

Bank of England

Quarterly Inflation Report Q&A  
16th November 2011

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Jason Douglas, Dow Jones:

As you mentioned, Governor, the forecasts show that there's a pretty good chance that inflation will be below the 2% target, so is the MPC satisfied that it has made enough asset purchases then to meet its objectives?

Mervyn King:

We decided to stay where we were at the meeting in November. As you point out, as I said, the big picture is that we think inflation will come down sharply, that it will towards the end of the forecast horizon perhaps be somewhat more likely than not to be below target. However, the central projection vis-à-vis the target is a relatively small difference compared to the very large distance to travel from 5%, where we are now, to 2%, which is the target.

So I think it is actually rather important that we, you know, see whether inflation does come down. We'll be able to judge these things every month, and no doubt, as information comes in, we can refine our opinion.

But I think what's important is not to see this in any context of fine-tuning. We cannot possibly do that. Certainly, in normal circumstances it would be a mistake to do it, but if there was ever a time when you might be tempted to do fine-tuning, this isn't one of them. So the big picture is what matters.

And we think that the big picture is that inflation, after quite a long period in which it's been well above target, will now come down towards, and we hope to, possibly even below, the target. Who knows? There's enormous uncertainty about that. But the big picture is that we're on track for inflation to come down to the target.

Richard Edgar, ITV News:

The Report seems to be characterised by uncertainty - uncertainty about the Eurozone crisis and its impact; uncertainty about household incomes next year, and uncertainty even about

## Quarterly Inflation Report - 16th November 2011

the measures that the Bank has taken. What guidance can you give to householders about the year to come?

Mervyn King:

Well, two things I would say. One is that we do believe that inflation is likely to come down sharply at the beginning of next year. But in the last three years we have seen extraordinary events. Who knows what's going to happen tomorrow, let alone in the next 12 months? So big changes in the next 12 months could unsettle that.

But unless there are unexpected developments, it is a quite reasonable view - and I think most people would share this view now - that inflation will come down sharply at the beginning of next year.

The consequence of that is that since - unless there are any further adverse movements in world oil, energy and commodity prices - then we would expect that next year real take-home pay will start to recover slowly. It will be slow and gradual, but the extraordinary squeeze on real take-home pay that we've seen in the past three years should now begin to come to an end.

Scott Hamilton, Bloomberg News:

Governor, the new ECB President, Mario Draghi, said that Europe is facing a mild recession. Is the UK facing one too?

Mervyn King:

We have said in this Report that there is certainly weakness over the next few quarters and no one can know precisely what the outcome will be. But thereafter we would expect output growth to pick up to much more normal levels. So we think we're in for a - we hope - what will be a relatively short period of some weakness, in large part because of developments in the euro area and the rest of the world.

What's happened since August has been very pronounced. We've seen a significant weakening of indicators of confidence and growth in the euro area that's bound to affect our net trade position. Over the past year we've benefited from exports to the euro area; that's not going to be true to the same extent, we would expect, over the next year.

We've seen that this has also caused problems in the financial sector in general. Our banking system is in a much healthier state than many of the banking systems on the Continent, but nevertheless - like all large banks - our banks are inextricably involved with developments in Europe. And if there were to be a sharp downturn in the euro area, then our banks would be affected by it. And that has meant that their funding costs have gone up. So we had hoped that by now we'd be seeing a compression of bank funding costs - the price which banks have to pay to borrow money relative to Bank Rate. That hasn't happened; if anything it's got worse in the last few months. So those higher credit spreads clearly will not help growth in the United Kingdom.

And more generally, and perhaps the thing that's most hard to work out is, as I said before, the Report mentions the word uncertainty a great deal, but financial markets themselves are mentioning the word uncertainty a great deal, as indeed are businesses.

And the uncertainty that's been created in the European and world economy by recent events must have - or is likely to have - some potential impact on the pace at which businesses will make investment projects, will they postpone projects, and on the pace of household spending. And that's almost impossible to forecast, but it's something we shall watch very carefully.

Chris Giles, Financial Times: Governor, you've always said that in the medium term Britain is the master of its own destiny. I make this about the 17th consecutive Inflation Report in which you've come here and had to say that the level of GDP is going to be lower than you previously thought it would be in the future. What does this persistent now sort of habit of coming back and telling us this about the economy being worse than we previously thought, tell you about both the UK economy and monetary policy?

Mervyn King: I think it tells you a great deal about the severity of what's happened in the world in the last four years. I think from autumn 2007 onwards, we've been in the middle of an extraordinary world financial and resulting economic crisis. I think many people felt that after the downturn that was very severe between 2008 in the autumn and the spring of 2009, that we were going to come out of it; but in fact what we've seen is that the financial sector has not come out of it, that the interest rates which banks - our banks - can borrow, have not fallen significantly relative to Bank Rate. And that has continued to mean a squeeze on the finance available for business lending.

And we've seen in the last couple of years some factors which have led to a very sharp squeeze in real incomes, hence in consumption. And it's consumption which has been the most important component of demand, which has really led to weak growth over the past year.

If you go back to the meeting when we met exactly a year ago, at that point we felt that sterling oil prices, which is a key part of both petrol and energy prices - a big component of real take-home pay - we felt that they would, in our central view, be rising by less than 10% between then and now. In fact they went up by 35%. That's a very big squeeze on real incomes and take-home pay, and has impacted on consumer spending.

Now we have never pretended - and we wouldn't dream of suggesting - that we have a crystal ball, and I'd like to suggest that no one else has a crystal ball either. That's why forecasts are not point estimates of what will happen. And there is always news, and you have to adjust to the news as it comes in. We make absolutely no apology for that. We make judgements about the balance of risks; other people can assess whether they feel they are reasonable judgements about the balance of risks or not.

Ed Conway, Sky News:

You said, Governor, in your speech in Liverpool recently that certain parts of the Eurozone were facing a solvency crisis - both countries and banks. But many within the Eurozone would deny that that was the case. They would say that that was absolutely incorrect, and if anything it's a liquidity crisis. Can you just expand on that a little bit, because I see you've mentioned solvency in the Report?

And can you also comment on the fact that for the first time the taboo about the Eurozone breaking up has been broken, now that the leaders of France and Germany have contemplated a break-up of the euro?

Mervyn King:

Well, on that latter point, that has to be for them. But on the first point, I think it's actually extremely simple, that in many ways this is - and indeed the problems in the world economy - are closely related to a very old-fashioned current account crisis in which some countries have very large trade surpluses and others very large trade deficits. Normally exchange rates would move in order to reduce the surpluses and reduce the deficits to prevent the resulting debts that arise in the deficit countries from reaching unsustainable levels.

That hasn't happened in the world economy because China and other Asian economies have linked their exchange rate to the US dollar, and that's created problems that we've been discussing now for about 12 years here. And within the euro area the same has happened. Over the last 12 years very significant losses of competitiveness have built up in some euro area economies. And the question which I think markets are looking at is - what is the plan to eliminate that loss of competitiveness in order to reduce the deficit and put the resulting debts on a sustainable basis?

Which is why we have been stressing the importance of thinking about trade surpluses and trade deficits within the euro area. It's no good saying that it balances out as a whole; that isn't the relevant issue. The relevant issue is - what is happening to sovereign governments with a large trade deficit and resulting borrowings, and will the rest of the world lend to them? And what is the plan in order to reduce that loss of competitiveness?

Until those questions are answered, then simply finding another temporary solution to a so-called liquidity problem will merely result in the problem being deferred, but not answered. And I think that is the issue which everyone has to confront now.

Ed Conway, Sky News:

But you're setting yourself up in direct opposition to the European Central Bank who say that across the Eurozone there is a balance.

Mervyn King:

Well, some people may have stressed that in the past - I don't think that is being stressed now. I think everyone understands that these imbalances are serious, because the private sector in the rest of the world has, since the summer, very clearly been unwilling to finance those current account deficits. Someone has to finance them. And this isn't a liquidity problem; this is a

problem about reducing the underlying macroeconomic imbalances.

It's the sort of issue which the IMF has been dealing with throughout most of its history. There's nothing terribly new about this.

Faisal Islam, Channel 4 News: Governor, unemployment is rising, youth unemployment's above a million, growth is flat. As you say, inflation is 5%. Are you sure that yourselves and the government have got this policy mix right, right now?

Mervyn King: Well, as I said, since August there has been a significant deterioration in the prospects. We've eased monetary policy in response. But there's a limit to what monetary policy can hope to achieve.

As I said, the UK has put itself, in the context of these current account problems which I mentioned - after all, we were a country with a large trade deficit; we were one of the countries with difficulties, and after the crisis, after we'd seen the impact of the collapse of output in 2008 to the spring of 2009 - out of that came a very large budget deficit, which is very high relative to many other European countries; and where the ratio of national debt to GDP is expected to go on rising for quite a few years yet. So these aren't problems that you can just ignore and put to one side.

So I think we have put ourselves in a position, with a combination of a path for the consolidation of the public finances in the medium term, combined with a broadly 25% fall in the real exchange rate - which has now been stable for three years, so we're not - it's not falling away, the exchange rate. We've had a one-off adjustment in the real exchange rate. This is exactly what one would think of as the right macroeconomic response to the

position in which we found ourselves. And I think we have to be patient now; I don't think this is a situation where you can think of quarter to quarter adjustments or growth rates as being the indicator by which we judge things. It's the medium term path.

Faisal Islam, Channel 4 News: Unemployment. Could you respond to the unemployment numbers?

Mervyn King: Well, I think everyone's concerned that unemployment has risen, particularly the rise in youth unemployment. I don't think what's happened is particularly surprising, given what's happened to the path of output, so I don't think we have to learn anything new about it. Unemployment - the claimant count - has crept up gradually from the spring, to reach 5% now from 4½% earlier. In a situation like this it's bound to be particularly difficult for new entrants into the labour force, and therefore young people. And I'm sure the government would feel that was a matter of concern.

We have seen that hours worked bounced back since the spring, so that total hours worked were actually up in the latest numbers. But that is reflecting I think the third quarter bounce-back in output relative to the temporary fall in Q2.

So what we've seen is we've seen - if you take the average out across the quarters - broadly we've seen slow, but positive growth over the past year. We think that, once the adjustment in the euro area gets through these difficulties, growth will pick up again. Net trade has responded. I don't think we can be at all confident of the accuracy of all the net trade figures; it takes several years for this to be got right - as indeed our figures for total output in the economy as a whole.

But I think we must look at the big picture, and take the long view. And the long view is that we have to put our trade deficit right. We

have had a depreciation of the currency. That has meant in part a squeeze on real incomes. I think we've largely been through that, and unless we were to see further rises in world energy and food prices, I think that immense squeeze on living standards and hence consumption has probably come near to the end of its path. And therefore we should be expecting some pick-up. That will be a positive force relative to the last two to three years. But I think that the net trading position for the next year will be more difficult than we'd anticipated because of developments in the euro area.

So if we stick to the big picture, with inflation falling back to the target, with a slow, gradual pick up in real take-home pay, which should impact on consumer spending, you know, towards the end of next year or into 2013. Gradually we are in a position where we can put things right.

But there are, in the short run, developments in the world economy about which we can do rather little. And it is very important that the world leaders, central bank governors, finance ministers - when they get together, whether it's in Basle or the IMF or the G20 - do realise that there are imbalances in the world economy which have to be tackled together; otherwise we will only resolve these imbalances through markedly lower levels of world output.

And I think it's something where, you know, we may be able to control our inflation destiny, but in terms of real output, we will not be unaffected by what happens in the rest of the world.

Linda Yueh, Bloomberg TV:

Governor, since the last Inflation Report you've launched a new round of quantitative easing. Can you talk us through how that is intended to support growth? So if quantitative easing helps with deleveraging, as in freeing up cash, making it easier to repay debt, then higher savings rate - which you have some information on in

the Report - means that the domestic sector investment consumers are saving, not spending; so therefore domestic demand is unlikely to rise. And if the external environment is very difficult, as you've pointed out a number of times today, then how does quantitative easing support growth? The only other sector is government spending, but I'm not going to push you on that.

Mervyn King:

Well, let me ask Charlie to explain the transmission mechanism of asset purchases.

Charlie Bean:

If I can refer you to the box on pages 12 and 13 of the Inflation Report, which reprises material that we've previously published both in earlier Inflation Reports and more recently in the Quarterly Bulletin, I mean the primary mechanisms whereby asset purchases boost nominal spending are firstly by encouraging investors who sell gilts to us to rebalance their portfolios in an appropriate fashion. So that puts upward pressure on the prices of corporate bonds, corporate equities, things like that - reducing the yields on those, so making it more attractive for businesses to invest.

Also the upward pressure on asset prices boosts wealth generally, so that may have an effect on consumer spending. And there may also be an effect through the exchange rate as well. The exchange rate may weaken somewhat because of the lower level of interest rates here, and that of course boosts net trade. So that's a broad outline of the transmission mechanism.

The work we have done looking at the impact of the first phase of asset purchases suggests that, broadly speaking, they lowered yields by about 100 basis points - not just for gilts, but also corporate bonds. And that is likely to have had an impact on GDP of somewhere between 1½ to 2%, and inflation somewhere

between three quarters of a percent and 1½%. Those are the peak effects.

Now you alluded to the deleveraging in your question. I mean, what of course is true is that, if you encourage, say, consumers or businesses to be spending more now, then you slow the deleveraging process. And this is a point that the Governor has alluded to in various speeches - the sort of Augustinian issue connected with policy at the current juncture, that maybe where you want to be in the long run is different from where you want to be in the short run.

But having the economy deleverage sharply at the current juncture is not what we want in the context of a depressed global picture. So by encouraging a bit more demand now, you smooth out the adjustment. Maybe you postpone some of it to further down the road, but it means that you take less of a hit in terms of higher unemployment, depressed activity and so forth than would otherwise be the case.

Hugo Duncan, Daily Mail:

Governor, how do you expect credit easing to work, and do you expect it to have any impact on the funding to small businesses?

Mervyn King:

Well, I think you have to define what credit easing means. I presume in this context it means measures taken by the government to improve the flow of finance to small businesses. And I think we'll have to wait and see what the Chancellor announces on the 29th November.

If they were successful, then it would help to reverse the decline in lending to small businesses that we've seen; so if you look at Chart 1.10, which is on page 16, you can see that - for whatever reason - the lending to businesses has been falling, particularly to small and medium sized businesses. And, depending on the

measures that we see announced on 29th November, that may or may not start to move back.

Jeremy Warner, Daily Telegraph: On the Continent, particularly in Germany, the prevailing view is that QE of the type that's been applied by the Bank of England and the Fed is both inflationary and that it is inappropriate for the central bank to be acting as lender of last resort to the government. Could you address those two points? Is it inflationary, and are you in effect bankrolling the government at favourable rates?

And just as an addition to that, is there any limit to which the Bank of England's balance sheet can be expanded through further QE?

Mervyn King: Well I think there are two very different issues which you raise there. One is the question of - I will call it asset purchases, if I may, where we feel that the programme of asset purchases we've made, focusing on government gilts - whether that is inflationary or not depends entirely on the circumstances in which you do it. So it is true that many of our friends on the Continent have an aversion to it, for the simple reason that for the whole of their adult lives, as indeed the whole of our adult lives, policy of that kind would largely be in the context of an attempt to reduce inflation, whereas this would obviously do the opposite.

So I think the reason why no monetary financing is thought to be important is to avoid the government being in a position to put pressure on central banks to buy the securities it issues, because that clearly has the potential in the long run to be inflationary if it's at the behest of the government.

If it's done by an independent central bank, and only done in circumstances where the central bank is concerned that inflation would be below its desired target, then that's a very different

kettle of fish altogether. And if you think back to the 1980s, there were long debates there about overfunding and underfunding. Overfunding was the dominant issue of discussion because we were trying to bring down inflation by doing the opposite to what we're doing now. What we're doing now with asset purchases is very similar to underfunding in 1980s' terminology.

So there's nothing new about this as a monetary policy instrument. It's an absolutely standard monetary policy instrument. And we're doing it, so - as Charlie said - initially we increase the amount of money in the economy, and then that increased amount of money is spent by private sector agents on a variety of assets that they get to choose. And that will then feed through to the rest of the economy.

So the answer to your question is - it entirely depends on the circumstances in which asset purchases are conducted. We've conducted them only in circumstances where we were concerned that, had we not made those asset purchases, the chances were that inflation might fall below the target. If we were in a different position, we wouldn't dream of doing it. And indeed, when the time comes in due course, when we feel it's appropriate to tighten monetary policy, then selling those assets will be one mechanism by which we can tighten it. And that would indeed be exactly equivalent to the overfunding in the 1980s.

Your second question is a very different one. This phrase 'lender of last resort' has been bandied around by people who it seems to me have no idea what lender of last resort actually means, to be perfectly honest.

It is very clear, from the origin, that lender of last resort by a central bank is intended to be lending to individual banking institutions, and to institutions which are clearly regarded as

solvent. And it's done against good collateral and at a penalty rate. That's what lender of last resort means.

That is a million miles away from the ECB buying sovereign debt of national countries which is used and seen as a mechanism for financing the current account deficit of those countries, which inevitably - if things go wrong - will create liabilities for the surplus countries. In other words, it would be a mechanism of transfers from the surplus to the deficit countries. And that's why the European Central Bank feels, I think - and with total justification - that it's not the job of a central bank to do something which a government could perfectly well do itself, but doesn't particularly want to admit to doing.

And I think it's very important to recognise that there are circumstances when governments will try and put pressure on central banks to do things that they would like central banks to do, in order to avoid their having to own up to the actions that they actually would like someone else to carry out. So I have every sympathy with the European Central Bank in this predicament.

And to go back to the discussion we had earlier, the only circumstance in which looking at the data for the euro area as a whole has merit is in realising that actually the euro area does have the resources, if you were to regard it as a single country, to make appropriate transfers within itself. So it doesn't actually need transfers from the rest of the world. But the whole issue is - do they wish to make transfers within the euro area or not?

And that is not something which a central bank can decide for itself. That is something which only the governments of the euro area can come to a conclusion on. And that is the big challenge which they face.

David Smith, Sunday Times:

Just still sticking with the Eurozone, can I just explore what the Committee's view is on how all this is resolved. I mean, you say in the Report, and you said that there's no meaningful way to quantify the most extreme outcomes in the euro area, which means that you must have considered those but decided they're just too difficult to model and quantify. You said just now that this is a matter of economic fundamentals, of imbalances within the Eurozone, and expressed your distaste for, you know, what some people call short term sticking plaster responses to the euro area crisis.

You must be making some assumption that the crisis is resolved in a fundamental way over the next few months, after which the uncertainties disappear and growth resumes in the UK from the middle of next year. How do you see the crisis being resolved? Is in the way that you've just described that we do see those transfers from the surplus countries to the deficit ones, what kind of solution do you have in mind there?

Mervyn King:

Well it's very hard to judge. I mean I'm all in favour of sticking plaster; it's just it's not a substitute for having proper medical treatment. So if you find yourself with a wound, by all means use sticking plaster, but use the time which it gives you to deal with the underlying problem. That is - you know - the right way to approach it.

I think we have no idea how this will be resolved. I think in the long run it's evitable that a means will be found to reduce the imbalance in competitiveness and trade deficits that has built up. But whether that happens quickly, or whether it takes a longer period, is almost impossible for us to judge. And there are many different ways in which that could come about. It could come about through an internal devaluation, or it could come about through many other means. And I think it's just impossible for us

to know what will happen. That's why, in addition to finding it hard to quantify, I'm not even sure if we're capable of enumerating all the possible outcomes that could occur.

Kathryn Hopkins, The Times:

Governor, at the last Inflation Report press conference you commented on the riots and widespread social unrest. Are you concerned that youth unemployment rising above the one million mark will fuel yet more social unrest? And what would you say to all the young people across the UK desperately struggling to find work?

Mervyn King:

Well I think all of us have great sympathy; even someone as young as you I'm sure will have great sympathy for young people looking for work. And that's the government's responsibility to respond to that, and we will do our part in trying to restore macroeconomic stability. As I said, and we've said for many years, our best contribution is to try to bring inflation close to the target. We believe that we will be able to go a long way towards that during the course of 2012. That, I hope, will then see an end to the very large squeeze on living standards which has depressed consumption and been a major factor responsible for slow growth.

Now, you know what happens in the world economy is not something that we can readily influence. But we've put in place the measures that we think in the long term are necessary to get back to a better-balanced economy and that has to be the basis on which we can move towards prosperity in the medium term and create jobs which are sustainable.

Phil Aldrick, Daily Telegraph:

Just looking at the Inflation Report, it looks like you are dropping very heavy warnings of a looming credit crunch, looking at CDS premia, etc., in the Report. I just wondered if when the Special Liquidity Scheme comes to an end at the end of this year, and

we've got the Credit Guarantee Scheme which is being run down, is there anything we can do - or the government, or you could do pre-emptively - to stop the credit crunch happening and the restraint of credit to businesses which will obviously have a damaging effect on the economy?

Mervyn King:

Well the most important thing is for financial markets to realise that our banks are in a healthier position than those on the Continent, and I think that perception is understood. So the difficulties that our banks have in obtaining funding - it has got more difficult since August, as it has for all banks, but it's become much less difficult for our banks than it has for many Continental banks.

But all big banks, as I said, are connected with the European economy and will be affected by a downturn in the European economy. That is reflected in the price they pay for obtaining funds.

Now, as far as the Special Liquidity Scheme is concerned - I'll ask Paul to comment in a moment - virtually all of that has been repaid and we've been working with banks over the past year to ensure that there would not be a funding cliff at the beginning of next year when that ran off. So they are actually in a much stronger position maybe than you may realise. There isn't a significant amount of the Special Liquidity Scheme to repay, and I think it's important that we convey to financial markets our judgement, that we think our banks are in a stronger position than many in the euro area. But let me ask Paul to comment on the current liquidity position.

Paul Fisher:

Yes, as you know the Special Liquidity Scheme, we published the last set of numbers at the end of August. At that point over 90% had already been repaid, largely earlier this year and last year

when the bank funding markets were open. I think UK banks are individually and collectively glad they did that now because they're now in a much better position for having got that funding out of the way.

There have been obviously more repayments since the end of August and we'll publish some new numbers in the December Quarterly Bulletin. The amount left in the Special Liquidity Scheme means that's no longer the issue.

If you look at funding markets more generally, the problem for UK banks and actually banks more generally, is not so much short-term liquidity pressure as medium term funding, where the markets, as you know, are very patchy at least. And ultimately the only way for banks to get medium term funding is from the market, and we'll be working with them to help them try and do that.

Yvonne Esterházy,  
German Business Weekly,  
Wirtschaftswoche:

I realise you've already partly answered my question, but if I may, I would still like to press you a little further. In your report you say implementation of a credible and effective policy response in the euro area would help to reduce uncertainty and so on, and you've spoken about the trade imbalances. Obviously this is a long-term measure - and also about the role of the ECB and how you sympathise with it. But could you please, you know, elaborate on what you mean with credible and effective policy response in the short term, and particularly what you think Germany should do to help in this situation?

Mervyn King:

Well I'm not going to advise Germany or any other country what to do. What I will say is what we meant by a credible and effective plan is that it's no good simply coming up with a short-term

financing plan over a few months, or even a year. What there needs to be is a credible plan under which the countries that have lost competitiveness will regain it, so that markets can see that there is an end in the continuing increase in the external indebtedness of some, not all, but some of the countries, which is the major problem they face. And those current account deficits need to be turned into surpluses so that they can support and finance the very large stock of external indebtedness that has built up.

So what has to be put forward is a plan, which it's up to others to put forward, but under which markets can see that over a reasonable transition period - which as you say will take a number of years - it is credible to believe that that loss of competitiveness will disappear, and that those countries will once again be able to sustain themselves without continually having to borrow from overseas.

Robert Watts, Sunday Times:

Governor, as you say, forecasting inflation is extremely difficult, the fan chart on page 8 suggests that your core forecast would be some way below the central target in 2013/14. I just wondered if there was a sense that after we've had this prolonged period of above target inflation that some time below target would actually be desirable for the economy?

Mervyn King:

No, I don't think we're planning deliberately to hold inflation below the target, in some sense to make up for what happened. I think what we're pointing out today is that we are at 5; that's way above our target. We're not relaxed about that; we want to bring it back to target. It's true that we think, on the central projection we think it's - well the balance of risk, it's a little more likely than not that inflation will be below target. But frankly the gap by which it's below target is pretty small compared with the much bigger gap which is where we are now relative to the target. So the big

challenge for us is to get inflation back to the target, that's the big picture, that's what we're focusing on.

We believe that under current policy settings, that is the balance of risk is in our favour in that direction, but we'll have to see. I mean there's a long way to go to bring inflation back to the target. Our central view is that we think that will happen, and we'll see a big improvement in the first few months of next year. But we haven't seen that yet, we've got to wait for that to happen; and I don't want to count too many chickens.

So I don't think we're in the business of sort of fine-tuning and saying, gosh, you know - why don't we get inflation down to just below target for a bit and keep there, just to sort of - you know make it look good for a few quarters? We're not in that game at all.

We're in the game of looking at the big picture here with massive changes in both our and the world economy. Remember that total output and productivity is roughly 10% below where it would have been had this crisis not occurred. That's an extraordinarily big change. And I think when we look at these charts we should say - well, what is the big message from this? What's the big picture?

The answer is, and we've given reasons for it, namely that unless there is a further increase in VAT, or further rises in energy prices, or further rises in world food prices, there are very good reasons to suppose that, as the 12 months window of measuring inflation moves onwards in time, that the early months of this year, when we saw big rises, those rises will drop out of the measure of inflation, inflation will come down and that the sharp fuel price increases, utility price increases in September/October will also drop out as we get towards the end of next year.

So during next year we would hope there would be a significant fall back in inflation. I think there are good reasons for expecting that, but you'll have to make your own judgement on that. But that is the big picture.

Trond Sundnes,  
Norwegian Business Daily:

I want to go back to the effective policy response. If you today were told that in six months from now there would be no such effective policy response from the euro area, what impact would that have on today's projections?

Mervyn King:

Well I'm not going to answer that because, as I said, the more extreme outcomes are not included in the Fan Chart, so I don't think the Committee feels it's sensible today to speculate on a wide variety of outcomes which we hope won't occur. So, if you'll forgive me, I'm not going to speculate on what might happen if certain things don't occur. All I will do is just to reiterate the point that I've made, that what I think financial markets are looking for is a credible path along which the existing imbalances can unwind. And no one expects them to unwind quickly; they can't. But it has to be credible that there is a policy strategy which means that they will unwind.

Phillip Inman, The Guardian:

You must have detected a degree of bewilderment at the growth forecast; that's a lot of the questions you've faced today seem to be - you've painted a very gloomy picture of the outlook for the economy, and yet you seem to have very strong recovery in 2012 and 2013. Could you explain a bit more why you're not taking big, big bets on a resolution in the Eurozone, on continued growth in America - which seems to be waning - there doesn't seem to be any growth next year in America? You know, you seem to be taking quite a bit bet on 2013 and 2013 growth?

Mervyn King:

Well some of the factors that we think are responsible for the weaker growth we think won't persist. So even in the United States I think one of the factors that's relevant there is quite a sharp fiscal consolidation as we speak, but that we think will unwind and that won't be repeated.

The squeeze on real take home pay which has been responsible for an extraordinarily large fall in consumption over the past three years, we think that squeeze is coming to an end, and therefore consumption won't be falling as rapidly as it was. We think that the fall in the exchange rate will, once we've got through the temporary slowing in growth we see in the euro area, start to recover again.

I'll hand over in a minute to Spencer to perhaps elaborate on some of these factors about the pattern of growth. But, I mean, what is true is that we expect a much weaker picture than we saw in August for the first half of next year. And in part it's because of three factors: it's a less buoyant picture for net trade, given what's happened in Germany and other countries in the euro area where growth prospects look weaker than they were - and that's new since August; the weakening consumer and business confidence, particularly in the euro area, but also obviously here; the higher credit spreads of which our banks are borrowing, but as Paul pointed out there's no reason to suppose that will persist indefinitely, that should come back at some point because the underlying position of the banks in terms of capital is stronger than many European banks.

And of course there's a general uncertainty that's been created since August, which I think is unlikely to persist indefinitely - if it were, all bets are off. So I think those factors we believe are likely to be temporary and that's where we get back to - not exciting

growth rates, but more normal growth rates. But let me ask Spencer to elaborate.

Spencer Dale:

Yes, perhaps to add a little bit more colour, I'd draw your attention to Chart 2.9 on page 23. This just compares the composition of recovery over the last two years - we've seen in the most recent two years compared with past recoveries. And then the big picture point clearly is the pace of this recovery we've seen over these two years is far weaker than we've seen in the past.

The second big picture is that that is due very largely to consumption. Normally consumption is what helps to drive recoveries; we haven't seen that. And to a very large extent that's exactly the reasons - for the reasons the Governor's been explaining - in terms of a very sharp squeeze in households' incomes.

If inflation does fall, as the Governor suggests, we will start to see a gentle rise in household incomes from the second half of next year, and we hope that will help to then support a rise in consumption. And if we get to consumption starting to look anything like normal, that will have a very material impact on the pace of our recovery.

Faisal Islam, Channel 4 News:

Just a follow up on Jeremy's question, a quote from your counterpart from France, Christian Noyer, who is obviously on the ECB Board, "We're paying the price for our virtue and our refusal to liquefy our debt through massive monetisation of our fiscal deficits," before referencing that Britain had bought 51% of total debt issued in 2009. I say this in the context that we're told the Prime Minister is going to Berlin on Friday to try and coax Angela Merkel into telling the ECB - to get the ECB to do something. Are you saying you disagree with that? You said you had sympathy with the ECB?

Mervyn King:

I have great sympathy for the position of the ECB, in not going around and buying all sorts of assets. The question really is one about transfers. And in order to finance the current account deficits, someone has got to finance that. The private sector has dropped out of that in the past three or four months; other euro area governments will have to do it.

Now there are various mechanisms that can be put forward. I was interested to see in the Financial Times this morning that they too have come round to the view that it's wrong to put pressure on the ECB to do it, as such. But there may be mechanisms under which a fund, or even the ECB, could act as an agent for the governments that would take decisions and bear the risk.

But ultimately it is a question of real resources. Central banks don't have real resources; they create money. And to the extent that governments feel that they have to take the burden of transferring real resources from one country to another in order to sustain a current account deficit for a period, that's a decision that can be taken only by governments.

Faisal Islam, Channel 4 News:

Was the Prime Minister wrong to reference the ECB?

Mervyn King:

Well, I've not seen what he said, and all I would say is that I think that the people who put pressure on the ECB misunderstand the nature of the challenge that the ECB faces, which is that this is a problem for governments. Now there may be circumstances in which the ECB can play its role as an agent for those governments. What it can't do is to pretend that, in its role as a central bank, that its role is to transfer resources from one country to another. That is not part of the remit of the ECB.

And I think that Jens Weidmann has made some very powerful points to this effect. I have great respect for what he says and thinks on this issue, and I would support him in it.

Tim Wallace, City AM:

We've seen that you expect inflation to fall below target for the next couple of years. Under what conditions might you start considering selling the assets that you've built up?

Mervyn King:

Well I think the circumstances, as we've said before, would be ones in which we were in a position where we thought it was appropriate to tighten monetary policy. And that day will come, and you know, I would hope the circumstances in which we might be considering that would come sooner rather than later, because that would be good news - it would be a situation in which our economy is strengthening and we thought we needed to take action to prevent inflation from rising above the target. But I think it is in the short run some way off, and we'll have to wait and see. But it will be driven by a judgement about the medium term outlook for inflation.

Norma Cohen, Financial Times:

Governor, to get back to the question of provision of credit. Your chart on page - 1.9 shows just how the availability of senior unsecured bank debt has fallen quite sharply over the year. And as you rightly say the SLS has largely been dealt with, but the reality is that UK banks have very significant refinancing needs over the next two years. Do you have any contingency plans for banks in the event that that window stays closed?

Mervyn King:

Well, let me not speculate on what we would do in the future. We have obviously a very different framework for providing liquidity now than we did in 2007. We have a discount window facility and we have our auctions. And those auctions can be expanded if we think it's appropriate. But let's not get too depressed about this. Remember, banks always have major funding challenges over

the next two years, since they borrow short to lend long, banks are always facing very large amounts of refinancing over a two-year period.

And as Paul said, the UK banks did actually achieve quite a lot in terms of funding in public markets, especially medium term funding - it's important they move more towards medium term funding, even if they have to pay up for it. And they did move in that direction in the first half of the year. From August onwards public markets have generally been closed. That's in part a response to concerns about what's happening in the euro area and the interconnectedness of all banks inside and outside the euro area, not entirely excluding even US banks. We've all been caught up in this, and that's made funding more difficult.

But what we're hoping for is that there will be a plan to resolve the problems in the euro area, which should mean that the challenges which funding markets are concerned about, at least are seen in perspective. They will be confident there's a plan of dealing with it, and that should mean that medium term funding markets open up again. And even if banks have to pay up, they will be well advised to put in place appropriate medium term funding.

So we have plans for a variety of contingencies, but I'm not going to speculate now on that. But I do think that in due course our banks will be able to obtain funding again. And it's up to them to ensure that they've got adequate capital positions, in order to persuade prospective funders that it's safe to lend to those banks.

Scott Hamilton, Bloomberg News:

I think it's fair to say there's a degree of scepticism amongst investors and commentators about the latest round of asset purchases. Could you please give your assessment for the latest round so far - obviously it's early days? And also what other

options for pursuing unconventional monetary policy easing does the Bank have?

Mervyn King:

Well I'm not sure I accept that there's scepticism; I think there's a degree of unfamiliarity about it - I think they are two very different things. But let me ask Charlie to talk about it.

Charlie Bean:

Yeah, I mean it's obviously early days, and it takes time for the effect of the purchases to work through. But there's one exhibit to give you a sense that it's quite likely that the second round of asset purchases are working very much in the same way as the first round. Have a look Chart 1.5 on page 13, which shows the evolution of UK gilt yields relative to those in Germany and the US.

Now it was the case that, if you just looked at UK gilt yields alone, they didn't move very much on the day that we started our asset purchases, and also on the day the September Minutes were published which encouraged more speculation that we might restart them. But that was because of movement in yields around the world. So the sensible thing is to look at comparative movements in UK yields relative to those overseas. And what you can see is that both relative to German bunds and relative to US treasuries UK safe rates have been falling. So it's natural to interpret that as being an asset purchase effect.

Now obviously we'll be monitoring the impact on other yields as we go along; you know, we'll learn more about the impact of this phase of asset purchases and whether they're operating in a different way from the first round. But so far we haven't seen anything to suggest that this round of purchases are operating in any way differently from the way they did the first time round.

- Scott Hamilton, Bloomberg News: Sorry, are there other options being considered for unconventional monetary policy easing, other than past QE?
- Mervyn King: Sorry other than - ?
- Scott Hamilton, Bloomberg News: Are there other options being consider by the Bank for unconventional policy easing?
- Mervyn King: No. I mean if we extend our asset purchases we will do it through buying gilts.
- Ed Conway, Sky News: Just a couple of quick ones. First of all ...
- Mervyn King: One quick one Ed, then you'll have to wait your turn again.
- Ed Conway, Sky News: They'll be very quick I promise.
- Mervyn King: One.
- Ed Conway, Sky News: Some ministers have been trying to attribute some of the gloomy news recently, in particular the rise in unemployment, to the euro crisis, in particularly Chris Grayling was doing this on Sky News just earlier today. Is that really fair, or are there more domestic kind of causes for these things?
- My second very quick question ...
- Mervyn King: No, you've only got one so I'll answer that one.
- Ed Conway, Sky News: It will be quick ..... promise.
- Mervyn King: No, no it's nothing to do with being quick, you know there are conventions and conventions; we'll stick to those if you don't mind. So let me answer that one. The big picture I think from the Report

is looking back, if you look back, then the biggest impact on growth in the past sort of year and a half has been the squeeze on real take-home pay and consumption. That's the sort of big factor there.

Looking ahead, why have we revised down our projection this time? That's largely news from the euro area. A quick answer to a quick question.

Have we got time for one more, but not from you Ed, from someone else.

Laughter

Nils Blythe: Actually Bill hasn't asked a question, so Chris pass the microphone ...

Chris: Can I not ask a very quick one, then Bill?

Nils Blythe: Okay.

Chris: Just to go back - you said just a few minutes ago that we may be able to control our inflation destiny, but in terms of real output we're basically at the mercy of the Eurozone. That sort of implies that growth doesn't have an effect on inflation. Is that really what you mean?

Mervyn King: No it's not. No in the short run, in the short run, there's not much we can do to control developments in the world economy, and that will have an impact on what happens here. We can try to offset it in terms of monetary policy, but as I said, given the extreme circumstances in which we find ourselves, with consumption having fallen so far and productivity having fallen so

far, at least in measured terms, there are limits to what monetary policy can do.

I would hope that in the long run we would expect to see output return to the potential levels that we would hope we could get to before. I don't see any reason in principle why this crisis should actually destroy the productive potential of which the economy is capable of operating. What we don't know is over what horizon it will take to get back to that point. And that is the seriousness and the metric by which to judge this crisis.

William Keegan, The Observer:

This has been a very interesting conference, but I felt a slight disconnection from concerns outside. Mr Governor, do you have a message for the protesters around the world?

Mervyn King:

Well, the difficult thing is to know quite what it is that is their common thread. And that is why I think it's difficult. I think the views that I've expressed about what's happened in the financial sector and the reforms to the banking sector that we need to see, and the need to implement the Vickers Commission are well known - I've explained them before. So I think all I would do is just refer you to what I've said on earlier occasions.

When there is a more coherent and unified commentary or manifesto, then ask me the question again. But it's quite difficult to respond to something that isn't quite so coherent. But what I do want to repeat is something I've said many times before - that I have immense sympathy with the people that I meet as I go around the UK, who are suffering; whether they are people experiencing lost jobs, lower consumption spending or seeing their businesses in difficulty.

These people were not responsible for the crisis, and they are suffering enormously as a result of it and I think many people still

don't really understand why. And I think I have enormous sympathy for people who find themselves in that position. It's an immense challenge and one I think which will be an issue that will affect the way we think about the world for a very long time to come. And in that dimension I have great sympathy with the people who are unhappy about the current state of the world.

I think the role of policymakers and economists more generally is to try to explain what were the underlying causes of this problem, and then to set out proposals for putting it right. And I like to think that we in the Bank have tried, at least as hard as anyone else, both to analyse the causes of the crisis and to set out the measures that we think the UK should take to put it right - and indeed at the international level too.

Nils Blythe:

Ladies and gentlemen, I'm afraid that is all we have time for, but thank you all very much indeed for coming.

END