Bank of England speeches

A short summary of speeches made by Bank personnel since publication of the previous *Bulletin* are listed below.

The structure of regulation: lessons from the crisis of 2007(1)

Paul Tucker, Executive Director for Markets and Monetary Policy Committee member, November 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech369.pdf

In this paper, contributing to a London School of Economics debate in the spring, Paul Tucker discussed five issues relating to lessons learned from the financial crisis thus far. These included: (1) the 'collective action' problem, whereby bankers and others have an incentive to herd together in an upswing; (2) how central bank collateral policies can be affected by a 'time-consistency' problem, and how important it is to protect liquidity insurance facilities from stigma; (3) the importance of clarifying the objectives of different central bank operations, and ensuring that market participants/commentators understand the difference between them; (4) the need for a debate on how the authorities can in future tame the credit cycle; and (5) the macroeconomic backdrop and the preconditions for financial system stabilisation. A connecting theme between these issues is that regimes matter, for the way they affect the behaviour of the financial system (and the authorities).

(1) These comments were given at the LSE's Financial Markets Group Conference on 3 March 2008. The paper is also available in the *Journal of Financial Stability* (2008), Vol. 4, Issue 4, pages 359–63.

Some lessons for monetary policy from the recent financial turmoil

Charles Bean, Deputy Governor, November 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech368.pdf

In a speech delivered to a conference on Globalisation, Monetary Policy and Inflation in Istanbul on 21 November, Charles Bean explained that while there have been a number of microeconomic misalignments in the financial system that caused the financial crisis, the preconditions were created by macroeconomic policies. Large and unsustainable global imbalances grew out of individually rational but collectively inconsistent policies. Reform of the international financial architecture is necessary to prevent these building up again, in particular the IMF should be more focused on the interaction of policy choices and ought to have the authority to prevent the adoption of frameworks which lead to unsustainable capital flows. Mr Bean also discussed the role of monetary policy during asset price booms and busts. The current framework is flexible enough to deal with this. But leaning against the wind is a difficult policy to implement. It is far better to use countercyclical capital requirements. The recent recapitalisation of banks was intended to build up a buffer of excess capital which can be run down as losses rise.

Learning from the financial crisis

Sir John Gieve, Deputy Governor, November 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech367.pdf

In this speech, John Gieve highlighted the fact that the crisis is a truly global event because its roots lie in unbalanced global growth and its consequence is a severe downturn worldwide. The crisis has changed in nature over fifteen months so the policy response has had to evolve too, in terms of monetary policy, emergency liquidity measures, bank recapitalisation, and lending guarantees. He then outlined lessons from the crisis which policymakers should draw for the medium term. These include closer international co-ordination of monetary policy, better ground rules for cross-border financial crises, and the development of macroprudential tools, aimed at dampening the financial cycle. He described three possible macroprudential tools: dynamic provisioning, where banks build up provisions which can be drawn upon in a downturn; growth-related capital requirements; and tougher liquidity standards that will discourage banks from using less stable sources of funding to grow rapidly.

Concluding remarks on the Royal Economic Society Public Lecture 2008

Timothy Besley, Monetary Policy Committee member, November 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech366.pdf

In a speech at the Royal Institution, London, Professor Timothy Besley discussed the challenges that the Monetary Policy Committee (MPC) face and the institutional setting for monetary policy in the United Kingdom. He noted that institutional change is a slow process and it is impossible to appreciate fully how institutions will work until they have been tested under all conditions. The current monetary policy arrangements were fashioned in response to previous periods of economic turmoil and the challenges that these posed to economic management. The strength of the current framework remains the fact that the MPC makes independent monthly decisions based on economic judgements in light of the data and economic analysis to achieve a clearly defined target. Professor Besley argued that this remains the best hope to make monetary policy work now and in the future.

Where next for the UK economy?

David Blanchflower, Monetary Policy Committee member, October 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech365.pdf

In this speech, Professor David Blanchflower explained that CPI inflation was likely to decline sharply in the near term. Oil and commodity prices had fallen, wage growth remained muted and measures of inflation expectations had turned down. Hence, the risks of a wage-price inflation spiral had now past. In contrast, the deterioration in financial market conditions was clearly having an adverse effect on the broader UK economy. Output had contracted in the third quarter and unemployment had increased at the fastest pace in 17 years. Furthermore, credit availability was likely to be tightened further in the final quarter of the year. The United Kingdom was likely to enter recession and the widening margin of spare capacity, together with dissipating inflationary pressure implied that monetary policy could be loosened to help stabilise the economy.

Some current issues in UK monetary policy

Timothy Besley, Monetary Policy Committee member, October 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech364.pdf

In a speech at the UBS Conference Centre, London, Professor Timothy Besley discussed some current issues in the UK economy. He noted that since last summer, the sharp fall in commodity prices and the consequently more benign prospects for food and services inflation, as well as the substantial weakening in demand, implied that the upside risks to inflation had diminished significantly. A cut in Bank Rate, on its own, would not be a magic bullet. No single instrument could work to achieve all goals. Monetary policy should remain focused on achieving the 2% inflation target in the medium term. Monetary policy could play a role in conjunction with other policy responses to meet the current challenges. Professor Besley discussed the extent to which the conventional channels for the effectiveness of cuts in Bank Rate on to the real economy were impaired.

Rebuilding confidence in the financial system

Sir John Gieve, Deputy Governor, October 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech363.pdf

In this speech, John Gieve set out a blueprint for the reforms that would have to be put in place to restore confidence in the financial system. He began by detailing the case for the co-ordinated policy intervention. Structural vulnerabilities in the banking system had become apparent: access to cheap funds in wholesale markets had enabled a spectacular expansion of banks balance sheets, leaving banks with insufficient capital and liquidity buffers. The package of recapitalisation, guaranteed funding and enhanced liquidity had been necessary to demonstrate that banks were capable of surviving the downturn. Looking ahead, John Gieve outlined three key lessons that needed to be learned by policymakers around the globe. First, macroprudential policies, perhaps along the lines of the Spanish system of 'dynamic provisioning', need to be developed. Second, a more effective regime for managing failing banks needs to be introduced. Third, cross-border crisis management has to be improved.

The Governor's speech to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward at the Royal Armouries, Leeds

Mervyn King, Governor, October 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech362.pdf

In this speech, the Governor explained how the industrialised world had been engulfed by financial turmoil and why the radical action taken by the UK authorities to recapitalise the banking system had been needed to ensure its survival. He noted that the scale of central bank liquidity support had been unprecedented but was not, and never could be, the solution to the banking crisis which reflected deeper structural problems in the banking sector. Risks built up during benign times, from securitised mortgage lending, particularly US sub-prime mortgages, from banks' own mortgage exposures and from their funding through short-term wholesale borrowing had been exposed by rising defaults and falling house prices, with the effects amplified by very high levels of borrowing relative to capital. The value of banks' assets had fallen with liabilities unchanged. And as uncertainty about the value of banks' assets had risen, markets had sent a clear message to banks around the world that they did not have enough capital. As that view spread, confidence in the system had been eroded. The recapitalisation plan was having a major impact in the restoration of market confidence in banks. But it would take time before the recapitalisation led to a resumption of more normal levels of lending and there might still be problems in other parts of the financial system and the emerging market economies. Attention had moved to the outlook for the UK and world economies, which had deteriorated quickly. It seemed likely that the UK economy was entering a recession. There were implications for fiscal policy, as well as monetary policy, from the crisis, though it should be possible for the Government to reduce its stake in the banking system, for example by selling units in a Bank Reconstruction Fund, and repay the additional debt issued.

But a fall in capital inflows to the United Kingdom would, unless replaced by other forms of external finance, lead to adjustments in the trade deficit and exchange rate that would be larger and faster in the short term than otherwise, implying weaker domestic spending in the short run.

Prospects for the UK economy and challenges for monetary policy

Andrew Sentance, Monetary Policy Committee member, October 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech361.pdf

In this speech, Andrew Sentance explained how monetary policy had moved into a new phase following the collapse of Lehman Brothers and the ensuing financial turmoil. The significance of this development had been aggravated and reinforced by an accumulation of downbeat news about the health of the real economy. Domestic demand had been hit over the summer by rising food and energy prices and the uncertainty created by the 'credit crunch'. But there was also now evidence that firms' export order books had softened and their stock levels had increased. This, Dr Sentance argued, pointed to increased risks of a bigger and more sustained downturn. He then went on to highlight that two key signals of inflationary pressure — rising wage and money spending growth — that preceded earlier recessions in the 1970s, 1980s and 1990s were absent today. Consequently, faced with much weaker demand prospects, monetary policy was in a better position than in earlier recessions to help stabilise the economic situation.

Global influences on UK interest rates

Kate Barker, Monetary Policy Committee member, September 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech360.pdf

In this speech, Kate Barker discussed how global influences (both the impact on UK credit supply of a financial crisis, and the rise in commodity prices) were dominating the UK outlook. These turbulent economic times were also leading to criticisms of the UK monetary framework. One criticism was whether a 2% target would remain valid in a period of high commodity price inflation. But Kate Barker argued that commodity price inflation was unlikely to remain high permanently. And while imported inflation might be a little stronger in the future than during the period when the share of UK imports from low-cost producers was rising, this was unlikely to prevent the achievement of the present inflation target. Another criticism was whether CPI, rather than some measure of core inflation, would still be the right target if commodity price inflation became more volatile. In practice there is not so much difference between the two approaches. The MPC takes less account of the first-round effects on CPI, but is concerned about the risk of high (or low) commodity price inflation becoming embedded in domestic inflation, due to a change in inflation expectations. A core inflation targeter would also have to be concerned about this risk. Finally, in commenting on the immediate economic outlook, the uncertain nature of credit conditions was identified as a major problem, and it was acknowledged that there were unusually large risks to the economy, and therefore to credibility, from policy mistakes in either direction.

Monetary policy: sticking to the basics

Andrew Sentance, Monetary Policy Committee member, September 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech359.pdf

In this speech, Andrew Sentance discussed how the twin shocks of rising energy and food prices and financial market turbulence were affecting the outlook for the UK economy and the MPC's task of keeping the economy on a low inflation course. He noted that sticking to the basic fundamentals which have underpinned the successful operation of monetary policy in the United Kingdom over the past eleven years would give the best chance of navigating the economy through a difficult period. Four key elements of policy were highlighted: keeping a focus on the objective of price stability; continuing the MPC's tradition of independence, openness and accountability; basing decisions on an understanding of how the real economy of business and households operates; and maintaining a forward-looking perspective. He emphasised that prospects for the UK economy were different to past recessions, but risks were finely balanced. Recent financial market turbulence highlighted the possibility of further shocks and the MPC remained prepared to respond to these.

The credit crunch and the UK economy

Sir John Gieve, Deputy Governor, September 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech358.pdf

In this speech, John Gieve discussed how the credit crunch was affecting the wider UK economy. He noted that like other central banks, the Bank of England had adapted its money market operations to provide the liquidity the banking system as a whole should require. First, the Bank of England had allowed banks to increase their reserve balances held at the Bank, increasing the size of overall provision of central bank money. Second, within that larger total, the Bank had shifted the balance towards longer-term lending as the terms of market finance had shortened. Third, the Bank had widened the collateral accepted for longer-term repos. And in April, the Bank had introduced a special scheme to provide banks with up to three years' finance for legacy assets which had become illiquid. He explained why the risk of inflation expectations drifting upwards had been such a central concern of the MPC over the past year. He highlighted the importance of not underestimating the deflationary consequences of the credit crisis and that the news on that front remained worrying. He noted that although the Bank would continue to work for the return of calmer financial markets, this work should not be relied upon to deliver a quick reversal of the macroeconomic slowdown. On the contrary, the risk at the moment was that the slowdown in the real economy could be amplified through a contraction in banks' balance sheets. He concluded by noting the need for longer-term measures to prevent such financial imbalances from building up again in the next upswing and commended the countercyclical 'dynamic provisioning' approach to capital that has been developed in Spain.

All along the watchtower

Spencer Dale, Executive Director and Chief Economist, September 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech357.pdf

In this speech, Spencer Dale described the two key uncertainties that were affecting the economic landscape. First, he considered the risk that deteriorating housing market conditions were posing to the outlook for consumer spending. He noted that the deterioration in the housing market was likely to amplify the impact of tighter credit conditions on consumer spending. Second, he emphasised the risk that the period of elevated inflation could lead to an increase in generalised wage and price pressures. Near-term expectations for inflation had increased. And there was conflicting evidence on the likely persistence of the rise in inflation expectations. Overall, the risks were finely balanced. As the economic environment changed, however, so too could the balance of risks.

Money and credit, twelve months on

Paul Tucker, Executive Director for Markets and Monetary Policy Committee member, September 2008.

www.bankofengland.co.uk/publications/speeches/2008/speech356.pdf

In this wide-ranging speech on the connections between the macroeconomy and finance, Paul Tucker set out what the current conjuncture suggested, from the policymaker's perspective, should feature in the research agenda of monetary economics. First, it was difficult to calibrate monetary conditions, currently, given that both credit market and cost shocks had affected any estimates of the 'equilibrium' interest rate. Greater interest in monetary and credit quantities, and indeed more generally in nominal quantities, would be needed, especially in a world in which quantity rationing had become more prevalent. Second, the cost and credit shocks had developed in tandem with global imbalances. More insight would be needed to identify how 'deficit' countries could in future shield themselves without succumbing to 'beggar thy neighbour' policies. Finally, the crisis had shown that further progress in integrating macroeconomics and finance, both on the theoretical and applied fronts, would be important. Most notably, thus far, the literature had given little indication on how to interpret risk premia from a macroeconomic and macroprudential perspective. And models which explored the macroeconomic effects of the crystallisation of nasty risks (such as default) were still in their infancy.