House of Commons

Treasury Committee

Appointment of Dr Mark Carney as Governor of the Bank of England

Eighth Report of Session 2012–13

Report, together with formal minutes, oral and written evidence

Ordered by the House of Commons to be printed 27 March 2013 pursuant to Standing Order No. 137

HC 944
Published on 19 April 2013
by authority of the House of Commons
London: The Stationery Office Limited
£14.50

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)
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)*
Mr Pat McFadden MP *(Labour, Wolverhampton South West)*
Mr George Mudie MP *(Labour, Leeds East)*
Mr Brooks Newmark MP (*Conservative, Braintree*)
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 and Adam Wales (Senior Economists), Hansen Lu, Matthew Manning (on secondment from the FSA) and Duncan Richmond (on secondment from the NAO) (Committee Specialists), Steven Price (Senior Committee Assistant), Jo Cunningham 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

Contents

Report

Page

1 Introduction **2**

The role of the Governor of the Bank of England 2

The process of appointment of the Governor 2

Special arrangements for Dr Carney 4

Term of office 6

Parliamentary scrutiny of the appointment of the new Governor 7

Our evidence session with Dr Carney 8

Criteria for appointment 8

2 Accountability and leadership style **10**

Accountability of the Bank of England 10

Openness 10

Leadership style 11

3 Financial Stability and regulation **14**

Introduction 14

Capital adequacy of UK banks 14

Leverage ratios 15

Liquidity 16

Recovery and resolution 18

Volcker alongside Vickers 19

Competition 19

Conclusions **23**

Recommendation **24**

Formal Minutes **23**

Witnesses **26**

List of printed written evidence **26**

List of Reports from the Committee during the current Parliament **27**

1 Introduction

1. On 7 February 2013 Bank of Canada Governor Dr Mark Carney, chosen by the Government as the next Governor of the Bank of England, gave evidence to the Treasury Committee in what amounted to a pre-appointment hearing. This was an unprecedented event: no Governor of the Bank of England had previously given evidence to Parliament in advance of taking office.

The role of the Governor of the Bank of England

2. The Financial Services Act 2012 has entirely reformed UK financial regulation and places the Governor of the Bank of England at the centre of the financial system. The Cabinet Office described the formidable extent of the role as follows when advertising for applicants:

> The Governor leads the Bank of England, and plays an important role in setting monetary and regulatory policy, chairing the Monetary Policy Committee, the Financial Policy Committee and (from next year) the board of the Prudential Regulation Authority. The Governor represents the Bank in important international fora, such as the G7, G20, the European Systemic Risk Board and the Bank for International Settlements in Basel. The Governor is an executive member of the Bank's Court of Directors.
>
> The Governor will work closely with the Chancellor of the Exchequer and HM Treasury, which is responsible for setting the framework under which the Bank operates.
>
> The new Governor will lead the Bank through major reforms to the regulatory system, including the transfer of new responsibilities that will see the Bank take the lead in safeguarding the stability of the UK financial system.[1]

The process of appointment of the Governor

3. When Mervyn King was appointed Governor in 2003, the then Treasury Committee did not feel it necessary to hold a hearing with him before he took up his duties, as he was already a member of the MPC—the Committee had held a hearing with him in 1998 after his appointment as Deputy Governor. It did, however, hold a hearing with Mervyn King in July 2003, shortly after he took up the post, on the prospects for his term of office.

4. The Treasury Committee recommended in 2007 that the posts of Governor and the two Deputy Governors should be recruited by open advertisement.[2] When Mervyn King was reappointed for five years with effect from July 2008, the Committee held a hearing with

1 *The Economist*, September 15 2012, page 19

2 Treasury Committee, Twelfth Report of Session 2006–07, The Monetary Policy Committee of the Bank of England: ten years on, para 84

him in April and subsequently published a Report. In June 2008 the then Chancellor of the Exchequer, the Rt Hon Alistair Darling MP, told the Treasury Committee that "In future, the Government will advertise vacancies for the Governor and Deputy Governors of the Bank of England".[3]

5. Sir Mervyn King's second five year term as Governor of the Bank of England ends on 30 June 2013. In September 2012 the Government for the first time openly advertised the post of Governor of the Bank, seeking applications by 8 October 2012. The candidate the Government sought was described as follows:

> The successful candidate must demonstrate that they can successfully lead, influence and manage the change in the Bank's responsibilities, inspiring confidence and credibility both within the Bank, throughout financial markets and in the wider public arena.
>
> *Prior Experience*
>
> The successful candidate will have substantial experience in one or more of the following:
>
> working in, or involvement with, central banking (for example a central bank, the Bank for International Settlements, the International Monetary Fund, or similar institutions);
>
> working at the most senior level of a major bank or other financial institution.
>
> *Role requirements*
>
> **Financial market and economic knowledge**. The successful candidate will have extensive knowledge and experience of financial markets and the risk cultures therein, and be credible on both micro- and macro-economic issues domestically and internationally.
>
> **Leadership and management skills**. The ability to be an effective leader of the senior management team, to encourage teamwork and to develop talent; given the breadth of the Bank's responsibilities, the ability to delegate will be particularly important. The successful candidate will have led a large organisation and will demonstrate personal effectiveness, determination and resilience.
>
> **Communication, influencing and interpersonal skills**. The ability to build good relationships with colleagues within the Bank of England and with other partners, such as the Chancellor of the Exchequer and HM Treasury, market participants, and international counterparts. To be able to communicate with authority and credibility to Parliament, the media, the markets and the wider public.

3 Treasury Committee, Seventeenth Report of Session 2007–08, Banking Reform, Ev 38

Policy skills. The ability to design frameworks and develop policies that will be appropriate for multiple scenarios, and the ability to implement those new policies in a fast-moving environment. This will require significant understanding of the workings of government and regulators—gained through membership of relevant public sector boards, industry bodies or working groups if not through direct experience in policy leadership roles. Acute political sensitivity and awareness will be crucial.

Undisputed integrity and standing. The ability to maintain discretion and engender trust in staff, peers and stakeholders. A willingness to abide by necessary conflict of interest constraints.[4]

6. The recruitment panel was chaired by Sir Nicholas Macpherson, Permanent Secretary at the Treasury. Sir David Lees, Chairman of the Court of the Bank of England, assisted in conducting the process. Nine candidates were shortlisted.[5]

7. The Chancellor himself interviewed the six candidates "deemed appointable" by the panel.[6] He then made his recommendation to the Prime Minister, who made the same recommendation to the Queen, who approved the appointment. The Chancellor announced to the House on Monday 26 November that Dr Mark Carney, at present Governor of the Bank of Canada, would be the next Governor in succession to Sir Mervyn King.[7]

Special arrangements for Dr Carney

8. Dr Carney had said to the BBC in August 2012 that he was not considering the job of Governor of the Bank of England.[8] He told us the reasons that he did not want the job at that stage:

> [...] there was a series of conversations over the course of last year that I had with the Permanent Secretary and with the Chancellor related to this position. My view in the summer of last year and right up and including the 8 October deadline for an application was to not proceed with an application for a few reasons. One was my current responsibilities at the time as Governor of the Bank of Canada. The second was the personal aspects of the job or the personal aspects that would be associated with the move. I have a young family and the transition of countries and schools here and then back was in the end decisive. It was a finely balanced decision, as I think I outlined in my written response, given the immense challenges that are associated with this opportunity.[9]

4 Cabinet Office, Role profile, Governor of the Bank of England

5 HC Deb, 26 November 2012, col 21; Letter from Sir Nicholas Macpherson to Chairman of the Treasury Committee, 9 January 2013

6 Letter from Sir Nicholas Macpherson to Chairman of the Treasury Committee, 9 January 2013

7 HC Deb, 26 November 2012, col 21

8 http://news.bbc.co.uk/1/hi/programmes/hardtalk/9743619.stm

9 Q 1

9. Dr Carney told us that his mind was changed for two reasons:

> What changed was that, subsequent to that decision, the Chancellor suggested to me that the position could be for a period of five years. That was the first point. Secondly, I was informed that Charlie Bean, Deputy Governor for Monetary Policy, had agreed that he would extend his term for an additional year from the time of the selection of the new Governor.[10]

Dr Carney added that this conversation with the Chancellor took place at the Mexico G20 on 4 or 5 November 2012.[11] Dr Carney had by that time been aware for about three weeks that a process had been devised by Sir Nicholas Macpherson for sitting governors of central banks. He had heard this in the period after the deadline for applications had passed on 8 October.[12]

10. Following the Chancellor's announcement, it emerged publicly that special arrangements had been made for Dr Carney to apply for the job. Sir Nicholas Macpherson told us in writing that:

> I decided that a special process was necessary for serving Governors. It became clear that it was impossible for a serving Governor to apply to the timeframe and thus open their own position to uncertainty for two months (on professional, political and economic grounds).
>
> Therefore I devised a process whereby serving Governors could apply at the same time as being interviewed, to limit the risk of potentially destabilising speculation. Since no other serving Governor expressed an interest in the job, this special process only applied to Dr Carney.[13]

In response to a further letter from the Committee Chairman, Sir Nicholas gave more details:

> I was in contact with Dr Carney from February 2012 onwards, as I was with a number of other potential candidates. No other central bank governor expressed an interest in the job, following the advertisement, and so this part of the process was designed with Dr Carney in mind. And given the lack of interest from other governors, I did not see any merit in publicising it. The process was exceptional, reflecting the importance and sensitivity of the appointment. Although I would not want to rule it out for the future, I would expect such a process to be necessary only in exceptional circumstances.[14]

---

10 Q 2

11 Q 3

12 Qq 5–7

13 Letter from Sir Nicholas Macpherson to Chairman of the Treasury Committee, 9 January 2013

14 Letter from Sir Nicholas Macpherson to Chairman of the Treasury Committee, 31 January 2013

Dr Carney told us that the interview took place around 17 November, on a Sunday.[15]

Term of office

11. Until the passage of the Financial Services Act 2012, the Governor of the Bank of England was able to serve two five year terms. Following a recommendation from this Committee, the Government agreed that in future the Governor of the Bank of England should serve for a single, non-renewable, eight-year term, and this is now in statute as a result of the Financial Services Act 2012. However the Chancellor told the House when announcing the appointment that Dr Carney had indicated that he wished to serve as Governor for five years. This, the Chancellor said, would "align with the timing of his role at the [Financial Stability Board], and reflects the fact that by then he will have served for 10 years as a central bank governor".[16] Dr Carney himself told us of several reasons for his preference for a five year term:

> The role comes during a unique period in the Bank's illustrious history as it takes on new responsibilities. The next five years will span a period that will be critical for the future development of the Bank of England itself, for the development of the British, European and global economies, as well as decisive for domestic and international financial reform.
>
> My tenure will oversee a significant transition at the Bank. To be most effective, transitions need to be sharp, sustained and finite. A five-year term is the right managerial timeline to relaunch the Bank of England with its broader responsibilities, and to develop considerable talent, undertake targeted external recruitment, and build a succession plan. Over the five years, we can establish the full potential of the new institutional structure, which combines monetary policy, macroprudential and microprudential regulation. I can also give life to the crucial governance reforms promoted by the Treasury Committee and incorporated in the Financial Services Act.
>
> As an outsider I can—for a period—bring different experiences and perspectives to help catalyse the necessary changes within the Bank to achieve these goals, and I look forward to working with employees of the Bank, the Court, the Government and the Treasury Committee to ensure that the full potential of all of these reforms is realised.
>
> The next five years will also be a decisive period for domestic financial reform. By 2018, the ring-fencing of core banking activities recommended by the ICB should be well on the way to completion and, following agreement of the European Recovery and Resolution Directive, the UK's Special Resolution Regime will have been developed to allow bail-in of banks' unsecured creditors. We will have done much to solve the problem of banks that are too big to fail.

---

15 Q 8. 18 November 2012 was a Sunday.

16 HC Deb, 26 November 2012, col 22

> Over the next five years, the Bank has the ability to extend and broaden its position as a global leader (intellectually and effectively) amongst central banks. The next five years will be the decisive period for international financial reform after the crisis. By 2018, all elements of the Basel III reforms will be agreed and implemented, with capital requirements and the Liquidity Coverage Ratio supplemented with the Net Stable Funding Ratio and a common leverage ratio. A wide range of reforms to OTC derivatives trading will also have been introduced, including capital and margining requirements, measures to impose mandatory exchange trading and centralised clearing of standardised derivatives, and new transparency requirements. In addition, the framework that is being constructed for systemic institutions will have been extended to global insurers and key shadow banks.
>
> Importantly, a five-year term corresponds with my maximum possible term as FSB Chair (terms are 3 years once renewable). Simultaneously serving in both roles will maximise intellectual, managerial and work process synergies at the Bank of England during the critical period for reform.
>
> Finally, from a personal perspective, there are two considerations. First, at the end of a five year term, I will have served as a Governor of a G7 Governor central bank for over a decade. In my experience, there are limits to these highly rewarding but ultimately punishing jobs. Second, the five year term has advantages given the ages of my children and the disruption that is involved in moving schools and countries.[17]

In oral evidence, he gave the impression that personal reasons were highly significant:

> [...] for me, given the ages of my children, it makes a material difference to come here and then return to Canada. I will be more specific. My eldest daughter will just finish high school over the course of five years. The second-eldest daughter will have two years in which to reintegrate into a French school system in the Canadian school system, which is what she would do.[18]

Parliamentary scrutiny of the appointment of the new Governor

12. In our Report of 2011 into the Accountability of the Bank of England we recommended that, in order to safeguard the independence of the Governor, the Treasury Committee be given “a statutory power of veto over the appointment and dismissal of the Governor of the Bank of England,” similar to the power given to the Treasury Committee over the appointment of the Chair of the Office for Budget Responsibility.[19] In its response to our Report, the Government argued against our recommendation:

> The Government believes the independence of the Governor of the Bank of England is vital, and is confident that this independence is safeguarded via existing

17 Ev 32

18 Q 2

19 Treasury Committee, Twenty-first Report of Session 2010–12, *Accountability of the Bank of England,* HC 874, para 148

> mechanisms, such as his appointment by the Queen. The Bank of England and the Office for Budget Responsibility perform materially different roles. The Bank of England undertakes policy actions that directly affect markets and, as such, appointments to the Bank's executive or policy committees are market sensitive. This market sensitivity makes these roles unsuitable for pre-appointment vetting. The Government hopes that the TSC will continue to hold pre-commencement hearings for the members of the Bank's policy committees, which include the Governor and Deputy Governors.[20]

13. When the Chancellor announced the appointment, he told the House that Dr Carney wished to appear before the Treasury Committee before taking up his appointment, and that Dr Carney would not otherwise be commenting at length on British economic policy until he took up his post.[21] The Committee announced later that day that it would hold what would amount to a pre-appointment hearing with Dr Carney and report its conclusions to the whole House. If necessary, the Committee said that it would request that its recommendations be debated on the floor of the House.

Our evidence session with Dr Carney

14. Our meeting on 7 February 2013 gave Dr Carney time to answer a detailed questionnaire in advance covering his views on a wide range of topics relevant to his role as Governor. This, along with the CV that he also provided, was the basis for much of our questioning. The publication of the questionnaire, and the public oral evidence, have allowed the general public, policy makers and those with a professional interest to have a clear idea of Dr Carney's views and approach in advance of his taking up his role.

15. **The incoming Governor made clear that he would speak to the Treasury Committee before making other statements. The detailed examination of his views in this hearing, and the wider public scrutiny that comes with it, should assist the Governor's efforts to explain his approach to the public. We will follow a similar pre-appointment process for the appointment of subsequent Governors, and maintain our scrutiny once he has take up his appointment.**

16. We are most grateful to Dr Carney for travelling to London specially for his meeting with the Committee, and for providing full and helpful answers—both in writing and in person—to the Committee's questions.

Criteria for appointment

17. When considering appointees for the Monetary Policy Committee, we judge them against criteria of professional competence and personal independence. The Governor's role is much wider than that of an MPC member, so we questioned Dr Carney on a range of subjects in order to reach a judgement in addition as to his skills and experience,

20 HM Treasury, A new approach to financial regulation: securing stability, protecting consumers, January 2012, Cm 8268, para B.30

21 HC Deb, 26 November 2012, col 22

leadership qualities and views on the governance and accountability of the Bank of England.

18. **Following the meeting with Dr Carney, the Committee issued a press release confirming his appointment. We conclude that he has the necessary professional skills, qualities and experience, and personal independence, to be Governor of the Bank of England.**

19. The Committee wishes Dr Carney every success for his term as Governor, and looks forward to our future meetings with him, including the regular evidence sessions we hold with the Monetary Policy Committee and the Financial Policy Committee.

20. Dr Carney's views on the UK's future monetary policy framework could be of great significance. Since we heard evidence from him, however, the Chancellor has announced in the Budget changes to the remit of the Monetary Policy Committee. The Government discussed the new remit with the present Governor and Dr Carney, and it has their agreement, but the content of those discussions has not been made public.[22] These changes have formed part of our inquiry into the Budget and we will report our conclusions, based in part on Dr Carney's evidence, in that Report.

22 HM Treasury, *Review of the monetary policy framework,* March 2013, p5

2 Accountability and leadership style

Accountability of the Bank of England

21. We asked Dr Carney whether the Bank should have a formal obligation to respond to reasonable requests from the Treasury Committee for information or for retrospective reviews to be conducted by the new Oversight Committee of the Court. He appeared somewhat surprised that this should be a matter of any dispute, and took the view that "we have a responsibility to respond to reasonable requests of this Committee". He had no objection to this being a statutory obligation.[23] **It is regrettable that the Government did not place a statutory duty upon the Bank to respond to reasonable requests from the Treasury Committee for information, nor for retrospective review, during the passage of the Financial Services Act 2012. It should do so at the next legislative opportunity in the Financial Services (Banking Reform) Bill. We nevertheless welcome Dr Carney's appreciation of his duty of accountability to this Committee and will expect it to be reflected in our dealings with the Bank under his leadership.**

22. Dr Carney also responded positively to the proposition that the Oversight Committee—the new sub-committee of the Court which will be able to commission retrospective reviews of Bank performance—should have a small permanent secretariat of Bank of England staff.[24] Again, his open-mindedness is welcome.

Openness

23. We welcome the fact that Dr Carney was prepared on occasion to offer views on things that his predecessors would have been reluctant to comment on publicly. For example, in his questionnaire he gave his view on how changes in individual countries could contribute to ameliorating the problems in the eurozone:

> [...] a sustained process of adjustment in relative competitiveness will be needed. The burden of that adjustment cannot be only on increasing unemployment and falling wages in countries like Spain. Deflation in the peripheral countries will not likely prove any more tolerable than it did in the United Kingdom under the gold standard of the 1920s. An increase in German wages and private demand (and inflation) would ease the transition. It is striking that German real wages barely grew in the two decades before the crisis.[25]

He told us that he intended to continue to offer such comment.[26]

23 Qq 45–6

24 Q 48

25 Ev 57

26 Q 99

Leadership style

24. In the questionnaire Dr Carney described his own leadership style:

> Given my background, I believe I know how to lead, when to delegate and how to forge consensus. I have long and varied experience chairing committees of independent experts (ranging from economists to national policy-makers, heads of global standard setters and senior representatives of international organisations) to develop timely, substantive policy conclusions across a range of monetary policy and financial stability issues.
>
> My leadership approach has been to develop a shared vision for the organisation, set out clear priorities to achieve that vision, ask critical questions to engage colleagues and spur analysis, and work towards consensus to take actions. I am comfortable adapting my opinions in the face of superior argument and analysis, but am also disciplined in the need to come to timely decisions (as my experience in crisis management demonstrates). I believe that this combination of flexibility and focus has enhanced my effectiveness as a leader.
>
> Both of the organisations I currently head operate on the basis of consensus. In my experience consensus can only be truly achieved if there is a shared understanding of objectives and all parties feel their views have been considered. In the end, effective central bankers must appreciate the inherent challenge they constantly face of making timely decisions under uncertainty. I am a firm believer in central bank accountability and I intend to do my part to ensure that the new accountability measures in the *Financial Services Act* are fully and effectively utilised.
>
> My experience as Governor of the Bank of Canada demonstrates a willingness and ability to implement significant organisational change. I manage an organisation of about 1,200 people across six offices, four time zones and in two official languages. Upon becoming Governor, I initiated a major reorganisation of our four policy departments, clarified the lines of responsibility of senior policy-makers, streamlined and delegated operating management. [...][27]

The repeated references to consensus are noteworthy, but Dr Carney was reluctant to be drawn into a comparison between his own style and that of the present Governor.[28] He did, however, concede that while the Bank of Canada operated on the basis of consensus, the structure of the Bank of England's committees would make his new environment a different one:

> [...] I fully recognise that with the voting structure of the FPC and the MPC, the individual accountability of the FPC and the MPC and the workings of the PRA board [it] will not always be possible to have consensus. That is fine. [...] I also recognise that, as Governor, I will from time to time likely be in the minority. That is

27 Ev 31

28 Q 20; Ev 32

> also fine. What I would view my job to be is to ensure that all views are heard, all arguments and all analyses are appropriately followed up, and then the decision is made by the individuals.[29]

Later, he told us that he was prepared for external MPC members publicly to disagree with him, and over the course of his term also to be outvoted on the MPC.[30] He believed, however, that consensus was of particular importance in respect of the FPC:

> [...] if we look at the decisions of the FPC and compare them to the MPC when there are decisions necessary around a range of possible instruments and working to an objective that is not easily summarised as one indicator—in other words, MPC ultimately working towards price stability as measured by CPI; the FPC working towards financial stability that can only be represented by a wide range of indicators, a wide range of tools—there it is particularly important to send a clear message as much as possible, which requires true consensus decision-making.[31]

25. Dr Carney also told us that "Transformed responsibilities will mean a transformed institution", and that among the challenges facing him would be the following:

> —A clear shared vision for the Bank needs to be established, synergies from the collection of policy functions maximised and the expanded senior management team melded into a cohesive unit.
>
> —Succession planning and talent management will be paramount. The Bank will need to attract, retain and promote an assertive, engaged, accountable staff at all levels. The Bank should develop its team culture that promotes timely, well-researched and consensus-based decisions.
>
> —The Bank will need to build an effective, efficient central support function to serve all areas of the expanded institution and fully leverage a new organisational structure, including a new Chief Operating Officer role, to ensure value for taxpayers.
>
> —The Bank must realise fully the complete potential of the accountability and governance changes instituted in the Financial Service Act to enhance the credibility of, and trust in, the institution.
>
> —Throughout, the Bank should reinforce its existing culture of excellence as a learning institution that engages with academia, other central banks and private sector experts in the pursuit of its core objectives.[32]

26. The Bank of England remains a hierarchical organisation, as the recent report to the Court by Bill Winters said:

---

29 Q 21

30 Qq 55–6

31 Q 22

32 Ev 30–31

> [...] the Bank retains a highly centralised decision-making structure, with ultimate authority and accountability residing with the Governor.
>
> [...]
>
> There are [...] likely to be costs associated with such a structure, the most significant one being the large volume of decisions that are required to be taken by the Governor and senior management. This has two potential consequences. First, it risks senior management being distracted from other pressing or strategic issues on which they might otherwise focus. And second, it may contribute to a perceived need by staff to undertake a degree of pre-filtering of policy options to streamline the decision-making process.
>
> Filtering of analysis and options by staff is a necessary process to allow effective decision-making by senior staff. Ideally, the decision-makers in an organisation should be presented with options that represent a complete range of relevant views from the organisation, on a timely basis, with clear accountability in place as to the ownership of those analyses and recommendations. But there appears to be some tendency within the Bank for staff to filter recommendations in such a way as to maximise the likelihood that senior staff will find the recommendation palatable. This facilitates an easier and speedier decision-making process on the issue at hand. But it risks reducing the range of views and options that senior management see and, as such, might lead to a less effective overall outcome, and with less clear accountability for the decisions that have been taken during that process.[33]

27. **The new Governor has given a commitment to consensus-based decision making, and to transforming the Bank of England. If these commitments result in meaningful change to the current hierarchical decision making processes and culture of the Bank, this will be a highly significant development.**

33 *Review of the Bank of England's framework for providing liquidity to the banking system,* Report to the Court of the Bank of England by Bill Winters, October 2012

3 Financial Stability and regulation

Introduction

28. Dr Carney in written evidence told us that he saw promoting financial stability—"by building a more transparently resilient financial system that engenders confidence and is able to provide the credit growth necessary to support a sustained recovery"—as his "second core policy responsibility" alongside monetary policy and the delivery of price stability.[34] Dr Carney outlined his priorities in order to achieve this goal, the second of which was building "understanding of the new regime as one in which it is understood that financial institutions can fail, but that, if they do, their failure will be controlled and will not threaten the system".[35] In oral evidence, Dr Carney explained that it was not his "intention to run a zero failure regime ... for institutions", and that "the thrust of many of the reforms was to ensure that institutions can fail safely".[36] Dr Carney, in written evidence, also stressed that "the implicit state subsidy for banks needs to be removed". To do this, he said, it was necessary "to make the ICB [Independent Commission on Banking] proposals a reality and to establish a full and credible resolution regime to sort out failing banks without recourse to the taxpayer".[37]

Capital adequacy of UK banks

29. The November 2012 meeting of the Bank of England Financial Policy Committee examined the adequacy of the amount of capital being held by UK banks. It concluded that:

> [...] the Committee recommended that the FSA takes action to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. Where such action reveals that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, the FSA should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy.[38]

Dr Carney, when asked about the FPC's recommendation, spoke of the importance of "ensuring that the core of the British financial system ... the core banks at the heart of the British financial system" were "transparently and adequately capitalised".[39] He acknowledged that "there have been some questions around the adequacy of their [the banks] capitalisation", adding that it was:

34 Ev 30

35 Ev 30

36 Q 33

37 Ev 30

38 Record of the Interim Financial Policy Committee meeting, 21 November 2012, 4 December 2013, para 19

39 Q 108

> in the interests of everyone that there is a speedy resolution or conclusion to that review, and that it is transparent and clear that the capitalisation is adequate of those institutions.[40]

30. We asked Dr Carney how banks could be expected to recapitalise in the current environment without adversely impacting on lending to the real economy. He told us that:

> The spirit of the FPC recommendation is exactly that that should not be what happens and that the adjustment in the capital ratios of the institutions is made through capital-raising. There are a variety of forms of capital-raising. It can be done through higher retained earnings, which can be got through a variety of mechanisms, asset dispositions, restructuring and other aspects, or shrinking of ex-UK balance sheets as opposed to British balance sheets.[41]

When pressed further as to whether banks would merely shrink their balance sheets rather than raise additional capital, he replied that "the alternatives are to shrink other aspects of the balance sheet outside of the country. Some alternatives could be accretive dispositions of certain lines of businesses or release capital from certain lines of businesses ...".[42]

Leverage ratios

31. The ICB in its final report made a number of recommendations on loss-absorbency and capital requirements on ring-fenced banks. It proposed raising Tier 1 capital requirements for large ring-fenced banks from 8.5% to 11.5% of risk-weighted assets. The Government has agreed to implement this proposal. The ICB also proposed increasing the leverage ratio requirement on these banks by the same proportion, from 3 per cent to 4.06 per cent. The Government rejected this proposal.[43]

32. Subsequently, the Parliamentary Commission on Banking Standards—which has been conducting pre-legislative scrutiny of the Banking Reform Bill which will implement the ICB's financial stability proposals—has called upon the Government to reconsider its decision in this area.[44] We asked Dr Carney where he stood on this question. Dr Carney said that he agreed with the "logic" of raising the leverage ratio, telling us that "in order for the leverage ratio to be an effective backstop it should similarly be raised". He believed that sticking with the lower leverage ratio would mean that the regulatory authorities would need to place:

> a bigger emphasis or importance on supervision of those assets that have a relatively low risk weight under the risk weighting scheme because as you know what the

40 Q 108

41 Q 122

42 Q 124

43 Independent Commission on Banking, *Final Report : Recommendations,* September 2011

44 Parliamentary Commission on Banking Standards, First Report of Session 2012–13, *First Report,* 21 December 2012, HC 848, para 294

> leverage ratio really protects the system from is those assets that we think are low risk but in fact are not.[45]

33. Dr Carney was asked about the leverage ratio for Canadian banks. He told us that "the leverage ratio in Canada is calculated differently but it is a 20 to 1 ratio", which meant Canadian banks operated "at about 16 or 17 times [leverage]". Dr Carney ended by stressing that if he could "pick one reason why Canadian banks fared as well as they did, it was because we had a [lower] leverage ratio".[46]

Liquidity

34. Basel III, for the first time, introduces global rules on liquidity. The importance of introducing new liquidity requirements on banks was demonstrated during the financial crisis when many institutions suffered strains on their liquidity:

> During the early "liquidity phase" of the financial crisis that began in 2007, many banks—despite adequate capital levels—still experienced difficulties because they did not manage their liquidity in a prudent manner. The crisis again drove home the importance of liquidity to the proper functioning of financial markets and the banking sector ... The rapid reversal in market conditions illustrated how quickly liquidity can evaporate and that illiquidity can last for an extended period of time. The banking system came under severe stress, which necessitated central bank action to support both the functioning of money markets and, in some cases, individual institutions.[47]

The new liquidity regime contains two minimum standards for funding liquidity:

- promoting short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month—the Liquidity Coverage Ratio (LCR);
- promoting resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis—the Net Stable Funding Ratio (NSFR) which has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities.[48]

35. In early January 2013 the Group of Governors and Heads of Supervision announced significant changes to the Basel III liquidity rules which gave banks an additional four years to meet international liquidity requirements as well as allowing them to use a wider range of assets as part of their liquidity buffer. We asked Dr Carney, who was part of the Group who made this decision, whether this was a pragmatic decision in the light of prevailing

45 Q 128

46 Qq 129–130

47 Bank for International Settlements, Basel III: International framework for liquidity risk measurements, standards and monitoring, December 2010, p1

48 Bank for International Settlements, Basel III: International framework for liquidity risk measurements, standards and monitoring, December 2010, p1

economic circumstances or the first step in watering down the new capital and liquidity regime. He told us that he "wholeheartedly supported the new agreement":

> The spirit of that meeting was to get the right ratio, the LCR, the liquidity-coverage ratio, so the Banks manage their short term liquidity appropriately, have appropriate liquidity buffers. We wanted to get the right requirement there, and that is why we have a medium term phase-in. That phase-in, as you know, does not just start in four years, it starts in a couple of years, and then starts from a 60%, ultimately to 100% of the new LCR. So it starts in 2015 and dovetails with the Basel capital regime.[49]

Dr Carney explained that the "definition of what is a liquid asset was broadened to be measured on the basis of liquidity, actual, demonstrable and demonstrated liquidity as opposed to credit-worthiness". He went on to say that "originally ... the only things that were [accepted as] liquid assets were government bonds", but that the "recent experience in peripheral Europe" showed "that there were a number of government bonds which were anything but liquid, but they would have counted under the old LCR".[50] By contrast, he noted that:

> equities, listed equities in the main indices, which, one might not like the price on a given day, ... are always liquid, you can always buy or sell those securities so, with an appropriate haircut, should be in the numerator of the LCR. They were brought in, as one example. We also brought in a broader range of corporate bonds and asset-backed securities. All sensible things measured on true liquidity, so the resources available to meet short-term obligations of the banks were expanded.[51]

36. We asked Dr Carney whether, and why, the Group of Governors and Heads of Supervision had initially focussed their attention on the capital requirements aspects of Basel III and whether this was to the detriment of the liquidity rules. Dr Carney explained that Basel I and II did not contain a liquidity standard and that "this was a new standard". As a result "there needed to be an observation period and to make adjustments as necessary to that liquidity standard".[52] He told us that it was important to have an initial focus on capital because:

> First, there was a manifest deficiency in capital as a result of the crisis, in the run-up to the crisis and in the aftermath of the crisis, and it was important to address ... to ensure that banks started to move, in a phased approach, to build capital.
>
> The second reason why there was less focus on liquidity than capital is because, in an environment where liquidity was strained in the major economies, and now this is largely an issue in Europe as opposed to the other major economies, but in an

49 Q 105

50 Q 105

51 Q 105

52 Q 106

> environment when liquidity is strained, this is not a minimum. The liquidity standards are buffers, not minimum.[53]

Dr Carney expanded on his second point, reiterating that "in a strained environment banks should be able to draw on these buffers and as necessary, central banks provide backstop liquidity through a variety of facilities". He expressed concern that it was not "widely enough appreciated either within the institutions or within the broader market, that these are buffers that are meant to be drawn upon".[54]

37. Some banks have been critical of the new liquidity standard on the grounds that it would constrain their ability to lend to the real economy. We asked Dr Carney about the extent to which he expected the relaxation of the liquidity standard to result in an increase in lending. Dr Carney appeared sceptical about the argument put forward by the banks, telling us that this "was an argument from the banks, to which I do not fully subscribe, quite frankly".[55]

Recovery and resolution

38. We asked Dr Carney about international progress on recovery and resolution plans. This was in the context of comments he had made at the World Economic Forum in Davos that regulators around the world were still some way from solving the problem of how to deal with the failure of a giant global bank despite making progress on the issue.[56] Dr Carney outlined the work and future programme of the Financial Stability Board in this area:

> The intention ... is that for all the 28 global systemically important banks, their recovery resolution plans are due to be submitted or completed by this summer. There is going to be a review of each one by a college, chaired effectively by me as Chair of the Financial Stability Board, and there is going to be a broader peer review of the effectiveness of the resolution approaches in the relevant jurisdictions.[57]

However, Dr Carney went on to explain that he expected to "find potentially a wide variance in the effectiveness of these plans, partly because of a variance in the legislative authorities that officials have, partly because of variance in the preparation of different institutions". When questioned about progress to date, he said he was:

> confident that we are making substantial progress and that it remains achievable but there is significant work still to be done even in the most advanced jurisdictions.[58]

53 Q 106

54 Q 107

55 Q 106

56 'Carney cautious on failing banks', *Financial Times*, 28 January 2013

57 Q 115

58 Q 120

Dr Carney singled out the UK and USA for praise, telling us that "the jurisdictions that are the most advanced, in my reading, are the United States and the United Kingdom, particularly because there has been work led by Paul Tucker and Adair Turner on cross-border resolution, cross-border agreements".[59] Dr Carney told us that "some banks" had missed the end of 2012 deadline for submitting recovery and resolution plans, but stressed that it would be "inadvisable" for these banks to miss the new deadline:

> If they miss the new deadline it will be brought to the attention of their head of Government, head of State at the G20 Summit in St Petersburg as being one of the elements of my report to them so it is inadvisable to miss the deadline[60].

Dr Carney went on to make clear "this is not an issue in the UK".[61]

Volcker alongside Vickers

39. The Parliamentary Commission on Banking Standards is examining the case for "supplementing the proposed UK ring-fence with something akin to the Volcker rule"—essentially a prohibition on banks engaging in proprietary trading—which would introduce "a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading".[62] We asked Dr Carney whether he saw any merit in this idea. His answer was unambiguous:

> No, I do not think you should overlay a Volcker Rule on top of the Vickers recommendations. I think the ring fence model is a superior model to the Volcker Rule.

He went on to outline some of the difficulties:

> It is extremely difficult to draw the line between market making and proprietary trading ... and it would unnecessarily, amongst many other things, divert the supervisor's attention from amongst other things, not just prudential responsibilities, but fulfilling that responsibility on ensuring that the ring fence is respected.[63]

Competition

40. In our questionnaire we asked Dr Carney whether we thought that the UK banking system was too concentrated. He said that, "as the prudential regulator" his focus would be "on the protection of depositors, policyholders and taxpayers".[64] Dr Carney did, however, offer some observations on the link between financial stability and concentration in the

59 Q 115

60 Q 116–117

61 Q 118

62 Parliamentary Commission on Banking Standards, First Report of Session 2012-13, *First Report,* Conclusions and recommendations, 21 December 2012, HC 848, paras 96–7

63 Q 136

64 Ev 50

banking sector and also outlined ways in which the new Prudential Regulation Authority (PRA) could contribute to reducing concentration levels in the UK banking sector. On the link between concentration and financial stability, Dr Carney argued that there was:

> no direct relationship between banking concentration and financial stability. Some countries (Canada, Australia) with concentrated systems proved more stable during the crisis. Others (the UK, Netherlands and Switzerland) did not.[65]

However, Dr Carney was "clear that concentration makes instability more costly". This was because:

> in concentrated systems, individual banks are more likely to be systemic and/or too big to resolve safely. In the UK, the six largest banks and building societies dominate UK deposit-taking and lending.[66]

Dr Carney went on to argue that the high level of concentration in the UK banking sector had a detrimental impact on the real economy during the financial crisis:

> The two largest lenders—Lloyds and RBS—account for 45 per cent of the total stock of lending. That concentration has meant that it has been difficult for other banks to fill the gap created in domestic lending growth caused by the adjustment at those banks. While larger corporate borrowers have had recourse to capital market funding, SMEs have seen their access to funds restricted. In that sense, the UK banking system was too concentrated prior to the crisis.[67]

Dr Carney outlined ways in which the PRA could contribute towards reducing concentration in the sector. Firstly, he spoke of how the PRA would act to "lower barriers to entry". Dr Carney argued that this was now possible, given that "with a deposit guarantee scheme and a resolution regime in place, banks, particularly smaller ones, will be able to fail without threatening the stability of the banking system as a whole". As a result, he believed that it followed that:

> the prudential requirements on new entrants can, and should, be lighter than they have been in the past, although some minimum standards must of course be maintained. The PRA is therefore reforming its authorisation requirements for banks in ways that reduce barriers to entry. We all need to recognise and accept that, under this regime, new entrants to the banking market may, from time to time, fail, but that this the flipside of a market that is truly open to competition.[68]

41. We also asked Dr Carney whether the PRA should be given a secondary competition objective. Unlike the FCA, which has an operational objective to promote competition, the PRA merely has a 'have regard' duty with respect to competition, namely to "the need to

65 Ev 50

66 Ev 50

67 Ev 50

68 Ev 49

minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions”.[69]

42. The Treasury Committee, during the passage of the Financial Services Bill, reiterated its view that the PRA should be given a secondary competition objective:

> It remains our view that competitive markets need both freedom to exit and freedom to enter. The Bill contains no proposal for specific objectives related to competition for the Prudential Regulation Authority. We recommend that the House of Lords consider amending the Bill to make competition an objective of the Prudential Regulation Authority.[70]

Dr Carney, however, believed that the “have regard to responsibility” struck “the right balance given the principal responsibility of the [PRA] organisation”. This was because:

> While I believe quite strongly in the value of competition and I do not view that vibrant competition is inconsistent with financial stability, I do think that it is important that the various policy arms of the Bank, to the maximum extent possible, have very clear remits in principal responsibility so I would be a little hesitant on further reinforcing that.[71]

43. **During the passage of the Financial Services Act 2012 the Treasury Committee called for the Prudential Regulation Authority to be given a secondary competition objective. The experience of the FSA shows that a ‘have regard’ duty in practice means no regard at all. The Committee notes the recent publication by the Bank of England and the FSA of *A review of requirements for firms entering into or expanding in the banking sector*. This is a step forward. Nevertheless, with only a ‘have regard’ duty given to the PRA, the risk will remain high that, in time, it may merely pay lip service to competition considerations. This would be of great concern, given the potential for prudential requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants. The concentration of the banking system, in particular, acts against the interests of both business and personal bank customers. For these reasons we do not agree with Dr Carney that the current legislation strikes an adequate balance in this area.**

44. The Treasury Committee has had a long-standing interest in increasing opportunities for personal current account customers to switch accounts. In our March 2011 Report Competition and choice in retail banking we examined the issue in some detail. At that stage, we recommended that “an independent technical study should be done into how account portability could operate”.[72] Two years after this recommendation, the relevant authorities have yet to produce such a study. **We deprecate the failure to produce such a study. There is clear evidence that in the retail banking market, customers often choose**

69 Financial Services Act 2012, section 6

70 Treasury Committee, First Report of session 2012-2013, *Financial Services Bill,* para 57

71 Q 114

72 Ninth Report from the Treasury Committee, Session 2010-11, *Competition and choice in retail banking,* para 121

not to switch supplier even when they have experienced high costs and/or poor levels of service. It is therefore very disappointing that account portability has yet to be thoroughly examined. We therefore welcome Dr Carney's comment that he is "very open-mined" on the question of whether the UK should introduce bank account portability.[73]

73 Q 113

Conclusions

1. The incoming Governor made clear that he would speak to the Treasury Committee before making other statements. The detailed examination of his views in this hearing, and the wider public scrutiny that comes with it, should assist the Governor's efforts to explain his approach to the public. We will follow a similar pre-appointment process for the appointment of subsequent Governors, and maintain our scrutiny once he has take up his appointment. (Paragraph 15)

2. Following the meeting with Dr Carney, the Committee issued a press release confirming his appointment. We conclude that he has the necessary professional skills, qualities and experience, and personal independence, to be Governor of the Bank of England. (Paragraph 18)

3. The new Governor has given a commitment to consensus-based decision making, and to transforming the Bank of England. If these commitments result in meaningful change to the current hierarchical decision making processes and culture of the Bank, this will be a highly significant development. (Paragraph 27)

4. During the passage of the Financial Services Act 2012 the Treasury Committee called for the Prudential Regulation Authority to be given a secondary competition objective. The experience of the FSA shows that a 'have regard' duty in practice means no regard at all. The Committee notes the recent publication by the Bank of England and the FSA of A review of requirements for firms entering into or expanding in the banking sector. This is a step forward. Nevertheless, with only a 'have regard' duty given to the PRA, the risk will remain high that, in time, it may merely pay lip service to competition considerations. This would be of great concern, given the potential for prudential requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants. The concentration of the banking system, in particular, acts against the interests of both business and personal bank customers. For these reasons we do not agree with Dr Carney that the current legislation strikes an adequate balance in this area. (Paragraph 43)

5. We deprecate the failure to produce such a study. There is clear evidence that in the retail banking market, customers often choose not to switch supplier even when they have experienced high costs and/or poor levels of service. It is therefore very disappointing that account portability has yet to be thoroughly examined. We therefore welcome Dr Carney's comment that he is "very open-mined" on the question of whether the UK should introduce bank account portability. (Paragraph 44)

Recommendation

1. It is regrettable that the Government did not place a statutory duty upon the Bank to respond to reasonable requests from the Treasury Committee for information, nor for retrospective review, during the passage of the Financial Services Act 2012. It should do so at the next legislative opportunity in the Financial Services (Banking Reform) Bill. We nevertheless welcome Dr Carney's appreciation of his duty of accountability to this Committee and will expect it to be reflected in our dealings with the Bank under his leadership. (Paragraph 21)

Formal Minutes

Wednesday 27 March 2013

Members present:

Mr Andrew Tyrie, in the Chair

Mr Pat Mcfadden
Mr Brooks Newmark
John Thurso

Draft Report (*Appointment of Dr Mark Carney as Governor of the Bank of England*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 44 read and agreed to.

Resolved, That the Report be the Eighth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

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

Written evidence was ordered to be reported to the House for printing with the Report

[Adjourned till Tuesday 16 April at 9.45 am

Witnesses

Thursday 7 February 2013 *Page*

Dr Mark Carney, Governor, Bank of Canada Ev 1

List of printed written evidence

1	Dr Mark Carney: Responses to the Treasury Committee’s questionnaire	Ev 29
2	Dr Mark Carney: Biographical note	Ev 60
3	Professor Simon Wren-Lewis, Oxford University	Ev 63
4	British Chambers of Commerce	Ev 64
5	Association of British Insurers	Ev 64
6	Professor Jagjit Chadha, Chair in Banking and Finance, School of Economics, University of Kent	Ev 65

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 475
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725
Twenty-sixth Report	Financial Conduct Authority	HC 1574
Twenty-seventh Report	Accountability of the Bank of England: Response from the Court of the Bank	HC 1769
Twenty-eighth Report	Financial Conduct Authority: Report on the Governments Response	HC 1857
Twenty-ninth Report	Closing the tax gap: HMRC's record at ensuring tax compliance	HC 1371
Thirtieth Report	Budget 2012	HC 1910

Session 2012–13

First Report	Financial Services Bill	HC 161
Second Report	Fixing LIBOR: some preliminary findings	HC 481
Third Report	Access to cash machines for basic bank account holders	HC 544
Fourth Report	Appointment of Mr Ian McCafferty to the Monetary Policy Committee	HC 590
Fifth Report	The FSA's report into the failure of RBS	HC 640
Sixth Report	Appointment of John Griffith-Jones as Chair-designate of the Financial Conduct Authority	HC 721
Seventh Report	Autumn Statement 2012	HC 818
Eighth Report	Appointment of Dr Mark Carney as Governor of the Bank of England	HC 944

Oral evidence

Taken before the Treasury Committee

on Thursday 7 February 2013

Members present:

Andrew Tyrie (Chair)

Stewart Hosie
Andrea Leadsom
Mr Andrew Love
Mr Pat McFadden
John Mann
Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witness

Witness: **Dr Mark Carney**, Governor of the Bank of Canada, gave evidence.

Q1 Chair: Morning, Dr Carney. Thank you very much for coming in to give evidence this morning, for what I think might turn out to be an important hearing. We are also very grateful to you for the very detailed response you gave to our full questionnaire, which we are publishing at the same time as this hearing. What we will do is divide this session into two areas: the first monetary and the second financial policy. We will take a short break between the two. Before we get on to that, I think there are a number of questions that it might be worth asking about the process of your appointment. Can I begin by asking you why you changed your mind about this job? Originally, you said no, I think, in August 2012. Then you completely changed your mind. Why; what changed your mind?
Dr Carney: Thank you very much, Chairman. Thank you to the Members for having me here today. May I also thank you for the quite wide-ranging and thought-provoking set of questions that you did send. I think it is a good way to start off this crucial dialogue.
In terms of the question, in terms of my decision process, there was a series of conversations over the course of last year that I had with the Permanent Secretary and with the Chancellor related to this position. My view in the summer of last year and right up and including the 8 October deadline for an application was to not proceed with an application for a few reasons. One was my current responsibilities at the time as Governor of the Bank of Canada. The second was the personal aspects of the job or the personal aspects that would be associated with the move. I have a young family and the transition of countries and schools here and then back was in the end decisive. It was a finely balanced decision, as I think I outlined in my written response, given the immense challenges that are associated with this opportunity.

Q2 Chair: These are explaining why you did not apply. My question really is: why did you decide to reapply?
Dr Carney: What changed? What changed was that, subsequent to that decision, the Chancellor suggested to me that the position could be for a period of five years. That was the first point. Secondly, I was informed that Charlie Bean, Deputy Governor for Monetary Policy, had agreed that he would extend his term for an additional year from the time of the selection of the new Governor.
The first aspect I can appreciate, given that it is a personal decision, may not seem so decisive, but for me, given the ages of my children, it makes a material difference to come here and then return to Canada. I will be more specific. My eldest daughter will just finish high school over the course of five years. The second-eldest daughter will have two years in which to reintegrate into a French school system in the Canadian school system, which is what she would do.
Chair: It was your daughters who were decisive in this decision?
Dr Carney: Yes, I did not take good counsel.

Q3 Chair: It is a novelty at least. When did the Chancellor have this conversation with you offering five years rather than eight?
Dr Carney: I can remember distinctly. It was at the Mexico G20, which was, I believe, the night before the American elections; so, 4 or 5 November.

Q4 Chair: Did it occur to you that the application deadline had closed about a month earlier?
Dr Carney: I was fully aware of that.

Q5 Chair: How did you respond? Did you not say, “Well, has the application deadline not closed?” Isn’t that the first thing one might ask somebody approaching you to apply for a job?
Dr Carney: Yes, I needed to speak to the Permanent Secretary based on the conversation that I had with the Chancellor of this possibility, since the Permanent Secretary was in charge of the Committee for selecting the next Governor. He had devised a process for sitting Governors, which allowed a sitting Governor to apply and be interviewed in short order.

Q6 Chair: When did you first hear about that?
Dr Carney: I heard about that in October, prior to the conversation with the Chancellor, prior to the conversation with the Chancellor.
Chair: How long prior roughly?

Dr Carney: Roughly three weeks or so.
Chair: Around the time of the closure of the deadline?
Dr Carney: After the closure of the deadline.

Q7 Chair: That was in a telephone conversation?
Dr Carney: It was in a telephone conversation, yes.

Q8 Chair: Then you came to interview. That interview, according to Bloomberg, took place on 17 November.
Dr Carney: It was thereabouts. It was a Sunday; so if that is the Sunday, yes.

Q9 Chair: Did it occur to you that some of the other candidates, one of whom is still in the Bank, might be a bit put out by the fact that a special arrangement had been put in place for you?
Dr Carney: What occurred to me is that anyone who had made the effort and had the desire to serve in this important role would be disappointed to not succeed, but what appeared clear to me then, as it does now, is that the process that was followed, in other words the specific interview—and obviously, I only went to my interview—my understanding of the questions that I needed to answer, both by the committee and then by the Chancellor, were exactly the same as were put to the other finalist candidates.

Q10 Teresa Pearce: No doubt you are aware that mortgages are quite hard to come by in the UK for many people, including my constituents. Is that why you need the extra quarter of a million a year as housing allowance?
Dr Carney: The offer of the housing allowance, which I accepted, is consistent with many arrangements for international executives who move for a period to this country or to other countries, in order to equalise in broad terms their living standard from where they are coming to where they arrive. Unfortunately, in this regard, I am moving from one of the least expensive capital cities in the world, Ottawa, to one of the more expensive, shall we say, capital cities in the world, London.

Q11 Teresa Pearce: Would you have done the job for less?
Dr Carney: I was offered these terms, and I accepted them.

Q12 Teresa Pearce: Given that Bank of England staff had had a pay freeze for the last two years, do you see there might be any resentment among staff at the level of your package, given their pay freeze?
Dr Carney: I am not aware of any.
Teresa Pearce: Do you not anticipate that in any way?
Dr Carney: I do not anticipate that. If I may say, in terms of the pay package, the pay package is properly viewed as pay and pension, and pay and pension relative to pay and pension that is currently in place for current Governors and deputy Governors. Since there is no pension associated with my package, I am advised by Court that the package is equivalent to the package of the current Governor. The difference is the housing allowance that you pointed out at the start.

Q13 Teresa Pearce: But given the level of pay package that you are getting compared to the previous Governor and given the pay freeze for staff, do you have any concerns about recruiting and retaining quality staff going forward in the Bank?
Dr Carney: Recruiting and retaining quality staff is always going to be a priority for knowledge-based institutions such as the Bank of England. In my experience, what one starts with is an enthusiasm for public policy and a demonstrated interest and skill in public policy to recruit people into central banks. There is a differential between my pay as Governor of the Bank of Canada and the staff in the Bank of Canada, and we have been very successful in recruiting from a broad range of outside areas, including quite broadly in the private sector.

Q14 Chair: Just on that last point, your current pay, total remuneration, in sterling terms is around a third of £1 million. Is that not right?
Dr Carney: Yes.
Chair: Your total remuneration is going to be in excess of £800,000 in your new job, correct?
Dr Carney: Yes.
Chair: That is a rather large rise, bearing in mind there is a pay freeze on at the Bank. I think that is the only point that seems relevant here.
Dr Carney: I will just reiterate that my pension is zero, but my pay and pension is equivalent to the pay and pension of the current Governor. The court has offered that. Secondly, the housing allowance relates to the fact that I am moving, as I said, from one of the cheapest capitals to one of the most expensive capitals. It is a relatively common arrangement for senior executives. It was offered to me. I accepted. I would add further that the combination of the two is broadly equivalent to the pay and pension of the outgoing CEO of the FSA—

Q15 Andrea Leadsom: Can I just put my hand up and say I think you will be earning it, so I suspect you will definitely pay the price. You have said that you are okay to do the job for five years and that there are certain things you want to achieve in that period of time. If you have not achieved those goals, would you consider staying on, or is 2018 the absolute deadline?
Dr Carney: I think there is value in clarity about the term, particularly given some of the quite considerable internal transformations that are necessary within the institution, giving them full life. I am sure we will have an opportunity to discuss some of the governance reforms that have been put in place: putting in place an effective talent management strategy succession plan, grooming potential successors, and having an arc of reform and restructuring of the institution that is consistent with a finite time line. I hesitate to take that finite time line away at the outset, but I can assure you my full intention is to accomplish what I am being asked to set out to do, and I will do everything I can to do that.

Q16 Andrea Leadsom: Have you been surprised by the amount of media attention you have had on your appointment and, in particular, about the accusations that you have political ambitions? Is there anything you want to say about friends among the political class that you might like to mention now rather than having dragged out under the spotlight later on?
Dr Carney: Have I been surprised? I have been surprised that it would be viewed as politically astute. I am in front of a range of people who are politically astute, demonstrably successful. I am surprised that it would be suggested that taking one of the most challenging jobs in central banking in another country would be viewed as politically advantageous in my home country. I think, if I had political ambitions, I would have pursued them in Canada, so I think this is revealed preference that I do not have political ambitions.

Q17 Stewart Hosie: Dr Carney, you were reported as having expressed concern about income inequality in Canada. First of all, can I ask if that is the case? More importantly, what did you see as the economic problems with wide income inequality in any country?
Dr Carney: Thank you for the point. The report, I think, relates to comments I made regarding the Occupy movement in the US and, by extension, into Canada. I will not give you the full context, but I made a distinction between the level of inequality and the change in the level of inequality in Canada versus what has happened over the course of the last decade in the United States.
Further, to ground this in monetary policy and my core responsibilities as Governor of the Bank of Canada, I made the point that one of the challenges in that environment, an environment that starts with increased inequality and marked increased inequality that is the case in the United States, is the danger of persistent unemployment and so-called hysteretic effects, if I can use the jargon, the gradual loss of skills because of prolonged unemployment, which has more severe consequences, obviously for the individual, but also for the productive capacity of the economy. That is one of the challenges that has been faced by the Federal Reserve and one of the reasons for which they have been as appropriately aggressive in their conduct of monetary policy.

Q18 Stewart Hosie: That is quite a helpful answer: prolonged unemployment, loss of skills, issues related to productivity. Does that drive in any way policy in your mind in terms of Central Bank policy?
Dr Carney: It is a consideration. It has to be a consideration in circumstances where there is persistent slack in the labour market. Judgment has to be made by the Central Bank, the extent to which that is caused by demand deficiency, and obviously the extent to which various monetary policy actions and which ones can address that demand deficiency. There is an issue in terms of the speed with which the labour market returns to a more natural equilibrium because, the slower it does, the higher the natural rate of unemployment can become, to use the terms again, because of the atrophy of skills and the loss of workplace attachment.

Q19 Stewart Hosie: We are going to be talking a little bit about the monetary and policy side later. I just want to find a little question. You mentioned the Occupy movement and the sympathy that you appear to have expressed for it in the context that you have given. How much of that do you think reflected a wider public anger at the behaviour of banks more generally?
Dr Carney: I think, clearly, that was a catalyst. Obviously, the movement itself, the physical location of its start, was on Wall Street. Particularly, it was not just the fact that the financial crisis triggered a very sharp recession, here as well as in the United States, but that the senior-most officials in those financial institutions appeared to escape unscathed, not pay the price. In fact, in many of the institutions that failed, some of the CEOs received large payouts prior to their demise.

Q20 Chair: You have produced some fascinating written evidence. One thing that comes through strongly is a distinctive or an attempt to describe a distinctive management style. You talk on a number of occasions about consensus. Are you using that word to contrast the style you intend to bring with that of the incumbent?
Dr Carney: I am not really in a position, not having worked in the institution, to comment on the management style.

Q21 Chair: You have picked up a few things, I am sure, from press reports and senior colleagues with whom you will be working.
Dr Carney: I may say that, in terms of the management style of Governor King, my direct experience of that has been in committees such as Governors and Heads of Supervision, which is the committee that oversees Basel Committee, which he chairs, the Global Economy Meeting, which he also chairs. I have found his style in those committees of experts, so to speak, to be consensual, if I may use that term, to seek consensus, to pick up argument, and to broaden it out. I would say, in terms of my personal experience, the Bank of Canada operates absolutely on the basis of consensus.
In some respects, the Financial Stability Board might be a better analogue to the committees of the Bank of England. I will explain that. In the Bank of Canada, the law states that the responsibility for monetary policy is grounded in the Governor, so the power ultimately is grounded in the Governor. Now, we built up the tradition over Governors of consensus and I have done, I think, everything I can to ensure that that has been enforced while I have been Governor. Within the Financial Stability Board, which is a collection of Governors, treasuries, standard-setters, supervisors of sovereign states and jurisdictions—the European Union is represented as well—you have to have true consensus. Derogation from the consensus on as important a reform as resolution strategies or a variety of things related to OTC derivatives stops that reform in its tracks. I follow the focus of this Committee. I know the focus that you put on reform and this is the moment to push things forward, but in order to do so

it requires a chair that works with the Members of the Committee to help to drive to consensus.

The last thing is that I fully recognise that with the voting structure of the FPC and the MPC, the individual accountability of the FPC and the MPC and the workings of the PRA board will not always be possible to have consensus. That is fine. I fully recognise. I also recognise that, as Governor, I will from time to time likely be in the minority. That is also fine. What I would view my job to be is to ensure that all views are heard, all arguments and all analyses are appropriately followed up, and then the decision is made by the individuals.

Q22 Chair: Quite understandably, you have avoided directly answering the question I asked you, which was to compare your style with the incumbent, but you are signalling something in your reply to the questionnaire, aren't you? There are a dozen references to "consensus", and you do not just refer to it in an idle way. You talk about developing a team culture; you talk about developing consensus-based decision-making; you talk about forging consensus in a number of specific areas, whereby a clear indication there is a weak consensus or none at the moment in decision-making structure. So there is something going on here, isn't there? This is a change of approach that we are meant to notice you are signalling.

Dr Carney: What I would signal or underscore is that it is an approach I think is essential for the institution to be successful. I will add one other point, which is that particularly if we look at the decisions of the FPC and compare them to the MPC when there are decisions necessary around a range of possible instruments and working to an objective that is not easily summarised as one indicator—in other words, MPC ultimately working towards price stability as measured by CPI; the FPC working towards financial stability that can only be represented by a wide range of indicators, a wide range of tools—there it is particularly important to send a clear message as much as possible, which requires true consensus decision-making.

Chair: We are going to come on to governance questions in the Bank, which are extremely lively as an issue of debate in Britain at the moment; but before I do that, David Ruffley.

Q23 Mr Ruffley: Dr Carney, welcome. I think it is worth pointing out that on your question of pay, you will be paid considerably less than recent England football managers, and I think you are likely to have more success than them.

We are going to get on to the policy issues in a minute, but you say in your written evidence to us that one of the key criteria to measure your success will be the effective communication of monetary policy and fiscal policy, and I quote, "That is well understood by the public". You also say, "Public understanding of macro-prudential policy is presently low" I am sure you are right in saying that, "and that the significance offer example, capital ratios and liquidity requirements are not widely understood by the public". What is a capital ratio?

Dr Carney: A capital ratio is a ratio of the equity of an institution relative to the assets, so the loss-absorbing equity relative to the assets of the institution.

Q24 Mr Ruffley: How would you describe "unwinding QE"?

Dr Carney: Unwinding QE is to return the balance sheet of the Bank of England to its historic level.

Q25 Mr Ruffley: What is a liquidity requirement?

Dr Carney: A liquidity requirement is the need for a bank to have funds to meet short-term obligations.

Mr Ruffley: I think that is all I have on that one.

Chair: I think you scored pretty well there overall.

Q26 Jesse Norman: Dr Carney, you will be inheriting a position in an institution that has gigantic power across the economy and growing power, given the new responsibilities in the financial sector. It is formally independent of Government; it is subject to low levels of accountability externally and has had a court that has not been very effective in ensuring high levels of accountability internally. Do you think it is appropriate for that job to be referred to as that of "Sun King"?

Dr Carney: Not as it is structured under the new Financial Services Act, no.

Jesse Norman: Why not?

Dr Carney: Because there are various mechanisms of accountability that are in place. First, the structure of the actual committees, the voting structure of the committees, both the MPC, the FPC, the structure of the PRA board; the clear remits that have been given to those committees by Parliament through the Act; the newly-formed Oversight Committee of the independent directors of the Bank, and extremely importantly, this Committee, which is the way through which not just the Governor but the deputies and the senior officials of the Bank and the external members of the policy committees are accountable through this Committee to Parliament and through Parliament to the British people.

Q27 Jesse Norman: Your conception of leadership clearly is one that requires the leader to be able to exercise, where necessary, a detailed grasp of aspects of the institution and aspects of policy. Given the spread of responsibilities and the number of committees that you are going to be on as Governor, how can you possibly exercise any detailed grasp across that entire spectrum of activity?

Dr Carney: In many respects, there are synergies and that is part of the spirit of this very important reform. At present, as Governor of the Bank of Canada, I have responsibility for monetary policy, very clearly defined responsibility there. We then have a contributory responsibility for financial stability, which means we oversee the payment system and we analyse potential risk to financial stability, but the levers on financial stability are controlled by others. We also, by dint of our role on the Financial Stability Board, participate in the development of a series of global financial reforms, many of which are applied domestically within Canada. But we do not exercise or see through those financial reforms, so we have an

opinion, for example, in the Bank of Canada, about how bail-in debt plays into resolution strategies for institutions and then in too big to fail, but all those decisions are taken by our Treasury or taken by our deposit insurer or taken by other entities within Canada. So these are all issues on which I, as Governor, in Canada need to be expert enough to contribute to decisions, but I do not see those decisions all the way through. If one does not see decisions all the way through, if one is not ultimately responsible for their implementation, in my experience that limits one's level of expertise.

Q28 Jesse Norman: You will not be responsible for some aspects of these policies or committees?
Dr Carney: I am sorry. The analogy I was drawing is that in Canada, I am not. In the Bank of England, the institution is, for all of the aspects that I just referenced, and in my opinion that reinforces the ability to be up to speed. Let me make another point, if I may.

Q29 Jesse Norman: That reinforces the requirement on you to be on top of the detail?
Dr Carney: It reinforces the requirement on me to be on top of the detail and the point I was trying to make—perhaps I was taking too long to make it—is it makes it easier for me to be on top of the detail as well, because the institution itself sees through to the detail of those aspects of policy.

Q30 Jesse Norman: That is how you read the Bank now? You think the Bank of England does that now?
Dr Carney: That is how the Bank is becoming, because of the reform to the Bank, the addition of the FPC and the addition of the PRA.

Q31 Jesse Norman: Have you thought broadly about how much time you are planning to allocate to each of these areas of your responsibility?
Dr Carney: I would say in this juncture in the British economy and financial system, there are quite strong overlaps between the various responsibilities. I will give an example: the work that the FPC has done in conjunction with effectively the PRA, I know the PRA is about to come, through the FSA on funding for lending and co-ordinated approach that has been put in place on funding for lending, that is macro-prudential policy, and it is also monetary policy at the same time. How one allocates one's time between the two of those one can debate, but I think at this point and for a number of years—this is one of the things that makes the job so challenging, but also so interesting—there will be quite strong overlap between putting in place the judgment-based supervisory approach of the PRA, putting in place macro-prudential tools and the monetary policy response that is necessary and the collective of these policies in order to grow the economy in a sustainable way.

Q32 Jesse Norman: Banking supervision essentially will have to take second place to that, will it?
Dr Carney: No, I don't think so. I am sorry if I left that impression. I would almost see that this is tiered. If you are pushing me—and it is fair—a third each between the three responsibilities, for a couple of reasons. Firstly, on banking and insurance supervision, importantly there is a new approach; very capable team, but there is a new approach that has been put in place. It needs to be put in place. As Members know, one of the core challenges in the financial system and therefore in the economy right now is that the core of the banking system is not as strong as it needs to be. It is a matter of some debate.
Jesse Norman: No kidding.
Dr Carney: Yes, a matter of some debate; and those judgments can only properly be informed by on the ground supervision. Ultimately, there are some macro-prudential judgments that need to be made around that, but it needs to draw on the supervisory expertise, and again, that I think is an advantage of the new structure, because the supervisory expertise is sitting right next to the macro-prudential.

Q33 Jesse Norman: A final question: so then, on the point of your command of the detail and of the fact that you uniquely will be sitting across all of these committees, in your view there will be very evident responsibility at the top for failures within that regime?
Dr Carney: It depends what you mean. First point, as I am sure you are aware, it is not an intention to run a zero-failure regime, meaning zero failure for institutions. In fact, the thrust of many of the reforms is to ensure that institutions can fail safely, that effectively the market can work, and ultimately that will provide more competition and ultimately provide a stronger system. As you know, it is not a zero failure, but certainly the responsibility of the Governor and of the relevant Deputy Governors is to successfully execute—

Q34 Jesse Norman: You will be running a zero-failure regime within the Bank?
Dr Carney: The bank will make mistakes, but all institutions make mistakes, all individuals make—

Q35 Jesse Norman: What is your tolerable level of failure within the Bank, Dr Carney?
Dr Carney: I am not grasping exactly how you define that level.
Jesse Norman: Low, medium—do you like low levels of failure or medium levels of failure?
Dr Carney: I prefer low levels to medium levels, yes.

Q36 Chair: That is what most people like. You just referred to insurance there. Of course, insurance has gone to the Bank of England. They don't know much about it, they are busy gathering together the expertise in order to do the job. Do you know much about insurance regulation?
Dr Carney: I know a reasonable amount about insurance regulation. Particularly, we have a relatively large life insurance industry in Canada. I sit on what is an inter-agency macro-prudential committee, a statutory committee. In fact—it does not matter—I was there earlier this week.

Q37 Chair: You are already covering this area in Canada?
Dr Carney: But the Bank of Canada is not the primary entity responsible for insurance regulation, so I would not over-represent. That said, I have that experience through that committee. We have a large life sector in Canada.
Secondly, at the Financial Stability Board, if I may, we are in the process of identifying globally systemic insurance companies and the regulatory response to those institutions. That, if I may suggest, is highly relevant to at least the larger insurance industries. I certainly recognise that this is third-largest insurance industry in the world.

Q38 Chair: Insurance played a major role in this crisis. Your position is basically you know a bit about it, but you have to get up to speed, like the Bank of England has?
Dr Carney: Yes, I will be much more expert next time we talk. Non-traditional non-insurance activities of insurance conglomerates played a major role in the crisis, if I just can make that distinction.
Chair: Yes, that is an important distinction.

Q39 John Thurso: Can I come back to your leadership style and qualities? In your very helpful answers to the questions, you divide the challenges between half of them as institutional challenges and the first thing you say there is, "There needs to be a clear, shared vision for the Bank that needs to be established". A classic definition of a CEO and leadership is having a vision, communicating it and resourcing it. What is the current vision of the Bank of Canada?
Dr Carney: The current vision of the Bank of Canada is that we provide price stability and financial stability to enhance the economic and financial wellbeing of Canadians; so, it is rooted in our legislation.

Q40 John Thurso: Clearly your answer indicates that, because you say, "A clear shared vision for the Bank needs to be established". There is an assumption that there is not one in the Bank of England.
Dr Carney: Given that the institution has been given considerable extra responsibilities as of the start of April, that creates the opportunity—
John Thurso: It is a new shared vision?
Dr Carney: Yes. It creates a need either to reconfirm or adjust the vision for the institution. Sorry, I don't want to eat up your time.
John Thurso: No, no.
Dr Carney: I think there are analogues to what the vision is in the Bank of Canada, and the two objectives of the Bank of England have been contributing to price and financial stability. I think it is important that it is recognised that those are cornerstones or building blocks of British prosperity: in other words, they do not guarantee prosperity, but without both, that will not come. But the important thing with a vision is that it is developed jointly with senior management, it is adjusted and there is buy-in, and then it is broadly recognised by all members of staff.
I will give one example that goes back to Mr Norman's question, which is that failures, to use your term, whether it is operational failures, individual failures in terms of expenses or personal conduct, issues around counterfeiting of notes—there are a variety of issues—all those issues, all those failures, to use that term, detract from confidence in the institution, confidence in the system, detract from financial stability and could, in the extreme, detract from price stability. So it needs to be—and I believe there is, but it needs to be continually reinforced—reinforced throughout the institution that everybody in the institution is responsible for the success of the institution, because everything that happens in the institution is watched closely and ascribed to the broader whole of the British financial system.

Q41 John Thurso: All good points, but a vision is a very simple, clear statement of what the whole institution is about. How will you go about achieving that vision, and at what point will we, as a Committee, be able to say to you, "What is the vision of the Bank of England?" and you will give us an answer?
Dr Carney: That is the first six months' work, without question, and I would hope before the end of that six months.

Q42 John Thurso: My second point, following on very much from Jesse Norman's questions—and it has been said that from April, the Governor of the Bank of England will be the most powerful central banker on the planet—there are all of these committees that he will chair, as well as being the Chief Executive and a major player on the international stage. There is the possibility, looking at all of that, for the way in that it is run to go in one of two ways. It can either be the sort of emperor, or it can be the constitutional monarch. Do you have an idea of which you might favour?
Dr Carney: You are going to back me into "Sun King" with the second option. I would like to link the two questions, because it is absolutely essential in this role to have a grasp of the detail, to understand the core of the issues that each of the three policy committees are engaged with and also to make the connection between those policy committees in order to get the full benefit of the institution, so that is essential. But that said, no individual is going to have the expertise of the collective of those committees. That is why the externals are selected and that is why we develop internally at the institution. So it cannot be an emperor; that cannot be the approach. It is not possible, even if one wanted to, but it also would be fundamentally limiting for the institution and an unsuccessful strategy.
I am not sure that then goes to your other option, but my view would be more of a managing partner, if you will, within a corporation.

Q43 John Thurso: Let's not worry about that, those are terms. The critical point is when it comes to corporate governance—and this Committee has been very critical of the past arrangements in the Bank of England—it is the manner in which you develop the style of leadership will dictate how best to achieve

the corporate governance of the position, in that good corporate governance is both a support to the key positions, but also a check and balance. Coming in, looking at it at the moment as an outsider, is that corporate governance fit for purpose, to coin the happy phrase? Are there things that you would like to see put in place either to help support or to help as a check and balance of the way that you are wishing to create?
Dr Carney: On the outside looking in, I think the answer is yes, but it depends on a couple of—
John Thurso: Is that, "Yes, you would like to do things", or, "Yes, it is okay"?
Dr Carney: Yes, I think it is fit for purpose, but it needs to be given life, I think is the way. In other words, we need to ensure—and obviously this is entirely out of my control, except from the perspective of co-operation—for example, that the Oversight Committee of court is active and effective.

Q44 John Thurso: Do you favour the Oversight Committee doing the reviews that this Committee has suggested?
Dr Carney: I certainly favour the process of the Oversight Committee identifying a series of issues that it wants to review. I think as well I welcome the fact that it is recognised that management may also want to initiate reviews as well from time to time. If I may say as a general point, which I believe I made in my written submission, there has been a series of useful external reviews performed. The bank is in the process of determining its response to those reviews. One of the first things I will do when I arrive is to take stock of that response, see how it has been put in place and within six months determine whether more needs to be done.
So to go back to your question, with respect to how to make sure that the governance structure works, it is management of committee and management of the various policy committees to make sure that they work as they should; it is ensuring that this Oversight Committee, which again we at the institution, we within management, if you will, can only ensure in terms of being co-operative and responding effectively to the reviews that come from the Oversight Committee, making sure that is an effective process and that is an effective process early on, and then subsequently it is with the interaction with this Committee obviously, which is our principal public accountability.
John Thurso: I will leave it there, having signalled that probably in about six or eight months' time those will be questions I will be asking you.
Dr Carney: Clearly.

Q45 Chair: It might be worth just picking up on a couple of the points you have made there. Do you think that the Bank should have a formal responsibility to respond to reasonable requests from this Committee for information or retrospective reviews to be conducted by the sub-committee?
Dr Carney: I am sorry, Chairman, should we respond to the requests of this Committee? Yes, sure.
Chair: Should you have a formal responsibility to respond to such a request, to a reasonable request?
Dr Carney: I would view that we have a responsibility to respond to reasonable requests of this Committee.

Q46 Chair: You will not have any objection to having this put in statute?
Dr Carney: I am sure there is something I am missing, but I don't have any objection.
Chair: It sounds as if, even though it is missing, you are happy to say yes to that, are you?
Dr Carney: It sounds reasonable, yes.

Q47 Chair: Yes, exactly. It does to us. We have not succeeded with that one so far, but as you say yourself, we are all reasonable men around this table and that is what we been asking for some time.
[Interruption]
The court: do you think that an 18th century name attached to this structure is sensible in the 21st century? Do you think it might be plausible to be able to think of something else?
Dr Carney: Yes. I would view the court as a board, if that is the question. I hesitate as a foreigner coming in and changing and suggesting any changes to some of the longer traditions of the institution, but this is distinct, those traditions; the name of the court or the board I would put in those longer traditions. Others should make those judgments rather than me.

Q48 Chair: The sub-committee that has been given the job of doing these reviews, and you referred favourably to them, doesn't have any staff at all, so I understand. Do you think it should be given some staff seconded to it from within the Bank, as we propose in our report, for a period with the duty of assisting the board or sub-committee of the board in performing this oversight role?
Dr Carney: Yes. In terms of conducting the actual review, the members of—
Chair: I am talking about a small secretariat to assist it in thinking through how to do this work on a permanent basis.
Dr Carney: Provided that we rotated through those members of the secretariat, it should be a positive learning experience on both sides for that, yes.
Chair: So, you support that as well?
Dr Carney: It is the first I have thought of it, but it seems a reasonable—

Q49 Chair: It seems a reasonable idea. Do you think that when these reviews come back, the court or board should be expected to assess the merits of these retrospective reviews that have taken place, the substance?
Dr Carney: You mean the quality of the review or the quality of—
Chair: The quality of the review and of the points that the reviewers have made and to be prepared to come before this Committee and explain why they think, "There are some very good points here", or, "There are some very weak points here".
Dr Carney: The review is for the benefit of firstly the Oversight Committee, but then ultimately the court and the institution as a whole, so there has to be reflection on it. My understanding is that the court has appeared at this Committee, and my understanding as

well is that records of minutes of the court will be furnished to the Committee, so it seems reasonable to—

Q50 Chair: Our problem though is at the moment, the court's formal responsibilities are confined to commenting on processes and procedures, not on the substance of the work they are commissioning, so they are in the extraordinary position where they commission a report that they are not permitted to offer review on its contents. We think that is, as I have just said, extraordinary, and we think that needs to change.
Dr Carney: I guess I would presume that any review that is commissioned by the court would become a matter of public record, the recommendations/ observations in those reviews and that the expectation would be that senior management and myself and other senior management would have a duty to respond to those recommendations. That first would be to the court, but obviously to this Committee, if the Committee took an interest.

Q51 Chair: But what I am asking you is whether you think the court or the board should be capable and be expected of being capable of expressing a view.
Dr Carney: A view—
Chair: About the merits.
Dr Carney: Of the recommendations?
Chair: Yes, of retrospective reviews. Does that sound reasonable, Dr Carney, or can we park it in this "reasonable" place that you have created for all these suggestions?
Dr Carney: Yes. I think the only hesitation I have is the line—which I do not think you are suggesting, but I will just put it on the record—between review of process and resourcing and then review and influence on policy decisions.
Chair: Current policy decisions?
Dr Carney: Yes, but retrospective, if retrospective is last month; it will influence current policy decisions, so there is a line here.
Chair: Where they will interfere with other committees, the FPC—
Dr Carney: There is a danger where that could happen, and of course what happens there is that the accountability is blurred, which is what nobody would want, and so this has to be somewhat circumscribed. I do believe that with any of the reviews, whether they are commissioned by the court, commissioned by management, commissioned externally, that it is the duty of senior management to respond directly to those observations and recommendations.

Q52 Chair: I got two out of three into the "reasonable" car park; so I am reasonably happy. Can we turn to monetary policy? You have made a number of interesting remarks about monetary policy recently, to say the least, and you have a number in your responses to the questionnaire. Is the UK's current monetary framework the right one for assisting economic conditions?
Dr Carney: I would say that the experience in Canada, Canada shares the monetary policy framework of the UK. It is a flexible inflation-targeting framework, a symmetric target of around 2%. I would note, as I believe I did in my written submission, that what we do in Canada is we review our framework every five years. There is a public review process and then that framework is either amended or reconfirmed through effectively an exchange of letters, a joint statement by the Bank of Canada and our Treasury, our Minister of Finance. We have found—and I personally have found—that that is a very effective process, because it ensures that there is constant learning about the operation of the framework and that there is shared understanding about the "flexible" word in flexible inflation targeting, and particularly over the course of the post-crisis period, where flexible inflation targeting is operating in a different environment and, in the case of the United Kingdom, an exceptional environment. I would suggest that it is important to ensure there is buy-in, if I can use that term, to the existing framework. I start from a position, to answer directly your question, where flexible inflation targeting is the most successful monetary policy framework that has been in existence, so the bar for change to that framework, the overall framework, is very high, but I would note that there seems to be an appetite for some debate about what exactly the framework is and what alternatives could be considered and that should be encouraged.

Q53 Chair: You said that we need buy-in, as you put it. Do we have buy-in now?
Dr Carney: I will go to the heart of the issue, or part of the issue, which is that one of the questions that has to be answered in these types of frameworks is how much flexibility can the Central Bank exercise in returning inflation to target? I am referring specifically to flexibility in terms of time, because there is a series of judgments made by the Central Bank over what is the optimal path to return inflation to target, and optimal in the sense of what impact would returning to target quicker or more slowly have on output and employment in the country. In Canada, in general we return inflation to target over six to eight quarters, but 25% of the time since we have recorded our forecast, we have done it less than six or more than eight, and in some cases 10, 11, 12, quarters, and the reason we have done that—we look to clearly explain the reasons behind it. For example, right now we are taking a little longer to return to target because we have issues with the rise of household credit and issues in the housing market, so even though rates are only at 1% we are leaning into the wind, if you will, on monetary policy to help reinforce macro-prudential measures that the Government of Canada has taken and slow the rate of growth of credit in Canada. But that is a very clear, transparent process. That is the exercise of flexibility in that regard.
One of the issues in the United Kingdom is the speed with which inflation is returned to target from above in an environment of necessary public and private deleveraging, and what is the optimal path of monetary policy in that environment, given the impact of different paths on output and employment. What discretion does the Central Bank have? That is where

there should be buy-in, because it is a delegated authority with responsibility to the Central Bank.
Chair: Do we have buy-in at the moment?
Dr Carney: The response to remarks that I made and what was read into remarks that I made suggests an appetite—at least to me—for proper debate about the monetary policy framework. I noted that the Chancellor said he welcomed that debate; the bar for change is high. I agree with that. The bar for change is high, but there should be that debate, a relatively short debate, because I don't think prolonged uncertainty about the framework is in anybody's interests, and then either a reconfirmation of the existing framework or a change.

Q54 Stewart Hosie: Dr Carney, irrespective of the debate or the outcome on the monetary policy framework, we are still going to have a situation that is different from Canada. You reached the decision, you say, about consensus in the governing council. The decisions here are taken by the MPC on the basis of one member, one vote, some internal, some external, some other external observers who can't vote. Will that be a culture shock, the way in that the MPC determines what it does?
Dr Carney: It is a different way of making these decisions, but it has proven itself to be an effective way of making these decisions, so I look forward to it. In the Bank of Canada, I operate in an environment, as you say, of consensus. That is absolutely clear, but in other environments it is more a working consensus.

Q55 Stewart Hosie: This is quite vital. You have been incredibly successful, but it is on that consensual basis within the Bank. Are you ready for strong-willed external MPC members to publicly disagree with you?
Dr Carney: Yes. I think some already have.

Q56 Stewart Hosie: Are you prepared to be outvoted?
Dr Carney: Yes. I forget the phrase earlier, but I would like to be on the right side more often than not; but obviously I would fully imagine that over the course of my term I would be outvoted.

Q57 Stewart Hosie: You spoke about transparency a little earlier. What do you think of the Bank of England's *Inflation Report* in its quarterly bulletin, its main public-facing publication?
Dr Carney: In many respects, the *Inflation Report* was best practice when it came out. It has had a number of innovations since. I think fairly clearly, at least in my reading of the *Stockton Review*, there are suggestions in there that could potentially be taken on by the Bank that would further improve the *Inflation Report*, for example, greater clarity about policy judgments that are made; alternative scenarios potentially that could be shown; there is also a potentially greater disaggregation of the forecast, which is a less disaggregated forecast than some others that are put out. So, my understanding is that I am certain all of these recommendations are being looked at by the Bank, but I would expect that some of them would find their way into a revised *Inflation Report* in due course.

Q58 Stewart Hosie: Would you like to see policy options as you have just described put into these documents?
Dr Carney: There is value from time to time of alternative scenarios, and there is certainly value in every case in highlighting the core assumptions that drive the forecast. I will give you an example, if I may—I am going to rely on the Bank of Canada—right now. What we particularly highlighted in our equivalent of the *Inflation Report* that came out two weeks ago was the export response and the investment response that is required to get the economy back to potential. The fact is there is a large rotation in the components of demand in Canada that we are expecting over the course of the next two years, it is sizeable. Reasonable people can disagree about the likelihood of that happening, and if it does not happen, obviously it will have an implication for output inflation and ultimately monetary policy in Canada. So, that is something that we wouldn't do as matter of course. We used a variety of charts and boxes to explain. We wouldn't do as a matter of course, but we did because it was particularly relevant to this forecast. So it is that type of communication.

Q59 Stewart Hosie: That is helpful. Just one final little technical question: the Bank of Canada meets eight times a year on monetary policy. The MPC meets 12 times by statute. Do you think 12 is too many, eight is enough, eight is too small—what would you do in terms of the frequency of this kind of meeting and determination?
Dr Carney: It is by statute, and I cannot imagine the statute would be reopened for this issue. It is certainly enough to meet 12 times.
Stewart Hosie: Is it too many?
Dr Carney: It verges on too many, yes.

Q60 Jesse Norman: Dr Carney, you have very interestingly said that you think there should be a brief but proper debate about monetary framework. Do you think that is also true about quantitative easing?
Dr Carney: My understanding is there is a review that has been launched by this Committee on quantitative easing.
Jesse Norman: No, but by the Bank. Do you think the Bank should have a wider consideration of the full effects?
Dr Carney: I would hope that the Bank would be invited to contribute to this Committee's review of QE.
Jesse Norman: I think we would be delighted. Thank you very much.
Dr Carney: Yes. I understand the interests of the Committee in the wider effects and I read your piece this morning, your personal interest in that, which is shared by us. I am aware also of the exchanges that have taken place in the past, and it is not going to surprise you, as a central banker, I start from a position that is very similar, if not identical to those of the current management of the Bank, which is to look at the wider economy effects; to look to root quantitative easing in the context of the Bank's remit and effectiveness of achieving that remit; to recognise that there are distributional consequences of QE—as

you pointed out and as others have pointed out—but to observe that all monetary policy has distributional consequences and that response to those distributional consequences of quantitative easing is more properly the job of others, as opposed to the Bank in and of itself.

Q61 Jesse Norman: In Canada, flexible inflation targeting has yielded a rate of inflation that is fractionally higher than 3% over decades, but in this country—
Dr Carney: Two.
Jesse Norman: Two decades?
Dr Carney: No, sorry. The flexible inflation targeting has yielded inflation of 2% in Canada over decades, since 1991.
Jesse Norman: I am sorry, I apologise.
Dr Carney: Just for inflation expectations.

Q62 Jesse Norman: If I said 3%, I apologise, but thank you for that. The point I want to make though is in this country, we have had a very long succession of quarters in which inflation has been well above target.
Dr Carney: Yes.
Jesse Norman: Do you think that means that inflation targeting is too flexible in this country, and if so, put it this way, is that because they are aiming high or just too tolerant?
Dr Carney: I think that there are a couple of factors. I would agree that the MPC has quite appropriately looked through a series of one-off shocks, upward shocks to the measured inflation rate and that it has appropriately provided stimulus to the economy that is facing very large headwinds, as you know. I think the nature of the question though reinforces the point I was trying to make earlier, which is that there should be a shared understanding of the flexibility that is there. In other words, over what period does it make sense to return inflation to target? It is fair to say that in a number of those circumstances, the actual expectation of the MPC, in good faith, was that inflation would return to target sooner than it did, because there were other shocks that occurred. So I stress that my view would be that it is important—again, I am slightly repeating myself—that there is a shared understanding that there is flexibility and why there is flexibility in terms of the returning to the target; the first point. The second point is that in these exceptional economic circumstances that the UK is facing at present, with inflation above target as it is at present, in the context of this discussion on the framework I think it would be quite useful to have a shared understanding about what potentially is the optimal timeline to return and why; what the impact could be on employment; what the impact could be on output.
I have suggested this in broad terms, that there is merit to considering some sort of Federal Reserve style—I apologise for the jargon—threshold-based guidance. The question in the UK is as it would be in Canada, if we were in that situation does one make that time-contingent or state-contingent? Is it around a particular economic variable that indicates—

Q63 Jesse Norman: In terms of my question, too tolerant rather than aiming high? They have been too tolerant in monetary policy rather than aiming higher to declare—
Dr Carney: Yes, I have no reason to doubt the MPC. I think further, in looking through these shocks, they have ensured that there has not been a deeper stagnation in the UK economy.

Q64 Mr Ruffley: Dr Carney, your 11 December Toronto speech: you talked about many things, but I want to focus on forward policy guidance. Your experience in Canada was that in April 2009, you announced that the policy rate, the interest rate would be held until the end of the second quarter of 2010. You were pre-committed to low interest rates, conditional upon the inflation outlook. What was the evidence on which you based that? Where has that worked before successfully?
Dr Carney: We looked at this. I would say a couple of things, and I will get to the specific policy in Canada as part of my explanation. The general view is not shared by all central banks, but the general view within the Bank of Canada—or certainly I share—is that in normal times, policy-based guidance is relatively ineffective, so publishing an interest rate path is something that we looked at and we decided against in the Bank of Canada because effectively it wouldn't move market expectations, and quite frequently the conduct of policy was materially different from the path, the expectation at the time. On the margin, that is another thing that the Central Bank is "wrong" about; it reduces its credibility. That is our view. There are some central banks we fully respect that continue to publish interest rates in "normal" times.
But our view is once we came to the zero lower band, the lowest interest rates could go, that we were faced with a couple of choices at that point, because we felt that the economy needed additional stimulus at that time in Canada. One was quantitative easing, we could have credit easing, and thirdly, we felt that we could use communication to provide the extra stimulus. We were not in the position that the Bank of England was in when it reached the zero lower bound, where the UK economy needed considerably more stimulus. We needed a bit more stimulus. So our judgment was, given the costs and benefits of quantitative easing and potentially credit easing, that we would use communication in order to help manage market expectations, because market expectations at the time were for a sharper increase in interest rates sooner than were our expectations. There was a material difference, in our view, on how long interest rates would be at that zero lower bound versus the market, and so within the bounds of our inflation target we did our best to credibly commit that we would keep rates low at that level for, at the time, 15 months. That had a couple of effects. It had an immediate effect in the money markets and out the interest rate curve, an immediate measurable effect that persists and we have event studies of this. Mike Woodford has done event studies; other people have looked at it. So that persisted, so there was a direct

sort of pass-through effect to broader financial conditions.

But as well, which is harder to measure exactly, but I firmly believe did happen, is it had a very important effect in that it reached over the heads of central bank watchers and the financial markets and directly to Canadians and sent a message that there was going to be stimulus for a period of time. Remember that the Canadian banking system was functioning well, so this was true, that borrowing was available at unprecedented rates for a period of time so that people could plan and put in place whether they were going to buy a house, renovate, make an investment. They had enough time to go out and act on this, and I can tell you anecdotally, everybody knew about this commitment in Canada, everybody who was active in the financial system knew about the commitment in Canada, and it had an effect.

So our experience has been that this is effective. It was a conditional commitment, as you know, and as you know as well, in the end, in part because of the response of households and businesses to the commitment, we ended up raising interest rates sooner than we had said, because we had made our commitment conditional on the outlook for inflation. Our view was that if we kept it on, by the time we came to the spring of the following year, of 2010, we would run a risk on inflation.

If one brings it to the situation in the UK today and thinks about the potential use of guidance in this economy—I should preface all of this in that, as you are all aware, I am not the Governor of the Bank of England; I will not be for another five MPC meetings. The MPC is meeting today and takes its own decisions, and so when I talk about policy and policy options, I am talking in the general, even though I am trying to use a UK-related example.

Mr Ruffley: Understood.

Dr Carney: Yes, because lots of decisions will be taken before I arrive and the economy could be in a different place by the time I arrive. That said, in the UK context, I think there is a valid discussion to be had about the potential use of this tool to provide additional stimulus, if it is appropriate, again within the context of what is the time path for returning inflation to target. I would further add that given some of the challenges with time-contingent guidance, in other words, rates will be lower for a certain period of time, some lessons can be drawn from what the Federal Reserve has done with state contingent guidance.

Q65 Mr Ruffley: Just following up that point, the Fed seem to have gone further, and you draw this to our attention in your 11 December speech, because apart from pre-committing in the normal way that they often do, they went further. You say, “For a considerable time after the economic recovery strengthens”. Is that something that we should have as part of the debate you refer to when you take up office?

Dr Carney: This is one of the judgments about the optimal path for inflation and the optimal path for the economy and where—

Q66 Mr Ruffley: But it is a pretty much open-ended pre-commitment, and I presume it will be conditional on the inflation outlook, as you have pointed out. I am just trying to understand whether you are quoting this with approval, Dr Carney, on 11 December, your Toronto speech, “For a considerable time after the economic recovery strengthens”. You refer to your happy experience in Canada in this speech, and I am getting—and other commentators have been getting—the clear impression that this is something you are very attracted to.

Dr Carney: At the zero lower bound.

Mr Ruffley: At the zero lower bound?

Dr Carney: Yes, at the zero lower bound, and thank you for drawing attention to it. At the zero lower bound, in order to get sufficient momentum in the economy to justify an exit from the zero lower bound, there may—and it is situation-specific and it requires analysis and clear exposition of why that might hold in the UK; where it does hold in the US, I believe that, and did hold in Canada, it was certainly the case there—be a need to develop sufficient economic momentum to justify moving off the zero lower bound. In the case of Canada and in the case of the United States, and I would suggest also in the case of the UK, in all of those cases, the extent to which that strategy is pursued is bounded in some way by the actual outlook for inflation. In Canada, we had a conditional commitment, conditional on the outlook for inflation. In the current guidance of the Federal Reserve, which is there was not the possibility—not their exact words, but effectively their words—of tightening policy in the United States until unemployment falls below 6.5%, they bound that pledge with, “Unless the outlook for inflation is above 2.5% one year out”. So again, there is an outward bound on this, and I think in the design, if that were the view and if circumstances ever mirrored it in the UK, something similar would have to be devised, because this has to be consistent, ultimately. All of this I view as being discussed under a flexible inflation targeting regime, so it has to be consistent with that regime and ultimately bounded by the medium term target.

Q67 Mr Ruffley: My final question; it will be quick.

Chair: If you could be very quick; and a quick reply.

Mr Ruffley: Adam Posen, who, as you know, left the MPC last year, has given evidence to this Committee that such forward guidance was a gimmick. He is obviously sceptical. Is there evidence that you can produce, going back to my earlier question, of the success of this, empirical evidence to show that if a change like this were to be made, it was founded on serious empirical evidence, because Posen doesn’t seem to think there is such evidence.

Dr Carney: First off, the decision of the Bank of Canada was made on extensive analysis. Secondly, the ex-post reviews of the effectiveness of the conditional commitment have found that it was effective, and I can furnish you a Bank of Canada working paper.

Mr Ruffley: That would be helpful.

Dr Carney: I would refer as well to the Michael Woodford, Jackson Hole paper of just this past summer.

Chair: In an earlier reply, you described it as an event study, I think, which sounds like the key document.

Q68 Mr Mudie: Welcome, Dr Carney. One of the things that a lot of people have zoned in on and that has given a lot of people some encouragement about your appointment has been your statement that, "Monetary policy has a key role to play in ensuring economies reach escape velocity". I know you are four months away from taking over and you are in Canada, but can we take it as said that the present monetary policy is not achieving escape velocity and are you prepared right from the outset—do you have the courage to, the ambition—to challenge present monetary policy re its fixation with inflation targets?

Dr Carney: Thank you for the question. I would answer the second part first, which is that obviously the responsibility of the MPC of the Bank of England is to discharge to the best of its ability the remit that is given to the MPC. The remit, as it stands, is to achieve 2% CPI inflation over the medium term, as you know. That is the best contribution ultimately of monetary policy. What I have tried to stress is this issue around the path to get to that medium term and the optimal path to get to the medium term, and I think the behaviour of the MPC, or the decisions, rather, of the existing MPC have demonstrated a concern with that as well.

To get to the first part of your question about escape velocity, the only reason I hedge is that I am not expert enough on the current situation in the UK economy and the forces affecting output and inflation. I am not party to all the analyses of the MPC. As you know, I am not a member at present. It is entirely possible, in fact probable, that the current stance of policy is consistent with the economy achieving escape velocity. In other words, the UK economy achieving a sustainable rate of growth into the headwinds that come from public and private deleveraging that will be with this economy for a period of time. The question is not where policy is today, but where policy is going to be tomorrow and in subsequent months and potentially years. To draw it back to the earlier discussion, the question is whether there can be any clarity given about the potential path of that policy and whether that can be usefully given at the time I take office in order to provide—

Q69 Mr Mudie: The question is, Dr Carney, will you be coming to the table in June immediately, recognising that we have flat-lined for two years, with fresh monetary policy initiatives that may raise the valid question of its effect on inflation and be prepared to say it is a balance that must be discussed but seized upon and decided upon?

Dr Carney: I take office in July. My views on the stance of policy in July will be conditioned on the outlook for output and inflation in this country, and so I do not want to pre-commit to my stance at that point because it will also be importantly affected by the decisions of the MPC today and in subsequent meetings. Your point, though, on instruments is that it clearly is the responsibility of the MPC and the staff of the Bank of England as a whole to continually review the effectiveness of the various instruments that are available to monetary policy. If stimulus is required to determine not just the cost and benefits of existing instruments—whether it is QE, funding for lending, other asset purchases, changes in the Bank rates, potential communications—but to devise, if necessary, new instruments that could provide stimulus more effectively, if it is required, and we certainly will do that when I am there.

Q70 Mr Mudie: I am hard-put to understand exactly what you are saying to me in terms of fresh initiatives, but the Chancellor has been in the paper with a speech yesterday asking the Monetary Policy Committee to be a bit more aggressive in terms of stimulating growth. Will that be your starting point? Do you understand the urgency in this country about stopping idolising and focusing totally on inflation policy and putting into place, as the Chancellor can't because of the fiscal difficulties—the ball for growth is in your court. Does this statement mean you understand that and you are going to, from day one, go for accepting a partnership with the Chancellor in terms of understanding you have to do something for growth because he is fiscally too tied in?

Dr Carney: Unquestionably when I come to the table there will continue to be considerable slack in the UK economy, as evidenced by the labour market and more broadly across industry. Unquestionably that will be a situation that merits, for a period of time, considerable monetary policy stimulus. Those judgments about exactly how much to calibrate, which instruments to use, have to be guided by the remit that is given to the Bank under the 2% inflation targeting. I think that, as I have stressed, in order to achieve an optimal, the ideal, the best, outcome in terms of output in inflation, it is discharging it at the moment but it continues to be the responsibility of the Bank to lay out the potential path back to sustainable growth in this economy that is consistent with that 2% inflation target.

Q71 Mr Mudie: Within the present remit, yes, but, as you will have a honeymoon period and as the Chancellor is anxious for your assistance in the Bank, would you consider taking that window of opportunity to persuade the Chancellor to go for a dual mandate along the lines of the Fed, which would help you with the voting members of the Monetary Policy Committee who may stifle your individual efforts to change monetary policy?

Dr Carney: I said at the outset of this section that I think there is merit in debating the framework in Britain and coming to a relatively quick conclusion on it. I would say as well that my view, where I am sitting here today, is that the best framework remains flexible inflation targeting. That is the best framework. Properly operated, properly understood, is the best framework and using the full power of that framework and the tools under that framework is going to be the best contribution, not just to price stability but to full employment in this country and in my home country at present. To answer your question, I do not start from a position of looking for a dual mandate. I do start from a position, which is I believe is shared by

the current MPC, which is in the current environment considerable monetary policy stimulus is required in order to take up that slack in the economy as quickly as possible. If more is required, once I am in office I will do my best to convince my colleagues to pursue it.

Chair: I have five colleagues who want to come in on this area, so I will ask them if they could be reasonably brief.

Q72 Mr McFadden: Have you had any discussions with the Chancellor during the interview process for the job or subsequently about changing the MPC remit or considering changing the MPC remit?

Dr Carney: We have had a couple of higher-level discussions not as detailed as we have had today but along the lines that we have had today about the merits of looking into the remit and considering whether there should be a change; not discussions that lead to a specific view of what that should be, but on the general issue. I would reconfirm that, subsequent to my December speech and the reaction here to that speech, that was a natural discussion to have given that there seems to be a broad interest or sufficient interest in at least discussing this. It makes sense to have this more broadly.

Q73 Mr McFadden: You have said that you think there is an appetite for the discussion and that you have had some high-level discussions with the Chancellor. Can you give us an indication of what the process for this might look like? You have said that it is something that happens periodically in Canada. If, on taking office, you are going to pursue this and look at this, what would that look like? On what timescale? Who will be involved?

Dr Carney: Any decision, as you know, on the remit is a decision for the Chancellor and for the Government, so I would not presume to give directions. Obviously what I can comment on is what happens in Canada and the way it happens in Canada is that, since the adoption of an inflation target in 1990, there have been reviews every five years. In the run-up to those reviews the Bank of Canada does a lot of research and interested academics do some research and then we have a series of discussions with our colleagues at our Department of Finance, our Treasury equivalent, and then a decision is made. I have made the point that I see value in having the debate. It is clearly a decision for the Chancellor and the Government whether they are satisfied with the level of debate or the shape of the debate and are satisfied to reconfirm or adjust the remit as they see fit. I am hesitating to dictate a process to those who have to make those decisions.

Q74 Mr McFadden: We have discussed in the questions in recent minutes some of the options that have been canvassed for this, whether it is guidance for thresholds and so on. Another one that you have discussed is nominal GDP targeting. Can you tell us your thoughts on that and whether you think it is a serious run-out as an alternative to the current remit?

Dr Carney: I would go further to specify that this would be a central bank targeting the level of nominal GDP; so real GDP as we conventionally think about it plus the level of the GDP deflator and the Central Bank would look to target the trend of that level. To put it into context, as I am sure you are aware, in the UK today the gap between the pre-crisis trend and now is about 15%. All of that gap and a bit more is because of a shortfall on real growth relative to trend. The actual price level has more or less kept up to trend but, nonetheless, this gap in nominal GDP has made the deleveraging process much harder for individuals because there is less income, much harder for Government because of the fiscal feedback that is there and it has challenged the recovery. There are advantages, in theory, to nominal GDP level targeting, particularly when an economy is at a zero lower bound and the advantages are based on augmenting inflation expectations and reducing effectively real interest rates with a higher degree of credibility than under conventional inflation targeting.

The reason for the higher degree of credibility, in theory, is because, to use the jargon, bygones are not bygones under nominal GDP targeting. If, in the initial years of providing stimulus to try to get back to the old trend—sorry, I should not be doing the trend like this—there is additional shortfall the Central Bank has to make it up because the gap has widened. That brings on more stimulus, and the knowledge that more stimulus would be provided in that event provides stimulus in the current environment. That credibility is there. The other advantages of nominal GDP targeting relate to when there is a supply shock; for example, the supply shock that we experienced here because of higher oil prices. The central bank is better able to look through those short-term supply shocks and, in what seems like a very distant past, is better able to respond to positive supply shocks, positive productivity shocks, because that encourages some increase in interest rates to lean into the wind against that, which reduces the prospect of financial imbalances.

Those are the core benefits of nominal level GDP targeting. The challenge is that people have to behave in reality as economists think they will behave in theory. In other words, there has to be a widespread understanding of the objective that the Central Bank is pursuing. Now, after decades of inflation targeting many people will know, "Okay, the Bank is supposed to get 2% inflation". I know when we look at businesses in Canada, when they run their forecasts, if they have an inflation assumption they just use 2%. They do not bother thinking about or monitor and that very act reinforces the effectiveness of the policy; that heuristic, that way of thinking about where inflation is going to be. For nominal level GDP targeting you have to think about where the gap is relative to some trend, a trend that is determined by the Central Bank, and it is much more complicated even for experts to follow let alone the man or woman on the street.

We have done a fair bit of research on nominal GDP targeting at the Bank of Canada and the related variant price level targeting and what we have found is that if a significant proportion of agents in the economy do not follow the rule, do not understand what the Central Bank is doing, effectively the main benefits of nominal level GDP targeting go away and flexible

inflation targeting dominates even in a zero lower bound scenario. There are some other downsides with it in terms of measurement errors and in terms of the fact that you are ultimately targeting GDP inflation, which is not the consumer basket. So, you are targeting a level of inflation that does not directly map to the level of inflation that individual's experience. Implicitly, that is what you are doing.

All of those factors leave me far from convinced of the merits of moving to nominal GDP targeting, but it is a valid part of the debate if one is looking at a framework—and I will end with this and pass back—because its best prospect of success, its most power and its biggest payoff is in a circumstance when an economy is in exactly the position that the UK economy is in. It is entirely appropriate for it to be analysed in that context but, as I think I have indicated, given what I have experienced and what I have known and the research I have seen, as I sit here today my view would be that flexible inflation targeting, potentially deployed in a slight different way depending on the circumstances, would remain a superior alternative to a shift of framework.

Q75 Mr McFadden: That is a very full explanation; thank you. Does part of you worry that in the discussions of these options there might be a danger in confusing people about what the future MPC remit might be, creating uncertainty about a regime that has been in place for a long time and which, as you say, is well understood, or do you take the alternative view that the conventional tools that have been used in the UK so far have not allowed us to reach, your phrase, escape velocity and growth has been so flat and confidence in the future has been so low that with the arrival of a new Governor it is time to reconsider the measures in the policy basket in front of us?

Dr Carney: The latter. I think that the economic circumstances here are clearly exceptional and, as the debate has shown, there are different points of view. There is a value to getting those out in the open and coming to a speedy conclusion on that and moving forward. As an institution that has delegated responsibility, obviously, reconfirmation of exactly what exists or some variant of that is what we need in order to discharge our mandate. If I may just re-emphasise, I think the process helps address your concern in that, if there is a widening range of opinion of what is right and the role of monetary process, the process of that debate and, reconfirming my view, the value of flexible inflating targeting is, in and of itself, valuable and important.

Q76 Mr McFadden: Even if we looked at all these and we ended up where we are, your belief is that the process of going through that is itself beneficial?

Dr Carney: Yes, and that is the experience. We have not had necessarily difficult debates in Canada, but there have from time to time been important issues over the past two decades that have come out during these review processes, and it is valuable because it leads to a broader shared understanding of what the Bank can and can't do.

Q77 John Mann: Dr Carney, would it be right to presume from what you have been saying that you think it is an appropriate position to take that the Bank of England should feel confident in questioning its own remit?

Dr Carney: Clearly the decision of remit is a decision for the Government. The bank is obviously very well informed on the conduct and the effectiveness of the current remit under various alternatives. In fact some of the members of the Bank, Charlie Bean for example, are leading experts in some of the alternatives. I think the Bank can play a role in informing that debate.

Q78 John Mann: That is not quite the same. Would it be reasonable for the Bank to question its own remit, presumably on the basis it felt that there was a question to be asked?

Dr Carney: I think that if the Bank were invited to question its remit, it is reasonable to respond.

Q79 John Mann: What if the Bank was not invited? What if the Bank felt that it was appropriate?

Dr Carney: It depends on how that questioning was conducted and here is what I mean. The bank is given a remit. The bank's job is to execute against that remit and do its best to achieve the objectives of the remit; whatever remit is given to it by Government, that is delegated responsibility. To go to Mr McFadden's point, active questioning of that remit can cause confusion about the remit and therefore make it less effective than it otherwise would be. I would make a distinction between a circumstance where debate has been invited—the question that has been asked—it is appropriate for the Bank to respond to that. I would also say further that it is appropriate as normal course through the research programme of the Bank that the Bank would look at various ways to improve monetary policy frameworks, macro prudential frameworks, publish on that, give evidence, go to conferences and those types of things, but that is distinct from having a bank view that the remit should be changed. Again, I would re-emphasise that once a remit is given, and the remit I know is given annually, then the Bank's job is to execute against that.

Q80 John Mann: In answer to an earlier question you stated that the policy of the Bank of Canada and the Bank of England were the same: "flexible inflation targeting". That is what you said. I recall questioning the current Governor on precisely this issue at some length. I believe it was in 2009, and I have returned to the issue with him since. Very explicitly I raised the issue with him for quite some time and he was explicit that they should not be flexible, that the inflation target was the inflation target. So it is not the current policy as outlined by the Governor. You are suggesting quite a significant change of policy happens to be the one that in a sense I was suggesting to him. Why are you suggesting it is the same policy?

Dr Carney: Two things. I am afraid I am not familiar with the exchange to which you are referring with Governor King but I am familiar with speeches and others of Governor King where he does refer to flexible inflation targeting and in fact he is one of the

intellectual founders, if you will, of inflation targeting through his research. What we share between the Bank of Canada and the Bank of England is a symmetric target, 2%, and a commitment to floating exchange rates; a policy that is anchored around a medium-term objective to achieve that inflation rate in recognition that that is the best contribution of monetary policy to economic outcomes; and a variance in the time horizon to return to target. Some of this could be the result of the structure of decision-making or it could be for other reasons, but where I think we have differed since the crisis has been in the Bank of Canada's maybe greater precision around the definition of what flexible inflation targeting is and how we have deployed that flexibility; initially with the conditional commitment as Mr Ruffley raised but also more recently, as I referenced, as we have leaned into the wind in the face of too-rapid credit growth.

Q81 John Mann: Eyebrows count for quite a lot, but the exchanges I have had with the Governor were unambiguous, and this terminology has suddenly crept in: "flexible inflation targeting". I note that in media briefings overnight the Chancellor of the Exchequer has used exactly this terminology and someone suggested it rather suits the Chancellor in terms of fiscal policy to have such a concept suddenly broadened. I wondered, as the Chancellor has been using precisely this, how quickly are you going to poor some salt on his head to create a clear independence between yourself as the new Governor of the Bank of England, or are we going to see a shift in that whereby the role becomes more political, less independent?
Dr Carney: First, a point of detail but an important detail. The terminology "flexible inflation targeting" is not new. The literature on inflation targeting, the academic literature and the policy usage of the term extends back decades, so this is not a new term.

Q82 John Mann: Its use in this context in this country has come in since you raised it.
Dr Carney: I would suggest that the practices of the Bank of Canada initially but, more importantly—and recalling as well that Mr Mudie referenced the dual mandate of the Federal Reserve—the Federal Reserve has, within the context of its dual mandate, defined itself within the past year as a flexible inflation targeting central bank. The conduct of policy of the Bank of Canada and, as I say, more importantly of the Federal Reserve has brought the issue of flexibility more to the fore, but you raise a crucially important point.
There will be no question about my independence as Governor of the Bank of England, the independence of the MPC or the independence of the institution. There is a governance structure that is being put in place that this Committee has very importantly contributed to, but there is an absolutely clear structure. We get a remit. We execute that remit as best as we see fit and no political influence will come to bear—it might be attempted but it will not come to bear—and have an influence on the execution of that remit. That is why, quite appropriately, such focus has been put on accountability and governance.

Q83 John Mann: But you will see the moment it moves from inflation target to flexible inflation target that "flexible' is not precisely defined. I happen to agree with that approach. I think it is sensible. However, one has to recognise that, first, that is a change and that, second, there is a political dimension. Not your or the Bank trying to enter politics but a Chancellor of the Exchequer trying to cling to your coat-tails because flexibility is great for politicians.
Dr Carney: The point in this broader discussion, which I very welcome, is to define and circumscribe that flexibility. I think the point that I have been trying to make is that that flexibility does exist and that flexibility is exercised from time to time, to different degrees and with differing degrees of transparency across central banks around the world. Best practice would be to clarify exactly how much flexibility the Central Bank has, in what circumstances and then delegate to the Central Bank to exercise that flexibility as it best sees fit to achieve the remit.

Q84 John Mann: Do you think we should judge your success on economic growth in the country over the next five years? I was the only Member who met our equivalent committee from Canada two weeks ago and it is an entirely different question but I would like to throw it in because I think it is important. To summarise, they suggested that one of the strengths of the Canadian economy was that the Bank of Canada had a strong regional input and, therefore, it looked at the whole economy. You are moving from Ottawa, which is a relatively small city economically within Canada, to London where one could, if one wanted to be mischievous, call it the Bank of the City of London rather than the Bank of England or the Bank of the UK. Quite separately, my second question is: are you intending to look at regional imbalance in terms of the culture and decision-making of the Bank of England that some would suggest, both across England and the UK, has been one of its great weaknesses and one of Canada's great strengths?
Dr Carney: Judgment of relative success in five years' time with respect to monetary policy is on price stability as defined under the remit. Five years is unquestionably the medium term and the remit, as it stands and quite appropriately in my view, seeks price stability. The responsibility of the Bank is to achieve that. There are various paths to achieve it, but that certainly has to be achieved, and that is how I would expect to be judged as Governor with respect to that.
Your second question: yes, I believe that is a strength of the Bank of Canada, and I believe, coming in, that it can be a strength and is a strength of the Bank of England. There are 12 agencies across this land and I intend to be out visiting them all. It is important, through the monetary policy process, that we draw input directly from those agencies because they are the ones out talking to businesses in the field and that is what supplements more important but abstract statistical data and statistical models.
Your point about rebalancing is absolutely right. One of the challenges in the UK economy is ensuring that the rebalancing that is taking place between the relative weight of the financial sector and, to some extent, the oil and gas sector, but away from those

sectors others that spread across the country, is necessary. Also, its relative success or failure has an important impact on productivity and, therefore, potential and inflationary pressure. So it is highly relevant to the Bank.

Q85 Chair: You have said a number of very interesting things there and I just want to be clear on what at least I think I have heard. On independence, you appear to be reasonably relaxed about the idea that a Chancellor might express a view about aspects of the conduct of monetary policy. Today he is reported as pressing the Bank of England over growth. That is a lead story in the *FT*. Do I have that right, first of all: more relaxed than has been the case in the past?
Dr Carney: Let me answer it this way. I do not anticipate making a large number of comments about fiscal policy, so I would not expect a large number of comments from—
Chair: That is not quite what you said in your written evidence to us, is it? In response to our question, "Should the Bank of England have a role in commenting on fiscal policy", you have hedged just a little, have you not?
Dr Carney: I didn't hedge.
Chair: "We have a duty to comment", you said, for example.
Dr Carney: In extreme circumstances where the fiscal position is such that it could imperil price or financial stability, which are the core objects of the institution, but as a general rule the Bank takes fiscal policy as given and then optimises against that.

Q86 Chair: It could be said that there has, since Bank of England independence in 1997, been a bit of a non-aggression pact here where you keep your tanks off the Chancellor's fiscal lawn and he keeps his tanks off the Bank of England's monetary policy. Am I wrong to have interpreted anything you have said on this to mean that you are more relaxed about there being a bit of a public debate than has taken place in the past, or do you want things to carry on exactly as they were with respect to the maintenance of that demarcation in debate?
Dr Carney: Let me say a couple of things if I may, first with respect to specific story to which you are referring today from *FT*. That is the sum total of my knowledge of "the Chancellor's remarks". I know in that story it indicated that I was meeting with the Chancellor this week. I am not meeting with the Chancellor this week. I never was and so I take that story with a grain of salt in terms of the overall thrust of it. That is the first point.
The second is that I stand by obviously what I wrote in terms of our role and, in commenting on fiscal policy, it is very much the exception. Obviously we have to be informed about fiscal policy. We have to take it into our forecasts. We have to make judgments about the multiplier effects of fiscal policy, but these are antiseptic, objective judgments against which we then optimise. To be honest, I think that answers in terms of approach from the Bank's perspective; but, to go back to Mr Mann's question that I guess you were picking up in terms of independence, the value of a remit is that it is delegated responsibility to the institution to execute against that remit.

Q87 Chair: Then you should be allowed to get on with it?
Dr Carney: Then we should be allowed to get on with it.
Chair: You do not want these tanks on your lawn and you are suggesting we should take with a grain of salt—
Dr Carney: What I recognise is that a large part of the reason for the independence is that difficult decisions on the monetary policy side, on the macro prudential side, will not always be met with shouts of joy and so there inevitably will be commentary and the Bank's job is to look through that.

Q88 Chair: The second area where I just want to be clear that I have understood what you have said is on inflation and on dealing with inflation. You think first that we should have a debate about the remit; that we should get on with it and that we should not have an undue period of uncertainty, but that might include GDP targeting as an approach.
Dr Carney: If there is a debate it would not be my contribution to the debate, but I clearly recognise that others would contribute. How is that?
Chair: You are going to sit quietly and let others engage in it all; like, for example, members of the MPC?
Dr Carney: I would expect that those who have a view would express one if they were—
Chair: But you are going to stay silent?
Dr Carney: No, I reserve the right to chip in if I may.
Chair: You do think there should be a debate about the remit and that that should be conducted in a way that creates a minimum of uncertainty. In other words, we should get on with it, but it should take place?
Dr Carney: I think it is taking place.
Chair: Yes, and that you are going to participate in it?
Dr Carney: I reserve the right to do that.

Q89 Chair: There have been some extremely interesting remarks, but the second thing that you have said is, whether or not we change the remit, there is a case for interpreting the remit somewhat differently. You have said, for example, you are interesting in pre-commitment, and you have touched on a number of other areas as well.
Dr Carney: I am glad you raise it for clarification. I think this could be, from my perspective, the principal benefit of that debate, which is not that the interpretation of the remit changes by dint of the Bank reinterpreting the remit. I thought Governor King in his last speech spelled this out quite nicely in terms of the trade-off between the path of output and inflation and that is something that was effectively delegated to central banks but needs to be more broadly understood. The extent to which that has been—I think this is a little harsh as an adverb—unthinkingly delegated, it should be thought through in terms of how much flexibility is delegated. I would not want to leave you with the impression that I think if there is not a debate, if there is not a process, that then the Bank can reinterpret its remit. It can't. The

point is that through the process of discussing what the remit is, and this has been our experience in Canada, by discussing what flexible inflation targeting meant in an environment of low for long, which is what we are living in, where you have a well-functioning banking system and macro prudential risk rising, what does that flexibility mean and how do you use it. We had that debate/discussion, and that has allowed us to reinforce the policies of the Government and our bank supervisor.

Q90 Chair: The last point I want to clarify on is you gave a very interesting set of replies to Pat McFadden about the pros and cons of alternative break, one of which you only touched on obliquely, and I just want to be clear how much weight you attach to this. One downside is the current view, a well-established view, that an anti-inflation strategy depends crucially on the establishment and maintenance of credibility over time. It takes a long time to construct that and, once you have it, it is a heck of a risk to change it because you accumulate that capital with great difficulty. You did not make that point. You obliquely touched on it at one point. Do you agree with what I have just said there or the description I have given for one of the arguments for caution before changing policy?

Dr Carney: It is one of the reasons.

Chair: If I may just add one more point, you said at one point, "This other approach might be particularly appropriate to the conditions of the British economy now". Of course, that may not be the case later, and that brings into relief that you should not change inflation policy to suit the seasons of the economy.

Dr Carney: Two excellent questions; I would endorse what you said on credibility. I think that is a consideration. It is one of the reasons why the bar for change is high, as I have said in my written submission and I think reconfirmed today. Secondly, yes, there is an issue with temporary adoption of a different framework for the economic circumstances and, as I think I have made clear, I am not advocating a wholesale adjustment framework to nominal level GDP targeting. Others have. I have not, but I will recognise that the exceptional economic circumstances in which the UK is in at present and has been for a few years is exactly the type of circumstances in which one would consider doing this. It is understandable that people have suggested that adjustment. My view is that I am not convinced, given the risks and other factors, and you rightly reinforced credibility, that it is a risk worth taking. In fact, my view is that, using the flexibility under flexible inflation targeting, we can achieve with lower risk more rapidly and more effectively the same economic outcomes. I mean broad economic outcomes in terms of output, employment and inflation.

Chair: You are right, of course, to say flexible inflation targeting is a term of art and the literature and goes back decades, but John is also right to say that it does seem to be given greater salience just now, and I notice that even in that reply it popped out.

Q91 Mr Newmark: I appreciate your Economic 101 tuition to Mr Ruffley earlier. I would like to focus on QE a little bit more. The Governor, in today's announcement, announced that further QEs, putting everything on hold, have marginal impact on growth. Do you think that there should be further work on the efficacy of further quantitative easing?

Dr Carney: When you say the Governor's announcement, is there an MPC announcement that has come out?

Mr Newmark: Yes, just this morning.

Dr Carney: All right, you are ahead of me. Should there be further work? I think that for all unconventional policies that the Bank has either pursued or could potentially pursue there needs to be additional work conduct on both the benefits but, very importantly, the costs as well.

Q92 Mr Newmark: I guess the analogy I used with the Governor when he was here is I have an old MG TD 1953 and, when I start it in the morning and it is cold, I pull out the choke and it sort of floods the engine and gets it going. I do not keep the choke out because the marginal effect of further fuel in the car does not have the same effect. I am fairly cynical on the effects of QE generally. That first £200 billion, I could see, had a positive impact. Do you see that there is much marginal benefit now to further QE?

Dr Carney: To be honest, it is not a question I am in a position to give a full answer to because it is situation-specific to both the state of the UK economy and the state of the UK financial system and I am not in the MPC. I am not looking at this on a daily basis. I have not done the analysis.

Q93 Mr Newmark: You must have done some analysis. This is a major economy in the world. You are looking at the Bank of England and this has been their whole raison d'etre. Their whole main driver is to effectively keep buying up gilts, printing money. You are coming in, and I am optimistic of you coming in. I have looked forward to you coming in because, as I said, I do not necessarily think that QE has been the answer to all our solutions when we do want growth. You have come up with, I think, some thoughtful alternatives in targeting growth. I am asking you a very simple question. Having looked at QE not just in this country but the US and the eurozone and Japan and elsewhere, do you think that printing more money today is going to have a significant or even a beneficial, marginal, positive impact on what you want to achieve and what I want to achieve, which is growth?

Dr Carney: The work that we have done at the Bank of Canada suggests that the returns to QE have declined, particularly in the United States, as the scale of the programme has increased. To some extent that is natural when you think about the main channel, in our view, of quantitative easing is through a portfolio balance effect; a shifting of investors from the risk-free asset into assets that start to have a risk. That is part of the logic, as I am sure you are aware, of why the Federal Reserve is concentrating increasingly on the mortgage market and then, potentially, one would extend that more broadly if that were necessary into riskier and riskier—

Mr Newmark: Do you think that is a good idea?

Dr Carney: I think that it is logical. Yes.

Q94 Mr Newmark: You think it is a good idea? It leads on to my next question, which is, when thinking about asset purchasers, should we be looking in a broader way including wrapping up SME loans and so on?
Dr Carney: Yes. I will take a step back. Obviously the responsibility of the MPC and what they are doing is to identify, first, whether additional stimulus is required—that is a discrete judgment—and then, if so, how and then to concentrate on those instruments that are going to provide the best stimulus with the least costs. I want to stress again that, with all unconventional policies, there are costs associated with those policies. With QE there are potential issues around market functioning. There are broader political economy questions that this Committee is looking into.
There are issues relating to QE, but the way I would answer the question is that in the current environment it seems that the efforts of the Bank, in conjunction with the FSA and the Treasury, to concentrate on ensuring that bank lending and particularly bank lending ultimately into the SME—our view, I guess, is the SME channel most effectively targeted and improved, through the Banks, both through the Funding for Lending Scheme and ensuring that the capitalisation of those institutions, is transparently adequate.

Q95 Mr Newmark: Do you think the Government is in a position to make a judgment on SME lending as opposed to credit officers in individual banks? Effectively what you are saying or what I know is out there is that the Banks, because of Basel III and shoring up their liquidity and their balance sheets and so on, have that pressure, but we are also, as politicians, saying we have to get the lending out to small and medium-sized businesses. Maybe a way of doing that is having the Government stand sort of behind that somehow. Is that a good idea or not?
Dr Carney: In the manner in which you expressed it I would say a superior idea is the construct of Funding for Lending because what happens there is that first off it is neutral. It is the decision of the Bank whether or not to extend the marginal loan. It is an advantage in terms of the funding cost obviously if it does extend it and it is also advantaged in terms of capital relief, but there is no direction to lend and there is certainly no direction to which SME to lend to. What has been established is a neutrality across lending to an SME or another corporate or establishing a mortgage under that scheme. To go back, you started with packaging SME loans and providing that.
Mr Newmark: Yes, and the same thing with mortgages; so looking at other asset purchases.
Dr Carney: Asset-backed security; CLO, CDO, based on SME lending.
Mr Newmark: Which were a great success, by the way, weren't they?
Dr Carney: There were very few elements of that market that were successful.
Mr Newmark: I was being facetious.
Dr Carney: That is one potential channel. I guess what I am suggesting to you is that a more direct and immediate channel would be to go through the Bank system; not direct lending, but through Funding for Lending effectively.

Q96 Mr Newmark: When you come in, just to be clear, you are not going to examine again the idea of buying other assets because you are happy with that or not?
Dr Carney: No. I think it is the responsibility of the institution to continue to continually, while we are in this circumstance, evaluate the different options, which would necessarily include buying other assets and particularly if it is the current judgment of the MPC that additional QE—and I am using the quote that you gave me—has a marginal impact on growth. I hope that is correct. I do not want to be misquoting them.
Mr Newmark: No, that is correct.
Dr Carney: If the judgment of the MPC were to be that additional stimulus were needed then obviously different channels would have to be used. Funding for Lending is a channel that has started. There are some early encouraging signs. We would have to see where it is when I arrive but if it were required, one would look at that but also look at a different range of alternatives.

Q97 Mr Newmark: I appreciate time is ticking on. My final question is that there have been some good benefits of QE. It has kept interest rates down low. It has meant that constituents of ours who are mortgage holders have had relatively low mortgages. It has mean that corporations have been able to borrow hopefully a little less expensively than perhaps if there had not been any QE programme at all, but the people who have paid the price are savers out there, particularly pensioners. Many of us on this Committee have many constituents who have saved up their whole lives. They are earning 0.5% or less on whatever savings they may have, yet the inflation rate is 3% and on a basket of goods for pensioners' goods is probably closer to 6% or 7%. Do you think that is a price worth paying?
Dr Carney: For the stimulus that is provided to date by quantitative easing?
Mr Newmark: Yes.
Dr Carney: I absolutely recognise that there are broader distributional consequences from quantitative easing. Pensioners in this country and pensioners in Canada are in difficult circumstances because of the lower rates of interest. I would underscore that pensioners in Canada are in difficult circumstances and there has been no QE in Canada, and in fact the differential between the ten year in sterling and Canadian is 10–15 basis points, with the Canadian ten year slightly inside sterling the last time I checked. There is a broad global reduction in interest rates, which is a product of the global economic outlook. It also is the product of global quantitative easing, but it is not just the product of global quantitative easing in the United Kingdom.
I recognise as well, as I am sure you would, that the policy has improved—and it is hard to be exact on

this—the valuation of other assets, which, depending on whether one is about to become a pensioner or whether one is an existing pensioner or whether you are running a defined benefit plan in surplus or deficit, accrues more or less to your benefit. Obviously if you are on a fixed pension or you have a fixed savings and you are reliant on gilt rates for your income for consumption then this is an extremely difficult circumstance, but the responsibility of the Bank is the broad economy, and we have to keep that focus.

Q98 Andrea Leadsom: Dr Carney, I would like to talk to you briefly about the eurozone. Obviously the next five years, we all hope, will see resolution of the eurozone crisis. You have said, "The bank will need to support the Government as it engages in efforts of the euro area to re-found the European Monetary Union", and yet you, like many non-Europeans, may feel that Britain should just shut up and get stuck in there and not try to defend her own national interests against the interests of the whole euro area. Can you reassure us that in your determination as the Governor to support the Government as it engages your interest will be in promoting British national interests and not just a resolution to the whole picture?
Dr Carney: Absolutely, I can reassure you on that and I will expand. I think that it is in British interests that European Monetary Union works for the economies that are in European Monetary Union. As you are well aware, this is Britain's largest trading partner and will be for the foreseeable future, certainly beyond the end of my term. There are enormous challenges in Europe that remain in order to properly re-found European Monetary Union and ensure that the economy of Britain's largest trading partner returns to sustainable and balanced growth.
I can tell you further from my experience at, to a lesser extent, the G20 but certainly my experience at the G7 that countries like Canada and the United Kingdom have been actively engaged in trying to help devise solutions, whether they are monetary, financial restructuring or institutional solutions—I will get to the last one, which is probably the most important, for your broader question—to help Europe help itself. That has been a difficult and intensive process over the last several years but it has been an important process to help ensure that the euro crisis was not worse for all of us. Obviously, if there is an external economy that has borne the brunt of the euro crisis, it has been the UK economy.
We need to keep that engagement and I would anticipate, moving from Governor of the Bank of Canada to Governor of the Bank of England, that that level of engagement central bank to central bank in terms of—I think we are moving from the acute phase of the crisis to a more chronic phase, but the crisis management element that is there would continue and it is absolutely in Britain's interest. When we get to the institutional side and the institutional development of European Monetary Union, they are very clear interests of Britain and I would support, as does the Government, the development of a true banking union in Europe. It is essential that the position of the British financial system, in particular the City of London, is adequately safeguarded and recognised in the structure of that banking union, and I am encouraged by the agreement that was struck in December with double majority voting around the single supervisor mechanism. I think it is a responsibility of the Bank of England and our role, and the PRA within the Bank of England, to be fully engaged in the interaction with the ECB and of course with the EBA, the European Banking Authority, to ensure that we are very clearly at the table; constructively engaged but very clearly representing the interests of the "outs" in the nomenclature of Europe. I fully intend to do that. I come to this, I would say one other thing, with relationships with obviously Mario Draghi, Mr Barnier and others in Europe that I will deploy, but I will deploy on behalf of the Bank of England and broader British interests.
Chair: A very quick question and then a very quick reply, if that is possible, and then I will bring in Andy Love, and we will wind up this part of the session.

Q99 Andrea Leadsom: Dr Carney, you suggested an increase in German wages and private demand in inflation would ease the transition from a balance of payments crisis within the currency area. Bearing in mind the, shall we say, slight reluctance on the part of European politicians to be offered advice by British politicians, do you think it is appropriate and do you intend to continue to offer this extremely helpful advice to the Germans?
Dr Carney: I am not sure it was that welcome coming from the Bank of Canada. Yes, I do because I do think that that is an essential piece of the rebalancing puzzle.
Chair: Very helpful answer indeed, not least that it is brief.

Q100 Mr Love: Welcome, Dr Carney. I have been struck in the responses you have given to various questions that you seem to be very committed to the flexible inflation targeting, with an emphasis on the flexible. Was it your intention to be absolutely clear about that? In the debate that we have talked about at the Committee this morning that is going on about monetary policy would you be speaking up on behalf of flexible inflation targeting?
Dr Carney: Yes. It was my intention to be clear about that and hopefully I have been. If there is an ongoing discussion of this, as appropriate, I would contribute, but recognise my current position in Canada and, to some extent, the best contributions I can give is the Canadian experience and observations on what the Federal Reserve is doing and how that might be applicable here.

Q101 Mr Love: Of course with this flexibility, around the word "flexible", and contrary to what Mr Mann said earlier, the current Governor of the Bank of England has expressed his view of the flexibility in terms of setting the policy framework to take into account output and employment issues so that, for example, we have not had inflation at 2% for some considerable time. That is quite a latitude. Would you see there being an increase of that latitude that the current Governor has undertaken in relation to hitting the target two years out?

Dr Carney: Not necessarily, is the short answer. There could be a different way of speaking about it or formulating what is effectively a very similar policy, by which I mean the current Governor speaking in terms of taking into account output and employment, that is another way of taking into account the timeline over which there is a return. Maybe I will stop there and give you the follow up.

Q102 Mr Love: All I wanted to do was to emphasise that when people have asked why they did not change the Bank rate or they did not change the position in relation to quantitative easing he would say that while their remit is to get the inflation target to 2% two years out he had to take into account other factors and they were important, and that gave him the flexibility. I just wondered whether that would continue and perhaps you would seek even greater flexibility recognising our economic circumstances.
Dr Carney: It is similar motivations for the flexibility, you are absolutely right. I think the MPC, in hindsight, has exercised considerable flexibility. The question is whether there is more flexibility and it is a question of circumstance, and circumstance only once I arrive, whether the economic circumstance is warranted but whether it would exercise more flexibility transparently ex ante, in advance, an expectation that it would take longer to return as opposed to a longer return.

Q103 Mr Love: The Monetary Policy Committee appears to be concerned about the level of inflation at the current time and the fact that we have not brought it back to 2% and that seems to be the rationale for not increasing quantitative easing at the present time. What do you see? You have mentioned several times during contributions the exceptional nature of economic circumstances. How exceptional do they need to be before there will be positive action to boost the economy?
Dr Carney: Again, I am slightly handcuffed because I have not seen what the MPC has said, but I made the point that in some cases if there is a deterioration in the output employment trade-off, in other words—I will do a hypothetical because I have not seen what they said—but if the view is that inflation is going to return to target later than originally expected and there is no reduction in stimulus that is exercising flexibility as well that should not be underplayed. Just because there is not positive action of additional stimulus does not mean there is not considerable stimulus that is being provided and, in the context, if there were a deterioration in the return to target then that is stimulative.

Q104 Mr Love: If a question can be quick I hope the answer will be quick, of course. Lord Turner, chairman of the FSA, earlier this week made a speech where he suggested injecting money directly into the economy. When pressed on that he said it was because of the current economic circumstances; we are bumping along the bottom. We have talked generally about escape velocities. He believes that the circumstances are good enough to suggest that. I am not suggesting he would go that far, but is there some recognition of the concerns that he is expressing about where an economy is at the present time, and what we need to do in monetary policy terms to move it out of that position?
Dr Carney: Let me say two things: first, with respect to so-called helicopter money, which was referred to there, I will be absolutely clear, I cannot envisage a circumstance where I would support that as a strategy; and I would say, secondly, that there is considerable policy flexibility that remains within the existing tools of the Bank of England if additional stimulus were required, and we have talked about some of them today.
But to your last point, which is that the circumstance of the economy moving sideways, considerable slack—still subject to considerable debate the degree of slack—but clearly slack in the labour market in the economy. That circumstance within the context of price stability over the medium term, that is a circumstance absolutely given that there are options that exist for stimulus. The MPC will, I am sure, continue to evaluate whether it is appropriate to use those. But that is grounded within the overall framework.
Chair: We are back to high monetary theology again where we have been for quite a bit of time this morning so far. We should take a break now. You have had quite a testing time so far but you certainly demonstrated that you know how to handle committees like this and you have also passed the three simple awkward question test put to you early on, one that often trips up candidates in pre-commencement hearings before Congress. You look a fit man so why do we not just have a five break and resume, and then we will do financial policy.
Dr Carney: Okay, thank you.

The Committee suspended for five minutes.

Q105 Chair: Thank you very much for putting up with the amount of this session. We do not normally take this long each time the Governor comes before us. We are now going to take a look at financial policy and the new responsibilities the Bank has acquired as a result of the legislation, which will be further amended as a consequence of the Banking Bill that is currently before Parliament.
Stewart Hosie: Dr Carney, in January of this year, the group of Governors and Heads of Supervision announced significant changes to the Basel III liquidity rules that gave the banks an additional four years and extended or provided for a wider use of assets as part of the liquidity buffers. How much of that was a pragmatic decision in the light of prevailing economic conditions, and how much of that should worry us, in terms of it being perceived as a watering down of the tougher new rules?
Dr Carney: I participated in that meeting, which was chaired by Governor King, as you may know, and wholeheartedly supported the new agreement. I will give you a bit of context, which is that the original agreement, we had spent a lot of time on the Basel III capital agreement. We, Governors and Heads of Supervision, had spent a lot less time on the original so-called liquidity-coverage ratio, and we had explicitly signalled that we would be reviewing that

LCR over the course of the subsequent year when the original Basel thing was put in place. We made a series of adjustments at that meeting and they all make sense. The spirit of that meeting was to get the right ratio, the LCR, the liquidity-coverage ratio, so the Banks manage their short term liquidity appropriately, have appropriate liquidity buffers. We wanted to get the right requirement there, and that is why we have a medium term phase-in. That phase-in, as you know, does not just start in four years, it starts in a couple of years, and then starts from a 60%, ultimately to 100% of the new LCR. So it starts in 2015 and dovetails with the Basel capital regime.

The changes that were made between the two are all, in our opinion, very sensible changes. The definition of what is a liquid asset was broadened to be measured on the basis of liquidity, actual, demonstrable and demonstrated liquidity as opposed to credit-worthiness. Originally, effectively, we said that the only things that were liquid assets were government bonds. Obviously, just look at any of the aspects of the recent experience in peripheral Europe and see that there were a number of government bonds which were anything but liquid, but they would have counted under the old LCR. Whereas equities, listed equities in the main indices, which, one might not like the price on a given day, but they are always liquid, you can always buy or sell those securities so, with an appropriate haircut, should be in the numerator of the LCR. They were brought in, as one example. We also brought in a broader range of corporate bonds and asset-backed securities. All sensible things measured on true liquidity, so the resources available to meet short-term obligations of the banks were expanded.

But equally importantly, on the basis of evidence, on the basis of experience during the worst financial crisis since the great depression, the assumptions around draw-downs from bank lines, so whether, if somebody uses a contingent bank line, they ask for the actual money, which is a call on the Bank's short-term liquidity. The assumptions around those and run-off rates on deposits, whether or not corporate or individual depositors take money out of banks, again, something that we had great experience with, unfortunately, during the financial crisis, so we can see what the draw-downs and the run-off rates were. The original specifications were wildly conservative, relative to experience and they were adjusted back to very conservative, relative to experience.

Q106 Stewart Hosie: The central banks, the Governors and the Heads of Supervision, presumably, in discussion or under pressure from the commercial banks, who were very critical of the way the liquidity buffer had been put in place, decided to take what you say are these sensible measures. I suppose the question I have is in two parts. Why was there so little focus on liquidity initially with Basel III and so much of a focus only on capital? Secondly, and this is really the key point, now this is likely to be changed, will it result in more lending from the commercial banks into the real economy, while maintaining the safety of the system?

Dr Carney: Two reasons for the relative focus on capital. First, there was a manifest deficiency in capital as a result of the crisis, in the run-up to the crisis and in the aftermath of the crisis, and it was important to address the deficiencies of the old Basel II regime, but also to ensure that banks started to move, in a phased approach, to build capital. As you are probably aware, there was never a liquidity standard in the old Basel II or the old Basel I. So liquidity was new. This was a new standard. We started to put it in place and because it was new, there needed to be an observation period and to make adjustments as necessary to that liquidity standard. The second reason why there was less focus on liquidity than capital is because, in an environment where liquidity was strained in the major economies, and now this is largely an issue in Europe as opposed to the other major economies, but in an environment when liquidity is strained, this is not a minimum. The liquidity standards are buffers, not minima.

So the point is, in a strained environment banks should be able to draw on these buffers and as necessary, central banks provide backstop liquidity through a variety of facilities. All of those aspects argued for immediate focus on capital; take your time to get liquidity right; adjust liquidity, because it is new, as appropriate. I think it has been appropriately adjusted, and I just underscore, to go back to the lending point, is that the behaviour in some markets—those markets that are liquidity strained—was that there was an argument from the banks, to which I do not fully subscribe, quite frankly, but there was an argument from the banks that the present liquidity standard was exacerbating pressure on funding liquidity for those institutions, and that was restricting lending to the real economy. In the end, the far more important thing, particularly in the European context, is concerns about adequate capitalisation of those institutions and that is what has been gradually addressed and could be, more aggressively.

Q107 Stewart Hosie: Just one final small question, on this issue about using buffers, liquidity buffers or capital buffers, when there is a strain on the Bank: do you think that is understood enough or do you think that even within banks, some people think these are de minimis levels, rather than contingent funds to be used when the circumstances demand?

Dr Carney: It is the right question. I do not think it is widely enough appreciated, either within the institutions or within the broader market, that these are buffers that are meant to be drawn upon, and that gets to a question of, what is the interaction between these liquidity standard and backstop liquidity of central banks.

Chair: On that point, the UK has taken a couple of policy initiatives in order to try to ease the liquidity positions of banks, in order to encourage them to lend. Have they done enough to eliminate the stigma attached to going to the discount window?

Dr Carney: If I can take that in two parts, outside looking in, what has been most effective policy measures to encourage lending have been the ECTR and the funding for lending scheme, both encouraging, but still early days. Obviously, that is potentially an iterative process, where learnings would result in further adjustment. I do not know, and this is a

decision for the FPC and MPC, maybe. With respect, though, to stigma, your direct question on stigma and the discount window, it is extremely difficult to eliminate stigma related to discount window borrowings. I know this is an issue that has been raised in the context of the Winters Review, for example.
Chair: And in this Committee.
Dr Carney: And in this Committee. My sense would be it is an issue that is not yet solved. My further sense is that part of what was agreed in Basel—these questions are very much related, as you appreciate—was that there will be work through the Basel Committee on the interaction of central bank facilities and the LCR over the course of this year and we, the Central Banks, would have to come to an agreement, let us say this time next year, about the appropriate types of facilities that could interact. The thinking in broad terms is that institutions could preposition collateral with the Central Bank, have more of a standing liquidity facility, prepositioned collateral, and then the pricing would be such that it is more expensive than the market in normal times but could be drawn against in stress times and that this would favourably count for some of the liquidity requirements that institutions would have to hold and by doing that can create a dynamic that provides a more continuous access to central bank liquidity that—maybe to go to your point—could address the stigma issue. But this is a very difficult issue. That may be one part of the answer, but my view would be it is ongoing work for all central banks.
Chair: Tough nut to crack, not yet cracked?
Dr Carney: Yes.
Chair: Definitely high on your agenda, is that what I am hearing?
Dr Carney: High on the agenda, yes, because of the interaction, yes.

Q108 John Mann: The high-street small businesses and consumers in this country have higher interest rates for borrowing but lower interest rates for savings than, for example, Germany, France, Ireland, Greece. Is this an issue for you, and if not, why not? If it is, what are you going to do about it?
Dr Carney: I am not sure about Greece in terms of superior borrowing and saving dynamics, but certainly Germany is the case. Yes, it is absolutely an issue. The spreads to which you are referring are a cause of concern. It is an inefficiency at the core of the economy. It is a brake or at a minimum it restrains the transmission of monetary policy, which is intending to be very accommodative to support the recovery. There is a sense of unfairness, I am sure, which you hear from your constituents in terms of ability to borrow as a smaller business, being more constrained than the ability of large businesses that can go to a very wide open at present capital market and borrow on very favourable terms.
I think there are a couple of challenges that explain it, both of which are being addressed or the intent of current policy of the Bank of England is to address them. First is to ensure that the core of the British financial system, the banks, the core banks at the heart of the British financial system, are transparently and adequately capitalised. There have been some questions around the adequacy of their capitalisation. The FPC has raised the issue. It is in the interests of everyone that there is a speedy resolution or conclusion to that review, and that it is transparent and clear that the capitalisation is adequate of those institutions; the first point.
The second is what the Chairman just touched on, which is funding for lending, which has a dual benefit. One is a direct benefit, which is if drawn upon, as you know, lowering the funding costs for those institutions, which should be in a competitive environment passed on. It is not fully passed on as yet, as you know. But the other benefit of funding for lending is its presence has encouraged a reduction, in my opinion and I think in the opinion of the Bank, in funding spreads in the market for banks so, therefore, getting the market multiplier from that.

Q109 John Mann: That is, if I may say so respectfully, a partial answer because it does not answer the difference and it is the case with those countries I quoted. It is their own statistics as verified at an international level. We are in a worse position on both borrowing and on saving. Another scenario would be that it is because we do not have any real competition and that that has led to a culture and a business model in our banks that is anti-competitive, anti-consumer, anti-small business. Do you think that the two state-owned or primarily state-owned banks would be better if they are broken up and, if so, do you intend to press for that?
Dr Carney: With respect to the direct question, I do not know is the honest answer. I have not looked at the particular circumstances of either of those two institutions and the relative merits, economies of scale, scope that would be necessary. The valuation potentially should be achieved in the ultimate interests of the taxpayer; the first point.
The second point is that without question competition and measures to improve competition in financial services, including in this country, are extremely important. There are some measures I am aware that this Committee has focused on that have been taken up this week by the Chancellor and that would appear to be welcome. There are other measures that can, I am sure, be taken. From the Bank of England's perspective, from our perspective, we have to ensure that the facilities that we provide, whether it is in liquidity, funding for lending, as examples, are available to as wide a range of institutions as possible so that we are not skewing the competitive landscape in any way, shape or form.
With 39, I believe, institutions signed up for funding for lending I think that is the case there. There is also consideration that is given to the structure of the financial system and, if you will, ultimately not purely for competitive reasons but it has this impact in some of the deliberations that the MPC has made on how low the Bank rate can go because of the impact on building societies and interest margins in building societies. It therefore by extension would have a competitive impact. But I guess I would make the point respecting the core mandates of the institution, so we do these things to ensure that we are not

hindering and in doing so with a level playing field promoting competition in that regard. The promotion of competition in financial services is more primary responsibility, as you know, for the FCA than it is for the Bank of England and we have to ensure that we discharge against our given remits.

Q110 John Mann: One of my colleagues might want to come back to that in a minute, but I would just like to move on to a separate area. If we take the 50 largest banks in the world, then every single one of them has been embroiled in the last year or two in criminal fraud without exception. The consumers and the general public are rather cynical about banking. I am quite sure what their questions to you would be, which is what are you going to do about all these greedy bankers. But I wanted to angle in on a slightly different angle, which is the US regulators have been far quicker, far more brutal. They have fined more. They have been happier to imprison more than we have in this country. We have seen that even this week with LIBOR in terms of the fines levied. What direction do you intend to take banking regulation in this country? More towards that American relative robustness or more towards the rather softer, gentler and significantly slower approach that we have had traditionally and in recent years in this country?

Dr Carney: Well, the first point I would make is that the behaviour that has been exhibited and confirmed this week, particularly, for example, around LIBOR, is reprehensible and should be prosecuted to the full extent of the law in the various jurisdictions that are affected. That is clear. I think we would all agree on that. The responsibility to do that does not rest with the Bank of England, either in its current guise or its future guise. Issues of conduct, apart from criminal conduct, as you know will reside with the FCA.

That said, in my experience in prudential supervision as part of the Inter Agency Committee in Canada that oversees all the banks and insurers, the patterns of behaviour, far less severe than what has been revealed with these institutions, but patterns of behaviour and an absence of control, proper control environments, weaknesses in culture, are material for the prudential supervision of those institutions. They are issues that have consequences in terms of how much capital—apart from what should be done on the conduct and the criminal side, the justice side, they have consequences in terms of what types of activities those institutions should be engaged in, the capital they need to carry, consequences for remuneration, other aspects. My point is of prudential—

Q111 John Mann: The Canadian banks are embroiled with criminality as well, but you are copping out with your answer. Are you not going to take, with this incredible level of power that this job now has as you come into it, proper responsibility for ensuring that this industry is treated as every other industry would be when there is such a level of criminality in all the leading players?

Dr Carney: Two things; as Governor of the Bank of Canada I take issue with your description of the Canadian banks. That is not to say that there are not—the word "embroiled" we will have to disagree on, and I would know given my role and given the oversight that we have.

The second thing is that it is not a cop-out to ensure that there are clear lines of responsibility for conduct in the financial services industry that runs through the FCA. My point, and I believe the policy consistent with the approach of the PRA, is that this type of behaviour even at a much less serious level—and this is at a very serious level, the issues that have been revealed in recent weeks and months—has consequences. It has consequences for prudential supervision. It has consequences for capital. It has consequences for activity. It has consequences for compensation. It has consequences for whether individuals are judged to be fit and proper. That is how one conducts effective prudential supervision and taking into account these type of issues. If I may, in parallel there are conduct consequences through the FCA and if it rises to a seriousness obviously criminal prosecution.

Q112 Chair: To pick up John Mann's question or an aspect of it in another way, by pointing out that the PRA if it has an enforcement issue has to trot along to the FCA to get any action undertaken do you think that is a sensible arrangement? Maybe that is too tough a question before you even come in, but do you think that at first blush there is a curiosity about having the prudential supervisor have to obtain the cooperation of the conduct supervisor in order to obtain enforcement action? These two things were in the same body.

Dr Carney: Yes, I understand. It entirely depends. I do not think I am qualified until I see it in action.

Chair: We will let you take a bye on that one for the time being.

Dr Carney: If I may, yes.

Chair: But it is certainly an issue that a number of us on the Banking Commission in another context have been looking at.

Q113 Andrea Leadsom: I think the Chairman is desperate for his lunch because he is not letting us question very much, so I am going to lead my witness slightly here. You have gone on the record as saying that you do not think concentration necessarily led to the financial crisis. But now coming into the UK you clearly accept that both the UK and Canada have concentrated banking systems. How important is new competition, specifically getting new challenge banks in? How far are you prepared to go with the PRA in ensuring that they do offer new banking licences to new challenger banks? Finally, a very specific question. Have you looked at the merits of bank account number portability as a means to achieve both resolution, in the event of a failure, but also as a means to allow new challenger banks direct access to the payments infrastructure that would give them the competitive level playing field that they are looking for?

Dr Carney: They are all excellent questions. At the heart of the PRA approach is it can be pro-competitive, by which I mean that one of the things that Andrew Bailey and the PRA have stressed from the start is that the intention was not to operate a zero

failure regime but the intention is to ensure that failures can be dealt with effectively and efficiently without wider systemic consequences. That ease of exit promotes ease of entry because the knowledge that one does not have to belt, braces, et cetera, a new entrant because of the fear of what the consequences could be if that entrant fails, should adjust the barriers to entry or the level of the entry requirements that should promote entry and competition.

I agree that it is important. As you know, it is not the principal objective of the PRA, it is not the principal objective of the Bank but by designing a system in this way, and truly designing a system in this way, and all recognising that the failure of a bank is not a failure of the system it is a failure of the Bank and the individuals associated with that. That is incredibly important. On the issue of bank account portability, I would say that I followed the debate here and was intrigued by it. I support the direction but I would defer to you and Andy Haldane and others who are far more expert in the issue than I.

Andrea Leadsom: But you are not closed minded to it.

Dr Carney: Given what I know, I am very open-minded to it but as I say, I am not the expert on it.

Q114 Chair: Would you also have an open mind, again, on a related question with respect to PRA responsibilities, that they acquire more than a mere duty to have regard to competition but also a duty subject to the overriding task of maintaining financial stability to promote competition?

Dr Carney: I am afraid my mind is a little more closed on that one than open in that my reading of the have regard to responsibility, which may be wrong, is it strikes the right balance given the principal responsibility of the organisation. While I believe quite strongly in the value of competition and I do not view that vibrant competition is inconsistent with financial stability, I do think that it is important that the various policy arms of the Bank, to the maximum extent possible, have very clear remits in principal responsibility so I would be a little hesitant on further reinforcing that.

Chair: I am fine with hesitancy, it is the closed mind I was a bit jumpy about.

Dr Carney: I said more closed, yes.

Chair: Okay, a bit more closed. We have had extensive experience of have regards and they have turned out to be disregards so I think something needs to be done.

Q115 Mr Love: Can I return to recovery and resolution plans? You were quoted in the press last week as saying, "Regulators around the world are still some way from solving the problem of how to deal with the failure of a giant global bank. Should we be worried?

Dr Carney: You should retain your focus on the issue, yes, as we have to. The intention or what will happen at the level of the Financial Stability Board is that for all the 28 global systemically important banks, their recovery resolution plans are due to be submitted or completed by this summer. There is going to be a review of each one by a college, chaired effectively by me as Chair of the Financial Stability Board, and there is going to be a broader peer review of the effectiveness of the resolution approaches in the relevant jurisdictions. I would expect that we would find potentially a wide variance in the effectiveness of these plans, partly because of a variance in the legislative authorities that officials have, partly because of variance in the preparation of different institutions. The jurisdictions that are the most advanced, in my reading, are the United States and the United Kingdom, particularly because there has been work led by Paul Tucker and Adair Turner on cross-border resolution, cross-border agreements.

There has been substantial advancement there but there is more work to be done, as they would attest. This is something that the right way to address it, speaking in my role at the Financial Stability Board, is with very clear transparency about it so that once these plans are in place, they are assessed. The deficiencies are brought to light publicly. They are also brought to the highest level of the G20 to take an assessment of what else needs to be done in order to ensure that the objective of ending too big to fail for individual institutions is achieved, but more needs to be done.

Q116 Mr Love: Some banks have missed the end of the 2012 deadline, I think you have now moved it.

Dr Carney: Some banks have, yes.

Mr Love: You have now moved it on developing the living wills?

Dr Carney: That is correct.

Q117 Mr Love: Should we be concerned about the deadline? Will they reach the new deadline? Is there a significant problem underlying these delays?

Dr Carney: If they miss the new deadline it will be brought to the attention of their head of Government, head of State at the G20 Summit in St Petersburg as being one of the elements of my report to them so it is inadvisable to miss the deadline.

Q118 Mr Love: Which banks are we talking about here amongst the UK domiciled?

Dr Carney: This is not an issue in the UK.

Q119 Mr Love: It is not an issue for the UK. That is one less problem, I am sure. Let me ask you a final question because we are strapped for time. Let me ask you a more general question. We are putting a lot of faith in resolution and recovery regimes. Can we achieve what we have set out to do in terms of being able to resolve a highly complex internationally based bank in the way that you are discussing at the present time?

Dr Carney: Yes. I think the imperative is to achieve it but equally the responsibility of the public sector is twofold. One, do not over represent what has been achieved, so be transparent about how much progress we have made and where we are coming short. I believe it is achievable, to be absolutely clear, but if events prove otherwise, to be absolutely clear about that because then other decisions might be taken in a broader political sense.

Q120 Mr Love: But at the present time, and you are in the best position to know, you are still confident that we can achieve this?
Dr Carney: I am confident that we are making substantial progress and that it remains achievable but there is significant work still to be done even in the most advanced jurisdictions, yes. Yes, it is still achievable.

Q121 Mr Love: What are the implications of that for a committee? Where should we be looking at to ensure that the UK authorities are playing a positive role in this? You have mentioned Paul Tucker and others who are involved in this, are there other things that we need to do as a UK authority to help ensure that this progresses?
Dr Carney: I will put the responsibility on the Bank because ultimately this comes back into the Bank and through the resolution responsibilities to report what else needs to be done and what is outside the power of the Bank to ensure. For example, one aspect that in a so-called, to get slightly technical, single point of entry resolution is to ensure that there is a proper corporate structure and that high enough up the corporate structure, ideally at a holding company, that there is sufficient bail-in-able debt at that holding company. We need to ensure that that is achievable. What I would say, specifically from a UK context, what is incredibly relevant here is the EU resolution directive that is working its way through, which from an FSB perspective is quite encouraging as an approach, there is a lot to be recommended in the directive as it currently stands. Obviously that is relevant from setting the framework for the UK regime so the stock-take comes as that comes through. The stock-take is with that and then also informed particularly by discussions with the US authorities that are currently progressing.

Q122 Mr Ruffley: Dr Carney, the FPC, in relation to higher capital requirements that are in prospect, have said that the extra capital required should be raised in ways that do not hinder lending to the real economy. Is it not the case that banks are not going to be doing it by going out into the markets and raising capital that way but rather they are shrinking their balance sheets with commensurate negative impact on SME lending, lending to the small businesses, the lifeblood of many of our constituencies and indeed the British economy? Is that not what is happening?
Dr Carney: The spirit of the FPC recommendation is exactly that that should not be what happens and that the adjustment in the capital ratios of the institutions is made through capital-raising. There are a variety of forms of capital-raising. It can be done through higher retained earnings, which can be got through a variety of mechanisms, asset dispositions, restructuring and other aspects, or shrinking of ex-UK balance sheets as opposed to British balance sheets. That is the spirit so I will leave it at that.

Q123 Mr Ruffley: Can you just say a bit more about what the alternatives are to shrinking the balance sheet because anecdotally, that is what most people perceive because banks are not going out into the capital markets to raise money that way in a significant way, are they?
Dr Carney: No, they are not, and—

Q124 Mr Ruffley: What are the alternatives to that if we are not to have shrinking balance sheets without a commensurate hit to the SME lending sector?
Dr Carney: The alternatives are to shrink other aspects of the balance sheet outside of the country. Some alternatives could be accretive dispositions of certain lines of businesses or release capital from certain lines of businesses would be—
Mr Ruffley: Asset disposals.
Dr Carney: Yes, which could be redeployed. To be absolutely clear, I am talking in the highest of generalities, not about specific institutions. I do not want to be misinterpreted as giving direction to specific institutions.

Q125 Mr Ruffley: But do you think you have any powers to ensure that these alternatives you have listed are utilised rather than the shrinking of the balance sheet?
Dr Carney: I did not catch the first part of the question.
Mr Ruffley: Do you think you will have the power as Governor of the Bank of England to ensure that banks are encouraged not to shrink their balance sheets and to deploy the techniques you have listed for meeting their higher capital requirements?
Dr Carney: It is the responsibility of the Bank to ensure that the institutions are adequately capitalised. From the context of monetary policy and achieving the inflation target in an environment of sustainable growth, it is the responsibility to ensure that appropriate instruments are used that flow through the banking system to support output, investment, growth, and ultimately consistent with price stability in the economy. I hesitate to say on a high level that it is the responsibility of the Bank to direct the activities of private financial institutions to specific sectors or regions. There are other policy levers in Government that can be used in order to do that but I think, and I am not party to because obviously I did not participate in the FPC deliberations, but I think the direction is informed not just by the requirements of the British economy but also by an informed view of the position of the institutions themselves and what their options could be in order to enhance their capital positions.

Q126 Mr Ruffley: But it might be the case that you have to go beyond exhortation. But I just want to ask one final question that relates to the true state of banks' balance sheets and how they account for what is on their books. Andy Haldane, among others, has commented on accounting and how it can be opaque and lack transparency. I wonder if you had any thoughts, not just in relation to British banks, but in the course of your international work about a new accounting standard, a separate accounting standard for banks so that they are more transparent and so that it is clearer what the state of their balance sheets truly are.
Dr Carney: The answer is yes, in terms of thinking about how to enhance the transparency of bank

balance sheets and improve their utility for all stakeholders, from regulators to investors to their clients. What we have done internationally, is we encouraged what became a private sector group of banks but more importantly investors in banks, and including both on the debt side and on the equity side, to do an analysis of bank accounts and make a series of recommendations to enhance the transparency and disclosure of the institutions in a way that is actually useful for the users of those accounts. There is a report that came out in early November, it is called "The Enhanced Disclosure Taskforce". That report, I highly recommend it. We have welcomed it at the FSB and in Canada.

It is the intention of the supervisor to encourage our banks to adopt the report in its entirety. If I can just give one or two examples of what it does to help accomplish what you and I and everybody wants instead of 600 pages of bank disclosure that tells you nothing effectively. Disclosure that maps from what they have to disclose for accounting reasons, so the accounting balance sheet maps from that balance sheet to how they manage risk, how the bank manages risk, so are mapping from the specific assets that are disclosed on the balance sheet and in the notes to that bank's measures of risk around those assets and how they manage them, where their tolerances are, and very importantly how they map, from the assets to how they make money, their profit and loss position and where the concentration of earnings are in the actual institution.

That is one initiative that we would like to see adopted in Canada. I would recommend it here as well and I would note that some of the largest institutions in the UK were very much behind this initiative. The other things we are looking at internationally are encouraging the major standard setters to get a converged—first a standard but the same standard on expected loss provisioning, so when banks make loans that they do take provisions for the expected loss and that that adjusts over time. The art here is to ensure that it is a faithful representation of expected loss, it is not a built-in hidden reserve that then is drawn upon over time. The IFRS and the American FASB are working on that. The last thing that we are looking at, amongst other things but the last one I will mention, is something that is an initiative of the Bank of England and the FSA, which is an approach that looks at prudent valuation of so-called level 3 assets.

These are assets for which there is no market and are valued on the basis of models, internal models. The idea, which is more complicated than this, but to simplify, is instead of taking the mid-point of a range of potential valuation outcomes that the model will give you, the Bank should value at the low-point or the tail of the range. The question is the utility of that relative to other measures that are in place. There are a number of initiatives that if fully put into place, and I would start with the Enhanced Disclosure Taskforce report, fully implementing that at the institutions. But there are a number of initiatives that can improve quite substantially the utility of bank accounts and therefore improve—not just make our jobs easier on the regulatory side but improve the discipline very much in the marketplace so that these are not just black box institutions that spit out earnings until they do not.

Mr Ruffley: As the new Governor you will be able to impose this in the UK, will you not, because you have talked about the international dimension.

Dr Carney: Yes. Working with my colleagues on the PRA Board, because again, it is not for me as the individual to impose, I would encourage the large institutions we cover to adopt at a minimum the Enhanced Disclosure Taskforce but that would be a decision that would quite naturally fall to the board if it has not been. It may be taken prior to my arrival at the Bank is the other thing I would say. But the broad initiative is absolutely right. The thrust of what you are asking about is right.

Q127 Chair: You are receptive to ideas for improvements to accounting on prudential grounds.

Dr Carney: Yes, I am although what I would say is that, and I suppose I could be convinced otherwise over time but I do start from a position where I prefer to not have two sets of accounts, a regulatory set of accounts and a public set of accounts.

Chair: We already have a couple, do we not because we already have a set for revenue purposes?

Dr Carney: Yes but we have a P & L balance sheet and cashflow, but there is a default sometimes of the accounting profession that says, "If you regulators really want certain things like expected loss, why do you not just calculate it yourself", or "if you want to adjust capital in a certain way, why do you not just do it yourself". That is very much best avoided, and the focus should be on ensuring that what is represented for accounting purposes and public reporting purposes is also what is used as the first cut for regulatory purposes.

Chair: Interestingly enough the Banking Commission, to which I referred a moment ago, took evidence yesterday from HSBC who accepted the need for this even if it meant three sets of accounts. I just put that on the table. Pat McFadden.

Dr Carney: Yes, I will just be clear, I disagree with that.

Q128 Mr McFadden: I would like to ask you about leverage ratios. We know that in the run up to the crisis over-leveraged banks were a problem. You have been involved in the Basel process that has recommended an overall leverage ratio of 33 to 1. In the UK the Vickers Commission recommended that banks hold at least 4% of capital in relation to their overall balance sheet, so a lower leverage ratio. Your soon to be predecessor, Governor King, has said he thinks it should be at least 4%. What is your view?

Dr Carney: Just to clarify what we are talking about, the specific recommendation, as I understand, from the Vickers Commission, and I have discussed this with Sir John, is that for the ring fenced bank there is, as you know, a higher primary loss absorbing capacity, various forms of capital, and the logic is that given that that has been raised in order for the leverage ratio to be an effective backstop it should similarly be raised. I agree with that logic, I think it makes sense if one is adjusting the minimum there. I understand that that is not currently in the Bill, that

recommendation of the Banking Commission has not been accepted. I stand to be corrected on that but that is at least my understanding. In a world where that becomes law, obviously the Bank has to respond to that reality and respect that reality if that is a discrete decision. It puts a bigger emphasis or importance on supervision of those assets that have a relatively low risk weight under the risk weighting scheme because as you know what the leverage ratio really protects the system from is those assets that we think are low risk but in fact are not. That was very much at the heart of the crisis so the regulatory response, if that is the decision and there are lots of different factors, I recognise that leverage in building societies and other factors would be a consideration in coming up with the final determination. But to address the risk that is created there, I would think higher regulatory— supervisory, sorry, scrutiny of what are so-called low risk assets under the risk weighting approach. But obviously we await final—

Q129 Mr McFadden: Do Canadian banks have to operate with such a ratio at the moment?
Dr Carney: Canadian banks have a leverage ratio and if you ask me what is—if I could only pick one reason why Canadian banks fared as well as they did, there were multiple reasons but if I had to pick one, it was because we had a leverage ratio that saved them from doing—
Mr McFadden: What is the—
Dr Carney: The leverage ratio in Canada is calculated differently but it is a 20 to 1 leverage ratio. That in effect means that they operate at about 16 or 17 times because always when you set these minimums people operate inside them so they do not inadvertently bump up against them.
Mr McFadden: But to be clear, we are having an argument in this country about 25 or 33.
Dr Carney: Yes.
Mr McFadden: In Canada, your banks are operating at 20 to 1.
Dr Carney: Yes, but to be clear, our banks—the denominator of that 20 to 1 is a broader definition of capital than the strict common equity tier one definition so it is a bit of an apples and oranges comparison.

Q130 Mr McFadden: You mentioned bail-in and the recovery resolution directive. I will not try to draw you into the country's European debate but of course that directive will only be helpful to us if we remain members of the European Union. It will not be much good if we are not. More generally though, how critical is a bail-in regime to ensure that the taxpayer is not on the hook in the event of future—
Dr Carney: I think it is critical. I do not think it is decisive. In other words, it does not assure that the taxpayer is not on the hook but it is essential to have a credible bail-in regime, and further, it is highly desirable to have identifiable tranches of bail-in-able debt. It does not have to be from the class of debt but identifiable tranches of bail-in-able debt in sufficient size to address historic experience of banking shocks in order to provide market discipline that will make the full power of the instrument be felt.
Mr McFadden: You are confident this will happen, then?
Dr Carney: We are moving in the right direction in a variety of jurisdictions, including Canada. The job has to be finished but significant progress is being made. At this stage I am confident and the commitment, to Mr Love's question, is if we lose that confidence or it starts to be shaken is to come back and report it.

Q131 Mr McFadden: Can I ask you one final thing? You have been taking questions now for 3½ hours on a full range of policy issues. Thinking about those questions and the publicity that has surrounded your appointment, are you concerned that expectations of what you might be able to do may be set too high?
Dr Carney: I can only assume those who are increasing the expectations are doing it so that they can have the pleasure of knocking them down almost immediately. That has probably been accomplished by now, I would think, on the basis of this testimony. Look, it is a fair question. The point is, and I made this point in my written submission, which is that part of the measure of success is, the exit is less news than the entrance, and that would be accomplished hopefully through successful execution of our responsibilities but also a bigger recognition that this is not a super Governor position or that this is a one person institution. It is a series of policy committees that do their work and make decisions and do their best to work together. It is a much broader, deeper institution that is discharging these responsibilities as opposed to an individual. As that becomes more apparent, then the individual becomes much less important.

Q132 Chair: I apologise now for having been running for 3½ hours. I have one more colleague who wants to come in and then I think we will wind up. Just on one point that Pat McFadden was touching on there, well, more than touching on, on the leverage ratio. Do you agree that the leverage ratio, it is absolutely essential you have a robust leverage ratio—
Dr Carney: Yes.
Chair:—given that the risk ratings are more or less manufactured by the banks using their own models and that they are scarcely worth the paper they are written on?
Dr Carney: I disagree with the first part. I agree that it is essential to have a leverage ratio as a backstop to a risk-based capital regime.
Chair: How do you feel about these bank models?
Dr Carney: There is a range of quality of those models and it is the responsibility of the supervisors, both within a country and across jurisdictions, to up the overall level. That is one of the reasons why the Basel Committee has just published a report last week on a standardised model—
Chair: Okay, plenty of scope on the upside.
Dr Carney: There is plenty of scope on the upside, yes, but there is plenty of value in having this system as the first test for capital—

Q133 Teresa Pearce: Thank you. We have already touched on LIBOR, so I will just ask some brief

questions. When you first heard about the LIBOR scandal, were you surprised?
Dr Carney: There are two aspects of the LIBOR scandal. The dysfunction of the LIBOR market was something that, as a central bank, one could not help but be aware of and we discussed in 2008/09 in a broader policy response. Associated with that was a suspicion that was being dealt with by conduct authorities that banks were low-balling LIBOR for purposes of self-protection. The term escapes me but basically to not let on that they were having the difficulties that they were having in borrowing and not be outliers in terms of reported borrowing rates, which is definitely a conduct issue being dealt with by the conduct authorities. I have to say that the second stage, and the conduct authorities investigated and discovered it, and discovered that this was much more widespread than we would have thought. That was a surprise but on a different order of magnitude was the surprise, or the shock, I think is the right way to put it, of the manipulation; the act of manipulation and sustained manipulation of LIBOR for the purposes of direct profit of the institutions and direct profit in the sense of compensation of the individuals. That was not something that I would have expected and something we found shocking and the scale of it is disturbing.

Q134 Teresa Pearce: This is the last question. The British Banking Association, the BBA and the FSA, within their remit is for them to monitor LIBOR. Do you think they failed in that task?
Dr Carney: Historically?
Teresa Pearce: Yes.
Dr Carney: Clearly.

Q135 Chair: Perhaps you could give brisk, very short answers to these questions as well, Dr Carney. Do you support the proposals that have been put forward for a reserve power in the hands of the regulator to bolster the ring fence? Have you come across these proposals?
Dr Carney: Yes, in the sense of on a—
Chair: To separate—
Dr Carney:—on an institution by institution basis, yes, I do.

Q136 Chair: Yes. Good. Could you give your view on whether or not we should, in addition to implementing the ring fence in the UK at the start, implement a Volcker Rule-type separation for proprietary trading, taking that completely outside the ring fenced or non-ring fenced bank?
Dr Carney: No, I do not think you should overlay a Volcker Rule on top of the Vickers recommendations. I think the ring fence model is a superior model to the Volcker Rule, and I will not make this a long answer but I would be very concerned. It is extremely difficult to draw the line between market making and proprietary trading. The first cut of the US authority is to which I wrote a very long letter in my current capacity, shows how difficult that is and it would unnecessarily, amongst many other things, divert the supervisor’s attention from amongst other things, not just prudential responsibilities, but fulfilling that responsibility on ensuring that the ring fence is respected.
Chair: Dr Carney, thank you very much for giving evidence today. You have been extremely lucid and so interesting that you have kept your audience. We are very, very grateful.
Mr Love: Have you kept your rock star image?
Dr Carney: It is gone.
Chair: Which was probably your intention to start with. We have ranged very widely but of course the number of subjects, even though we range widely, have still not been covered but I suspect that there may be further opportunities. For now, thank you very much indeed.

Written evidence

Dr Mark Carney: Response to the Treasury Committee's questionnaire

Personal

1. *How has your experience to date prepared you for the role of Governor of the Bank of England, including chairing the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC)?*

As Governor of a G7 central bank, I have led a team with a proven track record of monetary policy management. I have extensive experience operating a Flexible Inflation Targeting regime. The Bank of Canada has consistently achieved its inflation target, while the Canadian economy has grown jobs and output at the fastest pace in the G7.

As Governor, I chair the Bank of Canada's monetary policy committee and serve as the Bank's principle spokesperson. As such, I must communicate complex economic and financial concepts to broader audiences through public speeches, outreach events with a wide range of domestic and international stakeholders, parliamentary testimony, press conferences and media interviews.

During my tenure, the Bank of Canada has renewed Canada's monetary policy framework. The new framework better defines Flexible Inflation Targeting and clarifies the role of macroprudential instruments and objectives. Through a targeted and persistent public communications strategy, these changes were introduced to public acceptance. In addition, the Bank has developed an unconventional policy framework, including its approach to conditional guidance.[1]

As Governor, I chair the Bank of Canada's Financial Stability Policy committee and am a member of the Canadian multi-agency committees for microprudential supervision, macroprudential oversight and deposit insurance.

As Chair of the Financial Stability Board (FSB), I have senior responsibility for developing and driving a broad-based multilateral agenda for strengthening the resilience of the global financial system. This work includes coordinating at the international level regulatory, supervisory and other financial sector policies of national financial authorities and international standard-setting bodies. I am fully engaged in the design, negotiation and implementation of some of the most complex current financial reforms ranging from OTC derivatives, Basel capital and liquidity accords and reforms to shadow banking as well as contingency planning for cross-border crisis management for globally systemically important institutions.

As FSB Chair, I jointly oversee the development of the FSB-IMF Early Warning Exercise, which presents emerging risks to the international financial system twice annually to Finance Ministers and Central Bank governors.

As Chair of the Committee on the Global Financial System at the Bank for International Settlements, I led senior central bank colleagues in identifying and assessing potential sources of stress in global financial markets and promoting improvements to the functioning and stability of these markets. I initiated working groups that led to reports addressing specific challenges such as: the interactions of sovereign creditworthiness and bank funding; the risks of fixed income strategies of insurers and pension funds in an environment of low interest rates for a long period; and the practical application of macroprudential instruments.

I have experience in risk management in the private sector and crisis management in the public sector. In Canada, I was part of a team, which rapidly assessed the risks and instituted an effective, coordinated response to the global financial crisis, despite Canada's deep integration with the U.S. economy and financial system. I have worked closely with

Governor King and his colleagues throughout the crisis period on a series of unprecedented interventions, including a coordinated rate cut in October 2008, a series of coordinated provisions of emergency liquidity and a network of swap arrangements amongst major central banks.

I have a long history of close cooperation with the Bank of England on issues such as the reform of the international monetary system, cooperative oversight arrangements between our organisations (and with the FSA) and cross border liquidity arrangements. The Bank of Canada and Bank of England have also worked closely together in the design of a number of key financial reforms, ranging from OTC derivatives, Basel liquidity rules and bail-in debt.

2. *What do you regard as the main challenges you will face as Governor of the Bank of England in the next five years? What criteria do you suggest should be used to assess your record as Governor?*

The economic position and transformation of the Bank's responsibilities mean that the challenges I will face are many and varied. They fall into two groups: policy challenges and institutional challenges.

[1] Bank of Canada, "Framework for Conducting Monetary Policy at Low Interest Rates," *Monetary Policy Report*, April 2009.

Policy Challenges

The first core policy responsibility is to deliver price stability while promoting a timely, sustained recovery and the highest sustainable level of employment in the UK economy.

To achieve this in an environment of large external shocks and the ongoing rebalancing of the UK economy, a range of subsidiary challenges must be met:

- First, the Bank must enhance its forecasting, building on the recent Stockton review to make forecasts more accurate, transparent and better integrated with policy analysis.
- Second, the Bank will need to design, implement and ultimately exit from unconventional monetary policy measures in a manner that reinforces public confidence.
- Third, the Bank must improve continually its understanding and management of the interaction between monetary policy and macroprudential instruments.
- Fourth, given the international dimension to the crisis, the Bank will need to support the Government as it engages in efforts of the Euro Area to re-found the European monetary union, address global imbalances and build a better functioning international monetary system (see question 27).
- Finally, the Bank will need to complement price stability with confidence in the integrity of the currency, by continuing to produce banknotes in which people can have the highest confidence.

The second core policy responsibility is to promote financial stability, by building a more transparently resilient domestic financial system that engenders confidence and is able to provide the credit growth necessary to support a sustained recovery. In this regard, there are several priorities:

- First, the Bank, through the PRA, must implement effective microprudential regulation. That means fully implementing the PRA's new judgement-based approach to supervision and establishing the new regime as tough but fair, transparent and accountable.
- Second, distinct from PRA judgement with supervision, we need to build understanding of the new regime as one in which it is understood that financial institutions can fail but that, if they do, their failure will be controlled and will not threaten the system. The implicit state subsidy for banks needs to be removed. To do that, we need also to make the ICB proposals a reality and to establish a full and credible resolution regime to sort out failing banks without recourse to the taxpayer.
- Third, the Bank must, through the FPC, establish macroprudential policy as a complement to microprudential regulation. We need to embed a culture that assesses emerging vulnerabilities, stress tests the financial system, and monitors the boundaries of what activities are and are not regulated. The FPC needs to question whether, even if individual firms are doing the right thing, the system is structured in the most resilient way.
- Fourth, the Bank needs to continue to develop its market operations, building on the recommendations of the recent reviews by Bill Winters and Ian Plenderleith, so that those operations provide an effective liquidity backstop for the system in a way that does not encourage excessive risk-taking.
- Finally, as with price stability, the international dimension to financial stability means that the Bank will need to engage with European partners, including the ECB, EBA, and the ESRB to develop an effective working relationship between authorities. The Bank must continue to play an important role in ongoing efforts to develop a more resilient and efficient international financial system (consistent with the FSB priorities described in response to question 17).

An overarching policy challenge for me as Governor will be to maximise the synergies from the Bank's broad responsibilities, particularly through its new committee structure, while fully respecting the primary responsibility of each body. For example, the FPC can be an effective complement for the PRA, and both the PRA and the FPC can maximise the effectiveness of monetary policy stimulus, while minimising emerging vulnerabilities in a "low for long" environment.[2]

Institutional Challenges

Transformed responsibilities will mean a transformed institution. The priority challenges here will be that:

- A clear shared vision for the Bank needs to be established, synergies from the collection of policy functions maximised and the expanded senior management team melded into a cohesive unit.
- Succession planning and talent management will be paramount. The Bank will need to attract, retain and promote an assertive, engaged, accountable staff at all levels. The Bank should develop its team culture that promotes timely, well-researched and consensus-based decisions.
- The Bank will need to build an effective, efficient central support function to serve all areas of the expanded institution and fully leverage a new organisational structure, including a new Chief Operating Officer role, to ensure value for taxpayers.
- The Bank must realise fully the complete potential of the accountability and governance changes instituted in the Financial Service Act to enhance the credibility of, and trust in, the institution.

[2] M. Carney, "Living with Low for Long" (speech to the Economic Club of Canada, Toronto, 13 December 2010).

Throughout, the Bank should reinforce its existing culture of excellence as a learning institution that engages with academia, other central banks and private sector experts in the pursuit of its core objectives.

Key Criteria to Measure Success

— Achieve price stability measured by consumer price inflation without creating undesirable volatility in output and employment. This will need to be achieved in a rebalanced economy growing as fast as the potential of the economy will allow.
— Confidence in banknotes as measured by surveys and counterfeiting statistics.
— A financial system that is transparently resilient and robust to shocks. The system should be well-capitalised to withstand plausible stress tests. Credit growth should meet the needs of the real economy. Micro- and macroprudential regimes should be widely understood and effectively enforced/implemented.
— Effective communications: monetary and financial policy that is well-understood by the public; trust is restored in the financial system and confidence that inflation will remain close to target.

More generally, I would like to achieve an exit in 2018 that is less newsworthy than my entrance. That can be achieved if:

— the Bank's existing functions are reaffirmed;
— its new functions are embedded and understood;
— a strong leadership team is in place;
— the credibility of, and trust in, the institution are entrenched; and
— there is increased recognition that while the Bank of England's actions provide the cornerstones of British prosperity—price and financial stability—these are necessary but not sufficient conditions for growth.

3. *How would you describe your leadership style? How will the Bank look and feel different under your leadership?*

Given my background, I believe I know how to lead, when to delegate and how to forge consensus. I have long and varied experience chairing committees of independent experts (ranging from economists to national policy-makers, heads of global standard setters and senior representatives of international organisations) to develop timely, substantive policy conclusions across a range of monetary policy and financial stability issues.

My leadership approach has been to develop a shared vision for the organisation, set out clear priorities to achieve that vision, ask critical questions to engage colleagues and spur analysis, and work towards consensus to take actions. I am comfortable adapting my opinions in the face of superior argument and analysis, but am also disciplined in the need to come to timely decisions (as my experience in crisis management demonstrates). I believe that this combination of flexibility and focus has enhanced my effectiveness as a leader.

Both of the organisations I currently head operate on the basis of consensus. In my experience consensus can only be truly achieved if there is a shared understanding of objectives and all parties feel their views have been considered. In the end, effective central bankers must appreciate the inherent challenge they constantly face of making timely decisions under uncertainty. I am a firm believer in central bank accountability and I intend to do my part to ensure that the new accountability measures in the *Financial Services Act* are fully and effectively utilised.

My experience as Governor of the Bank of Canada demonstrates a willingness and ability to implement significant organisational change. I manage an organisation of about 1,200 people across six offices, four time zones and in two official languages. Upon becoming Governor, I initiated a major reorganisation of our four policy departments, clarified the lines of responsibility of senior policy-makers, streamlined and delegated operating management.

With the Senior Deputy Governor, I led a process to re-engineer the Bank's administrative and support services. As a result of that process, the Bank has achieved ongoing annual savings of $15 million and reduced staff by 7%.

Since becoming Governor, our employee satisfaction has increased and we were for the first time recognised as a Top 100 employer in Canada. We have now held that position for the past three years running. I believe this reflects an enhanced focus on workplace environment, clearer lines of authority, the opportunity for greater personal initiative and a sustained focus on internal talent management and development.

I have a track record of attracting and retaining senior external talent to public life including leading academics, several managing directors from the financial sector and senior IMF staff. Since becoming Governor, the Chiefs of our four main policy departments have been developed and then internally promoted. We have instituted and extended a comprehensive talent management strategy for the top 50 employees.

Based on recommendations of a senior working group, I helped shepherd through the FSB and the G20 Leaders process a major package of reforms to enhance the FSB's capacity, resources and governance. These substantial, detailed proposals are helping put the FSB on a more enduring footing, with clearer lines of

accountability and formal governance, consistent with the proposals of Prime Minister Cameron at the Cannes summit.

I am not in a position to comment on differences in leadership style.

4. *What is the reason for your decision to serve as Governor for five years rather than eight?*

Serving as Governor of the Bank of England will mark the pinnacle of my career. I am a strong believer in the value of public service, and I firmly believe that this responsibility offers me the opportunity to contribute where I can make the greatest impact.

This is one of the most important positions in central banking. The Bank's responsibilities are immense and varied. The role comes during a unique period in the Bank's illustrious history as it takes on new responsibilities. The next five years will span a period that will be critical for the future development of the Bank of England itself, for the development of the British, European and global economies, as well as decisive for domestic and international financial reform.

My tenure will oversee a significant transition at the Bank. To be most effective, transitions need to be sharp, sustained and finite. A five-year term is the right managerial timeline to relaunch the Bank of England with its broader responsibilities, and to develop considerable talent, undertake targeted external recruitment, and build a succession plan. Over the five years, we can establish the full potential of the new institutional structure, which combines monetary policy, macroprudential and microprudential regulation. I can also give life to the crucial governance reforms promoted by the Treasury Committee and incorporated in the Financial Services Act.

As an outsider I can—for a period—bring different experiences and perspectives to help catalyse the necessary changes within the Bank to achieve these goals, and I look forward to working with employees of the Bank, the Court, the Government and the Treasury Committee to ensure that the full potential of all of these reforms is realised.

The next five years will also be a decisive period for domestic financial reform. By 2018, the ring-fencing of core banking activities recommended by the ICB should be well on the way to completion and, following agreement of the European Recovery and Resolution Directive, the UK's Special Resolution Regime will have been developed to allow bail-in of banks' unsecured creditors. We will have done much to solve the problem of banks that are too big to fail.

Over the next five years, the Bank has the ability to extend and broaden its position as a global leader (intellectually and effectively) amongst central banks. The next five years will be the decisive period for international financial reform after the crisis. By 2018, all elements of the Basel III reforms will be agreed and implemented, with capital requirements and the Liquidity Coverage Ratio supplemented with the Net Stable Funding Ratio and a common leverage ratio. A wide range of reforms to OTC derivatives trading will also have been introduced, including capital and margining requirements, measures to impose mandatory exchange trading and centralised clearing of standardised derivatives, and new transparency requirements. In addition, the framework that is being constructed for systemic institutions will have been extended to global insurers and key shadow banks.

Importantly, a five-year term corresponds with my maximum possible term as FSB Chair (terms are three years once renewable). Simultaneously serving in both roles will maximise intellectual, managerial and work process synergies at the Bank of England during the critical period for reform.

Finally, from a personal perspective, there are two considerations. First, at the end of a five-year the term, I will have served as a Governor of a G7 Governor central bank for over a decade. In my experience, there are limits to these highly rewarding but ultimately punishing jobs. Second, the five year term has advantages given the ages of my children and the disruption that is involved in moving schools and countries.

5. *Which economist has influenced you the most, and for what reasons?*

While I have been influenced by a very broad range of academic economists, I am not comfortable identifying a single one. No theorist captures, or would claim to do so, the complexities of modern central banking.

6. *Which of your publications or papers are of most relevance to your future role as Governor?*

Following are the more relevant speeches and papers while Governor of the Bank of Canada. I would add the obvious caveat that they naturally reflect Canadian institutional and economic perspectives and therefore are not simply transferable to the role and responsibilities of the Bank of England.

Monetary Policy

— Guidance, Toronto, 11 December 2012.

— A Monetary Policy Framework for All Seasons, New York, 24 February 2012.

— Renewing Canada's Monetary Policy Framework, Montréal, 23 November 2011.

- Renewal of the Inflation-Control Agreement: Background Information—November 2011, Ottawa, 9 November 2011.
- Some Considerations on Using Monetary Policy to Stabilize Economic Activity, Jackson Hole, 22 August 2009.
- Inflation Targeting in a Global Recession, Halifax, 27 January 2009.
- Flexibility versus Credibility in Inflation-Targeting Frameworks, Lucerne, 27 June 2008.

Global Imbalances/International Monetary System

- Financing the Global Transition, Halifax, 21 June 2012.
- The Paradigm Shifts: Global Imbalances, Policy, and Latin America, Calgary, 26 March 2011 Restoring Faith in the International Monetary System, Calgary, 10 September 2010 The Evolution of the International Monetary System, New York, 19 November 2009 Rebalancing the Global Economy, Montréal, 11 June 2009 The New International Monetary Order, Toronto, 23 November 2004 (Delivered while in role as Senior Associate Deputy Minister of Finance).

Financial Stability

- Growth in the Age of Deleveraging, Toronto, 12 December 2011.
- Global Liquidity, London, 8 November 2011.
- Living with Low for Long, Toronto, 13 December 2010From Hindsight to Foresight, Toronto, 17 December 2008.
- Principles for Liquid Markets, New York, 22 May 2008.
- Addressing Financial Market Turbulence, Toronto, 13 March 2008.

Financial Reform

- Some Current Issues in Financial Reform, Montréal, 8 November 2012.
- Some Current Issues in Financial Reform, Washington 25 September 2011.
- Bundesbank Lecture 2010: The Economic Consequences of the Reforms, Berlin, 14 September 2010.
- Looking Back, Moving Forward: Canada and Global Financial Reform, Geneva, 9 November 2010.
- The G20's Core Agenda to Reduce Systemic Risk, Montréal, 10 June 2010.
- Reforming the Global Financial System, Montréal, 26 October 2009.
- What Are Banks Really For?, Edmonton, 30 March 2009.
- Building Continuous Markets London, England, 19 November 2008.

Monetary Policy

7. *What is your view of the monetary policy framework in the UK, and what assessment have you made of the merits of altering it?*

In my view, flexible inflation targeting—as practiced in both Canada and the UK—has proven itself to be the most effective monetary policy framework implemented thus far. As a result, the bar for alteration is very high. In any possible review, it would be vital to recognise that long and varied experience demonstrates that delivering price stability is the best contribution that monetary policy can make to the economic welfare of citizens.

I have not made an assessment of the merits of altering the monetary policy framework in the UK, and of course any change to the Monetary Policy framework would be the sole responsibility of HM government. I do think, however, that it is important that the policy framework is reviewed periodically. In Canada, the framework is reviewed every five years. That process helps to reaffirm our remit and to focus our research efforts. Our most recent review, completed in November 2011, intensively examined alternatives to our current framework, including a lower inflation target and moving to a price-level target. The Bank of Canada worked with the Government of Canada in a calm, reasoned examination of these options and in full consideration of the lessons of the financial crisis. At its conclusion, we reaffirmed Canada's flexible inflation targeting framework with a deeper collective understanding of the power as well as the interaction between monetary and macroprudential policies.

I can therefore report on my thoughts of the monetary policy framework in Canada and the assessment we made of the merits of alternative frameworks, recognising that the same assessment may not apply to the UK.

Bank of Canada's Monetary Policy Framework

The Bank of Canada conducts monetary policy aimed at keeping inflation, as measured by the total consumer price index (CPI), at 2%, with a control range of 1 to 3% around this target.

The inflation target is symmetric, which means that the Bank is equally concerned about inflation rising above or falling below the 2% target. The Bank uses core inflation as an operational guide for its monetary policy because it is an effective indicator of the underlying trend in CPI inflation in Canada. Core inflation, along with other measures of inflationary pressures, is monitored to help achieve the target for total CPI inflation; it is not a replacement for the latter.

As in the UK, a flexible exchange rate is a core element of Canada's monetary policy framework. A floating Canadian dollar plays a key role in the transmission of monetary policy and allows the Bank to pursue an independent monetary policy. It also helps to absorb shocks to the economy. Movements in the exchange rate serve as automatic buffers, helping to insulate the economy from external and internal shocks (See response to question 10).

At the end of the process of review in Canada, we reaffirmed our commitment to this framework.[3] We did so because, in a complex and continuously evolving world that no one can predict with certainty, policy-makers need a robust framework; one that remains appropriate no matter the circumstances. Inflation targeting, as practised in Canada and the UK is disciplined but flexible. It allows central banks to deliver what is expected while dealing with the unexpected.

There are two crucial features of that regime. The first is that that the central bank must be flexible about the horizon over which it returns inflation to its long-run target. The second is clear and open communication.

A Central Bank Should be Flexible Regarding the Time Horizon to Return Inflation to Target

The way in which a central bank achieves its inflation target can be adjusted, depending on the circumstances.

Under flexible inflation targeting, the central bank seeks to return inflation to its medium-term target while mitigating volatility in other dimensions of the economy that matter for welfare, such as employment and financial stability. For most shocks, these goals are complementary. However, for shocks that pose a trade-off between these different objectives, or that tilt the balance of risks in one direction, the central bank can vary the horizon over which inflation is returned to target.

Typically, the Bank of Canada seeks to return inflation to target over a horizon of six to eight quarters. However, over the past twenty years, there has been considerable variation in the horizon, in response to varying circumstances and economic shocks. This flexibility is required because, when taking monetary policy actions to stabilize inflation at target, the

Bank must also manage the volatility that these actions may induce in the economy. These trade-offs will differ depending on the nature and persistence of the shocks buffeting the economy. For example, in the projections published since 1998 in its *Monetary Policy Reports,* there were eight occasions when the Bank extended the horizon beyond two years and nine times when it was shorter than a year and a half. In other words, more than a quarter of the time, the Bank has used greater-than-normal flexibility.

There are, broadly speaking, three sets of circumstances under which it may be desirable to return inflation to target, from above or below, over a horizon that is somewhat longer than usual.

First, the unfolding consequences of a shock could be sufficiently large and persistent that a longer horizon might be warranted in order to provide greater stability to the economy and financial markets. Stability considerations could lead the Bank to accommodate over a somewhat longer period, for example, the inflationary consequences of an unusually large and persistent increase in oil prices, or the disinflationary consequences of a severe global slowdown, including the possible constraints of the zero lower bound on interest rates.

Second, through a longer targeting horizon, monetary policy can also promote adjustments to financial excesses or credit crunches. For instance, there could be situations where, even though inflation is above target, ongoing monetary policy stimulus and a somewhat longer horizon to return inflation to target would be desirable in order to facilitate the adjustment to broad-based deleveraging forces that are unfolding.

On the flip side, a tighter monetary policy that allows inflation to run below target for a longer period than usual could help to counteract pre-emptively excessive leverage and a broader build-up of financial imbalances. In recent months, the Bank of Canada has used such guidance to reinforce macroprudential measures implemented by the Government of Canada. By indicating that some tightening of monetary policy may be necessary, a degree of prudence in household borrowing has been encouraged. For example, the rate of household credit growth has decelerated and the share of new fixed rate mortgages has almost doubled to 90% this year.

Third, as the Bank of Canada has observed, the optimal inflation-targeting horizon will vary with the evolution of the risks to the outlook.[4] Shocks to the economy, both observed and prospective, are inevitably subject to a degree of uncertainty. In some situations, risks to the inflation outlook could be skewed to the downside. In these cases, a balance must be struck between setting monetary policy to be consistent with the most likely outlook and the need to minimize the adverse consequences in the event that downside risks

[3] Bank of Canada, "*Renewal of the Inflation-Control Target: Background Information—November 2011.*

[4] *Ibid.*

materialize. This would warrant a more stimulative setting for monetary policy than would otherwise be desirable in the absence of the downside risks. However, if the downside risks fade away rather than materialize, the resulting stronger inflationary pressures would merit returning inflation to target over a longer horizon. The opposite would be true under circumstances where risks to inflation are skewed to the upside.

In short, changing economic circumstances could demand some flexibility in the horizon over which the Bank seeks to restore inflation to target.

There are limits to this flexibility. The Bank's scope to exercise it is founded on the credibility built up through its success in achieving the inflation target in the past, and its clarity in communications when it uses it. That links to the second important feature of a flexible inflation target regime—clear and open communication.

Clear and Open Communication Matters

Clear and open communication enhances the effectiveness of monetary policy. In particular, successful monetary policy requires transparency around two aspects of the policy approach—what the central bank is trying to achieve and how it goes about achieving it.

With respect to the former, Canada has benefitted from a clear objective for monetary policy since the adoption of an explicit inflation target in 1991. As Canadians have come to understand the Bank's policy objective and have gained confidence in its attainment over time, inflation expectations have become firmly anchored around the 2% target.

This confidence allows households and firms to make longer-term plans with greater certainty, aligning their savings, investment and spending decisions with a common inflation-control objective. These actions collectively serve to make the inflation target self-reinforcing. They also give the Bank greater latitude to respond aggressively to economic shocks without fear of dislodging longer-term inflation expectations. In short, the common understanding of our monetary policy objective makes its attainment easier.

Of course, it would be quite remarkable if simply communicating the monetary policy objective were sufficient to ensure its achievement. The conduct of policy obviously matters as well. The Bank of Canada implements policy through changes in the target overnight interest rate, which has a limited direct impact on saving, investment and spending decisions. Far more important is the impact the central bank's actions have on the broader spectrum of market interest rates, domestic asset prices and the exchange rate.

What matters to these asset prices, however, is not so much the current setting of the policy interest rate but, rather, its expected path over time. Thus monetary policy affects the economy primarily through policy-rate expectations.[5] The more those expectations are aligned with the policy path necessary to achieve the policy objective, the higher the probability the policy objective will be achieved.

One goal therefore of central bank transparency is to allow markets and the public to "think along with us", not only promoting the appropriate formation of policy expectations given current information, but also allowing those expectations to evolve efficiently as new information is received.

Central banks would have an easy time communicating our "reaction function" if they followed a simple mechanical rule. Unfortunately, life is not that simple. Achieving an inflation target thus requires that central banks take a flexible policy approach, one informed by considered analysis and judgement. That is one reason why transparency—and occasionally guidance—matters.

Monetary policy actions take time to work their way through the economy and to have their full effect on inflation. For this reason, monetary policy must always be forward looking, with the policy rate set based on the central bank's judgement regarding how inflation is likely to evolve in the future. Making that assessment requires a careful examination of the economic evidence pertaining to the balance of supply and demand in the economy and other factors affecting underlying inflationary pressures.

To exploit fully the power of this framework, guidance about future policy actions, leveraging central bank communications, may be effective. These I discussed in a speech in December.[6]

Fully Leveraging Central Bank Communications under Flexible Inflation Targeting

In a perfect world, guidance would be unnecessary. The inherent uncertainty in economic outcomes and thus in the policy path would be widely understood. With full information and efficient markets, monetary policy expectations would effectively take care of themselves—knowing a central bank's inflation objective and its reaction function would be sufficient for markets and the public to form and evolve their expectations, without the need for any direct guidance from the central bank.

In the real world, monetary policy guidance can be useful in providing additional information. This is particularly the case when policy is at the zero-lower bound (ZLB) on nominal interest rates.

[5] J. Boivin, "How People Think and How It Matters" (speech to the Canadian Association for Business Economics, Kingston, Ontario, 23 August 2011).

[6] M. Carney, "Guidance"(speech to the CFA Society, Toronto, Ontario, 11 December 2012).

When conventional monetary policy has been exhausted at the ZLB, the additional stimulus that is likely to be called for is impossible to achieve using the conventional interest rate tool. Extraordinary forward guidance is one unconventional policy tool, along with quantitative easing and credit easing.

The Bank of Canada used extraordinary forward guidance in April 2009, when the policy interest rate was at its lowest possible level and additional stimulus was needed. At the time, we committed to holding the policy rate at that level through the second quarter of 2010, conditional on the outlook for inflation (so-called "time contingent guidance"). In effect, we substituted duration and greater certainty regarding the interest rate outlook for the negative interest rate setting that would have been warranted but could not be achieved. The Bank's conditional commitment succeeded in changing market expectations of the future path of interest rates, providing the desired stimulus and thereby underpinning a rebound in growth and inflation in Canada.[7] When the inflation outlook—the explicit condition—changed, the path of interest rates changed accordingly.

The Bank of Canada's conditional commitment worked because it was exceptional, explicit and anchored in a highly credible inflation-targeting framework. It also worked because we "put our money where our mouths were" by extending the almost $30 billion exceptional liquidity programs we had in place for the duration of the conditional commitment. And it worked because it reached beyond central bank watchers to make a clear, simple statement directly to Canadians.

One shortcoming of conditionality is that it ultimately limits the effectiveness of the commitment. This is one reason why doing more may require overcoming the familiar monetary policy challenge of time inconsistency—but not as it has been conventionally understood.

To achieve a better path for the economy over time, a central bank may need to commit credibly to maintaining highly accommodative policy even after the economy and, potentially, inflation picks up. Market participants may doubt the willingness of an inflation-targeting central bank to respect this commitment if inflation goes temporarily above target. These doubts reduce the effective stimulus of the commitment and delay the recovery.

To "tie its hands", a central bank could publicly announce precise numerical thresholds for inflation and unemployment that must be met before reducing stimulus (so-called "statecontingent" guidance).[8] This could reinforce the central bank's commitment to stimulative policy in the future and thus enhance the impact of its policies in the present.

The Federal Reserve has done exactly this with its state-conditioned threshold, specifically committing not to begin to consider raising its federal funds rate "at least as long as the unemployment rate remains above 6–1/2%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored".

Thresholds exhaust the guidance options available to a central bank operating under flexible inflation targeting. If yet further stimulus were required, the policy framework itself would likely have to be changed.

Beyond Flexible Inflation Targeting

If governments chose to go beyond flexible inflation targeting, there are two possible avenues. The first is to target a higher rate of inflation at all times. The second is to target not the growth rate of prices but the level of prices or nominal incomes.

Targeting a Higher Inflation Rate

Some have suggested that central banks should target an inflation rate higher than 2%. Two arguments are put forward. First, a higher inflation target might reduce the frequency and severity of encounters with the ZLB in the future. Second, and more immediately, a higher inflation target may be a way out from the burden of excessive debt in those countries struggling with deleveraging.

In my view, moving opportunistically to a higher inflation target would risk de-anchoring inflation expectations and destroying the hard-won gains that have come from the entrenchment of price stability. Moreover, if inflation is both higher and more uncertain, a higher inflation risk premium might result, prompting an increase in real rates that would exacerbate unfavourable debt dynamics across public and private borrowers.

These problems have led some academics, policymakers and private sector analysts to propose other mechanisms that may allow a different path of inflation in the short term, but maintain a long-run commitment to a fixed low inflation rate. There are several mechanisms—including targeting the level, rather than growth rate, of prices or nominal GDP—that could allow greater flexibility and deliver better outcomes for inflation and growth without a permanent change to the inflation target. These policy frameworks have the potential to achieve better outcomes in part because they add "history dependence" to monetary policy.

[7] Z. He, "Evaluating the Effect of the Bank of Canada's Conditional Commitment Policy," Discussion Paper No. 2010–11, Bank of Canada, 2010; and M. Woodford, "Methods of Policy Accommodation at the Interest-Rate Lower Bound," paper presented at the Jackson Hole Symposium, "The Changing Policy Landscape," Jackson Hole, Wyoming, 31 August—1 September 2012.

[8] See, for instance, C. L. Evans, "Perspectives on Current Economic Issues" (Speech to the Bank of Ann Arbor Breakfast, Ann Arbor, Michigan, 18 September 2012).

Price-Level Targeting

Our review of the Canadian policy framework considered this option. In contrast to inflation-targeting where bygones are bygones, under Price Level Targeting (PLT), monetary policy would seek to make up for past deviations in order to restore the price level to a predetermined path. For example, following a period of below-target inflation, policy would seek a period of above-target inflation in order to ensure that average inflation corresponds to targeted inflation (the desired rate of change in the price level) over time. The more the price level were to undershoot the target, the more the central bank would need to stimulate the economy to make up the undershoot, and the more inflation expectations would thus be expected to rise and real interest rates to fall, supporting spending and prices. This "automatic" provision of added stimulus could be particularly useful when conventional monetary policy is exhausted at the ZLB, while the rise in near-term inflation expectations would be self-limiting by design, unwinding as the price level approached the desired path.

PLT may merit consideration as a "temporary" unconventional policy tool in countries faced with extraordinary circumstances, notably those with policy at the ZLB and with a heavy burden of debt.[9] However, it also relies on inflation already having undershot the long-run target so that the price level is today below trend. That is not the case in the UK, where price pressures since the onset of the financial crisis have not, in fact, been weak.

Nominal GDP Level Targeting

The next step from Price Level Targeting is a target for the level of nominal GDP (NGDP). Under NGDP level targeting, the central bank is compelled to make up for deviations of the level of nominal GDP from some pre-determined trend. In theory, committing to restore the level of nominal GDP to its pre-crisis trend could raise expected inflation over the short and medium term but keep longer-term expectations well anchored. That would reduce real interest rates for a time, providing added stimulus to the economy.

Of course, the effectiveness of this strategy depends crucially on how expectations adjust. To reap the potential gains from NGDP-level targeting, expectations would have to adjust the way theory says they should. That requires the change in policy regime to be both credible and well understood. The public would need to be fully conversant with the implications of the regime and trust policy-makers to live up to their commitment. These conditions may not be met. In the worst case, if nominal GDP targeting is not fully understood or credible, it can, in fact, be destabilizing and damaging to the central bank's credibility.[10]

Bank of Canada research shows that, under normal circumstances, the gains from better exploiting the expectations channel through a history-dependent framework are likely to be modest, and may be further diluted if key conditions are not met. Most notably, people must generally understand what the central bank is doing—an admittedly high bar. However, when policy rates are stuck at the ZLB, there could be a more favourable case for NGDP-level targeting. The exceptional nature of the situation, and the magnitude of the gaps involved, could make such a policy more credible and easier to understand.[11]

Like flexible inflation targeting, NGDP-level targeting can be effective in dealing with so-called negative "supply shocks", such as a sharp rise in oil prices. It may also deal well with positive supply shocks (a productivity-enhancing new technology, for example) that boost real GDP growth while lowering inflation. A central bank that targets the level of NGDP would to some extent look through this "good deflation", thus avoiding a potential problem of helping to sow the seeds of an asset bubble.

The main drawback of an NGDP level target in this regard is that it imposes the arbitrary constraint that prices and real activity must move in equal amounts but opposite directions. As potential real growth changes over time, either the nominal target will have to change or else it will force an arbitrary change in inflation in the opposite direction. The challenge of determining the UK's potential growth rate at present highlights that this is not an academic concern (see answer to question 23). Another consideration is that statistics like nominal GDP are subject to revision, and these revisions can be large.

Conclusion: The Bar for Change is Very High but Review and Debate can be Positive

There are reasons why central banks have preferred to support employment and output by targeting price stability, rather than more directly through an approach like nominal GDP targeting. Central banks can neither determine the appropriate path for these real variables nor control them over the long run, and to imply that they can, could have negative consequences for economic stability and central bank credibility.

The benefits of any regime change would have to be weighed carefully not only against the potential risks but also against the effectiveness of other unconventional monetary policy measures under the proven, flexible inflation-targeting framework. Although the bar for change to any flexible inflation-targeting framework should be very high, it seems to me important that the framework for monetary policy—rightly set by Governments and not by central banks—is reviewed and debated periodically. That process, which in Canada is undertaken every five years, has yielded valuable insights on how we can best operate our framework in a way that

[9] C. Evans, "Monetary Policy in a Low-Inflation Environment: Developing a State-Contingent Price-Level Target"(speech to the Federal Reserve Bank of Boston's 55th Economic Conference, Boston, Mass., 16 October 2010).

[10] S. Murchison, "Consumer Price Index Targeting," Bank of Canada Working Paper (forthcoming).

[11] See footnote 10.

maximises the welfare of Canadian citizens. Similar insights may be possible in the UK given both the length of time since the inception of the inflation-targeting framework and the current extraordinary economic circumstances, which could not have been envisaged at its inception.

8. *What is your view of the measures of inflation used in the UK?*

I do not yet have a well- developed view of this, and I would note that the choice of price index used to define the MPC's "price stability" objective is for the Government. My preliminary view is that, in terms of methodology, the Consumer Price Index is the best available measure of price increases over a basket of goods and services typically purchased by consumers. Its main omission is of course that it excludes housing costs for owner-occupiers, but I understand that a new index—CPIH—will be launched next year incorporating these costs. This will be a useful development.

In general, my view is that to the extent possible the characteristics of a good measure of inflation to target are:

- It is representative of the costs facing households;
- It is well-understood and widely accepted as the relevant measure;
- It is produced by an independent statistical agency, and
- It is not subject to revisions.

In making judgements about the outlook for inflation, monetary policy should look through the temporary effects of, for example, energy and commodity price changes and variations in indirect taxes. At the Bank of Canada, we believe that measures of "core" inflation, which exclude certain volatile items from a price index, can be useful operational guides for policy, even though they are not appropriate definitions of long run price stability. If movements in commodity and food prices, for example, are judged to be temporary, a core measure that excludes those items can be a guide to where inflation will head once the effect of those movements has passed. These can complement other measures of underlying inflation pressures, such as growth rates of pay and unit labour costs.

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

To the extent that asset prices, including house prices, contain useful information about the future evolution of inflation at the *usual* monetary policy horizon (normally one to two years), this information should be considered in policy decisions in a manner analogous to any other indicator. In other words, asset prices may contain unique information that, when correctly interpreted, can lead to better inflation outcomes. However, it is important to distinguish asset prices as a useful leading indicator for achieving the inflation target from asset prices as the central bank target. No explicit recognition should be given to asset prices in the target index, beyond that accorded via their direct weight in the consumer price basket, such as the price of housing services in the CPI.

Certain asset prices, but more importantly measures of credit growth, may also provide a useful signal about potential risks to price stability beyond the usual inflation target horizon. Indeed, experience has shown that imbalances fuelled by a credit boom, which may manifest themselves in asset-price movements, pose the greatest medium-term risk to the economy, because of the powerful deleveraging process they induce when they unwind.[12] In principle, this means that, in responding to financial imbalances such as excessive credit growth, the central bank should take into account not only their direct effect on output and inflation at the usual horizon, but also any macroeconomic effects that could materialize later on, when these imbalances unwind. There is thus no inherent inconsistency between inflation targeting and the use of monetary policy to counteract financial imbalances, provided the time horizon is long and flexible enough. From this perspective, a lesson from the recent crisis is not that we need a different policy framework to address financial stability concerns, but that we need better analysis of the macroeconomic effects of financial imbalances.

Experience suggests that prolonged periods of unusually low interest rates can cloud assessments of financial risks, induce a search for yield, and delay balance-sheet adjustments. There are several defences.

The first line of defence is built on the decisions of individuals, companies, banks and governments.

In this regard, the Bank of Canada's advice to Canadians has been consistent. Canada has weathered a severe crisis—one that required extraordinary fiscal and monetary measures. Extraordinary measures are only a means to an end. Ordinary times will eventually return and, with them, more normal interest rates and costs of borrowing. It is the responsibility of households to ensure that in the future, they can service the debts they take on today. Similarly, financial institutions are responsible for ensuring that their clients can service their debts. More broadly, market participants should resist complacency and constantly reassess risks. Low rates today do not necessarily mean low rates tomorrow. Risk reversals when they happen can be fierce: the greater the complacency, the more brutal the reckoning.

[12] See for example, C. Reinhart and V. Reinhart ("After the Fall," *Macroeconomic Challenges: The Decade Ahead*, Federal Reserve Bank of Kansas City Economic Policy Symposium, Jackson Hole, Wyoming, 26–28 August 2010.

The second line of defence is enhanced supervision of risk-taking activities. Stress testing in major economies should focus on excessive maturity and currency mismatches, look for evidence of forbearance (such as ailing industries receiving a disproportionate share of loans or the loosening of standards for existing debtors) and analyse the impact of sharp moves in yield curves.

These efforts will be aided by the imposition of the new Basel III regulations. Measures, including a leverage ratio, new trading book rules and liquidity standards, will help curtail excessive leverage and maturity transformation.

The third line of defence is the development of and selected use of macroprudential measures. In funding markets, the introduction of through-the-cycle margining can help curtail liquidity cycles.[13] In broader asset markets, counter-cyclical capital buffers can be deployed to lean against excess credit creation.

In the housing market, the Canadian government has taken a series of important measures to address household leverage (see question 16). In addition, the Bank of Canada's interest rate increases reminded households of the interest rate risks they face. These have contributed to a more sustainable evolution of the housing market.

These defences should go a long way to mitigate the risk of financial excesses. But the question remains whether there will still be cases where, in order to best achieve long-run price stability, monetary policy should play a supporting role by taking pre-emptive actions against building financial imbalances.

The Interaction Between Macroprudential and Monetary Policies

The Bank of England has been assigned full responsibility for macroprudential policy. Specifically, the Financial Policy Committee (FPC) within the Bank is responsible for identifying, monitoring and addressing risks to the financial system as a whole. The FPC will address systemic risks using powers given to it by Parliament to make recommendations and directions. Alongside the FPC, the Prudential Regulatory Authority will be created as an operationally independent subsidiary of the Bank, responsible for supervising the microprudential soundness of individual firms. This institutional framework provides important advantages over other arrangements, including centralizing responsibility for macroprudential and microprudential regulation together within one institution, thereby reducing the risk of coordination failure between monetary and macroprudential policy institutions, as well as reducing the potential for "regulatory gaps" in which no single authority is in charge of controlling systemic risk. Such gaps are believed to have played an important role in the 2008 financial crisis.

The Bank of England's institutional structure also facilitates coordination in the MPC to help ensure a complementary role, if this is required. To be clear, I view monetary policy as the last line of defence against financial imbalances.

The effectiveness of monetary policy in in this regard depends on the nature of the imbalances, the influence of monetary policy and prudential tools on these imbalances, and the interactions between them. When financial imbalances remain concentrated in a specific sector, well-targeted macroprudential tools should usually be sufficient. Monetary policy is not well suited to address such imbalances, since monetary policy affects the entire economy, meaning that the interest rate increase required to curtail sectoral imbalances would come at the cost of undue restraint on the economy as a whole.

A credit-fuelled housing bubble is a particularly relevant example of a financial imbalance. Bank of Canada research suggests that a significant increase in interest rates could be required to stem the build-up of credit, with material consequences for output and inflation.[14] This illustrates that monetary policy might be too blunt a tool to stem financial imbalances emerging in a specific sector.[15] By contrast, macroprudential policy is as effective in addressing financial imbalances in the housing market without causing any undershoot in output or inflation. Rather, macroprudential in this scenario acts as a complement to monetary policy dampening the increase to output and inflation generated by the shock.

In this way, prudential measures will go a long way to mitigate the risk of financial excesses, but in some cases, monetary policy may still have to take financial stability considerations into account. For instance, where imbalances pose an economy-wide threat and/or where the imbalances themselves are being encouraged by a low interest rate environment, monetary policy might itself be the appropriate tool to support financial stability. Such could be the case when the risk-taking channel of monetary policy is present. The stance of monetary policy may itself lead to excessive risk taking by economic agents, which, in turn, can lead to financial instability.[16] Specifically, monetary policy could influence the degree of risk that financial institutions decide

[13] See "The Role of Margin Requirements and Haircuts in Procyclicality," a report prepared by a Study Group chaired by David Longworth and published by the Committee on the Global Financial System of the Bank for International Settlements as CGFS Papers No. 36, 23 March 2010.

[14] See for example J. Boivin, T. Lane and C. Meh, "Should Monetary Policy Be Used to Counteract Financial Imbalances?" *Bank of Canada Review* (Summer 2010): 23–36,).

[15] See, for example, C. Bean *et al,* "Monetary Policy after the Fall," (speech to Federal Reserve Bank of Kansas City Annual Conference, Jackson Hole, Wyoming, 28 August 2010).

[16] M. Carney, "Some Considerations on Using Monetary Policy to Stabilize Economic Activity," (speech to symposium sponsored by the Federal Reserve Bank of Kansas City Annual Conference, Jackson Hole, Wyoming, 22 August 2009).

to bear by influencing their perception and pricing of risk.[17] This can take place through three broad types of mechanisms: (i) the perceived predictability of monetary policy, (ii) the search for yield, and (iii) the insurance effect of monetary policy. The first two mechanisms incite more risk taking in a low-interest-rate environment, while the third provides incentives for financial institutions to take more risks through the moral hazard created by the authorities' perceived reaction function. These three mechanisms can lead financial institutions and economic agents to take on too much leverage and the associated maturity mismatches, which, in turn, can generate financial imbalances.

Because the consequences of financial excesses may be felt over a longer and more uncertain horizon than other economic disturbances, the potential may exist for tension among output, inflation and financial stability considerations over the typical two-year monetary policy horizon. In these circumstances, it may be appropriate to bring inflation back to target over a somewhat longer horizon, consistent with the longer-run pursuit of low, stable and predictable inflation. But that flexibility does not exist in a vacuum, and should never be used by stealth. Open and transparent communication is essential.

This timing difference can be partially bridged in a couple of ways. First, housing prices can be incorporated in the consumer price index, as they are in Canada and as is under consideration in the U.K. Second, monetary policy communications can adapt to reflect the behavioural dynamics of financial systems, including clearly communicating any change in the expected time required for inflation to return to target as a result of financial stability considerations. This has been the case in Canada. The Bank of Canada's recent policy guidance does this when it states: "If the Bank were to lean against such imbalances, we would clearly say we are doing so, and indicate how much longer we expect it would take for inflation to return to the 2% target".

To summarize, monetary policy should not target asset prices. Central banks, however, should be alive to the information contained in asset prices and wary of the impact on financial stability of excess credit growth.

Flexible inflation targeting is the standard approach to bridge the different time horizons for financial and price stability. However, there are limits. The time frame for inflation targeting can be stretched, but the credibility essential for its success may be undermined if such flexibility is taken too far or deployed too frequently. The paramount goal of monetary policy in Canada has been, and remains, price stability. The primary tools to deal with financial stability are micro- and macroprudential regulation and supervision. Macroprudential tools are not a substitute for monetary policy in controlling inflation, and monetary policy cannot substitute for proper micro- and macroprudential supervision and regulation in maintaining financial stability.

10. *The UK has a flexible exchange rate. Are there circumstances where you might use Bank of England reserves to affect the exchange rate?*

A floating exchange rate is, in both the UK and Canada, an important element of the monetary policy framework, allowing the central bank to pursue a monetary policy appropriate to its own economic circumstances. A floating exchange rate provides a buffer, helping economies to absorb changes in the international environment. It also helps economies adjust to domestic and global economic forces, signalling to shift resources into sectors where demand is strongest and minimising adjustments needed in other areas of the economy. The sharp fall in sterling since the onset of the financial crisis, for example, has helped to signal and promote the required shift in resources, away from domestic consumption and towards net exports. The necessary adjustment and rebalancing of the global economy would be assisted by the same degree of exchange rate flexibility in all major economies.

It is true that exchange rates can be volatile. However, countries cannot avoid adjustment; the question is simply *how* they adjust to global economic forces. With a fixed exchange rate, the adjustments would have to come through movements in overall output and in wages and prices. History has shown that these adjustments are more protracted and more difficult than exchange rate adjustments. For example, the current hybrid system of fixed and floating exchange rates in the international monetary system has not allowed the world economy to adjust efficiently to large shocks, such as the integration of China into the global economy, thus allowing the occurrence of large and unsustainable current account imbalances.

The absence of a target for the exchange rate does not mean a central bank should be indifferent to exchange rate movements. Inflation-targeting central banks care about the potential effect on output and inflation in order to set a course for monetary policy that keeps total demand and supply in balance and inflation on target. This means that they have to make judgements about the causes and likely persistence of exchange rate movements, the speed and degree to which the exchange rate changes "pass through" to domestic prices, and the possible impact of exchange rate movements on confidence and, through confidence, on consumption and investment.

A central bank's regular policy decisions, including both changes in interest rates and other measures such as asset purchases, will affect economic conditions through the exchange rate. In addition, the MPC has the right, in order to pursue its remit, to intervene in currency markets, either by drawing on, or adding to, the Bank's $6bn of foreign currency reserves. I do not, in general, think such action should be pursued when other instruments are available. In addition, consideration of any such action must take into account the G7

[17] See T. Adrian and H. S. Shin, "Money, Liquidity, and Monetary Policy," Federal Reserve Bank of New York Staff Report No. 360, 2009 and C. Borio and H. Zhu, "Capital Regulation, Risk-Taking and Monetary Policy: A Missing Link in the Transmission Mechanism?" Bank for International Settlements Working Paper No. 268, 2008.

convention against unilateral currency intervention. The Bank must pursue concentrated and sustained efforts with its G20 partners to ensure all systemically important currencies adjust appropriately.

However, in an extreme scenario, if other avenues had been exhausted and the MPC were to judge that such intervention was necessary to achieve its objectives, I would recommend that the Bank of England exercise that right.

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

Perhaps most importantly, medium and longer-term inflation expectations are a key indicator of the confidence that households, firms and financial markets have in the ability and willingness of a central bank to meet its price stability objective. They can tell us whether the target is effectively "anchoring" inflation expectations. As such, inflation expectations are key indicators of the credibility of the inflation target and the monetary regime.

The achievement of price stability in the medium term rests on the existence of a widely held belief that monetary policy will bring inflation back to target. Significant moves in longer-term inflation expectations away from target may indicate an underlying threat to price stability—especially if there is evidence that this is having an effect on wage and price setting.

Shorter-term measures of inflation expectations are in principle a guide to inflation in the near term because they will affect company pricing decisions and wage negotiations. But in a credible, flexible inflation-targeting regime, in which inflation is allowed to deviate from the target in response to temporary shocks, such as movements in commodity prices, short-term inflation expectations should move up and down without leading to significant changes in wages and other prices. For that reason, there tends not to be a strong relationship between measures of short-term inflation expectations and underlying inflation pressures.

More generally, inflation expectations affect real interest rates, and through that incentives to save, spend and invest. As such they are an important input to a consideration of the outlook for growth and inflation.

In view of the information inflation expectations contain about prospects and the credibility of the regime, monetary policy-makers should review a broad range of market and survey indicators when making their decisions. In practice we have to interpret measures of expectations with care.

Surveys can show a consistent bias in reported expectations. For these measures, short run expectations will naturally move around as near-term inflationary pressure varies, for example due to movements in commodity prices or the exchange rate. In fact measures of UK households' and companies' short-term inflation expectations have generally fallen back over the past year, reflecting the decline in actual inflation. Longer-term expectations measures suggest that UK inflation expectations are well anchored at present, despite current above-target inflation.

Financial market measures can also be distorted. In Canada, the market-based measures of inflation expectations rely on quoted Yields-to-Maturity (YTM) of Real Returns Bonds (RRBs) and YTM of nominal government bonds. The difference between the real and nominal yields, the so-called *break-even inflation rate (BEIR),* reflects long-horizon inflation expectations as well as duration mis-match, liquidity risk/market segmentation, inflation risk and variations in short-term expectations.

In this regard, caution must be used in interpreting short term market moves and changes in market-based measures can sometimes be more informative than absolute values.

12. *Are there circumstances where you might tolerate higher than target inflation for wider economic reasons?*

Please see answers to questions 7 and 9.

13. *What is your assessment of the effectiveness of the policy of quantitative easing in the UK, and of what needs to be considered when preparing for the UK's eventual unwinding of quantitative easing? What is your view of the distributional effects of QE?*

Asset purchases (QE), in addition to their direct effect of increasing the price of the purchased assets (eg gilts) and lowering their yields, affect the economy through multiple channels, including:

- Portfolio rebalancing—investors are incentivised to rebalance their portfolios towards riskier higher-return assets, thus exerting upward pressure on their prices and resulting in lower yields across a range of assets;
- Higher asset prices boosting financial wealth, supporting consumption and domestic demand;
- Lower yields feed directly to lowering debt-service costs and a lower cost-of-capital, spurring investment;
- Downward pressure on the exchange rate, which supports net exports and favours domestic demand for domestically-produced outputs;

— Improved confidence as the central bank demonstrates that it would do whatever is necessary to meet its objectives;

— Anchoring inflation expectations, thereby holding down real interest rates.

All of these channels are difficult to quantify, but it is very likely that had the Bank of England not introduced such unconventional measures as short-term interest rates reached their lower bound, the result would well have been a deeper recession, higher unemployment and very weak underlying domestic inflation pressures.

The studies by the Bank of England and Federal Reserve of their respective Asset Purchase programmes are broadly consistent. It is clear that the programmes have had some positive effects. They find the effects on financial markets to be material. Gilt yields were reduced. Corporate investment grade and high-yield spreads also fell markedly. The evidence is that the simulative effects then fed into equity prices. I do not think there is such a thing as a fixed "multiplier" from asset purchases to other financial asset prices. It seems to me likely that the scope to influence financial markets varies with market conditions. Asset purchases probably have a greater effect when markets are functioning poorly and liquidity premia are high.

It is even more difficult to judge how those effects in financial markets, whatever their magnitude, have transmitted to the macroeconomy. The weakness of growth since QE was introduced is not itself a reason to doubt that it is an effective policy. There seems to be some evidence that large scale asset purchases have boosted the demand for riskier assets, allowing those companies with access to capital markets to access funds more cheaply than otherwise. That probably includes banks, who have benefitted both from higher demand for their debt and from an improved liquidity position through the boost to their holdings of reserves at central banks. What is less clear is the extent to which that has translated into an expansion of bank lending.

The benefits of large scale asset purchases, and indeed persistently low interest rates, need to be judged against the potential costs of having a very stimulative policy for a very long time. Such policies can encourage excessive risk taking, distort the functioning of sovereign debt markets, and build vulnerabilities in the financial sector. In addition, central banks need to be mindful of the potential impact of very large purchases on market functioning.

The potential costs of QE and the uncertainty about the effect of QE on bank lending behaviour are solid reasons for supplementing QE with the Funding for Lending Scheme.

Exit

Given the scale of the expansion of central bank balance sheets, it is understandable that there are concerns about the exit from unconventional policies. The primary objective of unwinding the stock of purchased assets is to maintain price stability as the economy recovers. A credible plan is needed in advance in order to maintain confidence. The exit needs to be achieved without disrupting the gilts market. Such disruption could lead to sharp movements in a range of other asset prices, or possibly threatens to financial stability.

The MPC has stated that its strategy will be to announce in advance a schedule of asset sales, co-ordinated with the Debt Management Office. That seems to me an appropriate way to manage down the balance sheet. To ensure the MPC retains adequate room to respond to developments in economic conditions, it will be sensible for any tightening in monetary conditions to come about first through an increase in Bank Rate that could, if necessary, be reversed easily. In systems like the Bank of England's, in which reserves at the central bank are remunerated, there is no obstacle to raising short-term interest rates before the size of the central bank's balance sheet is reduced.

It is my intention that the MPC periodically revisits its exit strategy and updates the public, reporting any changes in a timely and transparent manner.

Distributional effects

It is important to remember that all forms of monetary policy, conventional or otherwise, have unavoidable distributional effects. These effects, significant though they may be for individuals, are small when compared to the distributional consequences of the macroeconomic instability that would have ensued had policy not been so stimulative. In the absence of such policies, in the UK and the rest of the world the resulting collapse in demand, confidence and financial stability would have harmed almost everybody: young and old, savers and borrowers, rich and poor. Any assessment of distributional effects needs to be seen in the context of avoiding these outcomes.

In normal cycles, the distributional effects of monetary policy are not long-lasting. The difference now is that policy has been so stimulative for so long. Some of the biggest distributional effects now stem not from QE but from the "conventional" monetary stimulus in the form of very low short-term interest rates, which have reduced the income of those who have deposits and boosted the incomes of those who have variable-rate loans.

Long-term interest rates and annuity rates have been driven down by the expectation that those low short-term interest rates will persist and, in addition, by the effect of asset purchases on term premia. That raises the cost of purchasing a given pension income at retirement, but at the same time, monetary policy has driven up the prices of a wide range of assets, so those about to retire have greater financial wealth than they would have

had in the absence of the stimulus. Depending on the composition of the assets used to purchase the annuity, those two effects—the higher cost of an annuity and higher asset values—can be broadly offsetting for those about to retire.

For the same reason, those that operate defined benefit pension schemes need not have suffered as a result of the monetary stimulus. Both assets and liabilities have increased. However, for pension funds that are already in deficit, even proportional increases in the values of assets and liabilities will make that deficit worse. The burden of closing the deficits—the extent of which depends on accounting treatments—will fall on future employees and employers.

More generally, although the Bank of England's analysis for the Treasury Committee of the distributional consequences of QE seems valuable not least because monetary policy-makers need to be conscious of the effects of their actions, policy should always be set consistent with the remit from Parliament for the economy as a whole. It is for others to decide whether to offset the distributional effects using other instruments.

14. *What do you regard as the strengths and weaknesses of the work undertaken by the interim Financial Policy Committee?*

This is an area where I do not yet have a well-developed view. My initial impressions are that the Financial Policy Committee will fill an important gap in the pre-crisis regulatory architecture—macroprudential regulation. Although to date in non-statutory form, the FPC seems to have provided leadership in developing a framework for macroprudential policy in the UK and in developing the toolkit that it should have to achieve its objectives.

My understanding from future colleagues in the Bank of England and FSA is that the FPC has strengthened the interaction between the central bank and the regulators. That has been an important step in the transition to creating the Prudential Regulation Authority as part of the Bank, a key benefit of which will be close co-ordination between micro- and macroprudential policies. The most notable example of that co-ordination to date has been on liquidity buffers. In June 2012 the FPC and FSA provided clarity about how banks could expect to use their liquidity buffers; the FSA loosened its stance; and the Bank of England launched its extended collateral term repo operations to provide a more substantial liquidity backstop for banks.

There is no doubt that, in its infancy, the FPC has faced a challenging set of circumstances as the banking system moves along the Basel III transition path, from its weakened position after the crisis, towards a more transparently resilient position. That transition is taking place against a backdrop of large and persistent risks from the euro area and weak credit growth in the UK. The FPC has been forced to focus on the shorter-term need to tackle the difficult challenge of achieving greater resilience without holding back lending and growth. As time goes by, it should be able to move some of its focus towards ensuring the structure of the financial system is as resilient as possible—an issue that will not be the primary responsibility of micro supervisors. A key example will be the risks posed by institutions—such as shadow banks, discussed further in my answer to question 21—that are just outside the scope of regulation.

The FPC has necessarily been learning as it goes, designing and implementing policy at the same time. As it develops, we should seek to continue to improve the clarity and strength of the FPC's messages. That is not straightforward when recommendations are balancing objectives, for example to raise capital in ways that will not encourage deleveraging, and when Committee members—rightly—have a range of perspectives and are individually accountable. My approach, which I outline further in my answer to question 32, will be to work wherever possible towards consensus.

15. *How do you propose to communicate financial stability policy and decisions, including the macroprudential tools? In particular, how will you communicate these to the general public?*

Transparency will be extremely important to the success of macroprudential policy, for reasons of both effectiveness and accountability. Public understanding of macroprudential policy is presently low—the significance of, for example, "capital ratios" and "liquidity requirements" for banks are not widely understood and it will require a good deal of hard work, over a long period, to broaden public understanding.

Credibility demands that Parliament and the public have a clear understanding of why the FPC has taken particular actions. It is crucial that the FPC, even if its recommendations and directions to supervisors are complex, can present a straightforward, easily-digestible explanation of its policy decisions to others.

This will require a range of communications. The Financial Stability Report should provide the entire context to our decisions and a clear statement of what those decisions were. The publication of that Report will continue to be accompanied by a press conference to explain the decision. The Record of the FPC's meetings will give more detail on any range or differences of view.

I intend to engage widely, using speeches and media interviews, both nationally and in the regions of the UK, to explain our decisions to the public. My media interaction will include both written and broadcast media. I will need to explain the FPC's actions as much as I do those of the MPC and present them in such a way so people understand how they are affected by them. It is relatively straightforward for the public to see how a change in the Bank Rate affects them. Other policies, including on the monetary policy side, asset purchases,

and in the sphere of financial stability, the FPC's recommendations, affect people less directly and so require more explanation.

I will make full use of the Bank's network of twelve agencies around the UK to engage with people on a regular basis. I also intend to develop further the use of social media for the Bank to broaden and deepen that engagement. For instance, the media strategy employed for the launch of the Bank of Canada's new polymer series of bank notes—using earned media and social media tools—garnered about four million web views of communication material on the polymer series. This successful strategy saved the Bank an estimated $1 million in costs for advertising and promotional materials versus the previous series of Canadian bank notes.

The FPC must also communicate with more specialist stakeholders, such as market participants. We can do that through a mix of regular market meetings and more focused roundtable sessions. As the FPC becomes statutory, that process should be developed further to inform FPC and build a constituency for its strategy.

The scale of this task of explanation and building understanding and engagement will require a team effort from the FPC. I plan to co-ordinate the work of members of the FPC to ensure our coverage is complete and our messages clear and effective.

16. *What is your assessment of the macroprudential tools that will be available to the FPC? Would you prefer the FPC also to have the ability to limit loan-to-value and/or loan-to-income ratios?*

It is proposed that the FPC will have powers of direction over the countercyclical capital buffer and sectoral capital requirements. I think these are necessary to achieve the FPC's objectives, giving it a tool to vary over time and a tool to vary across sectors at each point in time.

The *countercyclical capital buffer (CCB)*, which is embedded in Basel III, will give a tool for the FPC to use at the system-wide level to increase the capacity of the system to absorb losses and curtail excessive lending. Reducing the required buffer could help to mitigate the contraction in lending during a downturn. Decisions made to change the CCB in the UK will, up to a limit, be reciprocated by the home regulator of foreign banks active in the UK.

Sectoral capital requirements could target risks building in specific areas, such as real estate, more precisely than the countercyclical buffer. Changes in sectoral capital requirements would have more direct and transparent distributional consequences than changes in aggregate capital requirements. It will be important to justify clearly decisions over sectoral capital weights with respect to the FPC's objectives. The FPC will need to avoid an excessively "fine-tuned" approach in setting sectoral capital requirements.

I do not yet have a developed view about whether those tools will be sufficient to meet the FPC's objectives. But I take great comfort from the fact that the FPC will be able to issue so-called "comply or explain" recommendations on any issue to regulators. These will be an important way for the FPC to pursue its objectives and, with regulators working closely together, I hope that this ability will make the choice of specific directive tools for the FPC less important.

In time, as international standards evolve, the FPC's toolkit should be assessed. The FPC has said that it would be desirable to have directive powers over liquidity and margining requirements. I agree that these should be revisited in due course as, for example, the Basel III Net Stable Funding Ratio is developed and agreed.

LTV and LTI ratios

Research at the Bank of Canada suggests that a range of LTV ratios set at a lower level would dampen procyclicality in the housing market. Varying the LTV ratio countercyclically could mitigate procyclicality even further.[18] Some jurisdictions, such as Hong Kong, have used such tools to enhance to financial stability. Since 2008, the Government of Canada has taken a series of steps to strengthen the minimum standards for government-backed insured residential mortgages in order to support the long-term stability of the housing market.

Among these measures were:

- A reduction in the maximum LTV for insured mortgages from 100 to 95% in October 2008;
- A reduction in the maximum amortization period from 40 years in 2008 to 25 years in 2012;
- A lowering of the limit on the LTV for mortgage refinancing from 95% in 2010 to 80% in 2012; and
- A reduction in the LTV limit for investment properties from 95% to 80%.

These have contributed to a more sustainable evolution of the housing market. The cumulative effect of these measures, together with increased consumer awareness, is having an impact. In the past six months, the growth of household credit has moderated, with total household credit growth slowing to below 4% in recent months. If this is sustained, the ratio of household debt to disposable income can be expected to stabilize later this year.

The uncertainties about the effect of macroprudential regulation mean that it is probably sensible to employ a range of complementary tools. The advantage of LTV and LTI tools is that they complement the

[18] I Christensen, "Mortgage Debt and Procyclicality in the Housing Market," *Bank of Canada Review* (Summer 2011): 35–42.

countercyclical capital buffer in two ways. First, they can constrain the build-up of leverage in the private sector—the CCB prevents the build-up in the banking system.[19] Second, LTV and LTI restrictions would naturally apply to new lending *flows*, complementing the capital tools, which apply to banks' existing stocks of lending.

Nevertheless, LTV and LTI restrictions differ substantively from the directive powers of the FPC, which are focussed not on controlling the credit cycle directly, but in ensuring that banks hold sufficient capital to make them resilient to the exposures they take. These instruments will of course affect the incentives of banks to lend and to set the price of particular exposures, but they do not directly constrain the types of loans that can be offered to potential borrowers. LTV and LTI ratio constraints would do so and are therefore more intrusive. Such a degree of intrusion requires the tools either to be deployed by elected officials, as they are in Canada, or by Parliament agreeing to give unelected officials a clear mandate to use the tools. A decision whether to do so should consider that some of the benefits of LTV and LTI restrictions in making the financial system resilient are available to the FPC through the direction power over sectoral capital requirements, which might differentiate between LTV and LTI ratios when loans are extended.

17. *What lessons have you drawn from your experience of chairing the Financial Stability Board? What further progress is required in international financial regulation?*

Core lessons:

(1) **Ongoing need to maintain consensus in favour of an open and resilient global financial system**

An open, resilient global financial system will be central to the transformation of the global economy. In order to achieve that, financial sector reform is a must. Over the last year, the main risk has been that a series of contingency measures could extend to a global scale the current European trend towards fragmentation. Concerns over the effectiveness of cross-border resolution arrangements could encourage uncoordinated unilateral actions, leading to greater ring-fencing of capital and liquidity, and reducing the efficiencies and financial capacity of the global system.

The financial reform agenda must also address legitimate emerging-market concerns over the resiliency of the advanced-economy financial systems. Because of these worries, there is pressure for localisation to protect domestic systems and renewed use of capital controls to dampen the volatility of cross-border flows. If allowed to persist, these nascent trends could seriously restrain the global capital flows necessary for economic growth and that have helped lift millions of people out of poverty in the emerging market economies.

(2) **The new, stronger capital and liquidity framework for banks must be implemented**

With the new Basel III rules, the quantity and quality of bank capital are being improved immensely. These are to be phased in by January 2019, and the Basel Committee is closely monitoring and publicly reporting on countries' full and timely implementation. As a backstop to the inherent imperfections of a risk-based capital framework, a simple, but effective, leverage ratio has been introduced into the global standard. The leverage ratio sets a cap on how many assets a bank can hold for each unit [or pound] of equity. It protects the system from risks we might think are low but, in fact, are not.

(3) **Need to build diversity in the system (different load-bearing capacity for risk)**

It is important that the financial system comprises agents with different investment horizons and risk perceptions. This helps absorb short-term volatility and smooth asset price swings. Furthermore, different risk perceptions are necessary to have vibrant markets and allow agents to exchange risks and bear only those they feel comfortable holding.

(4) **Value of reinforcing market incentives**

There are several ways in which financial reforms are reinforcing market incentives. The new Basel capital and liquidity rules will encourage better risk management. New FSB compensation standards are better aligning incentives of bankers with the needs of the broader economy. More intensive and effective supervision will reinforce internal governance and risk management.

But no supervisory system can catch everything. The main responsibility for identifying and managing risk rests with each firm's Board and executive management, whose risk managers, compliance staff and internal audit personnel will always greatly outnumber the resources available to supervisors. And since regulation alone cannot optimise risk and return, the FSB is taking steps to enhance the role of the market in achieving the right balance:

- By reducing the mechanistic reliance on credit ratings, according to the roadmap agreed to by G20 Leaders in Mexico. Doing so will promote diverse private sector judgement, reducing cliff effects and building resilience.

[19] Bank for International Settlements "Operationalising the Selection and Application of Macroprudential Instruments," a report prepared by a Working Group chaired by José Manuel González-Páramo and published by the Committee on the Global Financial System as CGFS Papers No. 48, December 2012.

— By improving risk disclosure, risk governance and risk management. The private-sector Enhanced Disclosure Task Force, formed at the initiative of the FSB, offered recommendations to banks to provide more, and more useful, information about their business models, key risks and risk-measurement practices to investors. This should contribute, over time, to improved market confidence in financial institutions and financial market functioning, complementing regulatory and supervisory actions by the public sector.

— By promoting the strengthening of risk governance frameworks in firms to enhance the roles of the Board, risk committee, CRO and internal audit in setting, implementing and monitoring a risk appetite framework within the firm.

— By addressing too-big-to-fail, thereby forcing shareholders and creditors to confront the risk of losses, and thus subjecting firms to the ultimate sanction of the market, with the result that discipline in the system will increase.

As the Basel capital rules are implemented, as market infrastructure changes, and as banks—and, crucially, their investors—develop a better appreciation of their prospects for risk and return, banks are beginning to change their business models. Already, a couple of banks have fallen off the list of global systemically important banks (G-SIBs) because they have simplified, downsized and de-risked their business models. Other institutions are de-emphasizing high-profile but risky capital markets businesses that benefited employees more than shareholders and society. As the reform process progresses, we can expect further adjustments that should ultimately lead to a more resilient, diversified sector with a more sustainable risk-return profile.

(5) **Fundamental importance of timely and consistent implementation**

The focus on timely, full and consistent implementation of major reforms has increased as the policy work of developing standards in the priority reform areas has advanced. Consistent implementation is essential to preserve the advantages of an open and globally integrated financial system. Recent experience demonstrates that when mutual confidence is lost, the retreat from an open and integrated system can occur rapidly. A return to a nationally segmented global financial system would reduce both systemic resilience and financial capacity for investment and growth. The main objective of the FSB's Standing Committee on Standards Implementation (SCSI) is to promote timely, full and consistent implementation of global financial standards through disclosure and peer pressure by undertaking thematic and country peer reviews and other ongoing monitoring processes. The focus of SCSI's work is on the FSB's priority reform areas: Basel III framework, OTC derivative market reforms, the resolution framework [as specified in the FSB's *Key Attributes for Effective Resolution Regimes*], policy measures for global systemically important financial institutions (G-SIFIs), shadow banking, and compensation practices. SCSI coordinates this monitoring of implementation with the global standard-setting bodies, as appropriate, [as set out in the FSB's *Coordination Framework for implementation Monitoring*]. SCSI's workplan priorities for 2013 are:

— Thematic peer reviews on resolution regimes and risk governance frameworks in banks, which were started in 2012, and on actions to reduce reliance on credit ratings provided by credit rating agencies, which will start in 2013.

— Country peer reviews: US, UK, Indonesia and Germany, (which follow up on the key recommendations of recent assessments under the IMF Financial Sector Assessment Programs (FSAPs)).

What further progress is required?

The global financial system is safer today than before the crisis.

Despite the challenging economic environment, banks have substantially increased capital and liquidity. They are more actively managing risks. Countries are diligently implementing measures so that they can resolve failing institutions. The infrastructure of derivatives markets is being transformed to reduce systemic risks. The size of the shadow banking sector has fallen by 20 percentage points of GDP, back to levels last seen in 2004–05.

The case for reform remains as clear today as it did when the G20 began the process in 2008. Measures to strengthen financial stability support economic growth and create jobs rather than hold them back, even in the short term. Credit growth has resumed in most of those countries where financial institutions have decisively strengthened their balance sheets, refocused their core business activities, and improved their funding sources—in other words, returned to a more sustainable business model.

However, while progress has been made, the global financial system is still not as safe as it needs to be. While much has been accomplished, much more needs to be done.

The FSB's ambitious reform agenda described below will make a huge difference when fully implemented. That is why the FSB is increasingly focused on timely and consistent implementation of agreed reforms.

Building Resilient Financial Institutions

Achieving a stronger banking system is the overriding priority, hence the importance assigned to full implementation of Basel capital and liquidity standards.

With the new Basel III rules, the quantity and quality of bank capital are being improved immensely:

— The minimum requirement for common equity will rise from 2% to 4.5% under Basel III, and to 7% when the new capital conservation buffer is added. This more than triples the required amount of high-quality capital.

— A new countercyclical capital buffer will compel banks to further increase capital by up to 2.5 percentage points if threats of system-wide disruptions are rising.

— For those banks whose failure would pose a risk to the global financial system, even more capital will be required. By 2019, these institutions will face a capital surcharge that rises from 1% to 2.5% of risk-weighted assets.

In addition, the new rules will bring more exposures on balance sheets and require more capital against riskier activities (eg, trading activities and securitisations). For example, capital required for the trading book will be tripled.

The effective increase in capital is even larger once the tougher definition of capital is factored in. In total, the largest banks will have to hold at least seven times as much capital as before the crisis.

As noted above, a simple, but effective, leverage ratio has been imported from Canada into the global standard.

Banks will be safer as a result of Basel III capital and liquidity measures. Most importantly, the leverage ratio must be agreed and implemented. But much more is required. We need to ensure consistent implementation.

An extensive programme has been put in place by the Basel Committee on Banking Supervision, in coordination with the FSB, to monitor and assess the implementation of the Basel capital framework. There are 3 different levels of review:

— *Level 1* determines whether members have put in place the legislation necessary to enact the Basel capital framework as per agreed timelines. Eleven FSB members have put in place the necessary legislation as of 1 January 2013, and almost all of the other members will do so by the end of the year.

— *Level 2* assesses the consistency of the legislation with the Basel capital framework. To this point, Level 2 assessments have been conducted for the major jurisdictions of the European Union, Japan and the US. The results for these jurisdictions were published in October 2012 and they identified some material deficiencies (for the US and the EU) that will need to be addressed. Six additional Level 2 reviews are underway or planned for 2013–14 (including Singapore, Switzerland, China, Australia, Brazil and Canada).

— *Level 3* assesses the effectiveness of the Basel capital framework in influencing bank behaviour to ensure that the framework is having the desired effect of increasing the quality and quantity of capital held by banks in a consistent manner across jurisdictions. The initial focus of Level 3 assessments is on banks' determination of risk-weighted assets (RWAs) because a bank's required capital holdings are a function of the amount and riskiness of its assets. There are two separate reviews of RWAs being undertaken, one for the banking (loan) book and the other for the trading book, in order to determine whether there are material differences in the way banks apply the rules for determining RWAs.

These measures have lowered the probability of failure. However, our goal is not a fully risk-proofed system. That is neither attainable nor desirable.

Ending Too-Big-To-Fail

Since failures will still happen, there remains the need to reduce their impact, which is one of the reasons to focus on ending too-big-to-fail. More fundamentally, we must address, once and for all, the unfairness of a system that privatises gains and socialises losses. Moreover, the moral hazard problems associated with implicit public support may amplify risk taking, reduce market discipline, create competitive distortions, and further increase the probability of distress.

By restoring capitalism to the capitalists, discipline in the system will increase and, with time, systemic risks will be reduced. Most importantly, the knowledge that major firms in markets far away can fail, without meaningful consequences at home, would restore confidence in an open global system.

First, the FSB has identified those banks that are systemically important at the global level, based on size, complexity and interconnectedness with other aspects of the financial system.[20]

Second, to address the systemic and moral hazard risks associated with these systemically important financial institutions (SIFIs), the FSB has developed a range of measures, which comprise: (a) higher loss absorbency; (b) enhanced resolution authority and planning; and (c) more intensive and effective supervision.

[20] The FSB has recently updated the list of global systemically important banks, reducing the number of such banks by one overall, from 29 to 28, as two banks have been added and three banks removed from the list.

Higher loss absorbency—requiring SIFIs to hold bigger capital buffers, is intended both to reduce the likelihood that these firms will fail and to reduce the potential bill for taxpayers if they do. They also create incentives for these firms to downsize and simplify their operations so as to reduce their capital surcharge.

The FSB has developed a set of international standards for resolution known as the *Key Attributes*.[21] When implemented, these will help to ensure that any financial institution can be resolved without severe disruption to the financial system and without exposing the taxpayer to the risk of loss. Under the *Key Attributes*, bondholders, shareholders and management—rather than taxpayers—will have to bear the brunt of losses. Authorities will have bail-in powers that enable them to convert some private debt to new equity in order to re-capitalise, and share the losses among the creditors of, a failing institution. The knowledge that this could happen should enhance market discipline of private creditors who previously enjoyed a free ride at the expense of taxpayers.

FSB member countries will complete resolvability assessments and specific plans by mid-2013 to be able to recover or, if necessary, resolve each global SIFI. These plans will be evaluated through rigorous resolvability assessments and are to be to be supplemented by cross-border co-operation agreements between relevant resolution authorities. Finally, each SIFI should be subject to more intense and effective supervision.[22] Among other things, supervisors should hold these firms to higher standards in terms of their ability to identify, manage and control risk, the quality of internal control systems, and the ability of these firms to aggregate data about their far-flung operations.

While these measures are being implemented, the FSB is working to extend this framework to other systemic financial firms, including domestic systemically important banks, and global insurance companies, non-banks and core financial market infrastructure.

In particular, the FSB and the G20 have agreed to a principles-based approach to regulating domestic systemically important banks (D-SIBs) that complements the framework for global systemically important banks (G-SIBs) and provides for national discretion in the way that systemic importance is assessed and policy tools are applied. As countries implement their D-SIB frameworks, the frameworks will be subject to peer review to preserve a level playing field and ensure compatibility with the G-SIB framework.

While we have made solid progress, more is required. Some countries need to legislate, not merely propose. The EU's Recovery and Resolution Directive is an important development in this regard. Further measures are also required, including improving the effectiveness of cross-border agreements for handling a failure; and clearly identifying bail-inable securities and requiring a minimum amount of them.

When implemented, greater supervisory intensity and higher loss absorbency will ensure that the system is never again beholden to the fate of a single firm or group of firms.

Creating Continuously Open Markets

An important element of ending too-big-to-fail is ensuring that key markets can withstand the failure of systemic firms. It is unacceptable that core markets seized up during the crisis, and that relatively small firms had to be saved because of concerns that they would take markets with them if they failed. Creating continuously open core markets requires changes to the plumbing of derivative and repo markets, along with better data and tracking of exposures.

The G20 and FSB are fully committed to rapidly completing the agreed OTC derivatives reforms. In order to sustain momentum and bring about the necessary changes in market behaviour and infrastructure, issues that are impeding implementation need to be identified and addressed.

First, implementation will advance more quickly when key cross-border issues are resolved. Conflicts, gaps and overlaps in regulations across borders require immediate attention in order to minimise market disruptions and to promote effective implementation. Consistency in requirements across borders is also important.

Second, the reform process can be assisted through guidance to jurisdictions that are less advanced in the reform process on the prioritisation and phasing-in of their reforms. Experience indicates, for instance, that implementation of requirements for trade reporting should be a more immediate priority, because this will generate information that helps in the implementation of other OTC derivatives reforms. In addition, for practical reasons, full implementation is likely achievable in certain products and asset classes before others.

Third, FSB members need to carefully and holistically consider the incentives created by different aspects of the reforms. Incentives created should support the reform process and encourage sound risk management. Completion of the regulatory reform agenda will involve changes in market structure. Possible reactions by market participants to these changes must be considered in advance, and monitored and analysed once in place, to help to ensure that the reforms are successfully implemented and effective.

In 2013, the FSB will focus on three closely related strands of work:

— All jurisdictions must promptly complete their legislative and regulatory frameworks.

[21] FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions," October, 2011.

[22] See "Increasing the Intensity and Effectiveness of SIFI Supervision," a progress report of the FSB to the G-20 Ministers and Governors, released on 1 November 2012.

- — International policy work needs to be completed. In some areas, international principles and standards have yet to be finalised, such as certain capital and margining requirements. International policy work should be coordinated across areas of reform, where appropriate. For instance, the FSB will coordinate closely with BCBS and IOSCO to address potential inconsistencies and scope for regulatory arbitrage between international principles for margining of non-centrally cleared derivatives and those for securities lending and repos.
- — Regulators must immediately address conflicts between national rules that unduly increase costs for market participants and potentially impair market functioning. Inconsistencies, overlaps and gaps in regulations across jurisdictions should also be tackled. With the recent statement by senior securities regulators in early December, there is agreement on a basic approach to cross-border issues and priority areas have been outlined. This is an important first step. However it is essential that specific milestones and concrete timelines are set out for addressing these issues so that progress is measurable and accountable. In addition, jurisdictions should consider interim agreements or a moratorium on cross-border application of specific rules until a full solution is in place.

Moving from Shadow Banking to Market-Based Finance

There are valid concerns that as authorities take measures to make the traditional banking system safer, we will push risk into the shadow banking sector. That is one reason why the FSB has launched, and the G20 endorsed, a comprehensive reform of the oversight and regulation of shadow banking so that it is a source of competition (to promote efficiency) and diversity (to promote resilience) to the regulated sector.

The answer to Question 21 discusses this area in more detail.

18. *What is your assessment of the adequacy of the crisis management arrangements set out in the Financial Services Act 2012?*

The keys to effective crisis management are: a sense of shared responsibility amongst those responsible for meeting a common objective; open lines of communication; clarity of responsibilities; and appropriate powers for all those involved.

The new arrangements seem to me to do as much as possible to formalise this. The foundation is that the Bank will be responsible for managing a crisis and keeping the Treasury informed throughout. The Chancellor will be responsible for any decision about the use of public funds and the Governor has a duty to notify the Chancellor at the earliest possible stage of any risk of this happening. When public funds are at risk, the Chancellor and Treasury can direct the use of all of the Bank's tools of crisis management, namely, the use of the Bank's balance sheet to lend and the Special Resolution Regime for banks. These are sensible principles.

Effective crisis management cannot, however, be legislated. It requires contingency planning during "peacetime", decisiveness if "war" breaks out and, more than anything else, a good working relationship between the Bank and HM Treasury, and ultimately between Governor and Chancellor. That will be the focus of my efforts.

19. *Would the new Prudential Regulation Authority benefit from a specific secondary competition objective?*

I do not yet have a fully developed view of the PRA's objectives but I would be cautious about giving the PRA too many responsibilities. The PRA's focus should be on the safety and soundness of those firms it supervises and on the protection of insurance policyholders. Every additional objective runs some risk of diluting that focus, thereby putting at risk depositors, policyholders and financial stability in general.

That is not to say that promoting competition and reducing the concentration of the UK banking system do not deserve great attention. The Financial Conduct Authority will have an objective to promote competition—firms should not conduct themselves in ways that discourage competition. The PRA must have regard to competition in the way it pursues its objective to ensure the safety and soundness of firms. The PRA's approach—with which I agree—is not to operate a "zero failure" regime. It is to ensure that firms, if they do fail, do so safely. With a deposit guarantee scheme and a resolution regime in place, banks, particularly smaller ones, will be able to fail without threatening the stability of the banking system as a whole. It follows that the prudential requirements on new entrants can, and should, be lighter than they have been in the past, although some minimum standards must of course be maintained. The PRA is therefore reforming its authorisation requirements for banks in ways that reduce barriers to entry. We all need to recognise and accept that, under this regime, new entrants to the banking market may, from time to time, fail, but that this the flipside of a market that is truly open to competition.

It is also vital that central banks do not encourage concentration. Liquidity facilities should be open to all authorised banks, not just large ones and, in addition, unconventional policy measures, such as the Funding for Lending Scheme, which now has more than thirty participants, should be designed in such a way as not to discriminate against new entrants.

20. *Is the UK banking system too concentrated?*

As the prudential regulator, my focus will be on the protection of depositors, policyholders and taxpayers. There is no direct relationship between banking concentration and financial stability. Some countries (Canada, Australia) with concentrated systems proved more stable during the crisis. Others (the UK, Netherlands and Switzerland) did not.

It is clear that concentration makes instability more costly. In concentrated systems, individual banks are more likely to be systemic and/or too big to resolve safely. In the UK, the six largest banks and building societies dominate UK deposit-taking and lending. The two largest lenders—Lloyds and RBS—account for 45% of the total stock of lending. That concentration has meant that it has been difficult for other banks to fill the gap created in domestic lending growth caused by the adjustment at those banks. While larger corporate borrowers have had recourse to capital market funding, SMEs have seen their access to funds restricted. In that sense, the UK banking system was too concentrated prior to the crisis.

The PRA will make an important contribution to reduce concentration in two major ways. First, as described in my answer to question 19, it will lower barriers to entry. The second is through the implementation of the ICB's recommendations, embodied in the Banking Reform Bill, which should do much to remove any bias towards concentration in "core" banking services.

21. *What risks are posed by the shadow banking system?*

The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" or non-bank credit intermediation in short. Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity. It achieves this by providing alternatives for investors to bank deposits; channelling resources towards specific needs more efficiently due to increased specialization; providing for alternative funding for the real economy, especially when traditional banking or market channels may be impaired and; providing for a source of risk diversification away from the traditional banking sector. For example:

— Money market funds and some credit hedge funds participate in direct lending, thus providing for alternative funding for the real economy and diversification of risk away from the traditional banking sector.

— Securities lending and repo markets can serve as a means to preserve principal and liquidity for risk averse institutions (repo) and facilitate alternative sources of funing to the real economy.

— The process of securitization can facilitate a more efficient distribution and allocation of risk among agents who want or are better able to bear them. Securitized products are used by institutions such as banks, hedge funds and money market funds in the course of their business.

The crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (ie, longer-term credit extension based on short-term funding and leverage). Such risk creation was part of a complex chain of transactions, in which leverage and maturity transformation occur in stages, and in ways that create multiple forms of feedback into the regulated banking system.

Like banks, a leveraged and maturity-transforming shadow banking system can be vulnerable to "runs" and generate contagion risk, thereby amplifying systemic risk. Such activity, if unattended, can also heighten procyclicality by accelerating credit supply and asset price increases during surges in confidence, while making sharp declines in asset prices and credit more likely by creating credit channels vulnerable to sudden losses of confidence. These effects were powerfully revealed in 2007–09 in the dislocation of asset-backed commercial paper (ABCP) markets, the failure of an originate-to-distribute model employing structured investment vehicles (SIVs) and conduits, "runs" on money market funds and a sudden reappraisal of the terms on which securities lending and repos were conducted. But whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements.

In response, the FSB is working on a suite of reforms to strengthen the shadow banking system. The objective is to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks (indeed, a resilient system of non-bank credit intermediation would be welcomed.) The approach is designed to be proportionate to financial stability risks, focusing on those activities that are material to the system, using as a starting point those that were a source of problems during the crisis. It also provides a process for monitoring the shadow banking system so that any rapidly growing new activities that pose bank-like risks can be identified early and, where needed, those risks addressed.

The FSB has focused on five specific areas where policies are needed to mitigate the potential systemic risks associated with shadow banking:

1. Mitigating the spill-over effect between the regular banking system and the shadow banking system;
2. Reducing the susceptibility of money market funds to "runs";

3. Assessing and mitigating systemic risks posed by other shadow banking entities;
4. Assessing and aligning the incentives associated with securitisation; and
5. Dampening risks and procyclical incentives associated with secured financing contracts such as repos, and securities lending that may exacerbate funding strains in times of "runs".

In advancing these proposals, the FSB is conscious that shadow banking activities take a variety of forms. These have evolved in the past in response to changing market and regulatory conditions, and they will continue to evolve. So looking ahead, authorities must be mindful that, by strengthening the capital and liquidity requirements applying to banks (an essential pillar of the G20's financial reform programme), the Basel III framework may increase the incentives for some bank-like activities to migrate to the non-bank financial space. Other forms of regulatory reform may have similar effects. The FSB therefore believes that oversight and regulation for shadow banking must incorporate a system of "embedded vigilance" through on-going review and be capable of evolving in response to market changes.

22. *What is your assessment of the outlook for UK growth? What do you regard as the major risks to the outlook for the UK economy?*

The UK economy has not expanded for two years. That performance has occurred alongside a backdrop of a squeeze on incomes, balance sheet adjustment in both private and public sectors, restricted credit availability and very slow growth in the UK's main export market—the euro area. The outlook for UK growth depends on the persistence of these forces. Some seem likely to become less of a drag. There are some encouraging signs about credit availability on the back of the Funding for Lending Scheme (discussed in my answer to question 24). This should help to reduce constraints on supply that may be holding back business and household investments. Inflation, although still above the 2% target, is lower than a year ago, supporting the growth of real incomes. The ECB's actions in the autumn have reduced tail-risks in the euro area.

At the same time, there appears to be three main sources of risk. The most obvious is the world economy. The near-term outlook in the euro area remains weak. A renewed deterioration in the outlook there has the potential to drag on UK growth through trade, confidence and via the banking sector. It is also a real threat to the rebalancing that the UK economy needs to undergo in order to put itself on a sustainable footing. More generally, the world economy as a whole has a long way to go before reaching a sustainable position. Large current account deficits and surpluses remain. The rebalancing is unlikely to be either smooth or rapid.

The second source of risk stems from the huge uncertainty about the pace of recovery that the UK economy is able to sustain. Unemployment remains well above its pre-crisis level, indicating that there is a degree of spare capacity in the economy as a whole that could support an expansion of demand, but productivity growth has been remarkably weak (discussed further in my answer to question 23), so it is difficult to assess either how quickly unemployment will fall as any recovery begins or, once unemployment has fallen back, the extent to which growth could be sustained without generating higher inflation.

The third risk is the extent of deleveraging in the banking system, households and companies. Although funding costs have fallen dramatically since the autumn, major UK banks are continuing along a difficult adjustment path. That process needs to continue if a recovery is to be supported. UK households, although saving more of their incomes than before the crisis, have a large stock of debt. With debt, the distribution matters. Debtor households have been able to service their debt at very low interest rates, but it is likely that they will wish to continue to delever their balance sheets. The extent of that process—which, other things equal, is helping to hold back the recovery in overall demand—is difficult to determine.

23. *What is your current estimate of the extent of the output gap in the UK? What is your view of the UK's "productivity puzzle"?*

Output per hour worked in the UK private sector is some 15% below an extrapolation of its pre-crisis trend and remains well below its pre-crisis peak. The combination since 2010 of an absence of output growth and the creation of a million new jobs in the private sector is particularly difficult to understand but suggests that the explanation of weak productivity growth is not a standard cyclical story that companies are simply "hoarding" labour in the expectation that a temporarily low level of demand will recover.

The weakness of productivity growth is, in direction if not in scale, consistent with the experience of past financial crises around the world. It seems likely that the impaired banking system is hindering the efficient allocation of resources across the economy as it restructures. That is consistent with the fact that productivity performance has been weakest amongst smaller firms, which do not have access to capital markets and are therefore reliant on bank finance. Forbearance by banks, coupled with very low debt servicing costs, may also have impeded the necessary reallocation of resources by allowing firms that may not be viable in the longer term to continue to operate (although it should be noted that this type of forbearance is difficult to distinguish in real time from forbearance that allows businesses that do have a long-term future to continue operating through a period of weak demand). These reasons suggest that putting the banking system on a more resilient footing should help, to some extent, to restore the potential output of the UK towards its pre-crisis path.

It also seems likely that any recovery in demand and output will be accompanied by some recovery in productivity. In the present environment of weak demand, some companies may need to devote more resources

to generating sales and others may need a minimum level of input in order to sustain operations. For these businesses, a pickup in demand will not need to be met by increasing employment.

In contrast, I have also seen evidence to suggest that, at least as measured, productivity growth in the UK before the crisis was unsustainable. The relative decline in the importance of both oil and gas extraction and financial services, which display high levels of output per employee, will push down the apparent trend rate of productivity growth. The low level of business investment and therefore capital deepening in the economy will also have held down the potential growth rate. For these reasons, I would not expect the full extent of the shortfall in productivity relative to its pre-crisis trend to be unwound, even in the long term, but these effects are not close to explaining the full extent of the productivity puzzle.

Overall, there seems to me to be scope for some of the productivity shortfall in the UK to be unwound during any recovery and as the banking system is restored to full health. It is impossible to be confident at this stage of the extent of that scope, and the possibility that potential output could recover alongside demand means that the standard output gap—the difference between today's output and today's potential output—is a less relevant guide to policy than central banks have sometimes treated it to be in the past. I would only note that it does seem clear that there is significant spare capacity today in the UK labour market, where the level of unemployment is significantly higher than its pre-crisis level of around 5½%.

24. *What is your assessment of the impact of the Funding for Lending scheme and the activation of the Extended Collateral Term Repo Facility on the UK economy?*

I do not yet have a well-developed view of these operations. My preliminary view is that the introduction of the Extended Collateral Term Repo (ECTR) Facility served to emphasise that the Bank of England was ready to provide a liquidity backstop in a situation of heightened uncertainty around the euro area. Because it is a backstop, its impact cannot be judged solely by the usage of the facility, which has fallen back since its introduction. Moreover, its impact is also difficult to judge in isolation. As I noted in my answer to question 14, its introduction formed part of a co-ordinated set of actions by the FPC, FSA and Bank of England to discourage banks from holding excessive amounts of liquid assets. Its relative importance is obviously also affected by the success of European efforts to remove tail risks from the euro and refound the single European financial market.

The Funding for Lending Scheme seems to be well-designed to provide incentives for banks to lend more than they had planned. It will take time for the effects to be seen clearly, but, like the ECTR, it should not be judged solely on the amount borrowed by banks. The availability of the Scheme has helped to drive down bank funding costs, which since last autumn have fallen by more in the UK than in many other countries.

It is too early to evaluate the full impact of the FLS, especially on lending volumes, but the fall in bank funding costs seems to be beginning to feed through to the quoted terms and availability of credit. Spreads on fixed rate mortgages and unsecured personal loans have begun to fall and some have announced reductions in the price of corporate loans. In the Bank's Q4 Credit Conditions Survey, lenders reported significant increases in the availability of credit to medium and large corporates (although less so to small businesses) and secured lending to households. The early signs of the Scheme's impact are therefore encouraging.

25. *Should the Bank of England have a role in commenting on fiscal policy?*

In general, monetary policy can be set to achieve its targets taking fiscal policy as given. Policy-makers will of course have to make judgements about the effects of fiscal policies on growth and inflation. That requires calculating the fully worked-through—"multiplied"—effects of tax and spending measures on demand and, because monetary policy will typically look through the temporary effects on inflation of indirect tax changes, it requires calculating and disclosing those effects.

The need to make these judgements is not equivalent to commenting on the merits or otherwise of individual tax and spending decisions, which are rightly matters for elected Governments and Parliaments.

If fiscal policies are credibly and transparently sustainable, central banks should not have any need to comment on the overall stance of fiscal policy, and they should avoid doing so. The Bank of England is not a fiscal monitoring authority—that role is played by the OBR. There can, however, be circumstances in which the overall stance of fiscal policy threatens the ability of the central bank to achieve its targets. In extremis, unsustainable policies can make price stability more difficult and costly to achieve by creating doubts about a Government's commitment to low inflation. Moreover, because of the interconnectedness of banks and sovereigns—so apparent in the euro area—unsustainable fiscal policies, by creating instability in sovereign debt markets, can threaten financial stability. In these circumstances, the central bank will need to comment—and indeed will have a duty to comment—to Parliament on the overall stance of fiscal policy.

26. *Do you believe there are parallels between the recent Japanese economic experience and the situation of the UK?*

There are some parallels, but they must be seen in the context of some very important differences.

There are three main similarities. First, the UK's measured productivity growth has, like that in Japan after 1990, been weak, both relative to its pre-crisis rate and in absolute terms. Second, the UK's private sector, like Japan's, has been deleveraging after the financial crisis (although in Japan deleveraging was primarily concentrated in the corporate sector while in the UK it has been more skewed towards households).

Third, the behaviour of the respective banking systems has also shared some similarities. In both cases banking systems appear to have been slow to recognise the full extent of losses in the aftermath of asset price correction. Partly as a result, credit supply was very weak in both economies.

Other differences include that trends in demographics were much less favourable in Japan, while the external environment has been less favourable for the UK as efforts to grow exports have been hampered by headwinds from weak world activity, an apparent preference shock against UK services exports, and the tail risks in the euro area, which have added to uncertainty and depressed confidence.

The key differences, however, are those which suggest that the UK, like other advanced economies, has learned from the Japanese experience. The UK, with a clear inflation targeting framework, has avoided deflation. The MPC was able to respond aggressively to the financial crisis with sharp interest rate cuts and, when short-term rates were close to zero, with large-scale asset purchases. There is some evidence that those asset purchases had more impact in the UK than they did in Japan, particularly on asset prices. In contrast to the Yen, the sterling exchange rate fell sharply.

The UK banking system was also recapitalised at an early stage of the crisis and the UK has not faced a prolonged slide in asset prices like the one seen in Japan. Real-estate and equity prices continued to fall for over a decade following the 1990 onset of the crisis in Japan. This was an important additional driver of the increase of non-performing assets over time.

All of these developments mean that the growth of nominal GDP in the UK has exceeded that of Japan; inflation expectations have not fallen to low levels; and real interest rates have not therefore risen as the economy has slowed.

27. *When considering the UK economy, how much emphasis do you place on the international economic environment? How concerned are you about global imbalances? What is your view of the outlook for emerging market economies?*

Developments in the global economy are profoundly important for the UK economy.

The UK, like Canada, is a very open economy, with exports and imports both amounting to around one-third of GDP. The collapse in global demand during the financial crisis amplified the UK recession. Subsequently, the UK recovery has been held back by the continued weakness in the euro area. That reliance on the euro area, and associated under-exposure to fast-growing EMEs, is why the UK has seen its share of world trade fall dramatically.

The importance of the international environment is not restricted to these direct effects on demand. Funding conditions for UK banks have been affected by developments in cross-border debt markets, particularly in the light of the uncertainty created by the euro area crisis. That uncertainty has also fed through to domestic investment and consumer spending and has encouraged "safe-haven" flows into sterling assets, supporting the sterling exchange rate and adding to the challenge of rebalancing the UK economy.

The relative strength of EMEs has also influenced UK growth and inflation by driving up oil and other commodity prices. That has squeezed household incomes and consumer spending, and boosted headline inflation. With relatively limited exposure to these markets which are driving commodity prices, growth in UK exports has not been sufficient to offset these drags on growth.

More generally, there is a transformation under way in the global economy. Never in history has economic integration involved so many people, such a variety of goods and so much capital.

The financial crisis has accelerated the shift in the world's economic centre of gravity. Emerging-market economies account for roughly three-quarters of global growth—up from just one-third at the turn of the millennium.[23]

Although this shift to a multi-polar world is fundamentally positive, it is also disruptive. Labour, capital and commodity markets are changing rapidly. The effective global labour supply quadrupled between 1980 and 2005 and may double again by 2050.[24] Cross-border capital flows have exploded. Commodity markets are in the midst of a super cycle, reflecting both the expanding urban middle class in emerging economies and the

[23] 23Based on annual data from 2011.

[24] Adjusted for the percentage of the population in the traded-goods sector. See M. Carney, "The Implications of Globalization for the Economy and Public Policy" (speech to the British Columbia Chamber of Commerce and the Business Council of British Columbia, Vancouver, British Columbia, 18 February 2008).

fact that convergence to advanced-economy lifestyles is still a very long way off. Whether it is cars, airports or meat, consumption in major emerging markets is currently a fraction of that in advanced economies. Even though history teaches that all booms are finite, this one could go on for some time.

There are three consequences of these developments.

Changing Patterns of Trade

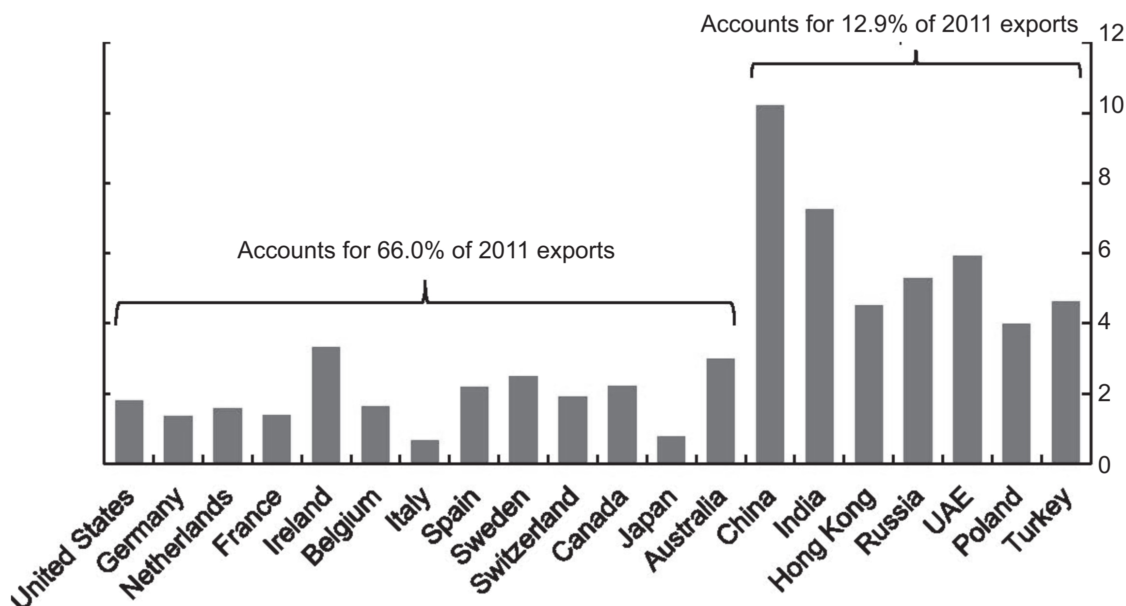
Patterns of trade are evolving rapidly. Merchandise exports now make up about 25% of global GDP, compared with about 9% at the height of the last great wave of globalisation.

The reorientation of production to Asia and the dramatic increases in its infrastructure spending have also fuelled an export boom of capital goods, which has supported the recoveries in major economies.

Currently, British exports are concentrated in slow-growing advanced economies, particularly in Europe, rather than fast-growing emerging markets (*Chart 1*). Going forward, exposure to emerging markets will be increasingly important.

Chart 1

THE UNITED KINGDOM'S TRADE DIRECTED TOWARD SLOW-GROWING ECONOMIES AVERAGE GROWTH RATES 2000–11, ANNUAL DATA



Source: International Monetary Fund World Economic Outlook. Last observation: 2011.

Given the UK's poor export performance (Chart 2), increasing market share in emerging markets will require sustained efforts to develop trade, technical and academic partnerships. In tandem, business needs to improve its competitiveness, source new suppliers, and prepare to manage in a more volatile environment.

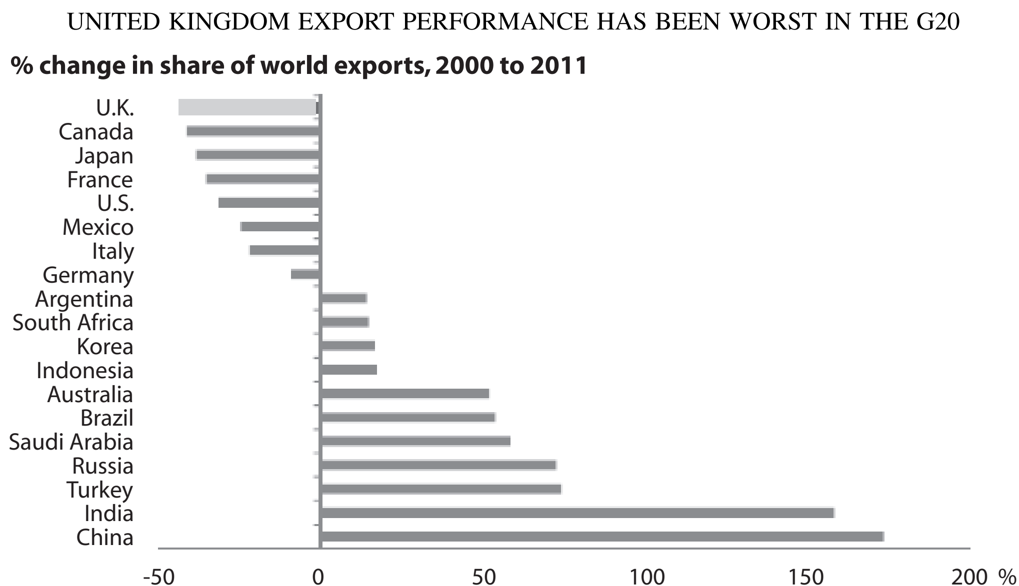
Changing Capital Flows

The second consequence of the shifting global landscape is dramatic changes in the scale, composition and direction of capital flows. These dynamics will have important implications for returns to British investors, the cost of capital for British businesses, and the risks to the UK economy. Given the expected growth differentials between emerging and advanced economies and the substantially underweight positions of most investors, the opportunities appear substantial. However, it will be a crowded field in the short term.

Investors from advanced economies are substantially overweight in their home markets: advanced economies represent half of current global GDP, but their equity market capitalisation is nearly three-quarters of the global capital market capitalisation.

Chart 2

UNITED KINGDOM EXPORT PERFORMANCE HAS BEEN WORST IN THE G20



Source: International Monetary Fund.

A reallocation of 5% of advanced-economy portfolios to emerging markets translates into a potential flow of $2 trillion, or 30 times portfolio equity flows to all emerging markets.

Emerging markets are currently net capital exporters. In effect, there is a massive recycling operation under way: private capital flows from advanced to emerging economies are being partially offset by official outflows in the opposite direction. This has important implications for exchange rates and the speed of global rebalancing.

Global Imbalances

It is reasonable to expect capital to flow, on a net basis, from advanced economies towards higher expected returns in emerging-market economies. This is what happened during the last wave of globalisation at the turn of the 20th century when Canada, then an emerging economy, ran current account deficits averaging 7% of GDP over three decades.

These were good imbalances. Imported capital was invested in productive capacity that later served to pay off the accumulated debts.

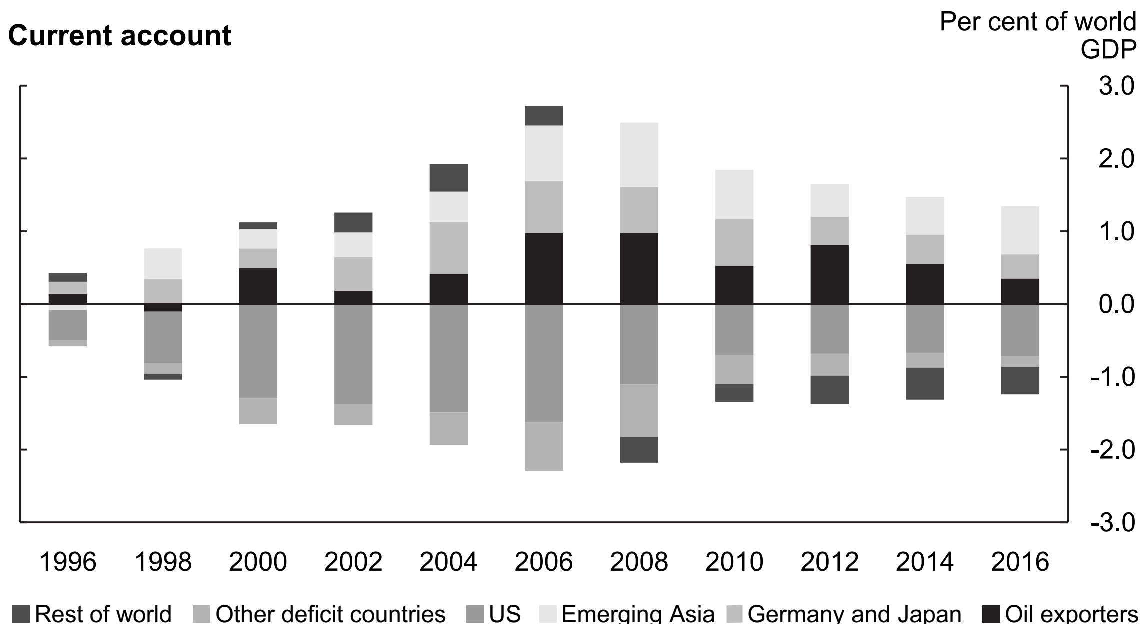
Global imbalances over the past decade have too often been bad. In some cases, public capital has flowed from emerging-market economies to advanced economies to be invested in non-tradable goods such as housing.

These bad imbalances were promoted by flaws in the current international monetary system. The current system is a hybrid of, on the one hand, mainly major advanced economies with floating exchange rates and liberalised capital flows and, on the other, a group of countries that actively manage their exchange rates. The result is a system that does not facilitate timely and symmetric adjustment to shocks or structural change. For example, despite its economic miracle, China's real exchange rate did not appreciate in the two decades prior to the global financial crisis.

At first glance, global current account imbalances may appear to have improved since the crisis (Chart 3). The real effective exchange rates of several important surplus countries have appreciated, and their current account balances have generally fallen. Export sales have declined and domestic demand now accounts for a larger share of GDP growth in these countries.

Chart 3

GLOBAL IMBALANCES APPEAR TO HAVE DECLINED, TEMPORARILY



Sources: IMF WEO October 2012

Sources: IMF WEO October 2012.

This apparent progress is, however, somewhat misleading. While some of the observed changes represent legitimate structural improvements in current account imbalances, most of the "correction" that has occurred has been driven by demand compression in the deficit countries. Weak demand in these countries has led to lower imports and therefore narrower current account deficits.

There has been little progress on the rotation of demand and global imbalances. The rising share of domestic demand in many surplus countries is not a case of domestic demand growing significantly faster but, rather, declining export sales in the face of falling incomes and aggressive belt-tightening in deficit countries. In those instances where surplus countries have increased their contribution to global domestic demand, it has often been concentrated in fixed investment, which was already inordinately high and frequently misallocated. When growth returns to deficit countries, imbalances are likely to re-emerge. True progress would require greater exchange rate flexibility and underlying structural shifts in current account balances that allow for a more balanced global economy in a context of strong and sustainable growth.

Rebalancing the Global Economy

There are several imperatives to rebalancing the global economy.

First, maintaining an open global financial system is incredibly important. Sovereign borrowing needs and business investment requirements will be considerable. One of the tail risks at present is the possible repeat of the Great Reversal of globalization in the aftermath of the crash of 1929.[25] Rather than turning our backs on financial globalization, we need to build resilient globalization by changing the design and operation of both the international monetary and financial systems. Buttressing the institutions and rules that support cross-border finance is thus essential.

Second, while over the longer term it is possible to envision a system with other reserve currencies in addition to the US dollar, a new reserve asset is not required. Importantly, the common lesson of the gold standard, the Bretton Woods system, and the current hybrid system is that it *is the adjustment mechanism, not the choice of reserve asset, that ultimately matters*.

The solution is not to change the current system, but rather to change policies to be consistent with it. There is no silver bullet. A constellation of policies across major economic areas is required.

The G20 Framework and Globally Coherent Policy

In this context, the success of the G20's Framework for Strong, Sustainable and Balanced Growth is important. The Framework has four key components:

[25] For a description of that process, see R. G. Rajan and L. Zingales, "The Great Reversals: The Politics of Financial Development in the Twentieth Century." *Journal of Financial Economics* 69 (2003): 5–50.

— fiscal consolidation in those countries that need it;
— sweeping financial sector reforms;
— ambitious structural reforms to the real economy to foster higher long-run growth; and
— a rotation of global demand (facilitated by greater exchange rate flexibility).

As my colleague John Murray has noted, "It is important to understand that the four points of the G20 Framework … are mutually reinforcing".[26] The first three points, though they are essential for stable and welfare-improving outcomes in the future, were known to have deflationary effects in the short to medium term, depressing global demand. The fourth point, the rebalancing of global demand, was necessary to counter these sizable headwinds, supporting global growth until the positive effects from the other three kicked in".

The stakes are very high for the British and global economies. The Bank of Canada estimates that delaying implementation of the Framework by three years could lead to a $6 trillion shortfall in global economic output.

28. *What is your assessment of the prospects for a solution of the eurozone's problems? How significant is the recent agreement on eurozone banking supervision? What are the minimum conditions for a banking union worthy of the name?*

Euro area GDP is still more than 2% below its pre-crisis peak, and private domestic demand sits 7% below. The contraction is driving banking losses and fiscal shortfalls. These are understandably receiving much attention, but it should be remembered that these challenges are symptoms of an underlying sickness: a balance-of-payments crisis within the currency area.

The ECB is now directly addressing the existential risks that were surrounding the euro via its Outright Monetary Transactions (OMT) program. By ensuring that yields on any particular euro-area country's short-term government bonds reflect the credit risk of that sovereign, not the risk that the country will leave the euro, the ECB has improved the transmission of monetary policy, and thereby increased the prospects for economic recovery in Europe, but this action will not be sufficient to solve the balance of payments crisis. A comprehensive adjustment is necessary, which includes the following four elements.

First, a sustained process of adjustment in relative competitiveness will be needed. The burden of that adjustment cannot be only on increasing unemployment and falling wages in countries like Spain. Deflation in the peripheral countries will not likely prove any more tolerable than it did in the United Kingdom under the gold standard of the 1920s. An increase in German wages and private demand (and inflation) would ease the transition. It is striking that German real wages barely grew in the two decades before the crisis. The process of adjustment would also be eased by reforms to enhance labour market flexibility and mobility, as well as measures to promote increased competition in product markets. Moreover, it is essential that the structural reforms, now under way across the deficit countries, serve to boost productivity.

Second, the European financial system has aggressively re-nationalised so further bold steps are required to restore the single financial market, including a true banking union. Although the steps taken in December to create a Single Supervisory Mechanism (SSM) under the auspices of the ECB are a necessary step towards that, they are not alone sufficient to reform the single financial market. A true banking union also requires a common resolution regime and a credibly funded and mutualised restructuring and deposit insurance fund, all at the level of the euro area rather than of its individual members. In this manner, European authorities can fully sever the toxic links between sovereign and banking sector positions.

It should be noted that the SSM will also have the benefit of simplifying cross-border supervisory arrangements in Europe, with most major banks being supervised either by the ECB or by the Prudential Regulation Authority of the Bank of England. The new arrangements for voting within the EBA safeguard the UK's interest and, beyond the legislation, I will work to ensure that the strong relationship between the Bank of England and the ECB continues, helping to maintain the co-operation that is necessary to ensure the stability of the pan-European financial system.

Finally, it would be helpful if European authorities would reframe the expectations of citizens and market participants regarding the time horizon over which European monetary union will be re-founded. Although there has been important progress at the seemingly endless series of Euro area crisis summits, there was never any chance any *one* meeting or single initiative could *solve* the issue. Ultimately, a viable currency union will require not just the reforms listed above, but also sustained fiscal consolidation in the periphery. By reframing expectations to a realistic timeline, and ensuring that any financing assistance program for countries is sufficient for this period, European authorities could arrest the cycle of crisis summits, and thereby reduce policy uncertainty.

29. *What research priorities will you set the Bank in your first year?*

I have not yet developed a view of this and intend to discuss it with the Deputy Governors and Executive Directors during my first few months as Governor.

[26] J Murray, "The Great Frustration: Hesitant Steps Toward Global Growth and Rebalancing, New York" (speech to the New York Association for Business Economics, New York, 27 November 2012).

The Bank's stated priorities are to advance understanding of each of: the macroeconomic environment; the impact of unconventional monetary policy; the linkages between monetary and macroprudential policy; the impact of macroprudential tools; and the functioning of the "non-bank financial sector. In many respects, these priorities are shared by the Bank of Canada and seem to me to be appropriately focussed on the areas where existing academic research has relatively little to offer.

30. *What is your view of the Treasury Committee's Reports on the Accountability of the Bank of England (21st and 27th Reports of Session 2010–12), and on the Financial Services Bill so far as it relates to the Bank of England (1st Report of Session 2012–13)?*

Having not yet been able to discuss these reports with the Treasury Committee or with my future colleagues (both inside and outside the Bank), I do not have a well-formed view of the detailed recommendations in these reports. Based on my own experience as Governor, and Chairman of the Board at, the Bank of Canada, I would make two general points about accountability.

First, the key elements of accountability in policymaking are: clear mandates set by Parliament and/or Government; transparency in policymaking processes; and a requirement on the members of policymaking committees to explain themselves to Parliament and public through testimony, speeches and reports. Parliament has set the objectives of the Bank with respect to monetary policy, macroprudential supervision and microprudential regulation. As chairman of the three primary policy committees, I intend to work with my colleagues to promote transparency and with the Treasury Committee to ensure we are held properly accountable for the pursuit of our objectives.

Second, I agree with the thrust of the Treasury Committee's proposals to ensure the Bank of England has an effective and transparent governing body, with a clear majority of independent, non-executive members, and that is accountable for both the overall management of the institution and for ensuring that policymaking responsibilities are discharged effectively. In this regard, the non-executive directors' oversight of the process of retrospective review will be constructive. It will be important, however, to avoid clouding accountability arrangements by creating a governing body that seeks to influence policies that are delegated to committees of experts. The operational discharge of policy must be clearly understood to be the responsibility of the policy committees whose members are individually accountable. In the same vein, it is not appropriate for executive members of the governing body to oversee their own policymaking, so the structure of the new Oversight Committee, formed only of non-executives, seems to me entirely appropriate.

The Treasury Committee's report made specific recommendations on the role of the Court, the Committees of the Bank, the office of the Governor and crisis management arrangements. My views on those issues are described in greater length in my answers to questions 31, 32, 34 and 18 respectively.

31. *What role should the Court of the Bank of England perform? How can it be made more effective?*

My views in this area are based on my experience as chairman of the Board of Directors of the Bank of Canada. I expect those views to develop as I have a chance to observe the Bank of England.

Broadly, I believe the Court should—and does—have two sets of roles. The first group relates to the management of the institution and is best discharged by a group including both executives and non-executives. It should include:

- approving the strategy to achieve the Bank's objectives;
- approving the Bank's overall budget and its allocation between areas;
- ensuring efficient use of public funds and providing value for the taxpayer, including approving the remuneration of staff;
- approving senior appointments and overseeing talent management and succession planning; and
- overseeing risk management and audit functions.

The second set of roles relates to the Bank's policy responsibilities. I do not believe that the Court should seek to manage, or even take a view on, the stance taken by each of the three statutory policy committees: MPC, FPC and PRA Board. Members of those Committees should be accountable to Parliament and to the public for their chosen policy stance. I do, however, believe that the Court should ensure that the policy committees are performing competently and executing their responsibilities in the right way. It can do this by:

- observing, and reporting on the effectiveness of, the way policy is made;
- giving assurance that the policy process is as transparent as possible and that information is not being withheld without very good reason, from Parliament or public;
- commissioning reviews, by independent experts and by policy-makers, of past policy settings; and
- overseeing the response of policy committees to the lessons in any such review.

This set of roles will be performed by the newly formed Oversight Committee at the Bank, formed of the Bank's non-executive directors. I look forward to working with the non-executives as they establish these new roles.

I have not had a chance yet to meet members of the Court or to observe the work of the Court, so it would not be appropriate for me to form a view of Court's effectiveness.

32. *What is your view of the structure and inter-relationship of the Bank's Committees? Could these be made more effective without loss of transparency?*

The voting structure of the MPC seems to me to have served it well by making individual members publicly accountable for their views. A formal voting arrangement works particularly well when there are a small number of specific decisions to be made, such as on the current level of Bank Rate or on the scale of asset purchases. Each member of the Committee brings experience and expertise and the addition of external members can help to widen the range of perspectives.

Formal voting is less likely to work quite so well when there is a wide range of options for a Committee to consider, as could be the case, for example, with the MPC's forecasts, and will be the case for the FPC and PRA Board. I plan therefore to work towards policy decisions by consensus to the extent that it is possible. Consensus decision-making brings advantages of consistency of public message and strategy. That will help to build understanding of each committee's actions and to help people understand how each committee is likely to respond to events. It will maximise the effectiveness of policy decisions.

Consensus does not absolve Committee members of their individual accountability to Parliament and public. Votes will be required when consensus is not possible and individual members will have the right to express differences of view. Consensus absolutely does not mean "group think". It means going through a process of debating different views to reach a decision; not starting with the same common view. I fully expect the Treasury Committee and the Bank's new Oversight Committee to scrutinise that process.

The cross membership of the different policy committees seems to me to provide an adequate degree of consistency and co-ordination. It is the role of the group of Governors—myself and three deputies—to ensure that consistency. I agree with those who have argued that close co-ordination of MPC and FPC will be necessary, particularly in the current conjuncture. To my mind, the co-ordination of FPC and PRA is at least as important.

33. *What lessons have you drawn from the three reviews commissioned by the Court and conducted by Ian Plenderleith, David Stockton and Bill Winters? What will you do about them?*

Although I have seen the three reviews, I have not yet had a chance to discuss them either with the reviewers or with senior Bank executives, so my views are not yet well developed. I am arranging to meet the three reviewers as soon as possible. On taking up my post I will review the steps taken and plans in place to respond to the recommendations in the reviews. Six months into my tenure as Governor I intend to assess, with the Deputy Governors and non-executive directors, the steps that have been taken and to consider whether there are other areas in which reviews might be helpful to learn lessons for the future.

At a more general level, the process of review seems to me to be a valuable one. I expect the non-executive directors on the Oversight Committee to commission regular reviews and am pleased that the statutory process does not preclude the executive initiating its own reviews from time to time. My own views on the process are that it will be important for reviews to take place routinely, rather than only in instances of perceived mistakes or failure, and that such reviews need to be well-targeted so that they bring benefits in terms of lessons learned.

34. *Does the role of the Governor in the governance and decision making structure of the Bank represent a single systemic point of risk? How can that risk be mitigated?*

I do not think it does. The range of responsibilities that the Bank is acquiring will mean that the Governor cannot be dominant in any single one. The Governor therefore becomes less, not more, a point of systemic risk. I fully recognise that, to be effective, responsibilities have to be delegated and shared.

Each of the Bank's major policy responsibilities—monetary policy, macroprudential regulation and microprudential supervision—are conducted not by an individual but by a committee of experts. The objectives of each committee are set not by the Chairman but by Parliament and, although as Governor I will chair those committees, I will be only one voice on each committee.

The chairman can help to ensure consistency of strategy and co-ordinate between the committees, but I will not play that role alone—I will be assisted in that by three Deputy Governors.

Moreover, the accountability of the Bank is not exercised exclusively through the Governor. The Bank is subject to extensive and varied processes of scrutiny. The Governor is always likely to be the main voice of the Bank and its public figurehead, but other senior executives and independent policy committee members are also held to account in public and by Parliament.

Finally, the Governor is not alone in leading the Bank. I anticipate being assisted by the three Deputy Governors and the new Chief Operating Officer. In conducting the day-to-day management of the Bank, I will be able to delegate to a very able team of senior executives. The management of the Bank will be overseen by

Court, of which I will be a member but which I will not chair, and I will not be a member of the new Oversight Committee, which will ensure that policy responsibilities are resourced appropriately and discharged effectively.

Dr Mark Carney: Biographical note

Mr. Carney was appointed Governor of the Bank of Canada effective 1 February 2008. As Governor, he is also Chairman of the Board of Directors of the Bank.

In addition to his duties as Governor of the Bank of Canada, he serves as Chairman of the Financial Stability Board (FSB) and as a member of the Board of Directors of the Bank for International Settlements (BIS). Mr. Carney is also a member of the Group of Thirty, and of the Foundation Board of the World Economic Forum.

Prior to joining the public service, Mr. Carney had a thirteen-year career with Goldman Sachs in its London, Tokyo, New York and Toronto offices: Mr. Carney began his career as an Analyst at Goldman Sachs working in the credit risk department in London from 1988 to 1990 before moving to the Tokyo office for a year. After completing his graduate work at Oxford University, Mr. Carney returned to Goldman Sachs in London with responsibilities as a Co-Head of Sovereign Risk and Executive Director, Debt Capital Markets, with responsibility for advising sovereigns in Europe, the Middle East, and Africa. In 1998, Mr. Carney transferred to become Vice President, Corporate Finance at Goldman Sachs, New York, where he worked on mergers and with corporate finance transactions. In 2000, Mr. Carney moved to Goldman Sachs in Toronto to manage investment banking relationships and where, in 2002, he was appointed a Managing Director of the firm.

Mr. Carney was appointed Deputy Governor of the Bank of Canada in August 2003. In this position, he was responsible for the Bank's analysis of international economic and financial issues and their relationship to monetary policy. As a member of the Bank's Governing Council, he shared responsibility for formulating and implementing monetary policy. Mr. Carney was also a member of the Bank's Executive Management Committee.

In November 2004, he left the Bank to become Senior Associate Deputy Minister of Finance and Canada's G7 and G20 deputy—a position he held until his appointment as Governor of the Bank of Canada. In these roles, he helped oversee five federal budgets

During his tenure as Governor of the Bank of Canada, Mr. Carney was appointed Chair of the BIS's Committee on the Global Financial System and Chair of the Audit Committee of the BIS. He was named one of the Financial Times' *Fifty who will frame the way forward*, one of Time magazine's *2010 TIME 100, Reader's Digest Editor's Choice for Most Trusted Canadian* and *Central Bank Governor of the Year 2012* by the editors of Euromoney magazine.

Born in Fort Smith, Northwest Territories, Mr. Carney received a bachelor's degree in economics from Harvard University in 1988. He received a master's degree in economics in 1993 and a doctorate in economics in 1995, both from Oxford University.

Key Publications and Speeches

2012

Guidance. Speech to the CFA Society Toronto, Toronto, Ontario, 11 December 2012.

Some Current Issues in Financial Reform. Speech to the Canadian Club of Montreal, Montreal, Québec, 7 November 2012.

Uncertainty and the Global Recovery. Speech to the Vancouver Island Economic Alliance, Nanaimo, British Columbia, 15 October 2012.

Dutch Disease. Speech to the Spruce Meadows Round Table, Calgary, Alberta, 7 September 2012.

Globalisation, Financial Stability and Employment. Speech to the Canadian Auto Workers, Toronto, Ontario, 22 August 2012.

Financing the Global Transition. Speech to the Atlantic Institute for Market Studies, Halifax, Nova Scotia, 21 June 2012.

Economic Outlook. Presentation to the Ottawa Chamber of Commerce and Ottawa Business Journal, Ottawa, Ontario, 27 April 2012.

Exporting in a Post-Crisis World. Speech to the Greater Kitchener Waterloo Chamber of Commerce, Waterloo, Ontario, 2 April 2012.

A Monetary Policy Framework for All Seasons. Speech to the U.S. Monetary Policy Forum, New York, New York, 24 February 2012.

Bank of Canada Submits Comments to U.S. Regulators regarding Joint Proposal on Prohibitions and Restrictions on Proprietary Trading. Comments submitted to U.S. Regulators regarding the Dodd-Frank Act, 13 February 2012.

Davos Panel—Global Economic Outlook 2012. Comments at the World Economic Forum Annual Meeting, Davos, Switzerland, 28 January 2012.

2011

Growth in the Age of Deleveraging. Speech to the Empire Club of Canada and the Canadian Club of Toronto, Toronto, Ontario, 12 December 2011.

Renewing Canada's Monetary Policy Framework. Speech to the Board of Trade of Metropolitan Montreal, Montreal, Québec, 23 November 2011.

Global Liquidity. Speech to the Canada-United Kingdom Chamber of Commerce, London, UK, 8 November 2011.

Some Current Issues in Financial Reform. Speech to the Institute of International Finance, Washington D.C., 25 September 2011.

Recent Economic Developments. Speech to the Saint John Board of Trade, Saint John, New Brunswick, 20 September 2011.

Housing in Canada. Speech to the Vancouver Board of Trade, Vancouver, British Columbia, 15 June 2011.

Canada in a Multi-Polar World. Speech to the Canadian Club of Ottawa, Ottawa, Ontario, 16 May 2011.

Monetary Policy and Resource Mobility. Presentation at the Bank of Finland's 200th Anniversary Conference, Helsinki, Finland, 6 May 2011.

The Paradigm Shifts: Global Imbalances, Policy, and Latin America. Speech to the Inter-American Development Bank, Calgary, Alberta, 26 March 2011.

2010

Living with Low for Long. Speech to the Economic Club of Canada, Toronto, Ontario, 13 December 2010.

Looking Back, Moving Forward: Canada and Global Financial Reform. Speech to the International Center for Monetary and Banking Studies, Geneva, Switzerland, 9 November 2010.

Employment in a Modest Recovery. Speech to the Windsor-Essex Regional Chamber of Commerce and the Giovanni Caboto Club, Windsor, Ontario, 30 September 2010.

Bundesbank Lecture 2010: The Economic Consequences of the Reforms. Speech to the Deutsche Bundesbank, Berlin, Germany, 14 September 2010.

Restoring Faith in the International Monetary System. Speech to the Spruce Meadows Changing Fortunes Round Table, Calgary, Alberta, 10 September 2010.

Fortune Favours the Bold. Speech to the Newfoundland Oil & Gas Industries Association, St. John's, Newfoundland and Labrador, 18 June 2010.

The G-20's Core Agenda to Reduce Systemic Risk. Speech to the International Organization of Securities Commissions, Montreal, Québec, 10 June 2010.

The Virtue of Productivity in a Wicked World. Speech to the Ottawa Economics Association, Ottawa, Ontario, 24 March 2010.

Principles for Interesting Times. Speech to Carleton University, Ottawa, Ontario, 11 March 2010.

The Coming Thaw. Speech to the Winnipeg Chamber of Commerce, Winnipeg, Manitoba, 4 February 2010.

2009

Current Issues in Household Finances. Speech to the National Forum, Toronto, Ontario, 16 December 2009.

The Evolution of the International Monetary System. Speech to the Foreign Policy Association, New York, New York, 19 November 2009.

Reforming the Global Financial System. Speech to the Autorité des marchés financiers, Montreal, Québec, 26 October 2009.

The Three Rs: Review, Reflect, and Reaffirm. Speech to the Greater Victoria Chamber of Commerce, Victoria, British Columbia, 28 September 2009.

Some Considerations on Using Monetary Policy to Stabilize Economic Activity. Speech at the symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009.

Building a Resilient Financial System: Lessons from Canada. Speech to the Canadian Financial Forum, Beijing, China, 11 August 2009.

From Green Shoots to the Harvest: Comments on Financial Stability. Speech to the Regina & District Chamber of Commerce, Regina, Saskatchewan, 18 June 2009.

Rebalancing the Economy. Speech to the International Economic Forum of the Americas, Montreal, Québec, 11 June 2009.

Rebuilding Confidence in the Global Economy. Speech to the Northwest Territories Chamber of Commerce and the Yellowknife Chamber of Commerce, Yellowknife, Northwest Territories, 1 April 2009.

What Are Banks Really For? Speech to the University of Alberta School of Business, Edmonton, Alberta, 30 March 2009.

Inflation Targeting in a Global Recession. Speech to the Halifax Chamber of Commerce, Halifax, Nova Scotia, 27 January 2009.

2008

From Hindsight to Foresight. Speech to Women in Capital Markets, Toronto, Ontario, 17 December 2008.

Building Continuous Markets. Speech to the Canada—United Kingdom Chamber of Commerce, London, England, 19 November 2008.

Reflections on Recent International Economic Developments. Speech to the Canadian Club of Montreal, Montreal, Québec, 25 September 2008.

Flexibility versus Credibility in Inflation-Targeting Frameworks. Speech to the BIS, Lucerne, Switzerland, 27 June 2008.

Capitalizing on the Commodity Boom: the Role of Monetary Policy. Speech to the Haskayne School of Business, Calgary, Alberta, 19 June 2008.

Principles for Liquid Markets. Speech to the New York Association for Business Economics, New York, New York, 22 May 2008.

Addressing Financial Market Turbulence. Speech to the Toronto Board of Trade, Toronto, Ontario, 13 March 2008.

The Implications of Globalization for the Economy and Public Policy. Speech to the British Columbia Chamber of the Commerce and the Business Council of British Columbia, Vancouver, British Columbia, 18 February 2008.

2004

The New International Monetary Order. Speech to the Toronto Society of Financial Analysts, 23 November 2004. Published in *The Bank of Canada Review: Winter 2004–2005.*

Note: All speeches as Governor of the Bank of Canada are published on the Bank of Canada's website (http://www.bankofcanada.ca/publications-research/speeches/).

December 2012

Written evidence submitted by Professor Simon Wren-Lewis, Oxford University

1. Monetary policy has two objectives: to stabilise inflation at an acceptable level, and to try to eliminate any output gaps. As a result, academic work on monetary policy has two ultimate goals for monetary policy: to minimise excess inflation and to minimise the output gap. Views about the relative importance of these two objectives vary, and our knowledge here is very partial, but both objectives matter.

2. The current UK monetary policy regime places one of these objectives—targeting inflation—above the output stabilisation objective. This is in contrast to the regime in the United States, which has a "dual mandate", which essentially corresponds to the two objectives outlined above. So why have in the past most macroeconomists, including myself, been relatively content with focusing on inflation as the primary policy objective?

3. The most important reason was that these inflation targets were interpreted in a flexible manner. (The regime is often called flexible inflation targeting.[27]) Specifically the Bank of England has interpreted this flexibility as trying to hit the inflation target in two years time. The general view was that over this kind of time frame, hitting the inflation target would be consistent with closing the output gap. So although minimising the output gap was not a primary policy objective, that objective would be fulfilled under flexible inflation targeting. The theory behind this view is that inflation is ultimately determined by a Phillips curve, which implies inflation will only be stable in the long run if the output gap is zero.

[27] See, for example, http://www.norges-bank.no/en/about/published/speeches/2004/2004–01–23/

4. Recent UK experience has unfortunately shown that view to be seriously incomplete. Inflation has been persistently above target, yet output is well below its sustainable level.[28] The MPC has currently set policy to achieve the inflation target in two years time, but it does not expect the output gap to come near to being closed in two years time. So the inflation objective is overriding the output gap objective.

5. There are probably two reasons why we now have a conflict between hitting the inflation target and closing the output gap. The first could be called bad luck. The UK economy has been hit by a series of positive inflation shocks: a large depreciation with lagged effects, increasing commodity prices, and increases in certain government charges and taxes. The second is more fundamental and also more a matter of conjecture. When inflation is low, high unemployment appears to have a smaller downward influence than when inflation is higher. One obvious reason for this is that workers are particularly resistant to nominal wage cuts.

6. Whatever the causes, there is now a clear conflict between what a sensible UK monetary policy would be doing and what is actually happening. Monetary policy is not providing enough stimulus to the UK economy, because it is focusing on the inflation target, and not the output gap. Inflation targeting in the UK is not working, and something needs to change.[29]

7. Some commentators suggest that a change in personalities may be sufficient to deal with this problem. I think this is quite wrong. It is clear to me that the MPC takes the Bank's interpretation of inflation targeting very seriously. It was put very well by Adam Posen in his recent (22 January 2013) evidence to this Committee: "anyone who was on the [MPC] basically took the equivalent, in my opinion, of an oath of office. They were serving on the committee under the terms of the given inflation target." Posen was generally a "dove", not because he wanted inflation above the target, but because he thought inflation would come down more quickly than others.

8. For this reason, I do not think the MPC would be able to do what the US Fed is currently doing with monetary policy. The Fed has said that they are willing to see inflation go (a little) above their 2% target in order to get unemployment down. I believe the MPC would regard that as violating their remit. It would be useful if the Committee could see if the new Governor takes a different view.

9. If I am right, some change (or official reinterpretation) in the UK monetary regime has to take place. There appear to be three types of change that could be explored: moving to a dual mandate, looking at other measures of inflation, or getting rid of the inflation target completely.

10. Perhaps the most straightforward change would be to make monetary policy in the UK more like policy in the US, by adding an output gap or unemployment objective alongside the inflation target. It would not be necessary, and given current uncertainties it would not be desirable, to specify a particular number for unemployment or output. Instead the MPC could be charged with ensuring output was at a level consistent with long run inflation stability, or some similar phrase. The risk that this change would lead us back to the 1970s is zero. What this change would enable the MPC to do is allow inflation to be above target in 2 years time if they expected the output gap to persist.

11. Another possibility would be to stay with an inflation target, but to broaden the range of inflation measures that were looked at. There is no reason from economic theory why consumer price inflation is the "right" inflation measure to target, and other measures (like output prices, or wage inflation) may be at least as relevant. Unfortunately the series of positive inflation shocks the UK has recently experienced have their maximum impact on consumer prices. Monetary policy in the UK would now be very different if the inflation target was for earnings growth—and there is no reason in terms of the macroeconomics why it should not be[30].

12. Both these suggestions have one apparent disadvantage: we lose the simplicity and clarity of a single target. By specifying more than one target, and not specifying the trade-off the MPC should use when the targets conflict, we are leaving more to the discretion of the MPC. However, such a regime would still give less discretion to the MPC than monetary policymakers in the US or Eurozone currently have. The targets would still be set by the Chancellor.

13. The third alternative is to replace a single inflation target by a single target for something else. Targets for nominal GDP have been widely canvassed. It is absolutely vital that here a clear distinction is made between targets for nominal GDP growth, and targets for the level or path of nominal GDP. It is the latter that many economists have recently suggested might offer some clear advantages over inflation targets, and which were discussed in a recent speech by the new Governor.

14. As some eminent macroeconomists, like Michael Woodford, have been arguing for the advantages of such "history dependent" targets for some time (well before the recession), a debate on their merits is overdue. Although this issue is widely discussed in the US, we have very little discussion in the UK. This may be because the natural host for such a discussion would be the Bank, but the Bank has felt that it would be inappropriate for it to question its own remit. I hope the new Governor does not take that view, and it would be useful for the Committee to ask him about this. If the Bank, under its new Governor, still felt it inappropriate

[28] Macroeconomists use almost as many names for this sustainable level as there are estimates for its magnitude (natural rate, NAIRU, natural level, output potential...), but unless anyone wants to suggest that none of those currently unemployed are capable of working, there can be no doubt that UK output is currently below this level.

[29] I discuss this point further here: http://mainlymacro.blogspot.co.uk/2012/05/inflation-targeting-is-not-working.html

[30] The economics are discussed further here: http://mainlymacro.blogspot.co.uk/2012/06/but-which-inflation.html

for it to lead a discussion on the merits or otherwise of NGDP targets, then the Committee itself should think about undertaking this role.

15. While I would welcome an extensive discussion of this type, it would be unfortunate if that debate put on hold any change in UK monetary policy. As I have argued above, policy is providing insufficient stimulus to the UK economy now, because of the form of the current monetary policy regime. Changes could and should be made to that regime now, without in any way prejudicing the results of a more extensive debate on NGDP targets. That is why I think it is important to address the possibility of moving to a dual mandate, or looking at alternative inflation measures.

January 2013

Written evidence submitted by British Chambers of Commerce

The British Chambers of Commerce (BCC) welcomes the opportunity to respond ahead of Dr Mark Carney's evidence session on the Treasury Committees Autumn Statement Report.

The BCC is an influential network of 54 Accredited Chambers across the UK, representing the interests of over 104,000 businesses. No other business organisation has the geographic spread or multi-size, multi-sector membership that characterises the Chamber Network. Every Chamber sits at the heart of its local business community, providing representation, services, information and guidance to member businesses and the wider local business community.

Background

Dr Carney will take office at a crucial time for both the UK and global economies as the Bank takes on greater supervision of Britain's financial services sector, and in particular our major lending banks.

Access to Finance/Business Bank

We also hope that Dr Carney will play an instrumental role in bringing the British Business Bank to life through his experiences with a similar institution in Canada. The Business Development Bank of Canada (BDC) is a financial institution owned by the Government of Canada and has been successfully serving Canadian SMEs for more than 65 years.

BDC have a mandate to support entrepreneurship and plays a leadership role in delivering financial and consulting services to Canadian small and medium-sized businesses, with a particular focus on start-ups, innovators, fast growth companies, manufacturers and exporters.

They currently help more than 28,000 businesses and as a complementary lender, they offer loans and investments, that fill out the services available from commercial financial institutions. It is also important to note that their funds are borrowed on the money market like other commercial banks and they do not receive government funding for the money they offer in loans.

The BCC believes that the British business bank must develop into a major source of both patient growth capital and risk capital, similar to the BDC in terms of outcome rather structure, if it is to succeed where decades of interventions have failed. Further to this, we believe that Dr Carney's views on the structure and purpose of the new business bank will be an important step to clarify the road map to attain the right type of business bank to help firms around the UK achieve their full potential.

Using Monetary Policy to Support Growth

We hope that the new Governor will be questioned on the role that the Bank of England can play in supporting business growth across the UK. In particular, the BCC believe that the new Governor must work closely with the Treasury to find ways to boost the supply of credit to new and growing businesses.

February 2013

Written evidence submitted by the Association of British Insurers

— The UK insurance industry welcomes the appointment of Mark Carney and looks forward to the start of his tenure as Bank of England Governor in July this year.

— The incoming Governor's recent comments at the World Economic Forum in Davos centered on growth. The UK insurance industry uses its significant assets to invest in growing the economy, with ABI members' current assets amounting to investments of £1.8 trillion in the wider economy—equivalent to 26% of the UK's total net worth.

— As you know, Mark Carney signalled at Davos that Central Banks inflation targeting should be approached more flexibly with the mandate of delivering sustainable growth in mind. He added this could include "the use of communication and use of other unconventional instruments."

— A second key issue for economic growth is how the un-wind of Quantitative Easing (QE) will be managed—which also carries consequences for savers annuity rates.

— **ABI members are concerned that if either inflation targeting or un-winding QE is unsuccessful, the UK will face a major inflation problem. Getting these decisions right and ensuring the markets have both certainty and a clear understanding of the Governor's position is therefore critical to investors.**

— The insurance industry has an important role in returning the UK economy to growth. With key government policy initiatives such as auto-enrolment into workplace pensions now successfully underway, the role of insurers as investors of people's hard earned money is central to delivering responsible capitalism. Maintaining good corporate governance in the way we act as investors and encouraging best practice in UK boardrooms is key to making the best use of people's savings—some of which could be put towards valuable infrastructure projects.

— As part of the overhaul of financial services regulation, the prudential regulation of insurers and asset managers will come under the Bank of England's remit for the first time.

— During final stages of debate on the Financial Services Act, the industry was reassured by Lord Newby's statement that "the Government absolutely agree that insurance expertise should be represented on the PRA Board." The PRA has a specific insurance objective and a distinct approach to supervising insurers, recognising their unique business model: **we look forward to working with the new regime so that these new responsibilities are best implemented for the benefit of our customers and the UK economy.**

About the UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. Paying out almost £200 million a day to our customers, insurance is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 30% of its net premium income coming from overseas business.

About the ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has almost 350 members, accounting for some 90% of premiums in the UK.

January 2013

Written evidence submitted by Professor Jagjit Chadha, Chair in Banking and Finance, School of Economics, University of Kent

EVIDENCE TO THE TREASURY COMMITTEE ON THE CURRENT MONETARY POLICY REGIME:

Time to Move to Nominal Income Targeting?

This short note considers the case for a move from inflation targeting to another widely championed form of nominal anchor, nominal income targeting, which can also be thought of as targeting a limit on the quantity of cash spending in the economy in any one year or average rate of growth in such spending over a number of years. As is well known, following the end of Bretton Woods, the UK experimented with a number of nominal anchors which dragged with alarming frequency from wage and price controls, to various forms of monetary targets through to shadow and then explicit exchange rate targets. The ultimate purpose of these mechanisms was to establish price stability and also inculcate agents with the belief that price stability would persist, so that consumption and investment plans were also formulated conditional on price stability. Even though inflation targeting was adopted rather hastily in the UK, after ERM exit in 1992, and in its current form with an operationally independent but goal dependent central bank, only after the election of the Labour government in May 1997, it has actually played a key role in the establishment of price stability in the UK and should not be lightly discarded.

Just as reform of the operating practices of the Bank of England (the inflation report, publication of minutes and operational independence etc) was part and parcel of the adoption of inflation targets, to some extent, the evolving nature of the Bank of England's role following the financial crisis leads to an open question about whether a different nominal anchor, such as nominal income growth, would be not only be more achievable but also more appropriate for a central bank mandated to ensure economic resilience. It has been argued that moving to a nominal income target will force the central bank to consider the growth consequences of both economic developments but also the implications of its new macro-prudential policies for growth and so ensure better co-ordination across these roles by helping to prevent the build-up of imbalances, which was, of course, the precursor to this crisis. Clearly even without the change in the structure of the Bank of England, the failure of monetary policy to prevent a financial crisis and also engineer a sustained recovery leads a number of reasonable people to conclude that it is the regime of inflation targeting that has failed, rather than, in my view, the more prosaic bread and butter of economic management that involves the careful analysis and understanding emergent economic tensions and, where possible, act against them.

Nevertheless, nominal income targets, it is argued, are consistent with price stability as they comprise a given inflation target plus the long run likely growth rate in output capacity. The policy maker thus simply sums these two numbers in his or her objective function and adopts policy choices that generate growth in nominal expenditures that is equal to inflation and growth. Specifically, it is argued that a nominal income target would allow the policymaker to stand back from two highly uncertain parameters. First they will be able to ignore the split between real output and inflation in the short run. Secondly, it would also imply less weight being placed on the measurement of the output gap, which is also rather hard to estimate, in order to forecast inflation. In some sense, nominal income targets would therefore be quite close in spirit to Milton Friedman's K% rule for the growth of money and as such would allow the continuation of rules-based monetary policy. Furthermore it is argued that in the presence of supply shocks, which send real output and inflation in opposite directions, the central bank could avoid having to make difficult decisions about the trade-off, or choice, between which of the two to stabilise.

At a practical level three types of criticisms have been levelled at nominal income targets. First that nominal GDP and the deflator are only available at a quarterly frequency, rather than monthly for CPI, and subject to large revisions, which would mean that current policy could only be assessed less frequently and also may have to offset previous errors that have only been discovered. Secondly, the index for the GDP deflator does not correspond to the expenditure patterns of households and so may be not impart significant surprises to the plans for real household consumption, even if targets are hit. Finally, from a technical control perspective, some have argued that because output responds before inflation to a policy shock, nominal income targetry may be more prone to generating dynamic instability as there is not necessarily a synchronised response in nominal GDP to any given shock.

My own main concern about any move from inflation targets is that it weakens the signal about price stability and credibility over a given inflation target. Following a hypothetical move to nominal income targets, the public will no longer be formulating their plans with respect to a given path for inflation but conditional on their real output forecast, so that high inflation should be expected when growth is low and vice versa, which seems a recipe for considerably more inflation variance. And so even if the central bank no longer has to worry about the split between inflation and growth the public will. Additionally, if we want to use signalling about the duration of a given interest rate stance, it seems to me that this is more difficult to achieve if the central bank is formally charged with twin rather than a single objective. Actually much of the strain for output stabilisation has traditionally already been assigned to fiscal policy and thus it makes sense to continue with price stability as the main assignment for monetary policy. In fact, in the face of severe dislocations in economic activity, the inflation target can be given a further degree of freedom by simply allowing or stating that return to target will be gradual over a number of years in the interests of limited output volatility—a flexible approach to inflation targeting can thus retain the commitment to price stability but also ensure that output is not ignored.

I certainly think that some considerable attention and thought needs to be given to the monetary policy making framework eg the development and transparency of the suite of Bank models, their ownership and use, as well as the level of support given to external MPC members may once again have to be considered. But given an economic history comprising an almost dilettante adherence to monetary frameworks, the retention of anchor in terms of inflation *per se* remains attractive. The failures of monetary policy over the most recent period, are not really ones about the form of nominal anchor but more about the integration of financial and monetary analysis into a more comprehensive analysis of economic vulnerability. There is much work to be done but that is probably where we should begin.

February 2013

ISBN 978-0-215-05695-5

Printed in the United Kingdom by The Stationery Office Limited
04/2013 027432 19585