Bank of England speeches

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

Tail risks and contract design from a financial stability perspective

Paul Fisher, Executive Director for Markets, September 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech515.pdf

In this paper, Paul Fisher and co-author Patrik Edsparr discussed how failures to take into account how the financial system as a whole operates can generate deviations between a financial contracts' true and intended value. Examples taken from the crisis include contracts where extreme events benefiting the insured party would wipe out the insurer, and contractual provisions which were not exercised because of potential reputational repercussions.

The authors drew a number of policy conclusions. First, regulators, investors and analysts need to take account of true stress correlations so that they properly capture the impact of tail events. Second, contract designs which are exclusively relevant in a tail event should probably be avoided, at least between banks, which are not a good home for tail risks. These conclusions are relevant for contingent capital instruments, which should be designed so that they do not completely disrupt the market if/when they are triggered.

The choice between rebalancing and living off the future

Martin Weale, Monetary Policy Committee member, August 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech514.pdf

In a speech to the Doncaster Chamber of Commerce, Dr Martin Weale considered the appropriate balance between consumption and saving — one of the key drivers of the longer-term position of the economy. He argued that the United Kingdom had a long history of not saving enough. A comparison of UK assets (including future labour income) with liabilities (mainly future consumption) showed that the country's assets were greater than its liabilities. The economy therefore needed to rebalance away from consumption and towards investment (either at home or overseas) if the consumption plans of current and future generations were to be met.

Dr Weale also considered developments in the economic outlook. Recent data pointing to slowing economic growth in major advanced economies, and a downward revision to the growth and inflation outlook in the August *Inflation Report* had led him to vote to keep Bank Rate unchanged in August. But while further asset purchases could stimulate the economy if required, Dr Weale argued that these were not yet needed.

Risk off

Andrew Haldane, Executive Director for Financial Stability, August 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech513.pdf

Since the onset of the crisis, market sentiment has alternated between periods of 'risk on' and 'risk off'. In this paper, Andrew Haldane explained why he believes we are now in a 'risk off' period and the role that macroprudential policy might play in this environment.

Mr Haldane outlined that risk aversion was driven by two factors: balance sheet disrepair and 'psychological scarring'. On the first, this process remained incomplete causing strong headwinds to risk-taking. On the second, behavioural factors may have led to overpessimism in markets as financial crashes may have caused perceptions of risk to become overstated. Given the detrimental impact of persistent risk aversion, Mr Haldane noted that new policy approaches might be needed to allay the 'fear factor', speed up balance sheet repair and stimulate risk-taking. He suggested a number of ways in which this can be achieved through the newly established Financial Policy Committee (FPC). Opportunistic raising of capital levels by banks, as recommended by the FPC in June, was one way. Communicating about the possible overpricing of risk was another. Recommending changes in regulation to lean against the wind would be a third.

Haircuts

Andrew Haldane, Executive Director for Financial Stability, August 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech512.pdf

Andrew Haldane released a paper drawing out the key messages and policy implications from a forthcoming *Journal of Monetary Economics* article entitled 'Complexity, concentration and contagion' co-authored with Prasanna Gai and Sujit Kapadia. The paper highlights the procyclical nature of haircuts on secured lending transactions which had the damaging effect of amplifying the credit cycle, both on the upswing as secured lending transactions became cheaper, and on the downswing as higher haircuts immobilised collateral and led to liquidity hoarding. The authors illustrate this by developing a model of a banking network in which connectivity provides a key channel for contagion when haircuts rise. These procyclicalities may call for intervention to regulate collateral requirements for macroprudential policy purposes, which the paper illustrates with a numerical simulation. This can help reduce materially the probability of a systemic liquidity crisis. The financial network set-up can also be used to assess other topical policy issues, such as central clearing to address system-wide complexity and targeting liquidity requirements on the most connected banks in the system to reduce the risks from concentration.

Monetary policy and banking fragility

David Miles, Monetary Policy Committee member, July 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech511.pdf

In this speech, Professor David Miles argued that revisions to the prudential capital framework did not add to the two problems that monetary policy makers were facing in the United Kingdom: above-target inflation and weak output growth. The policy rate had been lowered to almost zero. But bank lending rates had fallen by less, mainly because banks and their creditors had reassessed the risk of their exposures. In contrast, revisions to the prudential capital framework did not appear to have contributed substantially to the increased spread between bank lending rates and policy rate. Banks should find it relatively easy to raise sufficient equity to meet tighter capital standards gradually without restraining loan growth: as the risk of bank debt and equity declines when capital ratios rise, owners of bank debt should be willing to replace some bank debt with equity to maintain the risk profile of their portfolios.

Central banking then and now

Charles Bean, Deputy Governor, July 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech510.pdf

At the Sir Leslie Melville Lecture, Charlie Bean offered some lessons of the crisis for central banks. He said that central banks needed to show flexibility in crises and that monetary policy easing was not limited by the zero bound for policy rates.

Charlie Bean described the interaction of monetary policy and financial stability. He argued that macroeconomic stability leading up to the crisis may have contributed to the build-up of risks and that price stability did not guarantee financial stability. He identified the need for financial intermediation to be brought into macroeconomic analysis.

Charlie Bean discussed the policy instruments required to maintain financial stability concluding that, alongside monetary policy tools required to maintain price stability, macroprudential regulation should be used to maintain financial stability. He ended by describing the creation of a Financial Policy Committee charged with protecting and enhancing the resilience of the UK financial system.

The race to zero

Andrew Haldane, Executive Director for Financial Stability, July 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech509.pdf

In a speech at the International Economic Association Sixteenth World Congress in Beijing, Andrew Haldane discussed the increase in systemic risk associated with changes in the topology of trading and policy options to address these developments.

In particular, Mr Haldane attributed the change in speed to the dominance of high-frequency trading (HFT) where market advantage lies in being the fastest to execute a trade — a 'race to zero'. These developments may have led to an increase in price dislocation across markets, caused by a withdrawal of liquidity in stress situations, as evident during the so-called 'Flash Crash' on 6 May 2010. The advent of HFT and fragmentation of trading structures may have made this more likely, with HFT firms more inclined to withdraw and longer-term investors unwilling to fill the liquidity gap because HFT activity makes this risky. This poses a challenging set of issues for policymakers. Mr Haldane provided some possible solutions to improve the resilience of liquidity and forestall the 'race to zero'. These included circuit breakers to halt trading and provide a means of establishing a level informational playing field for all traders; and imposing a speed limit on trades through minimum resting periods to make bid-ask spreads less variable, especially in situations of stress.

The case for more CHAPS settlement banks

Chris Salmon, Executive Director for Banking Services and Chief Cashier, July 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech508.pdf

In a speech to the ifs School of Finance on 5 July, Chris Salmon examined the crucial but perhaps underexplored role of payment systems in the economy and their impact on financial stability.

While reflecting on the recent successes of the United Kingdom's payment systems infrastructure during the crisis — many of which were the result of advances championed by the international regulatory community in previous decades, for example the adoption of real-time gross settlement — the speech examined areas where improvements to resilience could still be made, with particular emphasis on the Bank's initiative to increase the number of banks that are direct members of CHAPS, thereby reducing 'tiering risk'.

In addition, Chris touched on several other initiatives currently under way to increase efficiency and decrease risk in the payment system. These included the Liquidity Saving Mechanisms project which will allow banks to settle their obligations at a lower liquidity cost, and Term DBV, which will decrease the operational risk associated with intraday expansion of the Bank's balance sheet.

The state of the financial markets

Paul Fisher, Executive Director for Markets, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech507.pdf

In this speech, delivered to a group of institutional investors at the end of June, Paul Fisher reviewed the progress of financial markets since their seizure at the height of the crisis in 2008. The process of gradual healing had reflected the impact of significant injections of central bank liquidity into the global financial system, depressing yields on 'safe' securities and prompting increased demand for risky assets through a portfolio rebalancing channel. The speech outlined how that process might have encouraged investors to reach for yield by moving into more illiquid or complex products. But to date, only a few specific markets had shown signs of excess. Paul also discussed the market impact of uncertainty about the precise rules and calibration of new regulations, aimed at solving the 'too big to fail' problem. As more details are finalised, that uncertainty, and its impact on markets, should dissipate.

Macro and microprudential supervision

Paul Tucker, Deputy Governor, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech506.pdf

In this speech, Paul Tucker set out how the key planks of the reform of the financial system amount to constructing a new Social Contract between banking and society. The two new guiding principles are an insistence on the feasibility of resolving distressed firms, however large and complex, without taxpayer solvency support; and on the importance of prioritising the health of the system as a whole so as to maintain key financial services to the economy. Reflecting that, a central element of the work of the planned new Prudential Regulation Authority will be to work backwards from what would happen in the event of a firm's failure. Supervisors will also look laterally across peer groups of firms for signs of short-term and longer-fuse threats to stability. The new Financial Policy Committee (FPC) at the Bank of England will steer and orientate this work from a macroprudential perspective.

He also summarised the decisions taken by the FPC at its first meeting in late June. He stressed two of the decisions in particular: first, the need currently for banks to retain a greater share of profits when they are buoyant in order to build up resilience against external threats; and second, the need to contain potential threats posed by the growing complexity of exchange-traded funds and similar instruments.

Not that '70's show: why stagflation is unlikely

Adam Posen, Monetary Policy Committee member, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/presentation110627.pdf

In this speech at the University of Aberdeen Business School, Dr Adam Posen argued that a repeat of the 1970s' stagflation in the United Kingdom is highly unlikely and a pre-emptive tightening of monetary policy is therefore unwarranted. He pointed to four factors whose interaction produced stagflation in the 70s — unanchored inflation expectations, real wage resistance, economically significant supply shocks and an unrecognised decline in productivity growth. He argued that institutional reform of monetary policy making since then has helped to anchor expectations, and that labour market liberalisation has eroded workers' ability to resist declines in real wages. Dr Posen also argued against revising down the estimate of trend productivity growth more than modestly. He noted that energy price trends remain a potential source of stagflationary pressures, but argued that there is no alternative to forecasting inflation using the prices implicit in forward contracts, which remain broadly flat or rising only slightly.

Current issues in monetary policy

Paul Fisher, Executive Director for Markets, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech505.pdf

In this speech, Paul Fisher discussed some of the challenges associated with setting monetary policy over the past three years. He argued that the recent overshoot of the inflation target reflected the impact of three real relative price shocks (VAT, commodity prices and the fall in sterling). Dealing with these real shocks has been uncomfortable for everyone. But given their nature, the best policy response consistent with the Committee's inflation remit, was to accommodate the one-off price-level effects, while ensuring there were no second-round effects.

In his speech he also discussed the role of forecasts in setting monetary policy. Because models can only ever provide a rough approximation of reality, setting policy is a matter of decision-making under uncertainty. That is why the MPC focuses on the range of possible outcomes and the balance of risks, as summarised in the *Inflation Report* fan charts, rather than on a single projection.

The Governor's speech at the Mansion House

Sir Mervyn King, Governor, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech504.pdf

The Governor commented briefly on three themes: monetary policy; macroprudential policy, and the work of the new Financial Policy Committee at the Bank; and the new approach to banking regulation that will follow the creation of the Prudential Regulation Authority.

The challenge facing monetary policy was obvious — the combination of high consumer price inflation and weak economic growth. The big picture was that the UK economy was going through a major rebalancing of demand and output, from private and public consumption to net exports and business investment, which would take several years to complete. The Monetary Policy Committee (MPC) could have raised Bank Rate significantly so that inflation would be closer to the target. But that would not have prevented the squeeze on living standards that had arisen from higher oil and commodity prices and the measures necessary to reduce the United Kingdom's twin deficits. The Governor noted that the MPC was watching extremely carefully for any signs of a pickup in domestically generated inflation and it would take action as soon as it was appropriate to do so.

Turning to his second and third themes, the Governor said that the creation of the Bank's new Financial Policy Committee (FPC) was a response to the lesson that monetary policy could not target stability of both prices and the financial system. A key part of the FPC's role would be to issue recommendations and directions to the new regulatory bodies, the Prudential Regulation Authority (PRA) and Financial Conduct Authority.

The style of regulation would change with the PRA. It was vital that the PRA collect and process data only where the supervisors had a need to know. Targeted and focused regulation, allowing senior supervisors to exercise their judgement, did not require ever-increasing resources. The obsession with detail was in fact a hindrance to seeing the big picture. And here the FPC had a crucial role to play. By drawing attention to system-wide developments, it could strengthen the hand of the supervisor in dealing with a particular institution.

Summarising, the Governor said that he felt the right course had been set, albeit through turbulent waters. There was an appropriate policy mix to rebalance the UK economy. The FPC was about to embark on its first meetings. And a new approach to prudential supervision had been identified. The Governor said he was confident that by sticking to that course and adjusting the tiller in response to changing conditions, the UK economy would return to both price and financial stability.

Why the Bank Rate should increase now

Martin Weale, Monetary Policy Committee member, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech503.pdf

In a speech at the Finance Directors' Strategy Meeting, Dr Martin Weale considered the case for the Bank Rate to rise earlier than expected by the financial markets, but for the path of Bank Rate subsequently to be flatter. He noted that alternative interest rate profiles could be used to bring inflation back to target, and argued that an early increase in Bank Rate would make it more likely that the inflation target would be met in two or three years' time as it allowed for greater flexibility. If inflationary pressures proved to be stronger than expected, an early rise would help. After a long period of above-target inflation, acting now would also help guard against the risk of inflation expectations becoming entrenched in people's behaviour. But if inflation was weaker than expected, future interest rate rises could be implemented more slowly or even reversed. He also noted that, even after his proposed small rise in interest rates, monetary policy would remain very expansionary.

Clearing houses as system risk managers

Paul Tucker, Deputy Governor, June 2011.

www.bankofengland.co.uk/publications/speeches/2011/speech501.pdf

In this speech, Paul Tucker set out several recommendations on how central counterparties (CCPs) can contribute more effectively to preserving stability. The role CCPs play in the financial system extends well beyond acting simply as a provider of operational and capital efficiency for clearing members. However constituted, they are *de facto* regulators and supervisors for the markets they clear; and through their risk management of their own balance sheet, they are risk managers for core parts of the financial system. In protecting themselves, they impose some financial discipline on clearing members and their customers. CCPs therefore need to monitor the robustness of their clearing members and of the business these members bring to CCPs, which would raise awareness of any fragility.

Second, he highlighted the lack of a clear *ex-ante* framework for resolving a distressed CCP. This was a very serious gap in official policies and needed to be remedied as a priority.