

## Mervyn King: Monetary policy developments

Speech by Mr Mervyn King, Governor of the Bank of England, at a dinner hosted by the IoD South West and the CBI, Bristol, 22 January 2008.

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It is four months since Northern Rock came to the Bank of England for support. And the headlines continue to be dominated by its fate. Northern Rock, however, is not the epicentre of the present global banking crisis. That lies in the very substantial losses made by many banks in the main financial centres as a result of the collapse of the US sub-prime mortgage market.

Those losses, and the fear of future losses on a wider range of loans, pose a threat to the ability of the banking system to finance continued economic growth – the so-called credit crunch. Concerns about the implications of a credit crunch, not only for the health of the US but for the world economy, lie behind the sharp falls in global equity markets over the past week. So the next year will pose economic challenges for all of us – more so than at any time since the Bank of England was given its independence in 1997.

Both industrialised and emerging market economies have been affected by the fall in asset prices but conditions vary across countries. It is striking that the banking crisis originated at the heart of the world's major financial centres. And the country most severely affected is the United States where the Federal Reserve today cut interest rates by 75 basis points – the largest reduction since August 1982 – to mitigate “increasing downside risks to growth”. The contraction in the US housing market has deepened and unemployment there is rising.

I want tonight to explain the nature of the challenges facing us and why many of them originate outside our shores. Exactly five hundred years before the Bank of England was given its independence, an Italian migrant who had made his home in Bristol, Giovanni Caboto, or John Cabot as he was known, set sail from this great city in May 1497 and became the first European to land on the North American mainland since the Vikings. A seafaring voyage like Cabot's is a good analogy for the challenges facing the British economy, which will have to navigate some distinctly choppy waters in 2008.

The challenge to the Monetary Policy Committee's ability to navigate our way through the next year reflects two strong economic winds; one from the west and one from the east. They correspond to what economists call demand and supply shocks. The former is the credit crunch which has blown across the Atlantic, and threatens a sharp slowing in output growth. The latter is the rise in energy and food prices, reflecting continued strong growth in Asia, that, together with rising import prices, threaten to lift inflation noticeably above target in the coming months. These two winds have stirred up the water through which the UK economy must pass.

The westerly gale first hit us in August as developments in the US mortgage market led to turmoil in global financial markets. For some years, banks were able to borrow cheaply in world capital markets to expand their lending. They packaged the resulting loans and sold assets backed by those loans to capital market investors. They were able to do that because some investors had failed to adjust to lower rates of return caused by high savings in emerging economies and low inflation at home. Those investors engaged in a “search for yield” by buying risky assets without always understanding fully the risks attached to them. Families and businesses had access to more finance at lower cost. That was most obvious in the growth of the US sub-prime mortgage market, where the potential problem of lending to people who could not repay when the interest rate was reset on their floating rate mortgages was becoming only too clear. In the United Kingdom too, borrowing and spending growth were strong and inflationary pressures built up.

But in August all that changed dramatically. Rising default rates in the US mortgage market led investors around the world to question whether they were being adequately compensated for the risks they were bearing on a wide range of assets – not just those associated with sub-prime mortgages. The prices of those assets fell, and markets closed for a range of complex credit instruments.

As I said two years ago, “risk premia have become unusually compressed and the expansion of money and credit may have encouraged investors to take on more risk than hitherto without demanding a higher return. It is questionable whether such behaviour can persist”. And, as we have seen, it hasn’t. The re-pricing of risk that is still continuing is not a process that we should try to reverse.

Adjustment to this has been painful for banks in the major financial centres in two ways. First, with some asset markets closed, banks found funding more difficult. Some needed to finance loans they had made but had then expected to package up and sell. Others needed to finance off-balance sheet investment vehicles that were no longer able to fund themselves.

At the outset of the crisis, banks were concerned to protect their liquidity position. But increasingly, attention has turned to a second, more fundamental concern. As a range of asset prices fell, banks began to report large losses. Uncertainty about the scale and location of losses led to concerns about the adequacy of bank capital and hence the ability of the banking system to finance continued economic expansion. At the end of last year, sentiment in financial markets worsened markedly. So in mid-December, central banks around the world announced a co-ordinated set of actions in money markets. These were designed to boost confidence by demonstrating that we were conscious of the risks of a credit crunch.

Since those actions, conditions in money markets have eased considerably. The benchmark 3-month interbank lending rate has fallen by around 75 basis points relative to expected policy rates. But conditions are not yet back to normal and remain fragile. Although central banks can and will respond to the consequences of strains in the banking system for their economies, the solution to the underlying problem does not rest with them but with the banks and financial markets themselves. Banks must reveal losses promptly, and, most importantly, raise new capital where necessary.

But these developments in financial markets and the banking system have started to affect activity in the economy more widely. Interest rates charged to both households and companies have risen relative to Bank Rate, reversing the relative fall in the year or so before last August. And our own survey of credit conditions last month revealed that lenders intend to tighten conditions further this year. This tightening is unlikely to be short-lived.

Tighter conditions will discourage borrowing to finance spending on residential and commercial property, on business investment and on consumption. The impact on property prices is already clearly visible. Commercial property prices have fallen by 12% since the middle of last year. And, after rising sharply earlier in 2007, house prices stagnated in the final quarter. Although there is a considerable stock of equity in owner-occupied housing, with banks tightening the supply of both secured and unsecured credit, consumers will find it more difficult to borrow to finance spending. So in 2008 it is likely that a less buoyant housing market will go hand in hand with slower growth of consumer spending.

Tighter credit conditions mean that, as a nation, we are likely to save more of our income this year than in the recent past. In the short run, that will slow economic activity, possibly quite sharply. And there is a risk that weaker activity and lower asset prices could result in another round of losses for banks and a further tightening of credit conditions.

The adjustment which not only the British but the world economy is experiencing is necessary as the imbalances, between spending and saving and between domestic demand and trade, unwind. As part of a longer-run rebalancing of the UK economy, an increase in our national saving rate, both private and public, is necessary. The low level of national saving is apparent from the current account deficit – our new net borrowing from overseas – which in

the third quarter of last year was, relative to GDP, the biggest in the past fifty years and the largest in the G7. It is possible to run a current account deficit for a considerable period. Australia, for example, has done so in every year since 1974. But our own position is becoming more difficult. For some years we have been able to finance current account deficits by borrowing, often through banks, at unusually low interest rates on world capital markets. Such borrowing is now becoming more expensive. Unless we spend less and save more, our current account position will deteriorate.

If we are to raise our national saving rate without overall demand, output and employment suffering in the medium term, we will need to export more and import less. Such a rebalancing is helped by the fall in sterling's effective exchange rate. Sterling has fallen, against a trade-weighted basket of currencies by almost 10% since August. And financial markets are pricing in a significant probability of a further decline in the exchange rate during this year.

A lower average level of the exchange rate can, by supporting overall economic activity, help protect us from the worst effects of the wind blowing across the Atlantic. But, by pushing up import prices, it will exacerbate the impact of the other wind now buffeting the UK economy, which comes from the east – the inflationary effect of higher energy and food prices. Strong growth of demand, particularly from China, India and other emerging markets in Asia, has been a key driver of the sustained rises in commodity prices over recent years, most notably oil prices.

Inflation has picked up in the industrialised world. It is now 3.1% in the euro area and 4.1% in the United States. And although consumer price inflation here is close to target at 2.1%, three developments now threaten to push it significantly above target this year. First, oil prices are around \$90 a barrel, although they have fallen back in recent days. In August, the price was \$70. Second, oil price increases have been accompanied by rising gas prices in wholesale markets. And this month we have seen announcements from suppliers of increases in household gas and electricity bills of the order of 15%. Third, world food prices have risen sharply as a result of strong demand growth on the one hand and poor harvests from South Australia to North Carolina on the other. Food prices on world markets are a third higher than they were six months ago, and that has been feeding through to prices in the shops. Food price inflation in our own Consumer Price Index reached almost 6% in December.

So 2008 is likely to see higher energy prices, higher food prices and, with a lower exchange rate, higher import prices, pushing inflation above the 2% target. It is possible that inflation could rise to the level at which I would need to write an open letter of explanation, possibly more than one, to the Chancellor. Although there is little we can do now to avoid some rise in inflation this year, the task of the Monetary Policy Committee is to ensure that it is short-lived. If inflation expectations were to pick up in the wake of a rise in inflation this year, then only a more prolonged slowdown would allow inflation to return to target. But if the rise in inflation does not affect longer-term expectations, then inflation could start to fall back towards the end of the year.

We are determined to keep inflation on track to meet the 2% target in the medium term. When the Monetary Policy Committee sets Bank Rate, it has to balance the risk that a sharp slowing in activity, by creating a margin of spare capacity, would pull inflation below the target, against the risk that, without such a margin of spare capacity, higher inflation in the short term might have a tendency to persist. So we face a difficult balancing act in the course of 2008. But we start the year from a position in which Bank Rate, at 5.5%, is probably bearing down on demand.

After a decade and more of a non-inflationary consistently expansionary (nice) economy, a phrase I coined in 2003, we moved to a somewhat bumpier but still rather stable path, which I described the following year as the not-so-bad period. You might think we have now

entered a not-so-good period. To put it bluntly, this year we are probably facing a period of above target inflation and a marked slowing in growth.

Although we have little control over the strength of the economic winds buffeting our economy, our framework of inflation targeting does, as I said in my first speech as Governor almost five years ago, provide a seaworthy vessel. We cannot avoid some volatility in the short run and it is important that everyone understands the limits to the ability of central banks to smooth the economy. But, by keeping our eye firmly on the need to keep inflation close to target in the medium term, we can reach the calmer waters of low inflation, steady growth and a better balanced economy. And our policy framework will, I hope, allow you not to be overwhelmed by the headlines and to focus on what really matters for our future prosperity – the successful running of your own businesses.