BANK OF ENGLAND

Speech

Speech given by

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Master Cutler, Lord Lieutenant, High Sheriff, Lord Mayor, My Lords, Ladies and Gentlemen.

I am very grateful to you, Master Cutler, for inviting me here to Sheffield to speak at this great annual Feast, to meet the leaders of such an important sector of British manufacturing industry, and to enjoy your magnificent hospitality.

We are now almost two years into the financial crisis, which broke in August 2007. The preceding decade or so was marked by steady growth and low inflation, not just in the United Kingdom but in many other parts of the world. In 2003, the Bank's Governor, Mervyn King, even went so far as to christen it the NICE decade – standing for non-inflationary consistently expansionary. He was at pains to point out that one should not expect that unusual stability to be maintained. But although we subsequently fretted about the vulnerabilities building up within the global financial system as a result of the relaxed attitude to risk and the easy availability of credit, we never imagined quite how extreme the unwinding would prove, particularly after the bankruptcy of Lehman's last September triggered a near collapse of the financial system and a world-wide plunge in business and consumer confidence. The result has been a sharp and synchronised contraction in economic activity across the globe and an unprecedented collapse in world trade.

In the twelve months following the onset of the crisis, it seemed natural to expect those countries where the build-up in debt had been greatest, such as the United States and the United Kingdom, and those sectors that seemed most exposed, particularly financial services and construction, to be the hardest hit. But that is not how it turned out. The fall in UK GDP of nearly 3½% over the final quarter of last year and the first quarter of 2009 represents the largest half-yearly decline since records began in 1955. But that is comparatively mild seen alongside falls of almost 6% in Germany and nearly 8% in Japan, both countries running consistent current account surpluses.

Moreover, as most of you will be only too aware, the downturn has hit manufacturing especially hard, with output in that sector down over 10% in the UK, 20% in Germany and 30% in Japan, reflecting the sharp decline in the demand for consumer durables and capital equipment that followed the loss in confidence and reduction in the availability of credit. Rigorous inventory control then propagated the fall in demand rapidly along globalised supply chains.

Now producers cannot run down inventories indefinitely, so the rate of contraction should start to ease as de-stocking slows. And indeed, business surveys around the world do suggest that the rate of contraction in activity has been moderating over the past few months and that business confidence has started to improve. So the bottom in economic activity may not be too far off.

Unfortunately these encouraging signs – I hesitate to identify them as “green shoots” – do not tell us much about the strength and durability of the subsequent recovery. Here there are reasons for both caution and optimism.

The main reason for caution lies in the nature of this downturn. Previous UK recessions were associated with the need to reduce inflation after a period of excess demand growth. But the period preceding the present crisis was not associated with excessively rapid growth in the demand for goods and services. Instead, it was characterised by excessive growth in the demand for financial and real assets, and in the prices of those assets. All of that went into reverse after August 2007, with a sharp reversal in perceptions of risk, falls in asset prices, a deterioration in banks’ balance sheets, and a drying up of credit.

The Senior Warden, in his introduction, drew attention to the harm that the reduction in the availability of credit is having on otherwise viable businesses in this part of the country. We hear the same message repeatedly across the nation through the business contacts of our network of regional Agents. The issue is very much at the forefront of our concerns.

The UK Government has already introduced a range of measures to underpin the banking system, including requiring the injection of additional capital, guaranteeing bank debt and providing insurance against losses on some of the risky assets on banks’ balance sheets. That has served to stabilise the banking system. But we are still some way from having banks that feel sufficiently secure that they can lend normally, and investors that have enough confidence in the banks to provide them with sufficient funds. The Bank will continue to work alongside the Government and the FSA in trying to ensure an adequate flow of funds to business. Unfortunately, past experience in other countries suggests that it often takes time for the banking system to mend after a crisis, and it is possible that the supply of credit will remain impaired for some while.

There are two reasons for optimism about the strength of the recovery. First, we have the advantage of a substantial depreciation in sterling, whose trade-weighted value is about a quarter down on its value before the crisis broke. That should encourage buyers to switch to goods and services made in this country and make it more profitable to produce them. As a result, it should facilitate the necessary re-balancing of the economy.

Second, an unprecedented policy stimulus is working its way through. In particular, the Monetary Policy Committee has lowered Bank Rate to 0.5%, a level unmatched in the Bank's 315-year history and only marginally above its floor of zero. But given the strong contractionary tendencies in the economy, we decided that further stimulus was needed. So in March, we announced a programme to purchase £75 bn of public and private financial assets, financed by issuing extra Bank of England reserves – an action going by the unlovely description of Quantitative Easing. And at our meeting at the beginning of this month, we upped the total amount of purchases to £125 bn, about half of which have so far been made.

The ultimate aim of these measures is to boost the annual rate of growth of nominal spending in the economy, which has been roughly flat over the past year, to a level consistent with a sustainable level and rate of growth of real activity and inflation meeting our target.

Quantitative easing has been described in some quarters as "printing money", though it is not literally that. It is more akin to us buying the asset with a cheque drawn on the Bank of England, which the seller then deposits with his own bank. As a consequence, the quantity of bank deposits in the economy goes up, while the claims that the banks hold on the Bank of England also increase.

The immediate impact of these purchases should be to drive up the price of the assets that we are buying, or equivalently to reduce their yield. That is indeed what we have seen, with gilt yields falling nearly ½ percentage point when the programme was initiated. But that is not the end of the matter, as investors need to do something with the proceeds from their asset sales. They could just sit on the proceeds, but it is more likely that in due course they will buy other assets, including those that offer a higher return. So, in the course of time, the whole range of equity and bond prices are driven up, lowering the cost of finance to companies and increasing its availability.

Our purchases of corporate assets are intended to have the additional effect of improving the functioning of those markets. By standing ready to buy commercial paper and corporate bonds, we hope to improve their liquidity, lowering the spread above safe assets of equivalent maturity, and with it the cost of finance to business.

There are signs that these measures are having a beneficial impact too. Spreads on commercial paper eligible for purchase have fallen by around ½ percentage point and the size of the market has increased by around 10%. Similarly, average spreads on sterling investment grade corporate bonds for industrial companies have declined by some 60 basis points and gross issuance of bonds by UK companies has been strong. These developments may reflect a range of influences, but feedback from market participants suggests that our purchases have indeed played a helpful role.

In addition to these channels, the banks, finding themselves flush with extra reserves, may choose to lend them on, providing a further kick by boosting the supply of credit. At the current juncture, however, a scarcity of funding and capital is likely to make banks cautious about doing this. That was exactly what happened in Japan during its so-called “lost decade”. But there are signs that the extra reserves may be contributing to a decline in the interest rate that banks pay to borrow from each other.

It will take some time before we can assess just how effective Quantitative Easing has proved to be. Our latest assessment is that the combined stimulus from policy easing and the lower value of sterling should be sufficient to lead to growth resuming as we move towards the end of the year. But the continuing drag from the financial sector means that the ensuing pickup is likely to take place relatively slowly. There is, however, considerable uncertainty surrounding that assessment.

Our primary objective is, of course, to control inflation, not growth. Our target measure, the Consumer Price Index, has been running above the 2% target for the past eighteen months, reflecting in particular the surge in energy and other commodity prices during the first part of last year. But it is now dropping back, reflecting both the sharp decline in energy prices in the latter part of 2008 and the growing margin of spare capacity in the economy. We expect it soon to fall below target and it is more likely than not to remain there for the next year or two. The inflation rate as measured by the more familiar Retail Prices Index has fallen even more sharply, reflecting the reduction in mortgage interest payments associated with the reduction in Bank Rate and falling house prices.

When the recovery does come, as it surely will, the margin of spare capacity in the economy will begin to shrink and inflationary pressures will start to build again. So at some stage, we will have to begin withdrawing the large monetary stimulus. Although this may be some way in the future, some market participants and commentators are already starting to worry about whether we will be willing and able to accomplish this sufficiently rapidly to prevent inflation taking off, particularly given the scale of the Government's prospective financing needs. Three points are worth making.

First, the timing of the withdrawal of the monetary stimulus will be governed by the need to meet the MPC's inflation objective, not by the Government's financing needs.

Second, with Bank Rate at its effective floor, we presently have only the asset purchase programme as a tool to stimulate demand. But when it comes to tightening policy, we have two instruments at our disposal: asset sales; and raising Bank Rate. It is not necessary to unwind the asset purchases before raising Bank Rate.

Third, if we felt the need to drain the extra reserves from the system rapidly, we could also do it by exchanging the reserves for short-term Bank of England bills, allowing us to stagger the sales of the gilts.

Of course, the execution of our exit strategy will still present us with a tricky judgement call. We do not want to nip a recovery in the bud prematurely. Equally we will not want to let the inflation genie out of the bottle. But that is the sort of balancing act that monetary policy makers regularly face, even if the scale of the downturn and the size of the policy stimulus that has to be withdrawn are so much larger now.

A previous guest at this Feast, Winston Churchill, declared that he "would rather see finance less proud and industry more content", shortly before he took the fateful decision to return the pound to the gold standard at an overvalued rate. Finance has certainly been humbled by the events of the past couple of years and the post-crisis financial world is bound to look very different from the pre-crisis one. But let us also hope that it is a world in which industry is more content.

It remains only for me to thank you again for a marvellous meal and to propose a toast. To the Manufacturing Industries of Hallamshire.