BANK OF ENGLAND

Speech

Monetary Policy and the Financial System

Remarks given by

Paul Tucker, Executive Director and Member of the Monetary Policy Committee of the Bank of England

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Alongside many others, the money market fund industry has for months now been grappling with turmoil and fragility across financial markets. It continues to pose serious challenges for all of us, and so I shall use this evening to summarise briefly a few of the strands in my own thinking about monetary policy and the financial system.

Monetary policy

First, monetary policy. The tightening of credit conditions domestically and internationally makes it likely that aggregate demand will slow, with a risk that it will slow considerably. There is, in consequence, a meaningful downwards threat to inflation over the medium term. Usually, the MPC would respond by cutting Bank Rate sufficiently to offset more or less entirely what we judged, over time, to be the impact of the tighter financial conditions on the path of spending, so as to ensure that aggregate demand remained broadly in line with the economy's productive capacity. But conditions do not favour such a "business as usual" approach to demand management. That is because, alongside those downside risks to inflation, there are also upside risks to inflation over the medium term – and I am stressing "medium term" – stemming from the rise in commodity prices and the decline in sterling's exchange rate. In the near term, CPI inflation is very likely to rise to materially above our 2% target. The question is whether that unavoidable temporary rise will remain just that, temporary; or whether it will feed into medium-term expectations of inflation, and so get reflected in wages and prices going forward and, thus, in domestically-generated inflation.

Given this unusual combination of significant downside and upside risks to the medium-term inflation outlook, the broad policy strategy is to offset some but not all of the adverse shock to demand from tighter credit conditions. And to do so by changing Bank Rate gradually and with transparency about that broad strategy. To be clear, this approach probably means allowing a degree of slack to develop in the economy, in the interests of avoiding taking risks with inflation on the upside. Only by underpinning the credibility of the nominal anchor provided by the MPC's commitment to the inflation target will we maintain scope to cushion the real economy from the effects of the stresses in the international financial system. If we implement this strategy successfully, we will be able to provide more durable support for demand and activity.

If, by contrast, we were to adopt a course that let the inflation genie out of the bottle, we would find ourselves needing to tighten policy, exacerbating the slowdown in activity.

That broad strategy is not a recipe for inaction. The central projection in February's Inflation Report was for inflation to return to close to the 2% target over the coming two to three years, conditional on the market's expectation of further cuts in Bank Rate. But nor does the strategy determine a definite path for Bank Rate over the coming months. Each of us on the MPC must form a judgment month by month on which of the risks to the inflation outlook – from financial conditions or from rising costs – is proving more potent, and so a judgment on the degree to which we can set a course that underpins demand.

Since the February Inflation Report, oil prices are around 10% higher, and sterling's exchange rate around 4% lower, so the immediate cost pressures are worse. The good news is that, in the labour market, nominal earnings growth has so far remained subdued, notwithstanding the rise in near-term inflation expectations revealed by a range of surveys. This is perhaps suggestive of the adjustment in real take-home pay made necessary by the sharp increase in firms' costs due to the further rises in commodity prices. In manufacturing, firms' input costs have risen sharply over the past twelve months; and output price inflation has reached nearly 6%. A big question is to what extent competition amongst retailers will dampen the pass through into retail prices. Anecdotally, retailers still sound as though they are competing fiercely on prices, and driving down other costs in order to maintain their margins.

Meanwhile, on the other side of the ledger, many essentially backward-looking indicators of UK real demand and activity have held up reasonably well. But we should not yet place great weight on that. It can sometimes take time for disturbances to affect real economic activity. In the United States, arguably there was quite a lag between the onset of problems in housing finance and the pass through to spending. The UK looks to be quite a lot better than the US. The latest data for Q4 last year did, however, suggest that household spending on durables slowed quite significantly. And we are seeing softening in consumer confidence and property market conditions. So the picture on the real economy is mixed.

What <u>is</u> clear is that credit conditions are unambiguously tighter than two months ago, underlining that source of downside risk to the outlook for demand and inflation. In retail lending markets, banks have raised the interest rates charged (relative to Bank Rate) on new lending, but they have all been doing much the same and many borrowers seem to have been willing to pay the extra. In consequence, banks generally may not have achieved their desired conservation of balance sheet capacity, and we are now seeing the withdrawal of some lending products.

And in wholesale markets, the spread between the price that the banks themselves pay for funds, roughly LIBOR, and the expected central bank policy rate has, again, widened significantly over the past couple of months across the major international markets. Many financial contracts are linked closely to three-month LIBOR so, other things being equal, the increase in money market spreads has the effect of reducing the level of Bank Rate consistent with unchanged monetary conditions.

At the Committee's March meeting, I judged that an immediate further cut, following February's, might very easily have been misunderstood as a change of strategy away from the one focused on the medium-term outlook for inflation that I have spelled out this evening. My own vote at the April meeting will depend on all the data, some of it still to reach us, since then.

Financial system deleveraging: legacy portfolios

Whatever path monetary policy takes in the UK in the months ahead, it is clear that the process of deleveraging in the financial system is not complete. Some asset prices embody a hefty discount for the current illiquidity in markets, which feeds into the accounting measure of financial firms' capitalisation, and so into perceptions of counterparty credit risk and money market conditions. In consequence, there remains a risk that credit creation – the lubricant that the financial system provides to the real economy – will be further impaired. Several features of our financial system lie behind this, and I want to touch on just a few of them.

Financial markets have swung from a prolonged period of underpricing risk to now plausibly overpricing risk on at least some products. And yet, one might think perversely, we have also swung from an over abundant supply of credit to a much more restrictive supply of new credit. The global insurance industry provides an interesting contrast with banking in this respect. For sure, it too is capable of systematically misjudging risks. But when a shift in risk appreciation and pricing occurs, the reinsurance industry often separates the run off of old portfolios containing mispriced contracts from the establishment of new vehicles, capitalised separately to take advantage of attractive terms on new business. And for regular insurance, many contracts are annual, so adversely priced business can run off fairly quickly. Banking typically works quite differently. Banks around the world are carrying portfolios of term loans that are the legacy of the boom years. There is uncertainty – amongst banks' management, shareholders and funders – about the degree of fundamental impairment in those portfolios. New loans are booked to the same balance sheets. And so many banks face a choice between, on the one hand, conserving capital and liquidity to support legacy portfolios; and, on the other hand, deploying capital and liquidity to write new business on what some see as the attractive terms and conditions now available. The banking system simply is not structured routinely to insulate new business from the legacy of past mistakes; funding and capital are fungible.

This predicament may be exacerbated by other features of the current environment.

One is an apparent reluctance on the part of banks to raise fresh capital except where the market thinks that it is beyond doubt that they need to do so. Given the feedback from credit conditions to asset prices and the real economy and so potentially to banks' future earnings, it might seem slightly odd for banks internationally to be maintaining distributions to shareholders but tightening credit availability in order to preserve resources. This has to be seen in the wider context.

One possible explanation for banks holding back from raising fresh capital is that they may want to avoid giving an adverse signal about themselves. <u>If</u> there is a co-ordination problem, the regulatory authorities internationally should be able to tackle it, allied to ensuring prudent valuations of legacy portfolios. But another possible explanation is that, like some other market participants, bankers may believe that many legacy assets are fundamentally undervalued at present and that the markets for securitised assets will, with time, recover and reopen. On that view, banks are avoiding becoming overcapitalised on a fundamentals (or forward looking) basis, and so setting off another expansionary phase in the credit cycle, a little further down the road. The serious puzzle which that underlines is why there is a dearth of buyers for the supposedly undervalued paper. With the terms and availability of financing from banks and dealers having tightened, levered funds are hardly likely to be the US Cavalry. But it is interesting that there has not been more interest from investment institutions with ostensibly long holding periods, which are largely unlevered and are not exposed to liquidity risk from borrowing short and lending long. What we commonly hear from contacts is that investment managers do not want to be caught out if asset prices fall further before they recover. But no one can seriously believe that they can spot the bottom of the market, and short-term horizons should not weigh heavily in longer-term investment institutions. All of which suggests that there may be structural impediments. Those could include some combination of the reasonable difficulty that some asset managers experience in assessing the quality of securitised assets; and mandates and accounting policies that may have the effect of shortening asset managers' time horizons.

The challenge for your own industry seems to have been slightly different. The managers of some money funds around the world, although I am sure not all of your members, joined in the 'search for yield' by going down the credit spectrum and increasing maturity mismatch during the boom in credit markets. As those funds have moved back towards home base, shortening the maturity and increasing the liquidity of their assets, one effect has been a reduction in the net supply of term funding into the international banking system.

That has been one of many contributors to the liquidity strains evident in money markets. But those strains have also been exacerbated by an unexpected breakdown in the technology for liquidity insurance provided by central banks.

For well over a century, throughout the industrialised world there has in effect been something akin to a Social Contract between the banking system and the authorities. The banking system is permitted to profit from undertaking leveraged maturity transformation in the course of intermediating the liquid savings of depositors into illiquid loans to households, firms and others. In doing so, commercial banks provide liquidity insurance, whether via demand deposits or committed lines of credit. They can do this because their deposit liabilities are money, which puts them at the heart of the payments system and is what makes them special; banks are at the heart of a monetary economy. In return, the authorities respond with a combination of prudential supervision, to contain the risks that banks run; deposit insurance, to protect savers; and liquidity insurance from the central bank. Smaller commercial banks can try to buy liquidity insurance from their larger brethren. Large banks cannot realistically do the same. They need to hold liquid assets. But there is no cast iron guarantee that asset markets will remain liquid in all conditions. So since Bagehot's day, central banks have stood ready to provide unlimited liquidity against good collateral at a rate that is higher than the normal market rate. However, during the period of turmoil since last summer it has proved toxic, here and overseas, for banks to access liquidity on those terms from central banks unless in broad and quality company. That has created uncertainty about the access of banks to the central banks in practice, and has required innovation and clear assurances from the central banking community. This alone will require reforms to the way in which central banks use their balance sheets, and money creating power, to sustain financial stability.

Banks will also need to adapt. It seems that at not a few firms, the discipline of risk management somehow got separated from that of balance sheet management (or funding). It was effectively assumed that financing markets would remain open come what may. There is a question of whether treasury management should somehow be insulated from the pressures of a profit centre. Separately, assumptions were made about relationships between asset prices that have proved groundless. One such is the spread between term money market rates and expected central bank policy rates. So long as the so-called LIBOR/Overnight Index Swap spread was narrow at all maturities, few market participants cared about whether they hedged against a LIBOR-based instrument when in fact sometimes they really needed a hedge relative to a risk-free rate. We sense that some international fixed-income asset managers would like there to be OIS-based contracts alongside LIBOR-based financial contracts, so that they can tailor their hedges more precisely. There should be wider benefits from contracts based purely on the risk-free rate rather than embodying liquidity premia and credit-risk premia of various kinds. That is something for the industry.

But better liquidity-insurance technology and better risk management will not abolish the credit cycle. Looking further ahead, the big question will be whether the authorities can tame the credit cycle without sacrificing the incentives to enterprise that are so important in a dynamic economy. The debate about the micro regulation of banks will need to take account of whether or not we can deliver that macroprudential objective. For too long, the debate has got sidetracked. Into whether we can rely on monetary policy "mopping up" after bubbles burst. Or into whether monetary policy could be used to <u>control</u> asset prices as well as doing its orthodox job of steering nominal trends in the economy, which I should say can include taking account of prospective risks of inflation volatility over the medium term. Ideas circulating already include minimum margin requirements or capital ratios that vary not only across instruments or firms but also through time as credit conditions change. We need calmly to explore whether there are also other possibilities. But let me make this absolutely clear: there are formidable obstacles to finding a solution. In the monetary sphere, a regime of floating exchange rates allows individual countries to pursue their own domestic monetary objectives. But in a world in which capital flows freely, local attempts to control the pace of credit creation, particularly within the financial system, may not work. All of that will need to be thought through. But first we need to concentrate on the immediate challenges.

Summary

In a speech four months ago, I stressed that "we must try to avoid a vicious circle in which tighter liquidity conditions, lower asset values, impaired capital resources, reduced credit supply, and slower aggregate demand feed back on each other". I identified monetary policy, liquidity policy, and regulatory capital policy as being amongst the instruments the authorities would need to use. That remains the case, as the stress in the global financial system has continued and, in the US at least, evidence of a feedback loop is apparent. Each of those instruments is constrained in some degree. That underlines the need for close co-operation between the authorities and the industry, and internationally.