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Finance: A Return From Risk - Speech By Mervyn King

In a speech to the Worshipful Company of International Bankers at Mansion House in London, the Governor of the Bank - Mervyn King - discusses the nature of risk in the financial system to draw lessons about the policy responses that are required to ensure greater monetary and financial stability in the future. He considers the design of future banking regulation and the more urgent need to recover from the present crisis.

The Governor states that at the heart of the crisis was an inability to perceive the true nature of the risks involved, which has been a persistent feature of crises over time. He notes that all forms of regulation, whether light or heavy touch ".failed to some degree to prevent the accumulation of risks. So it is unlikely that there is a simple answer". The Governor stresses that regulation should be "simple and robust". Regulatory design, he says, ".should be based on an explicit identification of the market failures that regulation can hope to correct". He highlights the need to reduce the exposure of the financial system to domino effects - arising from the interconnectedness of banks - and the pro-cyclical behaviour of risk-taking in the financial system. He says, "In particular, the authorities should maintain a clear focus on the issues that matter when the worst occurs - liquidity and leverage." He adds, "Given what has happened there is now international support for developing a counter-cyclical toolkit for the prudential supervision of banks."

The Governor argues that, "To correct these types of market failure will require a system of regulation that effectively marries the 'top down' assessment of the risks to the system as a whole to the 'bottom up' supervision of individual institutions. The present system has not delivered that." On the question of whether a new Glass-Steagall Act is required, the Governor says, "We need a public and informed debate on the merits of the arguments" for and against.

The Governor explains that, as in monetary policy, prudential supervision cannot be a set of mechanical rules nor left entirely to discretionary judgments. He says, ".we need to build into the system some simple and robust impediments to excessive risk-taking." and that ".the principle of constrained discretion, applied so successfully in monetary policy, needs to be applied to banking regulation".

The Governor goes on to discuss why these measures should not involve monetary policy being diverted from its role of controlling inflation. He rejects the case for interest rates to be used for wider financial stability

objectives, saying ".to argue that Bank Rate should have been set to achieve not price stability but other objectives would have meant accepting rising unemployment and falling inflation.. If we want to slow the growth of the financial sector balance sheet.we can surely do better than raising Bank Rate to a level that undermines the real economy and our commitment to the inflation target."

Instead, the Governor supports the introduction of additional tools. He says, "What is needed is an additional instrument, or possibly a set of instruments, to provide the authorities with the ability to control the growth of the financial sector and its interactions with the wider economy. A set of counter-cyclical policy instruments is the right response to the dilemma of trying to use Bank Rate to control both inflation and excessive expansion of the financial sector."

He also spells out the need to address the weaknesses in the international monetary system that allowed global imbalances - one of the underlying causes of the crisis - to grow unchecked. With the global downturn affecting virtually every country in the world, he says, "Surely now no country can be indifferent to the objective of improving the consistency of our macroeconomic strategies. So I hope that the debate about the need for symmetric obligations on surplus and debtor countries alike will move on from previous unsuccessful dialogues stretching back to the Bretton Woods conference in 1944". While the Governor stresses the need to take time to think through carefully the long run reforms required, at the same time he says, ". we need to commit now, while the political will exists, to a process for decisions on long-term reforms in key areas such as bank regulation, reform of the international monetary system and the governance of international financial institutions."

In terms of present policy to tackle the global economic downturn, the Governor states, ".the immediate need is to deal with the extraordinarily steep and simultaneous downturn in so many economies around the world, and to stabilise the banking system in those countries where it has failed. That should be the main priority at the forthcoming G20 Summit." He outlines three parts to the required policy response - an urgent restoration of confidence; a credible restructuring and recapitalisation of banks so that they can resume their normal functions and support the flow of credit; and a coherent exit strategy through which all of the unprecedented official policy actions can be unwound, to provide ".a bridge back to stability".

The Governor notes that, "A lesson of history is that few generations have been able to avoid a repetition of earlier banking crises. The essential problem is that we can no more bind our successors than our predecessors were able to bind us. Rare events, even when dramatic at the time, lose their power to shape policy as memory recedes. The role of institutions is to retain a collective memory and to resist the temptations of the present. That is one of the most important roles of a central bank. It is accepted as such in the domain of monetary policy. And there is an equivalent role in financial stability."

Concluding the speech, the Governor states that, "Most of us come from the generation that grew up believing that mass unemployment and world recession were things of the past, relevant to the history books but not the textbooks. That assumption is under threat. We must rise to the challenge."

Note to Editors

The published speech is an expanded version of the remarks the Governor made to the Worshipful Company of International Bankers.

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech381.pdf>