

Treasury Committee Opening Statement
Tuesday 25 November 2008
Mervyn King, Governor of the Bank of England

In the past two months, a remarkable set of events has transformed the outlook for the UK and global economies. As a result, inflation is now falling sharply and economic activity contracting.

Three factors have driven the shift in the outlook. First, following the failure of Lehman Brothers, the turmoil that has affected financial markets over the past year intensified into the most serious financial crisis since the outbreak of the Great War. The flow of lending to households and businesses has been severely disrupted. Confidence has been badly affected. All this will hold back demand growth looking into next year.

Second, the short-run indicators for activity have turned down sharply both at home and abroad. Surveys, reports from the Bank's Agents, and indeed my own discussions with businesses suggest that there was a significant fall off in demand coming into the fourth quarter. As I remarked last month, the UK economy probably entered a recession in the second half of 2008. That is reflected in the labour market – unemployment has been rising at its fastest rate for seventeen years.

Third, although CPI inflation did rise above 5% in September as we had expected, it has now started to fall sharply: to 4.5% in October. Oil prices have collapsed by around two thirds since the summer, and the price of metals on world markets has halved. Measures of short-run inflation expectations have retreated. And the cut in VAT announced yesterday will also lower inflation in the short run.

Given these three factors, the outlook for inflation has shifted down significantly. Over the next few months inflation will be markedly lower than we anticipated in August. It is likely that inflation will return to target at some point early next year, although the precise speed at which inflation falls back will depend on how quickly the recent depreciation of sterling feeds into consumer prices. As a result the upside risk to inflation

in the medium term, emanating from elevated inflation expectations that had been important for much of this year, has receded. And the downside risk, reflecting the possibility that weak demand might pull inflation below the 2% target in the medium term, has increased significantly. The MPC has responded accordingly – cutting interest rates, in concert with other major central banks by half a percentage point in October, and by a further 1 ½ percentage points to 3% in November.

This monetary policy response has been complemented by some very significant policy measures taken by the UK Government. In early October, a major package of measures designed to recapitalise and restore confidence to the banking system was unveiled. Those measures were designed to increase the buffer between the capital held by banks and the regulatory required minimum level of capital, allowing them to cushion future losses and restore normal lending to the rest of the economy. And yesterday the Chancellor announced measures designed to support aggregate spending in the short-run. These measures will act to mitigate the slowdown in activity over the next year.

Much though still remains to be done and very significant policy challenges lie ahead. Domestically, the most pressing is to ensure that normal bank lending is resumed. Without that, the downturn in activity could become protracted and extremely damaging. There is also work to do to guard against future financial crises. Given the global nature of our financial system, much of that will need to take place at an international level. In particular, reforms of the international monetary system and improvements to the regulation of banks' capital and liquidity provisioning are priorities.

Chairman, these are exceptional and difficult times. The financial crisis is affecting every family and business in the country. It also poses enormous challenges to policy makers around the world. But our inflation targeting framework remains well suited to confront the challenge of ensuring an overall balance between demand and supply in the economy in the medium term. The MPC remains very focussed on that task, and will take whatever action is necessary to ensure that inflation is close to target in the medium term and, in so doing, to help the economy resume growth at a sustainable rate.