BANK OF ENGLAND

The good things in life require stability

Article by

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Nearly a fortnight ago, the Bank of England's new Financial Policy Committee published its advice to the government on what binding powers it would need to rebuild and sustain the stability of our financial system. The choice of those "Direction" powers lies with the government and parliament. That is how it should be, since no one doubts the new regime will bestow considerable authority on the unelected officials who serve on the FPC. The committee will also be able to make recommendations to the Prudential Regulation Authority and the Financial Conduct Authority.

We have advised that, alongside controls over banks' leverage and risk-weighted capital requirements, the FPC should have the power, in effect, to require the banking sector temporarily to hold more capital against exposures to specific sectors of the UK or international economy, where a boom could threaten stability. Sometimes booms are initially localised and are best protected against locally. In those circumstances, simply increasing the headline capital requirement might, perversely, cause banks to cut lending to sectors of the economy that were not overly exuberant. But it is neither within the proposed remit of the FPC, nor the intention of the committee, to micromanage the banking system or the allocation of credit. As the record of its meeting on March 16 stresses, it will be "particularly important to justify clearly any decisions over sectoral capital weights with respect to the objective of underpinning the resilience of the financial system. [They] should not be used to try to steer the supply of credit to achieve [other] objectives. The FPC would need to avoid an excessively activist, fine-tuning approach". This is not an exercise in economic or social engineering. It is about stability, which is a precondition for steady improvements in economic activity and employment. The 15m or so extra people in the western world unemployed because of the financial crisis are a tragic reminder of that.

There is understandable interest in the FPC favouring controls over banks' and other lenders' balance sheets rather than over the size of mortgage loans that households can take out relative to the value of their home (so-called loan-to-value ratios). We are under no illusion that property-related borrowing booms often drive financial stress. It is a question of judging what will work best in our economy and society.

Outright bans on households taking out loans with high LTVs – including banning families borrowing from outside the UK financial system – would, in the view of many of us, be a matter not for the FPC but for government to pursue directly. It would be a major step, entailing reintroducing selective capital controls, which the UK has not employed for more than 30 years.

In terms of the FPC's objective of ensuring the resilience of the financial system, the same broad effect can, we believe, be achieved by temporarily applying higher capital requirements to banks' high-LTV lending when it would otherwise threaten to jeopardise stability. The higher the requirement, the closer it approximates to constraining portfolios of high-LTV loans. But it would not cut across lenders' judgments on the creditworthiness of individual borrowers. The FPC will, of course, follow carefully experience overseas and the public debate here.

This isn't all about banks. As the international community reregulates the banking system, incentives to book business in non-financial firms will increase. The powers we have sought for the FPC would extend to all UK-regulated financial firms, funds and vehicles.

We will not be able to control lending into our economy by foreign firms. But we hope the central banks and regulators of other countries will, in exercising their own macroprudential powers, place weight on our assessment of the risks. In any case, ensuring the resilience of our domestic financial system will help to sustain the economy through the bust phase of any credit cycles we cannot prevent.

There is a risk that, in framing new powers over the financial system, we come across as seeking to absolve macroeconomic policy makers of responsibility for the crisis. Not at all. Central banks must be attentive to the effects easy monetary policy can have on risk-taking. But we mustn't try to do too many things with monetary policy. Achieving low inflation eluded Britain for decades. We mustn't jeopardise that. There has been a gap in the authorities' armoury. The FPC and macroprudential policy are intended to fill that gap.

We want a thriving, innovative, profitable financial system, serving the economy effectively year in, year out. The good things of life require a lot more than stability. But stability is a precondition for achieving society's goals. The FPC means to deliver just that, without damaging medium-term potential growth. This needs calm and careful debate.