BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

19 May 2006

Uncertainty, the Implementation of Monetary Policy and the Management of Risk

In a speech given today to the Association of Corporate Treasurers in Newport, Paul Tucker – Executive Director for Markets and a member of the Monetary Policy Committee – discusses sources of volatility and uncertainty facing firms and financial markets.

Some past sources of uncertainty were avoidable. He highlights how a more stable monetary environment has helped to remove uncertainty about policy makers' objectives, although it cannot eliminate uncertainty about the short-term path of the economy or official interest rates as the MPC itself responds to unpredictable cyclical developments. Alongside this unavoidable uncertainty, there has been some avoidable and undesirable uncertainty about short-term sterling money market interest rates. As Paul Tucker stresses, given the MPC decides its interest rate each month, "…there should be no uncertainty about the general level of overnight rates in the money markets." The reality, however, has been that overnight interest rates in the UK have historically been highly volatile. Paul Tucker says, "That has created uncertainty for users of the sterling money markets – banks, asset managers and, of course, corporate treasurers."

He describes how the Bank of England's new framework for implementing monetary policy, introduced earlier in the week, aims to remove that uncertainty as far as possible. "By taking the noise out of the sterling money markets, we aim to achieve greater stability and greater transparency. That won't revolutionise your businesses, but I trust that it will bring a welcome reduction in the avoidable uncertainties…"

Paul Tucker goes on to discuss wider and less easily avoidable uncertainties facing businesses and financial markets and how they bear on risk management for both firms and the financial system as a whole. Noting the increase in employer contributions to pension funds and that the UK corporate cash surpluses have been employed in deposits to a far greater degree than in other G7 countries, he discusses the way in which pensions now seem to feature in firms' cash and risk management. He suggests that uncertainty about how to manage pension fund asset-liability mismatches may conceivably have been one of a number of elements behind recent weakness in measures of UK business investment.

Paul Tucker then discusses wider manifestations of funds' asset-liability management in financial markets, and reviews arguments on whether or not risk may have been under priced. Structural change – in monetary policy regimes, product and labour markets, and banking and financial markets – may plausibly have reduced risk somewhat over the past decade. Financial innovation in the form of new techniques for unbundling and distributing risk may have enabled investors to hold more diversified portfolios. A question is whether the lower price of risk implied by strong asset prices has reflected structural factors of that kind, cyclical factors or, rather, a search for yield. He says, “to the extent that a structural story of some kind holds true, the consequent reduction in risk premia, and the associated rise in asset prices, would broadly be a one-off – even if drawn out.” In that case, it would be important that financial market participants had not extrapolated forward the high returns of recent years. He stresses that that is for market participants to judge.

Against that background, Paul Tucker discusses some possible implications of recent innovations in structured finance. On the one hand, they distribute risk, which should buttress the stability of the financial system as a whole. On the other hand, questions are posed about whether the innovations have amplified the compression of spreads; whether the trade-off between the demand for financial engineering and for liquidity, not just amongst leveraged players, could switch in stressed conditions; and whether risk could flow back to the banking sector in adverse circumstances. He says that this makes it difficult for market participants to assess, and price for, how much risk there is across capital markets.

Key Resources

Uncertainty, the Implementation of Monetary Policy and the Management of Risk - Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2006/speech273.pdf