BANK OF ENGLAND

Speech

Monetary Policy in Turbulent Times

Speech given by

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I would like to thank Michael Hume and Jake Horwood for research assistance and I am also grateful for helpful comments from other colleagues. The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Monetary Policy Committee.

Good morning, ladies and gentlemen. It gives me great pleasure to address this Annual Conference of the Agricultural Engineers' Association. I was very impressed to learn from your website that the Association was founded in 1875 – which must make you one of the oldest industrial or engineering associations in this country. The Engineering Employers Federation, which was founded twenty-one years later in 1896, is a young upstart by comparison!

The origins of the AEA in the 1870s reflected the increasing mechanisation of agriculture in Britain and in many other countries at that time. The United States, in particular, was using a wide range of farm machinery – including early horse-drawn combine harvesters, grain elevators, conveyor belts and even steam-powered tractors – to open up the productive potential of the mid-West and export vast quantities of grain to Europe. Grain prices in Europe fell, which in turn put competitive pressure on more traditional farmers in Britain and the rest of Europe to raise their productivity by investing in farm machinery.

In the early 1870s, despite the fact that the Industrial Revolution had started nearly a century before, nearly a quarter of the UK workforce was still engaged in agriculture.[1] However, the competitive pressure from cheap grain imports, coupled with increasing use of farm machinery, reinforced the shift of workers off the land and into the industrial towns and cities in the closing decades of the nineteenth century. This movement of workers out of agriculture is evident in my own family roots, which can mostly be traced back to the area around Grantham in south Lincolnshire. And in my family history, I also have links with those very early days of the Agricultural Engineers' Association. One of my ancestors built a successful family business owning and managing agricultural machinery which continued from around 1860 to at least the turn of the century.[2]

[1] According to Broadberry (1997), the share of agricultural employment in the UK workforce in 1871 was 22.2%. It was even higher in Germany (49.5%) and the United States (50.0%) which experienced later industrial development later than Britain.

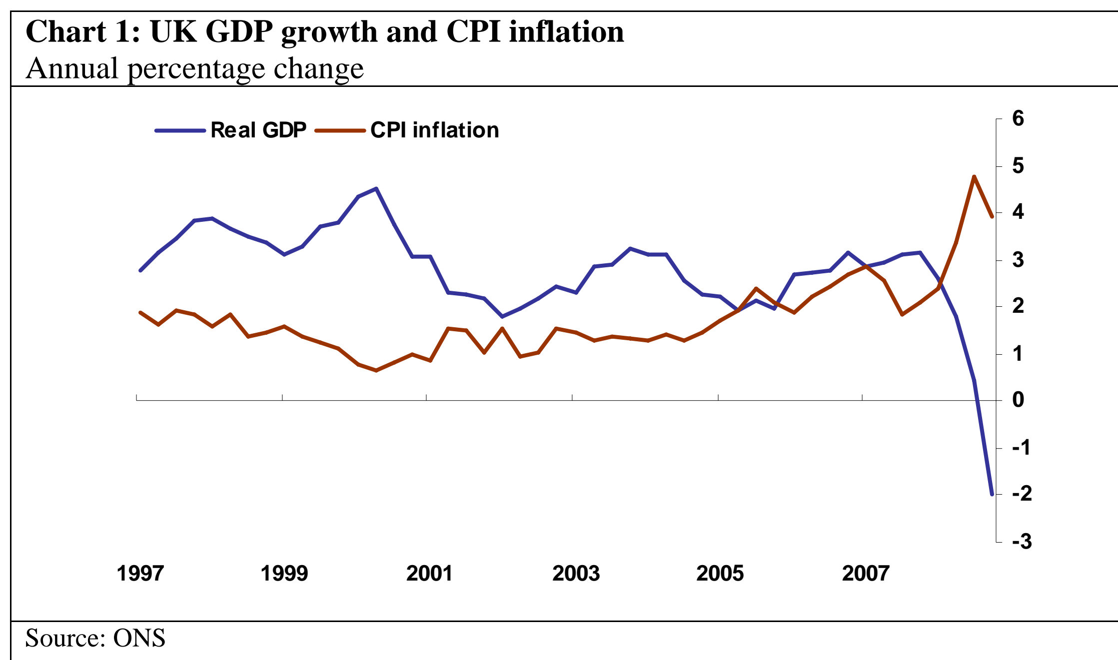
[2] According to the censuses from 1861 to 1891, Thomas Bagworth (1819-92) – my great (x4) grandfather or on my mother's side of the family - was a "thrashing (threshing) machine owner" working with his two sons Charles and Alfred and several other employees. Charles and Alfred subsequently became managers in the business and machine-owners in their own right, according to the 1901 census.

Like now, the 1870s were turbulent times both for the UK economy and the rest of the world. I will return to some interesting parallels between the current situation and the late 19th century later in this speech. But first, I will discuss the global forces which have buffeted the UK economy recently and are now shaping the economic outlook. At the end of my speech I will come back to some of the monetary policy challenges we currently face as a result.

Shocks from the global economy

When I joined the Monetary Policy Committee, in the autumn of 2006, it was possible to look back on a relatively stable period for the UK economy. The Committee had taken over responsibility for UK monetary policy in 1997 and its first decade was a period of steady and healthy growth accompanied by low inflation, as Chart 1 shows. This represented a continuation of the conditions established in the mid-1990s as the economy recovered from the last recession. From the early 1990s until the first half of 2008, the UK economy enjoyed the second longest continuous period of UK growth since the mid-19th century and a sustained period of low inflation not seen since the 1950s and 1960s.[3]

Chart 1: UK GDP growth and CPI inflation
Annual percentage change



Source: ONS

[3] See Sentance (2008a) for a comparison with previous long expansions in the UK economy.

This experience of steady growth and low inflation was not confined to the UK. The United States also benefited from a similar pattern of reasonably steady growth and low inflation going back to the 1980s and many other countries also experienced more stable macroeconomic conditions at around the same time. This was not because shocks to the global economy were absent. This period included the Asian crisis, the bursting of the "dotcom" bubble and the impact of global terrorism post-9/11. As I know firsthand from working at British Airways at the time – these shocks had very significant consequences for specific industries and sectors. But taking the economy as a whole, monetary policy appeared to be reasonably effective in cushioning the effect of these shocks and avoiding both a major burst of inflation and the deflationary risks of recession. In particular, there was a significant relaxation of monetary policy in many countries – especially the United States – from 2001 until 2003 to stave off the risk of recession and deflation.

Three broad categories of explanation are advanced for this rather benign period of economic performance – "good luck", "good policy" and structural change, both nationally and globally.[4] In my view, all three factors played a part. Whatever the cause, it is now clear that the conditions which supported this beneficial conjuncture have been suspended – at least for a while. As Chart 1 also shows, over the last year, the UK economy has experienced both a surge in inflation and a sharp downturn in output. We are now in the fourth major recession the British economy has experienced since the Second World War.

This change in economic conditions reflects three major shocks – all operating at a global rather than a national level – which have come along to disrupt the relative stability that the UK and many other countries enjoyed from the 1990s through to 2007.

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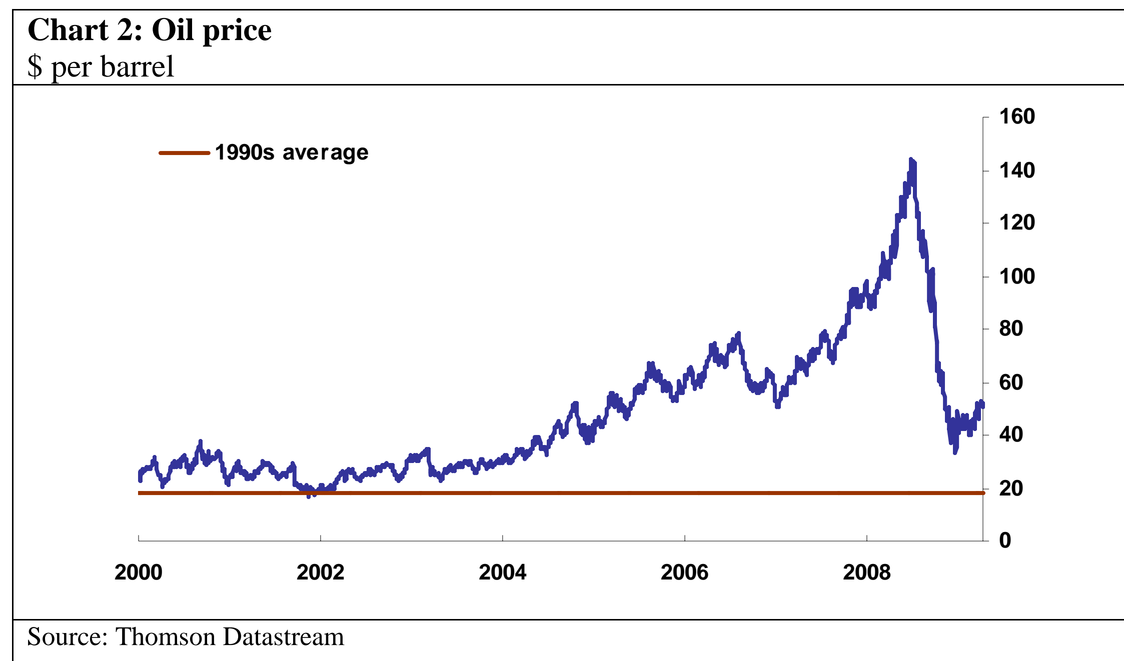
[4] See Young (2008) for a fuller discussion.

Chart 2: Oil price
$ per barrel

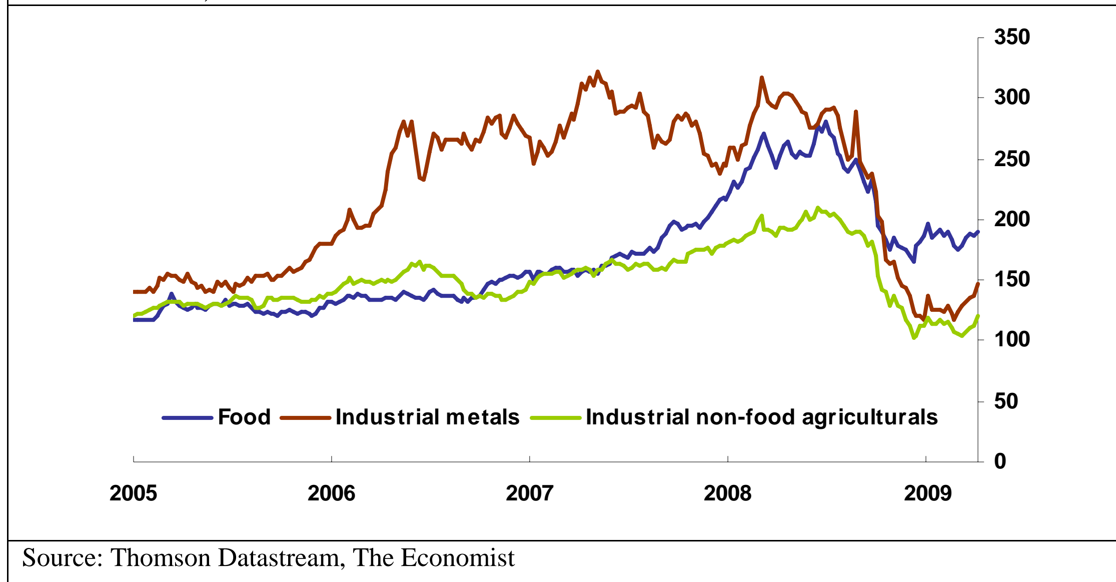


Source: Thomson Datastream

The first of these global shocks to be apparent was a surge in oil and other commodity prices which started in 2004 and peaked in the middle of 2008. As Chart 2 shows, the oil price in the first few years of this decade was close to its 1990s average of just under $20/barrel. Prices moved up in two phases, initially to 3 to 4 times the nineties level, and by the summer of 2008 to 7 to 8 times that level. The UK and other major economies absorbed the initial rise in the oil price without too much difficulty – partly because it came through less abruptly than the oil shocks of the 1970s and because demand continued to grow strongly across the world economy.[5] However, the second round of this shock occurred against a background of slowing demand. As well as pushing inflation significantly above its target level, it added to the pressures on profit margins and company finances which energy-intensive businesses faced over the summer of 2008.

[5] Walton (2006) analyses the 2004-2006 oil shock in more detail and concludes that differences in the size and the nature of the shock, supply and demand conditions in the UK economy when it hit and improvements in the monetary policy framework all contributed to a more benign outcome than the 1970s oil shocks.

Chart 3: Other commodity prices
Dollar indices, 2000=100



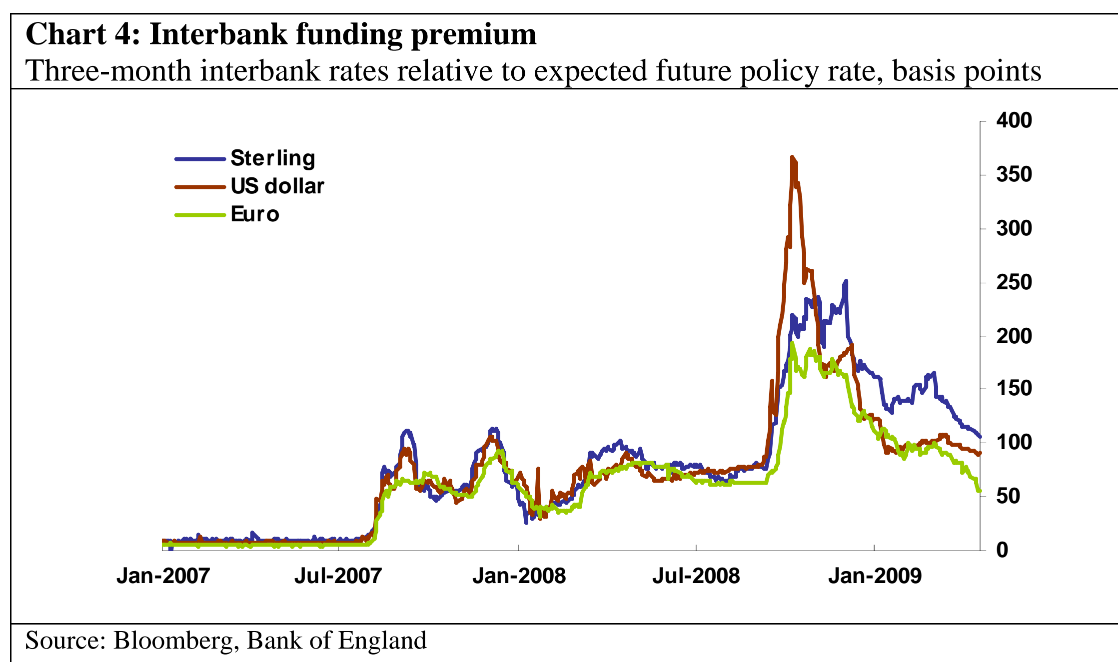
Source: Thomson Datastream, The Economist

The rise in inflation and the squeeze on spending by companies and households was reinforced by a broader upward shift in commodity prices which occurred between early 2006 and the summer of 2008. As Chart 3 shows, all the main indices of other commodity prices rose by 100-200% over this period. Even though these commodity prices have since fallen back significantly, as has the oil price, these earlier price rises were having their maximum impact on business costs and household disposable income in the summer and autumn of 2008.

At the same time, consumers and businesses were facing pressures to cut back spending due to the "credit crunch" which emerged from the summer of 2007 onwards, due to the fall-out from sub-prime lending in the United States. This was the second major shock to hit the world economy in recent times. Growing awareness of potential losses on complex mortgage-backed derivative products had a number of effects on financial markets and on the banking system. The cost of bank funding on the wholesale markets increased and its availability became restricted, undermining the financing structures of a number of banks and financial institutions to finance themselves. That, in turn, led to a number of prominent bank rescues, including Northern Rock and Bradford and Bingley in the UK, as well as a broader restriction in the availability of mortgage funding and company financing – particularly in relation to property-related businesses. It is also worth noting that the availability of finance to business was being restricted at a time when the working capital requirements of

many companies were increasing as the cost of energy and raw materials increased – creating a "double whammy" for energy intensive businesses.

Chart 4: Interbank funding premium
Three-month interbank rates relative to expected future policy rate, basis points



Source: Bloomberg, Bank of England

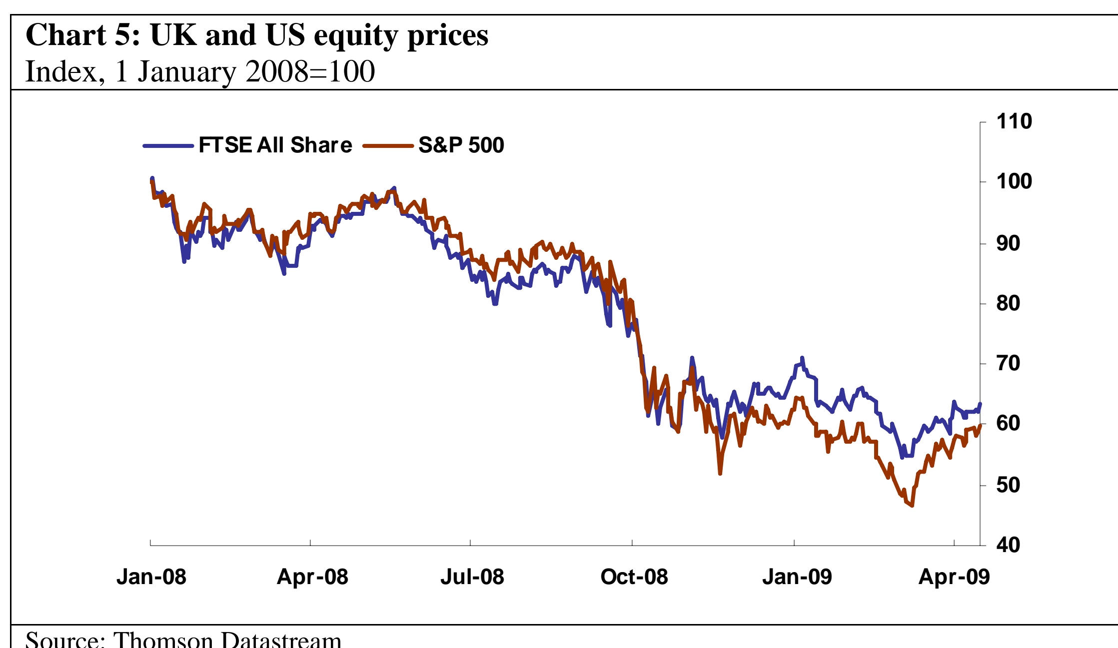
One measure of the impact of this squeeze on the financial system is the premium that banks have been required to pay in the inter-bank market compared to the rates set by the Bank of England and its counterparts in other countries. As Chart 4 shows, this premium rose significantly in the summer of 2007 and fluctuated significantly over the following year or so. Movements in this premium might be thought of as a market-based measure of confidence in the banking system. In periods of increased concern about the health of the financial system, the funding premium increased, falling again when confidence improved – though this decline was never sufficient to restore the position prior to the summer of 2007.

Two points stand out from Chart 4. The first is that inter-bank markets in the US, the euro area and the UK were all broadly affected in the same way. Though the epicentre of these financial problems was the US housing market, the mortgage-backed securities concerned had been traded very widely throughout the global financial system and were held by a wide range of banks in the US and Europe. Also, the seizing up of various credit markets had an impact on bank funding internationally, creating additional concerns about the profitability, liquidity and solvency of banks around the world.

The second feature which stands out from Chart 4 is the very large disruption to financial markets last autumn, associated with the collapse of Lehman Brothers last September. Following this event, the whole viability of the banking system began to be questioned. Significant bank rescues were required on both sides of the Atlantic, including Citicorp, Royal Bank of Scotland and HBOS. To maintain public confidence, significant amounts of government money have been committed in capital injections and loan guarantees to sustaining and safeguarding the banking system.

These events, which started in mid-September last year and unfolded over the following month, sent a massive confidence shock around the world economy – affecting both consumer and business spending. This sharp fall in confidence was the third big shock to hit the world economy in the current episode and it appears to have been the trigger which pushed many economies – including the UK – into deep recession. It was much more dramatic than the rise in oil and commodity prices and the emerging "credit crunch". But its impact was all the greater because company and household finances were already under pressure due to the impact of restricted credit availability and the rising cost of energy, food and other commodities.

Chart 5: UK and US equity prices
Index, 1 January 2008=100



Source: Thomson Datastream

Stockmarkets around the world reflected this big shock to confidence last autumn. Though equity prices had fluctuated quite a bit through 2007 and 2008, by the late

summer of last year they were still around the level seen in early 2006. As Chart 5 shows, last autumn, UK and US stock prices fell abruptly by 30-40%, with similar falls recorded in other countries. At the same time, measures of business and consumer confidence fell sharply – again across the world.

This confidence shock has had a particularly dramatic impact on some categories of spending – notably business investment and household purchases of consumer durables, causing sharp falls in the purchases of motor vehicles, capital equipment, and high-tech consumer goods. These purchases are very easy for households and companies to postpone if they are uncertain about future prospects. And because they are "big ticket" items, they are also the items of expenditure which are most affected by the lack of availability of finance. In its October and January surveys, the CBI reported around 15% of companies citing access to external finance as a constraint on investment – about three times the number of companies normally citing this as a factor limiting capital spending.

Sales of motor vehicles have been particularly badly hit, both here in the UK and across the globe. However, I was interested to see on the AEA website that tractor registrations appear to be bucking this trend and that March was a record month in terms of the recent history. So there are some glints of light from the agricultural engineering industry to illuminate what is otherwise a fairly gloomy picture.

The unfolding recession

The pattern of the recession which has unfolded over the last 6-9 months reflects the compound effect of these three major global shocks. There has been a sharp synchronised fall in output across the major economies of the world in the second half of 2008, as Chart 6 shows. This downturn has continued strongly in the first quarter, and forecasts are for significant output falls in all the G7 major economies in 2009. The current downturn is very widespread, with some of the sharpest falls in output being recorded in the emerging market economies in Asia.[6] The global nature of the

[6] GDP in South Korea in the final quarter of 2008 was 3.4% down on a year ago, and declines of 4.3% and 8.4% were recorded in Thailand and Taiwan over the same period. In the year to the first quarter of 2009, GDP in Singapore fell by 11.5%.

shocks affecting the world economy mean that no major economy is exempt from the downward pressure on demand and output.

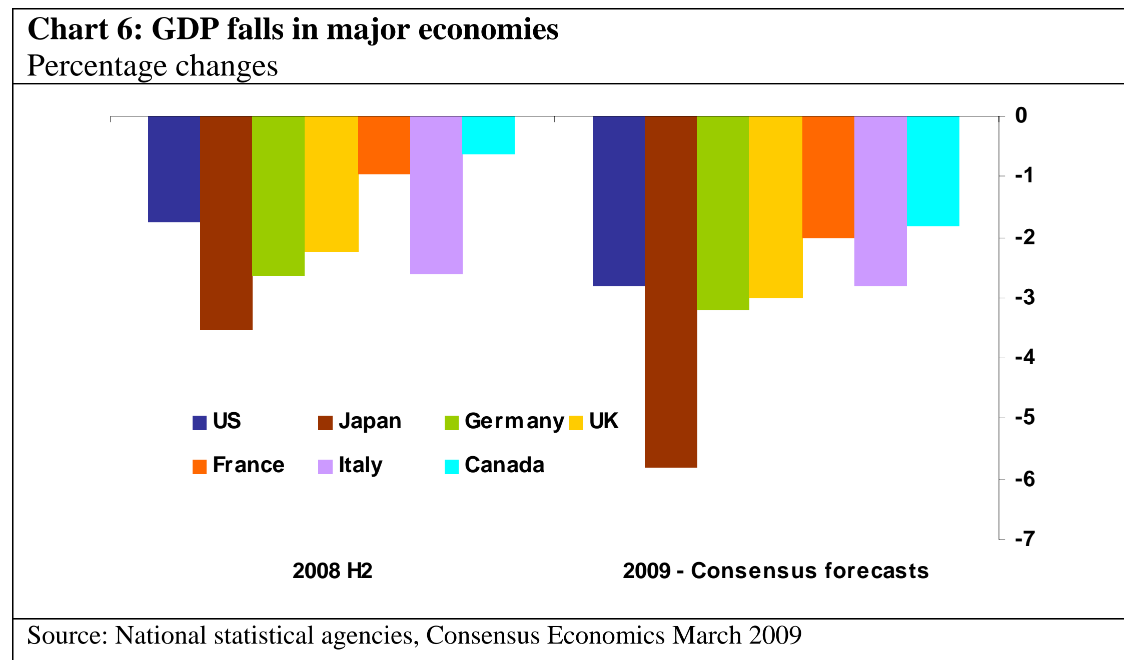
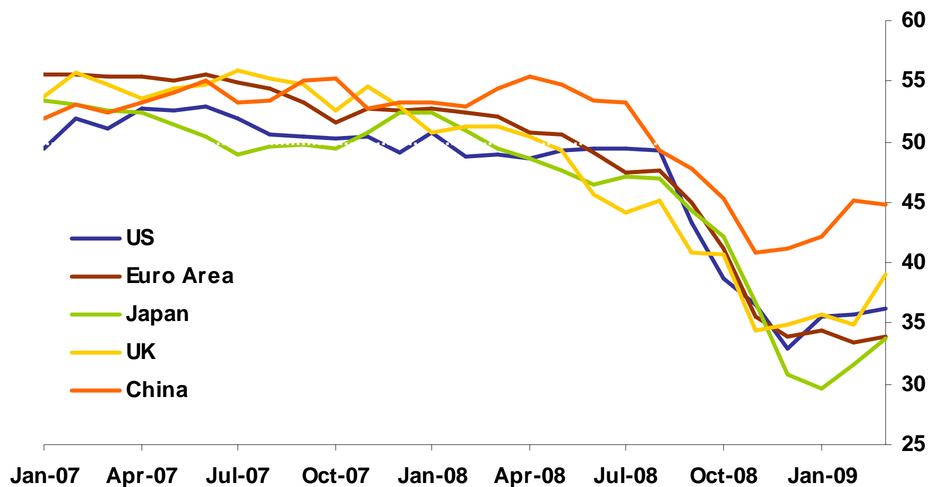


Chart 6: GDP falls in major economies
Percentage changes

Source: National statistical agencies, Consensus Economics March 2009

A key point to note is that the worst affected economies at present are not those which have the largest financial sectors, or which have seen the biggest rises in credit or house prices. As I highlighted earlier, the items on which expenditure is being cut back most sharply in response to the decline in confidence and restrictions on credit are capital and durable consumer goods. It is the countries which are major producers and exporters of these manufactured goods which are the hardest hit by the fall in demand, including Japan and Germany. In a globally integrated world economy, the impact of a recession depends on whether your economy is a large producer of the things where the cutbacks in expenditure fall.

Chart 7: World manufacturing activity
Purchasing managers' indices, seasonally adjusted



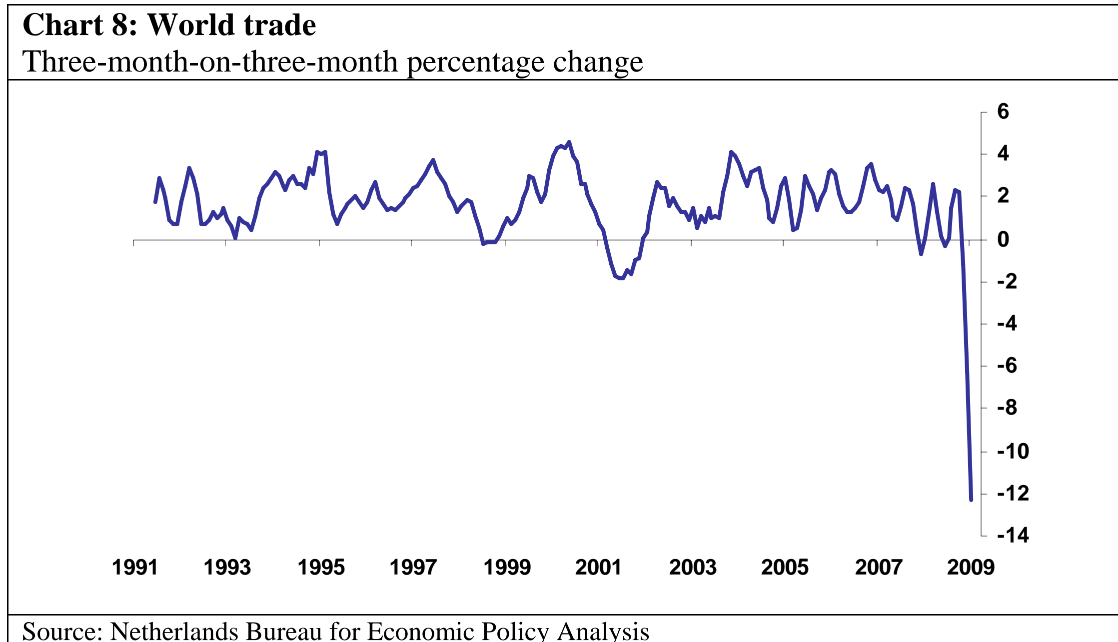
Note: Index number over 50 indicates expansion; below 50 indicates contraction

Source: Thomson Datastream, CLSA

As a result, manufacturing industry has been particularly hard-hit by the downturn over the last few quarters, as Chart 7 shows. The fall in manufacturing production has been amplified by the operation of a global stock cycle. Sharp falls in demand for a wide variety of capital and durable consumer goods have left producers and their suppliers with stocks of unsold products. As a result, production has to be cutback more dramatically than demand for a while as excess inventories are run down. We see this operating in the motor industry, with a number of manufacturers either radically scaling back production or even shutting down factories for a while in the early months of this year.

The combination of falling demand, cutbacks in production and excessive stock levels has also created a very sharp fall in trade volumes. According to data compiled by the Dutch Bureau of Economic Policy, there was a 12% drop in world trade in the three months to January this year, compared with the previous three months. As Chart 8 shows, this is an extremely sharp fall – unprecedented in modern times. Over a twelve-month period, the value of exports has fallen by around 20% in the US, France, Germany and China. And in Japan, the corresponding fall has been around 50%.

Chart 8: World trade
Three-month-on-three-month percentage change



Source: Netherlands Bureau for Economic Policy Analysis

A number of factors may account for this particularly sharp drop in world trade, some of which may prove temporary, leading to a bounce back later this year. First, it may reflect the composition of the downturn – focussed on manufacturing industry, which dominates international trade and on sectors within manufacturing which are trade-intensive – such as motor vehicles and high-tech products. Second, the globalisation of economic activity has boosted the ratio of trade to economic activity across the world, particularly when measured in volume terms, as Chart 9 shows for the UK. That is also likely to increase the sensitivity of world trade to a change in global demand and activity.

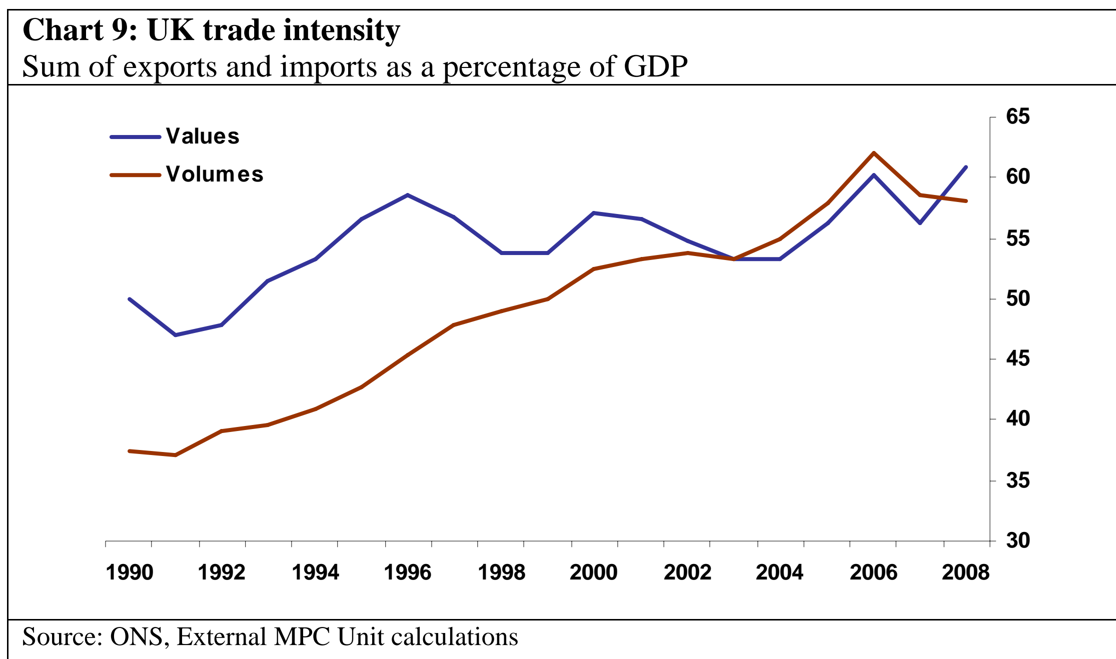


Chart 9: UK trade intensity
Sum of exports and imports as a percentage of GDP

Source: ONS, External MPC Unit calculations

Third, if we are seeing a period of global de-stocking, the flows of trade in finished goods and components are likely to be temporarily interrupted as manufacturers and distributors reduce stocks which they are already holding at factories and warehouses. Fourth, difficulties that companies are experiencing in obtaining trade credit and working capital more generally may also be aggravating the downturn in world trade.

The impact of globalisation

A common thread running through the shocks which caused the current downturn and the way the recession has unfolded is the operation of a highly integrated global economic system. The current highly globalised economy has been evolving over the period since the Second World War. But economic historians point out that the process of globalisation started even further back in the nineteenth century. However it was set back significantly in the first half of the twentieth century by the two World Wars and the Great Depression.

The period from the end of the Napoleonic wars until the start of the First World War is often described as "The First Era of Globalisation" – and the late nineteenth and early twentieth century saw particularly rapid growth in trade and economic activity,

supported by international flows of capital and labour.[7] Transport costs had come down and other barriers to trade and the movement of capital had been reduced. And it was in this globalised economy of the late 19th century that the agricultural engineering industry developed rapidly and the AEA was founded.

Just as recent decades have seen the inclusion of many developing and emerging markets into the global economic system, the rising economic power in the late 19th century was the United States. And agriculture as well as industry formed the competitive battleground – with the mechanisation of farming a key source of competitive advantage, as I noted earlier. In the words of the American historian Scott Nelson: "The 19th century version of containers manufactured in China and bound for Wal-Mart consisted of produce from farmers in the mid-West. They used grain elevators, conveyor belts and massive steam ships to transport train loads of wheat to abroad."[8]

And the parallels with the world in which the Agricultural Engineers' Association was founded in 1875 do not end there. The AEA was born into a recessionary world, with some uncanny parallels to the current conjuncture. The recession of the mid to late 1870s followed the "Panic of 1873", triggered by a collapse in confidence in railway bonds, which were the sub-prime loans of their day. That, in turn, led to wider financial problems including restrictions of credit to smaller firms and the collapse of many banks, particularly in the United States. The result was a severe recession, which continued through the 1870s and spread to Europe. In the UK, unemployment rose sharply through the 1870s – to a level which was not exceeded until the 1920s and 1930s.[9]

An integrated global economy, volatility in commodity prices, a financial crisis originating in the United States leading to a world recession. All this sounds remarkably contemporary. And yet this was not today's world but the world of the late 1870s, over one hundred and thirty years ago!

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[7] See, for example, O'Rourke and Williamson (1999) and the discussion in Wolf (2004)
[8] See Nelson (2008). The same source contains more detail on the "Panic of 1873" and the ensuing recession.
[9] See Figure 1 in Layard (1986), which is based on Feinstein (1972).

I mentioned earlier that the current wave of globalisation of economic activity has been proceeding for over half a century, mainly through the growth of world trade and the internationalisation of business activity. But in the last two decades it has deepened in two critical respects. First, the last two decades have seen the integration into the global economy of many emerging market economies, including China, India, Russia and much of Eastern Europe. Second, the deregulation and liberalisation of financial markets in many countries from the 1980s onwards has created much more globally integrated capital and financial markets, with financial institutions – especially banks – operating on a much more international basis. This deepening of the process of globalisation has given an added boost to the growth of world trade and economic activity. But it has also extended the globalisation of markets outside the sphere of trade and into the markets for labour and for capital and finance.[10]

The extension of global markets in these ways has provided the backdrop for the surge in energy and commodity prices and the evolution of the current financial crisis which has led to the present world recession. First of all, strong growth in China and other emerging markets, based on low-cost export-oriented manufacturing activity, was an important ingredient putting upward pressure on oil and commodity prices. Though there may also have been some speculative element driving the final surge in oil prices in the first half of 2008, a large part of the upward price pressure in commodity markets over the period 2004 and 2008 appeared to reflect fundamentals – strong demand in relation to supply. As I noted in a speech last year, the mid-2000s were an exceptionally strong period of world growth, with developing and emerging market economies as a group growing at the fastest rate since the 1960s.[11]

Second, the globalisation and liberalisation of financial markets provided a plentiful supply of global capital to support the inflation of a global credit bubble, centred on the United States, which developed a large current account deficit as a result.[12] It also provided an environment in which financial institutions, and in particular banks, pursued aggressive strategies to develop as global businesses – not necessarily

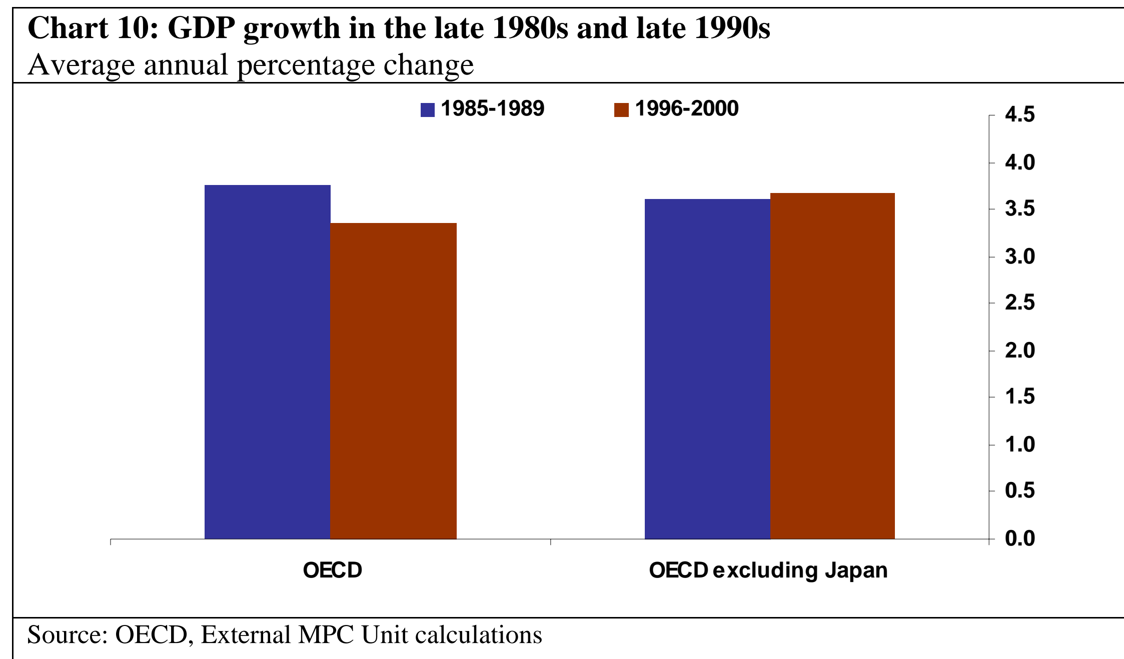
[10] The impact on labour markets comes partly through migration, but mainly through the indirect effect on the flexibility of labour markets from outsourcing to lower cost production locations.
[11] Sentance (2008b)
[12] Hume and Sentance (2009) provide a more detailed assessment of the ingredients contributing to the global credit boom which started in the 1990s and continued to 2007.

recognising the risks attached to these strategies. While there are many other factors which contributed to the development of the global credit boom which has imploded so spectacularly since the summer of 2007, increasingly globalised capital markets and institutions certainly provided a fertile environment in which financial risks could be underestimated because of the growth-orientation of the key players – the banks – and the increasing and probably excessive sophistication of the financial instruments developed.[13]

The third way in which globalisation may have contributed to the current round of global shocks is through the entry of many countries with low labour costs into the world market system. This helped – alongside a number of other factors – to contain inflationary pressures which might otherwise arisen from a long period of economic growth going back to the early 1990s. That meant that a significant global monetary tightening – which might have stopped the credit boom in its tracks earlier – was not applied until the mid-2000s. One point at which a monetary tightening might have been applied was after the strong growth of the late 1990s. As Chart 10 shows, in the years 1996-2000 economic growth in the advanced economies of the OECD was as strong as the late 1980s (1985-89) – particularly if Japan is excluded from the analysis.

[13] See Haldane (2009) for an excellent analysis of bank behaviour during the evolution of the global credit boom

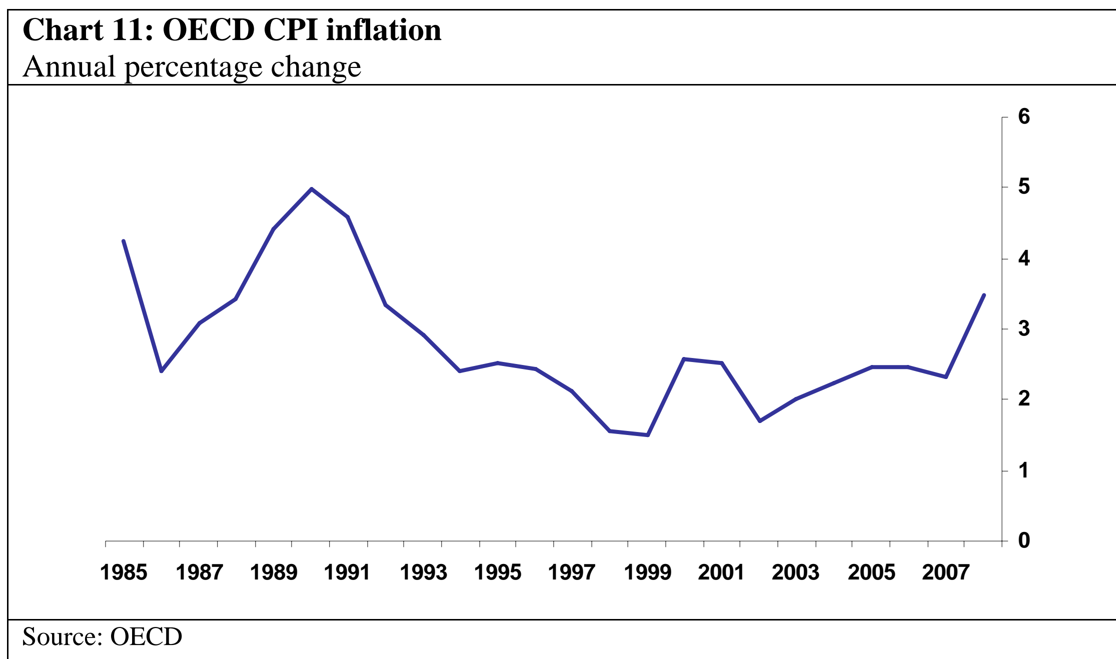
Chart 10: GDP growth in the late 1980s and late 1990s
Average annual percentage change



Source: OECD, External MPC Unit calculations

However, the response of inflation to this period of strong growth in the late 1990s was much more muted than in the 1980s, as Chart 11 shows. There were a number of reasons for this, but one important contributory factor was the impact of low-cost competition from China and other Asian economies in an increasingly globalised economy. In the wake of the Asian crisis, the "China effect" through which low-cost manufacturers based in the Far East drove down manufacturing prices in the West began to kick in much more strongly. This helped to keep down inflation directly and the potential for outsourcing processes to the Far East also acted as a disciplining force against wage inflation.

Chart 11: OECD CPI inflation
Annual percentage change



Source: OECD

As a result of this muted response of inflation, there was little tightening in monetary policy in response to the strong growth in the late 1990s, and a brake on the emerging credit boom was not applied until much later in the 2000s. Instead, the relaxation of monetary policy in the 2001-2003 downswing – particularly in the United States – gave added momentum to the growth of lending and the expansion of housing-related credit. The result was a much longer period of credit growth which came to an end in 2007 and 2008 with such spectacular consequences.

Policy challenges

So to sum up, recent events have exposed vulnerabilities in the highly integrated global economic system we now inhabit. In a highly globalised world economy, there is an increased risk of volatility in energy and other commodity prices, when the world economy as a whole is either in a strong upswing. Stronger linkages between national economies could be making these synchronised upswings and downswings more likely.

In addition, as our forbears discovered in the "First era of globalisation" in the nineteenth century, there is also an increased risk of financial cycles. Even if these cycles are not primarily driven by developments in our own economy – we can still suffer in the ensuing recession. As I noted earlier, the fact that Germany and Japan

were not major participants in the global credit and housing boom has not isolated them from the consequences of the unfolding global recession.

The solution to these potential volatilities is not to try and hold back the process of globalisation, which has brought great benefits to the world, supporting economic growth and allowing living standards in poorer countries to rise. Not only would this be like King Canute trying to hold back the tide. But as the statement from the G20 leaders at the beginning of this month recognised, now would be the worst possible time to introduce protectionist measures which aimed to limit flows of trade and global capital.

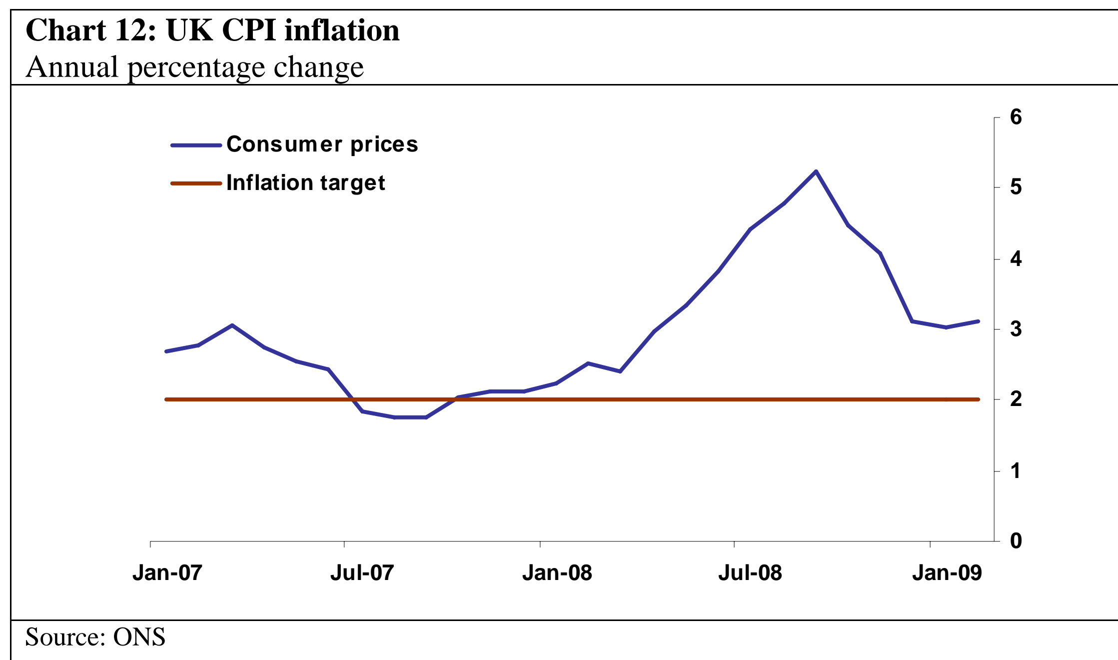
Monetary policy can play an important role in stabilising the UK economy in the face of shocks from the global economy. But we need to be realistic about what it can achieve in the face of the kind of turbulence we have recently experienced. We have seen recently how financial instability in the global economy can generate a severe recession. And in an economy more open to international trade, we are also exposed to more volatility in inflation from changes in world prices. Over the last decade we have seen this operate to hold down inflation in the late 1990s and early 2000s, and then to push up inflation more recently as energy and other commodity prices rose.

These potential sources of volatility do not require any change to the objectives of monetary policy in my view. We have realised a lot of benefits from focussing monetary policy on a consistent inflation target, which aims to measure inflation as it is commonly experienced by the general public. That in turn requires us to focus on the way in which developments in the real economy – including the current recession – affect the setting of wages and prices.

In the wake of the current financial crisis, some commentators have begun to argue that monetary policy might have played a stronger role in heading off the credit boom. That might be true at the global level, or for countries which are sufficiently large to have a global impact such as the United States. But in the UK case, I find this argument unpersuasive. We are facing a global financial crisis, driven primarily by developments in the US mortgage market and within global financial markets and institutions. It is hard to see that a different course for UK monetary policy could

have made much difference to these developments. Rather, if global financial instability is a problem, there needs to be a more effective regulatory approach – as Lord Turner's recent report has argued.[14]

Chart 12: UK CPI inflation
Annual percentage change



Source: ONS

If there are big swings in energy and commodity prices, we need to try and look through them and focus on the medium-term inflation outlook. That was a key challenge for the MPC last year when inflation rose above 5% last autumn (see Chart 12). The Committee did not raise interest rates in response to rising inflation over the summer of last year. And in response to the rapidly deteriorating economic outlook last autumn, the MPC cut interest rates aggressively even though inflation remained significantly above target in the short-term. We have also introduced a programme of "quantitative easing" to boost the money supply to reinforce the impact of lower interest rates. This aggressive relaxation in policy reflects the view – set out in February's *Inflation Report* – that inflation will, over a period of time, come back to target and risks dropping significantly below it once the effects of the recession on the setting of wages and prices are fully felt.

The recent data suggests that the downward momentum of inflation in the short-term may not be as strong as we thought in February – probably because of the very

[14] Turner (2009). For the Bank of England's initial response, see Tucker (2009).

marked depreciation in sterling since the summer of 2007. The next *Inflation Report* forecast round – which is just now getting underway – will allow us to reassess the evidence from the latest trends in demand, wages and prices, as well as gauging the potential impact of the £75bn asset purchase programme aimed at boosting the money supply. That Report will not be published until after the next MPC meeting, but its findings and the forecast will inform our next policy decision.

The other key feature of the May *Inflation Report* will be an updated forecast for economic growth, and the MPC's latest assessment of the course of the recession and prospects for recovery. Our February central projection suggested that the pace of the downturn would ease in the current quarter, with the economy bottoming out over the summer. On this central scenario, we saw the prospect of a slight improvement in the economy later this year and more significant growth as we moved through 2010.

Though there are still a lot of risks, the economic data since February has been broadly consistent with this projection. Some of the business survey data is now more positive – albeit recovering from a low base. There are tentative signs of a pick-up in housing market activity. And UK exports do not seem to be falling as sharply as other countries, suggesting the competitive value of the pound may be helping UK manufacturers. We should also expect the dampening effect on economic activity from a rundown in stocks to ease as we move through the year. Also, as we move through this year, the economy should feel more support from the significant cuts in interest rates made by the MPC last autumn and earlier this year, as well as the current programme of "quantitative easing".

Once we get into the recovery phase, however, it is important that the experience of the last two years is not quickly forgotten. The period of economic stability which we enjoyed in the first decade of the MPC's existence – what Mervyn King, the Bank's Governor has called the "nice" decade – may turn out to be a rather exceptional episode. With the world economy and the UK itself needing to correct some significant economic imbalances, the path ahead in the recovery phase may not be so smooth. And we have discovered that in the integrated global economic system we now inhabit, there are many potential sources of volatility to both growth and inflation in the short-term.

At present, the key challenge is to support demand and help lift the economy out of recession and head off the deflationary risks associated with that. I am hopeful we can achieve that as we move through this year and into 2010. When the recovery comes, there may be different challenges for monetary policy, including upside as well as downside risks to inflation. As a member of the MPC, I remain committed to keeping the UK economy on as steady a course as we can, while recognising that the integrated global economic system is always throwing up new and challenging problems for us to deal with.

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