House of Commons
Treasury Committee

Appointment of Mr Ian McCafferty to the Monetary Policy Committee

Fourth Report of Session 2012–13

Volume II

Oral and written evidence

Ordered by the House of Commons to be printed 11 September 2012

HC 590–II
Published on 26 October 2012
by authority of the House of Commons
London: The Stationery Office Limited
£6.00

The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

Current membership

Mr Andrew Tyrie MP *(Conservative, Chichester)* (Chairman)
Michael Fallon MP *(Conservative, Sevenoaks)*
Mark Garnier MP *(Conservative, Wyre Forest)*
Stewart Hosie MP *(Scottish National Party, Dundee East)*
Andrea Leadsom MP *(Conservative, South Northamptonshire)*
Mr Andy Love MP (*Labour, Edmonton*)
John Mann MP *(Labour, Bassetlaw)*
Rt Hon Pat Mcfadden MP *(Labour, Wolverhampton South West)*
Mr George Mudie MP *(Labour, Leeds East)*
Jesse Norman MP *(Conservative, Hereford and South Herefordshire)*
Teresa Pearce MP *(Labour, Erith and Thamesmead)*
David Ruffley MP, *(Conservative, Bury St Edmunds)*
John Thurso MP *(Liberal Democrat, Caithness, Sutherland, and Easter Ross)*

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/treascom.

The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth, Adam Wales, and Matthew Manning (on secondment from the FSA) (Committee Specialists), Alison Game (Senior Committee Assistant), Steven Price and Lisa Stead (Committee Assistants) and James Abbott (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk

Witness

Tuesday 11 September 2012

List of written evidence

Oral evidence

Taken before the Treasury Committee

on Tuesday 11 September 2012

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr George Mudie
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witness

Witness: **Ian McCafferty**, External Member, Monetary Policy Committee, gave evidence.

Q1 Chair: Thank you very much for coming to see us this morning. You do not have a big audience this morning, but I expect—assuming you get appointed—your audience will only increase as you get deeper into this work.
Can I ask you, first of all, about a number of things for which you presumably are responsible in developing—
Ian McCafferty: I cannot hear you, Chair.

Q2 Chair: Can I ask you about a number of points that you have made—or at least that the CBI has made—in the economic field, which I presume you take responsibility for, to get a feel for where you think policy should be? For example, is it your personal view that we need more state aid for medium-sized enterprises?
Ian McCafferty: I am not quite sure what you mean by "state aid".

Q3 Chair: I am looking at the executive summary of the recommendations of the CBI, so why not start with the CBI's proposal?
Ian McCafferty: Okay. Certainly, medium-sized businesses are very important to the economy, and the analysis that the CBI put out does suggest that, relative to other economies, our medium-sized businesses have not necessarily performed quite as well. They are a good engine for growth.
In terms of state aid, I certainly would not expect to see significant direct subsidy, but I do think that there is a climate for medium-sized businesses and, in particular as we speak, the issue about the availability of credit for those that are not large enough to access the corporate bond markets.

Q4 Chair: We are talking about state aid, though, aren't we? The Enterprise Investment Scheme is a form of assistance from Government. Whether or not it satisfies the state aid provisions, whether it gets past the EU definition of state aid, the CBI has been supporting it. I am just trying to clarify whether you personally support the recommendations of the CBI on these central issues. You were their chief economist.
Ian McCafferty: Yes, I do.

Q5 Chair: So you do favour an expansion of the threshold in the Enterprise Investment Scheme?
Ian McCafferty: Yes, I do.

Q6 Chair: What about the tax incentives to encourage those large corporates for whom it makes sense to invest and get cash off their balance sheets and into the economy?
Ian McCafferty: At this stage, given that the economy requires investment, I think temporary tax assistance, through increased capital allowances, can be of benefit.

Q7 Chair: All right. This is to large companies, and you support that too?
Ian McCafferty: Yes.

Q8 Chair: Okay. And personally? I am talking about personally here.
Ian McCafferty: Yes.

Q9 Chair: I am trying to clarify whether there is any distinction between the recommendations you have made in your professional capacity, which is presumably carrying collective responsibility in the CBI?
Ian McCafferty: Yes. As long as such assistance is temporary, I think the ability to bring forward some investment, given the nature of growth as we see it, can be very helpful.

Q10 Chair: But you are making a specific proposal here. It is the specific proposal I am asking you about—the tax incentive to get cash off the balance sheets of major companies.
Ian McCafferty: Yes.

Q11 Chair: You are supporting that?
Ian McCafferty: Yes.

Q12 Chair: We also have here strong support for higher public spending in aviation. By the way, I am not expressing any view of this Committee on any of these issues, I am just trying to elicit your views. Is it also your view that there needs to be an increase in public spending to bolster the aviation industry?

Ian McCafferty: If we start with my view on capital spending more broadly and then move into aviation, yes, I do think that the cuts in capital expenditure that we have seen as a result of the austerity programme will be damaging to the productive potential of the economy. The reduction from 2¼ to 1½ percentage points of GDP over the coming years is potentially damaging. I do think that there are constraints in the aviation industry and, as a result, we should be looking at whether we are providing sufficient capacity in our aviation industry to allow trade to continue in the medium term.

Q13 Chair: All of the policies you have come out in personal support of are policies that benefit, naturally enough, the membership of the CBI. You have been an economist/lobbyist for large business for a very large proportion—indeed, the most important part—of your career as a professional economist. An important question, it seems to me, is whether you are going to be able to show the independence to break away from that. You have just given four instances in which you are going to carry on supporting those views after leaving the CBI. This is not something that you felt the need to attach yourself to?
Ian McCafferty: I come to the MPC as an independent economist, not as a lobbyist for business. You have selected four issues in which the interests of business coincide with those of the economy more broadly. Part of my role at the CBI was also to act as a conscience. In some cases I disagreed with the views of individual businesses; for example, when many businesses were lobbying for further cuts in VAT. I was arguing that this was not the best way to stimulate the economy and, therefore, we should not be advocating them. So I think you have chosen four examples where I believe there is benefit to the broader economy, and I am certainly not coming to the MPC as a lobbyist for business.

Q14 Chair: It is very helpful to have that on the record. With respect to QE, the CBI has come out in favour of the Bank going beyond buying sovereign bonds, on the whole longer dated sovereign bonds, and buying high-grade corporate paper. Again, something that would benefit big business. Is that your personal view?
Ian McCafferty: I think my views on that are in the process of changing; perhaps there was a justification for it at an earlier stage. I am now of the view that perhaps the Funding for Lending Scheme addresses rather more directly the direct and central problem we have, which is the availability of credit for smaller and medium-sized businesses. As a result, I think some of the arguments that dictate against further intervention into broader assets, through direct QE, start to play a greater part. Those clearly are the fact that there is a risk to the Bank's balance sheet, so it would need Treasury sanction and that, compared with the United States, for example, those corporate and other asset bond markets are not as deep or as liquid as they are in the United States. Therefore, there is an issue about whether intervening in them introduces significant distortions within those markets.

Q15 Chair: You are distancing yourself from the approach taken by the CBI in their document *Financing for Growth*?
Ian McCafferty: As I say, my views on the way QE needs to be conducted are in the process of change because of other developments that the Bank has announced.

Q16 Chair: When did that process of change begin? It wasn't on the day of your invitation to join the MPC, by any chance?
Ian McCafferty: No. I have always felt that there are arguments on both sides about whether QE is beneficial if extended beyond the purchases of gilts. On balance, I supported the CBI view earlier on, but I do think, as we have certainly seen issues in the corporate bond market increase significantly over the course of the last year or so, which suggests that larger companies are having little difficulty in accessing credit, and now looking at the way in which the Bank has announced the Funding for Lending Scheme, as I say, my views are in the process of change.
Chair: We are going to come on to QE and the Funding for Lending Scheme in more detail, but several colleagues want to come in.

Q17 Andrea Leadsom: Good morning. You have talked about QE as something that you support, and clearly the MPC has decided to effectively purchase a third of the UK's national debt. What is your view on the potential to get out of those asset purchases? What do you think would be the impact on the economy—and particularly on business—of getting out of that 3½?
Ian McCafferty: That is clearly going to depend on quite the strategy that the Bank adopts once it wishes to start to reverse QE.

Q18 Andrea Leadsom: Yes. But as a member of the MPC you would have a view yourself on that, presumably?
Ian McCafferty: Yes, and, coming on to that, I think it depends very much on whether, as it were, the unwinding of QE is on the basis of allowing the bonds naturally to mature, which would have less disruptive impact on the gilts market than would selling those gilts directly back into the market. So I think there is a timing issue if the Bank is required to sell those gilts back into the market, not to disrupt and therefore steepen the yield curve significantly.

Q19 Andrea Leadsom: Without wanting to put words in your mouth, you do think that there is a risk that unwinding QE could be very disruptive to the yield curve if it is done through the sale of gilts back into the market?
Ian McCafferty: It is not to say that I do not think we would ever sell gilts back into the market, but I do think it is an issue that needs to be considered.

Q20 Andrea Leadsom: I would like you to be a bit clearer than that, because we have tried to get answers from the Governor of the Bank of England and it does seem to be in the too-hard-to-deal-with bucket, as to, "How do we get out of this?" We have a third of the

national debt of the UK economy on this asset purchase scheme, and there needs to be a strategy for unwinding it. I am asking you, as a member of the MPC, how you personally think that can best be done?
Ian McCafferty: As I say, I think some of the gilts that have been purchased will start to mature as early as the middle, or the spring, of next year, and that programme will start to unfold. Once that period starts to come we will then have to make a decision as to whether we let those gilts mature, which in itself would be a reduction in the amount of QE outstanding, or whether we will then repurchase. Therefore, once we have to tighten monetary policy, which I suspect is further out still, there is a combination of allowing the gilts already purchased to mature, plus the possibility of selling back into the market. One would hope that clearly at that stage the economy would be in a stronger position and, therefore, would be able to sustain some of those sales back into the market. But the exact timing of those sales is going to be subject to market conditions at the time.

Q21 Andrea Leadsom: Do you think that the sale of one gilt from the Asset Purchase Scheme back into the market will tip the yield curve significantly at the long end?
Ian McCafferty: No. I do not think so. I suspect you will clearly see a reaction. Once the market starts to believe that the MPC is beginning to tighten monetary policy again, then clearly there will be impacts in the markets, in terms of the steepness of the yield curve, and all sorts of other financial impacts. But I do not think these would necessarily be significantly disruptive. They are naturally part of the monetary policy cycle.

Q22 Andrea Leadsom: How can you justify that position? Obviously, what happened when the Bank of England started to buy gilts from the market is that it suppressed the yields and put up the asset prices quite significantly. There are lots of pension funds and asset holders who are now in a slight quandary not knowing what is going to happen to their portfolios, or indeed the timing of what is going to happen. So how can you possibly suggest that the day the Bank of England starts to unwind that position—whether it is through allowing gilts to mature, because I am sure that you are not suggesting that the Government won't bother to reissue that debt, and we are not in a position as yet to start simply repaying gilts, unless you disagree—that therefore, as a result, the Government will be reissuing gilts into the market but the Bank of England won't be buying. Will that not have the same impact on the yield curve in reverse to the impact that buying them in the first place had?
Ian McCafferty: The yield curve changes in steepness according to the time in the economic cycle, and you are suggesting that somehow the actions of the Bank would come as a significant surprise to the market and, therefore, would have a big shock impact. I do not expect that will be the case. I think we will need to provide significant signalling, both in terms of a strategy in advance of any repayment of gilts or the unwinding of QE, and my understanding is—much as I have only been at the Bank now a week—that there is significant work going on internally preparing such a strategy for communication to the market in due course, such that it would try to minimise any disruption to the functioning of the market.
Clearly, I would expect the yield curve to start to steepen, but to the extent that that would be due directly to the actions of unwinding QE, and to the extent that that would be due to the changing economic circumstances, you would expect the yield curve to steepen slightly as the economy started to strengthen.

Q23 Andrea Leadsom: Let me put it another way. Do you think that selling the gilts owned back into the market would have more of a steepening effect than raising the base rate?
Ian McCafferty: By definition, I think you would have to see a slight more steepening from selling gilts than you would from raising base rates at the short end, selling gilts is going to affect term yields more directly.

Q24 Andrea Leadsom: But you are saying that the sale of the gilts is simply indicating tightening on the part of the Bank of England, and the Governor has told us that he sees unwinding as simply a method of tightening. So you are now saying that is actually not the case; that raising the base rate would not have the same effect as selling gilts back into the market?
Ian McCafferty: It is impossible to quantify that at this stage. It is going to depend on market conditions at the time, and clearly any unwinding is going to have to take account of those market conditions, in terms of whether we decide eventually that we will start with an increase in base rate or whether we will start with an unwinding of QE.

Q25 Andrea Leadsom: As a very final question, would you accept that the only evidence of printing money or significant loosening in the way that QE has done in the past, has led to excessive inflation that has been very hard to control, or would you not accept that?
Ian McCafferty: Would I accept that—?
Andrea Leadsom: That in the past, in the few instances in history of effectively creating artificial money, through similar techniques to quantitative easing, has led to very hard to control inflationary pressures?
Ian McCafferty: I would not accept that that is a necessary conclusion of the current policy. I do think that the impact of the financial crisis, and the depth of the recession, has meant that there has been a significant shortfall in demand and a destruction of assets. Therefore, I do think that the current policy is designed to rectify that and does not necessarily—if managed properly—lead to significantly higher inflation.

Q26 Chair: But you do accept that the unwinding is likely to be accompanied by tighter short rates than would otherwise be the case?
Ian McCafferty: Tighter short rates than otherwise would have been the case? Quite how the policy

works will depend on, as I say, whether it is purely unwinding of the QE or whether we are moving base rate at the same time, which will clearly have some very differential effects on the steepness of the yield curve, and I think quite, therefore, what the Bank decides will focus on the independent market conditions at the time.
Chair: I am sure we will bat these issues around quite a bit, and I think there is some more coming.

Q27 Mark Garnier: What do you see as the primary purpose of quantitative easing, now that we are up to the £375 billion mark? What is it trying to do?
Ian McCafferty: It has done two things, and I think those ambitions remain the case. The first is the direct impact of QE has been to increase asset prices and to flatten the yield curve, and that has had an impact on economic activity. The Bank's own estimates suggest that it has increased activity by between 1 and 2 percentage points on growth, and a small increase in inflation relative to what would have been the case.

Q28 Mark Garnier: When we first started, this the country was in a financial crisis, and what I am trying to get from you is, it appears that day one when we had the first £75 billion of asset purchases, it was to try to stimulate the economy, to try, as you say, to boost GDP, boost monetary supply in the system, all that sort of thing. Now that we are in the fourth stage of it, I think, it appears to have a slightly different objective, in that it seems to be more about controlling the yield curve and asset prices than it does about necessarily stimulating the economy. Is that a fair assessment? How would you describe the change of primary purpose from day one to where we are now?
Ian McCafferty: I do not think I would make your distinction between stimulating the economy and somehow controlling the yield curve. I do think that its impact on asset prices, through the transmission mechanism, is designed to help stimulate the economy. Of course, measuring that against an unknown counterfactual has been very difficult. Clearly, the first round of QE was undertaken in a period of significant market disruption, as well as economic turmoil, and was designed significantly to stabilise asset prices at a time in which they were falling sharply. Clearly, as asset prices have recovered over the course of the last two or three years, the impact of QE in stimulating asset prices is likely to be diminishing slightly. But I think the overall impact, the primary purpose, has still been to try to stimulate the economy in a way that the MPC would otherwise have done using interest rates were it not for the zero bound. Therefore, I think that primary purpose, which is to use monetary policy, clearly primarily to deliver an inflation target, but behind that in order to help support the economy, remains valid.

Q29 Mark Garnier: The sense I have had, though, speaking to the Governor when he has come before these meetings, is that when you run out of room to control money supply with the base rate you then have to look for another way of doing it.
Ian McCafferty: Yes.

Q30 Mark Garnier: The sense I have been getting from the Governor is very much that the quantitative easing is about controlling interest rates and using asset purchases, and that is a direct effect, which is clearly incredibly important to this country if the country is continuing to try to raise £130 billion to £140 billion this year to keep the lights on.
Ian McCafferty: I have described in my previous role, when trying to explain quantitative easing to businesses, that QE is essentially monetary policy simply by another means. The arrival of the zero bound means that clearly we cannot continue to cut interest rates per se, and that the use of QE is a way of affecting interest rates in the market purely by another method.

Q31 Mark Garnier: Similarly, to follow on the other point Andrea Leadsom was making about unwinding QE, unwinding QE is about depressing the prices and, therefore, increasing interest rates along the yield curve.
Ian McCafferty: It is about increasing interest rates and, clearly, along the yield curve that will have a—

Q32 Mark Garnier: Will that be the specific purpose of it?
Ian McCafferty: I think the specific purpose of unwinding QE will be to restore normality to monetary conditions and hence tighten policy, if and once we believe that inflation risks are starting to rise.

Q33 Mark Garnier: The base rate is 0.5%; 10-year gilt yield is, what, 150 basis points or whatever. What would you describe as "normality"?
Ian McCafferty: It is very difficult to describe normality in the cycle to come, in terms of historic averages. I think there are some difficulties in this cycle that will be long lasting, which suggests that it may well be that interest rates will remain somewhat lower for somewhat longer than would have been the case.

Q34 Mark Garnier: What does that mean, though, because people talk about some point in the future? We have hugely indebted households, consumer debt of £1.46 trillion, and the consumer is now very used to this super-low interest rate environment, and admittedly I appreciate there is quite a steep yield curve at the shorter end, but nonetheless you talk about going back to a period of normalcy. The question that I have is how is this going to affect households as we go back to normalcy? Historically, when interest rates go up, it usually means it is following on the back of rising economic activity, trying to take a bit of heat out of the economy. Therefore, one would hope that household incomes are going up so they can cope with that. But if we are talking about going from a super-low interest rate environment to possibly just a low interest rate environment, it does not necessarily follow that you are going to have a picking up of economic activity and, therefore, it is possible that the interest rates will go up before households have that ability to service that debt which, in itself, could cause a great crisis of consumer demand.

Ian McCafferty: I think I would say that there is clearly a feedback mechanism here at work. One of the issues that we on the MPC will need to consider very carefully is the very issue you describe, that from a position in which the bank rate—and to some extent mortgage rates—start at a very low level, the degree of gearing back into consumer income of any increases in monetary policy is going to be quite significant. I would take issue I think with your notion that we would have to increase interest rates significantly before there is any indication that the underlying economy is starting to recover. I do think that the two are intimately connected.

Q35 Mark Garnier: But this is my question about what will be a period of normalcy? If we go back to just a normal low interest rate environment as opposed to the super-low interest rate environment, what do you see that as being? Although it may go to 0.5% to 2%—2% is still relatively low—it is still four times the—

Ian McCafferty: I do not think I can give you any figures on this, because it is going to depend on the inflation outlook and the requirements of monetary policy to deliver that stable inflation outlook at the time. It is clear that we are in a super-low interest rate environment at the moment, and that from here eventually as the economy—as I hope—recovers, we will start to see some rises in interest rates, but I do not think it is possible at this stage to speculate either quite how fast those interest rates will have to increase or at what level they may end up.

Mark Garnier: Thank you very much.

Q36 Mr Ruffley: The Bank of International Settlements has reported as follows, "Prolonged and aggressive monetary accommodation may delay the return to a self-sustaining recovery. It can undermine the perceived need to deal with banks' impaired assets". Do you agree with that?

Ian McCafferty: I think there is a risk. If we look at the conduct in Japan, for example, the non-addressing of the issue of addressing bank assets, was I think one of the main causes of the length of the Japanese stagnation in the 1990s. I do think we are, therefore, having to look at different policy measures to deal with bank assets. Certainly, the approach to rebuilding bank capital and encouraging banks to write off bad debt is one of the necessary elements of restoring the economic health of this country.

Q37 Mr Ruffley: You give the example of Japan, but in this country how high would you place the risk of it being the case, as the Bank of International Settlements says, that it may delay a return because it will undermine the need to deal with bank impaired assets? Is it high-risk, medium-risk?

Ian McCafferty: As yet I do not think it has impaired the drive to start to deal with those damaged assets. My understanding is that the banks have been writing off such assets, in a way that has not been over-disruptive but which is certainly starting to have an effect. Therefore, I think the risk is relatively low at this stage.

Q38 Mr Ruffley: Relatively low. Now, the Bank of International Settlements has also observed that there are certain companies who, apart from the aggressive monetary policy, might have folded. Is it your case that the resources in the case of those companies might have been transferred to more efficient and productive parts of the economy?

Ian McCafferty: I am not sure that I would attribute the failure rate of companies most to the conduct of monetary policy at this stage. I think there are other features in the current environment that have also contributed to the survival of companies, not least the attitude of HMRC and its "time to pay" policy. At this stage, given the potential damage to the economy of an even sharper rise in unemployment than we have seen over the course of this recession, I think the fact that we have smoothed some of the bankruptcy of companies has been beneficial to economic stability.

Q39 Mr Ruffley: The asset purchase facility involves a lot of crediting in commercial banks' accounts at the Bank of England with electronic money. Why is that sitting to the extent it is in commercial banks' accounts and not being lent on?

Ian McCafferty: There are two factors. Clearly banks are having to deal with their existing loan books, and a number of banks are trying to deleverage and, therefore, even if they are sitting on liquid assets they may not necessarily have the appetite to lend to the same degree. I think there is also—and equally importantly—a lack of demand for credit at this stage. Certainly, the work that I was doing at the CBI suggested that, while there are some individual companies who are unable to obtain the credit that they would like, that this is not at a macro level a significant issue, that there is actually a lack of demand as well as some element of lack of supply.

Q40 Mr Ruffley: How much further do you think QE has to go upwards? Another £50 billion, £100 billion?

Ian McCafferty: We are in the process of the current round of QE. That will continue for another couple of months. I think we are also in a position of significant uncertainty about quite where the economy is at this stage. We have had significant distortions to the short term because of extra Bank Holidays, and so on and so forth, which make it very difficult to read exactly how the economy is performing in an underlying fashion. As a result, I would like to see more evidence before I were to make any decision on whether QE needs to be extended further or not.

Q41 Mr Ruffley: In the context of QE and the next decision whether or not to extend it towards the end of the year, would you characterise yourself as a hawk or a dove?

Ian McCafferty: I think it is a very unhelpful label.

Q42 Mr Ruffley: It may be unhelpful, but it is the language that you will have to get used to.

Ian McCafferty: But I do not think I am either a hawk or a dove. I think I will be looking at the evidence in each meeting and, on the basis of the best data that we have, to make a decision on the basis of current conditions.

Q43 Mr Ruffley: I would just like to introduce you into the world of public policy, which you are potentially entering, and "dove" and "hawk" are appellations that will be affixed to you, and would you tend towards the dovish characterisation or the hawkish, or neither?
Ian McCafferty: I think I would say that I find the appellation is very unhelpful. It is not one that I am unaware of.

Q44 Mr Ruffley: I know it is unhelpful. We are agreeing with that. You will have to deal with it, and one of the reasons you are in front—
Ian McCafferty: I will have to deal with it.

Q45 Mr Ruffley: Let me finish. One of the reasons you are in front of this Committee is for us to make some kind of judgement as to how you might handle yourself. Your job is not just to be an economist counting the beans; it is to explain to the public and to economic actors in this country why you are making certain judgements. I repeat again, would you take the appellation "dove" or "hawk"?
Ian McCafferty: I would not take either. I think my position is such that I will look at the evidence at the time and make decisions on that basis. I am very well aware of the appellation. If others wish to apply either "dove" or "hawk" to me, that is for them to decide, but I do not think that it is a very helpful appellation, and it is not one that I wish to pre-apply to myself.

Q46 Mr Ruffley: Given the prolonged period we have had of very loose monetary policy, do you think any interest rate movements will have a disproportionately high impact on the economy once it is moved to a more normal monetary policy environment?
Ian McCafferty: Clearly, as we start from a position in which interest rates are particularly low, the leverage into personal finances of any increase is clearly higher than it would be were to we have started at a higher start point for bank rate. That is an issue—as I have already discussed—I think we will have to be very mindful of in terms of interpreting how an increase in either base rate or an unwinding of QE starts to affect particularly the finances of personal consumers, particularly through their mortgage rates and, therefore, how the transmission mechanism between monetary policy and the impact on the economy will work as we start to tighten policy whenever that happens to be.
Mr Ruffley: Thank you.

Q47 Chair: Do you have any reason to contest the Bank of England's assessment of the impact of round one of QE, for example, that it increased GDP by about one percentage point?
Ian McCafferty: It is clear that such estimates, as the Bank made clear in its own article, are subject to significant uncertainty.

Q48 Chair: But do you think it is in the middle of the fantail of possibilities?
Ian McCafferty: I did say in my questionnaire that I felt that such estimates that they had given were not implausible.

Q49 Chair: Okay. Well, I am asking you—
Ian McCafferty: Sorry. I am not trying to be difficult.
Chair:—what is the most plausible?
Ian McCafferty: The range that they have given, which is that it has increased inflation by between about 150 and 300 basis points, and growth by between 1% and 2%, is not unreasonable for the first-round period.

Q50 Chair: Okay. But the most reasonable estimate? I am just going to carry on. Do you think there is some other more plausible range that should be considered? I just want clarity on that point.
Ian McCafferty: No, I think that range is plausible. It is very difficult to give a point estimate within that range because clearly there are a number of different techniques and they throw up slightly different estimates, and, given that this is still a new set of policies for which the econometrics is still being developed, I think it is very difficult to give other than a range, but I think the range that has been given does not look unreasonable.

Q51 Chair: You do not have a more reasonable one up your sleeve?
Ian McCafferty: No.

Q52 Chair: Okay. You said earlier, in answer to a question from David Ruffley, that you did not think that QE's impact on the survival of companies was so great as the impact, for example, of the HMRC scheme to give more flexibility on the late payment of tax. Do you think that the HMRC scheme is really worth 1% to 2% of GDP?
Ian McCafferty: I would say that the HMRC scheme is worth 1% to 2% of GDP. What has happened clearly is that QE has helped growth and inflation broadly at a macro level. In terms of individual companies, clearly those that are in distress, the impact of the HMRC scheme has been more effective for those individual companies.

Q53 Chair: I am not sure I understand. At the margin, 1% to 2% of GDP is wipe-out for a raft of companies, isn't it? They would have been wiped out—as David Ruffley was saying—had it not been for QE.
Ian McCafferty: I do not think you can necessarily draw a one to one relationship between the level of GDP and exactly the number of companies that will have gone under as a result of this.

Q54 Chair: But you can draw a rough relationship, can't you? Don't you normally draw a rough relationship?
Ian McCafferty: I think you could draw a very rough relationship, but what we do know is that companies went into this downturn with their finances in rather better shape than has been the case in some other recessions and that, as a result, it may well be that that and the changes to the bankruptcy rules are more

affecting the number of liquidations than are specifically other factors.

Q55 Chair: It is specifically QE you were asked about.
Ian McCafferty: Yes. QE clearly affects the macro environment and, to that extent, has clearly helped companies survive. I am not sure that you can necessarily focus on individual companies, the micro element, as a result.

Q56 Chair: So the answer to David Ruffley's question is, no, you do not think that the capital could have been better reallocated elsewhere?
Ian McCafferty: The capital that has been used for QE?
Chair: The capital that is sitting in companies who have managed to hang on at the margins because of the effect of QE on growth.
Ian McCafferty: In the short term, no, I do not think it could have been better used elsewhere, because it is not clear that it would have been reallocated into companies that would have grown faster over the very short term than those that have survived. Clearly, over time, if those companies are truly inefficient, then they will see that capital reallocated. But I think the issue is one of timing at a time when the economy was extremely weak.

Q57 Jesse Norman: Mr McCafferty, there are nine members of the MPC, of whom five are Bank of England officials and four are independents. Of the four independents, two are academics and one is a banker. What do you think you bring to the table?
Ian McCafferty: I think I bring a number of things. But certainly, as an applied economist with significant experience of business, I think I complement some of the other experience of the externals. As an applied economist, over the course of my career of over 30 years now, I think I bring a significant understanding of the analysis of the economic conjuncture and of the outlook, an understanding of how forecasts need to be put together and certainly adding—

Q58 Jesse Norman: You are actually the only member of the MPC who has had any experience in business at all, aren't you?
Ian McCafferty: I do not think that is quite the case. My understanding certainly is that some of the externals have also worked for businesses and, therefore, have some understanding of business. But it may well be—and that has been an issue I think for those who selected me—that having a good understanding of business is a necessary part of the committee.

Q59 Jesse Norman: It is curious, isn't it, because the point of the MPC is to keep inflation low. Why? So that our productive economy in part is able to do its thing. Who benefits from that? Indirectly consumers, but in the first place business and we have one person on the MPC who knows something about business.
Ian McCafferty: As I said earlier, I do not think my role is to represent or support the views or the interests of business specifically. My role is to judge on the necessary conduct of monetary policy in order to deliver low inflation, first and foremost, and then as best we can to support that with economic growth.

Q60 Jesse Norman: Your job is to give advice or to reach a judgement?
Ian McCafferty: It is ultimately to reach a judgement. I have a vote on the MPC.

Q61 Jesse Norman: So your position is one in which you cannot be technocratic about it; at some point your own views and judgement have to come into play?
Ian McCafferty: Clearly.

Q62 Jesse Norman: If QE is not delivering the goods—and we know it is becoming less effective with time—if at the end of the £375 billion it has not delivered the goods, are you going to support further printing of money, as a businessman?
Ian McCafferty: I am not sure that I would necessarily conclude that it has not delivered the goods.

Q63 Jesse Norman: If it has not. Sorry, I am assuming—for the purposes of conversation—that it won't have by the time you come to it.
Ian McCafferty: It depends what you mean by "delivered the goods". Clearly, the estimates of the impact of the first round of QE have been positive to the economy, and I have no reason to expect that the second package will not have been equally beneficial to the economy. Clearly, we have difficulty in understanding what would have happened otherwise, and I do think there have been some other factors that have led the economy to perform rather more disappointingly than would have been the case. That is not to say that QE is not delivering the goods.

Q64 Jesse Norman: Yes. We are well into diminishing marginal utility. The first thing was one thing. We are now in the third or fourth session. We are running out of gas. The medicine is not working.
Ian McCafferty: I disagree, I am afraid. The reasons for the poor performance of the economy are not that QE is not delivering the goods. We have faced a number of significant headwinds, some of which are direct legacies from the credit crunch. Others have been external shocks that have affected the economy more recently, which have led to a disappointing GDP performance. I do not think that we can conclude from that that QE has not delivered the goods.

Q65 Jesse Norman: No, I was saying it has become less marginally valuable, not that it has not delivered the goods at a cost.
Ian McCafferty: I have seen no evidence for that as yet.

Q66 Jesse Norman: You have talked about the importance of not undermining the productive capacity of the economy. Do you think there is a case for the Chancellor making further cuts in public spending at the Autumn Statement?

Ian McCafferty: It is too early to decide, until we see what the OBR's estimate of the state of the economy and hence the public finances is. Were that to be the case then I think the Chancellor has to face a decision. It is going to be a difficult decision because clearly he has to balance the need to deliver the fiscal programme and, therefore, maintain confidence in the financial markets, with the need to both ensure short-term demand—

Q67 Jesse Norman: We are £100 billion over in spending largely because of automatic stabilisers. We are asking for your judgement. Do you think he should make more cuts if, as expected, the OBR—
Ian McCafferty: I think he needs to maintain the austerity programme because otherwise there are risks that we will see disruption in the financial markets, and that would steepen the yield curve and significantly damage what we are trying to do at the Bank. But within that, I think there are some decisions that he will have to take about the balance of spending between capital and current, for example, in order therefore to maximise the impact of Government spending in terms of short term growth.

Q68 Jesse Norman: Then why are you so sanguine about the Funding for Lending Scheme? Small businesses do not go to banks because they do not want all their facilities to be re-priced. What the Funding for Lending Scheme is doing is giving the banking system 50 basis points of extra capital rebuild over a period of time. What are you going to do for small business? How is that going to help from an MPC standpoint?
Ian McCafferty: The banks will only get the money at reduced cost if they actively increase their net lending, so it provides the incentive to them to actively go out and market their lending. Certainly, simply from reading the newspapers in recent days, it is clear that there are some initiatives on the part of individual banks now to actively approach small businesses in order to try to encourage greater lending, which I think is possibly—and in fact probably—a reaction to the announcement of the Funding for Lending Scheme. So I think there are incentives built in which provide small businesses with better conditions than the case previously.

Q69 Jesse Norman: Do you think the Bank, through the MPC, ought to be looking at the specific reasons why small businesses are not borrowing from the banks? Do you think they should actually be doing some proper, detailed field work to figure out why on earth so many small businesses are preferring not to go to the banks?
Ian McCafferty: My understanding is that the Bank spends a good deal of time trying to find that out, as other organisations—such as the CBI—have also done. Clearly the agents are spending a good deal of time talking to small and medium-sized businesses, and I think there are a whole series of reasons why the flow of credit to small businesses is less than we would like.
Jesse Norman: That sounds like a no. Okay. Thank you very much.

Q70 Chair: If I could take you back to an answer a moment ago. You would agree, wouldn't you, that the austerity programme has bolstered confidence in the markets. I think that is what you were saying, that you thought that is why it would be dangerous to deviate from it. How do you think those markets would react if the Government reactivated large-scale PFI-style off-balance-sheet finance?
Ian McCafferty: There is a risk that the market could take that somewhat negatively, and therefore I think that it has to be done carefully.

Q71 Chair: You mean that the fiddle has to be done skilfully?
Ian McCafferty: I do not think it is a fiddle because, although it is off-balance-sheet, it is clearly apparent to markets and I think there are limits as to the size of what one can do. Some of the issues that certainly the Government has been discussing, in terms of using its balance sheet to support contingent finance, I think have been helpful, but there are clearly limits as to the scale that that can reach before markets would worry that this would prejudice the overall achievement of the fiscal policy.

Q72 Chair: Have you any sense of the scale yourself?
Ian McCafferty: No, not at this stage.

Q73 Chair: That limit?
Ian McCafferty: No, I don't, I am afraid.

Q74 Chair: £5 million, £10 million, £15 million, £20 million, £50 billion?
Ian McCafferty: I suspect it is smaller than £50 billion.

Q75 Chair: Larger than £10 million?
Ian McCafferty: Probably not much larger than £10 million. But I would reserve my judgement because it is not an issue that I have tried to look at in detail.
Chair: Fair enough.
Ian McCafferty: It is not an issue that I have discussed with individual market participants. Therefore, I think it would be dangerous to give too precise an answer.
Chair: Okay. But you have given us a fair ballpark number of not much larger than 10.

Q76 John Thurso: I want to talk about the labour market if I can. After each quarterly GDP announcement, there is a debate that goes on roughly along the lines of, "That was disappointing, and a lot of the data doesn't seem to stack up in the classic way". People point particularly to the labour market data. How do you explain that puzzle?
Ian McCafferty: It is a big puzzle, and I suspect that we will not be able to explain it in full until we see some further developments to the data over the course of time. It is not only the labour market data that are suggesting that the economy has perhaps a little more strength in it than the GDP data themselves, it is also clear that the VAT and National Insurance receipts are also suggesting an economy that is slightly stronger than the GDP data, at least for the last three quarters.

There is a question mark about whether the GDP data are fully capturing what is going on currently. Clearly, there are some issues about the quality of the short-term construction data. The methodology for that is currently being worked on within the ONS. I also have some concerns—and it is something that I would like to look at in my time at the Bank—as to whether we are fully measuring the service sector economy accurately. It may well be that there are some issues there. I am minded of the time, back in the early 1990s, when the ONS struggled to measure industrial production correctly for a number of years. It took them several years to adjust their methodology because of the significant structural changes that were going on in the economy, particularly in the manufacturing sector, at that time. It may well be that there is some issue with the service sector, at a time when we are undergoing significant structural adjustment in the economy now. I think the short-term GDP data is puzzling. I suspect—although I have no proof of this, of course—that it may well be revised with time and, if anything, at this stage I think some of the other data do suggest that there is a little bit more momentum in the economy than the GDP data alone would suggest.

Q77 John Thurso: I want to come back to the labour market, but I just want to follow that point up. If we are in a period where, for various reasons, the ONS is having some difficulty capturing the data and there is a fairly widespread body of opinion that thinks that—as you have just expressed—in the fullness of time the data will be revised upwards, and we are therefore in a period not of absolutely flatline economy but of very, very small growth, actually that is quite a significant difference, given the policy choices available particularly to the Chancellor. He could be in danger of making some very serious judgements, based on poor data.
Ian McCafferty: I would perhaps take issue with your description between flatlining and small growth. The GDP data for the last three quarters has suggested the economy has actually contracted over that period. Therefore, I suppose my underlying reading would be that it has been flat rather than contracting, at best, at this stage. So I think to that extent it is not necessary that we have significant growth.

Q78 John Thurso: Going back to the labour market. In February, when Adam Posen was with us, we had a discussion about labour market regulation, and he said, "It would be a mischaracterisation of the UK labour market to suggest that we are hamstrung by labour market regulation at this point". Is that a view you share?
Ian McCafferty: There are clearly some elements of labour market regulation that have in the recent past posed some difficulties to businesses, changes to the agency temps directive, for example. I do think from my experience at the CBI that had affected a number of firms who were using temporary labour in a particular way, and they have had to change their business models as a result. Other than that, I would characterise the UK labour market as being relatively flexible, relative to some of our competitors, and I do think that we have seen evidence of that flexibility in the changing nature of the labour market over the course of the financial crisis and the recession. Clearly the fact that unemployment has not risen as much as would have been expected, given the fall in GDP, does suggest an element of flexibility in the way that firms are using their labour force. The fact that firms have been using much more wage flexibility to protect employment is an indication of a fairly flexible labour market.

Q79 John Thurso: Apart from the one point about the agency directive you brought up, you do not see any particularly burning need to deal with regulation as being a critical factor?
Ian McCafferty: I think there are bigger issues in the labour market than that of regulation in the broad. There are some specific and I have given you one example. I do think the issue of skills is probably a greater issue, in terms of the flexibility of the labour market going forward.

Q80 John Thurso: The fact that actually there are skills we need in our economy to grow, that we have not grown internally and we have to import them and we have terrible trouble getting those people into the country. Would you see that as a barrier?
Ian McCafferty: I don't know that I would see it as a barrier.

Q81 John Thurso: A concern?
Ian McCafferty: I think it is a concern, yes.

Q82 John Thurso: In your 2009 speech to Nottingham Business School, and going back to what you were just saying, you made the point that one of the characteristics of this recession is, because of our flexibility, firms have not just laid off, they have actually worked well with the labour force to be flexible. To what extent is that labour hoarding, in the sense that they are putting off the inevitable? Most people expected us to be back into growth by now, did not expect the eurozone crisis and all the rest of it. Are we storing up problems or is this actually a very constructive model that will help us go forward until we do start growing again?
Ian McCafferty: When I have spoken to and asked businesses about this issue, they do not recognise the notion of labour hoarding. I do think, though, that the labour market is perhaps functioning in a way different than would have been the case one or two cycles ago, and that that leaves us with a conclusion that probably productivity, rather than the level of employment, is becoming more cyclical, as it were, the residual in terms of how firms deal with shortfalls in demand in the short term. Were the economy to continue to struggle, there may well be some increases in unemployment. That certainly was a feature of the forecasts I was putting out at the CBI, so I do not think that we can say that unemployment may not rise. But I do not see this as necessarily a huge problem being stored up at this stage, because the more I have talked to businesses the more they are looking to smooth the numbers in their labour force, and particularly the availability of skills in that labour

force, through the cycle, for a number of different reasons. There are clearly issues to do with firm-specific skills. You do not wish to lose labour in the relatively short term if you then find very great difficulty in recruiting that same labour, if the firm-specific skills are an important part of your competitiveness.

Q83 John Thurso: In a way that is an indication of the skills shortage and problem we are having.
Ian McCafferty: To some extent, yes.

Q84 John Thurso: Actually, people are now frightened that they will not be able to get the skill back, therefore hanging on to people with skills has become more important.
Ian McCafferty: I think there is an element of that, but I do not think it is as simple as to say we are short of skills. I do think that there are a good number of businesses for which what you might call firm-specific skills are a very important part of their competiveness and their branding and their cost structure. If you lose staff who have a good deal of experience in that business, it is not necessarily the case that you recruit the same individuals back in future times. Then of course you have an impact on your short-term productivity as you are training up new individuals to understand how the individual firm works.
So it is clear to me that firms are smoothing their labour forces through the cycle rather more than they would have perhaps done 10 or 20 years ago. This, I think, is a function of a relatively flexible labour force. We have seen that, in terms of the way in which settlements, hours, and other elements of cost control have been employed over the course of this recession. What that means is that, as I say, when there is a shortfall in demand it may well be that we see a cyclical fall in productivity rather than the shortfall in demand being fully reflected in a fall in employment. But that then suggests that as demand picks up that productivity shortfall can be made up using the existing workforce.

Q85 John Thurso: So the extension of that would be that actually when we get back into growth there will be a lag before we start to see a real improvement in the labour market, because that productivity will be soaked up first?
Ian McCafferty: I think that is probably right, yes, and that has certainly been a feature of the forecasts that I have been making over the course of the last few years.

Q86 Stewart Hosie: In response to the Chairman's question earlier, you suggested the markets would be spooked if there was this additional capital investment anywhere north of £10 billion. Would the markets be spooked because it was capital investment or would they be spooked because it was off-balance-sheet PFI investment?
Ian McCafferty: I do not think it would be specifically for either reason. I think it would be to do with what it might tell you—and this is where we get into the issue of quantum—about the determination of the Government to continue to improve the public finances and drive towards balance over the course of the next few years.

Q87 Stewart Hosie: That is interesting because certainly if the metrics are right, and there is a one-to-one impact on GDP growth from direct capital investment, then the Government's plans could remain on target while seeing that stimulus in the economy. I am just concerned why that is not a good thing if the overall deficit consolidation plan remains on target but we get the stimulus now.
Ian McCafferty: There are two issues. One is that one-to-one impact. Clearly, on balance, the best estimates of the multiplier for capital investments are close to one-to-one, but it is going to depend very much on the projects that are chosen. Perhaps even more important is the timing issue. It is clear that large capital investment projects are going to take some years to come on stream and, therefore, the impact on the public deficit may well be negative in the first instance before then becoming neutral later on. I think that is an issue at a time when the economy is struggling.

Q88 Stewart Hosie: Just associated with that, you did say at the beginning—again, in response to the Chairman—you thought there was some merit in capital allowances for investment. What is the difference between giving a business a whopping big tax allowance to build a new factory to increase supply side capacity, and direct capital investment on the Government side?
Ian McCafferty: My answer is very similar to my previous answer, which is the question of the timing of the delivery. If you introduce capital allowances to individual businesses, and they are preannounced as being temporary, you hope to be able to bring forward some investment, and if the idea is to stimulate the economy over the short term, then of course that can have a relatively more immediate impact.
The risk with capital investment—and it is a risk that clearly we have to take account of—is the extent to which delivery of that investment is delayed by some of the issues surrounding that investment. You can allocate the capital but whether you can get through the planning system, whether you can achieve the spades in the ground—I think is the phrase—relatively quickly is still an issue and a challenge in terms of delivery.

Q89 Stewart Hosie: I am sorry to dwell on this. I actually want to ask about business investment more generally, but just on that specific point you would seem to be suggesting if there were shovel-ready projects—to get the spades on the ground now—that would be a more attractive proposition than simply putting in place the capital and hoping something might be delivered in a year or two or three's time.
Ian McCafferty: I think it depends on what your objective is. If your objective is to provide the necessary infrastructure for the medium and long term—and we come back to the point about aviation—then I think clearly you have one set of types of project that you would wish to pursue. If the ambition, however, is to provide a short-term demand

stimulus through the construction sector of the economy, then I think shovel-ready projects clearly have an advantage. Although, from my experience at the CBI, it is clear that even shovel-ready projects still take a little time to come on stream.

Q90 Stewart Hosie: Sure. In terms of business investment generally, what do you consider to be the main constraints on further growth in business investment?
Ian McCafferty: I think the key constraint at this stage is the high level of uncertainty that we face around the outlook for the economy. It has been clear, particularly over the course of the last year or so, that the uncertainties around the eurozone economies, both directly through the impact of slow growth/recession and those on our experts and indirectly on business confidence more widely, has been a significant depressant on the economy, and I consider that is likely to continue for the foreseeable future.

Q91 Stewart Hosie: Uncertainty and confidence. Given the role of the MPC, and the Bank generally, you only have two levers. One is QE and one is base rates. Unless the MPC want to delve into the realms of fiscal policy, what would you suggest can be done or ought to be done, if anything, with the base rate and QE that might help, in terms of confidence and uncertainty?
Ian McCafferty: What the Bank has done, in terms of the second round of QE, starting last October, has had a beneficial impact on confidence. In addition to the direct impacts of QE that we talked of earlier, one thing I was going to mention, which I can mention now, is that I do think there is a role for the Bank in helping support confidence in terms of its policy. From that point of view, clearly we will need to look at how the eurozone develops and the impact on confidence. It was clear that the first round of escalation in the eurozone had a significant negative impact on business confidence last September. I am very mindful of that from my CBI experience. As the outlook for the economy deteriorated at that time, that I think was what led the Bank to consider a second round of QE at that time, which as we know continues at present. We will need to study how events develop in the eurozone and elsewhere in the global economy, and the impact on confidence, when making our decisions on QE going forward.

Q92 Stewart Hosie: Businesses are allegedly sitting on huge chunks of money, massive amounts of cash. Yes, an assessment has been undertaken by the OBR, they have weakened the forecast of business investment on the back of some work they have done. If QE and the zero-bound base rate do help boost confidence, why are private businesses still sitting on huge amounts of unallocated capital?
Ian McCafferty: I think some of the estimates of what is commonly termed the cash mountain, stem from some curiosities in the statistics. Beyond that, I think there are significant issues about changes in corporate behaviour. It is clear that, at the behest of shareholders, companies are operating with higher cash balances than would have been the case before the crisis. They still have recollections of the time soon after Lehman Brothers when they were unable to get cash through the markets when required. As a result, they do wish to be perhaps more precautionary than would have been the case previously. It is also the case that finance directors, in my experience, are in the process of operating at different levels of gearing than would have been the case previously. Around those, we come back to the issue of confidence and until I think we see more confidence about not only the rate of growth in the future but also the certainty of that growth—because we live in very uncertain times—then I think that explains a good deal of why businesses are reluctant to invest more aggressively at this stage.

Q93 Stewart Hosie: Just a final question then. If the fears and uncertainty, the external shocks continue, there is not really very much that monetary policy can do to unlock that cash, is there, in monetary policy terms?
Ian McCafferty: Directly, I think there are limitations as to how you can unlock business investment through monetary policy. Clearly you can ensure that the cost of capital is maintained at as low a level as is possible, which is what has happened with the QE programme and the reduction in bank rate. As I said, beyond that, and to the extent that we can ensure that credit flows to those elements of the business community that are otherwise finding they cannot get credit, that there is a physical shortage of credit availability—and we come back to the FLS scheme in regard to that—then I think clearly there is an issue about animal spirits and that will determine to some extent how quickly business investment picks up over the course of the next year or two.

Q94 Stewart Hosie: One final question, then: if the base rate was doubled, put up by 0.5%, if QE was shifted £50 billion up or down, would it actually make any difference to business confidence?
Ian McCafferty: It is going to depend when such policies were adopted by the Bank and the underlying economic conditions that provoked that change. Clearly, the Bank will not be changing its policy until there is some evidence that the economy is in a recovery phase, at which point I think business confidence is going to be depending on that as well as anything that the Bank does.
Chair: Thank you very much for giving evidence before us this morning. It has been an interesting hour. I am sure we will have many more exchanges in the months and years to come, while you are serving on the MPC. I do not want to pre-empt, in saying that, what we may decide in a confirmation hearing. We will now go into private session. Thank you very much.
Ian McCafferty: Thank you.

Written evidence

Treasury Committee Questionnaire: Response from Mr Ian McCafferty

A. Personal and Professional Background

1. *Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC?*

No.

2. *Do you intend to serve out the full term for which you have been appointed?*

Yes.

3. *Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC? In particular, what areas of the MPC's work do you believe you will make a particular contribution to, and which will you have to undertake additional research into upon your arrival?*

I have been an applied economist for over 30 years, in a variety of roles in business (as Head of Macroeconomics at BP), in the City (as Chief International Economist for NatWest Markets and Director of Economics at Baring Securities) and since 2001, as Chief Economic Adviser to the Confederation of British Industry. In this last role I was responsible for leading and directing all of the CBI's work on economic issues—analysing and monitoring the economy, producing forecasts and developing economic policy positions.

I believe my experience equips me for my role at the MPC in a number of specific ways:

— I have significant expertise in the analysis of the economic conjuncture, the preparation of formal forecasts of the UK economy using forecasting models and making explicit judgements about the economy.

— I have expertise in the generation and interpretation of business survey data, and its strengths and weaknesses. Such data can provide invaluable information to supplement and test preliminary official data. Through the CBI I have also developed close direct contact with businesses and other economic agents, allowing me to develop good understanding of how business both shapes and reacts to economic developments.

— I have detailed experience in analysing other economies, including the US, Germany, France and China. The UK economy is now so integrated with the rest of the world that a good understanding of the developments in these economies is required to make sound judgements about the UK.

— Having worked in the City for 10 years, I have gained an understanding of the interaction between monetary policy and financial markets. From my time at BP, I also gained an understanding of energy and commodity markets, as well as how business operates and interacts with the broader economy.

— My roles have required me to develop an ability to present economic issues to both specialist and non-specialist audiences, and I am keen to use this further during my time on the MPC, to ensure that the work of the MPC is widely understood and supported.

I intend to use my experience as a business economist to make contributions to the work of the MPC in a number of areas. I hope that my knowledge of business surveys and business conditions will support the MPC's analysis of the economic outlook, in particular on pricing behaviour, profit margins and business investment. I also hope to support the Bank in the development of its economic forecasting activities. There are a number of topics on which I would like to undertake additional research on my arrival—these include company finances and investment; the current "productivity conundrum"; and the changing nature of international commodity cycles and their impact on UK inflation.

4. *Which of your publications or papers are of most relevance to your future work on the MPC?*

While at the CBI, and in the City, I regularly published commentary and analysis on the UK and international economies, as well as formal detailed forecasts. I have also published work on the Euro (eg NatWest Markets Guide to the Euro (1997); the CBI analysis on UK membership of the Euro (2002) and on energy markets (eg the BP Statistical Reviews of World Energy 1997–2001).

As an economist working in business, much of my work was not published, but was used as internal analysis by senior management, or as communication with government or information to businesses. While at the CBI, I provided regular briefing to the Bank of England, the Treasury, BIS and the OBR on the economic outlook and business conditions, as well as on topical economic issues. Recently, these have included such topics as: the impact of pension regulation on corporate finances and investment; the availability of credit to the corporate sector and its impact on investment, and changes in labour market functioning and their implications for productivity.

B. Accountability

5. *How important do you think it is for MPC members to be subject to ex post parliamentary accountability? What are the strongest and weakest parts of the current procedures in the UK?*

The operational independence of the Bank of England in setting monetary policy has been critical in delivering credibility that price stability will be achieved over the long term. Bank independence is only operational; the mandate is, rightly, set by Parliament and HMT. But for such operational independence to be democratically viable, it is also necessary that the conduct, thinking and decisions of the MPC are, as far as is consistent with candid discussion and financial market stability, transparent and subject to exacting external scrutiny. While a good deal of such scrutiny is conducted through the media, democratic accountability also requires formal accountability to Parliament.

Such accountability requires the MPC to explain and justify its decisions, and be subject to formal examination and challenge. This is achieved through the combination of the detailed examination of the Committee's thinking at the regular hearings of the TSC and the public letter of explanation to the Chancellor when inflation deviates from the target. I believe that, overall, the current system works well, and is in a number of respects superior to that practiced in other jurisdictions.

Its strengths are the openness with which the hearings are conducted and reported, and the degree of detailed challenge on matters of substance. I see no obvious weaknesses, but there is a risk that, if the letter to the Chancellor were to become a more frequent feature (if, for example, the UK were to be subject to a period of more volatile inflation than has been the case in the past), it might lose some of its effectiveness and symbolic status.

6. *Do you believe there is merit in having an individual paragraph in the minutes of MPC decisions in which to explain your most recent vote?*

One of the strengths of the MPC is the collective nature of its decision-making, and the active debate within the Committee that supports the decision-making process. I believe that that debate, and the opportunity for members to be influenced by the views of others in making their final decisions, is best served by the current system, in which differences of opinion and emphasis are recorded in the Minutes, but without individual opinions being attributed. Such attribution would likely hamper debate and encourage inflexibility in approach. Individual members of the MPC also have good scope to discuss their individual views in the external speeches that they make.

7. *If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?*

I would want to be judged on the basis of my positive contribution to the debate about the performance of the economy and to the analysis that supports the decisions of the MPC, as well as my contribution to communicating the activities of the MPC to wider audiences.

C. Other Professional Activities

8. *What other professional activities do you expect to continue/undertake in addition to your position on the MPC and how do you intend reconciling these activities with your position as a MPC member?*

At present, I have no plans for professional activities other than those related to my position on the MPC. While the contract is nominally for three days a week, more might be required in the early stages as I work myself into the position. Thereafter, if the opportunity arose, I would consider some part-time university teaching.

9. *Outside MPC meetings, what activities do you intend undertaking in order to add to the public's understanding of the role and decisions of the MPC?*

As an MPC member, I intend to be active in supporting the work of the Bank agents throughout the UK, assessing the current economic conjuncture and communicating the views of the MPC through dialogue with business and other audiences. Alongside other members, I intend to act as a representative of the MPC to the wider public, through speeches and other representational activities. I am experienced in communicating economic issues to non-specialist audiences, so am keen to visit schools and other bodies to help explain the work of the Bank and views of the MPC, including becoming involved in the annual Bank 2.0 Challenge.

10. *What role do you plan to take at the end of your term?*

I have no specific plans about my role once I leave the MPC.

D. Monetary And Economic Policy

11. *What do you regard as the major risks to the outlook for the UK economy?*

The continued uncertainty about the outlook for the sovereign debt and banking crisis in the Eurozone continues to weigh on business confidence and, with growth rates across the Eurozone slowing, the risk of a deeper Eurozone recession hitting export demand from the UK (to what is still our largest single export market) has increased. Serious financial market disorder or a banking crisis in the Eurozone would have significant negative effects on the UK economy.

Recently, there have also been signs of a loss of economic momentum more widely, with both the US and Chinese economies slowing since the early part of the year. If this were to persist into 2013, the outlook for the UK would be consequently weaker.

Domestically, the main downside risk lies with the consumer. One of the key reasons that the economy grew more slowly than had been expected in 2011 and 2012 was the significant decline in consumer real disposable income, squeezed by the rise in imported inflation following the sharp rise in sterling-denominated energy prices. UK inflation has fallen sharply, allowing real disposable income growth to start to pick up, and suggesting that consumer spending should slowly recover towards the end of this year and into 2013. However, recent increases in the prices of several raw materials, including crude oil and some agricultural products, if sustained, may lead to inflation falling rather more slowly than set out in the Bank's August forecast, posing a downside risk to the rate of UK consumer demand growth.

These downside risks are to a certain extent already built into existing forecasts of the outlook for the UK. If they do not materialise, or are quickly resolved, growth in the UK economy may be higher than current projections.

12. *What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?*

Both the level of the exchange rate and movements in asset and house prices are included in the framework with which the MPC thinks about the transmission mechanism of monetary policy. Asset and house prices give important information on the likely path of demand, and the exchange rate on import price pressures, so both are critical in considering the appropriate policy stance.

This does not imply that separate or explicit targets for either asset prices or the exchange rate would be appropriate for the MPC with its current mandate. The current inflation target has the advantage of simplicity, and with only a single set of policy tools (the level of short term interest rates and by extension QE), the MPC would risk being unable to achieve targets for different policy variables simultaneously, thus damaging its credibility.

It is, however, now widely accepted that asset prices—and the avoidance of excessive credit growth—are important to the broader stability of the economy, above and beyond their impact on the outlook for inflation, and that policy intervention to influence them directly may be required. Instruments other than Bank Rate, such as those being considered by the Financial Policy Committee, will be required if they are to be specifically targeted.

13. *What is your current estimate of the extent of the output gap?*

Estimates of the output gap are always uncertain, as we cannot measure potential output directly, and at times of major adjustment in the economy, such estimates are more imprecise than normal.

At present different sets of indicators give very different signals about the level of spare capacity:

- Estimates of the current level of GDP, relative to its pre-crisis trend, suggest that the economy is close to 15% below where it would have been had the financial crisis not occurred. However, both the sustainability of the pre-crisis trend in GDP and the current level of GDP are subject to significant uncertainty, and it is likely to be some time before this data is sufficiently robust to be used with full confidence.
- Other data suggest that the degree of slack in the economy is somewhat less than suggested by the GDP analysis. CBI measures of capacity utilisation, for both the manufacturing sector and the non-financial, non-distribution service sector, are closer to their long run means, although these often measure the potential to increase output only in the very short term, without changes to working practices or shifts. Recent trends in the labour market, and in particular, the increase in private-sector employment of the past year, also suggest that the degree of slack in the economy is somewhat lower.

— Direct estimates of the output gap, such as those employed by the OBR, suggest a figure in a range closer to 2½-3%, although these, too, are subject to significant margins of uncertainty.

On balance, I would estimate that the output gap is probably slightly greater than the direct estimates would suggest, but well below that given by the GDP trend analysis. However, at times in which the economy is undergoing major adjustment, with shifts in the contribution to total demand from different sectors and shifts in relative prices underway, a single estimate of the aggregate output gap is not, in itself, the best predictor of inflation, as the spare capacity is unlikely to be evenly distributed across the economy. A more sectorally-disaggregated approach, looking separately at trends in the labour market and capacity utilisation provides more information in assessing future inflation pressures.

14. *What has been the overall effect of quantitative easing on the UK economy?*

It is difficult to be precise about the effects of quantitative easing, both because we do not have a counterfactual of how the economy would have performed without it, and because there is little evidence about likely time lags between the implementation of the policy and the full impact on the economy—as far as the more recent programme of QE is concerned, we are still in the early stages.

However, it would be difficult to argue that it has had no impact. Following the announcement of the first round of QE, asset prices reversed their previous downward trend, and estimates of the impact on gilt yields suggest that they were up to 100bp lower as a result of QE than would have been the case. The impact on both market sentiment and liquidity of the first round of QE, undertaken at a time when credit markets were effectively frozen, seems also to have been positive.

The Bank has produced some estimates of the impact of the first programme of QE on the broader economy, estimating that it raised the rate of inflation by ¾-1½ percentage points, and the level of GDP by 1½-2%, relative to what would have otherwise been the case. These estimates do not look implausible, but are necessarily surrounded by a significant margin of uncertainty, given that the econometric estimates of the effect on the broader economy of an easing in policy through QE are as yet less well understood than those from changes in short-term interest rates.

15. *How important are current measures of inflation expectations when considering the outlook for future inflation?*

Inflation expectations are an important part of the monetary policy framework, in that the credibility of the MPC and of the inflation target are important elements in achieving the inflation mandate. The more stable are inflation expectations, and the more credible the policy framework, the lower the effect on underlying inflation of one-off price shocks to the system, and the greater the consistency of wage- and price-setting behaviour with the inflation target.

It is therefore important that the MPC monitors both the direct surveys of inflation expectations and other indirect indicators. However, such indicators are better interpreted in terms of what they indicate about short term attitudes and behaviour than as predictors of inflation in the medium-term, with which the correlation is poor.

16. *What impact do you think the Funding for Lending scheme and the activation of the Extended Collateral Term Repo Facility will have on the economy?*

Although the quantitative easing programme raised both equity and bond prices and has thus reduced the cost of finance to companies with recourse to the capital markets, the indirect impact of QE on bank lending appears to have been much less, with flows of lending to the broader economy remaining depressed. While some of this will have been due to low levels of demand for bank lending, reflecting the uncertain outlook for the economy, targeted incentives to both boost the volume and reduce the cost of lending, that are built into the Funding for Lending Scheme, are likely to be of benefit. The impact is likely to be supplemented by the changes in the amount of liquid assets that banks are required to hold recently announced by the FSA in response to the recommendation of the FPC. Together these should help expand lending flows to the broader economy, though the impact is likely to be more visible over the medium term, as it is likely to take time for the increase in lending to take effect.

Recent heightened uncertainty about the health of individual Eurozone banks poses risks of illiquidity stress in the inter-bank markets. If inter-bank liquidity were to dry up as it did in the months following the collapse of Lehmans, this would pose risks both to the stability of the UK banking system and further depress levels of lending. The activation of the ECTR, which would permit repo operations against a wider range of collateral, is a useful precautionary measure to help support lending conditions in the event of liquidity stresses within the banking system re-emerging.

CURRICULUM VITAE

Ian Alexander McCafferty

Born 1 July 1956

Education

1978–79 Europa Instituut, University of Amsterdam (NUFFIC scholar)
Diploma in European Economics (MA equivalent)

1975–78 Van Mildert College, University of Durham
Hons BA in Economics Class II 1

1967–74 Dulwich College

Career

2001–12 Chief Economic Adviser, Confederation of British Industry
Responsible for economic research and policy development, interaction with government on economic issues and provision of economic advisory services to CBI member companies

1998–2001 Head of Macroeconomics, BP plc
Responsible for research and analysis of the external economic environment, providing advice to senior management

1993–97 Director, International Economics, Natwest Markets
Co-ordinating regional economic research teams covering the UK, continental Europe, the US, and Asia-Pacific, in support of equity, bond, treasury and investment banking activities

1988–92 Chief European Economist, Baring Securities

1985–88 Head of Economic Trends, Confederation of British Industry

1983–85 Head of Statistics, The Economist newspaper

1979–83 Economist, International Chamber of Commerce, Paris

Other Positions

Member of the Advisory Board, UK Innovation Research Centre (University of Cambridge and Imperial College, London)
Fellow of the Society of Business Economists
Fellow of the Royal Society for the encouragement of Arts, Manufactures & Commerce (RSA)

Visiting Professor at London Metropolitan Business School (2008–12)
Member of the Franco-British Council (2008–12)
Member of the Advisory Board to the Centre for Business Research, University of Cambridge (2004–2010)
Member of the Advisory Board, International Economics Programme, Royal Institute for International Affairs (2004–2010)

ISBN 978-0-215-04969-8

9 780215 049698

PEFC
PEFC/16-33-622

Printed in the United Kingdom by The Stationery Office Limited
10/2012 023531 19585