House of Commons

Treasury Committee

Bank of England November 2007 Inflation Report

Oral evidence

Thursday 29 November 2007

Witnesses:

Mr Mervyn King, Governor of the Bank of England
Ms Rachael Lomax, Deputy Governor of the Bank of England
Mr Charles Bean, Executive Director & Chief Economist, Bank of England,
Professor Tim Besley, External member of the Monetary Policy Committee
Professor David Blanchflower, External member of the Monetary Policy Committee

Ordered by The House of Commons to be printed 29 November 2007

HC 139–i
Published on 17 January 2008
by authority of the House of Commons
London: The Stationery Office Limited
£5.50

The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue & Customs and associated public bodies.

Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)
Nick Ainger MP (*Labour, Carmarthen West & South Pembrokeshire*)
Mr Graham Brady MP (*Conservative, Altrincham and Sale West)*
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Mr Philip Dunne MP *(Conservative, Ludlow)*
Mr Michael Fallon MP (*Conservative, Sevenoaks*) (Chairman, Sub-Committee)
Ms Sally Keeble MP (*Labour, Northampton North*)
Mr Andrew Love MP (*Labour, Edmonton*)
Mr George Mudie MP (*Labour, Leeds East*)
Mr Siôn Simon MP, (*Labour, Birmingham, Erdington*)
John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)
Mr Mark Todd MP (*Labour, South Derbyshire*)
Peter Viggers MP (*Conservative, Gosport*).

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

Committee staff

The current staff of the Committee are Colin Lee (Clerk), Sîan Jones (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young and Jay Sheth (Committee Specialists), Lis McCracken (Committee Assistant), Michelle Edney (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

Contacts

All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

List of witnesses

Thursday 29 November 2007 *Page*

Mr Mervyn King, Governor of the Bank of England, **Ms Rachael Lomax**, Deputy Governor of the Bank of England, **Mr Charles Bean**, Executive Director & Chief Economist, Bank of England, **Professor Tim Besley**, External member of the Monetary Policy Committee and **Professor David Blanchflower**, External member of the Monetary Policy Committee Ev 1

Oral Evidence

Taken before the Treasury Committee

on Thursday 29 November 2007

Members present

Rt Hon John McFall, in the Chair

Nick Ainger	Mr Michael Fallon
Mr Graham Brady	Mr Andrew Love
Mr Colin Breed	Mr Mark Todd
Jim Cousins	Peter Viggers
Mr Philip Dunne	

Witnesses: **Mr Mervyn King,** Governor of the Bank of England, **Ms Rachel Lomax**, Deputy Governor of the Bank of England (Monetary Analysis), **Mr Charles Bean,** Executive Director and Chief Economist, **Professor Tim Besley** and **Professor David Blanchflower,** External Members of the Monetary Policy Committee, gave evidence.

Q1 Chairman: Governor, welcome to you and all your colleagues. We are here to discuss the November 2007 inflation report. You have kindly agreed to come in December to answer questions on financial stability and transparency, but today we will focus on monetary policy and the real economy. I believe you have an opening statement. Will you first introduce your colleagues?

Mr King: On my right is Mr Charles Bean, chief economist at the bank; on his right is Professor Tim Besley, one of our external members; on my immediate left is Rachel Lomax, deputy governor for monetary policy; and on her left is Professor David ("Danny") Blanchflower, also one of our external members. I am grateful for this opportunity again to explain the reasons for the decisions on interest rates by the Monetary Policy Committee since its appearance before you in December when, understandably, your main concern was about matters other than monetary policy. Bank Rate stands at 5.75% where it has been since July, although market expectations of where it will stand at the end of the first quarter of next year have fallen by 75 basis points over that period. In recent months the near-term outlook for both inflation and growth has become less benign complicating life for the Monetary Policy Committee, but the committee remains focused on meeting the 2% inflation target. Since March, when it reached 3.1%, CPI inflation has fallen back to around target as the committee had expected. In August, the committee judged that some slowing in the pace of output growth was necessary to meet the inflation target in the medium term. Although the official estimates of output still indicate firm growth, surveys suggest that the economy is starting to slow. Recent economic news has been dominated by the continuing turmoil in global financial markets which has led to a tightening of credit conditions particularly for the most risky borrowers. In the United Kingdom the consequences are difficult to assess and are likely to be evident first in the housing and commercial property markets. With borrowing more expensive and less easily available the personal saving rate is likely to rise, leading to slower growth of consumer spending. Abroad, the rebalancing of the world economy proceeds and the main news since the November inflation report has been a further weakness in the US housing market and continuing strong growth in Asia. At the same time, world energy and food prices have risen sharply and the latest data on earnings growth look somewhat less benign than before, so the short-term outlook is rather uncomfortable. The committee's current judgment is that the most likely outcome is that output growth will slow and inflation will rise at least for a period. The central projection further ahead is for growth to return to its long-run average rate and inflation to the target, but the outlook is also highly uncertain which makes the task of navigating through the next few months far from straightforward. Despite the accumulation of significant amounts of liquidity by many of the larger banks, markets are fearful that further falls in asset prices might impair the balance sheets of many banks. Although that fear has so far run well ahead of realised losses, it has the potential to lead to a further tightening in credit conditions. The bank will continue to assess how these developments will impact on the outlook for inflation. Given the continuing fragility in the banking system, there is a risk that money markets will tighten over the end of the calendar year which is the end of the accounting year for many banks. This could cause overnight market rates to rise relative to bank rate. To reduce that risk the Bank of England has talked with all of the reserve system banks about their reserve targets for the maintenance period that begins in the first week of December. To assure banks of liquidity over the year end the bank will be offering a substantial proportion of the reserves it supplies in the form of a five-week facility that will extend to the end of the maintenance period in the second week of January. We stand ready to take further measures in order to keep the overnight rate in line with bank rate, and this is similar to the measures announced in recent

days by both the Federal Reserve and the European Central Bank. We are keeping money markets under constant review. The challenge for the Monetary Policy Committee at present is that inflation may rise in the near term and pose a risk to inflation expectations, and that it may fall below target further ahead in the event of a sharp slowing in output growth. We shall return to the question of what all that means for interest rates at our meeting next week. Chairman, those are the remarks I would like to make this morning and I and the other members of the committee here today stand ready to answer your questions.

Q2 Chairman: That is as global a statement as you normally provide, particularly your comments about navigating the next few months. This week comments were made by Larry Summers and Peter Sutherland. Larry Summers said: "Three months ago it was reasonable to expect that the subprime credit crisis would be a financially significant event but not one that would threaten the overall pattern of economic growth." However, he says that, "The odds now favour a US recession that slows growth significantly on a global basis." Peter Sutherland, chairman of Goldman Sachs and BP, said: "I think we are going through next year, certainly the first half of next year, with considerable traumas, and it is a dangerous period for the world." Do you agree with the sentiments of both those experienced individuals?
Mr King: I am not going to make a judgment about the probability of recession in the United States. My colleagues on the Federal Reserve Board are much better placed to form their judgments. They stress that, as yet, much of the slowing we have seen and the problems are focused on the housing market not elsewhere in the US economy. I stress that this is a risk rather than something that has yet happened. Nevertheless, what we see, not just in the subprime mortgage market, are market fears about the possibility of further movements in asset prices which impair the balance sheets of the banking system in the United States and that would lead to a classic credit squeeze. The real risk is that there would be a contraction in the amount of lending available to household and corporate borrowers in the United States that had an impact on their spending, both consumption and investment, and might slow the rate of growth of output pretty sharply. Certainly, my colleagues in the US would say that the real focus of concern is whether the developments that might occur in the future will lead to a sharp credit squeeze. Of course, they have cut interest rates quite noticeably already in order to offset the increase in spreads charged to borrowers to ensure that borrowing costs really have not moved too far, but that is the big risk. I do not think you can say that what has been seen so far adds up to a major shock; it is the concern about what might lie ahead that impacts on the banking system. Some now put the scale of the losses on subprime mortgages in the United States at $200 billion; others put it as high as $400 billion, which is 40% of the total risky lending to the subprime mortgage sector and for that to be wiped out would be an extraordinary rate of default. Although $200 billion is an enormous amount of money it is no more than the equivalent of the loss of wealth that would result from a fall in the US stock market of about $1\frac{1}{2}$%. That represents a bad day on the US stock market. It is hard to believe that that alone would cause a major slowdown. I think it is the fear and sheer uncertainty out there that that drives the risk that there might be a more substantial credit squeeze. It is that which would cause the downside risk to output in the United States.

Q3 Chairman: Mr Bean, you said in an interview in the *Liverpool Daily Post* that only a relatively small fraction of the likely losses associated with the subprime issue had been declared by the banks. How likely is it that persistent financial market instability will lead the February inflation report to include a further downgrade to growth expectations?
Mr Bean: Obviously, we will have to wait until our February round to form that forecast. What I was concerned to draw attention to in that remark was the fact that there was still a lot of uncertainty about where the losses associated with the US subprime market lay. Only perhaps 20% of the likely losses have so far been declared by banks and other financial institutions. So there is likely to be a continuing period of uncertainty until there is greater clarity about who actually bears those losses. As long as that uncertainty persists, it is likely that financial institutions will be reluctant to lend to one another for anything other than rather short periods and obviously that may have spillover effects onto their lending to households and businesses, which is where it starts to impact on the real economy and inflation prospects.

Q4 Chairman: If I am correct, during the November inflation report press conference you referred to the likelihood of a recession in the UK.
Mr Bean: It was in the context of a question about the fan chart. If I remember rightly, it was Evan Davis who said it seemed to imply that we put a very low probability on a recession. I drew attention to the fact that the fan chart was for growth over four quarters, whereas people often use the term "recession" to refer to two successive quarters of falling growth and the likelihood of that was somewhat greater than the fan chart might appear to imply. There is a lot of uncertainty about growth prospects. Although our central projection incorporates a slowdown, it is nevertheless a relatively benign outlook. The slowdown is relatively mild and is of the same sort that we saw in 2004-05 and growth then recovers. But that is just a central projection. Certainly, encapsulated in that fan chart are significantly worse outturns that involve slower growth over a somewhat longer period. Equally, there are outturns that are less worse than the central projection.

29 November 2007 Mr Mervyn King, Ms Rachel Lomax, Mr Charles Bean, Professor Tim Besley and Professor David Blanchflower

Q5 Chairman: Professor Blanchflower, can you explain the reasons for your vote in the November inflation report?
Professor Blanchflower: In some sense it follows on from a number of comments that have been made. My view is that the fear of a recession in the US is perhaps greater than I thought it was a month or so ago and greater than others think. Having spent time in the US, my sense is that in the past month or so confidence has declined somewhat. Bob Schiller has been talking about how important that is. A number of commentators—Goldman Sachs and others—have said that the probabilities of a US recession have increased. There is also the latest evidence from Fannie Mae, Fannie Mac and so on. I think confidence in the US has slipped somewhat and the implications of a recession, which now have perhaps 50:50 probability in 2008, are greater than in the past. The implications for the UK economy in my judgment are greater, that is, at least a two-quarter set of negative growth. My first view of the US economy was perhaps more to the downside than others and concerns about the extent of monetary tightening that had gone on in the UK economy was somewhat higher than I had expected. I also had the view that there were interest rate increases still to come through. Therefore, those factors together seemed to suggest that going forward the potential for the downside was greater than perhaps my colleagues thought. I had also taken the view that there was more slack in the economy already than others had thought, so it seemed to me that the potential risks on the downside were substantial and we should act. That was why I voted the way I did knowing that in our inflation report reductions are built in based on market interest rates, but my judgment was that it was time to do it and get ahead of the curve rather than wait.

Q6 Chairman: I should like to bring in Rachel Lomax. What economic indicators will you be paying most attention to in the coming months given your brief in the bank?
Ms Lomax: I think I will be looking very closely at the business surveys because a lot of the concern about the impact of a credit crunch is in the forecast rather than the data. The surveys will give us a timely read on where business confidence is going. We are also looking very closely at any indicators of credit. We recently published for the first time a credit conditions survey and there will be another one in January. That will be a very good sign of how far these troubles in financial markets are feeding through. On the inflation side, which we have not talked about much so far, what is happening to commodity and oil prices is a big concern at the moment. And we are coming up to a big season for pay awards. We are very conscious that the RPI still has not fallen back in the way the CPI has, so we are looking very closely at what is happening in the labour markets and on wage settlements.

Q7 Chairman: You said in a speech to Hull Chamber of Commerce that current interest rate levels may be on the restrictive side. How great is the danger that that will turn out to be the case?
Ms Lomax: It is a very broad assessment. What is the neutral level of interest rates? Clearly, we are in a different place from where we were when interest rates were around $3\frac{3}{4}$% or in the low fours. Above 5%—at $5\frac{3}{4}$% or 6%—it is difficult to argue that interest rates represent an accommodative monetary policy, but how restrictive they are depends on quite a lot of things about what is happening on the supply side of the economy and so on. It is not a precise statement, but we are starting from a position where interest rates are high relative to recent experience and to other countries of the G7.

Q8 Chairman: Professor Besley, following those questions what is your current view of the UK economy?
Professor Besley: If we go back to August and think about how things have evolved since, a number of us thought then that it might be necessary further to tighten monetary policy in view of the low levels of spare capacity in the economy that we saw with fairly strong growth. It is important to benchmark what we are now seeing against the position in August. We see some slowing, but it is the kind of slowing so far that we would have been expecting in the August inflation report. To some extent, what has gone on in financial markets has done the work that monetary policy might have had to do in terms of tightening. I agree with the broad assessments of my colleagues about the kinds of factors that will be relevant going forward, but at the moment the measures we have suggest that there is still relatively limited spare capacity and therefore the kinds of things that might weigh against inflationary pressures from commodity prices and other sources mean that there is still a fair amount of potential inflationary pressure out there. We will have to see to what extent events going on in the real economy weigh against that and mean that the increase in inflation we see does not become embedded in expectations and wage settlements in the next quarter.

Q9 Chairman: What is the balance of risks in the growth of inflation?
Professor Besley: If I was called on that I would say it would be slightly to the upside on inflation and slightly to the downside on growth.

Q10 Mr Dunne: Governor, in the inflation report you draw attention to the cut in interest rates by the Fed of 75 basis points. Normally, you would expect other corporate rates and so on to follow by a similar amount but that did not happen between November and June. Investment grade debt is down by about 25 to 28 basis points and mortgage rates have barely moved. Therefore, are interest rates in the current difficult credit environment an effective tool of monetary policy?

Mr King: Are you referring to the United Kingdom? You mentioned the United States at the beginning of your question, but you meant the United Kingdom.

Q11 Mr Dunne: You referred to the cut in interest rates in the US in your inflation report and I am illustrating that cutting rates by 75 basis points has not had the normal reaction in the markets; it has not reduced the real interest rates that the corporate market and individuals pay.
Mr King: It has offset many of the rises in interest rates that would have resulted from the tightening in credit conditions and so it has achieved its desired effect, namely to keep borrowing rates where the level of demand that would flow from corporate and household spending is broadly consistent with the Fed's judgment as to where it wants to go. I do not think it means that monetary policy is less effective in any sense.

Q12 Mr Dunne: If we look at your chart 1.2 which shows the three-month LIBOR rate in the UK, you were anticipating a steady decline to a more normal level of spread of 15 basis points or so by the summer of next year. Yesterday the spread hit 90 basis points so instead of declining the spike has started to move in the other direction. It is not quite at the levels achieved in August and September but it is heading in that direction. Is that not a very worrying signal that we are about to hit the same conditions in the market that we had a couple of months ago?
Mr King: I think the conditions are different, and it is certainly a matter of concern. The expectations that spreads would eventually come down were not ours but those of the market at the time of the inflation report. There are three interesting aspects of the change in spreads. First, they have moved very similarly in the dollar, euro and sterling areas. This is a judgment about what is going on in the banking system of all the major developed economies. Second, if you look at the forward spreads the peak of over 90 basis points is very much concentrated at the end of the year and the beginning of the next. If you look at the six-month LIBOR spread that comes down quite markedly in the market's expectations. Therefore, there is concern about what will happen at the turn of the year and that is partly why all three central banks are taking action to deal with liquidity at the end of the calendar year. The third matter is in many ways most interesting and perhaps takes me back to what I said at the very beginning in my first answer to the Chairman. We have a technique which tries to disentangle whether these spreads result from concerns about liquidity on the one hand and credit risks about other banks on the other. It is quite clear that in August and September the sharp rise in the spreads was the result of concerns about the shortage of liquidity. All the banks tried to accumulate large amounts of liquidity. The major banks now have very large stocks of liquidity. The rise we have seen in the past two to three weeks is the result of concern about credit risk. I believe that reflects the point I made at the beginning, namely it is not so much that people are worried about the magnitude of the total losses in the subprime loan market; they are worried about where they are. First, there is enormous uncertainty as to where those losses are to be located. Second, there is great concern that in the future there may be further falls in asset prices that would impair the capital cushion of leading banks around the world. It is that concern, fear almost, that has been driving up the spreads. It is indeed a matter of concern, but it is what economists call a real phenomenon, not a monetary phenomenon; it is not to do with insufficient liquidity but genuine concerns about what might happen to the capital position of the banking system. I think the most welcome developments in this area have been the examples set by some of the large banks both in the US and here in terms of greater transparency about where losses have occurred and how big they are and the willingness to take on board and inject additional capital into the banks to restore that capital cushion faster than might otherwise be the case. The action of Citibank a couple of days ago is a good example. It is those developments as a means of bringing down those spreads to which we should look forward over the next few weeks.

Q13 Mr Dunne: You mentioned liquidity. If any other major banks suffer a liquidity crisis which leads them to seek the lender of last resort facility—you—does the bank's existing facility to Northern Rock constrain its ability to provide liquidity to the banking system?
Mr King: No.

Q14 Mr Dunne: Therefore, you will be able to provide facilities?
Mr King: I am certainly not going to imply that that is remotely likely, but what we have done so far does not constrain our ability to provide whatever liquidity we think is necessary.

Q15 Mr Dunne: In relation to the impact of credit tightening on the real economy, have you seen any signs of contagion from the financial markets into underlying credit availability to the corporate sector?
Mr King: In terms of corporate ability to obtain funds from the banking system, clearly there is a sign of a tightening of credit conditions in terms of both higher borrowing rates and, for the riskier borrowers—the non-investment grade corporate borrowers—tightening in the availability of credit. So far the surveys carried out of businesses do not suggest that this tightening in borrowing conditions is having a very big impact on investment spending or intentions, though one would expect that to come through in due course and that a tightening of credit conditions by the banking system would feed through to weaker spending. That is in our basic forecast. On the household side so far there is not a great deal of evidence of it apart from riskier borrowing, which in this country is described by the rather inelegant phrase "adverse credit borrowing", where for those kinds of borrowers who already

have a history of poor credit repayments, clearly conditions have become much more difficult in terms of both availability and a substantial increase in spreads, but for ordinary mortgage borrowers, whether floating or fixed rate, there has not been a significant change yet in credit conditions.

Q16 Mr Dunne: You do not regard the 37% reduction in mortgage advances in October as a significant sign of tightening?
Mr King: That is not necessarily a sign of tightening; it may be due to a reduction in demand, but certainly loan approvals have fallen. That is something which reflects in part demand and not just the supply conditions. If you look at the interest rates at which people are able to borrow there has not been a major change; there has certainly been a fall in the demand for borrowing.

Q17 Mr Dunne: Has there not been a significant fall in the loan to value ratios applied by mortgage lenders?
Mr King: Loan to value ratios have already been much lower than they were in the late 1980s and early 1990s. I do not believe that is the constraint. There is more of a constraint on loan to income ratios which have been higher than in the past. I am sure lenders will feel constrained because their ability to fund mortgage lending has become more expensive. I would expect to see that feed through. What I am saying is that if you look at the rates currently available there does not seem to have been a significant impact, but again we would expect to see this flow through; in other words, at present our judgment in the forecast is that, in the banking system clearly there has been a tightening in credit conditions both in terms of banks being willing to lend and the price at which they will lend. In terms of the borrowers, we do not yet see a major impact, but we do not expect it to continue. We would expect to see both on mortgage borrowing and corporate borrowing some impact. It is worth pointing out that even in the United States, when the Federal Reserve was asked whether it was still possible for investment grade corporate borrowers to obtain funds the answer was, "Yes, absolutely." This is something that is still very much focused on the housing market.

Q18 Peter Viggers: In its monthly bulletin the European Central Bank talks about a number of additional open market operations with varying maturities being made available. Press comment has talked about the Bank of England's reticence in providing three-month liquidity and other liquidity. There is less emphasis in your inflation report on market operations and yet your statement to us today says that your operations are similar to the measures announced in recent days by the Federal Reserve and European Central Bank. Would you please compare and contrast your attitude to providing funding with those of the European Central Bank and the Fed?
Mr King: I think actually they are all remarkably similar. One of the points most people fail to understand, perhaps quite reasonably since money market operations are a relatively arcane part of the central banking arena—many in the City often have difficulty understanding it—is that the European Central Bank has not increased the amount of liquidity at all since the beginning of August. It has redirected some of the liquidity that it would have done at one-week term to three-month term, but the total amount of liquidity that it extends to the banking system is absolutely the same now as it was in June and July before the turmoil began in August. That is not readily understood by many people. The amount of liquidity that we are extending to the banking system is almost 30% higher. I do not put enormous weight on that. I think what we have is a system, which I prefer, in which the banks can choose their own reserves targets. If they say they would like to hold more reserves with the Bank of England we readily supply it on demand. That is why we are supplying 30% more now than we were. Equally, the Federal Reserve has not raised the total amount of liquidity very much. There is a certain myth in all this that goes around and we take our share of the responsibility for not explaining it properly, but it is not easy to get across these points. I have tried to do so in the past two or three months, but understandably most people have more interesting things to worry about than the arcane matter of liquidity and money market operations. In terms of what the three central banks have announced in the past week—who work closely together—basically we are all doing the same thing, namely to ensure that in the maintenance period which spans, say, December into the January/New Year period, banks that are concerned about obtaining liquidity at the end of the calendar year will be able to lock into that liquidity at the beginning of the maintenance period by borrowing for a longer period that goes across the end of the year. That is something which all three central banks have done and what we are announcing today. We announce it today because this is the date of our weekly money market operation statement. The announcement went out on the wire services at nine o'clock this morning.

Q19 Peter Viggers: To switch to a different area, considering the components of the bank's gross domestic product forecast such as consumption or net trade, perhaps each of you would say which would have presented the greatest risk in September and how that situation has changed through until November. Professor Blanchflower, perhaps you would start.
Professor Blanchflower: Obviously, my concern has been that output will decline more to the downside than perhaps others have thought. At the moment the difficulty lies in forecasting exactly where it would be. My concern is that consumption will drop, but it has held up somewhat stronger than I would have thought. My concern is that the housing

market declines and there will be declines in consumption. Therefore, my concern has been on the downside in both consumption and output.

Ms Lomax: I would give a very similar answer. The big area of risk in my mind is consumption. It was so in September and it still is. It is by far the most important component of demand and one that is most likely to be impacted by a tightening in credit conditions.

Mr King: You asked about September. I would say that what most likely concerned me then was investment in housing and particularly commercial properties. I would put the focus back on investment given that is where we see the figures change in credit conditions and where in the United States it has been the main cause of the slow down in that economy. There has been a sharp fall in residential investment. Our housing market is very different, but I think the commercial property sector has the possibility of generating a sharper fall in investment and that is where I see the main downside risks.

Mr Bean: I have some sympathy for that view. Ms Lomax is obviously right about consumption being the largest component, but various elements of investment tend to be particularly volatile. As we go into the new year, the places where we might see particularly sharp contractions in demand are more likely to be associated with the investment part of demand.

Professor Besley: I agree with that. In the near term I am particularly concerned that with a much more uncertain macro-economic outlook there may be a tendency to postpone investment projects, so it is not coming through so much as a change in the cost of capital through the credit markets but more as a general sentiment that people will postpone particularly investment projects over the near term.

Q20 Peter Viggers: We are looking specifically at households. Why do you think they have been so slow to reduce spending bearing in mind the rising interest rates?

Professor Blanchflower: There are some signs that they have started to reduce their spending. I have made a couple of visits in the past month to Birmingham and Manchester. The story I hear is that from about the beginning of October the footfall started to decline quite a lot. I spoke to a number of retailers in large shopping centres in both Manchester and Birmingham. Yesterday people told me that in the past three weeks they had seen a significant decline and it was important to see what would happen this Christmas. That was the impression I gained from my regional visit which has not yet been picked up in much of the data. Literally, people have been saying to me that the past three weeks have looked soft.

Q21 Mr Fallon: Ms Lomax, I come back to your comment that policy may now be on the restrictive side. I think you told the Chairman earlier that you were still waiting for business surveys and the like, but if there is now a downturn in the commercial property market, given what the professor has just said about high street spending, is it not fairly obvious that the economy is slowing pretty rapidly?

Ms Lomax: There is not much hard evidence of that yet. So far the business surveys have been patchy rather than uniformly pointing to a sharp slow down. We had one month where we had quite a weakening in one of the important surveys, but recent surveys have suggested some bounce back. It is not yet a sustained picture even in the surveys.

Q22 Mr Fallon: But at the end of your speech in Hull you said that we were facing either a force 6 or force 8. That rather implies you think that rates may already be too high.

Ms Lomax: I put some weight on the forecast. We forecast a slow down and I still believe that is likely to happen but it is based on the implications of something which is very unusual, namely this particular event in the money and credit markets for which there is not much precedent.

Q23 Mr Fallon: Governor, to put a more general point which is related to Mr Dunne's question, if the interbank rate has been so far out of line with the policy rate for so long and households now face the prospect of paying much higher rates for their mortgages, what do you say to the criticism that this short-term rate-setting is now becoming rather academic and divorced from events in the real world?

Mr King: We have never set the interest rates paid by any individual borrower. Perhaps the best example of that is not what has happened in the past two months but the previous 18 months when we raised interest rates by a total of 125 basis points and on average only half of that came through into mortgage rates. The rest corresponded to a squeeze in spreads resulting from greater competition and keener pricing for mortgage lending. That is the result of the competitive market out there. Our job is to set bank rate and then competition and other changes, indeed the risk premium, will determine the interest rates that are actually charged to individual borrowers. For quite some years we have been through a period—this was really the story until August—when our concern in the central banking world was that the risk premia being charged in private financial markets had become excessively compressed. We were concerned that, although we were raising interest rates, those increases were feeding through insufficiently and risk premia had become too narrow. What has happened since then is part of a welcome re-pricing of risk. How far this will go is very hard to say, but our judgment—the forecast in the report is based on this—is that there will be some return of the high spreads we see at present but we will not go back to where we were at the very beginning of August. Some of the very narrow risk premia being charged in mortgage markets in particular but also elsewhere will be somewhat higher than was the case at that point. That will have a permanent impact on the link between borrowing rates faced by consumers and

the level of bank rate that we set. There is no doubt that the level of bank rate we set does influence the interest rates charged by private capital markets, but it does not determine them uniquely; other factors such as risk premia clearly enter into it, and should do so.

Q24 Mr Fallon: But it does not seem to have influenced them as directly and successfully as you might have wanted it to do so.
Mr King: I am not sure. Typically, if we change mortgage rates by 25 basis points that will come through over the next couple of months, but if there are other things going on at the same time—over a three-year period we saw a significant and steady compression of spreads in the mortgage market—over a period the cumulative total of our change in interest rates will not map one to one the cumulative change in interest rates to borrowers. I do not believe there is any evidence that our policy changes are less effective than they were before; it is merely a reminder that changes in sentiment and the analysis and nature of the real risks out there will clearly have an impact on the terms on which private markets will make credit available. That is a very important part of the world. We cannot just wipe that out; it matters.

Q25 Mr Fallon: I understand that. Do you reject the charge that you have lost control of rates?
Mr King: I reject the charge that we have lost control of rates. We can clearly determine Bank Rate and, as I have said, I think that when we change bank rate that can be seen to flow through to the rates which are being set. I do not accept that we have lost control of rates, but I agree that we do not uniquely determine them and in circumstances such as the past three months what has happened is a big reappraisal of risks in particular kinds of markets, but not all. There has been very little change in observable risk premia in equity markets, although perhaps some in the past couple or three weeks. Before that there was no sign of a general re-pricing of risk in those kinds of markets, but certainly in the mortgage market there has been a very significant change.

Q26 Mr Love: In the bank's November 2007 inflation report it states: "Although business investment growth faltered in the first half of 2007 investment intentions have remained relatively upbeat buoyed by the strength of corporate finances." You have been a little more pessimistic this morning about intentions. Why has your attitude changed in relation to that?
Mr King: The background to the past three years is that corporate finances have been very strong and profits high. The balance sheets of the corporate sector have been very strong.

The Committee suspended for a fire alarm evacuation from 10.24 am to 11.00 am

Q27 Chairman: Governor, perhaps you would continue.
Mr King: When we were thinking about investment earlier this year we contemplated a picture in which the corporate sector had made significant profits over previous years and had very healthy balance sheets. Therefore, the prospects for corporate investment looked fairly strong. That was backed up by the investment intention surveys. Since the beginning of August a number of things have crystallised: first, the financial turmoil has changed credit conditions so that the prospects for the cost of financing investment have altered; second, as Professor Besley pointed out earlier, there is a much more pervasive sense of uncertainty and so people may postpone investment projects; third, the world economy looks softer now than it did then; and, fourth, overall there is perhaps a sense of uncertainty affecting a range of different questions, one of which is clearly how the US economy will impact on the economy of the rest of the world and what will happen to the banking system. I believe those factors impact on our judgment about the prospects for investment in particular investment in property, be it residential or commercial.

Q28 Mr Love: How much of a factor is tighter credit? Many of the companies that undertake investment are large ones with choices of investment strategies. Are tighter credit conditions and uncertainty really the main factor here?
Mr King: It may be a little too early to judge at present. Certainly, when I have talked to representative of various trade groups in the CBI I have not gained the impression that the tightening of credit conditions or the financial turmoil has had a big impact on their decisions. I suspect that is because at least in part from their perception of the business conditions in which they operate—the real economy outside the City—there does not seem to have been a dramatic change. Therefore, they still see the same arguments for strategic investments and the need to ensure adequate capacity. I suspect that over time the impact of tighter credit conditions will show up as they ask questions about how much they would have to pay in order to borrow and how easy it would be to access credit. I do not think that so far there has been a big response by the non-financial corporate sector to the change in credit conditions. The real uncertainty is looking forward: how far will this eventually impact on investment? That is why at present we have put an enormous amount of weight not only on the surveys but focusing on the numbers and data. Where we are now is very much a quantitative judgment as to what we should do in terms of our policy response.

Q29 Mr Love: Ms Lomax, you said that the surveys were key in the sense of looking forward. What about your regional agents? What role do they play? Are they becoming more and more important as you look at what is happening round the country?

Ms Lomax: This is the sort of time when reports from our agents are particularly valuable. They are timely and you can also get behind some of the bare figures, unlike even the better known business surveys, because you can interrogate what the agents are being told. We have done some special surveys and we shall commission further ones with the agents to enable us to dig under the surface of what is going on. This is a moment when the agents are a very valuable resource.

Q30 Mr Love: I should like to put a question to all the witnesses. Governor, earlier you referred to possible losses of $200 billion in the subprime market in the United States and said that it was a relatively small feature within the overall economy. Do you think there is any chance that the Americans are talking themselves into a recession and is there any prospect of it happening here in terms of the critical importance of confidence?
Mr King: I do not think they are talking themselves into a recession. There is genuine uncertainty about the potential liabilities to losses of individual institutions, in particular the tremendous superstructure of financial derivative instruments built onto basic mortgage lending to subprime households. No one quite knows where that is and how big the losses will be. Since August we have moved from a period in which there was certainly a willingness—it may be a little unfair to call it hubris—to create instruments and to assume they could be sold on and not to look too carefully at what the lending was. Some of the lending decisions in the subprime market in the United States was quite extraordinary. We have moved almost in the opposite direction where people, perhaps having had a jolt to their belief that things will always be simple and work out well, really do not understand any of these instruments and are nervous about all of them. You see quite a disconnect between instruments linked to the housing market or structured credit products—that type of financial instrument—and normal corporate bonds, foreign exchange and the spot markets which work perfectly normally. There is an interesting difference between what has happened this year from August and what happened in 1998 which is the other example of a sudden loss of confidence in financial markets. In 1998 that was really spread right across all financial markets and liquidity dried up in all of them. This has not been true in all markets; it has happened in a particular set of financial markets. I suspect it will take time before the market recognises the true nature of these instruments and re-prices, restructures, and puts them back into a market setting where they can be traded again. I suspect that a lot of the activity in those markets will not resume. The model of securitisation will certainly resume but not in quite the enthusiastic form that it reached earlier this year.

Q31 Mr Love: We may go into that more deeply when you come back to speak to us again. Professor Blanchflower, you were one of the two members who mentioned consumption as having critical importance in future. Obviously, confidence is incredibly important for consumption. To what extent do you think the framework in which we are discussing all these things—earlier the Chairman quoted eminent economists, all of whom said that recession appeared to be round the corner—will condition that confidence, and will that be important looking forward?
Professor Blanchflower: Obviously, people's confidence is important. I do not think that anyone wants to talk it down. We face uncertain, difficult times. As an economist the way to think of it is that our experience of the recent past does not help us very well. People told me that central banking would be boring. It has not been. Experience over the past 10 years does not really help us very much. I think it is more an uncertain world than people talking it down. As to the sense in the US, there has been a change in my perception of confidence. The consumer confidence numbers are weaker there and so I have a sense that in the US confidence has changed. I do not have that sense here, although some data have started to look weaker. They are hard times and people are very uncertain and do not know what is coming. As an economist it is hard to forecast in this period.

Q32 Mr Love: Governor, as to tighter credit conditions there seems to be a particular impact on small businesses. I know that they do not make up a large amount of overall business investment but they form a key sector of the economy. Are there real worries there about their ability to invest going forward?
Mr King: You are certainly right that it is difficult for smaller companies, partly because they are often more reliant upon bank borrowing. In addition, they may well be perceived as the riskier types of borrowers and it is those for whom the credit spreads have risen most. That is certainly a factor. It is more difficult for smaller companies than many larger ones which may well have quite a large cushion of retained earnings to enable them, at least for the time being, to continue their investment plans until they have adjusted to the higher level of credit conditions in general.

Q33 Mr Brady: Governor, earlier you said that monetary policy in the US was achieving its intended purpose, but obviously there is also an impact on the value of the dollar. Where do you see that moving in future and what is the wider impact of that on the UK economy and the eurozone?
Mr King: As you know, I do not forecast exchange rates and do not know anyone else who can do so successfully, but what is interesting is that for a number of years people have anticipated a fall in the dollar, a rebalancing of the world economy and, within that, a significant rebalancing in the US economy as it moves to reduce its trade deficit and slow the growth of domestic demand. That is now clearly under way. Over the past three years the dollar has fallen in effective terms by between a

quarter and a third depending on precisely how you measure it. Exports are growing very rapidly in the United States and for the first time they have just seen a positive contribution to economic growth from net trade—something that we have not managed to achieve in over 10 years. I believe that rebalancing is happening, but, as interest rates are cut and domestic spending weakens in the US, there is no doubt that the currency tensions we see are being exacerbated. In parts of the world, primarily Asia, where there is still a reluctance to see the exchange rate move markedly away from the falling dollar, that reduces the extent to which the world rebalancing can occur in a fairly manageable way. Obviously, it creates currency tensions for currencies like the euro in particular which takes the strain as the dollar falls. Here it depends markedly on the particular business you are in, because at the same time we have seen sterling reach the highest level against the dollar for over a quarter of a century it has fallen by 6% against the euro. Our effective exchange rate index, having been very stable for the past five yeas, has now fallen by just over 4% since August. We have also seen a fall in our exchange rate on average against other currencies but at the same time a very sharp rise against the dollar. These movements reflect not what is happening here but largely what happens in currency movements in the US, in the euro area and Asia. We cannot withstand those movements. We have seen big bilateral movements. Of the major currencies in recent years sterling has been far and away the most stable in terms of its average effective exchange rate, but we have now seen it start to weaken. It is impossible to know where that will go, but we still have a trade deficit.

Q34 Mr Brady: How strong is the euro area economy and how well able is it to withstand the tensions and pressures of the current financial market instabilities?

Mr King: Again, that is hard to judge and our colleagues in the euro area have expressed their concern about the higher levels of the euro which is dampening off one of the buoyant sources of demand in the euro area economy, namely exports. Their structural growth rate on average is not that high and they would think of something of the order of 2% as being the long run average growth rate they could achieve. Obviously, that can alter over time. They had been recovering quite noticeably over the past couple of years. There was a good deal of belief that perhaps they had never really recovered. Would domestic demand pick up? It did; we have seen a recovery. What is happening now has made life more difficult. All of us face concerns here and they are part of the world economy. This goes back to the discussions that the IMF tried to engender in its first multilateral consultation which included the euro area. What we are now seeking are very large current account imbalances exacerbated by very large current account surpluses in the oil-producing countries. That is a new factor in the past couple of years and it comes on top of the large current account surpluses in the emerging markets in China. This creates tensions among currencies. What is important is that the rebalancing of the world economy which is now visibly under way is accompanied by not just a slowing of the word economy but a rebalancing of domestic demand. Domestic demand is slowing in the United States and it will probably slow here. We need faster growth of domestic demand in the emerging economies of Asia so we see a rebalancing without a sharp slowdown in the world economy. That is not an easy thing to try to bring about when the flexibility of exchange rates is somewhat blocked by a reluctance by one part of the system to have flexible exchange rates at the same time as another part of the world economy does have flexible exchange rates. These are issues in which the new managing director of the IMF will want to engage quickly to see whether or not he can bring together people to find a way in which together they can plan and find a way through to a rebalancing of the world economy that does not involve a sharp slowdown.

Q35 Mr Brady: In particular how vulnerable is the German economy to the current credit market turmoil?

Mr King: I do not want to comment on individual countries; their own central banks will have views on that. Germany is a country that has seen a sharp increase in export growth and the high level of the euro will make that particularly difficult for Germany, though it has a very successful track record at exporting.

Q36 Mr Brady: Earlier you made some interesting comments about the amount of liquidity that the bank had put into the market compared with the behaviour of the ECB and the Fed. Could I draw you as little more on your reasons for doing that and why you think it has been appropriate to behave in a different way from the ECB and Fed?

Mr King: I do not think there has been a significant difference. All central banks when injecting liquidity have done so in order to maintain broadly the same amount of liquidity in each maintenance period, usually a month, as they were doing before. The Fed and particularly the ECB have been very clear that they have not increased the total amount of liquidity that they have injected into the banking system since this crisis started; it has remained constant. We have a slightly different system whereby we allow banks to choose their own reserves targets which they can change at the beginning of each month. If they say to us they would like to hold more reserves with the bank because it gives them more liquidity we supply the total amount of liquidity which banks in aggregate say they want to hold. That has resulted in our supplying almost 30% more than we did at the beginning of August in response to the banks' wishes. I think we have a very good system of money market operations. But what brings all the central banks together is their common objective to keep the overnight market rate in line with their official policy rate. We have been very successful in doing that. In

the past two months we have been marginally more successful than the ECB. But we have been more successful at present than the Fed because, as its vice-chairman pointed out yesterday, it is constrained by laws that prevent it remunerating reserves with the central bank. That means their overnight rate has been much more volatile than that in either the euro area or London, but the objective of all three central banks is very clear: to keep the overnight rate close to the policy rate so that the decisions of the Monetary Policy Committee are implemented in the money markets. That is what we have managed to do. I believe that all three central banks are concerned that, as they get to the end of the year when all banks engage in what is called window dressing, there will be pressure on the demand for liquidity. We want to make sure that the supply is available to meet that demand. Basically, all three central banks have announced the same kinds of measures.

Q37 Mr Brady: So, the difference is systemic, not policy?
Mr King: There is no difference of policy; it reflects the different practical arrangements that the central bank has adopted.

Q38 Mr Todd: I want to turn to the issue of projecting GDP growth and analysing data provided by the ONS for that task. In your latest report there is an interesting discussion of this. There is an academic article, which I confess I have not read, on presumably the methodological issues involved. The impression given is of a gentle disagreement between the bank and ONS on how to estimate growth. Is that a reasonable impression to gain?
Mr King: I shall make one point and then ask Charles Bean, the world expert on this project, to discuss it.

Q39 Mr Todd: I have seen his speech.
Mr King: The speech is excellent. The article is also very good and would make an excellent Christmas present for those interested in such things. This is not a disagreement between ourselves and the ONS. I think the ONS sees its job as being to use all the methods at its disposal to acquire data on the economy and make estimates of what is happening to output and growth. Inevitably, data accumulate slowly over time. An obvious example is that one of the main sources of information for estimating growth and corporate profits is income tax data. There is quite a long lag between when the tax data are available to the ONS even in aggregate form and the period to which they refer. The ONS has adopted the strategy of saying that its job is to try to measure and record what has been going on. Inevitably, there is a lag between the time when you try to observe activity and the date when the data arrive. What we are doing is something rather different. We try to judge what is actually happening in the economy now, not record what data have arrived in the ONS. We have found that there are systematic patterns to the revisions that the ONS makes. There is nothing terribly surprising about that. Therefore, we try to anticipate when looking ahead in our judgments what revisions the ONS is likely to make. We also use business surveys which tell us quite a lot about what is going on. None of these things is perfect, but we use our best methods to try to bring together all this information to form a judgment about what we believe is most likely to have been happening in the economy with all the uncertainties around in the form of the fan chart.

Q40 Mr Todd: I think you are drawing a distinction between your role and that of the ONS which probably not many would be able to perceive. The ONS has to estimate growth at a particular point in time, which is what you also do. You then project into the future your expectations of growth. What your fan chart in the report shows is that over the past three years, not throughout the period shown in that chart, the ONS has become less and less able accurately to estimate what is going on at a particular point in time. You have taken the estimate it has produced and mapped it against what actually turned out to be the case.
Mr King: The ONS has decided that it does not want to get into the business of trying to forecast what might happen. The ONS says that given the information it already has this is its estimate.

Q41 Mr Todd: That is not what it does when it produces the estimate of growth at a particular point in time. It is not asked to forecast what it will be but to say what it is now. What the graph shows is that it is not doing that particularly accurately and that the revisions are consistently in a particular direction and by a reasonably consistent margin. I am wondering whether you are being just a little kind about this disagreement and there is not some basis for discussing with the ONS—it probably happens already—some of the methodological issues that clearly have led you to produce your own estimate of what is happening at the moment and use that as the base for your future projections.
Mr King: What we want to do here is to be transparent as to our judgments about what has been happening. Charles Bean has talked a lot about this to the ONS, so I ask him to comment.
Mr Bean: The point I want to really ram home is the distinction between measurement, which is what the ONS is about, and interpretation which is our game.

Q42 Mr Todd: But in producing an estimate it is interpreting, is it not?
Mr Bean: The ONS is collecting information from a large number of households and businesses and on the basis of that it reports.

Q43 Mr Todd: It is interpreting to produce an estimate, is it not?
Mr Bean: Not to the same degree that we do. It is trying to report the implications of the information that it collects from households and businesses, but more information accrues over time from things like

tax returns and stuff like that. Importantly, it does not immediately fully reconcile the demand, output and income sides of GDP, which should give the same message. It does not carry out a full reconciliation of that until two years after the initial estimates are in, because it recognises there is a lot more information still coming in. We have to take a view of what we believe is happening in the economy now. As the governor has already said, the past history of revisions suggests that on average there is a tendency for the output data to be revised upwards. You said that there was a consistency about it.

Q44 Mr Todd: Only for a period. If you take your graph as a whole in the period 2001-02 the ONS's estimate was pretty much in the middle of the span and the drift has happened only in the past three or four years.

Mr Bean: No; that is a misinterpretation of what is going on. Most of the revisions occur in the year or two after the initial estimates come in. Once you are two or three years down the road there is not much more information coming in, so the data do not tend to be revised very much. The fact that our central projection—if you like, a "backcast"—lies above the ONS data for the past couple of years is not an indication that suddenly it has got worse over that period, but merely reflects the fact that the information is still coming in and revisions are most likely to occur to the most recent data, not data that is some years old. Our judgment is that it is more likely than not to be revised up, although there is a great deal of uncertainty—the virtue of putting the back data in the form of a fan chart is that it shows that downward as well as upwards revisions are possible. That reflects both the past history of revisions, which information we use in forming our judgment, and the information from business surveys.

Q45 Mr Todd: Are there any other ONS data sets that you are examining with care to see whether or not you can work better with them?

Mr Bean: The methodology that has been developed here has been designed precisely so that we can apply it across a whole range of ONS data and take account of the fact that in principle there may be accounting identities across various series that we would want to impose. For instance, we know GDP is identical to the sum of consumption, investment, government spending and net exports. Therefore, if we take the view that output growth is stronger, then it must be associated with a stronger demand component. The technology that the staff have been developing over the past few years is precisely to take account of that multi-dimensional aspect of the problem.

Mr King: I think that the principle the ONS has followed is a perfectly sensible one based on doing only what one can do. All the ONS can do is measure the information that is coming in. Guessing where it might make revisions in future based on its past revisions and business surveys is something that anybody can do. We have done it in a particular way; city economists and others might do it in a different way. It is not obvious why the ONS should take on a role that other people could do. What it can do that no one else can do is process the information that comes to the ONS.

Q46 Mr Breed: Perhaps we can turn briefly to the labour markets. Professor Besley appears to have got of lightly this morning so I shall direct my questions to him. Your colleagues at the other end of the table have rightly expressed the view that consumption is an important element of this. An important part of that is security of income, job security and that sort of thing. Why has employment growth been subdued despite what appear to be capacity pressures and weak wage growth?

Professor Besley: As you have probably observed from the report, recently we had an agents' survey directed precisely at that question. Certainly, one of the reasons—I am quite persuaded by it—is that we have observed fairly weak employment growth, productivity improvements and, in the wake of the last increase in oil prices, firms have been inclined to cut back on labour hiring during a period when wages need to adjust downwards to compensate for the rise in energy costs. That would also explain in part why employment growth has been weak over that period. You have probably read the rather nice summary in the report of the agents' findings. What comes top of the list is the productivity story, but the other supply side stories corroborate the idea that there was a series of supply side factors including higher energy costs and productivity improvements.

Q47 Mr Breed: Leaving aside the financial sector—that is somewhat different—and looking at the rest of the labour market, do you foresee next year being just as tough or will we see some sort of bounce? Will there be more potential for employment growth? The fear is that it may be on the decline which obviously will affect confidence and consumption.

Professor Besley: To the extent that the economy is slowing and the demand side is weak there will be a knock-on effect onto employment, but the imponderable is how wages respond to that. To the extent that wages can adjust in the face of that and there is a lower demand for wage increases we would expect less of that to translate into increases in unemployment. One has to form a judgment on how far there may be wage rigidity in the face of that. That is why we look forward to the next wage round to see the extent to which people demand realistic pay increases in the light of demand conditions that prevail at the time. To the extent that they do we are hopeful that there will not be a marked increase in unemployment over that period.

Q48 Mr Breed: History tells us, although it is not exactly the same, that the incidence of a modest fall in the housing market and a slight rise in unemployment generates lack of confidence which starts what can be an unfortunate spiral. You do not believe that is likely to be the case?

Professor Besley: I take slight issue with your description of house prices having an impact on this. House prices are a reflection of a number of factors which themselves would drive what we describe, namely they reflect people's confidence about their income growth over time, the availability of credit and are generally a reflection of the economy. In that sense I do not think of one causing the spiral; they are all reflections of what might be a situation where we have a relatively more difficult or less benign climate as we have been anticipating in the near term in response to some of the difficulties in credit markets we have seen.

Q49 Nick Ainger: In relation to the turmoil in the markets you said that the consequences for the UK were difficult to assess and they would be likely to be evident first in the housing and commercial property markets. Taking the situation we have now and are likely to have for a considerable length of time, there are rising energy prices, difficulties for exporters particularly at the high-value end and the aerospace sector as well and a slowdown in the housing market, which presumably will have a knock-on effect on the construction industry and Ikea, Homebase and so on. Given all those circumstances—we have not had anything like them in the experience of this Government in 10 years—surely there will be a significant impact on employment levels. If you are not of that view why is that not the case?
Mr King: I think this question goes back to what I said before about looking at the numbers and making a quantitative judgment. The qualitative description that you give is quite consistent either with the central projection in the forecast in the November report or something more serious. The judgment we made in the November inflation report was that the quantitative impact of what we had seen so far would lead to a noticeable slowing in the growth rate of the economy but not a slowdown below the long run average growth rate for so long that it would have a marked increase in unemployment. One could imagine a much sharper slowdown in the UK economy which would have a noticeable impact on levels of unemployment. That is not our central projection. I think the role of the Monetary Policy Committee now is not to pretend it can be confident as to what will happen but to look at the numbers each day, week and month as they come in and form a quantitative judgment as to what is happening to overall demand to set monetary policy on track and keep inflation close to the target with the consequence that we return to broad economic stability. That is the central projection in the November report. Of course, there is no guarantee that it will happen, and it is unlikely that it will happen as smoothly as in a central projection, but we have to monitor the data very carefully. I do not pretend that we can be confident as to what will happen, but I am confident that we respond to developments as they evolve.

Q50 Nick Ainger: Professor Blanchflower, the exchange rate is particularly important for a company such as Airbus. I read recently that the recent falls in the dollar—because all aeroplanes are traded in dollars—means that it has had to look again at the possibility of further redundancies throughout its operation in Europe. What estimate is made of the possible employment impact if the current ratio remains the same or gets even worse?
Professor Blanchflower: It is hard to know. The governor said a moment ago that sterling has fallen against the euro and so it has had a positive effect in some sense on the economy, but clearly some who trade in dollars are impacted by the bilateral change in the dollar. I have concerns about employment and I have expressed those in a number of places. There has been more slack in this labour market than others have thought, so I do not think that in the labour market we come from a position of strength. I think the explanation for why wages have been benign is that unemployment is measured in a number of ways, including inactivity and fear of unemployment, so as to that I do not quite share the views of a number of other people. There is great concern going forward that growth will not be strong because we have seen two things. In the past we have seen a growth in public sector employment which is slowing. In the past two years I have written about a number of things about it. The vast proportion of job growth has been in self-employment and obviously that does not appear to be sustainable. Something like two-thirds of all the job growth has been in self-employment and the concern has been, as referred to a moment ago, that small firms are especially impacted by a credit crunch. You might think that those folks will be particularly impacted. I am much more concerned about that and probably share your initial comment. I believe and have been saying that the implications for the labour market are not benign and that monetary policy is restrictive. I am concerned about the effects on the labour market. That has been a central plank of the views I have held which perhaps are not that different from your initial statement.

Q51 Jim Cousins: Professor Besley, you referred earlier to realistic wage increases. I just wondered what they were.
Professor Besley: They depend on the conditions of any given business. There is no answer to that for the economy as a whole. It should be determined at plant level based on the business conditions faced by specific businesses. It is not my role to dictate what those numbers should be.

Q52 Jim Cousins: The governor said that your job was to look at numbers. What numbers would make you happy if you were looking at wage increases?
Professor Besley: Obviously, if wage increases are not to impose significant inflationary pressure they must be consistent with meeting the inflation target, so we look at rates of growth of labour productivity and, on top of that, we would expect a modest increase over and above that to reflect the

attainability of the inflation target. The kinds of wage increases we have seen historically—between 4% and 5%—have been consistent with maintaining the inflation target over the period that it has been in place.

Q53 Jim Cousins: Do you think that monetary policy will be successful in containing costs and prices over the next year or 18 months?
Professor Besley: Monetary policy does not work by containing costs and prices but by trying to balance the growth of potential supply with aggregate demand in the economy. To that extent our task is to try to manage that balance. Costs and prices are a reflection of a series of decisions that are made by firms in view of the pressure of demand and the supply conditions they face.

Q54 Jim Cousins: In the monetary policy review CPI inflation is determined by the stance of monetary policy ultimately?
Professor Besley: Yes.

Q55 Jim Cousins: Do you believe it will be determined by the stance of monetary policy over the next 18 months?
Professor Besley: By and large, yes. There are many factors, particularly on the cost side—what happens to commodity prices—which will have a significant impact over that period, but in terms of the broad outlook, trying to manage the balance of aggregate demand relative to the supply potential over the period, I think that monetary policy will play a significant role.

Q56 Jim Cousins: How can monetary policy affect the impact on the economy of commodity prices, fuel price rises and so forth?
Professor Besley: It has no direct impact. Obviously, it has indirect effects through the impact of monetary policy on the exchange rate, but more generally one has to try to set a path for aggregate demand with monetary policy to be consistent with the inflation target given the forces that arise from those cost shocks.

Q57 Jim Cousins: Do you agree with Professor Blanchflower who told us earlier that he did not know what was coming?
Professor Besley: In what sense? Of course, we do not know what is coming; we are not clairvoyants.

Q58 Jim Cousins: Professor Blanchflower drew a distinction between the past 10 years in which monetary policy had proved to be very effective in containing the impact of costs and prices and managing the real market interest rates in the economy as compared with more recent times where we do not know what is coming. What is your view about that?
Professor Besley: I certainly subscribe to the view that we are perhaps in a distinctly trickier period than some of the situation we have faced in the past. When people have discussed the feasibility of inflation targets and the sustainability of such a regime questions have been raised as to how far shocks on the cost side of the economy will be particularly awkward. When we had the run-up in oil prices, which we have now seen go up again, it raised a number of questions about how to use monetary policy to balance supply and demand in the event of cost shocks. To the extent we face very unfavourable tail winds, if you like, in the form of shocks coming from the cost side, it will make the conduct of monetary policy considerably more difficult. I do not think it is anything to do with a much bigger increase in the uncertainty of the outlook as such; it is just that one faces a particular set of shocks, that is, a demand shock through the credit effect and a supply shock through commodity prices at the same time. That makes for a non-benign environment in which to set monetary policy.

Q59 Jim Cousins: Professor Blanchflower, do you agree with the Governor that the decisions of the Monetary Policy Committee will be implemented by the money markets?
Professor Blanchflower: I bow to the Governor because I do not have a particular view on that.

Q60 Jim Cousins: How successful do you think monetary policy will be in containing the impact of costs and prices on the economy over the next year or 18 months?
Professor Blanchflower: Again, I am not an astrologer. I do not know and we will wait and see.

Q61 Jim Cousins: It is not a matter of astrology; we have just been told it is a matter of numbers.
Professor Blanchflower: If you ask me what it will be going forward it depends on how the shocks come and how circumstances evolve. We are waiting and looking; we will have to see.

Q62 Jim Cousins: Governor, in your discussions with us this morning you have been talking at a very high level of the economy, for example what the big banks do and so forth, but, as we know and as you have reported, at the supermarket checkout, the garage forecourt and the train station people expect price rises. Do you think monetary policy will be able to contain those price rises?
Mr King: In the medium term, yes. As Professor Besley said, over any short period—eighteen months is a short period in terms of monetary policy—there can be no guarantee, but it is very striking to go back three years. If one supposed that oil prices would rise from $30 to $40 to almost $100 a barrel, with associated rises in gas and electricity prices, and one asked what impact that would have on the overall inflation rate, one would have been surprised to learn that inflation would stay within 1% of the target except for only one month. I believe that the regime of monetary policy has had some impact on it, in that clearly we cannot affect what happens to oil or energy prices but by monetary policy we can affect the climate in which firms set other prices. There is some evidence to the effect that when prices

change relative to others firms believe we are prepared to take action to keep inflation close to the target in the medium run and it is risky for them to try to sell at higher prices than their competitors if the consequences of so doing are that inflation moves significantly away from the target.

Q63 Jim Cousins: You are talking about the world we have known, not the world we face now. Particularly in the light of the comments we have just heard about uncertainties by the non-executives on the MPC, do you not believe there is some real risk that the committee will not be effective and will lose control of the situation and not contain costs and prices?

Mr King: There is certainly a risk that we will make judgments which with the benefit of hindsight will appear to be the wrong ones. We cannot forecast at all easily what will happen in future and in those circumstances it is particularly easy to make mistakes. Unfortunately, it is not easy to know in which direction we will make mistakes; otherwise, we could set monetary policy more easily. There is certainly a risk, particularly given the elevated level of inflation expectations to which you refer, that it will not be easy to keep inflation close to the target in the wake of further increases in oil, energy and commodity prices. That is one of the risks that the committee firmly has in mind to counter the risks we have also talked a lot about today, namely the downside risks to activity which, other things being equal, will help to pull down inflation looking, say, two years ahead. We have to balance these risks. You are quite right; there is no doubt there are risks of inflation on the upside. We are trying to balance the risks from inflation expectations and all the things you mention against the downside risks to inflation which will come if activity slows sharply.

Chairman: Governor, these are very uncertain times. We are grateful to you and your colleagues for giving us your individual views in such an open way. We look forward to seeing you again in December.

Printed in the United Kingdom by The Stationery Office Limited
1/2008 386719 19585