House of Commons
Treasury Committee

Quantitative easing

Oral Evidence

25 October 2011

Sir Mervyn King, Governor, and Charles Bean, Deputy Governor, Monetary Policy, Bank of England

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The Treasury Committee

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List of witnesses

Oral evidence

Taken before the Treasury Committee

on Tuesday 25 October 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon	John Mann
Mark Garnier	Mr George Mudie
Stewart Hosie	Jesse Norman
Andrea Leadsom	Mr David Ruffley
Mr Andy Love	John Thurso

Examination of Witnesses

Witnesses: **Sir Mervyn King**, Governor of the Bank of England, and **Charles Bean**, Deputy Governor Monetary Policy, Bank of England, gave evidence.

Q1 Chair: Good morning, Governor, Mr Bean. Thank you very much for coming before us this morning. I know that you have a very busy schedule at the moment, and that this was an additional meeting brought in at short notice in response to the decision to reignite the QE programme.

Can I begin by asking you, Governor, how it came to be that the Monetary Policy Committee moved from having eight out of nine members not wanting any QE in September to a unanimous decision shortly thereafter, this month, to go ahead with it?

Sir Mervyn King: I think if you look at the minutes of the September meeting, where we basically held the position we had for a number of months, we came very close to voting for asset purchases in September.

Chair: You were teetering on the edge.

Sir Mervyn King: Absolutely. The reason we held back—

Chair: You were about to fall over.

Sir Mervyn King: No, not fall over. We did not take the step forward and we did so because, at that September meeting, we were very conscious that there had been significant news in August, particularly in financial markets, and it could have been that that was volatility that might reverse itself over the next month. I do not think we felt that the underlying position would improve but there was a possibility that the volatility would dampen down. Basically, we were in a position in September where, if nothing else changed over the following month, we would then implement further asset purchases. The volatility did not dampen down and we did not see a reversal of the asset price movements that we had seen, so we followed through and took the unanimous decision in October to resume the asset purchase programme.

Chair: So if we read really carefully between the lines that September—

Sir Mervyn King: Not in between the lines; it was actually in the lines.

Q2 Chair: So in those September minutes we would have spotted that everybody was lined up. I would like to move on if I may because we only have an hour. Governor, you said in a speech recently, "The Bank should not take decisions that discriminate between different sectors". Is that not exactly what macro-prudential tools might have to accomplish?

Sir Mervyn King: It depends on which macro-prudential tools, and that of course is exactly the question that you in Parliament will have to decide—whether you want to delegate that power to the Financial Policy Committee.

Chair: But you are saying that you do not want it.

Sir Mervyn King: I say that, in principle, we do not want it. I think the experience of both the European Central Bank and the Federal Reserve has been quite marked in that respect that, by being put in a position where the lack of ability to co-ordinate between the Executive and the independent central bank, which was very evident in both the United States and in the euro area, put a lot of pressure on the central bank to do things that it would have preferred not to do—it would have preferred the Executive do—and then, subsequently, they were heavily criticised for doing things which were the prerogative of the Executive. What is important to us is that you in Parliament decide what powers you want to give to the central bank. What we do not want to do is to abrogate to ourselves powers that properly ought to rest with elected politicians.

Q3 Chair: When you list—as you did in the minutes of that September FPC meeting—various categories of macro-prudential tools, one of which is loan-to-value ratios, although we cannot tell from reading it, you think some of these categories of macro-prudential tools are appropriate and some you think are inappropriate.

Sir Mervyn King: Some certainly go further in the direction of making decisions that more obviously discriminate among sectors.

Q4 Chair: As a macro-prudential tool, do you think the Bank should have loan-to-value ratios?

Sir Mervyn King: The Committee has not made a judgment on that, so I don't want to say what the Committee would or would not want to have.

Chair: So they have no view on this issue?

Sir Mervyn King: They are discussing it, and they will give a view to you and to the Treasury, in the

course of next year, as to what the Committee feels are the right instruments that we should have. We have not made a decision on that as yet.
Chair: Why not?
Sir Mervyn King: Because we are discussing it. We have been asked to give our views by the spring of next year and we shall meet that timetable.

Q5 Chair: When you said the Bank should not discriminate between different sectors, it may turn out that in the spring you will change your mind and say we should discriminate between some sectors, and those sectors may include ones for which a loan-to-value ratio tool is appropriate.
Sir Mervyn King: There is a spectrum. I don't think anyone on the Financial Policy Committee would think it appropriate that we should discriminate among individual companies. That is a key part of the—
Chair: Yes, but I am not discussing companies. I know that that—
Sir Mervyn King: That is the issue that does arise when it comes to credit easing.
Chair: That was also mentioned in the speech. It is not the issue I am challenging. I am challenging the word "sector".
Sir Mervyn King: Well, "sector" as in motor cars versus consumer durables; I do not think the Financial Policy Committee would be well advised to make judgments that discriminate overtly among those sectors on those grounds.

Q6 Chair: What about the housing market?
Sir Mervyn King: The housing market, well, it is a question there of the total amount of borrowing, much of which may go to the housing market, but it is not specifically, exclusively for that. Having a limit on the total amount of borrowing in the economy does not seem to me, in and of itself, to be something that blatantly discriminates between sectors.

Q7 Chair: Loan-to-value ratios are more targeted than just a general restriction on borrowing, aren't they?
Sir Mervyn King: They are not discriminating among individuals. It is a generic application of a restriction. We will have to decide. I am not particularly enthusiastic about thinking that we will achieve a great deal by imposing loan-to-value ratios. I think this also gets fairly close to the supervisory responsibility where the supervisors will have a view, quite clearly, as to how many mortgages they want a particular bank to have that is in a very high loan-to-value ratio.
Chair: It would be very helpful if you could give us a clearer explanation in writing over what you meant by "sectors", and if you could tell us whether you think that this rules out certain types of macro-prudential tools.
Sir Mervyn King: The speech to which you refer was not discussing macro-prudential policy; it was discussing credit easing and monetary policy.
Chair: But the same point applies.
Sir Mervyn King: It does, but I think that is something—
Chair: The fact that you may have been discussing something else does not change the relevance.
Sir Mervyn King: If you change the context, then I would respectfully suggest that the Financial Policy Committee should submit its views in writing and the Committee will do so, but it is not for me to front-run what the FPC will decide.

Q8 Chair: Could I ask you about the use of high-quality commercial bills? Until 2006, the Bank of England used to buy those or was willing to buy them. It is often argued that the resumption of such purchases would ease banks' liquidity problems and credit constraints on SMEs. What has changed since 2006 that has made these purchases undesirable?
Sir Mervyn King: That programme did not disappear because we decided to stop it. It disappeared because the demand for it went right down, and the way in which money market operations were implemented, there was no need for a programme of that kind. One of the ways in which we can increase the liquidity of a banking system is by increasing their reserves and asset purchases have the effect of very significantly increasing the reserves of a banking system. What really matters, in terms of trying to improve SME lending, is to alter the incentives that banks have to lend to SMEs.
Chair: It strikes me that there too it might be worth having another look.
Sir Mervyn King: At what exactly?
Chair: Commercial bills.
Sir Mervyn King: We can certainly send you a note on that if you would like.
Chair: Yes. I think that would be helpful.

Q9 Jesse Norman: When the Bank talks about Asset Purchase Facilities, or has done in the past, is that the same thing as the commercial bill purchase facility that the Chairman is referring to?
Sir Mervyn King: No, the Asset Purchase Facility was created in 2009.

Q10 Jesse Norman: How is that working?
Sir Mervyn King: Extremely well. We have just started it again. We have purchased already £205 billion of gilts.
Jesse Norman: Sorry, you are referring to the quantitative easing?
Sir Mervyn King: That is what the Asset Purchase Facility is.
Jesse Norman: Yes. I am talking about corporate debt.
Sir Mervyn King: There are two schemes that we have put in place there. One is the Corporate Bond Facility. The other is the Commercial Paper Funding Facility.

Q11 Jesse Norman: What is happening with the Corporate Bond Facility?
Sir Mervyn King: The total of the two facilities together, we have purchased £11 billion-worth of bonds and commercial paper together. The objective of the scheme was to reinvigorate the market so the market itself would start functioning. When we began the scheme there were difficulties in both markets.

The spreads between the buy and sell prices were very wide. There was a high degree of illiquidity. In the Commercial Paper Funding Facility we bought £9 billion. That has now run off. The market is working perfectly well, the same with the corporate bond market. We purchased £2 billion. We have sold £1 billion. We act there as a market maker of last resort by setting limits on the spread, which we would then be prepared to come in and intervene. It is still going and companies can come to us at any point and either buy or sell, and that happens. So that is working extremely well, and I think the proof of that is that the issuance of corporate bonds and corporate equity, in the period since we started, has been at record levels. We have managed to achieve the objective, which was to ensure that the market was functioning properly.

Q12 Jesse Norman: There is not a parallel between that and the credit easing facilities that the Government is currently contemplating?
Sir Mervyn King: No. They are in the same sort of family, but I think the key question is that for the asset purchases with gilts the objective is to put money into the economy. You test the strength of that by how much money you put into the economy. The other facilities all have particular objectives to deal with problems in the way the market is functioning. You need to identify the market failure, work out what that is and identify how you will overcome it. With our corporate bond and commercial paper facilities, we identified the failure; we took action and we corrected the failure. The issues about SME financing are rather different. There are different failures there.

Q13 Jesse Norman: Did the Bank ever look at using its corporate bond purchase facility as a form of credit easing or to extend that to include credit easing?
Sir Mervyn King: In a sense, what we were doing was credit easing because we were improving the functioning of two of the most important markets for corporate finance, corporate bonds and commercial paper.

Q14 Jesse Norman: I suppose I am asking the question, why did you not do a lot more given that the economy was in the dumps?
Sir Mervyn King: We did not need to do a lot more because the market failures we identified were corrected. To spend a lot of money to no effect seems to me rather pointless.

Q15 Jesse Norman: Why do you think the Government is now doing credit easing if there is no point to it?
Sir Mervyn King: Because it is looking at SMEs, which is a different issue. I have raised the question of SMEs with this Committee before and I raised it with the previous Government.

Q16 Jesse Norman: Did you contemplate the Bank ever using this kind of facility to help SMEs before the Government took it up?
Sir Mervyn King: There was no point doing it for SMEs because SMEs are too small to find it easy or cost-effective to issue large amounts of paper. The average employment of a company that issues a corporate bond is 10,000 people. It is very expensive to issue corporate bonds. It might be better if it were less expensive, but the fact is that if you want to help SMEs you need to look at the source from which they obtain finance normally, and that is the banks.

Q17 Jesse Norman: So you could not have adopted a credit easing facility with regard to the banks in order to help SMEs?
Sir Mervyn King: No. If you want to help by using banks you improve the incentives that banks have to lend to SMEs. I am all in favour of that, but that is for you to decide, not for us at the Bank, but I can certainly see a case for it.

Q18 Jesse Norman: Do you think that having a system that explicitly favours large companies that have bonds and does not help small businesses that don't have bonds is a form of discrimination?
Sir Mervyn King: That is a function of the way the market operates, not the way the Bank of England operates.

Q19 Jesse Norman: But you said that you don't discriminate between companies and sectors.
Sir Mervyn King: And we don't.

Q20 Jesse Norman: It seems you have a series of systems that are designed to help large companies without touching small companies.
Sir Mervyn King: No. I say you have to identify the market failure. There were different market failures for big companies and other market failures for small companies. I drew the attention of both the previous Government and this Government to the market failure affecting small companies. It means taking action vis-à-vis the banks.

Q21 Jesse Norman: It does seem to me that the Bank is very often motivated by a desire to avoid criticism rather than a desire to address the issue at hand.
Sir Mervyn King: You may think that, but that is completely false. What we believe it is sensible to do is to identify the problem that exists in the market and correct it, not just make gestures. What would you suggest we might have done?

Q22 Jesse Norman: I would suggest that if you had cared significantly about SME markets you would be framing papers specifically designed to address difficulties with SME funding and putting them to Government. That is what we pay our experts to do for us, to give some good advice.
Sir Mervyn King: I did give good advice to the previous Government and to this Government. You will see the effects of that in due course on this one. The previous Government decided that, although it owned two of the biggest banks, it was not prepared to use that in order to help SMEs.

Q23 Jesse Norman: Did you conduct any formal studies of the inflationary effect of a second round of quantitative easing before you undertook it?

Sir Mervyn King: We certainly undertook a study of the effects of asset purchases on both inflation and activity and we published a paper on that.

Q24 Jesse Norman: Did you come to the conclusion—you must have done—that the inflationary effects were sufficiently small to make it worthwhile doing on balance?
Sir Mervyn King: It was nothing to do with being small. Any monetary policy easing is going to have the effect of expanding demand, spending, output and, ultimately, inflation. That is what monetary policy easing was designed to do. When we undertook the next round of asset purchases we did it because, looking ahead, we thought there were real risks of inflation falling below the target and we wanted to offset that.
Chair: We are going to explore that in more detail in further questions.
Jesse Norman: Thank you very much indeed.

Q25 Mr Mudie: Governor, once again you take refuge in this business of "if Parliament asks", but Alistair Darling, when he was Chancellor, asked you to do a specific thing and gave you £50 billion of Treasury money. Yes?
Sir Mervyn King: No.

Q26 Mr Mudie: Then you extended it in the next Monetary Policy Committee to £150 billion, then £175 billion and then £200 billion. But Alistair Darling was quite clear that corporate bonds, commercial paper, syndicated bonds and a limited range of asset-backed securities created unviable securitisation structures. The present Chancellor asked you in his letter of 6 October, in view of the deterioration in economic conditions described in your letter, to go ahead with quantitative easing, which would include gilts and eligible private sector assets, and specifically refers to "my predecessor's letters of 29 January 2009 and 3 March 2009". I have indicated what was in those letters. Why do you ignore these two requests from Chancellors and spend this money on gilts?
Sir Mervyn King: We did not ignore it. The Chancellor knew perfectly well, then and now, that the vast majority of the expenditure would be on gilts. I explained why to them and I explained in the speech last week. We investigated a range of other options. We identified some that we thought would improve the functioning of markets and we implemented those and we spent £11 billion on those facilities. Others we looked at, and we tried very hard to persuade the market to work together to produce a useful securitised instrument that could be used for asset-backed paper, but in fact it proved very difficult to do it. The market has not produced one itself. We encouraged them; we put pressure on them to do it. We found no facility where it would have been sensible or useful for us to spend money on that, nor did the Treasury suggest one. We discussed it with them, we explained what we were doing and there was no complaint at the time.

Q27 Mr Mudie: Why does the present Chancellor ask you to do something that you have not done since 2009?
Sir Mervyn King: He is asking us to do what we are doing. The Corporate Bond Facility—

Q28 Mr Mudie: No, he did not. He said to include gilts and eligible private sector assets as set out in Alistair Darling's instructions.
Sir Mervyn King: That is what we are doing.

Q29 Mr Mudie: No, but your market notice, 6 October, "Asset Purchase Facility: the MPC has decided on a further £75 billion of gilt purchases". Gilt purchases. That is not what the Chancellor asked you to do.
Sir Mervyn King: The existing Corporate Bond Facility is still operational and the amount of money that that is used for is over and above the £75 billion extra limit. That is the difference. So we are able to purchase corporate bonds without any restriction of that £75 billion.

Q30 Mr Mudie: Mr Bean's two annual reports on asset purchases demonstrate that out of £198 billion, something like £197 billion was spent on gilts.
Sir Mervyn King: No, it is not that.

Q31 Mr Mudie: I think commercial papers were £0.1 billion one year.
Sir Mervyn King: No. That is completely—

Q32 Mr Mudie: I have the reports in front of me.
Sir Mervyn King: Well read them carefully because you might then understand them.

Q33 Mr Mudie: I do read them carefully.
Sir Mervyn King: Not well enough, clearly. We spent £9 billion on commercial paper and eventually that—

Q34 Mr Mudie: £9 billion out of £200 billion?
Sir Mervyn King: Yes, because you couldn't spend £200 billion on commercial paper, Mr Mudie.

Q35 Mr Mudie: I am less convinced that you have the will, because there were two instructions from Chancellors and you ignored them.
Sir Mervyn King: That is completely false, Mr Mudie.

Q36 Mr Mudie: No, but the argument is not whether you dismiss Parliament or Chancellors. The argument is that you are choosing a transmission method that everybody in this room knows is not working for SMEs. You are putting this money through gilts, and largely through the banks, and we know the banks are reluctant to lend to SMEs. You are continuing this despite, as the Chancellor says, the deterioration of economic conditions, growing unemployment, growing bankruptcies among SMEs, and you are sitting with this large amount of money, approval from the Government, but you are ignoring the Government's wishes.
Sir Mervyn King: That is complete nonsense, Mr Mudie. We are working closely with the Treasury on

schemes that will help SMEs through the existing banking system.

Q37 Mr Mudie: No. Let us just have a last question on that. Are you denying that you refused to do that credit facility work when asked by the present Government?
Sir Mervyn King: I certainly am, Mr Mudie. It is absolutely complete nonsense.

Q38 Mr Mudie: So the information in the *Financial Times*, detailed information, is total nonsense.
Sir Mervyn King: We have not refused to do anything with regard to—
Mr Mudie: Sorry?
Sir Mervyn King: I have told you before, and I will repeat it once more if you will listen this time. We have not refused to do anything which the Treasury has asked us to do. I explained to the Treasury, before and after the general election, what the different asset purchase schemes could achieve, why we had designed them in the way that we did. We had investigated some others where there were no appropriate assets that were eligible for schemes that were sensible for us to undertake, and I explained it to the then Chancellor and to the Treasury, and they accepted that.

Q39 Mr Mudie: There were about four issues.
Chair: Very quickly, please.
Mr Mudie: Credit guarantee, you withdrew. You did not tell Jesse Norman that the commercial paper ends next month.
Sir Mervyn King: There is a very good reason why it ends next month.

Q40 Mr Mudie: Of course there is a very good reason, but the Chancellor asked you to do that and you are not doing it.
Chair: Let the Governor reply.
Sir Mervyn King: The Chancellor did not ask us to keep it going indefinitely once it had achieved its objective. The purpose of this scheme—I repeat it again—was to make sure that a market that had been functioning, that had become highly illiquid and was not working very effectively, that we intervened to make it liquid and effective again. You do not make a successful market by a permanent presence of a public authority in that market; you undermine it, as happened in the housing market in the United States. We achieved our objective and then we exited.

Q41 Chair: Governor, you said a moment ago that you have not refused to do anything asked of you by the Treasury. So if the Treasury do ask you to take decisions to discriminate between companies or sectors you will take them?
Sir Mervyn King: I will discuss it with them and the Chancellor has told me very clearly—
Chair: Is that that you will do it or you will not do it?
Sir Mervyn King: Well, he won't ask me. The Chancellor has made it very clear to me that he thinks it would be inappropriate for the central bank to make that kind of decision.

Q42 Chair: That is not the question I asked you. What you have said here is that the Bank should not—not does not but should not—take these decisions. But you are saying that, even though you think they should not, you will change your mind if you are told to by the Treasury. Is that correct?
Sir Mervyn King: Well, he would have to give an explicit direction to do it. But the Chancellor has made it very clear he doesn't believe this is the function of a central bank, and nor does the Federal Reserve or the European Central Bank feel remotely comfortable doing this. I think it is important to understand why central banks don't want to do it. I find it very peculiar that it is the same people who are most worried about the powers of the Bank of England after the financial crisis becoming bigger and bigger who seem to be determined to push us into doing things that are properly your responsibility.

Q43 Chair: Central bankers, of course, like to take decisions and think they are better at taking decisions than politicians who might be—
Sir Mervyn King: Certainly not.
Chair: Who might be heavily influenced by all sorts of short-term considerations, which is why monetary policy was given to the Bank in the beginning. It does strike people as surprising that, in another related area with respect to this crisis, the Bank is deciding to withdraw from the field entirely.
Sir Mervyn King: No, it hasn't withdrawn at all. What I am pointing out is that if you write down very specifically and if you ask in legislation the Bank to take certain responsibility, we will do it.
Chair: Right, that's fair enough.
Sir Mervyn King: But what I do not want to do is to be seen to be taking decisions for which we have not got any authority from Parliament, and then you turn round afterwards when you don't like the consequences and say, "By what authority did you take that?" That is the problem that central banks have got—
Chair: That is very clear. Thank you, Governor.

Q44 Mark Garnier: I would like to have some focus on how the money gets into the system. I think you have spoken a bit earlier about how you have purchased £205-billion worth of UK Government gilts. What is the process that you go and buy this? Are you going into the initial IPO of the bond or are you going to the open market and buying them like any other consumer of bonds?
Sir Mervyn King: We organise a series of auctions. So we announce a programme of auctions, which we have announced now until the New Year. So everyone knows well in advance when the auctions will be. We announce, say, two or three a week. We announce the size of the auction each time and we announce the gilts that we will take at that auction. So typically, what would happen is that people who own gilts at present would sell to a market maker and the market maker would then take part in the auction. Then we publish the results of the auction immediately afterwards. That is the process we have used since 2009.

Q45 Mark Garnier: That will have an effect on the price of bonds because you are in there?
Sir Mervyn King: It will have an effect on the price of bonds, but primarily our view is that the idea is that the people who sell bonds to us receive money in return. That money they will then decide to reinvest in others types of securities.

Q46 Mark Garnier: This is an important point. That is not necessarily the Government issuing the bonds. It is you going into the open market?
Sir Mervyn King: Absolutely, and if we buy directly from the Government that will be against the European Treaty.

Q47 Mark Garnier: Brilliant. That is very clear.
My next question is can you give us a flavour of what is the maturities of these bonds, in terms of the range of maturity and what the average maturity is of your holdings?
Sir Mervyn King: The entire range, we divide the maturities into short, medium and long and we divide the auctions evenly across that. So we stay away from the very short term, below three, in maturity and we buy evenly pretty well across the spectrum in the others.

Q48 Mark Garnier: So you have nothing shorter than 3-year gilts and then it goes all the way out to 30-year?
Sir Mervyn King: Yes.

Q49 Mark Garnier: Where I am going with this and what I am trying to get is a flavour of how you reverse this position, because of course quantitative easing to be QE and not money printing has to be reversed. What I am curious about is how you go about selling those bonds back to the market. Do you wait for them to mature or will you sell them back into the market when the market condition is right?
Sir Mervyn King: It depends on when the Monetary Policy Committee decides that it wishes to tighten monetary policy.
Mark Garnier: Of course it does.
Sir Mervyn King: The method we would use is basically just to reverse what we are doing now—to announce a programme of auctions, to announce that we would sell evenly across the spectrum in those auctions. So, just put it into reverse.

Q50 Mark Garnier: So you would sell. You would not wait for them to mature?
Sir Mervyn King: No, but if the Monetary Policy Committee decided not to tighten until the first one had matured, then obviously, by default, one would have matured. The first one we own matures in 2013.

Q51 Mark Garnier: Thank you. That is very interesting. So when it comes to the maturity of that bond it is not inconceivable you may refresh by taking the money back in then buying; going back into the marketplace—
Sir Mervyn King: That is conceivable, and that is what the Federal Reserve has done with some of their transactions. It is up to the Monetary Policy Committee at the time to decide what it wishes to do.

Q52 Mark Garnier: My final question on this is, and I would like you to discuss this, but briefly. The Government currently has about £1 trillion-worth of Government debt and is anticipated to raise it to £1.5 trillion in order to deal with the problems between now, that is 2016. At some point you have £260 billion to £270 billion, when you have done this, of Government debt that you will want to be selling into the market. You are going to be in quite a lot of competition with the Government, because, of course, a lot of Government debt is maturing so it has to refresh it. So it is going to be selling £600 billion of gilts into the market over the next four or five years and at some point you are going to be trying to sell £275 billion. First of all, there is going to be a perception that you are competing against the Government for the market. The second point is a more general point, which is that if the market stops believing that you are going to unwind your quantitative easing book then it will become the printing of money and is that not an inflationary problem?
Sir Mervyn King: That will depend on what else is happening to the amount of money in the economy at the time, but there is no doubt that when we come to sell the assets the consequence will be to push down the price of gilts and force interest rates up. But that is exactly the objective of the tightening of monetary policy. So at that point we would only want to do it if we wanted interest rates to go up, so that tightening would be the appropriate thing to do. Now the scale and the magnitude of the sales would obviously depend on whatever else was happening. But there is no doubt that when we come to sell, other things being equal, it would be more likely to push up long-term interest rates. But that is exactly one of the consequences of monetary tightening.

Q53 Stewart Hosie: When the Japanese did this in 2001 they had a stated objective—
Sir Mervyn King: Sorry, I missed the first part.
Stewart Hosie: When the Japanese introduced their QE programme in 2001 they had a stated objective of accelerating credit, encouraging more bank lending. Bank lending fell throughout the entire period that their special measures were implemented and expanded. When QE1 happened here, bank lending fell every single month of the year following February 2009 when the purchases began. What confidence will we have that QE2 would do anything else? Will we see an increase in bank lending as a result of this at all?
Sir Mervyn King: I think the fall in bank lending would have been worse had we not conducted our asset purchases because what we were doing was injecting money into the economy and what the banking system has been doing is destroying money. As they reduce the size of their balance sheet and deleverage, they are reducing not just the size of their assets but the size of their liabilities. Most of the money in our economy—broad money—comprises liabilities of banks in the form of bank deposits. So

what we were doing was partially to offset what would otherwise have been an even bigger contraction.

Q54 Stewart Hosie: So is this £75 billion the same? Is this simply hiding the erosion of money through the impact on bank balance sheets you have just described, in a way?
Sir Mervyn King: It is certainly limiting it and it is unclear exactly where the deleveraging process will stop. The leverage ratio of our banks when we started this programme—when the crisis hit—was over 40 to 1. That is an astonishing figure. It is now down to 20 to 1. That is better. I would like it to go lower in terms of the long run, but I suspect it will decline a little but much more slowly. Indeed, if you look at the figures on total lending to the non-financial sector they are not falling any more; they are flat. So I think we are beginning to see some slowing of the deleveraging process. But I think you can see that one of the reasons why we were so keen to resume the asset purchase programme is that, when we started in 2009, we had expected then that the banking system would be in much better health than it is now. The premium that banks are paying to get funding over and above bank rate has not really narrowed since the beginning of 2009.

Q55 Stewart Hosie: That is helpful, but what you are really saying is you are not confident at all that another £75 billion will result in any significant or any additional bank lending into the real economy?
Sir Mervyn King: It depends on your definition of "additional". I can't guarantee that it means that bank lending will rise. What I do believe is that it won't fall as far as it might otherwise have done and it may start to rise now; we will see. I think the action will make a difference to the amount of lending, but it certainly does not guarantee that lending to the real economy is positive.

Q56 Stewart Hosie: You are a central banker and not a politician, but I will ask the question none the less. The £200 billion had the impact of perhaps 1.5% on inflation. The £75 billion will have some kind of impact. We understand that in the real economy, particularly the SME sector where they can't get financing but they are seeing inflationary costs, they might begin to ask, "Why on earth are we doing this?" Why on earth are you doing this when there is no discernible positive impact in the real economy, but it is driving inflationary pressures?
Sir Mervyn King: I am asked this question a lot by SMEs when I go round the country talking and I give a two-part answer to it. One is to say that any action we can take that will boost demand and spending in the economy will help SMEs. Anything that will improve the economic position will help SMEs.
The second part of the answer is to deal directly with the very evident problems that they are facing in terms of a contraction of the supply of credit, and I have absolutely no doubt that that has occurred. I think you have to go back to the proposition that only the banks are in a position to assess credit risks with SMEs. What we have to do is to find ways of giving incentives to the existing banks in order to lend more. If we were to set up a new institution tomorrow it would take 18 months to two years before it would be in any position to assess credit risks and start making loans. We need to use the existing banking system and soon, and I think there are ways of doing that and we are trying to give some advice to the Treasury on that. Of course, the Government still does own two of the biggest lenders in the country.

Q57 Stewart Hosie: Just one final question, getting away from the banks.
Chair: As quickly as possible, please.
Stewart Hosie: Yes. In your quarter 3 Quarterly Bulletin you did say that the purchases previously were "targeted towards long-term assets held by non-bank financial institutions, like insurers and pension funds, who may be encouraged to use those funds to invest in other riskier assets like corporate bonds and equities." Is that measurable? Did that work to any significant extent? Did the non-bank financial institutions invest in those areas in the way you have anticipated?
Sir Mervyn King: Yes, I think we can see that some of the risk premium did narrow. One of the things that matters most about asset purchases is that once the money gets into the hands of the private sector, whether it is pension funds, insurance companies, any other kind of fund, they then choose what to buy. They have the ability to buy a wide range of "risky" assets and reduce the premium of the return on those assets over bank rate. The benefit of that is that many of those riskier assets follow securities that are issued by companies when trying to finance themselves. So yes, we do think there is a benefit in that direction. Of course, any empirical study is bound to be subject to the difficulty of, "Well, we can't prove what would have happened if we had not done it." But I think we feel that the data are sufficiently encouraging, and I think it makes sense to believe that the circumstances in which these asset purchases would be most effective are really the circumstances in which the wedges between the return on Government assets—gilts—and the returns on risky assets are at their highest because then there is bigger scope for compressing the risk premium and reducing the cost of finance for those institutions that issued the securities.

Q58 Mr Love: Governor, can I come back to the first question that the Chair asked and amend it slightly to ask you, why did the MPC undertake quantitative easing now? Why did you not do it months ago?
Sir Mervyn King: I think we felt that there was a serious question of the balance of risks, and one of the things that has been concerning us—and I think many members of your Committee—over the last year has been whether the experience of inflation persistently above the target might lead inflation expectations to move up, and that that would cause some real problems in trying to bring inflation down later on. As time has passed, I think what we have seen is that there has been very little evidence that inflation expectations in the long term have risen—they seem to be fairly well anchored—and perhaps

most compellingly that wage increases have remained very subdued. I think the evidence on that, particularly as it came through in the late spring and through the summer, played a major factor in people feeling that the balance of risks had shifted, which is why we were much more inclined to contemplate this once we got to the end of the summer. But I think the thing that really made the big difference was a change in the outlook for Europe and the world economy. There were signs of slowing not just in Europe but in the US and China, but particularly the outlook for Europe deteriorated with very sharp falls in business and consumer confidence, and we felt this would have a material impact on the outlook for overall demand in the UK economy. As I said, in September we had pretty much reached that judgment but we just felt that perhaps things might improve; perhaps there might be some solution, albeit temporary, to the problems in the euro area that would lead to a restoration of confidence, but of course we have not seen that.

Q59 Mr Love: Isn't one of the criticisms that are now made of the bank that there were signs of a significant slowing in the domestic economy well in advance of what has happened in the euro, well in advance of any indications that the world economy was beginning to slow? Shouldn't you have taken action knowing that that was happening?
Sir Mervyn King: As I said, I think the reason we did not is that we were trying to balance the risks between the problem that inflation was high and rising, that that might affect inflation expectations. Normally, when I come to this Committee one of the first questions is, how can you possibly contemplate easing policy when inflation is so high and rising? We have to balance these risks and when we felt the risk change then we altered our view.

Q60 Mr Love: It was absolutely clear from all the Chancellor's statements that not only was he not going to introduce a plan B, he wasn't even going to introduce a plan A plus, and therefore the only one-club golfer available to the economy was QE. Didn't you read the signals from that with the domestic economy slowing and likely an austerity bearing down on it that, regardless of what was happening internationally, action had to be taken?
Sir Mervyn King: The international picture is highly relevant because going through a rebalancing we are not looking to domestic consumption to drive a recovery; we are looking to net exports and the world economy had actually picked up encouragingly. Then the situation changed, and I think the great virtue of monetary policy is that you can alter monetary policy very quickly when the data change and that is what we did.

Q61 Mr Love: If I may say so, I understand why you are covering yourself at a time when inflation is at 5.2% and you are predicting that it will come back to 2% in the two-year time horizon. I understand why you need to be absolutely certain. But you said at the time of your interviews, after the latest meeting of the Monetary Policy Committee, that we are facing the most serious financial crisis we have seen since the 1930s. Was that an appropriate time to introduce QE, or should we have been thinking in advance that maybe this crisis was coming down upon us very quickly?
Sir Mervyn King: I don't think the scale and the immediacy of how the problem deteriorated in the euro area was obvious at the beginning of the summer. Indeed, even on 21 July there was the package that they held out as being the solution to it. Now, the underlying problems had not changed at all and they won't change. The aim of the measures to be introduced over the next few days is to create a year or possibly two years' breathing space, but the underlying problems still have to be resolved. But the deterioration in business and consumer confidence and in the data in the euro area was very marked during August and everyone looked at this and said that, whatever view you held at the beginning of the summer, you should hold a somewhat different view at the end of the summer.

Q62 Mr Love: One final question.
Chair: A very quick question and a very quick response, please, Governor.
Mr Love: Recognising the deterioration in the economy, accepting some of the criticisms about the effectiveness of QE, will you be back at the Monetary Policy Committee with an extra £25 billion, an extra £50 billion, an extra £100 billion, to address the problems in the economy in the future?
Sir Mervyn King: We will do what we feel is appropriate at the time, and if we felt that doing more last month was the right thing we would have done it. So, we will see. The whole point is that you make these decisions one month at a time.

Q63 John Mann: Governor, this £75 billion figure, is this carefully calculated or is it plucked out of the air?
Sir Mervyn King: It is not plucked out of the air. It is based on the study that we carried out on the earlier asset purchases, and perhaps Charlie could explain the basis of the study and the certainty around it.
Charles Bean: Obviously, the article that we published in the *Quarterly Bulletin* tries to draw lessons from the first round of asset purchases. We think we have a pretty good handle on the immediate impact on an array of asset prices, gilt yields down about 100 basis points, corporate bonds, investment grade 75 basis points, high-risk corporate bonds 150 basis points and so forth. Following that through, it is the impact on activity and inflation that inevitably becomes a little bit harder to do, but we have made our best stab using a variety of methods. They suggest the impact of the earlier purchases on activity was something like 1.5% to 2% of GDP, and on inflation—as was mentioned earlier—something like maybe 1.5%, being the peak impact on inflation.
As regards the second phase that we have just started, we think it is reasonable to think that it would have a roughly equivalent effect, prorated of course, as it is only a fraction of the earlier £200 billion purchase. We are using that as a guideline for the likely impacts. But we may learn as we go along that the effects are smaller or larger than the first round impacts.

Q64 John Mann: You have had the advantage as being able to analyse for several years now and you have many clever people analysing. So you are saying inflation, the cost of this, is going to go up another 1.5%?
Charles Bean: Not from here and, remember, the 1.5% is for the £200 billion, so prorated, so—

Q65 John Mann: How much more inflation will be created and how many jobs will be created and what will the difference of employment levels from this £75 billion—
Charles Bean: Well, £75 billion is, what, about a third of £200 billion, so that is 0.5% on inflation, relative to what it would otherwise have been, and somewhat more than 0.5% on GDP, relative to what it would otherwise have been.

Q66 John Mann: What will that mean in terms of employment levels?
Charles Bean: Exactly how much that feeds into employment is one of the uncertainties at the current juncture. One of the things—
John Mann: No. You have had the chance to analyse because this is not new, so you are able to project based on what is happened before, so how many jobs? What will the impact on employment be from this QE?
Charles Bean: Roughly speaking, you might expect that if output goes up 0.5% employment will go up 0.5%, as an approximate rule of thumb. However, in practice at the current juncture—and there is uncertainty about that—one of the things that we have not understood particularly well through this downturn is the behaviour of productivity. Normally, what happens in downturns is that businesses hoard labour in the downturn and then when the economy recovers unwind that, so higher output might not lead to so much employment growth. However, the peculiar thing in the past 18 months or so is that, although productivity fell quite sharply during the downturn—and therefore, we wouldn't have expected much employment growth—over the last year and a half or so employment has grown surprisingly strongly and roughly in line with output. If that continues to be the case, as a result of this QE injection, then there will be a more beneficial employment impact—

Q67 John Mann: So, therefore there will be—
Chair: It will have to be the last question, John.
John Mann: Therefore, there will be higher employment than you would have projected previously because of the change in productivity. My point is this can now be analysed. If those outcomes don't occur, if inflation is higher than you are saying it will be, say in 18 months time, and if we don't have these new jobs in the way you are projecting, Mr Haldane is suggesting today there needs to be a direct link between bankers' bonuses and performance. Governor, is it not right that there should not be questions asked about the performance of the Bank, and what sanctions should there be if we don't get this performance based on this strategy?
Sir Mervyn King: That is entirely for you and your Committee. It is not for us to decide how we are assessed or what sanctions there are on us; that is for you.
Chair: We will give it some thought, Governor.
Sir Mervyn King: Thank you.

Q68 Andrea Leadsom: I think it is very easy to get into a £275 billion gilt purchase, as we have done over the last few years, but what about getting out of it? I would just like to understand: if I was a bank and I had bought £275 billion-worth of gilts from the market at market rates, I would have to mark them to market everyday and I would be showing on a daily basis massive losses, massive profits, depending on the markets. Is that exactly the same as it works in the central bank, or how exactly does that work and where is the liability taken if there is a huge loss or the benefit if there is a huge profit?
Sir Mervyn King: We publish accounts regularly and they show the mark to market profit and loss. I don't think we feel that is terribly relevant because these are securities issued by one part of the public sector and held by another. So, if the Government marked to market its liabilities they would offset each other. But eventually we will come to sell these and you will see the prices at which we sell them. There will be a final set of accounts; you will have all that information. As I explained earlier, the challenge will be to just reverse what we are doing now, to have a series of auctions. That is why we said before that when the time comes to tighten policy we would expect the first move to be a rising bank rate, and when we were confident that we were in a period where it was appropriate to tighten policy then we would put in place a programme of auctions over three to six months, as we are doing now, and then the process goes into reverse.

Q69 Andrea Leadsom: So, just to be clear, I completely understand the Government's liability matches off against the Bank's asset—that is absolutely clear—but you are not talking about holding them entirely to maturity.
Sir Mervyn King: No.

Q70 Andrea Leadsom: So that you will be taking a market risk in the meantime and it is entirely conceivable, isn't it, that there could be an enormous profit or loss if you come to sell them in the open market?
Sir Mervyn King: Yes, although that of course will be exactly offset by the mark to market profit or loss that the Government has earned on issuing those liabilities, because this is not the public sector issuing a security to the private sector, where there is a gain and loss between the two sectors. This is entirely within the public sector.

Q71 Andrea Leadsom: So if you then reach a point where, as you say, you have raised market rates and then you decide to start selling gilts into the market, what will be your determining factor? For example, will you be taking into account that if you raise base rates that hits mortgage owners, whereas if you simply sell gilts back into the marketplace that might not hit base rates, so all those who have mortgages linked to base rates will not suffer as a result? Is that going to form a part of your thinking or will you simply be working to an appropriate model that you have pre-agreed?

Sir Mervyn King: No, I think that will be for the Monetary Policy Committee at the time, and I don't want to prejudge what it would want to do. As I have said, the one thing we have said so far to guide the market is that we would expect that the first tightening move would be a rise in bank rate but that, thereafter, the Committee would have to make a judgment and it would announce the programme of auctions that is has. In either way, whichever instrument we use, I would expect to see the yield curve as a whole shift up when we started tightening policy. So, I don't think it would have much difference between the impact on people taking out loans of different maturities; I think what you would see is the whole yield curve would shift up because your—

Q72 Andrea Leadsom: Except that it is true to say, isn't it, that if people have loans that are linked to base rate and base rate only moves by a small amount—even if the yield curve shifts—if their loans are still linked to base rate that would protect certain loans in the economy?

Sir Mervyn King: It would, although I think it is very likely that the Monetary Policy Committee would think of a programme in which it would be balancing movements in bank rate with movements in gilt sales. Of course, as soon as you get away from the immediate very short overnight maturity you would expect the whole yield curve to start to shift up, affecting the interest rates at which banks could borrow and finance mortgages.

Q73 Andrea Leadsom: To what extent have you speculated forward the speed at which the day you start selling gilts the markets are going to pre-empt you and shift the yield curve up and, therefore, it will become harder to place those gilts in the market? Have you done some forward thinking about the relative speed with which the market will be on top of this, once you start selling?

Sir Mervyn King: I don't think it is a question of being difficult to sell it to the market; the price will adjust so that we can sell it. I think this is an important question, but it is a question that always comes when you start to tighten monetary policy, even if you just do it by raising interest rates. Indeed, if you look back at episodes when monetary policy starts to tighten there is always the question that the first tightening is a pretty big signal that the direction of policy has reversed and then you see the effects right across the yield curve. If you are not careful then, that can be too large to be something that you would like to see in the first tightening move, but you clearly want to see some impact. I think that is a question that all central banks worry about and they think about it in the context of the circumstances when they are trying to tighten policy, but it will be an important question.

Q74 Andrea Leadsom: Wouldn't you agree, though, that the facts that we have as a one-off experience—this £275 billion of assets to sell—it is going to be a uniquely problematic time when you do decide to shift monetary policy towards tightening? It will be almost a uniquely impossible task to try and manage your way out of this.

Sir Mervyn King: I am not sure, because when the time comes to sell the assets we will be right back into what we were in in the 1980s; then it was called overfunding. The consequences of what we would be doing when we were to sell gilts would be absolutely identical to what the Government did in the 1980s with overfunding. You can think of that another way. What we are doing now is underfunding. So the amount of gilts being sold into the private sector would be, when we come to sell, more than the Government needs to issue to finance its borrowing. Now it is less. Therefore, although people get terribly excited about the words, I just don't think this is unique. I think this is a long history in monetary economics and we have done it before, even though the words have been rather different.

Chair: I think funding is a problem we probably would not mind having at this juncture, but unfortunately we are stuck with what we've got.

Sir Mervyn King: No, indeed; look forward to it.

Q75 Mr Ruffley: Governor, with inflation at 5.2%—it is the highest since the early 1990s—do you accept that this is having a crippling effect on household incomes?

Sir Mervyn King: It is the same inflation rate as in 2008, technically true, but I certainly accept that what is happening in the economy now is a very large squeeze on household incomes. Real take-home pay has fallen by more in the past two years than any time in living memory. That is not the result of inflation being high; inflation is the symptom. The causes of that squeeze on living standards are real causes. They are a change in world prices of energy and the utility prices of gas and electricity at home. They are the consequences of higher Value Added Tax, higher food prices in the world, and the consequence of a fall in the real exchange rate, which was necessary to enable us to be able to rebalance our economy in the way that was vital after quite a long period of a relatively overvalued exchange rate. All of these things were inevitable and the only question was, at what inflation rate should we see the squeeze coming? But that squeeze was the result of factors that were real factors, which I don't think the UK could have avoided.

Q76 Mr Ruffley: You say they could not have been avoided, but the question this Committee has is, could it have been reasonably forecasted? I just ask you, as Governor, do you feel any responsibility for letting inflation get out of control because we have a lack of price stability now? It is well over 5%, inflation. This is undermining confidence in the British economy, consumers and households. Do you accept any responsibility for it spiralling out of control?

Sir Mervyn King: We certainly accept responsibility for not pushing up interest rates very sharply earlier this year and last year, in order to keep inflation closer to the target, yes. We did that because we were faced with a difficult decision, but we felt it was better, given that the squeeze on real incomes could not be avoided, that the only alternative to doing what we did was to push the economy, quite deliberately, into a deep recession with a high and rising unemployment. I think that would have made a bigger squeeze on real incomes and I am absolutely confident—I think this is the key point for us—that if we had done that and inflation were a little lower today than at the 5.2%, that come next year you would be giving us a very hard time for having got inflation to the point where it suddenly went way below the target once these temporary factors dropped out of the inflation measure. I think then I would have been saying to you, "Well, if you want us to try and keep it as close to 2% as possible all the time then we are going to have a zigzag strategy," and I think we avoided the zigzag. Now it is very uncomfortable and we are not at all happy that inflation is at 5.2%. But as I said last week, I think we do believe this is very close or at the peak, that it will come down sharply next year. It is quite hard to come up with any reasonable argument that would suggest it would do anything other than that. I think then we will be in a position where we can say to you, "Well, we didn't push the economy into a very deep recession and end up with inflation well below the target."

Q77 Mr Ruffley: Understood, but we have evidence from you that the first round of QE pushed up inflation, and there is another round of QE that you have just announced. Therefore, could you explain to us the sequence of events, if you would, that will deliver your forecast of 18 to 24 months from now, inflation back at target, because you are forecasting a very significant fall to around 2%? What we would like for you to do is just to explain the sequence of events from now to then.
Sir Mervyn King: The first thing that will happen, as we go into the new year, is that the effect of the increase in VAT last January will disappear from the 12-month window, which is used to calculate inflation. So, inflation is the measure of increase in prices over the previous 12 months. As we move forward in time, some of the price increases that came in this year will drop out of that comparison. We will see that some of the large energy price increases and food prices at world level drop out. Commodity prices have started to fall back. As a whole, energy and commodity prices in the world have fallen about 10% to 20% over the last couple of months. They had been rising at 30% to 40% a year. Once those things start to drop out of the window there will be a further fall back. That will carry on until the end of the year when towards the end of next year, 2012, the increase in gas and electricity tariffs, which came in in the last couple of months, will also drop out. On top of all that, gradually through the next two years, what seems to us a pretty large degree of spare capacity in the economies and still very subdued wage inflation—wage inflation is running at a rate well below the level that we would normally consider consistent with a 2% inflation target. So, as Charlie pointed out earlier, there is a lot of uncertainty as to what will happen to productivity, but given those factors we would see, as the window moves forward, a number of the price increases that have contributed to the 5.2% will be disappearing and they will not be replaced by equally large increases in prices.

Q78 Mr Ruffley: Final question, the—
Chair: There are more colleagues who want to come in and I know that you are pressed for time, so a very quick question and reply.
Mr Ruffley: Just a short one. A lot of us are concerned about the forecasting record of the Bank of England. If you had to score on a scale of 0 to 10, what would you give yourself for the last three years in terms of your forecasting record?
Sir Mervyn King: I am not going to score ourselves. That is for you and the others to do.

Q79 Mr Ruffley: Five, six, seven?
Sir Mervyn King: But I will point out that most of the reasons—

Q80 Mr Ruffley: Go on, Governor, between 0 and 10, how well do you think you are doing?
Sir Mervyn King: No, I am not going to do that. No. It is not my job to examine myself. It is your job to give us—

Q81 Mr Ruffley: You don't examine your own decisions?
Chair: We will take that as well as an invitation to take a look at that at a subsequent time.
Sir Mervyn King: Thank you very much. We do have to move to the airport pretty quickly.
Chair: Yes. We have a couple more colleagues who want to come in quickly. We did start a moment or two late, but we will get you to your plane on time.
Sir Mervyn King: Good.

Q82 John Thurso: Governor, I want to ask you a question about SME lending, but can I very quickly ask you a question relating to risk? The Greek situation has shown that sovereign debt is not entirely without risk. The Bank of England now holds a great deal of British sovereign debt. What credit assessment do you undertake on that?
Sir Mervyn King: I think with a credible medium-term fiscal plan, and if you look at the market's assessment of it, this is the first time that the credit default swap premium for the UK is well below that of Germany.

Q83 John Thurso: I am sure that is something we will come back to in due course. Can I turn to SME lending? What impact did QE have on SME bank lending, if any, in the first round?
Sir Mervyn King: It is very hard to judge because we don't know what would have happened had we not carried out that, but I think that any action of a monetary kind that would stimulate demand and spending in the economy will have helped SMEs. So, it did not tackle directly the problem of bank finance to SMEs. It wasn't designed to. But certainly by helping the economy it will have helped SMEs. As I said many times before and earlier today, if you want

to help SMEs obtain finance you need to go straight to that bank channel because banks have the infrastructure to assess the credit risk of SMEs.

Q84 John Thurso: The problem I am really driving at is that, whereas large corporates are being helped—and perhaps other people will talk about that—the SMEs, in particular, have the most difficulty in accessing credit, in part because they are the least attractive. QE tends to put money into banks, which it is designed to do, who then use it in the most effective way to get a return, which is largely not in SME or corporate lending, but much more in the capital market side. Would you agree that that is one of the core problems for policymakers?
Sir Mervyn King: I think the core problem is that, understandably, the banks have been under such market pressure that they have been trying to reduce the size of their balance sheet and they can't lend money out of thin air; they have to borrow money in order to lend it. The price they pay to borrow money is significantly higher, relative to bank rate, than it was before the crisis. As I said before, we had expected that to improve by now, but it hasn't. So the banks themselves are under great pressure from the market.

Q85 John Thurso: When we interviewed the Vickers Commission 10 days ago, the suggestion was made that SMEs would benefit from a ring-fence because money that is currently being used elsewhere would be within the retail and commercial operation. That would lead one to assume that currently banks are using those funds elsewhere in the market.
Sir Mervyn King: They are de-leveraging—

Q86 John Thurso: I am just trying to find out whether QE has an impact on that or whether other tools are required.
Sir Mervyn King: I don't think there is any obvious reason to suppose that SMEs are being treated less fairly by banks. I think all forms of lending by banks are being contracted and that the balance sheet has shrunk. As I said, leverage has fallen from around 40% on average for our biggest banks to 20%. So, that is a big change and that is the result of market pressure on the banks.

Q87 Michael Fallon: Can I just return once more to George Mudie's question? You identified a problem in the corporate bond market and you threw some billions at it. Then you make a speech a few weeks ago saying there is a problem in the small business market, a shortage of £5 billion, but that is somebody else's problem.
Sir Mervyn King: No, no, no—

Q88 Michael Fallon: That is not your problem, that is Treasury's problem, or you said it was Parliament's problem.
Sir Mervyn King: No, I did not say that at all. What I said was that the measures needed to tackle it have to be measures that are directed particularly on finding incentives for banks to lend specifically to SMEs and that is something that is appropriate for the Government to do and they have instruments to do it that we don't; fiscal incentives to persuade banks to lend to SMEs, or indeed the direct ownership of two of the biggest lenders. Those are the obvious instruments to use.

Q89 Michael Fallon: But there is a liability for these instruments. In essence, you are saying you don't want it on the Bank's books. It should be carried on the public finance books.
Sir Mervyn King: No, not at all. I am still waiting to hear of a credible scheme that we could carry out that would change the incentives of banks to lend to SMEs.

Q90 Michael Fallon: Let me help you here. Your own colleague, Adam Posen, has put forward a British Enterprise Investment Agency. Who would have the liability for that?
Sir Mervyn King: I have no idea, but it would take a long time to set up. As I said before, if you want to set up a new bank, a state bank, by all means do it, but frankly, given the way our bureaucracy operates, I would be very surprised to see any action of that within 18 months—the other schemes that were started before. I think one of the lessons from the attempts to help SMEs before was that many other schemes that were devised ended up putting a lot of the burden of bureaucratic functioning on to the SMEs themselves. That doesn't make any sense either and if you want to help SMEs you need to change the incentives of banks to switch the funding towards SMEs, marginally in favour of them versus others. That is how the market works. That would be an intelligent response and that is the kind of scheme we are discussing with the Treasury.

Q91 Michael Fallon: But why isn't that Adam Posen's scheme?
Sir Mervyn King: Sorry?
Michael Fallon: Adam Posen's scheme is a form of credit easing, is it not? It is bundling up these loans into single instruments to make them cheaper to process, isn't it?
Sir Mervyn King: One of the troubles with bundling up SME loans into a piece of paper is if I came to you and said, "I've got a bunch of SME loans here. I'd like to sell it to you," you might wonder which ones I had chosen to bundle up and sell to you. There is massive adverse selection in that. That is what undermined the securitised mortgage market—that people began to realise they did not know whose mortgages they were and then they realised it mattered whose mortgages they were. That is precisely why in the past it has proved very difficult to use capital market instruments to help SMEs because only the banks, and people close to the individual SME, know what the credit risk is. SMEs are not homogeneous in the way that mortgages were thought to be, and if you want to use a capital market instrument it makes an enormous difference whether these loans are homogeneous. The whole point of an SME is that one SME is very different from another; some have good ideas, some have bad ideas. The bank is supposed to be the vehicle by which you assess that credit risk,

and so that is the vehicle we should use to try to encourage more SME lending, if that is indeed what you wish to do, but that has to be a decision for you, not for us.

Q92 Michael Fallon: But if we are going to have successful credit easing who should manage that?
Sir Mervyn King: As I said, when you say "manage it", the great virtue of going through the banks is that I think if you want to do anything effective quickly only the banking infrastructure itself is capable of assessing credit risk, which SME to lend to and which not. That is what a bank is for. That is what is unique about a bank. They have people who can make that kind of judgment. I don't. You don't. The market doesn't. The banking infrastructure has been designed to do that. What is lacking at present is the incentive for banks to do it because they have come under enormous market pressure, understandably, to reduce the size of their balance sheet and the people who have suffered most from that have been those who are uniquely dependent on bank finance.

Q93 Michael Fallon: So you don't think it should be organised by a separate agency, as Adam Posen is suggesting, and you don't think it should be organised by the Treasury? You think it should be organised through the banks?
Sir Mervyn King: No, I think the Treasury are perfectly capable of organising a scheme that provides incentives to banks themselves to decide which companies to lend to and which not, but in which it is possible for the Treasury to shift the incentives so that banks choose to do more of it in total.

Q94 Michael Fallon: Where would the liability lie?
Sir Mervyn King: It depends on how it is set up, but it should lie with the Treasury. It is the taxpayers' money at risk. Surely you are not suggesting that we start now taking on an extra responsibility of managing the risk that the taxpayers face? There has to be you. That is why we elect you.

Q95 Michael Fallon: I was simply asking where you think the liability should lie. You think it should lie with the Treasury?
Sir Mervyn King: With the Treasury, absolutely.

Q96 Michael Fallon: Not go anywhere near your books?
Sir Mervyn King: Both the profits and the losses should lie with the Treasury.
Michael Fallon: Okay.

Q97 Chair: Governor and Charlie Bean, thank you both very much for coming before us today. There have been a lot of expressions of concern, which you have heard around the table, and of course this crucial period for the British economy and for the development of what people perceive to be the Bank's role in handling the crisis. We are very grateful to you for coming along at short notice and we will be seeing you in about a month's time to discuss inflation, among other things.
Sir Mervyn King: You will indeed, yes; other things, indeed.
Chair: Thank you very much.

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