WORLD TELEVISION

Bank of England

Quarterly Inflation Report - 14th May 2008

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Mervyn King: Finally, and speaking of patience, we say farewell today to Peter Rodgers who retires as the Bank's Director of Communications at the end of June. His successor, Jenny Scott, will be chairing the next press conference. Peter has contributed hugely to the Bank over the past decade, and I for one shall miss him greatly. Peter has been more patient with all of us than we deserve. Happy retirement, Peter.

Applause

Peter Rodgers: Thank you very much indeed. [Through applause] It's been a great privilege to work for you.

Mervyn King: Thank you.

Paul Wallace, Economist: If you look at charts 5.3 and 5.5 on page 41, if you were concerned about meeting the inflation target in the usual time looking out two years, it would tend to imply that you'd want to keep interest rates where they are. If on the other hand you're willing to extend the horizon out, as you implied in what you said, then maybe the implied cuts in market expectations might be necessary. And I'm just wondering whether you could clarify what you meant when you said that you would be seeking, in the light of the sort of extended overrun in the next few months, to be seeking to direct inflation down over a longer time period?

Mervyn King: I wasn't looking beyond two years. I think what we were saying was that the rise in inflation is coming from shocks from the rest of the world economy to the prices of energy and food, and now important prices, and these are coming in the next six months into the price level, and they will be there for another 12 months. Within that time frame it doesn't make sense to try to bring inflation back to 2% within that 12 to 18 month horizon. But looking two years ahead we should certainly be trying to bring inflation back very close to the target. And that's what we shall be trying to do.

Alex Brittain,
Thomson Financial News: Following on from that question, if we can assume that you want to bring inflation back to target within two years and that implies there's going to be little stimulus from monetary policy for the economy, do you think liquidity-boosting measures, such as the Special Liquidity Scheme, will be a more effective tool for supporting the economy than interest rates?

Mervyn King: Well I think they have different objectives. I think they match well together, precisely because they're trying to deal with different symptoms. With monetary policy we're trying to affect the level of spending and demand in the economy as a whole in order to affect the underlying degree of inflationary pressure and to bring it back to a level consistent with the target. The Special Liquidity Scheme was designed in the wake of a series of events in March which created an atmosphere of tremendous uncertainty in financial markets; there was a period in March when almost any bank could be thought to be at risk from the loss of confidence which we saw illustrated - particularly in New York - but around other financial centres as well, which meant that they were very seriously exposed to a loss of confidence among their counterparties.

The Special Liquidity Scheme is designed to restore confidence in the banking system so that banks contemplating dealing with other banks will know that those other banks can obtain access to liquidity when needed, and therefore they should be more at ease in dealing with natural counterparties. I think that's been successful so far. It will take along time before its effects feed through, and I think the events of the last six to nine months are not ones that people will forget in a hurry. So I don't think we should expect that conditions will suddenly snap back to either where they were or a sense of normality quickly. It will take time to rebuild that sense of confidence in the banking system. And during that period then credit conditions will be more difficult than they would normally be. But nevertheless, putting that scheme in place was an important part of the framework in which monetary policy plays its part, but I don't think they're sort of direct substitutes, they're complements.

Stephanie Flanders, BBC: I think it was at your last press conference, you encouraged us all to go north, or at least to get out of London, and to see how much less gloomy companies and others were in the rest of the country than in London. Do you think that's still true or relative to three months ago, do you think the gloom has spread a bit more evenly?

Mervyn King: I think that's still true. I think the difference between the mood and what's happening in the financial sector, and the property sector the difference between those two sectors and the rest of the economy is still extremely marked. And the growth rate for the first quarter for the non-energy part of the UK economy, the mainland part of the economy, was 0.5%. So I think it would be a mistake to equate the sense that the mood in the two parts - it is very different.

But having said that, there is no doubt that the squeeze on real incomes that's coming from the rise in energy prices, food prices, import prices, is affecting spending power right across the economy. And that is the main factor that has led to the downgrading of our forecasts for growth during the past three months. We've seen very significant increases in those external price level shocks from the rest of the world in the past three months, and over the past year as a whole oil prices have doubled, gas prices have doubled, food prices have gone up 60%. You can't experience that sort of shock to a price level from the rest of the world economy on the UK without some squeeze on real incomes, real living standards and real spending. So we are starting to see that slowdown in consumer spending, and that will affect the economy more generally.

Even so, I still think it is quite striking, how marked the difference has been between the financial and property sectors where, for example, the IMF have talked about financial conditions being more difficult than at any time since the 1930s. You cannot compare what we're seeing in the real economy now with the Great Depression; it's a million miles away. So I think that there is still that sharp contrast, but nevertheless what we're now seeing is undoubtedly a slowdown which is starting to affect the whole of the economy.

Larry Elliott, Guardian: The last time you had to write a letter to the Chancellor, you were able to say that you'd already taken action to bring inflation back down. You'd raised interest rates three times and you went on to raise them another couple of times after that letter. This time, as inflation's gone up, you've cut interest rates three times. What are you going to say to the Chancellor this time in that letter?

Mervyn King: Well, when it comes, and I shall write the letter in conjunction with my colleagues, based on the circumstances at the time; but I think we might point out in that letter that we did not fall prey to the sirens who were pressing us to cut interest rates as rapidly as some other central banks have done and we have all the time tries to maintain this difficult balancing act between being conscious of the impact of the slowing economy on pulling inflation down, possibly below target looking further ahead, and the impact of these price level effects from the rest of the world of pushing inflation well above target in the short run; and that possibly persisting further ahead.

Sam Fleming, Daily Mail: Can I ask a question about the housing market, please? It emerged yesterday that government ministers say a 5-10% decline in house prices this year would be a best-case scenario. I was wondering if you think that's being alarmist and what your own assumptions are at the moment about the outlook for the housing market?

Mervyn King: Well as I said in the opening statement, we have already seen house prices starting to fall, and they're likely to fall further, but I don't think anyone can honestly know how much. We've already seen quite a significant adjustment over the past six months in the house price to earnings ratio. That's the ratio which people looked at in order to try and judge whether house prices were likely to be able to remain at their prior levels. And, you know, in the last two or three years we set out arguments on both sides, explaining why on the one hand you might be sceptical that house price to earnings ratios could stay at that level, given how high they were relative to historical experience; on the other hand we pointed out that one of the very good reasons for expecting that ratio to have moved up was the very low level of real interest rates across the world economy. And those factors still remain true. So I don't think that anyone can actually be at all confident as to what will happen. The market will tell us and we will wait and see.

Dan Atkinson, Mail on Sunday: Governor, you've mentioned writing a series of letters. Isn't it a flaw in the system that you have to write consecutive letters when nothing much has changed? Isn't it - it's a bit public school, isn't it; you have to keep having to stand up and say you're sorry you let the house down and so forth?

Talking together

Mervyn King: ..... this thought of it as a public school example.

Dan Atkinson: Are you just going to send the same letter month after month?

Mervyn King: No, I'm sure - I mean, we write an inflation report every three months - I'd like to think that that changes. There's something new and interesting in the report for you to read that you didn't have three months ago, and I'm sure we can find the odd point or two to make that will have changed over the previous three months. I think if it had been every month, you would have had a good point. But it's not every month, it's every three months. I remember that being discussed when the idea of letters was being set up. In fact one of the suggestions initially was that it was every month; I did point out at that time that it might be easier for us to say something interesting in the letter if it was every three months. But I think we'll have plenty of opportunities to write letters.

Edmund Conway,
Daily Telegraph: Governor, when the Chancellor yesterday announced the fiscal loosening, when did you find out about that? Did you find out in advance of it? And could you also give us your assessment of the impact of that on inflation and on growth?

Mervyn King: Well I was briefed earlier in the day. I can't give an assessment of the impact on inflation and growth; that's a collective judgement that the Committee make, and no doubt we'll come back to it in our June meeting. And, you know, we'll see the impact of that when we move to our next forecast in August. It's a relatively modest measure; it amounts to 0.3% increase in household incomes; approximately 0.2 percentage points worth of GDP. But the impact of that on spending is not easy to judge, because of course we won't know until November exactly what measures the Chancellor will or will not be taking in order to make the change he announced yesterday consistent with sticking to the fiscal rules.

Chris Giles,
Financial Times: Just a follow-up on that last question. Six years ago in 2002 you came here and said, after the government increased spending on the Health Service finance by a large tax increase, that we should go back and look at our text books and look at balanced budget multipliers. What should we be looking at today? Is it Ricardian equivalence, that people won't trust this tax cut and won't spend it - ?

Mervyn King: Well that would be a good start.

Chris Giles: - or is it Keynesian multipliers at an inflationary time?

Mervyn King: Well that would be a good start. Ricardian equivalence would be a good start, but of course we don't - I mean, the expert on this is Professor Bean. I shall let him comment in a minute. But as I say, this is not a measure that's terribly significant for the economy as whole. It's not negligible by any means, but it's not something which drastically changes the picture. It is one that the Committee will have to take into account when it meets in June. But perhaps for a reading list, Chris, in the summer I can do no better than refer you to Professor Bean.

Charles Bean: I shall mail you one. [Laughter] The one thing I might add to what the Governor's already said - clearly it will be important what the offset is later on in the year. But the measures announced yesterday may have impacts not only on the demand side of the economy; they may also have some impact on the supply side as well, on labour force participation and things like that. So it is quite a complex assessment that's required of the overall impact, particularly on the inflationary balance in the economy.

Chris Choi,
ITV News: Governor, you spoke there of a bumpy road ahead. I just want to get a clearer idea of how long you expect that road to be. We've got a new survey for ITV News out today saying that a third of consumers except the economy to deteriorate further for at least another two years. Do you share that outlook?

Mervyn King: It depends how you define it. In our forecast published today we see growth slowing sharply over the next year, but then recovering in the second year. We see that there will be a squeeze on living standards over the next couple of years - consumer spending will not grow rapidly in the next couple of years. It's going to be a difficult period of adjustment for the country over the next one to two years. As I said in my opening statement, we will need to be patient.

These forces requiring the adjustment are coming from the rest of the world economy. The rise in oil prices, the rise in food prices - these are not being generated within the UK economy; these are coming from outside, and we have to adapt to them.

Rumyana Vakarelska,
Bulgarian National Radio: Is it possible to expand a little bit more on the impact of inflation on commodity prices probably by sector - because obviously commodity prices, as you mentioned, are going to go higher - they are already getting higher? And my second question is -

this week celebrates ten years of the start of Eurozone, and UK consumers could buy less in the UK but they could buy less, even less, when they go in Eurozone. Are there any considerations, any plans for UK to look back to Eurozone and possibly joining it in the long term?

Mervyn King: Well, I'll ask Professor Bean to answer the first question on commodity prices. On the second, that's a question you'll have to put to the government. Amidst all the political debate which has ranged over many subjects in recent weeks and months, I've not heard anyone suggest that joining the Euro area is an imminent possibility. And over the last decade we've been able to keep inflation extremely close to, on average, to our target. So I don't think there are many lessons; both the Euro area and ourselves have set interest rates in the interests of our respective areas, and I think done a good job.

On commodity prices, Charlie?

Charles Bean: Well at the risk of stating the obvious, the prospects for commodity prices depend upon both demand and supply, and a key driver in the run-up in commodity prices - oil, food, metals - over the past few years has obviously been the growth in demand coming from the emerging market economies, particularly, but not exclusively, China. However, it is worth recognising that's not been the only factor. In the oil market, despite elevated oil prices for some time now, the increase in supply has been relatively modest. That's partly been as a result of the decision by OPEC not to increase supply markedly, and it's also been because the oil in the rest of the world is quite often in relatively inaccessible places or in regions of the world which are politically relatively unstable, which makes companies less inclined to invest in extraction.

We take the view that - well, it's obviously very difficult to predict where oil prices will go - but it's difficult to see a significant increase in the supply of oil in the near future; further out it's plausible to expect increased supply.

On the other hand, as regards food prices, it is more reasonable to expect a supply response. I know that the past year we have seen some adverse supply shocks - poor harvests, particularly in Australia with the drought there. One wouldn't necessarily expect them to be repeated, so I think we would take a slightly more optimistic view of the prospects for food prices than we would for the oil market.

Laurance Norman, Dow Jones: First of all, Governor, is there now a significant risk of recession? And secondly, there's been a little bit of murmuring around the inflation target and whether that should be redefined in any way; are there any changes to that target that you think are worth considering?

Mervyn King: I think the most important point to make on that is that changing the target, changing the remit, having a different approach, does absolutely nothing at all to change the nature of the dilemma that we're facing. The fact that we have a combination of slowing growth and rising inflation is a difficult challenge for monetary policy; it results in these price level shocks from the rest of the world and it has absolutely nothing to do with the remit - facing the dilemma. The question of the remit is a question of how do you choose to resolve that dilemma and what path of interest rates do you pursue? This is not the moment to change the inflation target. There are many good aspects that you could investigate and think of and study, and I mentioned for a long time the fact that all of us I think have wanted at some point to see house prices enter the consumer price index. And Eurostat is sort of thinking away about that. Well, maybe some other people should now start working on it - bit of competition won't do any harm there. And I encourage you and the think-tanks and academics to reflect on that. But this is not the moment to change the target.

We are facing a difficult position and we have to make difficult decisions and come through it, and come through it we will. But to think that you can resolve a dilemma like this just by changing the target, is to misunderstand I think the nature of the challenges facing the Committee now.

In terms of recession, I said the last time, if you look at the forecast, the projections for GDP growth in field one, on page 7, I mean you can see that there is a sharp slowing of growth and it's quite possible that at some point we may get an odd quarter or two of negative growth. But recession is not the central projection at all. But clearly further shocks could push us in that direction, but it certainly is not our central projection.

Jenifer Ryan, Bloomberg News: I wanted to ask you about your remarks in the introduction about the credit cycle having turned, and then also I note in the report that there's a risk of continued overshoot in credit risk premia. After the Financial Stability report was published there were a number of people who took that as an indication that the Bank was of a mind that the worst was behind us. And then we've also had some bank executives say basically the same thing. Would you say that they were wrong?

Mervyn King: I'm not sure whether some of the reporting of the Financial Stability report gave an accurate assessment of the combined messages in that report. What we said was that some of the valuations that were being used to mark various assets on bank balance sheets to market were perhaps at an unsustainably low level because they were using fire sale prices to market, and hence some of the losses which have been recognised may yet turn out to be written back as profits next year if those prices recover, as they may well do if those assets are held to maturity. So we did say that there'd been some sign of overshooting in the valuation of assets.

But it's a big step from that to conclude that conditions, certainly in terms of the credit market, are beginning to ease. In some ways we're only beginning to see the difficulties that have faced banks feed through now to conditions in the credit markets for companies and for households. So I think you can't just go straight from the statement about how the valuations that are being used to market to a judgement that we've passed the worst in terms of credit conditions - we're clearly not. That situation is still extremely difficult.

And I think it's also very important to distinguish between what we said there about the valuations of bank balance sheets and some of the issues in the interbank market, where I think the Special Liquidity Scheme has helped to stabilise the situation, but conditions are still fragile. But let me ask Paul to come in on this and comment on where he sees the state of play at present.

Paul Tucker: I think the process of deleveraging in the financial sector will go on for some considerable time - I don't know precisely how long - and therefore it will inevitably be a bumpy road. But as the Governor said, things are for the moment a lot better than they were six or eight weeks ago round the middle of March. Not only is there more confidence in the bedrock stability of the system, not just here but internationally, but there's also - perhaps for the first time in a while - signs that people are coming back into the market and prepared to take risks, prepared to buy assets at slightly above fire sale prices. And if that continues, they'll be part of a broad recovery. But it continues in parallel with deleveraging across the system.

The financial system is probably in a position where the big question is whether or not it can more or less complete this process of deleveraging before the slowdown in the global economy starts to increase the real impairment of their credit portfolios. And to the extent that that is achieved, that will be good news for the macro-economic outlook; to the extent that it isn't achieved and the system is still fragile when the falls start to rise, then that will be a further adverse shock to the outlook for activity.

Stephanie Flanders, BBC: A couple of things. One, just picking up on that - at the time that the Special Liquidity Scheme was announced, you did make it - well, increasingly clear over the days following that you wouldn't judge the success by anything that happened in mortgage rates. But there was an expectation, at least among many people, that you would have expected some decline in the interbank lending rates, which has not happened to a great extent so far. Are you disappointed by that? Or how do you yourselves judge the success of that scheme? I don't know if you want to answer that and I'll do the other one as a bit separate.

Mervyn King: I'll comment first and then ask Paul to come in again. When we launched the scheme I said that my definition of success would be that when I woke up one morning and suddenly realised I hadn't been worry about the health of the banking system for two months, then I knew the system had restored enough confidence. We haven't yet got to that point, but maybe one day I'll wake up and accidentally realise that I haven't been worry about the banking system for a couple of months.

Spreads have come down, Libor spreads have come down since the date when press reports started to circulate suggesting that the scheme will be put into effect, spreads have come down by 24 basis points. Credit default swap premia have come down by 74 basis points. So there has been quite some impact there and that's in a period when in other markets spreads have not come down as much and in some cases have gone up.

But I don't want to evaluate it directly in those terms. As I said the real impact is to provide a basis for a gradual restoration of confidence in the banking system, so that people will be willing to take - to deal in an unsecured way with other banks.

But I think it's worth pointing out that what we've seen over the last six to nine months in a way that no-one had really planned or prepared for is that the inter bank market is moving significantly in my judgement towards greater reliance on secured borrowing rather than unsecured borrowing. And to the extent that that happens the residual unsecured borrowing that's left for which these quotes are relevant might well be characterised by a higher spread in the longer term and we saw before the trouble started. So that the historical average spread of you know 15 to 20 basis points between Libor and the OIS expected policy rate over three months might well turn out to be you know noticeably higher in the future. We shouldn't expect that a real equilibrium will necessarily go back to the same level.

Nevertheless I don't think we've got back to whatever that level is yes and it may be many months before we do so. So I think we're going through a period which will take a considerable time to get back to something more stable. But Paul is the expert on all of these markets, Paul?

Paul Tucker:

Well I agree with what we've said, I mean the test of success really is rebuilding confidence in the banking system and the anecdotal information on that, not just from the community in London but from pretty well all over the world is encouraging on that from.

I mean looking at the Libor-OIS spread as the acid test which some commentators have done is a really misleading thing to do. So say we brought the - say the effect of the scheme was to bring the sterling spread back into line with the dollar spread and the euro spread which is actually more or less what's happened, well this is still incredibly high. And as the Governor said the big question looking ahead is just how far the structure of this market is going to change. And I don't think it's just a matter of the inter bank market, the rate at which one bank will loan to another bank, but also the extent to which money market funds, mutual funds more generally, insurance companies, pension funds are going to reduce their appetite for having unsecured, untransferable, untradable deposits with the banking system at six months and twelve months.

Who knows where the spread will settle, but I suspect it will above where it was in the past and as the Governor said I suspect that the margin - activity will gravitate towards the secured markets.

Stephanie Flanders, BBC:

There was just one quick follow up, a totally different subject. There has been a very stark, or on the face of it quite stark, contrast between the official retail sales stats and all the other data that we're getting from surveys, British Retail Consortium and indeed company results. Do you have any view on that? Is there a view on that embedded in the forecast?

Mervyn King: Yes we put quite a bit of weight on the surveys, because they're consistent with all the other information we're getting including from our own agents that there is a noticeable slowing in consumer spending which didn't show up in some of the retail sales figures. But let me ask Charlie to reply?

Charlie Bean: Well the text on page 20 of the report bears directly on this very relevant issue. As you say the retail sales numbers do look somewhat stronger than really a raft of surveys, the CBI, Distributive Trades Survey, British Retail Consortium, what our own agents are telling us. Now there are possible explanations that have been muted for this divergence that the surveys don't have as wide a coverage as the official data, in particular that they don't have such a big sample of smaller retailers.

Arguably they don't also pick up some of the more unconventional retailing outlets, such as the internet. Also there has been a suggestion there may have been some peculiarities associated with the seasonal adjustment process, Easter falling unusually early this year and being a leap year and so forth.

So there are a number of possible culprits around. It has to be said so far we haven't been able to collar any one of them as being the one who did the deed. And given the uniformity of the picture from all of this other evidence the Committee has put some weight on that other evidence relative to the official retail sales data.

It should be said these divergences between the official data and the surveys are not unusual. If you go back and look in the past there often have been transitory deviations but they usually come back together after a month or two. But it's unfortunate that there is that confusions of signals at this current juncture.

Sean O'Grady, Independent: In your opening remarks you talked about a squeeze on incomes. I wonder if you could say a little bit more about that and quantify how bad and how long we can expect to be squeezed?

Mervyn King: Well of course real incomes in the sense of real take home pay per head has not grown quickly over the past four years. In a steady state you might expect real take home pay to be growing at about the growth rate of productivity, say 2% a year. Over the past four years real take home pay has risen well below 1% a year, between half a percent and 1% a year. That's quite a significant shortfall for growth rate to real take home pay. And over the next two years we would expect equally a period of at least as great a squeeze on living standards, because the impact of higher oil prices, food prices does clearly erode purchasing power. And this is coming from the rest of the world and it's a price which the UK is having to pay for what is happening in the world economy.

So I think we will have been through quite a significant period of very low growth in real take home pay. It's not falls in living standards but it is very slow growth in real take home pay.

Faisal Islam, Channel 4 News: Governor, you made a reference earlier to measures in relation to the tax cut yesterday, measures in the future to make this consistent with the fiscal rules. Am I right in thinking that you think that the measures took yesterday weren't consistent with the fiscal rules?

Mervyn King: Well that's for the Chancellor to say and I welcome his commitment to the rules and he said very clearly that he would return in the pre budget report to make clear what policies he would have to put in place in order to ensure that what he's proposing is consistent with the fiscal rules. I don't know what that will be and I'm sure he hadn't made up his mind up yet. That he will come back to at the time of the Pre-Budget Report.

Faisal Islam,
Channel 4 News: There were some moves in the consumer credit data which showed unsecured borrowing had up and secured borrowing had gone down. Are you concerned about that, that people are shifting money onto credit cards and overdrafts?

Mervyn King: I think we feel that some of the move to unsecured credit might reflect activity in student loans, rather than people reverting to an excess use of credit cards. I think the lessons in the run up in credit have been well and truly learnt and we're seeing quite a sharp slowdown in borrowing. And clearly on the supply side a significant withdrawal of the ability to borrow, particularly against you know 100% or more Loan-To-Value ratios. We point out in the report that none of the major lenders are willing to lend 100% Loan-To-Value ratio. We're reverting I think to a more sensible balance and a more prudent approach to both lending and borrowing. It's a difficult adjustment, but it's one that we really needed to make.

Marco Niada,
II Sole: Recently you spoke against the excessive culture of bonuses and retribution of the City, but probably that was one of the reasons why they had it so good for the last ten years or so in the financial sector. So looking forward, do you foresee if all that is going to change a different sort of evolution of the financial sector and probably also reduced weight of the financial word within the economy?

Mervyn King: Well it's almost impossible to know what will happen in the future. The point that I made was not an original one; I was neither the first nor the last to make the point that the structure of remuneration, not the level, but the structure of remuneration had created incentives towards excessive risk taking which were probably not in the interests of either the banks or their shareholders. And that is something I know that they will be thinking hard about when designing remuneration schemes for the future. But what they do is up to them and I can't easily anticipate the future. But as I say the point I made was about the structure or remuneration.

Heather Stewart,
The Observer: I just wondered if you could talk a little bit about what you think the impact on the wider macro economy will be of the housing slowdown that now seems to be underway. You've talked in the past about the fact that you don't think the wealth effect on consumer spending is that strong, but obviously there are other macro effects, and we've had a number of profit warnings from house builders, from retailers, DIY retailers and so on, not surprisingly with transactions being down a third on a year ago. I just wonder how important you expect the housing market slowdown to be a factor over the next year or so?

Mervyn King: Well it's clearly going to be a factor because it will impact in a number of ways. One is that one would expect that investment in housing seems to be falling back, as indeed is investment more generally, if you look at the investment intention surveys. So one would expect to see some impact there, though not as large as we've seen in the United States where the scale of residential investment relative to GDP is both higher and considerably more volatile than in the United Kingdom. So there will be some effect.

We've always said for a long time that in terms of the link between house prices and consumer spending is not a direct causal link it depends on conditions and it can vary markedly over time.

An interesting example of that can be seen in the United States where actually falls in house prices did not appear to have a very large impact on consumer spending until the squeeze on real incomes which arose in the US because of the rise in petrol prices really had a big income on disposable incomes and that led to a slowing in both consumer spending and quite possibly a further twist to house prices.

So I think one has to look at the third factors which are common both to house prices and consumer spending. And to go back to the question about the squeeze on living standards that is clearly coming into play in quite a significant way and is likely to affect both. And the change in the availability and price of credit will also affect what's happening in the housing market. And you would expect at a time when no one who is honest can say where house prices will go. And at a time of great uncertainty about the level of house prices it's not surprising that activity in that market contracts very sharply while people are tying to work out what the new equilibrium price level is. And that's what we're seeing; we've seen quite a sharp reduction in mortgage approvals.

But over time that will get back to normal again. And we've moved from the position where you know mortgage approvals were one third above the long run average rate to a position where they are one third below. And I'm sure at some point we'll get back to a position where they're close to the long run average again.

I don't know Charlie whether you want to add any more on house prices and consumption?

Charlie Bean: Well just merely to point out that it is a complex nexus. I mean commentary sometimes rather blithely assumes that there is a very tight link between house price growth and consumer spending. And it's true that in some past episodes that has appeared to be there, chart 2.5 of the report illustrates this. You can see for instance during the '80s and early '90s in that chart quite a strong correlation. But in our view that was because both were being driven by one of these third factors that the Governor referred to, namely views about future income prospects. And it is very noticeable that that relationship hasn't applied over the last few years when house price growth has been very high yet consumer spending has been growing pretty steadily. And that is because we think there have been other factors driving just the housing market alone, particularly the low real interests rates that the Governor referred to earlier, also some other demographic and structural factors.

And just as that period of relatively rapid house price growth wasn't associated with rapid consumption growth, so if house price inflation slowed sharply there's no reason to necessarily extrapolate that into a sharp deceleration in consumer spending. We do think consumer spending will slow but that's primarily because real income growths will be slower over the next year or two.

Daniela Milanese,
Grupo Estado, Brazil: I would like to know from now on what impact on global inflation do you expect from emerging economies?

Mervyn King: I'm not sure if I like the idea of sort of global inflation. Inflation is a fall in the value of money and therefore inflation is specific to a particular currency area. And in the short run shocks from the rest of the world can make it very hard to keep your price level under control, but in the medium to long term you can influence inflation by pursuing an appropriate monetary policy, or you can have high inflation if you want it.

What we're seeing in the world economy are changes in relative prices and very big changes in relative prices. We saw a fall in the price of manufactured consumer goods relative to services and other goods in the mid '90s to early 2000s. I know in the last four years we've seen a very sharp rise in the prices of all commodities whether it be oil, other energy, metals, minerals, all commodities have risen very sharply in price and now of course food. And this is reflecting growth in the emerging market world. And that's reflecting rising demand which is reflecting higher living standards which is a very welcome improvement in the world economy.

But it's a major challenge that we're seeing these big changes in relative prices and that's what a market economy is there for to guide and shape the incentives which will determine the response of different countries to those common world prices. And we're seeing it in the case of energy, we're seeing it in the case of food, we're seeing it in the case of other commodities. It's raising the costs of producing certain kinds of goods and services that are energy intensive or commodity intensive and it's lowering the prices of others.

And these are changes which are a direct consequence of globalisation. They are different challenges, because they often mean changes in the structure of production. But in the long run they can raise living standards.

But I don't think that in the long run they affect the overall level of inflation. That is to do with the Monetary Policy strategy of each of the individual currency areas.

Ian King, The Sun: A couple of questions if I may Governor. First of all on page 23 you say there's market intelligence that some lenders are increasingly using repossession orders as a way of encouraging repayment. Now I know you no longer have regulatory responsibility for the banking industry, but I wonder whether you might comment on that please?

And too on pages 46 to 48 in your discussion of the labour markets you say that the Committee is having difficulty in assessing future expectations for inflation. But I wonder whether I could invite you to give us your views on that?

Mervyn King: Yeah on the second one I'll ask Charlie to comment on inflation expectations. On the first one, possessions and repossessions are still markedly below the levels where they were in the early 1990s. Relative to mortgage arrears they're higher than they were, in part as we say in the report because we think that the use of possession orders is less now to follow through to obtain repossession and more to start a process which will lead to the repayment of the loan. And legislation came in which affected that.

Clearly any repossession is a family losing their home which is a story of great economic distress, and what everyone would want to avoid. Of course there are some repossessions all the time. As I said the level is still way below the level of the early '90s. And the level of mortgage arrears is even further below. The fraction of mortgagors who are in arrears to the extent of three months or greater is about 1% and it peaked at 6% over 6% in the early 1990s. So the scale of the problem is very different.

And I think it's worth hanging onto the fact that when families get into difficulty, the question is what will affect their ability to service the mortgage debt. And what caused major problems in the early 1990s was the doubling of interest rates and the very sharp increase in unemployment. Those two things created serious difficulties for many families in being able to service debt. Now those of those things apply at present, nor are they part of our central projection. They don't look very likely outcomes.

That should make it much more likely that the large numbers of people finding themselves in a position where it's difficult or impossible to service their mortgage debt will remain markedly lower than in the past. And I think it's very important to sort of hang onto that point. Even though we will start to see clearly a cyclical pick up in those aspects of mortgage problems that you would expect to find not just in the mortgage market but in all credit markets when the cycle turns in the way it's turning.

Charlie on the …?

Charlie Bean: Yeah inflation expectations are absolutely central to the conduct of monetary policy. If households and businesses believe inflation is going to stay relatively low they're less inclined to push for higher wage settlements, less inclined to push through price increases. And in that sense low inflation expectations help keep inflation low; it's a virtuous circle.

So, measures of inflation expectations which it should be said are not particularly good, but those measures that we do have are things that we pay particular attention to. We have some surveys of households. We also have information from financial markets. Now those measures have mostly moved up in the last year or so. If you look at chart 4.7 of the report that gives you both the shorter term household surveys and some longer term measures.

Now it's not surprising that the shorter term measures for inflation over the next 12 months have picked up. That's what we're expecting to happen to inflation. And what is most important for the Committee is that people's perceptions of longer term inflation, inflation in the medium term remain reasonably well anchored. And there's some suggestion that they've also moved up although there are issues of interpretation with the financial market measures. They will contain in there risk premium as well so they don't give a direct read on the expectations of inflation in the financial markets. And there are also questions about exactly what measure it relates to.

The other thing that makes it tricky for us in this area is actually knowing what are the key factors driving inflation expectations. We have carried out a survey that tries to dig a little bit deeper into this. We have this regular survey of household inflation expectations and we added some extra questions on recently which asked respondents what were the key factors driving their expectations. And you can see the results in chart 4.8.

And they're not far away from what you might have expected, namely people are most influenced by things that they buy regularly and/or they have to buy. So food, energy, transport weigh particularly heavily in the way people form their expectations.

So I think we have a sort of reasonably coherent picture of what's going on although of course as we're expecting further rises in energy prices over the next year, that would lead us to expect these inflation expectations measures, at least for the short term horizon, are likely to remain elevated.

Paul Wallace,
The Economist:

Well just following up from that. As I took it from some of the earlier answers you were saying that the current upsurge in inflation is essentially being imported from the rest of the world. But the recent CPI numbers seem to indicate that it's more broadly based with service sector inflation - services rising quite sharply. And to what extent are you concerned that it is now being domestically generated with for example inflationary expectations now having stepped up as Charlie Bean was just saying?

Mervyn King:

Well I think there are two parts to that. The inflationary expectations issue is crucial as Charlie said, to the extent that this temporary period of higher inflation resulting from external influences continues. As we've had more persistent shocks to oil and energy and commodity prices, then it makes it more difficult to expect that inflation expectations will come back down again. And that is a source of concern and that's one of our major worries, it's the major upside risk to inflation in the medium term.

But I think you'll find that in terms of the immediate increase in inflation that services companies too use energy quite significantly in fact, and so that the impact of these price increases is affecting the prices of all goods and services in the UK as they pass through. It isn't just a direct sale of petrol or home heating oil; it's the indirect passing through of these higher costs to the costs of producing all goods and services. And that is the major cause of this. And clearly the slowing down of the economy over the next year or so will help to reduce the possibility that any domestically generated inflation might be adding to the forces coming from overseas.

But I think the big picture that we see is of a sequence here of very significant cost shocks coming from abroad. I mean a doubling of oil prices in a year on top of the previous increases. Oil prices are more than four times as high as they were four years ago. That's a very, very significant increase. All the other increases coming through have led to quite a big impact. And yet despite that we've still only had one month when inflation was above 3%. We are now going to have probably many more but we will bring it back. And we will try to ensure and we will ensure that these external cost shocks will not feed through to a permanent increase in domestically generated inflation.

Larry Elliott, The Guardian: Just following up on that Governor, what's your assessment of the state of the labour market and the likelihood that these first round effects of higher imported inflation will feed through into higher wages? After all there's been no real pick up in average earnings when the economy has been doing well over the last three or four years when growth's been very strong. Isn't there only a remote possibility that wage bargainers, even given the higher cost pressures, are going to be able to bid up the prices of their labour at a time when you yourself are saying that the economy is going to slow quite sharply over the next 12 or 18 months?

Mervyn King: Well I think that view is broadly built into our central projection, but there must be risks that the squeeze on real incomes at some point provokes a reaction and an attempt to try to maintain living standards that can't in fact be preserved but will simply result in higher inflation. And that's something which we need to guard against and I think the concern we have is that some of the measures of inflation expectations have picked up as Charlie said. And that's a slight worry. But as you say broadly so far the labour market has produced a remarkably stable growth rate of nominal earnings and wage settlements through the last four or five years. And we very much hope that will continue.

Chris Giles,
Financial Times: In the mid '90s a similar depreciation of sterling had extremely benign effects on inflation given the large output gap. And our retailers in particular taking a lot of it on the chin with lower margins. What are you hearing about what retailers are likely to do about pass through? What are your agents saying? Are you expecting that sterling's fall this time round to be rather less benign?

Mervyn King: Well if you go back to the interpretation of what happened in the early '90s, I think that the direct impact of that on costs was passed through. What was happening at the same time was, as you pointed out, with such a large output gap underlying inflation was falling very sharply and the impact of the depreciation slowed that somewhat. But certainly it didn’t pass through into second round effects on wages. But as Larry says that's what we’ve seen in the last four years. So we might hope that the same would be true.

But it is very important that we can maintain the anchor of inflation expectations and assure people that we will bring inflation back to the target, all be it it will take a bit of time because once these price level effects have got into the price level they’re in the official measure of inflation for 12 months. And it takes 12 months before they drop out. But this is what happened last year. We said last year that inflation was going to rise. We said that it would come back. It did come back and inflation will pick up but then it will fall back next year.

Ed Conway, The Telegraph: Governor you said at the Treasury Select Committee a couple of months ago that we were in what you'd define as a credit crunch. Can you just tell us now whether we're still in the credit crunch and what would you define that to mean? And also just to follow on on the questions on arrears and repossessions. The level of repossessions and arrears was very low as well back in 1989 as chart 2.6 shows, so is it not disingenuous to suggest - I mean that was at the start of the last housing slump. Is it not disingenuous to suggest that now because arrears are low at the moment that doesn't mean that things aren't going to increase, potentially significantly in the future?

Mervyn King: Well they may well increase as I said at this stage of the credit cycle but the two enormous differences between then and now are then you had a large rise in unemployment and a doubling of interest rates. Well I don't know what will happen to interest rates but do any of you think that they're likely to double as a sort of realistic possibility in the next couple of years? That I think is the enormous difference. You know mortgage rates went to 15%. That was an immense drain on the cash flow of people who had just bought houses, and not surprisingly led to a significant rise in arrears and then repossessions. I just don't think we're in that situation now.

I don't want to give a general essay particularly given the time on the credit crunch, but I do think we've moved to a situation where you can see that the banks are in the process of adjusting their balance sheets. And one of the ways in which they're adjusting their balance sheets is to reduce the growth of their lending to non-financial customers, in a way that might not have been anticipated six to nine months ago. As I said for a long time one way of ameliorating that effect is for banks to raise more capital. That's another way and in many ways a better way for the economy as a whole for them to restore and rebuild their balance sheets. And that is beginning to happen now in the British banking system and that's very much to be welcomed.

William Keegan,
The Observer: Mr Governor I was going to ask you about second round of effects normally referred to as ….. but that has been partly answered. But may I follow up your earlier answer. On the fact of the slowing down of the economy and that impact on ….. first is the desire to recoup living standards which you mentioned. How would you weight those two ….. when it comes to subsequent wage demand?

Mervyn King: Well that's hard to judge. In the central projection I think we certainly think that the impact of some of the slowing of the economy will more than offset any attempt to rebuild real wages which are being squeezed by external factors. But I think there's one factor which makes us a little cautious about that which is that just as on the upside when employment was expanding rather rapidly the inflow of migrant labour, particularly from Eastern Europe, helped to dampen the impact that that might have had on pushing wages up. Helping to achieve a very benign outcome for earnings growth that I described.

So it could be that as the labour market slows some of the impact of that will not be in terms of pushing down wage growth, but in terms of migrant labour returning to Eastern Europe and not being as available. And as I said before migrant labour was acting as a safety valve and that applied both when there was potential upward pressure in the labour market, but equally it might do the same now. So we might not see quite the same downward pressure on labour costs in the next couple of years that we would have seen had there not been this pool of labour form Eastern Europe that we've been able to use.

Jennifer Ryan, Bloomberg: What is on your agenda for your second term?

Mervyn King: Things have been so busy recently that it hasn't been entirely easy to formulate. I have thoughts and ideas. I don't think this is the moment to spell them out yet. I'll be happy to do that in August, come back in August and we can discuss it then. But we haven't quite got into the second term and there are a number of issues to be decided before then. Not least of which is what the Bank's role in financial stability will be. That's a very important issue that the government need to decide over the next few months and the answer to that question will determine at least part of the answer of what my priorities are for the second term. But I'll be very happy to answer that question in August.

Wenxian Chen, Xinhua News Agency, People's Republic of China: Do you think that one or two of UK's relatively small scale banks, maybe Alliance or Alliance and Leicester and B and B will be acquired or merged by others before credit conditions are c…..

Mervyn King: I don't know what on earth leads you to imagine that I will comment on individual financial institutions and I don't propose to do so.

Faisal Islam, Channel 4: Can I just clarify, you said something last time about there being no great expectation for banks to pass on the rate cuts that you're putting through the system to mortgage borrowers. Is that still your position?

Mervyn King: Well I think what's happened is not very surprising, that banks have been rebuilding the margins which have been compressed very significantly over the previous 18 months. In the period up to the middle of 2007 it was quite striking that when we were raising interest rates, mortgage rates did not rise one for one with the increase in banks rates. Margins in the mortgage market were being significantly compressed. That wasn't likely to be sustainable and I think by the middle of last year they had reached a clearly unsustainable level.

What's happening now is that the market is now adjusting; margins are being rebuilt to a more sustainable level. Hard for me to judge exactly where that will be. But part of that process is that during the period when we cut rates by 75 basis points and obviously mortgage rates, you can see the table in the report, have not fallen as much. And I don't think that's very surprising. That's part of the process of rebuilding those margins.

Laurance Norman, Dow Jones: Governor do you think it's healthy or do you think it's a little bit worrying to the market and to people in general that there was a three way split on the vote? And is that something you expect given the rising inflation numbers that we saw yesterday is that something you expect not to be a problem in coming months?

Mervyn King: I don't think people are remotely worried about that. One of the things which I've been very struck by from the beginning of this process going around the country talking to business audiences is that they may not always agree with the decisions that we take, but what they really respect is that around the table at the

Monetary Policy Committee all the arguments are heard. What they don't want is someone to come along as various other people sometimes do when they speak to them, and say it's obvious what the answer is, I'm the only one with the right answer. It isn't that clear.

There are different arguments to be put and the great virtue of the MPC is that whatever decision we take we rely on the fact that collectively we have greater wisdom than any of us do individually. That's why we respect the majority vote. And to do that it's got to be the case that all the arguments are put on the table. There are good arguments sometimes for raising rates, good arguments for cutting rates. These need to be balanced. We have to demonstrate that these arguments are being put on the table to demonstrate that we are really taking them into account.

And that's what the process of publishing full minutes does, and sometimes that leads to split votes. I think that is not only healthy but actually people out there running real businesses understand this is a very natural way to discuss and reach a decision. And they respect it and I respect their judgement on that.

Arisa Yoshida,
Nikkei, Japan:

Two questions. Lately there are a couple of reports about the credibility of the Libor rates which several banks might be reporting the false rates to BBA. Would you please comment on this topic? And secondly you recently mentioned about the role of central banks in terms of financial institutions migrations especially on the focus of systemic risk that - if my recollection is correct you mentioned that central banks could play more role to stabilise or to prevent the risk of the systemic risk in the financial market. What kind of reform if possible - are you hoping to happen in the UK in terms of this role of financial revelations or central banks saying …?

Mervyn King: Well on that second one I'm going to ask you to be patient a little longer given the time because I'm giving a speech in June which will touch on some of those issues and I think it's better to deal with that. It's not really directly connected with the inflation report.

In terms of the Libor rate and what it measures, I think we should ask the expert on this, Paul.

Paul Tucker: There is a review of Libor going on. It's being conducted by the British Bankers Association which is responsible for Libor. We're following that debate with interest which I'll come back to but we're not driving it anyway, it is a market standard. It's a very important market standard, it's used throughout the wholesale markets; it's used in a lot of retail financial contracts as well. It's vital that not only that there is integrity in the Libor process but also but also that there is seen to be integrity in the Libor process. And this isn't just a UK debate, this is something used in Asia and in the States as well. My impression is that the review is wide ranging, taking opinions from all parts of the financial markets and I don't want to prejudge the outcome but I think it is very important that it does deliver confidence.

Male: Thank you very much indeed everybody for coming along.

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