BANK OF ENGLAND

Quarterly Bulletin

2007 Q4 | Volume 47 No. 4

Foreword

This quarter's edition of the *Quarterly Bulletin* begins with the regular *Markets and operations* report, reviewing developments in global capital markets and the Bank's official operations over the past three months. Following the financial market upheaval during the summer, there were signs of improvement in some markets during October. But conditions in credit and money markets deteriorated again in November, amid increased concerns about the magnitude and distribution of losses on structured credit investments. Coupled with the continuing difficulty of distributing securitised loans and the reintermediation of such loans back onto banks' balance sheets, this led to renewed funding pressures on banks.

A key issue facing the Monetary Policy Committee is how households' accumulation of debt in recent years will affect the way in which they respond to changes in interest rates and credit conditions. That response is likely to vary across households, so it is potentially fruitful to examine disaggregated data to assess the impact. Matt Waldron and Garry Young use the latest survey of households, carried out annually for the Bank by NMG, to examine how they have responded to changes in the burden of mortgage payments over the past year, and whether they are experiencing greater problems in servicing their debts. The survey suggests that around half of mortgagors experiencing an increase in mortgage payments had cut back their spending. But the proportion of mortgagors reporting difficulties in paying for their mortgage remains relatively low and appears to have changed little over the past year.

The November *Inflation Report* highlighted higher energy prices as one factor raising the near-term outlook for inflation. But the impact of such cost shocks on inflation in the medium term depends crucially on the conduct of monetary policy and the evolution of inflation expectations. Richard Barwell, Ryland Thomas and Kenny Turnbull set out the different channels through which higher energy costs affect the economy. So far, the impact of rising energy prices on both activity and inflation appears to have been much less pronounced than in earlier episodes of sharp energy price increases. That is probably related to the greater flexibility of both goods and labour markets, as well as the anchoring of inflation expectations.

Corporate bond spreads — the difference between the yields on corporate and government bonds — narrowed between the end of 2002 and the middle of this year, but have widened during the recent financial market turmoil. These spreads reflect both compensation for bearing the risk of default and the effect of other factors, such as market illiquidity. Lewis Webber and Rohan Churm describe a method to separate the spreads into these different components, using market information on default risks. Their analysis suggests that the recent rise in spreads reflects both an increase in the required compensation for default risk and the impact of heightened liquidity concerns.

The United Kingdom is currently the world centre of foreign exchange activity. Grigoria Christodoulou and Pat O'Connor present the results of a survey, conducted in April 2007, of foreign exchange market turnover. This showed that the United Kingdom accounted for a third of the share of the global foreign exchange market — a rise of 80% over the preceding three years. That is almost double that of the next biggest centre, the United States, which accounted for just 17% of the global market. A number of developments, such as the proliferation of electronic trading and the increasing number of market participants appear to have contributed to the strong growth in foreign exchange market turnover. The article also reviews recent developments in the over-the-counter derivatives markets.

Charles Bean
Chief Economist and Executive Director for Monetary Policy, Bank of England.

Research work published by the Bank is intended to contribute to debate, and does not necessarily reflect the views of the Bank or of MPC members.