

INFLATION REPORT PRESS CONFERENCE – 16 MAY 2007

OPENING STATEMENT BY MERVYN KING, GOVERNOR OF THE BANK OF ENGLAND

Inflation rose to 3.1% in March, thus triggering an open letter from me to the Chancellor. As you saw yesterday, CPI inflation fell back to 2.8% in April, as the substantial increases in household gas and electricity prices that occurred a year ago started to drop out of the twelve-month rate and the falls in this year's prices started to take effect. CPI inflation is likely to fall back further over the next few months as those effects continue. But the crucial question for monetary policy is where inflation is likely to be once energy prices have settled down. At that point inflation will reflect the balance between money spending and supply capacity in the economy as a whole. And it is the Committee's view of that outlook which has been behind its decisions to raise Bank Rate four times since last August.

Output growth is estimated to have been at or above its long-run average rate for five quarters and that strong growth appears to be continuing into the second quarter of this year. Asset prices, and money and credit growth, remain remarkably high. Although consumer spending has been volatile, the underlying trend is of recovery from the slowdown in 2005. Real take-home pay is expected to increase more rapidly than in the recent past after a period of slower growth reflecting rising taxes and energy costs. That will help to offset the drag from higher interest rates and rising debt. Business investment has been stronger than the Committee expected in February and surveys of investment intentions suggest continuing growth. And despite slower growth in the United States, robust growth in the euro area and in Asia is supporting a strong world economy.

The Committee's latest projection for GDP growth is shown in Chart 1 (GREEN CHART) on page 6 of today's *Report*. That projection is based on the assumption that official interest rates move in line with market expectations over the forecast period. The path of interest rates assumed in this projection anticipates a further rise in Bank Rate, as shown in the table in the box on page 41. The central projection is for GDP to continue to grow at around its recent rate before slowing a little towards the end of the forecast period. That is very similar to the February projection. In the Committee's view, the risks to output growth around the central projection are broadly balanced, as indeed they were in February.

The Committee's projection for CPI inflation is shown in Chart 2 (RED CHART) on page 8 of the *Report*, again on the assumption that official interest rates follow market expectations. CPI inflation falls back to, and a little below, the 2% target over the next six to twelve months, before picking up again as the effects of this year's cuts in gas and electricity prices drop out of the twelve-month inflation rate. Looking to the medium term, the central projection is for inflation to settle around the target. Against a background of rapid money and credit growth, the outlook for money spending appears strong. Supply capacity, however, also seems resilient with the supply of labour, including further inward migration, continuing to expand allowing earnings growth to remain subdued.

There are substantial risks around that central projection. In the medium term, the main downside risk is that there could be more slack in the labour market which would slow pay growth further. On the upside, a number of measures of inflation expectations have drifted up, and, with a limited degree of spare capacity and firm demand growth, the main risk is that businesses become more confident of their ability to raise prices and in turn pay higher wages.

Overall, the balance of risks to inflation around the central projection two years or so ahead is, in the Committee's judgment, on the upside. The Committee will monitor those risks carefully over the coming months. Indicators of pricing pressure are particularly important at present. If they remain elevated, that would be consistent with the possibility that inflation expectations had moved more persistently upwards or margins were being raised more aggressively, and that the upside risks were crystallising. If, however, wage pressures were to diminish, that would suggest that the upside risks had receded.

Given the outlook for inflation, and the balance of risks around the central projection, the Committee judged that a rise of 25 basis points in Bank Rate was necessary at last week's meeting. The Committee will look through the short-run volatility to the outlook in the medium term. It is determined to meet the 2% target, and will take whatever further action may be required to do that.

QUESTIONS

EVAN DAVIS, BBC NEWS – TOUGHER TIMES

Governor, you talked of substantial risks. How worried should people be of tougher economic times, not just for borrowers paying higher interest bills but of a slower economy perhaps affecting their job or their income?

MERVYN KING

Well the big picture is still for steady growth with low inflation, once we've moved through the period of volatility of energy prices; that's still the central outlook. But, of course, there are many risks, there always are many risks. We've been through a period in which perhaps not many of those risks materialised. That may happen in the future. I don't think there's any reason for people to be unduly alarmed. But they should nevertheless be cautious and careful of the fact that it's always possible for unexpected events to occur. That's what monetary policy is about and that's the thing that people should always bear in mind when making their own financial decisions.

STEPHANIE FLANDERS, BBC NEWSNIGHT – MPC MISTAKES/MONEY GROWTH

Governor, obviously in the wake of the 3.1% figure and the letter to the Chancellor, there's been a lot of debate about whether the Committee made a mistake of some kind and specifically quite a lot of debate as in the letter to the FT by a number of economists about whether the Committee didn't pay enough attention to strong money supply growth figures over the last year or so. Do you have a view on that?

MERVYN KING

Well I think that other people have to decide whether we did or did not make mistakes, it's not sensible for us to go back and I've always said that the only meeting that matters to us is the next one, so we're now completely focused on the June meeting. I would say this however that we have raised interest rates four times since last August. On a number of occasions when we did that, people claimed to be surprised and said maybe we were over-reacting. Now some of the same people are saying perhaps we're under-reacting. There is always uncertainty. We have made a change to the level of Bank rate since last summer; it is one percentage point higher. I don't know where it will go in the future, but we'll just remain very focused on trying to make sure that inflation stays as close as possible to the 2% target in the medium term.

STEPHANIE FLANDERS, BBC NEWSNIGHT – MPC MISTAKES/MONEY GROWTH

Do you have a view, I haven't been able to read all of this yet, on the money supply growth figures? I know you mentioned in other contexts that you did think it was an important measure.

MERVYN KING

Yes, it is an important measure and I think anyone who simply dismisses it fails to understand that inflation is a fall in the value of money. So you have to look at what's happening to money. But as I said in my last lecture to the Society of Business Economists two weeks ago, this isn't a question in which you'd have a mechanical link from a particular growth rate of a monetary aggregate to inflation. You have to ask the question - is what is happening to money and different measures of money a reflection of shifts in the demand for money - or is it a reflection of a shift in the supply of money? The former would not have inflationary implications, the latter certainly would, and I think the trick here is to actually have a very careful analysis of what's going on in the monetary sector and as I said two weeks ago, we will be devoting resources to do that.

DAVID SMITH, SUNDAY TIMES – INFLATION OUTLOOK/DIFFERENCES OF VIEW

I've got two questions if I may, shall I ask them separately?

MERVYN KING

That would help me David, yes. Memory is fading.

DAVID SMITH, SUNDAY TIMES – INFLATION OUTLOOK/DIFFERENCES OF VIEW

The first question is back in November, you had an inflation forecast which suggested that Bank rate of roughly 5% would be enough to achieve the inflation target over the medium term. Today's forecast suggests you need a bank rate of 5.75% or even higher to achieve the inflation target over the medium term. I just wondered what had happened in the space of just a few months to produce such a deterioration in the medium term inflation outlook?

MERVYN KING

What we've seen I think over the past 6-9 months is that inflation has moved up. Part of that is a consequence of unexpected increases last year in gas and electricity prices which moved in a

way rather different from energy prices in general, and in particular oil prices. But you can't explain all of the increase in that way. So there are several different views as to what may be happening. One view would be that firms, well the first view is perhaps that the response to the earlier increases in oil and energy prices was just delayed and what we're seeing come through now in prices is a more delayed response to the earlier increases in energy prices. If that were the case then you would expect this to be a one-off effect and it wouldn't have implications for inflation further ahead. A second view would be that perhaps demand growth has been really rather strong and perhaps a little stronger than most people had expected. Indeed a year ago when we published our forecast, I remember people saying that we were out on a limb and actually forecasting far too strong a potential growth of output. If anything, it's come in slightly stronger than we might have expected, and that strength has been continuing despite the increases in Bank rate. Now if that's the case then maybe greater pressure of demand on supply capacity in the economy and what we're seeing as a response of prices to that. Another explanation might be that in fact what's been happening is that expectations of where inflation might be going generally have risen and that makes firms much more confident in raising prices and indeed less concerned about the need to resist wage pressure, pressures for higher wages. And if that was the case, then we would be seeing more inflationary pressure down the line. Now it's not easy to disentangle what's going on and to distinguish between these three different hypothesis. But I think as time has gone on, we've seen that there has been something to the slightly stronger growth of the economy, we have seen some increase as I mentioned in inflation expectations. I don't think any of these things are dramatic but they're things that we have to take notice of and respond to, and that's what we've done.

DAVID SMITH, SUNDAY TIMES – INFLATION OUTLOOK/DIFFERENCES OF VIEW

The second question was just about the nature of the forecast, it being a collective forecast. You've had a range of different views on the MPC including one recent vote for a cut in rates. I find it difficult to see how those can all be accommodated in what is quite a hawkish forecast for inflation in the medium term.

MERVYN KING

Well, as ever, and the report makes this clear, there are differences of view about the central projection and the risks, though I don't think they are particularly large at this point. You'll see the results of last week's meeting in the minutes that come out next week. But I think it's very

important not to get carried away by small differences. These are judgements that we have to make, our judgements evolve over time. The big picture is the one that you should focus on and the big picture here is shown in the chart is that inflation picked up – we expect it to fall back over the next few months towards and indeed possibly below the target, a little below the target – then those base effects from this year’s cuts and prices wear off next year, inflation picks up a bit – but will settle around the target. Now precisely where it will be, no one can tell. And the only certainty in all of this is that there will be surprises between now and when we get to the two year forecast horizon. So the whole trick of monetary policy is not to assume that you know what the future holds but to be ready to respond to those events as they unfold. That’s what we’re doing and that’s why the Committee, I think, felt able to sign up to the report and the forecast.

WILLIAM KEEGAN, OBSERVER – FALL IN CPI INFLATION

Mr Governor, this may seem a strange question but I’ll give you the background. Has the announced fall in CPI yesterday helped or hindered your battle influencing inflation expectations? I ask that because there’s a very strange report in today’s FT’s market report where somebody is quoted as saying “that while the size of the fall might have been in line with expectations, it was still a fall and for a market that had another UK interest rate rise fully priced in, the retreat was not comforting”.

MERVYN KING

Yes. These people are very clever and it’s beyond my ability to quite see through all that. All I would say is this. The fall that occurred was exactly in line with our expectations. It hasn’t changed our view. The forecast is one in which we still see inflation coming back to target as these short run changes in gas and electricity prices feed through. That does not make us complacent about the medium term. There are important questions about where inflation will be once these cuts in gas and electricity prices have fed through and some of the 12 month effects have unwound into 2008. That’s what we’re focused on because that’s our task. I think it’s fair to say that there was a rather, there was a certain amount of rather excited commentary when inflation went to 3.1%. If inflation had merely stayed at the same average rate through the first quarter of this year, there wouldn’t have been so much excited commentary. I’m always keen not to have excited commentary and I would encourage you all to be as boring and realistic in your commentary as we try to be. We do expect inflation to fall back but as I say, the important question for monetary policy is not where inflation is today, it’s where the balance of risks to

where it might be looking further ahead two years or so. That's a difficult judgement to make and it's one which is a judgement about the implications of the growth of money and credit, growth of nominal demand, pressure of demand on capacity, pricing pressures that we see and business surveys and so on. That balanced against some of the changes on the supply side which have meant that I think, rather against our expectations, wage growth has still remained rather subdued. These things all have to be brought together to an overall judgement. It's not easy, reasonable people can take different views on that and I think it would be quite wrong for anyone to suggest that some views are clearly right and others are clearly wrong. It is a difficult judgement. But we know our task is to bring inflation back to the target and that's what we're determined to do.

LARRY ELLIOTT, GUARDIAN – BANK RATE INCREASE

Given what you've said about the substantial upside risks to inflation, was there not a case for raising interest rates by 50 basis points last week, rather than by 25 and if not, why not?

MERVYN KING

Well there's always a case, at any meeting, for raising interest rates by a little more or indeed by raising them by a little less, and the debates that the Committee had will be reflected in the minutes next week. So I don't want to comment on the minutes or the debate that we had last week until the minutes appear next week.

LARRY ELLIOTT, GUARDIAN – BANK RATE INCREASE

Isn't there an argument though that you have got behind the curve. Following on from what David Smith was saying, that actually the level of interest rates needed to actually get inflation back to target is creeping upwards and that actually you're playing catch up here?

MERVYN KING

Well events change. I rather suspect that you could either, at any meeting, you could either accuse us of playing catch up or having gone too far. I mean that's bound to be the case, the chance that we're spot on, precisely each time, the chance of that being true must be close to zero. So we make our judgements, I think it's always, in these matters, it's always said that you can make a perfectly reasonable case for having interest rates a little higher or indeed a little lower and reasonable people can make those cases and they do through your columns very often. All I can say is the Committee each time looks at the data it has in front of it and forms a

judgement and last week it decided that it was necessary to raise interest rates by 25 basis points. I don't know what we'll do at the next meeting, or the one after that. We'll take each one as it comes and we will see how the pattern of interest rates and inflation unfold.

SAM FLEMING, DAILY MAIL – INTEREST RATES AND SPENDING/HOUSING MARKET

I've just got a question on the box on Page 14-15, towards the end you talk about the fact that we have this rise in household debt and that could have a bigger impact on household spending, rate moves could have a bigger impact on household spending as a result. Does that lead you therefore to think that the four hikes we've had so far over the past year could have a more significant impact on household spending than perhaps we're all expecting? Does that effectively suggest that you think that households are more vulnerable than they were in the past to these rate moves. And I had a second question just on the housing market. Are the early signs that we're now seeing indicative of a sustainable slowdown in the housing market? Do you think this is finally now under way or are you not willing to make that judgement yet?

MERVYN KING

I think it's much too early to make the judgement on the latter one, we've seen that in the last three months house price inflation was actually slightly higher than in the previous three months although it is lower than it was in the final quarter of last year, so I think it's too soon to make that judgement. On the first, I think I would stress the need to distinguish between two issues here. One is will the gradually increasing share of incomes that are being devoted to interest payments and principle of debt repayment likely to affect the pace of consumer spending. And secondly, does this create more, a greater likelihood of financial distress among households. Now let me talk primarily now about owner-occupiers and the bulk of household debt, the 83% which is secured debt. Factored into our projection is indeed that a greater fraction of household incomes will be devoted to interest payments and debt repayment in the future and that's been occurring for some time now. It hasn't stopped the recovery in consumer spending growth. That's factored into our central projection. In terms of household financial distress, as far as owner-occupiers are concerned, I think it's very important not to exaggerate this. Mortgage arrears last year were lower than they were in 2005. It's the case that in terms of the ratio of loans to the value of a house on which the loan is secured, that has crept up. The proportion of new mortgages where the loan to value ratio is say 90% or more has crept up from about 25% to just over 30% in the past two years. But in the early 1990s, that reached over 60% so we're well

below the levels of financial distress or warning signs that we saw in the earlier period when there was a significant amount of negative equity. So I think if you look at the housing market it's quite difficult to see major signs of financial distress, although clearly the fraction of incomes devoted to financing those mortgages are rising slowly. It's in the unsecured debt market, and I keep making this point, that you see greater signs of financial distress. But there's no doubt that the rate of borrowing here is falling quite sharply. If you take credit card debt for example, 18 months or so ago, the growth rate of credit card debt was over 20% a year. Now it's below, below, 2.5% a year. A very significant slowdown in credit card borrowing. So I think it's important not to exaggerate this story.

PAUL WALLACE, THE ECONOMIST – MONEY GROWTH/ASSET PRICES

Reverting to the subject of money, I wonder whether you could tell us a bit more about how you're going to try to distinguish between supply side and demand side causes of rapid monetary expansion and secondly, the current pace of monetary expansion, broad money up 13% is generally higher than I think in most of the industrialised world. But to what extent is there a more general concern among the central bankers that they may have contributed to very frothy asset prices around the world through over-lax monetary policy?

MERVYN KING

On the first, we will pursue a research programme and this is something we've always known about and tried to think about. It is not easy, we will be looking carefully at the institutional developments in the financial sector where some of the increases in money holdings have taken place. I certainly don't want to underplay the current growth rate of money and credit, it is high, and it is a concern. But we will try to do more research to enable us to try and persuade you that, there are two extreme positions you can take on money, neither of which seem to me sustainable. One is to say that because on average in the past there doesn't seem to be a strong correlation, though this is clearly debatable, between short run movements in broad money and inflation, you should always ignore money. And the other view is that because you think money is important, you should always have a mechanical link from the current growth rate of the monetary aggregate to future inflation. Neither of those are sustainable. It's the same with every economic variable and I find it puzzling that people find it deeply reluctant to apply the same argument to money growth. Each time you have to ask the question 'why has it moved in the way that it has' and in the case of money, the key thing is, is it a demand shock to money or is it a supply shock? And we will have to do more research to improve our ability to distinguish

between the two. It is not easy, if it were easy, monetary policy would actually be more straightforward. The fact, the reason why these judgements are difficult is because it is not easy to distinguish between these two in practice, though we will redouble our efforts to do so.

On the second question about asset prices, I think that what central banks are very conscious of is that you can explain much of the movement in asset prices once you realise how low long-term real interest rates are. The puzzle is to work out whether the low level of real interest rates is reflecting what you can think of as long run real economic factors such as the high supply of savings in Asia relative to investment, or whether in fact some of the easy money that's being applied around the world, particularly in the United States and in Japan in the past five years, has also contributed to the low level of real interest rates and risk premium. That's not an easy question to answer but I think it's a question that many people are now asking. But what it shows, and I think this is an important point for us, is that the level of asset prices in Britain is not independent of what happens in the rest of the world. With an open capital market in which the real interest rate in the long run is determined by factors in the world capital market, whether they're financial or real, then asset prices in the UK can be heavily influenced by what is happening overseas, independently of UK monetary policy.

GABRIEL ROZENBERG, THE TIMES – IMPACT OF CHINA

Governor, do you believe that the China effect on productivity is coming to an end and if so, is the NIESR correct to talk of a return to a kind of a normal range for interest rates of between 5 and 6% in this country?

MERVYN KING

I think it's a bit odd given Britain's monetary history, to talk of a normal level of interest rates. They have been all over the place, so I'm not going to speculate on what a normal level would be. I don't think the China effect is coming to an end, no, but I do think you're starting to see signs of some inflationary pressure within China. So I think that having held their exchange rate against the Dollar down at a time when the Dollar was falling, it's not surprising that the impact of China on our import prices is not quite as deflationary as it was.

SCHEHERAZADE DANESHKHU, FINANCIAL TIMES – BUSINESS PRICING

PRESSURE/INFLATION EXPECTATIONS

You've emphasised a lot in recent months your concerns about businesses being able to push through prices. I wondered if you knew which sectors in particular that was occurring in, do you have that kind of information or is it across the board? And secondly on Page 37 you talk about how hard it is to work out how inflation expectations are formed. Is it possible to work that out, is the Bank going to do extra research on that to see how people make those decisions?

MERVYN KING

Well I'm going to ask Charlie to comment on both of those in a minute. That second one is much too difficult, I'll ask Charlie to answer it. On the first, which remind me Shari. Well it seems to be pretty broad based and that's what you get from the surveys. The surveys of course are pretty broad brush. You can distinguish between manufacturing and services but nevertheless it seems to be pretty broadly based, and I would say based on my experiences of making regional visits around the UK that the views that firms have expressed in the last 6 to 9 months have been pretty uniform about a change in the pricing climate. But let me ask Charlie whether he's got any comments on that, and then in particular on inflation expectations.

CHARLIE BEAN

Okay I mean first I would just draw your attention to Table 1 on Page 32 which reports some of the surveys of pricing pressures, and you will see that in both manufacturing and services and some of these different service surveys cover different sub sectors of services – they're all elevated relative to their historical averages. In most cases, the histories are not very long. The CBI manufacturing survey is the only one that has a very long history. But nevertheless, compared to the history of the last ten years or so which is when most of them cover, they are higher than their averages and in some cases at their highest ever over that period. And as the Governor says, when MPC members go around visiting our agents' business contacts, we get a pretty general message of a greater ability to push through prices and its particularly interesting I think that we see that in the manufacturing sector as well as in the service sector which might be more focused on just purely domestic conditions.

On the question of extracting measures of inflation expectations and whether we're going to do any more research on this. For a long time we've extracted measures of market participants' measures of inflation expectations and we have reasonably good mechanisms for doing that but

not without problems. You have to make assumptions about risk premiums when you compare returns on nominal and index debt. But at least we have a reasonable handle. The difficulties arise when you're trying to measure the inflation expectations of households and businesses. Households, we do have our own survey that we carry out quarterly. We're now in a position where we've accumulated a longer back-run of that, so it's becoming possible to do more investigation of what might be driving movements in that series. We are hampered in some respects by our success because inflation has stayed low over the period that we've been collecting that data there's not much variation to enable us to actually see what drives peoples' inflation expectations, to what extent it's affected by movements in particular products say that they purchase frequently, or that might be particularly visible, to what extent they're influenced by particular headline measures and so forth. But they're the sorts of things we would like to know more about. As far as business inflation expectations go, we have really no direct measures of their inflation expectations but these pricing surveys, as the Governor has already suggested, may give some indirect read on businesses' perceptions of the inflationary climate.

FAISAL ISLAM, CHANNEL 4 NEWS – END OF THE ‘NICE’ DECADE/NEW CHANCELLOR

Two questions Governor if I may. Over the past 10 years, you've said your aim was to make monetary policy boring and characterise the economy as 'nice'. Monetary policy seems to become less boring over the past two months, but are the 'nice' years over?

MERVYN KING

Well I think it is becoming boring again, I was quite struck by how little attention was paid to the fall back in inflation yesterday, given the excitement of when it reached just over 3% the month before, and I very much hope that we will return to that happy state. Now in terms of the 'nice' decade, that was a period which did end a few years ago. We're now in the 'not-so-bad' decade, I think that's perhaps a slightly more accurate description of what not only we are seeing but what we could expect to experience in the future.

FAISAL ISLAM, CHANNEL 4 NEWS – END OF THE ‘NICE’ DECADE/NEW CHANCELLOR

When we see you again, there's likely to be a new Chancellor. I'm just wondering whether the institutional structure, whether there's any changes or difference, whether you think the institutional structure of Bank independence is strong enough for a change in Chancellorship?

MERVYN KING

Oh certainly, I think the great strength of our arrangement has always been the institutional arrangements and I've said, ever since the very beginning that the whole point of the change was to create strong institutions, the success and operation of which were quite independent of personalities. So I'm confident that we have a strong institutional framework that will survive the change of many people.

ANDREW PEAPLE, DOW JONES – INFLATION PROJECTION

Obviously the central forecast seems to show that inflation will be bang on target in two years time, if, as markets assume, interest rates go up again. But looking at the Chart 5.9 where you've got interest rates steady at 5 and a half where they are at the moment, there doesn't seem an awful lot of difference in the path of inflation. I just wondered whether you see a significant difference in the path of inflation, whether there is a significant difference.

MERVYN KING

Well, I mean you wouldn't expect to see a significant difference because it only corresponds to a difference of maximum 20 basis points in interest rates over the next 2 to 3 years and I wouldn't expect a change of interest rates of 20 basis points to have a dramatic or even significant difference so I don't think one ought to be looking for a significant difference. It would be, contrary I think, to experience and all our knowledge to expect that a change in interest rates of less than a quarter point would have a significant impact on the path of inflation, it's never done so in the past and I would be rather surprised if it were to do so in the future.

ANATOLE KALETSKY, TIMES – CPI AND RPI INFLATION

Are you concerned at all about the divergence between the CPI measure of inflation and the RPI and RPIX which still seems to be the one that commands more attention in terms of public perceptions and in fact is used, as you say yourself, here is the one that's used in the markets for determining market-based inflation measures. It's the one used by the government in pension adjustments, the one used by employers and many retailers. And the fact is that if you're still following an RPIX target, you would have had to write another letter this month because you'd still be above the 3.5. Is it a worry that perhaps this is undermining the credibility of what you're trying to do and following the government target and perhaps could the government do

something to increase the prominence of the CPI, for example by changing the issuance of index-linked gilts and changing its own pension calculations?

MERVYN KING

Well in a minute I'll ask Paul to comment on approaches to indexation and changes that have been made and might be made, although it's clearly very much the responsibility now of the Debt Management Agency and not ourselves. Let me just correct you on one small point. We wouldn't have had to write another letter, the letter-writing provision means that the letter is written every three months, not every month, okay? Presumably to economise on stamps. But - well it's yes and no. I mean I think in the long run, we would expect that the differences between these different measures would be relatively stable. We said when the index was changed that we would expect on average that the difference between CPI and either RPIX or RPI would average about 0.7, 0.8 percentage points. Not a lot has really changed to alter that viewpoint. That will be the long run gap. The target was changed by half a percentage point. This wasn't a sort of big deal. But in the short run, it is a concern that with high levels of RPI that it might dislodge inflation expectations. That's why we are concerned about that. I think a number of things have come together, and perhaps not surprisingly have come together. One is that the pick-up of inflation itself has had the property that as I mentioned at an earlier press conference, if you were to in your own mind calculate an inflation rate based on the things that you had bought in the last six months, then you would have a higher inflation rate than if you were to take into account things that you had bought with all the frequencies, that what CPI is measuring and in fact what all the indices are measuring, is an average national consumption basket, not the consumption basket of a majority of people based on what they've happened to buy in the last six months, that the prices of things that have gone down most are the things that people buy relatively infrequently. That's come on top of some very visible increases in prices of gas and electricity which have been the subject of a good deal of publicity which constitute, you know, non-trivial parts of peoples' budgets. So the profile of the increases has been rather high. And of course, as far as RPI itself is concerned, it's come at a time when we started to raise interest rates as early as last August, so that too is fed into RPI. Now if this were to become a self-fulfilling increase in inflation expectations then we would certainly be concerned and that's why we try very hard to say to people, we're not setting inflation with respect to the current inflation rate, but we look ahead, because that's the sensible thing to do, to look through the short term volatility, we do believe that inflation will hold back towards the target. That is not an expression of complacency, it's an honest intellectual judgement about what we think is

likely to happen and that we do take seriously what is happening in the medium term and for that reason we have raised interest rates four times. And we hope that that just straightforward judgement about the prospects and our decisions based on that will help people realise that there's no reason why they should allow their own inflation expectations in the medium term to deviate from our 2% target. But clearly in the short run it raises question marks for us.

PAUL TUCKER

Two things, first of all I should stress that it's not our business but were the index to which index-linked gilts are linked to be changed, the government would have to think about redeeming the existing index links and also replacing them with new ones. Alternatively, there could be a very protracted transition period when there were two kinds of index-linked gilts in the market and balancing those considerations is not for us but for the Debt Management Office. I think the more important point is that the market knows that we are targeting CPI inflation and not RPI or RPIX and therefore it has as keen an interest as we do to form the view on the likely path of the wedge between CPI inflation and RPI inflation and I think that's something which perhaps isn't debated enough in the market and it's something which I suspect we could benefit from because it's a judgement that we have to make too.

BRIAN SWINT, BLOOMBERG NEWS – WAGE GROWTH

Governor King, in February you told us the biggest risk to inflation was wage growth and this month you're telling us its firms' ability to push through price increases and make them stick. I was just wondering if you think the danger is passed of faster wage growth, given that most wage deals are negotiated in the first part of the year?

MERVYN KING

No I don't think the danger is passed. It's clear that some time has elapsed since we were concerned about the prospects for the pay round in the time of the February report and so far those upside risks have not materialised and that's comforting. But I think it's too early to draw that judgement for a number of reasons. First, we don't have all the data corresponding certainly to the April month for settlements which is the second, you know, one of the two big months, January and April. Secondly that actually earnings growth is what matters more than anything else. That is volatile because of bonuses and we saw that this, in the data that came out this morning, that the bonuses have largely dropped out this month and that regular pay growth has been broadly stable and that's encouraging. However, the new index of average weekly

earnings which the ONS are producing is showing a higher path. That needs to be resolved and explained in a way its not immediately clear to us. So I think it's too early to say well the danger's passed, but the developments on that front have certainly been more encouraging than we might have feared in February. At the same time, we've seen that the concern from pricing pressures has, if anything increased. So events always evolve and change and we have to update our own analysis and that's why in this report you'll see the focus is slightly different from that in February, although as I say the big picture is really very much the same.

JOHN FRAHER, BLOOMBERG NEWS – HAS POLICY BECOME MORE DIFFICULT/COMMUNICATIONS

I've two questions. The first question on money supply again. Given the strength in money supply that we're seeing in the UK and also across the global economy in general and also the uncertainty that we're also seeing from policy makers in terms of how to interpret them, would you say that the job of central bankers is more difficult now even than it was five years ago. Second question, you said in your interview with the FT earlier that communication strategy is one of the issues that the Bank of England is looking at, at the moment – can you give us any guidelines in terms of how the Bank might change or make adjustments to how it communicates with financial markets.

MERVYN KING

Well on the first, I think it gets more difficult every year so let me move on to communication. I don't apologise for repeating first what I've always said before, which is to explain what communication is not about. What it's not about is dropping hints about where interest rates may go next month or the month after. The survey that was published by one of the banks recently showed, not surprisingly, but usefully reminded us that the big surprises in interest rates always come from big surprises in the economy. It's movements in the economy that generate changes in interest rates. That's the most important fundamental thing to point first. So the question 'what is communication about?' Well what I think it's about is trying to explain to financial markets and agents how we think about the economy. There's no point pretending that we can tell where interest rates are going, we don't know. That will be decided month by month. What is important I think is for financial markets to be able to gauge how we might react to the data when they occur. So that the surprises to interest rates should occur when the data emerge, people change their view about the economy. They will have some idea about how we'll react to it. But it can't be a mechanical thing. I talked about money and the need to

distinguish between demand shocks and supply shocks so you can't map mechanically from a given growth rate of money to its implications for inflation, you've got to analyse whether you think that's a demand shock or a supply shock. Equally in terms of every other variable in the economy, you have to ask whether that change is likely to be pushing inflation up in the medium term or is reflecting something which is perhaps positive on the supply side which may be having the opposite effect. So it's how we think about the economy. Monetary policy, just as I said before that it's not about dropping hints, it's not monetary policy by code word, equally in terms of thinking about how we react to the data, it isn't monetary policy by score card. That is, you can't say 'if earnings growth changes by this amount, that's what will happen to interest rates'. You can't have these mechanical rules or even rules of thumb. What you've got to have is an analysis which will change and evolve over time about what we think is happening in each of these markets, to help financial markets judge how our thinking is evolving and how we are likely to interpret data as they come out. But our thinking will evolve and we'll update it in the minutes and the Inflation Report. Now the reason I said in the interview that we needed to do more work on this was not because I thought there were problems in terms of recent surprises, I don't think that was an issue at all. What I think was revealing from the survey was that the respondents to the survey didn't ask for hints which they knew we couldn't give, but what they asked was 'would you please say more about your economic analysis of the risks to the inflation outlook' so that would give us a better feel for how you might respond to data as they emerge. And I thought what was interesting about the survey carried out by the Society of Business Economists was that they were actually asking for a more sophisticated analysis than perhaps we are even supplying now. Rather than going for the simple 'tell us what's going to happen, give us the code word', the opposite. They wanted a more sophisticated analysis which would help them understand our thinking because in financial markets people should not stop at our view on the economy, they must form their own judgement. And it's no good our saying well we think this is where interest rates might go. If you're in a financial market forming your own judgement, you want to know two things. First of all, what is your own view about how the economy is likely to emerge, and secondly how is the central bank likely to interpret these movements over time. And that second one is the one that we're trying to communicate because in order to help financial markets form a judgement about the future path of interest rates, it's simply inadequate to give our view as to where interest rates will go. We have to explain what we think and our analysis, but then people in financial markets have to combine that with their own judgements about what is going to happen in the US economy or in China, or indeed in the labour market in the UK.

CHRIS GILES, FINANCIAL TIMES – ONS MOVE TO NEWPORT

Just a three-part question all about the data and the ONS at the moment. Given the importance you've just been stressing in the last answer on people being able to make their own judgements based on the data, is the ONS' move, particularly of the national accounts, to Newport, a distraction for the organisation? Is it an institution that you feel you can rely on less at the moment because of the delays and the postponement, particularly of the reconciliation process this year, and what is the Bank doing about it, for example in the amount of, in the width of your fan chart, doing about the fact that we are living in even more uncertain times because we can't necessarily rely on the data as much as we could a few months ago?

MERVYN KING

Well on the first, we said in evidence to the Treasury Committee that we felt that the relocation did pose a risk but we went on to say that what matters is that the ONS manage that risk in such a way that it doesn't create a threat to the quality of economic data. And that's a decision and a judgement that the ONS will have to make when allocating its own priorities, setting its own priorities and allocating its budget across different functions. We have a very good working relationship with the ONS as indeed we stressed in our evidence. There's a lot of contact at different levels to help, and the ONS go to great lengths, to help us understand and interpret the data that they produce. And thirdly, the question of whether the data are more or less uncertain, is a function of the challenges which the ONS are facing. They have already made it clear that there will not be a full detailed analysis of the national income data for the Blue Book next year. That's a one-off, that will be resumed again in 2009 and we'll be able to return to normal service. But inevitably there will be some period in which there will be greater uncertainty. Whether that's a material uncertainty, the Committee will have to judge in the future. There are other reasons why recently we have widened the fan chart, but it's something we always bear in mind.

DAVID SMITH, SUNDAY TIMES – AVERAGE AND TREND GROWTH

I think you started by saying that growth was running above trend in recent quarters but the report says that both GDP and market-based measures of output are rising in line with their average over the past decade. I just wondered when a long-run average becomes a trend?

MERVYN KING

Well the one thing that's most difficult to work out from any data is what is meant by a trend, and indeed I didn't use the word trend in my speaking note, I said 'output growth is estimated to have been at or above its long-run average rate'. I think it's actually very difficult to think in terms of fixed trends. One of the things that we've seen, particularly in the United States but also I think more recently here, is that the idea of trend has become a more fluid concept. I think for a long time we thought that there was some fixed underlying trend growth rate of two and a quarter percent for the UK economy. What Alan Greenspan discovered was that there was a period when productivity growth appeared to have increased and during that period the 'trend' had risen. I think more recently the Fed have scaled back a bit its ambitions for the long-run growth rate of the economy and so the 'trend' has come back a little bit. Whether you can regard any of this as a change in the trend, is up to you. I think what's more important is to think about the growth of productive potential in any given year. What's the growth in supply capacity? So that's what we would look at, I think.

EDMUND CONWAY, TELEGRAPH – GAS PRICES/STERLING AND CURRENT ACCOUNT

Just a couple of questions, one of them is very simple. With the gas prices, I was just wondering whether you had figured any kind of future change in gas prices into the inflation projection or whether you were just basing this on what had already been announced by the gas companies?

MERVYN KING

No the report makes clear, Charlie will tell us which page in a minute, but we have taken the announced reductions in gas and electricity prices as being the price cuts which are relevant in Q2 and Q3 of this year, those are the periods in which they will come into effect. We have assumed for the central projection that there will be further cuts of the same order of magnitude – that's the same central view that we took in February, so further cuts of the same order of magnitude, giving an average cut of gas and electricity together of 20% during the period of cuts. We have made that judgement because of what's happened to the wholesale gas price which has fallen back very sharply. But the second wave if you like of those cuts is clearly uncertain, the cuts could be bigger or they might not occur, and that's one reason why the fan chart is a fan chart. But the central projections is for a further wave of cuts.

EDMUND CONWAY, TELEGRAPH – GAS PRICES/STERLING AND CURRENT ACCOUNT

Just secondly on Sterling, you've spoken in the past about how you feel that at some point there might have to be a fall in Sterling due to the size of the current account deficit. Since then we've seen the size of the current account deficit increase to new peaks, I just wondered whether this had intensified those concerns, particularly given that we haven't seen a massive depreciation since.

MERVYN KING

No we haven't. We've seen some depreciation of Sterling, it's now just over 2% since February. But as I said on many occasions, only a fool would forecast exchange rates though apparently there are quite a few who are happy to be given that description.

EVAN DAVIS, BBC NEWS – GOODS PRICE DEFLATION/FOOD PRICES

Two quick ones. The China effect on imported goods price deflation. Do you see the deflation we've had as a one-off process that at some stage stops and then we go at a lower price level back to the original inflation rate we might have had for imported goods, or do you see it as a kind of an ongoing process that potentially we always now have deflating goods prices, particularly those that are imported? The second one is we saw big food price rises over the last year, marked in yesterday's inflation figures. Your report mentions global impacts on that, I'm wondering whether maybe given that the world is becoming richer, commodity prices get pushed up as richer consumers overseas push up food prices, whether food might be the new energy in terms of inflation.

MERVYN KING

On the first, I don't think one should think of the deflation as a pure one-off. The opening up of the world economy to a much larger number of people who work in the market economy means that it's not easy to see the immediate end of the switch of people from agriculture into manufacturing in those countries, China being the leading example. So I would expect to see continuing changes in the relative price of goods and services. The productivity growth rate is different, and I think the effect is widened with the introduction into the world trading system of China and India and other economies. But the rate at which that's been occurring may not be quite as high as before, so that the rate of decline of those prices may not be as big as it was. I think this is very hard to judge because it's making a judgment, in essence, about the economic

strategy that China and India will follow. They're big countries that really do influence these relative prices in the world trading system. I think the point that's worth hanging on to is that if inflation, CPI inflation, averages 2% for the indefinite future, then many goods prices will continue to fall almost every year. It's not possible to have inflation as low as 2%, given the productivity growth rate difference between goods and services, manufacturing and services, without goods prices falling so that when averaged with the higher rate of increase of services prices, that they will end up averaging 2%. And that's why many manufacturers say 'well what inflation'. Well in the world in which they work, there won't be any inflation in the future if we can keep CPI inflation close to 2%.

On the second one, I mean food prices will move up and down, you've talked about food, you had some phrases, the world is using more food [Evan Davis – food is the new oil]; well I'm not going to use that phrase, if Evan wants to appear on Private Eye, that's up to him! I think you should - the world's getting a bit warmer perhaps and that may be affecting food prices. We've seen big changes in supply conditions in the last year or so and I wouldn't want to extrapolate these into the future. In January, we had the warmest January here since 1916, April rainfall was one third of the average over the past 100 years. In Italy it was the lowest rainfall for over a century. These are bound to impact on the prices of seasonal foods. Whether you can extrapolate any of this into the future as opposed to it being an effect that stays in the index for the next 12 months, I don't know. But may be Charlie would like to say something about food.

CHARLIE BEAN

I'm not sure I really have, I certainly don't have a lot to add on the global warming dimension. I think that there is a genuine issue about whether the growing incomes around the world, in Asia in particular, and obviously continued population growth, will be matched by corresponding increases in supply, I wouldn't want to focus this purely on food, it applies to all commodities and obviously a good part of what's driven up the oil price in the last few years has been the increased demand for energy from China and India, and equally they will be demanding increased foodstuffs and wood and all sorts of commodities. The central issue will be whether the supply of those commodities rises sufficiently fast to match the increased demand, and in different markets, there may be different answers to that question about how elastic the supply curve is.

FAISAL ISLAM, CHANNEL 4 NEWS – HOUSE PRICES IN CPI

How close are we to coming up with a measure for including housing in the inflation figure? Would there be a rationale for going this alone if European authorities continue to drag their feet?

MERVYN KING

Well that's a matter for the ONS in terms of the measure and for the government in terms of the target. At the European level, I don't think there's much early sign of a European harmonised measure including house prices, the work is continuing but I don't see any early resolution of that. But the target is for the government. We've had one change, I think a period of stability might be a sensible thing to opt for, for the time being.

SAM FLEMING, DAILY MAIL – US ECONOMY/ALAN GREENSPAN'S COMMENTS

A couple of questions on the US. I saw one forecast saying that we could actually have a contraction in the US economy in the second quarter and I was wondering how pessimistic are you about the US at the moment, or do you think people are getting ahead of themselves? The second one was another US question, Alan Greenspan has been providing a running commentary on the US outlook recently. I saw another piece of analysis arguing that he is running the risk of talking the US into an even sharper slowdown. Do you think that there is merit in former central bankers not providing running commentary on the outlook of their relevant economy? I don't remember Eddie George doing that for you when you took over.

MERVYN KING

I shall ask Charlie to comment on the United States, and as far as central bank governors are concerned I'll say only that I am very grateful to Eddie George that he has not been in the newspapers or on the radio all the time commenting on what the Committee was doing and in due course I will ensure that I do exactly the same.

CHARLIE BEAN

Our central projection is conditioned on a view which is not dissimilar from the Fed's, which is that slowdown in growth that we've observed so far will be relatively short-lived and that growth will gradually edge up again through this year. There are signs that the housing market may be starting to stabilise and that will mean that the downward impetus from residential investment that we've seen to US growth figures will dissipate. There has been weakness in

non-residential investment which we found hard to explain, given that the fundamentals for corporate investment still look reasonably good in the US, we think there are reasons to expect that to be a transitory weakness, but there is a downside risk from that. The main thing is that so far consumer spending has remained reasonably resilient in the US and employment has held up reasonably well. And given that consumer spending stays reasonably firm, one would certainly expect growth to be reasonably satisfactory in the US. So as I say, a reasonably optimistic view but we recognise there are downside risks to that.

PAUL WALLACE, THE ECONOMIST – GOODS PRICES

It's really just to ask for a bit of clarification about what the definition you're using for goods in the answer you gave to Evan Davis. Did you have in mind manufactured goods, where you excluding oil products in that?

MERVYN KING

Yes, no I was referring to manufactured goods. In the CPI goods includes energy and petrol too, and I was referring to manufactured goods.

HEATHER STEWART, THE OBSERVER – LABOUR SUPPLY/SLACK IN LABOUR MARKET

You say on page 26 that you think that growth in the labour supply has started to slow and if that continues it will reduce the amount of slack in the labour market, I just wondered is that to do with migration, do you think that the benefits that we've had from migration in constraining wage growth might be starting to tail off? A secondary question, how important is your judgement of the amount of slack in the labour market to the path of inflation in the next year or so?

MERVYN KING

Well clearly the judgement about the amount of slack in the labour market is important and one can take different views on it, and it will have some impact on the judgement about where inflation will lie two years ahead. We've seen some slowing in the labour force, in large part actually a fall back in participation in the last few months, particularly female participation, which may just be volatility but it's not entirely easy to explain. I rather suspect that the impact of migration will depend on the strength of demand for labour. We haven't seen any impact. If migration has fallen off, and I'm not at all sure that it has, but if it has then we haven't seen any

upward pressure on wages resulting from that I suspect it is a sort of safety valve for the pressure in the labour market. If demand for labour is very strong, inward migration will be stronger. If demand for labour eases, I suspect migration will ease back too.

GABRIEL ROZENBERG, THE TIMES – WEATHER FORECASTS

Briefly following on from what you said to Evan about rainfall and food supplies, any plans to set up a weather forecasting unit at the Bank?

MERVYN KING

No, we of course have our Weather Vane in the Court room which measures merely the wind speed, but we might add a rain gauge or something. But I think we monitor these things carefully anyway, I take an interest in it. But I doubt we're going to be wasting taxpayers' money on setting up a weather forecast unit, you can rest content with that. Our budget is flat in nominal terms.

MARTIN POSNER, CREDIT MANAGEMENT MAGAZINE – LABOUR MARKET

On Page 25 under the labour supply, it says it's estimated that the workforce is estimated to have declined by 40,000 compared with six months ago. This is really a supplementary to a previous question who said 'may it be due to inward immigration'?

MERVYN KING

No I think this is largely a fall in participation. We don't know how big or how small migration is so we find it hard to answer that, but what we do know is that there appears to have been some reduction in participation in the last few months. That often happens, there are the volatility in these measures and the surveys themselves are of course not 100% surveys, there's a fair amount of measurement error. But perhaps Charlie would like to add to that.

CHARLIE BEAN

No I think the most useful thing is just to draw your attention to Chart 3.8 on the next page where you can see the history of the participation rate which as you can see the series is quite jagged from month to month, quarter to quarter, so it may be that this downturn that we've observed right at the end of the series is just noise and doesn't signify any fundamental economic change. But it is possible that it may be indicating some genuine economic development. We don't know exactly what that might be. One possibility may be that it's

connected with the fact that within overall employment, private sector employment is still growing reasonably firmly but there has been a falling off in public sector employment with tighter public sector control. We do know that the share of women in employment is higher in the public sector than in the private sector, and what often happens when people lose their jobs is they may flow out of the labour force altogether rather than into the unemployment pool. So it's possible that what we're seeing here is indicative of the changing balance in employment growth in the economy. But until we get the latest data on the sectoral breakdown of employment and have been able to do some analysis of it, it's difficult to be sure. So at the moment, that is a conjecture rather than an established fact.

ZHEN YANG, CHINA CENTRAL TELEVISION – IMPACT OF CHINA

As the China effect has been mentioned, as China exports low price commodity products and purchase strongly in the world energy market, so if the Chinese effect is significant, then could you elaborate how it is felt here. Thank you.

MERVYN KING

Well it's clearly had a major impact in a number of respects, one is that we've benefited in terms of a higher standard of living from being able to import cheaper manufactured goods from China and elsewhere in Asia, and I think you can see that the terms of trade improved in the UK's favour for a number of years in the late 90s and early 2000s. Of course, eventually the demand resulting from the growth of the Chinese economy for energy and raw materials around the world pushed up the prices of those commodities and that actually then made us a bit worse off so there are swings and roundabouts here. But the most noticeable change I think is a big, big swing in relative prices, with cheaper manufactured goods, more expensive services as we've maintained inflation stable over all. But I do want to stress that in the end we're targeting inflation in the UK. We don't blame anyone else for that, whether it's high or low. Inflation is made at home. It's our responsibility and what inflation is depends on the monetary policy that we carry out. We've benefited enormously from trade with China and other countries in Asia and I've said this before and it's worth repeating, one of the things that the UK can be proud of is that all groups in the UK, whether it's politicians or trade union leaders or employers in industry, have all embraced trade and the opportunities to raise our standard of living by trading with China and the rest of the world and as a result we've benefited from that.

BRIAN SWINT, BLOOMBERG – EXPORT COMPETITIVENESS

I wanted to ask you about the pound, not for any forecast of course, and exchange rates. You note in the Inflation Report that the pound has risen against the dollar and fallen against the euro. I'm just wondering, how concerned are you about the competitiveness of the currency now and the competitiveness for exporters and how great of an impact on the outlook for inflation does the level of the pound now have?

MERVYN KING

Well I think our job is to react to changes in the exchange rate and we've done that. The remarkable thing is that, although we've not been targeting the exchange rate in the past decade, it's been more stable than for any decade for a long time. And that's the consequence of shifting to a regime close to price stability, and that's what we intend to keep. I don't think there's much point fretting too much about the exchange rate. It's the case that the deficit on trade in goods and services, at 4.2% last year relative to GDP, is high and at some point, we will need a rebalancing and that will need more resources to go into business investment and export and less in domestic consumption. We are seeing that switch of resources I think. Business investment has picked up, the exports in the surveys look pretty strong given the growth in the euro area which accounts for more than half our trade of goods and services, and we've become a little more competitive against the euro recently, and we're seeing a slowdown certainly in the growth rate of public consumption, and we're in an era now where the growth rate of household consumption will be somewhat lower than it was in the late 90s and early 2000s. So we're beginning to see that switch and that's important.

ENDS