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News release

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Roy Bridge Memorial Lecture by Paul Tucker: Macro, Asset Price and Financial System Uncertainties

In his Roy Bridge Memorial Lecture given today at the Financial Markets Association, Paul Tucker - Executive Director, Markets - discusses three related 'arenas' of uncertainty concerning the impact of structural changes in the economy and financial system. He considers whether, given the uncertainties over the macroeconomic outlook, financial markets are inadequately pricing risk - and thereby not insuring themselves properly - and placing too much weight on continued stability or the wisdom of the authorities.

Paul Tucker discusses how supply-side changes such as migration and globalisation are confronting policy makers with fresh challenges. Commenting on the economic outlook, he contrasts an 'orthodox' story, where robust demand growth and limited spare capacity prompts monetary policy to respond to prospective inflationary pressures, with an 'alternative' story where labour market developments such as increased inward migration lead to a more uncertain outlook for inflation. He says that if supply is able to respond more readily to demand conditions, then it becomes harder ".to judge inflationary pressures from gauging the amount of slack in the economy; and harder for the Bank to achieve our 2% target by broadly steering demand conditions". He stresses that the response of policymakers depends crucially on whether medium-term inflation expectations are well anchored.

Alongside these macroeconomic uncertainties, Paul Tucker considers the limited degree of asset price uncertainty implied by financial option prices. He says that various explanations for this circulate amongst practitioners, revolving around the expectation or hope that ".nothing really nasty will happen given the collective wisdom of the world's monetary authorities" and ".that if it does, today's liquid capital markets will contain the volatility anyway".

Paul Tucker goes on to discuss the process of disintermediation of the banking system and the implications for assessing both money and credit conditions and the resilience of the financial system as a whole. He points out that strong UK money growth is likely to be, in part, a product of structural change in the financial system; and that because asset prices are determined in global capital markets, global monetary growth may be a more relevant indicator. Considering whether the underlying structural changes increase or impair the financial system's resilience, he discusses how the major banks increasingly distribute their risks. Noting that, rather than reducing, their balance sheets have expanded rapidly, Paul Tucker explains that this relates to ".today's prevailing business model entail[ing] a significant commitment of capital by investment banks". He says this means it is less easy to judge credit conditions, which is one reason the Bank is planning to introduce a formal quarterly survey of credit conditions next year. And he suggests that ".stability relies on the liquidity of capital markets . proving durable under stress".

Linking these uncertainties together, Paul Tucker concludes that, "There are. lots of reasons for confidence in monetary and financial stability being sustained [but] .it is a potential concern that, looking forward, financial markets may not be pricing for. the range of uncertainties that preoccupy the official sector". He asks if risks crystallised, would asset markets be disorderly and would that create threats to the stability of the system as a whole? In noting that the answers are unknowable, he emphasises that central bankers must aim to ".understand today's global banking system and capital markets well enough to tell the difference. between a problem requiring solely a macroeconomic response and a more complex financial stability problem". And he concludes that central banks must strive to maintain the medium-term credibility of monetary policy.

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