INFLATION REPORT PRESS CONFERENCE – 8 AUGUST 2007

OPENING STATEMENT BY MERVYN KING, GOVERNOR OF THE BANK OF ENGLAND

Inflation has fallen back quite sharply, from 3.1% in March to 2.4% in June, as household gas and electricity prices started to decline. It's likely to fall back further over the next few months but could remain volatile in the short run, reflecting the unpredictability of energy prices and the British weather.

Output growth is estimated by the ONS to have been at or above its long-run average rate for six successive quarters. Business surveys have been even more upbeat than official estimates. Activity in the world economy has remained buoyant. And against a background of rapid growth of money and credit, business investment has been strong and consumer spending has remained firm despite only modest growth of real incomes and a higher level of Bank Rate. Nevertheless, there are tentative signs of a slowing of household spending.

In the past few weeks there have been falls in equity prices and credit spreads have widened, especially on riskier debt. We don't know whether these tremors in financial markets signal a more disruptive movement to come, or constitute a gradual release of pressure on spreads that had built up over some time. So it's impossible at this stage to judge how large and how persistent this tightening of credit conditions is likely to be. The Committee will monitor carefully data on both the price and quantity of credit.

Strong demand growth has put pressure on the supply capacity of the economy. The MPC judges that a slowing of the growth rate of total demand will be needed to keep inflation close to the 2% target. And today's projections are indeed for a slowing of demand growth.

The Committee's latest projection for GDP growth is shown in Chart 1 on page 7 of today's *Report.* That projection is based on the assumption that official interest rates move in line with market expectations over the forecast period. On this occasion the Committee has chosen to condition its projections on the average value of asset prices over a five-day rather than a fifteen-day window prior to last week's meeting to take into account significant price movements in the run up to that meeting. In the central projection, growth falls over the forecast period, reflecting a slowing in both consumer spending and business investment. That is a little weaker than in May, but, as then, the risks to growth are judged to be evenly balanced.

There is uncertainty about the path of output over the past year, and the MPC's judgement is that growth may have been stronger, and hence spare capacity less, than suggested by the current official estimates. Chart 5.2, on page 36, shows the central estimate of GDP growth in the recent past implied by the pattern of past revisions to official data and business surveys. It also shows projections for four-quarter growth over the forecast period given by those estimates of past output. Chart 5.2 displays a more noticeable slowing in growth than Chart 1, reflecting a higher starting point.

The Committee's projection for CPI inflation is shown in Chart 2 on page 8 of the *Report*, again on the assumption that official interest rates follow market expectations. The central projection is for CPI inflation to fall back to around the target over the next month or so, before settling close to the target for the remainder of the forecast period. Oil prices have risen sharply over the past three months, so in the near term the projection is a little higher than in May. Further out, the projection is a little lower, reflecting the more pronounced slowdown in demand growth.

The Committee judges that there continues to be greater-than-usual uncertainty about the outlook for inflation. Overall, the balance of risks to inflation around the central projection two years or so ahead is, in the Committee's judgement, a little on the upside.

In the medium term, there are risks to inflation in both directions from demand. Activity in the world economy – particularly in Asia and the euro area – may be stronger than in the central projection, posing upside risks to inflation. But downside risks stem from the possibility that consumption and domestic demand overall might slow more quickly than in the central projection, particularly against a background of tightening credit conditions. There is uncertainty too about the labour market where employment growth has been modest and pay growth has been steady. But it's not clear that pay pressures have been sufficiently muted to maintain employment following significant increases in energy and non-wage costs.

The main upside risk to inflation is that, with a limited degree of spare capacity, businesses may be more confident about raising prices than assumed in the central projection. And continued strong growth of the world economy may put further upward pressure on commodity and other import prices.

Given the outlook for inflation, and the balance of risks around the central projection, the Committee judged that leaving interest rates unchanged was the appropriate policy response at last week's meeting. Over the coming months, indicators of consumer spending, business investment and credit growth will show whether demand growth is slowing in line with the central projection. And indicators of pricing and capacity pressures remain particularly important. If they do not fall back, that would be consistent with the upside risks to inflation crystallising. The Committee will monitor developments carefully to judge what action may be required to keep inflation on track to meet the 2% target.

QUESTIONS

EVANS DAVIS, BBC NEWS – FOOD PRICES, FLOODS, FOOT AND MOUTH

We've had a rather odd summer of pestilence and plague with food prices going up, floods and foot and mouth. Can those be dismissed as insignificant in the monetary policy decisions you're making?

MERVYN KING

Well they can't be entirely dismissed but we haven't seen the full effects yet and it's too early to judge how big they will be. Clearly for those affected by the floods it was a disaster for them and an awful experience. But I think the impact on total economic activity in the UK is far from clear. And we've not yet seen any follow through on food prices. That's something that may become clearer in another month or two. The next figure we will get that comes out next week is based on data taken before the floods had their main impact.

Foot and mouth it's far too early to judge how extensive the outbreak will be and how big an impact the restriction on movement of cattle might have on food prices again.

So I think these will be temporary factors, so would not be likely to have a major impact on monetary policy. But of course if they were in the short run to lead to inflation remaining or being much higher than in our short run projection here that might affect inflation expectations, and that would be a concern. But I think it's just far too soon to judge what impact either the recent floods or indeed the current foot and mouth outbreak will have on food prices and on inflation more generally.

ASHLEY SEAGER, GUARDIAN – INTERST RATES AND INFLATION OUTLOOK

Morning Ashley Seagar from the Guardian. Looking at the inflation report at first glance it would appear to be quite a clear signal that rates need to go to 6%. Therefore it seems a little odd perhaps that the Committee didn't move last week. Might that reflect greater than usual disagreement among Committee members or is market turmoil something to do with that, the trouble in the credit markets. I mean it's an obvious question. I know you're not going to tell me how people voted last week or anything, but it just seem a little odd that the apparent prescription in the report perhaps wasn't followed last week by the Committee.

MERVYN KING

Well let me try and sort of help you out of your dilemma. I don't actually accept the premise of your question. This report is not intended to signal anything about interest rates in the future. It's intended to give some guidance to our thinking about the economy and what we think the main risks are.

I don't believe the differences among the Committee are actually large at all at this stage. And certainly they're no bigger than the average of the differences I see in every one of the meetings over the last ten years or so. But what matters here is that in this report we are trying to help you get away from this terrible habit of people getting their rulers out to see precisely where this forecast is going to be in two years time. That is not intended by the Committee to be a signal. If you at the fan chart you get a very clear impression that what we think is likely to happen, with plenty of risks from either side, is that inflation peaked at 3.1% in March and has fallen back as we've seen cuts in gas and electricity prices, broadly to target, broadly to stay around that level but with big risks.

And if you're really interested in the question of what will happen to interest rates, which I take it is what's driving your interest in this, then forget getting out a ruler, thrown your rulers away, be liberated Ashley and start to think. That's what we're trying to help you to do, to think for yourself, by our identifying what to us are the main risks. And what will happen to interests rates will not depend on whether people can get their rulers sufficiently accurate to look at the fan chart. What will happen to interest rates will depend on whether or not the risks that we discuss in this report crystallise or not.

And as I've said, there are risks on both sides. The Committee feels that the balance of risks to the inflation outlook is a little on the upside. We've spelt out the factors that are crucial in that, which is the extent of spare capacity in the economy. That's a judgement both about the growth of demand in the economy, but also about the growth of supply and the interpretation of the recent rises in unemployment. It will depend on pricing intentions and whether firms feel they are operating in a climate where they can raise prices. That of course reflects the growth of money and credit. And it will depend on inflation expectations. And there are risks on both sides to the outlook from demand factors, including one that you mentioned which is whether the tightening in credit conditions will have a more extended impact than we're seeing so far.

JENNIFER RYAN, BLOOMBERG – VOLATILITY IN MARKETS/CREDIT AVAILABILITY

Hello, Jennifer Ryan from Bloomberg News. I wondered if you could elaborate a bit on the extent to which the volatility in financial markets is complicating your forecasts. And also if you could discuss what kinds of concerns you have about the availability of credit going forward, both to businesses for investment purposes and to households?

MERVYN KING

Well clearly one of the important factors that the Committee did discuss at some length at its meeting last week was the events in financial markets, a certain amount of turmoil in financial markets in the two weeks or so leading up to the meeting. And I think there are three key principles to bear in mind that we follow when making our decisions.

The first is that monetary policy is set to meet the inflation target. It's based on a macroeconomic judgement of the outlook for inflation. So that the developments in credit conditions and the tightening of credit conditions, the widening of credit spreads, will matter only in so far as they affect the macro economic outlook.

The second is that interest rates are not a policy instrument for protecting unwise lenders from the consequences of their past decisions. And third, that the Bank as a whole in its financial stability work, not on the Monetary Policy Committee but as a central bank, obviously always monitors all the time and regularly whether or not there are risks to the stability of the financial system as a whole and whether there are any systemic risks posed by problems arising in particular institutions or markets.

Now on those three I think if you ask the fundamental question are we seeing signs of bad loans arising, clearly we are in the US sub-prime mortgage market. But I don't think there's much evidence of major damage to loan performance in other markets. And if you see how the financial markets have responded there's a chart 1.3 on page 12 or 11. Chart 1.3 on page 11; you see what's happened to sterling spreads for corporate bonds. And there has been a small pick up in investment grade but pretty small. A bigger pick up in sub-investment grade, but still those spreads are well below the levels that we've been used to for most of the past six or seven years. So I don't think there's any real evidence here of a fundamental challenge to the macroeconomic outlook.

In terms of financial institutions becoming exposed, I think many central banks, I've said this, others have said it, have been concerned about the compression of risk premia and credit spreads over some period now. And no doubt the expansion of liquidity around the world led from low nominal interest rates has been responsible in part for an increase in liquidity, which through a search for yield has led to surprisingly narrow credit spreads. To the extent that these are starting to widen, I think that's a welcome development as a more realistic appraisal of risks is being seen. And that's something that we should welcome. In terms of what I said in the opening statement of course we cannot be sure, no one can be sure at this stage whether what we're seeing so far foreshadows a more disruptive movement in financial markets or whether it's the sign of a gradual easing of pressure that allows credit spreads to return to more normal and sensible levels. That remains to be seen. I don't pretend to be able to know what will happen but we'll be ready to respond to it.

So we're certainly not going to – the second issue, we are certainly not going to protect people from unwise lending decisions that they've made before. But thirdly we do monitor very carefully what's happening in financial markets. We do that in conjunction with the Treasury and the FSA to see if and when there are threats to the financial system as a whole. So far what we have seen is not a threat to the financial system, either in the United States or Germany where they had a failure, let alone in the United Kingdom. It is not an international financial crisis, it's developments in spreads, which reflect I think a more realistic pricing of risk and that's to be welcome.

It was considered by the Committee last week, it entered into people's judgements and may well have been a factor influencing the votes of the Committee or some people. That remains to be seen. I think that the position last week was that we'd seen these developments over only a couple of weeks, we couldn't be sure how they'll evolve, time will tell.

ED CONWAY, TELEGRAPH – DIFFERENCES OF VIEW

Ed Conway from the Telegraph. I just wanted to ask because the Inflation Report is clearly a collaborative process and you've said in the past there have often been differences between different members of the Committee over the outlook for inflation, I just wondered if you could elaborate on what those were this time and whether the differences were more marked than in previous Inflation Reports?

MERVYN KING

Well I'll answer the second, which is that the differences are not more marked than we've seen in previous occasions over the last decade. These are small differences in judgement. They sometimes obviously show up in differences of votes on interest rates. I'm going to make no comment at all about the votes at the meeting last week. All that will be revealed in the minutes next week.

But I don't think you should run away with the idea that the differences are large on this occasion relative to the past. And in terms of the outlook what the Inflation Report provides which is most valuable in my view is a shared common analysis of what are the factors that will as I said to Ashley before determine what drives interest rates. I think it's a foolish game to sit down now and say oh gosh we now know that interest rates are going to go to a particular level or not. I don’t know, the Committee doesn't know and therefore I submit that actually no one out there, either you or in the financial markets knows either.

What is important is that we know what are the factors that will be very important in driving our decisions. And it depends on whether the risks that we've identified crystallise or not. And we've tried to move to a clearer way of explaining what those risks are and what sort of data we'll look at to decide whether we think the risks are crystallising in either direction.

ED CONWAY, TELEGRAPH

I wasn't asking about the differences in the meeting, I was asking about the differences in the Report itself?

MERVYN KING

Yes and as I say these are no larger than we're seeing on average.

ED CONWAY, TELEGRAPH

But could you elaborate on what those differences of opinion are when it comes to compiling the report itself?

MERVYN KING

Well there are differences of judgement about almost everything I think. The key one would be that there are bound to be nuance differences in judgements about the amount of spare capacity in the economy that we start with. There are likely to be nuance differences in the speed at which demand is likely to slow over the coming year or so. There are going to be nuance differences about the extent to which prices are likely to rise given the surveys of pricing intentions, or indeed about the path of inflation expectations. These are judgements that I would expect there to be differences of view on. I think if any two of you from this room were to go out and have a coffee after the meeting wouldn't you be amazed if you had exactly the same view on every single detail that went into a judgement about the future for the economy?

Of course there are going to be differences of nuance. But these are not particularly large. And the analysis in this report is shared by the Committee as a whole. It is the balance of opinion on the Committee that's represented here.

ERIC ALBERT, LA TRIBUNE – HOUSEHOLD DEBT

Eric Albert from La Tribune. I basically asked the same question six months ago, but still how worried are you about household debts? There has been quite a rise in - well do you still think that it's more a social problem then a macroeconomic problem? And if yes well how painful is it from a social perspective?

MERVYN KING

Well I think that judgement remains largely intact. We have seen upward revisions to the data on mortgage arrears and repossessions of homes. But the broad characteristic that I described earlier still remains, which is first that the scale of repossessions is markedly below the level that we saw in the late eighties, early nineties, roughly one quarter of the rates that we saw then. The rates of repossessions have been revised up; the rates of repossessions for 2006 have been revised up from 0.15% of loans to 0.19%. You know it's significant but it's not dramatic. It doesn't change the picture that the number of possession orders seems to have flattened off. It doesn't change the picture that this is still very small relative to what happened as I said in the late eighties, early nineties. And doesn't in and of itself at this stage constitute a major macroeconomic threat.

If you look at mortgage arrears we still have the same pattern that the level of arrears last year was actually lower than the year before. That pattern is still there, in the first half of this year compared with the first half of last year. So again mortgage arrears appear to have been relatively flat. Now does this - what's the potential for this to have an impact on the economy as a whole? I think the key argument that the Committee has been using for several years now is that what gave rise to problems in the late eighties and early nineties was partly the scale of debt, but particularly unexpected changes in either incomes through rising unemployment or interest rates through a doubling of interest rates that occurred then. And we're not seeing at present changes of that order of magnitude. We are seeing still a continuing rise in the total debt burden. And that I think is largely driven by this progressive transferring of the housing stock, following a large increase in house prices, from older to younger generation, where the new buyers take out much more mortgage debt than used to apply to the older generation that is selling or transferring the housing down to the younger generation. And that means that the stock of debt is gradually catching up to the higher value of the housing stock.

But this is something, which people know about, this isn't a surprise shock and it may well gradually dampen the growth rate of spending of the generations coming into the housing market. But this isn't going to lead to sharp changes. It's partly what lies behind our view that the rate of consumption spending over the future will not be as fast as it was in the ‘nice’ decade. But it's not likely to lead to a big shock.

What is important about the size of the debt burden however is that if there were to be a different shock from some other source which led to a slowdown in the economy, obviously the stock of debt means that households will be more vulnerable to that downturn in their income. So I think there is that aspect. There's a slightly greater fragility of the outlook because of the high stock of debt, but in and of itself it doesn't imply a sharp slowdown in consumer spending.

And the other aspect that people have talked about a great deal, which is the refinancing of fixed rate mortgages taken out in 2005. You'll see in the report that there is an analysis of the quantitative impact which that might have on total household disposable income. And it's only 0.1 percentage point of disposable income that would be taken up by the higher mortgage payments incurred as the fixed rate runs out and households move onto a higher rate mortgage.

Now, of course, that doesn't necessarily map into its impact on consumer spending, because that reduction in discretionary income is concentrated on a small group of people, namely those who took out mortgages in 2005. But its overall impact is still very small relative to total household incomes.

So that tries to put it into perspective. We're not you know ignoring it. But I think the rise in the debt stock reflects this transfer of housing from older to younger generations. That's not a surprise to anyone. It may affect the pace of consumer spending overall as we go forward over the next decade, but it's not likely to lead to sharp changes over the next year or so.

The stock of debt does make households more vulnerable perhaps to a downturn from some other source. And the problems in the unsecured credit market, which we've talked about at great length, are still there. But credit card growth has now fallen very markedly from over 20% a year to 1 to 2% a year. So there has been a significant adjustment in that part of the debt market.

SAM FLEMING, DAILY MAIL – SAVINGS

Thanks, Sam Fleming from the Daily Mail. I had a question about this saving ratio. We've seen quite a strong decline in the saving ratio recently. I wonder does that imply we're going to have to see a reigning in by consumers of their spending in order for that to adjust? I mean some economists have even talked about this requiring some sort of consumer recession in order for the adjustment to take place. And part of this story has been people becoming more reliant on their housing as a source of saving. Is that a wise thing for people to be doing?

MERVYN KING

Well there are two parts to that. I mean obviously the Committee's central view, as present in today's projects is that there will indeed be a slowing in consumer spending, but nothing on a dramatic scale. I mean the slowing we have of total demand in the economy over the next year from both consumer spending and investment is around a one percentage point reduction in the four quarter growth rate between the middle of this year and the middle of next year. That's a noticeable slowing.

But I think it would be a mistake to try to pin that on one observation of the household saving rate. That reflects the volatility in income, in particular the unearned income, and I think if you're concerned about saving, a better way of thinking about saving is the national saving rate, not the household saving rate, and that's all about the extent the economy needs to rebalance.

And we've talked about that for a very long time. We are seeing signs of a rebalancing, with a slowing of consumer spending. We've still got pretty strong business investment and the surveys are all consistent with fairly strong export growth. So we are seeing some rebalancing in the UK economy and in due course that will help to contribute to a stabilisation and perhaps a rise of the national saving rate.

But I think it's a mistake to focus too much on figures for the household saving rate. They are very volatile reflecting sharp movements in total household income, which very often reflect things like pension contributions by employers rather than take home pay by households.

SAM FLEMING, DAILY MAIL

Just on the housing as a source of saving?

MERVYN KING

Well I mean it would obviously be unwise to rely on it unless you planned to sell the house and move into a smaller one, or one that was less expensive. That's the only point I would make, otherwise it's a perfectly reasonable decision for households to think about. But I'm not going to give advice on that, that's for them to decide. But obviously you can't take the equity out of the house easily unless you reduce your inheritance that you pass onto the next generation through borrowing against the value of your house or sell and move to a smaller one.

STEPHANIE FLANDERS, NEWSNIGHT – FINANCIAL RISKS AND CENTRAL BANK INFLUENCE

Stephanie Flanders from Newsnight. You spoke about assessing global financial conditions and financial conditions here. I guess this is a two part question. Firstly is the greater complexity and international nature of financial instruments and the ways that risk is now being passed across the system making it harder for you to assess financial conditions here, liquidity conditions and indeed any systemic risk that might arise? And the second part would be is the greater complexity of financial markets making you worry that you have less impact on domestic financial conditions than you did in the past?

MERVYN KING

Yes and no, I'm going to need to elaborate. Yes, because I think as I said in the Mansion House speech, a common theme in many financial crises in the past was excessive leverage. And it's not entirely easy to work out precisely how much leverage there in the financial system when the instruments have become so complicated. And the fragility of institutions becomes much more difficult to judge.

But I think against that it is very important to set a very, very key point here, which is that our banking system is much more resilient than in the past. Precisely because many of these risks are no longer on their balance sheets but have been sold off to people willing and probably more able to bear it.

Now some have always had a preference for a banking system in which all the risks are sort of concentrated there. But I think then you create extraordinary risky institutions with highly illiquid assets in the forms of loans to households and medium sized business, matched by highly illiquid liabilities. And that's a very risky system and as I said in the Mansion House speech that's you know ultimately what gave rise to the concept of the need for a lender of last resort, where the central bank was thought to have to be ready to step in at any point to rescue a banking system that was vulnerable to quite small shifts in sentiment.

We don't have a system that is a fragile as that now. The growth of securitisation has reduced that fragility significantly. So that's a very big plus to set aside the difficulty that we face in trying to asses the degree of leverage both because of the complexity of instruments and the wider ownership of those instruments, but also because as you say it's become much more international.

And I think it's quite difficult to imagine a major financial crisis now that would be relevant to us in a systemic sense that wouldn’t have a major international dimension. And that's why both in international meetings but also in collaboration with our colleagues elsewhere we have tried to work together to think about how such a problem would be managed in exactly the same why that the Tripartite Standing Committee here has regularly carried out exercises to make sure that we are well equipped to cooperate and work together to manage any problems that might arise domestically.

On the second part of your question, no I don't think there is any risk to the ability of a central bank ultimately to control inflation. Inflation is a fall in the value of money, and if you produce enough money its price will fall and if you restrict it enough its price will rise. So those people who think that you know international developments and financial institutions are really what are driving the world rather than central banks I think have failed to differentiate between two very important aspects. One is that the real economy, which does move up and down in mysterious ways that I do not pretend to be able to predict at all precisely, what economists call a real business cycle, they will move around, they are influenced by changes in credit conditions as well as savings patterns, the development of China and India in the world economy. All of these, the flow of immigration into the UK, all of these things are effecting our economy in ways that have nothing to do with the central bank. And that we would neither pretend to be able to influence nor would wish to do so. These are the real movements in an economy that change what happens over time.

But when it comes to inflation it surely is the case that we can determine our own inflation rate. Zimbabwe has demonstrated very clearly that if you want to have a high inflation rate boy can you have one. And I could produce that here too if anybody was foolish enough to ask us to do it. And I merely put to you the observation, how many people in this room believe that if we raised interest rates to 50% it wouldn't have much effect on the British economy? Does anyone believe that if we changed interest rates to 50% it would have no noticeable effect on the economy? I think, I can see not a single hand raised to testify to the impotence of central banks here. We can control inflation in the medium term.

Now it's true we do it partly through our influence on, in the short run, the real economy. But ultimately it's to do with the growth of money and credit. So we can have that influence. It isn't easy and these difficult judgements that we come and discuss every quarter, are judgments about timing and the path of short term interest rates. But in the long run we can do it.

But behind all that, this is the absolutely crucial point, behind all that, God did not determine that every economy grow at precisely 2.6% or whatever every single year on a smooth path as long as central banks did nothing. The economy will grow at different rates, which change over time, reflecting all sorts of influences. That's the real economy. All sorts of policies affect that and developments and we cannot and should not be trying to influence that. What we should be trying to do is not injecting additional uncertainty which makes it difficult for people to make long term decisions on investment and on new products, by maintaining a stable outlook for inflation. That's our remit and I don't believe anything that's happened has prevented us from being able to do that.

ANDREW PEAPLE, DOW JONES – ALTERNATIVE GDP CHART

Andrew Peaple from Dow Jones. It seems quite an unusual step to publish a separate graph based on your own estimates of GDP compared to the official data. I just wondered how much difficulty is uncertainty about the ONS's GDP data and other data now presenting for the Committee in its judgement about the economy? Put simply, do you still have confidence in the ONS?

MERVYN KING

I certainly have confidence in the ONS and the fact that we have published our chart - the chart we've published in section five, chart 5.2, is because we don't want to present you with a misleading impression of what we think is happening in the economy. So let me sort of take that in steps. The ONS and the Bank have two very different objectives in life, two very different roles. The ONS's role is to process the data that comes in through the official sources and their official enquires to produce at different points their current estimate of what growth was at different dates. And as more information comes in through tax returns and the annual business enquiry they update their estimates at regular intervals and they're very open about that and very transparent and very clear. They've produced articles about it, which demonstrate that they expect to make revisions at different points. That's fine, that's their job.

Our job is somewhat different. Our job is that today we have to make a judgement about the amount of excess capacity in the economy in order to make decisions today on interest rates. So it will be remiss of us not to look at as wide a range of information as possible. Of course we look at the ONS data, they're very valuable. But it's not the only source of information we have.

We know for example that the ONS, because they say so themselves, will be revising their own estimates in due course. We can look and see whether there are any predictable patterns in those revisions. And we can also look at other business surveys from other sources and see what information they may contain on what is actually happening in the economy now.

In other words we are in the position, it's been described and well known for years that in order to set interest rates you don’t just have to forecast the future you have to forecast the past as well. And the difficulty of that is well illustrated on chart B, page 25, which illustrates an attempt here to show what sort of fan chart for past growth of GDP you would get if you tried to combine together the ONS data that's published so far, with the pattern of revisions that they have made. If you look at table one on page 24 you can see that on average over the last 12 years GDP has been revised up by half a percentage point between the first and the latest estimates. So there has been a pattern of upward revisions. And I think the source for that fan chart is business surveys, the pattern of revisions. And another factor which is relevant here is if you look at the expenditure data the ONS are publishing they are quite a bit stronger at present than the output data.

So either when they come eventually to make a rebalancing they'll revise the expenditure data down or they'll revise the output data up. And what this fan chart shows on page 25 is that the Committee feels that on balance it's likely that these data will be revised up. And as a consequence if that's our judgement as to what's more likely to happen, but there's enormous uncertainty. I mean as you can see from the fan chart in chart B the data could be revised down. That's certainly quite possible. We cannot be sure. There is a lot of uncertainty about where we are today let alone where we'll be in two years time and that's what this fan chart reflects.

But the important point at present, we've said this in words for some time now, we've said this very clearly in words in the May minutes, we had it said at the May Inflation Report, we discussed it in May 2006, that the chart that we normally publish for the past conventionally takes the latest ONS estimates which is usually the first estimate that they make of GDP growth for the two or three observations prior to the forecast starting. And then we show our forecast on the right hand side of that fan chart as you can see in chart one.

The difficulty with doing that is if we think that the numbers to the left hand side in the past don't give an accurate reflection of current growth rates and that's particularly true now where we think - we have done since May when we saw the ONS estimates for Q1. Remember there's no rebalancing exercise in this year's blue book. So some of this may be reflected in the fact that the ONS have not this year been able to do a complete rebalancing because they're modernising the national accounts.

You know we think that the starting point for growth is quite a bit stronger than the latest ONS number. Our forecast does have a slowing. I think you can see that to some extent in chart one, but not to as big an extent as you can see in chart 5.2. And we, particularly given some of the commentary about our forecast that had been made, we wanted to be very transparent in making clear to you and others that we do have in our forecast over the next year a noticeable slowing in total demand growth, led by consumption and business investment. And that was not transparent from chart one in these particular sets of circumstances. It is I think from chart 5.2.

But this is not new, we've said all this in words before. What is new is just the chart, the pictorial representation, because we think it's important to give something that shows it in that chart to avoid any risk of giving a misleading impression in chart one.

Now I'd happily take more questions on that precise point because it is important and I want to make sure everyone understands it. So could I just ask whether there are any questions on that particular aspect?

ANDREW PEAPLE, DOW JONES

Just a quick follow up. Really then when we see ONS data on GDP when it comes out, really we should be thinking that actually it could be higher most of the time if we want to get a picture of the economy that concurs with the picture that you have?

MERVYN KING

There's an enormous range of uncertainty. The sorts of average revisions that they've made over the last decade or so have been to the upside on average. But it's only sort of 0.1 percentage point a quarter. But over a year that aggregates to half a percentage point, which is not a trivial amount. So I don't think that it's that the quarterly projections are way out, estimates are way out. It's just accumulatively there has been in the past a gradual upwards revision. Not always, sometimes there maybe revisions downwards, you have to look at the corroborating evidence. And on this occasion, this particular occasion, given the strength of business surveys, given the strength of the ONS's own estimates of expenditure, which is growing faster than their current estimate of output, and given the past pattern of the revisions, you get the fan chart that you see in chart B.

Now there's no - you know it's a judgement, no more than that. The ONS have produced the data and they do it in stages, very rightly and properly. They take the data that comes in and typically in the past that has on average been revised upwards, though there's no guarantee of it.

What we have to do is to make a judgement. You know if we said we set interest rates solely on the basis of the current ONS estimate and ignored all the other information, the strength of business surveys or the strength of expenditure, I'm quite sure that a year later you'll come back to us and say why on earth did you ignore all this information. So we have to take into account all the information. And that's embodied in the estimate in chart B.

DAVID SMITH, SUNDAY TIMES – GDP PROJECTIONS

David Smith, Sunday Times. Just on that can I just ask you about the status of the projections in chart 5.2. Are they what you expect to be happening at the time or what the ONS will be reporting at the time once you've got over this hump in terms of the higher growth now slowing very sharply?

MERVYN KING

The projections for growth that we make are what we think is the true underlying growth rate, which ultimately we hope is close to what the ONS will finally publish. It's not an estimate of what they will publish quarter by quarter, no.

DAVID SMITH, SUNDAY TIMES

That's why they're quite similar when you go out a couple of years, the growth projections in 5.1 and 5.2?

MERVYN KING

The growth projections in 5.1 and 5.2 are identical. It's just that when you look at the - the quarterly growth projections from now onwards are identical in both charts. So the quarterly growth rate from now on is absolutely identical in both projections. The implied four quarter growth rate is obviously slightly different in the first year of chart 5.2 compared with 5.1, because it's comparing the growth we expect now and the growth rates in the quarters before today.

So the four quarter growth rates are slightly different, the quarterly growth rates are identical in the two projections.

GARY DUNCAN, TIMES – SAVINGS DATA ACCURACY

Gary Duncan from the Times, a related point Governor. There's been a lot of media interest in the figures as part of the national accounts on showing both the savings ratio declining sharply and big drops in disposable income in recent quarters. Does the Bank have similar reservations related to this about the accuracy of those figures? There have also been suggestions that they quite distorted by contributions to pensions funds. How much weight has the Committee places on those figures and how much doubt should we attach to them?

MERVYN KING

Well I said before that I don’t think you should doubt the statistical validity of the estimates of household saving ratios. What you should ask yourself is what they are telling us, that's a question of interpretation. And what they include are contributions to pension funds. So you have to judge whether or not you think that's telling you something about how households are likely to behave or what they've been doing in the recent past.

I think household saving ratios tend to be extremely volatile and may not be telling you very much in terms of short run movements, perhaps in terms of longer run movements. They are of course affected by changes in inflation too. So comparisons with the 70's and 80's are difficult to make. But ultimately the national saving ratio is what matters.

ASHLEY SEAGER, GUARDIAN – NATIONAL ACCOUNTS

Ashley Seagar again from the Guardian. This work that the ONS are doing on upgrading the national accounts and the fact that we're not getting a proper blue book this year, do you think - I mean to what extent may they in future be estimating slightly higher than they did before, you know to sort of make up for the fact that there have been these upward revisions over the last decade? Are they hoping to make changes to bring that more into line with where your estimates may be if you see what I mean?

MERVYN KING

Well I don't think that's the main objective. I mean there are all sorts of improvements are being made and they've taken a time-out on the rebalancing work for the blue book in order to invest in this project for modernisation of the national accounts, which is a big and wide ranging project. I think we should just take into account that there are sources of data which inform the national accounts which are absolutely crucial. Tax returns are one them, annual business enquiry, there is no way that the ONS could get those within a few months of the end of the quarter for which they're publishing an initial estimate.

So I mean we are grateful that they publish an early first estimate, that helps us. But we are very conscious that they cannot possibly have at that stage access to all the information that they will have later on. And we have to recognise that and I think outside commentators have to recognise that too, and I think largely do.

So as I say this in no sense is a reflection on the ONS. It's a reflection on the fact that we are making judgements in real time when inevitably good information takes time to come in. I think everyone who has ever set interest rates would love to be able to set interest rates three years in arrears. Then we'd have a much better feel for what was going on, but sadly that's not the position we're in.

SCHEHERAZADE DANESKHU, FINANCIAL TIMES – HOUSEHOLD SPENDING AND CPI GOODS AND SERVICES INFLATION

Scheherazade Daneskhu, Financial Times. You mentioned that household spending had been holding up quite well, particularly given the falls that we've seen in household disposable income. I mean what's your explanation for that, do you think it's a reflection of sort of the inaccuracy of the earnings data, or do you think it is that people have access to relatively easy credit? And what gives you the confidence then to think that people's resilience won't continue, do you think it will be past interest rate rises feeding through?

And I had a second question on CPI?

MERVYN KING

You'd better hold onto that otherwise I'll forget the first one. Well we said that if you averaged through the quarters consumer spending has been pretty resilient. But actually there are as I said some tentative signs that consumer spending is now slowing. You can see it in the growth rate of retail sales through the second quarter. The second quarter was probably strong for consumer spending relative to Q1 as a whole. It was partly a bounce back from a weak Q1. But through Q1 retail sales were not growing particularly strongly. And you can see some slow down in the data for credit growth and also showing up in the housing market where indicators of activity particularly in the housing market have slowed a little. And I think also our agents' reports from around the country based on our 8000 business contacts also suggest some slowing now in consumer spending.

I don't think this is particularly surprising. We did raise interest rates, this is you know when you'd expect to see the effect coming through. So I don't think there's any news there. And as I said we do expect a slowing of consumer spending over the next year, nothing terribly dramatic, but certainly a noticeable slowing from where we have been.

SCHEHERAZADE DANESKHU, FINANCIAL TIMES

On CPI inflation what I wanted to ask was that the Committee tends to concentrate on headline inflation and questions the utility of looking at core inflation. So I wondered why there has been this recent tendency to decompose the index between goods prices and service prices and how you square that?

MERVYN KING

Well I think looking at inflation overall is the key thing. The reason we decompose it is in order to learn something about the influences of what's happening overseas. I think one of the major factors in the ‘nice’ decade was the improvement in the terms of trade, which were visible to consumers in the form of falling prices of goods on the high street. And that doesn't seem to be happening to the same extent now, it hasn't gone away entirely but prices are not falling to the extent that they were. And that reflects a real change in the terms of trade and that is relevant to our understanding of the cost pressures on businesses and also the underlying growth of real disposable incomes to households.

GABRIEL ROZENBERG, TIMES - GOVERNORSHIP

Gabriel Rozenberg from the Times. Mr Governor, between now and the next Inflation Report we're expecting to hear to the identity of the man or woman who will be sitting in your chair for the next five years. And I know that that's a matter for the Chancellor, but I wondered that if he were to ask you to serve another term whether you could accept?

MERVYN KING

That's entirely a matter for the end of the year and no discussions have taken place.

DAVID SMITH, SUNDAY TIMES – CONSUMER SPENDING GROWTH

David Smith, Sunday Times. It's just a follow up on the question about consumption. You say that there are tentative signs, but perhaps no more than that of a slow down in consumption growth. And that that slowdown it appears is occurring a little later than in previous cycles when interest rates had risen, that the slowdown came through a little earlier. And you've mentioned the pass through effect there. Is there another effect which you touch on in the report on page 13, which is that although household debt payments have gone up by 2 percentage points as a share of post-tax income household interest receipts have gone up by one and a half percent? Could it be that we're getting a greater propensity to consume out of interest received now than in the past? Is there a possible change there occurring or are you still pretty confident that the normal interest rate induced slow down in spending will occur?

MERVYN KING

I don’t think anyone could be pretty confident about the transmission mechanism. Milton Freeman said it all; there are long and variable lags between changes in interest rates and their impact. A key point is that very often in discussions about the impact of rises in interest rates people always focus on the impact of the incomes of those who are indebted on average. And put to one side or ignore the fact that the incomes of those who are creditors are also rising. So that what's going on is very much a distributional shift between two different groups of people.

And that's certainly relevant and you're right to point to that. I don't think we have any evidence that there's been shift in the relative marginal propensities to consume of those two groups, but maybe Charlie knows more about it?

CHARLIE BEAN

Well the one thing I'd like to say at the outset, at the start of your question you asserted that consumer spending had not been slowing as quickly as in previous episodes. And I don't think there's any evidence particularly to suggest that. If you look at chart 2.3 on page 17 you'll see a comparison of consumption growth since we first started increasing Bank Rate back in August 2005 and a couple of previous episodes. Now this particular episode doesn't stand out for being particularly slow to respond, we're actually very early in the process given the normal lags between changing interest rates and their impact on consumption.

What is an issue for the Committee though looking forward is uncertainty about how this will play out? And this connects with the Governor's remarks about the interaction between the marginal propensity of consumers of debtors and creditors. We are in a world where some households have more debt but also other households have a lot more assets. And the impact of changing interest rates in the environment is going to depend on the differences in the marginal propensities to consume of those two groups of households. And that's something where we don't have a lot of very precise information. We can do illustrative estimates based on what information there is out there, but there is a great deal of uncertainty.

DAVID SMITH, SUNDAY TIMES

Just on that point the text says consumption growth showed clear signs of slowing three quarters after the first rate rise. And you're talking today about tentative signs of a slowdown in consumer spending?

CHARLIE BEAN

You mean the previous episode. The thing to remember about the 2004/5 period is there were other things going on. There was a particularly sharp reduction in the rate of growth of household income, which we believe was a primary driver for the relatively sharp slow down in consumer spending. Some of the outside analysis from city commentator's behaves as though the rise in interest rates from end of 2003 to mid 2004 was the only thing that happened, but there were other things also happening. So the difficulty is teasing out what's due to monetary policy, what's due to other factors.

CARLO PIOVANO, THOMPSON FINANCIAL – INFLATION EXPECTATIONS

Carlo Piovano from Thompson Financial. I'm wondering how concerned you are by the fact that inflation expectations have remained high despite the fall in headline inflation rates and previous interest rate increases?

MERVYN KING

Well as I said earlier it is a relevant factor, because if we are to be able to keep inflation close to the target right across the forecast horizon then I would expect some of the increases in inflation expectation measures that we've seen to fall back. And they haven't as yet fallen back. Whether that's some of the household measures in the surveys described in the report or whether it's estimates of break-even inflation rates from financial markets, which have risen pretty steadily over the last year or so.

So you know it's never easy to know precisely how much weight to put on these measures. They're not perfect measures by any means. They have picked up, they haven't yet fallen back and we would expect that they would fall back if we were to be successful in keeping inflation close to the target. So it's one of the factors that enters into our judgement of the risks and we'll be watching it pretty closely.

ARISA YOASHIDA, NIHON KEIZAI – FINANCIAL MARKET DEVELOPMENTS

Arisa Yoashida, Nikkei. The recent pricing of the excessive leverage in the global financial market was triggered by the problem in the US sub-prime mortgage market, which made me wonder what if the Yen carry trade eventually comes to the end and gets unwound? Suppose something surprising like BOJ surprise the market by interest rates, raising the interest rates beyond expectations. To what extent do you think this would affect the global financial market and eventually the macroeconomic situation?

MERVYN KING

Well I think there are two different aspects, a macroeconomic one and then the world financial situation. And I want in a minute to ask Paul to explain how we are monitoring carefully developments in financial markets through our market intelligence function because that's a key part of monitoring what's going on.

For myself I've always been rather dubious of phrases like sort of yen carry trade because in essence this is something very similar to a very long standing and old fashioned form of investment or speculation, which is guessing which way exchange rates will go. Or in this case guessing which way they won't go if there are large interest rate differentials. But it's all to do with a judgement about exchange rates.

The best contribution that central banks can make to ensuring the lack of disruption in international financial markets is to pursue domestic monetary stability in a predictable and sensible way. And of course the challenges which face the international financial system are partly because in the past decade or so some countries have had more difficulties than others in trying to achieve monetary and economic stability. And now because other countries are entering a system by fixing their exchange rates to other exchange rates, and they are a very different kind of player in the game of the regime that evolved for the international financial system after Bretton Woods broke down in the early 1970s. We gradually and painfully evolved over almost 20 years a new international financial regime based on central banks focussing on domestic inflation and allowing the exchange rate to float freely. And that's worked very well for most countries. It is harder to manage that system overall when some countries are playing in a different regime by fixing their exchange rates. And those are the challenges that face the international financial system.

The conclusion of that is that we on the Monetary Policy Committee should just carry on setting interest rates in order to meet our inflation target.

The broader question of financial markets goes back to the questions that came earlier about the significance of the degree of financial instability that we see at present, the events of the last two to three weeks. What this means are things that we pursue very closely through our market intelligence function, which feeds into the tripartite standing arrangements for monitoring financial stability in the UK. And the person who is in charge of all that here is Paul, so tell us how it works Paul.

PAUL TUCKER

Thank you Mr Governor, I mean this goes back to Stephanie's question as well about the complexity of today's markets. And perhaps the first thing to say is in the old world the only data we really received was about the quantity of credit. Whereas today so much more is traded that there are prices for many more things. And what's more the prices are available more quickly than the quantity data ever were in the past. And that is a benefit in terms of following what's going on.

But just as in the past we need to look behind the quantity data and the price data and we do that in a number of ways. One way is in a dialogue with the lenders about credit conditions. And as we've talked about before at this press conference, we're launching a credit conditions survey of the same kind that the Fed do in the senior loan officer survey, and the ECB and I think the Japanese central bank does as well. And the first of those will be published in the autumn. And that's quite a big step forward for us in terms of enriching our dialogue with the banking system. And crucially for the first time we're including non-bank originators of credit in that survey as well. And that goes to Stephanie's question about a more complex world in which more types of financial institution are involved in the credit markets.

But surveys can't be the end of the process either. Again if one goes back to the old world, the Bank's network of contacts in financial markets would largely have been banks and would largely have been in London. And today they certainly include as many banks as they ever did, they certainly include as broad a range of contacts in London, but they go well beyond banks to include CDO managers, hedge funds, more traditional asset managers, absolutely all over the world.

One of the tests that the Governor and I set each other a few years ago was that if anything went wrong we probably wouldn't be able to spot it but we should aim to be able to understand it if and when it happened. And for some years now we've been investing in two things - first of all an understanding, a comprehension of all the complicated instruments and types of financial institution that have developed. And going back to the early part of this decade, there are articles published in our Quarterly Bulletin and our Financial Stability Review on that.

And secondly we've been investing in this network of contacts. And if one goes back perhaps two to three years we've been highlighting two risks in the current environment, both stemming from the build-up of leverage in individual borrowers, sub prime and in parts of the corporate sector, a build-up of leverage in complex financial structures and a build-up of leverage in hedge funds and in parts of the banking sector. And we identified that that could cause either a fast fuse unravelling where asset markets correct, or a slow fuse unravelling as underlying borrowers come under difficulty.

And as the Governor said at the beginning what we've seen so far is a combination of those two things. Fundamental pressures only really evident in the US sub prime sector, in the US sub prime borrowers. But with some spill over to other credit markets partly because of renewed questions about securitisation vehicles and associated with that about the robustness of rating agency ratings of some types of new vehicle.

HEATHER STEWART, OBSERVER – HOUSING MARKET

Heather Stewart, The Observer. I'm going to be terribly boring and ask the housing market question I'm afraid. Have you been surprised about the resilience of the housing market thus far in the face of five interest rate rises and how much of a slowdown are you expecting in the next sort of year or so, and how does that play into your predication of a slowdown in consumption growth?

MERVYN KING

Well you know we don't make predications of the housing market. We have I think been surprised over the last year or so by the strength of the housing market. I think as I said before that to understand it does require those two little words demand and supply. The demand side is the things that we're used to analysing because they are things most closely related to interest rates, incomes and the overall economic position. The supply side is perhaps the aspect we are not quite so used to analysing. That's come into obviously prominence recently with discussions about the supply of housing. And I think that the combination of changes in demand, including increases in population, and on the supply side account largely for what we've seen in the housing market.

I'm not the only one who finds this a difficult area. There were two headlines, not in your newspaper Heather but in some of the more - I was about to say popular, that would be a completely unfair description, some of the newspapers with larger circulations, one of which said 'Home Information Packs Sent to Ravish House Market' and the other one said 'Houses Set to Rise by 40% Over Next Few Years', and there are always people who can get headlines by coming out with some outrageous predication. And it's difficult to make judgements.

But what I would say is that you know we obviously monitor it very carefully. We think deeply about its interaction with consumer spending and its impact on borrowing and debt. So it's obviously important. But in the end it's foolish to expect that we can easily predict this. Demand and supply developments are the crucial things that influence house prices.

They vary from region to region, and you know it's not easy to measure those demand and supply factors that enter into it. But we do follow carefully what's going on.

GARY DUNCAN, TIMES – INTEREST RATE IMPACT

[Inaudible]

MERVYN KING

Well let me ask Charlie first to comment on the National Institute point. And then I'll come back more generally on views about interest rates.

CHARLIE BEAN

Yes, unfortunately the National Institute assertion didn't seem to be backed with any evidence. We merely saw it reported in some press coverage. However, I have to say as far as the underlying technical analysis relating to the forecast goes, it's very difficult to see that we have any different view about the speed of pass through of interest rate changes from what the National Institute does. We've published our central estimates of the speed of pass through in the models book that was published a couple of years ago. And we know from simulations that the National Institute have produced on their model that the speed of pass through is actually very similar and the overall size of the policy multiplier is very similar.

Now as the Governor has already said earlier on there's a lot of uncertainty in any particular instance about how quickly monetary policy will react, there are long and variable lags. But we certainly don't feel that our assessment of the speed of impact from monetary policy is very different from either the National Institute or most of the other forecasting bodies that are out there.

MERVYN KING

Let me then conclude on this general question of why there may be a wider disbursement of judgements about interest rates than in earlier episodes of the life of the MPC. If you remember when the MPC was set up I gave a speech, a number of people talked about the challenges facing a committee. And the view was that when there were demand shocks to the economy this was a question, it wasn't easy, but it was a question of judging whether the -

what the pace of demand would imply for the degree of spare capacity and the resulting pressure, either upwards or downwards, on inflation that would result.

And it was recognised right at the outset that one of the big challenges facing such a committee was when we had a supply shock, which might reflect a large rise, say, in energy prices, which would mean that output, growth and inflation might move in opposite directions. And I think the particular problem that everyone has faced in the last 18 months, two years, is that we have seen not just one but a sequence of supply shocks of different kinds. Some were in energy prices, some to do with migration, different timing of shocks to energy prices where in fact the biggest challenge we faced over the past year was that the level of gas and electricity prices in the UK responded very differently to oil price changes than in the rest of the world. And that reflected particular structural factors in our gas market in particular.

But at the same time of course the fact that there's a supply shock doesn't mean to say there aren't any demand shocks going on. You've got both. And trying to disentangle what we're seeing from the data, trying to interpret the data in terms of how big are the demand shocks and how big are the supply shocks, is more difficult I think than you would find in a situation where there weren’t any substantive supply shocks. And I think that in essence is the reason why there are different views out there amongst many commentators about the degree of spare capacity in the economy and about the likely path of demand, because people don't - and we've discussed at some length earlier on you know, we're not sure what the current growth rate actually is in the economy over the past four quarters, let alone what it will be in the next two to three years.

These things do make it difficult to from judgements. In many ways what's surprising and perhaps comforting is that the differences of views are actually relatively small in terms of judgements of interest rates, compared with the big uncertainties that are out there. Now whether that means that despite the small differences we're all wrong remains to be seen.

But I think the big message from this is not to put too much weight on small differences in view or different nuance judgements about tiny things that are about you know will interest rates change by a quarter percent at the next meeting or not, that is not the big issue facing the

United Kingdom or the Monetary Policy Committee. The great strength of our framework is trying to avoid the big mistakes that were made in the past in monetary policy, trying to keep inflation close to the target. But no one can pretend to be doing it precisely at any given moment. There are always lots of challenges, and I hope that means that for you this is a more interesting period than normal, because instead of just boring old demand shocks you've got something more interesting to write about.

PETER RODGERS

Right that's all we've got time for, thank you very much everybody for joining us.

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