The Monetary Policy Committee of the Bank of England: ten years on

Twelfth Report of Session 2006–07

Volume I

Report, together with formal minutes, oral and written evidence

Ordered by The House of Commons
to be printed 24 July 2007
The Treasury Committee

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Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young, Harry Marin and Anna Leach (Committee Specialists), Lis McCracken (Committee Assistant), Michelle Edney (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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Summary

The contribution of the Monetary Policy Committee of the Bank of England over the last ten years to the goal of maintaining a low inflation environment in the UK has been significant. The monetary policy framework has also been broadly successful, and part of this success can be attributed to the Bank of England Act 1998.

The evidence we have received suggests that the economic environment in which the MPC operates in future might not be as benign as in the last decade. We are concerned, therefore, at the lack of understanding of monetary policy by the general public, especially given this potential for a less benign economic environment ahead.

We do not recommend changes to the mandate of the MPC, nor to the policy instruments it has at its disposal. We support the symmetrical nature of the current inflation target.

We are content with the current size of the MPC. We recommend a single term for ‘external’ members of the MPC of up to six years, with no reappointment. We welcome the Government’s changes to the appointments process. We recommend, to prevent delays in appointing ‘external’ MPC members, the creation of a confidential pool of candidates that can be drawn from at short notice. We also argue that the positions of the Governor and of the two Deputy Governors should be recruited by open advertisement as well as confidential search.

We recommend changes to enhance the transparency of the MPC, including immediate publication of a record of the votes of each MPC member after MPC decisions are released, greater transparency of individual MPC members’ positions in the minutes of the MPC, and further work on improving the public’s understanding of monetary policy.
1 Introduction

Building on success

1. The last decade has seen a period of sustained low inflation unparalleled in the history of post-war Britain. A target for inflation has been set and inflation has remained remarkably close to that target. The conduct of monetary policy has become the responsibility of the Monetary Policy Committee (MPC) of the Bank of England, which has discharged its responsibilities with a high degree of success. In this Report, we examine the reasons for that success, but we also look at ways to build on that success. We make recommendations designed to strengthen further the monetary policy framework to help to ensure that that framework is fully prepared to operate and retain high levels of parliamentary and public support in less benign economic conditions than those that have prevailed in recent years.

The conduct of our inquiry

2. We undertake regular scrutiny of the MPC's work, both through our sessions with members of the MPC about Inflation Reports and through the appointment hearings which we hold with appointees to the MPC. As the tenth anniversary of the establishment of the MPC drew near, we felt it was appropriate to undertake a fuller inquiry. We announced our decision to undertake an inquiry into the Monetary Policy Committee of the Bank of England: ten years on in November 2006, inviting written evidence by 24 January 2007 on four main themes, relating to the economic context, the monetary policy framework, the MPC as a body and the mechanics of setting and implementing monetary policy. In February 2007 we published all of the written evidence received in order to inform subsequent exchanges in oral evidence. We held five evidence sessions between March and June 2007, taking evidence from academic and City economists, representatives of the CBI, the TUC and the Court of the Bank of England, Lord George, who served as Governor of the Bank of England from 1993 to 2003, from four former ‘external’ members of the MPC, from the current Governor of the Bank of England, Mr Mervyn King, and all eight other current members of the MPC, and from the then Chancellor of the Exchequer, the Rt. Hon. Gordon Brown MP. We also benefited greatly from visits to the Bank of Canada in Ottawa and the Federal Reserve Board in

1 See Treasury Committee press notice No. 3 of Session 2006–07, available at http://www.parliament.uk/parliamentary_committees/treasury_committee/tc21106pn03.cfm
2 Treasury Committee, Written Evidence, HC (2006–07) 299–II. All references to Ev 1 to Ev 103 are to memoranda included in that volume.
3 Professor Anton Muscatelli, Heriot-Watt University, Professor Simon Wren-Lewis, Merton College, Oxford University, Mr Ray Barrell, National Institute of Economic and Social Research, Professor Tim Congdon CBE, Mr Laurence Sanders, Bank of Ireland, Mr Michael Saunders, Citigroup, and Professor Jagjit Chadha, BNP Paribas
4 Mr Richard Lambert, Director General, and Mr Ian McCafferty, Chief Economic Adviser
5 Mr Brendan Barber, General Secretary, and Mr Tim Page, Senior Policy Officer
6 Dr David Potter CBE, Deputy Chairman of the Non-executive Directors and Chairman of the Remuneration Committee, and Ms Amelia Fawcett CBE, Chair of the Audit Committee
7 Ms Marian Bell CBE, Dr DeAnne Julius CBE, Dr Sushil Wadhwani CBE and Professor Charles Goodhart CBE
8 Ms Rachel Lomax, Deputy Governor (Monetary Policy), Sir John Gieve, Deputy Governor (Financial Stability), Mr Charles Bean, Chief Economist and Executive Director (Monetary Analysis), Mr Paul Tucker, Executive Director, Markets, Ms Kate Barker, Professor David Blanchflower, Dr Andrew Sentance and Professor Tim Besley
Washington DC and from other meetings that took place during our visit to Ottawa and Washington DC. We are most grateful to all those who assisted us in the course of our inquiry.
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2 Reform of the monetary policy framework

Recent history

3. On 16 September 1992, the United Kingdom exited the European Exchange Rate Mechanism. In October 1992, the United Kingdom adopted a new monetary policy framework with an inflation targeting regime. In this system, the Governor of the Bank of England and the Chancellor of the Exchequer met monthly to discuss monetary policy, but actual responsibility for setting short-term interest rates lay with the Chancellor of the Exchequer alone. The inflation target was a range between 1% and 4% on the RPIX inflation measure, with an aim by the end of that Parliament of having inflation in the lower end of that range. In 1995, the inflation target was revised so that the inflation rate was to be 2.5% or lower on the RPIX measure of inflation.

4. In May 1997, this framework changed. Under the new system, the inflation target was to be set by the Government, and the MPC of the Bank of England was created with operational independence to set the level of short-term interest rates to achieve that target. At the time of its institution, the inflation target was set at 2.5% on the RPIX measure of inflation. The MPC has nine members, and operates on a one person, one vote system, designed to promote both transparency and independence. This contrasted with the circumstances we found on our visit to Canada and the USA. In Canada, decision making is based on a consensus format. In the United Kingdom, the Governor of the Bank of England has been outvoted twice in close decisions.

5. When we asked Lord George, who was Governor of the Bank of England in 1997, how important the changes at that time were, he told us that they were a culmination of a set of changes, both in policy and thinking. An inflation target had been adopted five years earlier. The role of fiscal policy moved to being seen as useful in the medium and longer term. Monetary policy’s role was not seen as maximising a trade off between inflation and growth but keeping aggregate demand growing in line with the growth in the supply capacity of the economy. As Lord George put it, there was a broad political consensus that it had become “a technical job to manage monetary policy to keep demand growing in line with supply”.

The need for further legislative reform

6. The Bank of England Act 1998 is the legislative centrepiece of the new monetary policy framework. During our inquiry, we have discussed with witnesses possible reforms which would require amendment of the Bank of England Act 1998. Examples of issues considered...
below which could be included in this category include changes to the frequency of meetings held by the MPC, the frequency of changes to the monetary policy remit, and the length of the terms of office for ‘external’ members of the MPC.

7. While much evidence concerned specific proposals for legislative change, several witnesses argued against legislative change at a general level. Ms Kate Barker, an ‘external’ member of the MPC, told us that while “tweaks” could be made, “Frankly, I am not sure that there is anything that I would change about the framework of the Act”.13 The Governor of the Bank of England agreed with this view, stating “I do not see a strong case for making changes in the legislative framework, but that is not to say that we cannot learn from other central banks about how they carry out their research or how to think about certain questions that come up”.14 The then Chancellor of the Exchequer told us that the “test of this framework is its success”, but that “we shall look at any reports that your Committee brings to us about possible changes that you wish to recommend”.15 The monetary policy framework of the last decade has been broadly successful. At least some of that success can be attributed to the Bank of England Act 1998. Continuity is an important part of this framework, allowing market participants to have faith in the stability of the system. In view of the broad level of success of the framework and of the legislation, we do not see any reason why legislation to amend the Bank of England Act 1998 ought to be accorded high priority within the Government’s legislative programme. Thus, while some of our recommendations might require legislative change, we accept that the opportunity for such change may not occur in the near future.

13 Q 238
14 Q 260
15 Q 409
3 The economic context

Introduction

8. Short-term interest rates are set by the MPC, with the Bank of England undertaking the money-market operations required to achieve that interest rate. Very briefly, short-term interest rates are set by the Bank through its role at the centre of the banking system. The official Bank rate is set by the Bank charging that amount of interest on the loans ordinary banks require overnight to balance their cash requirements. These banks will then change their interest rates in order to keep in line with the interest rate the Bank of England is offering. Subsequently in this report, unless stated otherwise, any mention of interest rates means short-term interest rates.

9. The inflation target is supposed to be met by the MPC raising or lowering interest rates. Inflation is affected by the interest rate in the following ways. Inflation should fall if interest rates are raised, but there is a lag to the full effect coming through, estimated to be around two years. When interest rates rise, loans become more expensive. Those on variable mortgages have to pay more interest, and therefore have less money to spend on other goods and services in the economy. The rate of interest paid on savings also increases, which means that people may choose to save more, rather than consuming today. In this way, demand in the economy is reduced. This reduction in demand means that those who supply products may have to lower their prices (or raise them less quickly) in order to maintain their orders. Inflation therefore falls.

The past decade

10. Over the past decade, inflation has only once gone beyond one percentage point either side of the target, in March 2007. Mr Michael Saunders of Citigroup highlighted three reasons for this good performance: “The framework is good, the judgment is good and they have been lucky”. It was difficult for us to assess the balance between these three factors. A lot of witnesses were prepared to acknowledge the record of the MPC. Professor Tim Congdon told us that it had been “massively successful”, a view supported by Professor Simon Wren-Lewis, of Merton College, Oxford University, who told us that “the MPC has been very successful”. Professor Charles Goodhart, a former ‘external’ member of the MPC, remarked that the recent stability in inflation was both “remarkable” and “quite extraordinary”.

11. Some attributed the success at least in part to luck. Professor Wren-Lewis told us that “There is no doubt that [the MPC] has been lucky in the sense that it has not been a very turbulent period, so in that sense it has not been severely tested, but there have been

17 Q 58
18 Q 6
19 Ibid.
20 Qq 143, 150
problems that it has had to deal with.” 21 Mr Ray Barrell of the National Institute of Economic and Social Research was only prepared to say that the MPC had been “successful” rather than “very successful”, because it had not had to “avoid an accident”, in that no such accident had loomed. 22 Mr Saunders also told us that the MPC were aware that they were operating against a “fortunate background”. 23

12. Others felt that more credit ought to be given to the MPC. Professor Anton Muscatelli of Heriot-Watt University commented that “if you look in terms of a sustained period of growth, the UK has actually fared very well compared to the other European economies which have been subject to very similar shocks, so I think [the MPC] has been very successful”. 24 Mr Laurence Sanders of the Bank of Ireland told us he believed that “the fact that the Bank of England was so close to that central target consistently over a period of time represents a strong element of judgment”, although with assistance from “global factors”. 25

13. The former Governor of the Bank of England, Lord George, was emphatic that he did not care whether it was luck or judgement, the outcome had shown the MPC to be a success. However, he did point out that the UK had narrowly avoided the recessions other countries had gone into after the Asian crisis, and that it was not “pure luck”. 26 Ms Marian Bell, a former MPC member, also highlighted that there had been external shocks which the MPC had dealt with, telling us that:

it would have been quite easy for the MPC to get it wrong at different stages and notably it has not. I think it is quite wrong to think that it has been plain sailing and there have not been any risks. There have been big structural changes in the world economy and the UK economy and also a considerable number of shocks. The MPC has dealt with that extremely well. 27

14. While it is difficult to quantify the contribution made by the Monetary Policy Committee to maintaining a low inflation rate over the last decade as distinct from the effects of wider changes in the global economy, the Monetary Policy Committee deserves a significant amount of credit for ensuring that inflation over the last decade has been both lower, and less volatile, than in preceding decades.

Risks ahead

15. Several different threats to the economic outlook for the next ten years were identified in evidence which might effect the work of the MPC. Professor Congdon highlighted the threat from the high rate of money growth, and the possibility of larger public deficits. 28 Mr
Barrell warned that the Bank would have to be vigilant for asset price bubbles, and continue to monitor the scale of personal debt, and that in the end, the risk of banking crises had not gone away. Professor Muscatelli commented on the continuing risk of a disorderly unwinding of global imbalances, a risk we have commented on in our Report on Globalisation: The role of the IMF. Professor Wren-Lewis commented that the global imbalance risk appeared at the moment to be mainly between the United States and the Far East.

16. The Bank of England in its written evidence highlighted two tailwinds that had operated over the last decade, globalisation and an increase in the effective labour force. According to the Bank, globalisation had benefited the economy by improving the terms of trade (by making imports cheaper), thus allowing a temporary reduction in the level of unemployment consistent with low inflation. The increase in the labour force, according to the Bank, was due to “a decline in the natural rate of unemployment; increased labour force participation; and net inward migration, especially from the A8 countries”. This increase in the supply side of the economy had also reduced inflationary pressure. However, the risk was that these tailwinds were beginning to weaken. The previous decade had been referred to as the ‘non-inflationary consistently expansionary decade’ or ‘nice’ decade. The Bank provided us with a warning that, as these tailwinds dropped off, the next decade might not be so ‘nice’:

We cannot guarantee that the next ten years will be so “nice”. Many of the benefits of globalisation have already worked through, and the adverse impact on commodity prices of the development of China and India is now being felt. And the effective labour force is unlikely to grow as rapidly as it has done over the past decade or so. Moreover, some aspects of the global economy look unsustainable, particularly the pattern of global current account imbalances and the low level of real interest rates and risk premia. So the macroeconomic context is likely to be somewhat less benign.

17. Mr Sanders agreed that there might be some weakness from a diminishing globalisation tailwind, but felt that there was additional impetus from other economies than those in the Far East, such as Latin America, that was still to be felt. Mr Richard Lambert, Director General of the CBI, commenting on the potential “lack of positive drivers going forward”, such as globalisation and migration, felt that this was not an area for the MPC, but the Government to deal with, such as through the Leitch review into

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29 Q 3
30 Ibid.
32 Q 3
33 Ev 7
34 Ev 8
35 Ev 7–8
36 Ev 8. The A8 countries are: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.
37 Ev 13
38 Q 62
The then Chancellor of the Exchequer noted that oil and commodities prices posed a threat to the current stability of inflation, and also reiterated the Bank’s conclusion that changes within the Chinese economy might mean that the benefits of globalisation might be diminishing. He added, however, that nobody knew what the effects of these different factors would be over the next ten years.40

18. Professor Goodhart highlighted that people had forgotten what the effects of high inflation were like, and that therefore people took the current stability of inflation “rather too much for granted”.41 Several issues, such as the recent rise in asset prices, the potential end of the tailwinds of an increasing effective labour supply and globalisation which have tended to reduce inflationary pressures in recent years, and the risk of a disorderly unwinding of global imbalances have been drawn to our attention as factors suggesting the possibility that the economic climate over the next ten years may not be as benign as that seen over the last decade. While we are sure that the Monetary Policy Committee are aware of this risk, it is important that the public are also prepared for the possibility of less benign conditions ahead. Later in this Report we examine actions that may be necessary to educate the public about monetary policy in more uncertain times.

**Asset prices**

"Leaning against the wind"

19. One potential weakness in the future economic environment relates to whether the recent rise in asset prices will be followed by a rapid fall in those same prices, leading to possible knock-on effects on both economic growth and inflation. Professor Jagjit Chadha of Citigroup suggested that one reason why asset prices had risen so much was because the Bank had had to stimulate domestic inflation to counter the global reduction in traded goods inflation, and that there had therefore been “elevated levels of asset prices”.42 Mr Saunders told us that weak consumer prices had allowed the Bank to “tolerate” this rise in asset prices to prevent inflation undershooting the target.43 He later said, however, that at times the MPC might not have put enough weight on asset prices in their deliberations, but that he agreed that they were unable explicitly to target house prices.44 Professor Congdon linked the rise in asset prices to the rise in the money supply.45 Ms Barker pointed out that, in a period of low-real interest rates, it was not surprising “to see asset prices rise because of course that changes the fundamental valuation of those asset prices”.46
20. Dr Sushil Wadhwani, a former ‘external’ member of the MPC, presented one potential response to the rise in asset prices in his written evidence. While not advocating an explicit target for asset prices, he wrote that there should be a ‘leaning against the wind’ policy: where an asset price bubble was thought to be occurring, the MPC could “aim-off”, raising interest rates to counter the bubble.\(^{47}\) Dr Wadhwani told us that he continued to believe that the MPC “should be leaning against the wind in terms of asset prices”.\(^{48}\) However, Mr Barrell, while supportive of the policy, explained the consequences of such an action, telling us that “Holding interest rates higher than they otherwise would have been in order to deal with debt and to deal with asset prices and those risks means holding them higher than they really need to be to hit full employment immediately, so there is a choice, a trade-off”.\(^{49}\)

21. Professor Wren-Lewis highlighted the problems with the Bank targeting such asset price ‘bubbles’:

> certainly it [The Bank of England] should be on the lookout for bubbles, that is periods in which asset prices in particular seem to depart from fundamentals, because potentially those bubbles can impact seriously on the economy. However, although in principle it should look out for those things and in principle could act to try and counteract them, in practice actually identifying when bubbles occur is incredibly difficult.\(^{50}\)

Lord George warned against having an explicit target for asset prices, telling us:

> Asset prices can be driven by all manner of outside considerations. It is tremendously important that the Monetary Policy Committee monitors, follows and studies what is happening to different asset prices, financial assets, housing and so on, as it does. Those subjects are studied extremely carefully within the bank and are discussed by the MPC. But if one decided to set a target for house prices and equity prices one would end up in ‘heap on floor’. One just cannot focus on more than one objective.

Ms Bell was also cautious about the ability of the MPC to counter asset price bubbles, warning that “the best job the MPC can do is to focus very precisely on achieving exactly the target that has been set for it and not try to stabilise asset prices as well”.\(^{51}\)

22. The recent period of low interest rates has seen a rise in asset prices. One possible response by the Monetary Policy Committee would be to target such rising asset prices by ‘leaning against the wind’—raising interest rates to deflate the bubble in those prices. However, such a move would presuppose the successful identification of such a bubble. On the evidence we have received, this is not possible with certainty. Furthermore, the only instrument available to the MPC is moving the interest rate, and increasing interest rates to counter a rise in certain asset prices could hamper economic

\(^{47}\) Ev 85  
\(^{48}\) Q 173  
\(^{49}\) Q 11  
\(^{50}\) Q 9  
\(^{51}\) Q 170
growth across the economy, not just in the markets with rising prices. For such a policy to be worthwhile, therefore, the risk to the economy of a rapid fall in asset prices would have to exceed the actual cost of raising interest rates to counter the rising asset prices.

The housing market

23. Any consideration of asset prices in the UK is likely to pay particular attention to housing, given that residential buildings accounted for 44.1% of the total assets (both financial and non-financial) of households and non-profit institutions serving households at the end of 2005.52 Housing is also of interest because of the way in which the downturn of the late 1980s and early 1990s was centred around the housing market. Professor Congdon outlined the present situation, and what happened after the most recent house price cycles:

At the moment you have got an anomaly really, because house prices are out of line with incomes. What has happened in two previous cycles - a cycle in early 1970s and again in the late 1980s - was that we had this very high house price: earnings ratio and then a bust. The ratio came back in the first case with a lot of general inflation and in the second case with house prices falling quite sharply in nominal terms.53

Professor Congdon went on to say that a collapse in house prices was not inevitable. Rather than a bust, his view was there could be ‘rust’, with house prices rising less quickly than incomes in general, a point he reiterated later, by saying that in the last housing downturn which had macroeconomic effects, inflation had been in double-digits.54

24. Professor Wren-Lewis on the other hand drew attention to some research at Oxford University suggesting that going beyond price-income ratios, house prices were actually currently sustainable.55 Mr Barrell agreed that this might be the case. In a world of more stable interest rates, the risk of owning a house may have fallen, stimulating demand, and thus prices. Therefore, in part, the MPC itself, by creating a low and stable interest rate environment, might have contributed to a rise in house prices.56 Mr Saunders again returned to the point that the MPC had had to stimulate the domestic economy to prevent an inflation undershoot, and higher house prices had been a consequence of that.57 Lord George told us that the need to stimulate domestic consumption had been the route chosen by the MPC at the beginning of the decade, in the face of weak business investment and global economic weakness, to prevent inflation undershooting the target, and that high asset prices – house prices in his example – were a “legacy to [his] successors” from the actions the MPC had undertaken under his Chairmanship.58 It was up to the present MPC to “sort it out”.59

52 Office for National Statistics, *United Kingdom National Accounts 2006*, Tables 6.1.9 and 10.10
53 Q 8
54 Qq 8, 15
55 Q 9
56 Q 10
57 Q 67
58 Q 117
59 Ibid.
25. As with the case of asset prices in general, Professor Congdon warned that the MPC could not target both house prices and the CPI together at the same time. All the MPC could do, and had done, was provide warnings. Using the housing market as an example, Lord George highlighted the problems in forecasting the end of asset price bubbles, telling us that:

> When I was still in my day job a lot of people forecast a collapse in house prices over the next six to eight months. We are still waiting for it. One must be very cautious about that kind of projection.\(^{60}\)

Another point of view was provided by Dr DeAnne Julius, a former external member of the MPC, who told us that she believed “that the issue of house prices in this country is mostly a supply-side phenomenon”, and outside the influence of the MPC.\(^{61}\)

**Household debt**

26. As a proportion of total financial liabilities of households and non-profit institutions serving households in the United Kingdom at the end of the fourth quarter of 2006, long-term loans secured on dwellings amounted to 76.4%, again highlighting the importance of the housing market to households’ financial position.\(^{62}\) Ms Barker confirmed that the rise in household debt was in part the other side of the same coin that saw rising house prices. She did not see any difficulties in repaying this debt as a monetary policy issue.\(^{63}\) Mr Sanders also felt that interest rates were the key to the recent rise in household debt, because the low level of interest rates had led to cheaper debt repayments.\(^{64}\)

27. Mr Barrell argued that the most effective way of dealing with the rise in household lending, by constraining lenders, lay with the Financial Services Authority, rather than the MPC.\(^{65}\) He thought that the MPC had to be concerned about the rise in debt, because that rise also could lead to rising insolvencies, and potential problems in the banking system.\(^{66}\) He felt that the Bank should have been signalling to the Financial Services Authority that there could be a problem.\(^{67}\) Professor Muscatelli also agreed that this was an issue for the Bank to discuss with the FSA, saying that leverage was very important, but he also stated that household debt was not an issue for monetary policy.\(^{68}\)

28. The rise in debt means that some consumers may have difficulties repaying that debt. Mr Sanders felt that there would be more problems with consumer debt over the next five to ten years.\(^{69}\) Professor Goodhart informed us that the Bank analysed this as part of its

\(^{60}\) Q 127  
\(^{61}\) Q 170  
\(^{63}\) Q 188  
\(^{64}\) Q 66  
\(^{65}\) Q 11  
\(^{67}\) Q 12  
\(^{68}\) Q 15  
\(^{69}\) Q 68
financial stability remit, and while not a systemic issue, the rise in household debt was a social, distributional issue. Professor Congdon was more forthright on this point, stating that “It is not [the MPC’s] job to deal with those people who have got excessive debts and so on.” Ms Bell felt that only when debt began to effect the monetary transmission mechanism should it be taken into account when conducting monetary policy.

29. We also heard evidence about the effect of the rise in debt in determining how interest rate movements would affect the economy. Professor Wren-Lewis pointed out that the rise in household debt, especially secured lending, had made the economy more sensitive to interest rates, and that the Bank would have to be more cautious when moving interest rates, because consumers might react more strongly to those movements than they had done in the past. Professor Muscatelli argued that, while in certain situations consumers might react smoothly to interest rate changes, if there was a sudden change in circumstances, perhaps due to a rise in unemployment or a deep recession, then the Bank might find it harder to react, because interest rates alone might not be enough. Mr Sanders felt that the increase in the stock of debt meant that the economy was more sensitive to changes in the interest rate, and that small changes in interest rates would now have a larger effect.

30. Dr Wadhwani pointed out that the US sub-prime mortgage market problems would prove illuminating on whether debt issues would lead to macro-economic effects. And Dr Andrew Sentance, an ‘external’ member of the MPC, reiterated that, because of the link between consumer spending and the build-up in consumer debt, this was something he was interested in building up a picture of. Mr Ian McCafferty, Chief Economic Adviser at the CBI, also considered that the build-up in debt did not pose a systemic risk unless interest rates went very high (he quoted Bank evidence suggesting interest rate rises would have to be “well north of 7% or 8%”), but that certain households were now very sensitive to any rise in the interest rate. He also thought that the MPC ought to keep this issue in mind, but that it was not the role of the MPC to deal with the individual circumstances of certain households.

31. The then Chancellor of the Exchequer assured us that, for those who were currently facing difficulties with debt, the Government was “putting in place measures that give proper advice, proper help, proper debt counselling, proper support, and obviously, we want the banks and the mortgage companies to be sensitive to people in the position that
they find themselves in”. However, as a systemic risk, he pointed out that debt repayments as a percentage of income were not in as bad a position as suggested by our questions to him. The weight of evidence we have received suggests that the rise in household debt is not on such a large scale as to exert significant influence on monetary policy. However, the risk remains that future interest rate rises will see larger numbers of households in financial difficulties than anticipated.

**Monetary aggregates**

32. Views on the extent to which the rise in money supply presented a threat to inflation in the future differed among witnesses. Different members of the MPC placed differing weights on the information monetary aggregates could provide. Ms Rachel Lomax, Deputy Governor of the Bank of England, was most sceptical of the information provided by the growth in the money supply, and told us that she found it “very difficult to see much information in short-term movements in any of these monetary aggregates for movements in inflation over the next couple of years or so”. On the other hand, Professor Tim Besley, an ‘external’ member of the MPC, while he did not agree with the simplistic notion that increasing money supply led to inflation and praised Bank research trying to assess the empirical implications of the recent growth in the money supply, believed that, when linked in with the asset and credit markets, the money supply figures posed an upside risk to inflation, because they “could ultimately spill over into demand-side pressures in the economy and therefore essentially lead to a different nominal path which leads to higher inflation”. The Governor of the Bank of England expressed concern about the recent rise in money growth. He stated that, while some of this growth was explained by inter-bank transfers, there still remained a component of broad money growth beyond this. He observed that inflation was a monetary phenomenon, and therefore the rise in money growth could suggest a pick-up of inflation in the medium term.

33. We asked our other witnesses how the recent rise in the money supply ought to be interpreted by the MPC. Professor Congdon said that he had repeatedly expressed his concern about the strong growth in the money supply. Professor Wren-Lewis agreed that the Bank ought to monitor monetary aggregates, but thought that, as an indicator, money supply was very unreliable and rapid increases in monetary aggregates had also happened with virtually no consequence to the real economy. Professor Chadha, while not going as far as to suggest that the MPC should follow the European Central Bank approach of having money supply as a “second pillar”, argued that “Money supply is absolutely a key variable to study in terms of thinking about the macroeconomy”, in that it could provide information on the real-time state of the economy, and on certain sectors of the economy.

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81 Q 422
82 Ibid.
84 Q 192
85 HC 414–i (2006–07), Q 42
86 Q 2
87 Q 18
88 Q 71
The then Chancellor of the Exchequer did not accept the idea of a fixed relationship between the money supply and inflation, and the view that therefore monetary aggregates could be targeted to keep inflation in check. We have received differing evidence about the importance that should be attached to the rise in the money supply. While we acknowledge that it is difficult to assess what information such strong growth in the money supply might provide for future movements in the inflation rate, there is a possibility that, in the medium term, the current rise in the money supply might presage a higher path for inflation.

Inflation expectations

34. One important risk identified in evidence related to the possibility of inflation expectations coming loose from their anchor, especially should economic circumstances be less benign going forward. Mr Saunders, in his written evidence, explained that, if inflation expectations rose, then individuals would bargain for higher wages. Should these increases in wages be granted by firms, this would lead firms to raise prices to cover the cost, increasing inflation. Explaining the importance of the recent anchoring of inflation expectations, Professor Wren-Lewis highlighted that “anchoring expectations does not so much make monetary policy more effective; I think it makes it easier, in the sense that if the economy is hit by shocks then the Bank has to do less to counteract those shocks than if expectations are much more volatile”. But Professor Chadha pointed out that there had been, in recent times, a slight shift upwards in inflation expectations, both on the CPI and RPI measures. He suggested that there was a danger in overusing inflation expectations as a measure of inflationary pressure, because monetary policy was expected to move to counteract any movements within them, thus neutralising their informative power.

35. Lord George pointed out that inflation expectations, while not anchored precisely to the target, were now no longer running into “double digits”, and that this had been a success of the regime. Dr Wadhwni agreed, stating that the lowering of inflation expectations since the 1997 reforms had been important, and “has made it much easier for the economy to handle the fluctuations in oil and commodity prices that we have seen”. Mr Lambert also said that inflation expectations had influenced the wage bargaining process, and that “people broadly trust the idea that, over time, the target will be met”. The anchoring of inflation expectations has had an important role in ensuring that inflation has varied by less than might have been expected given the external shocks faced by the economy in recent times. However, we remain concerned that, while inflation expectations appear anchored in financial markets, the general public appear to have less understanding of the monetary policy framework.

89 Q 423
90 Ev 48
91 Q 5
92 Q 73
93 Q 76
94 Q 105
95 Q 142
96 Q 374
4 The monetary policy framework

Mandate


In relation to monetary policy, the objectives of the Bank of England shall be—

(a) to maintain price stability, and

(b) subject to that, to support the economic policy of Her Majesty’s Government, including its objectives for growth and employment.

Price stability, and the economic policy of Her Majesty’s Government are then defined by the Treasury on an annual basis, in a remit letter from the Chancellor of the Exchequer to the Governor of the Bank of England.97

37. The type of monetary policy mandate set for the Bank of England is generally characterised as ‘hierarchical’, in that the primary aim of monetary policy is to maintain price stability, while support of the Government’s economic policy is secondary to that. On our visit to the United States, we discussed the US monetary policy dual mandate:

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy’s long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.98

Here, price stability and maximum employment share equal ranking. However, observers in the US suggested to us that the definition of ‘maximum employment’ was treated by the Federal Reserve as meaning the level of employment that would lead to price stability.

38. Mr Brendan Barber, General Secretary of the TUC, touched upon the remit of the MPC, telling us that:

the remit to the MPC is a remit relating to monetary stability but taking account of the implications for growth in the economy more generally. As an element of that slightly wider description of the remit, the needs of the manufacturing sector and the pressure of the manufacturing sector need to be taken into account.99

Mr Lambert was quick to rebuff the suggestion that the MPC should have such a wide remit, telling us that:

the Monetary Policy Committee has a single instrument, which is interest rates, and that it has a single target, which is a symmetric target - which is really important.

97 Section 12, Bank of England Act 1998
98 Section 2A, Federal Reserve Act 1913, as amended
99 Q 370
Within that, it is very difficult - and I do not think it would be advised to be trying, as it were - for it to deconstruct the economy and aim at particular sectors of it within its forecasting work.  

39. We questioned the then Chancellor of the Exchequer about the desirability of a dual mandate, with price stability and full employment equally weighted. He told us that the Federal Reserve’s objectives were written many decades ago, and were “a creature of their times”. He went on to say that the UK monetary policy objectives were set against a previous backdrop of high levels of inflation, and that the UK framework had achieved, as well as low inflation, low levels of unemployment. He then went on to argue that modern economic theory suggested that there was no long-term trade-off between employment and inflation, and that therefore a dual mandate was not a worthwhile objective. With only a single policy instrument of interest rates available, we agree that the Bank should have as its primary objective price stability. However, subject to that, we will continue to monitor the Monetary Policy Committee’s compliance with the secondary objective of meeting the Government’s intention of high and stable levels of growth and employment.

Setting the target

40. The inflation target—currently a central target inflation rate of 2%, measured on the Consumer Prices Index, with a letter to be written to the Chancellor of the Exchequer if inflation on the CPI index moves more than one percentage point either side of that central target—is set by the Treasury, through a letter once a year from the Chancellor of the Exchequer to the Governor of the Bank of England, as required by the Bank of England Act 1998. Since the inception of the MPC, there has only been one change in the target, in December 2003, when both the target and measure of inflation changed, from 2.5% on the Retail Prices Index, to the current 2% on the Consumer Prices Index.

41. During our visit to Canada, we discussed their system for setting the inflation target. In Canada, the target, the inflation measure via which the target will be assessed, and the next time the target will be agreed, are all set by an agreement between the Bank of Canada and the Canadian finance ministry. These agreements are for five years, as opposed to the annual remit in the United Kingdom. A consistent theme in evidence was that changes to the target had to be infrequent. Mr Saunders said it was too easy to change the target under the current system, and that “if you have a target you should stick to it and to me the cost is more changing the target rather than what the particular target is”.  

42. Lord George thought it was right that the Chancellor of the Exchequer, as an elected politician, set the target, but also thought that changes ought be minimised, and suggested

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100 Q 372
101 Q 410
102 Ibid.
103 Q 439
104 Section 12, Bank of England Act 1998
105 Bank of Canada press release, 23 November 2006
106 Q 78
that any politician making a change “would have a hell of a job explaining why he was doing it unless the argument was fairly convincing”.\textsuperscript{107} Lord George was also keen to keep the Bank out of the decision-making process around setting the target, because that “would draw the Bank into a political process”.\textsuperscript{108} He was unsurprised that there had been little discussion of the target level, because there was broad consensus behind it.\textsuperscript{109} Dr Sentance considered that it would make the job of the MPC harder if the target moved, either by changing the actual target amount, or the inflation measure used in the target.\textsuperscript{110} Ms Lomax called for there to be more consultation when the target was changed.\textsuperscript{111} The then Chancellor of the Exchequer confirmed that he believed the target should not change repeatedly.\textsuperscript{112} It is appropriate for the inflation target to be set by the Chancellor of the Exchequer. We consider that it would be valuable to maximise certainty about the target going forward. To that end, we recommend that the Government give consideration as to how this might be achieved.

### Target symmetry

43. One important aspect of the current inflation targeting regime in the United Kingdom is its symmetry. Inflation undershooting the target is considered to be as undesirable as inflation over-shooting the target. Professor Muscatelli, however, argued in his written evidence that empirical evidence suggested that the “Bank [had been] apparently putting greater weight on inflation control than one might have expected with a symmetric target”.\textsuperscript{113} When questioned about this research, Professor Muscatelli suggested that the possibility “that, as the Bank was trying to build up its credibility it might have been quite cautious and therefore inflation stayed below its target”. He stressed that these results were based on macroeconomic models, to which some uncertainty was attached.\textsuperscript{114} Mr Barber said there had been an earlier period where the Trade Unions had also feared an anti-inflationary bias on the part of the MPC, but pointed out that inflation was now overshooting the target.\textsuperscript{115}

44. Professor Congdon suggested that the appearance of downward bias might have been due to the MPC being surprised by the unanticipated strength of the exchange rate.\textsuperscript{116} Professor Goodhart supported this, telling us that, “Because the exchange rate was always somewhat higher than we expected, inflation turned out to be just a tiny bit lower, but the deviations were minute”.\textsuperscript{117} Lord George discounted the view that the MPC had been trying to win credibility at the start of its work by having an anti-inflationary bias, telling us

\textsuperscript{107} Q 131
\textsuperscript{108} Q 132
\textsuperscript{109} Q 133
\textsuperscript{110} Q 200
\textsuperscript{111} Q 289
\textsuperscript{112} Q 444
\textsuperscript{113} Ev 65
\textsuperscript{114} Q 25
\textsuperscript{115} Q 374
\textsuperscript{116} Q 26
\textsuperscript{117} Q 146
that “Symmetry was accepted by the MPC from the beginning and was a fundamental characteristic”.\textsuperscript{118} He said that the MPC had undershot on the inflation target early on because they knew that stimulating the domestic side of the economy was not a sustainable option and were thus cautious, rather than this being a deliberate action to gain credibility at fighting inflation.\textsuperscript{119} \textbf{We strongly support the symmetry of the inflation target. We will remain vigilant for any signs that there appears to be either anti- or pro-inflationary bias by the Monetary Policy Committee, and should such signs appear, we will ask for an explanation during our regular hearings on Inflation Reports.}

\section*{Measuring inflation}

\subsection*{Wage bargaining and the CPI}

45. The only change to the inflation target since the reforms of 1997 was in December 2003 when the target was revised from 2.5\% to 2\%, and the measure of inflation used for the purposes of the target moved from RPIX to CPI.\textsuperscript{120} The Retail Prices Index had traditionally been used for wage bargaining. Concern was expressed about the change from the RPIX to the CPI because wage increases might still be linked to RPI. As a consequence of this, if RPI were higher than CPI, wage expectations, and thus inflationary pressure, could be higher than if the target had been based on RPI. Mr Barber confirmed that the RPI remained the measure used in wage bargaining.\textsuperscript{121} Mr Barrell pointed out that wages were determined by the conditions in the labour market, not the RPI, and therefore even if worker demands related to RPI, it was up to employers whether or not they agreed to that level of increase in salary.\textsuperscript{122} Mr Lambert noted that wage bargaining was conducted within a market, and that market would determine the overall level of wage settlements, which the MPC would then monitor.\textsuperscript{123} Dr Wadhwani impressed upon us the need to inform the public that RPI-linked wage settlements were not for the good of the economy, should not be expected as of right, and could lead to higher unemployment.\textsuperscript{124} \textbf{We do not believe that the move from the Retail Prices Index (excluding mortgage interest payments) to the Consumer Price Index has adversely affected the work of the Bank of England in anchoring inflation expectations. While the Retail Prices Index may be the dominant index for wage negotiation, and thus of interest to the Bank, wages are, in the main, set by market forces.}

\subsection*{Including housing costs in the CPI}

46. The Consumer Price Index does not contain an element relating to house prices, unlike the Retail Prices Index. In evidence to the House of Lords Economic Affairs Committee, the Governor of the Bank of England outlined the problem:

\begin{itemize}
\item\textsuperscript{118} Q 129
\item\textsuperscript{119} \textit{Ibid.}
\item\textsuperscript{120} Remit letter from the Chancellor of the Exchequer to the Governor of the Bank of England, 10 December 2003
\item\textsuperscript{121} Q 357
\item\textsuperscript{122} Q 23
\item\textsuperscript{123} Q 360
\item\textsuperscript{124} Q 145
\end{itemize}
CPI ignores housing costs, which is unfortunate. It has rental housing but not owner-occupied housing. For some time we have been hoping that housing costs would come back in to CPI and indeed EUROSTAT is conducting an experiment to see how they could bring housing into different national measures and they control the definition of this harmonised measure across Europe. The latest date now for progress on this front has been pushed out to 2010, but frankly I doubt it will be in my lifetime. That is one of the downsides to CPI, that it is very hard to see now when housing costs will come back in to the index.125

47. Professor Muscatelli thought that it would be a “positive step” to include house prices in the CPI, because the danger was that people’s perceptions of inflation differed from the official measure.126 Professor Goodhart was also keen to include house prices in CPI, saying “It is a major issue, because the question of what inflation is will vary quite a lot if housing prices move quite differently from the price of other goods and services, as they have very frequently over the past 10 years”.127 While he acknowledged the difficulties of including house prices in the CPI, he stated “It is a complicated, technical issue but a very important one”.128 Mr Lambert also thought that house prices should be included in CPI, but acknowledged the difficulties, especially considering the European context, in so doing.129

48. Others did not support the inclusion of house price inflation in the CPI. Professor Congdon did not see any reason to include house prices in a measure of goods price inflation.130 Mr Barrell pointed out that it would take a European-wide decision to change the CPI coverage, and that, as long as the MPC knew the effects of the items that were missing from the CPI basket, “the CPI will do”.131 Professor Wren-Lewis was also “far from convinced that some measure of housing costs should play a very big role in the Consumer Price Index. It is not obvious to me why movements in house prices have an affect on people’s welfare.”132 Dr Julius was also committed to the CPI and thought that the house price element of the RPIX “was not a very good element and it destabilised that particular measure”.133 She encouraged the MPC to pay more attention to the core measures of CPI.134

49. Professor Chadha noted that, while the RPI did have a housing cost element, the indices did not diverge over the long-run.135 He urged the Bank to explain how, by meeting its CPI target, it expected the RPI measure to become more stable.136 Lord George said that

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125 Oral evidence to the House of Lords Economic Affairs Committee, 31 October 2006, by the Governor of the Bank of England, Qq 15–16
126 Q 24
127 Q 171
128 Qq 171–172
129 Q 361
130 Q 22
131 Q 21
132 Q 24
133 Q 144
134 Ibid.
135 Q 72
136 Q 73
he had not been keen at the time to change from RPI, but thought that “A 2% target for CPI is a good benchmark for the kind of broad balance and stability that is the big picture here”.\footnote{Q 112} Lord George felt that “One can have endless debate about precisely what one should and should not include”, but that “the overall objective will be undermined if too much attention is paid to particular measures which reflect the expressed opinions of particular groups of people in society”.\footnote{Q 115} Ms Bell thought that the measure used was unimportant, as long as it was “consistent and credible”.\footnote{Q 144} The then Chancellor of the Exchequer strongly defended the use of the CPI, telling us that “CPI is the internationally accepted measure of inflation and I believe it is right to continue to work through the CPI”.\footnote{Q 434} He also thought that it was best “for us to follow the general trend of what is happening in other countries” when determining what should be included within the CPI.\footnote{Ibid.} He went on to say that, when the change from RPIX to CPI occurred, his view was that the new inflation target was “a little tougher”.\footnote{Q 446} We do not, at the present time, recommend changing the Consumer Prices Index to reflect housing costs, before a pan-European consensus has been achieved. However, we recommend that the Government and the Office for National Statistics (with assistance from the Bank of England if required) work with their European partners in bringing about such consensus as quickly as possible.

**Monetary policy and fiscal policy**

*Coordination of monetary and fiscal policy*

50. The changes in the monetary policy framework in 1997 meant that fiscal policy and monetary policy were no longer set by the same institution. The Bank of England received one main policy instrument—raising or lowering the interest rate. Fiscal policy remained a Treasury responsibility.\footnote{Q 11} Much evidence received related to the nature of coordination between fiscal and monetary policy since that functional separation.

51. Mr Sanders told us that he had long argued “that fiscal and monetary policy must be compatible”.\footnote{Q 64} But he thought that the MPC had “quite sensibly taken the view that they will keep out of fiscal policy discussions unless fiscal policy starts to affect inflation prospects, and at the moment it does not”.\footnote{Ibid.} Lord George told us that the Bank would monitor fiscal policy, and would provide a warning to the Treasury if it were concerned about the effects of fiscal policy. He thought “the kind of advice the Bank would give would
be, ‘If you do this it will cause that to happen and interest rates will rocket. Is that really what you want?’.”

52. Mr McCafferty told us:

I think there is an argument to say that we have not yet achieved the optimal balance between fiscal and monetary policy and that fiscal policy has been somewhat loose over the course of recent years, with very rapid rates of public expenditure and a rising budget deficit, and this has led to interest rates being slightly higher than would have been the case. That suggests that there is room for further discussions between the two bodies in order to try to achieve that optimum balance between the two sets of policies.

He believed that, if required, the Bank should be vocal if fiscal policy posed a risk. Mr Lambert cautioned the Bank to keep out of politics, but told us “If, however, it thought fiscal policy was seriously and adversely affecting monetary policy, it should say so.”

53. The Governor of the Bank of England indicated that, “if fiscal policy were set in a way that would lead to a prospect of very large budget deficits, then I think it would be extremely difficult for us to manage inflation expectations which have been the anchor of the framework for monetary policy”. He told us “The Treasury itself knows when making its budget that we will take offsetting action if that appears necessary”. Given the influence that fiscal policy can have on the Monetary Policy Committee’s primary objective of maintaining price stability, it is right that the Monetary Policy Committee should monitor the Government’s fiscal plans, and, if necessary, provide a public warning about the potential effects of changes to fiscal policy.

Allocating temporary fiscal powers to the Bank of England

54. Earlier in this Report the possibility of ‘leaning against the wind’ and keeping interest rates higher than might otherwise be needed in order to stem the growth in asset prices. However, as Mr Barrell stated, this would come at a cost, in that “Holding interest rates higher than they otherwise would have been in order to deal with debt and to deal with asset prices and those risks means holding them higher than they really need to be to hit full employment immediately, so there is a choice, a trade-off”. To counter this trade-off, Professor Wren-Lewis suggested to us that the Bank be given control of certain fiscal policy instruments in order to target certain sectors of the economy, such as housing, where imbalances have built-up. He stressed that this policy proposal was “for the long term. I am not suggesting that this is something that should happen overnight.”
Lewis acknowledged that “the interest rate is the instrument”, but went on to say that “the question is whether you might want to supplement it on quite rare but important occasions by giving limited temporary control of certain fiscal instruments to the Bank”.154

55. The reaction to this policy suggestion was not positive. Professor Congdon disagreed with the notion of handing elements of fiscal policy to the Bank, telling us he was “strongly opposed to reactivating fiscal policy and I think that there are very fundamental disputes about what causes the economy to move”. He went on to say “Monetary policy is the effective instrument and recognising that has been crucial to the success of the MPC”155 Professor Muscatelli did not agree with the policy proposal of allocating certain fiscal measures to the Bank on the grounds that that he was worried about the “democratic deficit” created by such a move. He thought closer cooperation between the Bank and the Treasury ought to be the answer.156

56. When asked whether the Bank ought to be given control of fiscal policy instruments, Lord George replied:

I certainly would not want to put the bank in the position of managing fiscal policy as well because the considerations go way beyond economics. They have to balance social as well as economic concerns and that is the job of elected politicians. It is not a technical job like that of the Bank of England, so one must have much more input into that.157

He highlighted the lack of a democratic deficit for such a move, telling us the Bank “should certainly not be able to veto decisions or insist that politicians behave in a certain way. I should like to point out that we live in a democracy.”158 We see no merit in the case for the Bank of England being given control of any elements of fiscal policy, which should properly remain the province of elected politicians accountable to the House of Commons.

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154 Q 30
155 Ibid.
156 Q 28
157 Q 121
158 Q 125
5 The Monetary Policy Committee as a body

Size and balance of the MPC

57. The MPC comprises nine members, with five ‘internal’ members (The Governor, two Deputy Governors, and currently the Executive Director for markets and the Chief Economist) and four ‘external’ members. ‘External’ members are formally Bank staff, but hold no position at the Bank other than their MPC membership. MPC members themselves saw no division between the externals and internals. Professor Besley assured us that “If you look at the debates that we [the MPC] have and the discussions and the different positions people take, I do not think they correlate at all well at the moment with internal and external”.159 Sir John Gieve, Deputy Governor of the Bank of England, also downplayed the idea of a divide between ‘internal’ and ‘external’ members, and reiterated that “The important thing is that each individual is coming to their own decision and their own personal credibility is on the line”.160 Ms Barker also told us that “I am not sure anybody is particularly institutionalised, even the Bank people”.161 Ms Barker said the advantage of external members was that “it enables the Chancellor to draw on people from a range of backgrounds, and in particular it enables him to add financial markets experience to the panel or, of course, business experience”.162 Ms Lomax welcomed the inclusion of ‘external’ members, telling us “We have had rather a lot of turnover on the Committee in the last year, but the idea of having new people come on is one of the most important ways in which the whole process keeps itself fresh”.163

58. The Governor of the Bank of England defended the ‘internal’ majority on the MPC, “It is a Bank of England committee and it should be a majority of Bank of England staff on it”.164 He also confirmed that he would not want more than nine members of the MPC:

I do think that more than nine would run the risk of making the process much less effective because a conversation among the nine is a key part of it and to have many more people would run the risk, as I think happens in somewhat larger councils that set policy, that some people have more say than others; there may be inner deliberations that take place because a very large body is simply too big to have a sensible discussion.165

While he would accept slightly fewer members of the MPC, he warned “Suppose you were to change the numbers by one. I do not think it would achieve very much but there would be all kinds of commentary about whether a decision was a result of having one fewer

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159 Q 210
160 Q 257
161 Q 211
162 Q 179
163 Q 255
164 Q 275
165 Ibid.
The Monetary Policy Committee of the Bank of England: ten years on

We support the retention of an MPC with nine members, comprised as at present of five ‘internal’ Bank of England staff, and four ‘external’ appointees.

Profile of external members

General requirements

59. The Bank of England Act 1998 states that “The Chancellor of the Exchequer shall only appoint a person … if he is satisfied that the person has knowledge or experience which is likely to be relevant to the Committee’s functions”. Mr Barrell stated that it was difficult to find people for the role of MPC member, because academics were focussed on the long term, while financial market participants were focussed on the very short term. What was needed, in Mr Barrell’s view, was someone equipped with the skill set to look at issues in the medium term. Professor Congdon thought that members of the MPC should be equipped with an understanding of money and banking. Mr Sanders said that the key criteria of an MPC member should be that they were both an excellent applied economist, and an excellent communicator. Mr Saunders and Professor Chadha were not concerned whether MPC members had a City background, but whether they were, in the words of Professor Chadha, “good professional economists”. Professor Goodhart told us that the specification for a new external member should be that “the person involved is capable of achieving within a reasonably short time the ability to make a sensible and informed choice [of the interest rate to meet the inflation target]”.

60. Dr Sentance agreed that it was “good to have a diverse range of experience” and he thought “that people with a business background bring something to the Committee in terms of both understanding how businesses are reacting to things and also looking at some of the survey indicators that are actually quite important in tracking the economy”. In Dr Sentance’s opinion, keeping a “balance on the externals between business, academic and financial experience would be a good thing”. Professor David Blanchflower, an external member of the MPC, thought that ensuring that all ‘external’ members of the MPC had a “good, solid training in economics, either from business or from academia, is a fundamental thing”.

61. Dr David Potter of the Court of the Bank of England told us that he thought the role of a good external MPC member “clearly requires expert knowledge as an economist, although I would not eliminate people with huge experience, such as Richard Lambert, in

166 Q 275
168 Q 41
169 Ibid.
170 Q 83
171 Q 84
172 Q 152
173 Q 209
174 Q 225
175 Q 224
economic matters as a whole”. Dr Potter went on to explain that members of the MPC did not require economics PhDs to have value for the MPC. His second criterion was that “they do not do consensus”, in that they were prepared and able to take on the responsibility of a ‘one person, one vote’ system. Ms Amelia Fawcett, also of the Court of the Bank of England, similarly told us that “I would think it would be unwise for them all to be academics” and that therefore some having some external members of the MPC with financial experience would be critical. Mr Lambert thought there was a need to have “around the table a group of people focused on a single goal, articulate enough to express their views on that goal, and … the notion that they do not all come from exactly the same background adds to the quality of the decision-making”. Mr Barber broadly agreed with Mr Lambert, and stressed that, because each member was responsible for their vote, “you need a balance of experience reflected by more than anything you need people with the capacity to cope with the wealth of data that needs to be analysed and assessed each month and the confidence to play an active part in the work of the MPC”. When asked about whether there was a need for good communicators on the MPC, Mr Lambert told us:

They all strike me as being a very articulate lot who have no hesitation about expressing their views. I think that is fine, actually. I do not think there are any at the moment but there probably ought to be some giant brains who can hardly speak they are so clever but they can just get on with cracking things, provided there is the right balance of other more jolly types around. I think that works quite well, actually.

**Understanding economic models**

62. Some witnesses pointed to the possible value of an ‘external’ member of the MPC with economic modelling experience. Professor Wren-Lewis told us that “I think it is very important that there should be someone on the MPC who essentially is involved in producing and using the kinds of models which the Bank's current model is a class of”. Mr Barrell agreed, although he stated that:

I think expertise would be of great value but at the minute I suspect, with such a complicated model, the Bank staff are at a significant advantage over most outsiders, including most of the people sitting at this table, because they know this toy much better, and it would useful to have somebody outside saying, 'You are actually wrong there and I can prove it'.

Dr Julius told us that her view was “that certainly one or more should have real experience in using and interpreting forecasting models of the economy”. She also thought that,
“with the current structure, particularly the central role of the forecast in the MPC process, it is quite difficult for a non-technical person to participate fully in that exercise”.185 Professor Goodhart also thought that “one of the roles of the externals ought to be to be able to challenge the bank model”.186

63. Ms Bell disagreed, explaining that:

I am not sure one gains anything by having one person who can go through the nuts and bolts of the model. What one needs is that all the members understand the broad properties of the model and how it is put together and can hold the bank to account. There is plenty of technical expertise within the bank.187

Dr Sentance thought that “some familiarity with forecasting, which I have in my background and I know Kate [Barker] has, is helpful among the external members, but I do not think we should get hung up on the model as being the sole source of everything”.188 Mr Charles Bean, Chief Economist of the Bank of England, did not see the need to include such a person; he was concerned that the MPC might then concentrate too much on the detail: “I do not think it is essential to have somebody on the [MPC] who is familiar with the entrails of the model and in fact it might actually work against the [MPC] functioning well if the consequence was to keep on pulling us into peripheral details”.189

**Conclusions**

64. It would be inappropriate to consider places being available for certain ‘constituencies’ among the ‘external’ membership of the MPC. For that reason, while we would welcome the appointment at some time of an ‘external’ member of the MPC with experience of economic modelling, we would not expect the presence of such a member to be a permanent requirement within the membership. However, certain attributes are important: a good understanding of economics, either via academic research or experience in the financial sector or business; a strong degree of personal independence and confidence; and, finally, the ability to communicate their view of the economy, both to specialist audiences and the general public.

**Terms and conditions of ‘external’ members**

65. Several submissions questioned whether the terms and conditions for ‘external’ members of the MPC were appropriate. The Bank of England Act 1998 states that ‘external members’ must serve three-year terms. No limit is placed on reappointment, and Ms Barker was recently appointed for a third term.190 The terms and conditions of their appointment are determined by the Non-Executive Directors Committee of the Court of the Bank of England (NedCo). NedCo may also remove an external member of the MPC

185 Q 153
186 Q 164
187 Q 156
188 Q 234
189 Q 277
from office if they become bankrupt, are absent from MPC meetings without consent for three consecutive months, or are judged by NedCo to be unfit or unable to discharge their functions as a member.\textsuperscript{191}

66. We discussed with witnesses whether the terms of ‘external’ members ought to be renewable, how long such appointments should last, and whether ‘external’ members ought to be allowed to work full-time. On the term of appointment, Mr Barrell agreed with Mr Steven Nickell’s suggestion of a six-year term, without the possibility of renewal, because it took some time for people to adapt to the job.\textsuperscript{192} A similar point was raised by Dr Wadhwani, in relation to time needed to get up to speed with the forecast model used by the Bank.\textsuperscript{193} Professor Congdon was not keen on the idea of longer terms for members, suggesting it might dissuade those from a business background from joining. Professor Wren-Lewis was concerned about the implications of a six-year appointment if the new member was not up to the job.\textsuperscript{194} While accepting that a three-year appointment means that those from different backgrounds are not excluded from the role, Professor Chadha suggested that a longer term of appointment, for three years extendable to six years, might insulate people from the effects of the political cycle.\textsuperscript{195}

67. Ms Bell suggested that four-year terms, with no reappointment, might be a more suitable policy, with one external member leaving each year.\textsuperscript{196} Dr Julius thought that there should be a three-year term, followed by another three-year term if both sides agreed, but with a total limit of six years, even for internal members. She raised two issues that underlay her opposition to a single five- or six-year term: first, the need not to be left with a member of the MPC who was not up to the job; and second, that some might not want to stay for the full six years, and the possibility of market comment if they left early.\textsuperscript{197} Professor Blanchflower confirmed that, for him, a longer term would not have been feasible for his career. Professor Besley preferred a single-term of six years, with a minimum of three, and the option of extension being with the appointee.\textsuperscript{198} Ms Barker also expressed an appreciation for the idea of a single six-year term, with the minimum of three years, as long as the appointee had not breached any part of the relevant sections of the Act governing appointments.\textsuperscript{199} Mr Lambert accepted that a longer term, with no reappointment, would prevent political bias and allow someone to build up expertise but also noted that a longer term might mean some people would not want the job.\textsuperscript{200} Mr Barber felt the current arrangements were “about as well balanced as you could make it.”\textsuperscript{201} Ms Fawcett felt that the current system had not prevented the Bank from attracting the

\textsuperscript{191} Bank of England Act 1998, Schedule 3, paragraph 9
\textsuperscript{192} Q 45
\textsuperscript{193} Q 155
\textsuperscript{194} Q 45
\textsuperscript{195} Q 86
\textsuperscript{196} Q 157
\textsuperscript{197} Ibid.
\textsuperscript{198} Q 228
\textsuperscript{199} Q 229
\textsuperscript{200} Q 381
\textsuperscript{201} Ibid.
right people to the job. Dr Potter, however, had sympathy for the six- or five-year single term, with a minimum of three years, so that the appointments were truly independent.

68. We are mindful of the need to ensure that the MPC remains independent, and to allow a flexible system of terms and conditions that can enable recruitment from the widest base. We therefore recommend that, should the Bank of England Act 1998 be modified in the future, a new term of office for ‘external’ MPC appointments be instituted, based on a six-year term, with no option of reappointment, with a three-year minimum, after which continuation would take place only with the agreement of both the Non-Executive Committee of the Court of the Bank of England and the postholder. This would give the flexibility to remove those who are unfit for the job, retain flexibility for those who might wish to leave the post early, and ensure continuation was not at the discretion of the Chancellor of the Exchequer.

69. On the question of whether the job should be full- or part-time, Professor Wren-Lewis said that being an ‘external’ member of the MPC could be a full-time job, but that the option of either working pattern ought to be left open. Professor Muscatelli pointed out that it seemed to be that those from a business background that struggled with the part-time requirement, and that therefore there was an issue here. Mr Barrell also suggested those from some occupations found it easier to move into the part-time mode of working than others. Ms Barker felt that for those who had to give up all other work, the full-time option was attractive, and at the start of her time on the MPC, more time would have been useful, but as her experience increased, three days a week was adequate.

70. Dr Potter said that the Committee of Non-Executive Directors of the Court of the Bank felt that a three day week “is an appropriate time to do the job … and there should be time spent in broader matters to keep abreast of things as a whole through their other activities”. He did not think that an extension to a full working week would attract those in the City who might be giving up large salaries to join the MPC. He told us “people take on the role because it is eminent and it is status-enhancing at the peak of their career to be appointed to the MPC. That is why they will join.” We find the explanations of why the full-time option was removed for all ‘external’ members unconvincing, especially for new members of the Monetary Policy Committee. We recommend that all working patterns be available to ‘external’ members of the MPC, so that they may undertake their duties as they see fit, as their career progresses.

202 Q 335
203 Ibid.
204 Q 46
205 Q 47
206 Ibid.
207 Q 230
208 Q 337
209 Q 338
Appointments

Introduction

71. The nine members of the MPC are subject to three different methods of appointment. The Governor and two deputy Governors are Crown appointments made by the Queen upon the advice of the Prime Minister. Two members to the MPC, one who has executive responsibility within the Bank for monetary policy analysis, and one who has executive responsibility within the Bank for monetary policy operations, are appointed by the Governor of the Bank of England, after consultation with the Chancellor of the Exchequer. The four external members of the MPC are appointed by the Chancellor of the Exchequer.210

Appointments of ‘external’ MPC members

72. The evidence we heard on appointments mainly concerned those of ‘external’ members of the MPC. Mr Stephen Nickell had described the procedure as “opaque”.211 Mr Barber expressed frustration at the “extremely opaque” nature of the appointments process.212 Professor Goodhart commented that “there is no information or attempt to give any specification about what is wanted. How the Chancellor and Treasury go about obtaining names and what the role of the Governor of the Bank is in this is simply unknown”.213 Lord George provided us with some background information on the process. He explained that the Bank had provided a list of potential candidates to the Treasury, which would be discussed with Treasury officials.214 He told us that he “never felt particularly uncomfortable with the appointments process”.215

73. Professor Wren-Lewis contended that the present system was open to abuse by the Chancellor of the Exchequer, although he said added that “this Chancellor has not done that but we cannot rely on Chancellors never doing that”.216 Mr Saunders also claimed that the process was vulnerable to the Chancellor of the Exchequer, and told us “one of the issues is whether a future Chancellor at any point would seek to change the … appointment process in a way which undermines the aim of inflation stability”.217 He thought there ought to be some sort of external source of short-list or check on candidates.218 Dr Wadhwaní also suggested the process was open to change by the Chancellor of the Exchequer.219 Mr Lambert said that he thought the “there needs to be a

211 Ev 20
212 Q 381
213 Q 165
214 Q 101
215 Ibid.
216 Q 50
217 Q 79
218 Ibid.
219 Q 166
degree of discretion for the Chancellor and, indeed, for the Governor in settling on the line-up of the team”.220

74. Concerns were raised about the timeliness of appointments to the MPC. In Summer 2006, the MPC went down to seven members for two months, due, in part, to the untimely death of David Walton, the resignation of Mr Richard Lambert, and Stephen Nickell’s departure after two terms all occurring around the same time. Lord George admitted that some “appointments were made pretty much at the last minute and I believe that as much as anything else that was because the Chancellor had an awful lot of other things to do.”221 Mr Barber also noted the lack of timeliness of some of the appointments.222 Professor Muscatelli emphasised the important of avoiding the problems of 2006, and said that the appointments process should be speedier, perhaps by sounding out applicants in advance.223 One suggestion to alleviate such problems was for a pool of candidates from which to draw MPC appointees. Mr Lambert thought it a good idea to “collate a bench of relevant experts who might be available, so that when an appointment needed to be made it would be possible to choose from a pool of people who were sort of up and willing”.224

75. Dr Julius was forceful in her criticism of the present procedure, saying it had “not been very professional”.225 She suggested that there should be an open specification for the role, against which candidates could be judged. However, the names of the candidates should be kept confidential.226 Professor Goodhart was also cautious about making names public prior to the announcement of an appointment.227 Mr Barber highlighted the lack of a transparent mechanism for candidates to express an interest in the position.228 He wanted “an appointments process that was more comparable to the kind of procedures that are used in other major public appointments, with a degree of openness about the application process and with a selection panel, potentially, which could include a wider range of expertise”.229

76. The Court of the Bank of England undertakes scrutiny of the procedures of the MPC, and therefore we were interested to hear the impact of the lack of timeliness to the appointments. Dr Potter admitted that the Court, except through the Governor, had made no public admission of its dissatisfaction with the appointments process, but told us that there would be comment on it in the Annual Report, and that the Court had made its views know to the Treasury.230 Dr Potter did tell us that he would agree with an open advertisement for the post of member of the MPC, but stated the reservation that such a
search process was looking for “experts in their field”. Dr Potter later said that he thought there was “great merit” in part of the consultation process of appointments occurring through the Court. The section of the Bank of England’s Annual Report 2007 devoted to the report by the Non-executive directors said:

Non-executive Directors would support efforts to strengthen the process for MPC appointments … and to make them subject to normal public appointment procedures. This might also help to ensure that the balance of the MPC was maintained in terms of expertise and experience. The overriding purpose of any appointment is, of course, to recruit the best possible person for the job. Non-executive Directors are also conscious of the need to ensure that the terms and conditions of employment for external members of the MPC are competitive and do not limit the number of potential candidates.

77. We raised with the Governor several possible changes to the appointments process, including an open advertisement, a pool of candidates, ensuring the Governor had input into the process and ensuring a timely system of appointments. He did not have an objection to an open advertisement for a confidential pool of candidates for an MPC appointment. He agreed that it was important that the Governor could express a confidential view to the Chancellor of the Exchequer about the merits of certain candidates. He agreed that there should be a time limit in which appointments could be made.

78. The then Chancellor of the Exchequer, in his opening statement in evidence to us, outlined a new process for MPC appointments with several distinct elements. First, he responded to concerns about delays in appointments:

The timetable for replacing external monetary policy members will be pre-announced before the end of existing members’ terms and that will establish a clear set of dates for each stage in the process, including by when the Government will have confirmed a new appointee.

Next, he dealt with the challenge of attracting potential applicants for vacancies:

As part of this timetable and to enhance the openness of the process, the Treasury will … invite by advertisement expression of interest from economists and experts in other relevant backgrounds interested in serving on the Monetary Policy Committee, and these will be invited before the end of existing members’ terms and early in the timetable for appointment whenever a position is due to become available.

231 Q 318
232 Q 339
234 Q 268
235 Q 269
236 Q 270
237 Q 408
238 Ibid.
Third, he turned to methods of attracting the right applicants and choosing the right candidates in addition to the requirement upon him to appoint a person who “has knowledge or experience which is likely to be relevant to the [Monetary Policy] Committee’s functions”:

The Government will publish additional criteria on the qualities and skills set that it is seeking from successful candidates in terms of their expertise. In determining these criteria the Government will ensure that the composition of the [Monetary Policy] Committee retains an appropriate balance of different skills and backgrounds.239

The Chancellor of the Exchequer did not accept there was a case for the Governor of the Bank of England to select MPC members, telling us “I think some people are confusing the independence of the Bank of England with simply the position of the Bank of England itself in choosing its own members of the Monetary Policy Committee, and neither the Governor nor myself favour that particular set of proposals”.240 When asked why it had taken ten years for these changes to be made, the Chancellor of the Exchequer replied “It was important to establish a new system”241 and that “it was also right to bed down the present system in a way that commanded confidence”.242 He also stated that the changes outlined introduced more accountability and transparency, and moved the UK system beyond the US Federal Reserve, or the European Central Bank.243

79. We welcome the changes to the appointments process for ‘external’ members of the Monetary Policy Committee outlined by the then Chancellor of the Exchequer in evidence to us in June 2007. We welcome the fact that Government will advertise for different qualities and skills for each new ‘external’ member of the Monetary Policy Committee. We hope that they will lead to timely appointments of experts suited to the role of Monetary Policy Committee member. We note that there is no current proposal for a confidential pool created of experts who could be nominated to the Monetary Policy Committee where posts need to be filled at short notice. We therefore recommend that the Government consider adding a note to candidates as part of the appointments process asking them if they would be willing to form part of such a pool if not selected for the current vacancy.

The role of the Treasury Committee

80. Since 1998, the Treasury Committee in successive Parliaments has held appointment hearings with new MPC appointees.244 The Committee’s role does not have a statutory basis, and the Government has not generally undertaken to take any particular account of the opinions expressed about individual appointees. When asked whether the Treasury Committee’s powers ought to extend to formal confirmation, Professor Congdon told us

239 Q 401
240 Q 409
241 Q 413
242 Q 415
243 Q 413
The Americans have that and every now and again it is used. I would hope it would be used very rarely. You could give some input to the Chancellor and say perhaps these are the right sort of people or whatever.245

Professor Congdon thought that the Treasury Committee ought to be involved in drawing up a short-list of potential candidates.246 Professor Muscatelli disagreed with the Treasury Committee having the right of veto, saying “I think it politicises the process too much and I think the public scrutiny that this then presents might have an impact on the financial markets”.247 Professor Chadha also did not want us to have a right of veto, again presenting the opinion that this could politicise the process.248 Mr Saunders thought our hearing with new appointees were very important, but thought that a veto should only be allowed “if it was a very overwhelming vote of the Committee because otherwise you could get into a position in which you get political games being played”.249 Lord George expressed the concern that this was a technical appointment, and left us to judge whether we had the competence to make such a decision.250 He also warned against adding a political element to it.251

81. The then Chancellor of the Exchequer promised to listen to our recommendations in this area, but reminded us of the intricacies of dealing with market sensitive information. He thought the role, where possible, of the Treasury Committee should be enhanced.252 However, in a reference to the Treasury Committee having veto power, the Chancellor of the Exchequer referred to one occasion—the appointment of Mr Christopher Allsopp253—when the then Treasury Committee had asked the Chancellor of the Exchequer to think again about an appointment. He told us “I think probably in the [Treasury] Committee’s considered view, his period as a member of the Monetary Policy Committee was actually a successful one”.254

82. The Governor of the Bank of England told us that:

I know that normally your wish is for members to come here for a confirmation hearing before they start their work and that would be the sensible time at which to do it. What the world would look like with timely appointments would indeed be one in which you would have a chance to carry out the hearing before the individual joined the Committee.255

245 Q 52
246 Q 53
247 Ibid.
248 Q 82
249 Ibid.
250 Q 102
251 Q 103
252 Q 411
254 Q 419
255 Q 274
On 3 July 2007 the Prime Minister announced a series of reforms of parliamentary involvement in public appointments, some of which directly affect ‘external’ appointments to the MPC and responded to our concerns about timing. The Prime Minister proposed “pre-appointment” hearings for a nominee suggested by the Government, which would be “non-binding”, but which would precede the formal appointment.\textsuperscript{256} \textbf{We welcome the Government’s commitment to enable appointment hearings by this Committee for nominees for the post of ‘external’ member of the MPC to take place prior to formal appointment.} We note that the Government considers such hearings would be “non-binding”. We consider it important that such hearings can be scheduled sufficiently far in advance of the date of the formal appointment to enable the Chancellor of the Exchequer to be able to give proper consideration to any view expressed by the Treasury Committee without there being a danger of the MPC membership being temporarily reduced as a result of reconsideration of a nominee. We recommend accordingly that nominations be announced at least three months prior to the date on which the vacancy falls to be filled. We also consider that, if the Treasury Committee were to reach an adverse opinion on a nominee, which would only be after careful and considered reflection, the Committee ought to have the power to require a debate in the House of Commons on the nomination.

\textbf{Appointments of ‘internal’ MPC members}

83. When asked whether he has also considered open advertisement for the positions of Governor and deputy Governor, the Chancellor of the Exchequer pointed out that not only were they MPC members, but also administrators, and warned that “I do think some of the proposals that are coming from other people fail to recognise that any decision about any appointment made to the Monetary Policy Committee is market sensitive and is likely to affect people’s evaluation of the inflation expectations of the British economy or other aspects of the British economy, and I think this Committee will want to be very careful in its recommendations about what should change, knowing that that is the position”.\textsuperscript{257} The Government’s recent announcement about appointments confirms the separate status of these appointments, which it is proposed will continue to be announced prior to a hearing before this Committee.\textsuperscript{258}

\textbf{84. We believe that the positions of the Governor and the two Deputy Governors should be recruited by open advertisement as well as confidential search.}

\textbf{Frequency of MPC meetings}

85. The minimum number of meetings of the MPC in a year is set by the Bank of England Act 1998:

\begin{quote}
(1) The Committee shall meet at least once a month.
\end{quote}

\textsuperscript{256} HC Deb, 3 July 2007, cols 816 and 43WS; Ministry of Justice, \textit{The Governance of Britain}, Cm 7170, July 2007, para 76
\textsuperscript{257} Q 417
\textsuperscript{258} Cm 7170, para 79
(2) The Governor of the Bank (or in his absence the Deputy Governor of the Bank with executive responsibility for monetary policy) may summon a meeting at any time on giving such notice as in his judgment the circumstances may require.259

While in both Canada and the United States of America, we heard strong support for a meeting cycle involving around eight meetings a year. In one of our meetings in Canada, this was described as allowing for “thinking time”.

86. Ms Barker thought it would be possible to move to eight times a year, telling us “a natural alternative … would be to have the quarterly meetings around the Inflation Report and only one meeting in between”.260 However, she did acknowledge the argument that monthly meetings fit in with a monthly data cycle,261 but went on to say that “news can creep up on you because you look at it month by month, so we always have to be very careful when we are meeting not just to say what has happened over the last month but what has happened over the whole period since we last moved interest rates”.262 However, she concluded by saying “if you were to ask me would it be much worse or much better if we were to meet eight times a year, I have to say I do not have a terribly strong view either way”.263 Dr Sentance was strongly in favour of the status quo, and told us that the pattern of regular meetings helps to “build confidence” and minimise the need for emergency meetings.264 Professor Blanchflower agreed with Dr Sentance, and told us that “We do not want to be seen to be asleep at the wheel”.265 The then Chancellor of the Exchequer was also happy to remain with the current number of meetings, but stated that the change in economic circumstances meant that “you could probably afford to make a change, but I think the pattern we have is pretty well established”.266 We have heard differing views on the need for monthly meetings of the Monetary Policy Committee. With hindsight, it would have been better if the Bank of England Act 1998 had not mandated monthly meetings, but had left the number of meetings each year to be determined by the Court of the Bank of England on the recommendation of the Governor, but subject to the following conditions: that there were to be a minimum of eight annual meetings, that Monetary Policy Committee meetings were to be evenly spaced across the year, and that MPC meetings were to be pre-announced with a year’s notice, except in ‘emergency’ cases. We therefore recommend that, should changes to the Bank of England Act 1998 be required for any other purpose, these changes be made at that time.

The role of the Court of the Bank of England

87. The Bank of England Act 1998 places certain responsibilities on the Court of the Bank of England, and the Committee of Non-Executive Directors (NedCo) within the Court, for the Monetary Policy Committee. NedCo has the responsibilities around the terms and

259 Bank of England Act, Schedule 3, paragraph 10
260 Q 220
261 Ibid.
262 Q 221
263 Ibid.
264 Q 222
265 Ibid.
266 Q 450
The Monetary Policy Committee of the Bank of England: ten years on

(1) The court of directors of the Bank shall keep the procedures followed by the Monetary Policy Committee under review.

(2) In particular, the court’s function under subsection (1) shall include determining whether the Committee has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy.

88. When we asked our witnesses what the role of the Court was, Dr Julius, a former member of the Court of the Bank of England as well as a former MPC member, responded that “In some ways the court is a rather grand body with very little to do” and that “The role of court is not very well defined which I believe is a fault of the Act rather than either the people on the Court or the internal Bank of England people”. Ms Bell however disagreed, and said that “I believe the Act is quite clear about its role: it is to make sure that the MPC’s procedures are there and it is getting the right sort of information” but she added, “It receives quite a lot of information. Perhaps it could make more of it”. Dr Julius agreed that the role of the Court appeared to be that of “a good shop steward”. Professor Besley seem to corroborate this, telling us that he had “attended two Court meetings, one Court lunch, a Court away day and a dinner to meet with the Court informally”, and that he had “also met Sir John Parker [Chairman of NedCo] one-on-one” and it seemed to him “that the Court is at this point taking very seriously its job of settling in a new MPC member as I was, and checking that there are no issues that need to be dealt with”.

89. Dr Potter described the role of the Court:

Our general role in the Bank is the governance and oversight of the management of the Bank as a whole, and the Bank of course carries out many functions, including the implementation of monetary policy (that is the setting of interest rates) but the formulation of interest rates of course is the responsibility of the Monetary Policy Committee. Our role is to oversee that the processes and procedures there are working well and effectively.

When presented with the earlier criticism of the role of the Court, Dr Potter felt this was an underestimation of the role of the Court, which he described as “absolutely essential”. He said that while the role of the Court with the MPC was limited, it was there when issues, such as with research or processes or procedures, needed resolving. Ms Fawcett added that given her experience on other boards, the Court and NedCo seemed to have all the attributes of an independent board, and said “Whether it is setting strategy, financial

268 Q 160
269 Q 161
270 Q 163
271 Q 232
272 Q 299
273 Q 300
274 Ibid.
objectives, monitoring the management of the Bank, it is very clear that that is what court does do, and I think does very effectively”.275

90. We then discussed particular activities undertaken by the Court. Dr Fawcett described to us how the Non-Executive Directors Committee (NedCo) monitored the performance of MPC members. She told us there was an annual questionnaire and individual one-on-one meeting with the Chair of NedCo. There are monthly reports from the Chief Economist on how the MPC process is working, and informal meetings between members of the Court and members of the MPC.276 NedCo is empowered by the Bank of England Act to remove MPC members not performing their duties.

91. We also discussed the structure of the Court, and the frequency of its meetings. Although the monthly meetings are required by statute, Ms Fawcett thought a smaller number may be more useful, and informed us that “A traditional board would meet anywhere between six and 10 times a year”.277 She also told us it would “make more sense” to have slightly fewer numbers on the board.278 Dr Potter argued that around 12 members may be a better number.279 On the number of meetings he told us that “I think there is something to be said for a regular routine”.280 He also warned that “There is a huge amount of work to do to ensure that one is fully knowledgeable about the activities going on in the Bank and the issues”, and that he would suggest “You could argue to take it down to, say, nine; certainly 11 is appropriate with August free”.281 We believe that the present Court of the Bank of England is too large and should be reduced in size. We note the role played by the Court in the accountability process of the Monetary Policy Committee. We will continue to monitor the decisions of the Court, and at times may request additional information from it relating to the Monetary Policy Committee to ensure that it is undertaking its proper functions as related to the Monetary Policy Committee.

Resources

Overall resources

92. The Court is responsible for ensuring that the MPC as a whole had adequate resources to undertake its work. In undertaking that work, Dr Potter explained that the Court received an annual report from the Chief Economist about staffing and financial resources. He explained that current funding for monetary analysis was £61 million a year. He stated that the Bank’s intention was to decrease the number of economists, but increase their overall level of experience.282 While historically the Bank had been able to compete with the City to recruit the high calibre economists it needs. However, Dr Potter told us that the

275 Q 300
276 Q 332
277 Q 302
278 Ibid.
279 Ibid.
280 Ibid.
281 Ibid.
282 Q 345
Bank’s ability to retain them “is an issue in the long run, which we [the Court of the Bank of England] need to be concerned about”. Ms Fawcett also told us the Court receive quarterly performance reports from the Bank, which are extensively examined by the Court. On recruitment, she acknowledged the disparity between salaries available in the City and the Bank, but that traditionally this had not mattered, as “the Bank of England is an institution of the highest reputation and people are pleased to work there”. However, she noted that “Going forward, given the nature of the body, you are never going to be able to rectify the financial imbalance but there is something about whether we are properly structured and prepared for slightly more turnover and how we deal with a workforce that may come in and go out with a little more regularity”.

93. We continued this discussion with the Chief Economist of the Bank of England at his reappointment hearing. He told us that “It should be said that exit rates from not just monetary analysis but the analytical areas of the Bank in general have risen over the last couple of years reflecting the hiring that is taking place in the City”. More worryingly, he added “We have been losing some people I would have preferred to keep”. He confirmed it was a challenge for the Bank going forward, and stated that the Bank was trying to develop its secondment programme to enhance people’s career opportunities. We note with concern the questions raised by the Bank of England’s Chief Economist about the ability of the Bank of England to retain its analytical staff, and we will continue to monitor this situation.

Resources available to external MPC members

94. In 1999, the then Treasury Committee issued a Report on Research Assistance for Monetary Policy Committee Members after a public dispute about resources available to ‘external’ members. That Report cautioned the Bank to better manage such future disputes. One of the roles of the Court of the Bank of England is to ensure that the MPC has adequate resources to undertake its work. The then Treasury Committee, commenting on the episode which led to the increase in resources to external members, concluded “We believe that the Non-Executive Directors need to be much more pro-active in ensuring that the procedures of the MPC operate fairly with respect to both internal and external members.”

95. We were therefore interested to hear the views of those who had been on the MPC on the resources available. Dr Wadhwani explained that “When I got there the quantum of resource was not enough but that was resolved”. He told us that “There have been rumours

283 Q 346
284 Ibid.
285 Ibid.
287 Ibid.
288 Ibid.
289 Treasury Committee, First Report of Session 1999–2000, Research Assistance for members of the Monetary Policy Committee, HC 43
around that there may be an attempt to take these resources back from external MPC members which I believe would be a retrograde step”. Dr Julius raised the concern that there in her time on the MPC, it would have been useful “even after the expansion of resources, [if there] was more modelling capability in the external MPC staff”. Ms Bell thought it would be wrong to “dilute” the resources available to external MPC staff, describing the resources available as “adequate” but not “overly-generous”. On the modelling capability available to the external MPC members, she felt that there was no reason why people with economic modelling experience could not be recruited to assist the external MPC members, and at times had been.

96. Dr Potter outlined the procedure undertaken by the Court to monitor the resources required by the MPC. This included informal lunches, and a formal appearance by MPC members before Court every three months. His present opinion was that their data told them that things were “pretty satisfactory”. He stated, on the question of whether there was going to be a reduction in the resources available to external MPC members, that “There is no such intention of which I am aware”. He also confirmed that MPC members had access to him if required to express concerns about resources. We welcome the assurance given to us by the Court of the Bank of England that the resources available to external members of the MPC are not under threat. We will continue to monitor both these resources and the role of the Court in such matters.

291 Q 164
292 Ibid.
293 Ibid.
294 Ibid.
295 Q 342
296 Ibid.
297 Q 343
298 Q 344
6 The transparency of the Monetary Policy Committee

Inflation expectations and educating the public

97. As we saw earlier in our discussion of the economic context of the MPC’s work, it is important for inflation expectations to remain anchored, especially should economic circumstances change. In his written evidence to us, Mr Saunders described the inflation target as having “high financial market credibility”\footnote{Ev 47}. However, he went on to suggest that “the credibility of the inflation target framework in the real economy is far more doubtful. Household inflation expectations do not appear to be well anchored on the 2.0% inflation target.”\footnote{Ibid.} Ms Barker told us that “It is perhaps a little bit disappointing that we have not seen a greater growth of knowledge from the public” about who sets interest rates and how the monetary policy process works.\footnote{Q 183} She praised the work the Bank of England has done with younger people, as well as the Bank’s agents, but felt there was more that could be done.\footnote{Ibid.} Dr Sentance raised a more short-term concern that:

In my view the most important thing for anchoring expectations is people’s experience of inflation. I think the fact that since 1992 we have had a long period of low inflation has been a great benefit in the current framework. I think the longer that inflation remains above the target the more there is the risk that that does begin to affect people’s expectations, so I think, as the Governor’s letter indicated, the expectation that inflation returns to target quite quickly is quite important in this context.\footnote{Ibid.}

Mr Lambert also thought the MPC could do more to educate the public. While he acknowledged that the MPC is good at communicating with financial markets, he explained that:

It might well be in its interests to think about - and I know it is thinking about - how to inform and educate a broader public about its mission because […] when times get tougher its role will be more controversial and it would be a good thing, ahead of that, if more people knew why what it did was important and why its decisions, properly made, are to the benefit of the whole of society.\footnote{Ibid.}

98. Others were less worried about the risk of the anchor slipping. Lord George told us that while the inflation level may not have been precisely anchored to a certain number, it is anchored at a low level, “rather than in double digits”.\footnote{Q 105} He believed that:

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\begin{itemize}
\item \footnote{Ev 47}{\textit} \footnote{Ibid.}{\textit} \footnote{Q 183}{\textit} \footnote{Ibid.}{\textit} \footnote{Ibid.}{\textit} \footnote{Q 365}{\textit} \footnote{Q 105}{\textit}
public explanation is absolutely critical and it is an ongoing process. I do not think we will ever get to a situation where everyone in the country knows about the MPC and the details of the target and all that. It is the broader understanding that we have to keep reinforcing.  

Professor Besley told us it was an ongoing challenge to communicate with the general public, but that the anchor was currently not at risk. He told us that he did not think “personally … there is more that we need to do beyond what we would be doing anyway, which is to convey our views clearly”.  

Professor Blanchflower agreed, telling us “Going forward we obviously need to communicate what our strategy is and that we will do everything we can to keep the inflation rate down”.

99. The Governor told us that he thought “we [the MPC] have done a good job in explaining to people that the main aim of the MPC is to maintain a balance between demand and supply in the economy”.  

When asked whether there was more the MPC could do to cement lower inflation expectations the Governor replied “We have spent a great deal of time talking to people around the country to make clear that we are completely determined to bring inflation back to target”. We acknowledge the efforts the Monetary Policy Committee has made in educating the public, especially via its programmes for younger people, about its role, and the need for low inflation. However, certain of the Bank’s own measures of the public’s understanding remain low. We recommend that the Monetary Policy Committee and the Bank of England consider what the public need to know about the monetary policy framework, and then, with assistance from the Treasury if needed, consider a public education campaign to put across those points. It is important that if there are more uncertain times ahead, the public must understand and support the reasons behind movements in interest rates.

Writing letters

100. The remit letter of the Chancellor of the Exchequer to the Governor of the Bank of England states that, should inflation move more than 1 percentage point either side of the inflation target, the Governor should write an open letter to the Chancellor of the Exchequer, explaining why inflation has moved so far from the target, the policy action being undertaken to bring inflation back to target, the period in which it is expected inflation will return to target and finally how this approach “meets the Government’s Monetary Policy objectives”. We were repeatedly told, both in written evidence, and oral evidence, that this letter writing should not be considered a sanction, but a communication tool.

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306 Q 106
307 Q 182
308 Ibid.
309 Q 244
310 Q 243
311 Remit for Monetary Policy Committee, Letter from the Chancellor of the Exchequer to the Governor of the Bank of England, 21 March 2007
312 Ev 76, 102; Qq 148, 151
101. Lord George told us he wished he had written a letter so as to have relieved the pressure on his successor.\textsuperscript{313} Professor Goodhart went further, telling us that it was his belief that “that every central bank governor and most members of the MPC are looking forward to the first occasion of letter-writing”.\textsuperscript{314} While deviations from the target were not welcome, he felt people were keen in “getting this part of the institutional instrumentation in operation and showing how it ought to work”.\textsuperscript{315} Professor Goodhart explained that that external shocks were, at the time of the creation of the monetary policy framework, expected to push inflation outside the boundaries much more often than had occurred over the last decade, and therefore an explanatory mechanism was required.\textsuperscript{316} Professor Goodhart also pointed out that the Chancellor of the Exchequer, in his reply to the Governor’s letter, could disagree with the MPC’s suggested approach, and ask for a different policy to be enacted.\textsuperscript{317}

102. When we heard evidence from current members of the MPC, inflation had breached the boundary in March 2007, and a letter had been written. We asked the external members whether they had been fully involved in the letter writing process, and they agreed that they had, given the limited time frame in which there was to act.\textsuperscript{318} Ms Barker explained again that the letter writing process allows the MPC to explain the current position in regards to inflation, and what the MPC’s future policy will be, while also affording the Treasury a chance to comment on that policy.\textsuperscript{319} She explained that the letter’s function “is to ensure that there is some sort of public accountability to the population that when things have moved away from target we discuss them openly”.\textsuperscript{320} She did not think it was an attempt to restore credibility.\textsuperscript{321} She also stated that it was a possibility that the Chancellor of the Exchequer would disagree with the MPC’s suggested policy, and write back saying so.\textsuperscript{322}

103. The Governor of the Bank of England also saw the letter writing process as a chance to explain “why the [Monetary Policy Committee] thought that inflation had risen to that level … to point out again what our framework for policy is and to say what we would do to deal with that situation”.\textsuperscript{323} The Governor pointed out that the writing of a letter should not be associated necessarily with a “a failure of policy”, but that it should be considered as part of “the accountability of the framework”.\textsuperscript{324} The Governor also acknowledged that the Chancellor of the Exchequer may disagree with the policy of the MPC to bring inflation back to target, but that the letter made such a disagreement public.\textsuperscript{325} The Governor felt

\begin{footnotes}
\item[313] Q 129
\item[314] Q 149
\item[315] Ibid.
\item[316] Qq 148–150
\item[317] Q 148
\item[318] Qq 184–185
\item[319] Q 214
\item[320] Ibid.
\item[321] Q 215
\item[322] Q 218
\item[323] Q 242
\item[324] Q 261
\item[325] Q 264
\end{footnotes}
that in any disagreement, the Chancellor of the Exchequer would have to provide the MPC with a clear indication of what alternative policy he or she wished them to undertake, in a public forum.\textsuperscript{326} The then Chancellor of the Exchequer said that the “experience of the exchange of letters was a good one”.\textsuperscript{327} He also said that “It has obviously got to be at the discretion of any Chancellor to take a different view from the Governor about the overall effect on the economy”\textsuperscript{328}

104. \textbf{We are firmly of the view that the letter writing process should be regarded as part of the accountability mechanism of the framework, rather than a sanction. While the experience has been limited, at some point a Chancellor of the Exchequer and the Monetary Policy Committee may disagree about the steps to be taken to bring inflation back to target. In such a scenario, we would expect the reply from the Chancellor of the Exchequer to set out the Treasury’s view of the reasons for inflation breaching the target, as well as their suggested timeframe and policy for bringing inflation back to target. This would allow both the House of Commons and the public in general to see clearly the areas of disagreement.}

\section*{Future path of interest rates}

105. One criticism of the current level of transparency provided by the Bank of England related to the information provided by the MPC about their view on the future path of interest rates. Projections of gross domestic product provided in the Inflation Report are conditioned on either the current level of interest rates not changing, or future rates as implicitly forecast by financial markets. Professor Wren-Lewis suggested the idea of the MPC providing a forecast of future interest rates, telling us that “the procedure the Bank uses [of market interest rates] is entirely inconsistent, in the sense that it has in it a set of projections for interest rates which is not necessarily sympathetic with the rest of its forecast, so there is a problem”.\textsuperscript{329} Mr Barrell supported the idea, saying “it might be more effective to announce your plan in advance so people know you are going to react in the right way”.\textsuperscript{330}

106. Professor Congdon was not in favour of introducing such ‘official’ interest rate forecasts.\textsuperscript{331} Professor Muscatelli was also not in favour, telling us that there could be a scenario where “interest rates have to be adjusted quite dramatically, where the Bank would then decide to move away from its original forecast and that could cause potentially quite a bit of disturbance in terms of expectations adjusting in financial markets”.\textsuperscript{332} Professor Chadha told us that the economies in which such forecasts had been tried were “small, open economies,” and publication of these forecasts could “stifle the market revelation of private information about interest rate paths” and also it would be difficult to

\textsuperscript{326} Q 266
\textsuperscript{327} Q 435
\textsuperscript{328} Q 436
\textsuperscript{329} Q 54
\textsuperscript{330} Ibid.
\textsuperscript{331} Ibid.
\textsuperscript{332} Ibid.
get nine members of the MPC to agree to one forecast. Mr Paul Tucker, Executive Director of the Bank of England with responsibility for markets, also told us that under a system of “one person - one vote” it would be difficult to agree a common forecast, and secondly, and more importantly in his view, such a forecast would require such a lot of explanation that it would decrease rather than increase transparency and understanding.

107. In a lecture to the Society of Business Economists, the Governor cited four reasons why interest rate forecasts may not be useful. First, such forecasts would not explain what the MPC would do should certain risks crystallise; Second, while in the very short-term markets found it difficult to predict monetary policy decisions, in the longer-term, interest rates had been more predictable. Third, he questioned whether voting could be used to create a forecast for future interest rates. Finally, he wondered how MPC would prevent the public at large assuming that the central projection of such a forecast was going to be the actual outturn. However, in the same speech the Governor suggested that there appeared to be an appetite for the MPC to “talk more about what lies behind the fan chart and how we might change our thinking in response to developments in the data”.

108. The then Chancellor of the Exchequer told us that there was no proscription on the Bank preventing it publishing more information, but that he thought that the Bank’s current work in this area was “both adequate and probably in line with what people would expect of it, so I would not be proposing a change”. Whether or not the Monetary Policy Committee provides a forecast of future interest rates, there appears to us to be a need for more information to be provided by the Monetary Policy Committee to aid both financial markets and the general public. We therefore welcome the Governor’s thoughts on providing more information around possible policy reactions should certain risks crystallise. However, we also recommend that the Bank undertake regular work to assess the current academic thinking on the feasibility and desirability of publishing an interest rate forecast, and keep this matter under review.

**Transparency after the vote**

109. The current timetable for the release of information following a decision of the MPC is as follows: The decision is communicated to the markets at midday on the Thursday meeting. Occasionally, a short statement is released with the meeting decision notice. The minutes are then published on the Wednesday of the second week after the MPC meeting. The actual details of the vote, such as who voted for what policy decision, are only available with the minutes.

110. When asked whether the current arrangements for immediate post-vote transparency were adequate, Professor Chadha replied “We could give serious thought to publication of the vote split at the time of the notification of the interest rate decision, along with a

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333 Q 87
334 Q 285
336 ibid., pp 2–4
337 Q 447
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He pointed out that in the two week period in January 2007, between the vote decision being communicated to the market, and the publication of the minutes, uncertainty around how close the vote of the MPC was “led market interest rates to be priced higher than they would otherwise and appreciation in the exchange rate that came off when the information that there had been a 5:4 split was published two weeks later”. Mr Sanders expressed his strong support for the idea of such a statement, saying that the movements caused by the uncertainty in the intervening period did not sit well with the Bank’s role in promoting financial stability. Ms Bell told us she could see no reason why the immediate vote could not be published as markets could benefit from knowing whether it would be a close vote or not, but acknowledged it would be harder to agree an accompanying explanation.

Lord George opposed the idea of publishing the votes immediately without the additional information of the minutes, telling us “That would be great for the newspapers and sensationalism: a hawk voted this way and somebody else voted another way. I do not believe that that would convey very much.” When we asked the Governor of the Bank of England whether the split of votes could be published but without naming the individuals, to circumvent the criticism of Lord George, he was not supportive. He said that such a move would create speculation as to the identities of the different votes, and it would constrain members of the MPC from speaking until the minutes had been published, because if one person revealed their position, then the others would be forced to follow suit. He opposed the idea attaching a statement to every vote decision, preferring the fuller explanation of the minutes, telling us “It is much better to be able to explain at full length what were the arguments for and what were the arguments against the decision that was finally reached”. Mr Bean did not see the merit of a bias statement, viewing the minutes as the proper time for a fuller explanation of the merits of the various arguments around the different issues affecting monetary policy at the time.

We have heard different views on the need for immediate transparency on the voting pattern of the MPC. We have concluded that the balance of arguments supports the need for immediate transparency of MPC voting, which would allow financial markets to assess the strength of the support within the MPC for any given decision. We recommend accordingly that the Bank of England publish, alongside the interest rate decision, the outcome of the vote, indicating which individual MPC members voted which way.

338 Q 90
339 Q 91
340 Q 92
341 Q 167
342 Q 137
343 Q 286
344 Ibid.
345 Q 287
Dealings with professional economists

113. In their evidence to us, BNP Paribas suggested further improvements to enhance the MPC’s transparency to professional economists.\(^{346}\) One request Professor Chadha made was for the Bank’s model to be available, with full database and simulation suite support, above and beyond the book already provided.\(^{347}\) As well as this, Professor Chadha requested a direct forum for professional economists to engage with the MPC.\(^{348}\) Mr Saunders said that the model would be a “nice thing to have”.\(^{349}\) Mr Bean, Chief Economist to the Bank of England, in his reappointment hearing before us on 28 June 2007, said that:

> The question of whether we could do some general regular thing for City economists is I think one that is worth considering. An issue that we would have to address would be to make sure there is a level playing field. You cannot just have a subset; you would have to make it in principle accessible to all. It is something that we have actually been thinking about, whether we should do something along those lines, so watch this space.\(^{350}\)

We were pleased to hear that the Bank is considering a structured set of discussions between professional economists and staff members of the Bank, and members of the Monetary Policy Committee. We recommend that the Bank provide to this Committee within six months an outline of a plan for such meetings, that allows for a diverse membership of participants, and allows for an open and transparent record to be kept.

Transparency of the views of individual MPC members

Introduction

114. Because the MPC operates on a ‘one member, one vote’ system, knowledge of the views of the individual MPC members’ positions is important for financial markets to understand the current thinking of the MPC on the economic environment and monetary policy going forward. Below we discuss certain methods via which that transparency could be increased.

Minutes

115. The current practice for the MPC is not to individually name different viewpoints within the minutes. Professor Muscatelli regarded parts of the minutes as “rather cryptic” and stated that “it would be much more helpful if dissenting members of the committee were able to set out their positions more clearly in the minutes”.\(^{351}\) Professor Congdon agreed, telling us “There should be scope for members of the MPC to say a few things on their own, signed by themselves, and I think that actually the minutes should be a little bit

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346 Ev 101
347 Q 93
348 Ibid.
349 Q 95
350 HC (2006–07) 569–II, Q 4
351 Q 55
more forthcoming”. Ms Bell also saw no reason why individual views could not be identified in the minutes, but she acknowledged the danger of members arriving with prepared texts. 

Mr Lambert provided us with the following example as an illustration of where additional information on members of the MPC views may be useful: “I have been at meetings where it has been clear that some people are very close to changing their minds but just have not changed their minds. That is not caught in a yes or no vote”.

Some disagreed with the idea of further identification of individuals within the minutes, fearing it might alter the quality of debate within MPC meetings. Mr Saunders worried that MPC members would come with prepared passages for the meetings, rather engaging in a debate about the topics. Lord George was also “very sceptical” about assigning statements in the minutes to individual members of the MPC. He felt that because of the inherent uncertainty in the decision making, the lack of firm positions at the start of the meetings would mean “one would get the impression that they did not know what they were doing”. He pointed out that speeches and Treasury Committee hearings were the places for individual members of the MPC to state their positions. He thought to do so in the minutes would change the character of the MPC meetings, and would not be helpful. Professor Goodhart declared that “I think that individualism in this country is splendid, and it has already gone far further than any other country. To ask for much more at this stage is probably going too far.”

We are concerned about the effects on the debate within the Monetary Policy Committee of having a paragraph assigned to each member. However, we believe greater thought should be given by the Monetary Policy Committee to ensuring that the balance of views of members is more identifiable with particular individuals, rather than just identifying how individual members voted. We therefore recommend that, whenever the minutes at the moment refer to “one member”, that member be named within the text.

Statements to the Treasury Committee

One method we suggested of increasing the accountability of the position of individual members of the MPC was via an ‘annual report’ statement to be submitted to us by individual MPC members. Professor Congdon went further suggesting “At the Treasury Panel, everybody put in a submission every meeting, signed by themselves”. Mr Sanders agreed with the idea of an annual report, remarking that:

Most of us are subject to annual reviews and therefore since these people occupy such an important role in public life, my personal view is that it would be useful to ask each MPC member to provide an overview of what has been achieved over the
past 12 months and their views on the UK economic management over the next 12 months or two years, according to their tenure of office.\textsuperscript{360}

Dr Sentance also had no objection to providing such a report, but noted that MPC members appeared before this Committee every six months.\textsuperscript{361} Sir John Gieve also had no reservations about providing an annual report.\textsuperscript{362}

118. Professor Besley, while not rejecting the idea, did however have a reservation:

the timing of the report to you would be rather arbitrary in terms of what is going on in policy and therefore may focus too much attention on a particular date in the policy process. One of the things we have achieved by having an even pattern of communication with Inflation Reports at regular intervals and minutes at regular intervals is that we have a rather even pattern of communication. As long as some way could be established to make sure that undue significance was not placed on a particular date which would be somewhat arbitrary in the policy cycle, I would not oppose.\textsuperscript{363}

Others were less keen on the idea, fearing that the reports would serve little further purpose. The Governor was also more reticent to accept the reports, not wanting “to impose on the world … more pieces of paper”.\textsuperscript{364} He felt all that could be written down could be discussed at the Treasury Committee’s hearings.\textsuperscript{365} He went on to say that he would accept such a report if a good reason could be given for it.\textsuperscript{366} Mr Bean was willing to accept the idea of a report providing additional background material on key topics before attending Treasury Committee hearings.\textsuperscript{367}

119. We have listened with care to the arguments against each member of the Monetary Policy Committee providing an annual report to this Committee. We have particularly reflected upon the concern that such reports might focus attention on a particular date. However, we are persuaded that regular reports by each member of the Monetary Policy Committee to this Committee would further enhance their individual accountability and enhance the value of our regular hearings with members of the Monetary Policy Committee about inflation reports. To overcome concerns about timing, we will request each member to prepare his or her report for a 12-month period ending with a different month. We wish to receive a report on that basis from each member of the Monetary Policy Committee which:

- lists the work they have undertaken to promote transparency in and wider understanding of monetary policy in the preceding year;

\textsuperscript{360} Q 89
\textsuperscript{361} Q 240
\textsuperscript{362} Q 284
\textsuperscript{363} Q 241
\textsuperscript{364} Q 280
\textsuperscript{365} Ibid.
\textsuperscript{366} Q 281
\textsuperscript{367} Q 283
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• assesses their own voting record in the Monetary Policy Committee over that period; and

• sets out their thoughts on monetary prospects for the coming year.

Attendance at Inflation Report press conferences

120. After the publication of the Inflation Report, the Governor of the Bank of England holds a press conference, which is available live on the Bank of England’s website. At these meetings, generally the Governor, Mr Tucker as Executive Director for markets and Mr Bean, Chief Economist of the Bank of England, attend. The Governor answers the majority of questions, asking for Mr Tucker or Mr Bean’s comments if the questions require additional detail relevant to their areas. Dr Wadhwani suggested in his written evidence to us that ‘external’ members of the MPC, by rotation, should be present at these press conferences. When we put this idea to the Governor, he strongly disagreed, telling us:

We have two distinct publications that come out around that time: one is the Inflation Report and one is the minutes. They have quite distinctive purposes. The Inflation Report is to explain essentially the majority decision that was taken and to explain the collective view of the MPC about the forecast. When I speak at the Inflation Report press conference I am speaking on behalf of the Committee. Once we have reached our decision on that Thursday of that month we then spend quite a considerable amount of time discussing the drafting of the Inflation Report that we put out. We go through it word by word for good chunks of the text. If the Committee agree on that, my task is to explain that to the audience. That publication and my role in that is to speak on behalf of the Committee as a whole. Individual views where all nine members—not just the externals but internals as well—have different views, as you can see in this split of votes in the January decision this year, are set out in the minutes. The minutes are an opportunity for arguments to be set out and then people can make speeches and so on. We encourage people to make speeches to set out their views so that people outside understand why they have voted the way they have.368

We accept the argument presented by the Governor as to why other members of the MPC should not be present at the Inflation Report press conference. Members of the MPC who do not agree with the line taken at an Inflation Report press conference already have options at their disposal to explain their views in public. In addition, we consider that, where members of the Monetary Policy Committee do not agree with the line taken at an Inflation Report press conference, they should communicate this disagreement to us in advance of our ensuing Inflation Report hearing.

Our Inflation Report hearings

121. One of the means by which the accountability and transparency of the MPC is secured is through the regular hearings held by the Treasury Committee into the Inflation Reports of the Bank of England. Mr Saunders told us that “The testimony to yourselves is a very...
important part of what they [the Monetary Policy Committee members] do,”369 and Lord George described our hearings as “terribly important” in that it provides an “opportunity for us [the MPC] to explain to the Treasury Committee what we were doing, and for individual MPC members to explain their thinking”.370

122. While there was support for the meetings, some thought more could be done. Ms Bell told us that “I think that it is … the job of [the Treasury] Committee to be a bit stronger in eliciting individual views”.371 Ms Lomax was more forthright, telling us that

I do think that you let members of the [Monetary Policy] Committee off quite lightly. I come along to these sessions with the Governor and most of the questioning goes to him.372

123. Sir John Gieve noted that “The initial hearing that you held with me was a completely different degree of scrutiny from this Committee than I get coming with the Governor from time to time”.373 The Governor was more flattering, telling us that during our meetings, “I think that what has happened in the last ten years is that we have a genuine and evolving dialogue on the state of the economy and on whether monetary policy is being conducted in an appropriate way”.374 He pointed out that, unlike in the past, in his opinion, “It is not a vehicle for you and others to score political points and I think that is a big step forward as an observer of this for over 15 years now”.375 However, he still thought that we “could perhaps do a little more by way of asking us individually to explain why we had voted the way we had in a sequence of recent months, but by and large I think the debate that we have is a genuine discussion about the state of the UK economy and the outlook for inflation”.376 On a different point, the Governor of the Bank of England also requested that we hold hearings into the August Inflation Report, so that the natural pattern of one each quarter was maintained.377 We welcome the support we have received for our hearings into Inflation Reports. However, we will seek to respond to suggestions for improvement, including through greater questioning of all members of the Monetary Policy Committee present and hearings on August Inflation Reports.

369 Q 82
370 Q 104
371 Q 167
372 Q 282
373 Q 289
374 Q 279
375 Ibid.
376 Ibid.
377 Q 290
7 Conclusion

124. The monetary policy framework established over the last decade has had many successes. This is a tribute to those that established that framework and those who have operated it, most notably members of the MPC. Our recommendations seek to build on that success. We recommend ways to make a good system better, particularly by further enhancing the transparency and accountability of the monetary framework.
Conclusions and recommendations

Reform of the monetary framework

1. The monetary policy framework of the last decade has been broadly successful. At least some of that success can be attributed to the Bank of England Act 1998. Continuity is an important part of this framework, allowing market participants to have faith in the stability of the system. In view of the broad level of success of the framework and of the legislation, we do not see any reason why legislation to amend the Bank of England Act 1998 ought to be accorded high priority within the Government’s legislative programme. Thus, while some of our recommendations might require legislative change, we accept that the opportunity for such change may not occur in the near future. (Paragraph 7)

The economic context

2. While it is difficult to quantify the contribution made by the Monetary Policy Committee to maintaining a low inflation rate over the last decade as distinct from the effects of wider changes in the global economy, the Monetary Policy Committee deserves a significant amount of credit for ensuring that inflation over the last decade has been both lower, and less volatile, than in preceding decades. (Paragraph 14)

3. Several issues, such as the recent rise in asset prices, the potential end of the tailwinds of an increasing effective labour supply and globalisation which have tended to reduce inflationary pressures in recent years, and the risk of a disorderly unwinding of global imbalances have been drawn to our attention as factors suggesting the possibility that the economic climate over the next ten years may not be as benign as that seen over the last decade. While we are sure that the Monetary Policy Committee are aware of this risk, it is important that the public are also prepared for the possibility of less benign conditions ahead. Later in this Report we examine actions that may be necessary to educate the public about monetary policy in more uncertain times. (Paragraph 18)

4. The recent period of low interest rates has seen a rise in asset prices. One possible response by the Monetary Policy Committee would be to target such rising asset prices by ‘leaning against the wind’—raising interest rates to deflate the bubble in those prices. However, such a move would presuppose the successful identification of such a bubble. On the evidence we have received, this is not possible with certainty. Furthermore, the only instrument available to the MPC is moving the interest rate, and increasing interest rates to counter a rise in certain asset prices could hamper economic growth across the economy, not just in the markets with rising prices. For such a policy to be worthwhile, therefore, the risk to the economy of a rapid fall in asset prices would have to exceed the actual cost of raising interest rates to counter the rising asset prices. (Paragraph 22)

5. The weight of evidence we have received suggests that the rise in household debt is not on such a large scale as to exert significant influence on monetary policy.
However, the risk remains that future interest rate rises will see larger numbers of households in financial difficulties than anticipated. (Paragraph 31)

6. We have received differing evidence about the importance that should be attached to the rise in the money supply. While we acknowledge that it is difficult to assess what information such strong growth in the money supply might provide for future movements in the inflation rate, there is a possibility that, in the medium term, the current rise in the money supply might presage a higher path for inflation. (Paragraph 33)

7. The anchoring of inflation expectations has had an important role in ensuring that inflation has varied by less than might have been expected given the external shocks faced by the economy in recent times. However, we remain concerned that, while inflation expectations appear anchored in financial markets, the general public appear to have less understanding of the monetary policy framework. (Paragraph 35)

**The monetary policy framework**

8. With only a single policy instrument of interest rates available, we agree that the Bank should have as its primary objective price stability. However, subject to that, we will continue to monitor the Monetary Policy Committee’s compliance with the secondary objective of meeting the Government’s intention of high and stable levels of growth and employment. (Paragraph 39)

9. It is appropriate for the inflation target to be set by the Chancellor of the Exchequer. We consider that it would be valuable to maximise certainty about the target going forward. To that end, we recommend that the Government give consideration as to how this might be achieved. (Paragraph 42)

10. We strongly support the symmetry of the inflation target. We will remain vigilant for any signs that there appears to be either anti- or pro-inflationary bias by the Monetary Policy Committee, and should such signs appear, we will ask for an explanation during our regular hearings on Inflation Reports. (Paragraph 44)

11. We do not believe that the move from the Retail Prices Index (excluding mortgage interest payments) to the Consumer Price Index has adversely affected the work of the Bank of England in anchoring inflation expectations. While the Retail Prices Index may be the dominant index for wage negotiation, and thus of interest to the Bank, wages are, in the main, set by market forces. (Paragraph 45)

12. We do not, at the present time, recommend changing the Consumer Prices Index to reflect housing costs, before a pan-European consensus has been achieved. However, we recommend that the Government and the Office for National Statistics (with assistance from the Bank of England if required) work with their European partners in bringing about such consensus as quickly as possible. (Paragraph 49)

13. We see no merit in the case for the Bank of England being given control of any elements of fiscal policy, which should properly remain the province of elected politicians accountable to the House of Commons. (Paragraph 56)
The Monetary Policy Committee as a body

14. We support the retention of an MPC with nine members, comprised as at present of five ‘internal’ Bank of England staff, and four ‘external’ appointees. (Paragraph 58)

15. It would be inappropriate to consider places being available for certain ‘constituencies’ among the ‘external’ membership of the MPC. For that reason, while we would welcome the appointment at some time of an ‘external’ member of the MPC with experience of economic modelling, we would not expect the presence of such a member to be a permanent requirement within the membership. However, certain attributes are important: a good understanding of economics, either via academic research or experience in the financial sector or business; a strong degree of personal independence and confidence; and, finally, the ability to communicate their view of the economy, both to specialist audiences and the general public. (Paragraph 64)

16. We are mindful of the need to ensure that the MPC remains independent, and to allow a flexible system of terms and conditions that can enable recruitment from the widest base. We therefore recommend that, should the Bank of England Act 1998 be modified in the future, a new term of office for ‘external’ MPC appointments be instituted, based on a six-year term, with no option of reappointment, with a three-year minimum, after which continuation would take place only with the agreement of both the Non-Executive Committee of the Court of the Bank of England and the postholder. This would give the flexibility to remove those who are unfit for the job, retain flexibility for those who might wish to leave the post early, and ensure continuation was not at the discretion of the Chancellor of the Exchequer. (Paragraph 68)

17. We find the explanations of why the full-time option was removed for all ‘external’ members unconvincing, especially for new members of the Monetary Policy Committee. We recommend that all working patterns be available to ‘external’ members of the MPC, so that they may undertake their duties as they see fit, as their career progresses. (Paragraph 70)

18. We welcome the changes to the appointments process for ‘external’ members of the Monetary Policy Committee outlined by the then Chancellor of the Exchequer in evidence to us in June 2007. We welcome the fact that Government will advertise for different qualities and skills for each new ‘external’ member of the Monetary Policy Committee. We hope that they will lead to timely appointments of experts suited to the role of Monetary Policy Committee member. We note that there is no current proposal for a confidential pool created of experts who could be nominated to the Monetary Policy Committee where posts need to be filled at short notice. We therefore recommend that the Government consider adding a note to candidates as part of the appointments process asking them if they would be willing to form part of such a pool if not selected for the current vacancy. (Paragraph 79)

19. We welcome the Government’s commitment to enable appointment hearings by this Committee for nominees for the post of ‘external’ member of the MPC to take place prior to formal appointment. We note that the Government considers such hearings
would be “non-binding”. We consider it important that such hearings can be scheduled sufficiently far in advance of the date of the formal appointment to enable the Chancellor of the Exchequer to be able to give proper consideration to any view expressed by the Treasury Committee without there being a danger of the MPC membership being temporarily reduced as a result of reconsideration of a nominee. We recommend accordingly that nominations be announced at least three months prior to the date on which the vacancy falls to be filled. We also consider that, if the Treasury Committee were to reach an adverse opinion on a nominee, which would only be after careful and considered reflection, the Committee ought to have the power to require a debate in the House of Commons on the nomination. (Paragraph 82)

20. We believe that the positions of the Governor and the two Deputy Governors should be recruited by open advertisement as well as confidential search. (Paragraph 84)

21. We have heard differing views on the need for monthly meetings of the Monetary Policy Committee. With hindsight, it would have been better if the Bank of England Act 1998 had not mandated monthly meetings, but had left the number of meetings each year to be determined by the Court of the Bank of England on the recommendation of the Governor, but subject to the following conditions: that there were to be a minimum of eight annual meetings, that Monetary Policy Committee meetings were to be evenly spaced across the year, and that MPC meetings were to be pre-announced with a year’s notice, except in ‘emergency’ cases. We therefore recommend that, should changes to the Bank of England Act 1998 be required for any other purpose, these changes be made at that time. (Paragraph 86)

22. We believe that the present Court of the Bank of England is too large and should be reduced in size. We note the role played by the Court in the accountability process of the Monetary Policy Committee. We will continue to monitor the decisions of the Court, and at times may request additional information from it relating to the Monetary Policy Committee to ensure that it is undertaking its proper functions as related to the Monetary Policy Committee. (Paragraph 91)

23. We note with concern the questions raised by the Bank of England’s Chief Economist about the ability of the Bank of England to retain its analytical staff, and we will continue to monitor this situation. (Paragraph 93)

24. We welcome the assurance given to us by the Court of the Bank of England that the resources available to external members of the MPC are not under threat. We will continue to monitor both these resources and the role of the Court in such matters. (Paragraph 96)

The transparency of the Monetary Policy Committee

25. We acknowledge the efforts the Monetary Policy Committee has made in educating the public, especially via its programmes for younger people, about its role, and the need for low inflation. However, certain of the Bank’s own measures of the public’s understanding remain low. We recommend that the Monetary Policy Committee and the Bank of England consider what the public need to know about the monetary
policy framework, and then, with assistance from the Treasury if needed, consider a public education campaign to put across those points. It is important that if there are more uncertain times ahead, the public must understand and support the reasons behind movements in interest rates. (Paragraph 99)

26. We are firmly of the view that the letter writing process should be regarded as part of the accountability mechanism of the framework, rather than a sanction. While the experience has been limited, at some point a Chancellor of the Exchequer and the Monetary Policy Committee may disagree about the steps to be taken to bring inflation back to target. In such a scenario, we would expect the reply from the Chancellor of the Exchequer to set out the Treasury’s view of the reasons for inflation breaching the target, as well as their suggested timeframe and policy for bringing inflation back to target. This would allow both the House of Commons and the public in general to see clearly the areas of disagreement. (Paragraph 104)

27. Whether or not the Monetary Policy Committee provides a forecast of future interest rates, there appears to us to be a need for more information to be provided by the Monetary Policy Committee to aid both financial markets and the general public. We therefore welcome the Governor’s thoughts on providing more information around possible policy reactions should certain risks crystallise. However, we also recommend that the Bank undertake regular work to assess the current academic thinking on the feasibility and desirability of publishing an interest rate forecast, and keep this matter under review. (Paragraph 108)

28. We have heard different views on the need for immediate transparency on the voting pattern of the MPC. We have concluded that the balance of arguments supports the need for immediate transparency of MPC voting, which would allow financial markets to assess the strength of the support within the MPC for any given decision. We recommend accordingly that the Bank of England publish, alongside the interest rate decision, the outcome of the vote, indicating which individual MPC members voted which way. (Paragraph 112)

29. We were pleased to hear that the Bank is considering a structured set of discussions between professional economists and staff members of the Bank, and members of the Monetary Policy Committee. We recommend that the Bank provide to this Committee within six months an outline of a plan for such meetings, that allows for a diverse membership of participants, and allows for an open and transparent record to be kept. (Paragraph 113)

30. We are concerned about the effects on the debate within the Monetary Policy Committee of having a paragraph assigned to each member. However, we believe greater thought should be given by the Monetary Policy Committee to ensuring that the balance of views of members is more identifiable with particular individuals, rather than just identifying how individual members voted. We therefore recommend that, whenever the minutes at the moment refer to “one member”, that member be named within the text. (Paragraph 116)

31. We have listened with care to the arguments against each member of the Monetary Policy Committee providing an annual report to this Committee. We have
particularly reflected upon the concern that such reports might focus attention on a particular date. However, we are persuaded that regular reports by each member of the Monetary Policy Committee to this Committee would further enhance their individual accountability and enhance the value of our regular hearings with members of the Monetary Policy Committee about inflation reports. To overcome concerns about timing, we will request each member to prepare his or her report for a 12-month period ending with a different month. We wish to receive a report on that basis from each member of the Monetary Policy Committee which:

- lists the work they have undertaken to promote transparency in and wider understanding of monetary policy in the preceding year;
- assesses their own voting record in the Monetary Policy Committee over that period; and
- sets out their thoughts on monetary prospects for the coming year. (Paragraph 119)

32. We accept the argument presented by the Governor as to why other members of the MPC should not be present at the Inflation Report press conference. Members of the MPC who do not agree with the line taken at an Inflation Report press conference already have options at their disposal to explain their views in public. In addition, we consider that, where members of the Monetary Policy Committee do not agree with the line taken at an Inflation Report press conference, they should communicate this disagreement to us in advance of our ensuing Inflation Report hearing. (Paragraph 120)

33. We welcome the support we have received for our hearings into Inflation Reports. However, we will seek to respond to suggestions for improvement, including through greater questioning of all members of the Monetary Policy Committee present and hearings on August Inflation Reports. (Paragraph 123)
**Formal minutes**

**Tuesday 23 July 2007**

Members present:

John McFall, in the Chair

Mr Graham Brady  
Mr Colin Breed  
Jim Cousins  
Mr Philip Dunne  
Mr Michael Fallon  
Ms Sally Keeble  
Mr Andy Love  
Mr George Mudie  
Mr Siôn Simon  
John Thurso  
Mr Mark Todd  
Peter Viggers

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*The Monetary Policy Committee of the Bank of England: ten years on*

Draft Report (*The Monetary Policy Committee of the Bank of England: ten years on*), proposed by the Chairman, brought up and read.

*Ordered*, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 34 read and agreed to.

Paragraph 35 read, amended and agreed to.

Paragraphs 36 to 41 read and agreed to.

Paragraph 42 read, amended and agreed to.

Paragraphs 43 to 48 read and agreed to.

Paragraph 49 read, amended and agreed to.

Paragraphs 50 to 81 read and agreed to.

Paragraph 82 read, amended and agreed to.

A paragraph—(*Mr Michael Fallon*)—brought up, read the first and second time, and inserted (now paragraph 84).

Paragraph 84 (now paragraph 85) read and agreed to.
Paragraph 85 (now paragraph 86) read, amended and agreed to.

Paragraphs 86 to 89 (now paragraphs 87 to 90) read and agreed to.

Paragraph 90 (now paragraph 91) read, amended and agreed to.

Paragraphs 91 to 97 (now paragraphs 92 to 98) read and agreed to.

Paragraph 98 (now paragraph 99) read, amended and agreed to.

Paragraphs 99 to 102 (now paragraphs 100 to 103) read and agreed to.

Paragraph 103 (now paragraph 104) read, amended and agreed to.

Paragraphs 104 to 111 (now paragraphs 105 to 112) read and agreed to.

Paragraph 112 (now paragraph 113) read, amended and agreed to.

Paragraphs 113 to 118 (now paragraphs 114 to 119) read and agreed to.

Paragraph 119 (now paragraph 120) read, amended and agreed to.

Paragraphs 120 to 123 (now paragraphs 121 to 124) read and agreed to.

Summary read, amended and agreed to.

**Resolved**, That the Report, as amended, be the Twelfth Report of the Committee to the House.

**Ordered**, That the Chairman make the Report to the House.

Several Memoranda were ordered to be reported to the House for printing with the Report.

**Ordered**, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned to a day and time to be fixed by the Chairman.]
Witnesses

**Tuesday 6 March 2007**

**Professor Anton Muscatelli**, Heriot-Watt University, **Professor Simon Wren-Lewis**, Merton College, Oxford University, **Ray Barrell**, NIESR, and **Professor Tim Congdon CBE**

**Laurence Sanders**, Bank of Ireland, **Michael Saunders**, Citigroup, and **Professor Jagjit S Chadra**, BNP Paribas

**Ev 104**

**Tuesday 20 March 2007**

**Rt Hon Lord George of St Tudy**, Member of the House of Lords, former Governor of the Bank of England

**Marian Bell CBE, Dr DeAnne Julius CBE, Dr Sushil Wadhwani CBE, and Professor Charles Goodhart CBE**, former members of the Monetary Policy Committee of the Bank of England

**Ev 125**

**Tuesday 24 April 2007**

**Ms Kate Barker, Professor David Blanchflower, Dr Andrew Sentance, and Professor Tim Besley**, External Members of the Monetary Policy Committee of the Bank of England


**Ev 140**

**Tuesday 8 May 2007**

**Dr David Potter CBE**, Chair of the Remuneration Committee, and **Amelia Fawcett CBE**, Chair of the Audit Committee, members of the Court of the Bank of England

**Brendan Barber**, General Secretary, **Tim Page**, Senior Policy Officer, TUC, **Richard Lambert**, Director General, and **Ian McCafferty**, Chief Economic Adviser, CBI

**Ev 161**

**Thursday 14 June 2007**

**Rt Hon Gordon Brown MP**, Chancellor of the Exchequer, **Nick Macpherson**, Permanent Secretary to the Treasury, and **Jon Cunliffe**, Second Permanent Secretary and Managing Director, International and Finance, HM Treasury, and **Dave Ramsden**, Director Macroeconomics and Fiscal Policy, HM Treasury

**Ev 178**
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1. Bank of Ireland Global Markets, supplementary memorandum  Ev 187
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Oral evidence

Taken before the Treasury Committee

on Tuesday 6 March 2007

Members present:

John McFall, in the Chair

Mr Colin Breed
Jim Cousins
Mr David Gauke
Angela Eagle
Ms Sally Keeble
Mr Andrew Love
Kerry McCarthy
John Thurso
Mr Mark Todd
Peter Viggers

Witnesses: Professor Anton Muscatelli, Heriot-Watt University, Professor Simon Wren-Lewis, Merton College, Oxford University, Mr Ray Barrell, NIESR, and Professor Tim Congdon CBE, gave evidence.

Q1 Chairman: Good morning and welcome to our evidence session, the first one on the Monetary Policy Committee of the Bank of England: 10 years on. We are delighted that you have accepted our invitation to kick off this very important inquiry. We have an hour for this session so not everyone need feel obliged to answer every single question, and then maybe we will get through in that time. Could you introduce yourselves for the shorthand writer, please.

Professor Wren-Lewis: Professor Simon Wren-Lewis from Oxford University.
Professor Congdon: I am Tim Congdon. I was on the Treasury Panel in the 1990s and I am now associated with the London School of Economics.
Professor Muscatelli: Anton Muscatelli, Heriot-Watt University.
Mr Barrell: I am Ray Barrell and I am a member of the National Institute in London.

Q2 Chairman: Welcome. The MPC appears to have been successful over the last 10 years. However, even the Bank admits that the next 10 years may not be as easy. As the Governor said it will not be perhaps as “nice” a decade. What do you regard as the greatest threat to monetary stability over the next 10 years? Professor Congdon?

Professor Congdon: At the moment there is a rather high rate of monetary growth and I would say that is a threat over the next few quarters. Then in the longer run there is always the problem of large budget deficits, if they return. On the supply side of the economy I would mention the likelihood—well, the certainty—that oil and gas revenues will be less than they were in the last 10 years and in the 1990s.

Q3 Chairman: Does anyone else want to add to that?

Professor Muscatelli: I highlighted in my evidence the last time I met the Committee that I thought global imbalances were still an issue and I think that is something that needs to be watched, especially as we see what happens in Asia in terms of the rate of growth in these economies. The Bank has highlighted the impact from the incorporation of these countries into the world economy on the level of inflation and it has also been the cause of some of the global imbalances we have seen. It will be interesting to see how that unwinds over the next few years and if the rate of growth changes in these countries.

Mr Barrell: Monetary stability means a number of things. There is almost a continuum of issues here. One can say what are the threats to the short-term stability of inflation and obviously there are things like instability in exchange rates, shocks to expectations, but also there are risks, and we must not forget them, to monetary stability from the occasional dangerous event, like for instance banking crises. The Bank has to keep an eye on issues like the emergence of debt and asset price bubbles partly because large-scale personal debt and large-scale asset bubbles can be harbingers of banking crises. Banking crises are very unlikely but when they do turn up they are very dangerous, so stability is two ends of a continuum: keeping it stable now and avoiding the big dangers in the future. We have not completely removed the risks of banking crises. The fact that nothing has gone wrong partly reflects the fact that nothing has gone wrong, and we still have to keep on eye on those big risks.

Professor Wren-Lewis: I concur with all those thoughts. I have just one thing to say on the subject of global imbalances, which I agree is a risk. It is not necessarily something that is going to impact very strongly on the UK because I think it is essentially an issue to do with the United States and the Far East, China in particular, and it may be that the problem resolves itself just between those two countries, so there is not necessarily an impact on the UK, but if things do not work out as perhaps they should then there may be some repercussions in Europe and the UK.

Q4 Chairman: To what extent is the anchoring of inflation expectations around the inflation target important in ensuring that monetary policy is effective?
Professor Wren-Lewis: I think the MPC has been frameworks has reduced the impact of shocks, so extent to which the imposition of better policy anyone does say it is luck they under-estimate the Chairman of the Federal Reserve, in saying that if England in writing to us quotes Ben Bernanke, the judgment? Just to frame the question, the Bank of Monetary Policy Committee has been over the last 10 years and is its success more due to luck than Peter Viggers: I do not think I would quite Wren-Lewis? Q5 Chairman: Did you want to come in, Professor Wren-Lewis? Professor Wren-Lewis: I do not think I would quite put it the way Tim does. I think that anchoring expectations does not so much make monetary policy more effective; I think it makes it easier, in the sense that if the economy is hit by shocks then the Bank has to do less to counteract those shocks than if expectations are much more volatile. I think it certainly makes the Bank’s job easier and less painful, but it does not mean that if those expectations are not anchored the Monetary Policy Committee could not do its job; it could. I do not share the view that the source of all evil is in monetary aggregates. Chairman: Thankfully we have a difference of opinion early on in this inquiry and that is good! Peter? Q6 Peter Viggers: How successful do you think the Monetary Policy Committee has been over the last 10 years and is its success more due to luck than judgment? Just to frame the question, the Bank of England in writing to us quotes Ben Bernanke, the Chairman of the Federal Reserve, in saying that if anyone does say it is luck they under-estimate the extent to which the imposition of better policy frameworks has reduced the impact of shocks, so how successful do you think the MPC has been? Professor Wren-Lewis: I think the MPC has been very successful. There is no doubt that it has been lucky in the sense that it has not been a very turbulent period, so in that sense it has not been severely tested, but there have been problems that it has had to deal with. It has had to vary interest rates and it seems to me that it has varied them in a very intelligent and prudent way, so I think the MPC has been successful, in my view. Professor Congdon: I think it has been massively successful and that has been the result of good policy and, in particular, the adoption of a sensible framework. If one goes back to the period up to the Second World War, a period of about 150 years or so, the economy was basically managed on Bank rates and the economy was sensitive to movements in interest rates. That Bank rate system worked. The focus on interest rates was then very much diluted in the 1940s and 1950s because of Keynesian economics. We had all sorts of, in my view, mistaken approaches, in particular things like incomes policies and over-reliance on fiscal policies. What has happened in the last 20 years is a return, in effect, to the Bank rate tradition. But instead of it being focused on the exchange rate, it is focused on controlling the growth of domestic demand to keep output at trend, and it has been very successful. In my view, it is as if there are different ways of dealing with illness; some of them are bad therapies, some are good therapies, and they have chosen the right therapy. Q7 Peter Viggers: We do not need everyone to answer every question unless you particularly wish to add something. Professor Muscatelli: The only thing I would highlight—and I certainly would agree with what has been said so far—is the fact that when you try and measure success in an attempt by the Bank, as well as other commentators in the written evidence, just by volatility over the period then it seems as if the UK has done pretty well, just as well as some of the other economies. However, we have to remember just how much poorer UK macro policy was in the preceding two decades and really the UK lagged behind. Also rather than looking at volatility, if you look in terms of a sustained period of growth, the UK has actually fared very well compared to the other European economies which have been subject to very similar shocks, so I think it has been very successful. Mr Barrell: Although I would agree largely with what my colleagues have said, I would use only the word “successful”. You can only be “very” successful if you avoid an accident when an accident is looming and there has been no accident looming, therefore it has not really been tested. The Bank has been lucky, as Ben Bernanke says, in that the world has changed to a better monetary policy environment and that has allowed it to change to a better monetary policy environment and improve massively on the UK’s monetary policy performance. The Bank of England system since 1992–93 has been much more successful than any previous regime we have had in the UK in the post-War period: so successful, yes; very successful, we cannot know that yet. Q8 Peter Viggers: Okay because there may be problems coming. For instance, house prices are about two-thirds above where you would expect in terms of the average historical ratio of house prices to income. Do you think the Monetary Policy Committee has been successful in integrating house prices into its equations? Is there more it should do? Professor Congdon: There is this general problem about asset prices. In my view, in the end there is a relationship between the growth of money, the behaviour of asset prices and movements in national income and expenditure. In the long run these are all related. At the moment you have got an anomaly really, because house prices are out of line with incomes. What has happened in two previous cycles—a cycle in early 1970s and again in the late 1980s—was that we had this very high
house price:earnings ratio and then a bust. The ratio came back in the first case with a lot of
genral inflation and in the second case with house
ces falling quite sharply in nominal terms. I
think there is a medium-term problem out there
and the question is whether there will be a bust or
a gradual what is called “rust”, in other words a
long period in which house prices go sideways. My
guess is that it is more likely they will go sideways
for a period than collapse. Logically, history says
there should be a problem of adjustment in the next
few years with house prices.

Q9 Peter Viggers: So looking at what Professor
Wren-Lewis rather endearingly calls “bubbles”—
that is, as it were, irrational exuberance in prices—
do you think that it possible or wise for the Bank
of England to try to identify these bubbles? Can I
bring in here the comments of the International
Monetary Fund which has said that Mr Brown, the
Chancellor, should be building in cushions needed
to respond to adverse shocks and that should be a
priority. What they have indicated really is that in
following his predecessor Ken Clarke’s policies for
a couple of years the present Chancellor was
cautious. He then let the brakes off and we are now,
as it were, at scene VI of Hogarth’s A Rake’s
Progress where he is needing to slam on the overall
controls. Can you comment on that?
Professor Wren-Lewis: There are a number of parts
to that question. On the issue of house prices and
whether the Bank should try and identify bubbles,
certainly it should be on the lookout for bubbles,
that is periods in which asset prices in particular
seem to depart from fundamentals, because
potentially those bubbles can impact seriously on
the economy. However, although in principle it
should look out for those things and in principle
ought to do that and counteract them, in practice
actually identifying when bubbles occur is
incredibly difficult. Let us take the issue of house
prices. It is far from clear whether the current level
of house prices represents in any sense a bubble.
For example, some of my colleagues at Oxford
have suggested that if you go beyond rather simple
price:income ratios and look at other factors that
would influence house prices, then the current
house prices might well be at a sensible level and
not represent a bubble. So I think the problem with
trying to pick bubbles is that it is very difficult to
actually identify a bubble at the time. These things
are only clear 10 years after the event. That is why
I think it is dangerous to expect the Bank to do too
much in this area.

Q10 Peter Viggers: Because the thrust of the IMF
comment says that “the public spending surge of
2001-2004 led to a sharp deterioration in the fiscal
balance and rising net public debt, leaving little
room for manoeuvre in the face of a global
downturn.” Would you regard this as a problem?
Mr Barrell: I agree strongly with that and I have
said similar things myself. I do not think the MPC
can do very much about the Chancellor’s spending
and tax decisions. The MPC’s remit is to deal with
the consequences of that increase in public
spending. On house prices, I think there is
something one can add to that which is the same
thing about public spending. When there a risk, like
too much public spending for stability or too high
house prices, then the Bank of England can hold
interest rates slightly higher than it otherwise would
have done, and I think that is wise. We have to
remember though that the Monetary Policy
Committee may actually be part of the cause of the
rise in house prices and that could be a good thing.
Volatility has come down massively in the UK;
therefore the risks of owning a house have come
down massively in the UK, therefore the demand
for housing is shooting up. Exactly the same thing
has happened in Ireland and in Spain. Suddenly
interest rates are much more stable and the world
is more stable and people demand more houses and
house prices have come up, so it may not be a
bubble; it may be the result of the Monetary Policy
Committee’s actions being so successful rather than
the Chancellor’s actions of pouring in rather more
money than he perhaps should.

Q11 Mr Love: Can I turn to household debt: do
any of you think that the Bank of England should
have been more proactive in dealing with the issue
of household debt?
Mr Barrell: It is very hard for the Bank to do that
because one of the things that happened when the
Bank was given independence was that certain
parts of financial stability were separated from the
Bank’s remit into the FSA, and to the extent that
we might be seeing too much debt rising, the most
effective instrument for dealing with that would be
constraints on lenders and the Bank of England
cannot do that, so the Monetary Policy Committee
cannot do that. Again, it should be keeping a
careful eye on the rise of household debt because
the rise of debt raises the risks of bankruptcy and
raises the risks of problems in the banking sector
and therefore it is one of those long-distance
threats, it is not an immediate threat—and if the
banking system begins to have problems that scale
debt will cause it severe problems, so the Bank
of England should again perhaps be cautious on
interest rates and holding interest rates higher than
they would otherwise have been. That is not always
popular with this Committee and we have discussed
this before. Holding interest rates higher than they
otherwise would have been in order to deal with
debt and to deal with asset prices and those risks
means holding them higher than they really need
to be to hit full employment immediately, so there
is a choice, a trade-off.

Q12 Mr Love: Can I just ask you whether you think
that the Bank should have signalled action to the
FSA or the Treasury?
Mr Barrell: I personally think they should have
done. I do not know exactly what channels of
communication they have between each other. I
would hope that the Bank is aware of the risks from
excessive debt of banking crises because it is relatively well known in the academic literature. I think they should have been signalling perhaps more worry about the scale of debt than they have.

Q13 Mr Love: Do you agree Professor Congdon?
Professor Congdon: The Bank cannot try simultaneously to control house prices and the Consumer Price Index; that is not possible, so when you have (as we have had in the last few years) a large rise, an apparently anomalous rise in house prices to some extent, there is not much the MPC can do. Of course it can give warnings and it has been doing that. Can I just say, as I said in my evidence, that the striking feature of the behaviour of the British people is how sensible they are? The ratios of wealth to income have been fairly stable in the long run. Wealth is much larger than debt. At the moment net wealth to income is at an all-time high. The debt is dominated by secured debt, it is secured against houses, and the unsecured debt is always small—it is very small at the moment—relative to total wealth. On the whole people behave sensibly. I am not saying there are not exceptions, which is unfortunate, but on the whole people are very sensible.

Q14 Mr Love: Those who think there is a problem point out the fact that those who hold the wealth are not the same as those who hold the unsecured debt. Is there a problem for those people who hold the unsecured debt and is that an issue that the Bank should be concerned about?
Professor Congdon: This probably sounds slightly heartless but I think this is a problem really for individuals and social security; it is not a problem of monetary policy. This probably does sound a bit harsh but one cannot get round it; this is not the Bank’s job. It is not their job to deal with those people who have got excessive debts and so on. I am sorry for them, but that is not the point. It is not the Bank’s job to deal with those individuals. Its job is to keep the overall inflation rate stable.
Professor Wren-Lewis: I would agree with that in the sense that the Bank can express concern but it cannot act to deal with that problem. The one point I would like to add is that the big increase in secured debt does pose direct problems for the MPC because it probably means that the economy is going to be more sensitive to interest rate changes than it has been in the past. I think that makes the Bank’s job when it has to raise interest rates, for example to cool the economy, that much more difficult because it really needs to tread a little bit more cautiously than it might have done in the past because there is this amount of debt out there, and as a result consumers might react much more to interest rates than they have in the past.

Q15 Mr Love: I want to come on to that issue of sensitivity to rising interest rates but before I do, do any of you think, along with Mr Barrell, that there is a role here in terms of this unsecured household debt for the FSA and the Treasury? Do you think action should be taken by someone if not the Bank of England?
Professor Muscatelli: First of all, on the issue of leverage, I think this is the biggest risk. The thing is we have not had a recession over the last period. If we had a recession similar to that in the early 1990s, given the high leverage situation, it would pose significant problems for the Bank. In terms of what can be done, I think it is certainly a role for the FSA to look at the way in which lenders behave, but I would agree with Professor Congdon this is not a matter for monetary policy and it is certainly not a matter for the Bank of England. It is a matter for the Government and it is a matter for the FSA to keep an eye on to see whether the sector is behaving responsibly.
Professor Congdon: I am not denying that, if there were two years of 10% falls in house prices that would be very relevant to monetary policy because there would be effects on consumer spending and there would be effects on the banks and the building societies. In the early 1990s negative equity did impose heavy losses on the banks and building societies. But the situation now is not like the early 1990s when we were trying to get inflation down from double digits, and so in that sense I am not expecting a repetition of that.

Q16 Mr Love: Can I come on to this issue about sensitivity to changes in interest rates. Is there any way in which the Bank should be able to measure this more effectively and accurately than it does? Professor Wren-Lewis, you have an ironic look on your face so I thought I would start with you.
Professor Wren-Lewis: In a sense I am sure it is doing everything it can. The problem with macroeconomics is that you can never nail things down precisely, there is always a huge amount of uncertainty. However, I am sure with the kind of calculations where you look at the proportion of debt and you look at microeconomic studies of how individuals react to interest rate changes with particular levels of debt that the Bank has pored all over that evidence. I am not sure that there is anything obvious more that it could do.

Q17 Mr Love: Let me ask you all and maybe somebody could give a comment about whether or not there is a linear relationship here between increases in the interest rate and decreases in consumption or whether there is mythical problem that once you reach a certain level, consumption will change very, very rapidly. Does anyone have a view on that?
Professor Muscatelli: I think the problem is exactly what we were discussing a moment ago which is the relationship may be linear within certain bands, within a certain situation if that persists, but all you need is a major discontinuity because borrowers are constrained for that to change. If you have a situation where unemployment rises very suddenly or you have a big recession, then non-linearities do kick in and people do find it very difficult to smooth
their consumption over time and at that point it becomes much more difficult for the Bank to do something about it because it is not only necessarily about reducing interest rates and reducing the debt burden but also about the impact that has on employment prospects because it is a combination of a variety of things. It is the interest payments on the debt but it is also the extent to which people are in employment or not. If you look again back to the 1990s, in some cases the problems of negative equity and people defaulting on their mortgage payments were to do as much with their employment prospects as with the actual interest payments per se. These sudden major changes can cause discontinuities and at that point the uncertainty which Professor Wren-Lewis referred to kicks in because you are almost in a different regime at that point.

Q18 Mr Love: The other question I was going to ask arises from Professor Congdon's comments earlier. The Bank seems to have been paying much more attention to money supply figures than it has in the past and of course they have been rising very quickly. I think we know Professor Congdon's view in relation to that. I wondered whether anyone else wanted to comment on whether this was a sensible way for the Bank to respond.

Professor Wren-Lewis: It certainly is something that the Bank should be concerned about in that very rapid increases in monetary policy have, on occasion, signalled a more serious problem to come. However, as an indicator it is very unreliable and rapid increases in monetary aggregates have also happened with virtually no consequence to the real economy. In a sense it is something the Bank should keep an eye on, but if nothing else happens to worry the Bank and there is no supporting evidence that demand is building up, then I think it is just one of these problems that will turn out not to be a problem in the long run and that is how it looks to me at the moment. It is certainly right that the Bank should keep an eye on it.

Q19 Ms Keeble: To what extent do you think that the Consumer Price Index remains a credible target for inflation in the UK? Perhaps Professor Congdon if you could answer and Mr Barrell could you respond on that point.

Professor Congdon: There has obviously been a problem in the last few months with the Retail Price Index being so far ahead of the Consumer Price Index. There have been periods in the past when the two indices have diverged very markedly. I have not got any very strong thing to say about it. Obviously insofar as the Retail Price Index affects pay bargaining then that is, in a way, the one that really matters. By the way, I do not deny wage costs are very important to the inflationary process. There is obviously at the moment this whole question of monetary policy affecting largely the private sector. In the public sector it is much more a matter of bargaining and in a way just brute force, frankly, who wins between the Treasury and the Chancellor, and the public sector unions. I think that is something to watch out for because there has been a long history in Britain of trouble on inflation after the public sector unions force big pay rises through strike action. We seem to be facing something like that, on a lot smaller scale than in the past but it is there.

Q20 Ms Keeble: Ray, what do you think about that?

Mr Barrell: I think you can see that in the discussion on which index we should be using is an indication of the success—

Q21 Ms Keeble: I am sorry, I cannot hear you.

Mr Barrell: Even discussing which index we should use is an indication of the success that we have had, because the indices all tend to move together in the medium term. Consumer prices, retail prices, producer prices—there are reasons why they might move apart which we can understand but they all tend to move within 2% or 3% or so together and therefore any of them will actually do, and in 1992 anything would have done when we had inflation running at 10%. Stabilising anything would have been a good idea. One could argue that perhaps we should either include more things in the CPI (but that has got to be a Europe-wide decision because we use a common index) or we should move to a producer price index, which is harder than it might look to get more exact control over inflation. I think those are secondary issues and we have to stabilise something. The CPI will do; the CPI as measured will do, as long as we know what is missing from it and what the problems are with it.

Q22 Ms Keeble: The question was about credibility. Obviously what Professor Congdon referred to as the debate about inflation has been missing for quite some time and it is around the current public sector pay rises. Do you think that it remains credible for the MPC to retain a very rigid definition of inflation at a time when there is divergence in the public debate and when there is pressure to look at perhaps including house prices, one of the effects to which Ray referred. Professor Congdon, I know you think that it is not the MPC's job to worry about these things but there is obviously an issue about the public perception of inflation.

Professor Congdon: As far as one can tell, there has been some deterioration (or some rise at any rate) in pay settlements, but it is not that dramatic, in fact rather less than one might have expected given that the Retail Price Index has gone over 4%. I do not think house prices should be included in a large way in any measure of goods price inflation. They do come in in various ways in the indices and I have not much to add, frankly. The present situation is very interesting. May I just make one point, and it may seem slightly political? In my view there is a link between money growth and asset prices and that then affects the incomes of people involved in trading assets—stockbrokers and chartered
surveyors and people like that—and at the moment they are doing very well. Then you have got public sector workers being told they are going to get 1.9%. This is a classic situation where you get trouble. There have been many cycles like this in the past.

Q23 Ms Keeble: Ray, is there not a slight problem of “ivory tower-ishness” if this definition of inflation is far adrift from the public perception?

Mr Barrell: I think public perception is not always the thing that really matters in pay bargaining. Outside the public sector one can go along and say, “I want RPI as my wage increase,” and the employer has to say whether he can afford it or not. That is a wage bargain. Inside the public sector there is also a bargain and the public sector employee can go along and say, “I want RPI,” and the Chancellor’s response might well be to say, “The public sector has been expanding; I want it to stop expanding and in order for it to do that, my side of the bargain is not to give you RPI.” Pay bargaining is not just about fairness; it is about demand and supply in the market, and it is demand and supply in the market which will determine wages.

Q24 Ms Keeble: I know that the other people wish to say something. Professor Muscatelli, you said in your evidence that you thought one potential inflation target measure was domestic output price inflation. I wondered if you wanted to say some more about that.

Professor Muscatelli: Essentially one of the arguments there is that there is a feedback effect from the exchange rate on to consumer prices and essentially by focusing on the domestic price index you can avoid some of these issues. In the written evidence that Professor Wren-Lewis provided, he expands on that quite a bit. The other point I would add just to follow up on the discussion which I think is important is I think CPI is a narrow index. Obviously if housing costs can be incorporated that would be a positive step although, as Ray said, it has to be done at European level. If that does not happen, I think it could ultimately have an impact on the credibility of monetary policy. Going back to what we were discussing earlier about anchoring expectations, if you start targeting an index which is a million miles from what people perceive to be the inflation they are experiencing, then I think (especially at a time when inflation is higher) that can have a big impact on expectations. I think there is an issue there to confront in the medium term—if not now then quite soon—in terms of incorporating at least housing costs into CPI.

Professor Wren-Lewis: I just want to make three points. The first is I think the Bank of England has to stick to one index for a long period of time. It cannot keep changing the index that it is targeting because that would destroy credibility. That is the first thing to say. Secondly, however, it is wrong to believe there is one right index or price inflation measure to look at. I think the Bank should be looking at a range of price indices, not just consumer prices but also producer price indices and also wage inflation, so I think it needs to be looking at all of those and if it is the case that the CPI inflation is an outlier and all these others are rising then I think it should act. That is the second thing I want to say. The third thing is I am far from convinced that some measure of housing costs should play a very big role in the Consumer Price Index. It is not obvious to me why movements in house prices have an affect on people’s welfare. I think that is an interesting debate to have and it is not obvious which way the answer would come.

Q25 Ms Keeble: I just have one further question for Professor Muscatelli. You suggested that there may be evidence that although the target is symmetrical there is an anti-inflationary bias and I wonder if you could say a little bit more about that.

Professor Muscatelli: Essentially I cited some work which we had done to look at the extent to which the Bank had reacted symmetrically to deviations of output from trend and of inflation from the inflation target. We seemed to find some evidence, certainly from 1997, that there seemed to be some bias towards being more cautious, if you like, on inflation control. However, that is subject to the same caveats which a number of commentators have made, which is that there is a limited span of data, all of this conditional on the economic models. I think the evidence we have produced is intriguing because it might suggest that as the Bank was trying to build up its credibility it might have been quite cautious and therefore inflation stayed below its target but you cannot be 100% sure for the reasons that we were discussing earlier about the uncertainty of macroeconomic models.

Q26 Ms Keeble: Is that not just historical experience that is telling people to be cautious?

Professor Muscatelli: The historical data seems to tell us that they were being cautious.

Professor Congdon: Can I just say something? I think the Bank was very surprised at that time by how strong the exchange rate was. They were surprised by that and that is what kept inflation lower than expected. I think that is fair.

Q27 Jim Cousins: Professor Wren-Lewis, You have argued in favour of giving the Bank control over short-term fiscal instruments to achieve stabilisation. Could you give the Committee some idea of what sort of instruments you had in mind and in what sort of circumstances they would be used?

Professor Wren-Lewis: Thank you, yes, I have for a number of years argued that certainly the question of whether the Bank should be given additional instruments is something that should be
looked at. This is an issue for the long term. I am not suggesting that this is something that should happen overnight, but I think it is something that should be considered. The essential argument is that we have been through quite a benign period where moving interest rates around seems to have been enough and has not caused serious difficulties but there may well come a time when the Bank would like another instrument to do its job effectively, and particular tax instruments could be appropriate in certain circumstances. So one might think about the VAT rate for example or perhaps some instrument particularly targeted on the housing sector. If you believe that a serious problem—a shock to the housing sector—and using interest rates to deal with this is rather difficult, then you might think about having an instrument that is more targeted to that sector. This is something, in a sense, to think about in the long term and one would certainly want to do a lot of research on what the best instruments to be used were and whether they could be moved in a quick fashion, etc. I think this is something for long-term discussion about how things might move on.

Q28 Jim Cousins: Clearly the rest of the people do want to comment.
Professor Muscatelli: I would disagree with that approach, I have to say. I worry a bit about the democratic deficit issue here because it is one thing to argue that interest rates should be under the control of the Bank because ultimately it is affecting a variable which everybody agrees should come under control, which is inflation; it is another to give taxation control to an unelected body. I think there may be ways however to try and tackle this issue of co-ordination. I do not disagree that is an issue. I think there may be an issue of co-ordination at a time when in more turbulent macroeconomic times than at present when there is simply an observer of the Treasury in the Bank, there is very close communication on what the Budget implications are for fiscal policy, but there may need to be closer liaison between the Bank of England and the Government of the day if there is more of a disjuncture between fiscal and monetary policy, but I do not think handing fiscal policy to the Bank is the answer.

Q29 Jim Cousins: Should that liaison be transparent?
Professor Muscatelli: My intuitive answer is yes but it would be interesting to do some research on it.
Professor Congdon: This is where the doctrinal disputes really become quite—in effect, what has happened in the last 10 or 15 years—

Q30 Jim Cousins: —You did not say what doctrinal disputes became.
Professor Congdon: I will elaborate. In the last 10 or 15 years macro policy has in effect become monetary policy. This is why we are having a discussion about the performance of the MPC in its first 10 years. For heaven’s sake, we did not have the MPC in the 1940s, 1950s, 1960s or 1970s because that was not the way macro policy was conducted and, as Professor Muscatelli has said, you cannot have the Bank of England deciding fiscal policy. What has made this framework possible is the neutralisation of fiscal policy by the medium-term rules, which goes back in a way to the late 1970s but actually to the early 1980s. I think that has been a good thing. Then we get Professor Wren-Lewis saying that we should bring fiscal policy back. I do not deny fiscal policy can have some short-run effects on the economy. I am however strongly opposed to reactivating fiscal policy and I think that there are very fundamental disputes about what causes the economy to move. Can I just try and explain where I am coming from? I believe that in the long run there is a link between money, asset prices and goods prices, so when the quantity of money rises by 1% so also does equilibrium wealth. Since wealth is about £6 trillion, this means wealth rises by £60 billion and when money rises by 5% wealth rises by £300 billion. Some of that is consumed, which affects behaviour. That is far more powerful than anything fiscal policy can do. Monetary policy is the effective instrument and recognising that has been crucial to the success of the MPC. This is where you get to the really big doctrinal debates, because obviously my colleagues do not agree with me.

Professor Wren-Lewis: No I agree with you 100% that the interest rate is the instrument, but the question is whether you might want to supplement it on quite rare but important occasions by giving limited temporary control of certain fiscal instruments to the Bank. That is all I was suggesting.

Chairman: I think we will have the Bank of England Governor standing as an MP so that he is down in the House of Commons explaining why he is doing all these things. How about that?
Jim Cousins: I think he should stand on a list and be elected for 15 years.
John Thurso: Hear, hear.

Q31 Jim Cousins: Professor Congdon, in your evidence you have lots of nice things to say about our opposite numbers in the House of Lords and one of the things they say on this very point is that “from time to time monetary policy would have to respond to fiscal policy”, paragraph 25 of their report, and they are concerned about what they see as the consistently over-optimistic GDP growth forecasts and over-estimates of tax revenue and under-estimates of the budget deficit and borrowing requirements. Despite that, you see no attraction in either the Bank of England having access to fiscal instruments or perhaps some kind of tax equivalent of the Bank of England?
Professor Congdon: There has been no fiscal policy in the Keynesian sense in the last 25 years and you could not have the present framework of policy if that were to be restored. That is not to say that what happens to the budget deficit is not relevant to monetary policy. As I said in my own evidence,
if there is a large budget deficit which is monetised then that is very important. What I also said in my evidence was that it may be the case that at some future date debt management should again become part of what the Bank of England does—and by the way the Bank was responsible for that until 1997. They had discussions with the Treasury about it, but the responsibility for debt management really lay with the Bank of England, and that is again a subject that the Committee could think about. In my view, debt management policy is part of monetary policy and it should be considered as part of monetary policy, but again one could discuss that.

Q32 Jim Cousins: Professor Wren-Lewis, to go back to you, in your evidence to the Committee you were arguing in favour of an inflation target that was a "soft target". I perhaps to take account of some of the very points that Professor Muscatelli was saying earlier, that people’s experience of inflation is not homogenous and different parts of society have their own very different inflation rates. Perhaps you would care to put that point to the Committee.

Professor Wren-Lewis: I think in a sense it relates to an answer already given and that is if you found that CPI inflation was on target but wage inflation was substantially above target. RPI was above target, producer price inflation was above target, I think then you would want to raise interest rates. In a sense, that is why I think it should be a soft target because you should be looking at other measures of inflation rather than just CPI, and the circumstance I have just given is when you would want to depart from your target.

Q33 Jim Cousins: Can I ask Professor Wren-Lewis’s colleagues whether you would perhaps regard that as muddying the waters?

Professor Congdon: I rather agree with Professor Wren-Lewis on that. The puzzle—and this is in a way whether it has been benign circumstances or whether it has been policy—is that the last 10 or 15 years has been an extraordinary period because one would have expected far more divergences between the RPI, the CPI, and wages and asset prices than we have seen for most of this period. Obviously at the moment we are getting a bit of a problem with the gap between house prices and consumer prices but it has been an extraordinary period. I would rather agree with you; I think one should not expect this incredible period of over 15 years, basically staying within 2% or 3%, to continue. These years have been extraordinary, really.

Q34 Angela Eagle: I was just wondering. Professor Wren-Lewis, how on earth you could come to the thought that we should hand over taxation policy to non-elected people without effectively abolishing our democracy? Would you feel happy if your VAT rate went up or down that it was a non-elected person at the Bank of England doing it? Why would you bother voting in general elections if you did that?

Professor Wren-Lewis: First of all, the Bank does change interest rates, which has a very big effect on a large number of people.

Q35 Angela Eagle: Within a parameter set by an elected body. It is not a tax rate, though, is it?

Professor Wren-Lewis: My proposal would be if power was delegated to the Bank of England it would be to change just a few taxes on a temporary basis.

Q36 Angela Eagle: VAT is a fairly big tax instrument for most people.

Professor Wren-Lewis: I did not say unimportant, I said a few tax instruments on a temporary basis within set limits, so in that sense it is not very different in terms of the impact on people to changing interest rates.

Q37 Angela Eagle: So you are one of those people who thinks that fiscal policy should somehow be made independent as well as monetary policy, are you?

Professor Wren-Lewis: No, I do not actually think that. I think that it is very important that tax rates in the long run are set by a democratically elected government; absolutely I do.

Q38 Angela Eagle: That is good to hear.

Professor Wren-Lewis: That is why I very carefully specified that only changing these instruments on a temporary basis should be something that the Bank should be allowed to do within set elements as a way of stabilising the economy.

Angela Eagle: VAT rates do not go up and down very often, do they? They tend to go up and stay up.

Chairman: I think one of your students could get a good PhD in that and then you can come back to us with the findings. Mark?

Q39 Mr Todd: Can we turn to the MPC as a body and how it works. First, briefly, is it too large? By the silence I take it no, you are happy that it is about right. Professor Wren-Lewis, you have commented flatteringly on the model that the Bank of England uses and suggested that at least one external member of the MPC should have a working knowledge of the model. Are there people available who have that knowledge because I think you later go on to discuss the transparency of the model and its replication outside the Bank, which would suggest that that skill may be extremely rare?

Professor Wren-Lewis: What I actually suggest is that there should be one external member of the MPC who is familiar with the kind of model that the Bank operates. Obviously they do not need to have knowledge of the particular Bank model before they get appointed because if they know the kind of model that the Bank is using then it is quite
quick to be able to look at the particular model the Bank is using and understand it. I think it is very important that there should be someone on the MPC who essentially is involved in producing and using the kinds of models which the Bank’s current model is a class of.

**Q40 Mr Todd:** I sense the other three of you are non-modellers or not perhaps the enthusiastic modeller that Professor Wren-Lewis is. Do you share his views?

**Mr Barrell:** Can I answer that first because I am a modeller and I provide models to all sorts of people. They are slightly different to the sorts of models at the Bank, but I have spent much of my career using models for forecasting, and I do it every quarter, and I do recognise that there is a significant amount of investment in human capital in understanding what people are talking about. It is very easy for somebody like me to pull the wool over the eyes of almost any academic or business person in terms of the information I give them. It takes someone very bright to crack through the words I give them. Not everybody has the capacity to crack through that. I think there are some people who have got used to the patterns of doing those. It does not have to be somebody who has got a PhD in Dynamics Stochastic General Equilibrium Analysis, if somebody knows a bit about the techniques of separating signal from noise in forecasting and understanding whether this model tells you anything about the economy at all and which model you use. So I think expertise would be of great value but at the minute I suspect, with such a complicated model, the Bank staff are at a significant advantage over most outsiders, including most of the people sitting at this table, because they know this toy much better, and it would useful to have somebody outside saying, “You are actually wrong there and I can prove it.” That is difficult to do.

**Professor Muscatelli:** I would agree with Professor Wren-Lewis’s judgment that there has to be some academic input into the external membership and in fact I have suggested that we should retain a range of skills because I think everybody brings something very different to the table. I would also support what Ray Barrell said because I think the more discussion there is of the model, the easier it is for a non-modeller, external member of the MPC to gain not only some knowledge from the Bank staff but also from the outside which may balance their view about what the model is actually saying. There is an argument for making it more widely available and in the sense of understanding how the Bank is using it as opposed to making the equations available.

**Mr Barrell:** If I could say something before Tim. Charles Goodhart said something to the House of Lords Committee which I thought was very insightful because he has been on the Committee but is also a very good technician. He said it can take up to a year for a non-specialist to understand what is going on. I think that is a very important point, especially at the minute.

**Professor Congdon:** I think the role of computer models in British policy-making is very chequered. I would say that the improvement in the last 10 or 15 years has been partly because these have been put in the background. The improvement in information flow is not because of computer models; it is because of more business surveys. The quantity of business survey information available today is dramatically higher than it was 30 or 40 years ago. As I pointed out in my written evidence,4 purchaser manager surveys every month are very important. If you look at what then affects interest rates, the financial markets know that those surveys matter and that is why they are very valuable. On the computer model, can I say one other thing? Again these are doctrinal disputes. Most of these models are based on what is called the Keynesian income/expenditure model. They are very complicated things but in essence spending depends upon income. That is fine generally until you get something going dramatically wrong with asset prices when people can spend by selling an asset, so these models failed very badly in the early 1970s and the late 1980s, when you had big movements in the money supply and big movements in asset prices. In my view, they should not have much prominence in policy-making. Having said all that, I am all in favour of technically equipped and skilled members of the MPC.

**Q41 Mr Todd:** Can I broaden that from modelling to other skills. Are there other particular skills which you think should always be present amongst external members? I think there has been a reference to labour market economists from one of you, but are there other skills which people feel should always be there?

**Professor Congdon:** I think there should be someone who understands money and banking but I would say that, would I not!

**Mr Barrell:** What the Monetary Policy Committee is doing is slightly different from what is being done in, say, financial markets. If you are involved in financial markets often what you are interested in doing is looking at a survey or some piece of information to find out what is going to happen next month or next quarter. The Bank of England should not be concerning itself so much about next month or next quarter. The skills and the tool sets involved in that very short-term forecasting are very different to what is going to happen to inflation over the next year or two. That is a skill set that is unusual in the academic profession and in the financial professions. The academic profession tends to specialise in a skill set as to what happens in the long run and then building these theoretical models. The Bank of England needs people with the skill set in the middle, and where they get them I am not absolutely certain. It

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is not necessarily the best theoretical academic and it is not necessarily the best financial market operator. It is somebody who is used to operating and thinking about the medium term. They can be somebody from either end of that but there is a specific bundle of skills which again I would say Charles Goodhart had because he had been used to the whole range of things. It is the skills of the generalist who understands that things are the skills needed, not so much those of the specialist.

Q42 Mr Todd: Professor Wren-Lewis, you have suggested that there should not necessarily be a majority of internal Bank members. Which member do you think should be ejected from this gilded life?  
Professor Wren-Lewis: To be honest, I have not given that a moment’s thought so I cannot possibly answer that.

Q43 Mr Todd: You were incautious enough to venture a view.  
Professor Wren-Lewis: The context of that remark was simply building on my earlier remark that it seems to me that you need someone with some knowledge of the class of models that the Bank uses there. If that meant that you had to get rid of somebody else who also had some important expertise as one of the external members, you do not necessarily have to do that, you could expand the number of external members.

Q44 Mr Todd: Do any of you share the view that there should be an external majority on the MPC?  
Professor Congdon: In my view, no. We tend to treat the MPC or the Bank as if they were the same. If the MPC had a majority of non-Bank members and then things went wrong the Bank would say, “It is not our fault.”  
Professor Muscatelli: I would agree with that.

Q45 Mr Gauke: Can I do a quick straw poll on the subject of external members. What do you think should be their term of office and should they have the right of reappointment or the possibility of reappointment?  
Mr Barrell: I notice that Steve Nickell, for instance, suggests that six years would be a good term and I would agree with that. Six years with no reappointment is a good idea because it takes time to build up the knowledge you need to do the job. You cannot just walk in and understand it instantly.  
Professor Muscatelli: There is some argument perhaps for extending the period of office given what has been said. I think we have to normalise the nature of the reappointment process because at the moment there is a huge amount of uncertainty as to which members are reappointed and which ones are not and why. Normalising that and perhaps going to six years with no reappointment is one way of doing that.

Professor Congdon: I think six years is long for people with a business background and business career. I do not think they should be entirely academics.  
Professor Wren-Lewis: I agree that it should not be entirely academics. I do not really have any strong views about the length of time. I can see the attraction of Steve Nickell’s comments and I certainly think that if you have an external member of the MPC who is being very helpful and very productive you would want to keep them on there for six years definitely. However, you can appoint external members—it has not happened but it could happen—who turn out not to be up to the job and you would want some way of making sure that you are not saddled with those six years.

Q46 Mr Gauke: Could I also ask on a similar subject, currently external members are part-time; does anyone see an argument for them being full-time or any disadvantages in that. Do you have any strong view, Professor Wren-Lewis?  
Professor Wren-Lewis: I think it is potentially a full-time job so if someone wants to do it full time I do not think they should be stopped. However, I think that you could have very good people who are just not able to do it full time and if they wanted to do it 50% of their time I think that also should be an option, so I think it should allow both.

Q47 Mr Gauke: Anybody else?  
Professor Muscatelli: I think that one or two former members of the MPC who are non-academics have highlighted a problem with having part-time employment and I would support that. Although they can take up part-time employment as academics or quasi academics, it does make things more difficult for them, so I think that is an issue.  
Mr Barrell: I would agree that full-time employment seems wise from certain occupations; in others you can find something else to do with your time.

Q48 Mr Gauke: Moving on to the appointment process, and Professor Muscatelli you mentioned that a moment or so ago and, Professor Congdon, you have been critical and said that better procedures are possible. Have you any ideas for improvement in the procedure of appointing members of the MPC?  
Professor Congdon: I did not say much about that at all in my evidence.

Professor Wren-Lewis: I notice that the attraction of Steve Nickell’s comments and I certainly think that if you have an external member of the MPC who is being very helpful and very productive you would want to keep them on there for six years definitely. However, you can appoint external members—it has not happened but it could happen—who turn out not to be up to the job and you would want some way of making sure that you are not saddled with those six years.

Q49 Mr Gauke: You touched on it and you did say that a better procedure should be possible.  
Professor Congdon: Many people have been surprised that the external members have not been more obviously monetary economists. There is a large number of academics in Britain who are
monetary economists who, in my view, would have been better qualified than those who have actually been appointed.

**Professor Muscatelli:** I simply said in my evidence that the nomination process has to be speedier.\(^6\) Whether that is done through a process of sounding people out well in advance on vacancies arising to avoid difficulties such as we experienced last year is one possibility, but it is difficult to judge because we do not know what has been going on behind the scenes in terms of people being approached and perhaps turning it down, so it is difficult to comment in detail but I certainly do not think we can have a similar situation to last year.

Q50 Mr Gauke: Is there an argument for a pool of economists who could be considered to speed up the process?

**Professor Wren-Lewis:** I certainly think there should be transparency and there is clearly no transparency at the moment. We have a system which potentially could be abused by the Chancellor. This Chancellor has not done that but we cannot rely on Chancellors never doing that. The moment there is a suspicion that they are doing that it casts doubt on the whole process. I really do think the process should be more transparent.

Q51 Mr Gauke: Does anyone see an argument for this Committee having a greater role, whether perhaps by veto in a Senate-style hearing or greater involvement at an earlier stage? Is anyone sympathetic to any of those views?

**Professor Congdon:** I am in favour of that. I think it should not just be the executive, the Treasury. The legislative Parliament should be involved. How one structures that is very complicated.

Q52 Mr Gauke: Conceivably a veto system or something softer?

**Professor Congdon:** The Americans have that and every now and again it is used. I would hope it would be used very rarely. You could give some input to the Chancellor and say perhaps these are the right sort of people or whatever.

Q53 Mr Gauke: Or perhaps drawing up a short list?

**Professor Congdon:** Yes.

**Professor Muscatelli:** I have argued against it. I think it politices the process too much and I think the public scrutiny that this then presents might have an impact on the financial markets. I also think one could argue as to whether this Committee should require stronger accountability of members once they are appointed to hold them to account if there is any evidence that perhaps they have not displayed competency once in the job, but I am reluctant to see US-style confirmation hearings.

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there, this has happened, we will raise interest rates. It is announcing your plan in advance, knowing that you will never actually have to fulfil it, and it might be more effective to announce your plan in advance so people know you are going to react in the right way. Producing a forecast where inflation will actually explode, although the Bank says it will not, means the Bank loses credibility. We luckily have not been in that position in the last decade or so, but that could easily be happening if we found the exchange rate collapsing, the oil price rising, the Bank saying market interest rates say it is going to be 3% and inflation will be on target, and the rest of us know it is not going to happen, it is very implausible.

Q55 John Thurso: Can I ask a quick question on a completely different subject? This Committee has regular hearings with the Monetary Policy Committee on the inflation report; what more could we be doing or should we be doing as a select committee to ensure transparency within monetary policy, if anything?

Professor Muscatelli: One thing which is not strictly related to the activities of the committee but is important and has been echoed by others is the need for the minutes of the MPC to become rather more transparent. At the moment there are these rather cryptic discussions towards the end of the minutes which explain why there was a minority view in a particular set of circumstances, but it cannot possibly encapsulate the full nature of the debate and it would be much more helpful if dissenting members of the committee were able to set out their positions more clearly in the minutes.

Professor Congdon: I agree with that. I have been told kind of hush-hush that actually some of the debates in the MPC are quite fierce, and this does not come out at all in the minutes. For example, I know that some MPC members despise any mention of quantity of money; others think it is quite important. I know, I have been told this by people, but it is not in the minutes at all. There should be scope for members of the MPC to say a few things on their own, signed by themselves, and I think that actually the minutes should be a little bit more forthcoming. Some of this of course comes out in your own exchanges with the MPC.

Q56 Chairman: We have asked for that. Professor Nickell was before the Committee and I suggested that each member of the Monetary Policy Committee gave at least an annual report to this Committee so that there is something in their own name. It is an issue that we have looked at.

Chairman: That is even more radical: that is a great suggestion. Can I thank you for your evidence, it has been very, very helpful to us this morning. It is the first evidence session in what will be quite a lengthy inquiry, but your contribution is well appreciated, thank you.

Witnesses: Mr Laurence Sanders, Bank of Ireland. Mr Michael Saunders, Citigroup and Professor Jagjit Chadha, BNP Paribas, gave evidence.

Q57 Chairman: Welcome to the Committee for this evidence session from City experts; can I ask you to introduce yourselves for the shorthand writer, please?

Professor Chadha: Jagjit Chadha, I am at BNP Paribas, head of quantitative economics there.

Mr Saunders: Michael Saunders from Citigroup.

Mr Sanders: Laurence Sanders, treasury manager and economist at Bank of Ireland Group.

Q58 Chairman: You are all very, very welcome and we are here to get your expert advice from a City perspective of what we should do in this inquiry, looking ahead to the next 10 years. Could I ask a general question; to what extent do you think that the record of the Bank of England and the MPC over the last 10 years has been due to judgment rather than luck? Laurence, do you want to start?

Mr Sanders: I believe that it is primarily due to judgment, but there have been global factors. The global factors have been positive from a UK perspective and we have obviously seen the growth of internet purchases by UK citizens which has exerted a downward pressure on growth and on inflation, but I believe that it is primarily judgment. If you look at the track record of the MPC you will see that it not only maintained its target, but it was very close to central target when adjudged by the previous RPIX measure or by the current CPI measure. I believe the fact that the Bank of England was so close to that central target consistently over a period of time represents a strong element of judgment.

Mr Saunders: Let us start by saying the record has been very good; it is a bit of all three. The framework is good, the judgment is good and they have been lucky. The luck has come from very favourable external circumstances on the whole, the UK has had a much bigger decline in consumer goods prices than any other European country or than the US, and that has made it easier to keep inflation under control. I am not sure that the next decade is going to be so lucky.

Q59 Chairman: Let us say it will be a less nice decade. Jagjit.

Professor Chadha: I would agree with everything that went before really. The thing to think about when you think of the MPC is that it has been charged with hitting an inflation target and it has done that throughout its period. It has effected low and stable inflation throughout 10 years nearly; it
has been within its monitoring bands at all moments—that is a remarkable achievement. We know that when the current Chief Economist at the Bank of England (before he became Chief Economist) assessed the regime, his own work thought they would be outside the 1% band 40% of the time. That was written in 1998, but it turned out that the CPI was at 3%, not reaching the range of 3.1%. In fact, as a by-the-bye, I almost would have preferred the letter to have been written, that we could have then judged when we thought the letter may have to be written out they have not breached the band at all. There was a sharp collective intake of breath in January when we thought the letter may have to be written and it turned out that the CPI was at 3%, not breaching the range of 3.1%. In fact, as a by-the-bye, I almost would have preferred the letter to have been written, that we could have then judged the efficacy of this particular instrument as well, in terms of understanding what it meant for both the Chancellor and the Governor to have written the letter. There have been many factors in favour of the MPC meeting its target; it is an excellent regime and, as was mentioned by the previous speakers, there has been a widespread consensus for price stability, not only here in the UK but globally, and that has been a tremendously important factor in inflation being stable throughout this regime. The effects of globalisation and immigration have also been important.

Q60 Chairman: We have an hour to do all this, so we do not want to stop your flow but the issue of globalisation is what I want to go on to next. The Bank of England in its evidence to us has identified two “tail winds” by which they describe globalisation and an expansion in the labour supply, and they feel that they have provided the impetus for a benign economic environment over the last decade. That situation may change over the next decade; do you feel that enough is being done, either by the Bank or the Government to prepare for the loss of these beneficial drivers?

Professor Chadha: Let me just understand the question, you mean the beneficial drivers of globalisation and the labour supply.

Q61 Chairman: Yes.

Professor Chadha: Have we got a flexible enough regime to deal with the removal of these factors that have been beneficial in the past? It is a real issue looking forward and one way to think about the main risks of the current conjunction is that we have had a sharp downward shock to traded sector prices; that means in order to meet a given inflation target we have had to have higher non-traded inflation than you would otherwise have had. That has meant high levels of domestic consumption and public consumption and, along with that, low levels of real interest rates in order to stimulate domestic demand to get average inflation at its target. This has resulted in the consequences of there being elevated levels of asset prices, as most obviously observed by examining house prices. In a sense, what is going to happen when those head winds disappear, when the traded sector prices start to rise again—we are going to have to have a long period where the economy is going to have to be run at something less than full capacity, or over-full capacity. I am not sure, going ahead, how we are going to be able to take the steam out of the economy gradually and allow those household balances and those asset prices to adjust in a manner that does not leave a long-lived downward threat to economic stability going forward.

Q62 Chairman: Do you have any comments on globalisation, Laurence?

Mr Sanders: In terms of the head winds the Bank of England describes, this is important. The Bank of England has had a favourable environment internationally over the past 10 years and my perception is that the environment will be marginally less favourable over the next five years as the growth of the developing countries produces more consumption for consumer goods. To date there has been a significant benefit to the UK economy as a result of low cost imports, but as time goes by these countries will spend more of their GNP on domestic consumption. My personal view is that this will be an important factor, shall we say, between five and 10 years down the road, because there are new sources of supply coming on board—for example, the African countries are expanding rapidly now and I believe that the African countries will become what I would term the lion economies rapidly now and I believe that the African countries will become what I would term the lion economies rapidly now and I believe that the African countries will become what I would term the lion economies over the next 10 years or so, and also Latin America too has very significant potential, so I still see the beneficial effect. One point not in my submission is that since I wrote the submission I believe that there has been more progress on the Doha trade round. This is very important, both from the viewpoint of the developing countries and from a UK perspective. The UK is a major trading nation and if there is a reduction in import tariffs then this would of course smooth the path of the Bank of England over the next five years or so. There is a great deal more I could say on these subjects, but I had better pass on to Michael.

Q63 Chairman: I want brief but cogent answers the whole way through, please, because it helps you and us. Michael.

Mr Saunders: The MPC are quite aware, as their speeches have made clear, of the extent to which they have been operating against a fortunate background, and in a sense it has been the weakness of consumer goods prices which has allowed them to tolerate high growth of money, credit, asset prices and services inflation, because they have needed that to stop inflation undershooting the overall target, and they have made it very clear that they think the next few years could be less nice, the trade-off will be worse. The area where there are questions is whether the framework and the political support for the MPC are prepared enough for a period in which their job gets more difficult. They themselves are prepared for it though.

Q64 Peter Viggers: Circumstances have indeed been benign. Can I put it to you that the Chancellor of the Exchequer for a couple of years followed his
predecessor’s overall spending policies and then eased off very considerably and allowed greater growth in public expenditure, and this is now coming home. You will have seen reports of the International Monetary Fund Report which are published this morning and, just to pick five points out: the public spending surge of 2001 to 2004 led to a sharp deterioration in the fiscal balance—point number one. Rising net public debt—point number two. Leaving little room for manoeuvre in the face of global downturn—point number three. The Chancellor has started to rein in spending but much remains to be done, and then the final point, the IMF warns that further increases in tax rates would risk adversely affecting incentives to work and invest. Whereas the MPC has been very successful in working in a benign environment, what can the MPC do, how can the MPC prepare for a potentially less advantageous background?

Mr Sanders: It is very important that the MPC continues to monitor the economy rigorously. I attend the regional meetings, as do my colleagues, of the Bank of England, and they do speak to a wide range of business executives; therefore they are very familiar with the incentive aspects, and I know that the regional reports do play a role in the MPC decision-making. One important factor is the dialogue between the MPC and Government, and I have long argued that fiscal and monetary policy must be compatible. This is essential for economic success and I believe that fiscal policy has been broadly compatible with monetary policy over the past 10 years as a whole, and this is one reason why we have had the success in UK economic policy. It is important to maintain control over the fiscal stance; I am not an expert on public finance but I do perceive that the percentage of GDP accounted for by public debt has risen in recent years. In respect of the increase in 2001–02, that was appropriate; the world was experiencing a downturn and it was right that the Chancellor of the Exchequer did expand fiscal policy during that period. We have now reached a stage where UK growth is around about 3% per annum, the Bank of England is tightening policy and therefore the Chancellor will have to follow suit with a gradual tightening of fiscal policy over the next five years if we are to maintain our record of good sustained growth, low inflation and low unemployment. The Chancellor will probably have to tighten policy gradually over the next five years.

Professor Chadha: Very briefly, there are two issues as far as fiscal policy is concerned. We need to be absolutely sure that the fiscal plans are such that the debt to GDP level is stabilised, so there is no sense in which there should be drift in the level of debt to GDP, and that means writing down fiscal plans in terms of expected taxes and expenditures that mean debt is stabilised at some given level. What that level is, there is a range of estimates out there, but we think somewhere between 30% to 40% of GDP would be a sensible level for debt to GDP. As far as interest rates are concerned, the Bank of England will know when setting interest rates what the fiscal path is in terms of taxes and expenditure; therefore it can predicate its interest rate stream on that fiscal path and to the extent that fiscal policy is too tight—or too lax indeed—you will see interest rates higher to some extent, or lower than they would otherwise be. I do not think necessarily over the business cycle that that is a particular problem.

Mr Sanders: The issues which you have raised, of whether there is enough safety margin in policy, are all to do with fiscal policy and they are not ones which the MPC set. The IMF warnings on fiscal policy are well-taken; the deficit is higher than you would like it to be for this stage of the cycle, but that is not something which the MPC can affect, they have quite sensibly taken the view that they will keep out of fiscal policy discussions unless fiscal policy starts to affect inflation prospects, and at the moment it does not.

Q65 Peter Viggers: Of course, the MPC is very much, in golf terms, a one-club player is it not?

Mr Sanders: That is a very good description, yes; it is very effective club.

Chairman: We need Jack Nicklaus.

Peter Viggers: I will leave it at that, Chairman, thank you.

Q66 Mr Love: I was just going to agree with you, Chairman, what you need is a Jack Nicklaus to swing the club to make sure he gets it right. Can I turn to house prices? To what extent would you agree that the rise in house prices, indeed the rise in household debt, is a consequence of the low inflation we have had in recent years?

Mr Sanders: That has been a key driver of house prices, another key driver is personal disposable income, and the fact that we have had an upturn in economic growth, I believe that trend growth now is about 2½% as opposed to 2½% over the past 50 years as a whole, so the prosperity of the economy has also been another factor. Interest rates, both base rates and short term rates—in respect of the mortgage market it is the two and three year periods; interest rates in the longer periods are determined partly by international forces, but interest rates have probably been the key driver because they have increased people’s ability to repay debt. Another factor though has been the confidence factor, the fact that we have had relatively low stable inflation over the past 10 years has reduced people’s risk assessment of house purchase and therefore people are more willing to take on slightly higher levels of debt in the current environment, but you are right that interest rates have been the key driver.

Q67 Mr Love: Would anybody demur, I assume you all agree with that?

Mr Sanders: To me this brings us back to the point we were talking about a minute ago, that the MPC have had this fortunate background of falling goods prices. If you are to stop inflation
undershooting you need to pump up domestic demand, the service sector and inflation and with that tolerate, and at times encourage, an asset price boom, otherwise inflation as a whole undershoots. So if they had resisted the house price boom they would have had a bigger inflation undershoot and probably faced criticism for that. I think there are times when the MPC might not have put enough weight on asset prices, both houses and equities, as lead guides to growth, but that is not saying they should target asset prices as a separate objective because they cannot do that.

Q68 Mr Love: Let me take you on a stage, do all of you believe that the economy is now more sensitive to interest rates? Although we talk about fixed rates, most of them are still variable; how sensitive is the economy and has that been fully taken into account by the Monetary Policy Committee?

Mr Sanders: The economy is more sensitive to interest rates, but the build-up of household debt, even with two and three-year fixed rates, eventually those rates will run off and people will therefore be sensitive to the refinancing of rates. The economy is therefore far more sensitive to interest rates than has been the case and I would imagine that the Bank of England is aware of that. Certainly, I have discussed that factor with the Bank of England regional agent and I know that the agent speaks with our chief executive and the director of our mortgage division and the Bank of England closely monitors the mortgage market. I believe that the Bank of England has taken this on board and, as a result of the increase in debt, it probably means that the Bank of England can secure its objectives by a marginally lower level of interest rates than would otherwise have been the case. From the personal borrower’s point of view, there are going to be more challenges over the next five to 10 years or so, so the majority of borrowers, I believe, are taking the view that a fixed rate has advantages in the current environment and recently, we have seen a notable increase in the amount of 10-year fixed rate mortgage business written.

Q69 Mr Love: Mr Saunders, you mentioned earlier that they had to set interest rates in order to keep inflation within the target range. The recent period of economic stability that we have been talking about has been with a period of low interest rates, has this led to an inability of firms to correctly price risk?

Mr Saunders: Can I come back on this, because this is important; it is also important to put into context this question of increased sensitivity to interest rates. One of the other changes in the economy, apart from high debt levels and, hence, an increased sensitivity to rates, is increased sensitivity to the re-pricing of risk across the business cycle which affects the ability of both companies and households to borrow. If you like, it is the feedback from the state of the economy to the availability of credit, and that occurs through changes in credit spreads or just a willingness of lenders to advance credit to riskier projects. What we saw in 2001, 2002 and 2003, a period when the global economy was very weak, was wide credit spreads and consequent weakness in business investment, much harder for firms to get going, hence monetary policy had to be quite loose to provide a stimulus against that. Now that we have had several years of decent growth, credit availability is much more ample, so on the one side higher debt levels make consumers more sensitive to higher interest rates, but on the other side things that would never have got financed a few years ago, or not financed on as favourable terms, now do get financed, so there is a cyclical overlay to credit availability which you need to take account of.

Q70 Mr Love: The question I really wanted to ask you was if they did set interest rates in the way you have suggested and it had the impact, should they have been taking other measures, not the Bank of England but perhaps the Treasury or the Chancellor taking some measure to deal with the house price inflation that was a consequence of the interest rate policy that they were setting?

Mr Saunders: In respect of other measures, there are various fiscal measures which are available to the authorities, but interest rates are probably the key driver of the housing market and the interest rate weapon is probably the most effective weapon to control housing. The interest rate weapon feeds into a number of other areas as well; when it comes to asset prices interest rates have a major effect on equity prices and they also have a major effect on investment, so the interest rate weapon is a very powerful weapon and I believe it is probably the most effective weapon for controlling the level of house price inflation. The main reason for house price inflation is an excess of demand over supply; it is quite a significant factor and we expect this to continue for some time. Whatever measures the Government takes, this excess of demand over supply is probably likely to continue over the next five years or so. I am quite willing to go into this factor in more detail and I am quite happy also to provide a written statement on this if members require that.

Chairman: If you could give us a written statement that would be helpful. We will have to move on.

Mr Love: Just a quick one in relation to money supply. The Bank has noted the fact that money supply is increasing very rapidly, it is taking it more into account. It has not been terribly transparent about how much it is taking that into account; is this the correct reaction from the Bank in terms of money supply?

Q71 Chairman: Perhaps just one of you could give us an answer.

Professor Chadha: Money supply is absolutely a key variable to study in terms of thinking about the macroeconomy. It does not mean you should go to the extent of having a second pillar, such as we see at the ECB, but very briefly there are a number of...
reasons. Firstly, data gets revised. In real time we do not know the state of the economy, we do not know whether it is growing at 3% or 2% and the data that gets released gets revised in different directions. Money is a measure of real time transactions and therefore has information for us as we try to gauge the true state of the economy. Secondly, we know money has information on various sectors; for example, narrow money might tell us about retail sales or consumption patterns and certain aggregates of broad money may tell us about investment plans by firms, so by studying the components and particular measures of money we may get measures of real activity at a sectoral level. You are right to say that money is often associated with asset price inflation, so again if we look at the counterparties of lending and try to understand into which parts of the economy that is going, that may give us some information about whether there is an asset price bubble. That said—and I just want to finish on one brief point on housing itself—we should not necessarily think that house price inflation is a bad thing. A lot of theory tells us that consumers want to smooth their consumption over their income path. In the past, consumers were often credit-constrained because they required collateral in order to borrow, and the extent to which the equity in their houses increases allows them to borrow today for durable expenditure and smooth their consumption path through time, is beneficial to those consumers. So it is not necessarily the case that either house price inflation is necessarily bad, or that the debt that they take on is some kind of disequilibrium phenomenon that is going to crash as soon as interest rates return to some normal level. We should not necessarily think it is a bad thing therefore. Finally, I have not seen work to suggest that necessarily the economy is more sensitive now to interest rates than it was in the past, for some of the reasons Michael was suggesting: that we have new cohorts of people with access to credit, but also if we look at the asset side of the balance sheet, net worth is as strong as it was before so, okay, we are more indebted but we have also got more wealth than we had before so the net effects are not clear. We need more work in that area.

Q72 Ms Keeble: I want to ask about the consumer price index, whether or not it is the best measure of inflation for the MPC to use. Do you think it should be modified in any way, for example by taking into account house prices? Do you think there is an issue about credibility given that there is a current debate now about inflation and it is the first time I certainly have seen it in the public domain for a good many years? Do you think there is an issue perhaps about the credibility of the MPC if its discussions about inflation are out of kilter with what the general public experience, or should the MPC just say that is not our business, we do not have to worry about it?

Professor Chadha: It is true to say that the RPI as it was traditionally defined had a higher component of housing costs in it, the CPI has not. In a sense that increases the weight that the MPC should put on housing price developments in order to forecast future trend in the CPI because it is that which they are trying to stabilise. That said, it is also clear if you look at the very long run in these price indices they do not really diverge in a persistent manner over the long run, so it does not particularly matter which measure of the price level we target over the medium term as far as the MPC is concerned, but we must learn to extract the information that is given from the divergences that we may observe in real time.

Q73 Ms Keeble: There is a factor in management of the economy, especially around inflation, which is partly around public confidence and public credibility. Do you think it helps in managing the economy—and in particular the MPC has a very critical job in managing inflation—if there is a really serious feeling out there amongst the public, and while I do not know about my colleagues I get about 20 or 30 e-mails a day from public sector employees currently who are talking about inflation. They might be put up to it, but they are still doing it. Do you think there is an issue about public confidence if there is a serious debate about what rate inflation is currently and if that is perceived to be different, not just from what the Government is saying but from what the MPC is saying?

Professor Chadha: I will give you two bits of data that back up your observation from your constituents perhaps and other colleagues. Ten years forwards from the yield curve in early 2005 was something like 2.9% suggesting that RPI inflation as expected by market participants on their trading nominal and real bonds, was about 2.9%. Today that is 3.2%, it has gone up 30 basis points, so you look at the change rather than the level. If we do a survey of City and other forecasting houses on inflation, a year ago those survey expectations of 2007 were around 2%, and they have gone up as of February to about 2.3%, so there has been drift up in those key inflation expectations. The inflation expectation there may not be strictly aligned to the CPI target that the MPC is charged with pursuing; it is therefore incumbent upon the MPC in terms of transparency to explain how by meeting their CPI target these other measures, the RPI or the RPIX, would also come back to something in line with price stability. There needs to be further explanation of how these other things will come back into line.

Q74 Ms Keeble: Do you think they are providing that explanation adequately and do you think they have to either do that or adjust the CPI?

Professor Chadha: The argument they are following is that the Bank of England wants to pursue what they call flexible inflation targeting, which means that in the presence of maybe elevated asset prices there is a possibility of vulnerable household balance sheets. It may want to return inflation to its target at a slower rate than it may have wanted to in the past; the problem with that in real time is
that it is observationally equivalent to some drift in the inflation target itself. To some extent there has not been a clear explanation of what in effect flexible inflation targeting really means, and how you explain to people that you are in fact going to meet your target. We can talk about the inflation report in February later on, but I just want to give that very brief answer and I am happy to return to that point later.

Q75 Jim Cousins: Do you think there has been a systematic tendency by the MPC to under-estimate the impact of globalisation on product prices here and the impact on the labour market of inwards migration?

Mr Sanders: My personal perception is that that is not the case. When I attend the regional briefings of the Bank of England the question of migration is mentioned by the Bank of England representatives and by business-people consistently. In terms of the global effect, this too is something which is consistently mentioned at these briefings, so my feeling is that the Bank of England has taken due note of the factors. It is a challenge though, both to the Bank of England and other forecasters, that the global economy is now changing at a more rapid rate, so therefore it is probably more difficult for the Bank of England or indeed any policy-maker to ascertain quite what is happening in the global economy; its job in that respect is more difficult, but my perception is that the Bank of England does take full account of these measures, but that is just one personal perception.

Mr Saunders: I have to say that actually I would disagree. They probably have underestimated their impact and I would say that applies to virtually all economic forecasters. Almost everyone has been surprised at the extent to which consumer goods prices fell year after year for the last eight years, and the pace of inward migration from Eastern Europe after the opening up of the EU in 2004. The MPC has probably been quicker than most in appreciating the importance of those things, but those shocks have just been much greater and much more disinflationary than almost anyone had expected and, of course, the question going forward is just whether that will continue. I would say they have understandably underestimated the effect.

Professor Chadha: There has been more generally a problem with inflation forecasting equations, possibly for the sake of globalisation or labour mobility reasons, but also because of credibility. Inflation expectations have been reasonably well anchored, which means that when we try to run the models that we have run in the past, cost mark-up type models and others, we have not seen inflation emerge in the way that it has before and it has been a widespread phenomenon. There has been a lot of work in the States finding inflation-forecasting equations not working very well, and indeed in the UK as well, but as my colleague suggested there are some good reasons ex post to explain why those equations have fallen down. The key problem is the inflation expectations in all of this.

Q76 Jim Cousins: Dealing with inflationary expectations and taking the point that has just been made to the Committee about the re-pricing of risk, do you think there could be problems going forward in those matters?

Professor Chadha: The issue about inflation expectations is that in this world in which structural economic equations seem to have failed in some sense, inflation expectations have become almost a way of summing up all our knowledge of all the possible models into one key indicator, which is what is happening to inflation expectations. The central banks have tried to learn from inflation expectations in the sense that if we do not know the true model, what we will try and do is just learn about inflationary pressure through what agents and financial market participants expect inflation to be. From the learning process they may decide to manage those inflation expectations, in terms of the sense in which they may decide to feed back from them, so that when inflation expectations start to rise they may decide to raise policy in order to stabilise those inflation expectations. The problem then comes in the next step, that those inflation expectations may stop giving you the information that they gave you before because they incorporate an expectation that the policy itself will move to stabilise them and they will not necessarily themselves convey inflationary pressure. That is a real danger we are now in, that the inflation expectations themselves stop giving the information back to the central bankers that there is incipient inflationary pressure.

Q77 Jim Cousins: The point of my question was really precisely about those second order effects and I would be interested in the views of the other two witnesses.

Mr Sanders: In respect of the forecasters’ records, the Bank of England and most City economists place a great deal of emphasis on econometric modelling and, by definition, this involves observations of past experience. The experience of econometric modelling is that it works very well in a fairly stable environment, but when you have a major change in external factors it presents more challenges and that is one reason why some economists have not been too successful in the past two years. I hasten to add that I have a high regards, along with my colleagues, of most of the economists in the City, but it is more of a challenge when you get these changes and it is going to be more of a challenge over the next five years at a time when the global economy is expanding. The Bank of England does attach great store to survey data, feedback from industrialists and from those in the public sector as to what they perceive is likely to happen in the future. Economic forecasting is not only projecting what happened in the past forward, it is also a question of what is going to happen in the future and the Bank of England also spends a lot of time discussing with business leaders as to how they see their business over the next five to 10 years. This is going to be increasingly important in the international world. In respect of
the comments made, could I ask whether there is one specific point you would like me to comment on in respect of the Professor’s comments?

Q78 Jim Cousins: This particular bit of the democratic deficit will be in trouble with the Chairman if I encourage you to speak too much, but I am content with that. Just one more point, you have raised the issue yourselves that public sector workers may feel that the inflation they are experiencing as individuals is running at a much higher rate than is being recognised by the target-setters and they might conceivably try to put pressure on the Chancellor to produce a different inflation target to recognise that. Do you think it is the Chancellor who should set the inflation target or somebody else?

Mr Saunders: In the long run it makes little difference as to whether you target CPI or RPIX, both would be fine. I feel it should not be as easy to change the target as it is now; if you have a target you should stick to it and to me the cost is more changing the target rather than what the particular target is.

Professor Chadha: In terms of democracy the Chancellor is an elected person, he is representing the party of government and he should be the person who sets the target. The Bank of England is operationally independent to pursue that target with the MPC and the instrument at their disposal which is the short term interest rate, so I am perfectly happy with the current arrangements.

Mr Saunders: My view is that an inflation target must be credible, and my feeling is that there is a gap now between what people’s perception of inflation is and the CPI measure. I believe the European Union are going to move their own measure of CPI in 2009 to incorporate an element of housing costs and I would imagine that sooner or later we are going to follow suit. I believe that that change should come in the UK sooner rather than later and it is very important that public perception of inflation is the same as the financial markets’ knowledge of inflation. The general public can understand the concept of RPIX, which is headline RPI less mortgage interest; most people understand the concept that with mortgage interest they are buying an asset as opposed to spending money on consumer items, so that would be credible but I would not imagine that the average person in the street would fully comprehend what CPI means. I believe that the inflation target is credible, must be credible, and that is going to be more important over the next five years at a time when the inflationary climate will probably be slightly less benign than it is currently.

Chairman: You have given us a big educational challenge there: everybody has got to understand what CPI is; there will have to be a lot of money spent on that which will maybe have some implications.

Q79 Mr Gauke: Could I just turn to the appointments process and ask you whether you consider that a more transparent appointments process would be to the good, or whether you share the concerns of the Chancellor that this is an area that is market-sensitive, given your City perspective. Do you agree with that?

Mr Saunders: In respect of the appointment, first of all I would like to emphasise that the calibre of MPC members in my view has been very high and they have done a very effective job. In respect of the appointment process, that largely is a question for democratically elected politicians; from a City perspective what we are looking for is a person who can do the job effectively and, not only make the interest rate decisions, but also communicate the decisions to industry and to those in the public sector. The communication is going to be an increasingly important part of an MPC member’s role over the next few years or so. From a transparency point of view there may be a case for having a civil servant appointments procedure in place, but it is very important that the members of the MPC are questioned and endorsed by members of the Treasury Select Committee; it is very important that you monitor the process. In respect of the appointment, that is one for democratically elected politicians.

Mr Saunders: My view is that there should be some external source of shortlist or check on the candidates. People so far have been good, but you asked right at the start of the last session what are the risks for the next 10 years and one of the issues is whether a future Chancellor at any point would seek to change the target or the appointment process in a way which undermines the aim of inflation stability. That is a weakness.

Q80 Mr Gauke: Do you share the concern that if we make it more transparent and there are names produced, whether by this Committee or what have you, so it is a much more open process, that it will be market-sensitive?

Mr Saunders: It may be, but there may be some way in which that itself could be handled so that there is a list which is produced by somebody else and is not released in general. Plenty of things happen which are market-sensitive and are not broadcast.

Professor Chadha: I go back to the points made before. In terms of the performance of the MPC we have had an excellent quality of appointment, so what we have had to date has done a very good job. I would not see any great market sensitivity in discussing openly the kind of people who may be up for the job. Some arguments have been put in terms of having people apply for the job to a deadline, or we continue with names emerging. What we must avoid is a situation where we know vacancies are coming and appointments are made in a hurried way at the last minute.

Q81 Mr Gauke: Do you think the gap in 2006 was damaging?

Professor Chadha: Given that in a number of cases we knew the appointments were upcoming it would have been better to handle them so that we knew who was going to be appointed in advance without
a sense in which they were hurried. I do not know whether they were hurried or not, all I see is second-hand stuff through the media. There is a sense in which we should be managing that process, so that people are in place. We also talked earlier about how long it takes to get up to speed; we have had two new appointees saying that they did not want to say much about policy for the first three meetings, for example, and we had a discussion earlier on about the complexity of the Bank model which can take even professional economists a year to understand. In that context it might be good for people to know that they were going to be going onto the Committee some time in advance so they could prepare themselves.

Q82 Mr Gauke: Mr Sanders touched upon the role of this Committee. Can I ask the other two members of our panel what role you see for the Treasury Select Committee in the appointments process?
Professor Chadha: Thank you. My understanding of the current process is that the MPC appointee has been chosen and they will come to this Committee to discuss themselves and outline their plans and explain to you how they approach monetary policy, so in that sense it is not a conferral meeting such as you have in the United States when people are appointed to office. I am happy to stay shy of going to that level, we would not want to necessarily introduce an overtly political dimension to the appointments. I would prefer that we thought of the appointments as essentially technical appointments of professional economists to the role of managing the British economy and that is really what I want to see achieved in this process.

Mr Saunders: The hearings which they have with you are very important. It is important for MPC members to show their understanding of the issues and that they have their own voice and are willing to debate these things. As to whether it should be a binding vote, it would only have to be if it was a very overwhelming vote of the Committee because otherwise you could get into a position in which you get political games being played. The testimony to yourselves is a very important part of what they do.

Q83 Mr Gauke: There has been some comment that perhaps there should always be one external member with City experience. Do any of you have strong views as to the criteria that should apply to external members and perhaps the balance of their experience?

Mr Saunders: My feeling is that first of all they must have an excellent track record in applied economics; that is very important. We obviously need the academic ability and a very high academic ability, but it is the ability to apply economic theory which is crucial to the MPC appointment. I believe also in the modern world that the person has to be a communicator; you must have a person who is not only very good at looking at their econometric models, econometric forecasting and macroeconomic theory, but also a person who can communicate the Bank’s views to industry and to other important parts of the economy, and it is also very important that the person is able to listen because there is a limit to the amount of information you can gather from economic statistics, however good. An important part of the job is to ascertain what is actually happening in the real world outside, and the communication aspect will be more important over the next five years or so.

Q84 Mr Gauke: Do you have anything to add?

Mr Saunders: They should be good economists and whether they come from City backgrounds or anything else does not really matter.

Professor Chadha: I agree with that, just good professional economists.

Q85 Mr Gauke: Do you think the terms and conditions perhaps preclude economists coming from a City background joining the MPC, and is that something we should be worried about?

Professor Chadha: Do you mean in terms of the length of the term?

Mr Gauke: The length of the term.

Q86 Chairman: The three-day week etc.

Professor Chadha: We should leave it reasonably flexible on the time of appointment. We could get into the length of their appointment as well if you wanted to, but I would not imagine that the initial appointment of three years would be a hurdle for people from any background to go into the job. That said, there may be a case for considering longer appointments in the sense that if we want these people to be carrying out a role, we have discussed earlier some of the technical hurdles that have to be jumped in order to carry out the role properly and also we want a sense that the individual is free after appointment of any sense of the political cycle and we ought to think about appointments that may be three years extendable to six years, which is longer than the length of a Parliament or something like that.

Q87 Mr Todd: One or two fairly quick questions. To what extent do you think the Bank should publish its future path of interest rates and their expectations of that? Mr Saunders, you have already given a view in your submission.\(^8\)

Mr Saunders: In respect of publishing the path I personally think it is important because of course interest rates are such a key driver of the economy, and the Bank, which has published its econometric model, should make clear the means by which it has arrived at its decision. It sends out monetary minutes, it provides a detailed quarterly inflation report, so since interest rates are such a key driver of the economy my personal view is that the Bank should publish its interest rate forecast. That would help an understanding of the Bank of England’s position in respect of macroeconomic management.

\(^8\) Ev 66–68
**Professor Chadha:** It is a live academic debate at the moment, so we have not got a clear answer. The examples that have been cited are very small open economies; in Norway for example the MPC itself is not critical in setting the interest rate, it is mainly the governor and deputy governor. Very briefly, by publishing interest rates and in terms of the balance between managing expectations and learning from them there is a danger that by publishing interest rates we may stifle the market revelation of private information about interest rate paths, and there is a practical problem about getting large numbers of people, such as nine, to agree on the interest rate path instead of a relatively simple interest rate decision, so I would be against it right now.

**Q88 Mr Todd:** Good, I have got the range of opinions there. Individual MPC members are encouraged to publish articles and make speeches which reflect their individual opinions; do you think there should be a more formal process of reporting those opinions at the time of the meetings?

**Mr Saunders:** For myself I do not, otherwise you might set out for example what they particularly focused on, which visits they have taken part in and so on.

**Mr Sanders:** That is an interesting concept. Most of us are subject to annual reviews and therefore since these people occupy such an important role in public life, my personal view is that it would be useful to ask each MPC member to provide an overview of what has been achieved over the past 12 months and their views on the UK economic management over the next 12 months or two years, according to their tenure of office. That is a good idea.

**Q89 Mr Todd:** Could they present an annual report of their work on the MPC which alluded to more than just how they voted and why they voted; it might set out for example what they particularly focused on, which visits they have taken part in and so on.

**Mr Sanders:** That is an interesting concept. Most of us are subject to annual reviews and therefore since these people occupy such an important role in public life, my personal view is that it would be useful to ask each MPC member to provide an overview of what has been achieved over the past 12 months and their views on the UK economic management over the next 12 months or two years, according to their tenure of office. That is a good idea.

**Q90 Mr Todd:** As consumers of the MPC’s decisions do you think the decision is communicated adequately to you? Is there more information that should be given at the time the decision is made so that you have better information on which to base your own activities?

**Professor Chadha:** At the time of the decision we know there is a vote but we do not know the outcome of the vote, we have to wait until the minutes are published. We could give serious thought to publication of the vote split at the time of the notification of the interest rate decision, along with a mandatory short statement of the sort that is issued by other central banks.

**Q91 Mr Todd:** Would you support a bias statement which said we are inclined one way or the other if they voted to keep interest rates stable?

**Professor Chadha:** Yes, outlining the issues. We know that there has been a pre-MPC the previous Friday, we know that the issues have been raised in previous inflation reports, so we have a sense of what the issues are but it would be good to know at the time of the interest rate announcement whether there was dissent and what were the crucial factors that determined the decision. If I could very briefly say, in January for example with the surprise hike in interest rates there was a two-week period where the market was not sure in terms of what the resolve of the MPC was for future rate hikes that led market interest rates to be priced higher than they would otherwise and appreciation in the exchange rate that came off when the information that there had been a 5:4 split was published two weeks later.

**Q92 Mr Todd:** That is a very good example of the point you are making. Would you support a bias statement as appears in the US system of saying which one is leaning towards to give some steer in the marketplace?

**Mr Sanders:** My personal view is I am strongly in favour of this. We did have a serious problem in January that there may be people on the Bank of England who feel that a 1% movement in the exchange rate over 24 hours is immaterial; I would not agree, and there are many businesses which operate on very fine margins indeed. When you get this sudden unexpected shift in the exchange rate, this can have an effect on quite a few businesses; the Bank of England’s job is to promote financial stability and certainly there have been two occasions when it is doubtful whether they have achieved that in practice.

**Q93 Mr Todd:** Engagement with yourselves as City economists, Professor Chadha remarked that this could be improved.

**Professor Chadha:** There are two specific areas where we could improve engagement. The first is the Bank’s model which we discussed in the previous evidence session. It is published in book form—and I have an example of it here—but as far as I know, no one has been able to replicate the model and run it outside of the Bank. In terms of scientific understanding of what the Bank has done and understanding the decisions it makes, the Bank model should be something that could be run outside the Bank by economists or indeed students so that we could understand better the relationships the Bank has in place. That would require a full simulation suite and database support, but it would be an important improvement in transparency as we try to understand the Bank of England. The second area is—and this feeds into your previous question about the MPC members writing an annual report—I sometimes think that the fora for discussing MPC decisions with professional economists is limited. The Bank of England economists take part in research conferences of an
academic nature but do not necessarily always have direct fora where they discuss recent policy decisions and future policy risks regularly with professional economists. That would be an addition to transparency that would only help the formulation of policy.

Q94 Mr Todd: Would the two of you broadly endorse that?
Mr Sanders: I would certainly broadly endorse that, but I would emphasise that it is not just City economists but obviously academic and other economists as well, yes.
Professor Chadha: I did not mean to imply that it should be only City economists.
Mr Sanders: Of course not.

Q95 Mr Todd: That includes the availability of the model presumably.
Mr Saunders: That model would be a nice thing to have. The MPC and the Bank in general are quite good at getting opinions from outside economists; I would appreciate it if they themselves would speak more.

Q96 Chairman: Finally, just on the point that Mark was making in terms of individual views and corporate views, obviously the corporate views are very important, but where should that balance lie between the individual and the corporate view, and if individual members of the MPC came out with statements how as City economists would that help you? What deeper insight would you have in that area that you do not have just with the corporate view?
Mr Sanders: Given the experience of August and January when there did appear to be a problem with communication, there is clearly scope for improvement in that. I believe that MPC members probably should make more speeches and should communicate more freely to avoid those situations occurring again. The way in which they do this should be left to an individual MPC member; I suspect that when the MPC members testified before you they probably emphasised the importance of the independence of their role and it is a question of independent members deciding what is the best way. I believe there is significant scope for MPC members to communicate their views much more frequently. Certainly from a City economist viewpoint and certainly my experience of business and people in the public sector is that most people would welcome the opportunity to hear the MPC members' views.
Mr Saunders: I agree with that.

Q97 Chairman: Laurence, you said it was important for an MPC member to listen. As a Committee we have listened very carefully this morning for two hours, particularly to yourselves for the past hour. It has been very valuable to us, so can I thank you for your attendance here this morning and we look forward to further sessions in this very important inquiry. Thank you very much.
Mr Sanders: Thank you, Chairman; thank you, Committee members.
Tuesday 20 March 2007

Members present:

John McFall, in the Chair

Mr Colin Breed
Mr David Gauke
Ms Sally Keeble

Mr Andrew Love
Mr Brooks Newmark
Mr Mark Todd

Witness: Rt Hon Lord George, a Member of the House of Lords, former Governor of the Bank of England, gave evidence.

Q98 Chairman: Lord George, welcome to our inquiry into the Monetary Policy Committee of the Bank of England 10 years on. We are privileged that you have come along this morning since you were very much part of that. We would like to look at the next 10 years and take the lessons from the previous 10 years. I start with 1997. How much of a watershed was the establishment of the MPC?

Lord George: It is a great pleasure to be here. I always enjoyed coming before the Treasury Committee. How much of a watershed was it? I saw it very much as the culmination, not necessarily the end point, of changes that had been happening in the approach to the management of the UK economy over very many years. On the supply side we had a shift from a great deal of central control where people told the public at large what it could and could not do. My early years at the bank were involved with exchange and credit controls, rationing of access to capital markets and that kind of thing, but in the wider economy one had prices and incomes policies, public ownership of large parts of productive industry, powerful trade unions that knew they could not lose their jobs because the owner could not go bust, incredible rates of income tax which reached 83% at one time on earned income—it was even more on unearned income—and gradually over time on the supply side there was a movement towards a much more market-based economy. That is important because it is the supply side which determines the rate of growth, level of employment and all the good things in life that we can hope to sustain. It had very little to do with the Bank of England which was very much involved in the demand management side of the economy. As to demand management, equally we saw fundamental changes. We had lived with boom and bust but policy aggravated rather than mitigated that cycle. Fiscal and monetary policy operated together without any real distinction. When the economy was weakening the levers were pulled back in conjunction. One had a boom and bust cycle. It was worse than that because it was explosive. Every peak of inflation was higher than the previous one and at each trough of unemployment was lower than the previous one. We were really looking over a precipice. On the demand side we learned from the experience that we could not go on down that road. Government identified that fiscal policy was quite a cumbersome instrument to control demand certainly in the short term, and that opened the way to a specific role for monetary policy. We moved gradually not just to recognition of the role of the different elements of demand management but that fiscal policy needed to focus on the medium to longer term and the level of debt in relation to income—it was not a short-term instrument—and that in monetary policy the aim could not be to trade off growth versus inflation in the short run. The mantra of central banks everywhere these days is that stability is a necessary condition of sustainable growth. The target was to keep aggregate demand growing approximately in line with the underlying supply capacity of the economy to meet that demand. I am sorry that you have started me off. As an old man who has retired I reflect on this a great deal. What was terribly important was that they all came together across a broad part of the political spectrum. There was common political and, I think, public support for these directions which happened gradually over time. I believe that the establishment of the MPC and the devolution of operational control over monetary policy to that committee must be seen in that broader context. If all those other things had not happened it could have been a disaster. One would have had the central bank in public conflict with government every five minutes, but it took place in the overall context where it became a technical job to manage monetary policy to keep demand growing in line with supply. That was epitomised in the symmetrical inflation target which had been adopted years before. That target was adopted in 1992, five years before the MPC came into effect in 1997.

Q99 Chairman: I must ask this question for the public record. A number of experts have written in to say that the success of the MPC over the past 10 years has been due more to luck than judgment. Lord George: I have heard that. Frankly, I do not care too much whether it was luck or judgment. The great thing has been the result. Surprisingly, in this Committee I was often called an inflation nut as if inflation was the only thing about which I cared. What I found really satisfying and encouraging was the increase in employment to an all-time high, and it is still there. There has been a steady decline in unemployment from double digits and very low rates of unemployment compared with most of the rest of the industrial world and
certainly Europe. I do not mind whether people believe that is luck or judgment; it is the outcome that is important. I believe that we had tremendously good luck in that all these things came together at a political level which meant that there was a broadly accepted clear understanding of what the bank and the Government were trying to do. That was certainly fortuitous. I really do not believe it could have been done by just focusing on one little bit of the big picture. On the other side, at the beginning of the MPC we had the Asian crisis which spread around the world and recession in the industrial world. We narrowly avoided it, but most of the rest of the industrial world went into recession at the beginning of the current decade. It was not purely to say that there were quite difficult circumstances to deal with, as there always are. Indeed, we had to take action that on the whole we would have preferred not to, for example stimulating consumer demand because all the other elements of demand had fallen away. We were very conscious of the fact that that could give rise to problems in future. We tried very hard not to do more than we felt we needed to do in order to keep within the inflation target limits, but we knew that later on it would cause problems, which are still with us.

Q100 Chairman: Not to mention long-term capital management and the Russian defaults?
Lord George: Yes. I put those in the category of the Asian crisis.

Q101 Chairman: The appointments process has been described by Stephen Nickell as opaque. Many others have made the same point. Do you think it is necessary to have such secrecy surrounding the appointment process? From your point of view as governor at that time, how did the selection process work? Did you feel fully informed? Would you have liked more influence in the selection of members?
Lord George: I was certainly never shut out of it. The Bank suggested to the Treasury a list of potential outside appointees. We would discuss it with Treasury officials. An appointment with which I was not comfortable was never made. I was given the opportunity to say that I could not stand a particular bloke or that I thought he was hopeless. I never felt particularly uncomfortable with the appointments process. There were occasions when appointments were made pretty much at the last minute and I believe that as much as anything else that was because the Chancellor had an awful lot of other things to do. It might not have been perfect, but I did not think there was anything fundamentally wrong with it.

Q102 Chairman: In terms of the Treasury Committee itself, what role do you think it could have? Could it have an enhanced role? Could it be given the power of veto over appointments? Could there be more prior public discussion as to who should sit on the MPC?
Lord George: What you are talking about is the appointment of technicians. One needs people who know about the technical competence of the potential pool of people coming onto the MPC. You will judge whether you believe that the Treasury Committee has that kind of competence. In principle I am all in favour of public debate, but we are talking about something that is essentially technical rather than just democratic in a broader way. I do not know that public debate will be particularly helpful. It could discourage some people from participating because there is newspaper discussion saying this chap is better than that chap or this chap is no good. I do not know that that is terribly helpful in the kind of process with which we are concerned.

Q103 Chairman: The changes would be significant and the implications quite profound as a result?
Lord George: Absolutely. The last thing we want is to introduce a political element into that decision.

Q104 Chairman: You have been coming to the Treasury Select Committee for a number of years and putting forward the views of the MPC. How important are meetings such as this in terms of communicating with Parliament and the public in particular?
Lord George: Without flattering, I think they are terribly important. The opportunity for us to explain to the Treasury Committee what we were doing, and for individual MPC members to explain their thinking, was a very positive dimension. To have the technical job that the MPC is doing understood is terrific. When I was at the Bank—I imagine it continues today—we had regular meetings with groups of parliamentarians. That occurred probably four or five times a year. Those meetings at the Bank were precisely in order to explain to Members of Parliament how the Bank worked and open ourselves to questions from parliamentarians in order to try to understand it. We do it publicly through the inflation reports, publication of the minutes and so on, but that is a terribly important process which creates understanding, and I believe that on the whole it has proceeded fairly well; and it has helped to strengthen the consensus that I described at the beginning. If people feel they can understand it and it seems to be working reasonably well that is helpful.

Q105 Mr Todd: Do you think that inflation expectations have been anchored by the actions of the MPC either in the more technical financial community or the public at large?
Lord George: I think that “anchored” is a strong word, but there is an understanding—this has been happening to varying degrees from different starting points globally, not just in the UK—that people who manage economic policy now realise that the boom-and-bust approach is a dead end and
very damaging. I believe that that has been accepted by the public at large. It implies that they do not expect to see inflation reach 27% in a single year in the United Kingdom. I cannot believe that that was ever true but it was. In that sense inflationary expectations are much lower because people really understand that what government and the bank are trying to do in managing the economy is to produce greater stability. In that sense I agree. As to whether it is precisely 3%, 2% or 2%, I do not believe that one will ever succeed in anchoring that, but it is certainly down at that level rather than in double digits.

**Q106 Mr Todd:** Would it surprise you that Citigroup carried out a public opinion survey which showed widespread ignorance of the precise target, or even who set it, whether it had changed recently and so on? That reinforces your point that in broad terms people understand it, but in precise terms they do not. Do you believe that there is more to be done to educate the public on the various components of inflation, for example linking it to concepts of asset price inflation with which people are often quite unfamiliar in terms of the values of their properties? Is there more to be done to explain what these things are and how they relate to, say, one’s next wage demand?

**Lord George:** As I hope I made clear, I believe that public explanation is absolutely critical and it is an ongoing process. I do not think we will ever get to a situation where everyone in the country knows about the MPC and the details of the target and all that. It is the broader understanding that we have to keep reinforcing.

**Q107 Mr Todd:** You are aware of the debate about whether the precise inflation measures being used are the right ones and whether they include the correct components and so on. Therefore, there is a public dimension to that process.

**Lord George:** I believe that whilst they are important questions they are second-order compared with the overall understanding of the way macro-economic management is proceeding in a broad sense. The fact is that any technical subject is not widely understood. There is great debate about climate change. If one carried out a survey to find out how many members of the public knew whether it was due to solar energy or was manmade one would find a complete void. I am very keen that there should be greater understanding of that, but the mass of the population will never understand the technical details. I believe that the same is true of macro-economic policy.

**Q108 Mr Todd:** Should one be satisfied that if asked people would think that inflation was around 2½% or 3% and would not rise dramatically above that level?

**Lord George:** Yes—and that interest rates would be 5% or, at the higher points, at 6% or even 7%, or that at the low point it would be 3% or 4%. I do not believe that the mass of the population will ever understand those things, but I believe that the broad direction, which is the important matter, is fairly well understood.

**Q109 Mr Todd:** The banks sponsored a competition among schools which focused on the inflation target and the various levels that could be applied to achieve it. Do you think that more could be done there?

**Lord George:** I believe that that was a fantastic idea on the part of Mervyn King. That focuses on economics teachers and students of economics at the school level. Part of what they are doing is to study the technicalities of this kind of thing.

**Q110 Mr Todd:** Perhaps there should be more emphasis on lower level awareness?

**Lord George:** It is an ongoing task and we must keep on doing it. I do not believe that there are particular initiatives, but perhaps I do not have the imagination of others.

**Q111 Mr Todd:** It has been suggested from time to time that the MPC should have responsibility for bursting asset bubbles. Do you think it desirable that its brief should enable it to deal with house price inflation and specifically adopt measures to assist with that? I merely pose that question because it is put to us from time to time.

**Lord George:** For years I used to quote the Chinese proverb “the man who tries to juggle with too many balls ends up in heap on the floor”. I believe that that is extremely relevant to that question. The inflation target is really a form, but what it is talking about is aggregate demand in relation to the potential underlying supply capacity of the economy. The inflation target is really the barometer of success or failure in achieving that. Asset prices can be driven by all manner of outside considerations. It is tremendously important that the Monetary Policy Committee monitors, follows and studies what is happening to different asset prices, financial assets, housing and so on, as it does. Those subjects are studied extremely carefully within the bank and are discussed by the MPC. But if one decided to set a target for house prices and equity prices one would end up in “heap on floor”. One just cannot focus on more than one objective. To focus on inflation is not a narrow objective; that is the form of it, but it has broader significance than that.

**Q112 Ms Keeble:** Do you believe that the CPI is still a credible target for inflation in the UK or should it be modified?

**Lord George:** Do not misunderstand me when I say I believe that to be a second-order question. I was not particularly keen to modify it from the RPIX which we had for some considerable time. There were pros and cons in that respect given that it was going to be 2% rather than 2½% which helped possibly to reduce inflationary expectations. I would be fairly reluctant to jump about with it because inevitably people will say that the goal posts are being changed and it is being done for this or that particular reason. I honestly do not believe that it makes a fundamental
difference. A 2½% target for CPI is a good benchmark for the kind of broad balance and stability that is the big picture here.

Q113 Ms Keeble: But do you not think there is an issue about the credibility of the MPC? You say that the general public will never understand it, but I think they do. You said that you were an inflation nut. Inflation is a matter of public debate now whereas it was not for a long time. I think people understand the difference between inflation as they experience it and inflation as the MPC defines it because of the impact of house prices. Do you believe it would be helpful if there was a slightly modified target, or do you think it does not matter if the MPC has a target that is not really credible to the general public?

Lord George: I would question the statement that it is not credible to the general public. I believe that the general public knows that the objective is to maintain stability over time and that will be reflected in relatively low inflation on whatever measure over time. As to the precise target that is set I do not believe that you will ever get people at large to agree that this is the right thing as distinct from that. I was amazed the other day to see that the Office for National Statistics was enabling individuals to calculate their own inflation index. The implication is that somehow one can target individual inflation concerns with different sectors or individuals members of the public, which is barmy. It is a broader concept than that and it must be one that is across the board and reflects the balance between demand and supply.

Q114 Ms Keeble: Do you not think that in a sense the MPC has been a victim of its own success? People have been used to low inflation—at about the rate of 2½—for a long time but now it is increasing. If you look at the discussion in the area of public sector pay bargaining, the main issue of debate is the fact that public experience of inflation is well above official versions. Do you believe that that matters, or should the MPC perhaps recognise where the public is?

Lord George: What you are saying is that they should target house prices, to which I say: absolutely not. They look at what is happening to house prices and take account of the impact of that on wage bargaining and everything else. The increase in household debt was certainly a subject that we focused on in my day job, and that will be and should be continuously focused upon. But if one suddenly says that one must look at this or that there is no end to where it can lead. I am very happy with where we are.

Q115 Ms Keeble: How do you explain to the public whose experience is that prices are going up considerably—all of us as MPs hear that—that inflation is at whatever level the MPC thinks it is, which is about 2½%?

Lord George: It is not what the MPC thinks it is. That measure of inflation is calculated by the Office for National Statistics and that will anchor inflation. It may not do so to the same level but it will fluctuate around that and other measures of inflation, but it will anchor the general level of price increases. One can have endless debate about precisely what one should and should not include. I just think that the overall objective will be undermined if too much attention is paid to particular measures which reflect the expressed opinions of particular groups of people in society.

Q116 Mr Newmark: As a supplementary, you are setting the terms of reference. By definition you are saying that inflation is x because you have set those terms of reference by which to measure inflation, but I echo a lot of what Ms Keeble says. Either at the doorstep or in my surgery people say to me that they read in the papers what inflation is but their experience tells them otherwise. It is a big problem particularly for pensioners who say that for them inflation is running at 7%, 8% and 9%, not 2½%. That is problematic. We need to do some thinking as to what the terms of reference necessarily are.

Lord George: I think you should look at what would be the implications for the economy as a whole if you targeted pensioner inflation

Mr Newmark: I understand the point you make about targeting individuals, but if you ask the 646 MPs they will say that when they get onto the doorstep the feedback is that these may well be the facts that people read in the papers, namely that inflation is 2½%, but it bears no resemblance to real life experiences. It may be—I am not saying that we should—we need to think about what those terms of reference are for the inputs into whatever inflation index we are using, whether it is CPI, RPI or whatever.

Q117 Ms Keeble: What makes it worse is that the one tool that the MPC has is interest rates and that filters through to our constituents in the form of higher mortgages. That makes them complain even more; it becomes cyclical.

Lord George: Yes, if house prices are going up. But one has to step back and recognise—I referred to it earlier—that when we were in an environment of global economic weakness at the beginning of the decade it meant that external demand was declining. Related to that, business investment was declining. One had only two alternatives in sustaining demand and keeping the economy moving forward: one was public spending and the other was consumption. It is true that taxation and public spending can influence the demand climate and consumer spending, but confronted with what we saw we knew that we had to stimulate consumer spending. We knew that we had pushed it up to levels that could not possibly be sustained in the medium and longer term, but for the time being if we had not done that the UK economy would have gone into recession, just like the economies of the United States, Germany and other major industrial countries. That pushed up house prices and increased household debt. That problem has been a legacy to my successors; they have to sort it out, but we really did not have much of a choice about what we did unless we accepted that we would yank it back or give up
stability altogether. That is the point I am trying to make in answer to Mr Newmark. There are some people—maybe lots—who say that house prices is the biggest problem, that the mortgage rate is going up, housing is not affordable and so on.

Q118 Mr Newmark: There are a whole host of other issues including council tax.

Lord George: There are always things that one can bring into this kind of pot and within that there would be social judgments which are not for the MPC: they are for government. But my concern is that if it is said inflation or RPIX is so much that is one measure. If one looks at pensions a lot of pensioners will say that inflation is at 8% or 9%. If one really wants to target that measure of inflation, or include it within the inflation target, one will be giving up low inflation and accommodating those people. The only way in which we could bring down inflation would be to clamp down on the economy which would mean rising unemployment and falling output. Of course I understand when employees in the health service and schools say that it is not good for them, but one must look at it over time. If one focuses on that too much at the moment one will either inspire action that causes the economy as a whole to weaken or undermine the commitment to stability in the broad sense which has been so successful for us over the past 15 years.

Q119 Mr Newmark: For the past four or five months in a row effectively earnings, excluding bonuses, have not kept pace with inflation. Do you see that as a problematic trend? Is there an issue about which we should be concerned?

Lord George: I believe it is something that we should all applaud because if it had kept pace with inflation then underlying inflation would have been higher looking forward.

Q120 Mr Newmark: But from the point of view of the public, earnings in real terms are declining.

Lord George: They have been rising consistently over many years and if there is a setback this year on certain measures that is the price we pay for keeping the thing moving ahead as it has been doing up until now.

Q121 Mr Newmark: Interest rates are a powerful but blunt and untargeted tool. Is there more that the bank could do either to influence fiscal policy or request additional powers from the Government to provide a more nuanced response to changing economic circumstances?

Lord George: I certainly would not want to put the bank in the position of managing fiscal policy as well because the considerations go way beyond economics. They have to balance social as well as economic concerns and that is the job of elected politicians. It is not a technical job like that of the Bank of England, so one must have much more input into that. There was another dimension to your question which has escaped me.

Q122 Mr Newmark: I am just reflecting Professor Wren-Lewis’s written evidence to us that perhaps there is room for manoeuvre for some sort of fiscal inputs into decision-making rather than a focus on monetary policy.

Lord George: I have absolutely no doubt that tomorrow they will be listening to the Budget and studying the implications over the next period. The Monetary Policy Committee and monetary analysts and other permanent staff at the bank will be taking as much account of all those things as they can. It is not as if we are operating in ignorance of what is happening in the rest of the economy; quite the reverse.

Q123 Mr Newmark: As a related question, do you think that the bank must remain on guard against changes in fiscal policy that may be detrimental to the smooth functioning of monetary policy?

Lord George: If that sort of thing was happening in a significant way I am quite sure that the bank would draw it to the attention of the Treasury and Chancellor. The reality is that there are many things going on in the world that the bank cannot and does not expect to be able to influence or cause to be different. What the bank must do is take account of all those things that are happening, for example in the United States, China and India.

Q124 Mr Newmark: But there is a difference between taking account of something and trying to have influence over it. Is there any thinking as to the bank or MPC having some influence over fiscal policy if needed?

Lord George: It can express its views to the Treasury.

Q125 Mr Newmark: It is merely a matter of expressing a view rather than getting hands on any levers with respect to fiscal policy?

Lord George: I certainly would not want the bank to have levers over decisions about fiscal policy. They go much broader than purely the monetary policy objective, but I think that the kind of advice the bank would give would be, “If you do this it will cause that to happen and interest rates will rocket. Is that really what you want?” But it should certainly not be able to veto decisions or insist that politicians behave in a certain way. I should like to point out that we live in a democracy.

Chairman: Professor Wren-Lewis mentioned that in exceptional circumstances the bank should take responsibility for some fiscal policies. We questioned him and asked whether it would include VAT and whatever else. I think I can speak for Members here in saying that the argument was to some extent demolished. We entirely agree with you, Lord George.

Q126 Mr Love: Perhaps I may take you back to the earlier discussion about the role of the bank in terms of asset prices and possible bubbles. To go back to your time at the bank, your opposite number in the US, Alan Greenspan, talked openly about irrational exuberance. We did not say much on this side of the pond in relation to that. What are the limitations on
the bank in commenting on what is going on in the marketplace at any time? If you do comment does it make any difference?

Lord George: I do not believe there are any constraints on bank officials and members of the MPC expressing concerns about what is happening in financial markets and questioning whether that is justified in terms of the underlying situation. As I have already said, the bank takes account of what is happening because those things can have a powerful influence on demand and inflation. I think that anybody who claims to know with great confidence what is happening in the economy, let alone in financial markets, and what the explanation for that is does not understand the questions. It is an incredibly difficult thing. I would be quite surprised to find somebody saying that the exchange rate against one or other currency is much too high or low. Frankly, it can be said that it raises a question that is being determined by financial markets, but to be able to do anything about what is happening in financial markets is not realistic.

Q127 Mr Love: It just so happens that one of the current external members of the bank seems very sure that there is a bubble in terms of house prices. What he cannot comment on is when that bubble is likely to burst, but that is a different issue.

Lord George: When I was still in my day job a lot of people forecast a collapse in house prices over the next six to eight months. We are still waiting for it. One must be very cautious about that kind of projection.

Q128 Mr Love: That probably answers my next question. The odd comment on what is happening in the marketplace will probably not make any difference. Should the bank take a specific view and should all its members comment regularly on matters in order to try to influence markets more than they are doing at the present time?

Lord George: On the whole, I think they do comment fairly regularly on what is happening in financial markets. The side of the bank concerned with financial stability, not the MPC, produces six-monthly assessments of the risks to financial stability which is a different concern, although they are related and interconnected. Like love and marriage, you cannot have one without the other. I am not conscious of any need to do more than they do in terms of commenting on developments in financial markets.

Q129 Mr Love: One of the expert witnesses suggested that monetary policy might have been overly-restrictive especially in the early days but that that might have been a temporary phenomenon as the bank was building up its reputation. Do you think there was an element of conscious bias in those early days to establish the reputation of the bank?

Lord George: No, I do not. I was very conscious of the fact that it was a symmetrical target. That is terribly important because if it is lopsided it does not reflect the original intention. It is not the broader objective of balancing demand with underlying supply. That it is symmetrical is something that we all understood perfectly well from the beginning. But when we were undershooting fairly consistently and achieved 1.5% when the target was 2%, we might have written a letter of explanation to the Chancellor. I rather wished I had done so because it would have relieved the pressure on my successor. We did not have to do that, but fairly consistently we were on the down side. The reason for that I impliedly explained earlier. That arose in the period of weak external demand when business investment was weak because of global recession, so we had to stimulate household demand. That was the role that we could play in it. We knew that this was not a sustainable situation, so we were being very careful not to do more than we felt we absolutely had to in order to keep the economy moving forward, which we succeeded in doing. It was that which caused us to be careful on the “stimulus” side; it was not that we wanted to convince people that we would always undershoot the inflation target, because that was not what we were trying to do looking at it over the longer term. Symmetry was accepted by the MPC from the beginning and was a fundamental characteristic.

Q130 Mr Love: You think that is a critical part of it?

Lord George: I do.

Q131 Mr Love: Who should set the inflation target? At the moment, clearly the Chancellor sets it. Should it be set every year or on a different timescale?

Lord George: My understanding is that he has changed it only once and that was when he changed the index. If the Chancellor tried to set it every year people would wonder what was going on. I am sure I can imagine a set of circumstances—I cannot think of any immediately—in which it is felt justifiable to say that even 2% inflation is too high given what is happening in the world as a whole and therefore the target will be lowered, or that if we try to deliver the 2% inflation target we will face great weakness and therefore tolerate for a period a higher rate of inflation. I think that would be immensely dangerous and highly exceptional. An elected politician should have the right to take that decision but he would have a hell of a job explaining why he was doing it unless the argument was fairly convincing.

Q132 Mr Love: That would be particularly the case if he wanted to raise it rather than lower it. Should there be some form of consultation before he made a change of that nature?

Lord George: I am sure that he would consult with all sorts of people because it would be a very big decision. Although the Chancellor sets the inflation target I believe that is justifiable because there is still a perception that there is a short-run trade-off between growth and inflation. I am dubious about whether that is true, but I believe that is the perception, so in that sense it is a political decision. I think that if the MPC set the inflation target it would draw the bank into a political process. We are very happy to be outside that political process.
Q133 Mr Love: There has been surprise about the lack of real discussion about what the inflation target is. The Chancellor set it 10 years ago and he changed it only once in relation to the change in the index. There has been very little comment. Does that surprise you? Should there be more comment? Should politicians in Parliament and commentators be talking about whether the 2% symmetrical target is the appropriate measure?

Lord George: No. I believe that it reflects what I said right at the beginning that there was a broad consensus on what we were trying to do, namely to keep underlying demand growing consistently in line with the supply capacity of the economy. Over the past 15 years we have grown consistently quarter by quarter and I do not think that has ever happened before in recorded history. In those circumstances I believe that the view of the public and across the political spectrum — this is what I mean by “broad consensus” — is that this is a sensible way of carrying on these matters. But that must be low inflation and it must be symmetrical; otherwise, it would just be a doddl. If it was x% or lower one would always guarantee it by driving the economy into the ground which is not a sensible approach and is not consistent with the consensus that has been fundamental to what we have done.

Q134 Mr Gauke: I want to ask about the transparency of the MPC. Do you think more should be done to allow the positions of individual MPC members to be made public?

Lord George: It depends on what you mean. Some people have said that in the minutes of the meetings the statements of individual MPC members in the debate should be attributed. I would be very sceptical about that, because when I was there the characteristic of the discussion, particularly on Wednesday afternoon before the policy-making session on Thursday morning, was on the one hand and on the other; that is, lots of individual members would say that on the one hand a particular series of data could be interpreted in one way but on the other hand they could mean something else. If one really attributed individual comments it would be on the one hand and on the other and one would get the impression that they did not know what they were doing. I certainly do not go as far as to say that the minutes should be verbatim because it would change the character of the debate, which I thought was fantastic. People could be open-minded. That is the nature of it. If somebody thinks he knows for certain what the answer is frankly he does not understand the question because it is an art, not a science. Beyond a certain point you know where you are making judgments rather than speaking with certainty.

Q135 Mr Gauke: One idea that has been suggested is that individual MPC members should write their own personal reports to this Committee. Is that something for which you would have sympathy?

Lord George: They all participate in the discussion and the draft of the minutes is seen by the MPC. There is a meeting to discuss the draft of the minutes. MPC members are quite free to express their view.

Q136 Mr Gauke: But would you be sympathetic to the idea of members putting something in their own name as a formal part of the structure?

Lord George: They can come here and you can ask them questions and they can answer on their own behalf. There is no constraint on that. They can make public speeches and lectures. I believe that it would alter the character of the meetings if one had attributed minutes or nine different sections where individuals wrote their own thing and it was not a discussion of the meeting and interaction but a discussion of the individual point of view. I do not believe that would be helpful.

Q137 Mr Gauke: What about the idea of the votes on a particular interest rate decision being revealed immediately as opposed to a month later? Would you be sympathetic to that, or do you see difficulties?

Lord George: That would be great for the newspapers and sensationalism: a hawk voted this way and somebody else voted another way. I do not believe that that would convey very much. I believe that to do it in the context of the minutes is much more informative.

Q138 Mr Gauke: To return to the appointments process, to paraphrase your evidence you said that you were broadly satisfied with how it worked in your time, but certainly some indication has come from the Bank of England about more recent concerns in that regard. Do you believe that as far as your relationship with Gordon Brown was concerned there was a spirit of openness throughout your time as governor?

Lord George: Yes. It took time for it to build up, and it began before he became Chancellor. I used to have meeting with him. Ken Clarke encouraged me to do that and I thought it was terribly sensible. We discussed the question of the MPC before the decision was announced. It was important because one needed to develop a rapport and understanding. I had to persuade him that I could be trusted. I believe that that kind of relationship is terribly important, and I would encourage both sides to continue it. As far as I know, they do so.

Q139 Mr Gauke: This morning we see reports from Lord Turnbull, for example, that Gordon Brown has played denial of information as an instrument of power. Was that ever your experience as Governor of the Bank of England? For example, in relation to the FSA, not specifically the MPC, was that ever your experience of working with the Chancellor?
Lord George: I accepted that he had certain decisions to take, but he always gave me the opportunity to express my opinion. The FSA was different. I was very surprised; I thought we were going to talk about it, but it was introduced very soon after the MPC for reasons that you will have to ask him about.

Q140 Mr Gauke: But far as concerns denial of information as an instrument of power, do you recognise that as something which the Chancellor

Lord George: I do not think I would, but, as the Chairman said on the radio this morning, you would have to ask Andrew Turnbull about it.

Q141 Chairman: He has gone to ground. Lord George, thankfully you have not gone to ground. This session has been hugely helpful and we are privileged that you have come along to give evidence. Thank you very much for presenting it to us.

Lord George: It has been a great pleasure. It is quite like old times, Chairman.

Witnesses: Ms Marian Bell CBE, Dr DeAnne Julius CBE, Dr Sushil Wadhwani CBE, and Professor Charles Goodhart CBE, former members of the Monetary Policy Committee of the Bank of England, gave evidence.

Q142 Chairman: Good morning and welcome to the second session this morning of our inquiry into the MPC ten years on. As with Lord George, we are privileged to have the benefit of your experience. We hope to finish at about half-past 11. We shall ask crisp questions and I am sure you will give very crisp answers to them. To what extent do you think that the record of the Bank of England and the MPC over the past 10 years has been the result of the institutional reform since 1997? I asked Lord George how much of a watershed it was.

Ms Bell: Perhaps less 1997, but the overall inflation targeting framework has been a big contributor. One must remember that lots of developed economies have had similarly favourable experiences, though perhaps not as favourable as ours, because there has been a global consensus about the way to run macro-economic policy, in particular monetary policy. We have been part of that. Having said that, I think it would have been quite easy for the MPC to get it wrong at different stages and notably it has not. I think it is quite wrong to think that it has been plain sailing and there have not been any risks. There have been big structural changes in the world economy and the UK economy and also a considerable number of shocks. The MPC has dealt with that extremely well.

Dr Julius: I would agree. It has certainly been a mixture of international factors and improvements in policies here and some pretty good judgments by the various people who have been on the committee.

Dr Wadhwani: I would certainly endorse that. It has been a mixture, but I would not underestimate the significance of the change in 1997. What it did markedly was to bring down inflation expectations, as one sees in a variety of measures. It also gave one much greater confidence that inflation expectations would stay anchored. I believe that that has made a significant difference to the way in which the economy has responded to shocks. For example, it has made it much easier for the economy to handle the fluctuations in oil and commodity prices that we have seen. I believe that the anchoring has been very important.

Q143 Chairman: Professor Goodhart, in your submission to us you mentioned that the stability of inflation since 1992, particularly since 1997, has been extraordinary in comparison with previous eras, but it could be taken for granted by the younger generation and maybe down the line the MPC will be blamed for things which it really should not be blamed for.

Professor Goodhart: Absolutely. I believe there is great danger that because the past 15 years have been so incredibly stable people now think that if inflation varies by 0.3% in a month things are going wrong. One used to have variations of 1% or 2% a month quite regularly. The stability has been quite remarkable. I think that now people take it rather too much for granted. There could be occasions when there are greater shocks—other countries get into difficulties and all kinds of things could happen—and it might not be possible in future to repeat the stability of the past 10 to 15 years.

Q144 Ms Keeble: How supportive is each of you of the CPI as a measure of inflation, especially in view of the fact that the RPI is used in wage bargaining? What do you think about the current discrepancies in the public debate between the public’s perception of inflation and the measures which the MPC is using?

Ms Bell: I do not think it matters so much what measure of inflation one takes. I think what matters is that it is consistent and credible, and to achieve that it should not change around too much. As long as it is fairly representative of the cost of living—perhaps one can argue about whether or not house prices should be included—I believe that it is fine and for statistical reasons CPI has superior properties. It would be nice if it included house prices. I do not believe that RPI itself is particularly useful—the previous target was not RPI but RPI excluding mortgage interest payments—because interest rates themselves should not be directly included in the targeted measure of inflation.

Dr Julius: Of the measures currently available the CPI is the best one to target. There are advantages in having a geometric mean and various reasons why RPI would be the wrong measure to target
because it includes mortgage interest rates. Having said that, one has to look at the practicalities of how one can include the impact on inflation of house prices. It is not a clean-cut exercise and that is part of the reason the European Commission has not so far succeeded in coming up with a way to do that. Unless a good way to do it can be found, I think it is better to leave the clean-cut measure—CPI—as we have it. When we were looking at RPIX, which includes a measure of house price inflation with the owner occupied equivalent of rental costs, it was not a very good element and it destabilised that particular measure. I add that in times like the present when commodity prices are quite volatile it is useful to look at a core measure. The MPC does not currently pay a lot of attention to core measures of CPI, but I think that that can also add knowledge about where inflation is going in future.

Q145 Ms Keeble: I can see the point of having a fairly stable measure that is reliable as a statistical tool, but there is an issue about the public perception being completely out of kilter. You may think it does not matter whether or not the public thinks that the Government and MPC use credible measures. Nonetheless, there is a credibility issue especially when the use of interest rates can widen the perception because increases have a knock-on effect on mortgages.

Dr Wadhwani: I wonder whether it is a matter of attempting to educate the public, because it is quite dangerous to endorse public views that they deserve wage rises in line with RPI. Ultimately, in an idealised labour market wages should be going up in line with what a competitive business can afford and that need not be RPI. In the specific instance where RPI is boosted by interest rate increases that may not be something that businesses can afford to pay. If in the labour market people insist on getting RPI-style wage increases they may just end up boosting unemployment. Therefore, it seems to me that it is our duty and, with the greatest respect, possibly your duty to help educate the public about this issue. I also strongly suspect that in periods when RPI is running below CPI—that was certainly part of my experience when I was on the committee—there was not much heat from the public about the issue.

Q146 Ms Keeble: Do you believe there is any bias, particularly anti-inflationary bias, by the MPC despite the fact that the target is symmetrical?

Professor Goodhart: There was certainly no bias of which I was ever aware. I think the reason why inflation came out at a tiny bit below target was essentially that we all expected the exchange rate to come down a bit. It rose enormously in 1997 and the general expectation was that it would decline slightly from then on, but it never happened. Because the exchange rate was always somewhat higher than we expected inflation turned out to be just a tiny bit lower, but the deviations were minute.

Q147 Ms Keeble: Do you think that the interest rate should be the only tool used by the MPC, or should it have other tools at its disposal?

Professor Goodhart: The central bank has other functions as well. It is concerned with financial stability and it has to consider what kinds of instruments it might want to use for that purpose. There is also a question of whether the central bank should ever intervene in the foreign exchange markets. You probably are aware of issues in France about what the ECB should do. The question of whether there should ever be intervention in the foreign exchange markets is a very lively one.

Q148 Ms Keeble: I do not believe you agree that letter-writing is a form of sanction?

Professor Goodhart: Certainly not. Letter-writing is usually an explanation of what has happened. The MPC is always trying to achieve the inflation target. Shocks are bound to occur from time to time and they will drive inflation up or below the limit. At that point the MPC must explain why it has happened and what it intends to do. It is a form of explanation, and it also gives the Chancellor a chance to reply so that if inflation has deviated from what the MPC is trying to achieve the Chancellor can say that it should try to return quicker or more slowly than the bank suggests in its letter.

Q149 Ms Keeble: I was interested to hear Lord George say that he wished he had perhaps used it when inflation went too low. Do you believe that it is differently perceived?

Professor Goodhart: My belief is that every central bank governor and most members of the MPC are looking forward to the first occasion of letter-writing. Obviously, they do not want a deviation from target to occur, but they are quite looking forward to getting this part of the institutional instrumentation in operation and showing how it ought to work.

Q150 Ms Keeble: But it has not been used in 10 years and is seen almost as a tool of last resort.

Professor Goodhart: It is not a tool of last resort. When the MPC was founded in 1997 the historical experience and expectations were that there would probably be about two or three letters written per year. The decline in the volatility of inflation over the past 10 years has been quite extraordinary. If one went back to the kind of normal variations in inflation that occurred in all historical experience one would certainly expect letters to be written fairly frequently. Stability has been so great that it is almost unimaginable. It was not imagined that there would be anything like this when the MPC was established in 1997.

Q151 Chairman: Are there any other comments on letter-writing to be added to Professor Goodhart’s view?
Ms Bell: I agree that it is not a sanction and should not be seen as such. It is definitely part of the communication process. I also agree it is disappointing that we have not had a letter yet. I wonder whether perhaps the bounds should be narrowed or the committee should start writing letters when they get towards the end of it just to make use of that communication tool.

Dr Wadhwani: It would be dangerous if it was seen as a sanction. If it was seen as a sanction by the committee it would stop it doing the correct thing which is occasionally to allow inflation to stray outside and to bring it back only gradually.

Q152 Mr Love: We are all pining for a letter, and maybe we will get it one day. I move on to the characteristics of a good external member. Who better to answer that question than former external members. Perhaps I may start with Professor Goodhart who in his submission wrote a detailed spec as to who should be external members. Perhaps he would elaborate.

Professor Goodhart: The MPC is a remarkable institution which is charged by Parliament and the Chancellor with the job of changing interest rates in such a way as to hit an inflation target. That is a technical requirement. Effectively, the specification ought to be that the person involved is capable of achieving within a reasonably short time the ability to make a sensible and informed choice.

Q153 Mr Love: Do any of the witnesses believe that in trying to reach a balance of the external members there is a role for non-technical persons? You have had one such person on the committee.

Dr Julius: With the current structure, particularly the central role of the forecast in the MPC process, it is quite difficult for a non-technical person to participate fully in that exercise. It depends exactly on how one defines “non-technical”. I do not believe it means that one needs a huge amount of econometric model-building in order to be an MPC member. I note that one of the submissions suggests that at least one of the external members should have substantial experience in model creation.

Q154 Mr Love: What is your view of that?

Dr Julius: My view is that certainly one or more should have real experience in using and interpreting forecasting models of the economy. I am not persuaded that experience of building models is required, but every external and internal member needs to be professionally competent in interpreting models, asking the right questions about them and so forth. Without that the internal functioning of the MPC process and communication of the output is compromised.

Q155 Mr Love: Dr Wadhwani, Professor Goodhart says that it can take six months for the non-specialist to become comfortable with the forecasting procedures. The outside experts said to us that in order to keep the bank on its toes at least one member needed to be thoroughly acquainted with it. Do you support that view?

Dr Wadhwani: Yes. It certainly takes time to adjust to the model and to be on the committee. That is why I now feel that terms should be longer; instead of three years perhaps the term should be five or six years. Members should be given the option of perhaps serving a somewhat shorter term, but certainly should be encouraged to serve a longer term.

Q156 Mr Love: I want to come to that. I hope to seek a consensus among the four of you. First, for how long do you think members should be appointed? Should members be eligible for reappointment? There seems to be a broad consensus developing.

Ms Bell: If I may comment on the external member who is a modeller, I am not sure there is a need for somebody who is able to be hands on and run his or her own model, because the external members do not work as a block, or should not do so; they should all be there as individuals. I am not sure one gains anything by having one person who can go through the nuts and bolts of the model. What one needs is that all the members understand the broad properties of the model and how it is put together and can hold the bank to account. There is plenty of technical expertise within the bank.

Q157 Mr Love: You appear to suggest in your evidence that four years without reappointment is the correct way to go forward.

Ms Bell: I agree that perhaps terms should be a little longer. I also think there should not be reappointment. The suggestion of four years arose because with four external members one would have a very neat roll over. We had a problem a few years ago when there were big internal changes going on at the bank and two external members came to the end of their term at the same time. I think that potentially it causes difficulties. Were we to have a committee with five external members and four internal members perhaps we would have rolling five-year terms.

Dr Julius: Reading everyone’s evidence, it seemed to me that most if not all of the former members of the MPC felt that there should be longer periods and more protection for the independence of external members. There was a difference in terms of length of appointment. My own view is that a three-year term is quite a good length for the first time and a second term should be permitted if both sides feel it is appropriate, but that the six-year total limit should be applied to both internal and external members so there would be an equality of historical experience and continuity on the committee. The reason I am not in favour of a single five or six-year term is that it has two disadvantages. One is that it may well be somebody is appointed who is not really competent for the job, and to be stuck with that person, as it were,
for five or six years is not particularly helpful. In the public or private sector often one does not know that. Someone can look very good on paper and do very well at interview and in the job it just does not work out. I think there is a risk in having a long-term appointment like that. The second issue is that if it is an appropriate, good person a five or six-year appointment is quite a long commitment to a rather cloistered job that may be out of the mainstream of the individual’s own career path, particularly if he or she is not from academia and comes from the private sector or financial markets. Although that person could resign, say, four years into a six-year term it would be something of a political issue; it would be in the newspapers and there would need to be a good reason. It might be difficult to attract that sort of person to a job for which the term was, say, six years.

**Q158 Mr Love:** Professor Goodhart, you talked of the possible danger that internal Bank members could become subject to “group-think”. Do you think there are any dangers of a herd mentality among external members; if so, how would you guard against it? How do you ensure that all the external members do not think similarly?

**Professor Goodhart:** They certainly have never had a herd mentality.

**Q159 Mr Love:** That is reassuring.

**Professor Goodhart:** One of my colleagues, Willem Buiter, was particularly individualistic. How do you guard against group think? I would encourage some of the externals to keep a foot outside the Bank. The kinds of people who would be appointed are at a sufficiently mature stage of their careers that they are unlikely to be subject to excessive pressure. I do not believe that this is likely to be a danger, and there certainly never has been any kind of danger.

**Q160 Chairman:** We have had the opportunity to visit the Bank and meet the Court. Do you think it is the Court’s job to pick up weaknesses in MPC members? What is its job?

**Dr Julius:** That is a good question. In some ways the Court is a rather grand body with very little to do, particularly since the introduction of the new Bank of England Act and the FSA regulatory side split away from the Bank. The Court is getting the right sort of information. It receives a set of documents annually. When Pagan made a report on modelling at the Bank that went to Court; when observers from other central banks sit through some of the so-called pre-MPC briefing meetings there are peer review questionnaires prepared and all of that goes to Court. It receives quite a lot of information. Perhaps it could make more of it.

**Q161 Chairman:** Dr Julius, I believe that you are the only one here who has been a member of the Court as well, so your evidence is very pertinent to that. I gained the feeling from talking to the Court previously that its role was ill-defined and perhaps it is something on which we should comment in our report.

**Ms Bell:** That might be the practice, but I believe the Act is quite clear about its role: it is to make sure that the MPC’s procedures are appropriate and it is getting the right sort of information. It receives a set of documents annually. When Pagan made a report on modelling at the Bank that went to Court; when observers from other central banks sit through some of the so-called pre-MPC briefing meetings there are peer review questionnaires prepared and all of that goes to Court. It receives quite a lot of information. Perhaps it could make more of it.

**Q162 Chairman:** Perhaps an education process must take place here.

**Dr Julius:** I think that the Court has a useful role as backstop. At times of strain—there was a period of strain when the external members felt that more resources were needed to support them—the Court played a very useful role. Certainly, one would hope that if there should be any sort of financial irregularity inside the Bank the Audit Committee, which is a subset of Court, would discover that weakness.

**Q163 Chairman:** Therefore, it acts as a good shop steward?

**Dr Julius:** Yes.

**Q164 Mr Gauke:** I want to follow up the point about resources more generally. How do you feel about the amount of resources provided to external members? Is there anything that you feel you could have done that you were not able to do because of lack of resources?

**Dr Wadhwani:** When I got there the quantum of resource was not enough but that was resolved. I was then perfectly content with the situation. There have been rumours around that there may be an attempt to take these resources back from external MPC members which I believe would be a retrograde step.

**Dr Julius:** One element that would have been useful, even after the expansion of resources, was more modelling capability in the external MPC staff. Ms Bell has been there more recently than I have, so she will have a better view on what is available now, but during the time I was there it...
would have been useful to be able to have the capacity between forecast meetings, for example, to run the model with some different assumptions that I might think were a little more appropriate than whatever might have been the joint view of the committee. That capability was not there, and the internal Bank modelling staff was entirely preoccupied, naturally, in preparing for the forecast rounds in which we were involved.

Ms Bell: I think that some of that is to do with the sort of people who are recruited into the unit. I see no reason why you could not have modelling, and at times there have been people with that capability. My experience was that the resources were adequate. I do not say that they were overly-generous. At some points they were really needed. For example, when the new model was coming in the staff in the external unit spent a lot of time working with the external members to make sure they understood the model. There were lots of in-depth briefing meetings with the modelling team. Little seminars were run by the external unit staff for themselves and for us about the new model. All of that was quite resource-intensive and essential. I agree that it would be wrong if that resource was diluted in any way.

Professor Goodhart: It takes us back to the earlier question of whether there should be at least one expert in modelling. Ms Bell has just talked about the model. There is not just a model; there is an infinite number of macro-economic models. One of the dangers for the Bank is that people place too much weight on whatever the current bank model may be. There is no such thing as a correct model. One of the points that always needs to be considered is whether possibly the model that the bank currently uses may be insufficient and inadequate in certain ways, and one of the roles of the externals ought to be to be able to challenge the bank model.

Q165 Mr Gauke: I move back to the issue of the appointments process. Do you have any views as to the adequacy of the current process or suggestions as to how it could be improved? Professor Goodhart has raised one or two issues in this area and perhaps he would wish to kick off?

Professor Goodhart: I think it is a very difficult question. The question about whether your Committee should have the ability to refuse appointment is part of a much wider issue of the relative role of the legislature and executive and the position of the MPC is one among many. It is a very much wider issue that should perhaps be looked at in a broader sense. Subject to that, there are difficulties. One cannot go too public because for a variety of reasons various people may be approached and not want to accept the position. I think it would be unfortunate if their names became known and somebody realised that they were not necessarily the first choice. The difficulty is that nobody knows anything at all about the whole process. The word that has been used is “opaque”. There is no information or attempt to give any specification about what is wanted. How the Chancellor and Treasury go about obtaining names and what the role of the Governor of the Bank is in this is simply unknown.

Q166 Mr Gauke: How much do you think that is to do with the structure of the arrangements about appointments and how much of it might be more to do with the individual personalities involved?

Professor Goodhart: I do not really know the answer to that. If my colleagues are better able to answer it I would be very happy.

Dr Wadhwani: There has been a lot of criticism about the appointments process, but when I think back to 1997 and the introduction of the independent Bank of England and it was explained that the external members would be technocrats—indeed, the first crop were—I remember having a fear that over time that would be eroded and one would have increasingly overt political appointments. That has not happened. One should congratulate the Chancellor or Government for the fact that that did not happen. It may be that over time that will not prove to be resilient. A different Chancellor may act differently and that may be the justification for changing the process.

Dr Julius: In my view the process has not been very professional. It is known that these are three-year terms and so it is public knowledge well in advance who is coming to the end of the term. In most organisations when you know that you will be losing someone in a year or so you begin to figure out the specification for the kind of individual you want to replace that person. Possibly you will hire head-hunters, go out yourself or look internally to find that person. How to replace someone in a structured, organised way is not rocket science. I think that it would be easily possible to do that also for an MPC member. I suggest in my evidence that at least six months before someone’s term is coming to an end there should be a conversation between that individual and the Chancellor, or whoever he designates, on both sides about whether or not that person should go for a second term and it should be agreed. If that person is not to stay on, or it is the end of the second term, there should be a published specification for the kind of expertise that would be sought, because one does not want one uniform external member. One might want an academic depending on who else was on the committee; one might want a business person or a forecaster or modeller; one might want a City person. One wants a diverse committee that has the ability to look at the economy from different dimensions. Based on that published specification, which this Committee could well review or have an input into—because it should be an open specification—the process should take place to find the person. I do not support using the Nolan process as suggested by Stephen Nickell. Because it is such a narrow specification and one is looking for a rather technical person one is more likely to
find such an individual if it is a confidential process. That could take place very easily. When the person is presented to this Committee it will be able to look at the specification on the one hand and the person on the other and make its own judgment as to whether the individual is appropriate.

Q167 Mr Gauke: It has been suggested to this Committee that there should be some formal report from external MPC members annually. Does that find favour with you? Do you believe that there is a need for more to be done to allow external members to express their personal views?

Ms Bell: I believe that a lot more can be done within the current structure. I see no reason why the votes should not be published when the decision is made, although it would be harder at that early stage to have accompanying explanations. There have been times when the market would have benefited from knowing it was a close vote as opposed to a unanimous one. That sort of information can be given. I would be against members turning up at the policy meetings with a prepared text feeling that they would be quoted verbatim in the minutes, because it would make it a much more stilted and a less dynamic discussion. As a result the decision might be less good, but I see no reason why when you get to the minutes meeting and the immediate policy decision paragraphs are being written individual views cannot be identified by name. Occasionally, if someone is in a minority of one it is quite clear what his or her views are but if it is more than one person it may be helpful to start to break down who said what. Perhaps where there is a divergence of view in the Inflation Report that could also be brought out a little more. I think that it is then the job of this Committee to be a bit stronger in eliciting individual views.

Professor Goodhart: We are much more individual at the MPC than any other equivalent central bank. The ECB does everything by consensus and in America the FOMC very rarely dissents from what the chairman indicates. The criticism in most other countries is that the UK is far too individualist and as the chairman indicates. The criticism in most other countries is that the UK is far too individualist and to ask for much more at this stage is probably going too far. It has been suggested to this Committee that there should be some formal report from external MPC members annually. Does that find favour with you? Do you believe that there is a need for more to be done to allow external members to express their personal views?

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Q168 Chairman: Dr Wadhwani, were you consensual?

Dr Wadhwani: I was collegiate.

Q169 Mr Gauke: Is there a consensus that you are all individuals in your own right?

Professor Goodhart: Absolutely.

Q170 Mr Breed: I turn briefly to house prices and household debt which come up on a number of occasions in our discussions. To what extent is it right to characterise the rise in house prices and household debt as two sides of the same coin which have been caused for so many years by the generally low level of interest rates within the economy?

Ms Bell: One certainly could characterise it in that way. The job of the MPC is to understand what is going on, but the role is to target inflation so these things should be taken into account only insofar as they affect the forecast and outlook for inflation. I disagree with some other members of the panel about the time horizon over which that should be looked at. If issues such as debt and house prices start to affect the monetary transmission mechanism that is something that needs to be taken into account. Perhaps one of the downsides to the incredible success of the Monetary Policy Committee is that there is a feeling out there that it has done well with inflation and perhaps a few more targets should be thrown at it to see if it can control everything. I believe that that misunderstands the nature of monetary policy and how really narrow it is. I think that the best job the MPC can do is to focus very precisely on achieving exactly the target that has been set for it and not try to stabilise asset prices as well.

Dr Julius: I believe that the issue of house prices in this country is mostly a supply side phenomenon. I am a fan of the Barker report and the finger that she points is to the planning system. Those are matters which the MPC has no competence or ability to influence.

Q171 Mr Breed: We should not worry about it at all?

Professor Goodhart: I am not entirely in accord with my two colleagues to my left. My view is that housing prices ought to be in the CPI and the fact they are not is a grave disadvantage. The problem as to how to include housing prices in the CPI is an extremely difficult one. Nobody has yet come to a consensual agreement about the right way to do it. There has been a great study in EUROSTAT about which of the alternatives is better. Since it cannot come to any agreement the simplest way out of it is not to include housing prices at all, which in my view means that the inflation measure in this country has been wrong. I entirely agree with Lord George and my colleagues that it is crucial the MPC should control a broad measure of inflation. I also agree that the fact the CPI is not best designed at the moment is a secondary issue. The MPC is doing a very good job and anyhow the index is the Chancellor’s choice, but I believe that one way or another housing prices ought to be in it. It is a major issue, because the question of what inflation is will vary quite a lot if housing prices move quite differently from the price of other goods and services, as they have very frequently over the past 10 years.
Q172 Mr Breed: I was quite interested in reading your evidence about contra-cyclical and pro-cyclical trends. I recall competition and credit controls in about 1970 when the bank took special deposits out of the banking system in order to reduce the money supply and act as a flywheel. All of that went out of the window and now everybody is lending money on houses left, right and centre, and I believe that that has contributed significantly to the overall increase. The amount of money available for house purchases is significantly greater than it was. To what extent is the fact that in the UK housing is such an important factor—perhaps more important than in many other countries—a problem in bringing house prices into the CPI? Is that situation unique to the UK economy as opposed to others?

Professor Goodhart: No, it is not. Everybody has difficulty with housing prices and I can think of at least three ways that one might try to include housing prices in the CPI. In different countries there are different approaches. It is a complicated, technical issue but a very important one.

Q173 Mr Breed: In your opinion could it be done? Dr Wadhwani: Even if you do not include housing in the CPI because you await resolution of some of the technical issues there is something that the MPC can and should do, in the sense that historically the major monetary policy mistakes—perhaps more important than in many other countries—a problem in bringing house prices into the CPI? Is that situation unique to the UK economy as opposed to others?

Professor Goodhart: It does take account of it in looking at the developments in the broad economy. Remember that household debt has also been matched by very considerable increases in household financial assets, but they are not held by the same households. The problem is that this is a distributional issue, and it can also be an important social issue. It does not necessarily play so much of a role in trying to maintain the inflation target overall. The Bank and also the FSA have been very careful to consider how far the debt issue may affect the stability of the financial system. You are all aware of sub-prime mortgages. Very considerable studies and stress tests have been made that have asked banks and building societies what might happen if house prices suddenly came down and people were unable to pay their debt.

The general result of those tests has been that it would not affect the British financial system very much but it could have serious adverse effects on some people who got in over their heads.

Q175 Mr Breed: It is not a new phenomenon. I remember so many years ago the secondary banking crisis and things called lifeboats and so on. There does not seem to be anything new in this. Is the level of household debt a concern of the bank?

Dr Wadhwani: Broadly, I agree with virtually everything that Professor Goodhart said on that subject so I will not repeat it. The only small qualification is that what we are seeing in the US currently may be quite illuminating for us. The consensual view is that the sub-prime mortgage problem is confined to the poorer sections of society; it is a distributional issue and it will not have wide macro-repercussions. That belief is about to be tested and we will have to wait and see.

Dr Julius: It is also relevant that much of that segment of the market is not an element to which commercial banks—the basic financial institutions in this economy, or indeed the US economy—are exposed. That is the reason they sell prime mortgages. Although the risk has been spread in the economy when the banking system is profitable and in pretty good shape the issue of household debt is not nearly as big a concern as it would be if the banking system was also marginal.

Mr Breed: Those who have the assets may have the ability to service the underlying debt; those who do not have assets may not have that ability.

Q176 Chairman: Before we finish perhaps I may ask each of the witnesses for their views on the next 10 years, because that is part of our inquiry. What is the one thing that should be done in the next 10 years, or what message do you think we should be considering for the next 10 years?

Professor Goodhart: Do not get too worried if the economy does not behave as well in the next 10 years as in the past. We have to recognise that we have been living in a golden age, but it is really too good to last. Do not let your expectations get too high.

Dr Wadhwani: Again, I agree with Professor Goodhart. The only other comment is that I hope in the next 10 years the MPC becomes more confident in some sense. In the past 10 years as it has felt its way there has been a reluctance to project forward some of the supply side benefits that it has begun to see in its forecasts. I think that that has led it to be too cautious in terms of setting policy. I hope that it does not repeat that in the next 10 years.

Dr Julius: I am more optimistic about the next 10 years. Nonetheless, I think that it is very important that the excellent structure we now have for monetary policy in this country is continually monitored by this Committee, the press and others to ensure that the calibre of the people who make the decisions within that structure remains high and

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that individual accountability, equality through the voting system and the competence of all members of the MPC is retained.

Ms Bell: The next 10 years will undoubtedly be different from the past 10 years and I do not think we can guess at what the shocks might be. I believe that the framework is a good one and the MPC ought to be able to continue to do pretty well, although it would be nice to have the odd letter. As to confidence, which Dr Wadhwa mentioned, it may need to continue the battle on the importance of low inflation. Professor Goodhart said earlier that a lot of people did not remember the problem of inflation in the past, and I do not believe that we should become too relaxed in believing that the importance of maintaining a stable monetary framework is accepted widely.

Those areas of communication and continuing to build a consensus for low inflation are matters that might have to be strengthened and built upon over the next decade.

Chairman: We have lots of written evidence for which we thank you. As I went through it, I have good news for one of you. Mr Austin Mitchell wrote to us to say that soon after the MPC was established, as MP for Grimsby, he invited the Governor and the members to Grimsby to see the real problems in the world. That invitation was declined but to her great credit DeAnne Julius came and was impressed and influenced by what local business told us. Dr Julius, I am sure you are popular everywhere, but you are really popular in Grimsby. I thank the witnesses for their time and evidence.
Tuesday 24 April 2007

Members present:

John McFall, in the Chair

Angela Eagle
Mr Michael Fallon
Mr David Gauke
Ms Sally Keeble

Kerry McCarthy
Mr George Mudie
Peter Viggers

Witnesses: Ms Kate Barker, External member of the Monetary Policy Committee, Professor David Blanchflower, External member of the Monetary Policy Committee, Dr Andrew Sentance, External member of the Monetary Policy Committee and Professor Tim Besley, External member of the Monetary Policy Committee, gave evidence.

Q177 Chairman: Good morning and welcome to this evidence session on the MPC ten years on. For the shorthand writer can you introduce yourselves please, starting with Professor Besley?

Professor Besley: My name is Tim Besley and I am an External member of the Bank of England Monetary Policy Committee.

Professor Blanchflower: David Blanchflower, also an External member of the MPC.

Ms Barker: Kate Barker, External member of the MPC.

Dr Sentance: Andrew Sentance, External member of the MPC.

Q178 Chairman: Good morning everyone and can I start by congratulating Kate on her reappointment as a MPC member.

Ms Barker: Thank you.

Q179 Chairman: You have our congratulations. Can I ask you a question as a result of that. How important do you think the role of the external members of the MPC body has been, and maybe in particular your contribution?

Ms Barker: Having external members on the Committee is extremely important because it has been clear to me in the time I have been on the Committee—and I have obviously been able to observe a number of other external members—that a fresh appointment frequently brings some different views and some different thinking. The other advantage of it is that it enables the Chancellor to draw on people from a range of backgrounds, and in particular it enables him to add financial markets experience to the panel or, of course, business experience. In the course of time I have been on the Committee I have done two reports for the Government on both housing and planning, the first of which in particular has enriched my understanding of the housing market. I have been able to bring quite a lot of that back to the Committee. The other role which I have tried to play is on communication. I have been a very assiduous visitor of the regions, talking to business audiences and engaging business audiences and also wider audiences. I am always keen to engage wider audiences with an understanding of what the Committee does.

Q180 Chairman: In terms of your review of housing I think one former civil servant mentioned that these were what you would call “celebrity” reviews by the Chancellor. First of all, would you agree with that comment and, secondly, how useful has it been given that you have undertaken one of those reviews for the Chancellor?

Ms Barker: Useless for the Committee do you mean, or useful more generally? I was rather startled to hear myself described as a celebrity, which I would have thought was rather unlikely. The reason for having independent reviews, a little bit like the reason I suppose for drawing in management consultants, is that you want to have some independent mind when there is disagreement between different people in government or when you want to bring someone in to take a good, hard look at the evidence. One of the things I think that is important when you are doing independent reviews is the interim report stage when you lay a lot of evidence out for public debate, and in some sense because you are independent that can be done very openly. It is a little bit more difficult sometimes for government, who after all has been involved in setting the policy that is concerned, to lay it out in such an open and honest way. I think that is the contribution that external reviewers of a subject can make. They come to it with genuinely fresh eyes.

Q181 Chairman: Good but like management consultants you do not want too many, do you?

Ms Barker: When you are working in a company you certainly do not want too many. The Treasury has of course run a number of reviews. They are running rather fewer at the moment. Last year of course the reviews that were run were on related topics. It made quite a lot of sense to run my review alongside the Eddington, Leitch and indeed Lyons Reviews. Personally I think the four independent reviews there added up to a big body of work. I look forward to the Government taking it forward.
Q182 Chairman: Good. As we know, the Governor wrote a letter to the Chancellor last week because inflation is above 3%. This session is nothing to do with that. We do that business in the Inflation Report when the Governor and the rest of the MPC Committee come before us. Maybe one question that arises from that is the issue of low inflation and the need to cement low inflation. Does the Bank have more to do to convince people about low inflation and the fact that it is non-negotiable?

Professor Besley: Obviously when you say there is more to do it is an on-going challenge for us, particularly at this time when CPI inflation is running at 3.1% and RPI inflation at 4.8%. I think a very central part of the success of the monetary regime we have had is the way it has anchored inflation expectations around the target. If we were in danger of losing that anchoring that would of course be deeply problematic. I do not believe at this point that we are and I think it is going to be critical in the May Inflation Report for us to lay out our thinking about inflation going forward over the medium term and to see through what seems to be short-term level of volatility. I do not think personally think that there is more that we need to do beyond what we would be doing anyway, which is to convey our views clearly.

Professor Blanchflower: I agree with that. I think it is very important that we communicate our views to the general public and make it clear that we are going to contain inflation. Clearly there has been some degree of volatility recently and I think that is some of the story that Tim has talked about. Going forward we obviously need to communicate what our strategy is and that we will do everything we can to keep the inflation rate down.

Q183 Chairman: Kate, you have made comments.

Ms Barker: In terms of doing more to convince the public, one of the things that I have looked at over the time I have been on the Committee is the responses to the Bank’s survey in terms of people’s knowledge about who sets interest rates and how the whole process works. It is perhaps a little bit disappointing that we have not seen a greater growth of knowledge from the public. Those percentages have not risen very much during the time that the MPC has been around, so the work that the Bank has been doing is important, particularly with young people. We of course run a schools competition, we have also prepared quite a lot of material for schools, so certainly at the younger end of the audience we are doing quite a lot to communicate, but obviously that leaves a lot of people we do not get to. One thing I would say about the Bank’s agents—and we often talk about the work they do in the business community bringing information back to us—something we talk about a bit less is the amount of time they will spend talking to different groups such as Women’s Institutes and other groups of people who meet who look for speakers. The Bank’s agents are good speakers on our behalf and they are very good about helping to spread the message more widely. But I am concerned we still have more to do there.

Dr. Sentance: In my view the most important thing for anchoring expectations is people’s experience of inflation. I think the fact that since 1992 we have had a long period of low inflation has been a great benefit in the current framework. I think the longer that inflation remains above the target the more there is the risk that that does begin to affect people’s expectations, so I think, as the Governor’s letter indicated, the expectation that inflation returns to target quite quickly is quite important in this context.

Q184 Chairman: On the issue of the Governor’s letter how are you as external members involved in the letter writing process and do you feel your views were adequately represented?

Professor Besley: Yes.

Professor Blanchflower: Yes.

Dr Sentance: We participated fully in the drafting process.

Q185 Chairman: And you had adequate discussion?

Dr Sentance: Obviously there was a limited time available, but, yes, we met together as a Committee and had an opportunity to give a further round of comments.

Professor Blanchflower: We have met in the past to talk about what would happen if this occurred, so we have planned it and prepared for such an eventuality and talked about it in the past as well.

Q186 Chairman: We did question some former members of the MPC and they felt it would have been good if they had been involved in the letter writing process so it must have been quite good for you, was it not?

Ms Barker: Yes.

Chairman: Kerry?

Q187 Kerry McCarthy: Can I ask about the housing market. One of the banks that gave written evidence to us said that they felt the MPC’s decision to downplay the role of the housing market has gone too far. Do you agree with that or would you agree with the analysis in the first place that the MPC has made that decision?

Dr Sentance: I am not conscious that we have made that decision. We are following the housing market because experience has taught us that housing market developments, while they do not necessarily cause broader demand conditions to change in the economy, are often associated with changes in demand conditions. Factors like income expectations and interest rates affect both the housing market and broader consumption decisions which is the biggest element of demand. So I think if you look at the Inflation Report and the communications in the minutes, you will see there is still a considerable amount of discussion about housing market developments. I think the sense in which we are maybe down-playing it is we are not reacting to every minor movement in the housing market by changing interest rates. Certainly to my mind, looking at the demand
conditions that we have seen changing in the UK economy over the last year, the fact that the housing market picked up strongly has been a very important signal that demand had picked up. 

Ms Barker: It is true that we had a discussion a little while ago, I cannot remember exactly when it was, when house prices were rising very strongly, about the relationship in the model between house prices and consumption. Of course it is a matter of some dispute whether or not rising house prices really add to consumption directly or whether they only do so through their role in terms of giving people more collateral to borrow against. The conclusion we drew then was that if you looked back at the historical tie between house price and consumption, a lot of that had been driven by the fact that previous periods of strong house prices were linked with strong periods of rising income expectations and that that was what had led consumption to rise more strongly in those previous periods. The rise in house prices that we have seen over the few years has not been so strongly linked with rising long-term income expectations, it has been linked rather more with the big fall that we have seen in long-term real interest rates, and to some extent with the restrictions of supply in the housing market relative to demand. In those circumstances, it seemed to us more likely that the link between house prices and consumption would not be so strong so we took the decision to reduce that a little bit in our thinking. Subsequent experience with continued rising house prices and continued growth of consumption has not led us to need to go back and retake that judgment, so I feel that was the right judgment, I do not feel we are downplaying it relative to what empirically seems to be going on.

Q188 Kerry McCarthy: Would you say that the rise in household debt is the other side of the same coin as the rise in house prices, which are both linked to the low level of interest rates? Is that something that you would take in tandem when you are making decisions? 

Ms Barker: The rise in long-term debt clearly is linked to the rise in house prices. The Bank published a study on this, again around the same time, pointing out that as house prices rose you would of course expect, as different cohorts moved into the mortgage market, rising long-term debt, and I think that is added to by increasing evidence that parents of course are borrowing against their houses in order to fund their children’s mortgages, so both those things you would expect to be linked to a rising level of secured debt, and to the extent house prices prove to be sustainable in the long run I do not think that is a matter for concern. The concern on debt has always been much more the rise in unsecured debt, where we are aware—and I do not think it is a big concern to monetary policy but it is certainly a big concern more generally—that there are a number of households which have unsustainably high levels of unsecured debt and that of course has led to the difficulties we have seen. However, it has not led to difficulties in monetary policy and the consumer has obviously gone on spending, because although this is personally very difficult for those individuals there are not so many of them that it has actually so far sent the economy off track.

Q189 Kerry McCarthy: We are here to look at 10 years of the Committee. On a historical level, the perception now that investing in property is the safe bet and the increased number of people that are entering the buy-to-let mortgage market and building property portfolios; is that a major factor or is it a small, fairly insignificant factor in terms of looking at both people taking on more debt by borrowing to buy these properties but also the impact on house prices? 

Ms Barker: It is not surprising in a period where you have got falling long real rates to see asset prices rise because of course that changes the fundamental valuation of those asset prices, a point that has been made particularly in speeches by Steve Nickell and I have also made that point in speeches I have given. To some extent of course, this creates difficulties for the housing market but it is not necessarily a concern for monetary policy. There is a real question about how influential the role of buy-to-let has been in pushing up prices. It obviously has pushed them up a little bit. Whether or not this is a bad thing this is not the place to discuss and whether or not this is a bad thing for the market as a whole is difficult it say. It has, after all, opened up a lot of private rental opportunities. We used to argue in the UK that not having a good private rental market was a bad thing because it reduced labour mobility so there are good sides to that coin as well.

Q190 Kerry McCarthy: In terms of setting rates you have already talked about the rise in personal debt. How big a factor is that and is that something that has increased over the various periods on the Committee?

Dr Sentence: It is difficult for me to comment on the period of the Committee as a short-serving member, but I think—

Q191 Kerry McCarthy: I suppose I am interested in how do you decide which factors become more important over given periods?

Dr Sentence: One of the key things at the moment particularly has been tracking the change in demand conditions in the economy over the last year. It is quite clear that demand conditions did change from the end of 2005 when demand appeared to be much weaker. Consumer spending is the biggest element of demand and these factors like household debt all can have a bearing on consumer spending, so we are interested in building up—certainly I am interested in building up a picture of what is happening to the consumer as one of the big drivers in demand. That is the sense in which we look at it, as something that feeds into demand pressures in the UK economy, or certainly in my case.

Kerry McCarthy: Thank you.
Q192 Mr Gauke: Can I turn to the question of monetary aggregates. Dr Sentance and Miss Barker have previously given evidence to this Committee specifically on that point but can I ask Professors Besley and Blanchflower how much weight you place on monetary aggregates?

Professor Besley: Personally I regard the growth in monetary aggregates that we have seen since 2004 as potentially creating an upside risk to inflation going forward, but I would class that as a risk because there is a variety of things that have been going on in terms of where money balances have been accumulated and the extent to which they will ultimately or could ultimately spill over into demand side pressures in the economy and therefore lead to a different nominal path which leads to higher inflation. I think that is something that we do not understand particularly well empirically. The Bank is engaged in a significant and I think excellent project to really get to the bottom of what is going on as an empirical matter, but to my mind it is something that we as a Committee cannot simply ignore, and if you look at our minutes, at least in the period I have been a member of the Committee, it is a factor that we cite regularly as imposing upside risk. Let me make clear that one has to join it up with what is going on in credit and asset markets more generally. I think it would be a mistake to simply view this as a phenomenon that is entirely about some simplistic story of if you have an elevated money stock that implies you are going to have higher inflation down the line. I think we have to see it in the context of the portfolios that people are holding and choosing to hold money alongside other assets, asset prices have changed to reflect that, so I think one has to have a joined-up view of all of this. I do not want my views to be misrepresented as saying that somehow there is an inevitable monetarist logic to this because I do not think that is true, but it is a cause of concern to me personally.

Professor Blanchflower: I think I would say the same thing that it is a cause of concern. Perhaps I am rather more sanguine than Tim is about what the growth in monetary aggregates actually means.

Q193 Mr Gauke: You are described as “disdainful” of monetary aggregates.

Professor Blanchflower: I have no idea where that came from. Nobody actually interviewed me about it. I did not actually say such a thing. I am not disdainful at all. I have perhaps less of an upside concern than Tim does. Certainly it seems to me if you look at some of the household balances, that has not changed to the degree that the overall aggregate has, and the velocity of circulation appears to have come down as well. The holdings by other financial corporations are a concern. I take Tim’s view that it is a concern but I certainly would not take the view that I was disdainful. I think if you look back in history the relationship between these money aggregates and other macro phenomena have been somewhat variable over time so I am an empiricist. I share Tim’s view that there is an upside risk but in my view the jury is still out on what the relationships are. I would certainly not say that I was disdainful. I have somewhat less of a concern than Tim has but it is a reasonable argument.

Q194 Mr Gauke: Would it be fair to say that the more concerned about monetary aggregates an individual MPC member is at this precise moment the more likely that member is to be hawkish? Is that a fair comment? Dr Sentance and Professor Besley have both been relatively hawkish of late. Professor Blanchflower, you are seen as somewhat of a dove. Is that a fair characterisation?

Dr Sentance: I was going to come in as someone you might be referring to as being hawkish. In my mind I see it very much as Tim has said, there is a risk there, and you put that risk into the mix with all the other factors. The other factors that are weighing heavily with me have been that we saw quite a change around demand conditions and previous experience has shown that when demand begins to pick up sometimes all the statistics do not properly reflect that. We saw in the late 1980s and the late 1990s that when the conventional National Accounts Statistics were underplaying the growth in demand in the economy then we did have rapid monetary growth as well, and so it might have been telling us something about the strength and durability of that demand. The other issue that I have been looking very closely at is the business surveys, which have generally been very positive, and particularly business surveys of price expectations. Given that our prime objective is to control inflation, the signal that has provided about the pricing climate and linking that to other demand pressures is one of the big worries that I have had over the last six months or so.

Q195 Mr Gauke: Ms Barker, you will be aware of the criticism reported today from Professor Charles Goodhart, Tim Congdon and Gordon Pepper of the MPC of not placing sufficient weight on monetary aggregates. Do you feel that a failure to do that in 2005 may be one of the reasons why inflation is now at a relatively high level?

Ms Barker: I think it is always very difficult, when you are in the middle of something, to disentangle exactly what has driven it, but I am not sure that I would draw that conclusion. If you think back to the factors that have been driving inflation up, we of course know that one of the main things that has driven inflation so far away from target in the short term is the move upwards in energy prices which I do not think was very much related to monetary aggregates. However I think it is quite right to say that beyond that demand growth has turned out to be rather stronger than we anticipated. Whether that is due to the influence of the monetary aggregates or whether it is due to other things—the greater buoyancy of employment and migration in the economy—is pretty difficult to disentangle. but the main point I would make is that stripping out the energy prices, the move of inflation away from target at the moment is not quite so impressive.
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Q196 Mr Gauke: Can I just move on very briefly to the relationship between monetary policy and fiscal policy. How important is that relationship and how important is the Government’s fiscal policy in determining the level of interest rate that you need to set?

Dr Sentance: We are helped by the fact that the Government has some medium-term fiscal rules, and I think we noted in the submission that the Bank of England put in as written evidence to this Committee that that helps to provide a more stable background. I am not conscious that fiscal policy has been a major factor swinging around demand over the recent few months. In terms of feeding it into our forecasts, I think probably the main thing we have been trying to factor in is some of the restraint that the Government is now putting on the expenditure side in its spending plans. There has been some upward drift in the effective tax rate. We try and take into account, as I have observed it, the outlook for fiscal policy, but I would not say it has been a major swing factor causing us to change judgments over the period that I have been on the Committee.

Q197 Mr Gauke: Ms Barker, obviously you have been there longer. Did the fiscal loosening from 2002 onwards have much of an impact on monetary policy?

Ms Barker: Of course, we take into account in our decisions the demand impacts of the change in fiscal policy and you will know from previous evidence sessions that we have done some work on how we interpret government spending, and how government use of resources feeds into the economy and adds to demand pressure. So to that extent of course it was an influence in the decisions we took because it influenced the demand relative to supply, and that is the way in which you would expect us to take it into account. The other way in which you might take fiscal policy into account is if you had a wider concern about sustainability—and of course that concern has not arisen.

Q198 Mr Gauke: Would you agree with the NIESR that interest rates were higher than they would otherwise have been because of that fiscal loosening in 2002?

Ms Barker: It is always very difficult to go back and say what would have happened because of course if we had not had the growth of government spending and the change in fiscal policy in that sense the pattern of growth elsewhere in the economy might have been a little bit different. It is possible that if we had not had the fiscal loosening that interest rates would have been different but of course that would not necessarily mean that growth would have been any different. Interest rates would have been lower precisely because growth was a little bit lower and the balance of demand in the economy would have been different. That of course is a matter, I think rightly, for the Chancellor to decide.

Q199 Angela Eagle: We have a symmetric inflation target but in the period in which the MPC has been in existence we have shifted the definition of inflation from RPI to CPI. Has it caused confusion that the definition of the inflation target has shifted?

Professor Besley: Only one of our number was on the Committee at the time so it becomes slightly awkward.

Q200 Angela Eagle: I would hope that members of the MPC would be able to analyse the difference between the different methods of measuring but I am thinking in a wider context as well.

Dr Sentance: There is no doubt, viewed in that wider context, that one would hope now for a stable inflation target going forward because our job would inevitably be made more difficult by the extent to which the target is moved around, either in terms of the way it is measured or in terms of the target itself. So I would say that looking forward I am hoping that there will be stability which will make it more straightforward for the Monetary Policy Committee to do its job of reaching that target. As for the specific episode, it was anticipated, as I understood, and there was a certain amount of analysis done to smooth the transition, so I am sure that was helpful to members of the Committee at the time knowing it was coming and being able to take the necessary steps to make a smooth transition but, as I say, only one of our number knows what it was like to experience such a transition.

Ms Barker: Because we knew it was coming and the nature of the gap between the two measures at the time, there was not any great difficulty in smoothing the transition between one or the other, but I take it that to some extent your question is about whether in the public mind the CPI commands much attention now. In some sense of course I would argue, as a lot of economists would, that the CPI is a better measure of inflation and the way in which it allows for substitution between goods as their relative prices change makes it a better measure of inflation in that sense. It also covers some products that the RPI did not cover. Nevertheless of course it does not include housing costs which are very significant and there are questions around that, and that means that when people are coming to the wage bargaining, which of course is important to us, they will look at other—

Q201 Angela Eagle: They use RPI. do they not?

Ms Barker: They always start off with using RPI.

Q202 Angela Eagle: They use the highest.

Ms Barker: But if you look at what has been happening to settlements recently, they have not increased anything like as much as RPI or indeed as RPIX have increased, so the idea that that feeds through mechanically is not right. What it does mean of course is that we have to pay—

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Q203 Angela Eagle: I was not saying it might feed through mechanically. I was saying is it causing confusion? There is no evidence yet that wage bargaining is pushing inflation because RPI is higher than CPI, but is it causing confusion and perhaps should there be a shift in wage bargaining to CPI measures rather than RPI measures?

Professor Blanchflower: In some sense we are not seeing pay automatically linked to these measures so much as we have in the past. In some sense the settlements themselves are coming out related to what inflation is, I guess, in the longer term, so I do not think there is evidence that lots of pay settlements over time are directly linked to those measures or that because the trend has been up (because I think the trend is generally downwards) there are direct links to those measures. I take the point that Kate made that probably there is more confusion in the public’s mind with this multitude of measures and the various ways of calculating your own inflation.

Q204 Angela Eagle: There is an older person’s inflation rate now, is there not, there is a whole burgeoning of inflation rates. You seem to be able to pick your own these days.

Professor Blanchflower: You can literally, can you not, because you can go to the web sites and do so, so there is some confusion.

Ms Barker: Can I come back on this question of wage bargaining because in some senses in the long run what you think of as determining wage growth in the economy is of course productivity, not how inflation is measured, and so moving from measuring inflation one particular way to another you would not expect to have had a big impact on wage bargaining. I hate to refer to yet another speech by Steve Nickell but he did give a very good speech setting this out and explaining what you might expect the impact on wage bargaining in the long run to be. I do not think it is particularly important that wage bargainers change their habits but I think it is helpful if, like us, they look at the different measures of inflation and have some understanding of the differences between them.

Q205 Angela Eagle: Can I ask as independent members is there a tension between the people with business experience and the academic theoreticians?

Professor Blanchflower: I would object to the term “theoreticians”.

Q206 Angela Eagle: The modellers, the thinkers?

Professor Blanchflower: No, I will not accept that characterisation but I am happy to answer the question. I think the great strength of this Committee is having a diversity of views and experiences. I think the externals bring that. We each have different backgrounds and experiences. I do not see them as a contradiction. What is the famous phrase “You put six economists together and you get nine opinions”. We have put nine economists together—

Q207 Angela Eagle: At least.

Professor Blanchflower: So I do not think there is a tension. It is a discussion amongst nine people. I value the discussion. Personally I do not find it a tension, I find it is something I have been used to over the years and there are many different ways to skin a cat. I personally do not see it as a tension. I cannot tell you what the others say but I find their contributions valuable.

Q208 Angela Eagle: What do the business experts say?

Dr Sentance: Kate has more experience than me but what I have observed on the Committee is that differences of judgment that emerge are not so much associated with pigeonholing someone into a category, whether it is academic versus business or internal versus external—

Q209 Angela Eagle: —I was going to ask about that next.

Dr Sentance: —But more differences of judgement in looking at the whole experience that people have had in their careers. I agree with the general observation that it is good to have a diverse range of experience. I do think that people with a business background bring something to the Committee in terms of both understanding how businesses are reacting to things and also looking at some of the survey indicators that are actually quite important in tracking the economy.

Q210 Angela Eagle: Is there an obvious difference between internal and external appointments? I will ask them too so that we get an asymmetrical or symmetrical view.

Professor Besley: At some level that has already been brought out. There is as much diversity of opinion about where things have been going in the recent past on this panel—as you would find on any similar panel. If you look at the debates that we have and the discussions and the different positions people take, I do not think they correlate at all well at the moment with internal and external.

Q211 Angela Eagle: Kate Barker, you have probably been the longest serving of the people before us at the moment, how long do you think it takes the external members to get institutionalised by the process? Is it in danger of happening to you?

Ms Barker: I wondered when you asked that question whether you were going to ask how long it took people to get up to speed because a different comment I would make is that when you start on the Committee there is a great deal to think about and, as it were, to catch up on. There is an acquis in Bank thinking which people need to know about and perhaps this comes back to the question of how much time people should spend on Committee work. I am pretty confident I have not become institutionalised. I do not feel like a long-term Bank employee. I continue to do some things outside the Bank. I am at the moment a board member of the Housing Corporation for example and I hope that
enables me to continue to bring something into the Bank. I think all of us as a Committee try quite hard to fight against institutionalisation more generally. We have in fact over the last few months been doing some thinking about how we could improve the way in which we tackle the forecast process. That is absolutely vital. It is true that when you get new people on they help you to think about that because they say, “Why are you doing this?” A level of turnover on the Committee alongside some continuity is very useful. I am not sure anybody is particularly institutionalised, even the Bank people.

Q212 Angela Eagle: The system has worked very well to date in terms of its outcomes. Do any of you think it needs to be changed at all or are you pretty happy with the way that it is panning out in practice?

Professor Blanchflower: We have pondered long and hard on a number of possible alternatives. I suppose my response would be that I think we have done pretty well. The system ain’t broke and there is probably not much fixing to be done, except perhaps at the edges and we can think about a number of issues, but in general I think the framework is a very good one. If change is going to come it may come at the edges, but fundamentally I think it has been very successful. That is my view but I would be interested to hear what others have to say.

Q213 Angela Eagle: So that is a tweak rather than anything radical. Is that the general view, perhaps a bit of tweaking at the edges but nothing radical.

Dr Sentance: The thing that has struck me on regional visits that I have done as an MPC member and through the process of joining the Committee is that there is a lot of credibility around the Committee in terms of the inflation performance being achieved, and if you go out and meet business people generally they are satisfied that the arrangements put in place have worked reasonably well. I think that should create a predisposition against changing unless real changes are seen to be needed. We are not necessarily the best people to judge but you are hearing a range of evidence from different people and I do not think the Committee should rule out recommending changes. In a sense we have to work with the existing arrangements because they are in place and we adapt to them and from my point of view they are quite workable.

Professor Besley: A couple of comments on this, one is I think the process has been a dynamically evolving process from the start. I do not think it would be fair to call it a static process. We hear as members of the Committee and I am sure you have heard of the variety of changes that have already been implemented over the life of the Committee. It may now have reached a steady state. Right now we are re-thinking the forecast process because we wonder whether that needs a new lease of life, so the Committee does have a natural dynamic within it. The other thing I would mention of course where I get a sense of most public disquiet is around the appointments process. It is clear that that is something which by popular acclaimation in a way has been raised as an issue that people are concerned about. Obviously if there is one issue that comes out of what we hear it is that there is a concern about that issue.

Q214 Mr Fallon: Kate Barker, there was a lot of advance spin about the letter writing that this should not be seen as any kind of admission of failure but rather as more of a routine event that is bound to happen from time to time. If the letter writing is routine what is the point of it?

Ms Barker: I think the point of letter writing—and of course in a sense it is a question for the Treasury who devised the system—is that obviously when inflation has moved quite a long way away from target there must be a question that comes up in people’s mind about credibility and about whether or not the Committee has been behaving in an appropriate way. The letter writing offers an opportunity for the Committee (and although the letters are written by the Governor as we have already said the whole Committee talks about them) to set out on the day that the inflation rate comes out, and we would repeat it if the inflation rate stayed away from target for a period, exactly what the rationale is for the decisions it has taken, the way in which perhaps things have not evolved quite as expected when those decisions were taken and in some general sense how we would propose to tackle it. That then affords the Treasury an opportunity to write back and of course in that sense it could raise any concerns. It is quite right if there were going to be any concerns raised they should be raised in a public way rather than privately. That I think is the function. It is to ensure that there is some sort of public accountability to the population that when things have moved away from target we discuss them openly.

Q215 Mr Fallon: So it is an attempt to restore credibility that has somehow been damaged?

Ms Barker: I do not think it is an attempt to restore credibility. I would not think if you look at the way in which inflation expectations have been developing over the past year or so that there has been any great change in credibility and I think the reason for that, as I set out in one of the earlier answers, is that of course one of the key reasons behind the upward move of inflation is the rise in energy prices. If you look back at the remit and the reason that this was discussed in advance, and I think rightly discussed in advance to try and give it some context, it is very clear from the remit of the Committee that one of the things the Treasury is worried about is that if you stuck too hard to keeping inflation at target at all times and you had a shock such as the energy price shock and very rapid rises in inflation rates, to cut out the first round effects of that would have caused unnecessary output volatility, and of course the letter is the opportunity to set that kind of argument out.
Q216 Mr Fallon: You are suggesting you have been too good at meeting the target over the last 10 years; is that right?
Ms Barker: No. I am suggesting that over the last 10 years we were perhaps fortunate in that we did not have an external shock of the size that led us to have to think actively about that kind of trade-off, and as everybody generally has said in commenting on the letter, given the experience of the previous 10 years, frankly that has been somewhat of a surprise.

Q217 Mr Fallon: You said in your first answer that it was an opportunity for the Chancellor to comment on your explanation. However, Ed Balls in his Oxford lecture in June 2001 said the open letter system allowed the approach to be explained by the MPC and “allows the Chancellor publicly to endorse it”. That is not quite what you said, is it?
Ms Barker: No it is not, but I would have to say the Chancellor did indeed endorse it. However, I would stick to the point I made that it would also allow him the opportunity to say something slightly different if he felt it was appropriate.

Q218 Mr Fallon: Because the obvious question is what would have happened if the Chancellor in his reply had disagreed with the MPC's assessment?
Ms Barker: You are raising here a very hypothetical question. I would hope that the Chancellor would never have occasion to disagree with the assessments that we have made, but we are always conscious that we are accountable to you in terms of our decisions and we are accountable to government and if it was thought appropriate for the Chancellor to make a comment perhaps he would do that.

Q219 Mr Fallon: I am just trying to confirm the purpose of a letter writing exercise where you expect the Chancellor simply to agree with you.
Ms Barker: I think that is why I have suggested it would not necessarily strike me as the case that he would on all occasions agree. I think the purpose of the letter writing exercise should not just be seen as something that happens between us and the Treasury, it is also part of our public accountability, so our accountability to you and as I say to the wider public.

Q220 Mr Fallon: I understand that. Can I turn to something that I think was forced on you by statute—and that is the number of meetings you have each year. You meet more often than the Federal Reserve and it has been suggested by Rachel Lomax in a discussion with this Committee that that makes our Committee rather fidgety in watching what is going on. We do not want to be seen to be asleep at the wheel so I take the view, as Andrew has done, that we are probably all right as we are.

Q221 Mr Fallon: Sorry to interrupt but that is provided for anyway in the statute.
Ms Barker: That is provided for anyway, so personally I would have thought it would be possible to move to eight times a year. You commented on the fact that it makes us fidgety. There is of course the opposite danger that, as it were, news can creep up on you because you look at it month by month, so we always have to be very careful when we are meeting not just to say what has happened over the last month but what has happened over the whole period since we last moved interest rates. I do not, I have to say, have a terribly strong view on this. Meeting every month I have found absolutely fine. It has enabled good thorough analysis of every month’s data but if you were to ask me would it be much worse or much better if we were to meet eight times a year, I have to say I do not have a terribly strong view either way.

Q222 Mr Fallon: Do any of the other three actually have a strong view on this?
Dr Sentance: I have a very strong view in favour of the status quo. I think from the point of view of the public having confidence in the Bank of England’s arrangements, the notion that we meet every month at the beginning of the month and they can see the pattern of meetings, they can see the interest rate decisions come out on a regular monthly cycle does help to build confidence. I have found the monthly cycle quite workable. It does head off the demand for emergency meetings because we are meeting with that frequency, as laid down in the Bank of England Act, so I find it difficult from my personal point of view to mount an argument which says we should meet less often. I would rather go to the public and say we are meeting every month to reassure them that we are on the case, we are reviewing the evidence as it comes up on the monthly cycle, and we will change interest rates or not as the case may be on that period.
Professor Blanchflower: I have the same view. I think the concern would be if we went to eight times a year the potential would be that something would come along and we would have to start to call emergency meetings, and that probably would not be good, so I think the benefit of having meetings every month are we are seen to be watching what is going on. We do not want to be seen to be asleep at the wheel so I take the view, as Andrew has done, that we are probably all right as we are.
Q223 Peter Viggers: For such a carefully planned and structured body the appointments procedure seems to be rather unprofessional, opaque and patchy. Are you as external members consulted about the appointment of other external members?
Professor Blanchflower: No.
Ms Barker: No.

Q224 Peter Viggers: Do you as a group either as four external members or perhaps as an MPC consider the balance of skills and experience on the MPC and do you have a view individually or collectively as to the kind of person who might be suitable for further appointment?
Professor Blanchflower: I take the view that diversity on that Committee is a good thing and that we would like to have people with different views from different walks of life. I think the one thing you would certainly want to see though is somebody with good experience and background in economics, not necessarily a PhD, but it is an economics intensive activity so I think good, solid training in economics, either from business or from academia, is a fundamental thing. You need diverse experience but you need to be able to understand the economic data.

Q225 Peter Viggers: Because you are the people who do the job, I wonder whether if you have either individually or collectively formed a view as to the kind of person who should be invited to fill a particular gap or do you just receive who is appointed?
Dr Sentance: Just observing the pattern over the last 10 years, there has been a mix of business, academic and financial experience brought onto the Committee and I think that is probably right, to try and keep that mix to those three elements. The extent to which you have individual backgrounds depends, I guess, on the availability of individuals. I think it should also depend on what might help to complement the internal members. We are not privy to the processes that the Chancellor goes through in selecting the members but my opinion would be keeping that balance on the externals between business, academic and financial experience would be a good thing.

Q226 Peter Viggers: Do you think that as external members you have anything to bring to the table, as it were, in terms of suggestions as to who might be suitable? Would you feel that it would be helpful for you to be able to express a view? Is there a mechanism for you to express a view about appointments?
Professor Besley: I would tend to take quite a strong view that as an independent external member I would not want to be involved in appointing other members to the Committee. Part of being independent as an external is being away from the job in hand which is trying to make the right policy decision. That is not to say I do not endorse the general views about what would make a good composition of the Committee but in particular as an external I think it would be inappropriate to be intimately involved in the appointments procedure.
Professor Blanchflower: I agree.

Q227 Peter Viggers: On the period of appointment, Ms Barker you have been reappointed but it is with effect from the end of next month so it is really quite short-term activity. Has there been any difficulty caused by a failure to make appointments when there have been shortfalls in appointments?
Ms Barker: I think the time at which people have expressed concern clearly relates to last year where of course there were two things that happened in quick succession. One of which was that Richard Lambert left the Committee unexpectedly and at quite short notice and secondly, of course, David Walton died tragically, and in those circumstances it was inevitable that there was going to be some kind of gap. I would make a wider point however. People often talk about the need to appoint people in advance, but of course one of the difficulties here—and we were discussing this—is that people come in from very different backgrounds. Academics, for example, might prefer quite a long period of notice before they join the Committee because they will have teaching commitments signed up and it is more difficult for them to move in short order. If you are appointing somebody from the financial sector however they will often have to move out of their job very quickly and it would suit them to have the appointment made much nearer. I think people from the business community would probably occupy an intermediate position. So the idea that there should be some timetable for appointments is theoretically attractive, but in practice it is actually quite difficult to see how it would work.

Q228 Peter Viggers: Do you individually think that the three-year renewable term is the correct one or would you support those commentators who have said that a rather longer term would be helpful?

Professor Blanchflower: For an academic it would be very difficult to accept a longer term. My university gave me three years’ leave. That is the first time anybody has been given a three-year leave and I think the chances of getting leave from a tenured job would be nil for a longer time period, so for an academic that would be a problem in that you would have to give up your endowed tenured chair so a longer time period for me would have been an issue.
Professor Besley: I am rather in favour of Steve Nickell’s suggestion of having a six-year appointment with a possible minimum of three where the option is on the side of the appointee, so that you could take the longer view that you were going to do it for six years but you could decide at the end of three whether in terms of your career it was the right decision to carry on or not. I think that was what Steve said in his written submission said and I thought that was a rather good idea.
Q229 Peter Viggers: Ms Barker, you would have an individual view on this?
Ms Barker: To some extent I would share the view that Tim has just expressed, that one of the difficulties again of fixed-term periods is that it is very difficult to find a period that does suit people from different backgrounds. David has set out very clearly why for an academic it is difficult to take on a long-term period. However, Andrew and I, both had to give up all our private sector work when we came to join the MPC, might well have found something that promised us longer than three years of job security rather more attractive because we do not automatically have positions to go back to in the way that academics do. So something where you had a minimum period that you agreed to do but the possibility of staying on for longer, provided of course you had not fallen foul of some of the provisions in the Act for the removal of members, seems to me more attractive. Something with some flexibility to meet a range of circumstances I think could be quite important. I said we saw last year some surprising circumstances and against that background I think some flexibility would be helpful.

Q230 Peter Viggers: Or would a full-time option also be attractive?
Ms Barker: For people who have had to give up the rest of their work, to some extent a full-time option is attractive. However, I have to say when I started doing this job I was doing it on a four-day a week basis. I hinted in an earlier answer that particularly at the beginning it is quite helpful to have more time to spend on it. As you move on with the job three days a week is certainly an adequate time to do it but then that does raise the question, given the limitations on what other activities MPC members can do, how they should pass the rest of that time.

Q231 Peter Viggers: Professor Blanchflower, I suppose I should give you the opportunity of responding to the suggestion that there has been diminished engagement by external members?
Professor Blanchflower: I have been fully engaged. I have made numerous regional visits. I think I will have done eight by the end of the year and numerous speeches. I have been fully engaged. I guess if you want to take it up you can speak to the Governor about it, but I have been fully engaged.

Q232 Peter Viggers: Can I ask please how you interrelate with the Court of the Bank of England? Do you have much contact with them? Do you find this productive? Have you any suggestions as to any structural changes that might be helpful in your relationship with the Court of the Bank?
Professor Besley: In the period I have been doing this I have attended two Court meetings, one Court lunch, a Court away day and a dinner to meet with the Court informally and I have also met Sir John Parker one-on-one, so it seems to me that the Court is at this point taking very seriously its job of settling in a new MPC member as I was, and checking that there are no issues that need to be dealt with. I have no complaint. I do not know about the other members.

Q233 Chairman: Kate, you mentioned earlier that you were thinking about the forecasting round. Are there any key issues that need to be addressed, that need changing?
Ms Barker: The conversation is to some extent an internal one. Actually I should say in the time that I have been on the Committee the forecasting round has been altered in the number of meetings and the way we have tackled those meetings, and the key thing that we are trying to achieve this time around is to try and maximise the opportunity for the members of the Committee to have as much conversation as possible about the economics of the issue rather than to have longer presentations from the staff. We are anxious to try and ensure that we are able to fully explore all the issues in the meetings and there are some rather tedious questions about the way in which we arrange the room to make sure that we get that high level of interaction.

Q234 Chairman: For the other members it might be a good question. How well have you been introduced to the economic modelling undertaken by the Bank? Is there greater scope for the Bank to release more information on the modelling process and the Inflation Report?
Dr Sentance: Certainly we are provided with an introduction to the model. I think, however, the job of producing an inflation forecast is not the same as the job of using the model. In my experience, a model is a tool and a forecast is a product of trying to bring all the available information to bear. I notice some of the comments from Professor Wren-Lewis who seemed to lay a greater emphasis on expertise in modelling with the external members. I am not sure that is quite right. I think some familiarity with forecasting, which I have in my background and I know Kate has, is helpful among the external members but I do not think we should get hung up on the model as being the sole source of everything. We have to produce a forecast and anyone who is practically involved with forecasting knows that that involves bringing in a wide range of information and judgments as well as modelling.
ProfessorBesley: That is exactly the direction in which we are trying to take the forecast process now, in the sense that we are trying to achieve a better balance between cranking the handle and getting out of the model something that is helpful in looking at the medium-term prospects for inflation, but the need to understand the economic
forces that are going to shape that going forward. That is a back and forth process and it is getting that balance right. I think that is just echoing what they are saying.

Q235 Chairman: The Treasury model is used and maintained outside the Treasury. Should the same apply to the Bank?

Dr Sentance: Actually I did not know that, I confess my ignorance about the Treasury. I am not sure. I think there are some sensitivities about the actual detail of the model given the purpose for which it is used. I think the Bank should be free to use the tools that it needs to do the job that it has to do, and the job that it has, as laid down in the Act, is to produce an inflation report, an inflation forecast, and I think one of the difficulties I could see of that approach is it would perhaps put too much emphasis on the model as against the way in which the model is used to produce a forecast, so I am not sure I would want to necessarily go in that direction.

Q236 Chairman: Is there any opposing view to that?

Professor Besley: I agree with that.

Q237 Chairman: So you all feel the same? Okay. For most of you here your time at the Bank has been short. Notwithstanding that, what impression have you gained from the Bank and if there was one thing that you want to leave us with in this Committee for the next 10 years, one thing that should be changed, let us know now. Kate, since you have been on longer, is there one thing you want changed, and then the rest of you?

Ms Barker: Are you asking me a question about the way the Bank conducts itself or the Act?

Q238 Chairman: Anything. You are privy to things that we are not. A lot of things go on behind closed doors so give us a shaft of light on it.

Ms Barker: Somebody said earlier that they did not think there were big things that needed changing, they are in the tweaks. I have indicated that in terms of thinking about how we work internally we try ourselves very actively to think about the ways in which we could improve it. I very much hope that we will continue to do that. Frankly, I am not sure that there is anything that I would change about the framework of the Act. There are always things that you think as a team perhaps you could do a little bit better, in particular one of the things that sometimes causes concerns is the way in which differences of opinion are communicated clearly in the minutes. That is something that we are paying more attention to, so I think it is always right looking at the way in which we perform and the way in which we could behave better. You have raised some questions about the appointments process. I raised some points about the fact I thought setting out a very clear process was not necessarily going to be possible given the different backgrounds that people come from, but I do think that advertising positions on the MPC in order to draw up a full list of potential candidates might be something that was worth pursuing.

Q239 Chairman: Professor Blanchflower?

Professor Blanchflower: I do not have an obvious thing to recommend. On the point I made earlier, which is the system seems to be operating very well, at the edges there may be things we would need to change a little bit, perhaps on the appointments process, but in general I think many of the changes we can make we have tried to do internally so the framework allows us to make changes as we go and, as colleagues have said, we are making changes particularly about how the Inflation Report is done. There are other issues about how we communicate and that is obviously something we need to keep thinking about.

Q240 Chairman: I am thinking, for example, how about each of you as a member writing a letter to this Committee or a report every year giving your point of view?

Dr Sentance: I would have no objection to that if the Committee would like to have that. It is difficult to judge because every six months on the Committee we have the opportunity to come and talk to you.

Q241 Chairman: It would help if we had your views laid down so that we could look at them.

Dr Sentance: If you would find that helpful then I would have no objection to that at all.

Professor Besley: I do not want to pour cold water on the idea, but I have one reservation and that is the timing of the report to you would be rather arbitrary in terms of what is going on in policy and therefore may focus too much attention on a particular date in the policy process. One of the things we have achieved by having an even pattern of communication with Inflation Reports at regular intervals and minutes at regular intervals is that we have a rather even pattern of communication. As long as some way could be established to make sure that undue significance was not placed on a particular date which would be somewhat arbitrary in the policy cycle, I would not oppose it.

Chairman: I think through informal channels we could achieve that and you would be quite happy with that. Thank you for your time. It has been very helpful to us.

Q242 Chairman: Governor, good morning to your and your colleagues and welcome to this inquiry, ten years on. Inflation reached 3.1% in March and you wrote a letter to the Chancellor explaining what the MPC were trying to do to keep inflation on target. What was the principal aim, in your mind, of that letter? Governor, may I say that we are not going to be talking about the Inflation Report here; that is for another time.

Mr King: Indeed. I think it was to give an opportunity to explain in greater detail what otherwise had been the case—why the Committee thought that inflation had risen to that level—although of course there was little opportunity for the Committee to have an in-depth discussion of that to point out again what our framework for policy is and to say what we would do to deal with that situation. That was the purpose of the letter and I think it served it pretty well.

Q243 Chairman: Some commentators have said that the Bank needs to do more to cement low inflation and to convince people that low inflation is non-negotiable. How far have you got to go on that?

Mr King: That remains to be seen. Most of the measures of inflation expectations are still close to the target. There is not very much evidence of any significant pick-up. We have spent a lot of time in the last 12 months thinking about whether inflation expectations have risen. That is referred to in almost all the minutes over the past year. We have talked about that. We have spent a great deal of time talking to people around the country to make clear that we are completely determined to bring inflation back to target. In the end, I think what people should draw most comfort from is that the arrangements for the Monetary Policy Committee give each member of the MPC individual and personal accountability for taking decisions in a way that ultimately will bring inflation back to target. That is our purpose in life and we are held publicly accountable by you and others for that. It is the strength of the incentives that we face that should give people comfort.

Q244 Chairman: You mentioned in your submission to us the tailwinds of globalisation and the expansion in the labour supply. If these do go on, do you think you are doing enough to prepare people for that?

Mr King: As conditions change then we will need to rethink our policy stance and decide what the level of interest rates needs to be. I think we have done a good job in explaining to people that the main aim of the MPC is to maintain a balance between demand and supply in the economy. As the supply conditions change in the economy, we need to take steps to lead to a change in the outlook for demand.

Q245 Mr Gauke: We heard last month from three of you about your views on the importance of monetary aggregates. Can I ask Paul Tucker and Charles Bean to what extent do you think monetary aggregates should play an important role in your deliberations?

Mr Tucker: We cannot deliver our objective by just looking at real economy variables such as output growth and employment and so on. We have to look at so-called nominal things and that includes inflation expectations which the Governor has already mentioned and discussed, and money forms part of that. I see it as probably no more than an amber light. I do not think the relationship between money and inflation over the past 20 to 30 years has been sufficiently reliable that we can say: yes, we have something that we can rely on. To have put that part of our history behind us is a good thing, but it can be an amber light. What does that mean? It means that if one sees rapid money expansion, or indeed very low money growth, one should take the lid off and try and see what is going on underneath. That is my own approach and I did that in a speech in December.

Mr Bean: I would very much endorse that. People used to think that there was a close relationship between money stock and nominal demand and therefore you could control the level of spending in the economy by keeping the money supply growing at a steady rate. What the experience of the last 20 years or so has shown us is that relationship is not a tight one. That is not the same as saying there is no information in movements in various measures of money, but it does suggest that you need to try and understand exactly what is driving the relationship between money and nominal spending in the economy. At the current juncture quite a lot of the rapid money growth is confined to a particular sector—other financial companies—which is a very heterogeneous collection of institutions. It is not clear what is driving all of those factors, so a task that we have been faced with is trying to dig down to better understand what is going on. The real answer is not to look at it as a single, all powerful indicator, but to look at it as one of a range of variables that potentially provide useful information; look at it alongside measures of the development of credit in the economy, look at what has happened to asset prices as well and try to form an overall picture of the monetary forces that are embedded within the economy.

Q246 Mr Gauke: Governor, you said to us last month that you were more concerned about the monetary aggregates than some of your colleagues. Do you feel there was something of a criticism made yesterday by the likes of Charles Goodheart, Tim Congdon and Gordon Pepper that we had a recent double digit rise in the monetary base and that this is storing up trouble and that perhaps the MPC has not done enough about that?
**Mr King:** I believe you are referring to a letter that I saw published this morning in the press. I think they made two very important points in the letter which I do not think members of the Committee would disagree with. First, the two key points they make are the need in present circumstances to look beyond the short-run volatility of energy prices. We saw in the last part of last year the pick-up of CPI inflation reflecting partly a rise in domestic energy prices. We now expect a fallback reflecting the “base effects” of those changes last year and cuts in gas and electricity prices this year. Our view is broadly as it was in February, that there could be quite a sharp fallback in inflation over the next four to six months. But we will see. For monetary policy the important point is not to get caught up in all that, although it was important to draw that to people’s attention in the wake of inflation hitting 3.1%, but to look beyond that through this fog to the medium term picture. I totally agree with that. The second important point they make is that, when looking at inflation beyond the fog, you do need to think carefully about inflation expectations and about monetary and credit growth, because these are the nominal variables that will shape the path for inflation. That is an extremely difficult thing to do and I think in their letter they acknowledge and, as Paul pointed out, there is great difficulty in making a clear numerical link between a picture growth rate of money and credit and the consequences for inflation, but that there is a link I am perfectly confident of and think it is an important factor for the Committee to look at. There is a third point where I would not agree with them and I thought they did not give enough weight to this because they rather linked together money and credit growth in the UK with the behaviour of asset prices in the UK. I think that in recent years that has not been so obvious a link. In a global capital market, where money can move in and out freely, what determines asset prices in the UK is very much a function of what is going on in the world capital market. A big feature of recent years has been the very sharp fall in real interest rates, not just in the UK but around the world, and also a fall in risk premia around the world. That has driven up asset prices—all types of assets—as we have discussed before. That is not something that you can easily say is the logical consequence of rapid money growth in the UK. It may well reflect, and it is probably to some extent does reflect, easier monetary policy around the world, but UK assets are being bought by overseas’ residents, and we in turn are buying overseas’ assets. The impact of higher asset prices, if that is thought to be important, cannot just be linked solely and exclusively to UK monetary policy and the growth of money and credit here. That is an area where perhaps the letter did not do enough justice to the openness of the capital market, but in the end I totally agree with them that inflation is made at home. Whether or not we have inflation in the UK does depend on the monetary policy stance of the MPC. As we all pointed out in the letter that I sent to Gordon Brown, the MPC to a person is determined to bring inflation back to target.

**Q247 Mr Gauke:** Do you think that in particular the cut in interest rates in August 2005, with the benefit of hindsight given where we are with inflation just at the moment, was unfortunate and that one of the reasons why that may have happened was because insufficient weight was placed on monetary aggregates?

**Mr King:** That kind of judgment I leave to the commentators and to the historians. For the Monetary Policy Committee the only meeting that matters is not one that took place two years ago, but the next meeting.

**Q248 Mr Gauke:** You sound like a football manager.

**Mr King:** It is a very good principle. The only meeting that matters to the MPC is the next one. There is no point playing today meetings that we are going to have in August, September, October; the one that matters to us is the next one in May. Equally, I am not going to revisit the ones we have had in the past. We do, as a Committee, look back and learn from what has happened in the economy and whether the outturns were different from what we had expected (or the same for different reasons)—that is an important part of our work—but I do not think it makes sense to go back and say what would we have done then had we known what we know today. That is the proper role of a historian and we should not be judging that ourselves.

**Q249 Mr Gauke:** Can I move on to a different area which is the relationship between monetary policy and fiscal policy. How important is that relationship and how important is the Chancellor’s decisions on fiscal policy in determining interest rates in your role on the MPC?

**Mr King:** At one level it is very important in that if fiscal policy were set in a way that would lead to a prospect of very large budget deficits, then I think it would be extremely difficult for us to manage inflation expectations which have been the anchor of the framework for monetary policy. In a big sense fiscal policy does matter because it can undermine monetary policy. I do not think that has been the case in the past decade. Equally, I do not think there is a great deal of fine-tuning here. The most important point about the link is that when decisions in the Treasury are made about taxes and revenues—and the consequences for borrowing—that they know we on the Treasury are made about taxes and revenues—and the consequences for borrowing—that they know we on the Monetary Policy Committee will be looking at the impact of that on the level of demand in the economy and taking steps to ensure that nothing that happens in the budgetary side is going to affect the chances of our meeting the inflation target. The Treasury itself knows when making its budget that we will take offsetting action if that appears necessary. The fact that they know that we will be behaving in that way gives them a pretty strong incentive to stick to their fiscal rules.
24 April 2007  Mr Mervyn King, Ms Rachel Lomax, Sir John Gieve, Mr Charles Bean and Mr Paul Tucker

Q250 Mr Gauke: In your time on the MPC—we had a tight fiscal policy after 1997; in 2002 there was something of a loosening—would you agree with what the National Institute of Economic and Social Research have said in their evidence to us that: “there is little doubt that the conduct of fiscal policy in recent years has meant that interest rates have needed to be higher than they would otherwise be”? Did you detect any changes in fiscal policy in 2002? Is that a matter that you were conscious of and adjusted policy accordingly?

Mr King: I think it is very hard to know what would have happened to interest rates had fiscal policy been somewhat different because I cannot judge how the Committee as a whole would have responded to that. I do not think there has been any real significant change. What happened was that spending grew much quicker than it did before and taxes rose. There has been a significant increase in the share of taxes in household incomes in GDP but then that was necessary. What matters to us is not the rate of spending growth or taxes taken separately, but looking at them together. I do not think there has been a dramatic change but your own report made clear that it makes sense for the rules to be set in a somewhat more forward-looking way and I see some merit in that. We are a million miles away from some of the fiscal policies that we have experienced in the past.

Q251 Angela Eagle: Governor, the day it emerged that you had sent a letter to the Chancellor explaining the current rate of inflation as required, I was phoned up by a journalist who was wondering whether I would be demanding your immediate resignation.

Mr King: I did not receive it if you sent it.

Q252 Angela Eagle: You did not see me demanding it. Do you think that this response says more about your successes as a Committee in never having to send a letter for 10 years, or your failure as a Committee to communicate to the journalistic profession precisely what your role is?

Mr King: I think the ambition of explaining monetary policy successfully to the journalistic profession, as you put it, is a continuing task that we engage in all the time and we repeat this at all of our Inflation Report press conferences. I think there has been a significant improvement in the quality of reporting among the specialised economic press. Undoubtedly when something like this happens it has what I might call “political overtones” and then you drag in a different kind of journalist who writes about it from a different perspective and I rather suspect that is a large element of what you have been seeing.

Q253 Angela Eagle: You are a very perceptive man, Governor. Earlier we were talking about perhaps some changes to the way the MPC works, Rachel Lomax. The independent members used the phrase that the whole process has been “dynamically evolving”; in other words, there has not been any great shift in structure but there have been tweaks and changes in the past 10 years. Is that your experience of the way the Committee has worked and do you think that the system needs any radical change or the dynamic evolution just needs to continue?

Ms Lomax: I think there have been modest changes during the time that I have been on the Committee; for example, in the way that we run the briefings from the staff for the monthly policy meetings. It is actually quite a stable process, very heavily engineered. We do the same thing every month and every quarter. There is not a huge amount of change; it is very predictable. That is actually part of its strength. You can envisage doing it quite differently. I do not think there is any real need to do it quite differently. I do not think there is a pressing need to change the way that we do it but I could certainly envisage approaching it in a slightly different way, as indeed other people do. “Dynamic” is not quite the word I would use for the amount of change we have had.

Q254 Angela Eagle: Do you think there is a risk on the other side that if there is radical change it might actually disrupt the process and cause a volatility in the way the Committee works that might be damaging?

Ms Lomax: I think that is one reason why the amount of change has been pretty modest. There is a great strength in behaving in a predictable way in terms of communicating with the outside world and in terms of going through the data in a systematic way as it comes in. We probably ought to avoid radical change unless there is a really good reason for it.

Q255 Angela Eagle: Do you think that if there is this predictability and it is not dynamic, but marginally evolving as a process, that there may be a risk of it becoming institutionalised and somehow staid and not able to respond?

Ms Lomax: It is always a challenge to keep the process fresh and that is one of the reasons why it is good to have turnover on the Committee and to have fresh people. We have had rather a lot of turnover on the Committee in the last year, but the idea of having new people come on is one of the most important ways in which the whole process keeps itself fresh.

Q256 Angela Eagle: Therefore are you happy with the kind of length of appointments that there are? Do you think that is about right or that it should be wider or smaller?

Ms Lomax: If one were starting again one would probably go for longer terms for the externals. Three years is actually quite a short period of time for somebody who has not been engaged in this kind of process before to fully get themselves up to speed, to make a real contribution, to develop their own ideas and see the consequences of their own past decisions come back to haunt them. On reflection, three years is probably too short.
Q257 Angela Eagle: John Gieve, do you think that there is any obvious tension between the internals and the externals on the Committee, or are you all just mucking in together?

Sir John Gieve: I do not think it does split down into the internals versus the externals. All the meetings I have about monetary policy, apart from meetings I arrange with individual members of staff, are with the whole Committee. We do not have a pre-meeting of the internals. I have not noticed a particular tension. It is a collective process but it is not a consensus process. The important thing is that each individual is coming to their own decision and their own personal credibility is on the line. It is not a team event in that way.

Q258 Angela Eagle: This is possibly an odd question to ask of an ex Permanent Secretary, but do you think there is a potential problem of institutionalisation on the Committee; that you just get into grooves that you cannot get out of?

Sir John Gieve: I do not think it is happening to the MPC but I think that there is a very important risk in setting up an independent body that it gets into ruts. You get into a particular way of thinking and you get group think. What has happened here is that because you have external members—this is the main reason for having external members—you have people who challenge and who bring different viewpoints to the party and constantly shift the debate; I think that works very well. I was talking, for example, to another central bank which is thinking about its arrangements and currently has only internal members appointed working full-time in the bank. I think that arrangement would risk an institutionalisation of certain attitudes and approaches.

Q259 Angela Eagle: We have got it about right in terms of turnover and mix and adding different things to the mix, do you think?

Sir John Gieve: Yes, I think it does work well.

Q260 Angela Eagle: Governor, you have a lot of contact with other central bank organisations, all of whom have their own way of doing these things. Is there anything that happens elsewhere that you think could sensibly be imported into our current system, or again are you reasonably happy that the institutionalisation danger is avoided?

Mr King: I am happy that we do not have the risk of institutionalisation. I do not see a strong case for making changes in the legislative framework, but that is not to say that we cannot learn from other central banks about how they carry out their research or how to think about certain questions that come up. It is much more trying to ensure that there is continuous, to use a rather pompous phrase, intellectual cross-fertilisation. We are always trying to learn from other central banks and talking to them. That is one of the benefits that external members can bring because, by being partly outside the Bank they can bring new thinking regularly inside the Bank. We try to do that too through talking to our peers overseas—there are a lot of regular meetings—and indeed to non-central bankers outside the Bank of England as well to make sure that we are continually refreshing our thinking. When I went to the Bank I said to the staff: “whatever you are working on, one of your jobs is to know the five people in the world who are really experts in the area that you are responsible for; phone them up and talk to them, get to know them.” That way we bring ideas into the Bank. In terms of ensuring that we are always open to ideas and to new thinking, that is crucial. I do not think that requires a change in the legislative framework within which the Bank works.

Q261 Mr Fallon: Governor, can we come back to this art of letter-writing. There was plenty of advance spin—some of it from you—that this should not be seen, once it happened, as any kind of admission of failure that the plane missed the runway, that this should simply be seen as a routine event. If it is routine, what is the point of the correspondence?

Mr King: It is not routine in the sense that it happens every month, but nor is it something that you should expect to be associated with what you might call a failure of policy. A one percentage point deviation from the target is actually very small relative to the movements in the past until we got to the last decade. I think it is still pretty small relative to what it would be reasonable to expect in the future. I think it is put in there as part of the accountability of the framework. It is not something that we put into the framework; it is part of our accountability so that we have to explain to you and to others why we think inflation has reached this level and you can then judge whether you think we have a good explanation for it or a bad explanation; whether you think the course of action we propose to take is sensible or not. It gives you a chance and it gives the Chancellor an opportunity to comment on what we have done. It is part of the accountability framework. I am not quite sure what you mean by “advance spin”—that is a term of political art, not central banking art—but over 10 years we have given speeches about the role of the letter and saying in what circumstances we would expect to write it and what the purpose of the letter was. That is the explanation.

Q262 Mr Fallon: It was you in your letter two years ago who said it should not be seen as an admission of failure.

Mr King: I said that 10 years ago as well.

Q263 Mr Fallon: Can you tell us about the Treasury reply. Do you show your draft letter to the Treasury?

Mr King: No.

Q264 Mr Fallon: Ed Balls, in June 2001, said, “The openness of the system allows the approach to be explained by the MPC and allows the Chancellor publicly to endorse it”. That is not what you said
to me a moment ago. You said it allows the Chancellor to comment on it. What would happen if he did not endorse it?

Mr King: It is certainly open to the Chancellor at any point to effectively change the target. That is something which he has the ability to do at any point but he must do it openly in front of you and in front of Parliament. If he wishes to give us different instructions then that of course is an opportunity that he has.

Q265 Mr Fallon: What would happen if he did not endorse your explanation, which is what I think you described the letter as?

Mr King: I do not think it is a question of endorsing an explanation; it is more a question of endorsing the action that we propose to take.

Q266 Mr Fallon: What would happen if you did not?

Mr King: To give you an example, it is conceivable, although it is not relevant in the present circumstances, that we would say, for example, there had been a very substantial increase in oil prices that no-one had anticipated, that pushed inflation more than one percentage point above the target. There were reasons—I cannot imagine what they are but there might be reasons—for supposing that we would expect inflation to remain above target for a year or so and that we would bring it back to target, not within the normal 18 months to two year horizon, but over two and a half to three years. That would be the plan that underlay our proposal for a path of interest rates. He might write back and say no, that is not good enough and I want you to get inflation back much faster. The remit that we are given says that we should not try to bring inflation back to target next month or within two or three months because that might induce undesirable volatility in output. If we said that our judgment was that we were proposing to bring inflation back to target over a somewhat longer horizon than normal to avoid undesirable volatility in output, it would be open to him to write back to us and say no, you had better bring it back faster than that. That, it seems to me, would be one of the options that he has. It would have to be a very clear and explicit statement. It could not be something that would just be done in a private meeting.

Q267 Mr Fallon: I understand that. Governor, could I turn to the appointments process on which Steve Nickell gave evidence to us and has described as “opaque”. Could I put to you four practical suggestions for improving it and ask you whether you agree with them: firstly, the pool of candidates, whilst being kept confidential, should be advertised for and that the search should be more rigorous and thorough?

Mr King: I have no strong feelings either way on that. I do not think this is a process which would throw up candidates that we had not already thought of, but I certainly have no objection to the idea that people can put their name forward and there is a process which would look at names, confidentially of course, as you said, and form a judgment as to which ones were competent to serve on the MPC. I would have no objection to that at all.

Q268 Mr Fallon: But through an open Treasury advertisement?

Mr King: Indeed, I would have no objection to an open advertisement.

Q269 Mr Fallon: Secondly, that when an appointment is made that you yourself should be involved and given the opportunity to give your views on that appointment before it is made.

Mr King: I think it would be sensible for the Governor to have a conversation with the Chancellor about the appointment. That, of course, does take place now, but whether that needs to be formalised, I do not know. Again, I think it is important for the Governor, as I am sure is true in most cases around the world, to be able to express a private view about the merits or otherwise of respective candidates.

Q270 Mr Fallon: You said that happens now. Has that changed?

Mr King: No, as far as I know there has always been some consultation between the Chancellor and Governor during the appointments process.

Q271 Mr Fallon: Thirdly, I think you have agreed with us previously that there should be some presumptive time limit for making appointments, obviously taking into account appointments that have to be made when you are not expecting them, such as following the death of David Walton and so on.

Mr King: It is a matter of good process that they are taken in a timely fashion. When Steve Nickell says that the process is opaque, I do not think that it is so much opaque as it has been left very much to the last minute. Trying to find a way of putting some constraints on preventing that would be welcome.

Q272 Mr Fallon: You would agree that they should be made within a presumptive time limit of, say, within two months or whatever would be useful?

Mr King: Yes.

Q273 Mr Fallon: Finally, in order to encourage a timely appointment would you see any merit in recommending that members of the MPC, once appointed, should not vote until they have been confirmed by this Committee?

Mr King: That is a trickier one. It all depends on what can be achieved in practice. Let us suppose there was a sudden vacancy that arose just after you had risen for the summer recess.

Q274 Mr Fallon: I said “normally” in order to encourage the appointment itself to be timely; in other words, there would be an onus on the Treasury to get on with it.
Mr King: I do think it would be a good idea if the outcome of whatever process we had was one in which the names were clearly put forward, you then had time to carry out the informal confirmation hearing and then members joined the Committee. I know that normally your wish is for members to come here for a confirmation hearing before they start their work and that would be the sensible time at which to do it. What the world would look like with timely appointments would indeed be one in which you would have a chance to carry out the hearing before the individual joined the Committee.

Q275 Peter Viggers: A 10 year review gives us a chance to look at the MPC in fairly fundamental terms. Is nine the right number with a balance of five internal and four externals? Is that, in your view, the correct balance?

Mr King: I think you could argue until the cows come home about precisely the right number. I do think that more than nine would run the risk of making the process much less effective because a conversation among the nine is a key part of it and to have many more people would run the risk, as I think happens in somewhat larger councils that set policy, that some people have more say than others; there may be inner deliberations that take place because a very large body is simply too big to have a sensible discussion. I am comfortable with nine as an upper limit. Whether it should be seven, eight or nine I think you can argue about. I do think the current balance is right. It is a Bank of England committee and it should be a majority of Bank of England staff on it. I think the system works pretty well. If you were to say to me, looking back, what are the things that have worked and not worked, they are all really to do with the informal interaction, not to do with the actual formal processes. I would stick where we are. It is easy just to make changes. Suppose you were to change the numbers by one. I do not think it would achieve very much but there would be all kinds of commentary about whether a decision was a result of having one fewer person. Once you have a system that works, stick with it and make sure the right people are appointed.

Q276 Peter Viggers: Can I ask the five internal members of the Committee the same question as I put to the external members: would you value an opportunity of having a method of input where you could indicate the kind of skills that you thought would be useful of a new external candidate?

Mr Bean: I suppose I do have an input insofar as I can discuss informally with the Governor about what sorts of people we might usefully have on the Committee. It is not something I have ever felt impelled to raise with him but that channel does exist.

Q277 Peter Viggers: Do you think it is important that there should be one or more external members who understand the Treasury model and who are conversant with this field of activity?

Mr Bean: No. I know this was an issue that Simon Wren-Lewis raised with you but it is in some respects a misconception of the way that the Committee works. What we should not do is get dragged into the mechanics and detail of the model. The model is a crutch that helps us have discussions in a quantitative framework, but it is not sensible to drag all nine members into discussing technicalities of the model. As far as possible when we have discussions, particularly in the forecast round, they work better when we try to avoid that happening. I do not think that it is essential to have somebody on the Committee who is familiar with the entrails of the model and in fact it might actually work against the Committee functioning well if the consequence was to keep on pulling us into peripheral details.

Q278 Peter Viggers: Two of you—Charles Bean and Paul Tucker—are effectively ex officio; you hold your positions through your positions within the Bank. From the Bank’s point of view, and from the point of view of the individual committee member, is there a relationship between your appointment within the Bank and your membership of the Committee? Are these valuable and necessary?

Mr Bean: It certainly is in my case because, as Chief Economist, I have the responsibility for running the economics in the Monetary Analysis area of the Bank which supports the MPC and it supports the MPC as a whole, not just the Bank members or anything like that. I have a particular role acting as the conduit between the Committee and the staff in making sure that the staff are doing the right sort of work to support the MPC’s deliberations.

Mr Tucker: I think it is on the other side too. One of the things that comes up in our deliberations, and indeed in front of this Committee, is whether policy is credible, how will financial markets react to this? if there is a disturbance in capital markets around the world what on earth are we to make of it? Having somebody on the Committee who runs the part of the Bank that will give the briefing to the Committee and be tuned in to where the Committee’s questions are focused is valuable. In both cases I think I should say that both for me, and for Charlie, once we are in the Committee we are not speaking to those briefs then. We are just members with one vote covering the whole waterfront. We are going to go back to our desks and run our particular bits of the Bank. There is indeed synergy in terms of bringing inputs to the Committee.

Q279 Peter Viggers: As members of the Treasury Select Committee we come to this table from completely different backgrounds. Is there any way you think that the Treasury Select Committee can be more effective in promoting the objectivity and the work of the Monetary Policy Committee?

Mr King: One of the real advances over the last 10 years has been that these sessions are conducted in a very different spirit than they were 10 years ago.
Ten years ago, when the Governor and representatives of the Bank came to the Treasury Committee the sole purpose of these sessions—as far as I could see from accompanying the Governor then—was very often that members of the Treasury Committee would be looking for quotes, or inadvertent slips of the tongue, which could be put to the Chancellor the next day to make a political point; in other words, it was not a dialogue on substance. I think that what has happened in the last 10 years is that we have a genuine and evolving dialogue on the state of the economy and on whether monetary policy is being conducted in an appropriate way. You are representing the public in holding us accountable. I think you could perhaps do a little more by way of asking us individually to explain why we had voted the way we had in a sequence of recent months, but by and large I think the debate that we have is a genuine discussion about the state of the UK economy and the outlook for inflation. It is not a vehicle for you and others to score political points and I think that is a big step forward as an observer of this for over 15 years now.

**Q280 Chairman:** On that point, Governor, in the previous session we asked the witnesses about the advisability of them sending a letter to us or a report. I realise that if everyone writes a report every month then people are going to compare it and we get into a bit of a dog fight, but given that we can have a sensible arrangement in terms of increasing accountability, would you consider that a reasonable idea?

**Mr King:** I am slightly reluctant to impose on the world and on you yet more pieces of paper. We produce a lot. My honest feeling is that we all come before you. I come three or four times a year; every member must come at least twice a year. You have them in front of you in person for as long as you want. You can make the session last for as long as you wish. You could put all the points that you wanted orally to that person and ask them to give an account for what they have done in the past year, how many visits they have made, why they make speeches several times a year. I certainly have no objection to providing an account once a year. If people send us a written report it gives us time to look at it and reflect on the issues and it draws out issues which maybe are not possible during a session where time is limited. It gives people the opportunity to imprint their personality on it as to why they are doing things. Rather than asking people to do it all at one time, if people did it, say, at a different month at a time I think that would certainly be of benefit to us. What about other members of the Committee? Do you feel that would provide a benefit?

**Ms Lomax:** To go to the question underlying it all, I do think that you let members of the Committee off quite lightly. I come along to these sessions with the Governor and most of the questioning goes to him. You never ask us along without the Governor. If you were to decide that you wanted to explore the positions of individual members in more depth, then I think a letter might serve a purpose as briefing you for a different kind of hearing with individual members. In isolation in the context of the sort of Committee hearings we have at the moment, I am with the Governor; I am not absolutely certain what purpose it would serve.

**Q282 Chairman:** If people send us a written report it gives us time to look at it and reflect on the issues and it draws out issues which maybe are not possible during a session where time is limited. It gives people the opportunity to imprint their personality on it as to why they are doing things. Rather than asking people to do it all at one time, if people did it, say, at a different month at a time I think that would certainly be of benefit to us. What about other members of the Committee? Do you feel that would provide a benefit?

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**Q283 Chairman:** But you send a letter and you are coming to the Committee a couple of weeks later. We have that letter and we can sit and reflect on that. Surely that is a good idea, Charlie?

**Mr Bean:** If you have in mind a particular issue that you want to probe on or something like that that you may well want to gather some prior information, very much like we provided the note on the economic context for you. That then becomes a sort of ad hoc reaction to things that are particularly interesting you at the time with a particular focus, rather than some regular letter-writing or report-writing process.

**Q284 Chairman:** It would not end up like a minister replying to Parliamentary questions, would it, where you do not get any information at all?

**Sir John Gieve:** No, I think you would probably get more paper than you wanted. I very much agree in that I am opposed to everyone having a paragraph in the minutes every month. We do, as you know, make speeches several times a year. I certainly have no objection to providing an account once a year of what has happened.

**Q285 Chairman:** Paul, would it be possible for the MPC to provide more information in the future on the path of interest rates? For example, would it be possible to produce a future path of interest rates as seen by the MPC?

**Mr Tucker:** I think it would be pretty hazardous for the Committee to start publishing its expected path of interest rates for two reasons. First, and this has run through a lot of the discussion this morning, is that the thing that distinguishes the MPC from equivalent bodies elsewhere is that this really is one person-one vote; it may be almost unique in that respect. I think it would be formidable difficult for nine people to agree on a path of rates. The second, and perhaps more
important point, because it would apply to almost every Monetary Policy Committee I can imagine, is that such a path would be conditional. It would be determined by so many factors that it would be a communications nightmare in my view because we would be quickly in the position of saying well the curve that we published of course is not quite what we would now envisage if we were to do it again because X has happened, or Y has not happened, or Z has happened. The public would, I think, feel justifiably confused. I think the financial markets would be pretty confused. And that would not enhance the accountability of the Committee and, most importantly of all, it would not enhance our ability to do our job. Some of the central banks in the world are doing this and so I think it would be a mistake to say never, and we should watch and learn from what they do, but I certainly would not want to leap into doing that now.

Q286 Chairman: Governor, Lord George, when he appeared before us, expressed disquiet at publishing immediately with the interest rate decision information on how individuals voted. Would you however support the numerical split of votes being published so that markets could gauge how a decision was made?

Mr King: No, I would not. I am not particularly sympathetic to markets who want to know one day rather than five days earlier some piece of information. What really matters is that we get a good explanation of the reasons for the decision that was taken and the range of issues that were debated around the table and to do that requires us to construct the minutes. We do it as quickly as we can. A lot of work and effort go into that process. The minutes go through several rounds of discussion and changes before we finally publish. If the numerical vote were published before the minutes were to come out you would simply be caught up in, first of all, an enormous amount of speculation, much of which would be inaccurate, about which members had voted which way. That would not give any useful information and it would make it almost impossible for a member who actually wanted to go out and speak after our purdah period finishes. People would not be able to speak in public before the minutes come out, because the focus of attention would inevitably be on whether they were in the majority or the minority. Once one person made clear where they were it would make it impossible for those who had not yet spoken. I think you get sucked into a position where people would start to reveal which way they had voted much earlier and that mitigates against a very clear explanation of the full debate that the Committee had. I am struck by how many of my central bank colleagues overseas see merit in having a long substantive set of minutes which spell out all the issues as opposed to an immediate short paragraph statement where you get sucked into monetary policy by code word. One word is meant to summarise a whole set of views on monetary policy. It is not like that. It is much better to be able to explain at full length what were the arguments for and what were the arguments against the decision that was finally reached.

Q287 Chairman: Charlie, would you support a bias statement similar to the US model?

Mr Bean: Not particularly, no. First of all, it is not something we agree on at the moment as a Committee and, as Paul has already indicated, it is difficult enough to agree on the current interest rate, let alone a path of interest rates. A bias statement is a step in the direction of providing a complete path for future rates with all of the problems that Paul has already mentioned. I do not see it as a particularly useful thing to do. What we do of course in the minutes is seek to give an indication of our thinking about how the economy is developing, where the risks are and so forth. That is reinforced in the Inflation Report which contains our projections and market participants and others who are interested should be able to draw their own conclusions from the outlook that we describe in the Inflation Report for the possible evolution of interest rates in the future. That seems to me a perfectly adequate way of doing it.

Q288 Chairman: Governor, would you think it was a good idea to include the external members at the press conference for the Inflation Report?

Mr King: No. We have two distinct publications that come out around that time: one is the Inflation Report and one is the minutes. They have quite distinctive purposes. The Inflation Report is to explain essentially the majority decision that was taken and to explain the collective view of the MPC about the forecast. When I speak at the Inflation Report press conference I am speaking on behalf of the Committee. Once we have reached our decision on that Thursday of that month we then spend quite a considerable amount of time discussing the drafting of the Inflation Report that we put out. We go through it word by word for good chunks of the text. If the Committee agree on that, my task is to explain that to the audience. That publication and my role in that is to speak on behalf of the Committee as a whole. Individual views where all nine members—not just the externals but internals as well—have different views, as you can see in the split of votes in the January decision this year, are set out in the minutes. The minutes are an opportunity for arguments to be set out and then people can make speeches and so on. We encourage people to make speeches to set out their views so that people outside understand why they have voted the way they have.

Q289 Chairman: Is there one thing that we, the Treasury Committee, could do to improve the process? Secondly, is there one thing that you would advocate needs change that we could include in our report?

Mr Bean: We have already raised the most significant process issue that could usefully be improved and that is the speediness of
appointments. From our perspective that will enable us to operate more effectively. From the point of view of the way you actually conduct these hearings, the point that Rachel raised about quizzing us more intensively on why we voted the way we did I think would be something to take away.

Ms Lomax: The one thing that we have not talked about is the process for setting the target and changing the target. There is quite a strong argument for that being a bit more consultative than perhaps it has been in the past, at least in respect of major changes to the target variable.

Sir John Gieve: I agree with both of those. The initial hearing that you held with me was a completely different degree of scrutiny from this Committee than I get coming with the Governor from time to time.

Q290 Chairman: Are you advocating coming along on your own then?

Sir John Gieve: No, but I think you might balance the questions differently. I think the point on the target is a good one, although my own view is that we should not change the target except for a very good reason and that it needs to be stable.

Mr Tucker: Not remotely. The defining feature of the MPC is, one person one vote, and virtually all of its strengths come from that, and virtually all of its challenges are then how to communicate something that is not misleading, because what the market cares about is the outcome rather than our individual to’ings and fro’ings.

Q294 Chairman: You do not look at him? Rachel, would you keep an eye on the boss when you are making your decision? The Governor is the boss man.

Ms Lomax: Do I vote to please the Governor? No.

Q295 Chairman: What would you say, John?

Sir John Gieve: I always try to vote on the basis that mine might be the swing vote. Very often you do not know whether it is or it is not because it depends when you speak.

Mr King: Absolutely.

Q292 Chairman: Who are the pains in the necks on your Committee?

Mr King: I cannot think of any.

Q293 Chairman: Do the rest of you keep an eye on the boss man when you are making your decision?

Mr Bean: Certainly not.

Mr King: There is no sequence of voting in the sense that nobody is called on to cast their final vote until the very end of the process when they know how everyone is thinking. There is a sequence in which people speak. At the beginning of Thursday morning, which is when we come to our decision, I will open the discussion by presenting a summary of our discussion on the previous day. I do not normally at that stage indicate which way I myself would be inclined to vote. I then turn to Rachel who leads off and who presents as Deputy Governor for Monetary Policy, her view as to where the evidence suggests interest rates should be set. After that it is a random order in which people talk. I then speak at the end and people may or may not indicate as we go round how they wish to vote. We do not record votes until the very end of the discussion when everyone knows what everyone else thinks and it is clear where everyone is coming out. That may take some time. Somebody may well say I am inclined to think that we should cut interest rates today but actually I am not sure and I would like to hear what everyone says before I finally cast my vote. No-one is called upon to vote until the very end of the morning when we record the votes that have been expressed once it is clear we know how everyone is thinking. In that sense there is no order.

Q296 Chairman: What sequence do people vote in? I have attended lots of meetings and it is important who speaks first.

Mr King: I cannot think of any.

Mr King: Absolutely.
Mr King: I think you can see that it is not always easy to get a team to perform and of course that is the challenge.

Chairman: Governor, you have been very helpful. We thank you and your colleagues very much for attending this morning.
Tuesday 8 May 2007

Members present:

John McFall, in the Chair

Mr Michael Fallon
Mr David Gauke
Ms Sally Keeble
Mr Andrew Love

Mr Brooks Newmark
John Thurso
Mr MarkTodd
Peter Viggers

Witnesses: Dr David Potter CBE, Chair of the Remuneration Committee and Ms Amelia Fawcett CBE, Chair of the Audit Committee, members of the Court of the Bank of England, gave evidence.

Q298 Chairman: Welcome to the Treasury Committee inquiry into the MPC: ten years on. Would you like to introduce yourselves?

Dr Potter: We apologise for John Parker, the Chairman of the Court, not being here. I am technically the Deputy Chairman of the Non-executive Directors and Chairman of the Remuneration Committee of the Bank.

Ms Fawcett: I am an Executive Director of the Court and Chairman of the Audit Committee.

Q299 Chairman: May I ask a general question to begin with? In relation to the MPC, what do you regard as your overall role and how do you discharge your responsibilities?

Dr Potter: Our general role in the Bank is the governance and oversight of the management of the Bank as a whole, and the Bank of course carries out many functions, including the implementation of monetary policy (that is the setting of interest rates) but the formulation of interest rates of course is the responsibility of the Monetary Policy Committee. Our role is to oversee that the processes and procedures there are working well and effectively.

Q300 Chairman: Dr DeAnne Julius was before the committee and when I asked her about the function of the Court, she said, and you will be aware of this: ‘‘. . . the Court is a rather grand body with very little to do, particularly since the introduction of the new Bank of England Act and the FSA regulatory side split away from the Bank.’’ How do you answer that, which was from someone who was a member of the court and also a member of the Monetary Policy Committee?

Dr Potter: Indeed, I served with DeAnne Julius. The members of the Court are experienced in matters of organisation of larger organisations and how they are managed, controlled and governed. Members of the MPC are in general economists and expert in matters of economics, and that is the function of the MPC. DeAnne Julius’s comments I think rather underestimate the importance of the role of a governing authority of an organisation. I think the role of the Court is absolutely essential. Imagine there was not a Court there, then who would be the governing authority, particularly when issues arose? The role in regard to the MPC is limited but it is concerned that members of the MPC have a reference to ensure that they are well served in terms of their research and the processes and procedures. In fact, I think it is rather a critical role and, providing everything is working well, it is in the background. When there are issues, of course, it comes to the fore.

Ms Fawcett: May I add that from my experience of sitting on other boards, both for instance a university council as well as plc boards, that the Court has had and increasingly has all the hallmarks of the kind of oversight and responsibility you would expect an independent board to have. Whether it is setting strategy, financial objectives, monitoring the management of the Bank, it is very clear that that is what court does do, and I think does very effectively.

Q301 Chairman: In terms of setting strategy, that is interesting because there is a difference in management style from Lord George to the present Governor, Mervyn King; he has changed things quite fundamentally. How much were you involved in that change of strategy and what type of advice did you give the present Governor as to re-shaping the Bank?

Dr Potter: I joined the Court at the same time or a month before the current Governor became Governor, so I saw the transition immediately happen. It was the Governor’s suggestion that the roles of chairing the court should be split from that of effectively the Chief Executive of the Bank, and indeed that has been put into effect so that most of the activities of the court are carried through the non-executive directors’ committee, which is then ratified by the court subsequently. In this sense, we have split the roles. In terms of setting strategy, the strategy concept, the vision, was laid out by the Governor and that vision was supported strongly by the court as a whole, and much discussed by the court at its various monthly meetings subsequently. There then followed, during that year, 2003–04, an examination of the nature of how that vision is turned into strategy. I will give you an example. In the annual reports of the Bank, you will see that the core purposes of the Bank are defined under two remits: one is the setting of monetary policy, or at least the achievement, should I say, of monetary stability in the economy; and the second is to ensure financial stability of the system as a whole. In previous years, there was a third purpose, which was to represent in a sense, the interests of the financial community or the City as a whole, and I
paraphrase. That purpose was removed in the new strategy and so the essential remit of the Bank was concentrated on those two core purposes. An example where that has had an effect is that the Bank is withdrawing from providing bank services to customers other than the core banks themselves; so no longer serving the Government itself, as the bank to the Government. Those are examples of the change of strategy. The Court is much involved in all of this.

**Q302 Chairman:** It is suggested that the frequency of the meetings could be reduced—I think the meetings are monthly—and perhaps also the size of the Court itself. What views do you have on that?

**Ms Fawcett:** I do not think anybody feels particularly strongly about it. My personal view is that smaller meetings, rather than, say, 16, are particularly strongly about it. My personal view is that we need to meet 12 months of the year? Probably not. A traditional board would meet anywhere between six and 10 times a year. I would favour reducing the number somewhat and probably it would make more sense to have slightly fewer members on the board, although it works effectively now.

**Dr Potter:** I comment that by statute we are required to have a meeting every month. In fact, in August we have a very modest meeting, shall I put it like that. We have a meeting but it is a small one. I think there is something to be said for a regular routine. Of all my experiences of non-executive roles both in the public sector and in publicly quoted private companies, the demands on a non-executive director of the Bank of England are greater than in most of those other roles by a considerable way. There is a huge amount of work to do to ensure that one is fully knowledgeable about the activities going on in the Bank and the issues. The issues are complex. So, in fact, I think it is quite a substantial job in terms of monitoring and ensuring the quality of what is going on in the Bank, the processes going on in the Bank. You could argue to take it down to, say, nine; certainly 11 is appropriate with August free. In terms of the numbers, yes, I think there is an argument to take it down possibly to 12 or that kind of level.

**Q303 Chairman:** The annual reports of the Bank state that you are about to undertake a review of the remuneration of MPC members. Has that begun and why are you undertaking this review?

**Dr Potter:** I am the chairman of the Remuneration Committee, so I will answer that question. The Court is charged, and that is delegated to a Remuneration Committee of the Court which reports back to the Court, with setting the remuneration of external members of the MPC, for setting the remuneration of the Governors (that is the Governor and the Deputy Governors), for setting the remuneration of the executive directors who are not members of Court but they are the executive team, and also the key advisers to the Court. This is done annually and in the nine years since the MPC was formed, there has been an increment annually of 2.5% in parallel with the RPIX and similar increases for Governors and Deputy Governors to which I referred. This is increased annually every year and is reviewed by the Remuneration Committee each time. Last year, the Remuneration Committee examined the situation of MPC members with regard to pensions. In the previous annual report in 2006, the Bank had carried out a study of the cost of pensions in changing circumstances to the Bank. This was calculated at 41% of salaries. The Bank set a target, as it articulated in that year, of 30% and gradually over a period of years to reduce the 41% to that target, and it is the aim of the Bank’s executive to achieve that. In the light of that, when MPC members had been appointed, an allowance was set for cash in lieu of pensions of 15% of what members were paid, and because of the change in longevity and the reduction in the long bond, the cost of pensions had increased considerably. Accordingly, in the annual report which will be published shortly, members of the MPC have had their pensions increased to the target, not the level of the Bank which is higher, but to 30% of salaries in lieu of pensions.

**Q304 Mr Fallon:** If we turn to the appointments process, you have referred to the Court being the governing authority and you are involved in everything. Why do we not hear from you on the appointments process?

**Dr Potter:** The appointments to the MPC and the appointments to the roles of Governor and Deputy Governors as well as non-executive directors are all in the hands of the Treasury, the shareholder if you like. We do agree that we should have some input into that and there are issues associated with that. The Court does have a view, which is articulated through the Chairman normally.

**Q305 Mr Fallon:** You speak about input. I am interested in your output. The MPC is your Committee. Everybody else has made criticism of the appointments process—the lack of transparency, the delay in making timely appointments, the balance of membership and so on—except for you who is supposed to be supervising it.

**Dr Potter:** We are supervising the process. We are not supervising the Committee itself. As I said, it is a matter for the Chancellor.

**Q306 Mr Fallon:** In 10 years, you have not made a public comment about the glaring weaknesses of the appointments process to one of your own Committees. What is the point of the Court if you cannot comment on that?

**Dr Potter:** We have not done that publicly, no. We have expressed that clearly to the Treasury.

**Q307 Mr Fallon:** Why have you not done it publicly?

**Dr Potter:** The court has not, nor has the executive of the court.
Q308 Mr Fallon: Why have you not?

Dr Potter: Because I do not think that it is the function of the court to express that publicly. We can express it directly to the Treasury that is the shareholder.

Q309 Mr Fallon: But the Committee is your Committee; surely it is up to you to make sure that its appointments process is proper? If there are weaknesses, you should be addressing them and commenting on them in your annual report, should you not?

Dr Potter: We do have some comment in the coming annual report. I think these weaknesses have come to the fore in the last 12 months.

Q310 Mr Fallon: That is nonsense. We have had criticism from the Governor himself about delays in appointments well before the last 12 months.

Dr Potter: The Governor is a member of the Court.

Q311 Mr Fallon: Absolutely but the Court is the governing authority of the Bank. What is not clear to me is why the Court has never commented publicly in 10 years on some of the well-known weaknesses in the appointments process. Why are you not prepared to stand up occasionally?

Dr Potter: I think we are prepared to stand up and we do so very clearly through the normal channels. The Chairman of the Court itself is in fact the Governor and the Governor has spoken, and indeed those views are supported strongly by the Court.

Q312 Mr Fallon: The Governor is not here this morning. You are here. I would like to hear from you. Are you satisfied that appointments to the MPC have been made in each case in time?

Dr Potter: No, we are not satisfied with that. We have expressed that.

Q313 Mr Fallon: Are you not satisfied?

Dr Potter: Correct.

Q314 Mr Fallon: How have you made that criticism known?

Dr Potter: Through the Governor.

Q315 Mr Fallon: You have complained to the Governor?

Dr Potter: It has been discussed in Court and in turn the Governor, as Chairman of the Court, has articulated that publicly.

Q316 Mr Fallon: Are you happy with the transparency with which appointments appear to be made?

Dr Potter: No, personally speaking, and I speak on my behalf not representing the Court as a whole necessarily. I am not satisfied. I would say that in general the Court itself is not satisfied and it has expressed that in its minutes and at its meetings in Court and again that has been articulated through the Chairman of the Court, the Governor. As for how that should be more transparent, these issues have been rehearsed in this Committee I believe, but I think there is merit in having a panel, for example, perhaps a privately-held panel, and secondly that there might or might not be merit in appointments being discussed for example in your Committee.

Q317 Mr Fallon: I am trying to get your particular views. You yourself were appointed after open advertisement for non-executive directors of the court. Why should that same advertisement and transparency not apply to members of the MPC?

Dr Potter: Indeed that might be the case.

Q318 Mr Fallon: Would you favour it or not? I know what might be the case. I want to know your view.

Dr Potter: I think I would favour it but I am going to qualify that by the following point. There is a difference between membership of the MPC and a non-executive director of the Court in the following sense; they are experts in their field and we need to draw the people of the highest calibre into that Committee who are appropriate for that Committee; they are experts. If I were to take the role, for example, of being on the board of Rolls-Royce, and if we had an engineering Committee to deal with the latest design of the next engines, we would need experts in that of the highest calibre. Therefore, in a sense, we should be looking towards the peer group of those experts.

Q319 Mr Fallon: You would not appoint the chairman of your engineering Committee, which I find a rather shocking parallel, without ensuring as a director that you had made the best possible search.

Dr Potter: Definitely.

Q320 Mr Fallon: Why has not the Court then promulgated the idea of open advertisements for memberships of the MPC? Why has not the Court in 10 years expressed any kind of view on anything to do with the appointments process?

Ms Fawcett: I think there are several ways this has happened and we can address personal views on whether it should be more public or more enhanced. First, there have been discussions between Court through the senior non-executive—Sir John Parker—with Treasury on this very issue. Second, the Governor has come to this Committee and has explained the view of the Court on this issue and that it lacks some transparency and is opaque. Third, this year in our annual report, which is a public document, we will make that very same statement that the appointments process could indeed be improved.

Q321 Mr Fallon: That is after 10 years, Ms Fawcett?

Ms Fawcett: I cannot speak for seven of those last 10 years.
Q322 Mr Fallon: There was silence for 10 years. There has not been anything in the annual reports making any comment at all about the appointments process to your major Committee.

Ms Fawcett: I do not know the reason for that lack of a comment. I will say that the issue has become more acute, particularly in the last year, and Court has dealt with it.

Q323 Mr Fallon: Has the Court ever communicated with the Treasury about the appropriateness, costs or background of any particular appointment to the MPC in your knowledge, Dr Potter?

Dr Potter: Not to my knowledge, no. There have been private conversations but not officially formally.

Q324 Mr Fallon: Has there been a private complaint?

Dr Potter: No. There are obviously private discussions that go on. There are personal discussions that go on and these matters are discussed in a broad sense, but, no, the Court has not specifically tasked a formal complaint to the Treasury. I would make the comment, Mr Fallon, that rigorously and strictly speaking, the appointment to the MPC is in the hands of the Treasury according to the Act. We can comment about the nature of those appointments, and we have publicly through the Governor and, secondly, through Sir John Parker, our Chairman, and through the Governor to the Chancellor and the Treasury. That has been expressed both publicly and to the Chancellor. This has only occurred in the last 18 months or two years. I am not aware that there was a general complaint of the process in the preceding seven or eight years.

Q325 Mr Fallon: I do not think, with respect, that references in some of the Governor’s speeches or private communications to the Treasury exonerate you from your duty over 10 years, even though the Chancellor makes the appointment, from commenting on the appointments’ process when there has been widespread criticism of the lack of transparency, the delay in making timely appointments, the balance of membership, all of these things, and in 10 years we have not had a word of commentary, let alone criticism, in the annual report of the Court whose principal Committee this is.

Dr Potter: I think we have commented in the non-executive directors’ section of the annual report, but then there is also the annual report as a whole, and in that there is comment.

Q326 Mr Love: This question arises from the discussion so far. In your opinion, what makes a “good” MPC member, Dr Potter?

Dr Potter: Firstly, I think that the role clearly requires expert knowledge as an economist, although I would not eliminate people with huge experience, such as Richard Lambert, in economic matters as a whole. In general, it does require the great majority to be expert economists.

Q327 Mr Love: In relation to Richard Lambert, his replacement was a professional economist? He was not a professional economist. Is there a role for somebody like Richard Lambert in the future?

Dr Potter: I believe so. That is my personal belief as a non-expert, not in the Committee. I believe that there are people who can give value, like Richard Lambert, and there are business people, people from the financial world, who have spent most of their careers in that world and understand the workings of the economy, even though they do not have a PhD in economics, if you like. To answer your question about what the skills are: obviously people with a particular emphasis in macro-economics, but clearly drawn from different fields in the economy, such as we have seen; people who are experts in labour; experts in macro-economics or econometrics or whatever. The second thing I think that is essential and fundamental for the Committee is that “they do not do consensus” and that they each have their own independent vote. I think that changes the whole culture of the workings of that Committee. As part of that, I think it is essential to have a diversity of backgrounds, personalities and experiences. There are five members appointed from the executive of the Bank itself, and there are four externals. The four externals should be drawn broadly and I think there is merit sometimes in one of them in general having a City economics background. I would generally believe that is necessary in the complex world we have.

Q328 Mr Love: To what extent do you believe that the non-executives should mirror the executives in a sense in order to hold them to account or to what extent do you believe that they should have a wider range of economic expertise to bolster the Monetary Policy Committee as a whole? Is there a tension or a challenge between the two of those?

Dr Potter: No. Within the membership of the Court, the non-executive directors are not expert economists in general. There are some that might be. There are quite a number who are experts or are hugely experienced in the financial world. In general, they are characterised by wide experience in running or managing businesses or organisations, public or private. No, I do not think they can mirror it. Remember that the MPC is one of the functions; there is also the issue of how interest rates are transmitted through to the system. There are many functions in the Bank. Because of the importance of the MPC and the high profile that it has had in the 10 years, these other functions are less considered but they are critically important and that is part of the role.

Q329 Mr Love: Perhaps I can draw Ms Fawcett into this question as well. To what extent do you think they have concentrated too much on academics for the non-executive directors rather than practitioners? Do you think that is something they need to correct?
Ms Fawcett: Coming back to Dr Potter’s earlier point, it is critical that we have a diversity and a balance of views on the Committee. That would include academia, financial sector experience and business experience and the externals in particular bring a very broad array of background to that Committee and should continue to do so. I would think it would be unwise for them all to be academics but I do not think that is how the Committee is currently structured.

Dr Potter: May I add one rider to what you suggest, Mr Love? The five members from inside the Bank often in the past would have had different experiences. I think in general, without making any comment on the particular current membership that include the highest calibre of people in my view, nevertheless it is extremely important that the appointment of governors and deputy governors looking out in the long run—10 or 20 years out—should not be drawn from purely the Civil Service or the public sector. If one looks at some of the history of the Bank and the appointments from outside, that is an important factor too because that will define the MPC as well. That is a very important factor.

Q330 John Thurso: Could I clarify one point on remuneration? I fully understood the point you were making about the review and the pension side of things. In terms of the base salary, is that dealt with by the Remuneration Committee or is that set by the Treasury?

Dr Potter: That is set by the Remuneration Committee.

Q331 John Thurso: In that instance, how do you go about benchmarking that salary? What factors do you use to decide the basic remuneration?

Dr Potter: In the case that Mr McFall previously mentioned where he understood there was a review going on, that is correct, there has been. To answer your question, we retained an organisation that is expert to carry out a review of the pay of economists in general at that level. That is a complex matter because economists work in many different fields. There are academic economists; there are economists working for large corporations; there are economists working in the City of London who are hugely paid. So there is a wide diversity of pay and roles for the potential candidates who could be members. Nevertheless, we commissioned that report and in reviewing and discussing the balance of the report as a whole, that is how we defined it, benchmarked it, if you like. I might comment that the Committee came to the conclusion that the general level of remuneration for members of the MPC is broadly compatible with the review.

Q332 John Thurso: Can I move on to the Non-executive Directors’ Committee and ask Ms Fawcett: how does the non-executive directors’ Committee monitor the performance of the members of the MPC?

Ms Fawcett: There is a process that is both a regular process and an annual process. The annual process, first, is through an annual questionnaire, individual one-on-one meetings that the Chairman of the non-executive directors, Sir John Parker, has with each member of the Monetary Policy Committee, external and internal. The results of that questionnaire and those specific meetings and any issues are discussed privately with the non-executives. In addition, throughout the year, we have informal meetings with MPC members—we had an excellent working lunch with them not too long ago—where we are able to discuss with them their issues, both in a macro context but also in the context of the Committee. We have regular reports, a monthly report from Charlie Bean on how the process is working and any particular issues that are emerging, internally and externally. It is an iterative, continuous process anchored each year in an annual process.

Q333 John Thurso: Are there any particular concerns that they express to you that come up regularly?

Ms Fawcett: Nothing urgent or compelling at this stage has come out. In the past, there was a big issue about support, which has been addressed; some concern about the forecasting round, which has also been addressed; some concern about data, ONS data on services for example, which they addressed directly with the ONS. Again, all of this has been what I would consider part of the process—refining it and making it better but nothing particularly acute or damaging to the process of the MPC at this stage.

Q334 John Thurso: The Bank of England Act also gives you the duty to deal with MPC members that you are not satisfied with and you can remove them at the end of the day. Have you ever had a case where there is an MPC member that you are not satisfied with or considered in any way?

Ms Fawcett: Not in my time in Court, which is the last three years.

Q335 John Thurso: I did not think so somehow but I thought I would ask the question anyway! Are you satisfied with the current terms of appointment of the external MPC members, which is three years with the possibility of a three-year reappointment, or whether you would prefer to see a longer term that was fixed or some other variant?

Ms Fawcett: The main thing here is to attract the very best people we can, picking up Mr Love’s point, from the broadest possible base with the broadest possible experience. When you are an academic, you will have different constraints on your time in terms of how much time you can be away compared with someone in the City. The key here is to be flexible and not necessarily set in our ways. I have not seen or heard in my time in Court that the three-year term “with the possibility to renew for three years” has been an issue for any
member of the MPC, and I am not aware that it has prevented us from attracting the right people to the MPC.

**Dr Potter:** I believe there is an argument to appoint members for, say, six years. Professor Nickell suggested six years or five years with a cut-out at three; in other words, of their choice. The reason I say that is that I think that there is great merit in being completely independent of the appointment. There is huge merit in that.

Q336 John Thurso: The point would be that by not being up for reappointment, you would say that that gives a greater degree of independence?

**Dr Potter:** Yes, to the individual, not that the values and ethics of individuals currently are not independent but, nevertheless, it is better not to have any thought like that in one’s head.

Q337 John Thurso: Following on from that, in the evidence we had from Stephen Nickell, he suggested that there had been full-time external members in the past but there were now only three day per week members and that this might create some difficult. Is there actually a formal policy at the moment to hire new external members only on a part-time basis?

**Dr Potter:** The question is: what is the amount of work involved in that activity and also whether there is merit in other activities beyond the Bank? It is the view of non-executive directors that the period of three days a week, apart from holidays, is an appropriate time to do the job, if you like, and there should be time spent in broader matters to keep abreast of things as a whole through their other activities, and so we believe that three days a week is the appropriate level, and that is the current position formally. In the past, during my time, there were members who were there for four days and paid for four days out of five. I cannot recall prior to my time, which is since 2003, whether there were five days but perhaps there were.

Q338 John Thurso: The point that I am looking at here is that we have talked earlier about remuneration and getting the highest possible quality of people. If you had a candidate who was working for a major financial institution and therefore on a large City salary, clearly to do a job on the MPC at three days a week, they would almost inevitably have to resign that other job. They are faced with the choice of three-fifths of the salary that you decide upon, probably giving up several times that to take the job and many people will say, “No, thank you, I will keep the well-paid job”. Are you not therefore then unnecessarily restricting the pool of applicants by making it three days regardless?

**Dr Potter:** I think if you made it five days times the amount that we have been talking about here it still would not impact hugely on the scale of the City salaries that are involved and therefore I think the point is moot. In addition to that, if they were employed on the MPC and coming from a City institution, they would undoubtedly have to leave their position because of conflicts of interest or possible conflicts of interests that could occur. I am afraid it is a serious problem that the remuneration that can occur in the City is of such a different order, if you like, compared to the general level of economists in the academic world for example, or in the business world more generally. My only answer to that is that people take on the role because it is eminent and it is status-enhancing at the peak of their career to be appointed to the MPC. That is why they will join.

Q339 John Thurso: It comes back to the point that Mr Fallon was making about the appointment process. Because you are disjointed from that, you do not really know how much this impacts because that is being dealt with by the Treasury. If you had a Nomination Committee and were dealing with it as a plc would do, you would be more aware and alive to these issues.

**Dr Potter:** I totally agree with that. I think there is an argument, as I think has been discussed in the Committee, that the process of appointment could partly occur through a consultation internally in the Court, which would go towards this panel. It has been suggested the Chancellor could ultimately set it but I do think there is great merit in that.

**Peter Viggers:** Chairman, could I say that we regard this inquiry as important and when a significant witness is due to appear and then fails to appear, that is a disappointment.

**Chairman:** There has been a communication that there are legitimate reasons why Sir John Parker is not here.

Q340 Peter Viggers: I did say “disappointment”. The Court is specifically tasked with determining whether “the Committee has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy”. How do you carry out this duty?

**Dr Potter:** Firstly, I would comment that the Bank has a set of agencies across the country in the different regions and countries of the United Kingdom that reports back, by having monthly interviews in their regions or countries, the results of the activities in their region or country to the Bank of England in Threadneedle Street. That agency is very substantial and important. To give you some idea, we compared the Bank of England with the Bank of Canada and the Reserve Bank of Australia. In the Bank of England, some 25% of our resources are supporting monetary policy are devoted to collecting regional economic intelligence. In the Bank of Canada, the equivalent figure is 7% and in the Reserve Bank of Australia, the equivalent figure is 12%. The Bank of England spends two to three times as much relatively as these other equivalent reserve banks in doing that. Members of the Monetary Policy Committee and members of the Court travel across the country; many of them give lectures and have meetings with business people in those different regions. We also, as members of the Court, attend pre-MPC meetings.
where we see the agencies delivering their reports. Usually one of the agencies will deliver the report to the MPC. In a whole variety of ways, we check that this process is carried out extensively. I believe it is.

**Ms Fawcett:** I would add that this is a critical part of the questionnaire process that I was mentioning earlier. Each year we will ask every MPC member what their view is on the agencies, on the regional information, country information, including how well the agents are working and this will be discussed with MPC members.

**Q341 Peter Viggers:** The MPC is of course not completely transparent; it is not intended to be. Mechanisms are built in terms of delay and in terms of anonymity to a certain extent. How do you monitor the transparency of the MPC and make sure that it is as transparent as it should be?

**Dr Potter:** Every month we have a report on the previous weeks activities of the MPC. We get the minutes. We attend pre-MPC meetings and we have quarterly discussions from the Chief Economist of the Bank, Charlie Bean, on the MPC process and how it is going. Therefore, we are in a position to study how matters are articulated publicly and the balance of that and those members on the MPC who are members also of Court discuss that at Court. There are discussions about the transparency but in general the Bank tries to be as transparent as it possibly can. I think this has been discussed by the Governor and the issue arises as to whether you get into sign language which can be unfortunate. In general, the Bank tries to be transparent. I am satisfied that it is.

**Q342 Peter Viggers:** Yes, it tries to be as transparent as it wishes to be. The Court has been praised by former external members of the Monetary Policy Committee for the work that it undertook to ensure that members of the Monetary Policy Committee had sufficient resources available to it. Would you say a word or two about that and about the manner in which that operated and the manner in which you ensure that sufficient resources are made available?

**Dr Potter:** Ms Fawcett has said that every year we carry out a survey with an extensive questionnaire, which is filled in and on scores in the range of one to five last year that figure of satisfaction by MPC members was round about four out of five, so pretty satisfied overall. In addition to that of course they are questioned formally by the Chairman of the Non-executives, Sir John Parker. In addition to that, we have a variety of opportunities throughout the year to meet with MPC members. This can be informally over lunches or it can be formally in Court when about every three months MPC members will come along and be quizzed and there will be discussion as to how satisfied they are. Through these various procedures and processes that occur regularly annually throughout each year, we do get comprehensive feedback. I believe that overall at the present time our data says that things are pretty satisfactory. There are some evolutionary changes. If you go back five or seven years ago, there were many more substantial changes than there are currently because the system appears to be working pretty satisfactorily as far as they are concerned.

**Q343 Peter Viggers:** One witness, Dr Wadhwani, taking to us in March of this year has said, and I quote: “There have been rumours around that there may be an attempt to take these resources back from external MPC members which I believe would be a retrograde step.” Are those rumours that you have heard?

**Dr Potter:** Absolutely not; I have no knowledge either of the rumour or the fact. There is no such intention of which I am aware.

**Q344 Peter Viggers:** You are satisfied that MPC members have access to you and could communicate if they were concerned about resources?

**Dr Potter:** Absolutely.

**Q345 Peter Viggers:** Does the Court hold any other concerns as to resources allocated to monetary policy by the Bank, whether in terms of staffing or financial resources?

**Dr Potter:** Let me comment and then ask Ms Fawcett to comment as well. Annually, we receive a report on that issue from the Chief Economist to the Court and we discuss it in Court extensively. We also discuss the budgets very comprehensively of the Bank of England every year, so you have the strategy and the three-year plan below that and then you have budgets as well. The Court is tasked with ensuring value for money and the efficient use of resources of the Bank. The issue arises as to how many economists do you need and how much resource do you need in order to produce policy? You can argue that one economist and a computer would do the job but do you need 500 economists, as you have in the Federal Reserve or in the ECB, or some 180, as you have in the Bank of England? There are about 106 economists in monetary analysis and they are of high calibre. What has been changing is that the number is being reduced somewhat but the experience and expertise, the level of those, is being increased, so there is that change going on. The level of funding assigned to monetary analysis was £64 million during the last financial year. On all the reports that we have had, both by external assessors like Kohn and Pagan, or by external people who attend the pre-MPC meetings and see the process, it is considered that the provision of analysis and data is of the highest calibre and quality.

**Q346 Peter Viggers:** Then the Court straddles the two worlds of the official government structure, the Bank of England, and the financial world outside. From that privileged position, are you satisfied that the Bank of England is able to recruit people and box its weight because the distorting effect of some City salaries now is having a very significant effect?
Dr Potter: I think that is an important and key question. The answer historically is “yes”. To spread the question, it is an issue for the future and it is a matter that I have raised and indeed the Court is concerned about and we have discussed considerably. I do think that the fact that one has a very wide range of economists who will play many different roles in our society means that we tend to attract obviously the most eminent graduates coming in, the highest calibre graduates coming in. We take them through their 20s and 30s but do we lose them in their 30s? The issue is our ability to retain those people and groom them for the highest levels in the Bank, and also the ability to attract people in their 30s when they are at the peak of their careers, if you like, as economists. I think the threat of City salaries is a major issue. The reputation of the Bank of England is very substantial. The nature of the work and the fact that you are influencing policy and you are concerned with public policy is a magnet, and all this helps currently to allow us to attract and retain staff, but it is an issue in the long run, which we need to be concerned about.

Ms Fawcett: I would add further to what Dr Potter has said. Quarterly we do get a very extensive performance report across all the various strategic and business objectives and financial objectives of the Bank. What comes out of that as well are some detailed statistics on recruiting and retention by area. I would add that this is an issue not just for monetary policy or monetary analysis but also for financial stability. In Court we take a great deal of time to go through that information and discuss with the Bank what their procedures are. We have pressed very hard for a specific strategy on how to retain the very best people that they can. Originally I am from the City. I would be the first person to tell you that there is a rather large disparity between City salaries and those of the Bank. In the past this may not have been such an acute issue, for the reasons that Dr Potter mentioned, and I have seen it from my own institution. The Bank of England is an institution of the highest reputation and people are pleased to work there. Going forward, given the nature of the body, you are never going to be able to rectify the financial imbalance but there is something about whether we are properly structured and prepared for slightly more turnover and how we deal with a workforce that may come in and go out with a little more regularity.

Chairman: Can I thank you for your evidence. We wish Sir John Parker a quick recovery. If there is anything we have missed this morning, we are happy to receive further written submissions from you.
Q350 Chairman: In the Leitch review, does that contribute towards that debate, do you think?

Mr Lambert: Yes, I think so, in two ways: one, it provides a great deal of data to show the areas of strength and more particularly the areas of weakness in our skills set in this economy; and, two, it comes up with what I think are some sensible policies.

Q351 Chairman: Does your report on higher education have any links, do you think?

Mr Lambert: I think the process which I describe in that report does have links. If you go round our universities in the UK, you will see them playing a much more dynamic role in the economy than they did 10 years ago at every level. That is a very exciting part of what is going on here.

Q352 Mr Fallon: Mr McCafferty, Lord George told us that because of global economic weaknesses when he was in charge, we pushed consumer spending up to levels that could not possibly be sustained in the medium and longer term. In turn he says, and I quote, “That pushed up house prices and increased household debt. That problem has been a legacy to my successors; they have to sort it out . . . .” Do you agree with him?

Mr McCafferty: I think it was clear that over the period of the early years of this decade consumer spending growth was rather faster than would be expected in terms of a long-term equilibrium rate of growth for that consumer spending and was, to some extent, dependent on increasing debt as well as growth in real, personal, disposable incomes. It has left a legacy for some individual households of perhaps an uncomfortable debt level, which would be very sensitive to further increases in interest rates, and that clearly, as Lord George and the present Governor have said, leads to a potential of individual social tragedy. It is also clear, however, that the rise of debt in this economy in the consumer sector is as yet insufficient to threaten the systemic stability of the UK economy; it is simply not quite large enough as a phenomenon and would require, on the Bank’s own calculations, interest rates to go much higher than any commentator has so far suggested before it was to become a systemic risk for the stability of the economy. However, I do think that it is clear that consumer spending growth will have to slow in the coming years, as economic conditions change.

Q353 Mr Fallon: Lord George is saying that it is for the MPC to have to sort this out, or indeed perhaps the Government.

Mr McCafferty: I would not necessarily agree with the phrase “sort it out”. I do think that the MPC needs to be mindful of consumer debt levels and other conditions in the consumer market when setting inflation, but unless that particular phenomenon becomes a systemic risk to the stability of inflation, it is not really within the ambit of the MPC to deal with the individual credit decisions of individual consumers.

Q354 Mr Fallon: But the MPC is running monetary policy. Do you think it has given insufficient weight to the new position of housing within the UK economy as above other asset classes?

Mr McCafferty: No, I do not because I do not think that it is possible, given the structure of the MPC and the architecture with which it controls inflation, to target individual asset prices explicitly, nor do I believe that it is possible necessarily to consider how those individual asset prices affect underlying inflation with any certainty or consistency. I think from that point of view, to the extent that house price inflation impinges on the stability of overall inflation, the MPC needs to be mindful of that and take it into account but should not target individual asset classes specifically.

Q355 Mr Fallon: Tim Page, do you think the MPC is sufficiently aware of the risks of a rise in house prices and increased household debt?

Mr Page: I would imagine the MPC is sufficiently aware, yes. Obviously, the MPC needs to balance a whole range of needs for the economy: the needs of industry, the needs of house prices; the needs of a wide range. I would fully expect the MPC to be aware of that.

Q356 Mr Fallon: Are you satisfied they are doing enough to show awareness of that?

Mr Page: On the evidence that I have seen, yes, I am.

Q357 Mr Gauke: May I ask about the monetary policy framework. Mr Barber, the TUC’s evidence to us has stated that RPI remains the basis of most wage negotiations.2 Given that, does the TUC think that it is right that CPI is the target of the Bank of England for the MPC?

Mr Barber: We do not object to the CPI being used as the measure for the inflation target for the Bank but we make the observation, as you say, that in terms of wage bargainers, I think RPI remains the index of which they take closest account.

Q358 Mr Gauke: Where there is, if you like, a divergence between the two, in some respects monetary policy will not be designed to prevent large wage increases. Is that fair comment?

Mr Barber: Monetary policy obviously takes account of wage bargaining and is designed to influence expectations of wage bargainers, but that is not the only factor that drives the decisions the MPC makes month on month of course.

Q359 Mr Gauke: Mr Lambert, do you think that CPI is the right target for the MPC?

Mr Lambert: I think two things: one that it is very important that there should be consistency of targets, so I think it would be a big mistake to chop and change the targets from year to year. One change in 10 years is more than enough because it is all about credibility in the end and that would be undermined.

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Q360 Mr Gauke: Do you think the change to CPI itself was in some respects regrettable?

Mr Lambert: No, I do not. I think the CPI is a good index for the purposes that it serves, but I would think it would be very regrettable were the index to be changed again, simply because it would confuse the public. As far as wage bargaining under the RPI is concerned, it is for the market to decide. That is for individual employers and employees to decide what is appropriate for them, but the Monetary Policy Committee in its deliberations obviously spends a lot of time thinking about trends in earnings and trying to project that forward and drawing conclusions about the likely impact on inflation and that bears through on their decisions about interest rates. So the fact that bargainers may or may not use the CPI for their decisions does not have any implications on the MPC’s judgments about the path of inflation going forward.

Q361 Mr Gauke: Do you think there are any dangers in house price inflation not being included in CPI?

Mr Lambert: I think ideally that you would find a way of getting house price inflation into the index because obviously it is a very important part of everybody’s budget. It turns out to be a very difficult thing to do. As I understand it, it is not in the HICP and continental Europe either; no-one has completely cracked that one, have they, Ian?

Mr McCafferty: That is right. It is not in the current HICP for the ECB or for any of the individual countries. There is, however, a good deal of work going on centrally in order to try to include house prices in the HICP as followed by the ECB, and that work would also lend itself possibly to include house prices into the UK defined CPI as well. As Richard Lambert says, because of the differences in ways in which you can do this, it is not an easy calculation as to how you include house price valuations in this instance.

Q362 Mr Gauke: Mr Page, would you be sympathetic to house price valuations being included within the inflation target?

Mr Page: I would be very sympathetic to that because house prices are such a large part of any working person’s monthly outgoings, so an inflation rate that does not reflect house prices is a less than perfect inflation rate from that point of view.

Q363 Mr Gauke: Looking at the last 10 years, it has clearly been a good time for the MPC both about benign conditions and, as the Governor has pointed out, there is no guarantee that the next 10 years will be as successful. Can I ask Mr Barber: in the event that circumstances are not as strong in the next 10 years and that we see interest rates having to rise because of perhaps inflationary pressures and so on, how strong is the support for the MPC within the trade union movement and, in the event of higher interest rates and higher unemployment, to what extent do you think that the trade union movement would be much more critical of the MPC?

Mr Barber: I think the trade union movement has certainly been a real appreciation of the degree of economic stability that has been achieved over the last 10 years. I certainly remember earlier periods when wage bargainers were chasing inflation rates at ever higher levels and not being able to deliver real improvement in living standards in those periods. The benign circumstances you describe that we have enjoyed over the last 10 years I think have been appreciated by the trade union movement as a very important component in providing a platform on which we can really see people’s living standards progressively improved. Against that background, I think there has been real appreciation for the role that an independent Bank of England has played and that the MPC has played by taking some of the politics out of short-term decisions on interest rates and helping to create a climate in which there are widespread expectations that the low inflation environment that has been created can be sustained.

Q364 Mr Gauke: The MPC has had a fairly fair wind behind it in the sense that globalisation has meant that the prices of a lot of goods have come down and so on. The next 10 years might not be the same. There might be more international shocks than we have seen in the last 10 years. How resilient do you think that consensus that we have in the CBI and the TUC at the moment, under the current structure, is in the event of waters becoming choppier?

Mr Barber: As the Governor has pointed out, the problem with shocks is that they come as a surprise! We cannot anticipate what those shocks might be and where they might come from and of course, in circumstances where there has been a major shock to the economy, that potentially throws up all sorts of pressures and concerns. I have a concern at the moment, for example, just about the extent to which unemployment has been creeping up over the recent period, but a major shock to the system puts all sorts of pressures on our arrangements, but I think the MPC has established itself very solidly over the last 10 years. It has acquired a lot of respect for the way in which its decisions are made, the evidence on which its decisions are based and the objectivity the members of the MPC bring to their deliberations, and that provides a very solid basis for coping with shocks that might arise.

Q365 Mr Gauke: Mr Lambert, do you think more could be done for the MPC or whoever to educate the public as to the role of the MPC in the event that times prove a little bit more difficult in the future?

Mr Lambert: It is worth remembering that there have been some very big shocks over the last 10 years, ranging from the Russian defaults and the quadrupling of energy prices, and they have been absorbed but you are right to raise the question for the future. I think the MPC could probably do...
more to educate the public on its role and its mission. It is very good indeed at communicating with financial markets and economic analysts about what it does and why it does it. It might well be in its interests to think about—and I know it is thinking about—how to inform and educate a broader public about its mission because, as you suggest, when times get tougher its role will be more controversial and it would be a good thing, ahead of that, if more people knew why what it did was important and why its decisions, properly made, are to the benefit of the whole of society.

Q366 Mr Gauke: One point that has been raised with us is the relationship between monetary policy and fiscal policy. Mr McCafferty, to what extent do you think fiscal policy is important as far as inflation is concerned, that the MPC has to take into account fiscal policy? For example, the argument has been put that fiscal loosening in 2002 has resulted in slightly higher interest rates than would have been the case. Do you agree with that?

Mr McCafferty: Clearly, fiscal policy is important to take into account when considering the inflation outlook because, of course, fiscal policy affects demand in the economy and that clearly has a knock-on effect into potential inflation. To that extent the Bank does have to pay close attention to the fiscal conditions and their impact on total gross domestic product or the growth therein. I think there is an argument to say that we have not yet achieved the optimal balance between fiscal and monetary policy and that fiscal policy has been somewhat loose over the course of recent years, with very rapid rates of public expenditure and a rising budget deficit, and this has led to interest rates being slightly higher than would have been the case. That suggests that there is room for further discussions between the two bodies in order to try to achieve that optimum balance between the two sets of policies.

Q367 Mr Gauke: Do you think the Bank should say more publicly if it has concerns about fiscal policy or is that straying into areas best left alone?

Mr McCafferty: I think I would start by discussing it more privately and if there are concerns in the Bank about this balance they should perhaps express these to the Treasury individually, but there is finally a role for public comment if that is required.

Q368 Mr Gauke: Mr Lambert, you have worn various hats with regard to this issue. Would you agree with that?

Mr Lambert: Yes. Obviously the Bank, in making its central projections, incorporates the Treasury view of public spending going forward and it deduces from that the inflationary effect in the way that Ian said. I think the Bank should be strongly advised to steer out of politics and not get involved in political debate. Its job is to get involved in monetary conditions. If, however, it thought fiscal policy was seriously and adversely affecting monetary policy it should say so. It would come out in the minutes in the first instance.

Q369 Mr Gauke: Mr Barber, again the TUC evidence has said that “a monetary policy framework that recognises the need to support industry as well as to keep inflation low would be welcomed by trade unionists.”3 How do you think the MPC might go about doing that? How, indeed, could the Government change the structure to enable it to do so?

Mr Barber: Within the constraint of a body that has a decision to make each month on interest rates, it is clearly not possible to target one particular sector of the economy. The point we were making is a broader point, in a sense, that, in weighing up the pressures within the economy, the pressures on the manufacturing sector are an important part of the mix that need to be considered by the Monetary Policy Committee, but clearly it cannot make a decision month-on-month specifically targeted to the needs of one sector of the economy alone.

Q370 Mr Gauke: When you say that the need to support industry as well as to keep inflation low should be recognised within the monetary policy framework, are you, in saying that, suggesting that perhaps the target should be widened or that there is a higher inflation target? What should be the response to that?

Mr Barber: I think we are saying that the remit to the MPC is a remit relating to monetary stability but taking account of the implications for growth in the economy more generally. As an element of that slightly wider description of the remit, the needs of the manufacturing sector and the pressures on the manufacturing sector need to be taken into account.

Q371 Mr Gauke: Do you not think that would weaken the counter-inflationary credibility of the MPC?

Mr Barber: No, I think the real needs of the economy are to maintain a viable economy going forward, including a vibrant manufacturing sector, maintaining high levels of employment to reduce pressures on the public finances. These are all part of the mix.

Q372 Mr Gauke: Mr Lambert, do you think that the MPC could give greater weight, say, to the manufacturing industry when determining monetary policy?

Mr Lambert: I think the Monetary Policy Committee has a single instrument, which is interest rates, and that it has a single target, which is a symmetrical target—which is really important. Within that, it is very difficult—and I do not think it would be advised to be trying, as it were—for it to deconstruct the economy and aim at particular sectors of it within its forecasting work. Obviously

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it takes into account its projections of the output of the manufacturing sector and the services sector but it also has to think about the likely implications for the exchange rate acting in a particular sector’s interests.

Q373 Mr Gauke: You state it is important that it is a symmetrical target. Some evidence to us has suggested that there is an anti-inflationary bias, or perhaps there has been in the earlier years, to establish credibility. Do you detect that at all?

Mr Lambert: I was on the Committee when we were one basis point above having to write a letter for being on the down side. I can tell you we were nervous about that and we took that very seriously.

Q374 Mr Gauke: Mr Barber, do you detect an anti-inflationary bias?

Mr Barber: During that period that Richard describes, when for a long period we were coming out well below the target, I think there was a concern in the trade union movement that there appeared to be a bias, if you like, on the down side. We have now seen a period when it has gone the other way, of course.

Q375 Mr Love: I would like to go back to a comment made by Mr Barber earlier on about inflationary expectations. Earlier this year there was some notable concern, most notably by the Monetary Policy Committee itself, that there may well be in this wage round inflationary awards given. That has not turned out to be the case and I would be interested to get both your views about why that is. Is that a one-off, or has there been a change in the signalling mechanism between the Monetary Policy Committee and the wage bargaining process; in other words, a longer term improvement?

Mr Barber: As you say, there were some signals of a degree of apprehension that wage bargaining might lead to settlements that put up-side pressure on inflation but I do not think that has been the evidence of what has occurred in recent months. I think that has been acknowledged by the Bank in its own inflation report. Why that is the case, I am not sure. In the public sector at the moment we have a very tight squeeze on pay settlements, to a level that I do not think is justifiable, with the limit seeking to be imposed by the Chancellor coming in under the 2% inflation target, when inflation, of course, as measured by RPI, is running currently at 4.8%. That is applying major, major pressures on the living standards of public service workers in a way that I do not think is advisable. We are still in a period where wage bargainers have not been fazed by the rise that we have seen in inflation and still regard that as a short-term change and a short-term pressure rather than signalling a major change in the inflation environment and I think that led to settlement levels at a level that have not contributed to inflationary pressures.

Mr Lambert: I think there has been a long-term change in the outcome of wage bargaining over the last 10 or 15 years, which is that inflationary expectations have been well anchored around the target and people broadly trust the idea that, over time, the target will be met. That has changed the behaviour of bargainers on both sides of the table and that is a really important gain. Going around the country I see quite different stories coming out of different sectors of the economy. In some areas there are real bottlenecks and, as you would expect, wage awards are going up in those areas, but, taken overall, it is clear so far, at any rate, that the wage round appears not to have had the inflationary implications that might have been a concern at the beginning of the year.

Q376 Mr Love: I am going to assume that both of you think the Monetary Policy Committee, by anchoring those inflation expectations, has been a major contributor towards that. If we look back in history, we have often had one year, perhaps even two years when things were relatively turbulent and wage awards have been subdued, only to find them racing forward again. What confidence do either of you have that if we have further turbulence, further increases in inflation as a consequence, that will not lead inevitably to the sort of wage rounds we have seen in the past?

Mr Lambert: Because if you look back over history and see the changes that happened around the early/mid 1990s—the process started before independence—there has been a clear and marked change in inflationary expectations which has been sustained now for 12, 13, 14 years. Somebody like me, who can remember the seventies and eighties very well, finds it absolutely amazing that this should have happened but it is a clear and I think sustainable change, going forward, in the way people think about inflation. That is a very important success that must be sustained.

Q377 Mr Love: I would expect you to be a little more cynical than that, Mr Barber, and discussing it with your trade union members you may find there is some considerable concern. I noted your concern about the public sector norm. How concerned are you that the Monetary Policy Committee and, indeed, everyone has to realise that inflationary times will inevitably lead to a greater demand in the wage bargaining round?

Mr Barber: Of course people at work want to see their living standard maintained and improved. I agree with Richard. Essentially, we are in a period where there is widespread acceptance of the low inflation environment being the environment in which we all operate, but I am concerned that, in particular in the public sector, we are in danger of creating again, to use a phrase, a “boom and bust” approach. We have had a period of reasonable increases in earnings for public sector workers in recent years but to be faced with pay awards coming in at less than half the level of inflation and for the Government to seek to impose those in the way they are looking to do at present, is in danger of creating a backlash, and I do not think that is in the interests of the services concerned or the economy more widely.
Q378 Peter Viggers: To focus on appointments to the Monetary Policy Committee, specifically appointments of external members of the Monetary Policy Committee, Mr Lambert, what criteria should be used in selecting external members of the Monetary Policy Committee?

Mr Lambert: The criteria should be that the appointments should sustain and enhance the credibility of the Committee.

Q379 Peter Viggers: Should it be balanced? Are there particular skills you would wish to see on the Monetary Policy Committee; for instance, business experience?

Mr Lambert: No, I do not think the Monetary Policy Committee should be representative in that sense. In other words, I do not think there should be somebody there who is there because they are a business person or because they are a trade union representative. I think you need around the table a group of people focused on a single goal, articulate enough to express their views on that goal, and— you would expect me to say this—the notion that they do not all come from exactly the same background adds to the quality of the decision-making. If everybody had a PhD in a particular line of economic research, it might not lead to as lively a debate as if there were a few people with different experiences sitting around the table.

Q380 Peter Viggers: Mr Barber, do you feel there should be representation or that there should be one or more members who have particular knowledge of one particular aspect; for instance, trade union affairs?

Mr Barber: No, I broadly agree with Richard’s description. You need a balance of experience reflected but more than anything you need people with the capacity to cope with the wealth of data that needs to be analysed and assessed each month and the confidence to play an active part in the work of the MPC. It is a body that cannot carry passengers: every member is directly accountable for their own vote month-by-month and you need people with the expertise and the confidence to play that role.

Q381 Peter Viggers: Do you think the current three-year term, re-appointable, is the right system or would you recommend a different period of time?

Mr Lambert: Perhaps I may describe the argument for and against. The argument for having a longer period, non re-appointable is that the person then would build up experience, be able to make a substantial contribution, because it takes a little bit of time to get the hang of what is going on there—and then non re-appointability, as it were, would underwrite the independence of the Committee. Against that, I think there have been some very talented and important external members of the Committee who simply would not have come if it had been for more than three years; for example, if they were distinguished academics who could manage their life to take a big chunk of three years out to do that but the four years would be harder. So I am afraid I do not have a clear view on that.

Mr Barber: Richard, again, has described a mix of considerations. On balance, I am content that the current arrangement is about as well balanced as you could make it.

Q382 Peter Viggers: The appointments process itself has been described as opaque. We were giving evidence earlier this morning, which you may have heard, from the Court of the Bank of England, in which they pointed out that they regard the Treasury as being the body that makes the appointment. Are you content with that or do you think there should be changes?

Mr Barber: The reality is that it is the Chancellor who makes the appointment. The Act specifies that very clearly. I share the frustration that has been articulated by quite a few people during the course of this inquiry, that the arrangements on which those decisions are made are extremely opaque. There is no transparent process through which candidates can apply, can signal an interest. The decisions appear like a puff of smoke, without any awareness of what the range of candidates might have been and so on. I think a greater transparency and openness would be highly desirable.

Q383 Peter Viggers: And timeliness is relevant too, of course.

Mr Barber: Yes. The same point: there have been instances where the membership has been incomplete for a period and so on, so I do not think the processes have worked desperately well. In terms of managing the balance of experience within the membership of the MPC, it is notable that, apart from Kate Barker at the moment, the external members are all of relatively short experience and trying to manage the appointments process over time to produce a blend of greater experience along with the newer members within the external members, seems to me to be an important consideration that ought to be factored in too.

Mr Lambert: I would add a slight gloss on that. I certainly agree with Brendan that time limits are extremely important but it should be noted that last year was a bit unusual. There was the tragic death of David Walton, my unexpected departure and Steve Nickell clearly was going to move on after doing two terms. Last year was a bit special in that sense.

Q384 Peter Viggers: Have you given thought to how some greater level of transparency could be introduced? Would it be through the Court, for instance? Does the Treasury Select Committee have a part to play? Does the trade union movement have a contribution to make?

Mr Lambert: My own feelings are that there needs to be a degree of discretion for the Chancellor and, indeed, for the Governor in settling on the line-up
of the team. I think the Treasury Select Committee has an important part to play in testing the robustness of the appointments and the integrity of the appointments and that is what you do do, so I think that works well. I would have thought it would be a good idea, one way or another, to collate a bench of relevant experts who might be available, so that when an appointment needed to be made it would be possible to choose from a pool of people who were sort of up and willing. To have some kind of pooling arrangement of that kind would be better than to leave it, as sometimes seems to happen, until the last minute and move in that way.

Mr Barber: I agree with that, and having an appointments process that was more comparable to the kind of procedures that are used in other major public appointments, with a degree of openness about the application process and with a selection panel, potentially, which could include a wider range of expertise. If the ultimate decision remained with the Chancellor, so be it, but I think one could build into the processes leading up to the final decision on the appointment a wider range of expertise and so on that would just build greater confidence in the process overall.

Q385 Mr Newmark: I have a couple of questions to do with what Ian was talking about earlier, to do with systemic risk. We have the inflation rate pretty close to its 16-year high. Interest rates keep moving up and up and we see personal debt at trillions of pounds at the moment. Ian, you said that we are not at a tipping point (that is, a point of systemic risk) on personal debt. At what point do you see that happening? How much do interest rates really have to go up to start changing people’s behaviour?

Mr McCafferty: Perhaps I could put some context before I answer the question itself. Yes, inflation has risen quite sharply over the course of the past 12 months to the peak of 3.1% on the CPI, triggering the letter, but it is clear that that measure and the RPI measure for inflation, certainly RPIX, will be coming down quite substantially over the course of this year as the changes in energy prices, which were one of the key factors driving inflation up over the course of 2006 and early 2007, start to fall out of the equation. I think it is generally expected that we will be coming back close to the target of 2% at some stage close to the end of this year. It is difficult to be specific in terms of months. This concern that somehow inflation is ratcheting up and will continue up almost ad infinitum is perhaps slightly misplaced. The Bank’s own work on debt sensitivity suggests that for what I have already termed as the “problems for individuals”, which one should not underestimate, to become so widespread as to become of systemic risk to either the banking system or the broader economy would require interest rates well north of 7% or 8%. Against that inflation background that we expect and I think is fairly consistent amongst those who study these issues, that is—

Q386 Mr Newmark: Before we can start changing people’s behaviour, you think we still have a long way to go.

Mr McCafferty: That is a slightly different question. You asked me what it would require for debt to become a systemic risk. You are now suggesting that we somehow need to use interest rates in order to change people’s behaviour.

Q387 Mr Newmark: If you want to keep the lid on inflation, other than energy prices, to which you have correctly alluded, there is the whole consumer boom at the moment.

Mr McCafferty: The consumer boom at the moment is not being driven by debt. Other than the debt being taken out in the mortgage market to purchase houses, the consumer debt growth has slowed very dramatically over the course of the last six months or so. Unsecured debt has been growing now much more slowly than it has for the past five years or so. The reason that consumer spending has started to accelerate slightly, relative to the very slow growth that persisted through 2005, and which has since grown a little faster over the course of 2006 and then into 2007, is changes in the rate of growth in real disposable incomes, which are expanding slightly faster as inflation has headed off the peak and is expected to continue do so.

Q388 Mr Newmark: We have seen a huge wave of mergers and acquisitions going on. We have seen companies take on more and more debt to fuel these acquisitions. Do you see a tipping point coming up? If interest rates keep moving up, suddenly there will be, to use Brendan’s phrase, a “shock to the system”. Something will suddenly happen. One of these big acquisitions will not be able to service its debt, which may lead to a problem, or are you not concerned about that?

Mr Lambert: If you look at corporate balance sheets as a whole over the last five or 10 years, I think I am right in saying that you will see a steep rise in corporate debt in the period up to about 2004. In the period of rising profitability and rising cash flows, overall debt levels were contained and then reduced, so balance sheets strengthened for the couple of years after that when taken as a whole. In the last months, there has been, as you say, a surge in acquisitions, some but not all financed by cash. The FSA has done work on this and published it and concluded this does not pose a systemic risk. It is always possible that some large company will take on too much debt and will run into trouble but I do not think there is any reason to fear that that would have broader consequences for macroeconomic performance, particularly at a time when bank balance sheets look pretty robust.

Mr Barber: I think this question from Mr Newmark is perhaps anticipating another inquiry the Committee has in hand on the role of private equity. I do have some concern that the level of debt involved in some of the takeovers that we have seen recently and, indeed, some of the transactions in prospect, are now reaching a level where there has to be some concern that along with that debt...
comes a greater risk to the viability of the business and a greater vulnerability should pressures arise in the economy with an increase in interest rates, for example. I know that concern is shared by a number of independent commentators too. I would not want to sound alarmist that I see this in a sense threatening financial stability more widely, but I do think it raises question marks.

Q389 Mr Newmark: It was more to do with the systemic risk and by how much interest rates have to go up.

Mr Lambert: Sure.

Q390 Mr Newmark: My final question is to Tim and it is to do with Ian’s attitude about RPI and CPI. For ordinary people out there, it seems that RPI and CPI have no bearing on their lives whatsoever. All of us have pensioners in our constituencies and their inflation rate would seem around 9% or more. I am curious about the thinking. What goes on trying to feed that sort of input in when discussing which index, when one is looking at RPI and CPI, and whether these have any relevance whatsoever? You talked about having housing costs as another input in there.

Mr Page: Sure. The trade unions would want to see levels and measures of inflation that reflect the real pressures that their members face. We make the point about RPI as opposed to CPI because housing is such an important part of the spending of most families within any one month. We would say that the measure of inflation needs to reflect the pressures that people face. I do not know about figures like 8% or 9% but—

Q391 Mr Newmark: Would you have things like council tax thrown in?

Mr Page: Council tax would be included in RPI but would not be included in CPI. I do not have a list of things that should go in or not go in. Most people looking at their outgoings each month and looking at an inflation rate of 3.1% would find some divergence between those two phenomena. Brendan made the point about public sector workers: an increase of 1.9%, when they would see the costs that they face being so much higher. I do think these points need to be borne in mind.

Mr Newmark: When you are having these discussions, what is the reaction from the other members? What is the response to saying that the index has no reflection on your members and what they are seeing out there?

Q392 Chairman: I think that should be addressed to Richard because you are the only person here who has been on the MPC.

Mr Lambert: There would be two responses. One would be something which the Governor always says, that everyone can make their own personal inflation index depending on their lifestyle and life choices. You have to arrive at some kind of median that represents broad things. I do think, however, that if the inflation measures which are used for policy making do not bear on people’s lives then there is a risk to credibility going forward. So I think it is not a trivial matter.

Q393 Mr Todd: If membership of the MPC is not representative and you have argued very strongly that it should not be particularly so, it makes it all the more important that there are mechanisms to speak to the real world outside rather than being driven by a set of data provided. To what extent are you satisfied with that engagement and the ability to communicate with the real world about, for example, the matter you have just been discussing?

Mr Lambert: The Bank has, as you know, representative offices around the country and executives whose task it is to communicate as widely as possible with business and economic actors in their region and to funnel that back to the Bank. That works really well. Another thing that works well is that members of the Committee spend a lot of time going round the country, again talking to lots of individuals, lots of companies and so on, trying to get a sense of what is going on in the air out there, and you can learn things from that obviously that you never pick up in the data. Where it is possible, as I suggested earlier, that more could be done is when on a regional tour you might speak to 10 companies and just to the local newspaper, you could get a wider audience for your views if you really focused on a broader audience than perhaps happens now. That is the only point I was making.

Mr Barber: I think it works pretty well. Richard has referred to the work of the regional agents. They do have a very wide range of business contacts, including colleagues in the trade union world, and keep in regular touch and so are able to get a feel for what is going on across the economy pretty broadly, I would say. My impression has always been that the members of the MPC are very open to talking to different interests around the economy. They will accept invitations, come and meet with trade union colleagues. We certainly had a number of exchanges of that sort. They certainly would not want to be thought of as sitting in an ivory tower, simply looking at the numbers every month and reaching their decisions. I think there is a sense that they want to be closely in touch with a lot of people around the economy and bring that feel into their deliberations too.

Q394 Mr Todd: Just extending what Richard said, there is an external communication function as well. Not everyone is blessed with strong communication skills to explain the role of the MPC, explain the information that has been gathered and how that information is weighed to produce an appropriate decision. Do you think that skill set is adequately represented within the MPC, or do you think it should be more sought in an appointment process?

Mr Lambert: They all strike me as being a very articulate lot who have no hesitation about expressing their views. I think that is fine, actually.
I do not think there are any at the moment but there probably ought to be some giant brains who can hardly speak they are so clever but they can just get on with cracking things, provided there is the right balance of other more jolly types around. I think that works quite well, actually.

Q395 John Thurso: Following on the theme of what and how the MPC should communicate, perhaps I could ask you, Mr Lambert, would it be useful for business, especially with regard to future planning, if the MPC were to provide more information on the future path of interest rates as they saw it?

Mr Lambert: I think that is a great and difficult question. Obviously some central banks in the world do that, but the ones which do it specifically do not, any of them, as far as I am aware, have Committees of independent people producing them. For a Committee of nine individuals to produce an agreed forecast of the outlook for interest rates over the next couple of years would be a very, very difficult process and you could imagine them coming up with nine different forecasts, which might be more confusing than helpful. The Governor, as I understand it, has said he thinks the Bank could and perhaps should be doing more work to explain the risks in the fan charts that they publish in the quarterly inflation report. That would be great, if they could find a way of doing that, but I do think that interest rate projections, if it is not simply being done by one or a couple of personalities, would lead to endless debate and endless compromises, unless you were going to have more than one—and if you have more than one I think you would be in trouble probably.

Q396 John Thurso: Broadly, the down side far outweighs the up side.

Mr Lambert: I think that is the case. Step one is to try to think of more ways of explaining the risks that the Committee sees in their central projections, going forward.

Q397 John Thurso: Going on from that, do you think more should be done to allow individual members of the MPC to communicate their views and have opportunities to express things to the public—and particularly the interested public, the markets and so on?

Mr Lambert: They do have opportunities, as they choose to take them, in making speeches—which they are encouraged to do. I must say I find myself in growing sympathy with the comments that Steve Nickell made in his submissions to you that there would be an argument for allowing individual members of the Committee to have a little paragraph at the end of the minutes expressing where they were coming from. The reason I think that is: a vote is just a vote. It is either yes or no. I have been at meetings where it has been clear that some people are very close to changing their minds but just have not changed their minds. That is not caught in a yes or no vote.

Q398 John Thurso: There has been an idea mooted, for example, that they could kind of rotate coming here to the Treasury Committee, if we gave them a slot to face questioning and express their views. Do you think that would be useful or would that be going over the top?

Mr Lambert: That happens.

Q399 John Thurso: Yes, it happens now as part of the general reporting with the Governor but I was thinking of something where, in turn, individual members would come, so that it would be their show rather than the team show.

Mr Lambert: Now I am off the Committee I will say it is a very good idea.

Q400 John Thurso: What a surprise! What would you say generally about the concept of getting more of a handle on what individual members are thinking?

Mr Barber: I think there is merit in that but within limits. A balance needs to be struck in this. I agree with Richard’s point that the key role in the Committee is in trying to explain the balance of risks going forward. The extent to which that would be enhanced by greater transparency about the exact positioning of individual members I am not sure about. I think periodic opportunities for them to come and give evidence to the Committee here would add value. I am not entirely persuaded by the idea of having a mini-paragraph for each member of the Committee within the Committee minutes.

Q401 John Thurso: Let me ask you all a broader question. Is there any information or any addition to the statement that is released that you think might be useful, that you would like to see in there that would help people have an understanding and therefore make better decisions, whether it be bargaining for wages or whether it be business planning?

Mr Lambert: One point which might be worth considering is whether the votes should be published more quickly than they are. As you know, the votes only get published when the minutes come out, which is 10 days after the decision is taken. The argument for doing it that way is: only when the minutes come out can you give the context for the votes that were cast. That is a legitimate argument. Against that, I think it is uncomfortable that what can be very price-sensitive pieces of information should be kept out of the public domain for any longer than is absolutely necessary for them to be kept out of the public domain. That is an area that is perhaps worthy of reflection.

Q402 John Thurso: What about the idea they have in the United States of a kind of bias statement?

Mr Lambert: I personally do not think that is a good idea. I think it is important and valuable that the Committee means what it says when it says that it goes into each meeting with a fresh and open
mind, determined to look at the data and make a decision accordingly. There have been times—and I think the case was 2004—when rates were picking up from a low point and it seemed appropriate to give a bit more of a steer about the likely continuation of that path, going forward. That seemed to be appropriate, but to have some kind of bias statement as a regular part of life I do not think would be a good idea.

Q403 Chairman: Is there any more the Treasury Committee can do?
Mr Lambert: I think the Committee performs very valuable functions in interviewing new candidates. That is a serious event. I should tell you that people who come along here for their first meeting do not come along casually. That is a strong point.

Q404 Chairman: To get out the flavour of each individual’s views, there is the point of view that maybe too much focus is on the Governor. How do we get the views of other members?
Mr Lambert: I think, personally, when the Governor and his colleagues are here you could throw more questions than you do at other members of the Committee. It tends to be a bit of a one-to-one.
Mr Barber: The regular sessions that you have with the Governor and others from the Bank I think are an important part of the system. I would not downplay the value of the sessions you already build into your proceedings.

Q405 Chairman: Brendan, you are a member of the Court and I have a last question for you. You heard us say that Dr Julius, who was an MPC member and a member of the Court, said that it “is a rather grand body with very little to do”. You will be aware of some grand bodies with very little to do but does that fit the bill as a grand body with very little to do?
Mr Barber: It is certainly the case that when most commentators think of the work of the Bank they think of its responsibilities for the interest rate decision and monetary policy, and the greatest public focus is on the MPC and rightly so. The Court’s responsibility explicitly is not those monetary policy decisions. It is to support the work of the MPC, to ensure it has sufficient resources to carry out its functions and so on, and it is responsible for the rest of the functioning of the Bank and its responsibilities for financial stability, which are not unimportant. I would certainly agree that in the public mind the MPC responsibilities are the responsibilities they would most identify with the Bank. The Court has other responsibilities. They may not be in the sharpest focus but they are of some value.

Q406 Chairman: Richard, private equity is mentioned. We are having our own inquiry into that and I do not want to ask you a detailed question about it, but there has been a view that debt and leverage is exclusive to private equity companies and public quoted companies cannot to the same as private equity companies. Could I have a quick answer from you on that.
Mr Lambert: I spent the weekend drafting a submission to your Committee on this.

Q407 Chairman: Is it all going to be revealed?
Mr Lambert: All will be revealed. It is interesting that private equity is having an impact on publicly listed companies and publicly listed companies are starting to look at their balance sheets in a different sort of way from the way they did before.
Chairman: We will look forward to that. I would like to thank you for your time, particularly in getting together on this. It has been very helpful to us.
Thursday 14 June 2007

Members present
John McFall, in the Chair

Mr Colin Breed
Angela Eagle
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love
Mr George Mudie

Mr Brooks Newmark
Mr Slon Simon
John Thurso
Mr Mark Todd
Peter Viggers

Witnesses: Rt Hon Gordon Brown MP, Chancellor of the Exchequer, Mr Nick Macpherson, Permanent Secretary, Mr Jon Cunliffe, Second Permanent Secretary and Managing Director, International and Finance, and Mr Dave Ramsden, Director Macroeconomics and Fiscal Policy, HM Treasury, gave evidence.

Chairman: Chancellor, good morning to you and your colleagues and welcome to this session. Can you introduce everyone for the shorthand writer please?

Mr Brown: Yes. Let me say first of all it is a pleasure to be part of this review that you are doing. With me are Nick Macpherson, the Permanent Secretary to the Treasury, Jon Cunliffe, the Second Permanent Secretary and Dave Ramsden, who is Head of the Macroeconomics and Fiscal Policy side of the Treasury. I have some opening remarks that I think might be helpful to the Committee.

Q408 Chairman: Which you have informed us will be brief; is that correct, because time is short?

Mr Brown: Yes. In the Mais Lecture in 1999 I set out how our macroeconomic framework, with Bank of England independence at its heart, was built around four economic propositions. Because there is no long term trade-off between inflation and unemployment demand management alone cannot deliver high and stable levels of employment. In an open economy rigid monetary rules that assume a fixed relationship between money and inflation do not produce reliable targets for policy. Therefore, thirdly, the discretion necessary for effective economic policy is possible only within a framework that commands market credibility and trust and that credibility depends upon clearly defined long term policy objectives, on maximum openness and transparency and clear and accountable divisions of responsibility. Before 1997 inflation was the British problem. Monetary policy decisions were made in a political process susceptible to short term pressures. There was no system of appointments governing who the Chancellor chose to advise him and there were no clear mechanisms of accountability. Since 1997, with interest rates set independently to meet the Government’s stated symmetrical inflation target, UK inflation has now averaged around half the rate in the G7 to having one of the lowest, and in fact the most stable inflation performance. It is, however, important that monetary policy continue to evolve to maintain its status at the forefront of international best practice and this is the principle that has guided ongoing policy developments in our framework since 1997, including our decision for the introduction of CPI in 2003. I now propose changes to the process of monetary policy making. First, the timetable for replacing external monetary policy members will be pre-announced before the end of existing members’ terms and that will establish a clear set of dates for each stage in the process, including by when the Government will have confirmed a new appointee. Secondly, as part of this timetable and to enhance the openness of the process, the Treasury will also invite by advertisement expression of interest from economists and experts in other relevant backgrounds interested in serving on the Monetary Policy Committee, and these will be invited before the end of existing members’ terms and early in the timetable for appointment whenever a position is due to become available. Thirdly, in addition to the criteria already set out by the Bank of England Act 1998, which states, “The Chancellor shall only appoint a person under subsection (2)(c) if he is satisfied that the person has knowledge or experience which is likely to be relevant to the Committee’s functions”. The Government will publish additional criteria on the qualities and skills set that it is seeking from successful candidates in terms of their expertise. In determining these criteria the Government will ensure that the composition of the Committee retains an appropriate balance of different skills and backgrounds. In terms of what will happen over the next three years, therefore, the enhanced appointments process will be used when Dr Andrew Sentance’s current three-year term expires in May 2008, Professor David Blanchflower’s term in May 2009, Professor Tim Besley’s in August 2009 and Miss Kate Barker’s current three-year term expires in May 2010. Neither the Federal Reserve nor the European Central Bank publish timetables for appointing members or invite expressions of interest from potential members, nor do they specify criteria for suitable candidates, so our system will now not only be more transparent than it has been in the past but more transparent and accountable than the other major systems in the world. We are already a world leader in our transparency and the success of this framework in
delivering low and stable inflation is testament to the abilities of the various Committee members over the past decade, whom I thank for their work, the Governor and his predecessor as Governor, and the Government will continue to do everything that it can to support the Monetary Policy Committee in the forward-looking decisions it takes for the future. Thank you, Chairman.

Q409 Chairman: Thanks very much, Chancellor. As you know, we have been reviewing the major aspects of the monetary policy framework and in the past month or so have visited both the Bank of Canada and the Federal Reserve. One interesting aspect is the possible need for any legislative changes in the monetary policy framework. The Governor of the Bank of England was before us and he did not see any need for legislative changes. Do you envisage that there could possibly be legislative changes as a result of your announcements?

Mr Brown: What I am proposing today is an elaboration of the existing framework which is set down in legislation. Obviously, we shall look at any reports that your Committee brings to us about possible changes that you wish to recommend, but I do think we should bear in mind in all our examination of this that the test of this framework is its success. Over the last 10 years it has not only achieved a great deal of success but also, by the stability of the arrangements in which it operates, it adds to the credibility of our monetary policy framework and indeed our general economic policy, so I would be cautious, for example, about proposals such as I have seen where selection of members of the Committee is handed over, for example, to the Governor of the Bank of England. I think we have an appropriate balance between the members that are appointed through the Bank of England itself and members that are appointed externally, and I think some people are confusing the independence of the Bank of England with simply the position of the Governor of England itself in choosing its own members of the Monetary Policy Committee, and neither the Governor nor myself favour that particular set of proposals.

Q410 Chairman: At the moment the MPC operates under a hierarchical mandate with inflation as the first target and, subject to that, to support the economic policy of the Government. The US uses a different system where the two are nominally equal. In our discussions in particular with Barney Frank, the Chairman of the House of Representatives Financial Services Committee, it seems the politicians on Capitol Hill are very keen on maintaining that dual mandate. Why do we not use such a system here?

Mr Brown: The mandate that was written for the Federal Reserve was written many decades ago. The mandate that we wrote in 1997 was based on the experience particularly of the large inflation problems that we saw in the 1970s, 1980s and 1990s, and we argue, as I have done in the opening remarks I made to you, that there is no long term trade-off between inflation and unemployment and therefore man management on its own cannot deliver high and stable levels of employment. If you start from that proposition the terms in which the Bank of England operates make sense in the new economic understandings that we have both about how economies work and how we have to respond to inflation in the modern world. I would say that the objectives set for the Federal Reserve’s constitution are a creature of their times and I would say that we have achieved more for employment in the last 10 years by the means by which we have, if you like, attacked inflation and therefore the fact that inflation is low and employment high is testimony to the success both of our analysis and the framework. Remember: inflation has been half what it was in the previous 18 years and at the same time we have created two and a half million jobs, we have more people in work than ever before and unemployment itself has halved over that period.

Q411 Chairman: The appointments process has been described to us as “opaque” by former members of the MPC and others and I think the statement you have made this morning has gone some way towards ensuring that that is not the case, but one of the statements you made in launching your campaign to be leader of the Labour Party was, “One of my first acts as Prime Minister will be to restore power to Parliament in order to build the trust of the British people in our democracy”. Do you envisage any changes to the role of the Treasury Select Committee in the appointments process or elsewhere in the light of that statement?

Mr Brown: No. I will be very interested to hear what the Treasury Select Committee says about these issues. The major change that we made when I became Chancellor was to remove from the power of the executive the making of the decisions about interest rates and I tried to set up a parliamentary accountability mechanism where the Governor of the Bank of England published an inflation report on which he was questioned by this Committee regularly, and at the same time the Governor of the Bank of England and any other appointees to the Monetary Policy Committee could come before this body. I am very happy to listen to what this body says about any future system of dealing with this matter. I do suggest to you that this is different from the traditional Nolan system of appointments. You are dealing with market sensitivities which are obvious when we are debating interest rate rises even at this moment and a signal that is sent before appointments are ratified about whether someone would do X or Y is a market sensitive issue and I would ask the Committee to bear that in mind in any recommendations it makes. However, generally speaking, where it is possible to do so, there should be more parliamentary accountability, not less, and the role of the Treasury Select Committee, where it is possible, should be enhanced and not diminished.

Q412 Mr Fallon: Chancellor, it was the Governor who complained to us that these appointments were “left very much to the last minute”, and today you have announced a timetable and more open
advertisement. Why has it taken you 10 years to admit that you have been too secretive and rather badly organised?

Mr Brown: I do not accept that analysis at all.

Q413 Mr Fallon: You could have done this at any point in the last 10 years.

Mr Brown: By its very nature, if I may point out to you, a decision that is not pre-announced is announced at the last minute. Neither the Federal Reserve nor the European Central Bank, nor the major central banks around the world, have a system either for publishing timetables for appointing members, which is implied in your question, nor do they invite expressions of interest from potential members, nor do they specify criteria for candidates, and that is what we are proposing to do today. I myself feel that we had to establish the current system and bed it down without major changes in its first few years because the whole point of what had happened previously was that governments had moved from one inflation target to another, one system of making inflation decisions to another. The confidence in monetary policy had been lost. It was important to establish a new system. We are moving today from the system that is operated by the European Central Bank and the Federal Reserve Bank and therefore introducing more transparency and more accountability. That is on the basis of experience but I would hesitate to think that the Committee should somehow condemn us for not doing this earlier. We are doing what no other major central bank does and we are doing it now, having learned from experience but still aware that any appointment is a market sensitive issue.

Q414 Mr Fallon: But you have not quite explained why it has taken you 10 years to make this process more open.

Mr Brown: We made changes to the inflation target in 2003.

Mr Fallon: No; the appointments process I am asking about. Why has it taken 10 years to dawn on you that it should be more open?

Q415 Mr Newmark: Because he is leaving.

Mr Brown: I did not think that we should move from the system that was operated by other central banks, the ECB or the Federal Reserve, without having bedded down the present system in such a way that it commanded confidence and credibility. I believe the test of the system we have applied over the last 10 years is its success. I do not think you can argue as a committee that this system has not been successful. It has been successful. Having evaluated it over these last few years, I think we can now make these changes, but remember the changes we are making are not the practice of other central banks and we are moving further in accountability, as we have done before. I think it is the right decision to do so but I think it was also right to bed down the present system in a way that commanded confidence. Major changes in the system that were made quickly after 1997, as has been recommended by your party, would have been a mistake. To move to a new inflation target was the right decision, but that had to be bedded down as well. To move to this new system of appointments where there is greater publicity in advance of both the availability of people and at the same time people being given the chance to submit their names is a good thing, but I think the old system had to be bedded down first.

Q416 Mr Fallon: You still nominate the two Deputy Governors at the Bank. Would you favour open advertisement for those two posts?

Mr Brown: We can look at that, but I think it is pretty well known in the system when the positions of Deputy Governor are coming up, and in the legislation it is not as clear-cut as to what you are asking for in this position because basically you are asking for administrators in two different areas as well as people of economic expertise.

Q417 Mr Fallon: So that will still be secretive?

Mr Brown: I would not say it is secretive at all. It is based on us doing the right thing for the British economy in a market sensitive environment and I do think some of the proposals that are coming from other people fail to recognise that any decision about any appointment made to the Monetary Policy Committee is market sensitive and is likely to affect people’s evaluation of the inflation expectations of the British economy or other aspects of the British economy, and I think this Committee will want to be very careful in its recommendations about what should change, knowing that that is the position.

Q418 Angela Eagle: Talking about these other suggestions coming from other quarters, including the Shadow Chancellor recently saying that there should only be one term for the Governor of the Bank of England and various bits of tinkering around with appointments also being suggested, do you think there is anything in any of those suggestions or do you think that he is just playing fast and loose with economic stability?

Mr Brown: No. In terms of the proposals that have come from other people, first of all that the inflation target is set annually by the House of Commons, I believe you should look very carefully at that proposal and question it because essentially to set the inflation target annually is a recipe for people to believe that Parliament may in certain circumstances simply change the target and cause a great deal of instability. I think you should be very careful about that proposal. The second proposal that the Governor should choose more of the members of the Monetary Policy Committee is, it seems to me, based on a complete misunderstanding of what independence means, and I hesitate to work out why that proposal was made. Of course, the Governor is the most important member of the Committee. He is the day-to-day Governor of the Bank itself as well as the Chairman of the Monetary Policy Committee, but the number of people chosen by the Governor is set down in the legislation. As far as the external members are concerned, it seems to me a matter of principle that these should not be chosen by the Governor; they should be chosen by reference to the
democratic political system of our country, and it is a mistake to believe that independence is guaranteed if the Governor makes all the decisions about the appointments. That is a complete misunderstanding of what independence is all about, so I would caution the Committee against going along with the Opposition’s proposal that suggests that the Governor should make most of the appointments and that there should be no role, in a sense, for the democratic system in making both recommendations and the appointments themselves. That is also a question in the context of market sensitivities.

Q419 Angela Eagle: On the issue of appointment hearings there have been a few occasions when this Select Committee has expressed doubts about particular individuals who have been appointed anyway. Do you think there is any merit in this Committee having the power to prevent an appointment rather than just making a bit of a fuss about it and then it happens anyway?

Mr Brown: I will obviously be interested in what you have to say about it. Again, the test of this system is whether it has worked. I know you expressed reservations about one appointee but in my view, and I think probably in the Committee’s considered view, his period as a member of the Monetary Policy Committee was actually a successful one. I know you question people very precisely and in a great amount of detail, and I think that is a very good part of what independence is all about, so I would caution the Committee against going along with the Opposition’s proposal that suggests that the Governor should make most of the appointments and that there should be no role, in a sense, for the democratic system in making both recommendations and the appointments themselves. That is also a question in the context of market sensitivities.

Q420 Mr Todd: Chancellor, could you expand on what you mean by “the balance of skills”? What sorts of skills are you thinking about, because you will be seeking to publish these criteria following the announcement that you made at the start of this hearing.

Mr Brown: That is the essence of the debate that we can now have. The Act says “knowledge or experience relevant”. Funnily enough, the European Central Bank—and maybe you would expect this—says it is not just that but relevant standing in their field, so I think we have to look at both the experience that people can bring to bear and at the expertise they have. As I said, there are two points that I would bear in mind in setting out the criteria for the future, that we have to get the balance right between, if you like, market skills and academic skills, and that is what I have always tried to take into account. For example, when it was controversial that we appointed a business leader to the Committee, in the context of a large committee to have someone who had that experience was the right thing in my view to do. Equally, I think we need a balance between the macroeconomic skills and general skills related to the economy, so again I think it was controversial for the Committee that we appointed people who have expertise in employment as opposed to macroeconomic expertise, but, again, getting the balance right between Mr Nickell and Professor Blanchflower, for example, who had long term projects related to employment in the economy, and those who had more specific skills in relation to the macro economy was a very important part of what we did as well. These would be the two essential criteria, but we will obviously publish a paper on this and we will elaborate on what is in the Act, “knowledge or experience relevant”.

Q421 Mr Todd: Would that also include the technical aspects, because one of the tasks that the MPC has is to work with a model that the Bank of England operates to provide forecasts for our economy, and having at least one member of the MPC who has a strong technical knowledge of the model might appear to be an advantage. Would you share that view?

Mr Brown: That could be said to be the case. On the other hand, all members of the Committee have access to the very considerable expertise of the Bank of England’s own staff. Some of them are engaged in their own research projects and that is part of the work in the Bank of England. They are perfectly able to draw on the experience and expertise that exists outside the Bank to inform their research or their thinking, and I do not think at the moment in British economic policy, or even in the Bank itself, that there is a shortage of expertise available to the Committee itself if they want to either look in detail at the models of economic behaviour or any other aspect of economic policy. I think we are learning quite a lot and this suggests to me that the debate ought not just to be narrowly focused in the future of the MPC on membership. I think we have learned a lot over the last 10 years about how we manage inflation, and I think the behavioural changes that are taking place in the British economy as a result of the new system are something that this Committee might want to look at at some point as well. I think in particular that if we had started in 1997 with our inflation target first of all nobody could have predicted, as did happen, that inflation expectations would come very much in line with the inflation target. Before 1997 you had a 2.5% inflation target but you had a 4% inflation expectation. Very quickly these inflation expectations and the inflation target aligned themselves and I think that was a great success of the new system, so it did command confidence. The second thing to say is that you might not have expected that wages or earnings would have come in line in the way they did, in other words that people would have acted as if you did not have the inflation target, or even that if you did, and I think what happened quite early on, and it may be good fortune but it did happen, is that wage expectations also moved in line with the inflation target and, while we had great difficulties over
average earnings figures for a while because they were factually wrong, that is a big change that has happened over these last few years.

Chairman: Chancellor, we are conscious of the time. We know you want to get away and we understand that but we have a lot of questions and we are looking for your wisdom.

Q422 Mr Breed: One of the consequences of the lower interest rates has been the rise in household debt. It has been described to us as not of importance in terms of monetary policy but very important in terms of a social issue. Do you think enough is being done between the Treasury and the Bank to address these social issues, like household debt?

Mr Brown: There are two issues here. One is a group of people who themselves get into real difficulty as a result of either over-extending themselves or something happening to their employment position or their family income, and I think we are putting in place measures that give proper advice, proper help, proper debt counselling, proper support, and obviously, we want the banks and the mortgage companies to be sensitive to people in the position that they find themselves in. That is one aspect of it. The second aspect is the general economy and how it is moving forward, and I would suggest to you that if you look at the level of debt as a percentage of overall income, the level of people's borrowings as mortgage holders and what they have to pay back as a percentage of their income, we are not in as bad a position as you are implying by your question. In other words, in an economy where you have relatively low inflation people are able to pay back their debts generally. The wider issue about affordability in housing is something that we might deal with separately and I have already said that I think that is a priority for our country.

Q423 Peter Viggers: How much weight do you think the Monetary Policy Committee should be placing upon monetary aggregates when assessing future inflation?

Mr Brown: I am rather pleased that I set out the four points in my Mais Lecture right at the beginning, and this is what has guided our economic policy since 1997. I said then in that lecture, and I will be very happy to give the detail of what I said to the Committee, that rigid monetary rules that assume a fixed relationship between money and inflation do not produce reliable targets for policy. I know that in the European Central Bank there are the two pillars of policy that include the examination of monetary aggregates, but our experience of the eighties was that in an open economy, far more open, far more global in its capital markets than ever before, this assumption that you had a fixed relationship between money and inflation and that you could therefore set quite rigid and fixed monetary rules was found not to be workable.

Q424 Peter Viggers: I think the consensus view is that the creation of the Monetary Policy Committee, where you appointed experts and then exercised reticence, has indeed been a great success and it contrasts starkly with the interventionist micromanagement in the disaster areas like pensions and means testing and tax credits. Do you think there is a wider lesson here for the Government?

Mr Brown: I disagree with you fundamentally. There are millions of people who are better off as a result of tax credits. I think you forget, despite what happened to the Stock Exchange and the loss of Stock Exchange value for pension funds, that the value of the pension funds in this country over these last 10 years has risen from £500 billion to a trillion, in other words has doubled. I think you forget that in the question that you are putting forward. As far as general wealth in this country is concerned, as a result of all the changes we have brought about the 60% increase in the personal wealth of this country is a reflection of the fact that, while you say these things have not worked, in actual fact people are in a better position now than they were 10 years ago. I am grateful to you for acknowledging the success of monetary policy but I would ask you to look at the growth rate of the economy as a whole, the growth in employment in our economy, the growth in living standards in our economy and the growth in personal wealth.

Q425 Mr Simon: I was at Hay a couple of weekends ago listening to you talk about how the political class needs to find completely radically new ways of involving and engaging an alienated populace. How does that transfer to this, where you have interest rates set by a committee of experts for a generation of consumers under Labour that have never heard of inflation?

Mr Brown: I think it transfers into saying this. In 1997 we took perhaps the boldest decision in monetary policy that had been taken in a century where, after 20 years of the failure of governments effectively to deal with inflation, we set up a new system and we gave up power. The executive was prepared to surrender power over interest rate decisions in the interests of having a better system and in the interests of making sure that the system itself was credible to deal with the inflation problem that we had inherited, and I think that model does have application to other areas of policy and perhaps this is not the right time or place to detail that. The Chairman would rule me out of order if I did so.

Q426 Chairman: Absolutely.

Mr Brown: The idea that an executive in the modern world is prepared to surrender its power in the interests of better decision making is, I think, the fundamental principle here, and I think the relationship between the executive and legislature and the executive and the people of our country is something that is subject to both criticism and the potential for reform in a whole series of different areas similar to what we have managed to do with the Bank of England.

Q427 Mr Newmark: Sally is going to talk about RPI versus CPI but I just want to focus on CPI, Chancellor. It would be helpful if you could explain
why the average CPI inflation rate is higher in the UK now than in the rest of the EU, why it is twice as high as it was in 1997, and why you have now missed your target for over a year. Who is to blame? You or the MPC?

**Mr Brown:** As you know, there are three forces governing inflation around the world. The first is manufactured import prices; that is effectively the China and India effect. The second is oil and commodity prices, which I think you are mistaken in believing hit every economy in exactly the same way. They hit economies in quite different ways. Why we have been hit by oil prices later than America is simply because the second round effects on utility prices have been what have been most prominent in our inflation figures, and the third is service sector costs. America moved to inflation of 4.4%. It was at 4.3% or 4.4%, I stand corrected; it may be 4.3%, but America has been—

**Q428 Mr Newmark:** I am talking about the UK versus the EU, Chancellor, not America.

**Mr Brown:** Exactly, but America was 4.3%. If I am right, the European peak was 3.3% and our peak was 3.1%, so our peak has been a lower peak than the European peak.

**Q429 Mr Newmark:** Chancellor, do not play semantics with me. We are now 2.8% in the UK versus 2.2% in the EU. In 1997 it was 1.6% inflation. We are now at 2.5% inflation. Why is that the case? You put great stock in achieving your targets. You have failed.

**Mr Brown:** And you are completely wrong again in your analysis.

**Q430 Mr Newmark:** It is not my analysis. These are the facts.

**Mr Brown:** It is the peak of inflation that you should be looking at and, as I keep explaining to you and you do not want to understand,—

**Q431 Mr Newmark:** I do understand. You want to hear something different.

**Mr Brown:**— the reason that the oil effect in the United Kingdom is quite different from the oil effect in other countries is that it is the second round effect, the utility price effect, that has had the biggest impact on our inflation. Our inflation was a lot lower last year than in other countries. It has been higher but only to the point of 3.1%. It is now down to 2.5%, and I just repeat for your information that the peak of inflation in the USA was 4.3% and the peak of inflation, as I understand it, in Europe was above the 3.1% figure that we have had and we are now down to 2.5% in the latest CPI figures, so I think my case is made by the information I am giving you.

**Mr Newmark:** I do not think it is but I will pass on to Sally.

**Q432 Ms Keeble:** You said just now, Chancellor, that you wanted a new deal. You thought that you should deal separately with the issue of house prices and the pressures which that puts on people, but I wonder if you would say whether you think there is any merit in including in the calculation of inflation something to reflect house prices, given that the increase in interest rates is putting increased pressure on this and this is indeed the biggest single factor in household incomes. If you are not going to look at CPI and changing that slightly, how else will you deal with the housing price issues that you referred to earlier?

**Mr Brown:** I think housing is a big issue that is about demand and supply. It is about the rising demand, through the changing composition of households, for new housing and particularly for smaller new housing, and it is about supply, and that includes the issues of planning and the issues of the construction industry itself and its ability to deliver the house building numbers that are needed. At the moment we are not supplying enough houses to meet the demand and that is one of the reasons why house prices are high but it is also one of the reasons, obviously, why a lot of young people find that the houses they want are not affordable. The second thing which is an issue is the form of the mortgage market at the moment, and remember the Miles review looked at that, and there are certain things that I believe we can do about that and one of them is shared equity, but there are other things that we can look at. I would say the third thing is the lack of supply of rented as well as houses to buy, which is an issue in the housing market as well.

**Q433 Ms Keeble:** Can I come back on that because I appreciate all the stability that the MPC has brought but the one lever it has is to put up interest rates which feeds through into mortgages and it is not about people coming into the housing market; it is about people who—and I am thinking about most of my constituents—put their household incomes together very carefully and plan out their spend and a small increase in the interest rate feeding through to their mortgage can be very destabilising and then all it needs is somebody to lose a little bit of overtime or whatever, so what would you do about the issue of interest rate rises and the impact on people's household incomes?

**Mr Brown:** Interest rate rises are a matter for the Bank of England, so what would I do about them? I would retain the power of the Bank of England to make the decisions about interest rates.

**Q434 Ms Keeble:** What about CPI?

**Mr Brown:** CPI is the internationally accepted measure of inflation and I believe it is right to continue to work through the CPI. There are international analyses now being done about what should and what should not be included in the CPI, and I think it would be better for us to follow the general trend of what is happening in other countries. It is in our view a superior measure and there is the ONS paper The New Inflation Target: the Statistical Perspective, if you would like to look at it. Housing demand and supply, however, are a wider question and the Committee may wish to come back to that at some point.
Q435 Mr Love: Can I turn to the recent experience on letter writing? It has been put to us that it should not be regarded as a sanction. How do you regard the recent experience of letter writing?

Mr Brown: Rare. I have had two letters: the previous Governor of the Bank of England writing to me to say he was pleased he had not had to write a letter and the new Governor writing the one letter that I think to some extent demonstrated the credibility of the system because people accepted that this was a proper way of dealing with a problem, and one of the problems obviously had been the very big rise in oil and commodity prices that we are dealing with, but he also looked at what was specific to the United Kingdom economy and I think the experience of the exchange of letters was a good one.

Q436 Mr Love: In the evidence to us the most interesting feature has been a focus on the letter that you write back to the Governor rather than the Governor’s letter to you and it was suggested to us whether or not you as Chancellor would consider writing a letter suggesting to the Governor that he may be bringing inflation back to target rather faster than you would like in terms of the overall impact on the economy. Would you consider writing such a letter?

Mr Brown: It has obviously got to be at the discretion of any Chancellor to take a different view from the Governor about the overall effect on the economy, but fortunately over these last few years we have generally been in agreement and a lot of the arguments have been arguments held with the votes that are taking place in the Monetary Policy Committee. I think you underestimate the extent to which these are heated debates that are taking place themselves, sometimes in the Monetary Policy Committee where there have been very tight votes on certain occasions, and the tradition of voting, including members of the Governor’s staff not voting with the Governor, has been pretty well established over these years. Again, I come back to the results of the process. We have been successful. The average UK inflation rate since 1997 is 1.5%. In France it is 1.61%, in Italy it is 2.32%, in Germany 1.5%, the same, but, of course, Germany has had to suffer four million unemployment while it is trying to keep inflation low. Generally speaking our record has been superior to Europe and I believe that that is something we should be proud about.

Q437 Mr Mudie: Chancellor, why are you so adamant against the dual mandate?

Mr Brown: When you say “the dual mandate”, do you mean in relation to inflation and employment?

Q438 Mr Mudie: Yes.

Mr Brown: We take into account employment in the decisions. That is clear.

Q439 Chairman: I know you do. Why are you so adamant against it?

Mr Brown: Because I think the old system was built on the idea that you were trading off inflation and employment and that at some point you should make the decision to go for employment against inflation, and there may be other points where it is inflation against employment. The new understanding is that there is that there is no long term trade-off between inflation and unemployment. If you cannot get inflation low you are in the end probably going to have high unemployment and if you cannot keep a stable economy it is not good for either growth or employment, so that is the new understanding of how modern economies work.

Q440 Mr Mudie: Are the Canadian and American economies not modern economies? They have a dual mandate.

Mr Brown: Yes. If I am right, in America the mandate was written many decades ago. I may be wrong about that. I am not sure about the Canadian economy.

Q441 Mr Mudie: We were there a couple of months back and I can assure you they are. Why do they accept it as modern and you do not?

Mr Brown: I do not think the results are so different in America and Canada from the United Kingdom.

Q442 Mr Mudie: So you could change it.

Mr Brown: I think what we are doing is reflecting a modern understanding of how the economy works, that there is no trade-off in the long term. There may be a short term trade-off but there is no long term trade-off that is worth emphasising in any way between inflation and employment.

Q443 Mr Mudie: You have indicated some changes to the membership selection but have you given any thought to whether you need to set an annual target for inflation? Canada is at 5%. There is a difference between 5% and 1%.

Mr Brown: We set an annual target in the Budget, and we have not changed that target.

Q444 Mr Mudie: I know.

Mr Brown: It has been based on RPI previously and now CPI, but in effect the target has not changed for 10 years. Personally, I feel that the stability of having the same target is the right course of action.

Q445 Mr Mudie: Have you ever thought about it, Chancellor? Your answer suggests you are going through the arguments as you speak.

Mr Brown: You are very kind and generous in your—

Q446 Mr Mudie: I have always been kind and generous.

Mr Brown: When we moved from RPI to CPI we moved from an RPI of 2.5% to a CPI of 2%. Obviously, at that point we considered whether we wanted a target that was tougher or a target that was less tough. We decided we wanted a target that was as tough and in fact this target is a little tougher in my view, and I thought that was the right thing to do at that point in time, so we did have that debate and I think it is right where possible to hold to a target that is working rather than make changes. I have just
been given all the figures about the inflation performance of different countries in answer to previous questions, and I think the best thing is that I send them to the Committee. Spain peaked at 4.2%, Greece 3.9%, France 2.4%, the EU 27 at 2.6%, and 2.6% was the peak in 2006, so I am happy to send all these figures to you.1

Chairman: We will digest those at leisure, Chancellor.

Q447 John Thurso: Chancellor, can I just say that the independence of the Bank and the MPC has clearly been a great success, which pleases me as the manifesto I supported in 1997 included the proposition, but I think there is, as you have said, room for some improvement. In your opening remarks you talked about the four propositions, the third one of which mentioned market credibility. In this regard we have had quite a lot of evidence of a lively academic debate that is going on around how much information the Bank should provide on the future path of interest rates. What is your view on whether the Bank should provide dire statements or forecasts of the future path of interest rates?

Mr Brown: What the Bank has done, which you would probably say is not sufficient, has been both adequate and probably in line with what people would expect of it, so I would not be proposing a change but it would be a matter for the Bank. There is no prescription or prohibition on the Bank for being far more predictive, if you like, in what it wants to say to the public in its inflation report.

Q448 John Thurso: Do you think in the future the path of interest rates would give any better insight or help government departments, for example, including the Debt Management Office, in the planning of their activities?

Mr Brown: I think it would help only to this point, that I have said there are three big factors operating on inflation at the moment and therefore we cannot predict what is going to happen to oil and commodity prices. That has been the major impact on inflation over these last two or three years. In the period I have been Chancellor oil prices have been $11 a barrel at their lowest and I think $77 at their peak, and so this is the volatility of the oil market. The commodity market has been equally volatile. Nobody would have thought in 1997 that the Chinese or the Asian effect on consumer prices would have been as big as it has been and nobody can be absolutely sure what the effect of this will be with changing Chinese labour prices and so on over the next 10 years.

Q449 John Thurso: Do you see that as a bigger threat than oil prices?

Mr Brown: No, I do not see it as a bigger threat than oil prices because I believe that the Chinese growth will almost certainly continue and I believe there are other countries able to compete as well, and therefore you are seeing the evolution of the global economy, but when you have that level of volatility, no matter what the Bank or others do to predict the course of interest rates it is bound to be affected by what has happened. Your only way would be to do what the Australians do, and that is to exclude some of these external factors from their calculations about the inflation target, but that is not something that we have done.

Q450 Chairman: Chancellor, whilst in Canada we heard evidence that eight meetings, one for each forecast and a meeting in between each forecast, worked well. It was suggested that that would allow thinking time for both MPC members and the Bank. If you were writing the legislation for an independent Bank of England now would you again include a requirement for the MPC to hold a meeting every month, 12 times a year, in other words?

Mr Brown: I think we should continue with what we have got. Obviously, the context in which regular meetings were held about monetary policy, even before there was devolution of this to the Bank of England, was the fast-changing situations in the seventies and eighties which meant that interest rate decisions were sometimes being made on two or three occasions in every month, so people came to the view that you should have regular meetings. That is not what is happening now and you could probably afford to make a change but I think the pattern we have is pretty well established. Professor Blanchflower, I gather, told the Committee that reducing the number of meetings would risk the MPC being perceived as asleep at the wheel, so you have to balance the suggestion of inactivity with the need to have a stable set of meetings.

Q451 Chairman: Maybe that was to help his air miles.

Mr Brown: I think the Committee should be more generous to him than that.

Q452 Chairman: Chancellor, we look forward to welcoming back Mr Macpherson to the Committee but he will be on his own in future, I believe, because you, Mr Cunliffe and Mr Ramsden are going to new jobs. Whatever new jobs you go to can we wish you well as a Committee? You have made 31 appearances before this Committee and your officials have been extremely generous and courteous in their dealings, so can we thank you all and, as I say, wish you every success for the future?

Mr Brown: Thank you very much, Chairman. When you say 31 appearances it sounds like someone coming before a court.

Q453 Mr Fallon: It is!

Mr Brown: I will send the information about the inflation figures directly to you, the comparisons with all the other continents about what has been happening over recent years, and I am very happy, because of the shortness of the time we have had today, to answer in writing questions that you have put to us but we perhaps have not been able to go into as much detail on as normally. I thank the Committee for understanding that this had of necessity, given the date, to be a shorter session than

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previously. Could I say that despite all the ups and downs of appearances before this Committee I have enjoyed it very much. I think it is a very important part of the political and democratic process and I commend the Committee on the work it does, not only in this area but in so many areas, which is important for the health of both our economy and our democracy, so thank you very much.

Chairman: Thank you, Chancellor, and we hope to produce our report in July for consideration.
Supplementary memorandum submitted by Mr Laurence Sanders, the Bank of Ireland Global Markets

In response to the question from Mr Love [Q 90] relating to the use of fiscal policy measures to control house price inflation:

In my verbal submission, I emphasised the key role of interest rates in controlling asset price inflation and referred to the excess of housing demand over supply as the root cause of house price inflation in the UK.

The deficiency in UK housing supply was examined in detail by the Barker Review. The Review made reference to the use of fiscal measures to enhance supply. I am not a tax or house building expert and therefore do not feel competent to comment on the proposals. Based on empirical evidence, there may well be scope for using the tax system to encourage both the renovation of existing housing stock and the conversion of former industrial and office units into residential accommodation.

Demand for owner occupied housing has grown in recent years due to a number of factors. These include: the relatively stable interest rate climate; the upturn in UK growth and hence personal disposable income, the increased preference for owner occupied accommodation and the significant increase in net migration, which has impacted on both the owner occupied and buy to let markets. The increase in the number of higher education students has also increased demand for rental properties. We expect all these factors to be significant drivers of the housing market over the next five years.

There are fiscal measures can be taken to reduce housing demand. Each measure has drawbacks. The Barker Review made reference to increased council tax, but accepted this would result in an increased burden on the elderly population. An increase in stamp duty would need to be significant if it were to produce the desired impact on housing demand. The challenge with stamp duty is that its impact is greatest on the first time buyer sector. Stamp duty is also effectively a tax on labour mobility.

Past UK experience suggests that a major fiscal initiative in respect of housing demand raises the risk of a sharp downturn in the housing market. The current US scenario clearly shows the impact of a significant downturn in the housing market on the American economy, via a series of transmission mechanisms. These include the impact of reduced housing demand on retail sales and the translation of lower consumer confidence into the equity market and hence pension fund returns. If fiscal policy is to be used as a mechanism to control asset prices, any reform should ideally be phased in over a long period in order to minimise the impact of the wider economy.

Whatever measures are adopted the imbalance of overall housing supply and demand is likely to continue for a number of years. A prime driver is the increasing level of net migration, which we perceive to be in the region of 300,000 per annum. The impact of this factor is most pronounced in the social housing and buy to let markets, although the large number of skilled migrants has made a notable impact on the owner occupied market.

One encouraging factor is the gradual increase in housebuilding activity in recent years, as can be seen from the following table.

<table>
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<tr>
<th>Housebuilding: UK Permanent Dwellings Started and Completed</th>
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<tr>
<td>Dwellings Started</td>
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<td>2003–04</td>
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<th>Dwellings Completed</th>
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<td>2004–05</td>
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<td>2005–06</td>
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Source: Dept of Communities and Local Government
My view is that, in the short term, interest rates are the most appropriate instrument to control house prices, given the significant correlation between house price inflation and the overall rate of UK economic expansion. From a longer term perspective, my view is that the focus needs to be on measures which increase housing supply. These may well include fiscal measures.

March 2007

Memorandum submitted by HM Treasury

INFLATION IN EUROPE SINCE 1997

— At the Treasury Committee hearing on 14 June the Chancellor of the Exchequer undertook to provide a note on levels of European inflation [Q 453].

— Table 1 shows the annual and monthly inflation rates since 1997 in the European Union (EU27), euro area and selected euro area Member States. Inflation rates are presented on an annual basis from 1997–2005, and on a monthly basis since January 2006.

— The measure of inflation shown in the table is the annual growth rate (percent change on the same period year earlier) of the Harmonised Index of Consumer Prices (HICP—All items), as this measure is directly comparable across the EU Member States.

— In addition to the annual and monthly data, Table 1 presents the averages and peaks since January 1997 for the selected economies. A number of European countries, including Spain, Greece, Ireland, Luxembourg and Portugal, experienced inflation rates above 3% over the past year.

July 2007

Table 1

HARMONISED INDEX OF CONSUMER PRICES (HICP) INFLATION RATES (PER CENT CHANGE, YEAR-ON-YEAR)

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<tr>
<th></th>
<th>Euro Area</th>
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<th>Germany</th>
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<th>Italy</th>
<th>Spain</th>
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<td>1.4</td>
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<tr>
<td>Peak since 1997</td>
<td>3.1 (May 01)</td>
<td>8.4 (Nov 97)</td>
<td>2.8 (May 01)</td>
<td>2.8 (May 04)</td>
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<td>5.5 (April 01)</td>
<td>6.7 (Jan 97)</td>
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<td>Recent peak</td>
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<td>2.6 (June 06)</td>
<td>2.1 (July 06)</td>
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<td>3.9 (July 06)</td>
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