Bank of England speeches

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

Costly capital and the risk of rare disasters

Ben Broadbent, Monetary Policy Committee member, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech581.pdf

In a speech delivered at Bloomberg in London, Ben Broadbent argued that investors' fears about downside risks and the possibility of an extreme economic outcome had driven a rise in the premium for risky investment, however it is financed. This will have particularly marked effects on hurdle rates for irreversible, sunk-cost investments that are necessary to improve productivity. Therefore, he suggested that those fears, in turn, have affected the growth of UK activity. However, if those fears of downside risks were to recede, this could have pretty powerful effects on output — potential as well as actual — in a positive direction. He concluded by saying that were the (still unlikely) worst-case risks in the euro area to be realised, then our own monetary policy would again play its part in mitigating the impact. That said, he acknowledged that these interventions have their limits.

Monetary policy and the damaged economy

David Miles, Monetary Policy Committee member, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech576.pdf

In this speech, delivered at the Society of Business Economists Annual Conference, Professor Miles explained why he believed there was a case for making monetary policy more expansionary, even when inflation had surprised repeatedly on the upside. He argued that inflation inertia could be explained by two factors: lower (but still substantial) spare capacity in the economy; and a lower impact of spare capacity on inflation. The weakened link between spare capacity and inflation meant that the costs and benefits of bringing inflation back to target faster or slower have changed. On the one side, a lot of spare capacity would be needed to reduce inflation quickly — and this meant that capital would be used less and unemployment would be higher, which would be costly in terms of welfare. On the other side, stimulating demand would put less pressure on inflation. In addition, the economy's capacity risked falling the longer output remained below potential. Professor Miles concluded that these reasons made an exceptionally expansionary monetary policy appropriate.

What is the FPC for?

Alastair Clark, Financial Policy Committee member, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech575.pdf

In this speech, Alastair Clark discussed the objectives and instruments of the Financial Policy Committee (FPC). Alastair noted that the objective of the FPC — protecting and enhancing the resilience of the financial system — was meant to help avoid crises, not to manage them: it was a fire prevention officer, not the fire brigade. Delivering this macroprudential objective would be challenging; there was no universally accepted definition of financial stability, still less agreement on how to translate financial stability into a target for policymakers. And there were also possible tensions with other areas of public policy, in particular the objective of trying to promote economic growth. Alastair highlighted that using policy instruments for macroprudential purposes and calibrating their impact was now, and was likely to remain, partly a matter of experiment. There was relatively little empirical evidence on the effect which most potentially useful instruments had on financial stability.

The future of UK banking — challenges ahead for promoting a stable sector

Andrew Bailey, Executive Director, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech574.pdf

In this speech, Andrew Bailey discussed the current conditions facing retail banks from a prudential perspective. Andrew spoke about the pressures on interest margins, and contrasted this with previous recessions where more of the pressure came from loan losses in the context of higher nominal interest rates.

Andrew also spoke about the risks UK banks face from the euro area and the importance of continuing to develop contingency plans in the event of countries leaving the area. UK banks should take actions to maintain adequate capital against foreseeable risks, but it is important that in encouraging such actions, the authorities do not create unnecessary uncertainty.

Andrew ended by arguing that the public should be told what they pay for the services they receive from banks. So-called 'free in-credit banking' creates an illusion which does not match the reality.

Pension funds and quantitative easing

Charlie Bean, Deputy Governor, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech573.pdf

In a speech to the National Association of Pension Funds' Local Authority Conference, Deputy Governor Charlie Bean discussed the impact on pension funds of factors such as the fall in equity prices after the collapse of Lehman Brothers and the fall in long-term interest rates, in part as a result of quantitative easing (QE). Bearing in mind that QE raises the prices of other assets as well as depressing gilt yields, he found that the path of the deficit for a pension fund starting 2007 in balance, would have been broadly the same with and without QE. For a fund that was initially underfunded by 30%, however, QE would have widened the deficit by about 10 percentage points. Consequently the impact of QE depends critically on the initial position of the fund. He also noted that a variety of factors were likely to keep gilt yields low for some time yet.

Articles on the framework for macroprudential policy

Paul Tucker, Deputy Governor, March-May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech580.pdf (Co-authored with Andreas Dombret)

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech578.pdf

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech562.pdf

In these three articles (two published in the *Financial Times* and one in the *Eurofi High Level Newsletter*), Paul Tucker set out the need for countries to have a macroprudential policy framework. Though central banks around the world broadly delivered price stability in the run-up to the crisis, the financial system expanded rapidly without check. The consequences have been dreadful.

While international work is under way to strengthen micro-regulatory regimes, any reforms will eventually be overtaken by structural change or by bursts of misplaced exuberance. Policymakers will need a rich macroprudential toolkit, with room temporarily to adjust regulatory requirements to head off future threats to the resilience of the financial system.

Mr Tucker stressed that, within the EU, national flexibility and regional differentiation are important. Credit cycles are not always synchronised. National macroprudential policies could be particularly useful within the euro area, where one setting for monetary policy is not always guaranteed to suit financial conditions everywhere.

Currency in search of confidence

Robert Jenkins, Financial Policy Committee member, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech572.pdf

In this article, published in *The Times*, Robert Jenkins highlighted how a lack of confidence in the viability of the eurozone has brought risks associated with cross-border lending to the fore. Robert noted that the creation of the euro area was supposed to eliminate cross-border risk for lending within it, but that current concerns threatened to undermine this principle. While banks can plan for and manage cross-border risks in the long run by growing local deposits to match local loans, Robert noted that in the short run they may instead seek to cut, or at least limit, local loans — and thus exacerbate local deleveraging.

On counterparty risk

Andrew Haldane, Executive Director for Financial Stability, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech571.pdf

In this paper, Andrew Haldane examined the vulnerability of financial structures to counterparty concerns. Sketching a model of financial structure of the unsecured money market, Andrew demonstrated that management of counterparty credit risk was inadequate during the financial crisis. Andrew identified three possible solutions that have been proposed to mitigate such risks in the future: improved network visibility to understand credit chains; the clearing of transactions centrally to improve transparency and reduce intra-financial system debt; and building protection against counterparty default through higher capital and margining requirements. Taken together, there is an enormous amount still to be done before counterparty risk is properly recognised and managed. The good news is that the technological frontier of counterparty risk management is being pushed out by financial firms, central counterparties and systemic risk regulators.

Bank executives: now we have your attention…

Robert Jenkins, Financial Policy Committee member, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech570.pdf

In this article, published in *Financial News*, Robert Jenkins called on bank shareholders to direct their protests at bank Boards by calling for the use of risk-adjusted performance metrics that are more closely aligned with shareholder value. The focus on short-term return on equity over recent years created incentives to increase returns — which many banks managed some of the time — and to reduce equity — which many banks did all of the time; this had resulted in short-term gains for employees at the expense of long-term shareholder value. Robert also noted that the higher cost of capital facing some banks is not necessarily the result of rising capital requirements but more to do with the market's new-found understanding of the risks that banks run and the prospective removal of government subsidies and safety nets.

Basel II proved to be inadequate, so are the new rules really 'too severe'?

Robert Jenkins, Financial Policy Committee member, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech569.pdf

In this article, published in *The Independent*, Robert Jenkins highlighted how the Basel II capital regulations proved inadequate to ensure that banks held enough capital to support a given level of risk. Sovereign debt and senior tranches of collateralised debt obligations are cited as examples of bank exposures that proved to be a lot riskier than implied by the Basel framework. Robert concluded that 'time will tell' whether the strengthening of bank capital regulations under Basel III will prove sufficient and that it is surely prudent to err on the side of caution rather than assuming that bankers or regulators can predict the future with certainty.

Resolution: a progress report

Paul Tucker, Deputy Governor, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech568.pdf

In this speech, Paul Tucker, Chair of the Financial Stability Board's Resolution Steering Group, provided a progress report on global planning for resolution regimes aimed at addressing the problem of 'too big to fail'. Progress in this area was not optional: if risks in banking were not incorporated into the yields of bonds issued by banks, they would end up being reflected in higher sovereign borrowing costs. Specific strategies were needed to resolve complex systemically important financial institutions (SIFIs). If there was enough debt issued by the firm's holding company, one such strategy could be to write off the equity and parts of the debt, converting some of the residual debt into equity. In that case, a SIFI could be recapitalised through 'bail-in' without the complexity of separating its business lines. Some authorities were working on how to operationalise this strategy. In other circumstances, where a giant commercial bank was funded by insured deposits, the resolution strategy might revolve around using the resources of the relevant deposit insurers. In all cases, the necessary tools had to be in the statutory resolution regime. The forthcoming EU directive was crucial to this.

What we know now: the BoE's past 15 years

Charlie Bean, Deputy Governor, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech577.pdf

In this article, Deputy Governor Charlie Bean examined the lessons for monetary policy from the MPC's first fifteen years. First, hitting the inflation target did not guarantee economic stability. The answer, though, was not to jettison the inflation target but rather to utilise regulatory tools of the sort considered by the Bank's new Financial Policy Committee. Second, it was easier than expected to enter uncharted territory. During the first decade of the MPC, there seemed little danger of Bank Rate approaching zero, let alone of the MPC resorting to quantitative easing. The financial crisis changed that. Third, a long period of abnormal monetary policy settings had undesirable distributional side effects and could strain support for a central bank's actions. But the highly stimulatory policy stance should help return the economy to an even keel, which was the best medicine for all.

The 2012 BBC Today Programme Lecture

Sir Mervyn King, Governor, May 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech567.pdf

In his radio speech, the first by a Bank of England Governor since Montagu Norman in 1939, the Governor reflected on three questions: what went wrong in the run-up to the financial crisis; the lessons learnt; and the reforms needed to prevent future crises.

The Governor began by noting the period of steady growth, and low and stable unemployment and inflation, in the years preceding the crisis. Though overall growth had been sustainable, fragilities had built up in the banking system, an issue the Bank raised repeatedly — though perhaps not forcefully enough — in its publications. Fuelled by an implicit taxpayer guarantee, banks became highly leveraged and too big to fail. The resulting lack of confidence in the banking system prompted significant injections of central bank liquidity and government recapitalisation of two of the United Kingdom's largest banks.

The Governor reflected on the lessons learnt from the crisis. Three areas of reform would be important. First, bank regulation, where the Financial Policy Committee would guard against the big risks to the financial system. Second, enacting a resolution mechanism would ensure that badly run banks failed safely, without causing damage to depositors. Third, restructuring the banking system by enacting the proposals made by the Independent Commission on Banking to separate essential banking services from riskier trading activities. Regulation, resolution and restructuring of the banks were the three Rs of a new approach to make banking, and so the UK economy, safer. They would be central to the work of the Bank of England.

The Governor concluded by emphasising the importance of looking to the future, and to the economic possibilities for the grandchildren of today's generation. To give them the prospect of economic stability, it was vital to reform the three Rs of the financial system. There was a historic opportunity, and a duty, to do that.

Shadow banking: thoughts for a possible policy agenda

Paul Tucker, Deputy Governor, April 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech566.pdf

In this speech, Paul Tucker set out a possible ten-point policy agenda to address risks to stability from shadow banking. The objective should not be to curb non-bank finance, but to recognise where intermediation is banking in substance or in the systemic risks it creates. Shadow banking that was sponsored or operated by banks should be consolidated on to banks' balance sheets. Committed credit lines to financial companies should attract a high liquidity charge. Reforms were needed to improve the resilience of money market funds. Other lending businesses that were materially financed by short-term debt should be subject to bank-type regulation. Only banks should be able to use client moneys and unencumbered assets to finance their own business to a material extent. Reforms were needed in securities lending and repo markets. A trade repository could improve transparency. The authorities should also be able to step in and set and vary minimum haircut and margin levels.

Financial arms races

Andrew Haldane, Executive Director for Financial Stability, April 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech565.pdf

In this speech, Andrew Haldane noted that competitive battles for dominance in many fields led to arms races and negative externalities. Andrew discussed three examples of arms races in the financial sector: races for return, races for speed and races for safety. The race for returns on capital led to banks significantly increasing their leverage, leading to a risky equilibrium and sowing the seeds of the financial crisis. The increasing dominance of so-called high-frequency trading was a race for speed and led to a huge increase in order cancellations, order congestion and periods of dramatic disappearance of liquidity. Post-crisis, the race for safety led to a greater proportion of banks' refinancing done on a secured basis, increasing asset encumbrance. At high levels of asset encumbrance the financial system as a whole may be riskier as it is more susceptible to procyclical swings in the underlying value of bank balance sheets. Competitive races can generate unhealthy outcomes for the system as a whole. In finance these tragedies of the commons are, if anything, more likely than in other fields. Macroprudential policy, in the United Kingdom executed via the Financial Policy Committee, has been set up precisely to deal with these systemic phenomena.

Credit conditions for firms: stability and monetary policy

Paul Tucker, Deputy Governor, April 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech564.pdf

In this speech, Paul Tucker addressed some issues facing businesses as the economy rebalances and the financial system rebuilds. Bank lending conditions were likely to remain tight for some time. Some larger companies were not heavily reliant on bank finance given access to internal funds and to capital markets. They could support smaller firms through direct lending or by setting up programmes to allow suppliers to borrow against unpaid invoices. The revival of old instruments such as bankers' acceptances, or innovations creating new instruments, could also support bank lending to business. The Monetary Policy Committee would continue to support demand so long as that was consistent with bringing inflation back to the 2% target in the medium term. Underlying growth was probably better than headline numbers would suggest. Inflation was likely to fall back more slowly than had been expected, which was potentially problematic.

Liquidity support from the Bank of England: the Discount Window Facility

Paul Fisher, Executive Director for Markets, March 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech561.pdf

Since the start of the crisis in 2007, the Bank has reformed and redesigned much of its Sterling Monetary Framework. One of the most significant changes to the Bank's arrangements for the provision of liquidity support was the introduction of a Discount Window Facility (DWF) in 2008. In this speech, Paul Fisher explained the principles underpinning the design of the DWF, as well as recent developments. Those included encouraging banks to 'pre-position' collateral — so that it need not be assessed at short notice in the event of a sudden and unexpected need to borrow. By March 2012, £265 billion had been pre-positioned, giving a drawing capacity of £160 billion.

Paul expected that amount to increase further over time. Paul also described the Bank's new Extended Collateral Term Repo Facility, introduced in December 2011 as a contingent operation, which could provide liquidity against illiquid collateral pre-positioned in the DWF, through a market-wide auction.

Why is their recovery better than ours? (Even though neither is good enough)

Adam Posen, Monetary Policy Committee member, March 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech560.pdf

In this speech, Dr Posen explained the superior recovery in the United States to that of the United Kingdom from the global financial crisis so far. He noted that the two economies suffered similar shocks and pursued similar monetary responses. The respective responses of net trade and automatic stabilisers only add to the gap in GDP to be explained. Dr Posen pointed to the stronger private investment and consumption recovery in the United States and argued that the former can be explained by lesser availability and greater misallocation of bank credit in the UK economy as well as its greater exposure to the euro area. He put the difference in consumption performance to greater fiscal austerity in the United Kingdom and a greater impact of energy costs on UK households. The relative inflation performance can be explained by one-off price-level shocks in the United Kingdom, so inflation expectations continue to be well anchored in both economies. Most of these differences are likely to diminish, but the relative inefficiency of the United Kingdom's allocation of capital to business remains a concern.

Government debt and unconventional monetary policy

David Miles, Monetary Policy Committee member, March 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech559.pdf

In this speech, David Miles outlined why he feels concerns about the monetisation of government debt by central banks are misplaced. In the United Kingdom, those concerns have become more acute over the past few years as public debt has increased, and as the Bank of England has purchased a significant amount of government debt. Professor Miles argued that the purchases of government bonds were not undertaken to finance the Government's fiscal deficits. Rather, they were undertaken in order to loosen monetary policy and offset recessionary forces that might otherwise have created a lasting depression which could have generated deflation. Other major central banks have carried out similar balance sheet expansions in response to the impact of the financial crisis. Professor Miles noted that the tricky task ahead for those central banks is to know for how long to keep monetary policy exceptionally expansionary; not because of any practical difficulties in unwinding asset purchases, but because of the much more fundamental and timeless challenge of assessing the outlook for the economy and judging the appropriate monetary stance.

Crisis and crash: lessons for regulation

Michael Cohrs, Financial Policy Committee member, March 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech558.pdf

This speech outlined the lessons for regulators from the financial crisis of 2008, for which Michael Cohrs had a front-row seat, as the (then) co-head of corporate and investment banking at Deutsche Bank. Michael suggested it was clear (in hindsight) that the premise of 'efficient' market behaviour, the structure of the banking industry, and the regulatory framework, were unsuitable prior to 2008. One particular failure of regulation was that there was no single institution mandated with the responsibility, and powers, to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted actions. The changes to financial sector regulation in the United Kingdom, proposed in June 2010, gave this responsibility to the Financial Policy Committee (FPC), which was currently in interim form. Michael noted that the prize for the FPC fulfilling its mandate — focusing on protecting and enhancing the resilience of the UK financial system — would be huge, given the sizable and persistent impact of financial crises on real activity.

Rebalancing the supply side of the UK economy: what; how; and issues for monetary policy

Spencer Dale, Executive Director and Chief Economist, March 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech554.pdf

In a speech to mark the centenary of the Department of Economics at the University of Aberystwyth, Spencer Dale discussed the imperative of rebalancing the supply side of the UK economy, and explained two reasons why this process poses significant challenges for UK monetary policy.

The first policy challenge Spencer Dale highlighted was that rebalancing can be associated with a slowing in the growth of the supply capacity of the economy, including via a detachment of the long-term unemployed from the labour market. While Mr Dale was convinced that the substantial loosening of monetary policy over recent years was necessary to prevent an even deeper recession, the second challenge he noted was that this loosening may also serve to blunt some of the incentives driving the rebalancing of the economy. It encourages people to spend more and save less, and delays the reallocation of capital and labour to more productive uses. This leaves monetary policy makers facing a delicate trade-off between short-term support and stifling longer-term change.

Spencer Dale also explained that the Monetary Policy Committee (MPC) has recently begun to use a new forecasting platform to produce inflation projections, consisting of a relatively simple central organising model and a surrounding suite of alternative models. Mr Dale stressed that the introduction of this platform did not, in itself, imply any changes to the MPC's forecasts or how they set policy.

Deleveraging

Ben Broadbent, Monetary Policy Committee member, March 2012.

www.bankofengland.co.uk/publications/Documents/speeches/2012/speech553.pdf

In this speech, Ben Broadbent considered what the build-up of debt by UK firms and households prior to the financial crisis can tell us about the prospects for a sustainable recovery, the key risks currently facing the economy, and the implications for policymakers. He argued that non-financial domestic leverage does not need to return to some historical 'norm', because UK firms and households accumulated assets as well as liabilities before the crisis, in response to the decline in real long-term interest rates. Furthermore, there is no empirical evidence that links relative levels of debt to output growth. He suggested that an alternative explanation for the severe credit crunch was the spillover effects from the losses UK banks sustained on non-UK assets. The prospects of a sustainable recovery are therefore more closely tied to developments in the UK banking sector than the domestic non-financial sector. This means that a withdrawal of monetary accommodation could begin even if domestic debt to income ratios remain well above historical averages.