Bank of England speeches

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

Interpreting monetary policy

David Miles, Monetary Policy Committee member, February 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech425.pdf

In this speech, David Miles discussed quantitative easing (QE). Asset purchases triggered a process of portfolio rebalancing as newly injected money was passed from investor to investor. The channels through which the money might flow were helpful in alleviating problems in the banking sector. The most important channels were difficult to identify, but most were helpful, and none were obviously harmful. QE could have relatively rapid effects on asset prices and credit conditions, and then with a lag on activity and spending, even if the impact on broad money aggregates was less evident.

Financial market conditions prior to the QE policy had been poor. Interbank lending and corporate borrowing costs were high and asset prices had fallen sharply. Since QE began Libor-OIS and corporate bond spreads had declined, asset prices had recovered, and gross corporate bond and equity issuance had been unusually strong. Broad money growth had been weak, but might have been even weaker in the absence of the QE policy. And QE had positive effects, by helping companies to pay down bank debt, or banks to issue equity, which had little impact on broad money.

The size of many central bank balance sheets had expanded as policies, with many similarities to QE, had been implemented. So although financial market conditions had improved internationally, this did not mean QE had had little impact in the United Kingdom.

Holding the stock of asset purchases at their current level meant their impact on the UK economy would be allowed to continue. It was plausible that an even more expansionary monetary policy might be required. If so, the stock of asset purchases would be added to, and at some point reduced, depending on economic events. In formulating monetary policy it was important to consider not only the most likely path of inflation but also the risks and uncertainties. For this reason the Monetary Policy Committee was ready to change monetary policy in either direction.

Inflation, growth and stability: balancing the Bank of England's economic priorities

Paul Tucker, Deputy Governor, February 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech424.pdf

In this speech, Paul Tucker discussed some of the current challenges facing monetary policy and issues relevant to the overall framework for preserving macroeconomic stability.

He highlighted four aspects of the current conjuncture that will be central to monetary policy judgements over the coming months. First, the effects of household and bank balance sheet repair on aggregate demand, which pose a downside risk to the outlook for activity. Second, that the economy's supply capacity is likely to depend on the strength of the recovery. A weak recovery would probably lead to a reduction in capacity, whereas a robust recovery would cause firms to bring back on line capacity that has been suspended so far. That makes it harder to gauge the outlook for inflation. Third, inflation will be above target in the short run due to external factors, posing a risk to inflation expectations. Fourth, the strength and lags in the effects of quantitative easing were uncertain, but it seemed likely that it was still to have its full effect on some asset prices, as well as on demand for goods and services. In contemplating its 'exit strategy' in due course, it would be important for the MPC to take into account how that would affect banking system financing conditions.

He then considered a number of issues for the policy framework for maintaining macroeconomic stability. Those include: the need permanently to embed renewed interest in financial markets, money and credit, so that we truly learn from that information in future. This would entail making sense of risk and liquidity premia. Second, it was clear that relying entirely on using monetary policy to 'mop up' after credit cycle excesses was a mistake by policymakers worldwide — the debate about macroprudential instruments was, therefore, very important. If effective macroprudential tools could be developed, it would be the most significant extension in the overall international macro policy framework in a generation. And finally, that given governments provide the final protection against economic collapse, debt levels as well as deficits matter. The higher the level of debt over coming decades, the more resilient the financial system would need to be.

The corporate sector and the Bank of England's asset purchases

Paul Fisher, Executive Director for Markets, February 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech423.pdf

In this speech, Paul Fisher outlined the rationale for the Bank of England's interventions in the corporate credit market, reviewed the schemes and evaluated the results so far. Importantly, he noted that the Bank's responsibilities do not give it a mandate to provide a source of long-term funding for the commercial banking system. And in that regard, he reiterated that the Special Liquidity Scheme will close at the end of January 2012. He described how a central bank may step in as a 'Market Maker of Last Resort' in order to maintain conditions for the stable provision of financial services. The corporate Asset Purchase Facility (APF) schemes, launched over the past year, should be seen in that light. The interventions appear to have contributed to improved liquidity in the sterling corporate bond and commercial paper markets. And by boosting the demand for risky assets, the APF gilt purchases have been complementary to the corporate schemes.

The debt hangover

Andrew Haldane, Executive Director for Financial Stability, January 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech422.pdf

In this speech, Andrew Haldane discussed the implications of the stocks of debt held by agents across the economy — the 'debt hangover'. This debt hangover is affecting households, financial and non-financial companies and sovereign states to varying degrees, but is perhaps greatest in the financial system. In terms of possible remedial actions, first, banks should take advantage of the profits they have achieved this year to bolster their balance sheets and, second, debt claims could be restructured into equity to benefit both lenders and borrowers, of which there have already been some examples. In order to moderate the frequency and scale of crises going forward, two policy reforms are proposed — macroprudential policies designed to curb the credit cycle and redesign of debt contracts such that they become state contingent.

Economic recovery, the housing market and inflation

Andrew Sentance, Monetary Policy Committee member, January 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech421.pdf

In this speech, Andrew Sentance argued that common influences had been driving developments in the UK economy and housing market. He suggested that the housing market recovery was more likely to resemble that of the 1980s than that of the 1990s, mainly because of a limited supply overhang. He also discussed the positive prospects for economic recovery more generally and cautioned that there were a number of uncertainties. Balance sheet adjustments in the financial sector and the need for public sector rebalancing were two particular areas of concern. Risks also remained around the inflation outlook. For example, as the world economic recovery gathered momentum, there was a danger it would put upward pressure on global energy and commodity prices. But the MPC stood ready to adapt its policies to the changing economic situation — just as it had through the recession.

Shadow banking, financing markets and financial stability

Paul Tucker, Deputy Governor, January 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech420.pdf

In this speech, Paul Tucker discussed one aspect of the financial sector 'structure' debate: the role of shadow banking. Shadow banking can be thought of as the collection of instruments, structures, firms or markets which, alone or in combination, and to a greater or lesser extent, replicate the core features of commercial banks: liquidity services, maturity mismatch and leverage. They are often considered a product of 'regulatory arbitrage' and can be problematic if the resulting non-bank forms of financial intermediation replicate the systemic risks posed by banking itself without being subject to equivalent oversight and safety nets.

He discussed a number of examples that developed prior to the recent financial crisis. Those include: money market mutual funds; finance companies; structured investment vehicles and asset-backed commercial paper; the prime brokerage services of securities dealers; the use of securities lending as a financing market; and the repo-financing of mortgage-backed securities.

With the 'regulation and structure' debate focused on how to make the core banking system safe and sound, he emphasised the need to think through what might comprise shadow banking and how the regulatory system should respond. In particular, it is important to think through how to avoid the problems of the past few years replicating themselves beyond the perimeter of the regulated banking sector in the future. Where shadow banking provides an alternative home for liquid savings, offering *de facto* deposit and monetary services, he argued that the authorities should be ready to bring them into the banking world itself. In the latest episode, constant net asset value, instant-access money funds and the prime brokerage units of the dealers seem to have been examples of that.

Speech by the Governor

Mervyn King, Governor, January 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech419.pdf

In this speech, the Governor focused on describing how the imbalances in the world economy over the past decade or so had contributed to the crisis. New entrants to the world trading system had followed an export-led development strategy — relying on running current account surpluses by providing huge quantities of manufactured goods at low prices. At the same time, countries importing these goods ran deficits and required low savings to maintain overall demand in their economies. Both sides seemed to gain from this arrangement — they were the benefits of trade.

But corresponding to the trade flows were enormous capital flows. Over time these cumulated into massive and unsustainable balance sheet positions. This provided the fuel which the developed world's inadequately designed and regulated financial system ignited to produce a firestorm that engulfed us all.

Dealing with these issues is not something a single country can do by itself. It is an issue of how countries interact. It is not a new issue — it was a problem debated at the Bretton Woods conference at the end of World War II. The problem is essentially political, rather than economic: are countries willing to ensure that their economic policy frameworks are consistent with each other?

The Governor highlighted that the G20's new policy co-ordination framework is a promising mechanism through which this problem can be tackled in the near term. In the longer term, this framework could be enhanced if more countries could be encompassed, giving it greater legitimacy. That might be achieved if the G20 were to metamorphose into a Governing Council for the IMF.

The Governor concluded the speech by highlighting that, as well as working with international partners, there were also important domestic policy actions that we should not neglect, in order to raise our national savings rate.

The future financial landscape

David Miles, Monetary Policy Committee member, December 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech418.pdf

In this speech, David Miles discussed the outlook for the financial sector. The belief that banks had *de facto* state insurance, borne out by government interventions during the financial crisis, had led to falling capital levels and liquid assets holdings and lower bank funding costs. But regulatory responses to the financial crisis, such as stricter capital and liquidity requirements, would increase the cost of bank lending.

The impact of a smaller banking sector would depend on the substitutes to bank lending. For both non-financial companies and households bank debt accounted for around one fifth of their assets. Households were more dependent on bank debt for external finance but relied more on savings to finance asset accumulation.

Bank finance, through debt rather than equity, might be beneficial when informational asymmetries existed in assessing inherently risky investments. Banks could have some comparative advantage or exploit economies of scale in assessing these risks. However, the mispricing of assets and risk by the banking sector had demonstrated such benefits were likely to be limited. Rather, the growth of the banking sector had reflected a combination of tax factors (favouring debt over equity finance) and implicit subsidies from state insurance. And government interventions had demonstrated the costs of providing such insurance.

The mark-up between the central bank policy rate and the effective cost of funds could be affected by a smaller banking system. The level of Bank Rate consistent with a particular average rate of inflation might be lower. In the short run substitutes to bank lending would be limited. Quantitative easing (QE) smoothed the adjustment by making it easier for non-financial companies to issue equity and debt — as investors who had sold gilts to the Bank of England sought to replace them with close substitutes. Since QE began corporate bond spreads had fallen and equity prices increased.

Banknotes in circulation — still rising: what does this mean for the future of cash?

Andrew Bailey, Executive Director for Banking Services and Chief Cashier, December 2009.

www.bankofengland.co.uk/publications/speeches/2009/speech417.pdf

In a speech to the Banknote Conference 2009, Andrew Bailey considered explanations for recent trends in the demand for banknotes. He noted that sustained low inflation had increased confidence in the real value of the currency since the mid-1990s, while more recently the demand for banknotes, particularly £50 notes, had risen during the recession.

Turning to the challenges faced by the Bank in managing the circulation of its banknotes, he set out the importance of maintaining the physical quality of notes in circulation and of meeting the public's demand for different denominations and noted the ongoing difficulties in ensuring there were enough £5 notes in circulation. Bailey added that while there had been some increase in £5 notes in circulation over the past two years, there was still more to be done and noted that two recent pilot exercises with HSBC and Sainsbury's suggested that progress could be made.