

WORLD TELEVISION

Bank of England

Quarterly Inflation Report - 12th August 2009



Ashley Seager,

Guardian:

I was just wondering, Governor, from your remarks about the recovery being slow and protracted, and all these factors weighing down on growth, such as balance sheet adjustment, households and financial sector - you seem to be showing quite a go-ey return to growth in your GDP projection. It seems to be as fast out of the recession as we went into it. I was just wondering - is that a bit over-optimistic?

Mervyn King:

Let me ask everyone to look at Chart 1, which is the GDP growth chart. And just think very carefully about what this chart is actually saying. It's saying that, during the worst of the recession around now that over the past year output has been falling at somewhere between 5% and 6% a year. That's going to be true for a few quarters. And then over time we see a recovery, so that the 12-month growth rate goes back to something pretty close to its long run historical average.

But just think what that means for the level of output. Having fallen by so much during the recession, what we do not see in this forecast as being a particularly likely outcome, though it's clearly possible - the Fan Chart has bands on the upside here - it's going to take a long time before the spare capacity created by this recession is used up.

So in terms of growth rates it may look as if we get back to a position something akin to a more normal period for growth rates, but it certainly won't feel like that. And indeed, while there is this large margin of spare capacity, what that means in human terms is unemployment is high and for the foreseeable future rising. So it will take some considerable time for that margin of spare capacity to be used up.

Now this is a more sophisticated audience than - I might be tempted to use the following phrase, but I think the big message today from this - tempted to say is - it's levels, stupid. It's not growth rates, it's levels that matters here. That's what matters in terms of thinking about the downward pressure on inflation in the medium term. And after a deep recession you would normally expect a period of robust growth in order to use up that margin of space capacity.

And whereas that would be something we would normally expect to happen in a, quote, normal recession, it is less likely to happen in a period when balance sheets are being repaired, because that takes quite a long period of time.

So I think in essence that's why - I don't think it's unrealistic to suppose that growth rates come back, but that doesn't mean that as far as most people and most companies are concerned, the recession will feel as if it's over.

Joel Hills,
Sky News:

You mentioned companies patching up their balance sheets; they're also - sorry banks patching up balance sheets; they're also being asked to lend to the economy. Are you happy that that's a balance that they've got right?

Mervyn King:

Well, I don't think there's any point just exhorting people. I've always said right through this financial crisis that the key thing is to look at incentives. And at present the banks face very strong incentives to rebuild their balance sheets; that is a necessary part of the healing process, if you like, of what happened to the banking sector. And in one way or another it's got to happen.

Now it's not terribly desirable that we see the contraction in lending that has been going on. Some of that is undoubtedly

due to weak demand in response to the recession - investment intentions are very weak. But nevertheless there is clearly a supply component to that too, and the state of the banking system means that, if you look at total lending to individuals or households for secured borrowing - mortgage borrowing - that's barely grown over the past year, and lending to the business sector has actually fallen. So that this is not something that's going to make recovery remotely easy.

But I think that what we have to do is to recognise that the banking sector is still in a very bad way, and it will take several years for it to repair its balance sheets to get back to the point where it will be weaned off very large amounts of public support, and in a position again to lend normally.

Ed Conway,
Daily Telegraph:

Really to follow on from that point, I mean you've said before, and the FSR made the point, that the banks might be under-capitalised when it comes to the amount by which they can lend out, as opposed to being capitalised enough to survive. I just wondered whether you can update us on where we are on that.

And given that there is that kind of under-capitalisation, isn't it also fair to say that a better way of solving the credit crunch would have been to recapitalise rather than to pour so much money into the system through quantitative easing? Because I mean, we've seen banks' reserves rise at a massive level, we haven't seen much of that money go through to M4 and to the broader economy. So I'm curious to get a kind of update as to where on earth we are on that as well.

Mervyn King:

I don't see any conflict between those two approaches. I mean, recapitalisation of the banking system is a necessary feature of recovery of the health of the banking sector; there is still a very

long way to go. There is no doubt that, looking five, ten years ahead, the banks will be required to hold much higher levels of equity capital than they were before we went into the crisis. So the banks are facing a period in which they must know that over the medium to long term they will need to find a lot more capital and liquid assets - that's a clear part of the change in the regulatory framework that is coming down the road. And we are in an environment in which banks know that and therefore face every incentive gradually to rebuild the levels of equity capital in those banks.

Now recapitalisation is not something which a central bank can do; only something which either the bank's shareholders can do or the government. So that's really a question for the government.

I don't see any contrast or conflict between recapitalisation and the policy of asset purchases. As I said, the main purpose of asset purchases is to increase the supply of money to a level that's consistent with meeting the inflation target. And we would want to do that whether or not there was recapitalisation of the banks. You may say it would affect the amount that had to be done, but the policy of doing it, which is to ensure that money grows neither too quickly nor too slowly, is central to trying to achieve the inflation target - and that's what we're focused on doing.

Daisy McAndrew,
ITV News:

Governor, really following on from Joel and Ed's point, if we're to avoid the double dip in the recession that many people are now warning of - that the economy will recover a bit and then come crashing down - we all know that the banks must start to lend. But do you have in your mind any sort of timescale by which they must start to increase their lending to a proper degree?

Mervyn King:

No, and I don't think it's helpful to talk in terms of double dip, let alone crashing down. What we're talking about here is the pace of recovery, and I think that the short-term indicators are indeed encouraging and we shouldn't overlook that - it's important not to forget that.

Nevertheless, it will require a long period of robust growth in order to make up for the falls in output that we've seen over the past year - so deep and sudden has been the recession. And that means that we will still, I think, find ourselves in a difficult position for a long time to come, and the banking system - it would be desirable if it were able to finance a somewhat stronger recovery, but at present it's not really in the financial shape to do that.

Sam Fleming,
Daily Mail:

The extra £50 billion that you announced last week took markets by surprise. Could you explain some of the reasons why, given what you're saying about the short-term indicators turning up, why that extra £50 billion was necessary? I mean, how much steeper for instance, would the decline in inflation have been had you not done that extra £50 billion?

And, as a follow on to that, could I ask about this whole issue of the slow and protracted recovery we're talking about? How big a factor is the balance sheet rebuild and the government going to be in terms of leading to that slow and protracted recovery, given what you're saying in here about the fact that we'll probably have tax hikes and also spending cuts in the coming years?

Mervyn King:

Well, I think it's pretty clear, and the Government's set out its fiscal plans, that there will need to be a reduction in those

deficits. That's something which I think everyone understands and accepts. There's a political debate about how best that should be done, but that's not for the Central Bank to enter that debate.

I think the answer as to why we did an extra £50 billion last week is very simple. Just look at the inflation projection. It's quite clear that on that basis we felt that there were real downside risks to inflation and that on balance inflation was more likely to be below the target. And so we felt it was sensible to take some action now - increase the scale of asset purchases - in order to avoid a period of perhaps quite protracted below target inflation.

That's exactly the same way we would have reacted had inflation been above the target. There when it was above the target we too were very keen to ensure that it came back to the target. While it's below the target, we have the same reaction. So we are determined to bring inflation back to the target, and it's that which led us to take the action.

You say that markets were surprised. I mean, I'm sure that's right. But I'm actually surprised myself that they were surprised in that, if you look at the minutes that we published at the July meeting, I don't think we could have been clearer. Let me just read to you what we said in the minutes in July. We said, "There have not been enough clear evidence to suggest that the £125 billion target should be changed at this meeting. In the short term therefore asset purchases would continue over the month ahead, as they were still short of the target level of £125 billion. The Committee would keep the scale of the programme under review, and the preparation of the August Inflation Report offered an opportunity to reassess the stock of asset purchases

in the light of a fully updated assessment of the outlook for inflation and growth at its next meeting."

Now I think that was about as clear as we could come to saying that we would make up our minds in August. And we always do this month by month. And it's natural that a good time to reach a decision about something like the scale of asset purchase is the Inflation Report month because that's when we, as it says here, carry out a fully updated assessment of the outlook for inflation. But that's what it's based on, and I think if you read those words, it's actually quite surprising that people would have concluded that we'd already made up our mind as to what to do, when it says quite explicitly that we haven't made up our mind but would do so at the August meeting.

So, I mean, that's just to say I'm surprised that people were surprised, but the substance here is that we did it because of the outlook for inflation.

Brian Swint,
Bloomberg News:

I just wanted to follow up on both of Sam's points there. About the move in August - why £50 billion? Why not more if the projections are still for an undershoot, given market expectations? Was that a compromise among members or are you convinced that £175 billion is now exactly right to get the economy back on an even keel.

And secondly -

Mervyn King:

Let me answer that, and then - You can never be convinced that this is exactly the right number; there are always kinds of uncertainties, and it's - you know, when you take a decision, it's always a balance of risks here. But let me remind you that the Fan Chart for inflation is conditioned not only on the level of

asset purchases of £175 billion, but also on the market yield curve. And there are many ways in which interest rates could evolve in a way that's not consistent with the current market yield curve.

So I don't think you should ever - you know, these are never unconditional forecasts for inflation; these are conditional upon very precisely stated assumptions about the path for policy. And it doesn't mean to say we'll follow that path for policy, but it gives people a guide as to where we think the balance of risks to inflation lies.

Brian Swint:

How did you come up with 50? How did you get the number? And are you suggesting in what you just said that the market path is not something that you would necessarily agree with as far as a forecast?

Mervyn King:

Sorry, that the market - ?

Brian Swint:

That the market rate of projected rate of interest is not something you would necessarily subscribe to -

Mervyn King:

We never endorse or otherwise the market yield curve. What we do is to explain our views about the outlook for the economy; we make clear our reaction function - our adherence to the inflation target. And then markets will make their own judgement, given their own views about the state of the economy, as to what we're likely to do to interest rates. So it's not for us to either endorse or otherwise the market yield curve.

The figure of 50 was one that we discussed and, you know, the minutes of the meeting will come out next week, so I'm not going to go into the pros and cons of various numbers today. That's really for next week. But it was a judgement about the scale that

was necessary - it's a three-month programme that we've announced of asset purchases to take us to the November meeting - to make it more likely that inflation would meet the target in the medium term.

Now we felt it was necessary to take more action than was consistent with stopping at £125 billion.

Brian Swint:

And on Sam's other point there, is there an assumption in this forecast for fiscal tightening after an election next year? I mean, you make assumptions about oil prices, utility bills and what not; are you making an assumption in this that - ?

Mervyn King:

We're assuming that fiscal policy will follow the path outlined in the spring Budget. That's our conventional assumption.

Dan Pimlott,
Financial Times:

You've said that in the inflation forecast even two years in the medium term you're going to be, more likely than not, below target. Does that leave the path open therefore to further quantitative easing?

And secondly, you've put quite a lot of emphasis on the importance of sterling's depreciation on the recovery in the economy. Sterling's risen quite sharply since March; how worrying is that and how much does sterling's rise affect the prospects for recovery?

Mervyn King:

Well on the first, we make our minds up each month and we'll come back and do that, so that there's always scope for a change in policy, and that's what monetary policy's about. You don't announce it and then do nothing for three years. So this is something we will always review very carefully.

On the second, in terms of sterling, if you look at Chart 1.19 on page 18 - bottom left hand corner. As you say, you can see that sterling did fall very sharply - fell by between 25% and 30%, but has recovered somewhat in the past quarter or so, to leave sterling around 20% below where it was before the financial crisis.

Now I think the big picture is that. The big picture is that sterling is still some 20% below where it was when the financial crisis started. That will likely have some effect on the level of prices charged for imported goods and goods that compete with imports. And we've taken that into account in our projection, and I mentioned it in my introductory remarks.

But the big picture is that it's still below, and that will have some impact in terms of spending - shifting spending away from goods produced overseas to goods and services produced in the UK. And that's one of the factors behind some of the encouraging short-term indicators. I don't think there's any point getting worried or upset by exchange rates; they always move around. Since we don't control them, the best thing is to respond to them in the most sensible way that you can, which is to - as we do - look at the implications for inflation and activity.

Hugh Pym,
BBC News:

Are there really more reasons for optimism than there were when you presented your May report about the general state of the economy?

Mervyn King:

Well, it depends what you mean by the general state of the economy. I think there are - if you like, two things have happened since May. One is that we now know that the back data were weaker than we thought then; so the big news about the greater degree of spare capacity that we thought in May is

not to do with the second quarter - in fact the second quarter was very much in line with what we expected in May. But it's the periods before that when the data have been revised. So we now know that the fall in output was bigger than we had thought in May.

That's looking backwards. That's the weaker side. The shorter run indicators, as many people have talked about, obviously are more encouraging, and that's good news in the short run.

But I don't think any of this really changes the big picture for the medium term which is that the nature of this recession, its linkage to balance sheet problems, means that recovery, in terms of levels of output, is likely to be slow. And that I think is the big picture. It underlies why we think there are clearly risks on the downside to inflation; also risks on the upside clearly, but, you know, no one can foretell the future. You take a balance of risks, but be ready to move policy whenever we get more information.

But the big picture, which is one of expecting - given the financial crisis - a relatively slow recovery, is still there and that is unchanged from May.

Natasha Brereton,
Dow Jones Newswires:

I was wondering - obviously inflation remains your target, but you've put a lot of stress on money supply growth - and I was wondering if you have any kind of figure in mind where you'd like money supply growth to get back to, and whether you see a need for an overshoot - given that we've had an undershoot recently - in order to get spending back to acceptable levels?

Mervyn King:

Well I think we've talked, when we introduced asset purchases, about the shortfall of money spending in the economy, and money growth, of between 5% and 10%. That may now be a bit

bigger than we'd thought, and money growth has not picked up in the way that we might have hoped - which I think tells us the situation was actually probably worse than we thought, and that's consistent with the revisions downwards of the activity data. So there is something to be made up.

But I don't want to speculate on precise numbers. I think the counterfactual is very hard to judge, and what we'll want to do is to get back to a point where we start to see relatively steady growth and money, nominal spending rates of the kind that we saw in the 10 years leading up to the crisis, and which are clearly consistent with steady growth and meeting our inflation target. And that is clearly significantly above where we are now.

Faisal Islam,
Channel 4 News:

Governor, did you have a forecast, given this slow recovery, for when the unemployment cycle might turn? And secondly do you have any response to this IMF Staff Report that suggests one of the most tangible impacts of QE is that merely the Government's cost of issuing debt has gone down and that others have suggested that this is really monetising the debt?

Mervyn King:

Let me take the first one. We don't make forecasts of unemployment, and it's extremely difficult. Clearly unemployment is rising, and I think - let me just first comment on the figures on unemployment, the two different series, before turning to why it's difficult to forecast where unemployment will go.

Some have made a lot of the apparent difference between the claimant count and the LFS measures. I think we're less inclined to think this is a puzzle. The LFS measure that's published is a three-month moving average of the data, and

then you can take differences in that three-month moving average. The claimant count is a monthly measure.

If you recalculate the claimant count as a three-month moving average, then actually - if you plot the series in a comparable way - there seems to be very little difference between the two. The big picture is they're giving the same picture - sharp rise in unemployment, but more recently some evidence that the pace of increases of unemployment has eased.

Now that's not - we haven't really had enough observations yet to be confident of that. We've had an extra one for the claimant count, because that gets published sooner than the LFS measure. And there is some evidence in both the LFS and the claimant count measure that the pace of the increase of unemployment is falling.

Now as far as it goes that's encouraging, but it still means unemployment is rising. Now I don't know where it will go, and I think one reason for that is - if you look at Table 1 on page 29 of the Report - in the box there on Employment and output in the current recession - if you look at the first row for GDP, what this gives you is the fall in GDP five quarters after the beginning of the recession, in the 1980s downturn, the 1990s downturn and the current downturn. And you can see that actually the current downturn has a bigger fall in output. This is a sharper recession - so far - than either the eighties or the nineties - they were the first five quarters.

But then you look at the next two rows which tell you what happened to employment - where interestingly employment has fallen by less over the same period than did employment in the eighties and the nineties. And the same is true for average hours. So if you add the last two rows, then what you find is that

in both the eighties and the nineties that you had something like a 5.5% fall in total hours and in the current downturn about a 3% fall.

Now that may reflect a more flexible labour market. There is some evidence that pay has been - real pay has been more flexible - and that that has enabled employment to stay stronger than would have been the case had we been back in the days of the late seventies early eighties, late eighties early nineties. And it may well be that the more flexible labour market means therefore that the past relationship between unemployment and output may not be a good guide as to where unemployment will reach now. But I don't know that, and no one can know that; time will tell. But I think it illustrates that caution would be appropriate in simply extrapolating past experience or somebody's regression equations. There has been I think a change in the nature of the labour market, and you can see that in Table 1.

[Question on QE]

Mervyn King:

Do you want to comment on that, Spencer?

Spencer Dale:

I think the IMF paper is a thoughtful and careful paper analysing the impacts of QE. I don't think we agreed with every single piece of the analysis in it, but I think the main conclusions that that paper reaches is pretty similar to us. First order - it's still too early to know the precise impact that the asset purchases will have on nominal spending, but there's some encouraging signs. It does appear that gilt yields are lower than they would otherwise have been, and it does appear that the function in a private corporate credit market trying to identify the marginal impact of our asset purchases in contributing to either of those developments is hard, but they have gone in the way

we would have expected it to happen. So - so far, so good, but the overall impact remains uncertain. That was their conclusion and I think that's very much in line with everything we say in the Report and the Governor said this morning.

Simon Nixon,
Wall Street Journal:

The communication around quantitative easing seems to have changed at various stages over the last few months. At the beginning of the process you emphasised quite a lot the price of money; then the rhetoric seemed to change to the quantity of money; and now it seems - in your recent statement and letter - you seem to be talking again, quite focused on the price of money again. And I don't know whether it's coincidence or not, but some of the recent changes in the policy seem to track the change in rhetoric. So I'm interested to know what - how much attention the Committee is paying to the short-term price of money versus the long-term quantity of money arguments you were deploying a few weeks ago, and how much the Committee's looking at the counterfactual of what the price of money might be through the economy if you weren't doing quantitative easing.

Mervyn King:

I don't think there's been any change at all in the way we think about it, and I hope there's been no change in the way in which we explain it. And indeed, it's very difficult to think about prices and quantities as being independent; I mean they have to move together - so that you can't have one view about prices and a different view about quantities.

Right at the very outset, when we launched asset purchases, I actually explained very clearly to a television audience what the aim of asset purchases was, and it was explained very clearly in terms of the quantity effect. Now there are also price effects that go along with that quantity effect - you can't buy £125 billion

worth of gilts without having some effect on the price. And indeed, that's what the thing is designed to do. It's to increase both the quantity and indeed the price, lowering the yields.

So I don't see any conflict between these two; they absolutely go together. A view about quantities has to be consistent with a view about prices. And as Spencer said, you know, right through this we've been describing asset purchases as an attempt to increase the amount of money in the economy. And if we are successful in doing that, relative to where we would otherwise have been, then many of these yields will be lower, asset prices higher. That is a conventional transmission mechanism of monetary policy and it's actually how Bank Rate works as well. It isn't something that's unique to this instrument called asset purchases; it is part of the normal transmission mechanism of monetary policy.

Simon Nixon:

I was referring more to the time lag between the quantity effect translates into a price effect, and to what extent you're looking at the short-term price effect versus how the stock of money might over time translate into a price effect.

Mervyn King:

Well, I think you'd expect the price effect to come pretty quickly in response to announcements. Now we've seen that; the original announcement of asset purchases and the announcement of the extension both coincided with immediate effects on yields. And that's what you'd expect to see, that it would show up in those yields in highly liquid and tradable instruments very quickly, and then flow through over time to the quantities as measured in terms of the amount of broad money in the economy.

Paul Mason,

BBC Newsnight:

This is the central problem though isn't it - it hasn't flown through. I think what the consumer wants to know is how do they judge when quantitative easing is working? You've raised Chart 1.3 money for now into the status as a target for yourselves. We note that in the two quarters that QE has been in operation growth in M4 has fallen back, it's probably averted disaster but it hasn't turned things around.

Leaving aside exhorting the banks, how long is it acceptable to you for this graph to be where it is now before it poses a severe downside risk, both to the inflation target and to the growth projection?

Mervyn King:

Well I think as you implied in your question the programme of asset purchases has had some effect, it may not have got money growth back to where we would like it to be in the medium term, but it has prevented a more serious fall and a more serious outcome. And in that sense it's had an effect and it's therefore working, but the depth of the recession has turned out to be deeper than we thought on our last report. That's why we've expanded the scale of the programme.

I think we'd certainly hope that over the next six to nine months we would see more signs of a pick up in money growth. But of course to counterfactual is hard to judge. What would have happened had we not done this programme? I find it very hard to believe that this programme - you know just simply demand and supply. We buy now £175 billion worth of gilts, that is bound to have some impact both on the price and on the amount of money out there in the economy. And we will carry on this policy, we'll keep that stock of asset purchases there until we start to see some signs of money growth, nominal spending in the economy recovering and in turn that will affect our judgement as to about where inflation will go.

Paul Mason,
BBC Newsnight:

But how long can the consumer and the borrower, the retail borrower go on seeing you pouring money into the economy, gilt yields fall but their real interest rates do not fall and the availability of credit actually reduces? I mean how long is that acceptable to you?

Mervyn King:

But real interest rates at least to mortgage borrowers have fallen. I accept that they've not fallen much to corporate borrowers. That's because banks have been widening the spreads in order to try to rebuild their balance sheets. And this is part of the process of the healing of the banking sector.

I see no easy way around that in the short run; we need to create in the longer run a healthier banking sector, one with a different structure of banking and a more competitive banking sector. Those are important long run objectives. But in the short run banks will need to rebuild their balance sheets.

Sean O'Grady,
The Independent:

We've seen the big banks report some remarkable results over the last couple of weeks as you'll have seen, especially in their investment banking arms. Do you take the view that it's business as usual for the banks and do you think that they've - especially in their investment banking arms that they've managed to rebalance the rewards and the risk taking for their staff in the form of bonuses and salaries?

Mervyn King:

Well I sincerely hope that they don't think it's business as usual. We should not forget that the results outside investment banking reflected a deep recession with large losses and further increases in loan provisions - bad loss provisions. So we're a long way yet

from having come through this as far as the impact on the banking sector is concerned.

I said before that I think the long run solution that we'll need to reach is a situation where we try to ensure that those institutions that want to engage in risky, proprietary trading cannot do so on the back of a taxpayer guarantee. And that is a long run structural change. So until we make those changes, until we get to that new structure for the banking sector then I hope nobody will think that this is just business as usual.

We've been through an extraordinary financial crisis, one doesn't have to ask questions about the worse since when, since it may be hard to find any period when it was actually worse than this. This has been an extraordinary financial crisis which has caused mayhem for the non-financial part of the economy. What we should not forget here and those in banks particularly ought not to forget is that the institutions that have really suffered through this recession have not been banks or financial sector institutions, they've been ordinary companies that suddenly were hit by this worldwide downturn, many of them have gone out of business and people are losing their jobs. And that recession is still there and it's very deep. And you cannot point to structural failings in the real economy as to the causes of this recession. And I think therefore we in the medium term have to look to the long term changes in the structure of our financial system that we need to put in place to make sure that even if we can't ensure that there is never a crisis again at least it will not be as big or as virulent as this one.

Dan Atkinson,
Mail on Sunday:

Governor, please forgive me if the answer to this is written down somewhere in the rules of the Asset Purchase Programme and I ought to have read it. When you expanded the programme the

announcement of the expansion and the permission from the Chancellor to expand it were announced simultaneously. Had the Chancellor turned you down or were he to do so in the future would we the public have been told about it? And if the answer is yes, what affect would that have on confidence in the markets?

Mervyn King:

Well the main reason why I write to the Chancellor is because this is not an operation The Bank of England should carry out without an indemnity from The Treasury. Our balance sheet is far too small for that. So where taxpayers' money is potentially at risk it's reasonable for the Chancellor to have to give his approval and it's the indemnity that matters.

If he had not wished to give an indemnity we would not have been able to carry out the purchases. These are purchases of gilts; the purchases of gilts are very much standard monetary policy operations. They are on a very large scale but this is a very deep crisis. But it's the scale that is so different not the nature of the purchases.

Where there is a difference I think is in the purchase of corporate credit instruments. And that is something which clearly is a more risky undertaking, where it is taxpayers' money that's at risk and it should be the Chancellor that decides what are the appropriate risks. And he's made it very clear in the letter that we should only be willing to buy instruments from investment grade companies and we've structured the scheme in accordance with that.

Dan Atkinson,
Mail on Sunday:

And so would we have been told if he said no?

Mervyn King:

Yes absolutely.

Paul Wallace,
The Economist:

You warned in May about the sustainability of the recovery and you've warned again in August about that. Are you any more confident that the recovery, slow as it might be, will prove to be sustainable and what should we be looking for the evidence that it is sustainable?

Mervyn King:

Well I think there are risks both on the upside and the downside. One of the things we should take comfort from over the past three months is that we do now see more short term indicators that output first of all is not falling at the extraordinary rate that it was when we met in May and that indeed over the next year we may well see signs of positive growth.

As I said we think it's likely to be slow but it might not be, it could be either faster or indeed even weaker than that. No one can be entirely sure. And I think just to put in perspective the uncertain here, just go back exactly a year when if you look at the spreads in financial markets it was natural to say well you know things have recovered a bit, it's not as bad as it was in the spring. But at that point no one had any idea that the consequences of the failure of Lehman Brothers were about to hit world financial markets and confidence around the world.

So all kinds of unexpected things can happen, it makes no sense to try to pretend that you can always anticipate things, you can't, you can react to them and you can make judgements about the likely path of the economy in the absence of big surprises. But you can't anticipate big surprises. We have no greater crystal ball than anybody else. And if we could all anticipate these big surprises then they wouldn't be big surprises, they'd have been already incorporated in our current decisions.

So you know there will be shocks from time to time and we have to accept that and respond to them when they come. That's why there's uncertainty.

Paul Wallace,
The Economist:

So would you say that actually you are a bit more confident about the sustainability than in May?

Mervyn King:

Well I'm more confident about the short run sustainability than I was in May yes.

Paul Wallace,
The Economist:

But sustainability is that something that you're ...

Both speaking together

Mervyn King:

But sustainability over a longer period, there is no change, as I say the big picture has not changed. The balance sheet adjustments that need to occur are still there and we haven't got very far down the road. So I don't think the big picture on that front has really changed since May.

What we have seen is signs that the falls in output have now stopped and therefore that we've seen output stabilising. That's the way I'd put it, we see signs of output stabilising. But what it tells us about the medium term I don't think is terribly informative, it just tells us about the short run.

Steve Schifferes,
BBC News:

I'd just like to follow up a bit on the question of timing and possibly in relation to what you might be thinking in terms of an exit strategy. Clearly the remarks that you're making today suggest - and I just really want you to confirm this, that for some

time to come while your inflation projections are so negative that your stance would be accommodative and indeed suggests that perhaps you may want to add further to the quantitative easing. I just wanted to understand if that is the right interpretation?

And the second part of this question is, is it also the fact that your view is that the government finances are in the state that they don't have any scope for being more accommodative in fiscal policy and therefore in a sense the strain of ensuring that this recovery is sustainable falls on The Bank and its monetary policy perhaps more than in some other countries which have larger fiscal packages?

Then finally I'd just like to follow up on regulatory reform in relation to the G20 meeting. Do you feel that the pace of regulatory and banking reform that is being agreed internationally is at the pace you were hoping for? Or do you think that we won't be at the G20 yet at a position to agree these major reforms and regulation that you believe are so important?

Mervyn King:

Let me comment briefly on fiscal policy and regulatory reform and then ask Charlie and then Paul who's in charge of the Asset Purchase Schemes to comment on exit strategies.

First on regulatory reform, I don't think it's possible yet to judge what will come out of the summit in Pittsburgh, it's too early people are still debating these issues. But I think what's important is to maintain the political impetus for reform. What's not important is to rush into some half baked reforms that we hadn't thought through. And there are many areas of the long term reforms of the financial structure, including these so called macro prudential reforms that haven't yet been fully thought through.

It's an urgent task, we're working hard on it, but I don't think you should expect to see progress on that in a matter of just a few weeks.

On fiscal policy I think it's pretty clear from the government's own projections that it sees the need to reduce the structural deficit in the public finances, the precise time to do that must depend on the state of the economy. Any consolidation must be contingent on the state of the economy. But I think that has been fully set out in the Chancellor's plans. So let me ask Charlie to say a few words about the principles of the exit strategy and then perhaps to ask Paul about some of the details?

Charlie Bean:

Okay, the principle of the exit strategy is extremely easy. It is the inflation target, stupid - basically it's the inflation outlook that will determine how much longer we need to keep monetary policy set in stimulative and it will be the inflation outlook that will determine when we start having to withdraw that stimulus as we surely will at some stage. We have really two instruments that we can use to withdraw that stimulus. There's not only selling back some of the assets that we bought but also we can raise Bank Rate.

Now the mix of those two we will decide at the time. But the fact that we can raise Bank Rate means that we can stagger sales back to the private sector in a way that recognises market conditions at the time.

But the big guiding light in this is going to be the inflation outlook.

Paul Fisher:

I think the main thing to add is that the pace and the nature of the exit programme must be an MPC decision consistent with

our policy for hitting the inflation target that is the overriding thing. Subject to that we will of course not be looking to disrupt the gilt market excessively. And we will talk to our colleagues in the DMO and seek advice on what the best way is to minimise any such disruption.

I hope the announcement we made last week about gilt lending is sort of a model as to how that will work. That is set up in such a way that completely protects the MPC's purchases and stock of purchases of gilts and yet enables the DMO to undertake its responsibilities in terms of maintaining an orderly market.

Ed Conway,
The Telegraph:

Just a quick one to follow up on the whole regulatory reform question. You talked in your Mansion House speech about how banks should not be allowed to become too big to fail. Since then we've had the White Paper from the Government and we've had the Tory's equivalent. Do you think that both of these papers are consistent with meeting that objective and are you happy with the measures that they are putting in place?

Mervyn King:

Well I'm afraid I don't want to go into those issues today; this is a conference about the Inflation Report and monetary policy. It's the most important thing the Bank of England does and I think I really want to keep the press conference if you will permit me to those issues and not get side tracked into the areas of regulation, particularly in terms of the UK.

Ed Conway,
The Telegraph:

I think it is consistent when we're talking about economic projects to understand quite how the financial sector is going to be structured in the future. I mean that's been central to what's happened.

Mervyn King: Yes and I've made a general comment on that this morning. So what is the question you would like to ask about the financial structure in general?

Ed Conway,
The Telegraph: Well actually I mean the real question that we'd like to ask the elephant in the room is the Conservative proposal to hand over power of financial regulation to the Bank of England. I mean do you really want to have full control over financial regulation? In a year's time, it looks like, if the polls are right that could be the way we're heading. What I think everyone would like to know is really have you got the appetite for that?

Mervyn King: What I really want to do Ed is to talk about monetary policy and the Inflation Report. And that is what I am going to be doing at least for the next ten minutes.

Laughter

Claire Jones,
Central Banking Publications: Charles Goodhart said last week that The Bank should follow the Riksbank's lead in making its deposit rate negative so as to stop what he labelled the socially useless trend of banks hoarding more and more of their assets in the Central Bank's coffers. I just wondered if it would be possible to get your view on this.

Mervyn King: Yes, I think first of all it's important not to think of the scale of Central Bank reserves as sort of socially useless, because the scale of reserves in aggregate is determined by what we do not by the actions of individual banks. And we have taken some actions to scale down the size of reserves through reducing the short term repos.

Essentially the scale of reserves is determined now by the size of asset purchases. So if we conduct asset purchases it just follows that there will be larger reserves in the Central Bank held by banks. There is nothing banks can do about that that is a logical consequence of the actions that we've taken. And since I feel that the asset purchases have been socially useful it must follow from that that therefore the increase in Central Bank reserves must be socially useful. So I wouldn't accept the generic description of it.

But it is certainly true that it would be useful to think about ways to encourage banks individually to try to convert some of their reserves into say shorter term gilt holdings or purchases of other assets which would then reinforce the transmission mechanism of the direct assets purchases that we make. And in normal circumstances you might expect that to have some impact. And there is no doubt that the interest rate that we pay on reserves does affect the incentives which banks face to turn those reserves bank by bank individually into other assets. And it's an idea we will certainly be looking at to see whether in fact the effectiveness of our asset purchases could be increased by reducing the rate at which we remunerate reserves.

But I think the important thing to hang onto here is that these are not socially useless reserves they are the direct consequence of the asset purchases that we've made and there is nothing that banks can do themselves to alter the aggregate total of reserves. That reflects our actions.

Brian Swint,
Bloomberg:

There has been a lot of unanimity in the votes, in the minutes that we've seen since the crisis began really. It stretches credibility a little bit to think that nine independently minded economists will come to the exact same conclusion about what

to do every month. I just wanted to ask you if you think it's important in turbulent times to have a consensus on the MPC and if not why can't people be more open in disagreements?

Mervyn King:

Well I'm not going to comment on - you know you'll see the minutes of the meeting next week. But the general point is ...

Brian Swint,
Bloomberg:

But I don't get to ask questions after the minutes.

Mervyn King:

... From time to time I get asked questions, you know if we've been through a period when we've been broadly unanimous or unanimous for seven out of nine months people always come along and say this is terribly. You know surely it's unreasonable that nine independent people could come to the same view. When we've been through a period where there have been votes like 6-3, 5-4 for seven or eight months in a row then I get accused of, this is a rabble, it's a shambles, an academic debating room. You know you can't have it both ways.

There will be times when it will be natural for people to think in terms of outcomes which are broadly the same. I think it's particular true when you get a big shock and when it's pretty clear what you've got to do. And it may not be clear precisely how much you will have to do in the end and there may be differences of views on that. But the actions that you take month by month will very much seem to be ones which everyone on the Committee falls in line with and agrees on.

There will be other times when it's not quite so obvious, there isn't a very big shock, you're thinking about relatively small movements in Monetary Policy where it's perfectly reasonable to have people to hold different views. All I can say is that we've not in any way changed our view that the Committee is a group

of nine people who form their own independent view. And that is true all the way through. And so when individuals speak they speak for themselves not for the Committee. That's another thing people have to hang on to and remember, individual members of the Committee speak for themselves and not for the Committee as a whole. And that is just as true when there are unanimous votes as it is when there are votes in different directions.

So - you know I'm sure there will come a time when we will start to see split votes again, just as in the past when we've been accused always of having split votes then there were times when the votes were unanimous. So I think it just depends on circumstances and it doesn't reflect any change. But I do think that when you get a big shock it is perhaps not surprising that it is obvious the direction in which policy needs to go and as I say even if you don't know quite how far you're going to have to go the route on which you travel people naturally congregate on the same view.

Arisa Yoshida,
Nikkei:

I'm sure you have looked into Japan's experience before you started quantitative easing and actually it took a decade for Japan to get away from the balance sheet adjustment. And over the course of the lost decade there were a couple of cycles which Governor Shirakawa called false dawn, which means that a couple or a few quarters with positive growth and then we went back to the downturn. Do you think that the UK will be able to avoid that cycle? And if you do believe so, why and how are you going to make it?

And secondly what lessons did you learn from the Bank of Japan's experience in terms of the quantitative easing?

Mervyn King:

Well it's very important that we do learn from the Japanese experience, because we definitely do not want to have a wasted decade. So I think the main lessons that we learnt from the experience of Japan and our colleagues in the Bank of Japan have been very clear in trying to make sure that we do learn from that experience and they've been very helpful to us in thinking through the lessons from their own experience.

The first lesson I draw is that once interest rates have reached very close to zero if you do think there is a case of having a further monetary stimulus then you need to get on with asset purchases sooner rather than later. I think in the Japanese case it was five or six years before they moved from a situation having reached close to zero bank rate and actually engaging in asset purchases. So we didn't, we just got on with it and I think that's one important lesson.

The second is that the banking system has to be fixed. And that is something which over a period of time will need to be done here too. The banks will end up with much higher levels of capital than they did going into this crisis. But that is not something that is easy to do quickly, it will take time. But the need to fix the banking system should be central also to our view as to what needs to be done.

So I think those are the main lessons. We're very conscious of the Japanese experience and we do not intend to go down the same road because in part we have the benefit of the experience that they went through and our colleagues in the Bank of Japan have been very helpful in helping us to think through how to avoid that.

Facilitator:

We have run out of time, thank you all very much for coming.

END