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Financial markets, monetary policy and credit supply – speech by Paul Fisher

In a speech to Richmond University, Paul Fisher – Executive Director, Markets, and member of the Monetary Policy Committee – reviews developments in financial markets over the past year, including the period of heightened volatility since May and the introduction by the MPC of forward-looking monetary policy guidance. He concludes that the economic and financial outlook is brighter than it was a year ago and, with policy set to be supportive, there are good reasons to expect those improvements to continue. He also assesses the working and impact of the Funding for Lending Scheme (FLS), which he says continues to support the supply of credit and has become more focussed on encouraging lending to SMEs.

Fisher describes the last year in financial markets as a “game of two halves”. Financial markets were relatively calm until May, when market volatility was triggered after Ben Bernanke indicated that the FOMC was considering tapering its asset purchases. Despite the subsequent sell-off being wide ranging, Fisher doesn’t sense any long-lived market dysfunction: “Market infrastructures worked and prices adjusted to the revised policy outlook …and for many market participants the ‘shock’ is seen as a healthy correction to what had become a complacent outlook.”

Fisher says that, over the past year, “financial markets have become less stressed about tail risks in the global economy and more stressed about the outlook for monetary policy”. He notes that the market participants’ expectations for accommodative monetary policy in the US and Europe had become overly certain, and emphasizes that “monetary policy setting is about decision making under uncertainty” and “...the actual outcome for policy will always be dependent on how the economy, and hence the outlook, evolves.”

It was in this environment of increased volatility that the MPC provided explicit guidance regarding the future path of its monetary policy instruments. Fisher disagrees with the claim that the policy is complicated: its simple message is that the MPC remains “committed to returning CPI inflation to its 2% target in line with our remit but, in doing so, we will not act in a way which would risk choking off the recovery prematurely, given the potential for a substantial amount of spare capacity in the economy.” He highlights that: “It is important to stress that forward guidance is not a guarantee to hold rates where they are for a set period of time” but “...it allows us to explore how much spare capacity there really is in the economy before raising Bank Rate.”

Much has been made of the rise in yields since the introduction of forward guidance, but Fisher does not think that implies that the policy "isn't working". Fisher stresses that "The important thing is to get the message across to businesses and households about what the outlook for monetary policy really is." And on that front, the early reactions from businesses and the public suggest it is adding to confidence: "in terms of supporting the real economy, I think the policy is working."

Fisher then assesses the extent to which credit conditions have been improved by the FLS since its launch. The Scheme has been "remarkably successful" in reducing bank funding costs, so much so that the scale of FLS draw downs by banks should not be seen as a measure of the Scheme's success. Lending rates to the economy and credit availability have improved. This has been less marked for small and medium-sized enterprises, but Fisher says that "it is likely that any person or business who has borrowed from a bank since the middle of last year will have done so at a cheaper rate than they would have done in the absence of the Scheme." He notes that the housing market is clearly gathering momentum and, although he does not see any evidence of bubble behaviour as yet, he stresses that the Bank will be keeping a close eye on developments, and "both borrowers and lenders need to be careful not to over-stretch themselves."

He points out that the majority of FLS participants have increased their net lending since the launch, with most of the contraction accounted for by large groups that are reducing their 'non-core' portfolios. Banks have also reduced lending to the commercial real estate sector, which has weighed on the aggregate lending figure. He concludes that, "Overall, I believe the FLS has successfully shifted the supply of credit to households and businesses over the past year, and is achieving its policy objectives."