

# Speech given by

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At the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House

15 June 2011

My Lord Mayor, Mr Chancellor, My Lords, Ladies and Gentlemen:

In recent years, I have set the Mansion House audience a numerical examination. After a pleasant dinner, you will not want to listen to more numbers. A more literary style is appropriate. So my question to you tonight is: which aspect of financial regulation is most deserving of the adjective “tragic”? The answer comes later.

A year ago, we met in the wake of a major sovereign debt crisis in Greece with market nervousness about how far that might spread. Since then, this crisis of external indebtedness has consumed Ireland and now Portugal, as well as Greece. Current account imbalances in the euro area remain large, should concern us all, and will certainly affect us all.

Inexorably, the world economy is adjusting from an unstable disequilibrium to a new equilibrium. Trade imbalances and the associated levels of borrowing proved unsustainable. In more biblical language, failure to tackle the imbalances during the seven years of plenty before 2007 threatens seven lean years thereafter for at least part of the world economy. After a deep-seated banking crisis, now transmuted into a sovereign debt crisis, the need to reduce debt as the world adjusts to a new equilibrium pattern of spending and trade will mean only a gradual recovery in many advanced economies.

Storms from the world economy are likely to stir up the waters through which the UK economy must pass as it too adjusts to a new equilibrium with lower levels of debt and a rebalancing from domestic to external demand. So, my Lord Mayor, there is no shortage of challenges at home. Consumer price inflation has risen to 4½%, and further large rises in utility prices are expected. Output has probably grown by only around 1% or so over the past year. Our banking system faces a need, over time, to build higher levels of capital and find new sources of domestic funding. And regulation must be reformed to respond to the lessons from the crisis.

So I want tonight to comment briefly on **three** themes: monetary policy; macro-prudential policy, and the work of the new Financial Policy Committee at the Bank; and the new approach to banking regulation that will follow the creation of the Prudential Regulation Authority.

The challenge facing monetary policy is obvious – the combination of high consumer price inflation and weak economic growth. Both of these might seem surprising given the large amount of spare capacity in the economy. But the rise in world energy and other commodity prices, and the need to reduce both the external and budget deficits, are squeezing real living standards, pushing up on consumer price inflation and slowing domestic consumption.

The big picture is that the UK economy is going through a major rebalancing of demand and output, from private and public consumption to net exports and business investment, which will take several years to complete. A necessary precondition for that rebalancing was a fall in the real exchange rate. Markets anticipated that need. The nominal effective sterling exchange rate fell by around 25% between the start of the crisis in 2007 and the beginning of 2009, since when it has been broadly stable. The Monetary Policy Committee (MPC) decided to look through the first-round effects of this depreciation on the price level. We could have made a different judgement. We could have raised Bank Rate significantly so that inflation today would be closer to the target. But that would not have prevented the squeeze on living standards arising from higher oil and commodity prices and the measures necessary to reduce our twin deficits. And it would have meant a weaker recovery, or even further falls in output, despite our having experienced the worst downturn in output and spending since the Great Depression. To force nominal wages below their already depressed level would have meant much higher unemployment, a greater erosion of living standards, a marked degree of “undesirable volatility in output” (contrary to our remit), and a risk of inflation falling well below the target in the medium term.

With the freedom granted from having our own currency, the mix of tight fiscal and loose monetary policy is necessary for a rebalancing of the economy. Because of the measures taken to reduce the enormous fiscal deficit here at home, UK sovereign debt funding costs have actually fallen relative to those in Germany since the start of last year. Of course, there can always be differences of judgement about the overall stance of policy, but to change the broad policy mix would make little sense.

Of course, at some point, Bank Rate will need to rise to more normal levels in order to ensure that inflation returns to its 2% target. There has been, as you know, a lively debate among the members of the MPC as to when that point will come. The Committee is watching extremely carefully for any signs of a pickup in domestically generated inflation and it will take action as soon as it is appropriate to do so. So far, subdued rates of increase in average earnings, as well as remarkably – some might say disturbingly – low growth rates of broad money have provided strong signals that inflation will fall back in due course. Banks are still contracting balance sheets and reducing leverage. Spreads between Bank Rate and the interest rates charged to many borrowers remain at unprecedentedly high levels, if indeed borrowers are able to access credit at all. When conditions in the banking sector return to something closer to normal, those spreads will contract and the rate at which that takes place will have an important influence on the speed at which Bank Rate will rise.

Uncertainty inevitably surrounds both the speed of the rebalancing and the impact of today’s consumer price inflation on tomorrow’s domestically generated inflation. So it is simply impossible to know now at what point monetary tightening will begin.

Let me turn now to the Bank’s new Financial Policy Committee (FPC). Its creation is a response to the lesson that monetary policy cannot target stability of both prices and the financial system. Before 2007, the

massive build-up of leverage in the banking system, accompanied by a rapid growth of broad money, led to an expansion of bank balance sheets and a rise in financial fragility, but not inflation. In most industrialised countries, central banks successfully set short-term interest rates to combine steady growth of output with low and stable inflation. But this did not prevent the emergence of unsustainable patterns of demand and unstable financial systems. The FPC aims to deal with that problem by expanding the range of instruments available to the authorities.

The FPC has been hard at work preparing for our first policy meeting tomorrow and our first report will be published on 24 June. The other voting members of the Committee – Adair Turner, Hector Sants,

Michael Cohrs, Don Kohn, Alastair Clark, and my Bank colleagues Paul Tucker, Charlie Bean, Paul Fisher, and Andrew Haldane – make a formidable group with great experience. So what will we be doing? In devising new macro-prudential policy instruments, there is inevitably a degree of learning by doing. The FPC will be both doing and learning. In the wake of such a severe crisis, it is unlikely that excessive credit growth will be the major problem over the next few years. Indeed, the present problem is the reverse – lending is weak. We shall next week make recommendations in areas where in our judgement risks to the resilience of the system are increasing.

In future, when legislation has been enacted, a key part of the FPC’s role will be to issue recommendations and directions to the new regulatory bodies, the Prudential Regulation Authority (PRA) and the

Financial Conduct Authority. The PRA will be part of the Bank, led by our new Deputy Governor,

Hector Sants, and his Deputy, Andrew Bailey. Its objectives and style will differ from those of the FSA. The primary objective of the PRA will be to secure the stability of the UK financial system through its supervision of individual firms. It will not be to protect individual institutions from failure. The new legislation will make clear that the aim of banking regulation will be to ensure that the adverse impact of a failure of a firm on the stability of the system as a whole is minimised. That is why resolution will be at the heart of the new regulatory regime – supervisors should act knowing that resolution powers can and will be deployed in the event of failure.

But adequate resolution procedures are not an alternative to ensuring that banks have sufficient

loss-absorbing capital; rather they are complements. All institutions, especially so-called systemically important financial institutions, must have much higher levels of loss-absorbing capital than before the crisis. That should be in the form of common equity. A crucial part of the new Basel III framework is the recognition that only common equity is ultimately a truly loss-absorbing layer of capital. I am, therefore, concerned that the European Commission will propose a weakening of the Basel standards in that area. Moreover, as the IMF made clear in its recent Article IV Report, it would be misguided for the EU Capital Requirements Directive to prevent member countries from imposing higher capital requirements to protect the interests of domestic taxpayers. Nor should European legislation try to prevent the FPC from varying macro-prudential instruments, including capital ratios and risk weights, as appropriate to national circumstances. The

Basel framework was agreed globally after long and difficult negotiations, at the request of the G20. It sets

minimum not maximum capital requirements, and it envisages the use of countercyclical capital buffers set by national regulators.

Until we find a solution to the “too important to fail” problem, the size of our banking system will remain too large for the UK taxpayer credibly to support in future. London is a natural home for an international banking system, with its language, time zone and, most important of all, a large and successful critical mass of banking and supporting activity. But it cannot be allowed to benefit from an unsustainable dependence on the UK taxpayer. To allow that would be unfair to millions of people, not here tonight, who are now bearing the costs of the financial crisis. It is precisely because we do want to be an international banking centre with assets a multiple of annual UK GDP that we have to find a solution to the “too important to fail” problem. A resilient banking system is in the collective interest of the financial services industry. A robust solution will surely involve a combination of limits on the leverage of individual financial institutions (as envisaged in the Basel III agreement), a resolution framework for allowing individual institutions, no matter how large, to fail, and a change in the structure of banking. I await with interest the final Report from the Independent Commission on Banking.

The style of regulation will also change with the PRA. Process – more reporting, more regulators, more committees – does not lead to a safer banking system. One of the reasons for putting the PRA inside a central bank is to integrate the work of the two institutions more closely. In particular, the market intelligence team at the Bank will work closely with the supervisory body. I believe that we can operate prudential supervision at lower cost than hitherto by reducing the burden of routine data collection and focussing on the major risks to the system. It is vital that we collect and process data only where the supervisors have a need to know. Targeted and focussed regulation, allowing senior supervisors to exercise their judgement, does not require ever-increasing resources. For example, we will reduce the number of people subject to the intensive regulatory interview process before appointment by limiting such interviews to the most senior people. And one of the benefits will, I hope, be to make entry into UK banking easier and so promote competition.

Let me return to the question of which aspect of financial regulation is most deserving of the adjective “tragic”. Is it light touch regulation? No – it is the mistaken belief that by compromising on unduly low capital requirements and inadequate limits on leverage, regulators can compensate by a detailed oversight of every aspect of a bank's activities. It did not take complex reporting to see that the balance sheet of the banking system nearly trebled in five years, or that leverage ratios had reached levels of 50 or more. The obsession with detail was in fact a hindrance to seeing the big picture. And here the FPC has a crucial role to play. By drawing attention to system-wide developments, it can strengthen the hand of the supervisor in dealing with a particular institution. Requiring prudential changes will be easier for that supervisor with the public guidance and support of the FPC.

The granting of new powers to the Bank of England leads naturally and properly to questions about how we should be held accountable. The same challenge arose when the Monetary Policy Committee was set up. We took that head on and we responded. As the Treasury Committee concluded in February, “The Monetary Policy Committee and the Bank of England have repeatedly demonstrated their commitment to transparency. They have seen their engagement with the Treasury Committee as a means of securing accountability”. We will show equal commitment to accountability for the FPC and the PRA, and I look forward to discussing with the Treasury Committee how that might best be achieved. The Bank must be fully accountable to Parliament and the public.

I know that some of you are concerned about the powers of the Governor. But with decisions taken by committees and enhanced accountability, those powers are not what they were. In the 1880s, the Metropolitan Railway wanted to extend the line to Amersham and Chesham. That meant acquiring land from the then Governor’s estate at Chorleywood. The Governor insisted that the company build a private station next to his home to expedite his travel to the City. I regret to say that the present Governor neither has the power to command a private railway station nor would he know where to put it if he did.

My Lord Mayor, you will see that there are indeed many challenges for economic policy. We have to pass through turbulent waters. But we have set the right course. There is an appropriate policy mix to rebalance the UK economy and reach a new equilibrium. With the Financial Policy Committee there is a new body responsible for monitoring and, more importantly, responding to risks to the financial system as a whole.

And a new approach to prudential supervision will be implemented by the Prudential Regulation Authority. If we stick to this course, adjusting the tiller in response to changing conditions, I am confident that we shall return to both price and financial stability.

Lord Mayor, all of us here tonight would like to pay tribute to your charitable work since you became Lord Mayor. Your personal involvement in the regeneration of Spitalfields, and the Lord Mayor’s Appeal in support of disaster relief and to help children and young people in need, are a demonstration of the charitable instincts of the City of London. We salute you for that leadership, and I am sure that everyone here tonight thanks both you and the Lady Mayoress for the splendid hospitality which you have 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”, Michael and Barbara Bear.