BANK OF ENGLAND

Speech

Speech given by
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My Lord Mayor, Ladies and Gentlemen:

Five years ago, at this same dinner and just before the crisis began, I quoted a banker who had said to me, "I cannot recall a time when credit was more easily available". Today, the sentiment is exactly the opposite. Over those five years, the authorities around the industrialised world have thrown everything bar the kitchen sink at the problem – record low interest rates, unprecedented operations to flood financial markets with liquidity, fiscal forbearance which allowed budget deficits to reach record levels, and a raft of reforms to the structure and regulation of banking. Yet the calls for more and bolder action continue. So tonight I want to reflect on the challenges posed by a banking system that has not yet returned to full health and vigour and on the case for further action to stimulate our economy.

Cast your mind back two years – to the first weekend of May 2010. The world economy was recovering from a deep recession. Financial markets were focussed on the fiscal strategy of an incoming government in Britain, and on the decisions taken at the first of what turned out to be frequent crisis meetings in Brussels to deal with the problems of Greece. At that point, the euro area was confident that its problems would be contained to Greece.

Here in the United Kingdom, the big picture was, and remains, the need to generate a recovery while rebalancing our economy, supported by a loose monetary policy and a large depreciation of sterling, on the one hand, and a gradual but steady reduction in the structural budget deficit, on the other. Two years ago, a gradual recovery was in prospect, with business investment and net trade expanding to offset lower spending by households and government.

Since then, events have taken a different course. Instead of a gradual recovery, output has been broadly flat. That reflects unexpected increases in world energy and commodity prices, leading to an unprecedentedly long and severe squeeze on real take-home pay and so weak consumer spending. But it also reflects events in the euro area where the crisis has grown to cast a long shadow over our own recovery, holding back both exports and investment.

The euro-area crisis has had more dramatic moments, in which the ultimate resolution seems to be at hand only to be confounded by subsequent events, than there are episodes in *The Killing*. And the Danes aren't even members of the euro area. Perhaps the sequel will be the provision by the ECB of liquidity as *The Bridge* to the other side of the crisis. No central bank has done more in recent months to flood the system with liquidity than the ECB – one trillion euros injected through two long-term refinancing operations. Those two operations demonstrated that liquidity is not the issue because after a few months we are back to where we were. The problem is one of solvency.

Where there are debtors who cannot afford to repay, there are creditors who will not be repaid. Until losses are recognised, and reflected in balance sheets, the current problems will drag on. An honest recognition of those losses would require a major recapitalisation of the European banking system.

Hope in markets will fade if the wrong diagnosis is made. Fundamentally, a cumulative loss of competitiveness in periphery economies, leading to continuing external deficits and large external debt, is at the root of the euro-area crisis. Until competitiveness can be restored, some way must be found to finance those external deficits.

The crisis in the euro area is affecting our own economy in two ways over and above the direct effect of a dampening in the demand for our exports. The first is via bank funding costs, which have risen since the middle of 2011 as the crisis has intensified. In turn, that has led to higher borrowing rates on mortgages and loans to SMEs. This rise in bank funding costs reflects in part the exposure of our major banks to the periphery economies. Any significant re-denomination of their currencies, or a default on domestic debts, would, both directly and as a result of the consequences for all our economies, put a dent in the capital position of our banks. As a result, investors demand a higher risk premium on loans to banks, pushing up the cost of borrowing for home-owners and businesses.

The other effect of the euro-area crisis has been to create a large black cloud of uncertainty hanging over not only the euro area but our economy too, and indeed the world economy as a whole. Complete uncertainty means that the risks to prospective investments that will yield returns in five or ten years' time are simply impossible to quantify. The black cloud has dampened animal spirits so that businesses and households are battening down the hatches to prepare for the storms ahead. The result is that lower spending leads to lower incomes and a self-reinforcing weaker picture for growth.

The world economy is a much less welcoming environment in which to rebalance the UK economy than two years ago. Not only have the euro-area problems escalated to the point where exit for Greece and other periphery countries is the subject of widespread speculation, but signs of a slowing in China, India, and other previously buoyant emerging economies, such as Brazil, are appearing daily. That slowing does have a silver lining. Energy and other commodity prices have fallen, reinforcing the welcome decline in inflation from 5.2% last September to 3.0%. And as inflation at home falls back, families will see an ease to the squeeze on real take-home pay.

Our recovery and rebalancing may have become more difficult, but they are no less important. Meanwhile the imbalances in the world economy still await resolution. It is an ugly picture. Leaders of the G20 will next week confront formidable challenges. In the United Kingdom, we can and will get through this. But it would be naive to pretend that any of us can know when the storms from overseas will have passed over our shores and the economic skies begin to brighten.

Since our *Inflation Report* only four weeks ago, conditions have deteriorated with weakening business surveys, a downward revision to measured output, and further slowing in economies overseas.

How then should the Bank of England respond to this weaker outlook, with the black cloud of uncertainty and higher bank funding costs brought about by the euro-area crisis? The paralysing effect of uncertainty, with consumers and businesses holding back from commitments to spending, raises the question of whether any conventional macroeconomic measure could do much to stimulate private sector spending. And that has led some to question whether further monetary easing would prove effective and to advocate instead more targeted measures to revive the economy and, in particular, bank lending. But further monetary easing and attempts to lower bank funding costs are not alternatives. We can do both.

Let me start with monetary easing, before turning to the banking sector. The view that further monetary stimulus is, in present conditions, simply "pushing on a string" is, in my view, too pessimistic. The creation of money by the Bank of England has helped offset what would otherwise have been an extremely damaging contraction of the money supply. In the Great Depression, the money supply in the United States fell by around one-third. In Greece, broad money has fallen by over 25% since the end of 2009. The consequences are self-evident. Here at home, thanks to asset purchases by the Bank, broad money has continued to expand, albeit slowly.

There is a widespread misunderstanding that the impact of an expansion of the broad money supply is limited to the first round effects of gilt purchases. But the private sector which sells gilts to us then uses the money thereby created to purchase other assets, including private sector paper. And it is the private sector which decides which assets to purchase in the second, third and all subsequent rounds as the additional money percolates through the economy.

With signs of a deterioration in the outlook, especially in world markets, the case for a further monetary easing is growing. There are those who feel that any further monetary easing should take the form of purchases of private sector assets and not gilts. There are three reasons for treating that idea with caution. First, the Bank has no democratic mandate to put taxpayers' money at risk. Buying risky assets outright has implications for future taxes. That is why the role of central banks is only to lend against risky assets, and to do so with appropriate and often large haircuts. There may be circumstances in which purchases of risky assets would be justified, but the decision as to which assets to buy, and hence which activities and individuals to subsidise, should be taken by the elected government. I rather doubt that Bank independence, essential in my view for monetary policy, would survive the extension of its responsibilities into areas that are the proper domain of government, as recent debates in Parliament suggest. It is strange that those in Parliament and the press who feel the central bank should not talk about fiscal policy are often the most enthusiastic to see the Bank actually do it.

Second, adverse selection greatly increases the risk of credit losses, especially in areas such as small business or mortgage loans where only the originator of the loan can easily understand its quality. It was precisely for this reason that markets in securitised loans of this type closed in 2007. The Bank has been working with others to see if the transparency of such instruments could be improved sufficiently to support greater market activity. But adverse selection remains a deterrent to issuance, and purchases by the public sector would represent a real risk to taxpayers.

And, third, there are better ways to deal with the current problems of credit supply, and it is to these that I now turn.

Measures to ease conditions in the banking sector can complement any further easing in monetary policy. Before the crisis, banks attracted funding at only modest margins over Bank Rate despite high levels of leverage. Some got by on faith and the hope that nothing would go wrong. When it did go wrong, they relied on the charity of taxpayers to survive. It is no longer acceptable for banks to rely on faith, hope and charity. In present circumstances banks face acute challenges of liquidity, funding and capital – and the greatest of these is capital. Difficulties in liquidity and funding are often a reflection of insufficient capital.

The black cloud overhead means that today only very large amounts of capital will attract funding at rates close to those in the past. Banks are at risk of future losses from a further downturn in the economy and exposures to the euro area. That is why the Financial Policy Committee has encouraged banks to find additional capital in order to increase their resilience to such losses, so reducing funding costs and increasing their ability to lend to the real economy.

But today's exceptional circumstances create a case for a temporary bank funding scheme to bridge to calmer times. Such a scheme could prevent an aggregate deleveraging of the banking system that might hold back recovery. Prior to the crisis, risk premia and bank funding costs were unsustainably low. Today, the black cloud of uncertainty has created extreme private sector risk aversion. Should the public sector, therefore, take upon itself some of those risks? Or put another way, should we collectively take on risks in return for lower compensation than we would demand as individuals? In present circumstances, when private sector spending is depressed by extreme uncertainty, there may be a case for a scheme to underwrite risks which the market itself is unwilling to take.

What I can say tonight is that the Bank and the Treasury are working together on a "funding for lending" scheme that would provide funding to banks for an extended period of several years, at rates below current market rates and linked to the performance of banks in sustaining or expanding their lending to the UK non-financial sector during the present period of heightened uncertainty. The Bank would lend, as in its existing facilities, against a much greater value of collateral comprising loans to the real economy to protect taxpayers. But the long term nature of the lending and its pricing mean that the Bank could conduct such an operation only with the approval of the Government, as offered by the Chancellor earlier. So such a scheme would be a joint effort between Bank and Treasury. It would complement the Government's existing schemes, and tackle the high level of funding costs directly. It could, I hope, be in place within a few weeks.

On liquidity, I want to make clear that the Bank, through its discount window and other facilities, will provide banks with whatever liquidity they require given the prospect of turbulence ahead. Last December, the Bank announced the new Extended Collateral Term Repo Facility under which auctions of short-term sterling liquidity can be held at any time. It is now time to activate that scheme, in the words of the Bank's Red Book, "in response to actual or prospective market-wide stress of an exceptional nature" over the coming weeks. The Bank will start holding auctions of sterling liquidity with a maturity of six months, and tomorrow morning the Bank will issue a market notice explaining details of the timing and size of these auctions.

At present, the value of sterling liquid assets has never been higher, and has increased more than ten-fold since the beginning of 2007. But the demand has also increased significantly. It is important that the regulation of liquidity does not increase that demand unnecessarily. Next January, the Basel rules for the Liquidity Coverage Ratio will be agreed by central bank governors and heads of supervision. Much work still needs to be done to ensure that those rules are properly integrated with the regime of liquidity provision by central banks. In current exceptional conditions, where central banks stand ready to provide extraordinary amounts of liquidity, against a wide range of collateral, the need for banks to hold large liquid asset buffers is much diminished, and I hope regulators around the world will take note.

On liquidity, funding and capital, the measures that I have outlined will support the banking sector, and provide it with incentives to increase lending to the real economy.

Finally, a word on regulation. I want to thank Hector Sants for his enormous contribution to the creation of the new Prudential Regulation Authority. I am sure we will see Hector in a new role before long. I would also like to acknowledge the contribution of Angela Knight to British banking. Angela has had to conduct an orchestra which struggled at times to find the right notes, and she drove it *con brio.* Angela, we wish you well and welcome Anthony Browne as your successor.

By the time we meet next year, the Bank of England will, I expect, be in charge of prudential regulation. How will we approach our new responsibility? The crisis has presented us with an opportunity, and we must turn it to our advantage. A new approach to regulation can be a positive change for banks, regulators and taxpayers alike. We intend to change both the culture and style of prudential supervision, and to base it on three key principles:

First, banks must have adequate loss-absorbing capacity. Once the big risks we face now have passed, banks should be allowed to follow the gradual transition to the new Basel III capital requirements. But we also need to recognise that the Basel ratios proved a poor predictor of bank failures. Simple leverage ratios will also play a key part in our assessment of risk.

Second, banks must be able to fail safely. We need a resolution mechanism, both at home and abroad, that permits troubled banks to be reorganised in a way that protects the essential services they provide to the wider economy. That means putting an end to the 'too important to fail' problem. By implementing the proposals of the Independent Banking Commission to restructure our banking system, together with international agreement on resolution, we can achieve this objective.

Third, the spirit of our approach is simple: less focus on unnecessary details and more on the big risks. If banks have adequate capital and low leverage, and are resolvable, we won't need to focus on the details of their day-to-day business. So alongside the much greater engagement on the big risks, we are committed to a root and branch review of all reporting requirements.

I believe that this new approach is one to which everyone can sign up. The Government has been clear about its vision of judgement-led regulation replacing rules-led regulation, and supportive of our wish to achieve it. We intend to do just that.

Five years ago, I posed this audience the question "are we really so much cleverer than the financiers of the past?" We now know the answer to that question. Faith in a market economy, and especially the financial sector, has been dented by the crisis. Many millions of people around the world, including the United Kingdom, have lost their jobs, their businesses and their economic livelihoods. They have justifiable grievances. Let us all work together to show that in a market economy our financial sector can get us out of this mess, that we can navigate our way through the storms threatening our economy, and that we will eventually reach calmer waters.

Lord Mayor, your commitment to the promotion of education and sport for the underprivileged has enhanced the reputation of the City. You chose as the theme of your Appeal, "Fit for the Future". What better theme in an Olympic year. And on behalf of the Bank, can I say how grateful we are to all those who have organised such a splendid ceremony in the Olympic Park on the 27th of July to celebrate the 318th birthday of the Bank of England.

All of us here tonight would like to pay tribute to you Lord Mayor, and to thank both the Lady Mayoress and yourself for the splendid hospitality which you've extended to us all this evening.

So I invite you all to rise and join me in the traditional toast of good health and prosperity to "The Lord Mayor and the Lady Mayoress", David and Liz Wootton.