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Deleveraging – speech by Ben Broadbent

In a speech delivered at Market News International in London, Ben Broadbent – External Member of the Monetary Policy Committee – considers what the build-up of debt by UK firms and households prior to the financial crisis can tell us about the prospects for sustainable recovery, the key risks currently facing the economy, and the implications for policymakers.

Broadbent notes that, consistent with historical evidence on recoveries from financial crises, recent growth in the UK has been sluggish. One view is that the crisis was the result of excessive borrowing by the domestic (non-financial) sector, and that healthier rates of economic growth can only resume when, after a period of higher saving, their gross debt ratios have retreated. But, despite the obvious importance of debt and the dangers of excessive borrowing, Broadbent is "... not convinced that, as a general matter, non-financial domestic leverage was the key reason for the UK's financial crisis or, therefore, that it needs to return to some historical "norm" to declare the crisis at a definitive end."

He says that is in part because UK firms and households on aggregate did not borrow to finance "profligate" spending. Instead, they accumulated financial assets at an equally rapid rate – in stark contrast to the Eurozone 'periphery', for example – so that UK households' net financial wealth was no lower in 2008, relative to income, than in 1992. Broadbent argues that this accumulation of assets and liabilities was an automatic response to the significant and protracted decline in the real risk-free, long-term interest rate. This pushed up equilibrium property prices, necessitating higher mortgage debt for those trading up the market, but – simultaneously – faster cash accumulation for those trading down. This intergenerational transfer of financial resources raises important questions of its own. But the rise in gross borrowing was in the main just that – a transfer from one group to another, not a means by which the private sector (in aggregate) financed above-income spending.

Broadbent then investigates the empirical evidence regarding growth and debt. There is some evidence that rapid growth of debt, ahead of the crisis, is correlated with poor economic growth since. It is also the case that lending to commercial real estate companies, which grew particularly rapidly in the years leading up to 2008, has seen much bigger losses than other categories of corporate lending. But the link between the rate of change of debt and subsequent economic growth is not especially stable. As for relative levels of debt,

there is no evidence that this forecasts anything, whether growth or losses. To take one striking example, losses on US mortgages, where debt:income ratios are lower, have been more than twenty times bigger than those in the UK.

Broadbent's analysis points to an alternative explanation for the severity of the credit crunch in the UK, namely the size and growth of its banks' non-UK assets. These account for around three-quarters of their total losses and "It is hard to imagine that the subsequent tightening in domestic credit supply, or the weakness of UK growth, would have been as severe had its banks not had such extensive overseas balance sheets going into the crisis."

For Broadbent, then, the prospects of sustainable recovery are more closely tied to developments in the UK banking sector specifically than to those in the domestic non-financial sector. And, in turn, "... the most important risks facing the UK banks, and therefore the supply of domestic credit, emanate from outside the UK." Broadbent emphasises that he is not advocating a withdrawal of monetary stimulus "any time soon". But any abatement in overseas risks, especially from the Eurozone, "... could warrant a withdrawal of monetary accommodation by the MPC even if domestic debt:income ratios remain well above some notional historical "norm"."

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