House of Commons

Treasury Committee

Bank of England February 2010 Inflation Report

Oral and written evidence

Tuesday 23 February 2010

Witnesses:

Mr Mervyn King, Governor, Mr Charles Bean, Deputy Governor, Mr Spencer Dale, Executive Director and Chief Economist, Ms Kate Barker, External member of the Monetary Policy Committee, Professor David Miles, External member of the Monetary Policy Committee, Bank of England

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Oral evidence

Taken before the Treasury Committee

on Tuesday 23 February 2010

Members present

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Jim Cousins
Mr Michael Fallon
Mr Andrew Love
Mr James Plaskitt
John Thurso
Mr Andrew Tyrie
Mr Mark Todd
Sir Peter Viggers

Witnesses: **Mr Mervyn King**, Governor, **Mr Charles Bean**, Deputy Governor, **Mr Spencer Dale**, Executive Director and Chief Economist, **Ms Kate Barker**, External member of the Monetary Policy Committee, **Professor David Miles**, External member of the Monetary Policy Committee, Bank of England, gave evidence.

Q1 Chairman: Governor, welcome to you and your colleagues on this examination of the February Inflation Report. Can you introduce your colleagues for the shorthand writer, and I believe you have a short statement afterwards.

Mr King: I do indeed, Chairman. Good morning to you all. On my right is Spencer Dale, the Bank's Executive Director for Monetary Policy and Chief Economist. On his right is Kate Barker, one of our external members and, sadly, making her last appearance before this Committee; on my left is Charlie Bean, the Deputy Governor for Monetary Policy, and on his left is Professor David Miles, another of our external members. If I may, Chairman, since members of the Monetary Policy Committee last came before this Committee there have been some signs of a recovery in demand around the world and also at home. But this nascent recovery is fragile. The tensions that underlay the build-up of large world imbalances have not been resolved and, at home, bank lending to the non-financial sector continues to fall. So the risks to the Committee's central view of a gradual recovery of output remain to the downside. Some countries, especially those whose banking systems were relatively unscathed by the crisis, have seen strong growth in recent quarters, but recovery in our largest export market, the euro area, appears to have stalled and, as I highlighted in my speech in Exeter, to maintain levels of economic activity around the world, high savings countries must expand their domestic demand while low savings countries are reducing their net borrowing from abroad. At present, there is little evidence that this is taking place. Some countries are reducing significantly their borrowing from abroad, but without a compensating pick-up in external demand for their goods and services, these countries will continue to experience weak recoveries. The euro area is a microcosm of that broader problem. In contrast, conditions in financial markets have continued to improve with the prices of many risky assets rising and risk premia declining somewhat. Short-term funding markets are almost back to normal with interbank lending spreads remarkably close to their pre-crisis levels. That has fed through to some recovery in property markets where prices have risen by around 10% since their troughs last spring. Nevertheless, markets in a range of securitised instruments have not re-opened and are unlikely to do so without fundamental reforms to their design and transparency, and there is a considerable challenge for the banking system to refinance the funding it has obtained with support from the public sector. As the financial sector repairs its balance sheet other sectors of the economy, especially the public sector, also need to strengthen their finances. As a result, there is likely to be a considerable drag on spending. To offset the effects of these headwinds the Monetary Policy Committee decided at its February meeting to maintain the unprecedented level of monetary stimulus by holding Bank Rate at 0.5% and maintaining the stock of assets purchased over the past year at £200 billion. The effects of the money financed asset purchases will persist and, together with the low level of Bank Rate, will continue to provide a substantial boost to money spending for some time to come. In addition, output in the economy is still benefiting from the effects of the depreciation in sterling that occurred in 2007 and 2008. Judging how these various factors will play out is an extremely difficult challenge. In part that is because the effects of the stock cycle, the restoration of the standard rate of VAT to 17.5%, and even the cold weather in January, mean that data are likely to be volatile over the next few months. Last week I wrote an open letter to the Chancellor to explain why inflation had risen to 3.5% in January, more than one percentage point away from the target. This is the third episode in which I have written such open letters. As in the previous episodes, the Committee believes that the current high level of inflation reflects temporary factors such as the increase in VAT, higher oil prices, and the effects of the exchange rate depreciation continuing to feed through. We are conscious that just four months earlier inflation was only 1.1%, and the Committee believes that although it is likely to remain high for

a few months more, inflation is more likely than not to fall below the 2% target over the forecast period, as the influence of spare capacity bears down on inflation. Chairman, our economy has embarked on a process of healing; that will take time. The crisis has left us facing many serious challenges. Among them are how to reform the international financial system, how to reduce our largest peacetime fiscal deficit, and how to restructure our banking and financial system to prevent another more serious crisis in future. The crisis did not originate in the non-financial sectors of the economy, but that is where most of the costs are falling. You do not need me to tell you that its impact is not just economic but also social and political in nature. Throughout the crisis your Committee has led the way in putting forward proposals to leave the UK economy better placed in future to meet those challenges. I thank you for that, and I look forward to working with the Committee again in a new Parliament, and, with that, I and the other members of the Monetary Policy Committee here today stand ready to answer your questions.

Q2 Chairman: Thank you very much, Governor. In November 2009 you told us that the key risk to the UK's Triple A credit rating would arise "from possible concerns in financial markets that might arise if other countries got into serious fiscal difficulty and it created a more generalised concern about fiscal deficits around the world". Given the need for a bail-out of the Greek economy and serious concerns around the fiscal position in other European economies, such as Spain, Portugal and Italy, are you now more concerned than was the case in November last year about the possibility of the UK's credit rating being downgraded?
Mr King: No, I do not think anything has changed and I think we are very different from Greece. It is very clear that we have a political consensus on the need for fiscal consolidation; we have a very good track record in the past of meeting our obligations; we have our own currency which gives us greater freedom of manoeuvre, and we also have a public debt which has a much longer maturity so that we are not faced with the same rollover re-financing problems which afflict many other economies. In fact, in the UK we should be grateful that we have a maturity of our public debt which is almost twice that of any other country.

Q3 Chairman: Examining the statistics on the UK's budget deficit and debt levels compared to other EU Member States, it appears that debt levels are comparable to those of countries like Germany, France and Austria. Do you think analysts and the rating agencies are exaggerating the problems that the UK faces and "unfairly" focusing on the UK?
Mr King: We do have a very large fiscal deficit and we have yet to tackle that, and I think the rating agencies are bound to remain somewhat uncertain until we see measures clearly announced and defined that will deal with that fiscal deficit over the lifetime of the next Parliament, but I do not believe the rating agencies are concerned in the sense they are not re-rating the UK and I would be immensely surprised if they were to do so. I think they expect, as we all do, that either in the next Budget or after the General Election measures will be announced that will make clear precisely how this deficit will be tackled.

Q4 Chairman: Good. How exposed is the UK banking sector to government debt of the so-called PIIGS, Portugal, Italy, Ireland, Greece and Spain?
Mr King: I think we are very different from many of those countries and, as I say, what really matters is a combination of a political consensus to deal with our problems both in terms of the fiscal deficit and in terms of dealing with the banking sector, and the fact that we have a track record of doing that. Clearly, as I said, two of the main domestic challenges facing us in the future are to deal with the fiscal deficit and to find a way of restoring the finances of our banking sector. These are not simple or easy challenges, they have arisen out of a great world financial crisis, so I do not downplay the significance of the problems or challenges but I do think there is a broad consensus in the UK both to understand that we need to deal with these problems and, I think, a determination to do so.

Q5 Mr Fallon: Governor, you have just said you want to see measures in the Budget clearly announced and defined to deal with the deficit and presumably you want the next Government to start straight away?
Mr King: What matters is that I am sure that rating agencies and the markets will be looking, whether it is just before or just after the General Election, for a more detailed explanation of exactly how the structural fiscal deficit will be brought down over the lifetime of the next Parliament.

Q6 Mr Fallon: But you do not want it postponed?
Mr King: Well, you certainly cannot eliminate the deficit in one year. There has to be a programme announced that will start and then continue right through the lifetime of the next Parliament.

Q7 Mr Fallon: So you have to get started at the beginning of the Parliament?
Mr King: We need to get started but I honestly think that much of this debate is being overblown because even if you announce very clearly a programme either just before or just after the General Election, to the extent that a significant part of the fiscal consolidation will come from measures or adjustments to public spending, it is very difficult to make those changes start immediately. Anything, for example, that is done on public sector payroll has to wait until the next pay round, so it is inevitable that it will take time before these measures come through. Starting with a very clear and detailed plan, however, seems to me very important.

Q8 Mr Fallon: Getting started is the key. Fine. David Miles, if the inflation projections are even lower than they were in November, and now lower for the whole of the three-year forecast period, why did you not favour further asset purchases?
Professor Miles: For me it was a pretty finely balanced decision. The inflation profile is that, more likely than not, inflation stays above the target for most of this year and, in fact, slightly more so than I had thought a few months ago. It then drops beneath it for most of 2011 and gradually then comes back towards the 2% level during 2012. By the end of the forecast horizon the probabilities of being above or below the 2% level are pretty finely balanced. You could make a case that with the central projection, the most likely outcome for inflation, being beneath the target level for much of 2011/2012, that might suggest that policy should be slightly easier and that you should continue with the asset purchase facility and buy some more assets. I felt that keeping the stock of purchases in place, which is really maintaining an extraordinarily expansionary monetary policy, was, on balance, the right thing to do this month. It is a decision that is finely balanced; it is one we will come back to in future meetings. The next meeting is next week. If we had had to make a decision to keep the stock in place for many, many months it would have been an extremely difficult decision, but this is a decision about what to do at that meeting and, as I say, for me it was a pretty finely balanced decision.

Q9 Mr Fallon: But what is the evidence you are looking for that would persuade you finally to vote for more asset purchases?
Professor Miles: It would depend very much on the probabilities of inflation falling in different ranges as we look forward. As I say, at the moment the judgment is that on balance inflation is probably going to be above target most of this year, beneath it for most of next year, then coming back towards target level. Now, if the news is that the economic outlook seems even weaker, inflationary pressures lower, and that moves down that inflation profile, there is a strong case, then, for expanding further the asset purchases. If it goes in the other direction that would be a case for pushing the lever in the other direction.

Q10 Mr Fallon: Governor, you have said it is far too soon to conclude that no more asset purchases would be needed. Does that not indicate that a continuing weakness of the economy might well make that further stimulus necessary?
Mr King: It may be; we will have to see how things pan out. My particular concerns at present derive from the state of the world economy and our largest trading partner, the euro area. Within the world economy we are seeing countries that ran deficits take measures to rein in domestic demand, it was inevitable that countries would do that, and we are yet to see evidence in the major surplus countries a sustained expansion of domestic demand, and that must throw some question mark about how sustained the expansion of overall demand in the world economy can be, and that will inevitably have an impact on the UK. You have already seen that, despite the depreciation of sterling, we have not so far—though I suspect we will in due course—seen much evidence of a pick-up in net trade for the UK which is an important part of our rebalancing. Those are the cautious signs overall and we need to look very carefully at that but, as David says, this is a decision we look at month by month.

Q11 Mr Fallon: Spencer Dale, the Bank says the beneficial effects of quantitative easing have not been fully felt. Could you explain that? You have spent £200 billion, most of it on gilts. That has helped the Government deal with its debt, but how has it really helped the economy? How can we measure that?
Mr Dale: Measuring it precisely is very difficult because one has to think what would have happened absent that asset purchase programme and that is clearly unknowable, but I think one can point to very clear beneficial impacts of those asset purchase programmes. We have seen a very substantial rise in asset prices, where equity prices have increased by 50% since we started our asset purchase programme and corporate bond yields have fallen by 200 basis points or so. I do not think all of that can be attributed to our asset purchases but I have no doubt that some of it can be. At the same time we have also seen record amounts of issuance of both corporate bonds and equities by UK companies which again has been helped by our asset purchase programme and the increased liquidity that has provided.

Q12 Mr Fallon: The Governor spoke about trade, Charlie Bean. In the Inflation Report the Bank points to continuing weakness on the export side. The substantial depreciation of sterling does not seem to have boosted exports as much as one might have expected. If exports are not going to help us recover the capacity we have lost, what will the main other drivers of growth be?
Mr Bean: The key here is to recognise that it takes time for a depreciation to feed through. Looking at the lessons of past significant depreciation in, say, the wake of the 1992 exit from the Exchange Rate Mechanism, it took some years for the full effect of that substantial depreciation to work through. What we have seen so far is exporters primarily taking the benefits of the depreciation in terms of increased profit margins rather than cutting prices to expand sales, but one would expect that in due course to lead to an expansion of supply because it is more profitable than would otherwise be the case. So I am not altogether surprised that we have not seen a large effect yet from the depreciation, but I would expect it to be working through over the course of this year and into next year. The precise speed at which that happens, though, may well depend on the strength of the recovery in overseas markets. The Governor has already referred to the worries about the euro area, and if the euro area remains relatively sluggish in the rate at which it recovers, then it may well take that bit longer for the beneficial effects of the depreciation to work through.

Q13 Mr Plaskitt: Continuing with quantitative easing for a moment, Governor, in your statement to us this morning you said that it is providing "a substantial boost to money spending". How are you measuring that?
Mr King: As Mr Dale said, one of the difficulties we face is knowing what the counterfactual is, but we have injected £200 billion of money into the economy and that, through a wide variety of channels, leads to higher asset prices, lower spreads, perhaps even a lower exchange rate, greater issuance spreads the sale of both debt and equity, all of these things feed through to higher nominal spending in the UK economy.

Q14 Mr Plaskitt: Should we be looking at what is happening to M4 as an indicator of the effectiveness of QE?
Mr King: We influence M4 directly by injecting the money into the economy and, by and large, that increase in M4 stays in the economy and that is why you can argue that looking at the money numbers tells you a good deal of what would have happened had we not injected this money. Now, there are some aspects to the recovery in the economy that involve banks themselves issuing debt and equity or companies repaying bank debt, which mean that will be part of a downward pressure on broad money even though they are part of the measures which help recovery, so I do not think it is a single statistic where you look at one number and say that that is the answer to our problems. The steps in this are very clear, however. We inject money into the economy as the first step, that is the important part, and we did that in large part because when you look at the monetary squeeze that was being imposed through the contraction of the balance sheet of the banking system we were starting to see very sharp falls in monetary growth, not just in the UK but in the US and euro area, and in some of those other countries monetary growth is actually negative now. This is a serious position to find oneself in, and you need to get back to a position in which monetary growth is clearly positive, and that is what we are trying to do, so we inject the money into the economy as the first stage. The way that works is through a very traditional transmission mechanism, not dissimilar to the way changes in the Bank Rate work, by leading to changes in asset prices, in the spreads on particular instruments in the economy which can lower the cost of finance to companies and households, and through a range of channels which we have spelt out in many of our publications, all of which in their different ways help to influence overall spending in the economy which, given the supply in the economy, then determines the balance between demand and supply and hence inflation.

Q15 Mr Plaskitt: M4 growth has been very small since the start of QE.
Mr King: Indeed.

Q16 Mr Plaskitt: Are you saying that the significance is there has not been a big fall off in M4?
Mr King: Indeed.

Q17 Mr Plaskitt: So all it has done is compensated for what would have happened by other means?
Mr King: I think we would have seen a very serious monetary contraction because the UK's banking system has been very severely damaged, probably more so than that of any other advanced country, so we were facing a very tight monetary squeeze—of a kind we have not seen ever, probably.

Q18 Mr Plaskitt: So it would be better to describe QE as having filled a hole rather than putting additional support into the economy?
Mr King: So far it has filled the hole but, of course, the bulk of the action on quantitative easing took place only in the last six to nine months and, even if the lags were as short as they might be with Bank Rate changes, we would still have yet to see the bulk of the impact of that come through. So we have seen so far it has filled a hole and that has been very important, but we have yet to see much of the impact of the asset purchases we have made come through in terms of nominal spending in the economy, or even broad money growth, and we will see that over the next year, I expect.

Q19 Mr Plaskitt: Have you any concerns about the impact that QE has had on asset prices, in particular if you look at equities, that it is something of a bubble?
Mr King: Well, I think it is rather odd to go from one extreme to say it has had so little effect that monetary growth has been shrinking or close to static, and then to worry that it is so important that it has pushed up asset prices. The way in which asset purchases operate is, indeed, to raise asset prices, that is one of the main vehicles in the transmission mechanism and that is what we were trying to see, and I think one of the main factors lying behind the rise in asset prices, which has been considerable, particularly in equities over the past year, has been that a year ago financial markets were contemplating the sort of downturn that we did see in the Great Depression. After all, we were right in the middle at that point of the fastest decline in world trade ever seen, and two consecutive quarters when output was falling in many countries around the world by 5% or 6% or more in just two quarters. There was an unprecedented rapid collapse of output and confidence. The measures we have taken and the measures which other central banks have taken around the world have all contributed to a reversal of that concern that we would see a re-run of the Great Depression, and those serious downside risks, I think, have now been eliminated. That is not to say we do not face enormous problems and challenges but we have dealt with the short-run problem, and in the light of that it is not surprising that financial markets have priced in the disappearance of some of the worst outcomes that could have occurred which had previously accounted for the sharp falls in asset prices from the middle of 2008 to early 2009.

Q20 Mr Plaskitt: What sets of circumstances will be in place that will lead you to think it is appropriate to begin reversing the process of QE?
Mr King: It will be based on a judgment about the outlook for inflation. There are many factors that go into that. We would want to look at what is happening to world demand and different aspects of domestic demand, and we would also want to see whether there are more upward shocks to the price level in the UK through, for example, changes in world commodity prices or oil prices. We have seen a 70% rise in oil prices in the past year and that has clearly had an impact on our domestic inflation rate. We would want to look through, so far as it seems sensible to do so, some of those short-run effects but if they continue, or appear to be likely to continue, then clearly we will have to factor those in. Now, all of these things go into our normal inflation judgment and it would be natural for us to wait until we had a chance to think through the outlook for inflation in its entirety, in the round, before making a judgment, and if we felt that the main risks to inflation were on the upside of the target rather than the downside, that would clearly be a signal for us to start to tighten monetary policy.

Q21 Mr Plaskitt: Do you expect in due course it will be fully unwound, or do you think it is now a permanent feature of monetary policy?
Mr King: No. I suspect we will sell these assets in due course.

Q22 John Thurso: Governor, on page 15 of the report you make it clear that banks will need to replace the funds that they have under the Special Liquidity and Credit Guarantee Schemes, and you also note the difficulties that may arise with sources of funding such as asset-backed securities which would imply that funding should come more from retail deposits, but there is gap over the last 10 years between what has come in in retail deposits and what has been required of something like £180 billion. The Council of Mortgage Lenders has made the point that this will cause considerable difficulties for banks and building societies when the scheme comes to an end. You have made it clear that there is no way it is going to be extended. Do you reject their analysis of what is going to happen?
Mr King: I reject the argument that we should keep it going because they are not prepared to find alternative sources of funding, and the main reasons for that are the following. We made very clear that this scheme was temporary; it was a three-year window where the taxpayer would help to finance illiquid assets which had become illiquid in the course of the financial crisis and which it had not been entirely easy for those banks to anticipate would become illiquid, so this was a temporary scheme to offer them the chance to finance a very large stock, almost £200 billion, of assets which they could not easily otherwise finance. We gave them a three-year window to do that: there is no scheme in the world that is as generous as this scheme, and the banks were given full notice that they had three years to find alternative sources of finance. Many banks are doing just that and it would be quite wrong to argue that a taxpayer-subsidised scheme should be extended in order to penalise those banks that had recognised the need to find other sources of funding, even though they are clearly more expensive, but some banks are going out and finding other sources of funding, and it would be quite wrong to subsidise and reward those banks that had not bothered to find alternative sources of finance. The bulk of the SLS is accounted for by a relatively small number of institutions. We are working with them to make sure there is a proper pattern of refinancing over the next two to three years, so we do not suddenly face what is sometimes described as a "cliff" in which the funding just runs out; we are working with them to make sure they do look for other sources of funding beforehand. There may be some institutions that will find it difficult because of the nature of their business model, but there is nothing coming out of this financial crisis that will justify the taxpayer subsidising an existing structure for the financial sector. Some institutions may well need to accept a smaller balance sheet in future if they cannot attract new sources of funding. New institutions or other institutions that can attract new sources of funding will be able to expand their balance sheet, so there will be a shift, and I think the most important thing to hang on to in all of this is there is clearly no shortage of savings in either the UK economy or the world as a whole. The savings are there, the demand for borrowers is there, and we will need to find perhaps new ways to channel those savings to borrowers, so we are working directly with the banks in order to ensure that the SLS is unwound in an orderly way, and we are working with Government and the FSA to think about either new ways of constructing securitised instruments so that a different type of securitised market could be regenerated, or, indeed, alternative ways to channel savings to borrowers, both corporate and household.

Q23 John Thurso: What would be the characteristics of those securities that would make them more palatable than those which largely caused the crisis?
Mr King: I think the most important is that what turned out to be the case when the crisis occurred was that many of the pieces of paper that represented claims on mortgages, to take that one example, turn out to be extremely hard to value when people somehow finally realise that house prices could go down as well as up, because when house prices go down as well as up you need to know something about whose mortgages they are and whether these are the kind of people who will repay the mortgage, whether they will be affected by unemployment or not, and it turned out that the pieces of paper contained no information about these characteristics. It is not impossible to design securities which contain aggregate information on the pool of mortgages which is represented by those pieces of paper, and if there is to be a viable securitised market in mortgages, which I firmly believe can be recreated, it has to be on the basis that there is greater transparency and greater

information about the liabilities and the people who are carrying the obligations to repay, otherwise it is very hard to know how much money you want to pay for that piece of paper. That is one aspect of it. There are other more detailed aspects to do with the specifically UK nature of master trusts in the securitised instruments which, in the case of Northern Rock, created a very difficult situation in which there was a tremendous pressure to keep issuing new mortgages to feed the trust with new mortgages each year. This is a very dangerous outcome in terms of the macro economy because you do not want to have instruments which have built into them an incredibly strong pressure to keep generating more and more mortgages. Mortgages will go up in the upswing of the cycle and may come down in the downswing and we need to allow that to happen naturally, so there are ways in which these instruments can be designed but, in the end, the market will determine it. What you cannot do is somehow believe it is sensible to sustain a particular market only on the basis of taxpayers' subsidy.

Q24 John Thurso: Professor Miles, both the Governor and Paul Tucker when they were before us recently, and on other occasions, have welcomed the role that contingent capital ("cocos") can play in providing an emergency buffer for a bank when its financial strength falls below a pre-agreed level. However, since then there has been a concerted howl of anguish from a lot of senior bankers and top institution investors who have labelled it amongst other things "death spiral convertibles" and saying it would be a "red flag" to the market. Do you have any sympathy for their views, or is that just what you would expect of them?
Professor Miles: Going back over a long period there is a view amongst many bankers that holding more capital is very costly, and that view was very influential in the whole design of the capital requirement structure and the Basle agreements. In retrospect it meant that capital requirements were far lower than they should have been. So in some sense the response of bankers to this particular recommendation is in keeping with a general view that having more capital is very costly and we must be very careful. I must admit I have much less sympathy for that view than I have ever had—I was always somewhat sceptical about it. I think the big story here is that, ultimately, banks right across the world need to hold very much more capital than we thought might be adequate two or three years ago. I am pretty open-minded about whether that capital should be in the form of capital that is always there—ordinary issuance of equity and the capital sits on the balance sheet—and what proportion of it might be contingent capital that gets called when a bank's capital ratio falls beneath a certain level.

Q25 John Thurso: If I may, the argument is that, whilst the idea of having a buffer is fine, it is the fact that it gets triggered which causes a run on liquidity.
Professor Miles: Yes.

Q26 John Thurso: Do you think they have a point there?
Professor Miles: One needs to be careful in defining what the trigger is and you would need to make sure the trigger was not perceived as being a sign that this institution is in very serious trouble. So I would set the trigger at a level which clearly was well short of a point at which the bank was clearly in great difficulty.

Q27 Jim Cousins: I wonder if I could ask you, Kate Barker, if you think that the commercial property sector might still deliver a very significant aftershock to the British financial system?
Ms Barker: I am not sure I have an incredibly strong view on that, but I certainly think it is true that we are not necessarily out of the woods as far as the commercial property sector is concerned. We have seen some pickups in parts of the sector recently, some of the pricing has improved, particularly in prime property, but it is apparent that some of the loans that the banks have made to commercial property remain under water, and it is possible that if we do not see a recovery taking hold through this year—and there has been a lot of forbearance so far, so it is difficult to work out whether that will continue—then we will see an aftershock from some parts of the commercial property sector. We know that in retail property many of the decisions on retail property are no longer going ahead, there are a great number of vacancies in the retail sector and clearly in some areas perhaps values have further to fall, so I agree there is some risk still in that sector.

Q28 Jim Cousins: You have obviously studied mortgage lending very thoroughly and there was a lot of concern about the fall-off in mortgage lending last month. Do you think that is just a temporary blip caused by the weather, or is it something more that should worry us?
Ms Barker: I have to say I am never quite sure whether things like the weather will affect mortgage lending. It is often quite difficult to find really good weather effects in a lot of economic series. However, we also had some changes in Stamp Duty which may have had a temporary effect, but I think the most significant question is really how far is mortgage lending going to be constrained going forward and clearly, given the difficulties which we have just been talking about with the banks and bank financing, it seems more likely than not to me that mortgage lending is not going to be available going forward on the terms it used to be. That suggests to me that there are still adjustments in the housing market potentially to come. We are not really quite sure whether over a three or four-year view this market is going to settle out. Like others, I was rather surprised by the strength of prices in the housing market through last year, it is possible that some people were delaying decisions to move or put houses on the market and in some sense that cannot continue, so while I would make no strong prediction on this—the Governor is always warning

us about the dangers of making predictions on house prices—it is also possible that the housing sector will continue to be quite weak through this year.

Q29 Jim Cousins: Mr Dale, if we just go back three or four years, a flow of funds from outside Britain was supporting a lot of home buying and buying of commercial property and lending to private companies in Britain. There is absolutely no sign that foreign money is coming back into the housing market; there is a slight sign it is coming back into the private company market. How concerned are you that we will be able to raise money from outside the country to keep our own financing problems going?

Mr Dale: I think one of the features of the credit crunch we face both in terms of the residential market and within the corporate financial market is the withdrawal particularly of foreign banks. Foreign banks accounted for a significant component of the increase in corporate bank lending through much of the middle part of the past decade, and we have seen a very sharp contraction of that lending by foreign banks most recently, as you suggest, and I think that is one of the key features about the risk going forward, the extent to which either new foreign banks will enter the market or the extent to which UK lenders will be able to make up that gap. In the most recent few months there are signs that some foreign banks are starting to come back into the market for corporate loans, and that is recorded in our most recent Trends in Lending Reports, but that is still very early days, so the risk you highlight is a real one.

Q30 Jim Cousins: Governor, in your opening remarks to us you absolutely correctly drew attention to the huge refinancing problem that banks and private companies, and indeed private individuals have, and also to the huge sums of money that government is going to have to raise, come what may, about the future of public spending over the next couple of years. You also said there is likely to be a considerable drag on spending in the economy as a result. How serious could that drag be? Could it drag us back into recession?

Mr King: It is very hard to know what will happen, there is enormous uncertainty, and, as you pointed out in your question to Spencer, we are going through a period in which there is significant rebalancing of the UK economy in addition to no longer being able to borrow from abroad to finance much of our banking and domestic lending activity. The other side of that coin is that we will need to increase our net exports so that we will not be borrowing that much from abroad, and that is why we would expect to see over the next few years, and it is hard to put a timescale on it, a considerable change in the balance between domestic demand, where there will be a drag on spending, and net exports, which will be the source of growth that will enable the economy to pick up again. One of the challenges that faces us, however, and there is no way round this, is that the timing of these things is very hard to make coincident. We would very much like to see a recovery in the world economy led by our biggest trading partner, it would be a big help if the euro area were to grow more rapidly. That would enable us to expand our exports and that would be a source of growth and would make it possible to achieve a better balance in our economy as domestic demand is held back by the need of all of the domestic sectors to get to a more sensible financial position. So there is big challenge, and this is one of the challenges which we on the Committee face in trying to work out the balance of risks between upside and downside risk to domestic spending and activity as a whole, which then feeds directly through to upside and downside risk to inflation.

Q31 Jim Cousins: But, Governor, given the fact that we will have to rely on foreign funders doing the right things in terms of our own homes and jobs here, and foreign purchasers doing the right things to help us to produce goods and services here, they may not be as kindly to us as we might want them to be. Against that background do you not think you will have to go back to quantitative easing or special schemes to support the financial sector to avoid a return to recession?

Mr King: I do not know but we stand ready to do whatever seems appropriate. That is one of the great virtues of monetary policy. We have already lost a lot of the overseas financing, and as a result we have seen an improvement in net trade, in large part a contraction in imports, we hope to see a better balance in future, but monetary policy can either be more expansionary or more contractionary as the situation demands, and we stand ready to do that.

Q32 Sir Peter Viggers: Would I be wrong in thinking there is a slight change of tone between the Quarterly Inflation Report and the thoughtful statement you gave to us at the beginning of our meeting? I read the Inflation Report as looking forward with expectation, hope, possibly even a hint of optimism, and I read your statement as being one of caution and concern. Would I be wrong in thinking there was a slight change of tone?

Mr King: I do not think there is a change of tone; the outlook is still the same. I wanted to draw your attention to the concerns we have about the outlook, in particular for the Rest of the World. I was struck by the mood at the G7 meeting that I attended with Charlie in Canada, where several of the major economies around the world said very openly that they were relying on external demand growth to generate growth in their economy. Well, that cannot be true of everybody. That was a concern about the world economy, which I have, but I think our central view is still that the most likely set of outcomes is along paths which involve a gradual recovery, that is the most likely, but anyone who has lived through the last two years will surely know there must be enormous uncertainty on either side of that, and it is only fair to set that out.

Q33 Sir Peter Viggers: In the Inflation Report, and I am referring specifically to the gross domestic product projection based on market interest rate

expectations, it says that the assumption is that the issuance of Central Bank reserves remains at 200 billion throughout the forecast period. What would the GDP projection be if you made a different assumption, if you assumed more or less?
Mr King: I do not know because the Committee would have to meet and form that judgment, so I cannot answer that. Maybe in future months we will have the opportunity to tell you.

Q34 Sir Peter Viggers: Fair enough. The statement in your preliminary statement that lending to the non financial sector continues to fall came to me as both a surprise and a disappointment—a surprise because many bankers have sat in front of us and absolutely sworn that they have increased their lending to the non financial sector, and a disappointment because most of us have assumed that quantitative easing is about encouraging banks to lend to the non financial sector. Would you comment on that?
Mr King: Yes. I do not think that asset purchases is about directly affecting the amount of lending to the non financial private sector. It is, first, about the amount of money in the economy, not the amount of credit, and that would expand demand overall. What is happening, which there is very little we can do about, is that the banking sector itself, given the enormous problems that have occurred to it in the past couple of years, is still contracting its balance sheet. Now this is not unique to the United Kingdom. Bank lending to the non-financial sector is falling even more rapidly in the United States, despite the fact that they have seen some signs of recovery. That is because the measures they have taken and that we are taking in terms of asset purchases can stimulate money spending even at the same time as bank lending is contracting. It is not a position we are comfortable with, we would like to get back to a situation where the banking sector can expand its lending, but I am not sure if that is going to happen until we see further consolidation of the balance sheets of the banking sector, and there is still quite a way to go on that front.

Q35 Sir Peter Viggers: Looking for engines of growth, and I am addressing this to Charlie Bean, I think, the figures for the eurozone were disappointing in the last quarter, and some commentators have said that is a flat period and that the eurozone is likely to improve quite soon. Would you comment on that general point?
Mr Bean: There is a bit of a dichotomy within the eurozone, in that manufacturing has continued to strengthen, which reflects the general strengthening of manufacturing around the world in the recovery phase, but services has remained pretty flat and, as you correctly note, has eased back, and that is behind the easing in growth in the fourth quarter there. Obviously the real issue is how much strength there is as we go through this year. The eurozone is struggling with the same headwinds as we are, namely a deleveraging banking system; different countries' banking systems are in different positions, but in general there is still that headwind against which they are struggling. As we have already discussed, there are some countries that are also struggling with difficult fiscal positions, which are difficult which puts more weight on the countries that do have some room for manoeuvre continuing to maintain their policy stimulus on the fiscal side and on the ECB continuing to maintain an accommodating monetary stance. But I think we expect the euro area to have a sluggish recovery in very much the same way as the UK will.

Q36 Sir Peter Viggers: Will there be a tailwind from the BRICs? The expanding economies?
Mr Bean: Almost certainly the emerging markets will continue to grow quite robustly. It is possible that Chinese growth may tail off a little—the Chinese authorities, being concerned about potential overheating there, have started to tighten policy a little bit—but the overall picture from the emerging markets remains one of reasonably strong growth. Of course, however, they are still a relatively modest market for the euro area in particular and ourselves. So that provides some tailwind, but unfortunately not as strong as it might be. There is a little bit of a quid pro quo for that in that strong growth in emerging market countries is likely to put upward pressure on commodity prices which is obviously less good for domestic growth prospects.

Q37 Nick Ainger: Mr Bean, the Governor in his letter to the Chancellor and also in his statement this morning refers to the temporary nature, the temporary deviation from the target, and he puts it down to three factors—firstly, the increase in VAT back to 17.5%; secondly, exchange rate issues, and, thirdly, the 70% increase in the price of oil. Clearly—hopefully—the VAT increase is a temporary measure and I do not want you to suggest where exchange rates are going to be, but why do you think, bearing in mind the huge volatility we have seen in the past in the oil markets, that, in fact, the effect of oil prices is also temporary?
Mr Bean: It is quite possible there may be further adverse movements in the oil price and, of course, my last answer referred to that possibility. As it looks at the moment, there is certainly some scope for a further expansion in the world supply of oil without putting upward pressure on oil prices; there is some spare capacity, and some of the past investments are gradually starting to come on-stream. However, I do not rule out the possibility that we may find ourselves subject to further upward shocks from oil and other commodity prices and, were that to happen, of course, that would make the inflationary backdrop less kind. The projections in the Inflation Report are conditioned on an assumption for oil prices that comes out of the futures market and which assumes a pretty flat oil price. But there is a lot of uncertainty about that and within the oil market itself, if you look at oil options, there is a big spread of possibilities. So you are absolutely right to flag that as one of the risks.

Q38 Nick Ainger: Because what we have seen this year, and the Report refers to this, is the 70% increase at a time when the two largest markets for oil, North America and Europe, were contracting, so you would have expected after the plummet from the peak in the summer of 2008 that oil prices would have reflected the fundamentals in the market which was there was not a lot of demand out there and, therefore, they would have stayed at a low level, not risen by 70%. We have had this discussion in the past. I met with the Commodities and Futures Commissioner in Washington recently and there is a strong view that speculation in the oil market is affecting prices adversely, not reflecting fundamentals, and that perhaps international action is needed to try and regulate far more the futures markets, the over-the-counter trading. What is the Bank's view on trying to tackle this issue?
Mr Bean: Our view is that speculative behaviour, while it can have short-run effects on the dynamics of prices, probably does not have lasting effects on, if you like, the trend in oil prices, which is driven primarily by supply/demand imbalances. The nature of the oil market is one where, where we are at the moment, the supply might be reasonably elastic, as Saudi Arabia has a certain amount of spare capacity. But when you get up to hitting those capacity constraints, it is quite difficult to increase supply much, so the supply curve becomes pretty inelastic at some point. The demand for oil is also pretty inelastic with respect to prices. So what that can mean is when you hit world capacity constraints in oil, then the price becomes extremely volatile. So our reading, primarily, of what went on through 2008 when, of course, the oil price continued rising—I think it was about $80/$90 a barrel at the beginning of the year up to about $150 a barrel in mid summer—was that was primarily being driven by underlying fundamentals, particularly robust growth in emerging markets. That is not inconsistent with speculative behaviour having some influence on the short-run dynamics. But our view would be that it is not the prime driver of these previous swings.

Q39 Nick Ainger: The IMF were concerned about this issue, because obviously it was not just oil futures but other commodities as well, including food, and they made the assumption that it was not fundamentals that were driving certainly what happened from mid-2007 to mid-2008, it was speculation, and while there may well have been fundamentals forcing up or causing change, the way that the commodities markets operated massively geared up that change. Have you a view on that?
Mr Bean: Well, I think if you go back and look at what has happened to the prices of a range of commodities you find that commodities where there are not significant futures markets and insignificant speculative behaviour were subject to exactly the same broad movements as we saw in the oil market during that period, which suggests it is not a story purely about speculation because you would have expected to see very different behaviour between markets where there is futures trading and those where there is not.

Q40 Mr Brady: Spencer Dale, all of the projections in the Inflation Report are predicated on 200 billion of asset purchases. Do you produce Fan Charts for other levels of asset purchase?
Mr Dale: No, we do not, and I should stress in some senses it is forced upon us because of a lack of a good alternative produced by the market. As you know for our interest rate assumptions we have two; we have a constant interest rate assumption and an interest rate path implied by the market. Unfortunately there is not an analogous path for the stock of asset purchases produced by the market on which we could also condition.

Q41 Mr Brady: So you are not able to say what the implications are of the fact that it is predicated on 200 billion of asset purchases; it is simply where we are?
Mr Dale: It is a conditional assumption, yes.

Q42 Mr Brady: So you do not even have working assumptions within the Bank?
Mr Dale: Not in any precise formal way, no.

Q43 Mr Brady: Would you care informally to hazard a guess or give an estimate of what you think the impact of that 200 billion is?
Mr Dale: It is very hard to come up with any sort of single point estimate of how much these asset purchases are affecting the economy. As the Governor said, the Committee comes together, it takes a view of the impact of the stimulus, together with all the other factors affecting the economic outlook when producing its forecast for inflation and growth. It is very hard to take out one incremental impact of that and say absent that this is what the economy would look like.

Q44 Mr Brady: You cannot do that at a single point but presumably you could look at a range of possibilities.
Mr Dale: You can certainly think through a set of counterfactuals but, again, when one carries out those sort of counterfactuals it would beg a number of other questions about why was the degree of quantitative easing less, to what extent was that expected by the market, how was that interpreted in terms of the behaviour of the Monetary Policy Committee and why would it be behaving in that way. One would need to make judgments about all of those other factors before you could come up with a coherent simulation.

Q45 Mr Love: Mr Bean, economists have referred to the presentation given last week of the February Inflation Report as "misleading and confusing". This appears to relate to the change in the CPI inflation rate two years out which is projected to fall from your Report, which says 1.79% to 1.57%, yet the Monetary Policy Committee appear to have not ignored the implications of that adjustment in the inflation rate. Is there a growing sense that the Monetary Policy Committee is predisposed to hold

quantitative easing when, in fact, the evidence that you produce in your own report would suggest otherwise?
Mr Bean: The numbers that you are quoting there are falling into the trap of assuming that you can look at a single measure of central tendency in the forecast, whether it is the most likely projection—the mode—the mean or anything like that, and mechanically back out from that the policy decision. When we make the policy judgment, implicitly we are looking at the whole distribution, the whole range of possible outcomes. Some of the risks you may learn something about in the near term. For instance, at the moment inflation is significantly above target, and one of the risks might be that that period of above-target inflation leads to inflation expectations rising. Once inflation has dropped back that risk would no longer be relevant, so that is a risk that might resolve itself quite quickly. There are other risks that we may not know for a great deal longer about, such as the extent of the headwind from the banking sector and so forth. So in informing the policy judgment you have to factor in quite a lot of elements of the outlook—it is not simply a case of looking at one measure of central tendency, one path, within the whole range of outcomes. And there are various other issues that we'll also factor in, like uncertainty about policy multipliers and so forth.

Q46 Mr Love: What seems to have surprised the economists, and I am not an economist, let me state straight away, is this idea of skewness which had not existed in your November or August reports but has been introduced in the February report—
Mr Bean: No.

Q47 Mr Love: —between the modal and the mean.
Mr Bean: Quite the opposite. As far as the growth protection went, in November we had an extremely large downside skew and that reflected the fact that we thought there were a lot of downside risks facing the economy. As we have moved through to this year, the outturns for growth have been a bit weaker than expected but we think some of those downside risks now look a bit less threatening. So as far as the growth protection went, we lowered the modal protection but reduced the downside risk, roughly offsetting in terms of their effect on the average across the whole distribution, the mean. Now, what does that imply for the inflation protection? Well, if you are just thinking about the modal projection for inflation—what we sometimes refer to as the central projection, that deep red line in the middle—if you have a weaker growth profile, then you would expect a weaker inflation profile to go with that. So that is why the mode comes down. But because the downside risks to growth are less, that means less downside risks to the inflation profile. Back in November we had roughly balanced risks either side on the inflation profile, but we have now taken some of the downside risks away, so that leaves you with some net upside risks. If you want an economic story to explain where those upside risks come from, it is from the fact we are presently undergoing a period of elevated inflation which may raise inflation expectations; then there is the possible risk to commodity prices which we have just been talking about, that is another upside risk; and there are probably others that one could enumerate.

Q48 Mr Love: Do you accept that the case that is being made by a number of economists in introducing this issue about the short-term spike in inflation being greater than originally expected and comparing that with the longer term reduction that is the implication of your February figures is, to say the least, confusing and there does seem to be some form of mismatch between the figures that you are producing in your February Report and the decisions of the Monetary Policy Committee?
Mr Bean: I am not sure it is confusing. The reality is that we are in the position where inflation is currently elevated but we think the underlying inflationary pressures are relatively weak because of the large margin of spare capacity in the economy, and that will in the medium term push down on inflation. There has to be a degree of uncertainty about the strength of that downward pressure. We are uncertain about the margin of spare capacity, the size of the output gap if you want to call it that. We are also unsure about the impact of any given output gap on inflation in these current circumstances, so the extent of that downward pressure is unclear. We think it is probably enough to pull inflation below target a year and a half to two years out, but then as the economy recovers it will be pulling inflation back up as the margin of spare capacity gradually starts eroding, so that by the end of the forecast horizon, conditioned on market interest rates, the risks of inflation being above or below the target are roughly balanced.

Q49 Mr Love: One last question. Governor, it has been described by a number of economists as a bit of a mess. Do you accept that there has been any form of fudging between the decisions of the Monetary Policy Committee and the figures that have been placed before them, and do you think there is a need, perhaps, for greater clarity so that not only the public but the economists will understand what you are saying?
Mr King: I do not, and the reason for that is that the policy decision turned out to be one that everyone had expected and they had access to the same information about the economy as we did, so there was no disparity between the information on the economy and our decision. As David said at the beginning, once we had completed our projections—if you look at the projection as a whole—there was clearly a bigger chance in our view that inflation would be below the target for most of the forecast horizon than above it, so that naturally posed the question of whether we should conduct some further asset purchases. We put that question to ourselves and we decided on balance, no. The factors that loomed very important in our decision were other aspects of that very same projection: first of all that inflation is well above target now, it will stay there for a while, we do not want to run the risk of inflation

expectations moving up and being dislodged from the target. There are risks that there could be further upward movements, whether it be commodity prices or other changes in indirect taxes, who knows. The second reason is that it seemed to us to be a very good time to take stock of what we had done because, as I said before, the bulk of the asset purchases we conducted has really only been in the last six to nine months and much of the effect of this is still to come through, so to have a period where we took stock of what we had done, concerned that at this juncture inflation is above target, seemed to us wholly consistent with the outlook. There has never been a strictly mechanical link between someone saying get the slide rule out, this is the mode at 2 years—

Q50 Mr Love: We do not use slide rules any more.
Mr King: It is a shame we do not. It is a broader judgment about the outlook in order to meet the inflation target in the medium term.

Q51 Mark Todd: Governor, can I turn you to section 3.1 which discusses the ONS's figures on growth. In the very polite way in which this Report is phrased it might suggest some variance of opinion from the data that ONS have produced to date. Are you comfortable with the quality of ONS's data supplied to the Committee?
Mr King: I am very glad we do not have the task of actually publishing the data which they do, but they publish pretty early on their first estimate of GDP and they do that because we and other people ask them to publish a first estimate, but they make very clear that this is not their final estimate and that they will over time have access to better information as it comes in and, when it comes in, they revise their estimates. What we have to do is to try and make a guess, and we do it in our fan chart, of do we think there is a balance of risks to their final estimate compared with the initial estimate? On average we think there probably is some very small upward revision on average more likely to be made than not, we take into account the other data for the economy and obviously many people were pointing to the fact that many indicators, business surveys and others, were giving a somewhat more upbeat picture than the ONS data. I do not attach great significance to that.

Q52 Mark Todd: Presumably your bank agents have got access to the information as well.
Mr King: The agents too, absolutely. Look at chart 3.2 on page 25. You see here our back-cast, our judgment of the possible range in which the data might finally turn out to be when the ONS have had all the data, and the big picture is basically unchanged as to whether you take the ONS figures or our estimate from the back-cast. The big picture is a very sharp fall of about 6% in output as the crisis hit and basically, since then, bumping along the bottom, and then we give our forecast.

Q53 Mark Todd: But it is fair to say there is quite a significant variance in the dip, to be honest, is there not?
Mr King: I do not think it is massive.

Q54 Mark Todd: The reason I am asking about this, Governor, is because we have discussed this before.
Mr King: Yes, absolutely.

Q55 Mark Todd: And the concern was expressed at one stage about whether ONS were as well-resourced to provide the data that the MPC needed as they should be. That is the background to my question; I understand the points you are making.
Mr King: They do a pretty good job of producing it; they use a very large number of sources to produce their data. We certainly, when we saw the numbers coming in—which were weaker than we and others had expected given some of the survey results—did not react in the Bank by saying "Oh gosh, the ONS must be wrong", we reacted by saying "Ah, we must take note of this" and we should take note of it. The great danger is that outside commentators have a fixed view and they feel the job of the ONS is to come into line with their view. That is wrong. We take great note of what the ONS say and I have no reason at all to suppose that their estimates are in any way distorted. Of course if they had more resources I am sure they could do more, but I rather suspect over the next couple of years you will hear that from every single component of the public sector, not just the ONS. You will not hear it from the Bank.

Q56 Mark Todd: Nevertheless, this data is quite an important tool, not just to yourselves but to many other people.
Mr King: Yes.

Q57 Mark Todd: And gives an indicator which prompts policy across quite a wide range of activity. You touch on the impact of uncertainty on your projections on labour issues, for example, on the next page, which you hark back to. Maybe part of the explanation for the relatively resilient paper market is that growth has not been as negative as the ONS has projected, so you can see the wider implications if there is a quality issue.
Mr King: Absolutely, but it is wrong to criticise the ONS for not producing—

Q58 Mark Todd: I am not criticising, I am really suggesting that maybe there is a more robust partnership that can be found if you are looking at some of the issues on how they produce their data and whether there are gaps. In the past we have found that they have under-estimated certain parts of the economy because the economy flexes and changes quite rapidly.
Mr King: Indeed, and we do have a very good working relationship with them where both the Committee and also at working level Bank staff talk to the ONS on a regular basis. We expressed very openly and frankly our concerns about some aspects of their processes; we were concerned that the process of producing a revised and balanced set of

national accounts was postponed for some considerable time. That did give us cause for concern and we made it very clear to them. In terms of the conceptual methods of how GDP is estimated and whether that should be changed in the future, we have a very frank and open and productive conversation on a regular basis with the ONS which helps to improve these things.

Q59 Chairman: Governor, in your opening statement you mentioned the need to reform the international financial system and to restructure our banking system. Since your appearance at our Too big to fail? Inquiry we have seen a concerted fight-back from the large global banks. Both Barclays and Goldman Sachs, who have appeared before us, rejected President Obama's proposed reforms, they rejected the limits on the size of banks, they rejected the restructuring activities that they engage in. Are you concerned by the attempts of the banking sector to block structural reform to the banking sector and that in the absence of such reform the moral hazard problem will grow even more acute and, as you mentioned in your opening statement, we could witness another more serious crisis in future?
Mr King: That is a real concern. I am not at all surprised that the banks are defending their present position. They have an implicit subsidy through the "too big to fail" outcome that we have and it is not surprising that anyone who receives a public subsidy in effect tries to defend it and keep it going; it is quite natural that they would try to do it. That is no reason why we should go along with that. There are very good reasons for thinking that in future it would be much better to put at least some weight on putting in place firebreaks and firewalls in different parts of the financial sector and not relying on getting regulation absolutely right. There is plenty of scope for improving regulation and that needs to be done, but the real lesson from the regulation of other industries which is a very important thing that we should look at, is that you cannot get regulation exactly right. None of the banks set out to destroy themselves in the way that some banks effectively did; there were regulators all over the banks in some countries and in some banks they did not spot the risks. Risks will occur which are very hard to anticipate in advance; the big lesson from that is not to pretend that we can calibrate a Basel regulatory system so finely that we can guarantee that these risks do not materialise, but to ensure that when they do, we have firebreaks and firewalls so that the entire system does not bring down the rest of the economy with it.

Q60 Chairman: What advice do you have for us in terms of the future and the reform of the financial architecture?
Mr King: I hope the Treasury Committee will keep looking at this and studying it because I do not think it is reasonable to expect governments to say, "Ah, we will definitely adopt this particular policy path or that policy path", there is a genuine debate to be had about the right way in which our financial sector should evolve, how it should be restructured, what kind of regulatory framework we should have, how big the capital requirements should be. As David said, they could be much larger than they are now. This is not a question of making marginal changes. The impact of this crisis has been so large that just to fiddle at the margins will be a wholly inadequate response but it is perfectly reasonable to take our time now and to have a proper debate about where we want to get to in the medium to long term. I have one area of sympathy with banks which is that it is not sensible for us to try to impose on them big changes in structure or capital very quickly. That will make it much more difficult for them to finance lending to the real economy but, equally, we must not let the need to have a long transition period deflect us from the need to keep up the pressure and momentum on what that debate should result in ultimately.

Q61 Chairman: Governor, can I thank you very much for that and can I thank Kate Barker for her tenureship in the Monetary Policy Committee. I believe that you have done almost nine years with three terms and been the longest-serving member so the Committee would like to thank you for your appearances before us and wish you well in the future. Given, Governor, that this is going to be your last appearance and Inflation Report before the election can I as Chairman thank you very much for your co-operation and your ever willingness to come to the Committee at all times. I know it has been quite demanding on you but we are grateful for that and we wish you and your fellow committee members well in the future. Thank you.
Mr King: Chairman, thank you very much. This is in fact my 17th appearance before the Committee since the crisis began, my 19th appearance in front of a parliamentary committee in 29 months. That is almost some sort of record. It has not been fun, if I am honest, it has not been easy, but it has ultimately been productive. I would like to thank you and your Committee for having played a major role in taking forward the debate, particularly on the restructuring of the financial sector. I know that you and some of your colleagues may not be here after the election on the Committee so can we thank you very much for your help on the Committee. You should at the end, particularly you, Chairman, take pride in what the Treasury Committee has achieved; the quality of the reports has been very high and it has actually resulted in reform in the UK which perhaps has not been seen in other countries. Thank you very much.
Chairman: Thank you very much, Governor.

Written evidence

Report to Treasury Select Committee from Charles Bean, Deputy Governor for Monetary Policy

VOTING RECORD

My previous report, in November 2008, was written in the immediate aftermath of the worst international banking crisis for at least 100 years, and as the international and UK economies entered their sharpest downturn in the post-war period. It was already clear then that the downturn would be sharp, warranting a substantial reduction in Bank Rate, but its precise magnitude was uncertain. I fully supported the sharp reductions in Bank Rate to 2% in December 2008 and then in steps down to 0.5% by March 2009, as the economic news came in to the downside.

By the early part of 2009, it was also clear that further monetary stimulation would be required to boost demand and keep CPI inflation on track to meet the 2% target. With Bank Rate at its effective floor, that would have to come through asset purchases financed by the issuance of central bank money ("quantitative easing). The MPC had little historical evidence to help it assess the likely quantitative impact of such purchases, but in the light of what we did know, an initial stock of purchases of £75 billion appeared appropriate. Given that the outturns for UK activity continued to surprise to the downside, I then found it relatively straightforward to support the subsequent extensions in May and August, to total purchases of £125 and £175 billion respectively.

My decision was more finely balanced in November. There was uncertainty about the magnitude and timing of the impact on nominal spending of the purchases we had already made, and a risk that large-scale purchases could raise inflation expectations and long-term interest rates if people failed to grasp that the purpose of the programme was to prevent money and nominal spending growth, and hence inflation, falling too low. In the event, the unexpectedly weak release for output growth in Q3 persuaded me that a further increase to a total of £200 billion was warranted.

The Committee lowered its central (modal) projections for GDP growth and inflation in its latest Inflation Report. But at the same time it also moderated the downside risks to GDP growth and correspondingly increased the upside risks to inflation. As a result, the average (mean) projections for both growth and inflation taken across the whole of the fan charts are broadly similar to those in November. In the light of the continuing uncertainties already mentioned, I therefore did not feel that a further extension of the programme was presently warranted.

THE OUTLOOK

The UK economy appears to have been "bumping along the bottom" during the second half of 2009. I expect to see the economy gradually pick up steam through this year, reflecting: the substantial stimulus from policy, much of which is still working through; the lower level of sterling, which should gradually boost exports and discourage imports; a gradual decline in uncertainty, which should make businesses and households more willing to undertake expenditures that were put on hold over the past year. But against that, there is a considerable headwind in the shape of the continuing de-leveraging within the financial sector. As a result, the availability of bank credit is likely to remain restricted for some while; an open question is the extent to which a revival in bank lending is necessary for a healthy recovery. The need to strengthen public and private sector finances will also weigh on demand. On balance, I share the view in the Committee's latest Inflation Report projections that the recovery is most likely to be rather slow and protracted, leaving output below its previous peak for some time.

CPI inflation was 3.5% in January. The pickup in inflation from 1.1% in September reflects both higher petrol prices and the restoration of the standard VAT rate to 17.5%. Assuming stable oil prices, and in the absence of further increase in indirect taxes, inflation should fall back this year, reflecting the waning influence of the depreciation of sterling and the growing influence of the substantial margin of spare capacity. There is, however, substantial uncertainty about both the impact of the recession on supply capacity and the impact of the margin of spare capacity on inflation. Past international experience suggests that recessions in the aftermath of banking crises can have a lasting effect on an economy's supply potential.

There is, though, considerable heterogeneity of experience and isolating the mechanisms whereby supply is depressed, and their likely importance at the current juncture, is not straightforward. It is likely that supply is, in part, endogenous to the course of demand, so that a rapid recovery might result in only limited impairment of supply in the longer run, while a very protracted recovery might have more lasting effects. At the present juncture, I believe that the stance of monetary policy is appropriate to keep inflation on track to meet the target in the medium term, but that will need to be continuously re-evaluated in the light of economic developments.

Explaining Monetary Policy

Since my previous report in November 2008, I have given five on-the-record speeches on monetary policy issues, together with numerous off-the-record presentations to a variety of audiences. Between 13–21 July, I visited 13 towns and cities (Leeds, Newcastle, Edinburgh, Manchester, Maidstone, Brighton, Nottingham, Derby, Leicester, Reading, Bristol, Cardiff and Birmingham) explaining quantitative easing to a variety of business audiences and doing interviews with local media; BBC News also accompanied me on the first leg of this "roadshow". I subsequently participated in separate London events explaining quantitative easing to City economists and to journalists. I also made four other regional visits (to Southampton, Sheffield, Inverness and Newcastle) involving various meetings and events with local business people. Finally, as Deputy Governor for Monetary Policy, I also represent Bank views in a number of international settings, including the G7, G20 (which the UK chaired in 2009) and the OECD.

February 2010

Report to Treasury Select Committee from Spencer Dale, Chief Economist and Executive Director

Voting Record since March 2009

Since March 2009, I have voted to maintain Bank Rate at 0.5%.

During this period, the Committee has provided additional stimulus to the economy by conducting a large-scale asset purchase programme. The aim of the programme is to stimulate nominal demand by injecting extra money directly into the economy. The Bank's purchases of government bonds encourage investors to diversify into alternative assets, such as corporate bonds and equities. And by operating directly in commercial paper and corporate bond markets, the Bank's purchases aid the functioning of those markets. Both actions help to boost the prices of corporate assets, reducing yields and lowering the cost to companies of raising funds in capital markets. Although it is not possible to identify precisely the incremental impact of the Bank's asset purchases, I have no doubt that the purchases have improved the supply of overall credit, particularly to the corporate sector, and this in turn is helping to support additional spending.

The Committee voted in March 2009 to purchase £75 billion of assets. The scale of asset purchases was subsequently increased to £125 billion in May and to £175 billion in August. The main risk facing the economy during this period was that, following the very large falls in output caused by the financial crisis and the collapse in confidence, the strength of the economic recovery would not be sufficient to maintain a level of nominal demand consistent with meeting the inflation target. As such, I judged that it was appropriate to conduct an asset purchase programme and to increase the scale of the programme along the path agreed by the Committee.

In November 2009, the Committee voted to increase the scale of asset purchases further to £200 billion. However, I dissented preferring to maintain the stock of purchased assets at £175 billion. I fully recognised the potential benefits of expanding the scale of the asset purchase programme given the downside risks to the economy. However, I was also wary of the potential risks of such a policy. My main concern reflected the considerable uncertainty about the degree of spare capacity in the economy and the behaviour of inflation when output is growing at above trend rates. These uncertainties are always present, but come to the fore in situations like the current environment in which there is a very substantial degree of economic slack. In order to keep inflation on track to hit the inflation target this slack needs to be eliminated. But given the uncertainties about the precise margin of spare capacity and the behaviour of inflation as this spare capacity is being closed, there is a risk to eliminating the slack too rapidly.

I was also concerned that further substantial injections of liquidity might result in unwarranted increases in some asset prices. I did not think there was any strong evidence to suggest that the increases in asset prices seen to date had been out of line with the improving economic outlook and the desired impact of our asset purchase programme. Rather, I was conscious that the stance of monetary policy—in which Bank Rate was very low and substantial amounts of liquidity were being injected into the economy—increased the likelihood that asset prices may in the future move out of line with their fundamental values.

The Outlook

My view of the current economic outlook is broadly in line with the projections for GDP and inflation contained in the February Inflation Report. The considerable stimulus from the easing in monetary policy and the past depreciation of sterling should help to underpin a gradual recovery. But the headwinds stemming from the need for banks to repair their balance sheets and for the public sector to improve its financial position mean that the strength of this recovery is very uncertain. Inflation is likely to remain above target in the near term reflecting the continuing impact of sterling's depreciation, higher petrol prices and the reversal of the VAT reduction. But as these effects wane, downward pressure from the persistent margin of spare capacity is likely to cause inflation to fall back to below the target for a period.

Given this outlook, there are merits to increasing the scale of asset purchases further. A more expansionary policy would help to stimulate a stronger recovery, and so eliminate the degree of spare capacity in the economy more quickly and reduce the time that CPI inflation is likely to persist below the 2% target. But it would also entail significant risks. Some of those risks relate to the same concerns I had in November. In addition, the likelihood that inflation is likely to remain above target for a period means there is a greater chance that expectations of medium-term inflation may move upwards. My judgement in February was that these risks were best balanced by maintaining the stock of purchased assets at £200 billion.

Looking further ahead, I am confident the Committee will be able to reduce the current exceptional degree of monetary stimulus when we think the time is right. Our policy decisions will continue to be determined by the outlook for inflation relative to target. And the Committee has two instruments through which it can withdraw the stimulus, raising Bank Rate and selling assets. The most difficult issue will be to decide the timing of the withdrawal, but these decisions will continue to be made in an open and transparent manner.

Explaining Monetary Policy

Since March 2009, I have delivered four on-the-record speeches, given three press interviews, and made numerous off-the-record presentations to a variety of audiences. These included background briefings for market economists and economic journalists on the asset purchase programme. I have made five regional visits which involved various meetings and events with local businesses and media. As the Bank's Chief Economist, I have extensive liaison with economists in the private and official sectors, both in the UK and internationally.

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