



BANK OF ENGLAND

Speech

Speech given by

Mervyn King, Governor of the Bank of England

The Grand Hotel, Brighton

24 January 2012

My Lord-Lieutenant, High Sheriff, Ladies and Gentlemen

As we head into a challenging year for the world economy, we have seen more positive sentiment in financial markets, and, at home, a fall in inflation. But none of this implies that 2012 will be an easy year. We begin it with the level of output more than 10% below a continuation of its pre-crisis trend, and the unemployment rate at a 15-year high. These are huge changes in our economic fortunes. Tonight I want to talk to you about what is happening to our economy, what it means for the years ahead, and how the Bank of England is responding.

A year ago, in a speech in Newcastle, I explained that inflation was uncomfortably high, and was likely to rise to between 4% and 5% in 2011, before falling back in 2012. With a fiscal consolidation and tight credit conditions, prospects for domestic spending growth appeared weak. In the event, outturns were even worse than expected. Inflation reached 5.2% in September and growth last year was substantially weaker than most people predicted at around only 1%.

The forces behind our high inflation rate are also an important part of the explanation for slow growth last year. High inflation was driven not, as in the past, by rapid growth of the broad money supply and of wages. In fact, the growth rates of money and wages have been remarkably weak. Inflation was pushed up instead by the rise in VAT, higher import prices and rising energy costs. The consequence has been a ferocious squeeze in the purchasing power of take-home pay. That led to a fall in consumer spending which accounted for much of the weakness in growth in 2011.

But the pattern of high inflation and falling real wages for those in employment has been going on for much longer than just the past year. Since 2007, increases in VAT, import prices and energy prices have together pushed up the price level by as much as 15%, squeezing real wages. As a result, we have now experienced the longest period over which real wages have failed to rise since the 1920s.

Some argue that if only the Bank had kept inflation down, the squeeze could have been avoided. But inflation could have been lower only with higher interest rates, lower wages, and even higher unemployment. Real take-home pay would probably have been weaker not stronger.

The good news is that the effect on inflation of the rise in VAT, import costs and energy prices is now waning. Inflation is falling. And, unless commodity prices rise again – the main risk being tensions over Iran – it should continue to do so through this year. Some utility bills have already come down in the wake of reductions in wholesale gas prices. In fact, after taking into account normal seasonal variation, the rate of price increases in the past few months has been close to 2% a year. The fall in inflation will relieve the squeeze on real income growth and with it the pressure on consumer spending.

But, as I said earlier, this does not mean 2012 will be an easy year. In addition to the sharp squeeze in real take-home pay, **three** factors have shaped the economic environment over recent years, and continue to set the scene for 2012: tight credit conditions, higher household saving, and the dark clouds hanging over the world economy. The common thread linking them is that each is a symptom of the debt hangover that followed from the overextension of balance sheets in the run-up to the financial crisis. The continuing need for banks, households and nations to reduce their indebtedness is part of the broader story of the unwinding of the imbalances in the world economy as a whole.

The banking sector was, and remains, at the centre of the debt overhang. And the consequences of problems in the banking sector affect us all. Banks stand between savers and borrowers, and many businesses and households rely on bank finance. So when banks' leverage increased to such a degree that each hundred pounds lent was backed by a buffer of only two pounds of shareholders' capital, we were all at risk. That degree of leverage was unsustainable, and, as the weakness of banks' balance sheets was exposed, markets reappraised their soundness. Funding costs increased, raising the cost of borrowing for everyone dependent on bank finance. In addition, to rebuild their buffers, banks increased the margins on new lending and reduced the availability of credit. The resulting tightening of credit conditions has created problems for many borrowers and in particular for small businesses.

It is hard to quantify the full impact of this on our economy. There is clearly a risk that credit constraints may hinder the reallocation of resources required to rebalance the economy. And over time, a lack of finance may reduce productivity growth.

The interconnectedness of the financial system means that the fortunes of the banks important to the UK economy are tied up with those of banks overseas. Until the problems in the euro area are resolved, concerns about the scale of such exposures will mean that UK banks will continue to experience elevated funding costs. As a result, their ability to provide credit on reasonable terms to businesses and households will remain impaired. And credit conditions will continue to act as a headwind to the economic recovery.

For households, the flipside of cheap credit in the run-up to the crisis was rapid growth in household borrowing which, by 2008, had reached 170% of income. Much of this borrowing financed house purchases and allowed some, who sold their homes, to accumulate financial assets. But household saving overall – and indeed national saving – fell to levels that were unsustainably low.

The increase in households' borrowing came to an abrupt halt in the 2008/9 recession. At the same time, instead of rising by 3½% a year, as it had in the previous decade, consumer spending fell by 5% in 2008. And it remains at that depressed level. I have already explained how a squeeze on real take-home pay played a role. But the other part of the story is a rise in household savings – prompted by greater uncertainty about future incomes and job prospects, falls in asset prices, and tighter credit conditions. After the crisis began, many households came to realise that their debt levels were probably too high relative to incomes

and they set about correcting this. The unavoidable result was a lower level of spending. Households as a whole have been net savers, rather than net borrowers, for each of the past three years.

At the same time, the Government's fiscal deficit inevitably increased sharply during the downturn. Private borrowing was replaced by public borrowing. So the United Kingdom is still borrowing from the rest of the world. If, as a nation, we are to reduce that borrowing, we must export more and import less. There are encouraging signs of progress: net exports have improved by two percentage points of GDP since 2007, thanks, in part, to a fall in the value of sterling against other currencies of around 25%.

Of course, our ability to continue with this rebalancing depends on the outlook for economic activity elsewhere in the world – the third factor relevant to UK prospects in 2012.

Recent developments in the world economy have been mixed. In the United States employment has expanded for 15 months in a row, although it is still well below its peak of four years ago. In contrast, in the major emerging market economies of Brazil, India and China, growth has eased. In China, export growth continues to fall and there are indications that domestic demand too is slowing. Not surprising, perhaps, given the appearance of an unsustainable investment boom, especially in construction, in recent years. Closer to home, the depressing effect on growth of the fiscal contraction in the peripheral European economies is leading to a downturn in the euro area as a whole. Taken together, we are seeing a global slowdown.

Underlying this is an international landscape still dominated by imbalances – between saving and investment, exports and imports, lending and borrowing. In many cases these reflect misperceptions about how long it is possible to maintain high levels of consumption or investment. Imbalances are a problem not just for debtor countries but for creditor countries too. For each debt incurred, a loan is extended. So if the position of debtors is unsustainable, so is the position of creditors. In practice, this means that large losses will need to be recognised and absorbed. Nowhere is this more apparent than in the euro area, where the challenge of restoring competitiveness and financing the current account deficits of the peripheral countries remains.

Rebalancing the world economy, and the UK economy within it, is not proving to be a smooth process. But it is necessary.

The common thread in all three factors affecting the outlook is the need to correct over-leveraged balance sheets. After many years in which the stock of debt built up rapidly, there has been a reappraisal. A reappraisal by markets of the strength of banks, by consumers of their income prospects, by lenders of the likelihood that debts will be repaid, by investors of the value of assets, and by markets of the value of currencies. It became apparent that previous spending patterns and debt levels were unsustainable. The world economy is moving to a new equilibrium.

This correction in balance sheets will take time to work out. Past experience shows that recoveries from recessions that are linked to banking crises are slow – but do eventually come. And there is a relationship between the indebtedness of an economy before the recession and its rate of recovery afterwards. Two big unknowns are the extent to which balance sheets will continue to weigh on demand over the coming years, and how far the growth rate of potential supply has been affected by the falls in actual output and tight credit conditions. In the near term, the timing of changes in the pattern of spending is hard to predict. Uncertainty is the prevailing mood. Markets remain averse to risk, but find it difficult to avoid.

So what does this mean for policy in the United Kingdom? The main objective must be to ease the transition of the economy to the new equilibrium, smoothing its passage through troubled waters while remaining on course to complete the inevitable adjustment.

Three areas of policy are particularly important.

First, monetary policy – to prevent the deleveraging process from tipping the economy into a renewed severe downturn. As spending adjusts to the new equilibrium, the ability of monetary policy to bring forward spending from the future to the present is limited. But low short-term interest rates and – partly because of the Bank of England's purchases of gilts – unprecedentedly low long-term interest rates have helped to smooth the adjustment of balance sheets. And, with inflation falling back and wage growth subdued, there is scope for interest rates to remain low, and, if necessary, for further asset purchases, to prevent inflation falling below the 2% target.

Second, rebuilding a healthy and competitive banking system – so that it can provide the finance to households and businesses necessary for the economy to thrive. UK banks have made substantial progress in rebuilding both their capital and liquidity since the dark days of 2008. This provides them with a cushion against stress – a cushion which has been valuable recently. The Bank of England stands ready to provide liquidity to healthy banks against good collateral should market conditions deteriorate. Since the start of the financial crisis, the Bank's framework for such lending has been completely overhauled. We learnt from experience. And last December we added to it by introducing to our toolkit a new auction of central bank money against wider collateral (the Extended Collateral Term Repo Facility) and coordinating an expanded network of swap arrangements among the world's major central banks. We are also, through the Bank's new Financial Policy Committee, recommending to banks that they limit distributions to employees and shareholders, and instead build their capital in order to improve their resilience in an uncertain world while maintaining their lending to the real economy. There is no necessary contradiction between repairing balance sheets and continuing to lend. Every pound used to boost capital could support an extra twenty pounds of lending without increasing banks' leverage.

Third, supply-side reforms – to raise future output. The level of debt in the UK is probably still too high relative to expectations of future income. There are two ways to change that: reduce debt, or raise future incomes. Reforms to the supply side of our economy can, by raising income expectations, reduce the impact of deleveraging on spending by validating some of the past increase in debt.

Above all else, we must strive to maintain support for a market economy and an open world trading system. They provided the basis for the great prosperity experienced since the Second World War. The tragedy of the financial crisis is that those who have suffered most have been those who bear no responsibility for it, and who, whether employees or businesses, accepted the disciplines of a market economy only to find that others were excused that discipline because they were “too important to fail”. But the legitimacy of a market economy will inevitably be challenged if rewards go disproportionately to a small elite, especially one which benefited from the support of taxpayers. Those taking decisions on remuneration, in the financial sector and elsewhere, need to understand that a market economy rests not just on incentives, but on the acceptance that the distribution of rewards is fair. That sense of fairness underpins the commitment to a market economy. An even bigger tragedy would be to deny the prosperity that flows from a market economy to those who need it most.

After the steepest downturn in output since the 1930s, the UK economy is in the process of rebalancing. Starting from a position of excessively leveraged balance sheets, the path of recovery is likely to be arduous, long and uneven. The position of the world economy, especially in the euro area, is serious. But there is no reason to despair. All crises come to an end, and businesses will find ways to trade with each other and meet the needs of consumers whatever the transitional problems posed by deleveraging. Helped by the right policy actions, the UK and world economies can and will recover. And when they do so, they will be on a more sustainable footing than at any point in the past fifteen years.