BANK OF ENGLAND

News release

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

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Uncertainty, Policy and Financial Markets - Speech by Sir John Gieve

In a speech at the Barbican Centre in London, John Gieve, Bank of England Deputy Governor for Financial Stability, discussed the range of uncertainty facing monetary policy makers, emerging lessons from the US sub prime market and the significance of influential investors, including Sovereign Wealth Funds.

John Gieve argued that the 'Great Stability' seemed to have reached its zenith of total predictability between summer 2004 and summer 2006, 24 months when interest rates scarcely moved at all. Even in that period "there was a vigorous debate underway (within the MPC) about the state of the economy and the policy response" reflecting "genuine and unavoidable uncertainty about the economy which was disguised by the stability of rates but never went away". He described the current position as "a return to normality after two years of exceptional predictability in monetary policy both in the UK and elsewhere". He noted that that the level of uncertainty was not reflected in the range of independent forecasts whose "central projections tend to cluster in a remarkably narrow range…To gauge the real range of uncertainty you need to look beyond the central forecasts at the full probability distribution of possible outcomes". This was why the Bank always published its forecasts in the form of fan charts.

On recent financial market developments, John Gieve highlighted the "risk of becoming alarmed by good news". "In our last *Financial Stability Report* we identified the low risk premia in credit markets as the principal vulnerability in financial markets…The rise since then has not been large in a longer context but in itself it is a healthy correction. At the same time we have seen a fall in the dollar over recent months which should tend to reduce the risk of a sudden correction of global imbalances". However he argued that developments in the US sub-prime market had pointed out vulnerabilities in new credit derivative markets, including a potential misalignment of incentives along the distribution chain, the changing way that exposures impact balance sheets, market liquidity drying up in stressed conditions and the difficulty of valuing instruments on the basis of only a few years experience.

He noted that the growth of Sovereign Wealth Funds over time would "tend to increase the price of riskier assets, like equities and corporate and emerging market bonds, compared to government bonds. The impact will be greater if there are concentrations of investment in particular asset classes or countries. More widely,

the switch of reserve rich countries from lenders to owners of financial or real assets is also likely to lead to political tensions and pressures for protectionism".

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2007/speech321.pdf