

WORLD TELEVISION

Bank of England

Quarterly Inflation Report - 13th May 2009

Michael Wilson, Sky:

You peppered your brief introduction with the word 'uncertainty'. Looking at the GDP chart, it looks like we've turned the corner. Are you confident about that?

Mervyn King:

I think the whole point of the Report today is to say that many things could happen and it would be, I think, extremely unwise for anyone to claim that they know what the future is going to hold. After the last 12 months, anyone who says 'well, we now know exactly what's going to happen' I would have thought was rather deluded.

So there is a balance of risks, and what we spell out in the Report are some pretty solid reasons for supposing that there will be a recovery over the next year, but also some pretty solid reasons for questioning whether that will be sustained and for supposing that the process of getting back to a more normal path for growth and inflation may take considerably longer.

And how the balance between those things pans out will depend on events over the next couple of years that are not easy to predict, and in particular what happens in the rest of the world. One of the most important factors influencing the UK economy at present has been the extraordinary collapse in trade and output in the world as a whole over the past year, since last September.

Sam Fleming,
The Daily Mail:

Could I ask you - the recovery and growth in 2010 gets us towards about 3% growth, looking at the Fan Chart. Could you explain why it is that, given that sharp recovery - or apparently sharp recovery - you expect inflation to remain so low, below target, throughout the projection period, especially since it appears that you underestimated the upside risks of inflation in

the first quarter of the year; and also in light of the recent rebound in energy prices?

Mervyn King:

I think we've had news on energy prices, retail energy prices, over the next year or so, which actually is on the downside. I think we've seen downside news to activity since we put together the February Inflation Report, and that's clearly affected our view.

But I would urge you again, if I can, Sam, not to focus on a central projection. The probability of that occurring is close to zero. We're concerned about all possible outcomes and the probabilities we'll attach to different possible outcomes.

In fact, if you look at the chart we produce for - if you look at the Fan Chart and also the Ziggurat Chart, which is shown in Section 5 on page 41 - if you look at growth to the middle of 2010, Chart 5.2 on page 41 - what that chart shows is that the probability that growth - you know, if you imagine yourself in the middle of 2010 and look back over the 12 months between now and then, the chance that output will be higher - the level of output will be higher in the middle of 2010 is according to - in this projection - no higher than the probability that output will be lower in the middle of 2010 than it is now. In other words growth has just as much chance of being positive over the next 12 months as it has of being negative.

And I think it's a better way to think about it in terms of the balance of possible outcomes - not a central projection - what is the range of outcomes? Because, as I said, the most important thing to stress in today's Report is that, yes, there are indeed signals in the economy - in the surveys particularly - that the pace of decline has moderated and that a number of indicators

are clearly picking up. This is not just, you know, an artefact; the data are clearly showing that.

And that links to the three solid reasons for supposing that you would expect some recovery over the next year. The fact that we've seen a very sharp stock cycle which can't continue indefinitely; that will automatically unwind. The fact that we've had a massive policy stimulus, both monetary and fiscal - not just in the UK, but in the world as a whole. And the fact that the UK has had a sharp depreciation of sterling. All of those things will tend to lead to a recovery.

But on the other side, there are solid reasons for supposing that the pace at which spending will recover to normal levels will take a long time because of the balance sheet problems, which have only just begun to be unravelled. And none of us know, if we're honest, how the speed between these two opposing forces will work out. The argument is there will be a recovery - yes, but the timing and the pace of it is very, very hard to judge.

This is not like the typical business cycle in the post-war period. This is something which is driven by balance sheet problems starting in the financial sector, moving to the household sector - many now being taken back into the public sector. These things take time to deal with, and it's very, very difficult to judge whether the upward momentum from the three factors I described, will in the short run - it may well in the short run - outweigh the longer run balance sheet factors. But even if there is some recovery in output in the next six to nine months, what we don't know is how sustainable that will prove to be, given the weight of the balance sheet burdens that still have to be unravelled.

And that I think is a judgement where the Committee can form a view about the balance of risks, but it certainly is not prepared to say that this is *the* path that we think the economy is bound to follow. This is very much a moment when it's important to stress the different forces affecting the economy and the fact that many things could happen, and where exactly do we think the balance of risk lies? And we've tried hard in the Fan Charts to explain where, in our judgement, the balance of risks actually lies.

Dan Atkinson,
Mail on Sunday:

Hi there, Governor. You seem to be saying, from page one of your overview onward, that the business of forecasting inflation is a rather more complicated one than it used to be. Can I ask in the light of that, whether or not there have been any preliminary discussions - looking to the world after the smoke has cleared and things have improved a bit - as to changing the business of inflation targeting and the post-1997 system that we've operating up until now, for a more wide-ranging sort of system?

Mervyn King:

Several of us on the Committee have made our views clear in speeches already, which is that it's pretty obvious that inflation targeting or the use of short-term interest rates, which is the key issue - the single instrument for central banks - was not sufficient to ensure stability; that's pretty clear. But in my view it was necessary, and indeed - unless anyone's proposing that we abandon our objective of hoping for an economy with low and stable inflation, which I've not heard anyone argue in favour of - then inflation targeting is in my view a necessary part of the framework.

But the fact that something is necessary, but not sufficient, does not lead you to throw it away; it leads you to augment it. That's what the phrase 'necessary but sufficient' means. You augment the instrument. And what we've argued in speeches is that

extra instruments will be needed in order to ensure stability - particularly the financial stability side.

Now there are a range of those, and today's not the opportunity to go into a great, detailed discussion of that, but whether you call it macro prudential, whether you call it supervisory - whatever phrase you use - there are some very big questions about both the structure of the financial sector and the way in which it is supervised and regulated, that we'll need to reflect on.

The advantage we have is that there is absolutely no need to rush into that and come to judgment now; we have time to reflect on it. Meanwhile, the MPC - despite the fact that present circumstances make it more difficult quantitatively to predict where inflation will go - nevertheless qualitatively the issues are still the same. We are trying to ensure an adequate growth of money and money-spending in the economy in order to get inflation back to the target consistent with growth close to our potential path.

Dan Atkinson:

Sorry, I was just meaning - have we gone beyond speeches, which are all well and good? Is there any sort of official or semi-official working group or steering party or anything like that?

Mervyn King:

There are more working groups than you could possibly want to be on - I can assure you. I mean, there are both domestic and international. What we need now is not process, it's not committees, it's not meetings - it's actually some thinking. So we are going to go away and think deeply about this. We are doing that already. But when you think about it, you take your time before you reveal the products of your thinking, and we're going to do that as well.

Dan Atkinson:

So will there be a 'new' Bank of England at some point?

Mervyn King: Sorry?

Dan Atkinson: Will there be a 'new' Bank of England at some point?

Mervyn King: I don't think it's a question - again, this is not process or acts of parliament that's needed; it's actually some serious thinking about the instruments. Once we have got to the point where it is agreed that we, and indeed other countries, have hit upon the right additional instruments - and I stress these are not substitutes, these are additional instruments - then will be the time to think about process, legislation, who does what.

But we're - you know, the great temptation of what I'll call the 'bureaucratic classes' is to think that the really interesting question here is not 'what is this instrument?' but 'who wields it?' That is not the interesting question. The interesting question is - 'what is this instrument that we need to have?' And what it reflects is that, actually, you know, if you've only got one instrument - and this is not to do with inflation targeting - you could be targeting anything else - if you've only got one instrument, you can only guarantee to attain one target. And if we have many things that we would like to hit, either you're forced to make compromises, which I think is not terribly attractive - surely we can do better than just sticking with one instrument? What we need to do is to move to a world where this is more than just the official Bank Rate as the instrument to try to deal with growth and volatility of the financial sector.

That's the challenge. I don't pretend we're at the point where we're willing to unveil a clear answer. I think the general direction has been talked about - it comes under the heading of macro prudential. But there have been more than enough speeches already which talk about it in general terms, and - as

you rightly say - what we need to do is to go away and make it more concrete.

But that requires a period of serious thought and reflection and analysis. That's what we're engaged in, and we're not going to bring back anything which is half-baked; we'll wait until it's well thought through before we come back. But come back we will.

David Smith,
Sunday Times:

Can I ask about quantitative easing and the decision to increase the amount by £50 billion last week? Should we be thinking of that as perhaps the amount, the limit, to what the Bank is likely to do in this area? And how disappointed are you by, you know, some of the things that have happened, such as the subsequent rise in gilt yields following the initial fall on the announcement - the possible leakage to overseas sellers of gilts. How much has that sort of diminished the impact of the policy? And also, can you say something about the exit strategy from QE as well?

Mervyn King:

Well, let me start with the exit strategy. I'll say at first - we're certainly not disappointed. I'll explain why in a minute.

The exit strategy is very simple. It's a combination of raising Bank Rate and selling some of the assets that we've purchased. And we're ready to do that whenever we think it's appropriate to do so. The decision will be based on a judgement about the outlook for inflation, so there's no change in the strategy or approach; this is simply another way of conducting monetary policy. And when we feel that the balance of risks to inflation is that inflation is likely, looking ahead, to go above the target, then we'll withdraw some of the stimulus and we'll make the decision at the time as to whether we'll do that - you know, how we will do that - what combination of rises in Bank Rate and sales of assets.

In that sense it's completely straightforward. I see no difficulty at all about this. What matters is the willingness of the Monetary Policy Committee to do it. And I can assure you that every member of that Monetary Policy Committee - we've discussed this on the Committee - every member of the MPC is ready and willing to follow the exit route when it's appropriate to do so.

At the last meeting we felt that, in contrast, it was appropriate to expand the scale of the asset purchases that we're conducting. Why was that? Not because we were disappointed by evidence of its effect - and I'll come back to that - but because we felt that the case for the apparent undershoot of the growth of money and nominal demand in the economy was somewhat bigger than we had thought when we embarked on this. We therefore thought it sensible to expand the scale.

So why are we not disappointed? Well, the honest answer is that no one can know much about the effectiveness so far. We've only seen, in terms of data, about three weeks worth of data between when we embarked on this process of asset purchases, in terms of actually buying assets, and the likely impact on money and credit. So I think it's far too early to judge.

We were certainly, you know, pleased by the initial impact on yields. Of course yields have backed up somewhat since then, but of course many other things have happened at the same time. And what is very hard to judge is the counterfactual - what would have happened had we said in February - 'we've lowered Bank Rate and that's it; we're not going to do anything else; we won't buy any assets; we will do nothing?' I think - I feel these actions are likely to have had some impact.

But we'll have to wait and see. It'll take, you know, six to nine months I think before we'll see more evidence. I don't think there's any evidence that the sales have been made by the banking sector; we've been buying from the non-banking sector. The fact that some of them are overseas holders does not actually cause us great concern, because those holders will either use their additional holdings of sterling, broad money, to buy UK assets - in which case the impact on other asset prices and yields will be just the same as if UK residents had bought them, or they will sell them to try to buy foreign currency denominated assets - in which case you will see another impact of asset purchases, which is that people will be disposing of sterling, pushing down the exchange rate, which is part of the normal transmission mechanism of monetary policy.

So, either way, you'd expect to see a play into the normal transmission mechanism of affecting prices and yields of financial assets, including the exchange rate.

But as I say, I think we'll have to wait and see; it's much too early to come to a clear conclusion. There is uncertainty, but the Committee felt that, given the balance of risks here, the right thing to do was to extend the scheme of asset purchases, given what the evidence that we saw on what had happened to nominal demand and money growth, you know, since we started on the scheme.

Chris Giles,
Financial Times:

Governor, before the crisis the Bank was, how shall I put it, 'quite sniffy' quite often about balance sheets in terms of economic forecasting, particularly on the household side. And now you're saying it's one of the key reasons why the recovery might be quite slow. Is this a change of view and a change of emphasis - at least, not necessarily a change of view, but a

change of emphasis in the Bank's thinking? And does this underpin the apparent deterioration in the long run trade-off between inflation and growth which seems to be evident in the Fan Charts?

Mervyn King:

I'll make two comments on that. I'm not quite sure why you think we were 'sniffy' about balance sheets. I don't think that's - you know, I don't think that was the view that we took, and indeed if I can read you some words written 15 years ago:

"In the early 1990s the most severe recessions occurred in those countries which had experienced the largest increases in private debt burden. Was it some accident of history or did it reflect deeper forces affecting market economies?"

Chris Giles:

I'm sure we can find other quotes from slightly more recent years about household debt and how that wasn't underpinning the growth in the economy in recent years. And that's what I was actually -

Mervyn King:

Well, that's a separate point, with respect, Chris. I mean, that isn't a point about balance sheets not mattering; that was a question about, you know - what were the causes of the increase in the household debt burden? And I think the point I would make to you is that actually there is very little evidence to suggest that what we saw happening to domestic consumer demand was the result of a build-up in debt as opposed to - because in fact there's no evidence that there was that happening. What happened to household debt was that it built up in response to a rise in house prices. And what the argument that was made by the Committee at the time, which seems to me solid then and just as solid now, was that if you expected house prices to stay at those higher levels, then you would expect over the following decade that household borrowing

would rise as the stock of housing moved down from older households, who were taking out lower mortgages and benefited from the capital gains, to younger generations who needed to borrow more in order to finance and purchase the housing stock.

And that itself was a reflection of what had happened to asset prices, not a cause of it. The big increase in debt - the big increase in debt in the UK economy over the past decade was within the financial sector. Over two thirds of the increase in credit went within the financial section. And that is the phenomenon that didn't actually affect the levels of private sector non-financial spending in the economy. The level of demand and output was broadly in balance; hence we didn't see a pick-up of inflation.

What we did see, however, was a rapid rise in the balance sheet of the financial sector and a ballooning of the problems in the financial sector that led to the financial crisis. And that I think is absolutely parallel to the view that, if you want to be able to control both the balance between demand and supply in the economy on the one hand, and also prevent excessive build-up of imbalances in balance sheets, you need more than one instrument. But I think balance sheets we attach great significance to.

Chris Giles:

And the longer run trade-off between supply and demand?

Mervyn King:

Well, I don't think there's - I mean, the idea that there is some sort of fixed trade-off is not something that we would subscribe to. We form our judgements about the short-run movements in output and inflation - and if you like there's an implied, quote, 'trade-off' that falls out of looking at the Fan Charts. But it's not because we start by saying there's a trade-off and therefore

these movements will have the following automatic effects on growth or on inflation.

We form these judgements about output, and the judgement about output certainly feeds through to the judgement about inflation. But there are other things affecting inflation too, including the operations we've taken on asset purchases and also the fall in the exchange rate. So those things will clearly affect the apparent short-run trade-off.

How much does that get to the heart of your question on the trade-off?

Chris Giles: Well, I was trying to find out whether there was - whether you had a view on the supply ...

Mervyn King: ... Oh okay ...

Chris Giles: of the economy as well, which seems to have deteriorated.

Mervyn King: Yes, we do have a view on supply, which is that we do think that the reduction in credit supply through the banking system will adversely affect the supply side of the economy. Maybe Charlie would like to add a comment on that?

Charlie Bean: As the Governor says, we do have a significant allowance for the impact of the credit crunch on the supply capacity of the economy. You can see that coming through potentially in a variety of ways. Firstly, firms may be unable to get access to working capital in the normal way. That will restrict their ability to supply output. Secondly, lack of availability of credit will affect the ability to invest, so you get a hit on the capital stock. Thirdly, it might well affect research and development, so you have an effect on total factor productivity.

On top of that, we know that in past downturns there's usually been an adverse effect on the supply capability of the economy, partly operating through the labour market as workers' skills atrophy or they become disconnected from the labour market.

Now we think this time round - because of the increased flexibility of the labour market - that those labour market channels will be less important than was the case say in the eighties' or early nineties' downturn, but there's still some potential for that. So there's a number of ways that you can get a hit on the supply side, and the projections here - as indeed was the case in February - assume a pretty significant impact on the supply side, which means that the rise in the amount of spare capacity in the economy is not as large as you would think simply by looking at the projection for growth.

Faisal Islam,
Channel 4 News:

Governor, we've had the biggest rise in government debt issuance in peacetime, how comfortable is the Bank with that? Conversely if growth comes in at the lower end of your estimates, would it still be the right thing to withdraw stimulus, raise taxes and lower spending as is currently planned in a years time? And then can you just explain a little bit between how the interaction between the Bank buying gilts and the government selling lots of gilts works, if there is any interaction between you?

Mervyn King:

Well let me take that last one first and then I'll return to the questions you asked about fiscal policy. The judgement about whether or when the Bank decides to sell assets is entirely for the Monetary Policy Committee. But of course we've said, I think it would be only sensible, commonsense that we would consult with the Debt Management Office before we suddenly

decided to dump a lot of gilts onto the market. This is something we want to - the timing of it we want to co-ordinate with the Debt Management Office. But the decision about the scope of the sales and the broad timing is that solely for the Monetary Policy Committee, it's a monetary policy judgement. But we will liaise with the DMO on that.

On the first one, it's clearly helpful that the Budget was extremely honest and open about the scale of the fiscal problems that we're facing. Again, I don't think one should put too much weight on the precise numbers there because that's a central projection and they could be in either direction. But there certainly seems to us at least as many reasons to suppose that it may turn out to be a smaller deficit than a bigger one.

So I think they were a really very honest appraisal of the fiscal position. And clearly as you implied that in the immediate circumstances this is not the month to start changing that. But there is no doubt that we will need to move back to a path for fiscal sustainability; that is very important. And you know we have a little time now to reflect on what that path should look like and no doubt the Chancellor will have more to say in the Pre-Budget Report in the autumn.

Ed Conway,
The Telegraph:

In a sense this follows on from what Faisal was asking about. You said in your opening remarks that over the past couple of years you've had a lot of debt shifted over from the private sector and from the banking sector to the public sector effectively and the debt and risk now lies there. I mean does that mean by implication that in the future the greater risk is not of a bank collapse but of some kind of a government - well a failure, a default, or some kind of a bailout of a major sovereign?

And following on from that and talking about exit strategy, again you said it's a monetary policy consideration. But clearly when you come to sell those gilts back into the market it will be at a point where the government is issuing a lot of debt, where those pressures will be far greater. Surely that plays some kind of a consideration, you know to the Monetary Policy Committee when it decides on that?

Mervyn King:

Well I mean - the consideration is not because the government is selling gilts, but obviously the number of gilts the government will need to sell will depend on the state of the economy. If output is still very depressed then revenues may be depressed and that may require a higher level of gilt sales. Now those are precisely the circumstances when it's less likely that the Monetary Policy Committee would feel it necessary to withdraw that stimulus. So I don't think there's an obvious clash there.

I think the most important thing to say is that the actions that were taken to deal with the banking system have I think stabilised the banking system and removed the fear which was clearly a genuine panic last September/October that the banking sector was going to fail. And indeed we got very close to failures in the large institutions. So that did stabilise the system. And much of that debt as you said has been transferred to the public sector.

But these problems are manageable; I mean they are certainly manageable it's a question of will. And provided we take the measures which are necessary to stabilise the public finances, there is absolutely no reason for people to talk in dramatic terms at all. And I hope that they won't. These are certainly manageable problems.

Stephanie Flanders,

BBC News:

You talked about the importance of consolidating the public finances and that's already built in to some of the Chancellor's Budget forecasts. But those forecasts are also linked to an expectation of forecast that the recovery will be pretty much like past recoveries, that there will be quite a rapid above trend growth for several years after recession as we have seen in the past.

But you've said repeatedly this morning that this isn't a typical business cycle and that you think the balance of risks are - or the balance of probability is that this will be a weaker than usual recovery. Is it fair to say that you do think that the probabilities for growth in the economy coming out of this is rather different than the Chancellor does?

Mervyn King:

Well I'll leave him to talk about his probabilities, I mean I would like to encourage the Treasury to publish their forecasts in the same sort of format as ours, because then it would be possible to see their probabilities. I don't know what their probabilities are. It's clear what ours are and we've talked about it and we've said - you know one example that the balance of risks is such that in the middle of 2010 - you know it's just as likely that output will be lower at that point than it is now as it will be higher.

If you look further ahead to - say the two year horizon in our forecast - then what our forecast implies and again this illustrates the real uncertainty involved here, is that the probability that at that point growth will be - that the growth over the previous 12 months to the two year horizon as shown in Chart 1 will be over 3% is the same as that it will be below zero.

So you know there are certainly genuine possibilities and a real chance that growth will be well above trend two years from now. But it is also possible that it might still be falling slightly, even if it

has recovered over the next 12 months it might fall back. We simply don't know what will happen and there is this balance of risks and I don't think it sensible to pretend that our judgements can be encapsulated in saying, well you know - you must choose, which of these is going to happen. We don't know exactly what will happen. What we can try to do is to give you our assessment of the risks. And that we've done in the fan charts here.

Stephanie Flanders,
BBC News:

But given the importance for the whole economy of what happens to the public finances, these forecasts are resting on an assumption that things will be as usual, that there will be above 3% growth in 2011. You're saying that is not the most likely scenario?

Mervyn King:

What I'm saying is that there are many possible outcomes and you have to be aware of the balance of risks. I think what we're saying is that the balance sheet considerations mean that yes you may well get a growth over the next year, that may well happen for the reasons I explained at the beginning. Whether that will be sustained depends on the adjustment to balance sheets. I just don't know, we may well get a recovery that proves to be sustained then again we may not. It isn't a question of yes or no.

What we've said is that there are risks on the downside as well as risks that growth will be above trend. At some point, at some point growth will return to above trend levels in order to absorb the spare capacity that's been created by the very savage fall in output over the past six months. So it's a question of timing I think rather than anything else.

But we are pointing out to in the report I think is that there are real risks from the nature of the downturn and the role of the financial sector that mean this could be a slower return to normal growth paths than we might have expected if this had just been a normal business cycle, a typical post-war business cycle.

Yvonne Esterhazy,
Wirtschaftswoche:

What is the impact of the reduced direct foreign investment on inflation and do you see this changing by any big deals coming in favour the UK economy?

Mervyn King:

Sorry, what is the impact of ...?

Yvonne Esterhazy,
Wirtschaftswoche:

Of the foreign direct investment, the reduced foreign direct investment into the UK economy, what is the impact of the reduced foreign direct investment on inflation? And do you see any big chunks of money coming to the UK economy in the near future, is that changing?

Mervyn King:

Well there's no doubt that the fall in the exchange rate has made assets of all kind in the UK more attractive to overseas than was the case before. And we're seeing examples of that in the case of the property market and I suspect that we'll also see it in terms of people thinking - you know what businesses to purchase, that the UK now is rather an attractive place. And that's one of the stimulatory consequences of a lower exchange rate.

What we've seen in terms of investment as a whole which is what matters to our judgement about the outlook for inflation and growth is that we have seen a very sharp fall in investment and indeed it is still the case the investment intention indicators are

at pretty weak levels. And that is something which again illustrates that it won't be easy to get back to normal.

The supply of credit is very important to financing investment and it is being held back at present by restrictions on the supply of credit.

Now, all of this will be sorted out in time and I think what is genuinely unknowable is precisely how long. That I think is the point I made to Stephanie Flanders and it applies to all these issues. We just cannot know. You can't look back and say you know in the last six episodes when we've had this kind of nature of the downturn, what has been the average response. This has been something we haven't seen since quarterly data were produced.

We certainly go back and study historical episodes, they are all different in their own ways, but the big lesson I think from the historical periods is that balance sheets do matter. And if Chris thinks we haven't given enough attention to balance sheets in the past, I assure you we will correct that and give the attention in the future.

Eric Albert,
La Tribune:

Governor, you said last year that the 'Nice' decade was over, clearly indeed it is. Looking at the next decade would you say that the adjustment needed, higher setting rate, less government spending means that actually the whole decade, the whole potential will be necessarily lower than the last decade?

Mervyn King:

No, in fact I talked about the 'Nice' decade in October 2003 and the whole point of that speech was to argue that the following decade would not be as nice, that we shouldn't assume that the degree of stability that we had had up until that point would

continue. I did not project the degree of instability that we have seen in the last year.

I think the likely impact for the next decade is going to be dominated by recovery from this financial crisis. I don't think that means that the growth of productive potential will permanently be reduced, no; I think there will be some short run effects as the financial sector adjusts. Because of the restrictions from the supply of credit it is very hard to know how long that will persist. A lot will hinge on how quickly the banking sector can move back to levels of capital which will encourage it to lend under the same terms as before, in terms of spread. And the growth of productive potential will I think return to what has been a pretty boring, long run, stable growth rate in terms of productivity growth.

So I don't think we need assume that it's all doom and gloom and we'll simply see a reduction in supply indefinitely, no. What I am saying today and I think this is clear from the report is that it's very difficult to judge the timing of the return to get back to the historical growth rates we've seen in the past.

Sean O'Grady,
Independent:

Governor, even after six months of more of efforts by the authorities to get the banks to support business and first time buyers, the mortgage market generally, you still hear as I'm sure you do a lot of stories about businesses, otherwise viable businesses that are being pushed close to bankruptcy and in some cases beyond by unsympathetic banks. What are you going to do now to get the banks to do what they ought to do to support business and the economy more widely?

Mervyn King:

Well the measures that have been taken over the past six months which started with the recapitalisation of the banks in

October were designed to stabilise the banking sector and prevent failure. I think they have been successful in that objective. I think what's become apparent is that nobody really knows, I'm not sure if even the banks themselves entirely know what level of capital they need to hold in order to be willing to make the judgements about lending on the same criteria as you would regard as normal. That is judging - taking into account the riskiness of the project which it's proposed to finance, which clearly is much greater now we're in recession than we before. So that has been adjusted for.

But nevertheless we are hearing many stories and indeed you can see in the data, both in terms of the actual lending which I think you can see in chart - in section 1 here. Page 14, charts 1.8, 1.9 show the growth in loans to companies and to households. And you can see charts 1.8 to 1.9 show a very substantial reduction in the growth of net lending to both companies and households.

Now, part of that - quite a large part is the reaction of weaker demand. That's what you'd expect in a downturn with falling house prices and prospects for investment which look unattractive. So part of this is clearly a demand factor, but not all. And I think you can see we've got a reduction in lending capacity as overseas banks have withdrawn from the UK market. It's also the case that our banks have withdrawn from overseas markets. And what we're not seeing is an expansion of lending by UK banks to offset the reduction in capacity. And the increase in charges, which are made to prospective borrowers and you hear many stories about this from small and medium sized companies around the whole of the United Kingdom, does suggest that there is clearly a supply element to this and not just a demand element.

Now in the long run, the only way to overcome this is for banks to get back to a position where they are sufficiently well capitalised that the degree of risk aversion that they exhibit towards their lending practices returns to a more normal level of risk aversion and not the extreme risk aversion which is being exhibited today. It is very understandable why banks are very risk-averse today. They are extremely worried that the losses that may yet be revealed as we move through the recession will move their levels of capital down below say the minimum level, which the regulators think is required, then some action would be necessary. And they are obviously very risk-averse to that prospect.

Higher capital would help resolve that; how much high capital we simply don't know. There was an interesting contribution I think only yesterday from, Alan Greenspan, which suggested that several percentage points extra capital would be needed in American banks, over and above the levels which the regulators are pushing them to, to get them back to a more normal lending state. Whether that will be enough we won't know until that is tried and we get there.

So I think what's very important to distinguish between and to my mind this is the big lesson of the last three, four, five months is that there is quite a big difference in practice between the levels of capital that banks need to be stabilised, in the sense that the creditors are reassured that the banks can continue as viable entities, stabilising the system on the one hand. A big difference between that and the levels of capital that are required to persuade banks to exhibit normal levels of risk aversion.

How big that gap is, is absolutely impossible to say, I know of no scientific basis on which you can set that figure. But it looks as

if it could be quite big. And what that means I think is - and this is one of the reasons for believing that these balance sheet adjustments will take time in the banking sector, it will take time for the banks to get that extra capital.

One of the reasons they have raised their charges is they need to earn - you know to retain profits out of their earnings in order to rebuilt capital. They are bound to be cautious about the rate at which they expand lending. And that gives everyone I think - you know it's a difficult problem to deal with, because if the banks are going to continue as private sector entities they will naturally behave in a risk adverse way for a while. That is one of the lessons of history in terms of balance sheet problems.

Sean O'Grady,
Independent:

But you don't see the public sector, the state authorities having any role in plugging that capital gap?

Mervyn King:

Well that's a matter for the government. I mean they could put in more public sector capital if they decided to do so. But that has to be a judgement for government and it does have ramifications for the government's shareholdings in banks. Because the amount that you would need to put in, would undoubtedly been significant relative to the size of privately owned capital at present. And that does raise a whole series of awkward questions. But that is a matter for the government.

Natasha Brereton,
Dow Jones Newswires:

I wanted to come back to the issue of the exit strategy from quantitative easing and ultra low interest rates. And you have a forecast which shows the scenario for inflation, if rates are kept at 0.5% and the stock of asset purchases at 125 billion for the duration of the period. I was wondering if you see an argument for actually committing to keep either interest rates at that level

or a certain amount of stock of asset purchases for a certain period of time, to give greater certainty to markets and clarity. And in that way possibly enhance the effectiveness of the asset purchases and low interest rates?

Mervyn King:

Well the short answer is no, I think, and the reason is very simple. It is that we don't believe that giving false expressions of certainty actually does create more market confidence. No central bank can if it's wise say with complete certainty that it knows what interest rate it wants to set over a long period. And we're not going to do that. We've always said that we will make up our mind month by month; that is the role of the Monetary Policy Committee.

What we have said, however, is if you look at our fan charts you can form your own judgements as to what is likely to happen to the policy level of both bank rate and asset purchases because you'll be able to see what we think are the balance of risks. You may disagree with us about the judgement on the economy, but then you can substitute in your own judgement and make guesses as to what you think we will be likely to have to do.

I think the lesson of the last 12 months is surely that very major changes can occur unexpectedly, nobody can anticipate the future with any close proximity to certainty, it is vastly uncertain. The most important thing about policy is that it remains alert and ready to respond to changes that occur. So we for example cut interest rates by four and a half percentage points in only a few months. Now it was important that we were flexible and could do that. I don't anticipate that in the future we'll need to make quite such violent changes. But I do anticipate we'll need to make changes; when and precisely by how much I don't want to anticipate now, because that would lock us into something that might prove damaging down the road.

What I hope people will understand is that what will guide those changes in policy is absolutely crystal clear: it is our judgement on the committee about the outlook for inflation. And we will take whatever steps are necessary to ensure that we try to keep inflation close to that target. There is no way that we are going to allow the lack of focus on an exit strategy to allow inflation to pick up and 'move into the stratosphere'. We will not allow that to happen. And what do know is that we have the policy instruments to hand to ensure that. We know that we can raise Bank Rate, even though today we have the problem that we cannot lower it.

Lesley Curwen,
BBC World Service:

Governor, can I ask you a question for our global audience? Looking ahead probably beyond today's battles are there still concerns that we may face the prospect of rising inflation on a global level, what do you think is the extent of that risk?

Mervyn King:

I think the biggest risk at the international level is that having spent a decade talking about imbalances in the world economy and doing nothing about it, the current crisis largely stems from the failure to deal with that. And we haven't still dealt with the underlying causes. So that at present everyone is focussed on raising domestic demand in every part of the world economy. Once this strategy starts to work and we get back to a more normal position, then we will see the need for a rebalancing of the world economy and we still haven't put in place a mechanism for ensuring that the problems which underlay this crisis cannot recur again.

That to my mind, which is all about reform of the international monetary system, is the biggest challenge facing the countries in the world today. It is no good, you know, sitting around in

these international meetings saying we're each doing our bit because we did that successfully for ten years. Each economy did run pretty successfully on its own for ten years. It was the interaction between them that built up these balance sheet imbalances across countries that caused the problem. And we still have no mechanism for dealing with that. That is the issue that we should focus on.

The immediate issue is not inflation, but of course inflation is a judgement about the currency of each individual country. So you know it is quite possible to have inflation in a country even if the rest of the world is not experiencing inflation at all. And that is a question of the management of each individual currency. So that must be a focus for each central bank around the world.

Lesley Curwen,
BBC World Service:

Are those imbalances being addressed yet?

Mervyn King:

Sorry?

Lesley Curwen,
BBC World Service:

Are those imbalances being addressed at all?

Mervyn King:

Well the short run problem is how to restore domestic demand in all economies around the world. Once we get through that then we will need to sit down and have what I hope will be a productive discussion about reform to the international monetary system. That discussion did not take place prior to the crisis breaking out, I hope - and there's no immediate urgency about this, it's something that we mustn't forget. The only urgency is to keep it as a priority, again not to rush to judgement. And a lot of discussion and work will need to be done on this. But it's something which I hope that central banks in particular will take

a lead on and it's something which when we meet we can't pretend it isn't our problem, because it's a collective issue.

David Smith,
Sunday Times:

Governor, you and the Deputy Governor talked about the damage to the supply side of the economy, but you just said that over the longer term we'd return to the same old 'boring productivity trend'. Does that mean that the Bank's assessment of trend growth in the economy is the same as it has been since independence in 1997? And can you remind us what that assumption is about trend growth?

Mervyn King:

Well there are two key parts to any assumption about the rate at which productive potential is growing and I'll get Spencer to comment on this in a minute. But if you remember during the late 1990s early 2000s there was a lot of discussion, particularly in the United States about the underlying productivity growth rate having gone up. Now we saw no sign of that in the UK, we saw no sign of it going down, but we made no change to our judgement about that.

What we did see a change in however was the growth of the labour force. And in particular when we embarked as a committee on our work, it was clear the unemployment could come down over quite a long period from the high levels that it reached in the early 1990s to whatever the level of the sustainable rate of unemployment would turn out to be, but it could come down some way. And that was a sort of additional labour supply over and above the normal growth rate of the labour force.

And then more recently we saw migration, particularly from the accession countries in the European Union, which boosted the supply of labour and temporarily boosted the potential growth

rate of the UK economy and when we were forming our judgements over two years, then we took that into account. Now we're now seeing some signs that perhaps that rate of inward migration is tailing off. But I think that's the sort of broad picture, but the person that knows more about it than I do is Spencer.

Spencer Dale:

Thank you; so the two components which the Governor refers to when thinking about trend productivity or the growth of the potential supply is - the extent to how productive labour is and the extent to which the labour force is growing. As the Governor suggested in the past the extent to which the labour force grows has been a relative constant and predictable component. That has been less so in the last few years with the growth of migration and I think it will be - a key issue for us going forward will be to understand both in the near term to what extent the relative cycles we're going through will affect those flows of migration and how those longer term flows will feed through.

In terms of labour productivity, some of the channels which Charlie mentioned that are affecting potential supply in the near terms in the terms of the effects of tight credit on working capital, they should dissipate over a period of time as the financial markets return to normal. But some of those effects that Charlie mentioned may persist for longer. For example, if you have a predicted period of weak investment that will lead to a lower level of the capital stock and then that will affect productivity, labour productivity going forward.

David Smith:

Is there a number ...

Mervyn King:

I don't think we want to encourage you to look at central projections and have one number in your mind David. I think

you should have a range of numbers because there is always uncertainty.

Daisy McAndrew,
ITV News:

Coming back to your growth forecast and I see obviously from the fan chart there's a certain amount of hedging your bets and that's in a way fair enough, you've been keen to emphasise today that you want us to tell the nation there are good reasons to believe that the economy recover quicker and there are equally good reasons to believe that the recovery might be slower. But when you've been talking about bank lending you very much seem to be on the more gloomy side. In the Report you say that you've now changed your opinion since February, that you think bank lending will not resume at the pace you initially thought, which certainly sounds as if you are now on the gloomier side and you think the recovery will be slower rather than faster.

Mervyn King:

I mean I think that in terms of the fan charts it is the case that since February you know the fan charts have a somewhat lower growth profile right across the spectrum than they did in February. That is certainly true and one of the factors is indeed a judgement that it may take longer to restore bank lending than we had hoped it would in February.

Of course against that you know there are positive signs, the signs you can see in the surveys. But more importantly just these three solid reasons I gave at the outset for supposing that we should expect to see some recovery. The massive amount of policy stimulus, the benefits from the fall in the exchange rate, which you can already see in terms of import substitution and the fact that we have a smaller fall in exports than many other countries and the turn around of the stock cycle which - it has the potential to be very large because the fall in stocks in the

last quarter of last year was the biggest since quarterly data was collected.

So you know those things add up to a pretty solid set of reasons for expecting there to be some recovery. The real uncertainty is you know how long it can be sustained given the need to make the balance sheet adjustments.

Now you call it hedging our bets, I would prefer to say it's a true statement of the risks as we see them. Indeed people who are tempted to go - not to hedge their bets I mean - do get into real trouble by pretending to know the ...

Daisy McAndrew,
ITV News:

People like the Chancellor?

Mervyn King:

Well not the Chancellor no; there are many other forecasters who only give one set of numbers, in fact most do. But in general terms you know hedging your bets, if fewer people had hedged their bets in general in the British economy - if more people had hedged their bets in the last couple of years we would perhaps not be quite in the mess we are now.

So being cautious and actually setting out what we see to be the picture, not pretending to know what the future holds, but giving an honest assessment of where the risks lie. I mean it's not that we know nothing; we do know quite a lot. We have these three solid reasons for supposing there will be a recovery and we've also got some solid reasons for supposing that this time, relative to earlier post-war business cycles it may take longer because of the balance sheet adjustments. Now, it may not, but what we can do is to monitor what's happening on the balance sheets and update our view as time goes by.

What it tells you is what you should look at, so in order to see what's happening as time passes, look and see whether the balance sheet adjustments are being made, if they are then we're further down the process and we'll more rapidly get back to normal growth.

So it's not that we know nothing, we know quite a lot, but that is a far cry from saying, you know I know it's going to be 2.25% next year. I mean that's a mad way to present a forecast.

Pause and Chat

Paul Wallace,
The Economist:

Can I actually ask two? The first one being, when the plan for asset purchases was first announced it was envisaged that about a third would be for private paper, but in fact you've scaled back that ambition and I'd just like to know why? And secondly, if you had had the additional instrument to bear down on build up of debt in the 'Nice' decade, would it not have been the case that the 'Nice' decade would have been considerably less nice than it turned out to be?

Mervyn King:

On the second one absolutely not, because it would simply have restrained the growth of the expansion of financial instruments, it wouldn't have affected the growth of consumer spending or investment. So I think it would have been just as nice, in fact it would have been nicer if we'd had the instruments and been able to wield them. Now whether it fact it would have been easy to have designed an instrument that would have worked in restraining the growth of the financial sector balance sheet is a different question. But in principle it would have been nicer.

On the first, I'll ask Paul Fisher in a minute to say something about the mechanics and the operations we're carrying out. I

think it's clear though - let me try and correct your misapprehension about the limit. It was not intended that we set out to buy £50 billion worth of private sector assets. Buying private sector assets creates a credit risk which buying public sector assets issued by one other part of the government does not. So there is real credit risk to taxpayers in buying these private sector assets.

The Chancellor wanted to impose some limit on what those credit risks might mean for the taxpayer. So he put very sensibly two restrictions on us, one was an upper limit on the amount that we could purchase, which was likely to be well above what we would in fact purchase, but just some limit to constrain the extent of the credit risk. And secondly he gave us the remit that we should buy only high quality assets, broadly equivalent to investment grade. And that is what we have done. And that's imposed to protect the taxpayer from loss.

I'll ask Paul to say something about how much we've purchased and the relative size of the two. But the key point in all this is that the objectives of buying gilts are different from the objectives of buying the private sector paper. The objective of buying the two together is to inject a certain amount of money into the economy. So the scale of asset purchase is to do with the objective of putting enough money in the economy to ensure that money spending grows at the desired rate.

There is no way that we can guarantee to do that by buying private sector assets, subject to the restraints which the Chancellor has sensibly imposed on the nature of the assets that we should buy. So we buy gilts to make up the difference between the total amount we want to buy for the purposes of injecting money and the amount that we actually happen to buy in the private sector purchases.

The objective of buying corporate instruments, whether it's commercial paper or corporate bonds is and it's spelt out clearly in the remit, to improve the functioning of those markets for corporate credit instruments and to improve their liquidity. And the aim is to try to increase if we can the private sector issuance of those instruments which can be sold to other private sector purchasers. I think we've had some success on that, but they are two different objectives.

But let me ask Paul to say something about the criteria we use and why it is that the scale of the private sector purchases is inevitably a lot smaller than those of the gilt purchases, Paul?

Paul Fisher:

Thank you. I think overall for the size of the programme the 75 billion, now 125 billion of purchases the MPC have decided on, the only market which is big enough, deep and liquid enough for us to buy that scale of assets on the time frame that we're doing it, is the gilt market. I don't think there is any question. The commercial paper market in sterling is only about 6 or 7 billion as a total market size, the sterling corporate bond market only about 50 billion and many of those assets are very tightly held by the asset managers and they wouldn't want to sell them to us.

So right from the start we were very clear that the majority of purchases for the MPC's programme would be gilts. And I think we said that in the March statement.

What we're trying to do, as the Governor says, with the corporate purchases is encourage the flow of finance directly from investors into the UK corporate sector. We are not trying to displace it. And there is a risk that if we went out and just

bought very large chunks of those markets, all we would do is displace private sector investment into the UK economy.

So what we're trying to do in the commercial paper market is bring down the spreads by offering a backstop bid for a commercial paper and encourage new issuers into the commercial paper market. And we have some evidence that that is working. And on the corporate bond side the primary market is working very well. There have been record amounts of issuance in the first quarter and it continues at a high level and there is strong demand for those assets from the asset managers. And we don't want to disrupt that, but what we did notice is that the secondary market for corporate bonds was not functioning very well. And so we are operating in the secondary market with relatively small purchases to try to establish some price transparency to aid the working of the secondary market and thereby encourage even more demand in the primary market.

So the success of those schemes shouldn't actually be evaluated on how much we're purchasing. It is about other indicators of how those markets are functioning. And actually those schemes could be working extremely well and we wouldn't buy anything because we'd encourage the private sector market to function fully.

END