# Bank of England

## Quarterly Inflation Report Q&A
16th May 2012

Jeremy Warner, Daily Telegraph: What preparations are being made by the Bank of England for a eurozone break-up, and what would the initial stages of any crisis response look like?

Mervyn King: Well, I think you'll understand if I don't want to speculate in any great detail, not least because I don't want to fan the flames that are already seen vividly in the euro area at present. Contingency plans are being discussed, and have been for some considerable time, between the government, the Bank of England and the FSA, and that will continue.

And of course, the Financial Policy Committee has been looking and thinking quite carefully about the measures that banks should be taking in order to protect themselves against some of the consequences of the difficulties we've seen in the euro area.

But I hope you'll understand if I don't go into detail and elaborate on contingency plans this morning.

Linda Yueh, Bloomberg TV: Governor, on Chart 2.3 you show the household savings rate in the UK. It's about 8%. That's consistent with a longer term sort of average. The reason I point to that is that you said in your statement that consumption by households would be a source of growth in terms of driving the recovery. However, that depends on real incomes rising. So that implies that inflation needs to slow in order for real incomes to rise, if household savings are now about at the level that it was before the credit boom of the last decade.

If that is the case, is that the reason why you've paused in terms of quantitative easing, because you are worried that inflation is high and that is dampening a source of growth that you've identified?

Mervyn King: Well, I think there are two parts to that question. The first is the outlook for consumer spending, where you're absolutely right that, given where we are now, the outlook is heavily conditioned on the likely recovery of real take home pay. That has been squeezed very sharply over the past couple of years. We see further rises in gas prices later this year; there were some changes in the budget which pushed up tobacco duties.

So we see a slightly higher inflation rate than we had thought in February as a result of those specific pieces of information, and therefore that will mean that the rate of recovery of real take home pay will be a little slower over the next 6 to 12 months than we had thought in February. Not a great big deal, but it certainly affects it, and it's altered our forecast for both inflation and indeed growth.

But, I mean, I don't think that undermines the view that we do see a steady recovery coming through over the next couple of years, and it would be reasonable to suppose that the factors that have squeezed real take home pay in the last couple of years won't recur. Of course, they may - you can't be sure. But if you look at the chart we have on oil prices and metals prices, you'll see that futures markets are not expecting another leap up in those prices. And that's what would be required in order to have a repeat of the squeeze on real take home pay.

So I think it's a reasonable central view to think that inflation will come down, and that will help to reduce the squeeze on real take home pay, and hence to allow consumption to pick up.

The second part to your question is the decision that we reached last week. Now I'm not going to go into detail on that, because you'll see all the discussion the Committee had reported in the minutes next week. But I think if you just look at the outlook for inflation here, pretty close to February, where we saw that inflation is likely to come back to target - take the central view - probably a bit below, but what really matters is the balance of risks. And the balance of risks around the target two to three years from now is broadly evenly balanced.

And in that situation, yes, you can make an argument for doing more asset purchases or indeed an argument for making fewer asset purchases. But I think it's perfectly reasonable that the decision we took last week is consistent with the outlook for inflation, and that's ultimately what has to drive our decisions.

Sam Fleming, The Times: You've repeatedly been predicting that inflation will fall to 2% in recent years, and yet have repeatedly been proven wrong. Why should we believe that the Bank has got its forecasts right now? And what measures has the Bank been taking to ensure that its forecasting is more robust in the future? I mean, is there an argument, for instance, that the Bank has mismeasured the amount of spare capacity in the economy?

Mervyn King: No, well that - several different parts to that question. I think the first thing is - can I just make the point that I've been making for 20 years now - I know not to you, but I have been making it for 20 years. Forecasting is not about producing a number. It's not a spot the ball contest where you say 2.7 or 3.2. The most that you can hope to do - and we've been very open about this for 20 years - the most that you can hope to do is to assess the balance of risks.

Inevitably, if you take a forecast as a point forecast, with probability almost one, it will turn out to be wrong. The question is - what do you see in the data and does that change your view about the balance of risks looking forward?

So I think the question of whether you should take what we say seriously has to depend not on looking at precise numbers or even at the fan charts, but on - do you think the explanations we give for why inflation has moved as it has are plausible explanations? And do you think that the inferences we draw from those explanations about the balance of risks to the future are reasonable?

If you do, then I think you would say - yes, of course, no one can know the future, but these are reasonable judgements. If you disagree with our interpretation about the economic analysis, then you would probably take issue with the judgements we make about the future. But I think what's most important is that whatever debate is had is not in the context of right or wrong, it's in the context - were the explanations reasonable and did they lead to reasonable judgements about the future?

The last few words of your question - can you remember what they were?

Sam Fleming, The Times: Spare capacity -

Mervyn King: Well, I'll ask Charlie to come in on this in a second. I don't think any of us know how much spare capacity there is, and I think the big point I would make is that too much of the debate tends to turn on the question of - has there been a permanent loss of potential output and if not, why can't we recover that lost output over the forecast horizon of two to three years?

It seems to me that it is perfectly possible to believe two things which have sometimes been claimed to be contradictory, but I don't think they are. One is that I personally feel that there is no obvious reason to believe that we can't get back to the level of output that we were on on the pre-crisis trend path, but it may take 10, 15, maybe even 20 years to get there. The idea that the growth of the labour force in the long run has been affected by the crisis, and the idea that the pattern of innovations has been adversely affected is not an obvious one; it may have had some effect and maybe we have lost a bit forever. But I don't think the experiences of past crises have led to that conclusion.

But it doesn't follow from that - and it's very important that we realise it doesn't follow from that - that over the next two to three years there is a vast amount of spare capacity that you can just put your foot on the accelerator, use up, in order to expand output.

In particular the impact on the supply potential of the economy from the breakdown in credit conditions may well be holding back the supply potential of the economy. But I don't think that will be there still in 10, 15, 20 years. But it may well be there over the next two to three years.

And so I think the Committee has to make extraordinarily difficult judgements. If any of you happen to know how much spare capacity there is, then do let us know. The surveys give contradictory results. I don't think there is any easy or obvious answer to this. But maybe Charlie's got one.

Charlie Bean: Oh, well, I certainly don't have an answer. The first thing I think I'd just like to add to what the Governor has said is to stress that the primary reason that inflation has been running above the target over much of the past few years is not to do with the assessment of internal inflationary pressures, it's been due to a succession of external events. There's obviously the substantial depreciation of sterling, down 25% from just before the start of the financial crisis to the immediate aftermath of the collapse of Lehman's at the end of 2008. That's a very big depreciation.

Assessing the impact of that on inflation is obviously very difficult. That's an area where I think in retrospect we would say we were overly swayed by the experience of the early nineties, where a substantial depreciation there didn't feed through into particularly strong domestic inflation. The behaviour this time has been closer to the response after large depreciations in the seventies, eighties than that early nineties experience.

We've also had big movements in oil and commodity prices, obviously partly driven by what's happening in the emerging markets, but also driven by geopolitical events in North Africa and the Middle East. We've also had the increase in VAT, which obviously has a pretty immediate effect on inflation. So they're the most obvious things that have actually been driving inflation. It's not really been down to what's happening to the measure of excess supply.

Now, as the Governor has already said, measuring the margin of spare capacity in the economy is something that's extremely difficult. I mean, as early as I think August 2008 in the Inflation Report we started talking about the impact of the financial crisis on the supply side of the economy. It was some time in 2009 I think we started drawing attention to the tension between the business surveys, which suggested only a modest margin of spare capacity, and the output numbers, which - if you just naively projected the pre-recession trends forward would suggest that there's a lot of spare capacity.

Over successive Inflation Reports, and including this one, we talk about some of the factors which may have led to slow capacity growth, and slow productivity growth, some of which - as the Governor says - may not actually ultimately be permanent. If firms mothball capacity, they may be able to bring it back on stream. Workers may get disconnected from the labour market if they're out of jobs for a long time, but they may be able to gradually over time come back in, particularly if there's suitable policies that help them to get reconnected into the labour market.

And it's quite possible that, if firms are put off investing to implement new ideas during this period when uncertainty is high and credit might be more restricted in its availability, when conditions improve, you might find actually quite a sharp pick-up in investment in productivity advances and in potential output.

I think the other thing I'd add to this issue of uncertainty about the level of potential output, there's also uncertainty about the impact that spare capacity has on inflation when the economy is in an environment like this. It may well be different from the sort of impact that it has in more normal recessions, in particular maybe more muted firms may be less inclined, say, to cut prices if they've got spare capacity, because cutting prices may take time to show benefits in terms of increased customers. And if you don't have access to credit, or you have limited financial resources, you may not be able to take that route of suffering a temporary hit to your cash flow in order to build market share further down the road.

So there's a lot of complex issues here, in part connected with the particular financial crisis that we've gone through and the associated recession.

Ed Conway, Sky News: Governor, you said that you're reluctant to spell out the worst case scenario for the eurozone, but even the kind of best case scenario that's spelt out in the Inflation Report makes for slightly depressing reading. It says, "Even if a credible and effective set of policies is successfully implemented, the scale of the necessary adjustments suggest that a prolonged period of sluggish growth and heightened uncertainty is likely". That's quite - well, it's a thoroughly depressing prospect that the euro crisis, even if everything is done right, is still effectively going to haunt us for years.

Mervyn King: Well, I don't think we should be under any illusion that we're going to be all affected by this. The fact that we're not in the euro area does not mean we're exempt from the consequences of what happens. Our banking system is exposed to the euro area, and that will have an impact on their capital position. And our trade position is; we saw last year our exports to the non-EU countries rise, to the EU they fell. So we're certainly going to be affected.

And I suppose - I'm not going to elaborate on this - but all I would do is just refer you to what I said three months ago at this press conference. What is so depressing about it is that this is a re-run of the debates we had about the banking sector in 2007/08. These are not liquidity problems; they are solvency problems. There are big - the imbalances between countries in the euro area have created creditors and debtors, and at some point the credit losses will need to be recognised and absorbed and shared around. And until that is done, then there will not be a resolution of the problem.

And that is why just kicking the can down the road is not an answer. The European Central Bank has performed heroically in trying to buy time, but that time hasn't been used to put in place underlying fundamental solutions.

So, you know, back in 2008, the United States, United Kingdom did recapitalise the banking system. It did grip the solvency problem. What we now need is action to grip the solvency problem in Europe. And it's been two years - two and a half years now - in the making, this crisis. I hope the action will be taken.

But I think what we need to understand is that an awful lot of the debate is about - will the euro survive or will it not? And actually, that's not the interesting economic question. The interesting economic question is - the imbalances, the external deficits, the loss of competitiveness of some countries and the extraordinary gain in competitiveness of other countries, which means that some have large deficits - external deficits - and others trade surpluses. One way or another, irrespective of whether the euro survives, but one way or another those things have to be dealt with and brought into equilibrium.

And so, whatever happens, there has to be a recognition of the credit losses, a change in the relative competitiveness and a reduction in the external deficits and surpluses. And what's needed is a credible path, spelt out by the euro area, as to how they propose to achieve that.

Ed Conway, Sky News: You've been saying this for years and years, as you've said. Is it frustrating that no one seems to be listening, even when you are kind of shouting from the rooftops about this particular crisis?

Laughter

Mervyn King: I have. I will do no more shouting. I will simply rest where I've made that point; others now have to respond.

Larry Elliott, The Guardian: Just two quick questions, Governor. The first is - as you say, growth is weaker than you thought three months ago and inflation is higher, which you say makes monetary policy particularly difficult. I just wonder where you see the balance of risks there, though. Do you see the balance of risks - this is for you personally, obviously - on the growth side from the euro zone crisis intensifying or do you see the balance of risks from higher inflation? Because that's obviously going to affect your decisions.

The second one is this - if you look at Japan in the 1990s, it had very, very low short term interest rates, extremely low bond yields for very many years, zombie banks that weren't lending to the private sector and extremely low growth - a whole lost decade of low growth. That's Japan in the 1990s. Is it also Britain in the 2010s?

Mervyn King: Well, let's take the second one first, and then that leads naturally back I think into the first part.

The point about Japan was, and what we have to do, is to make sure that we don't end up with zombie banks. And I think that the measures that have been taken in the last two or three years are precisely designed to ensure that we don't. And I think one of the reasons for being concerned about the impact of the euro area's long term refinancing operations, if that were regarded as a solution and nothing else were done, is that it will create a large number of banks utterly dependent on central bank financing.

In the first half of last year our banks did pretty well in obtaining new funding - not cheaply, but at reasonable costs, and certainly better than other European banks. That became much more difficult in the second half of last year when funding costs rose, in part because our banks are exposed to the euro area periphery. There was an improvement in funding conditions - it's deteriorated a little bit in the last month or so. But our banks are seen as being standalone banks that can raise money from the private sector.

And although it's not cheap and it's not easy, that's what they have to do. And the aim of the recommendation - unanimous recommendation of the Financial Policy Committee banks was to say - look, although we've been through very difficult times, there is another storm coming towards us from the euro area. You need to be conscious of that. And rather than pay out cash distributions now, whether to employees or to shareholders, keep the cash in the bank. You can still pay it in compensation in the form of shares to employees, so it doesn't affect overall compensation - but it means you're not running down the capital of the bank. And keep the money that might have been paid out to shareholders in the bank. The shareholders have a claim on it; they haven't lost the money in any sense - to give the bank just that bit more protection when the storm comes.

Now these are difficult times. And if we'd gone into this crisis with much higher levels of capital, then we'd be a in a different position altogether and banks could be running down the buffer of capital to absorb the position.

But we're not in that position. We didn't start there. We started with an undercapitalised banking system, and we have to accept that. So that's why the FPC has been saying - well, if you have the opportunity to find more capital or to retain capital in the bank, then do so.

And I think it's very difficult to expect one to be able to predict or even, to be honest, Larry, assess the quantitative balance of risks with a situation like this. This is not a situation where it's easy to say - oh, you know, 10% probability of that and a 25% probability of something else. These are genuine uncertainties.

So to come back to the first part of your question, I think the view of the Committee is well summarised in the Fan Chart for inflation, which is looking down the road, two to three years ahead. We see inflation coming down to target, yes, in the central view. But the chance of that happening is close to zero. Something unexpected will happen, but we have no idea whether it's on the upside or the downside. You can think of downside risks resulting from significantly weaker activity as a result of a collapse in demand in the euro area, or you can see that a continuation of inflation above target might lead to a pick-up in wage increases or a loss of inflation credibility that would lead to risks on the upside. Or indeed maybe the recovery is a bit stronger than at present we think.

All of these things are very hard to calibrate. The Committee as a whole believes, on that balance, these risks are evenly distributed around the target. That's why it made no change in its policy response last week. But this is - I would stress again - this is a time when thinking about risks or forecasts in the way that we used to before 2007 doesn't to my mind make very much sense.

We have been through a big global financial crisis, the biggest downturn in world output since the 1930s, the biggest banking crisis in this country's history, the biggest fiscal deficit in our peace time history and our biggest trading partner - the euro area - is tearing itself apart without any obvious solution.

The idea that we could reasonably hope to sail serenely through this with growth close to the long run average and inflation at 2% strikes me as wholly unrealistic. We're bound to be buffeted by this and affected by it.

What we can do, and this is the great virtue of monetary policy, is to - when we see these winds coming along and buffeting us - we can change tack or course, but continuously with an eye to get back to those calmer waters of steady growth with low inflation. And that's what we can do. We have the ability to change policy fairly quickly. And that's the task of monetary policy. But it isn't easy, and I don't think that it makes sense to pretend that the risks that we face are easily calculable in terms of quantitative probabilities. There is enormous uncertainty out there.

Stephanie Sprague, M&I and Need to Know News: Governor, US Fed officials have been pretty clear lately in saying they could launch more QE in response to growing eurozone problems. Would the Bank of England be quick to respond with more QE, say if there is a disorderly Greek exit or if the problems escalate on some level? Would you be ready to respond with more QE? And would it be on a pre-emptive basis would you move, or would you like to see more evidence of problems in the banking system, tighter bank lending and so forth?

Mervyn King: Well, I don't want to link our asset purchase programme to what is happening in the euro area. What's happening in the euro area will affect our asset purchase programme via our judgement about the outlook for inflation and growth over the medium term. But if there were to be major developments in the euro area, there are all sorts of ways in which we might have to respond. And I don't want to limit it or restrict it or to link it one-to-one to the asset purchase programme.

But I'm sure every central bank in the world has been thinking about what the consequences of developments in the euro area might be and might mean for them. And I've been very struck by the time and attention which our American colleagues have devoted to thinking about the euro area and pressing our colleagues in the euro area to get a grip on it.

Stephanie Flanders, BBC: We're very aware and you've spoken a lot about the potential negative effects of a country leaving the euro or a worsening of the crisis. I just wondered whether you - I mean, one of the reasons it's so hard to calculate is obviously there's lots of things that could happen in lots of different directions. I wondered if you wanted to say something about the potential positive impacts on us of one or more countries leaving the euro, either in the short term or the long term? It's something the Office of Budget Responsibility spoke about last year when they did this scenario. Short term maybe safe haven flows.

Medium term - going to your point earlier - if this is not really about whether or not countries stay in the euro, but really about whether they address these long term imbalances, surely there could be a positive impact to us if the net result was that these imbalances were dealt with more quickly and then over the medium term some of these countries actually grew faster and were better trading partners. I understand there's a lot of uncertainty, but do you see any of those arguments as potential possibilities?

Mervyn King: Well, as I said earlier, I think the real economic issue is about how the differences in competitiveness are resolved, how the external deficits are brought down and how the imbalances are unwound. And that really is the essence of it. I don't want to speculate on whether one method of restoring competiveness of countries in the south is better than others, either for them or indeed for us. I think that draws me far too close to being seen to advise them as to what they should do, and I don't want to do that.

What I do want to do is to suggest that when *we* think about it, it is not sensible to think of this solely in terms of euro stays together - you know, excellent; euro comes apart - disaster. Whatever happens, there are major problems ahead; there are credit losses to be realised, and however they choose a solution here this is going to be a very difficult path to go through because countries like Germany and the Netherlands have yet to face up to their rebalancing which will be required, as well as the rebalancing of counties in the south.

So whatever happens, there are going to be difficulties ahead which will undoubtedly affect us. And that's a problem that we've got to navigate through.

They will have to choose the methods that they think best for finding a way to resolve those problems of external deficits and competitiveness. But I mean, your underlying point, which is that the issue should not be thought of simply as - if the project stays together that means it's good news for everyone and if it doesn’t it's bad news for everyone - is too simple. Methods have to be found now for tackling the underlying competitiveness, external financing, imbalances and indeed solvency problems.

Stephanie Flanders, BBC: But another way of putting that would be that - some countries leaving the euro is not necessarily the worst case scenario for us or for Europe?

Mervyn King: Well you'll understand why I'm very reluctant to use a form of words that could be misrepresented as my - you know advocating a solution to this. I've made the point in economic terms; I'll leave it to you to interpret that in terms of what policymakers should do.

Faisal Islam, Channel 4 News: Governor, in the past you've welcomed the impact of the depreciation of sterling on the rebalancing of the British economy to make a more sustainable economy. At what point do you get worried about the rise of sterling?

Mervyn King: Well, I don't think Central Bank Governors can ever expect the exchange rate to move exactly as they would wish. And I think the developments in recent weeks have not been entirely unexpected, given what's happening in the euro area. We have to accept that and feed it into our judgement as to what we should do for our own policy.

But there is no doubt that the big depreciation, 25% - that's still intact broadly speaking - is a vital part of the rebalancing; it's an absolutely essential part. And that's why I've always said that the approach to policy that is very important, and which I think very few people I know dissent from, is a mixture of a loose monetary policy, with low interest rates, asset purchases and a large depreciation of sterling; and on the other hand a gradual tightening of fiscal policy to get back to a much lower structural deficit over the medium term. And that broad balance of policy is the right approach, and it's the one which we are pursuing and few other countries in the world have actually got round to doing yet.

Faisal Islam, Channel 4 News: How do you explain the box on page 27 which says that the Jubilee could see half a percentage point weakness in GDP growth in Q2?

Mervyn King: Let me ask Spencer to explain the Jubilee, the Olympics and all things in between.

Spencer Dale: Thank you Governor. So as we explain in the box, there is a number of special factors which are likely to affect the quarterly pattern of growth over the next few quarters. The particular one is the Jubilee, the Diamond Jubilee where the late May bank holiday is shifted into June, plus there's an extra bank holiday as well in June. That will have the effect that output recorded in June and in Q2 as a whole will be less than it otherwise would have been if those celebrations were not happening.

We saw similar types of effects with the royal wedding last year, and our best guess was the impact of that royal wedding reduced growth in the second quarter by around 0.4 percentage points or so. And our best guess is, if anything, the Jubilee effects will be slightly - have a slightly bigger effect on the quarterly growth, in part because it is happening that much later in the quarter, it is happening in June rather than April, and so the impact - the ability for companies to make up that output within the quarter - is that much less.

So when we observe output growth in Q2, I think the way to think about it is underlying quarterly output growth would be something in the order of around half a percentage point stronger than that headline measure will show. We will then see that in the Q3 data when we go back to normal and we see a bounce back in growth.

The other effect factor which is likely to affect quarterly growth during this year is the Olympics. Trying to work out exactly how the Olympics will affect output growth is very difficult, it depends on precise - in part the way the statisticians calculate when output is assumed to actually occur. But our best guess is that that is likely to boost growth somewhat in the third quarter.

So as you look through here, I think our best guess is output, when you look at the headline numbers, underlying growth will be around half a percentage point stronger than the headline measure in Q2. In Q3 the combination of the bounce back from the Jubilee and the Olympics means you can see the growth being exaggerated by slightly more than half a percentage point, and then you'll get back to sort of a weakening in Q4 as you go back from the Olympic effect. So all sorts of zigzags in the next few quarters due to the Jubilee and the Olympics.

Jennifer Ryan, Bloomberg News: This is to follow on a little bit from the remark you just made about the balance between monetary and fiscal policy. I just would wonder if you could comment a bit on, you know whether - at a time when you've lowered your growth projections, when your central projection for inflation is to be perhaps below the target in two years' time, there's been a decision not to add stimulus into the economy when the government is looking like it's going to continue with the tightest fiscal squeeze. I mean I would have thought at this point the government might well be disappointed that there's not been a decision to add more stimulus. And you know are you also of a mind that perhaps there might be scope to loosen the austerity measures in order to promote more growth and you know - sort of following on from what's going on in Europe?

Mervyn King: Well, our task is monetary policy. We set interest rates and the programme of asset purchases. And as I said, looking ahead two years, our judgement last week was that the risks around the target were evenly balanced. So I think it was a perfectly reasonable decision to do no more.

I think you need to bear in mind that the asset purchases we've made between October and last month will continue to stimulate the economy for some time to come. The fact that we're not continuing the programme at this stage doesn't mean to say that that the effect doesn't continue to pass through the economy; it does. And the option is always open to resume the programme. I mean, we haven't made any decisions, of stop it and do no more. This is a decision we can review every single month.

But we have our task, which is to look at the balance of risk to inflation. That's what we've done and that's how we made our decision.

Chris Giles, Financial Times: Just staying on the monetary fiscal mix, could you tell us what assumed multiplier the MPC is using, given the particular form of fiscal tightening we're getting over the forecast horizon? You can tell us either it as a Keynesian multiplier or define what the headwind taking off growth in percentage points of GDP or either would do?

Can you tell us what discussions the MPC have had about whether you want to change that assumption in this forecasting round? And then maybe a follow up for Spencer, which is …

Mervyn King: You can only ask one, Chris.

Chris Giles, Financial Times: Well it's on the same question because he'll be here for the next two years at least. What would make you change your view on that particular point, on what the fiscal multiplier is and how that affects monetary policy?

Mervyn King: Let me ask Charlie to answer that question.

Charlie Bean: Okay, well I mean as far as the multiplier goes, I mean there's different multipliers associated with different elements of spending and …

Chris Giles, Financial Times: … The particular fiscal tightening that is planned?

Charlie Bean: I'm not quite clear what you're driving at when you say the particular fiscal?

Chris Giles, Financial Times: The outlines in the budget, the ones that you stick in that you assume you're sticking to …

Both talking together

Charlie Bean: I mean we basically take the various elements of spending, which are laid out in the plans, and there will be different multipliers applied to expenditure on employment, expenditure on goods and services and according to whether it's current spending on goods and services, or capital spending - because they have different import propensities and things like that. So there's not really a single number. And obviously of course there's a sort of distributed lag on these things, so that - you know it takes time for the effects to come through. So there's not really a single number for a multiplier that I can give you.

Chris Giles, Financial Times: You could take a counterfactual, which the Treasury does, which is to assume that you won't have any fiscal tightening and say - what would therefore be the effect on growth?

Charlie Bean: Oh well you could certainly conduct counter-factual policy simulations; that is not a policy simulation which certainly I've seen the results of. I mean, it's possible staff may have done some experiments which reveal that, but that is not something that I could give you an answer to here and now.

Phil Aldrick, Daily Telegraph: I just wanted to return to households quickly and the inflation projections of inflation to be above - around 2.5% to the end of the and above 2% for part of next year. You warned about a rise in mortgage costs as well, and at the same time we're seeing wage rises going up at about 1.5%. Are we going to see another year in 2012 of a squeeze on household incomes? Because you say over the longer term, you know, things are getting better, but are we going to see another squeeze this year in your judgement? And in light of the pressures on households, I just wondered if - with hindsight - you wish you had raised rates a lot earlier, looked through inflation at the time to choke off borrowing, even if it had possibly induced a recession back in 2005?

Mervyn King: Well, the question of what we might have done prior to 2007 is something we can come back to on another occasion, and of course different members of the Committee voted for different paths for interest rates during that period.

Let me refer this back to where we are now. I think - I mean you've mentioned two or three of the factors that mean, yes, there will be more of a squeeze on real take home pay this year than we had previously expected. We do know that higher energy prices, some other indirect taxes, will be higher than we had thought. We do know that the funding costs of banks have risen and that they're being passed through in mortgage rates, so at least some households will see that as an additional cost. And we do know that average earnings is rising at a lower rate than we might have expected. That's been, you know, really quite surprising, but welcome in terms of containing domestic cost inflation.

So that will continue perhaps for a bit longer, and that's the reason why our inflation projections published today are a little higher in the near term than last time, and growth is a little lower. But it doesn't affect our view about the big picture, which is that the big picture remains one of a gradual recovery and inflation falling back to the target. And that is the big message I want to get across to you.

Phil Aldrick, Daily Telegraph: But in 2012 in particular - we had 2011 and 2010 were difficult years for households. Is 2012 going to be as bad, or is it going to be another year of falling real household incomes?

Mervyn King: I don't think it's likely to be as bad. I mean, last year inflation was 5.2% in September; we said it would fall back; it has fallen back, and it has further to go. And we think that as we get into next year it will come back towards target. So, you know, there are a great deal of uncertainties; this is clearly affecting spending and demand, but the squeeze on real take home pay is continuing a little longer than we'd expected for the specific reasons that I have just mentioned.

| | |
|---|---|
| Nils Blythe: | So let's stick to the one question rule. |
| Guy Faulconbridge, Reuters: | Governor, with the storm clouds on the horizon and inflation above target, I wonder if you could give us a little bit of an insight in what sort of options you see for supporting growth and helping the recovery? And - I will break the rule - are you concerned that quantitative easing might be bringing diminishing returns for the real economy? Thank you. |
| Mervyn King: | Which question would you like me to answer? |
| Guy Faulconbridge, Reuters: | Both. |
| Mervyn King: | No you've got one or the other, I'll give you the choice otherwise I'll choose. |
| Guy Faulconbridge, Reuters: | Well everybody else had two, probably three I think. But the first one then, please. |
| Mervyn King: | The first one. |
| Guy Faulconbridge, Reuters: | A little bit of an insight in your thinking on what you could do to help? |
| Mervyn King: | Well our options are fairly constrained; I mean we have monetary policy, that's the tool that we have. Clearly the Financial Policy Committee can try to improve the resilience of the banking system in the light of the storms heading our way, but the real question is how much monetary stimulus we inject into the economy.<br><br>And I think what's quite important is that people don’t run away with a thought that - because there are uncertainties and unexpected things happen - therefore we should abandon the |

view that the major instruments of macroeconomic policy can work; they can work. And the MPC will have to make a judgement month by month as to whether it does or does not want to inject more monetary stimulus.

Laura Kuennsberg, ITN: Thank you. Mr Governor, you say we should look at the big picture. For many families the big picture has been expecting inflation to come down by the end of this year; you've told them that again and again. Now you're telling them that's not going to happen. Why should they trust you this time? And I know it's very difficult to put numbers on it, but you say the euro is tearing itself apart with no solution in sight. What might the consequences of a real deterioration in the eurozone look like for families in this country?

Mervyn King: Cleverly tried to wrap two questions into one. One has to admire the technical merit and the artistic interpretation. Let me try and give you an answer that blends perhaps into both of those.

We have never said what would happen to inflation, we've always talked about the balance of risks. And we've talked about the fact that we thought it was very likely that inflation would come down. And I'd just remind you that, when we met here six months ago, the inflation number was 5.2% and it has come down very close to the number that we thought it would do.

Now what's happened since is that we got very specific news about gas prices in the autumn, we had some news in the budget, which lead us to feel that inflation is likely to be higher over the remaining part of this year than we thought. But it's still the case that, even if those gas price increases take place, that you should expect to see some further fall in inflation at the end of the year as the large increases in domestic energy prices that took place at the end of last year drop out of the 12 month comparison.

So I'd still expect that to happen, and I think we still expect - and I think it's a reasonable view - that given the spare capacity in the economy which you can see in the unemployment rate, that this will gradually bear down on inflation and that inflation will fall back. And we see very contained domestic cost inflation, which is the main argument for thinking that gradually inflation will come back.

Laura Kuennsberg, ITN: Sorry can you just answer on the euro point, what might the consequences look like?

Mervyn King: Well we'll come back to that if there's a chance for another one. We must go around to others first.

Ben Chu, The Independent: Governor, in your opening remarks you said that there were two major factors behind the fact that the recovery has been less healthy than we hoped for - the credit squeeze and high commodity prices. But what you didn't mention was the fiscal tightening that's been put in place. I was wondering what your view is on the effect of that fiscal tightening on the pace of the recovery? And also if you could give us an insight into the view of the MPC as a whole on what impact the level of tightening has? I'm thinking particularly of the infrastructure cuts which were quite high last year.

Mervyn King: Well I don't think the Committee has formed detailed views about particular aspects of public spending. Of course the fiscal consolidation is a dampening effect on demand; that's clear. And that's why we need a rebalancing where you've got expansionary monetary policy and a weaker exchange rate boosting exports, offsetting the dampening effect on demand of the fiscal consolidation. But the point I was making was that we knew that two years ago, and there hasn't been any significant news since then.

So I think it's fair to say that current spending may have been a bit weaker than was planned, but the big picture is that fiscal consolidation has worked out as expected. What hasn't has been - and this is really quite significant - is that the funding costs of UK banks have not fallen back as we had expected, and that's because of their links with the euro area and also that the squeeze on real take home pay has continued for that bit longer and that bit more than we had thought. And we will have to see how these things evaluate, no one can forecast these things precisely. Our job is to monitor what's going on and then react to it.

Tim Wallace, City AM: Governor, you've spoken a lot about the need for rebalancing in the eurozone and the length that might take in various aspects. Are you worried that the austerity consensus in the eurozone is showing signs of fraying around the edges?

Mervyn King: Well that's not for me to judge; it's for them. All I would say is I refer you to what I said earlier, which is the underlying problems are not really fiscal problems. The underlying problems are ones of competitiveness, external deficits and the need to ensure that the differences in competitiveness that have emerged in the last decade can be undone. Then economies move back to a position where the very large flows can be significantly reduced in order that the debtors can no longer be as large debtors and the creditors won't be as big creditors. And that has to be - that is the ultimate problem that has to be tackled.

Now there are several ways you can do that, and that's for the euro area to judge and not for me.

Ainsley Thomson, Dow Jones: Can you please explain a bit more by what you mean when you say credit losses being recognised in the eurozone. Do you

| | |
|---|---|
| | mean that there'll have to be more sovereign debt restructurings that impose losses on bank holdings of sovereign bonds? |
| Mervyn King: | That depends entirely on how they choose to resolve it. But if you've got countries which have lost so much competitiveness that they are having to continue to borrow from abroad without any obvious end in sight, someone has to be prepared to finance that. And what happened in the second half of last year was that the private flows financing external deficits dried up and have been replaced by official flows. They can't go on indefinitely, otherwise the debt burdens become unsustainable. Some means have to be found for ensuring that those flows get reversed. |
| William Keegan, The Observer: | Mr Governor, further to Faisal's question, you did say then that there's substantial devaluation of rates. But what happens - we know markets tend to overreact. Supposing the pound just goes on up and up and up? Is your policy to continue to be one of non-intervention? |
| Mervyn King: | Well, that's a question which is a perfectly reasonable question to ask, but it's one I will answer if and when it happens and not as a hypothetical question. But I'm very pleased to see someone here who remembers the days of trade deficits and the problems that can result from that. |
| Nils Blythe: | Anyone else who hasn't asked a first question. I think Sam has his hand up first for a second question. |
| Sam Fleming, The Times: | Just another question on GDP. You have been quite sceptical about the GDP numbers in Q1; I think that's reiterated in the Inflation Report. I just wondered - what are the particular areas of concern? For instance, do you question whether services growth in the first quarter was as weak as the ONS seems to think? Is |

your scepticism focused on the construction data more than anything else? I'm just wanting a little bit more detail on how much weight you're placing on the Q1 GDP figures?

Mervyn King: Let me pass that to Spencer.

Spencer Dale: So I think it's fair to say - and we've said it in the Report - there's a number of indicators which you can look at which point to a somewhat stronger pattern of growth or stronger level of activity in Q1 than is currently estimated by the ONS. So one of those would be the business surveys for both manufacturing and services. I think developments in the labour market are also quite hard to square with falling output, when you see employment increase and you see hours worked increase. And it's also quite hard to square with the sorts of anecdotes and reports that we get from our network of agents all around the country.

So I think we think there's some - some of these other indicators suggest activity may be somewhat stronger and then hence the ONS data may be revised up.

But I think the big picture that both the ONS data are pointing to and which these other indicators still point to is one of pretty weak growth. So I don't think there's a sort of huge distance between the two of us, both of us in terms of the ONS data and these other indicators are pointing to an economy which is growing weakly, which is growing less strongly than either households or companies want to see. And that's exactly why the MPC in October and again in February increased its asset purchases to try and stimulate growth.

So I think in terms of the big picture, we have an economy growing too weakly which is why monetary policy remains highly stimulatory.

Guy Faulconbridge, Reuters: Are you concerned that quantitative easing might be bringing diminishing returns to the real economy?

Mervyn King: No, I don't think we have any serious concerns that there are diminishing returns. I think - as I think I pointed out at an earlier press conference - the circumstances in which you carry out asset purchases can certainly affect its impact. But I don’t think in or of themselves there are inevitably diminishing returns, no.

Guy Faulconbridge, Reuters: So are you suggesting that the circumstances could change?

Mervyn King: No, well the circumstances in which we've carried out our three programmes have been rather different in each case. And, you know, in one case it was completely unexpected and in another case it was expected. So I think the impact you'd expect to see on yields and so on will differ according to circumstances.

But I don't think that in and of itself we believe that there are diminishing returns. What we see is - when we carry out asset purchases, we inject money into the economy. The people who swap money for the gilts that we buy then use that money to buy a whole range of other assets. And that happens - will happen again if we do more, just as it happened when we started it. So I don't think diminishing returns we see to be the big issue here.

Jennifer Ryan, Bloomberg News: Governor, you've got a year left in your term. Can you imagine leaving with all of this stimulus that's been provided still in place, and do you imagine that might be a difficult legacy to leave your successor?

Mervyn King: Whether or not it is, and whether I can imagine it, will depend entirely on what happens to the economy and in particular the world over the next 13 months and 12 days - whatever it is. And I don't have a crystal ball. If you've got one, do tell me so I can make my plans; otherwise we will just have to see how these things evolve over the next 12 months.

Nils Blythe

And I think that is a fitting note on which to end. So thank you very much indeed, all of you, for coming along this morning.

END