BANK OF ENGLAND

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

News release

6 November 2013

The interactions of macroprudential and monetary policies: a view from the Bank of England's Financial Policy Committee - speech by Donald Kohn

In a speech to the Oxford Institute for Economic Policy on Wednesday, Donald Kohn explains how the policy actions of the Financial Policy Committee can complement those of the Monetary Policy Committee.

He explains that monetary policy is a blunt tool for addressing financial stability risks that can stem from asset cycles, while macroprudential policy may be an inefficient tool for managing economic and credit cycles too closely.

Donald Kohn observes that a clear advantage of macroprudential policy is that it can be targeted at the specific sector that might pose a threat to financial stability, while monetary policy, if used to address financial stability risks, can have a broader impact on spending, borrowing and areas that do not pose threats to stability.

Moreover, an important benefit of macroprudential policy will be to limit the constraint that financial risks may place on monetary policy. For example, increasing capital and liquidity buffers in good times will mean the MPC does not need to be as concerned about the effect of its policies – both tightening and easing – on financial stability.

He acknowledges that the interaction between monetary policy and macroprudential policy has been more difficult in the aftermath of the financial crisis than it is likely to be under more normal circumstances. The weak recovery and cautious lending behaviour has necessitated a prolonged period of low interest rates and sizeable asset purchases, with potential implications for financial stability. Meanwhile, the FPC has needed to strengthen financial markets by requiring banks to rebuild their capital buffers and by tightening regulations.

"But a weak banking sector cannot and will not support lending to households and businesses — as we have seen in recent years. And if we do this right, the result will be a considerably more robust and resilient financial sector, one that creditworthy households and businesses can count on for finance, one that is much less vulnerable to unanticipated developments, and therefore one less likely to amplify business cycles and in particular, one in which a repeat of something like the past few years had become much, much smaller."

Donald Kohn welcomes the inclusion of a Financial Stability knockout in the MPC's Forward Guidance policy, saying that it shows the MPC recognises that its policies could lead to vulnerabilities in the financial system. However, he explains that if the FPC saw any risks to financial stability from the stance of monetary policy, it would attempt to tackle these with its macroprudential tools first.

"Only if those tools are unable to contain the risks would we activate the knock-out – it is a last resort. And one that you should be able to see coming, if needed, as we take actions and consider publicly their effectiveness and discuss the FPC's collective view of the risks in our Financial Stability Reports and the Records of our meetings."

Turning to the present, Donald Kohn says the FPC will be carefully watching the housing market, which is being boosted by the Bank's Funding for Lending Scheme and the government's Help to Buy mortgage guarantee, for any signs of an emerging bubble.

"One reason that the FPC knows vigilance is needed is that housing cycles have been important in a number of past UK credit cycles. The FPC will take action as needed to ensure that the financial sector remains resilient to developments in the housing market – that credit standards do not become too lax in the mortgage market and that lenders are adequately capitalized to manage losses that might arise. And between our powers of recommendation to the micro-regulators – the PRA and FCA – and our powers to direct some capital requirements, we have the tools to do that."

However, Donald Kohn stresses that it is not the role of the FPC to micro-manage asset or credit cycles. "Instead it primarily would be about stopping these cycles from being amplified by financial markets and generating costly fallout for the wider economy. Financial cycles, imbalances and asset bubbles will persist. It is human nature to become overly optimistic and pessimistic, to go through cycles of greed and fear. Herding behaviour in markets reinforces this tendency."

In conclusion, Donald Kohn says that having separate bodies operating macroprudential and monetary policy tools is consistent with the idea of matching tools to the objectives that they are best suited to achieving, and that having overlapping membership is an important feature of the institutional set-up.

"It will help to manage and make more transparent the complicated interactions between monetary and macroprudential policy, ensuring an ongoing dialogue and deep understanding of each other's policy problems in real time."