BANK OF ENGLAND

Speech

Speech given by

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Introduction

My Lord Mayor, Ladies and Gentlemen.

A year ago when my predecessor Lord King delivered his final Mansion House speech, he noted "clear signs that a recovery in the UK, albeit modest, [was] underway."

That recovery was due in no small part to measures he and his colleagues had initiated including extraordinary monetary stimulus, recapitalisation of the banking system and innovative support for lending.

The task a year ago was to secure that recovery in the face of continued domestic frailties and ongoing international weaknesses. At home, unemployment and underemployment remained elevated, productivity growth was anaemic, and debt levels were high. Abroad, the European crisis had moved only from its acute to its chronic phase and financial markets were demonstrating their fragility during the 'taper tantrum'.

With this backdrop and with real wages around 10% below their pre-crisis levels, it was not surprising that consumer confidence, though improved, remained low. Business confidence was similarly shaken by past shocks and current scepticism about the ongoing strength of demand.

The Bank responded to these challenges.

Forward guidance gave households and businesses confidence that Bank Rate would not be raised at least until jobs, incomes and spending were growing at sustainable rates. Guidance encouraged businesses to hire and spend, and helped keep expected interest rates low, even as the economy recovered strongly.

In parallel, we encouraged banks to continue repairing their balance sheets. Changes to the Bank's liquidity policy further supported lending. The core of the financial system is now on a sound footing and making an increasingly important contribution to the recovery.

We are now faced with the challenge of turning that recovery, which has steadily gained momentum and breadth over the past year, into a durable expansion.

To do so, we need balance.

Its absence can have serious consequences. One has only to look back to 1931 when Britain's economic prospects were strained by high unemployment, a large budget deficit and a deteriorating balance of payments. In the ensuing crisis the government of the day resigned and sterling was forced off the gold standard.

And the Governor? With the uncanny foresight of a central banker, Montagu Norman had already left the scene "to get a bit of rest [in Quebec]", he said, "for I have had a very hard time of it lately and I have not been so well as I would like to be."[1]

However tempting, I will lean on Canada not for restoration but for a nautical analogy to describe how we can address the challenges we now face. Rather than appeal to the stately Duchess of York on which my predecessor sailed, I will look to the trusty canoe – a craft that can navigate the most rapid and treacherous waters…provided its paddlers work in sync.

Those economic currents are flowing swiftly, with the economy expanding at an annualised rate of 4% and jobs growing at a record pace.[2] But there are rapids ahead, with old imbalances persisting and new ones emerging. The economy is still over-levered. The housing market is showing the potential to overheat. And the current account deficit is now at a record level.

Navigating these hazards requires close coordination between all those in the boat; that is, between fiscal, monetary and prudential authorities. Tonight I want to explain the Bank's contribution to delivering a durable expansion characterised by balance in the macroeconomy, the housing market, and the financial sector.

Before doing so, I would like to join the Chancellor in paying tribute to two individuals.

The first is Sir David Lees, who as Chairman of Court has overseen the transformation of the governance and responsibilities of the Bank. David, I am extremely grateful for your support during my first year as Governor.

I'm also enormously grateful for the wise counsel of Charlie Bean during the past year. Always working, Charlie is tonight discharging his duties as President of the Royal Economic Society. Throughout his career, at the Treasury, in academia and at the Bank, Charlie has been a leading thinker and practitioner in the pursuit of macroeconomic balance. Internationally he has inspired countless policymakers, myself included. On behalf of all colleagues past and present, I would like to echo the Chancellor by thanking Charlie for his exceptional period of public service and the enormous contribution he has made to the economic well-being of this country.

Macroeconomic balance

The UK economy is currently unbalanced internally and externally.

[1] As reported in the Montreal Gazette, August 17, 1931. The Financial Times of the same day reported Norman as saying "I feel I want a bit of a rest, because I have had a very hard time lately. I haven't been quite as well as I would like, and I think the trip will do me good".
[2] Bank staff project annualised growth of 4% for the current quarter. That incorporates expected upward revisions to early official estimates.

Internally, there is wasteful spare capacity – an output gap – concentrated in the labour market. The Monetary Policy Committee (MPC) currently estimates this gap to be around 1-1½% of GDP, though we caution against false precision as there are wide confidence bands around this central view.

The MPC's current guidance makes clear that we will set monetary policy to meet the inflation target while using up that spare capacity. This has implications for the timing, pace and degree of Bank Rate increases.

There's already great speculation about the exact timing of the first rate hike and this decision is becoming more balanced.

It could happen sooner than markets currently expect.

But to be clear, the MPC has no pre-set course. The ultimate decision will be data-driven. At this point it is safest to conclude, as the MPC has, that there remains scope for spare capacity to be used up before policy is tightened and that a host of labour market, capacity utilisation and pricing indicators should be watched closely to determine how that slack is evolving.

Growth has been much stronger and unemployment has fallen much faster than either we or anyone else expected at last year's Mansion House dinner. So far this has been largely matched by indicators which suggest that there is more supply capacity in the labour market than we had previously thought.

As a result of these two welcome developments, despite rapid jobs growth, pay pressures and unit labour cost growth have remained subdued.[3]

The MPC expects the rate at which slack is being eroded to slow during the second half of this year as output growth eases and productivity growth recovers. But thus far there are few signs of a deceleration in output growth. And a challenge in deciding when to begin normalising policy is that actual output can be observed but potential supply cannot. That is why the MPC is monitoring a broad range of indicators including coincident ones such as the behaviour of wages and prices.

Of course navigating the upcoming bend in the river isn't the end of the journey.

The MPC has rightly stressed that the timing of the first Bank Rate increase is less important than the path thereafter – that is, the degree and pace of increases after they start. In particular, we expect that eventual increases in Bank Rate will be gradual and limited. That is because the economy will face the ongoing challenges of public and private balance sheet repair, a 10% appreciation of sterling over the past year or so,

[3] In May 2013, the MPC projected annual growth of 1.7% for 2014Q1, only half of the rate at which it now estimates the economy to have grown over that period. Meanwhile the 2014Q1 outturn for unemployment, at 6.8%, was some 0.8ppt below the MPC's May 2013 central projection. Despite these upward surprises to activity, annual earnings growth in 2014Q1 was 0.5ppt weaker than expected in May last year. That contributed to annual unit wage costs growth around 1ppt below the MPC's May 2013 central projection.

and muted growth in our main export markets. In addition, in the medium term, higher capital, liquidity and other prudential requirements can be expected to lead to higher spreads between borrowing rates and risk-free rates than before the crisis.

Moreover, a highly indebted private sector is particularly sensitive to interest rates.[4]

Caution over the path of rate increases once they begin is also needed because we start at a point from which interest rates cannot easily be reduced. The effects of an excessive or an excessively rapid tightening of monetary policy could prove damaging and difficult to undo.

Perhaps for these reasons, financial markets expect Bank Rate to rise to only 2¼% over the next three years and, on that basis, the MPC expects the economy to move towards internal balance – almost closing the output gap – in the same period.

Just achieving internal balance will not be enough to guarantee a durable expansion. It matters how we do so. Excessive reliance on consumption or non-tradable sectors, such as housing, all financed by borrowing abroad at an overvalued exchange rate would prove only temporarily satisfying.

The UK's current account deficit is at a record level. The perennial trade deficit has been reinforced by the fact that the UK is growing much faster than its main trading partners. More recently the sharp fall in the returns we earn on our investments abroad has led to a negative 3% swing in our net investment income.

This is not an immediate cause for alarm. As the world and particularly Europe recovers, demand for our products and returns on our investments should increase. More competitiveness gains from the past depreciation may yet be realised, and in any event, unlike for much of Montagu Norman's time, our exchange rate will remain flexible.

Nonetheless, sustained borrowing from abroad to consume at home is hardly a recipe for a balanced and sustainable expansion. Borrowing to invest, improve productivity, competitiveness and incomes is.

Amidst much commentary about an unbalanced recovery, it should not be forgotten that business investment has accounted for more than a quarter of GDP growth over the past six months. The MPC's forecasts rely on continued rapid growth of business investment over the next few years, leading to a revival in productivity and real wages, which in turn will allow consumption to grow without an unsustainable decline in household savings.

[4] Private non-financial sector debt is 163% of GDP. Around two thirds of bank loans to individuals and more than half of loans to businesses are at variable interest rates.

Creating the right conditions for investment is thus essential. In a world of corporate caution this will likely require interest rates consistent with our guidance.

The Bank is well aware that such a monetary stance could encourage other risks to develop.

For instance, there is evidence of growing vulnerabilities in financial markets. Across asset classes, implied volatilities are well below their long-term averages. Spreads in high yield and peripheral bond markets have collapsed. And covenant-light loans are the new normal. While the banking system is much more robust to spikes in volatility, end investors may not have fully absorbed the extent to which financial reforms will distribute shocks across the financial system.

This may be a case of still waters running deep – often the most dangerous time on the river.

That is why an essential counterpart to our monetary stance is macroprudential vigilance and activism. Nowhere is the need for that more acute than in the housing market.

Balance in Housing

Across the country, house prices have risen by around 10% over the past year, approaching their early 2007 levels. Price inflation has broadened and accelerated across regions. Expectations that prices will continue to rise are now most marked outside London.

There have been some signs of a slowdown in activity, with mortgage approvals falling back to their mid-2013 levels. The Bank is watching closely to determine the extent to which this reflects an underlying slowing of housing demand. However, some of this likely stems from lenders adjusting to the Financial Conduct Authority's (FCA) tough new Mortgage Market Review underwriting requirements. More worryingly, surveys suggest some slowing could reflect would-be sellers holding back properties from the market in anticipation of higher future prices – an early sign of extrapolative price expectations.

The underlying dynamic of the housing market reflects a chronic shortage of housing supply, which the Bank of England can't tackle directly.[5] Since we are not able to build a single house, I welcome the Chancellor's announcement tonight of measures to increase housing supply.

To be clear, the Bank does <u>not</u> target asset price inflation in general or house prices in particular.

It is indebtedness that concerns us.

[5] Ten years ago, former MPC member Kate Barker estimated that construction of around 260,000 homes a year would be necessary to contain real house price growth at 1 per cent per annum (Barker, 2004). Far fewer have in fact been built in the years since – just 110,000 in 2013. Because housing demand tends to rise more than one-for-one with income, supply constraints are likely to put increasing pressure on prices in a now rapidly-growing economy.

This is partly because over-extended borrowers could threaten the resilience of the core of the financial system since credit to households represents the lion's share of UK banks' domestic lending.

It is also because rapid growth in or high levels of mortgage debt can affect the stability of the economy as a whole.

An economic expansion is more precarious if there are a large proportion of heavily indebted households. History shows that the British people do everything they can to pay their mortgages. That means cutting back deeply on other expenditures when the unexpected happens, potentially slowing the economy sharply. That's why recessions that follow rapid credit growth tend to be deeper and longer lasting.

It is for these reasons that the Bank of England's Financial Policy Committee (FPC) is mandated to address systemic risks arising from unsustainable levels of debt, leverage or credit growth.

In this regard, the UK starts from a vulnerable position with household debt at 140% of disposable income.[6] There are some signs that underwriting standards are becoming more lax, with the proportion of new mortgages at high loan-to-income ratios now at an all-time high.[7] The increase in house prices in the past year means we can expect the proportion of high loan-to-income mortgages to grow further in the coming year even if the housing market begins to slow. This is concerning because a durable expansion requires mortgages to be serviceable over their lifetime not just when interest rates are at record lows.

The vulnerabilities associated with debt build up over longer periods than the ups and downs with which monetary policy is usually concerned. In that sense, the credit and business cycles are distinct. Using monetary policy now to target indebtedness would risk undershooting the inflation target and damaging growth. For all of these reasons, monetary policy is the last line of defence against financial instability.

Raising interest rates today would be the wrong response to this potential vulnerability tomorrow.

Fortunately, we are not up the proverbial creek without a paddle. We have many of them which we can use to steer towards two objectives.

The first is to ensure that the banking system is resilient. To that end, the Bank is conducting a stress test to assess how well major banks and building societies can withstand a sharp housing market correction during a prolonged and painful recession. The results and any consequences that flow from them will be announced later this year.

[6] That is high relative to other advanced economies. Household debt stands at between 105% and 115% of disposable income across the Euro-area, US and Japan (IMF, 2014).
[7] By latest estimates, around 40% of new mortgages were at LTIs of at least 3.5x. 25% at were at LTIs of at least 4x. 10% were at LTIs of at least 4.5x.

The second objective is to reduce the risk of excessive indebtedness itself by taking out insurance. Given recent experience, few can now believe that the right policy is to wait to mop up the consequences of debt-driven busts after they crystallise. That is even more obvious when Bank Rate is at its effective lower bound.

In other words, when you hear the thunder of the falls, it is wise to get off the river.

Measures to take out insurance can be graduated and proportionate if action is taken sufficiently early. We can limit risks tomorrow by acting against a loosening in underwriting standards in new mortgage lending today.

The value of acting early is reinforced by uncertainty around the precise impact of macroprudential tools. While these have proven effective in other countries, they are still relatively novel here.[8] By acting, assessing, and if necessary re-calibrating, we are more likely to strike the right balance to support durable growth over the medium term.

That's why authorities have already moved. Last autumn we took our foot off the accelerator by removing capital relief for banks on new mortgages and, with the Treasury, by re-focussing the Funding for Lending Scheme away from mortgages towards business lending. Those steps were followed by the implementation in April of the Mortgage Market Review to reinforce banks' underwriting standards and the stress test to underpin their capital discipline.

The FPC has a wide range of other tools if further action is justified. We can direct lenders to raise capital held against mortgages or against all credit. Thanks to the FCA, we are now able to recommend a tougher interest rate stress to which new borrowers are subjected when banks assess affordability. We can also make prudential recommendations about the share of high loan to income, loan to value and long tenor mortgages in banks' and building societies' new lending.

In this regard, I applaud the Chancellor's intention to grant the FPC additional directive powers in relation to these aspects of mortgage portfolio composition.

I also welcome the Chancellor's commitment to adjust the Help to Buy Mortgage Guarantee Scheme to comply in full with any FPC actions.

[8] Lim et al (2011) use data from 49 countries from 2000-10 to examine the efficacy of various macroprudential measures, including loan-to-value and debt-to-income caps, on mitigating systemic risk. They find that caps on loan-to-value ratios, caps on debt-to-income ratios, ceilings on credit or credit growth, reserve requirements, countercyclical capital requirements and time-varying/dynamic provisioning help to dampen pro-cyclicality. See also Dell'Ariccia et al (2012).

When we meet later this month, the FPC will weigh carefully recent and prospective changes in activity, prices and credit as well as the merits of graduated and proportionate actions to mitigate the potential vulnerabilities arising from what is the greatest risk to the domestic economy.

Balance in financial markets

The housing market is not the only market at risk of losing balance.

Confidence in some core financial markets has been buffeted by revelations of manipulation of interest rate, FX and commodity benchmarks. There have been too many such episodes to think each is an aberration.

We are working to restore balance through reforms based on the firm belief that the City's strength is founded on markets. To restore the primacy of true markets, authorities are already seeking to:

- End too big to fail. I thank many of you who are engaged with the Bank and the Treasury to help make this the year we complete the job.
- Align risk and reward by developing a new remuneration code. This is not about the societal question of the level of pay, but about the prudential question of its structure. To properly align risk and reward, the Prudential Regulation Authority will be prescribing deferral of variable remuneration, the ability to reduce deferred bonuses when subsequent performance reveals them to be undeserved, and the ability to claw back bonuses after payment.

But as the Chancellor stressed tonight, we must do more.

Recent events have shown the necessity of measures to ensure the fairness and effectiveness of core markets.

That is why I welcome wholeheartedly the Fair and Effective Markets Review announced tonight by the Chancellor, and to be led by the Bank's new Deputy Governor, Minouche Shafik. Through that Review, we will build true markets:

- Markets that are open and transparent;
- Markets where access extends beyond a privileged few;
- Markets where all who wish to trade have common information and commonly accessible prices; and
- Markets where the informational integrity of key benchmarks is beyond question.

Some of this will require changes to the way markets work, including changes to how benchmarks are calculated and the implementation of reforms currently underway to create greater pre- and post-trade transparency of standardised derivatives.

Some can be delivered, as the Chancellor announced, by bringing more activities within the scope of regulation.

And some may require new codes of conduct. Specific codes for professionals in markets will complement broader efforts to raise standards in banking by the new Banking Standards Review Council. For those in markets we need a simple approach that recognises a fundamental principle of the City: namely that true markets are the source of dynamism, prosperity and progress.

Seeking to manipulate, game or profit from unfair access transgresses that principle. It weakens the effectiveness of markets for all. It holds back prosperity. It should thus have clear consequences, including professional ostracism.

We must work together to ensure that everyone on every trading floor understands that dealing in a market means serving the needs of clients, investors and customers fairly and effectively. I am delighted that one of the City's most experienced professionals and proven leaders, Elizabeth Corley, has agreed to chair a panel of market practitioners that will inform the Review.

Now, recognising the centrality of markets doesn't mean the Bank has a naïve faith that all markets always function smoothly. The City's markets are not those of a textbook. We all know that real markets can seize up in crises of confidence, threatening financial stability and the wider economy.

Just as there will be times when central banks must backstop the banking system, there are also times when they should backstop core markets in a way that supports their contribution to the real economy but doesn't encourage excessive risk taking.

That need was behind the recent transformation of the Bank of England's sterling market framework for banks, and it is why I can announce that, in the coming year, the Bank will widen access to our facilities to include the largest broker-dealers regulated in the UK and to those central counterparties authorised to operate in UK markets. We will also look into whether we should further develop our capacity to lend in currencies other than sterling.

Conclusion

As tonight's announcements demonstrate, promoting a durable and balanced expansion will sometimes require coordination between the Bank, the Treasury, other public authorities and the private sector.

The Bank will also have to act on its own by using all of its tools in as complementary a fashion as possible. The FPC is considering using macroprudential tools to insure against potential vulnerabilities associated with the housing market. Doing so could reduce the need for monetary policy to be diverted to address a sector-specific risk.

However, macroprudential policy is not a substitute for monetary policy. If it is used for insurance it won't necessarily affect the path of interest rate increases. The need for internal balance – to use up wasteful spare capacity while achieving the inflation target – will likely require gradual and limited interest rate increases as the expansion progresses. The start of that journey is coming nearer.

Unlike a canoe trip, the quest for economic balance never ends. With economies and markets always moving between equilibria, it is the journey that matters. By working together we can make that journey as pleasant and as prosperous as possible.

The need to work together extends beyond policymakers to all in the City. So I am delighted to take up co-presidency of Heart of the City with you, Lord Mayor. This umbrella group for City charities, co-founded by Eddie George fourteen years ago, is a great example of how cooperation and social responsibility can be at the heart of business, building the social capital necessary for vibrant and inclusive capitalism.

Fiona, you are to be commended for the energy and enthusiasm you have brought to your role – as well as the excellent hospitality you have provided tonight.   So let me invite everyone here to rise and join me in a toast of good health and prosperity to "The Lord Mayor and the Lord Mayor's Consort", Fiona and Nicholas Woolf.

References

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