House of Commons
Treasury Committee

Bank of England
February 2009
Inflation Report

Oral and written evidence

Tuesday 24 March 2009

Witnesses:

Mr Mervyn King, Governor, Bank of England,
Mr Paul Tucker, Deputy Governor, Bank of England,
Mr Spencer Dale, Executive Director, Bank of England,
Professor Tim Besley and Professor David Blanchflower,
external members of the Monetary Policy Committee, Bank of England

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The Treasury Committee

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Mr Graham Brady MP (Conservative, Altrincham and Sale West)
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Sir Peter Viggers MP (Conservative, Gosport)

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Oral evidence

Taken before the Treasury Committee

on Tuesday 24 March 2009

Members present

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Nick Ainger
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Mr Andrew Love

John Mann
Mr George Mudie
John Thurso
Mr Mark Todd
Mr Andrew Tyrie
Sir Peter Viggers

Witnesses: Mr Mervyn King, Governor, Mr Paul Tucker, Deputy Governor, Mr Spencer Dale, Executive Director, Professor Tim Besley and Professor David Blanchflower, External Members of the Monetary Policy Committee, Bank of England, gave evidence.

Q1 Chairman: Good morning, Governor, and to your colleagues. Welcome to this hearing on the Inflation Report. Can you identify everyone for the shorthand writer, please?

Mr King: On my immediate right is Spencer Dale, the Executive Director for Monetary Policy, and on his right is Tim Besley, one of the external members of the MPC. On my immediate left is Paul Tucker, the Deputy Governor for Financial Stability and on his left is David Blanchflower, another of our external members.

Q2 Chairman: Welcome. Governor, Lord Mandelson seems to have been everywhere, even regarding his comments on the Bank of England, saying that the Bank of England is in pole position and that he wished that negotiations with them had gone quicker regarding the car industry. First of all, do you accept that charge and, secondly, do you feel that the public and highly voluble attacks on the Bank of England undermine your independence?

Mr King: I was puzzled by the statement, but let me just explain what our position is. We opened last autumn a facility for the use of asset-backed security paper, including paper-backed loans to finance car purchase. That facility has been open since September and, indeed, some paper related to car loans is being used in that facility. That is one thing that we are doing. The second thing we are doing is that the measures we announced recently in the asset purchase facility for the Bank to buy commercial paper are also open to car firms, and, indeed, the industry has access to that facility. I was slightly surprised, because the car industry is, indeed, getting help from the Bank. Of course, the question is whether it deserves special help. I have a great deal of sympathy for the car industry, I think they are facing particular problems at present, but the judgment as to whether an industry deserves special help really has to be one for the Government, it cannot be one for the Bank of England. Indeed, a piece of paper arrived on my desk this very morning for a joint press release from the Federal Reserve and the US Treasury, issued overnight, which said, “Actions taken by the Federal Reserve should also aim to improve financial or credit conditions broadly, not to allocate credit to narrowly defined sectors or classes of borrowers. Government decisions to influence the allocation of credit are the province of the fiscal authorities.” I think that makes it pretty clear that central banks should not be in the business of making judgments about which sectors of the economy should benefit from a preferential allocation of credit, even if there is a good argument for doing that, it must be in the hands of the Government, and since the Government owns a large majority stake in one and a significant stake in two of the three main domestic lenders, if it wishes to engage in preferential credit allocation, the ability to do so is in its own hands.

Q3 Chairman: So, in summation, you and your colleagues have delivered what has been asked of you?

Mr King: I have not been asked to engage in any preferential credit allocations, which is one reason why we are slightly surprised to see the comments, to be honest.

Q4 Chairman: But in that and other areas generally, you have done what is asked of you?

Mr King: Absolutely, and these facilities have been available since September for the asset-backed paper.

Q5 Chairman: Good. The rate of return on average instant access savings accounts is now what people would describe as a pathetic 0.17%, and as Members of Parliament and as Committee members we have had a lot of correspondence on that from savers. You have expressed your sympathy for savers in the past, but how concerned are you that people will lose the savings habit?

1 Note by witness: This facility in fact opened in the first week of October.
Mr King: I think this goes back to what I call the paradox of policy. I think it does not make sense to engage on a national campaign to raise savings rates in the very short run; we will need to do so once we get out of the crisis. In the short run we have to engage in measures to ensure that spending returns to more normal levels in order to prevent significant falls in output and rises in unemployment. Once we have got through that immediate problem, then the challenge will, indeed, be to raise the national savings rate, both public and private.

Q6 Chairman: Will there be a chance of getting on the national debate the policy of banks charging customers for looking after their deposits? Do you think that will be an issue we will be talking about in the future?

Mr King: I think certainly the banks will want to raise the question, if interest rates are at such a low level, what is the basis on which they will make their return? In the past they have been doing so on the turn between borrowing and lending rates. That has now narrowed very substantially, so the question of charges may well come up, but that is a matter not for me, it is a matter for the banks and those who regulate the banks.

Q7 Sir Peter Viggers: Quantitative easing. Why is buying assets better than printing money and throwing it out of a helicopter?

Mr King: Because we get the asset. I think the important thing is to make sure that what we are looking to do here is to have an increase in the amount of broad money in the economy such that that money is then used, we hope, to buy other assets, which might lead to an increase in the prices of those assets, which will have a positive wealth effect that might encourage spending and it might reduce some of the risk premium in the other asset markets which have been deterring corporate borrowing and making it more expensive. I think we feel the right thing to do is to really engage in a range of measures, and I think the twin-track approach that we have adopted is both to engage in asset purchases in order to increase the amount of money in the economy, but we have also been engaging in asset purchases in those corporate credit markets where we feel that it may be possible that a limited range of purchases would stimulate further private sector issuance, and that is why we engaged in the schemes to buy commercial paper and why we announced last week the scheme to buy corporate bonds, and the first purchases of bonds will take place tomorrow. For those particular kinds of operation—commercial paper and corporate bonds—the criterion for success is not the amount of purchases that we engage in, it is the leverage that such purchases might have on the credit spreads in markets and the private sector issuance of that paper; and it is only two or three weeks into the scheme but I think we are mildly encouraged by what we are seeing so far. The spreads on commercial paper have come down by about 30 to 50 basis points. We have seen an example of a company that said, having been able to issue commercial paper to the Bank of England, that having been done, the next time it was actually possible to issue it at the same spread to the private sector in the market. That was encouraging, but the scale of these purchases is not the criterion for success. We expect these to be small. They are not meant to substitute private sector issuance and take-up of the paper but merely to try to reduce the spreads, improve the liquidity in these markets in order to make it easier and cheaper for companies to obtain finance in this way given the difficulties that we see in the banking sector.

Q8 Sir Peter Viggers: So there are two distinct tracks.

Mr King: Yes.

Q9 Sir Peter Viggers: You referred in your February Inflation Report to purchases of high quality but temporarily illiquid assets issued by private sector borrowers. So those are meant to be high quality assets.

Mr King: That is what I call the unconventional purchases.

Q10 Sir Peter Viggers: That is completely different from the asset purchase facility, which is intended to provide a market for—

Mr King: They both are under the umbrella heading of the asset purchase facility, but they are different kinds of operations. The asset purchase facility is designed to enable the Bank both to engage in these commercial paper corporate bonds, if we think there is a case for doing other credit instruments, then we will look at that, but then the other operation, what I call the conventional unconventional purchases, is about relatively standard use of the central bank, which is to buy government gilts in the secondary market. We are doing this all the time. The difference is that we are now doing it in order to increase the supply of broad money in the economy; and the reason this looks unfamiliar, obviously, is that for the last 40 years we spent most of the time trying to reduce the amount of money in the economy to prevent inflation picking up. We are at the point now where we feel that, looking ahead at the two to three year horizon, the risk is on the downside, hence we want to do the opposite of what we would normally do.

Q11 Sir Peter Viggers: Inflation targeting through interest rate policy has been developed over decades and is very sophisticated, whereas how much do we know about the effectiveness of inflation targeting, as through quantitative easing? How certain are you of success in this field?

Mr King: I do not think the choice of the target is the issue here. You could have money supply targeting, you could have price level targeting, almost any kind of targeting, without a single remit—you could have a Fed type remit—you would still have the same issue as to whether the instrument that is now available to the Bank of England is adequate.
Obviously, with the bank rate very close to zero, that is no longer an effective instrument open to us in order to ease policy. In order to ease policy, therefore, we have adopted what is a relatively standard approach, which is to buy government securities in the market. That way we do not distort private sector yields or take a judgment on which private sector assets we should buy, and this increases the amount of money in the economy. The reason we are doing that is because our judgment is that since last autumn, with the remarkable change in conditions last autumn, the amount of money in the economy is simply not growing fast enough to enable us to reach a sustainable growth rate with inflation close to the target. As I say, this is quite the opposite of most of the last 40 years, where the challenge has been to bring down the growth rate of money in order to limit inflation.

Q12 Sir Peter Viggers: As sure as night follows day, I put it to you, the inflationary pressures which are being built into the system will eventually force their way up and governments around the world will find that a level of inflation will be helpful to them to pay for the expensive measures they are currently taking. Do you recognise that scenario and do you think for the expensive measures they are currently taking.

Mr King: No, that kind of scenario is never too far down the road to worry about at this point? Should we be preparing for it?

Q13 Sir Peter Viggers: Can I ask one special question. I have a declared interest as the chairman of a pension fund. Are there special problems for pension funds arising from deflation?

Mr King: I do not think there need be. It has always seemed to be that a good strategy for a pension fund is to invest in a portfolio of assets that match their liabilities, and a pension fund that did that would find that, whatever the swings in long-term interest rates, their assets would be moving around in value in the same way as their liabilities. The pension fund that hedges its risks by investing in assets that match its liabilities would not find this a problem.

Q14 Mr Fallon: Governor, your initial decision was to pump £75 billion in, in new money. Why £75 billion? Where did that figure come from?

Mr King: When we looked at the numbers, we said, as I explained before, that we thought that both broad money and the growth of nominal demand in the economy were running at a growth rate which was too low to enable us to meet the inflation target and see economic recovery. Indeed, the growth rate was pretty close to zero. We thought the growth rate ought to rise by something of the order of 5%, almost a one-off injection of broad money of 5%. Five per cent of total nominal demand in the economy is pretty close to 5% of broad money held by the nonfinancial sector and happens to be £75 billion. That was the method we used to calibrate, broadly, the scale of transactions. That cannot be exact, because the final impact on the broad money supply, or nominal demand, will be either higher or lower than the initial injection, depending on what agents who sell their gilts to us do with the money, and that is something we will discover over time. We need to be prepared to adapt that strategy in either direction, but as a starting point, I think, it made some sense.

Q15 Mr Fallon: You referred earlier to the leverage effect. You must have made some calculation of the multiplier of the £75 billion. If it worked successfully, what will the multiplier effect be?

Mr King: I think it is very hard to quantify, because we do not have the experience to do it. It would be a false position to try and pretend to do that. It could be higher or lower. If people who have got the money, having sold assets to us, decide to repay bank debt and the banks then decide not to expand the balance sheet in other directions, then actually it could be less than one for one, but, on the other hand, if people, having sold assets to us, use their extra money balances to buy other assets, then the effect could be bigger than one for one, we will just have to wait and see, but we are monitoring that carefully. Obviously the numbers on money and credit and nominal demand will be key factors in our judgment as to whether we need to modify the scale of the operations.

Q16 Mr Fallon: When do you think we will know whether the £75 billion is working or not?

Mr King: It is hard to know what the counterfactual is, of course—so that is one of the difficulties—but I think in six months’ time we should be able to look back and see what impact this has had on money, credit and nominal spending. We will be looking at it month by month, and we have our quarterly forecast horizon, but I think over that horizon we certainly should see some of the immediate impacts of the operations.

Q17 Mr Fallon: The total allocation was 150, I think, agreed by the Chancellor. You have done 10 so far. Would you expect over six months to have done the whole 75 or the whole 150?

Mr King: I think we would aim to do something close to 75 in three months. We would then be able to wait and see the impact of that and then decide what to do, but the target we are working to is to try to complete something of the order of 75 in three months.

I cannot be precise because how much we will sell through the credit easing operations, the unconventional operations, is hard
to judge. As I say, the experience of the Fed has been that, actually, they have cut back on the scale of those sales because the operation has been quite successful in generating private capital raising, so we might need to do less if it works.

But we will watch this and we will aim to do about 75 billion in three months. That is the target we are working to.

Q18 Mr Fallon: You have moved on from commercial paper to corporate partners. Is there agreement in the MPC about the type of assets that should or should not be purchased under the facility?

Mr King: There is certainly agreement on the general level of riskiness involved. We are going for investment grade operations—that is the remit we have been given by the Chancellor because of the potential risk to the taxpayer—but the choice of the individual instruments and the precise methods has been delegated to the Executive of the Bank by the Chancellor, not the MPC.

Q19 Mr Fallon: What is the exit plan for all this? If you put £75 billion worth of new broad money into the system, is there an exit plan for getting it out again?

Mr King: It may be that we do not need to take it out, provided the further growth of money is in line with the growth of nominal national income, but we have an exit strategy. The obvious thing is that we would raise interest rates, tighten monetary policy. That we can do at any point the Monetary Policy Committee decides. The key anchor for us is the inflation target. That is what will guide the exit strategy. We have to take actions that we feel are consistent with keeping inflation close to the target in the medium-term. We will have to consult with the Debt Management Office and obtain their agreement to sell the assets, and that is reasonable because we got the Debt Management Office to agree that they would not offset our purchases through their issuance strategy. So the one thing that has to be done is that any operation we carry out with these asset purchases, perhaps subsequently sales, has to be co-ordinated with the Debt Management Office.

Q20 Mr Fallon: What is the timescale for the exit?

Mr King: We have set no timescale on when we would need to sell or when we would even consider raising interest rates. That is something we consider each month that we meet. I can assure you that what will keep our feet to the fire is the inflation target. That is why it is so important that we have an inflation target.

Q21 Mr Fallon: If you have misjudged the amount of money that you are printing, that would affect the future path of inflation, would it not?

Mr King: Exactly.

Q22 Ms Keeble: I wanted to ask you a bit about the asset purchase facility. You said just now that the MPC was providing a sort of broad framework for the decisions, but the details of what assets are purchased are going to be left to the Executive of the Bank. Is that right?

Mr King: Yes.

Q23 Ms Keeble: What would you expect the shape of that to look like? Can you give us a breakdown between the different classes of assets?

Mr King: We have announced that there are two kinds of asset that we are purchasing in these unconventional operations: commercial paper and corporate bonds—commercial paper, typically a three-month facility. We have said if it is investment grade we are willing to buy it, either in the primary or in the secondary market. We have laid out the terms on which we would buy it and then people can bid in the auctions for that. Ditto for corporate bonds. We announced last week our scheme for that. The first auctions start tomorrow. So there is a generic level of rating which companies have to satisfy before they can engage in these operations. Subject to that, anyone can take part in the auction.

Q24 Ms Keeble: Have you put amounts on each type, or is that being left to the Executive to decide?

Mr King: No, that is left to the Executive. Of course, the amount that we actually sell depends on the outcome of the auctions and the number of companies that come to us.

Q25 Ms Keeble: The issue of the valuations or the assessments does not arise because you have set the criteria down in advance. Is that right?

Mr King: Yes, and we have said that there are maximum prices that we are willing to pay for instruments of a given credit rating.

Q26 Ms Keeble: Who is doing the monitoring? You said you were going to look very closely at the uptake and the impact, and so on. Is that going to be the Executive? Are they going to be formally responsible for that, or will the MPC come back and look at that at a later date?

Mr King: Both, in the sense that the Executive has the formal responsibility for monitoring, reporting that to the Treasury, reporting it in public. We publish the results after each auction, and we report this to the MPC together with information about what has happened and the prices—that is happening, most importantly, to the spreads in the markets where these instruments are being issued—so that the MPC can form a judgment about how successful this has been.

Q27 Ms Keeble: We will get that information month by month, will we?

Mr King: Week by week typically. The information is already being published.

Q28 Ms Keeble: Okay. How about assessing the impact in terms of actually improving the number of transactions and the flow of money through the
system? Presumably the different categories of asset will have a quite different impact on the economy. Who is going to assess that?

Mr King: We will be commenting on that, and I am sure other commentators will too, but they will be able to look at the market, they will see the scale of issuance in the market, they will see what has happened to the spreads in the market. All of that is information which is largely in the public domain, but we certainly will be commenting on that because it will be a test of whether the scheme has proved effective. These operations in individual credit markets, as I have said, are not designed with the aim of increasing the supply of money by a certain amount, they are designed to facilitate the ability of companies to raise money in these markets by improving the liquidity of these instruments and by reducing the spreads that we think were unnaturally high and were high because of illiquidity in financial markets in general.

Q29 Ms Keeble: Increasing the supply is one thing, the demand side is quite another problem, and it is not your responsibility either, I suppose. What measures would you like to see, or which areas do you think are the most critical for actually improving demand, which ultimately is the only thing that is going to resolve the current problems?

Mr King: I think we see these operations as distinct from the general purchase of gilts. These operations are about trying to help companies obtain finance more cheaply in order to encourage their investment demand, so it is to stimulate their investment demand, and we are very much hoping that these operations will both reduce the spreads (and there is some evidence for that already in the commercial paper market), will reduce the cost of finance to companies relative to the overall level of interest rates and, by making the markets and those instruments more liquid, make it easier for companies to issue their paper, and if it is cheaper that will stimulate the demand by companies to issue the paper and also should stimulate the demand by those people who might buy the paper and hold it.

Q30 Ms Keeble: If the interest rates and then the asset purchase facility do not actually succeed in those people who might buy the paper and also should stimulate the demand by companies to issue their paper, and if it is cheaper that will stimulate the demand by companies to issue the paper and also should stimulate the demand by those people who might buy the paper and hold it.

Q31 Ms Keeble: How large is large enough?

Mr King: It is clear that what we want to do is to bring back the level of nominal spending to a path along which the economy can grow at a sustainable rate and inflation is close to our 2% target. That gives us a clear path for what we think the growth of nominal spending and broad money is likely to be. In the short run, it is almost impossible for us to judge how far a given increase in money will be divided between a real change in output and a change in inflation—a change in the price level—but these things we have to monitor month by month, and we will do so. As I said in reply to the question from Sir Peter, we will be monitoring this all the time and trying to judge whether or not the scale of operations is appropriate.

Q32 Ms Keeble: Some of the tables in your report show that the risks of deflation are going to persist for quite a long time and certainly show some of the real downside risks to this well into 2010. Would you like to comment on those and also say what you think is most needed to guard against those particular risks?

Mr King: Clearly, in the Inflation Report we said that there were downside risks. There are also some upside risks, one of which I think we have probably seen in this morning’s inflation numbers, which is the depreciation of sterling into the Consumer Price Index. The biggest concern I have is the state of the world economy. That has changed quite dramatically since last October. World trade fell in the last quarter of last year by 5%, exports from Japan fell by 40% in the year running up to January. Almost all of that has occurred since October—falls in the value of trade, 20% in three months in France and Germany. Almost every country in the world that has issued data has shown a very sharp fall in industrial production in the fourth quarter. These are unprecedented and synchronised falls in output in the world economy and it is very hard for any economy to be immune from the influence of that, and that is going to be the biggest downside risk facing us in the next couple of years.

Q33 Ms Keeble: You mentioned the risk of increased arrangement fees and other charges resulting from low inflation rates. I have certainly had a lot of feedback on that, and I just wondered how much information you have had coming back on that from your agents and what your assessment of that is?

Mr King: We have had it in terms of our agents’ contact with business customers, clearly, and many people have talked to their bank agents or, indeed, written to me saying that they understand why perhaps the interest rate that is charged has had to be adjusted in the light of the risks as we go into a recession, but they were taken aback by the scale of the charges which were implemented.

Q34 Mr Tyrie: Governor, you have said that broad money growth was too low, so you will be looking at broad money carefully to see how it responds to the measures you have taken. What definition of broad money are you using in order to measure that?

Mr King: I think all the way through this, both in the decade leading up to the crisis and now, we have said it is important to distinguish between money holdings by the non-financial sector and the financial sector, and it is the money holdings of the non-financial sector that have been particularly weak. Money holdings within the financial sector
have not been particularly weak, largely because of structural readjustments to the balance sheet of the bank system. Indeed, I think a fact that is very clear right through is that the build up of credit in the economy and the build up of money in the economy was very largely within the financial sector, much less so for the non-financial sector, with the one exception of house purchase. That was the one area where credit was extended and where growth rates were very rapid. Indeed, if there had been a rapid build up of money and credit in the non-financial sector over 10 years, it would have shown up in inflation, and it did not: inflation was actually very close to the target.

Q35 Mr Tyrie: You are publishing a chart with aggregate broad money going in one direction and excluding the OFCs of broad money going completely in the other direction.  
Mr King: Yes.

Q36 Mr Tyrie: One indicator pointing to the ceiling, and one to the floor. I take it that you are looking at the moment at the one that is going to the floor. Mr King: That is because the other one is distorted at this stage by the re-absorption onto balance sheets of many of the vehicles that went off balance sheet in the run-up to the crisis breaking out.

Q37 Mr Tyrie: Have you changed the definition that you are using? You published a paper in 2007 on this, with recommendations. Have those been implemented? Mr King: They have been implemented, but we have published a consistent series in the charts there. Perhaps Mr Dale can comment on the changes that we made. It is a bit unfair since he was not here actually!  
Mr Dale: The key point is the one the Governor has stressed, I think. Throughout this period we have been focusing on the movements in broad money holdings outside of the financial sector, and I think all the charts and analyses and tables we publish do give consistent time series data for that series.

Q38 Mr Tyrie: If I may say so, Governor, it would be very helpful if you could publish a more detailed and clearer explanation of exactly what you are taking account of in the MPC with respect to broad money. It is certainly the case that at an earlier phase in this boom/bust you were looking at the figure including holdings by non-bank financial corporations. You yourself made it clear that you were concerned by the sharp rise.

Q39 Mr Tyrie: Now, in the bust phase you have decided that you should be concentrating on the indicator that is going to the floor.  
Mr King: As I say, in part we do think there is distortion in terms of the indication of money and its ability to predict future spending through the re-absorption of some of those vehicles on to bank balance sheets, but I would be very happy to do that and spell it out in more detail.

Q40 Mr Tyrie: You said in 2005, in the first quarter of this year the broad money rose at an annualised rate of nearly 13%, and I went away and took a look and that 13% figure was including these holdings, even though you had not changed the definition at that time and did not change the definition for a further years.  
Mr King: Indeed, but at that point there was not the big switch from off to on balance sheet going on; it was a fairly steady expansion. We were concerned about that growth rate.

Q41 Mr Tyrie: Rather than pursue this further now. I think it would be helpful if the Inflation Report could have a box or something to give us a much clearer view about what is really going on, because even after having read the paper recommended in tiny type size in charts one and two, it is still very difficult to know how the Bank has been using broad money to assess overall monetary growth conditions.

Mr King: We will certainly do that, and we will make sure the font size is large enough to read.

Q42 Mr Todd: This is directed to the external members. You are two outliers to some extent in the MPC. I think it is fair to say, and you are departing. Do you feel that the dynamics of the MPC have assisted you in getting your views across and persuading others of your positions? Professor Blanchflower: I think so. I have been in a minority for quite a long time, but the structure did allow me to express that independence and express those views. I said on a number of occasions perhaps I blame myself for not persuading the others, but the structure of actually having an independent member who can come and say what they want to say, I think, was important, and we did have debate, often blown up certainly between Tim and myself, although we actually had much more in common than perhaps many people thought, but I think the very fact we are independent members is an important part of the structure. I have been able to stand up and say what I thought, so I think that is a great strength to the system. Perhaps the differences between Tim and myself have been blown up to be much greater than they actually were.

Q43 Mr Todd: Tim, as you were actually voting for interest rate increases last summer as the outlier there, what about you? Professor Besley: Indeed I was. I partition my period on the MPC into three periods. There was the period prior to August 2007 where I was an outlier and we were raising rates, then there was the period where, again, I was an outlier until last October, but since last October, as you will observe, there has been an
enormous amount of unanimity of purpose. In some ways it has been the easier period in which to be on the committee, although the quantitative judgments of how we should loosen monetary policy have been difficult. I think by and large it has been clear what the direction has been. I think it has been extremely easy to both debate and discuss alternative views on the MPC. It is a very open environment. The thing you have to remember is that the discussions themselves are closed, which makes it very easy for one member to try out ideas and encourages discussion.

**Q44 Mr Todd:** Do you think you have sufficient resources to argue your position, sufficient data that is at your disposal to assist the presentation of your position?

Professor Blanchflower: I think so. I have not found a shortage of resources being a problem; it is the complexity of the issues that has been the problem.

**Q45 Mr Todd:** The reason I am pursuing this, Governor, is obviously we went through this long comfortable period in which the MPC got lots of rounds of applause, and this is perhaps the opportunity to look at the dynamics and how it works and how it deals with dissidents and different views. What is your perspective on how this has been coped with? You may remember the question I asked last time about “David’s crystal ball”, which you were all envying at that particular point.

**Mr King:** I shared David’s view that this was a remarkable open process and committee. I do not think there is another monetary policy committee in the world that has as much open debate as we do, and each individual member is held personally to account. That individual accountability is something distinctive in the British system, and I think it has served us well, so I think I am happy to see this continue.

**Q46 Mr Todd:** Looking at the challenges of the future and the lessons we can learn from the past, and also if we reflect on the debates we have had over the quality of data you have had available in order to guide some of your judgments, are there additional investments which should be put into improving data quality and sources of information for the MPC, particularly as we are facing a period where tools are being used in unusual ways and their effects, as you have said earlier, are quite unpredictable? Each year the committee is asked to write a letter from the whole committee to the ONS expressing our views about their performance in data collection, and there is no doubt that the committee in the last couple of years has been concerned by the constraints on the ONS, leading it to be unable to carry out, for example, the revisions to the past data which you would normally see in each Blue Book. There was a programme to try to modernise the national accounts, and we have been concerned that this has come at a time when it was more important than ever to have high quality data. One of the things that is always striking, that we keep making the point and everybody ignores it because it seems academic at the time, is that data get revised. What we think happened last year may actually look very different in two years’ time, and that is a problem for the MPC because, sadly, we cannot take decisions two years in areas, we are taking them now. I do think the ONS has gone through a very difficult period and they have not been well endowed with either lots of resources or people there. Could you, perhaps after this meeting, reflect a little further on that and write to us.

**Mr King:** You will be seeing the letter we have written to the ONS and they will be publishing that in due course.

**Q47 Mr Todd:** That would be helpful. As departing members, what do you think the attributes are that an external member should bring to the MPC?

Professor Besley: It is a very difficult question. I think one has to be somewhat thick-skinned if one is going to dissent, certainly—I would certainly not recommend it to the faint hearted in that sense—but in terms of one’s contribution to the committee and the committee process, I think it has to be somebody who has a certain amount of courage of their own convictions and is willing to engage in an open debate in a courteous manner with others about the issues facing the committee at the time.

**Q48 Mr Todd:** Are there any skill elements? To some extent you have brought in the labour market element of this.

Professor Blanchflower: I completely agree with Tim. I think honestly being thick-skinned is a good thing, being independent, but perhaps it is very important to have a good background in economics and be prepared to challenge conventional thinking in some way and bringing to the table some new attributes and experiences. Professors of economics sometimes can do that; they are used to being in the world of dissent.

**Q49 Mr Todd:** I wonder, in your case, did the transatlantic link actually provide a useful additional insight?

Professor Blanchflower: It did actually. I remember the very first meeting when they came for mine to be confirmed here, there was a great debate about whether it made any sense for anybody to come from the US and whether coming from there would be helpful. It turns out it was extremely helpful. I think actually the Tsunami that blew from the West I probably saw pretty early. Rachel Lomax said to me the biggest thing I had brought to the committee was an understanding of the US economy, perhaps, even that I was more bearish on the US economy than the Fed and others were. For me it has really been a unique experience and really I have seen this wind blowing from the West, through the UK, through Europe and elsewhere, so actually I think that was probably the most helpful thing, that I probably brought a different experience than others had.

Chairman: Good.
Q50 Mr Brady: There has been unanimity regarding decisions recently, but the report refers to a range of views, both on the central inflation projection and the balance of risks. Of those of you who are here today, are there any dissenters?

Mr King: Can I say just in general, the most important thing I have ever said to the committee, and I have been coming for almost 20 years now and I have said it on almost every occasion, is that nobody can foresee the future. There is a central projection. The chance of that occurring is close to zero. There are all kinds of other possibilities and there is a balance of risks. Each person has to form their own judgment about what they think is the most likely outcome of the risks, and one of the things that characterises the committee is, yes, we are prepared to take different views on that, but no-one ever pretends that they know exactly what is going to happen, and one of the things that is wrong with the way in which forecasts are presented in the press is that they are still presented very much as numbers, so that people say the forecast is 2.6%. That is not a meaningful or helpful statement. No one can really know that. No-one is going to put everything on that number turning out to be the outcome, and it is not helpful in setting policy. What matters in setting policy is the balance of risks, and that is where the debate on the committee has been and where it has been productive. People have challenged the balance of risks and whether the risks are more to the upside or the downside.

Q51 Mr Brady: My question is do we have anybody here who is going to challenge the central projection? Professor Blanchflower: The central projection for output? Can you be more specific? What central projection?

Q52 Mr Brady: Both for inflation and the balance of risks.

Professor Blanchflower: There is a balance of views on the committee and, as the Governor said, there is the central projection with a range around it with an emphasis to the downside on output. I think perhaps my view of the extent of that would be greater than others, but I do not dissent from that.

Q53 Mr Brady: You lean clearly more to the downside.

Professor Blanchflower: I signed up to the central projection, and it says there are a range of views. There was a range of views about the time to decide how much quantitative easing to do—a very hard thing to do a metric on—and we discussed it and came to a considered view. When I signed up to it there were a range of views, as the Governor says, and we are not coming down to a single number, and I agree with that.

Q54 Mr Brady: I appreciate that. Governor, coming back really to the points that were raised by Sir Peter, you acknowledge that inflation is not too far down the road to worry about, though there is always a concern. To what extent is your decision-making on that conditioned by the question of your assumption about the shape of the recession, whether it is a V-shaped recession, or whether it is a straight U, or a long L, or all of those different possibilities?

Mr King: Certainly the view we take about the path of output is important for our view about the path of inflation. It is not the only thing, but the degree of spare capacity that is built up in the economy as a result of a prolonged period with output growing below trend is relevant to judging the downward pressures on inflation that would emerge from that degree of spare capacity. So, from that point of view, it is clearly one of the most important features influencing the outlook for inflation. That is not the only one.

Q55 Mr Brady: The central projection is a fairly sharp V in the report.

Mr King: In the February Report, and obviously we are about to begin the process of starting the next round of discussions to be published in our next forecast in May, so I do not want to say this is our view today—and I do not think anyone should be held to that—that was our view in February. We felt that there were several good reasons for supposing that broad shape of recovery, namely a very steep downturn in 2009. When we published that in February that profile for the downturn was even steeper than that in the IMF forecast, but followed by some recovery next year. The reason for that broad shape was as follows. First, the enormous amount of stimulus which has been put into the economy through monetary policy, through fiscal policy, through attempts to restore the banking system back to health—those things should have some impact down the road—second, a very large depreciation of sterling, which is likely to have some impact, if nothing else, on imports, even if exports are going to struggle in a falling world economy and, third, the fact that we do feel that the current downturn in output is reflecting to some significant extent a stock cycle in which companies are continuing to sell but out of stocks and have cut right back on production. If you like, this is the Honda effect. You see sales fall: you stop producing at all for several months; then you resume production. Even if it is on a much smaller scale than it was before, nevertheless output starts to pick up relative to where it was in the period when the plant was closed. Those three factors are all quite powerful factors, I think, leading us to expect some sort of recovery. There are also downside risks, and we highlighted the downside risks in February because the risks are more on the downside, and, as I said to you before, I think the biggest downside risk is what is happening to the world economy. I cannot recall any previous experience of such a sudden, severe and synchronised downturn in world output of the kind that we have seen in the last three to four months. That is why I think the UK is right to put so much weight on the importance of a collective commitment at the G20 Summit of countries to say they will do whatever is necessary, they will do their part and are confident that, because other countries...
will make their commitments, it is safe for them to make their commitment and will play their part in ensuring economic recovery.

Q56 Mr Brady: Would it be fair to say that it is harder to make the decisions you have to make regarding monetary policy and inflation, keeping to the inflation target, if you do get that sharp V and easier if it is, perversely, a slightly more protracted curve?

Mr King: Since last summer when we saw the panic of the 2008, as I call it, financial markets and then, after that, the extraordinary downturn in the world economy, those events are making monetary policy extremely difficult, but we are paid and paid well to do it and that is what we shall do.

Q57 Mr Brady: Finally, regardless of the shape of this and how quickly it is going to happen, in the current circumstances, what are the key triggers that you will be looking for to indicate that the risk on inflation might be moving to the upside rather than the downside?

Mr King: I think even if we see significant pass-through of the depreciation of sterling that has occurred in the last 18 months that is more likely to mean that inflation will be close to the target rather than a long way below it, I do not see that as creating a new risk of inflation being above the target. I think what we will have to monitor very carefully is what the impact of the operations we have engaged in is on nominal spending and nominal demand in the economy. We will have to watch whether there is clear evidence of the stock cycle, because if there is and we are coming out of it, it will be more likely that demand is picking up, and then we will need to move to the exit strategy sooner than we otherwise would.

I think you are right in highlighting the difficulties, something that Mr Fallon identified earlier; it is going to be very important that we identify the timing of moving to the exit strategy very carefully.

Q58 Nick Ainger: On page 34, you have got a chart 4.5 which shows the unprecedented spike in oil prices.

Mr King: Yes, absolutely.

Q59 Nick Ainger: This graphically shows this spike in oil prices, and I have asked you in the past about this. How do you explain that, bearing mind that this was a period when we now know that the largest consumer of oil, the USA, was actually already in recession?

Mr King: I do not pretend to be able to explain any asset prices in advance, clearly. Many of them I cannot explain ex post. I think what we saw last year was a situation in which a number of reputable commentators who claimed to know a lot about the oil market were saying maybe oil prices can go up to $200 a barrel.

Q60 Nick Ainger: Indeed, they did say that.

Mr King: A year ago oil prices were $100 a barrel, they then went to $150 a barrel last summer, from which point they then started to ease, and they are now, remarkably, down to $50 a barrel, in broad terms—$51 I think was the latest reading. This is an extraordinarily big move. I think it reflects the fact that oil prices do seem to be overly sensitive to short-run movements in the balance between supply and demand, and it goes back to a point I made to you when we last discussed this, which is that you would expect, perhaps, that deep and liquid futures markets would help to provide some of the liquidity that would mean that short-term movements in the imbalance between demand and supply would not necessarily show up in spot prices or short-term futures prices because the weight of future demand and supply would bring it back to current prices. That clearly is not working, and it is an issue I think some further thought needs to be devoted to, because what we are seeing is remarkable swings in oil prices of a kind that have implications for every country in the world and, to be parochial for a minute, clearly the impact on our inflation performance relative to target has been hugely influenced by movements in oil prices over the last two years.

Q61 Nick Ainger: Do we need a clear analysis of what happened so it does not happen again because the risk would be that once we go back into recovery and the alleged pressure on the oil supply, we would end up yet again with this huge inflation in what is, after all, the most important commodity in the world for all our economies?

Mr King: I have some sympathy with that view. We did discuss it, in fact, at the G7 several years ago when thinking about the structure of the oil market, and I think there will be time to return to it. I think the immediate concern is that we get out of the current financial crisis. I think everyone’s capacity is very much taken up with thinking through the measures needed to resolve the banking system and to deal with the macro-economic crisis, but at some suitable point, I agree, it would be sensible to have an inquiry to think about ways in which we could ensure the oil price was less volatile given the relatively small swings in the balance between current demand and current supply that are leading to very volatile oil prices.

Q62 Nick Ainger: It has been put to me, and I think it has been put elsewhere as well, that this is a classic speculative bubble. Would you agree with that?

Mr King: I do not know is the answer. I think the trouble with the proposition is that in many ways having these deep and liquid futures markets is the obvious way to try to bring less volatility to the oil market, but people operating in futures markets can be described as speculators. It is the old question: is speculation stabilising or destabilising? The answer is a lot of the time it is stabilising; some of the time it is destabilising. It is quite hard to see how you
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could ever guarantee that it will always be stabilising, but I certainly think it is worth thinking further about the structure of the market.

Q63 Nick Ainger: Can we move on then perhaps to David. Last week we hit the two million unemployed mark. The Inflation Report says that the deterioration in labour market conditions has been a key factor in restraining household spending. Does that mean that we cannot depend on household spending to actually help us out of the recession? Professor Blanchflower: I think in many ways what we are trying to do is to boost household spending. That is part of what we have been looking at. Obviously, the problem at the moment is that the labour market is loosening very quickly, people are very fearful about unemployment and perhaps even more fearful than they should be. One of the pieces of evidence that I look at is when people are asked: “What do you think the chances are that you will lose your job in the next six months?” and actually, “What do you think the chances are that you will lose your job in the next six months?” and actually, it is much higher than the real chance of them losing it. So that is the first thing. People are fearful about the future and they are spending less. In some sense that is a big part of the problem, and part of our action is to try and boost that to get the economy moving again, but the labour market is going to continue to loosen for some time. It has got to keep loosening past the stage at which spending starts to increase and then, eventually, the labour market will tip up, but it has certainly been a crisis, not just of the financial market, but it has been a crisis of confidence amongst consumers and workers.

Q64 Nick Ainger: But you are also saying, in your document which you gave in a presentation to certain members of the committee yesterday, that more needs to be done in a focused way on creating new jobs in the economy. Professor Blanchflower: I am saying that, and I set it up in a sense, with the answer. You asked me about consumer spending, and that is the focus here, but, obviously, the labour market will loosen, and I have been particularly concerned about focusing on a group of people who turn out to be the group that is particularly hit, and that is the young: 40% of the unemployed at this moment are only young. The numbers are going to change dramatically past June, when the class of 2009 enter the labour market, and the big problem as a labour economist, we know, is that a spell of unemployment when you are young has a long-lasting effect through the rest of your life, and, to cap it all, we have a very large cohort coming right now and that cohort size will diminish by about 70,000 a year. That is not a matter for monetary policy, it just happens that this has come at a time and these things have hit together, so the argument, as a labour economist, is we have to do things to focus on unemployment separate to the things that a central bank can do, and particularly it has to be targeted on a group that are really going to be hurt.

Q65 Nick Ainger: Governor, you were asked by the Chairman questions about the car industry. Why has the car industry in particular been so badly hit by this collapse in confidence? It is not just the car industry, but certainly the car industry seems to have really borne the brunt of these huge reductions in output. Mr King: The remarkable thing is it is true in almost every country in the world. My Brazilian colleague said, “why on earth did car sales in Brazil collapse in October?” He did not see any reason for it. I think it comes from a collapse of confidence. When confidence falls amongst a wide range of people, their decisions to buy consumer durables are immediately affected, and I think that cars perhaps are that one item where people buy not every month but sufficiently often that when there is a collapse of confidence you immediately see a sales fall, but it is really quite a remarkable phenomenon and it is true of the industry right across the world.

Q66 Nick Ainger: You would not have any problem in principle with a specific aid package for that industry? Mr King: I have no problem with governments making those decisions. It is not for a central bank to say that it is a good or a bad idea.

Q67 John Thurso: Governor, can you outline for us recent developments in the interbank lending market and what your central forecast might be for the next few months? Mr King: Of course banks do not obtain funds from the interbank market, it is a method by which they can distribute funds in a relatively short-term sense. The spreads in those markets remain at extremely high levels relative to the long-run experience before the summer 2007. They have been coming down, but they still are pretty high, and they are a bit higher in sterling markets than they are in dollar or euro markets. In the end this must reflect, I think, two things. One is the fact that, in general, there is still a tremendous preference for liquidity that financial institutions of all kinds, when they have liquidity, decide to hang onto it and not to risk it by putting it out to someone else in the financial sector and, secondly, it is because they are concerned that the people to whom they might put it out to, say for three months, there is still a great deal of uncertainty about and the one thing that we have learnt in recent months is that there is still uncertainty about the balance sheets of the major banks in our financial systems and, until that uncertainty is resolved, it is very hard to see why people would not be demanding a premium or a spread over bank rate to be willing to lend unsecured to other financial institutions. I think that what you are beginning to see again is the development of financial institutions saying, “This is an experience that most of us have never seen before. Maybe in future we should be a lot more cautious about lending unsecured to anybody and switch more to the secure market”.


Q68 John Thurso: When do you think that the fiscal laxative that you have been administering will work through to the LIBOR rates, the spreads in particular?
Mr King: I think it will require a restoration of confidence in the balance sheets of banks, and that will require two things. It will require the process of carefully, forensically, going through the balance sheets of banks, item by item, to ensure that past loans can be assessed in terms of what are these instruments really worth. Secondly, I think we will need to see some evidence that the recession is bottoming out in order to give confidence to people that there will not be new loans leading to losses that will augment the problems facing banks on the balance sheet. The balance sheets of banks are a moving target at present, they are changing as the world recession changes, and we still have not yet got to the bottom of exactly what each item on the balance sheet is worth. That is what the US in its package that it announced under the new Administration and in which the Government has announced for the two banks that have engaged in negotiations and signed programmes for the Asset Protection Scheme show, that there is now a serious process underway to examine those balance sheets, but it will take many months, I think, before we are really to the bottom of it.

Q69 John Thurso: In the Inflation Report you stated that in the longer term banks are likely to increase their reliance on retail deposits but went on to say that the flow of deposits from UK households and companies to UK banks has been weak. Are we in a catch-22 here, which is that without a decent return for money people are not going to go back to the culture of saving and creating deposits, but without the deposits we have not got the cash to flow through the system to create the confidence that we want? What can we do about that in this environment?
Mr King: I think one important thing is that the Credit Guarantee Scheme which the Government introduced enables banks to obtain funding from those who have got funds by guaranteeing that source of funding and that should make it easier and cheaper for banks to raise funding for loans that they want to make. I put some weight on that. If households are reluctant to spend then they will have savings they want to flow through into fairly safe vehicles and the challenge for the banks is to really demonstrate that their balance sheets are safe and secure and they are vehicles in which people should trust their savings to be placed.

Q70 Jim Cousins: Mr Tucker, the Bank of England has been throwing liquidity at the banks now for some time. The Government has joined in the party by trying to underpin the capital situation of banks and now this spectacular attempt to insure the dodgy assets of banks has come on top of that. Can we all say now that our banks as a class are safe, that we can rely on them?
Mr Tucker: I think we can say about the Western World in general that governments are standing behind the banking system and it is a remarkable thing to find ourselves in these circumstances, but also that should provide great reassurance in the rebuilding of confidence that the Governor was referring to a moment go. That goes for confidence in the financial system and confidence amongst households in the banking system, not just here but elsewhere in the Western World. Once confidence has been fractured in the way that it was in October it is not going to be healed and restored overnight.

Q71 Jim Cousins: A particular feature of our banking system and our lending to businesses is that it has relied on overseas lenders. More than half of the funding gap is covered by overseas deposits. We do not have the up-to-date figure on that but they are turning down. I wonder if you could bring us up-to-date on that?
Mr Tucker: Not completely, but I suspect that pattern will have persisted. There are two things going on. Financial systems generally are retrenching to their home markets and that is partly associated with government programmes around the world, which obviously place weight on banks lending into their home markets. And it is also, as the Governor said, that the financial system has been de-leveraging, not just within the national economy but across the international economy, so I am afraid I would expect that to continue for some while. What it shows is the risks, the dangers of allowing that kind of imbalance to grow up in the first place, which is precisely what one facet about the debate on macro-prudential supervision is about.

Q72 Jim Cousins: The Treasury have been kind enough to tell this Committee in the last week that if we look at the Asset Protection Scheme, insurance for banks’ poor investments and debts, a great deal of it is in fact outside Britain. In the case of RBS well over half of it is outside Britain. It would seem that the scale of insurance to debts that are outside Britain was roughly two-thirds of all the overseas lending to British banks as they stood, according to your figures, halfway through last year. That is a frightening situation, is it not?
Mr Tucker: What the Asset Protection Scheme is doing is underpinning the capital of the banks so that they can sustain new lending, and the lending agreements are focused on lending into this economy. In terms of what the Asset Protection Scheme has to insure and protect against, it is where the losses are going to come from, and they are where they are. If those losses are going to come from abroad then the capital of those institutions needs to be protected against those losses in order that they can sustain lending in this economy. There is no way through that. Again, it goes back to the starting position which is avoiding getting into this kind of position.
Q73 Jim Cousins: The overseas lenders are going home and the British taxpayer has just taken on a considerable set of obligations that are outside Britain to secure foreign bank debt.

Mr Tucker: The same would be true across the world. RBS and other UK banks will have withdrawn from elsewhere and overseas banks are still doing some activity in this country sustained by capital support from their home governments. We cannot cut ourselves off from the international nature of this crisis. I completely agree that the facts you describe are facts. I repeat, the best way of thinking about it is that our banks have needed insurance against the losses that they face wherever those losses come from, and they happen to be coming from abroad to some degree, but not entirely.

Q74 Jim Cousins: Governor, do you think that the G20 is likely to agree to British banks’ foreign problems, dodgy foreign debts, having access to other countries’ support schemes?

Mr King: As Paul said, the principle that all governments are following is that they want to guarantee all the creditors of the banking system of any important bank at present to remove any doubt whatsoever that it is risky to lend to a bank. That is the position which governments are taking up. How they do that varies from country to country, but that is the basic principle. What that means is that the capital of a bank, the equity capital, has to be underpinned by the Government. All the way through this I have said the way that should happen is the Government should be prepared to put in money where necessary but take equity shares in return. That is the simplest way of doing it. There are different ways of doing that but the principle, as Paul said, is if banks are incurring losses which are eating away at their capital, unless governments guarantee that minimum level of capital the banks will find themselves in a position where they will not be able to obtain funding, where they will be vulnerable to further attacks on the banks and they will not be able to finance lending to the UK economy.

Q75 Jim Cousins: Professor Besley, your interest is very much in business. Overseas lending directly to British businesses seems largely to have stopped. The underlying situation of British banks raising money either from at home or abroad is subject to this massive funding gap and this trail of debt abroad with obligations we cannot yet see the end of. Do you not think the constraints on lending to business are not easily going to be resolved and are going to continue for some years to come while this is all corrected?

Professor Besley: I am not sure that I can predict the time horizon over which this will continue with any confidence. That will depend on many of the facts that we have already discussed today around what is going on in the global economy and asset markets. As for your general observation that part of the issue that is imposing real constraints on lending to business is coming from closing the funding gap, that is absolutely right. If the measures that have been put in place by the Government to support banks do indeed assure people that banks are now safe and people are willing to lend to banks, then banks in time will become confident enough, I assume, to start lending. And in accordance with the concordats that have been reached already in discussion with the Treasury, we should see a resumption of business lending as the economy recovers and as the prospects for recovery emerge. I view this as very much tied to the prospects for the economy—lending will follow as economic recovery is in prospect.

Q76 Jim Cousins: Governor, when you went over to purchasing assets in an attempt to free up supply of ability to lend, you said you wanted to target those purchases at the domestic non-financial sector. In terms of the quantitative easing that has so far taken place and your purchases of assets so far, have you been successful? Is it, in fact, the non-financial domestic market that you have been buying from?

Mr King: Can I distinguish between the credit easing operations of commercial paper and corporate bonds that we start tomorrow? Commercial paper has been going just over two weeks. There has been some success there though it is only a couple of weeks. As I mentioned earlier, we have seen at least one firm first of all able to issue commercial paper to us and then, on the back of that, to issue commercial paper to other private sector purchasers. We have seen the spreads in that market come down which has reduced the cost of financing of those companies that issue commercial paper. That clearly has been targeted at the UK corporate market and there is some sign of success but it is very early days. In terms of buying gilts more broadly we will be able to find out in the new few months precisely how that has changed the pattern of gilt ownership within the UK. Yes, I do believe that these will come from domestic sellers of gilts and will increase the holdings of their money and that will enable them to use that money to reallocate their portfolios which will have wealth and yield effects that generally will be helpful in stimulating demand in the economy.

Q77 Mr Mudie: When the Committee was in Edinburgh and Leeds lending kept coming up as a great issue, or the lack of lending. Just putting some facts on the table for the Committee, when the overseas banks disappeared what percentage of the lending market did we lose? Approximately, obviously.

Mr King: It depends on whether it is mortgage or corporate.

Q78 Mr Mudie: I am happy if you give us both.

Mr King: Well, I cannot I am afraid. Can I come back to you on that?

Q79 Mr Mudie: We are just trying to find out.

Mr King: Most of the foreign banks did not lend in the mortgage market, but the Irish banks did and there has been some withdrawal of mortgage lending from Irish banks. By and large the big reduction in
capacity in the mortgage lending market was through the withdrawal of Northern Rock and Bradford & Bingley when they exited the market.

Q80 Mr Mudie: What about the corporate market?  
Mr King: I do not know what the figure is. We will find out for you and let you know.  
Mr Tucker: About the corporate market, a lot of lending by overseas banks would have been for takeovers rather than for working capital finance or real investment. My broad guess would be that in terms of real economic activity there is a greater dependency on credit from the domestic banking system than there is on the overseas banking system, big picture.

Q81 Mr Mudie: In terms of their disappearance from lending you will be suggesting that has not really affected the amount available for corporate customers.  
Mr Tucker: It will have affected it, but what I have described will have ameliorated it a bit in terms of the effect.

Q82 Mr Mudie: Mr Cousins made the point in terms of foreign banks. Clearly that will be reciprocated and our domestic banks will have been lending to foreigners as well.  
Mr King: Yes. This was quite a big issue at the G20 discussions at the Ministerial, and in particular many emerging market economies, middle range, Brazil, Mexico and others, were talking about the impact on them of overseas banks cutting bank lending to their economies.

Q83 Mr Mudie: The banks which have signed lending agreements, is the target they have seen just as restoring the lending levels to their previous lending levels or is there any ambition to fill whatever gap has been left by the foreign banks disappearing?  
Mr King: I think this is something you really ought to put to the Treasury because they have been responsible for drawing up and negotiating the lending agreements. I do not think it is sensible to expect that UK banks could easily—  
Q84 Mr Mudie: The Treasury are not as forthcoming as yourself, would you believe that!  
Mr King: It is quite hard to be forthcoming about something like this. If you read the lending agreements they are not quite as precise as they might be, put it that way.

Q85 Mr Mudie: That is why I am asking these questions actually.  
Mr King: It is perfectly fair to ask the questions. I do not think it would be sensible to expect a bank that clearly, as Mr Cousins pointed out, is in difficulty and may take some time to adjust its balance sheet to suddenly expand its balance sheet and fill in the gap which other banks have created by withdrawing capacity. The constraint there is capital. They ought to be able to get the funding because the Credit Guarantee Scheme is available there to obtain the funding, but the capital position is the one that is problematic. That is something which goes back to a point that Paul made. Even if you raise the capital level to what looks like a high level, the people in the banks will say to themselves, “Where are the risks that face us? Where could we go wrong?” and the answer is they will not go wrong by finding their capital go up a bit further but they will go wrong if they find themselves right down at the minimum capital constraint, so they are naturally going to be resistant to lending on that basis.

Q86 Mr Mudie: I understand that, but I am an old-fashioned individual who believes if I make an agreement and receive something then I promise to do something back. Although you have said the lending agreements are pretty loose, the banks signed them and said they would do certain things, but what we find as we go round the country is they are not doing these. That is what I find personally objectionable. We seem to be thrusting money at them, billions, and the ordinary person out there is saying, “Okay, but what about their side of the agreement? I went to try and save my company and I have banked with them for 20 years” or “I’m being pulled in to renegotiate the terms”. That almost seems to be bad behaviour by the banks who have agreed to do something and seem not to be doing it.  
Mr King: I totally share that concern and over recent months we have seen the growth rate of lending tail off quite significantly. What I would say is that the lending agreements were signed pretty recently and we have yet to see in the data the impact of that. Maybe when we get the next Bank of England Lending Panel Report—  
Q87 Mr Mudie: Governor, sorry to interrupt you, but when you say that are you referring to the October agreement or the January agreement?  
Mr King: The one signed as part of the Asset Protection Scheme.

Q88 Mr Mudie: What happened to the October agreement?  
Mr King: As far as I know nothing happened until the Asset Protection Scheme came in.

Q89 Mr Mudie: So they signed an agreement in October and got £37 billion and did nothing and were only taking it seriously when they asked for more money?  
Mr King: That you will have to put to the Government and UKFI. The banks have signed the lending agreements in return for being part of the scheme. I think what we should do is see over the next few weeks and months how far credit conditions start to ease, and we will wait to see that in our next survey, and what happens to the lending data. We are looking carefully at the data. I accept that so far the lending data have not been encouraging, but we are just now at the point where
if these lending agreements which banks have signed are to have an impact we should expect to see it come through in some of the numbers.

Q90 Mr Mudie: One thing your agents have picked up, and we picked up when we were in the north, is that businesses were reluctant to go in and ask for any type of help because banks were taking that as a signal that these firms were in trouble and their existing agreements were in danger of being reviewed. Your agents reported that. How serious do you think it is? Is there anything that the Bank can do in old-fashioned terms by taking a dim view of it and indicating that you do take a dim view of it, or is it something you note, it is bad but you cannot do anything about?

Mr King: I think part of it is the inevitable consequence of what happens when you go into recession. Any company that says, “Look, I need some help to tide it over” is giving a signal about its judgment of the prospects and the potential lender can use that information to say, “Well, if you think that maybe we should be more cautious”. I do not think there is anything you can ever do to prevent that. Clearly the problem we are facing now is that one of the roles of the banking system is to be there to provide finance when companies need it and you would expect in normal circumstances when an economy did slow down that banks would be willing to extend more lending to deal with some of those distress cases because there would probably be a lower demand for expansion from other companies, but our banking system has been unable to do that because of the weak state into which it got and the weak state of its balance sheet. The most important thing that Government can do is try to restore the health of the banking system and to get that balance sheet sorted out. The big lesson from all previous crises, whether in Japan, Sweden or elsewhere, is get on with it, sort out the banks, because the sooner you do that the sooner they will be back in a position where they can lend. Letting it drag on is the biggest problem that all of us have in this area.

Q91 Mr Mudie: That is absolutely good advice, but when you do that and you expect the banks to live up to their side of the bargain and they do not deliver, it is very, very sad.

Mr King: That is why the lending agreements need to be specified in quantitative form so they can be monitored.

Q92 Chairman: As a Committee, Governor, we are a wee bit frustrated with UKFI because we are not really sure of its mandate and what it is doing. It negotiated these lending agreements. We really need transparency. As George said, in our visits around the country what we picked up was a lot of anger, frustration and betrayal. If the transparency is not there then taking the public along with us is going to be even harder.

Mr King: I totally share that view. I think that far and away the biggest problem we have in explaining all of this is for 20 years we have been saying market discipline is jolly good for an economy, we are all better off if we allow ourselves to be subject to market discipline, and unions, employees and businesses accepted that for 20 years, but suddenly out of the blue comes a crisis which reflects no development in the real economy over which they had any control at all and must seem bewildering. An immediate consequence is that the people who are suffering most in the economy is manufacturing business. It is the manufacturing sector now that is suffering more than any other part of the economy.

Q93 Mr Love: Governor, were you surprised that CPI inflation went up in February? To what extent do you think those figures are due to the significant depreciation of sterling?

Mr King: I think it was somewhat higher than we had expected but there are big movements from month to month which you cannot easily predict. We were certainly prepared for it. We only saw the numbers yesterday so it is quite early to form a definitive judgment and we will want to do more detailed work, but at first sight this looks like a fairly broad based increase. Perhaps one might have expected inflation to tail off more. The impact on the inflation rate is fairly broadly based. It seems particularly concentrated in those industries where they are most exposed to imports so that the import intensity of the sector seems to be related to the impact on inflation and that, therefore, does suggest that the exchange rate is having some effect. Of course, with a 28% fall in the exchange rate over 18 months we clearly expected a good part of that to feed through to the domestic price level. It is always unclear precisely how much and at what speed it will come through, but this was bound to have a significant impact on the price level and that was factored into our February forecast and I am sure will continue to come through in the months ahead. The big picture offsetting that is a big downward pressure on inflation as the degree of spare capacity builds up.

Q94 Mr Love: Can I ask you about the depreciation of sterling. Is that a necessary adjustment long overdue or, more worryingly, has there been a loss of faith on the part of investors in the future of the UK economy? Is there any sign of that?

Mr King: I see no reason why there should be a loss of faith. We still have a clear economic framework. It is still the case that following the events of last autumn most countries in Europe and the rest of the world have been more severely affected than the United Kingdom. Germany is much worse affected so far than we are. This is a very significant fall in world trade and what is happening is the initial banking crisis that occurred in those countries, and it is no accident it occurred in those countries which had large current account deficits, therefore big capital inflows, which we were unable to deal with effectively and prevent the expansion of the financial sector, led to problems in our banking sector and our moving into recession, but the result is it is the surplus countries, the countries that rely on export,
which are being the most severely affected now. If you look around the world, the countries with the biggest falls in industrial production and GDP are the surplus countries, those who relied on export, those who may have had no troubles in their banking sector and certainly no problems in their housing sector. This is a reflection of world imbalances and you can see it very clearly. Given that picture, I think that some fall in sterling was very likely because, after all, we had spent much of the late 1990s coming to this Committee saying we could not really explain why sterling had been so strong, so it was not that much of a surprise when that fell back. I have been talking about the need for a rebalancing of the UK economy for many years and this is part of it. Who knows how much that fall needed to be, it is very hard to say, but our job is to respond to that and ensure that none of this is allowed to mean that inflation remains above target, we will try to keep inflation as close to target as possible, that is our firm objective.

Q95 Mr Love: One of the submissions to us talked about an engineered depression in the exchange rate. How do you respond to that accusation that it has been engineered?

Mr King: Goodness knows what kind of engineers you would need, certainly neither financial engineers nor other engineers. It was not engineered then and nor is it now. When these things occur our job is to respond. The message that comes from the market in the long run is usually telling you something about the underlying position of the economy. Our exchange rate was very strong and that had led to a significant current account deficit. This was the counterpart to some of the surpluses elsewhere in the world economy and these are unwinding. Part of the adjustment is reconfiguration of exchange rates. It has happened already to the dollar, it has happened now to sterling and I see no reason why it should go any lower, but who knows, there is no point trying to speculate on where exchange rates will go. What we are doing is trying to pursue a clear economic framework that for our part keeps inflation close to target and for the Government’s part, as reiterated in the Chancellor’s letter to me this morning, is committed to a sustainable path for the public finances.

Q96 Mr Love: You have mentioned on a couple of occasions this extraordinary downturn in the world economy. Taking that into account, what is the outlook for growth in Europe and the United States in the coming months?

Mr King: Clearly in the short run it is not bright because the first quarter looks as if it could be even more of a downturn than the fourth quarter of last year. As I said before, the same factors that lead us to believe that there will be a recovery in the UK also suggest there will be one in the world economy, namely a very large degree of policy stimulus that has been injected, and in parts of the world economy, particularly in connection with the car industry, signs of a stocks effect in which stocks are being run down, production is being cut back and you cannot keep cutting that back indefinitely without running out of products to sell. Those two factors should lead one to expect some recovery, but the precise timing and the strength of it are very, very hard to judge not least, as Mr Cousins pointed out, because of the difficulty of getting the banking system back to a healthy state.

Q97 Mr Love: The IMF in successive reports has forecast a larger and larger decline in world output and, therefore, one presumes in the short-term the continuing of that series. Is there an argument to be made for a second fiscal stimulus to respond to what is likely to be a further decline in the world’s economic output?

Mr King: I am sure the Government will want to be cautious in this respect. There is no doubt that we are facing very large fiscal deficits over the next two to three years, there can be no doubt about that. I think it is right to accept that when the economy turns down and the automatic stabilisers kick in, so the increased benefit expenditures and lower tax revenues are bound to lead to higher fiscal deficits and it does not make sense to try to offset that so we are going to have to accept for the next two to three years very large fiscal deficits. Given how big those deficits are, I think it would be sensible to be cautious about going further in using discretionary measures to expand the size of those deficits. That is not to rule out targeted and selected measures that may find those areas, whether it is in the labour market, whether it is in corporate credit, that can do some good, but the fiscal position in the UK is not one that would say, “Well, why don’t we just engage in another significant round of fiscal expansion?” We can do more monetary easing if necessary. Monetary policy should bear the brunt of dealing with the ups and downs of the economy. We have put in an enormous amount of stimulus: we have cut interest rates in a few months by 4 1/2 percentage points; we have now moved to unconventional operations in order to try to expand the money supply. These are quite dramatic policies. The fact that we still see a rapid downturn should not lead people to forget that there are inevitably lags between when these policies are implemented and when they will start to have an effect. The fact that the world economy is in the middle of this quarter of a very sharp downturn is not evidence that this policy stimulus injected in only the last few months will not come through in the future.

Q98 Mr Love: Professor Blanchflower, how do you respond to the second fiscal stimulus argument?

Professor Blanchflower: Obviously one has to be concerned about fiscal sustainability. In many senses, and this is what the Governor has said, there are arguments for targeting parts of the labour market because of the long run consequences that we are going to see if we do not do that. I have not suggested what that metric would be, but if you do comparisons with the US the numbers will be quite
large and one has to look at the fiscal sustainability of those things. On the other hand, you are going to have to do something about unemployment.

Q99 Mr Love: Professor Besley, how do you respond to the argument for a second fiscal stimulus? Do you think the overriding argument is to the level of debt that we are building up for the future?

Professor Besley: I broadly agree with what both the Governor and Danny have said. Let me be clear, both as a taxpayer and a citizen, I care that whatever we do we do with a very clearly stated objective around the fiscal rules and we are clear about the implications of what we do and the impact that is going to have on the future sustainability of public finances. I do not think I particularly want to enter the debate on the right level of fiscal stimulus. All I will say is that, whatever we do, I think we need to do it in a way that is open and transparent about the implications.

Q100 Chairman: Professor Blanchflower, you mentioned yesterday in your speech about unemployment being three million and there is some suggestion of it going to four million by 2012. How do we deal with that?

Professor Blanchflower: In some sense it was partly answered with my last question, that there has to be some focus on trying to create jobs. One of the things we can do is take advantage of one of the things that naturally happen in a recession, which is there is a reduction in the effective supply of labour. One of the things we can do is take advantage of one of the things that naturally happen in a recession, which is there is a great demand for more education, so that is something I have encouraged. We have to think strongly about how we are going to create jobs at a time when simply the numbers are swamping us.

Q101 John Mann: Page 27 of the Inflation Report, paragraph 3.3 reads: “Downward pressure on wages may be dampened by a reduction in the effective supply of labour”. What is the evidence base that is supporting that claim?

Mr King: Let me ask Mr Dale to answer that.

Mr Dale: In some sense you could argue it is encouraging that participation rates have remained high and that is an encouraging sign.

Q102 John Mann: So you are contradicting your own report then because your own report says the opposite is going to happen.

Mr Dale: Indeed.

Q103 John Mann: So why is that in the report then?

Mr Dale: Because one of the features we have been surprised about since we wrote the report is the extent to which participation rates have remained high and that is an encouraging sign.

Q104 John Mann: What is discouraging is that your report is suggesting the opposite direction from what your evidence base is which suggests that the labour market analysis is not sufficiently robust. Let me ask a different question on the labour market. How many migrants have entered the UK since October and how many have left?

Mr King: I do not think we have any means of knowing.

Professor Blanchflower: I do not have an answer to that.

Q105 John Mann: It is important to know.

Mr King: It may be important to know but you, as parliamentarians have not put in place a process by which these are measured.

Q106 John Mann: I am not looking at blame. I am interested in the evidence base on which you are writing this report. Am I right in thinking that there is a labour market analysis on statistics that are not there and there is a presumption in it that may, therefore, be wrong?

Professor Blanchflower: The standard assumption in the textbook and the standard thing we have seen in previous recessions is as unemployment rises people leave the labour force and migrants will leave the country because they see there are not any jobs here. That is a standard thing to expect. This is a unique thing. It has started to happen in the US and it is happening here. People have actually increased their participation and some of it reflects the decline in their savings, the decline in pensions and so on. In some sense you could argue it is encouraging that they have not left but, on the other hand, my view is it is a response to financial distress. Within the family the husband is unable to work as much perhaps, there is a reduction in hours, and the family feels less confident so an additional member of the family participates. We have not seen that before. These are new events that are really occurring. The standard expectation that you teach to all labour economics students is the opposite. That is an unfolding event.

Q107 John Mann: So we can expect a rather different narrative in the next Inflation Report from what you are saying.

Mr King: It depends on the data.

Q108 John Mann: Will you have the data? Every other major global recession has led to mass migration of labour and the transportation possibilities now are greater than they ever were. We have had major riots this year in a number of EU countries. Can we expect to see and, more critically,
do you need the data on whether we are seeing, significant changes in emigration or immigration from this country in terms of the real labour supply?

Mr King: Certainly we have said for some time that in order to analyse the labour market or, indeed, for that matter levels of demand, we would like to have much better data on migration. We do not have those data and I think there ought to be enormous confidence intervals around the estimates that people make of those numbers. The database which is used to construct those estimates is not good.

Q109 John Mann: Are there major regional disparities in terms of the performance of the labour market and, indeed, of the economy that are worthy of particular attention?

Professor Blanchflower: In a way, the sad part about this recession is that it is really located everywhere, it is not predominantly in a particular place. Perhaps the only real surprise is that Scotland has done relatively better than it has done in the past. This is a set of events that seems to cover all sectors and all regions.

Q110 John Thurso: Can I ask you one quick question. Throughout this crisis you have underlined the importance of getting credit flows back into the real economy, and I think that is particularly important with SMEs. The Government has put in place a series of schemes designed to enable the banks to lend where the banks commercially might not otherwise. What was referred to earlier was that there is a clear disconnect between the desire for that money to go in at the top and what every company is telling all of us out on the street. Is there any way the Bank’s agents can monitor this so that we can know what is happening because if you ask a Government minister they tell you it is all working wonderfully and any MP anywhere will tell you of the problems he has got. Is there any way the Bank can help by getting factual data as to what is really happening?

Mr King: Of course we do get data from the banks about lending as part of our normal statistical reporting. It is those data that lead me to this conclusion that so far the growth rate of lending will still be positive but it has been declining very sharply and we have not seen any sign of recovery. That may change.

Q111 John Thurso: It was not on the wider issue, just on the specific issue of are the schemes doing what they are meant to do?

Mr King: There are two aspects on that. One is we can nationally get data on certain subsets of borrowers, so we can look at corporate lending and within that we can try to look at SMEs. The question of whether the schemes are working is difficult because you have to have a counterfactual, what would have happened had the scheme not been introduced, and that is almost impossible to say. We can try to provide a broad picture of what is happening in absolute terms to lending to these different sectors. I totally accept the comments you have been hearing as you have made your regional visits are very similar to the comments that we have been hearing and are being fed back to us by our agents. That suggests that we are still waiting for signs of improvement. That does not mean to say we will not get it. The lending agreements which are meant to be serious, and I hope will be monitored carefully, have only recently been signed. We will see in our Credit Conditions Survey and in the Bank’s Survey of Bank Lending whether this starts to improve in the next few months. That is something we will monitor very carefully because it clearly is germane to the question of the timing of our ability to get out of recession.

Q112 Chairman: Governor, I know you want to be away for 11.30 but I have got a last question for you. The Inflation Report says that many specialist institutions focused on lending to riskier customers and they have now exited the market. Do you welcome or bemoan that exit?

Mr King: Let me ask Mr Tucker to talk about this in his capacity as Deputy Governor for Financial Stability.

Mr Tucker: I do not think they will come back for quite a long time. We can build a system for underpinning the banking system, with difficulty but more readily than we can build a system for underpinning essentially unregulated intermediaries in credit. The fact that they have withdrawn in this crisis has plainly made the crisis a lot worse, but I would not expect them to re-enter for quite a while.

Chairman: Governor, thank you very much for coming this morning.
Written evidence

Memorandum from Professor Anton Muscatelli, Heriot-Watt University

INTRODUCTION

1. The UK and the global economy have suffered a sharp downturn over the latter half of 2008, and the Bank’s latest Inflation Report seems to be finally catching up with the predictions of independent forecasts regarding the prospects for the UK economy. The recession currently facing the UK is already shaping up to be one of the worst in the last 30 years. But perhaps more worryingly, the prospects for recovery seem less good than in previous downturns (the recessions that began in 1973, 1980 and 1990).

2. In previous evidence to the Committee I had highlighted the fact that the GDP forecasts published in the Inflation Report seemed too optimistic (cf. the August Inflation Report). The central case for the GDP forecast has been revised downward in the last two Reports (November and February), but I would still disagree with the Bank’s predictions about the shape of the upturn. The forecast (eg Chart 1, p.7 of the February Inflation Report) shows a clear “V-shaped” recession and recovery cycle, which is classic of a standard business cycle.

3. However, the nature of the current downturn is different. It has been massively conditioned by the financial and banking crisis, which has distorted the standard transmission mechanism of interest rate policy. The power of fiscal policy in this situation may also be affected by consumer concerns about future tax liabilities as future governments have to deal with the high levels of government debt. As I discuss below, it is very likely that the shape of the current cycle may be closer to a “sloping L” curve, with a very gradual recovery from the trough of the recession.

4. I will not spend much time discussing the inflation forecast by the Bank. Although in the medium term there are interesting issues around how current money supply creation might feed into inflation, this is an issue which will not need to be addressed until later in 2010, at the earliest.

5. Instead I will discuss the issue of “unconventional monetary policy tools”, which are highlighted in the February Inflation Report and have also been much discussed in the media under the title of “quantitative easing”. Details of these measures were finally announced on 5 March by the Bank.

THE FINANCIAL CRISIS

6. The dynamic of the financial crisis has been analysed quite closely in the media, and most of the analysis does not bear repetition. In what follows I shall focus mainly on the current prospects for an effective expansionary monetary policy at a time when financial institutions have fragile balance sheets.

7. In summary, the features of the current financial crisis are threefold. The first feature is one which is new to this financial crisis relative to previous ones, and which complicates the recovery phase from the crisis because it has undermined confidence in financial intermediation. This is the lack of transparency in the size and incidence of portfolios held by both private investors and intermediaries. This has been caused by the existence of various layers of securitisation, which has resulted in a complete loss of information in markets on how to assess risk. This feature of the crisis is very insidious, because the lack of confidence changes the nature of market behaviour by both investors and intermediaries, which makes it much more difficult for policy-makers like central banks to assess the right monetary policy stance. We know that monetary expansion through interest rate cuts and some “quantitative easing” (as discussed below) is required. But as the transmission mechanism of monetary policy has changed, we cannot fully predict the expansionary impact of these measures.

8. In passing one should note that some measures might have prevented the global financial boom-bust cycle, or at least contained it: statutory maximum loan to value ratios could have prevented the worst excesses of the property boom in countries like the UK and Ireland. Second, giving some attention to asset prices and financial stability in setting monetary policy in addition to inflation targeting might also have shortened the boom phase of the cycle. Third, paying some attention to the massive international financial imbalances (the Committee may recall that around two years ago in oral evidence I highlighted this as the greatest risk facing the world economy, although the trigger for adjustment has come from an unexpected source: the crisis in US and OECD financial institutions). There is no doubt that the excess of savings in current account surplus economies allowed the boom cycle to persist for longer than was desirable; it provided some of the fuel for it. Addressing this in future might require some degree of international policy co-ordination through international institutions such as the IMF.

9. There is also much misinformation about future regulatory reform, such as recourse to modern equivalents of the Glass-Steagall Act to separate commercial and investment banking, which might not be as effective in a modern financial system (the collapse of Northern Rock and HBOS had little to do with investment banking activities). There are regulatory changes in terms of banking and financial markets which might be considered and which I do not have space to explore here, but which should be examined in the near future after the recovery begins.
10. But, turning again to the more immediate issue of how to manage the liquidity crisis, there have been a variety of approaches across the global economy, from the TARP programme of the US aimed at dealing with market mispricing, to countries like the UK directly injecting capital and acquiring control of key banks. The size of the bailouts has been massive, and the problem has been aggravated by the sharp deterioration in the real economy, which means that financial intermediaries are facing losses in asset values which are far in excess of the “toxic assets” which were generated by securitisation. As governments deal with bank rescues two key issues should be borne in mind, as these will not be solved by the bailouts: first, governments have to be careful not to cause the survival of insolvent banks which would simply soak up capital whilst maintaining non-performing assets on their balance sheets. This was a feature of the Japanese 1990s crisis and could prolong the crisis. Second, we have to distinguish between the need to restore the supply of bank lending, which is helped by the bailouts, with the need to eliminate the liquidity crisis—the “credit crunch”, which may not be. Bank bailouts may not necessarily stop a prolonged credit crunch, as this is not due to bank lending, but due to the collapse in the trade of market-based instruments. Only if the bailouts restore confidence levels in financial intermediation in markets (cf paragraph 7 above) will there be an elimination of the liquidity problems.

FORECASTING THE RECOVERY

11. As noted in the introduction, the February Inflation Report predicts a classical V-shaped recession and recovery. The rapid recovery phase seems to rely heavily on assumptions about the reversal of de-stocking, as the inventory cycle plays an important part in the business cycle (see p.24 of the Report), as well as an assumption about the net trade position, following the sharp depreciation in Sterling.

12. However, I have concerns about the likelihood of such a “V-shaped” recession on various counts. First, some of assumed fiscal stimulus through the VAT cut and other measures (which in the pre-Budget report were assumed to fractionally offset the reduction in GDP in 2009) may be negated by negative expectations on the part of consumers who might factor in future tax increases. The assumption may be on the Government’s part that these “Ricardian” effects aren’t very strong, especially as consumers are credit-constrained in the current financial crisis. But the sheer size of the fiscal deficit and debt levels are such that it may have an impact on consumer expectations.

13. Second, the deterioration in world economic growth is sharper than many predicted, in part because of a more rapid deterioration of economic conditions in export-oriented emerging economies. This reduction in world demand will dominate the export and import substitution effects due to the more competitive level of Sterling.

14. Third, as noted in Section 5, partly because of the financial crisis, there are fundamental uncertainties about the recovery in business confidence and hence the inventory and investment cycle. These seem to have induced the bank to weigh the GDP growth risks to the down side, as reflected in a skewed fan chart (see Charts 5.1–5.3 on pp. 38–39 of the Report).

15. Overall, my view is that the prolonged nature of the financial crisis, which means that monetary policy may take longer to have effects on the real economy, plus the uncertainties regarding the potency of expansionary fiscal policy, suggest that a recovery will be shaped more like a “sloping L” than a “V”. In other words, I would think it more likely that the UK economy will evolve towards the lower end of the Bank’s GDP forecast fan charts.

UNCONVENTIONAL MONETARY POLICY

16. The Bank highlights the problems of managing monetary policy as Bank Rate edges towards the zero nominal bound, and the need to use alternative monetary measures (see pp.44–45 of the current Report).

17. The Bank describes the mechanism whereby it can generate a monetary expansion through changing the quantity of base money as opposed to setting the price (Bank Rate), financing purchases of the Asset Purchase Facility (APF) through the creation of bank reserves. The Report also highlights the two effects through which these operations will generate a monetary policy stimulus: first the standard effect of boosting the quantity of base money, and hence the supply of credit by banks and the supply of broad money. Second, by providing greater confidence to holders of temporarily illiquid assets that they can sell these assets, thus addressing the confidence issue in financial markets. As I highlighted in par. 10 above, although both channels matter, I attach some importance to the second effect in ensuring that the transmission mechanism of monetary policy is fully restored. As is noted by the Bank, the experience from Japan shows that the first channel may be unpredictable, especially if combined with weak consumer and business expectations.

18. On 5 March, the Bank unveiled the details of the money creation policy, through a £75 billion scheme to purchase gilts. The figure seems to have been chosen to grow monetary base in line with a desired growth in nominal spending of 5% of GDP per year. It is a major intervention in gilts markets as £75 billion constitute about 30% of outstanding 5 to 25-year gilts. The initial reaction of gilts markets, not surprisingly was positive, lowering yields at lower maturities, which is exactly the desired effect from the announcement of the additional monetary base creation.
19. One of the main problems, however, as noted above, is that bank lending is unpredictable. This means that the "bank multiplier" the ratio between broad monetary aggregates (which include bank lending) and the monetary base (central bank money) has been shrinking very fast. This ratio has fallen from around 60 in 2007 to around 25 by end 2008. Hence a growth in monetary base might not translate into overall money supply growth unless bank lending increases. It is essential that greater efforts are made to ensure that the supply of bank lending is maintained for this “quantitative easing” to have effect.

20. Indeed, if bank lending still fails to grow, it may be better for the central bank to further extend its policy of purchasing corporate bonds, and to find ways of encouraging larger companies to borrow through this channel, thus beginning to lower the yield on corporate bonds and particularly the spread between corporate bonds and gilts.

5 March 2009

Memorandum from Bridget Rosewell, Volterra Consulting

CHARTING THE FUTURE

It is notorious that the opening gambit of many forecasting presenters is to point out that “this is a particularly difficult time to be forecasting”. In fact it is probably truer to say that the period after a turning point is easier because turbulence is more widely expected.

The ranges of outcome defined by the Bank in succeeding copies of the Inflation Report on the other hand do not seem entirely to illustrate this or perhaps they represent continued policy optimism. The table below estimates the central range of outcomes along the charted line which represents the policy outlook of two years. It is based on visual inspection of the charts in the publications.

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<td>1.7–2.2</td>
<td>1.8–2.3</td>
<td>0–1.2</td>
</tr>
<tr>
<td>Total range</td>
<td>1.0–2.9</td>
<td>0.9–2.9</td>
<td>0.9–3.2</td>
<td>0.9–3.5</td>
<td>1.5–2.1</td>
</tr>
</tbody>
</table>

Thus the current view of the picture two years ahead is the only one which has substantially shifted and then only for inflation and the total output range. Thus the Bank’s current view is that the central range for output in February 2011 has now moved slightly towards the upper part of the potential, even though there is a greater risk of continued recession.

On inflation, there has been an extraordinary volte-face. The central view is utterly different than any over the last five years. The Bank expects to miss the target on the downside and with a high probability that a letter will need to be written. The total range has equally moved dramatically.

It is interesting that this major shift has not been given more attention. It also raises the question of what these numbers represent in a wider context. Five years ago, we examined the ranges in the fan charts of the day across a wider data frame. At the time, it was strongly argued that ten years of data were enough and this longer period added nothing. Today, this seems like hubris. Indeed, Andrew Haldane, a Bank Executive Director, in a recent paper has also concluded that longer time periods are essential. The Tables below are taken from that earlier analysis.

The table compares the estimated range from the fan charts from the 2005 report and those estimated from longer periods of UK data.

1 Defined as the dark coloured range in the charts, approximating to 50% of the outcomes
2 Defined as the whole coloured area, approximated to 90% of the outcomes
3 A G Haldane, Why Banks Failed the Stress Test, Marcus Evans Conference on Stress Testing, February 2009
Table 1

RANGE FOR REAL ANNUAL GDP GROWTH RATE (%) IN THE UK IN 2005: 90% RANGE

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
<th>Probability of growth &lt; 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary Policy Committee judgement</td>
<td>1.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Linear interpolation of probability density function of data 1949–2004</td>
<td>−1.4</td>
<td>5.1</td>
</tr>
<tr>
<td>Kernel density estimation of pdf 1949–2004</td>
<td>−1.3</td>
<td>5.4</td>
</tr>
</tbody>
</table>

The statistically based estimates of the 90% range of the data are much higher than the judgmentally based ones of the MPC. In retrospect, no recession took place in 2005. But anticipating turning points, and recessions in particular, is well known to be the weakest aspect of macroeconomic forecasting. In recession years, forecasts made early in the year have often projected positive growth. Indeed this was certainly the case for 2008. The longer term data suggests that the range now set by the fan charts is closer to the potential variability, but is still too narrow.

In terms of inflation, the current rate has now moved outside the previous probability band and indeed is at the top of the current one. In 2005, the MPC saw the then current rate of 1.5% as persisting during 2005, within a 90% probability band of 1–2%. In the event the outturn was slightly higher than this, at 2.1%.

Table 2 sets out the various estimates for the 90% probability band for 2005 using the data on the change in inflation. With the inflation data we cannot reject the hypothesis of the data being normally distributed, with a Kolmogorov–Smirnov normality test returning a p-value of 0.5.

Table 2

RANGE FOR INFLATION (%) IN THE UK IN 2005: 90% RANGE

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
<th>Probability of inflation &lt; 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary Policy Committee judgement</td>
<td>1.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Linear interpolation of probability density function of data</td>
<td>−0.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Kernel density estimation of data</td>
<td>−1.0</td>
<td>3.8</td>
</tr>
<tr>
<td>Hypothesised distribution of data (normal distribution)</td>
<td>−0.7</td>
<td>3.8</td>
</tr>
</tbody>
</table>

(note that since Inflation is highly autocorrelated all calculations are carried out on the difference of inflation, i.e this is actually 2005 predictions calculated using 2004 value of inflation)

The Bank’s latest view on inflation is now seen to be outside the bounds of previous experience. Their total range suggests deflation of 1.5% might be possible. This would be outside the ranges based on post war history. Moreover, the upper bound is also set well within the data ranges.

The table below shows the probability ranges based on 10 years of data from 1995 to 2005—these bear a strong relationship with the published ranges up until this year.

Table 3

RANGES (%) in 2005: 90% RANGE BASED ON 10 YEARS OF DATA

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
<th>Probability of growth &lt; 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK data</td>
<td>1.7</td>
<td>4.3</td>
</tr>
<tr>
<td>UK data</td>
<td>0.6</td>
<td>1.9</td>
</tr>
</tbody>
</table>

It is now clear that we have moved into a world which is going to be unlike the past decade and the Bank will need to take a longer historical period as their frame of reference. It would be good to know what the relevant frame of reference is in which future fan charts can be judged.

---

What is a third quartile recession?

One way to judge the current situation is to place a view on the likely outturn in relation to previous recessions. We have analysed this in relation to all recessions in the developed world over the period 1870 to 1994. A “Third Quartile” recession is one in which only 25% of all recessions are worse. Such a recession will last two years, and have a fall in output of 5% from peak to trough with it taking three years to regain the previous peak.

In the recession of the early 1990s, the total cumulative fall in output below the 1990 peak was 2.5%, and the level of 1990 was not regained until 1993. In the early 1980s, the 1979 level wasn’t regained until 1983, another four year shortfall. But the total drop in output was even worse, at 7.2%.

So if we have a “third quartile recession”: output will not get back to the 2008 peak until 2012. And the total cumulative fall below the 2008 level will be around 7%. The table below compares the third quartile recession with UK post-war experience. If this is what we are heading for, the 1979–81 example is the closest.

<table>
<thead>
<tr>
<th>Table 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>RECESIONS</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recessions</th>
<th>1970s</th>
<th>1980s</th>
<th>1990s</th>
<th>3rd Quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peak to trough duration</td>
<td>73–75</td>
<td>79–81</td>
<td>90–91</td>
<td>2 Years</td>
</tr>
<tr>
<td>Recover to peak duration</td>
<td>73–76</td>
<td>79–83</td>
<td>90–93</td>
<td>3 Years</td>
</tr>
<tr>
<td>Peak to trough fall %</td>
<td>1.9</td>
<td>3.5</td>
<td>1.4</td>
<td>4.9</td>
</tr>
<tr>
<td>Recovery to peak loss %</td>
<td>3.2</td>
<td>7.2</td>
<td>2.5</td>
<td>6.9</td>
</tr>
</tbody>
</table>

Interest rates, savers and borrowers

If this is indeed a serious recession, then what can policy do? How far can the tools of monetary policy (or indeed other tools) offset this? There is no doubt that there has been a significant policy response to the credit crisis, while the effects of high commodity prices and the impact of indebtedness have been also proximate causes of the downturn. These required policy tightening, while the banking crisis has overwhelmed these impacts and generated enormous loosening.

Since all recessions are different, it is extremely hard to compare different responses. However, the record lows in interest rates before any money supply increases have been put in place may have perverse consequences. First, although indebtedness has certainly increased, it did so alongside financial assets. The table below shows household sector net wealth and I am indebted to Martin Ellis at HBOS (Lloyds Banking Group) for this updated material.

<table>
<thead>
<tr>
<th>Table 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>HOUSEHOLD SECTOR WEALTH (£ BN)</td>
</tr>
</tbody>
</table>

|Value of Residential Properties | 1,301 | 1,505 | 1,968 | 2,869 | 3,336 | 3,696 | 4,077 |
|Less Mortgage Loans | 431 | 457 | 536 | 775 | 967 | 1,079 | 1,187 |
|Net Housing Equity | 870 | 1,04 | 1,43 | 2,09 | 2,36 | 2,61 | 2,89 |
|Total Household Financial Assets | 2,502 | 2,692 | 3,117 | 2,975 | 3,620 | 3,918 | 4,056 |
|Less Consumer Credit Loans Outstanding | 91 | 106 | 135 | 180 | 211 | 213 | 221 |
|Net Financial Wealth | 2,412 | 2,58 | 2,98 | 2,79 | 3,40 | 3,70 | 3,83 |
|Net Household Wealth | 3,282 | 3,63 | 4,41 | 4,88 | 5,77 | 6,32 | 6,72 |

Source: ONS, Bank of England, Halifax estimates

Up to 2007 at least, net wealth was increasing, while consumer credit growth slowed in recent years. It is of course unclear as yet what 2008 figures will show. But this can mean that low interest rates are as much a disincentive to economic activity as they are an incentive. Borrowing is certainly cheaper but low returns on financial assets may also deter spending.

Alternatively, low base rates may increasingly not be reflected in saving and lending rates. Institutions trying to attract funds may well have to continue to offer rates further above base rates than in the recent past and lending rates will of course have to reflect in turn the cost of funds. At one level this is realistic—mortgage rates were historically much higher than base than they were, for example, when a fixed rate deal could be struck at below base rate in 2006. But we simply do not know how consumers will respond to these unprecedented conditions.

In these circumstances, it may be judged premature to reduce rates effectively to zero as was done this week.
INFLATION

Chart 2 February 2005
Current CPI inflation projection based on market interest rate expectations

Chart 2 – February 2006
Current CPI inflation projection based on market interest rate expectations

Chart 2 February 2007
Current CPI inflation projection based on market interest rate expectations

Chart 2 February 2008
Current CPI inflation projection based on market interest rate expectations

7 March 2009
Memorandum from Professor Sheila Dow, University of Stirling

1. Again the MPC has been taken by surprise by economic developments, so that the forecast for output contraction in 2009 is now much more severe than in November. As a result the danger of deflation setting in is increased, i.e. further deviation from the inflation target. The bounce back predicted in the Report for mid-2009 is more optimistic than most commentators have been predicting. But the new quantitative easing policy is designed to promote such a recovery (explained in the Box on pages 44–5 of the Report).

Quantitative Easing

2. The MPC is seeking to inject new money into the economy in an effort to increase aggregate demand to meet the inflation target. In particular, they will use the Asset Purchase Facility (currently substituting Treasury bills for private sector debt) to substitute new money for government and private sector debt. The reasoning offered on page 44 is that, since the repo rate is now so low, banks will be unable to pass on any further reductions on loans and still earn a profit, given that there is little room left for reducing rates on deposits. So this approach is designed to provide a better way, both to drive down yields and to increase credit.

3. This “quantitative easing” is not altogether a new policy tool, being based on the traditional mechanism of open market operations, whereby the Bank managed market rates through its own market activity. What is new is the announcement of the amounts to be injected (£75 billion over three months), the inclusion of corporate bonds for a minority of these purchases, and the special circumstances of a near-zero official rate. In addition the monetary policy framework is different from pre-1997, in that it is the Treasury which now manages government debt, not the Bank.

4. The general theoretical justification for quantitative easing also has a long history. Monetarist theory, which became the explicit rationale for monetary targets from 1979, was used to justify attempts to reduce the growth of the money stock. It is based on the idea that inflation and deflation are caused by the rate of growth in the money supply. The policy was eventually replaced by inflation targeting partly because it proved difficult to control the money supply. As now, the banks themselves decided how much credit to create, and that is the main source of changes in the money supply. Monetary tightening was unable to discourage credit creation directly. Now the problem is to encourage banks to expand lending. Particularly when there are now no reserve requirements as such, banks may choose to hold onto the additional reserves rather than expanding lending, a problem acknowledged in the Inflation Report. On the other hand, had banks chosen themselves to expand lending at current rates, the Bank of England would have supplied the necessary reserves anyway as a matter of course.

5. Growth in money held outside the financial sector has indeed slowed significantly. We are now seeing banks not passing on reductions in official rates and not using their capacity to create credit and thus deposits (i.e. money). This in itself can explain the fall in broad money growth shown in Chart 1.2: the credit and money trends are closely matched for the non-bank sector. But weak lending (and thus weak deposit growth) cannot be explained only by the banks tightening credit conditions. The CBI investment intentions survey, as noted on page 24, shows tightening credit conditions as becoming more important as a break on investment. But the Banks’ Agents have identified weak demand and uncertainty about the depth and duration of the recession as the most important causes (also page 24). Firms don’t want as much credit to finance new investment—although there is urgent demand for working capital. So the weakening growth of money cannot be said to be the main cause of deflation, but rather a symptom; the focus should rather be on both the supply of and demand for credit and how they are being influenced by the recession and by uncertainty.

6. The move away from monetarism after the 1980s also reflected this argument, that money was the symptom of forces changing aggregate demand rather than the cause. In the current climate, also, the monetarist notion that the money supply could be changed in order to control inflation, without any consequences for the real economy, is very difficult to sustain. While the stated goal of the MPC is to get inflation back up to target, it is clear that it is hoped that this will also involve increased output and employment. The connection between the money stock and inflation is thus much weaker than monetarist theory would suggest. It is to be hoped that this new focus on money does not in fact mean that the MPC is returning to monetarist thinking, with money supply control the main tool for meeting the inflation target.

7. So what can be expected of injecting new money into the economy, either into bank reserves, or directly into non-bank deposits (depending on who sells securities to the Bank)? The MPC accept that the outcome is very uncertain: the new money may be hoarded, either by banks still unwilling to lend, or by non-banks being relieved of illiquidity problems. In the current uncertain climate this is a real danger. What will be critical will be whether the policy can help to lift spending plans. If either banks or non-banks are at a tipping-point where the additional demand for bonds and additions to money balances increase confidence that the recession’s depth and duration will be reduced, the strategy could work, and new spending could be encouraged. The illiquidity premium on corporate bonds is shown to be high in Chart 1.9, and the monetary easing policy could reduce that.
8. While increased demand for bonds and increased bank reserves will play an important part in the recovery, the critical factors are the level of uncertainty (or confidence in expectations) and animal spirits. If confidence in expectations improves, the current tendency for banks, companies and households to stay as liquid as possible, and thus likely to hoard any additional liquidity, will lessen. Secondly, there needs to be an emergence of animal spirits, in Keynes’s sense of an urge to action, in spite of uncertainty. The liquid balances will then be used to increase aggregate demand, and increased credit will add to this.

THE MONETARY POLICY FRAMEWORK

9. The MPC is clearly concerned also about the need to promote financial stability and do whatever can be done to cure the recession by encouraging an increase in aggregate demand. This raises questions about the current framework for monetary policy, which is premised on a separation between the real side of the economy as the focus of fiscal policy, and inflation as the focus of monetary policy. The Governor has emphasised that the inflation target remains the primary focus of the MPC, a target set for it by government, and the goal for this new policy is framed in these terms. But there is also a recognition that there may be conflict between inflation control and the goal of helping the economy out of recession. If the new monetary policy does encourage more borrowing and lending to finance spending, especially new investment, so that aggregate demand starts increasing and the economy moves back into the ‘virtuous’ circle of rising expectations about rates of return, then it is possible that inflation may go above target. Indeed this applies whatever the cause of rising aggregate demand. But, given the seriousness of the current economic situation, the judgement has been made that that seems a risk worth taking.

10. Similarly, there is potential for conflict between the inflation target and the Bank’s other core responsibility, financial stability. Monetary policy has been set with some reference to the build-up in asset prices which created the fragile financial environment, but more with reference to its effect on spending plans than on financial stability itself. It would be helpful for the MPC to clarify its thinking about how it has in the past addressed, and in the future proposes to address, the financial stability goal alongside its monetary stability goal. This involves not only theoretical questions about the relationship between the two goals, including the potential for conflict, but also practical issues about organisation within the Bank, and data requirements (not least given the reduced range of Bank statistics on credit).

BANK FORECASTING

11. The Executive Director for Financial Stability, Andrew Haldane, made a speech recently on the subject of shortcomings in banks’ stress tests, arguing that these had relied on extrapolating from a Golden Age within which markets were relatively stable. Indeed this argument applies more generally to risk assessment practice, that it relies on historical data, assuming a continuation of current structure. Within its financial stability function, the Bank conducts its own stress tests. This is one of the key contributions a central bank can make: not only to encourage individual financial institutions to be more conscious of the possibility of unusual risks, but itself to assess the financial system as a whole for its capacity to deal with such risks. The incentives for market participants are to ‘dance till the music stops’ rather than focus on when and how the music might stop. It is up to the central bank to take the system view. However, as suggested above, what is then done with that knowledge coming out of system stress testing is something which could usefully be clarified by the MPC.

12. But we should also consider the models used to underpin the Inflation Report. While a range of models is used, there is nevertheless a core model which is the main driver of the forecasts, albeit adjusted according to the judgement of the MPC. For all its sophistication, this model too has had difficulty in picking up developments, because it too is based on the market structure and behaviour patterns which prevailed in the past. The model can be used to simulate the effect of stylised “shocks”. But unless the crisis itself can be predicted, it is very difficult to begin to predict the structural and behavioural changes that go along with it, and thereby produce good economic forecasts. So the Haldane argument could usefully be considered for the Bank’s own forecasting. The difficulties of forming expectations during periods of particular uncertainty are in fact endemic to the crisis. The uncertainty in the economy which underlies the unwillingness to spend, and the possibility that the new money might be hoarded, stem from the general di
issues. Particularly when considering how the Bank’s financial instability analysis and monetary analysis might be combined, it would be worthwhile for the MPC to look afresh at a wider range of approaches to understanding the economy and monetary policy.

REFERENCES


March 2009

Memorandum from Professor Jagjit Chadha, Chair in Banking and Finance, Keynes College, University of Kent

FEBRUARY 2009 INFLATION REPORT

The Committee may seek to explore the forecasts presented by the February 2009 Inflation Report (IR). It is worth bearing in mind that forecasts are really just a planning tool. By which I mean that they allow the policy maker to assess the likely scale of any monetary policy action required to offset expected deviations in the policy target. This assessment is particularly problematic at present because the central case about the paths for inflation and for output seem to be even more uncertain than usual and the effectiveness of traditional monetary policy seems hampered, which adds considerably to the overall level of uncertainty.

Sadly we know relatively little about the effectiveness of even traditional monetary policy but when it is hampered because of approach of the zero lower bound in nominal rates and a dysfunctional banking system, the level of overall uncertainty about the impact of any given monetary policy is at extraordinary levels, which obviously further complicates the task of monetary policy. The monetary authorities have responded with rapid cuts in nominal interest rates, an “engineered” depreciation in Sterling and with plans for extensive quantitative and credit easing. The relatively quick and large-scale response in traditional interest rate and exchange rate policy stands at some variance to the stated plans for quantitative easing, which at around 5% of Sterling M4, may not be sufficient to offset the collapse in the money multiplier and move the economy more quickly towards creating the necessary growth in nominal GDP.

1. The IR’s GDP projection suggests a central case of a rapid return to positive growth, which is to some extent in line with postwar experience of recessions (p20). But major recessions may have quite a different pathology ie with a co-ordinated downturn in global activity, an asset price deflation and a debt overhang acting to suppress demand and supply (p17) for considerably longer. The IMF would seem to be tending towards this view as well. The argument is made in the IR that the fiscal, monetary and exchange support to demand has been both earlier and larger than these previous recessions, but given the novelty of the situation we now found ourselves in how can the Bank be at all sure about the validity of such a bullish projection and the how exactly were the error bands calculated with only a handful of recessionary experiences on which to draw? Thus are the error bands around the central case for this Inflation Report the widest that the Bank has projected to date?

2. The IR hints that the outlook for potential supply is weaker than previously thought (p8). Does the Bank of England believe that the credit crunch has accelerated capital and labour scrapping such that the sharp fall in demand does not drag inflation down as far as it otherwise would? In which case why are extraordinary monetary measures required? But across the forecast horizon the central view is that output will grow at around 3%, which given the lower level of potential should be inflationary and yet the central profile for inflation is below target, which is then doubly surprising given the 25% depreciation in Sterling and quantitative easing. So is inflation below target simply because the lags from output growth are thought to be very long? Or because interest rates cannot alone deliver the necessary inflationary fillip to the economy in which case why does output return so quickly to higher than trend levels of growth?

3. Quantitative easing involves creating central bank reserves in order to purchase government securities and corporate bonds to drive down their yields. And a promise to sell those securities at the right time to offset the monetary stimulus and eliminate the newly created central bank reserves. The basic idea is to get broad money growing in line with trend real income and the inflation target, assuming fixed velocity, but the quantity of purchases promised look too low to bump up broad money growth to “normal” levels. Can the Bank explain how they calculate the required amount of quantitative easing to substitute for the impairment of the traditional interest rate channel? If QE is carried out gradually is there a danger that the extra money simply is held by agents rather
than spent on other assets, particular if inflation is expected to hover below the inflation target?

How will the Bank re-calibrate its view of the necessary quantity of bond purchases is the elasticity of demand for money turns out to be highly elastic at low or near zero interest rates?

4. Most monetary economists argue that the best way out of a zero bound problem and the danger of a debt-deflation is to create expectations of inflation, which will drive down real rates. But if then inflation expectations do become unhinged then will nominal rates along the term structure not begin to reflect an inflation risk premium and so delay any recovery? So to what extent are the monetary authorities engaged in the engineering of a surprise inflation by forecasting below target inflation but running expansionary monetary and fiscal policies of that will guarantee significantly higher inflation?

23 March 2009

Report to the Treasury Select Committee
Paul Tucker, Deputy Governor Financial Stability, Bank of England
18 March 2009

VOTING RECORD

In February and April 2008 I voted for modest cuts in Bank Rate. Between May and September, I voted for maintaining Bank Rate at 5%. Since October, I have voted for each step of the rapid and significant easing of monetary policy and, in the latest month (March), I supported both the cut in Bank Rate to 0.5% and the programme of further monetary stimulus via asset purchases.

Through early 2008, output growth was set to slow in response to the combination of global financial stress and extremely high commodity prices. The rise in commodity prices was also pushing up inflation, to rates not seen since the early 1990s. Surveys suggested a sharp increase in perceptions of inflation; and medium-term inflation expectations derived from bond markets were creeping up.

On balance, I concluded that monetary policy should provide some support to demand but also allow the economy to slow somewhat in order to mitigate the apparent upside risk to inflation expectations. But at the same time, we could not not be remotely complacent about the risk that the economy would slow more sharply and, as I said in early September, I believed that if the balance of risks shifted clearly to the downside, the Committee would be able to shift the stance of policy. In the event, that proved imperative sooner and more decisively than I had anticipated.

In March, I had advised that there would have been “meltdown” if Bear Stearns had been allowed by the US authorities to fail. At that point, as I commented in April, we faced “a race involving whether the deleveraging process … could be sufficiently advanced for financial conditions to stabilise before macroeconomic slowdown [raised] loan defaults and so [brought] a new dimension to the challenges….. to the supply of credit to the real economy.”

Lehman’s failure in September tore the fabric of international commerce. It blew a hole through the assumption, underpinning so much economic behaviour, that some financial firms were too big, or at least too complex/interwoven with the financial system, to fail in a disorderly way. Confidence evaporated internationally. World trade and global manufacturing output declined sharply. The supply of credit, and crucially of working capital finance to companies, crunched. Money and credit growth fell sharply, as did commodity prices. The upside risk to inflation disappeared. As a result, I voted with my colleagues on the MPC to cut interest rates aggressively. By December, I thought it very likely that we would reach a level of Bank Rate close to zero and that “quantitative easing” would follow. I was keen that such a policy should commence only when Bank Rate had more or less reached “zero”, but also while inflation was positive, so that any money injected into the economy would not be hoarded and instead be used to purchase financial and real assets, goods and services. But I was also keen that the “quantitative easing” policy should be properly prepared—analytically, operationally, and policywise.

THE OUTLOOK

The United Kingdom is obviously in a severe recession. Output looks set to fall sharply in Q1. CPI inflation is likely to fall further, below the 2% target, in the coming months. That partly reflects the temporary cut in VAT and sharp falls in energy prices. But more important, the sharp decline in output will mean that there is a growing margin of spare capacity in the economy. That will put significant downward pressure on inflation, though that may in degree be offset by rising import prices following sterling’s depreciation. For a while our policy will need to be directed to a danger of activity and inflation remaining persistently low.
The MPC's contribution to the authorities' overall policy package is to stimulate spending—nominal demand—in the economy. The Bank's implementation of quantitative easing can potentially operate through three connected channels. First, by swelling banks' holdings of reserves, their most liquid asset, one of the impediments to banks' balance sheet growth may be alleviated. Second, perhaps more importantly, purchases from the non-bank private sector will be tend to increase broad money as sellers deposit the proceeds in their banks. Investment institutions may well wish to shed that cash for higher-yielding financial assets. Third, if the effect is to reduce yields on not only gilts but also corporate bonds, the capital markets may become relatively more attractive than bank borrowing. That may be aided by the Asset Purchase Facility schemes the Bank is rolling out to support the functioning of corporate credit markets.

It is also vital for the MPC to underline our unwavering commitment to low and stable inflation over the medium term. Such nominal stability is a necessary precondition, but not on its own a sufficient condition, for sustainable growth and employment. In that sense, of course, prudent monetary policy is a means to an end, which is a message we can never repeat enough.

**Explaining Monetary Policy**

During the past 12 months I have given five public speeches dealing with monetary stability (including financial) issues. I have given over 10 off-the-record talks. I have made four visits to UK regions outside London—to Birmingham, Bristol, Northampton and Watford/St Albans—taking part in round table discussions with business people and visiting a range of companies.

During the past year, I led much of the Bank's market intelligence effort. This provided many opportunities to explain the Bank's thinking on monetary policy (and financial stability issues) to firms, and trade associations, across the financial community. As part of that effort, during the past year I led a series of structured visits to the financial sector in the UK and in New York, Boston and Connecticut; held over twenty meetings with trade associations or groups of firms; and held a lot more meetings with individual firms. I also represented the Bank in Basel and elsewhere, where I was able to help explain the Bank's thinking and actions at meetings of central bankers.

**Voting Record since Joining the Committee in July 2008**

I voted to maintain Bank Rate at 5.0% in my first three meetings. In the subsequent six meetings, I voted to cut Bank Rate by a total of 4.5 percentage points from 5.0% to 0.5%. In addition, I voted at the March meeting to purchase £75 billion of assets in order to increase the supply of money and improve the functioning of corporate credit markets.

Before I joined the MPC, the Committee had for some time been monitoring two substantial risks to the inflation outlook. On the upside, there was a risk that the period of high inflation associated with the increase in energy and other commodity prices might become embedded in wage and price setting and in longer-term inflation expectations and thereby lead to a persistent period of above-target inflation. On the downside, there was a risk that the squeeze on households' spending power caused by the increase in commodity prices, combined with the financial turmoil and the associated tightening in credit conditions, might lead to a sharper than expected slowdown in economic growth. Between July and September, I viewed these risks as broadly balanced and therefore judged it appropriate to maintain Bank Rate at 5.0%.

However, as is now clear, the balance of risks to inflation shifted decisively to the downside between the September and October MPC meetings. Oil and other commodity prices fell sharply, reducing the upside risks to inflation. At the same time, the prospects for economic growth deteriorated markedly, reflecting in part the sharp worsening in global banking and credit markets following the failure of Lehman Brothers. This substantial change in the economic outlook meant a lower level of Bank Rate was required and I voted to cut Bank Rate by 0.5 percentage points to 4.5% at the special meeting of the MPC in October.

By the time of the November Inflation Report, the economy had moved into recession and further falls in output were likely. Without a substantial loosening in monetary policy, I judged that the downturn in economic activity was likely to open up a significant margin of spare capacity in the economy which could pull inflation materially below the 2% target in the medium term. I therefore voted to reduce Bank Rate by 1.5 percentage points to 3.0% in November.

The near-term outlook for economic activity deteriorated further in the months following the November Report, in part reflecting a marked worsening in the prospects for world demand and trade. It is now clear that the global economy entered a very sharp and synchronised downturn in the final quarter of last year. The deterioration in the prospects for economic growth, and hence the growing risk that CPI inflation may materially undershoot the inflation target, explain my decisions to vote for a lower level of Bank Rate in December, January, February and March.
It is essential that the Committee use every tool at its disposal to ensure that inflation meets the 2% target in the medium term. At the March meeting, I judged that reducing Bank Rate lower than 0.5% might have counter-productive effects on the lending capacity of the banking system and on the functioning of some financial markets. However, I did not believe that reducing Bank Rate to 0.5% would be sufficient to ensure that inflation would be close to target in the medium term. Therefore, I voted to purchase £75 billion of assets financed by the issuance of central bank reserves, in order to boost the supply of money and improve the functioning of corporate credit markets.

The Outlook

The UK economy looks set to contract significantly further during the first half of this year. The falls in output are likely to be especially pronounced in the manufacturing sector, reflecting sharp declines in global demand and in investment spending. My central view is that the pace of contraction should ease during the middle of this year, with some signs of recovery evident by the turn of the year. This expected gradual turnaround reflects the substantial stimulus in the economy, stemming from the easing in monetary and fiscal policy, the various initiatives to stabilise the global banking system, the very substantial depreciation in sterling, and the past falls in commodity prices. The scale of this stimulus is significantly greater than that seen at comparable stages of the recessions in the 1970s, 80s or 90s. However, the risks around my central view are weighted to the downside, reflecting the possibility that the actions taken by the authorities at home and abroad to improve the availability of credit and to restore business and consumer confidence are slow to take effect.

CPI inflation fell to 3.0% in January, still significantly above the 2% target. I expect inflation to decline further through much of this year, reflecting the past falls in commodity prices and the increasing margin of spare capacity. But the extent and pace of that decline will depend on the scale of the feed through from the lower level of sterling into import and retail prices. The prospects for inflation further out rest importantly on the extent to which the actions taken by the MPC, including the large scale asset purchases, succeed in restoring the growth of money and credit and of nominal spending to more normal levels. I, along with the rest of the Committee, will monitor the effectiveness of these actions at future meetings and will adjust the scale of purchases as necessary to hit the inflation target.

Explaining Monetary Policy

In the eight months since joining the Committee, I have made one on-the-record speech, given three press interviews, and made numerous off-the-record presentations to a variety of audiences. I have also made four regional visits which involved various meetings and events with local businesses. As the Bank’s Chief Economist, I have extensive liaison with economists in the private and official sectors, both in the UK and internationally.

Report to the Treasury Select Committee
Professor David Blanchflower, External Member, Monetary Policy Committee
March 2009

Voting Record

In the last 12 months I have voted for cuts in Bank Rate at all MPC meetings.

In the first six of those months I voted for cuts in Bank Rate despite a sharp increase in CPI inflation driven by rising energy, food and commodity prices. I believed the risks of a persistent rise in CPI inflation, due to entrenched inflation expectations, were benign and that CPI inflation would fall back. Muted wage growth, combined with deteriorating labour market conditions, were key reasons for this view. Wage growth was never likely to pick-up at a time when workers were concerned about their employment prospects.

I believed that the medium term risks to CPI inflation lay on the downside due to the slowdown in the economy. In my speech at the Royal Society, Edinburgh in April I highlighted that labour market developments and further machinations of the credit crunch could trigger a rapid downward spiral in activity. Subsequent events have borne out this view.

During the summer the slowdown was evident across a range of surveys of economic activity and labour market indicators that peaked, and began to decline, around April of last year. As it became apparent output had contracted in the third quarter it was most likely that this contraction would continue and intensify. The underlying adverse influences on economic activity had most likely not fully played out. Indeed, house prices continued to decline, and the Bank of England’s Credit Conditions Survey indicated lenders would constrain credit availability further. I believed the MPC needed to look-through a short-term spike in CPI inflation, and cut Bank Rate to stimulate a rapidly decelerating UK economy.
From early September it became clear the UK was going to experience a very severe recession. There was a realisation across the world of the balance sheet difficulties facing financial institutions, following on from declines in house and asset prices and the difficulties in the US sub-prime mortgage market. Government interventions were required in many financial institutions across many countries. The collapse of the Lehman Brothers investment bank stands out as a key moment during this period. However, once a realisation of the underlying problems in the financial sector had begun, with the knock-on effects on confidence and spending that such a realisation implied, a sharp contraction in output was always likely. It would be incorrect to think, had Lehman Brothers not failed, a crisis would have been avoided.

At the MPC meeting on Thursday 4 September I was alone in voting for a cut of 50 basis points. As indicated by the minutes of that meeting I felt that the prospects for UK demand had deteriorated over the previous month, the risks to CPI inflation were clearly on the downside in the medium term, and that the slowdown might be amplified by financial institutions’ responses to financial fragility. I believe that subsequent events have borne out this view.

In the last six months I have consistently voted for sharp cuts in Bank Rate. In late 2008 I voted with other MPC members to cut Bank Rate by a total of 3.0 percentage points (pp).

In 2009 I felt the pace of cuts in Bank Rate to the minimum level needed to be maintained. At the January and February meetings I voted for cuts of 1.0pp. In March I voted for a reduction of 0.5pp so that Bank Rate reached 0.5%, which in my view is close to the minimum operational level. I have also voted with the MPC for asset purchases of £75 billion by the Bank of England, as an instrument of monetary policy, to stimulate nominal spending in the UK economy.

THE OUTLOOK

Annual UK GDP growth is likely to be negative in 2009. Past experience of recessions suggests the recent deterioration in labour market conditions is likely to be persistent. I expect that the unemployment rate will enter double figures by the end of the year.

The prospects for the UK economy remain highly uncertain and will be dependent on restoring a healthy financial sector to channel our savings to the most productive investments. Conventional monetary and fiscal policy can only accommodate the required adjustment in the financial sector by helping to avoid another costly cycle of falling asset prices, constrained credit and further doubts regarding the capital adequacy of our banks.

I hope that recent policy initiatives are successful in resolving the remaining problems in the financial sector and restoring the flow of credit to firms and households. The Asset Protection Scheme is designed to insure banks against further losses from their holdings of asset backed securities, together with commitments from participating banks to extend their lending to firms and households. However, it may be sometime before overall credit conditions improve.

A risk to the economic outlook is the rise in unemployment. As redundancies rise more households will face the grim prospect of both unemployment and negative equity in their homes. This could lead to forced selling and further downward pressure on house prices. As defaults and arrears rise banks will suffer losses from their mortgage lending. Therefore I have argued that any fiscal stimulus should be focussed on job creation and sustaining employment.

EXPLAINING MONETARY POLICY

In the past year I made five visits to areas outside of London—to Scotland (twice), the East Midlands, Northern Ireland, and the South West. I have met with a range of companies and business groups to learn their views. I found these meetings extremely important, particularly to understand the impact of the credit crunch on smaller and medium sized companies.

During a period when my views have often diverged from those of other MPC members it has been important to articulate my views publicly. I have given interviews to both the print and televised media. Furthermore, my speech on Tuesday 24 April at Cardiff University will be my fifth in the last 12 months.
Supplementary memorandum from the Bank of England

LENDING BY FOREIGN BANKS

1. When he last appeared before the Treasury Committee, the Governor was asked to provide figures on the slowdown in lending by foreign banks. This note uses official Bank of England statistics to gauge the extent of the changes in lending capacity, where lending is classified according to whether the lender is domestic or foreign.

LENDING TO BUSINESSES

2. The growth rate of lending to businesses peaked at over 30% on a three-month annualized basis in October 2007. At that time foreign banks were contributing around 13 percentage points to growth in lending to businesses (Chart 1).

3. Since then, lending to businesses by both domestic and foreign lenders has eased markedly. In the six months to February 2009, net lending to businesses by foreign banks fell to £1.4 billion from £21.1 billion in the same period a year earlier, whereas net lending by domestic lenders fell to £7.2 billion from £32.4 billion in the same period a year earlier.

Chart 1: Contributions to growth in lending to private non-financial businesses

4. The amount of loans outstanding to private non-financial corporations in February 2009 was £590.3 billion. Of this total, £188.2 billion had been lent by foreign banks, giving them a 31.9% share of the market. This share was broadly in line with what it had been in October 2007 (30.9%).

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6 This was in response to Mr Mudie who had asked “when the overseas banks disappeared what percentage of the lending market did we lose?” (Q77).

7 Foreign banks are defined as banks whose parent bank or holding company is incorporated outside the UK. The only exception is Abbey, which as a traditional major High Street lender is treated here as a domestic bank, despite its parent Santander being incorporated in Spain.

8 The data presented in this note include both sterling and foreign currency loans. The sterling value of the latter has been adjusted for the impact of the recent movement in the exchange rate. However, the general results of the analysis remain unchanged even if foreign currency lending is excluded from the data.
MORTGAGE LENDING

5. Mortgage lending has also slowed significantly over the past 18 months. On a three-month annualised basis, lending growth slowed from an average of over 10% in 2007 to 0.3% in February 2009. The contribution of foreign lenders to the growth in mortgage lending has always been relatively modest (Chart 2).

![Chart 2: Contributions to growth in secured lending to individuals](chart2)

6. In the six months to February 2009, net secured lending to individuals by foreign banks fell to £3.7 billion from £5.7 billion in the same period a year earlier, whereas net lending by domestic lenders fell to £8.2 billion from £38.1 billion in the same period a year earlier.

7. The amount of secured loans outstanding to individuals in February 2009 was £1,225.8 billion. Of this total, £99.3 billion had been lent by foreign banks, giving them a 8.1% share of the market. This share was little changed from October 2007 (8.2%).