



BANK OF ENGLAND

# Speech

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## **Opening Remarks for an LSE Panel on the Global Economic Crisis: Meeting the Challenge**

Speech given by

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The world is now in the grips of a major economic downturn. It is impossible to know how protracted or severe this will be. A great deal depends on the success of the policy responses.

One striking feature of the current downturn is the apparent degree of synchronisation across economies. This is illustrated for industrial production in Chart 1. While some signs of weakness were already apparent, it is also noticeable how the global economy took a turn for the worse after the collapse of Lehman brothers last September.

This evening I want to say a word or two about the policy responses to the downturn. The extent of policy activism in responding to this crisis is remarkable by any historical standard. There are three main elements of this.

The first is a series of measures aimed at limiting directly the fall out from the financial crisis – including efforts to improve liquidity in financial markets, to recapitalise banks and to limit the impact of their difficult-to-value-assets on their lending activity. Without such measures, we would face the prospect of an even more severe credit squeeze with a further impact on households and businesses. Some of these measures have been needed to prevent a wholesale collapse in the global financial system. The aim of policy now is to restore lending to levels that does not cause excessive damage to the real economy.

The second is the loosening of monetary policy – mainly so far by lowering official policy rates. This is illustrated in Chart 2 which gives official policy rates for a number of countries. While there are some differences in the mandates of central banks, a common feature of the policy response is the need to limit the potential deflationary implications of weakening nominal demand growth. This reduces the chances of a period of debt deflation which would have further adverse feedback effects onto indebted households and businesses directly and hence into the financial system.

Third, there have been fiscal policy responses. These are geared towards supporting demand in the face of weakening private investment spending and softening household demand. Chart 3 indicates how they have varied in magnitude around the world.

It is clear that in all three policy domains there is unfinished business.

There is much interest in the supporting role of monetary policy in the current climate. The state of the economy complicates the conduct of monetary policy in a number of ways. Chiefly, it is difficult to be sure how large the stimulus to the economy through the cuts in interest rates that we seen since last autumn will eventually be. Lags in monetary policy transmission are often acknowledged to be 'long and variable' and it is particularly difficult to judge the likely speed of any response at the moment. There are also uncertainties due to the headwinds coming from restrictions in the creation of credit and from the weaker global economic outlook.

Unlike previous episodes of economic weakness, we entered the current downturn after a period of low and stable inflation. This is broadly true across the developed world. In the U.K., the inflation target has served as an effective anchor for inflation expectations over the past ten years. The challenge for the MPC in the coming months will be to ensure that the inflation target remains credible in the face of a weaker economy and with the much weaker outlook for global commodity prices. However, in our case, pressures from weaker sterling will likely provide some upward pressure on prices of traded goods as it passes through to consumers.

In general, the role of monetary policy in an episode like this one is to support the growth of nominal demand to guard against deflationary risks. While, this will support the real economy, it is important to be realistic about the role that monetary policy can play in that respect.

The first order issue for the economy remains trying to stabilise the banking system, using appropriate financial market policies to achieve this while not unduly constraining households and businesses from accessing finance.

Direct measures to prevent a sharper than desirable credit contraction should be understood and evaluated against the background of clearly defined policy objectives. The inflation targeting framework with independent decisions by the MPC remains in my view a sound structure for monetary policy in the U.K.

In the conduct of both monetary and fiscal policy, there is a need to maintain a disciplined approach. We all understand that debt is only deferred taxation and that the challenge is to provide a time path for fiscal policy that is sustainable over the medium term. It is also clear that globally coordinated fiscal expansion as opposed to each country going it alone has particular merits in a world of economic integration. As I am sure you are aware, the need for a coordinated global policy response is a key refrain from last weekend's G7 meeting.

But nobody should expect a return to the kind of business as usual of the early part of the millennium. The 'originate and distribute' model of bank finance needs rethinking. The merits of adopting some kind of dynamic provisioning for capital requirements will surely be an important proposal for discussion. Regulators also seem destined to scrutinise and regulate some aspects banks vulnerabilities induced by their funding structures. This must include an assessment of the potential externalities across institutions. Households too may also find that access to mortgage credit, particularly loans at high multiples of earnings, is more keenly scrutinised. It will also be necessary for greater international surveillance of global imbalances and how they might unwind. But it is only possible to act if there is effective global policy coordination. Thus, questions about the global financial architecture to deal with this must be resolved.

To be effective, authorities have to be given the right instruments to target the right problems with clearly defined policy objectives. There is much confusion on this. The idea that we can and should use short-term interest rates to quell asset booms or to curb lending practices is intellectually and practically suspect. It is essential that policy instruments tackle the problem at source rather than distorting policy instruments better suited to other ends.

While the manifestation of the current global crisis is visible at the macro level, many of the issues both now and in the future are micro-economic. The crisis in part reflects poorly designed risk control and incentive structures in financial markets. It is also important to understand the macro-economic implications of how these spillover from one institution to another so that bad apples do not poison the barrel.

Even though we are dealing with the immediate fall-out and mitigating its consequences, it is also important that policy responses remain focused on long-term policy goals. There is an underlying need for a period of economic adjustment both here and elsewhere. It is important that this takes place and it is neither possible nor desirable for policies to prevent this from happening. This adjustment will lay the foundations for the recovery when it comes.

A move towards protectionism and to limit the beneficial role of competitive forces is particularly to be avoided. While there are many questions being raised about the period leading up to the credit crunch, this period of globalisation undoubtedly created huge economic benefits in both rich and poor countries. It is important that these global gains remain in place. While there are forces that are working in the opposite direction, it is important for the long-term health of the U.K. and the global economy as a whole to strengthen globalisation rather than retreating from it.

I am sitting on this platform more as an academic than as a part-time policy maker. Thus, I will end these comments, by joining the current episode to three key themes that have played a dominant role in my academic research and thinking on economic policy over the past twenty years.

The first is the study of market failure. Economists have long been armed with an appreciation of the importance of market failure. Indeed, contrary to what is sometimes claimed, economists have a much more refined sense of what makes markets fail than what makes them succeed. For much of the past few years, there are some things that seemed to work in practice even though they should not have worked so well in theory – some asset backed securities markets are a case in point. It was always a mystery how the severe adverse selection problems were kept at bay. I am certain that the burden of proof will now shift and that this will have practical consequences for the way in which business is conducted. Regulation will be effective only when it has a clear focus on the exact source of market failure.

The second is the forces that shape the rise of the state and the growth of fiscal capacity – the power to tax. A remarkable feature of the current episode is how the

very considerable fiscal resources available to the state are being marshalled to solve the problems of private banking and capital markets. This is a reminder of the very important market supporting role that fiscal capacity – developed over years of crises and wars – plays in modern economies. While nobody welcomes the human consequences of major events like wars and depressions, it is in the face of tough rather than easy times that many important long-term policy reforms are undertaken.

The third is the study of government failure. Government and state institutions work well when incentives are clear and accountability structures are in place. The modern democratic state is, on the whole, the finest form that mankind has yet devised for this purpose. Reflecting this, the past twenty years or so have seen a remarkable wave of democratisation. Using the widely accepted Polity IV definition 36% of independent states were democratic in 1983 compared to 67% in 2003. But democracy naturally creates expectations among citizens. It will be a while until we know whether the very considerable government activism that we are now seeing is deemed to have been successful. But it is clear that the stakes are extremely high and this will shape the perception of state effectiveness for a generation or longer.

Chart 1: Industrial Production

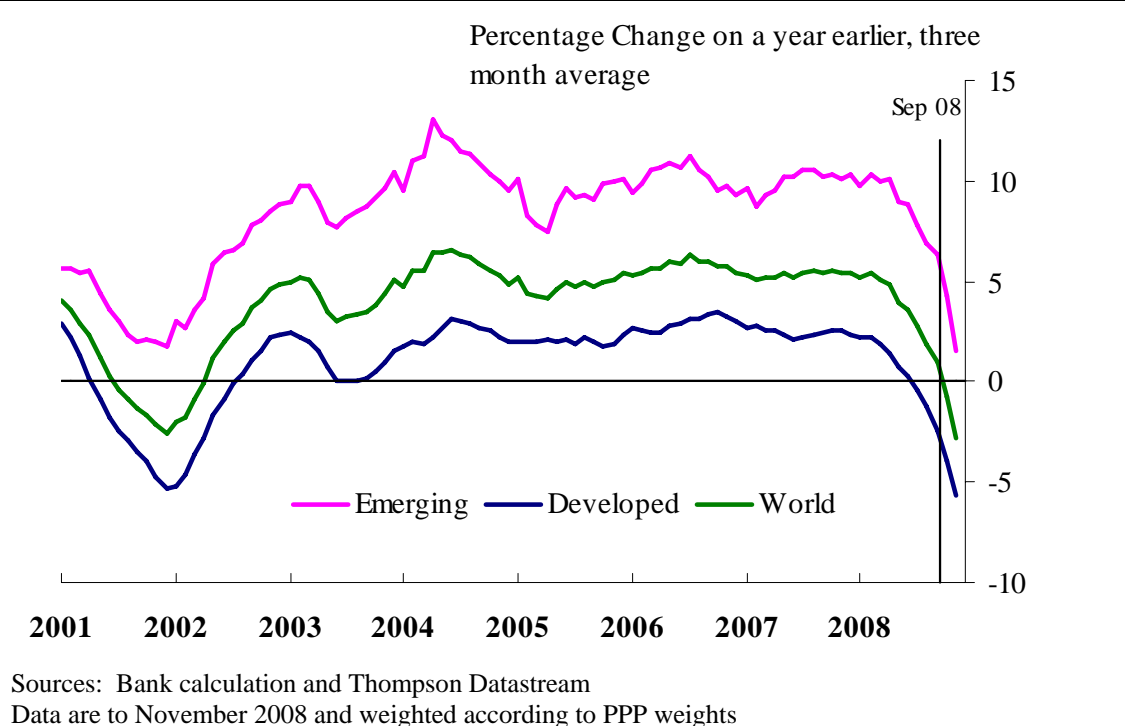


Chart 2: International Monetary Policy

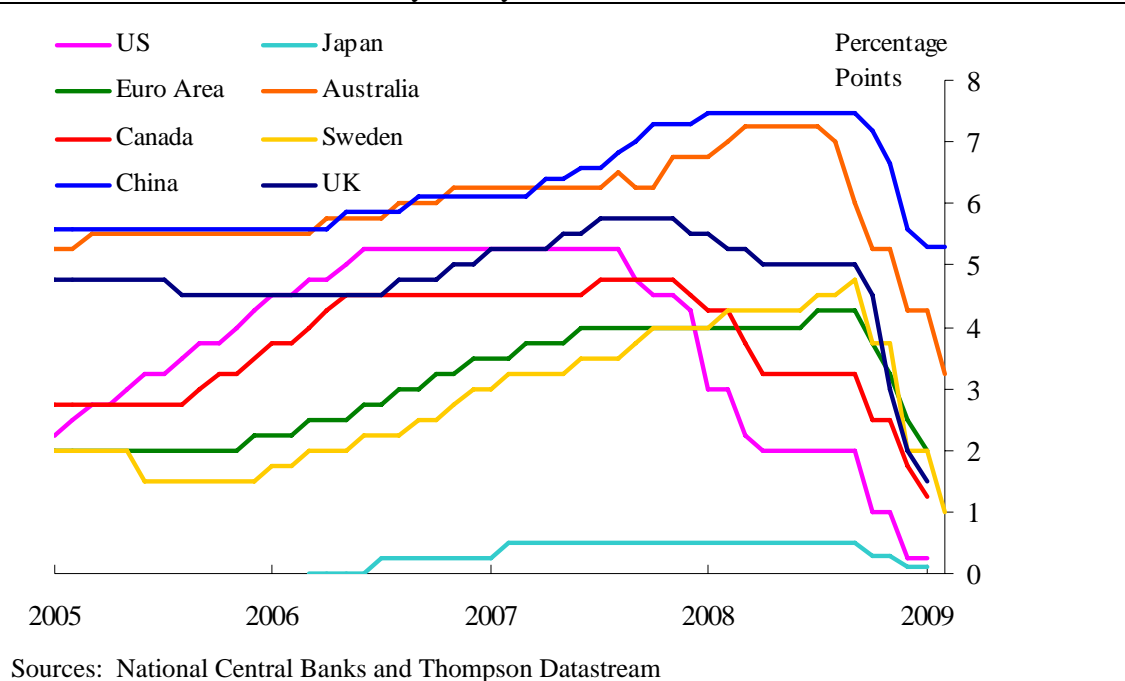
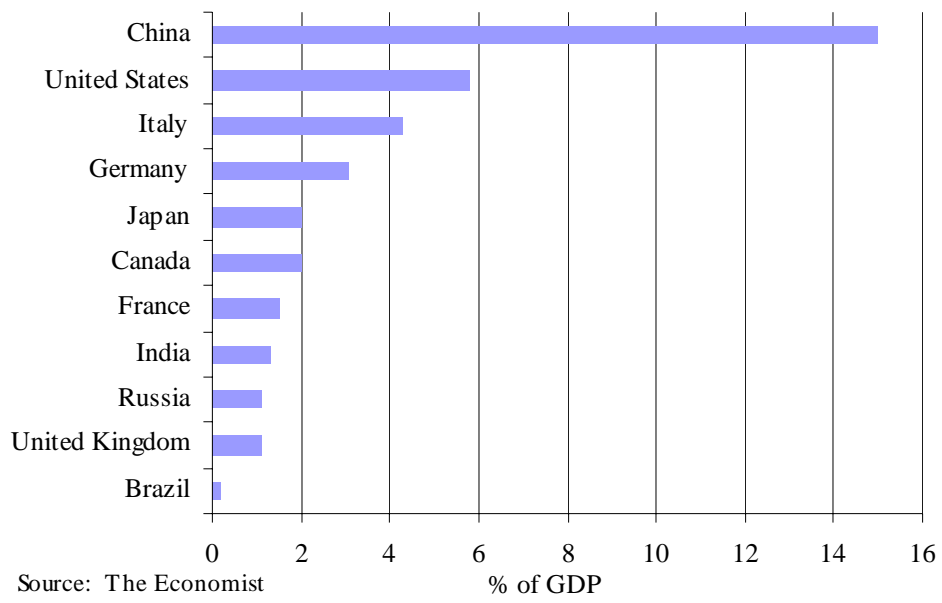


Chart 3: International Fiscal Stimuli <sup>(a)</sup>



(a) Excludes Financial Sector Support