

Treasury Committee Opening Statement

Wednesday 28 July 2010

Mervyn King, Governor of the Bank of England

May I first congratulate you Chairman, and all members of the Committee, on your election. I very much hope our sessions together will prove constructive. I am particularly grateful to the Committee for allowing this session to take place today so that earlier this week I was able to attend the meeting in Basel of central bank governors and heads of supervision that took a further step forward towards a new global Basel III deal for capital and liquidity requirements on banks.

In the years ahead, stronger capital and liquidity standards will help to ensure our financial system is more robust, leaving it less likely to succumb to a crisis. But in Basel we reaffirmed our collective view that it is important to implement the new standards over a long transition period because bank balance sheets are still recovering from the current crisis. And we need banks to be able to expand their lending in order to support the wider economy before they are required to meet the new standards.

The gradual improvement in credit conditions that was evident earlier in the year seems to have come to a halt in recent months. And financial markets more generally have been volatile. In part that is because continuing concerns about the ability of some countries to achieve necessary fiscal consolidation are affecting confidence in the ability of banks to repair their balance sheets. More fundamentally, the key underlying causes of the crisis – in terms of the imbalances in global demand – have still not been tackled. Those imbalances are likely to be larger this year than last, and will probably still be around three-quarters of their level at the peak immediately prior to the crisis. Until these underlying problems are resolved, uncertainty about the outlook for the world economy will remain.

Last week, we learned of the strong 1.1% estimate of GDP growth in the second quarter. On the face of it, that is encouraging. But we must be careful not to read too much into one number. And the wider economic problems around the world underline the fact that we cannot be confident that the recovery in demand, output and employment here in the UK will be sustained. We continue to face the challenge of rebalancing our economy away from

consumption towards net exports, and raising our national savings rate. During the rebalancing, there is a risk that the level of money spending in the UK will remain weak, with the economy operating below capacity. That would push down on inflation – potentially to a rate that is significantly below the 2% target.

But there are also risks on the upside. CPI inflation is currently above target at 3.2%, and it has been high for much of the past four years. Given the changes to VAT announced in the Budget, it is likely that inflation will remain above target for much of next year. If this high inflation were to become engrained in inflation expectations, it would be difficult to bring inflation back down again.

The MPC faces a difficult challenge in balancing those risks. To do so, we judge that at present it is right to keep our foot firmly on the monetary accelerator. As you would expect, there is a debate about quite how hard we should be pressing on the accelerator. In the months ahead it may be that the MPC judges that the inflation outlook warrants pushing down even harder or that we should ease back somewhat. The debate is about the appropriate degree of stimulus, not about applying the brakes.

Of course, there will come a point when we will certainly need to ease off the accelerator and return Bank Rate to more normal levels. I look forward to that time because it will probably be a signal that there is a smoother drive ahead, with the economic outlook improving in a durable way. But I fear there is some considerable distance to travel before we can begin to use the word “normal”.

With that, Chairman, I and the other members of the MPC here today stand ready to answer your questions.