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Speech

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Speech given by

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It's very good to be here – or, I should say, good to be back. About seven or eight years ago I spoke to this conference about the raft of reforms then underway in the gilt market: repo, strips, regular auction schedules etc.

Market intelligence and the Bank of England's mission

Since the 1997-98 reforms that gave the Bank monetary independence, codified our financial stability role and created the FSA, gilt issuance has, of course, been the responsibility of the Debt Management Office. There is, though, an important continuity in the Bank's role and outlook: seeking dialogue with market practitioners. Just as many of those mid-1990s' reforms came from listening to the asset managers who bought and held gilts, so now we seek a dialogue to support our core mission: monetary and financial system stability. Let me stress: the Bank's interest in financial markets and participants in markets – and our use of market intelligence to help us figure out what is going on in markets – is undiminished. If anything, our range of interests and contacts has been expanding as financial markets become more sophisticated and integrated.

On the monetary side, the main focus is on markets and financial intermediaries as part of the transmission mechanism through which our interest rate settings affect the economy: credit conditions, financial wealth, the exchange rate etc. And, of course, we implement policy in the money markets, with the yield curve reflecting expectations of the path of policy. This means that, on the monetary side of our business, we tend to focus on core markets – money markets and government bonds, equities, exchange rates. Markets that are, on the whole, pretty efficient. So our starting point – our default hypothesis, if you like – is to assume that asset prices in these markets reflect fundamentals, and that we can use them as a diagnostic of expectations of economic prospects and of the path of policy. We do not, though, kid ourselves that we can stop there. We are on the look out for where there are transitory or persistent frictions that distort the message from asset prices – for example, on account of regulation, features of the infrastructure, particular market conventions, or information asymmetries. Identifying and making sense of such frictions requires intelligence about actual markets in the real world. Plenty of examples come to mind that will be familiar to this audience, not least the hump that featured in the gilt forward curve for so many years on account of the demand for long-dated bonds from life companies and pension funds.

On the financial stability side of our business, we think of markets as a medium for taking and hedging risk. Most of the time, they promote stability by dispersing risk. But they are also part of the mechanism through which a crisis could spread from one part of the system to others, including across product, sector and geographical boundaries. Contributing to avoiding, or containing, debilitating systemic disorder in markets is part of our mission. So for financial stability, the canvas is wide. We are on the look out for symptoms of actual or incipient stress: for example, high leverage coupled with 'crowded' trades – ie with 'everyone' positioned similarly – in markets that could prove illiquid just when trades are suddenly unwound. In the event of a crisis, we are not going to be able to cope – indeed, the financial authorities collectively, here and internationally, are not going to be able to meet the challenge – unless we can comprehend the instruments and structures involved. Given the growing technical sophistication and complexity of today's capital markets, that is unavoidably more difficult than a decade or more ago – a world in which exotic options, securitisation, hedge funds etc hardly featured. One precondition for doing our job properly is that we should understand how global financial markets and the key players in them fit together. Another is to understand modern risk management structures and practices.

For many of the core markets, we have a natural entry – in the sterling money markets because that is where we implement monetary policy; in the high-grade sovereign bond, swap and foreign exchange markets through our management of the government's foreign exchange reserves and liabilities and of our own balance sheet. But for both monetary policy and financial stability, the Bank's market surveillance role has to extend beyond those markets, including to a wide range of derivative markets and structured finance.

This is not the kind of task we can begin to fulfil solely by sitting in our building doing desk-based analysis and research. That vital work has to be integrated with intelligence gained from a wealth of relationships across the market, both in the UK and overseas. Thanks to many of you here – and I really do mean a big thank you – we already have a good network. But we have more to do. The Governor, Mervyn King, has asked me to develop a medium-term strategy to deliver our goals on this front, so I was really delighted to be invited here today to leave the Bank's calling card.

With that bit of advertising out of the way, let me say something about how I see the current environment as it affects monetary policy and financial stability.

The monetary policy environment

Compared with when you met at this event a year ago, conditions both for you as asset managers – or rather, I should stress, asset-liability managers – and for us as monetary policy makers are brighter in some important respects but uncomfortably familiar in others.

Most obviously in the context of today's event, equity prices are some 15% off their March 2003 low, even after the falls since the second half of last week. And default risk in the corporate bond markets seems to have receded – partly reflecting balance sheet restructuring amongst large corporates on both sides of the Atlantic, itself aided by low yields encouraging firms to extend debt maturities.

These improvements in asset markets have, of course, both reflected and contributed to stronger global macroeconomic conditions. I was recently asked at a conference whether the external environment mattered to UK monetary policy – with a goal specified in terms of preserving domestic purchasing power, did we look beyond the domestic economy?

In fact, of course, as a highly open economy, the UK is very much affected by international conditions: more so than either the US or the euro area. Indeed, for some years now, UK monetary policy has been directed at offsetting weaknesses in the external environment. In other words, we have been stimulating domestic spending in order to keep aggregate demand more or less in line with the expansion in the economy's productive potential, consistent with keeping inflation expectations in line with our target. In terms of our mandate, it has worked: inflation has stayed pretty close to target, averaging 2.3% on the RPIX measure since the beginning of 2000. But as is now familiar, this has been accompanied by accumulating 'imbalances' in the economy, manifested in a variety of ways – weak manufacturing but strong services; consumption growing well above its long run average rate for the past three years, or more rapidly than disposable income since; rapid accumulation of debt by the household sector alongside burgeoning house price inflation.

That strategy has in principle always had limits, but whether they would be tested – and whether we would identify them – has depended, in part, on external prospects. Other things being equal, the healthier the international environment, the more we could withdraw the stimulus to domestic spending.

For policy, that is the significance of the recovery over the past year in the US. Until last summer, the risks looked to me to be pretty clearly weighted to the downside relative to a central projection of a fairly rapid return to trend levels of output. But, after declining for five quarters, business investment spending in the US has bounced back since Q2, with output recovering rapidly back towards trend and capacity utilisation rising. Risks do nevertheless remain. For a while last autumn it looked like the recovery in demand was being accompanied by similarly robust job growth, but since December net job creation has fallen back to well below the average rate of growth of the workforce. Commentators – and policymakers, it should be said – take two views on this. The first view sees employment picking up in an environment of sustained output growth and reduced scope, over time, for extracting greater efficiency from current labour and capital inputs at the rates recently achieved. That's persuasive, particularly with US monetary policy remaining so accommodative. The other view worries that protracted weakness in the jobs market could dent household confidence and so spending, slowing output growth. US surveys suggest that sentiment is sensitive to job prospects, but so far spending has remained robust, as has house price inflation (over 3½% quarter-on-quarter in Q4). My take is that the most likely outlook is positive but that downside risks have, again, become tangible.

I think it is fair to say that analysis of the euro area is tougher – on both the monetary policy and financial stability sides of our business. Essentially, that reflects less timely and rich data, together with varying regional conditions – and so economic stories – across the area. For some time now, we have been forecasting recovery. That is based on stimulative monetary policy – short real rates are around zero in the euro area as a whole – and some recovery in consumer and, particularly, business confidence. Signs of recovery have, though, recently been more apparent in the surveys than in the data. In particular, domestic demand has remained weak, although it picked up in France in Q4. In Germany, not only has household spending been subdued, but investment (at current prices) is lower relative to economy-wide output than at any time since unification. On the one hand, that suggests that there is plenty of scope for recovery back to trend levels. But, on the other hand, there has to be some risk – perhaps not high – that trend output growth is down a bit. If so, and if that were to have adverse knock-on effects on other parts of the euro area, it would create downside risks for us as the euro area is by far our largest trading partner. For the moment, I continue to place greater weight on the encouraging surveys.

The euro area may be our biggest trading partner, but conditions in the rest of the world make quite a difference to us, both directly and indirectly. In fact, growth has been so strong in parts of Asia that in 2002-03, the 'rest of the world' contributed more than a percentage point on average to UK-weighted world output growth. The outlook in various parts of Asia and the Far East may mean we have a second engine of global growth alongside the US.

The domestic picture has also gradually changed since the autumn. Last October, there were the upward revisions to the Q2 GDP data, a pick up in business surveys, and greater-than-expected strength in the housing market. Taken alongside diminished risks in the external environment, that was enough for me to vote for a 25bp rise. I regarded that as unwinding the Committee's July cut, which I had viewed as 'precautionary' or 'insurance' against the downside risks then apparent.

In the event, the MPC's rate was raised a month later, November, and since then the debate about the course of policy has altered somewhat. There have been references to 'caution' in raising rates, and to moving 'gradually' as medium-term inflationary pressures mount. I hope I can provide some clarity about what those terms mean for me.

Our January minutes recorded that if the economy evolved as envisaged in the November *Inflation Report*, with inflationary pressures gradually building, then a gradual rise in interest rates would be necessary. We are in a similar position now. The February increase in the MPC's rate, bringing it to 4%, leaves policy stimulating the economy. Indeed, I prefer to think of our recent policy adjustments as withdrawing <u>some</u> – but not all – of the previous stimulus.

If, as projected, output continues to grow above trend then, depending of course on any other developments affecting the outlook, I for one would expect us to continue gradually to reduce the degree of stimulus to demand broadly in line with the take up of slack in the economy and any consequent pick up in inflationary pressures looking ahead. That seems to be more or less the view of the market, as reflected in our February *Inflation Report* projections using market interest rates; and in the implied forward curve, derived from index-linked gilts, for short-maturity real rates relative to longer-maturity real rates, which in principle should not be affected by cyclical variations (Chart 1).

While policy must be forward-looking rather than overly focused on the current rate of inflation, which at 1.3% in February is obviously below our 2% CPI target, there is already some evidence of inflationary pressure. Looking at the categories of goods and services in the CPI basket, the median rate of inflation has risen over the past year or so, as have the 70th and 30th percentiles (ie cutting out the categories for which prices have risen most and least in order to exclude erratic changes) (Chart 2). But we take a month at a time. As each month passes, data may reveal that the outlook is either weaker or stronger than expected.

This takes me to what has been said about 'caution' in raising rates, which at times has perhaps been misconstrued as implying 'hesitant'. The idea here is that we care about the extent to which inflation varies around the target and so, amongst other things, about the degree of uncertainty about the effect on inflation of changes in our interest rate. The marked increases in household debt do somewhat increase that uncertainty. With higher debts relative to incomes, interest rate changes will tend to have a bigger effect on the income that households have free to spend after servicing their debts. But we do not <u>know</u> what the sensitivities are. The implication is that, other things being equal, policy would tend to move towards neutral more slowly than would otherwise be optimal, or 'cautiously' for want of a better word.

But care is needed here, as developments in the economy associated with the debt accumulation have other possible implications. I want to mention two.

First, household borrowing has grown alongside a robust housing market. The ratio of house prices to earnings is up by over 40 percentage points since 2001. The increased value of collateral consequently available to households to secure borrowing has, unsurprisingly, been evident in mortgage equity withdrawal, which as a percentage of personal disposable income is estimated to have reached around 7% in the third quarter of last year. Some of that borrowing has probably substituted for more expensive unsecured debt; some of it has been used to finance consumption. Either way, the increased collateral values will plausibly have reduced the credit constraints faced by some households. If so, other things being equal, the short-run effect may have been to increase slightly the level of interest rates at which output and inflation are stabilised. So the same underlying phenomenon could have more than one effect on the optimal path of interest rates.

The second point is that, although there has been some deceleration since the end of 2002, house prices have continued to rise more rapidly than expected over recent months. This is not especially a London or South East of England thing. Over the past nine months or so, prices have risen more strongly in the north of England, Scotland and Wales. Indeed, the regional dispersion of house price inflation remains very high by historical standards (Chart 3 and 4).

For the UK as a whole, relative to the path we incorporated into our February projections, there appear to be upside risks in the near-term. As well as straightforward momentum, that would seem to be the message from the rise over the past few months of the ratio of the number of houses sold by estate agents to the stocks of unsold houses on their books – one measure of 'tightness' in the market. This has been a reasonable contemporaneous, or even slightly leading, indicator in the past (Chart 5). The significance for policy is that, taken together with fairly buoyant business surveys, it suggests that the near-term outlook for domestic demand may be slightly stronger than it looked a couple of months ago. We will need to consider that in reaching our policy judgment, alongside other developments, including risks in the international environment.

But, in addition, it separately suggests an argument to be placed alongside that in favour of 'caution'. Namely, that it could be argued that policy may need to be tighter than would otherwise be the case in order to arrest somewhat the continuing strength in the household sector. The argument would be that we should try to reduce the risk of an abrupt correction, which would complicate monetary policy and so make achievement of the inflation target more uncertain further ahead. This is an argument that has to be weighed alongside the analysis pointing towards 'caution'. I would not, however, subscribe to making a surprise policy tightening as a form of shock therapy. One of the emphases of the MPC's approach has been to do our utmost to help households, businesses and financial markets to understand our strategy and, in particular, how we react to developments in the economy.

From my perspective, that was the backdrop to the Committee's debate and to my vote at our most recent meeting at the beginning of March. A tightening then would have come as a surprise. My own view was that there was not sufficient evidence to construct a compelling explanation for a rise in terms of the outlook for inflation. And that being so, I was concerned that an earlier-than-expected policy change might well have been misunderstood as implying that my, or more broadly the Committee's, policy reaction function had changed for some reason. With inflation expectations well anchored, that was not a risk worth taking. So I voted for no change.

Looking ahead, I just take one month at a time, assessing the domestic and international data, and revising my view of the outlook where necessary.

Financial stability environment

A few words on financial stability. The past year or so has also brought calmer conditions in most financial markets. Signs of some potential fragility were perhaps most evident around October 2002. Credit default swap prices for a number of the world's largest banks registered sharp rises as losses in corporate loan portfolios, and volatile trading revenues coincided with an uncertain macro outlook, the unwinding of the equity bubble, continuing worries about some emerging market economies, and the fallout from Enron and Worldcom.

On the whole, the environment now looks somewhat more comfortable. In the equity markets, realised and forward-looking volatility is down, and the IPO market seems to have sprung back to life. Most measures of credit risk – spreads, credit default swap premia, default rates, ratings downgrades-to-upgrades – have improved (Chart 6). At the banks and dealers, profits have been used to bolster or replenish capital; and credit default spreads are lower for virtually all banks (Chart 7).

But the environment is not without hazards. One may be sourced in the 'search for yield' that has been a feature of international markets over the past [18] months or so – as evidenced, for example, by record inflows into hedge funds and into emerging market and high-yield bond mutual funds in the US (Chart 8). Just as eighteen months ago some commentators asked whether credit spreads may have overshot on the upside, over the past few months some have wondered whether they might have overshot on the downside – although there has perhaps been a degree of correction since January.

Separately, the global pattern of current account deficits and surpluses creates risks for financial markets, most obviously the foreign exchange markets – although, as I have taken to noting on these occasions, one wouldn't guess that from what seem to be quite low implied volatilities on most currency pairs.

Perhaps more significantly, there are risks of volatility in fixed-income markets given the inevitable uncertainty about the path that the FOMC will take back towards a more neutral rate.

There are signs of that uncertainty in options markets (Chart 9). Those implied volatilities might be exaggerated by the bid for options to manage the negative convexity of US mortgage-backed security portfolios. But, in terms of the risk of volatile markets, that convexity hedging can itself create strains, as events during July-August last year underlined rather graphically.

I mention the US MBS market because I guess it has some interest to you given your demand for long-duration fixed-income assets to match long-dated fixed-income-like liabilities etc. So it was good to see that, in his review of the UK mortgage market, David Miles flags the importance of thinking through how any prepayment risk in UK fixed-income mortgages could be managed. Since prepayment in the US seems to have a 'behavioural' element, it is not so easy to get an exact hedge via a 'matching' financial option. It was also good to see that David has not advocated a Fannie-Freddie type structure for the UK, with the attendant concentration and moral hazard risks – a conceivable source of systemic issues in global markets.

Intelligence on fixed-income markets and UK long-term savings industry

This takes me back, briefly, to the Bank's market intelligence work, as I want to conclude by mentioning just a few of the issues that we would like to explore with you going forward.

In particular, we have an interest in understanding the implications for asset prices and market dynamics of the increasing emphasis on joined-up asset and liability management, including giving fund managers benchmarks based on actual liabilities rather than standard market indices. Some of these implications arise from the demand for long-duration assets to match long-term liabilities; moving towards hedging more directly the optionality present in some liabilities, such as guaranteed nominal return annuities; and the search for returns from a wider class of assets. Concretely, the big issue has been – and probably remains – the balance of equity and bonds in asset portfolios. But there are also questions such as whether the industry is a material participant in the newish inflation-swaps market in order to hedge long-dated real defined-benefit pension liabilities; whether swaptions and equity derivatives are being used more to manage risks, and if so whether near to being 'in-the-money' options and well 'out of the money' options; why demand for long-dated gilt strips has not been greater, especially as many in the industry called for strips; the extent of UK pension fund investment in hedge funds, and whether that is pursued principally via funds of funds; the degree of involvement in other 'alternative asset classes', such as private equity or emerging markets; more speculatively, whether there are 'missing markets' that would be useful to the long-term savings industry – for example, longevity-risk securitisations; and, more prosaically, whether there is a greater interest in more mundane ways of enhancing returns on asset portfolios, such as securities lending.

Finally, in that connection, I hope that the recent multi-agency report on securities lending will prove helpful to pension fund trustees and others. As some of you will know, my colleague David Rule, chair of the Stock Lending and Repo Committee, helped to facilitate the exercise. But it was written by the industry for the industry, and it has been welcomed by the NAPF. It has been an exercise where the Bank has learned from interaction with you. I hope there will be other such occasions to do so.

My thanks again for inviting me to join you today.

Chart 1

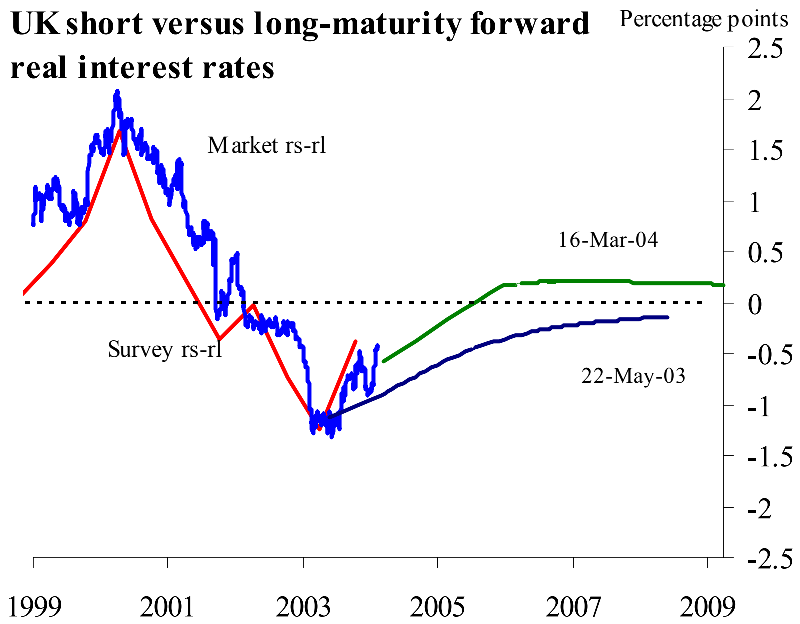


Chart 2: Percentiles of the distribution of inflation rates in CPI and RPIX

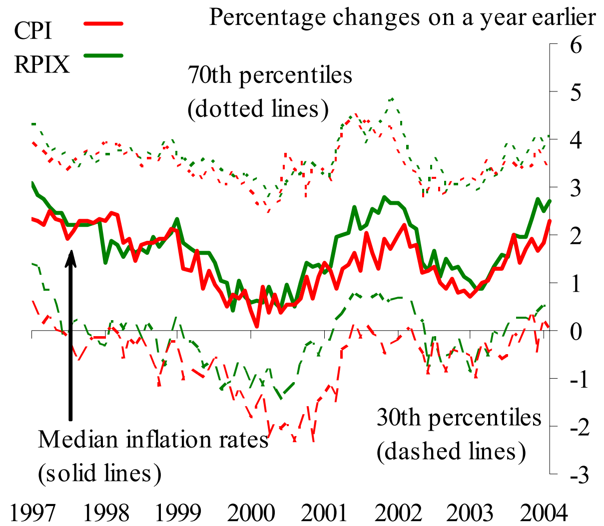
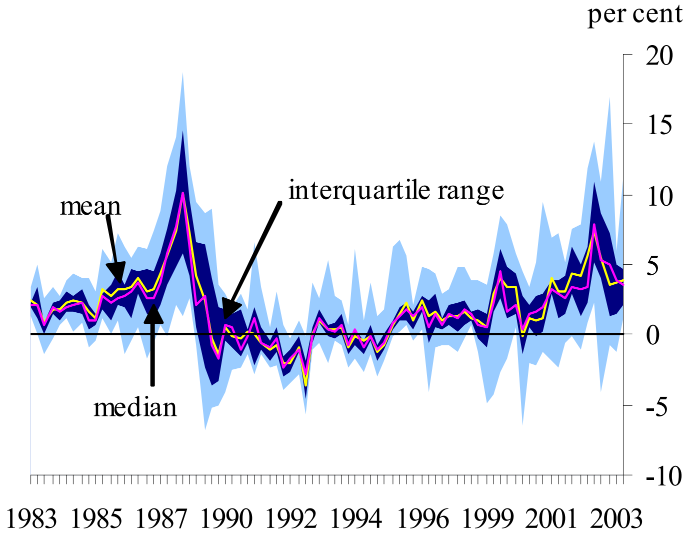


Chart 3

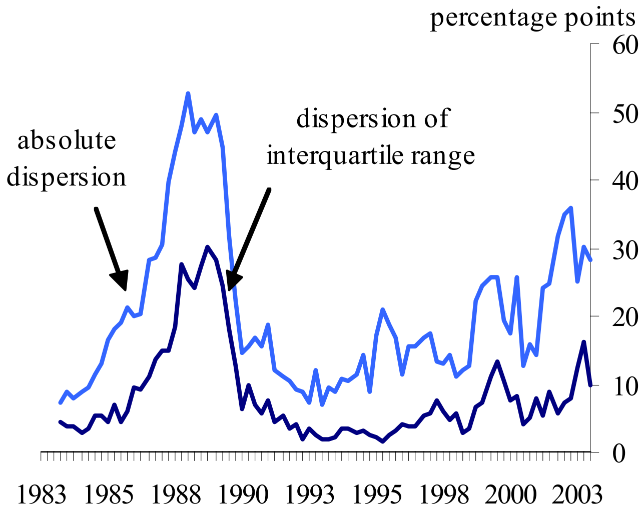
Quarterly regional house price growth



Source: Halifax

Chart 4

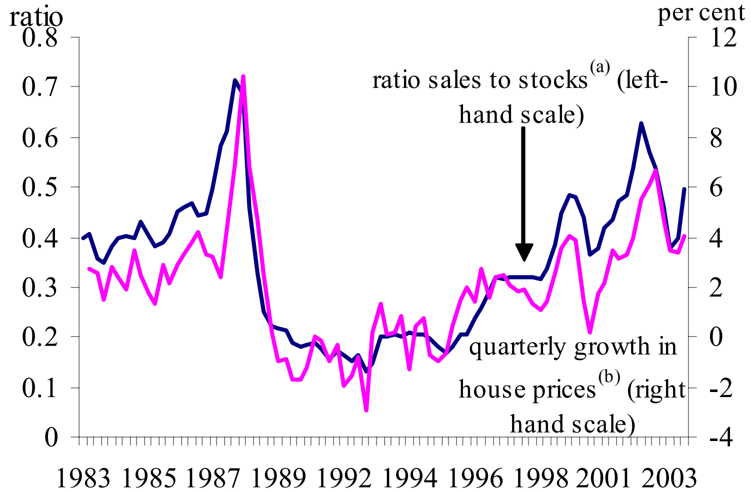
Dispersion of annual regional house price growth



Source: Halifax

Chart 5

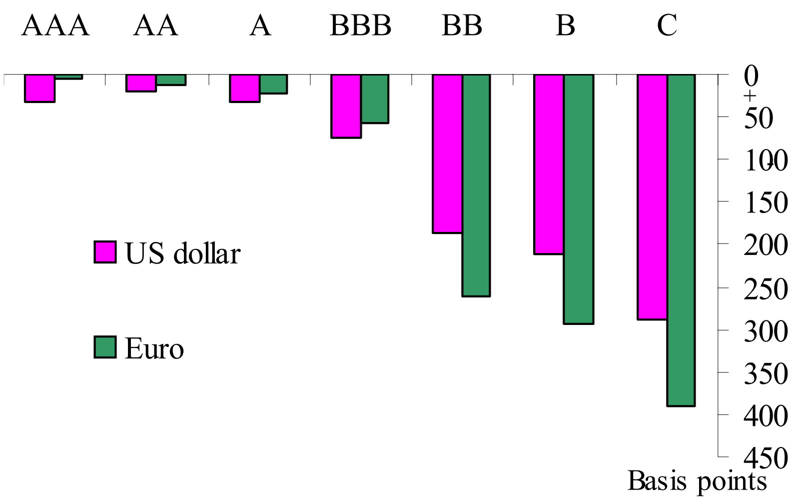
Housing market tightness



Source: Halifax, Nationwide and RICS
(a) Ratio of number of houses sold per surveyor over the past three months to stocks of houses on books per surveyor.
(b) Average of the Halifax and Nationwide indices.

Chart 6

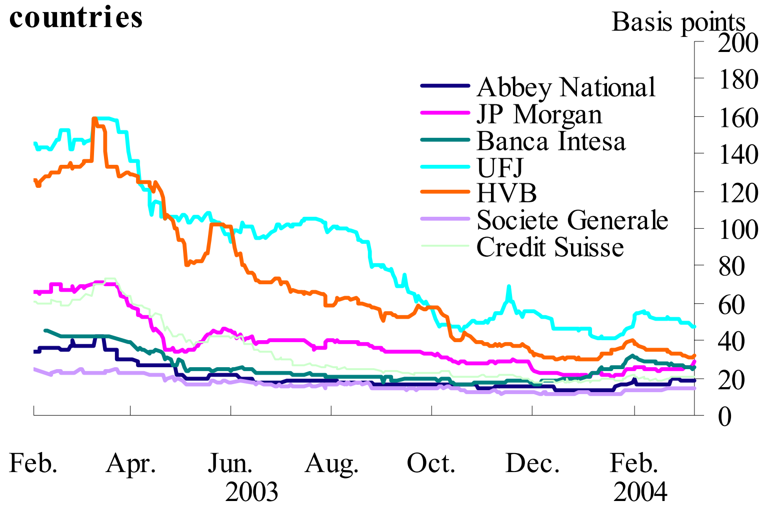
Changes in credit spreads by rating[(a)(b)]



Source: Merrill Lynch
(a) Spread over swaps.
(b) Changes between 22 May 2003 and 16 Mar. 2004.

Chart 7

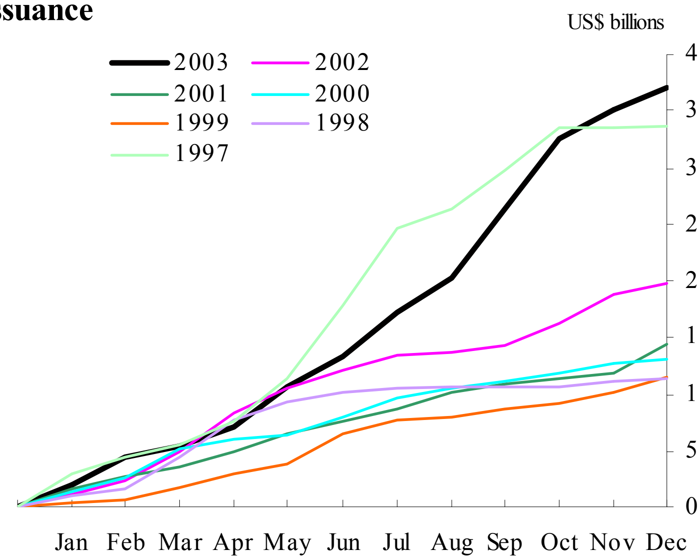
Highest CDS premia of major banks in selected countries



Source: Mark-it Partners and MorganMarkets.

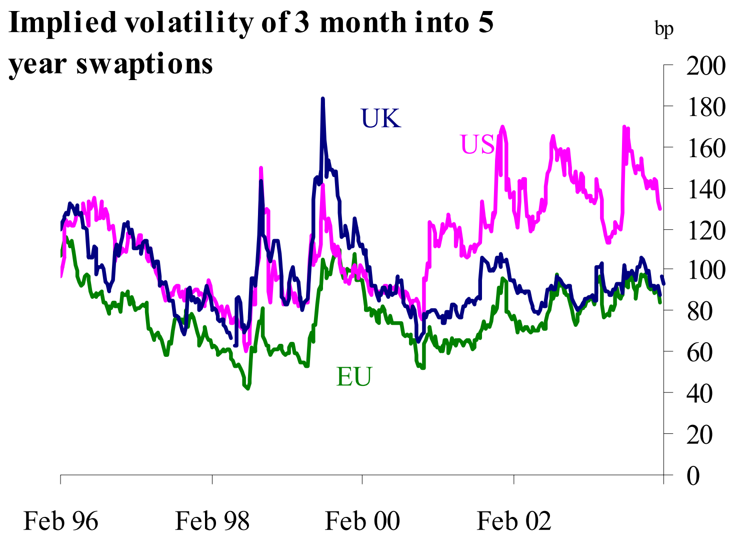
Chart 8

Cumulative emerging market corporate bond issuance



Source: Dealogic bondware

Chart 9


Implied volatility of 3 month into 5 year swaptions
bp
200
180
160
140
120
100
80
60
40
20
0
UK
US
EU
Feb 96
Feb 98
Feb 00
Feb 02