's job description. The credit juggernaut had no driver. Little wonder, then, that it had all too often been on a collision course.

That is all about to change. The government recently put in place a financial policy committee, housed in the Bank of England. It meets for the first time on 16 June. It can be thought of as the twin of the Bank's monetary policy committee, which sets interest rates.

The FPC will aim to keep the financial system strong and stable, as its contribution to keeping the economy strong and stable. Success will mean that savers feel confident about their deposits and credit keeps flowing through the arteries of the economy in bad times as well as good. In time, this will form part of an international regime.

The FPC will need some tools – so-called macro-prudential regulation. That means applying the brakes when credit is running out of control to reduce the risk of a financial pile-up. For example, it might increase the amount of capital or liquidity banks are required to hold. On these matters, the FPC will advise the government on tools, which it will ultimately decide. The aim would be to take the heat out of credit markets.

But, as importantly, it may also mean the FPC releasing the brakes when credit is stalled at the roadside. That might call for a loosening of the regulatory reins to inject some life into credit markets. If the FPC does its job, future credit feasts may be less raucous, but financial famines will stunt growth less often.

The stakes could scarcely be higher. In the UK, and a number of other developed countries, we cannot afford another credit crunch. Quite literally cannot afford, for the credit crunch has stretched sovereign sinews to the limit. The scars from this time's crisis will be borne by our children, perhaps grandchildren. That should serve as a reminder of the need to break the risk-taking loop.

With the FPC at the wheel, we hope to make the financial road safer.