Group Economics

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The King's last speech as the focus shifts to Carney

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Last month Sir Mervyn King delivered his final regional speech as Governor of the Bank of England in Belfast. Although it will be another five months before it can be definitely declared that *'the King has left the building'*, financial markets have already shifted the focus onto the words of his successor - Mark Carney.

In the world of football, the transfer window closed on the 31 January with no premiership side signing a megastar last month. However, in the sterile world of central banking, the UK Chancellor unveiled a central banking galactico which took the global financial community by surprise. George Osborne unveiled Mark Carney as *'the outstanding central banker of his generation'*. Praise has been heaped upon the Canadian central banker with the Chancellor stating *"he is quite simply the best, most experienced and most qualified person in the world to be the next governor of the Bank of England and to help Britain's families and businesses through these difficult economic times."*

Given this billing it is quite clearly a case of *'No pressure Mark!'* Financial markets eagerly await what he will or won't do. We got a glimpse of Mark Carney's views in a rare speech on monetary policy at the World Economic Forum in Davos. He was quick to shoot-down views that monetary policy is maxed out. This suggests there may be more policies in his toolbox, to inject additional stimulus into the UK economy, when he starts his 5-year term in July. As a result, financial markets are forming the view that the new governor will be even more dovish on inflation than the current one.

Now, what has Mark Carney's view on monetary policy got to do with the price of bread? Well, quite a lot actually. To the layperson, inflation may be one of the most boring subjects within the dismal science, but it will continue to have far reaching implications for all of us. Furthermore, if the new governor has a higher tolerance for *'temporary'* above-target inflation *(current MPC target 2% y/y)* will weaken sterling on the currency markets. In turn, this fuels further imported inflation.

While we may see further monetary policy action from the Bank of England in the months ahead, it is worth taking a stock take on the action so far. Next month represents the fourth anniversary of the Bank of England's benchmark interest rate being lowered to a record low of 0.5%. In addition, £375bn of Quantitative Easing *(QE)*, or asset purchases, has been undertaken. In his Belfast speech, Sir Mervyn King was quick to point out that this injection, equivalent to 25% of UK GDP *(or 13 times the annual economic output of Northern Ireland)*, was crucial in avoiding a depression. However, these gains from the monetary policy applied thus far have not come without substantial costs too. Not least, the persistent above target inflation that has seen consumer price inflation (CPI) average 3.5% over the last three years.

For heavily indebted corporates, households and governments inflation is their friend. After all, debts are fixed in nominal terms and its value, in real terms, is inflated away. From another perspective, however, inflation can make it more difficult for households to reduce their debts. Indeed, for many UK households the rampant food and fuel price inflation has significantly reduced the income left to pay down their credit card and mortgage debt. In effect, reducing or de-leveraging

household debt is deferred as prices are rising faster than incomes. Looking at UK inflation over the last five years, food prices have risen by 28%, electricity and gas bills are up 59% and transport prices *(includes public transport)* have increased by more than 50%. Whose incomes have risen sufficiently to offset the costs of these necessities? Meanwhile, the overall consumer price index has increased by almost 18% over the same period. Inflation is certainly not the friend or those with no debts and / or on lower incomes. Relative to the UK, Northern Ireland has a higher proportion of lower income households. As a result, inflationary pressures have more of a negative impact in NI relative to more prosperous parts of the UK.

The same applies to those individuals in receipt of state benefits. Last December's Autumn Statement announced that many working-age benefits will rise by just 1% per year for the next three financial years. This marks a break with the past whereby benefit recipients were guaranteed that payments would rise in line with consumer prices. Now, this link has been broken and the higher inflation is, and the higher Mr Carney's threshold for above-target is, the bigger the squeeze on household incomes.

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