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4 September 2013

Why institutions matter (more than ever) – speech by Andrew Haldane

In a speech at the Centre for Research on Socio-Cultural Change, Andrew Haldane – Executive Director for Financial Stability and member of the Financial Policy Committee – argues that the radical growth and transformation of integration and information over recent years may have increased the severity of the tail risks facing global systems, as recently evidenced by the global financial crisis. He explains that institutions such as the Financial Policy Committee have the qualities necessary to address these risks and, for that reason, matter now more than ever.

Andrew Haldane explains that the forces of integration and information have undergone rapid growth over recent years. While they have generated significant benefits to wealth, welfare and productivity, their rise has not been costless. For example, connectivity in the financial sector can act as a shock absorber, but "when shocks are sufficiently large, the same connectivity serves as a shock-transmitter. Risk-sharing becomes risk-spreading." Information too has benefits but can also generate systemic risk by lowering the quality of decision-making and increasing short-termism. Together, the interaction of fat tails and short minds – connectivity and myopia – means that "systemic risks may be rising at precisely the time societal insurance against these risks is most needed."

For Andrew Haldane, institutions "are the perfect antidote" to these risks because they have institutional memory and are prepared to invest in future stability. He explains that institutions are especially important when tackling economic and financial policy problems that involve difficult trade-offs between today and tomorrow. For example, delegating monetary policy to central banks that operate arms-length from government represents an institutional solution to the time-inconsistency problem of monetary policy.

He argues that it may be even more important to place financial stability policy in the hands of an arms-length institution. That is because financial cycles are longer-lived than the typical business cycle and impose much larger costs. They also tend to generate stronger constituencies of winners and losers, increasing lobbying and making it even harder to lean against long-duration, high amplitude financial cycles.

Three institutional features are likely to be particularly important in safeguarding financial stability. The first is institutional memory, which reduces the risk of disaster myopia. Second, financial policymakers should ideally be arms-length from the political process as that "reduces the temptation to trade off an asset boom today for a bust tomorrow.” Third, a system-wide, macro-prudential, focus is essential in an integrated financial world where crises, when they come, are fat-tailed and global.

In large measure, explains Andrew Haldane, these characteristics are reflected in the UK’s new regulatory arrangements, in which the Financial Policy Committee (FPC) at the Bank of England has responsibility for macro-prudential regulation. The primary objective of the FPC is to preserve the resilience of the financial system and, subject to that, to support the government’s objectives including for employment and growth. “That ordering of the FPC’s objectives helps lean against short-term pressures to go for growth today at the cost of instability tomorrow. In effect, the FPC provides the long-sightedness necessary to preserve future stability”.

He continues: “This macro-prudential regime, with the FPC at its centrepiece, is an explicitly institutional solution to the financial policy dilemma. It is regulation of the system for the system… Macro-prudential policy protects the financial system from itself and the wider economy from its consequences.”

Andrew Haldane notes that the FPC’s actions to date have been completely consistent with those objectives. For example, it has called for UK banks to increase their capital levels to safeguard their future resilience. It has also relaxed liquid assets requirements for UK banks to support future growth: “Through these actions, the FPC has sought to protect the financial system from itself and the wider economy from its consequences.”

These actions will not always be popular. But, notes Andrew Haldane, “financial policy is not a popularity contest, for that way lies the time-consistency dilemma, the myopia trap.” Party-pooping accusations have come thick and fast through this crisis...Yet, though uncomfortable, these are a sign of the new system working, not failing.”