Bank of England speeches

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

2010: a progress report

Spencer Dale, Executive Director and Chief Economist, December 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech465.pdf

In this speech, Spencer Dale provided a progress report for 2010. The pace of recovery to date compared favourably with previous episodes, but economic recovery had to be judged in terms of the level of output. The recovery would be hampered by reduced public sector spending and the position of banks. But the highly accommodative stance of monetary policy and the level of sterling would support economic activity. Another development of 2010 was the announcement of the Bank's planned new responsibilities for macroprudential policy. This was likely to be a major advance in responding to the missing instrument problem. But it was not the solution to all problems associated with financial markets and the international monetary system. He concluded by explaining why, in the face of persistently high inflation, the MPC had not tightened policy. The MPC remained as hard-nosed as ever in their determination to hit the inflation target.

Getting back to business

Andrew Sentance, Monetary Policy Committee member, November 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech464.pdf

In this speech, Dr Andrew Sentance discussed the prospects for the private sector and business activity to sustain UK growth while public finances are rebalanced. He highlighted the strength of the rebound in UK and global activity in the first year of recovery. He also pointed to the resilience of various aspects of UK supply-side performance through the recession, with employment, company finances and business failures being sustained at more healthy levels than in previous downturns. However, inflation has persistently overshot the inflation target and is set to remain high through 2011 and possibly longer. This provides a strong case for a monetary tightening from the very low Bank Rate put in place last year when downside risks were much bigger. Delaying this adjustment risks undermining confidence in low inflation and larger future interest rate rises.

Curbing the credit cycle

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

www.bankofengland.co.uk/publications/speeches/2010/speech463.pdf

In this speech, Andrew Haldane examined the causes and consequences of credit cycles, drawing implications for the design of macroprudential policy. Sketching a model of the credit cycle, Andrew demonstrated that a credit cycle arises from a collective action failure among banks. Using a long time series, Andrew showed that empirical evidence is consistent with this result, suggesting a case for state intervention to help co-ordinate lending expectations and actions by banks. Macroprudential policy may provide the answer by helping increase the long-term cost of credit extension to banks during booms and lower costs during busts, hence smoothing credit supply over the cycle. Key factors in the design of such a policy are the need for simplicity and clarity of objectives, particularly given the importance of the expectations channel. Added considerations include the international dimension and the need to police the regulatory boundary to prevent regulatory arbitrage.

Do we know what we need to know in order to lean against the wind?

Adam Posen, Monetary Policy Committee member, November 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech462.pdf

In this speech, Dr Posen challenged the validity of the assumption that monetary policy makers could correctly identify asset price bubbles in time to respond pre-emptively, or at least usefully. Only a relatively small fraction of real estate and equity price booms lead onto busts. Reacting to asset price movements pre-emptively on the basis of price movements alone is likely to cut off more booms that would do no harm than dangerous booms that would be desirably pre-empted, and so could damage productivity growth. It is also difficult for a central bank to credibly commit to pre-empt asset price bubbles as subjectively identifying costly booms in a timely fashion appears unrealistic, and even when achieved it may take time to put a needle through the bubble. Using an early warning indicator approach Dr Posen noted a lack of robust indicators of booms (or busts). This is likely to prove frustrating for policymakers hoping to get ahead of asset price movements. Additionally, there is little evidence that excessive monetary ease is a precondition for, or cause of, asset price booms.

After the recession: thoughts on the growth potential of the United Kingdom

Martin Weale, Monetary Policy Committee member, November 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech461.pdf

In this speech, Martin Weale discussed the impact of the recent crisis on the level and future growth rate of potential output in the United Kingdom. He reviewed three factors that might affect UK supply capacity: increased cost of capital for companies; skills lost with increased unemployment; and a potential rebalancing of the UK economy away from public spending towards private sector manufacturing. Overall, the financial crisis may have resulted in a loss of output of 2½%–5% of GDP relative to what seemed to be sustainable before the crisis, although a successful rebalancing might offset some of that decline. While uncertain, these calculations implied there was spare capacity of the order of 4%–6½% of current GDP. However Dr Weale added that, with inflation more than 1 percentage point above target, the MPC should be wary of introducing additional monetary stimulus given the possible effect on inflation expectations.

Financial crisis and G20 financial regulatory reform: an overview

Paul Tucker, Deputy Governor, November 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech460.pdf

In this speech, Paul Tucker provided an overview of the contribution of the Financial Stability Board (FSB) to the G20 financial regulatory reform agenda. He highlighted five areas. On surveillance of the financial system, the FSB has been encouraging new machinery to survey and head off risks, as well as establishing its own vulnerabilities group. In the supervision of individual firms, the FSB has sponsored an exercise on effective supervision of Systemically Important Financial Institutions (SIFIs). It has examined the various styles of banking supervision around the world, producing an evaluation of what is needed to supervise SIFIs. On capital and liquidity, the Basel Committee has agreed tougher standards for the definition, deductions from and quantity of capital. Minimum standards will also be introduced for holding resiliently liquid assets and the funding of illiquid assets. And the Basel Committee will undertake a fundamental review of capital requirements for the trading book in 2011 to address the regulatory arbitrage that has existed between the 'banking book' and 'trading book'.

Central to the FSB work has been to address the 'too big to fail' issue. Reforms in this area aim to reintroduce market discipline back into the financial system and ensure that governments do not have to provide fiscal support if a large financial institution gets into trouble. The acid test will be whether, for every financial institution in the world, it could be resolved if it faced distress in a way that does not disrupt the flow of essential financial services and without state solvency support. This could include ideas being developed for putting losses in the largest firms not just onto shareholders but onto their unsecured, uninsured creditors. Beyond the changes to bank regulatory requirements, there has also been work, under the FSB umbrella, to reform capital markets. In particular, the use of central counterparties (CCPs) to clear over-the-counter derivatives and increased transparency around, and much reduced reliance on, credit rating agency ratings. On the latter, too many investors and banks have given up on reaching their own view on borrowers and on instruments, but have effectively subordinated their own judgement to that of the credit rating agencies. The FSB has sponsored and led work to reduce the extent to which credit rating agency ratings are embedded in the regulatory fabric of capital markets.

Institute of International Bankers Annual Breakfast Regulatory Dialogue, Washington DC

Paul Tucker, Deputy Governor, November 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech459.pdf

In this speech, Paul Tucker noted that a big contributor to the financial crisis was the failure of official regimes for regulating and overseeing the financial system to keep up with the evolution of global capital markets. As such, the international programme of regulatory reform is both formidable and transformational. He outlined three key areas of work in the international arena over the past twelve months and two areas for future work.

First, the new Basel Capital Accord, while not quite as rigorous in some respects as the Bank of England would have liked, significantly stiffens the prevailing regime and remedies a number of problems in earlier Accords. However, there is more work to be done on capital, with a fundamental review of the capital requirement for the trading book due in 2011. Similarly, the new Liquidity Accord requires further work, but will for the first time put requirements on holding resiliently liquid assets and funding of illiquid assets. Second, the G20 Financial Stability Board (FSB) has delivered a package of recommendations to address the problem of 'too big to fail'. Those include greater loss-absorbing capacity for the largest and most complex firms, and improved resolution regimes that are equipped with the necessary tools to resolve the large, complex cross-border banks. Third, the FSB work programme on the interconnectedness of global capital markets has recommended the use of central counterparties in over-the-counter derivative markets. It has also led and sponsored further work on reducing the reliance on credit rating agency ratings.

Looking ahead, as regulation of the banking sector is reformed, it will be necessary to watch out for new forms of regulatory arbitrage. That could manifest itself in the 'shadow banking' sector, which will require having a capability to adapt the regulatory regime when threats to financial stability arise outside the regulatory perimeter. Finally, macroprudential regulation — taking a system-wide perspective to micro regulation — will mean equipping the authorities with a range of tools, including the ability to adjust the regulatory boundary, to increase resilience of the financial infrastructure and leaning against the credit cycle to make the system more resilient when it would otherwise threaten financial stability.

Developing an EU cross-border crisis management framework

Paul Tucker, Deputy Governor, November 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech458.pdf

In this speech, Paul Tucker put forward a number of propositions for developing an EU cross-border crisis management framework. First, it is essential that each Member State, and indeed all countries around the world, have a national US-style resolution regime for conventional commercial banks. That would allow the authorities to take a distressed medium-sized commercial bank and transfer the deposits to another viable bank, transfer or sell the good assets, and put the bad assets into receivership or run-off. Second, tools must be developed that enable the resolution of the largest, most complex financial institutions without the use of taxpayer solvency support and without severe disruption to the flow of essential financial services to the economy. Such tools could include the ability to run down a group from a bridge company and sell off the most attractive parts of the business, as is being pursued in the United States. Another is to be able to write down, or haircut, claims of unsecured, uninsured creditors and impose partial conversion from debt to equity in conditions of distress, in what would be a going concern if the underlying franchise was viable. Third, tools need to be developed to cope with the cross-border element of a financial firm failure within the European Union. Fourth, the largest banks in Europe are global, and so there needs to be arrangements for dealing with global resolution, not least by removing legal obstacles to global co-operation. And fifth, there needs to be improved planning by the regulatory and resolution authorities through the development of firm-specific recovery and resolution plans or 'living wills'.

Measuring recession and recovery: an economic perspective

Charles Bean, Deputy Governor, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech457.pdf

In a speech to a conference organised by the Royal Statistical Society, Deputy Governor Charles Bean discussed the role of statistics in the study and control of the business cycle. He described the particular challenges of forecasting downturns in the wake of financial or banking crises, which tend to be less predictable in nature than more conventional downturns. In particular, the complexity of the great financial crisis of 2008 meant that neither its precise evolution, nor the full extent of its impact on the real economy, could have been easily foreseen. Better statistics could not have helped in this task. He went on to note that a particular measurement challenge at the present juncture was the assessment of the degree of spare capacity in the economy, with different approaches to measuring space capacity leading to very different conclusions. He closed by noting the benefits of improved financial sector data for the delivery of the Bank's monetary and financial stability objectives.

Monetary ease and global rebalancing: debunking the Japanese scare story

Adam Posen, Monetary Policy Committee member, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech456.pdf

In this speech, Dr Posen discussed the management of global rebalancing and argued that major surplus countries should adjust their current accounts more than they have so far. In particular, Dr Posen argued that, because accommodative monetary policy does not cause asset price bubbles, emerging markets' fear of feeding an asset price bubble is not justification for keeping an exchange rate undervalued. The example of Japan in the 1980s works against that claim, rather than for it. Although monetary ease coincided with the late stages of the Japanese equity and real estate bubbles, those booms began more than two years ahead of interest rate cuts. Dr Posen noted that in 1980s Japan the cause of asset price increases lay in unrealistic expectations of participants regarding trend rates of productivity growth, contradicted by monetary policy. Slow and partial financial deregulation also supported overcapacity in the banking system, and regulatory rather than monetary factors directly encouraged the real estate boom. Moreover, Japanese asset prices have remained subdued since 1995, despite an expanding money supply, zero interest rates and declining prices. The implications are that emerging market asset booms could be better managed at present by a combination of exchange rate appreciation and monetary ease. Raising interest rates in response to the bubbles (and leaving currencies undervalued) will only attract further capital inflows and exacerbate asset price booms.

Banking: from Bagehot to Basel, and back again

Mervyn King, Governor, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech455.pdf

In this speech, the Governor started by explaining how the size, concentration and riskiness of banks had grown markedly in recent decades. The fundamental fragility of banks reflects their use of short-term debt to fund long-term, risky illiquid investments. Therefore to treat banks as if they were riskless was akin to financial alchemy. To work, this requires the implicit support of the taxpayer, which incentivised banks to take on yet more risk.

The Governor then considered a number of proposals designed to offer a solution to this incentive problem. The first proposal was a permanent tax on the activity of maturity transformation. But, the Governor noted that given crises occurred infrequently, it would be almost impossible to calibrate the appropriate size of any levy. Second, the Governor felt that limits on leverage, which were embodied within the capital standards set by the Basel framework, had much to commend them — although, Basel III on its own was unlikely to prevent another crisis.

Other, more radical, reforms could include moving to capital requirements several orders of magnitude higher, ensuring large amounts of contingent capital in a bank's liability structure, introducing 'limited purpose banking' or having some form of functional separation. A key challenge with these more fundamental proposals was to ensure that maturity transformation did not simply migrate outside of the regulated perimeter and end up benefiting from an implicit public subsidy.

In concluding, the Governor stressed that he was not offering a blueprint for reform, which in the United Kingdom was the job of the Independent Commission on Banking. Going forward, the challenge was to think a way through to a better outcome before the next generation was damaged by a future and bigger crisis.

Speech by the Governor

Mervyn King, Governor, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech454.pdf

In this speech, the Governor started by outlining the challenge of rebalancing the world economy. All countries accepted that global rebalancing was necessary. But there was a clear difference between the path of adjustment desired by the surplus countries and the path of adjustment preferred by the deficit countries. It was just a matter of time, if no agreement could be found, before one or more countries resort to trade protectionism as the only domestic instrument to support a necessary rebalancing.

The Governor suggested two principles for the way ahead: first, focus discussion on the underlying disagreement about the right speed of adjustment to the pattern of spending; and, second, many potential policy measures should be put on the table — not just the single issue of exchange rates. What was needed was a 'grand bargain'. A natural forum in which to strike such a bargain was the G20.

Turning to domestic policy, the Governor noted that inflation had been high and volatile. The MPC was conscious that the continuing high level of inflation posed the risk that inflation expectations may move up. But, at the same time there was also a risk — at least as large — that once the temporary upward influences on inflation had dissipated, the influence of spare capacity in the economy would push inflation below the target.

The Governor ended by suggesting that the next decade would not be *nice* — non-inflationary consistently expansionary. History suggested that after a financial crisis the hangover lasted for a while. So the next decade was likely to be a ***sober*** decade — a decade of *s*avings, *o*rderly *b*udgets, and *e*quitable *r*ebalancing.

An unconventional journey: the Bank of England's Asset Purchase Programme

Paul Fisher, Executive Director for Markets, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech453.pdf

In March 2009 the Bank of England's Monetary Policy Committee embarked on an 'unconventional' journey. Having cut Bank Rate to a historic all-time low, the MPC initiated a programme of asset purchases financed by the issuance of central bank reserves — commonly known as quantitative easing. In this speech, Paul Fisher recounted why the MPC embarked on this journey and why, in his view, the policy proved extremely successful in meeting its immediate objectives. He also discussed some of the more technical reasons behind the design of the policy, including the motivation for buying assets from the non-bank private sector and the various operational considerations associated with the auction design. Paul also addressed the strategy for eventual exit, while acknowledging the possibility of further purchases in the meantime.

Sustaining the recovery

Andrew Sentance, Monetary Policy Committee member, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech452.pdf

In this speech, Dr Andrew Sentance discussed the challenge of creating the right conditions for a sound and sustained recovery. His speech started with a comparison of the current recovery with previous UK cycles, highlighting the resilience of employment. He also noted that the rebound in the global economy was helping to support the United Kingdom's recovery. Despite headwinds to growth from fiscal policy and the banking sector, a similar fiscal adjustment had not prevented private sector-led growth in the 1990s. And recent survey evidence suggested easing credit conditions for firms. There was a risk of overstating UK trend growth following the long expansion prior to the financial crisis, which implied that spare capacity could be eroded quicker over the recovery. That, coupled with persistent above-target inflation, pointed to the need to withdraw monetary stimulus sooner rather than later by gradually increasing Bank Rate.

Leverage and monetary policy

David Miles, Monetary Policy Committee member, October 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech451.pdf

Some argue that one lesson from the financial crisis is that monetary policy tools should be used to prevent asset price booms. On this issue, Professor Miles made three points in his speech. First, not all episodes of rapid asset price inflation are disruptive to the wider economy, but the ones accompanied by sharp increases in leverage generally are. Second, monetary policy tools are not likely to be effective in controlling the leverage of banks. Third, a much more direct and effective tool to control leverage in the financial sector is through capital requirements.

On the immediate UK monetary policy issues, Professor Miles argued that the recovery following the current crisis is not likely to be a normal one and risks of inflation deviating from the target exist on both sides. He concluded that it was not yet appropriate to start withdrawing the extraordinary level of monetary stimulus.

Managing liquidity in the system: the Bank's liquidity insurance operations

Paul Fisher, Executive Director for Markets, September 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech450.pdf

In this speech, Paul Fisher described the various measures the Bank had taken during the crisis to extend liquidity insurance to the financial system. Those measures included increasing the size and maturity of its lending operations, widening the pool of eligible collateral, and the introduction of a Discount Window Facility (DWF) in October 2008. The changes culminated with the introduction of the Bank's indexed long-term repos (ILTRs) in June 2010. Those operations allow counterparties to simultaneously bid against two distinct collateral sets, with the proportion of funds lent against 'wider' collateral responding automatically to changes in demand (and by extension, changes in market conditions).

Paul also discussed how the banks had been making good progress in repaying funds lent under the Special Liquidity Scheme (SLS). Of the £185 billion of Treasury bills initially advanced, £57 billion had already been repaid. While the SLS will not be extended or replaced, the ILTRs and DWF would continue to provide liquidity insurance to the banking system.

The case for doing more

Adam Posen, Monetary Policy Committee member, September 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech449.pdf

Dr Posen presented his case for why monetary policy should continue to be aggressive about promoting recovery, and, at present in the United Kingdom and other major economies, further easing should be undertaken. There remains such a significant gap between what the economy could be producing at full employment and what it currently produces, that if price stability is at risk over the medium term it is on the downside. Dr Posen suggested that tightening prematurely or loosening insufficiently could risk sustained subpotential growth turning into a self-fulfilling prophecy by eating at supply capacity. In both the Great Depression and Japan's Great Recession, nascent recoveries were aborted by premature macroeconomic policy tightening based on underestimates of potential growth, as well as the weight of financial problems accumulated over a period of prolonged slow growth without reform. In discussing how central banks should do more, Dr Posen argued it must primarily take the form of large-scale asset purchases, initially of long-term government bonds — because of market limitations in the United Kingdom, but also the absence of overt financial distress reduces the potential relative advantage of private credit purchases. Dr Posen also discussed why more should be done now in the United Kingdom specifically — recent data on growth in output offers insufficient reason to characterise the United Kingdom as being in an inflationary recovery (it is indistinguishable from either the United Kingdom in 1991 or Japan in 1993), while comparisons of credit growth with previous recoveries are worrisome.

Inflation, Inflation, Inflation

Spencer Dale, Executive Director and Chief Economist, September 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech448.pdf

In this speech, Spencer Dale argued that although inflation had been above target for much of the past four years, the MPC had not gone soft on inflation. The economy had been hit by a series of large price-level shocks — to oil and other commodity prices, to VAT and to the sterling exchange rate. By raising companies' costs and putting upwards pressure on prices, these shocks could together more than account for the strength of inflation. But it was important to learn from the behaviour of inflation. Changes in the structure of the economy, the nature of the financial crisis, and the different role played by policy had all affected the behaviour of inflation during the downturn. Looking ahead, although inflation was above target and expected to remain so for some time, there were significant risks to both sides of the inflation outlook. This created an unusually difficult balancing act for the MPC.

Remarks by Andrew Bailey on financial reform

Andrew Bailey, Executive Director for Banking Services and Chief Cashier, September 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech447.pdf

In this speech, Andrew Bailey spoke about why the stability of the financial system is in the public interest; why the public should expect the authorities to act in their interest; and why it is important that the case for financial stability is understood.

Andrew made the comparison to the public's understanding of monetary policy tools; and what the public would want from financial stability. He spoke about the tools that would be required to meet the public's expectations that taxpayer money should not be put at risk to save a failing financial institution and noted that at present, there is not a sufficient resolution tool to solve the too big to fail issue.

Andrew went on to discuss how judgement should be at the centre of the new Prudential Regulation Authority. It should be used by regulators to mount a robust challenge to stop dangerous and risky business models. He went on to explain how recovery and resolution plans should be integrated within supervision.

Speech by the Governor

Mervyn King, Governor, September 2010.

www.bankofengland.co.uk/publications/speeches/2010/speech446.pdf

In this speech, the Governor described the fundamental causes of the crisis: the imbalances in world trade and capital flows; and the inability of the banking systems to intermediate such large inflows of capital without taking excessive risk.

The Governor outlined how policymakers could prevent this happening again: first, the financial system needed radical reform. In the long run, banks would have to hold much more capital and be much less highly leveraged. And, second, just as the world economy needed rebalancing, so did the UK economy. This implied a shift in spending and production away from domestic consumption and towards exports.

Turning to domestic policy, the Governor noted that no one could forecast the gusts the economy would face looking ahead. There was considerable uncertainty about the prospects for the United Kingdom's most important export markets, Europe and the United States. At home, business and consumer confidence had weakened, and it would be some time before the banking sector would be able to finance a recovery on the usual terms. The transition to a better balanced economy would be difficult. But, if the recovery was slower than expected, then monetary policy could react and the automatic fiscal stabilisers would act to stimulate demand.

The Governor ended by saying that the costs of the crisis would last for a generation. Policymakers owed it to the next generation to seize this opportunity to put in place the reforms that would make another crisis much less likely and much less damaging.