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News release

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A Perspective on Recent Monetary and Financial System Developments - Speech by Paul Tucker

In a speech given today at a Merrill Lynch conference for hedge funds, Paul Tucker – Executive Director, Markets and a member of the Monetary Policy Committee – discusses the current interaction between global monetary and financial conditions and the risks to price stability and financial stability.

Paul Tucker explains that global monetary and financial stability has continued despite the significant increase in oil prices over recent years. Central banks and financial markets might have feared a much worse outcome. Central banks have responded by seeking to ensure that medium-term inflation expectations remain anchored. He explains that UK monetary policy has had to grabble with the interplay of cost shocks, and the consequent volatility in headline inflation, with demand conditions. UK monetary conditions have been edging towards being 'restrictive', which has been appropriate as firms gain greater pricing power. Paul Tucker says his future interest rate votes "… will depend on balancing the medium-term prospect for demand pressures alongside uncertainties about supply conditions and near-term inflation expectations… ".

Paul Tucker explains that price stability in itself is not enough to insulate the global economy or financial markets from all shocks. He considers potential adjustments to two key risks that have for a while pre-occupied commentators on global capital markets – current account imbalances and low risk premia, both of which feature in the Bank's recent Financial Stability Report. Views vary as to which is the more serious threat to stability. Tucker says "… the fundamental changes in the structure of credit markets over the past half decade or so have left many practitioners uncertain about the dynamics of adjustment… with some seeing the system as clearly more resilient… but on the whole practitioners seem to be more uncertain about the potential for nasty spillovers from adjustment in low risk premia than in global imbalances". He notes that the key financial intermediaries are no longer just banks, securities dealers and the like but now include a range of financing vehicles including hedge funds and collateralised debt obligations. Capital is being allocated to wherever its cost is cheapest, taking account of rating agency requirements.

In view of these developments, Paul Tucker asks whether or not it matters that we no longer know where risk lies? He says that, provided liquidity holds up, the transfer of risks across new markets via new instruments

and institutions should aid the system's adjustment to shocks. But he says "… there are most certainly qualifications to such an apparently alluring conclusion." He discusses the potential for risk to flow back to banks in adverse circumstances, as banks warehouse risk, and finance its acquisition by hedge funds and others. He therefore suggests, "… the question is not so much 'where is the risk?', as 'in what circumstances could risk flow back to the banking system?'; and 'do banks have enough capital and liquidity to absorb such flows without stress?'"

Paul Tucker says that this puts a premium on firms' stress testing embracing both macro scenarios and their complex market risks and counterparty credit risks. Practitioners need, in particular, to understand the prospective impact of impaired market liquidity. Greater transparency about these 'tail' risks might help influence incentives. He concludes by saying, "In ten years time, we may… know whether 'global imbalances' and 'low risk premia' were resolved with or without stress; and we may be better informed on whether the changes in the structure of our financial markets help or hinder the preservation of stability. A benign outcome would be more likely if the industry were to maintain its efforts on improving ex ante measures to handle stress."

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2007/speech308.pdf