TC OPENING STATEMENT 26 MARCH 2008

MERVYN KING, GOVERNOR OF THE BANK OF ENGLAND

Chairman, the past week has seen significant volatility in financial markets, a further sharp cut in interest rates in the United States and, at home, the news that inflation rose to 2.5% in February. I would like to explain our own interest rate decisions – we have cut Bank Rate twice to its present level of 5.25% since the Monetary Policy Committee (MPC) last appeared before you in November.

Following increases in gas and electricity bills, consumer price inflation has risen. The central projection in our February *Inflation Report* is for it to rise further, to around 3%. That pronounced pickup stems from sharp rises in commodity prices around the world. Food prices on world markets are more than 50% higher, and oil prices two-thirds higher, than they were a year ago.

The time lag between changes in interest rates and their impact on inflation means that the MPC can have little effect on the short-term path of inflation. What is crucial is that the pickup proves to be temporary, just as the rise in inflation last year was. Even if commodity prices remain at their present high levels in the face of a slowing world economy, our central projection is for inflation to fall back towards the 2% target, starting later this year.

In judging where inflation is likely to settle, we have to gauge the balance of two risks. The **first** is that a sharp slowdown in the economy this year, driven by the credit crunch, creates a margin of spare capacity that pulls inflation down below the target next year. The **second** is that rising inflation enters the expectations of those setting prices and pay and that, without some margin of spare capacity, inflation persists above the target.

Our central projection in February was for economic activity to slow quite sharply this year as the world economy turned down and credit became less widely available. But we also judged that some slowing in the pace of activity from the rapid rates of last year would be necessary to make sure that inflation returned to the target next year.

Surveys suggest that the economy has slowed, but so far modestly. The world economy, particularly the United States, has weakened, but the recent fall in sterling should help to cushion the impact on exports. And the official data on retail sales show that spending has this year been surprisingly resilient. In contrast, both activity and prices in the housing and commercial property markets continue to weaken. That stems in part from the continued tightening of credit conditions reflecting the turmoil in financial markets.

The financial crisis has moved into a new and different phase. Across the world, confidence in financial markets is fragile. It is not that banks, at least in the United Kingdom, have made loans that are likely to result in unsustainable losses. The heart of the problem is not in the real economy; it is in the financial sector itself. It stems from an ‘overhang’ on banks’ balance sheets of assets in which markets have closed. These assets cannot now be sold or used to secure funding in the market – they are difficult to finance. That has created uncertainty about the strength of banks’ financial positions.

These are the sort of circumstances I described in my statement to you in September as those in which central bank action is necessary to prevent a major shock to the system as a whole. I want to assure you that the Bank will provide the liquidity assistance that the system needs in order to restore confidence. Such lending can be only a temporary measure but it can be a useful bridge to a longer-term solution, which is why the Bank expanded the range of eligible collateral to include mortgage-backed securities in its 3-month lending operations in December, January and March. I can confirm that the January auction will be rolled over on 15th April, with the size of the auction to be decided in the light of market conditions at the time.

It is unrealistic to assume that markets for many asset-backed securities are likely to re-open speedily or, when they do, to their previous levels of activity. So we are discussing with the banks how a longer-term resolution of the problem might be reached. It is too soon to say where those discussions will lead, but two principles would underlie any central bank role. First, the risk of losses on their lending should remain with banks' shareholders. The banks neither need nor want the taxpayer to insure them against these losses. Second, a longer-term solution must focus on the overhang of assets and not subsidise issues of new assets. One of the lessons of this financial crisis is that providers of mortgage finance had underestimated the risks, and hence the true cost, of the securitisation process.

Chairman, I am grateful for the opportunity to make these remarks. I and the other members of the MPC here today stand ready to answer your questions.