BANK OF ENGLAND

Speech

Speech given by

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My Lord Mayor, Mr Chancellor, My Lords, Ministers, Aldermen, Mr Recorder, Sheriffs, Ladies and Gentlemen:

Can it really be only a year since we last met in this magnificent room? With the financial crisis continuing, I was tempted to deliver last year's speech again. But that would not allow me to welcome the Chancellor to his first Mansion House Dinner as Chancellor. After the past – difficult – year, could I say, Chancellor, how much we at the Bank have appreciated the patience and good humour with which you have handled the "slings and arrows of outrageous fortune".

Over that year, the west wind of a credit crunch emanating from the United States and the east wind of higher energy and food prices resulting from the strength of Asian economies have been stirring up the waters through which our economic ship must pass. These two challenges of rising inflation and falling economic growth have led to a crop of doom-laden predictions best captured by my less well-known addition to the well-known words of Robert Frost:

Some say the world will end in fire,
Some say in ice.
But whichever it is
It won't be NICE.

That 'non-inflationary consistently expansionary' decade, as I described it in 2003, has drawn to a close. Yesterday we learnt that inflation in May rose to 3.3%. In line with our remit, I sent an open letter to the Chancellor. As I said in my letter, inflation is set to increase further over the next few months. Oil prices have doubled since the beginning of last year, and, in real terms, are now as high as they were in the 1970s. And further sharp increases in domestic gas and electricity prices are probably on their way.

So what should the Monetary Policy Committee do in the face of this rise in inflation?

The immediate cause of the current pickup in inflation is increases in food and energy prices relative to other prices. They are caused by the pressure of demand on the supply of food and energy in the world as a whole. Part of that pressure may well reflect expansionary monetary policy in the world as a whole. But the rise in commodity prices cannot, by itself, generate sustained inflation in the United Kingdom unless we allow it to. We will not. So although inflation in the UK will rise in the short term, inflation will then fall back.

That means that the rate of increase of other prices and domestic costs, notably pay, must remain low. The MPC does not take that for granted. Surveys – including our own – indicate that expectations of inflation have risen, meaning that inflation is likely to have some tendency to persist. That is why, as I explained in my letter to the Chancellor, we believe that a slowdown in the economy this year, creating a margin of spare capacity, will be necessary to dampen price and wage pressures and ensure that we fulfil our remit by returning inflation to the target. And growth is now slowing quite sharply – broad money growth is falling, business surveys point to particularly weak output growth in the second quarter and growth is likely to remain subdued for the rest of the year.

Where Bank rate will ultimately need to move to bring inflation back to target is impossible to judge now. Decisions on Bank Rate will be made one month at a time in the careful way that the MPC has developed over more than ten years. But there should be no doubt that the MPC is prepared to take whatever action is needed to return inflation to the 2% target and to keep expectations of inflation in the medium term anchored to the target.

The fact that growth and inflation are heading in opposite directions has led some commentators to question our monetary framework. Target growth not inflation is the cry. I could not disagree more. This is precisely the situation in which the framework of inflation targeting is so necessary. Without it, what should be a short-lived, albeit sharp, rise in inflation, could become sustained. Without a clear guide to the objective of monetary policy, and a credible commitment to meeting it, any rise in inflation might

become a self-fulfilling and generalised increase in prices and wages. And surely the lesson of the past fifty years is that, when inflation becomes embedded, the cost of getting it back down again is a prolonged period of sluggish output and high unemployment. Price stability – returning inflation to the target – is a precondition for sustained growth, not an alternative.

We are in the most challenging period since the MPC was set up in 1997. But we have the right framework in place to ensure that inflation returns to the target and growth recovers. The stormy waters we are navigating now make for an uncomfortable passage compared with the calm conditions of the *nice* decade. Our inflation performance then was surprising not so much because inflation was low, but because it was so remarkably stable. Neither inflation nor growth are likely to be as stable in the future. But even if inflation proves to be more variable, it will not be systematically either higher or lower than the target.

The right framework is essential if we are to maintain low inflation and steady growth. But there are two recent developments in our economy at present that no monetary policy, whatever the framework, can prevent.

The first is the impact on living standards of rising food and energy prices. These prices have risen relative to most other prices. Monetary policy should not, and in the end cannot, prevent such changes in relative prices. They will show up either in higher consumer prices or in a lower level of other prices and pay. Either way, the result is the same – a loss of real purchasing power.

This year our real take-home pay will rise at a slower pace than national productivity. Rising fuel, gas, electricity and food prices, mean that average real take-home pay will stagnate this year. It will not be an easy time, and I know that some families will find it particularly difficult. But it is only a temporary slowing in the growth of our real take-home pay and remember that this is the opposite side of the coin to the falls in prices of

manufactured goods from countries such as China and India, which in the *nice* decade allowed our standard of living to rise at a rate faster than productivity.

The squeeze on real take-home pay will arguably be an even more significant restraint on consumer spending this year than the credit crunch. And it will affect the housing market too – lower demand in the high street will go hand in hand with lower demand in the property market. I have said in the past that there is no causal link between house prices and consumer spending. That remains the case. How closely they move together depends on the underlying forces that are driving them both. This year, the squeeze on real income growth is likely to mean that both house prices and consumer spending weaken together.

The housing market leads me to the second recent development – the reassessment and re-pricing of risk in the financial sector. It is clear that the housing market is being severely affected by the reluctance of the banking system to expand its balance sheet further. Banks are adjusting to the fact that many asset markets are unlikely to re-open in their old form and, as they do so, the supply of mortgage finance is being restricted. Once the adjustment in the financial sector is complete, banks will be able to resume lending. But the era of cheap mortgage finance that underpinned the housing market in 2006 and the first half of 2007 is over and, as a result, it is reasonable to expect the ratio of house prices to incomes to fall back, though with real interest rates still low by the standards of the past fifty years, not to previous averages.

These changes to our spending power and to the housing market are 'real' shifts that, although not easy to accept, we cannot side-step. Lord Mayor, we face the most difficult economic challenge for two decades. But I am confident that we can meet it. Inflation will fall back and growth will recover. But the cost of the necessary adjustment will depend on the credibility of the framework for monetary stability. After all, the value of paper money rests on only one thing – trust. Trust in the ability and determination of those setting interest rates to maintain the value of money. Central to that is the independence of the Bank of England. An independent central bank has, over time and

around the world, proved to be a cornerstone of the arrangements necessary to underpin trust in paper money.

So, Chancellor, I welcome your intention to introduce a proper process for making appointments to positions on the Monetary Policy Committee.

I welcome too, Chancellor, the announcements you made tonight about the shape of a new framework for financial stability to be embodied in a Banking Bill. I particularly welcome the new responsibilities for the Bank of England and associated reforms to our governance. We now have the chance to put in place a set of reforms that provide a coherent framework for banking regulation. It is an opportunity we must not throw away. I can assure you all that the Bank of England will devote time and resources to meeting the new responsibilities which the Chancellor plans to give us.

Lord Mayor, shortly after assuming office, you were quoted as saying, “I think like a lawyer. I’m very prudent, very risk-averse”. What a pity you weren’t running a bank a year or two ago! But in a difficult year for the City you have provided leadership and thrown yourself into the enormous workload of your office. Tonight all of us here would like to pay tribute to your work since you became Lord Mayor, and to thank both the Lady Mayoress and yourself for the splendid hospitality which you have extended to us all this evening.

So I invite you all to rise and join me in the traditional toast of good health and prosperity to "The Lord Mayor and the Lady Mayoress, David and Theresa Lewis".