BANK OF ENGLAND

News release

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Mansion House Speech by Mervyn King

The Governor of the Bank of England, Mervyn King, today welcomes the new responsibilities given to the Bank for micro prudential and macro prudential regulation. Speaking at the annual Mansion House Dinner, the Governor says: "I welcome those new responsibilities. Monetary stability and financial stability are two sides of the same coin. During the crisis the former was threatened by the failure to secure the latter."

The Governor outlines the Bank's priorities for monetary and financial stability.

For monetary stability, the priority is to maintain low and stable inflation. For much of the past three years, inflation has been above the 2% target. He says: "Of late there have been those who doubt our ability or willingness to meet the inflation target." He stresses that the MPC is not complacent and is determined to meet its target. He explains that inflation has been above target and volatile largely because of the impact of sterling's depreciation, oil prices and VAT changes. Although pushing up on inflation for a period, by themselves these effects do not generate a continuous rise in prices. He says such a rise "...would ordinarily be associated with strong money growth, wage inflation, rapid increases in money spending and an excess of demand over the supply capacity of the economy. The UK economy exhibits none of these traits..." and the MPC judges that spare capacity in the economy will press down on inflation.

The Governor says that the MPC will not hesitate to begin to withdraw the current degree of monetary stimulus when it is judged to be necessary. When that happens, it will most likely be through "...a rise in Bank Rate with asset sales being conducted later in an orderly programme over a period of time, leaving Bank Rate as the active instrument".

The priority for financial stability will be to accept the new responsibilities announced by the Chancellor - oversight of micro prudential banking regulation and macro prudential control of the balance sheets of the financial system as a whole. The Bank looks forward to working with colleagues at the FSA to implement the new arrangements, building on the improvements they have made in recent years.

The Governor says the financial crisis has shown that combining prudential regulation with the oversight of consumer protection and market conduct did not work. "Separating them - the so-called 'twin peaks' model of financial regulation - is the right direction of reform", he states. The crisis has also shown that when banks are in difficulty the central bank needs to be fully involved in resolving those problems. He says: "The Bank of England cannot effectively perform its role as lender of last resort without first-hand knowledge of the health of the banks to which it might provide support". In a crisis, the central bank, working with government, needs to be in charge.

The Governor explains how the Bank will approach its new responsibilities. The focus will be on maintaining stability of the banking system as a whole. Regulation will reflect two different but complementary perspectives: a bottom-up perspective, focused on setting institution-specific capital requirements, and an overall perspective with a set of system-wide capital requirements that vary over the economic cycle. Judgements on the level of these capital buffers will be part of the remit of a new Financial Policy Committee. Macro prudential policy would aim to tighten and relax capital standards in response to changing credit conditions. He says, "...a credible macro prudential regime could help forestall both excessive exuberance and unnecessary caution". He adds: "This type of regulatory regime, and its objectives and tools, are largely untried and untested. But that is not a reason for not trying and not testing".

The Governor states: "Over the next few years we will put in place a framework for financial stability to parallel that for monetary stability. We need both. As we have seen, one without the other is not enough. Just as the role of a central bank in monetary policy is to take the punch bowl away just as the party gets going, its role in financial stability should be to turn down the music when the dancing gets a little too wild."

Key Resources

Mansion House Dinner – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech437.pdf