



BANK OF ENGLAND

# Speech

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## The Future of Monetary Policy

Open Lecture by

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*"A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it." Max Planck.*

## **1. INTRODUCTION**

It is with great pleasure I come to Cardiff University. I did my Masters degree in economics here in the early 1980s. Indeed, I also went to Canton High School for Boys, subsequently Cantonian High School, just down the road from here in Llandaff from 1966 to 1970. There are one or two people still here who even taught me all those years ago.

In this speech I will consider the future for monetary policy. The current institutional framework has been found wanting. While we cannot expect to abolish the cycle, the credit crisis has been just too costly. Reform is required. The 'one-tool one-target' approach to monetary policy of using Bank Rate to target CPI inflation has been inadequate. Inflation targeting alone will not suffice. This approach failed to prevent the build-up of imbalances that presaged the crisis and was insufficient in dealing with failing banks and financial market stress as the crisis developed. There is now a consensus that new tools are required to regulate the financial sector and prevent such crises in the future.

This debate has focussed on methods to limit bank lending over the cycle. Unfortunately, current macroeconomic research has had little to say about bank lending, financial instability and house and asset price bubbles. So we are largely starting from scratch. We do not possess a coherent intellectual framework to describe how such macro-prudential instruments might operate and how they would interact with more traditional policy instruments such as the Bank Rate and the CPI inflation target. Providing such a framework will be a challenge.

In this speech I would like to describe how we arrived at the current crisis and how policy might have operated differently. I will describe the global context of the crisis, events within the financial sector and our policy responses to them. I will then offer some thoughts on where macroeconomic research can help to fill in the gaps in our

current thinking, and finally what changes to the policy framework we might consider.

## **2. THE GLOBAL CONTEXT**

The problems facing the UK and global economy stem from those identified, but not solved, at Bretton Woods (at the Mount Washington Hotel which is just up the road from my Dartmouth office in the White Mountains of New Hampshire). That is, placing responsibilities on those countries that run persistent current account surpluses and deficits. The credit crisis reflects developments in the debtor countries such as the UK and United States but also in the surplus countries such as China (see [Chart 1](#)).

In the UK, the falling household savings rate, high levels of indebtedness and bubbles in house and asset prices have been linked to the strong growth and light regulation of the financial sector. But the underlying imbalances in the global economy were also the product of the capital controls, fixed exchange rate regimes and high savings rates in emerging Asian economies such as China. The counterpart to any laissez-fair approach in developed economies was an interventionist policy approach and under-developed financial sector in the emerging Asian economies. Why did this come about?

Following the Asian crisis in 1997, the painful experience of rising debt, capital outflows and currency depreciation led to a reassessment of economic policy. The outcome for many developing economies was export-led growth strategies, associated with fixed or managed foreign exchange regimes, and current account surpluses driven by rapidly expanding export growth.

For a decade, stunning growth in the Chinese manufacturing sector was matched by the exuberance of Wall Street and the City of London as the world economy enjoyed an exceptionally prolonged period of growth. This success reflected disparate economies pursuing their comparative advantages. The Chinese economy rapidly expanded employment of its enormous pool of low paid, low skilled, labour. In some developed economies the manufacturing sector performed relatively poorly as services, particularly financial services, grew as a share of the economy. And it wasn't

only investment bankers that joined in the party! Falling imported goods prices pushed up on real incomes throughout the developed world and credit was extended ever more favourably, often to the least credit worthy.

We should not forget the success of the last decade. **Chart 2** illustrates that world real GDP per capita grew at exceptionally high rates over the last five years. In previous decades, economists had struggled to explain the lack of convergence in living standards between the rich and poor nations. Economists now ask how quickly living standards in India and China will converge with our own. It is important to remember this success at a time when free trade and globalisation are being questioned.

Ultimately, as is so often the case in economic development, the configuration of global growth became unbalanced, dependent on an unsustainable flow of capital from the surplus countries such as China to the main debtor countries such as the UK and United States. This flow of capital pushed down on interest rates, up on house and asset prices, and contributed to rising levels of debt in the deficit countries.

The size of global current account imbalances received much attention and concern. The implications for house and asset prices from the configuration of global growth, and the exchange rate policies pursued by Asian central banks was first recognised by Ben Bernanke in his speeches on the '*global savings glut*' in 2005.<sup>1</sup> But little policy action was taken. In fact, the combination of floating exchange rates for developed economies and interventionist foreign exchange policies by Asian central banks were labelled by some as *Bretton Woods II*, as if the global imbalances they were associated with were sustainable.<sup>2</sup> More recently, there have been calls for a '*new Bretton Woods*' to rethink the global financial system.<sup>3</sup>

However, we need to understand that the interventionist policies in emerging Asian economies reflected a lack of confidence in their own domestic financial systems following on from the Asian crisis. Part of the solution to the world's imbalances will

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<sup>1</sup> Ben S. Bernanke, 'The Global Saving Glut and the U.S. Current Account Deficit' Remarks at the Homer Jones Lecture, St. Louis Missouri, April 14, 2005.

<sup>2</sup> For one of the earliest descriptions of this idea see Michael P. Dooley, David Folkerts-Landau and Peter Garber, 'An Essay on the Revived Bretton Woods System', NBER Working Paper No.9971, September 2003.

<sup>3</sup> Agence France-Presse (AFP), October 13, 2008. "World needs new Bretton Woods, says Brown"

not only be greater regulation of financial markets and bank lending within the developed economies, but also the freeing up of capital markets, and development of the financial sector in developing Asian economies, so that their growth can be less reliant on exports and driven more by domestic demand. Nevertheless, we need to put our own house in order.

### **3. THE FINANCIAL SECTOR**

Why did our banks take such enormous risks? The primary reason was the influx of capital from developing Asian economies into the global financial system which pushed down on bond yields. This led banks and financial institutions to take ever greater risks in their '*search for yield*' subject to diminishing scrutiny from both shareholders and regulators. But why did investors and regulators allow such risks to be taken? First, as time elapsed since the last severe recession in the early 1990s, investors and regulators may have placed too small a probability on such a recession reoccurring. Second, investors may have been over-confident in their statistical models of risk, and risk management strategies. Third, some academic economists indicated that there had been an improvement in the conduct of monetary and fiscal policies and a structural reduction in the volatility of the macro-economy. The idea that recessions belonged to some *crude distant past* permeated.

In their optimism, investment bankers found ever more creative ways to channel the flow of easy credit to the most risky borrowers – in particular in the US sub-prime mortgage market. Complex assets were designed such as mortgage backed securities. Through the alchemy of bundling risky and riskier borrowers together within opaque structures it appeared that investment bankers had turned lead into gold. Credit rating agencies were certainly convinced by the new technology, awarding generous credit ratings to the new assets that had been created. Many banks became dependent on wholesale funding, through the '*originate and distribute*' model and increased their leverage. In short, few people expected that the era of cheap money would end and their pricing of risk was based on that premise.

As Warren Buffet has said, '*only when the tide goes out do you discover who's been swimming naked*'.<sup>4</sup> The tide began to turn at the beginning of 2007 in the US as arrears and defaults in the sub-prime mortgage market began to rise. This led to a re-appraisal of risk as investors realised the probability of default had increased, given the downturn in the housing market. At the same time, investors realised that the complex and opaque nature of mortgage backed securities meant it would be very difficult to judge where the risks lay. Hence, both risk and uncertainty rose together.

Greater cross-border asset holdings, and the risk-sharing between economies that these holdings implied, meant that non-US based banks would also suffer profit losses from the US sub-prime market. This became apparent in August 2007 as the French bank BNP Paribas announced it was having difficulties in valuing many of its assets because the markets for them had dried up. These financial market linkages complemented the greater level of trade integration which had occurred over the last decade as trade barriers fell.

I will not attempt to give you a blow-by-blow account of the banking failures and central bank and government interventions that have been necessary to prevent a collapse of the global financial system. Many commentators have attempted to characterise the credit crisis as a stream of unprecedented and unanticipated events that quickly led economic prospects to deteriorate dramatically. But this view misunderstands the problem. The first warning signs of the crisis began around the beginning of 2007, and the full scale of the crisis began to be realised from August 2007 as markets for mortgage backed securities began to dry up. Economic conditions became progressively worse through 2008.

The collapse of the Lehman Brothers investment bank certainly stands out as a key moment during the most recent phase of the crisis. But once a realisation of the true extent of balance sheet problems facing financial institutions began, coupled with the knock-on effects on confidence and spending that such a realisation implied, the global recession was always likely to intensify.

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<sup>4</sup> Warren Buffett, Berkshire Hathaway 2001, Chairman's Letter.

In his speech to the CBI in Leeds in October 2008, the Governor of the Bank of England, Mervyn King described the problems in the financial sector prevailing at that time.<sup>5</sup>

*“Just as a fever is itself only a symptom of an underlying condition, so the freezing of interbank and money markets was the symptom of deeper structural problems in the banking sector..... Confidence in the banking system had eroded as the weakness of the capital position became more widely appreciated. But it took a crisis caused by the failure of Lehman Brothers to trigger the coordinated government plan to recapitalise the system. It would be a mistake, however, to think that had Lehman Brothers not failed, a crisis would have been averted. The underlying cause of inadequate capital would eventually have provoked a crisis of one kind or another somewhere else.”*

I agree. There is therefore little point in focussing on the scale of the Lehman Brothers collapse and its inevitable consequences. Rather, we need to ask tough questions why the structural problems within the financial sector were allowed to build up so that a recapitalisation of the system was eventually required. Also, as the credit crunch intensified from the beginning of 2007 onwards, why were the problems not recognised, with commensurate policy responses, before a full blown global financial crisis was at hand? In doing so, we need to consider the conceptual framework driven by current macroeconomic research that underpins monetary policy.

### **3. THE INTELLUCTUAL BASIS FOR MONETARY POLICY**

As a monetary policy maker I have found the ‘*cutting edge*’ of current macroeconomic research totally inadequate in helping to resolve the problems we currently face. I am far from alone in these views. To take a couple of observations:

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<sup>5</sup> Speech by Mervyn King, Governor of the Bank of England to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward at the Royal Armouries, Leeds, Tuesday 21<sup>st</sup> October 2008.

*“New classical and new Keynesian research has had little impact on practical macroeconomists who are charged with the messy task of conducting actual monetary and fiscal policy.”*

Gregg Mankiw, 2006.<sup>6</sup>

*“In fact “modern macro” has been notable for paying very little rigorous attention to data. .... I am left with the feeling that there is nothing in the empirical performance of these models that could come close to overcoming a modest scepticism. And more certainly, there is nothing to justify reliance on them for serious policy analysis.”*

Nobel Laureate Robert Solow, 2008.<sup>7</sup>

*“There is a danger that the macroeconomic models now in use in central banks operate like a Maginot line. They have been constructed in the past as part of the war against inflation. The central banks are prepared to fight the last war. But are they prepared to fight the new one against financial upheavals and recession? The macroeconomic models they have today certainly do not provide them with the right tools to be successful.”*

Paul De Grauwe, 2008.<sup>8</sup>

and

*“The widely used DSGE paradigm – designed to help control inflation – seems ill suited to understanding the origins of the crisis or designing measures to solve it.”*

Marcus Miller and Joseph Stiglitz, March 2009.<sup>9</sup>

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<sup>6</sup> Mankiw, N. Gregory, (2006), ‘The Macroeconomist and Scientist and Engineer’, *Journal of Economic Perspectives*, 20(4), Winter, pp. 29-46.

<sup>7</sup> Solow, R. (2008), ‘The state of macroeconomics’, *Journal of Economic Perspectives*, 22(1), Winter, pp.243–249.

<sup>8</sup> *Financial Times*, July 22<sup>nd</sup>, 2008.

<sup>9</sup> Miller, M. and Stiglitz J. ‘Leverage and Asset Price Bubbles: Averting Armageddon with Chapter 11?’ Working Paper University of Warwick.



Why has macroeconomic research been so irrelevant and why did central bankers fail to take any concrete action as house and asset price bubbles emerged? I would like to identify a number of shortcomings with the macroeconomic literature.

*a) Efficient Markets and Random Shocks*

The ‘*efficient market hypothesis*’ upon which most macroeconomic research is based suggests that persistent mis-pricing of assets is highly unlikely. Bubbles in housing and equity markets are assumed to be arbitrated away instantaneously rather than persist and grow. There is no conditional probability within these models. That is, imbalances may grow because of false assumptions or imperfect information within markets, but eventually the true state of the economy will become apparent. The longer the deviation from the equilibrium continues, the conditional probability of a correction in the next period towards the equilibrium may rise. But our macroeconomic models have little to tell us when the tipping point may come.

In a recent excellent article Willem Buiter describes the problems with modern Dynamic Stochastic General Equilibrium (DSGE) models.<sup>10</sup> These models assume close to or complete markets and information. Hence, the structure of these models is akin to a centrally planned economy. In such a utopia there would be no disadvantage in allowing a social planner to maximise utility for society as a whole. A decentralised economy with incomplete markets and imperfect information, characterised by herding behaviour and speculative bubbles is a far better approximation of the real world.

The other problem that Buiter describes is the *linearity* of the DSGE models:

*“Those of us who have marvelled at the non-linear feedback loops between asset prices in illiquid markets and the funding illiquidity of financial institutions exposed to these asset prices through mark-to-market accounting, margin requirements, calls for additional collateral etc. will appreciate what is lost by this castration of macroeconomic models. Threshold effects, critical mass, tipping*

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<sup>10</sup> The unfortunate uselessness of most ‘state of the art’ academic monetary economics.  
<http://blogs.ft.com/maverecon/2009/03/the-unfortunate-uselessness-of-most-state-of-the-art-academic-monetary-economics/>

*points, non-linear accelerators – they are all out the window. Those of us who worry about endogenous uncertainty arising from the interactions of boundedly rational market participants cannot but scratch our heads at the insistence of mainline models that all uncertainty is exogenous and additive.”*

So are economic shocks expected to be random and temporary? We have little understanding of how imbalances build, propagate and eventually unwind and what the appropriate policy responses should be. Another problem with current macroeconomic modelling is that it excludes a key part of our economy, the financial sector. There is only one interest rate, the central bank policy rate. The deviation of actual market interest rates around that policy rate is assumed away. Perhaps this is another reason why we have such little understanding of house and asset price bubbles.

Indeed, the efficient market hypothesis encouraged economists to search for structural reasons to explain global imbalances and the asset price booms. Central banks were lulled into a false sense of security by appealing arguments that linked apparently sustainable movements in asset prices to structural reductions in the volatility of the economy. In summary, modern macroeconomic research pointed policymakers in the wrong direction.

#### *b) Inflation Expectations, Credit and Money Supply*

With no financial sector within macro models, there was little room to assess the macroeconomic implications of financial instability. This may be one reason central bankers were slow to realise the severity of the credit crunch until a full blown crisis had emerged.

My colleague the Executive Director for Financial Stability at the Bank of England, Andy Haldane has already provided an excellent critique of the risk management modelling techniques that were employed by both banks and regulators to assess financial stability concerns and which have been found to be wholly inadequate.<sup>11</sup>

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<sup>11</sup> Haldane, A. ‘Why Banks failed the Stress Test’, Basis for a speech at the Marcus-Evans conference on Stress Testing, 9-10 February 2009.

Once more, the view that there had been a structural reduction in the volatility of the economy may have contributed to complacency in assessing risk.

Many monetary policymakers had expressed the view that heightened inflation expectations posed the risk of a persistent rise in CPI inflation if they became entrenched. Hence, monetary policy might have to remain restrictive to contain this danger. To my mind this argument is a confusion between cause and effect. Inflation expectations should be formed by credit conditions, the supply of money and monetary policy, not vice versa. Once the credit crunch took hold a reduction in inflationary pressure was always likely as the supply of credit contracted. Lower inflation expectations would follow.

The New Keynesian Phillips Curve (NKPC) literature has been the workhorse model for monetary theory in the past decade and stresses the role of inflation expectations. However, we have recently experienced a sharp rise in survey measures of inflation expectations, but without a persistent rise in inflationary pressure ([Chart 3](#)). One explanation relates to the labour market. Although workers' inflation expectations were heightened over the recent past, they were unwilling to bargain for higher wages at a time when labour market conditions were deteriorating and workers' fear of unemployment was rising sharply ([Chart 4](#)). And firms' employment intentions were falling back precisely because of the adverse effects on demand from the credit crunch ([Chart 5](#)).

In the New Keynesian literature there is little discussion of how inflation expectations feed into wage growth and how this relates to the unemployment rate in the economy. Yet I fear policymakers drew inferences from the NKPC literature despite the lack of a coherent labour market or credit market within this framework.

### *c) Microeconomic Phenomena*

In attempting to understand asset price booms, there are potentially some fruitful avenues of inquiry. George Soros holds that these fluctuations are predictable. And given his profitable record in financial markets who are we to doubt him. Furthermore, there are already a number of well established micro phenomena that

may help to explain asset price booms which Andy Haldane has discussed in a recent speech.<sup>12</sup>

The first of these is *disaster myopia*. That is, the tendency of people to place less probability on extreme outcomes, as time goes by and the experience of these events becomes more distant. Hence, investors, banks and policy makers underappreciated the risks they were taking and the imbalances within the global economy as they became ever more apparent. And as the last recession became more distant, the premium investors demanded for risk fell.

The second micro phenomena, has been the *principal-agent* relationship between the shareholders of banks, and their employees. It is debatable how much of the risk-taking was driven by shareholders or their employees. But it is certainly possible that the remuneration structures within banks gave employees incentives to take large risks. Central banks have an interest in understanding the incentives and risk preferences of the relatively small amount of people who channel our savings into investments.

Whatever incentive structures are in place within banks, they will clearly have implications for overall financial stability. There is, however, a further principal-agent problem. That is, the relationship between the authority responsible for overall financial stability and the individual financial institutions. This problem has been characterised as the difficulty of regulating financial institutions that are deemed '*too big to fail*' both by the public authorities and by the financial institutions themselves. If so, such institutions will take bigger risks, confident they will be rescued by the authorities in the event that their bets fail to come off.

All of these microeconomic phenomena have clear implications for the manner of risk-taking in our economy. A better understanding of how investors both individually and collectively price risk, and the macroeconomic implications of that price-setting behaviour, would be a valuable tool for central bankers. It is important to remember

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<sup>12</sup> Haldane, A. 'Why Banks failed the Stress Test', Basis for a speech at the Marcus-Evans conference on Stress Testing, 9-10 February 2009.

our lack of knowledge at a time when new regulations are being proposed to manage the degree of risk-taking in the economy.

#### **4. WHAT DOES THIS MEAN FOR THE INFLATION TARGETING FRAMEWORK?**

It is clear that the intellectual basis for inflation targeting has been called into question. The economic models that provided the rationale for this approach do not describe well the features of the global economy that led to the current crisis; the build up of global imbalances, perceptions of risk in the economy and stresses within the financial sector. Similarly, these economic models have been of little help in formulating policy as the crisis has developed. There is now a consensus among monetary policymakers that a new approach is required. An inflation targeting regime alone will not suffice. For example, the Financial Stability Forum (FSF), in which the Bank of England is participating, is considering the use of macro-prudential instruments to influence bank lending over the cycle.

##### *Macro Prudential Tools*

Macro-prudential tools would have been useful over the recent past. By limiting bank lending they might even have helped to contain the global imbalances that were the root cause of the crisis. However, providing central banks with new tools could be uncharitably viewed as attempting to close the stable door after the horse has bolted. Though such instruments may have been desirable in the past, it is very unlikely that banks will take undue risks in their lending for the foreseeable future. Rather, the immediate policy focus should be on how to stimulate lending by ensuring a healthy financial sector.

Of course, macro-prudential instruments are intended to be symmetrical in nature, but at the moment banks may be reluctant to lend given their expectation that capital requirements will be stricter when the upturn finally comes. Hence, the costs and benefits of placing restrictions on bank lending will be least favourable in the

aftermath of a financial crisis. The current problem is that banks are risk averse. I entirely agree with the sentiments of the Governor, Mervyn King expressed in his speech last week that we need to take our time in deciding what measures to take.<sup>13</sup> If we close, bolt and lock the door shut we may find it harder to get the horse back into the stable. Are we in danger of constructing a new Maginot line to fight the last battle but not the next one?

How might these macro-prudential instruments work? One example would be to link the required level of reserves held by commercial banks to macroeconomic variables such as the GDP growth rate of the economy. This would restrict bank lending in the good times so that banks had excess reserves during a downturn.

Such policies would have a clear interaction with more traditional instruments such as the Bank Rate. In an inflation targeting regime central banks adjust the policy rate to meet the inflation target in the medium term. The transmission of this process occurs through the price of credit within money markets. So macro-prudential tools designed to control the quantity of bank lending would interact, and potentially conflict with inflation targeting regimes implemented through changes in the price of lending.

Consider the hypothetical example of a large expansion of the supply capacity of the economy due to a shift outwards in the technological frontier. If macro-prudential instruments were enforced, perhaps through an automatic link with the growth rate of GDP, bank lending would be constrained in such a scenario. At the same time the MPC might struggle to push up falling CPI inflation by reducing the Bank Rate. In this case the macro-prudential and inflation targeting regimes would be in conflict. Central bankers might have one foot on the accelerator, whilst simultaneously applying the hand brake.

Indeed, the global economy experienced such a supply shock during the first half of this decade as the growth of exports from low-cost economies pushed down on consumer prices. Many central bankers expressed concern about the risks of deflation around this time. But falling consumer prices, driven by a positive supply shock to the

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<sup>13</sup> King, M. 'Finance: A Return from Risk', Speech to the Worshipful Company of International Bankers at Mansion House in London on 17 March 2009.

global economy, the integration of China into global trade, would have had very different implications to debt deflation driven by bursting house and asset price bubbles.

Perhaps less expansionary monetary policies in the first half of the decade might have led to falling consumer prices, but without large contractions in output and employment, and large increases in debt, house and asset prices. If pursued, such policies might even have led to more balanced global growth as the real appreciation of China and emerging Asian economies would have been more pronounced. In considering these arguments we should remember that in the medium term there can be little trade off between inflation and growth.

Of course, the potential use of macro-prudential tools poses bigger questions about the interaction of monetary policy and financial stability. If we are to adopt the use of macro-prudential tools we must believe there is some difference in the transmission mechanism to the economy from measures that affect the price or quantity of bank lending? If not, then central banks need only assess the overall stance of monetary conditions. It could be that there is no one target or tool that is optimal for monetary policymakers to consider at all times. Rather, a more nuanced approach may be necessary to achieve balanced growth, stable inflation and at the same time avoid financial crises.

#### *Should we lean against the wind?*

It may be that there is little difference in the transmission mechanism between controls on the price and quantity of bank lending (at least in normal times when Bank Rate is not close to the nominal zero bound). And it will always be very difficult for central banks to influence investors' herd-like perceptions of risk. As these perceptions of risk change over time it is likely that asset price bubbles will continue to occur, despite constraints on bank lending.

So should central banks '*lean against the wind*' when asset prices appear to rise unsustainably? I agree with my colleague Sir John Gieve that central banks may need

to consider such a course.<sup>14</sup> In doing so, central banks will need to take action when asset prices appear to rise unsustainably over a prolonged period. At the same time, it is probably unrealistic to expect equity prices to be included in some explicit target, given their volatility.

However, I do agree that house prices should be included in the target the MPC considers. House prices are the most important asset for many households as it is the price of their home that they secure their mortgage lending against. As house prices rose, UK households were able to secure ever more favourable mortgages as their loan-to-value (LTV) ratios fell. Now that house prices are falling, banks are unwilling to lend so favourably given the risk of losses from those households close to, or already in, negative equity.

I believe there is a broad consensus that it would be better to include house prices within the CPI index. The main difficulty appears to be agreeing a pan-European measure of housing costs that can be consistently applied across the EU. However, this does not preclude changing the target back to RPIX, the measure of inflation the MPC had targeted and which includes a measure of housing costs.

So what does all this mean for the future of monetary policy? I certainly haven't provided all the answers but at least I've posed some questions, and come to a few modest conclusions. First, I believe central banks require additional tools such as macro-prudential instruments. Essentially this implies a more nuanced and less target driven approach to monetary policy. Second, central bankers will have to consider house and asset prices, rather than measures of consumer price inflation alone, and judge whether current levels are sustainable. Third, central bankers need to recognise that monetary policy cannot affect growth in the medium term. Stable growth in lending and money supply, however hard they are to measure, are our ultimate goal.

## **5. THE CURRENT OUTLOOK FOR MONETARY POLICY**

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<sup>14</sup> Gieve, Sir John. 'Seven Lessons from The Last Three Years', Speech at the London School of Economics, February 19<sup>th</sup> 2009.



The immediate macroeconomic policy questions concern stimulating lending in the UK economy within dysfunctional money markets. The Bank Rate has now been cut to close to the zero nominal bound, the MPC has voted for asset purchases of £75bn to help provide liquidity to money markets and the government has announced a range of measures to support the financial system.

In short, a large part of our financial infrastructure remains dysfunctional because of the difficulties in valuing complex assets and derivatives, for which there is little investor appetite as a re-appraisal of risk takes place within the global economy. That these assets remain on banks' balance sheets has increased uncertainty about our banks' capital adequacy and remains a barrier to private investment.

The most important measure to address this problem is the Asset Protection Scheme. This scheme is designed to protect banks from future losses from their holdings of assets that are currently difficult to price due to illiquid markets. At the same time those banks that participate in the scheme will commit to increase their lending to UK firms and households. I certainly hope these measures will work and allow the UK economy to gradually recover. However, the risks of a protracted recession are clearly evident. It may take longer than expected for policy initiatives to restore more normal lending conditions in financial markets. Additional policy initiatives may be required if conditions continue to deteriorate within the financial sector. A range of solutions have been proposed to solve this problem in other economies. For example, public purchases of 'troubled' assets, the creation of a 'bad bank' to purchase 'troubled' assets from financial institutions and finally outright nationalisation of banks.

A risk to the economic outlook relates to the rising level of unemployment in the economy. As redundancies rise and house prices fall, more British households will face the grim prospect of experiencing both unemployment *and* negative equity in their homes. Forced selling in the housing market could lead to further downward pressure on house prices, pushing more households into negative equity. In this case mortgage arrears and defaults will rise, putting further pressure on the financial sector.

For these reasons I have argued that any fiscal stimulus that is being planned should be concentrated on maintaining employment and sustaining labour demand, perhaps

through expansions of public sector employment where appropriate. I outlined some policy options to deal with the rising level of unemployment in my last speech in Stirling in February.<sup>15</sup> It is particularly important to target the young because long spells of unemployment while young cause permanent scars rather than the temporary blemishes that occur for older workers who already have a foothold in the labour market.

Dis-inflationary pressure within the UK economy is now clearly evident. Though the annual rate may be volatile in the months ahead, CPI inflation has fallen sharply from its peak in September. RPI inflation has now fallen to close to zero. At the same time conditions in the labour market continue to weaken. The claimant count this month increased by a record amount of 138,000. Many firms are reporting wage freezes as economic activity continues to contract, and unemployment and redundancies rise. There is even talk of wage cuts. So an accommodative monetary policy stance is likely for the foreseeable future.

## **6. CONCLUSIONS**

The credit crisis has already been a painful experience. And most of the pain will be felt this year as redundancies and unemployment rise. Going forward the medium term prospects for the UK will remain reliant on ensuring a healthy financial sector.

The intellectual basis for inflation targeting that had existed has been called into question. There is a consensus that central banks require additional tools to address the problems that can occur in financial markets and that inflation targeting was an insufficient policy tool in the past. However, we do not possess a coherent intellectual framework to assess what form such macro-prudential instruments might take, how we would use them, and how they would interact with traditional monetary policy instruments such as the Bank Rate.

We should not be overly ambitious. We cannot and should not expect to abolish the economic cycle. Assessing the appropriate level of risk taking and regulatory

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<sup>15</sup> Blanchflower, D. 'What should be done about rising unemployment in the UK?', Speech at the University of Stirling, February 25<sup>th</sup> 2009.

supervision within our economy will be a very difficult challenge. Given the premise of modern macroeconomic research that financial crises are unlikely we are poorly prepared to make this judgement. No one individual can answer these questions so we need to consider a range of views. And in the midst of the recession we should be wary of the reflex reaction to over regulate, which could be counterproductive in allowing the economy to eventually recover.

These questions pose severe challenges for academic economists which I hope they will rise to answer. However, a new approach within macroeconomic research will be required, grounded in the realities of the data and the world around us rather than as an enterprise in theory. As Larry Summers has said,<sup>16</sup>

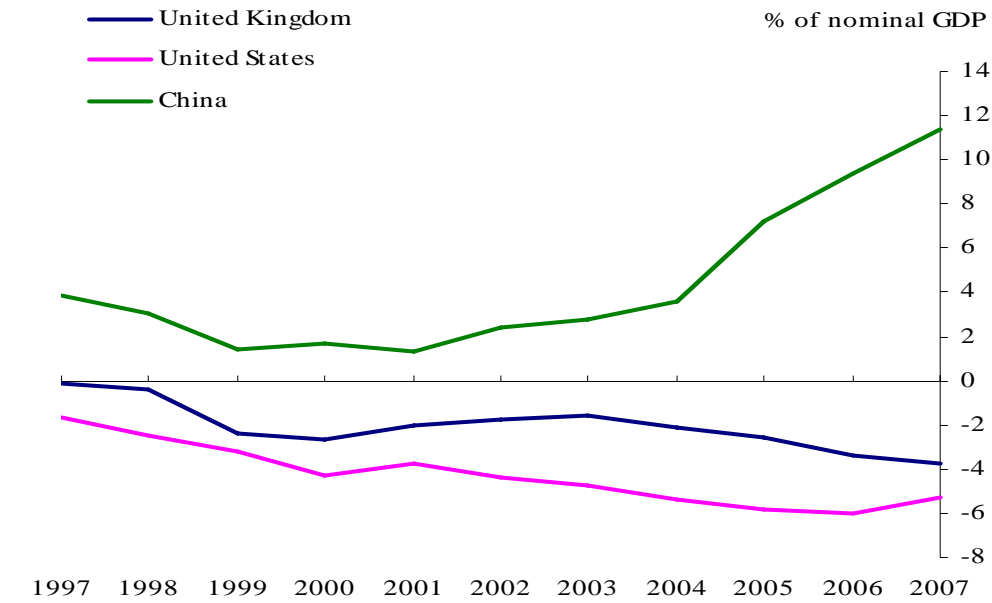
*“progress is unlikely as long as macroeconomists require the armor of a stochastic pseudo-world before doing battle with evidence from the real one.”*

Sadly, the scars from past battles within the academic economics community may be too deep to heal. It may be that a new generation of economists, unimpeded by past dogmas and orthodoxy is required to bring common sense back to macroeconomics. I hope we are intellectually honest enough to move on and accept new ways of thinking and frameworks for economic policy. Monetary policy and financial stability are too important.

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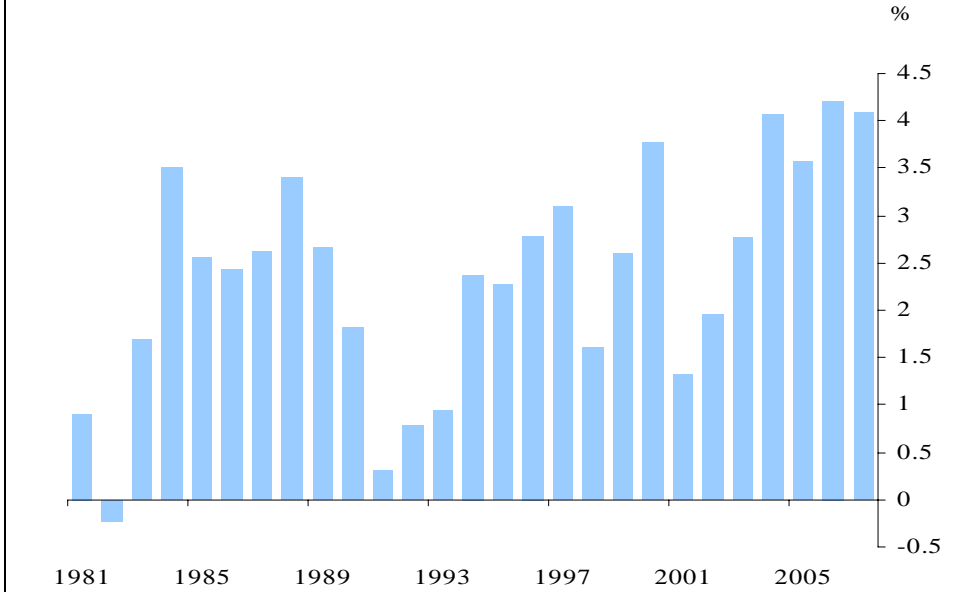
<sup>16</sup> Summers. L.H. (1991), ‘The scientific illusion in empirical macroeconomics’, *Scandinavian Journal of Economics*, 93(2), pp. 129-48.

**Chart 1: Current Account Balances**



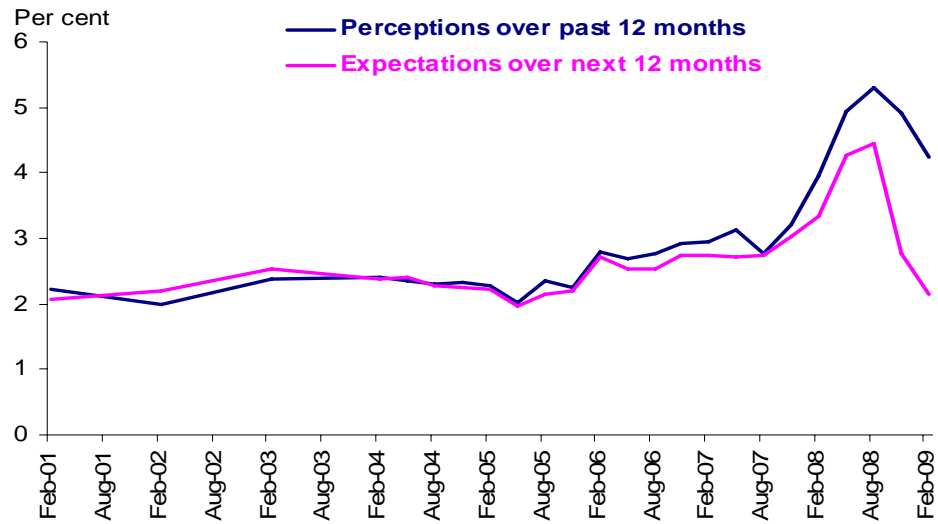
Source: IMF World Economic Outlook, October 2008.

**Chart 2: World Real GDP Per Capita Growth**



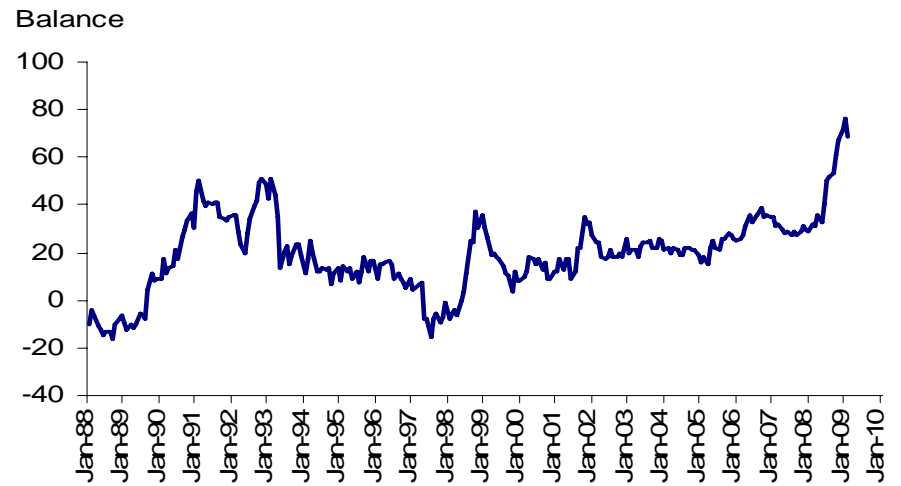
Source: IMF World Economic Outlook, October 2008.

**Chart 3: Inflation expectations vs. perceptions**



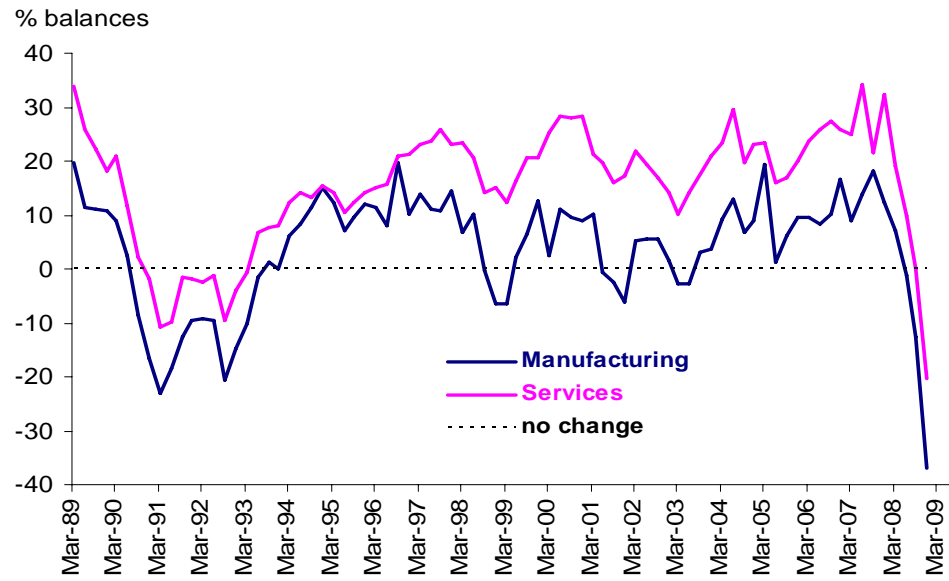
Source: Bank of England/NOP

**Chart 4: GfK: Fear of Unemployment Survey**



Source: GfK

**Chart 5: BCC Firms Employment Intentions**



Source: BCC