BANK OF ENGLAND

News release

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Central banking in boom and slump – speech by Charlie Bean

In the JSG Wilson Lecture, at the University of Hull, Charlie Bean considers how policy was set during his tenure at the Bank of England, and considers what lessons have been learnt from the financial crisis.

"My first seven years at the Bank coincided with one of the most tranquil periods in British macroeconomic history. The past five years since the eruption of the global financial crisis have been anything but. It has been a challenging but humbling experience. We knew less than we thought. And we forgot some of the lessons of history. As a result of the crisis, we have found ourselves providing liquidity support in unexpected ways, deploying unconventional monetary policies in alien circumstances, and developing a whole new lexicon of macroprudential policies. Hopefully we will be in a position to leave our successors both wiser and with a better toolkit to deal with similar challenges in the future."

Charlie Bean attributes the financial crisis to various factors. He suggests that households, businesses and especially financial institutions had increasingly underestimated the risks they were exposed to, resulting in a debt-fuelled search for yield. This was exacerbated by "pay packages that encouraged high-risk trading strategies; and informational deficiencies stemming from the underlying complexity of new financial instruments" among other things. He considers the debate around whether monetary policy should have been tighter in the run up to the crisis to contain the credit boom. He concludes that "monetary policy on its own therefore does not seem especially well suited to preventing credit/asset-price booms". "So the crisis exposed ...not only the inadequacy of our understanding of the true nature of the risks that had built up in the financial sector, but also the need for suitable instruments to deal with them".

He then explains a key new reform – to establish the Financial Policy Committee (FPC) with the responsibility of overseeing the stability of the financial system. As a member of the FPC, he describes its objectives and potentially what tools it will have once the Financials Services Act has passed into law. He also sets out some general principles on how the FPC might carry out its responsibilities.

Charlie Bean concludes by discussing monetary policy in the aftermath of the financial crisis. He notes that demand is often weak for a protracted period after such crises. That reflects the sharp and sustained impact on household and business confidence that often occurs, and also the need for high rates of saving to repair

balance sheets. He warns that in the current recovery several other factors have depressed demand. Spending has been depressed by uncertainty emanating from the euro area. Real income growth has been held back by the sharp rise in commodity prices. And it is inevitably taking time for the economy to restructure and for “resources to transfer to the tradable sector from the domestically-facing sector”.

He points out that “It is against this background that monetary policy needs to be set. On the one hand, a highly stimulatory policy stance can encourage households and businesses to bring forward expenditure, boosting demand and mitigating the destruction of the economy's supply capacity that can result from a prolonged period of weak demand as firms are driven out of business and the skills of unemployed workers atrophy. On the other hand, such policy can also delay the transition to a new growth path if it slows the process of balance sheet repair and inhibits the process of 'creative destruction' as unprofitable firms are closed and the liberated resources shifted to the expanding sectors.”

He discusses the MPC policy of Quantitative Easing (QE). He explains how the policy works by pushing down on longer term interest rates, and sees little evidence that its effect on yields has diminished over time. But he does question “the degree of traction these lower yields have on demand at the present juncture”. “For instance, a modest fall in the cost of capital may do little to boost investment spending when the environment is so dominated by uncertainty about the outlook for demand.”

He then discusses some of the alternative policy suggestions that have been made by various commentators. He notes that these can usually be “split into two legs: a fiscal leg, involving some bond-financed public expenditure and which ought to be subject to the control of the Chancellor and the Treasury; followed by a second monetary, or financing, leg in which the Bank buys the corresponding quantity of government debt on the secondary market and is just conventional quantitative easing.” He notes that if an attempt is made to pass it directly to households through, say, a temporary income tax cut, one might expect “the vast majority of such a temporary windfall to be saved rather than spent” and so “is not the obvious way to try to boost demand, unless one can direct the additional income to credit-constrained consumers who are more likely to spend it”.

He also discusses cancelling the gilts in the Asset Purchase Facility (APF) which he thinks “is not as good an idea as it sounds”. He notes that this would “deprive the Bank of the assets it needs to sell back to the market in order to suck the bank reserves out when the time comes to unwind the policy. It would also deprive the Bank of the wherewithal to pay the interest on the reserves in the mean time”. He goes on to note that “In undertaking quantitative easing, we are, for a period, replacing part of the government gilt stock with a monetary liability paying Bank Rate; cancelling the gilts is tantamount to making that period indefinite. In contrast, under present arrangements, how long that period lasts will depend on macroeconomic conditions....Making gilt sales/purchases contingent on the economic environment must surely be the right way to set policy”.

Key Resources

http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech617.pdf

Full speech by Charlie Bean (327k)