HOUSE OF COMMONS

ORAL EVIDENCE

TAKEN BEFORE THE

TREASURY COMMITTEE

# QUANTITATIVE EASING

TUESDAY 23 APRIL 2013

GAVYN DAVIES, ROGER FARMER and STEPHEN KING

Evidence heard in Public Questions 102 - 186

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 23 April 2013

Members present:

Mr Andrew Tyrie (Chair)
Mark Garnier
Stewart Hosie
Mr Pat McFadden
Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Mr David Ruffley
John Thurso

**Examination of Witnesses**

*Witnesses:* **Gavyn Davies**, Chairman, Fulcrum Asset Management, **Roger Farmer**, Distinguished Professor of Economics, UCLA, and **Stephen King**, Chief Global Economist, HSBC, gave evidence.

**Q102 Chair:** Thank you very much for coming to give evidence this morning on this extremely interesting subject, which, five years ago, very few of us thought we would be looking at. Perhaps the subject can be divided up into four questions, although people will come from different angles on this. The first is: has QE made a major contribution to stabilisation and to the avoidance of deflation? Is more QE subject to diminishing returns? Does it have unintended costly consequences, and what is the exit strategy? There are other questions, but those are four big ones.

Can I begin with you, Mr Davies, by quoting Bill White of the OECD? He said, "Ultra easy monetary policies could eventually threaten the health of financial institutions and the functioning of the financial markets, threaten the 'independence' of central banks, and can encourage impudent behaviour on the part of Governments. None of these unintended consequences is desirable". Are you concerned by those risks?

***Gavyn Davies***: Yes, Chairman, I am very concerned by those risks. I think each of them, taken alone, is a significant issue for all of the major developed countries, with the central banks now holding somewhere around 25% in GDP in their balance sheets, most of which is government bonds. It is clear that, in theory and in practice, there can be significant distortions in the financial system derived from that: the risk of loss in the central bank balance sheet, which I do not discount as a problem, and really encouraging behaviour, both by Governments and by financial asset holders, which can absorb too much risk in their balance sheets. I am absolutely clear that those risks exist. The issue is whether those risks are now applicable and threatening, and, if so, are they sufficient to stop the programme of quantitative easing, which has other benefits?

**Q103 Chair:** What is your answer?

***Gavyn Davies***: My answer is that, at the moment, those risks need to be monitored and we shouldn't pretend they do not exist. We should have a plan for dealing with all of them.

But, in my mind at the moment, they do not constitute a sufficiently large risk to reverse the quantitative easing programme, given the way the economy is behaving.

**Q104 Chair:** Mr King, what would you like to add?

***Stephen King***: Chairman, I agree with Mr Davies that clearly there are a series of risks associated with QE. I should also stress that, had it not been for QE and other related policies, back in, say, 2009-2010, we could have been facing in the western world a significantly worse outcome than the one we have been through. So, there were some significant advantages of QE when it was first adopted.

My concern is that the performance of economies, relative to the expectations when QE was first adopted, has probably been worse than expected. Yet, at the same time, asset prices have risen very, very strongly, which is in part what QE is designed to do. My concern is that the rise in asset prices has not as yet been reflected in underlying economic performance. In other words, a gap is opening up between the value of asset prices and that underlying performance.

If I give you one example, not related to the UK but rather to the US: if you look at the performance of the US economy over the last five or six years, the performance has been the best in the G5—if you go back to the peak activity, say, in 2008—which suggests that QE has been quite successful. At the same time, the performance by US economic standards has historically been remarkably poor; if you go back to previous economics cycles, it has been very poor. At the same time, the performance of the US stock market, which might be one beneficiary of QE, in real terms adjusted for inflation, taking into account dividends, has not been out of line with previous experience. So, put another way, you might say that a gap has opened up between what is incorporated into financial assets, from the point of view of hopes for the future, and what has happened in terms of underlying economic performance. That gap concerns me.

***Roger Farmer***: It is quite an advantage going third, because I get to agree with much of what has been said already. I would like to add a couple of things. I think that quantitative easing has two dimensions that are sometimes confused. One is a big expansion in the size of balance sheets, which has occurred in pretty much every major central bank in the world. The other is an unprecedented change in the kinds of assets that banks have been holding, in particular, a change in the risk composition.

To begin with the point on the effectiveness of QE, again, I am going to draw initially from US experience, which I know better. When the size of the US balance sheet began to increase dramatically, after the collapse of Lehman Brothers, there was clear evidence that the expectations of inflation, which at the time appeared to be precipitously negative, turned around almost overnight. That was a very good thing, because I believe that if the economy had moved into a deflationary period, the economy would have deteriorated much more than it did. Shortly after that, when the Fed began buying mortgage-backed securities—which are to some extent riskier than anything the Bank of England has bought—there was a large turnaround in the stock market.

To get to Stephen King's point, my own research has shown that in the data, over the past 40 or 50 years, there has been a very stable relationship between the real value of wealth—and in particular stock market wealth—and unemployment. I described that relationship in a newspaper piece. It is technically what we would call co-integrated random walk. It is like two drunks walking down the street tied together with a rope. They can move apart for some period of time, but eventually they pull back together again. I believe that what is driving unemployment and real growth is demand driven by wealth, and a large component of that is stock market wealth. So, I think the mechanism on the side of economic activity, which has helped to prevent what I believe would have been a much worse recession than occurred, I believe is working through wealth effects on consumption. I believe that that is something that can and should be continued. Again, is there a risk to that? Yes. It is a fiscal policy basically, and, yes, there is a potential risk to the taxpayer.

**Q105 Chair:** The real wealth effect that you are describing, if it is still there, means that more QE could still be effective?

***Roger Farmer***: Let me put it a different way. In economics we learn from big events, and this is one such big event. There have been a couple of other big events that we learned from in the last century: one was the Great Depression; another was the stagflation of the 1970s. In my view, this big event is causing us to rethink things quite fundamentally. One of the things we have learned—and we should have known this before—is that asset market instability is extremely dangerous for the real economy. I believe that we have also learned through the experience of what I would call "qualitative easing", which is the component of QE that involves changes in the risk composition. I believe we have learned that that can potentially act as an alternative to traditional fiscal policies.

**Q106 Chair:** I will have one more go at asking the same question. Some argue that each bout of QE delivers diminishing returns. You are arguing that, whether or not that is true, it still has considerable kick left in it, because of the real-world effect?

***Roger Farmer***: I am, yes.

**Chair:** All right; just to be clear.

**Q107 Mr Newmark:** I am going to have to disagree with you, because I am troubled as to where you see the benefits. Do you say that there are not diminishing returns or that there are returns but we have to accept that there will be positive returns, but not as much as the first and second time?

***Roger Farmer***: I think that there are diminishing returns to continuing to buy nothing other than long-term gilts. I would be in favour, first of all, of recognising that this is not a monetary policy; it is a fiscal policy. A lot of the confusion that has been going on politically, with the Bank of England and this Committee, has to do with concern over fuzzying that boundary. Once you recognise that this is a fiscal policy, I believe that there are not diminishing returns if one were to expand the policy and buy not just long-term gilts but riskier assets.

**Q108 Mr Newmark:** I will get on to that in a minute when we look at the US. As I think Gavyn Davies mentioned, it was important at the start, the first 200 billion, and I sort of buy into that. The analogy I have always used before is that it is like cold-starting a car; you pull out the choke and you let the petrol flow in, and it gets the car going. But when you leave the choke out there are negative impacts. Two of those that I see going on are, one, that inflation is now running at something like 50% above target; we have also seen our currency diminish in value by 7%, 8%, 9%. To me, those are signposts along the road of continuing QE that there is a risk that it will continue to push up inflation and continue to diminish the value of our currency. Gavyn is nodding, so I am going to go to Gavyn first. Do you agree with that or not?

***Gavyn Davies***: Yes, I do agree. One of the things that strikes me about the UK at the moment is that we have this discussion about QE and whether we should do more of it—often in the public arena, not in the MPC—as if we are not missing the inflation target. If we had an inflation rate of 1%, I would be voting with Mervyn King and the three that want more QE. I would see that as a clear missing of both a growth and inflation and an unemployment objective, which would make it very straightforward to do more QE. But we are not in that position in the UK. They are in the US and they are in Japan, and they probably are in the eurozone as well. We are not. We have missed the inflation target for five solid years at least. Inflation expectations in the bond market are not consistent with the medium-term inflation objective that the Government is setting. So, I would currently be somewhat nervous about having yet more QE until we get these inflation expectations back down.

On the question of whether the next round of QE—if we do another round—would be less effective, I think that is a tough one. In my mind the answer is yes, it would be less effective if we are going to limit ourselves to the kind of QE that we have done in the past.

**Q109 Mr Newmark:** Yes. Ian McCafferty effectively says that it is becoming part of the intellectual economic landscape that, for want of any other analysis—this is what slightly disappoints me about the Governor and his team—there is no imagination. I am going to flip to the US in a minute, but it seems as though, "Let's keep doing the same thing, even though we're not getting what we want at the end of it". We are getting inflation, we are getting a diminishing currency and we are not getting the growth, which was the whole point of QE to begin with.

***Gavyn Davies***: May I just add one point?

**Mr Newmark:** Yes, go ahead.

***Gavyn Davies***: I have some sympathy for that, Mr Newmark. There is limited point in continuing to buy 10-year bond duration, but there are other things the bank could be buying if it changed its thinking. I do think the Funding for Lending Scheme is not the same form of policy; it has value and should be expanded.

**Mr Newmark:** I would not disagree with you there. On the—

**Chair:** Sorry, just before we move on.

**Mr Newmark:** Go ahead, Chair.

**Chair:** What else should they be buying?

**Q110 Mr Newmark:** I am going to get into that, Chairman. If we look at the US, the US has been much more imaginative in its use of QE. So, just to enlighten us—I will go to Stephen; he hasn't talked for a while—can you let us know how the US QE programme differs from the UK programme?

***Stephen King***: As to the primary difference—and it is partly an institutional difference between the countries—it is that the range of assets that the US could purchase was always much bigger in the first place. It included a large amount of—

**Q111 Mr Newmark:** You say they could purchase; was there anything stopping the Bank of England—

***Stephen King***: They did purchase.

**Mr Newmark:** They did purchase. But is there anything stopping the Bank of England saying, "Actually, we see what is going on in the US. Let's widen the scope of what we are doing with QE"?

***Stephen King***: What I am getting at is the size of the mortgage-backed securities market in the US is far bigger than anything that might equivalently exist in the UK. The same is broadly true of the corporate bond market as well. The kinds of assets that might be purchased in the US just do not exist in the UK or, alternatively, if the UK were to purchase them, the impact on the free-market liquidity of those particular assets would be limited extremely quickly. So, I think there is a difference from the point of view of the institutional arrangements that made it easier for the US to buy a much wider range of assets than was true in the UK. The other thing I would add, of course, is that if we take the banking crisis—and this is not so much directly associated with QE itself, but it is in part a reflection of the need for QE—the banking crisis in the US ultimately has proved to be significantly smaller than the banking crisis in the UK because, of course, the banking crisis in the UK had much more limited backing by taxpayers than was the case in the US.

**Q112 Mr Newmark:** Do you think that—the three of you can jump in here—because of the size of the UK market, we couldn't be going into effectively a pooling of mortgages and buying pools of mortgages, going in and buying pools of SME loans? Is that something that we should not be looking at with QE in the UK, even though it is going on the US?

***Stephen King***: I would say that SME loans is an interesting area, because there is no doubt that, from the point of view of the original effectiveness of QE, the bit of the economy that did not really get affected very much was SMEs. If you think about growth and the sources of growth, I would argue that a lot of it does come from small- and medium-sized enterprises that become eventually bigger enterprises. Thinking about the kinds of assets you might purchase in the future, there is a strong case of thinking about doing something with SMEs.

**Q113 Mr Newmark:** But to try to kick-start construction, which has been suffering, in signalling that particular sector that has been very hard hit recently, are you saying that when Mark Carney comes in that is not a direction he should go down; he should focus purely on SME loans as an alternative strategy with QE?

***Stephen King***: I should say here I feel slightly uncomfortable with the idea that central banks should start to engage in the picking of winners and losers within the economy. There is a big problem here. If we say that construction, in particular, is weak, that may be true, but is it the job of the central bank to allocate capital towards construction? Instead, isn't that the job of either the market or the Government rather than the central bank?

**Q114 Mr Newmark:** I am going to go to Gavyn, then Roger. Gavyn, you were wincing as I was speaking, so what made you wince?

***Gavyn Davies***: I was only wincing at the suggestion that the central banks should pick the construction sector and the retail sector, which is having a tough time in the high street, and try to direct lending to those sectors. One thing that I hope the Committee will focus on is that we should not be overloading the central banks with so many tasks that, first of all, they can't actually fulfil. Secondly, they inevitably get drawn into the political system in trying to fulfil them. I feel that we should be aware of these risks. The central banks are now being asked to target inflation, usually growth as well, or unemployment, the health of the financial system, sometimes the exchange rate, and now they are clearly being asked to target the funding costs of the banking system. The list is going on and on. Everything that is wrong with our economy seems to be laid at the door of the central banks, even though they only have one or two instruments to operate with. So, I think there are dangers in this.

**Q115 Mr Newmark:** I am going to ask Roger and then I have one last question, Chairman.

***Roger Farmer***: If I could jump in there, again, I agree with a lot of what has been said. I am also extremely concerned that the UK has not been meeting its inflation target. To come back to Gavyn's point about putting too much on to central banks, for the last 40 or 50 years, US, UK, many central banks, although their primary goal has been the inflation target, they have also been charged with the secondary goal of maintaining economic activity. What has happened, particularly since inflation targeting became widespread in the mid-to-late 1980s, is that when economies went into recession interest rates were lowered. That helped to get economic activity back moving again. Then when they came out of the recession interest rates went back up. When we got to the point in 2007—over this whole period interest rates were coming down—and interest rates were at zero, that whole modus operandi of banking with this dual goal but one instrument was now gone. Now we are floundering around holding the interest rate at zero, doing lots of things that we hope will make the economy recover, and using what are broken theories to try to understand what is happening.

I am not particularly optimistic that holding interest rates at zero for a long time and buying lots of long-term gilts is going to do anything. My view about the way that the qualitative part of quantitative easing has worked is not the traditional channel. People are overly concerned and looking at what is perceived to be a credit problem. It is perceived that there is somebody with deep pockets, somebody with an idea, and some constraint stopping the person from lending. That is not what I think is going on. That is a symptom and not the cause of the problem.

**Q116 Mr Newmark:** Surely, the problem is confidence. There is 750 billion on corporate balance sheets. The banks have cash—

***Roger Farmer***: That is precisely right.

**Mr Newmark:** —so it is more of a confidence issue than anything else.

***Roger Farmer***: It is confidence and it is the debt overhang. I believe the channel by which qualitative easing has worked is through raising wealth. Wealth in western economies is something like two-thirds factories and machines, one-third housing. On top of that, there is another piece that is four times as big, which is what we all expect to earn in the future, our human wealth. Those components of wealth are all moving together. In my view, restoring demand, restoring health to the economy and reducing unemployment is precisely a matter of restoring confidence. There is a practical way of doing that, which is through intervention in asset markets to restore the value of wealth.

**Mr Newmark:** I am getting pressure from the Chairman. I have one last question.

**Chair:** Very quickly, and a very quick reply.

**Q117 Mr Newmark:** One last question. One of the conundrums that we have here is we have more men and more women in work than ever before. Employment is looking great. Unemployment is looking a little bit shakier, particularly youth unemployment. The Fed has committed to continuing QE until employment falls before 6.5%. How far can the effects of a pre-commitment be distinguished from those of QE itself?

***Roger Farmer***: Commitment has a role, but I think that people have mis-identified the channel. It is wishful thinking to think that announcement of facts about when we are going to come out of QE is going to help restore—

***Gavyn Davies***: Could I just add a very brief addendum to this, Mr Newmark? The Fed has promised many different forms of commitments, and I think the one that you quoted there is the commitment on interest rates, not on QE itself. The commitment on QE is similar, but it is to maintain asset purchases until there is a substantial improvement in the labour market, subject to price inflation being under control.

One issue that I feel we should focus on here: the Fed has so many commitments at the moment, and I follow every single word written in any Federal Reserve document, that I get confused to which commitment applies where. If we are going to use commitments, I think they should be fairly straightforward, maintained for lengthy periods and not chopping and changing and have one applying to QE, another applying to interest rates, another applying to macroprudential stuff. In my opinion, they are over-committed.

**Mr Newmark:** Thank you, Chairman.

**Q118 Stewart Hosie:** Chairman, I apologise as I am going to have to leave slightly early, so I will look at your oral evidence. However, if I can start by asking Professor Farmer about QE. When it was introduced in Japan originally, one of the stated objectives was to see an increase in lending. As we know, lending fell for a prolonged period when it was introduced and then expanded. One of the softer but nevertheless stated objectives here was we would also see an increase in lending, and we saw that lending fell month on month over three years after its introduction. Why did Japan and the UK get that so wrong, in the sense that lending didn't increase, didn't flat-line, but actually fell when an objective was to see it rise?

***Roger Farmer***: Again, to the extent that people got it wrong, it was probably misdiagnosing the problem. Again, I don't think the problem is in the credit markets. The problem is with the proportions of debt and equity that are now in the economy. What we saw in the boom years was an increase in debt, a big increase in the value of share prices and assets. The debt was not a problem while share prices were high and while people were working and producing the profits necessary to maintain the value of the corporate sector. It is when the crash came, and the value of equity prices plummeted and people were laid off, that there was now a debt overhang. The problem now is in the relative values of debt and equity. I do believe that reflating the bubble and then letting it down slowly would be a better way to restore demand in the economy than, say, traditional fiscal policies.

**Q119 Stewart Hosie:** That is a very helpful description of reflating the bubble and letting it out gently. Let me ask that question to you, Gavyn, in a slightly different way. Why do you think that the UK authorities misread the Japanese example and effectively ended up with the same result when, for a variety of reasons, they stated that it would be different?

***Gavyn Davies***: Yes, I think I am less pessimistic than perhaps you sound on what happened in the UK's case. I am not disputing the data at all—the data are exactly as you said—but I have perhaps a different counter-factual in my head, which is what would have happened without QE. It is hard to compare Japan and the UK on this. Japan introduced its QE after a decade of near-depression. We did it earlier, and I think we were clearly more responsive. Mervyn King has said a few times that without the first 200 billion of QE, the broad money aggregate, M4 and so on, therefore bank lending would have dropped a great deal further than it did. It doesn't look as if QE boosted bank lending, but what I do think it did was slow down what would otherwise have been an enormous and dangerous de-leveraging in the banking system. For me that first round of QE, unlike what is going on now, did have a very large effect on bank lending, but only because it would have been so much worse without it.

**Q120 Stewart Hosie:** The banks are continuing to de-leverage, and massively. Have we simply put off the point that you are talking about there?

***Gavyn Davies***: I am moving towards thinking that we have to have another round of sorting out the banking system. I am reluctant to do that, to be honest—and I will say that to everyone on the Committee—because it will be costly, it will require raising more capital in the banking system and it may not immediately work. It may well work slowly through time. If we compare the Swedish experience in the 1990s with the Japanese experience, and also with the American experience more recently and with the European experience, I would argue that the sooner we get the bad assets off the balance sheets and dealt with—properly capitalised, if necessary—the sooner we can get our banking system back to normal. If we do not do that, then I think all of the things that we are doing to try to help may well just be palliatives.

**Q121 Stewart Hosie:** Just a "yes" or "no": more on the basis of the Scandinavian model from the 1990s than anything else that has been done?

***Gavyn Davies***: Also, remember what the United States did in 2009. They did a series of stress tests that the market believed were realistic—unlike some of the things we have seen in Europe—and they said that the Federal Government or its entities would recapitalise those banks that couldn't recapitalise themselves in the private market. I think all of them did recapitalise themselves in the private market.

I believe that decision is perhaps as important as the different fiscal stances between the US and the UK in explaining why we have had a slower recovery in the UK.

**Q122 Stewart Hosie:** I am sure we will come back to the banks, but, just to stay on QE for a moment, you will all be aware there is a lot of talk and disquiet about the misallocation of capital, about businesses holding capital to quite an extraordinary extent. How much of that do you believe was the result of the implicit expectation of more bank lending with QE? That goes back to my original question.

***Gavyn Davies***: I don't know, and we need to be humble in the great uncertainties that all of this involves. My own gut feeling—and it is really no more than that—is that this has mainly been an issue deriving from the activity of the banks, for the following reason. I think the banks have been reluctant to write down the bad debts they have on their books, and they have been understandably eager to keep those companies operating. We have seen, in the Financial Policy Committee's exercise in the last few months, that the regulators still do not believe that the banks have fully accepted the potential losses on their assets in a downside scenario. I think that is the main reason why we have had this zombie-company problem.

***Stephen King***: Could I just add on that, that with the Japanese banking problems in the 1990s and beyond, part of the problem was that, with the continuous absence of growth, eventually the good assets turned bad. If you look at the kinds of consensus forecasts that existed at the beginning of the 1990s in Japan, they were almost continuously far too optimistic relative to the subsequent outcome. I would argue that part of the reason why non-performing loans increased was precisely because the outcome was worse than expected. That is a problem that I think we have with the UK today: that the outcome has been persistently worse than expected over the last few years.

Secondly, on the Japanese experience with QE between 2001 and 2006, it is certainly true that when you look at the monetary aggregates, narrow money picked up very, very strongly but broad money did not. I think that was a concern that the Bank of Japan eventually recognised was something that suggested the policy was not working very well domestically.

However, I think there is a difference between the Japanese experience then and the UK experience now, associated with the weakness of the exchange rate. It is not obvious what the benefit of a weaker sterling has been over the last three or four years. It has been more obvious what the benefit of a weaker yen was between 2000 and 2006. Although the domestic economy in Japan did not recover very strongly during that period, the GDP numbers did pick up reasonably; not fantastically, but reasonably. They picked up largely because exports grew a lot more strongly than imports, partly thanks to the fact that the global economy was doing better over that period, but also, I would argue, because the yen had softened and gave Japan a competitive advantage.

One question for the UK is, given that we have had a huge fall in sterling, the equivalent in 2008-09 to what we saw when we came off the Gold Standard in the 1930s, why is it that the rebalancing that Japan appeared to achieve towards exports, in the 2001 to 2006 period, did not really materialise for the UK over the last four or five years?

**Stewart Hosie:** If anyone can ever answer why we now have a £100 billion deficit in traded goods after such a depreciation, I will welcome the answer. I think you are absolutely right.

**Q123 Chair:** Mr Davies, when you were talking about the need to restructure the banks, could you give a view on the argument that RBS is trying to lend but demand is deficient?

***Gavyn Davies***: Demand for loans, Chairman?

**Chair:** Yes, and that, in any case, although it may be valuable to restructure them, SME lending is only a very small proportion of total national income.

***Gavyn Davies***: Yes. I am sure there is truth in both of the arguments, Chairman. It is just a matter of trying to weigh them against each other and look at other international experiences and see—in a big-picture sense—what worked and what did not work. I want to also say that we are moving in the right direction on this. In the last six months, the new regulatory and Bank of England mechanism has, in my mind, actually worked. The MPC had a view. The FPC stated a Bank of England view, asked the FSA to go and look specifically at what the banks needed to do, and then that report came back to the FPC and they asked for action. It is not like we are doing nothing.

**Q124 Chair:** If you think we are already moving in the right direction, and you think there is force in these powerful mitigating arguments, why did you make your remark that we need a second big wave of bank reform?

***Gavyn Davies***: Because of the comparison with other countries. The recovery started more or less when the banking sector problem was solved. The other thing I would say, Chairman, is I own and—

**Q125 Chair:** So, it is a psychological and confidence issue. It is that people then start to trust banks again. Is that what you are saying?

***Gavyn Davies***: No, I don’t think it is people personally trusting banks. I think it is the banks having the confidence to act normally, to go out into the marketplace.

**Q126 Chair:** So, it is a confidence factor?

***Gavyn Davies***: In the banking system, yes, and also in the funding of the banking system. We are currently in a position now where, like the southern part of the eurozone, our banking system is increasingly being funded by the authorities. I really believe that is not the right way to run a banking system over the next decade, and I hope we don’t get trapped into that. Increasingly, through the FLS and other things, the funding counterparty is now the Bank of England. It is not other private sources, and I think that is regrettable. So, we are moving in the right direction. I would like to see us move, perhaps, to take the final step.

**Q127 Mr McFadden:** Gavyn Davies, I would like to ask you about Japan more recently, not the historical picture. They just got in a big monetary bazooka, a big move. What is your view of this? Do you think it will be enough to get Japan out of the cycle that it has been in for the last decade or so?

***Gavyn Davies***: What they have done is announced a programme over 18 months, which is about the same scale as the Fed has done over the last five years. Adjusted for the size of the economy, this is an enormous programme. It is mostly plain vanilla quantitative easing of the Fed or Bank of England variety. It is just all coming in a relatively short space of time. It does seem to be working in some regards. It certainly has had an effect on inflation expectations in Japan, and this is the first time they have ever tried to operate with a 2%

inflation target. Many people wish they had done that before. I think that is healthy. The other consequence of course is the yen. The yen has moved down by nearly 25% over a very short space of time, so they have had a massive devaluation of their currency. Will that work, and over what timescale? I think it will certainly have some effect, for sure. I think it will work better in the Japanese case than it has in the UK case.

**Q128 Mr McFadden:** Why?

***Gavyn Davies***: Because I think that the productive sector in Japan, in the traded goods sector, is more ready to react to an improvement in competitiveness than ours was. I think ours was shrunk.

**Q129 Mr McFadden:** So, in clear terms, their manufacturing is in a better position to take advantage of the currency depreciation?

***Gavyn Davies***: I think so. I would be interested to see what actually happens, but I think that is the case. The other thing again that we should all bear in mind: the shrinkage of our financial services sector is one of the reasons why we have had a problem on the export side. It is a very big reason for that. Japan has not had that. I think they are playing catch-up. I think it is going to work to a degree. The danger for them is that they unhinge inflation expectations to such a degree that the bond market sells off—does not rally; sells off—and then we see the problems in the financial system, which we are all worried about here as a potential long-term result of QE as well.

**Q130 Mr McFadden:** I want to bring your colleagues in in a minute, but I will just ask you: looking at what Japan has done, and looking at the expectations that have been set around the arrival of the new governor here, what do you think the implications are for the UK, if any, of what they have done on what people are expecting from the arrival of Mark Carney?

***Gavyn Davies***: I hope that people are not expecting a parallel in the UK, and the reason is that Governor Kuroda in Japan took over a situation where the inflation rate had been under zero for seven to 10 years, something like that, and where you could make the case for a really dramatic break with previous policy, in order to adjust inflation expectations and perhaps the exchange rate.

My reading of the UK is that our problems are not parallel to that. We have inflation above target. It has been for a very long period of time. We have already made a big exchange rate adjustment, and we have already done most of the Japanese QE programme. It has already taken place. I do not make a comparison between these examples.

**Q131 Mr McFadden:** Mr King?

***Stephen King***: If I could offer a few words of caution. I may not be quite as confident as Mr Davies with regard to Japan. The first note of caution is that I think it is difficult to explain 20 years of stagnation—which effectively is what Japan has been through—purely through an absence of macroeconomic stimulus. There are other factors that are working to hold Japan back. Most obviously, they would include the demographic structure, which is a familiar story, of course; a huge amount of offshoring from Japan into other parts of Asia, which has limited the volume of capital spending compared with what might otherwise have been the case. I would argue that the treatment of women in the workforce has been rather unimaginative—in other words, that women work in the workforce but are not necessarily used as productively as might be the case elsewhere—and there has been rather an unenthusiastic attitude towards immigration, all of which have added to what may be described as a lack of entrepreneurial drive in Japan over the last 20 years.

The second factor is this: through the foreign exchange rate, yes, it is quite possible that there will be a significant pick-up in exports in Japan, as indeed we saw in the 2001 to 2006 period. At the same time, it is not obvious what the mechanism will be that leads not only to higher price inflation but also to higher wage inflation. Interestingly, the Prime Minister, Shinzo Abe, has recently made the point that it is important in Japan that large corporations pay higher wages, in line with the increase in inflation expectations. I do not think there is any guarantee that that will happen, and, even if it were to happen, it may simply be the case that it would encourage more in the way of offshoring to other parts of Asia.

So, one danger with the Japanese experiment—which I would suggest is rather close to the UK danger—is that prices rise relative to wages, that leads to a squeeze in real household spending, and it turns out, perhaps, that you rebalance the economy without necessarily getting quite the acceleration in overall growth that is currently planned to be achieved.

**Q132 Mr McFadden:** Do you agree with Gavyn Davies that we should be very cautious about saying, "Oh, the Japanese have really gone for it there"? Is that what our new governor is going to do?

***Stephen King***: I would certainly agree that there is a huge difference from the point of view of requiring a structural shift in Japan compared with the UK. I agree absolutely with Gavyn, with regard to the differences in the inflationary performance for the two countries. I think the jury is still out on Japan. I have covered Japan over the last 20 years, on and off, and I have seen lots of occasions where there has been an incredible improvement in enthusiasm and confidence in Japan, based on some kind of policy initiative, and a year or two later we then discover that the policy initiative either was not fulfilled or proved to be a lot less powerful than originally assumed.

**Q133 Mr McFadden:** Mr Farmer?

***Roger Farmer***: I do not have a lot to add to that. I would stress the point that Gavyn made earlier that, yes, much of the shock and awe treatment in Japan has been a quantitative increase in the size of the balance sheet. Again, I agree with Gavyn that the problems there are quite different to the one we have. They have had a deflation for a while, and a big change in regime is important.

I would also stress that it is important to think about asset prices and consumer prices differently. This is moving away a little bit from Japan. But when asset bubbles have appeared in the past, it has been suggested that we should perhaps add asset prices to the price index that central banks look at when they are trying to control inflation. In some circumstances, that would have led to raising interest rates in response to asset booms, asset bubbles, and I believe that would have been a big mistake. The point I am trying to make is that I think that policies that can help potentially to control consumer prices, which are potentially interest rate controls and controls in the size of the balance sheet, should be separated from policies that could potentially help economic recovery on the real side, which have to do with relative prices, asset prices, so those are independent.

**Q134 Chair:** Mr King, you have made some extremely interesting remarks about Japan there. I wonder whether you would be prepared to give the Committee, in the fullness of time—and there is no rush—a short note on it. There would be considerable appetite.

***Stephen King***: Yes, fine.

**Q135 Mark Garnier:** Mr King, can I carry on with Japan? Your counterpart at Nomura, Richard Koo, has argued that there are two types of recession, which are those triggered by the usual business cycle and those triggered by private sector deleveraging of debt minimisation. Then he goes on to argue that one of the problems Japan has is a very, very high level of household debt. Do you see any similarities between that and the situation we have in the UK?

***Stephen King***: First of all, I would suggest that in Japan it was more a corporate debt hangover than a household debt hangover. In the late 1980s, corporations had borrowed hugely, justified by significant increases in the assets on their balance sheets, which was basically land of some sort or another. The process over the last 20 years has been strongly associated with attempts to deleverage within the corporate sector. One of the peculiarities that it has led to is that, although there has been a huge increase in Government borrowing, which in normal circumstances we might expect to be associated with a larger and larger current account deficit, in Japan's case the increase in Government borrowing has merely offset a huge increase in corporate saving, or—put another way—of corporate debt repayment over the last 20 years.

I would suggest the difference is that in the UK's case it is more a household debt problem rather than a corporate debt problem. In fact, across the Western world, I would argue that, in the majority of cases, corporations found themselves during this crisis in a reasonably healthy position. That healthy position has probably improved, post-the beginnings of the crisis. Profit shares and GDP are generally very, very high. Corporate balance sheets look pretty healthy. I would say, in general, household balance sheets look less healthy.

Of course, the difficulty here is working out how much deleveraging is required. I think that is a really awkward issue, and I am sure that Richard Koo would probably accept that it is an awkward issue. But to describe the mechanism, a lot about how much you deleverage depends on what the expectations are for the future, which of course is then incorporated in asset prices, and that is a moving feast.

**Q136 Mark Garnier:** To my way of thinking, this is key to the whole thing. If you look back at the numbers, you go back to household debt as a percentage of household income through the Lawson boom in the 1980s, where it went from 70% to 80%, but then when you had the independence of the Bank of England it went from 80% to 140%. That is quite a significant increase. In real terms, in the beginning of the 1990s, we saw household debt at £565 billion. Now it is just under £1.5 trillion, so it is significantly higher than Government debt; in other words, a 260% increase in household debt.

Gavyn Davies, you talked a little bit about forbearance within the banks. I think you were possibly talking about corporate forbearance; so, the small zombie companies. Given the fact that consumption is 30% of our economy, surely this household debt problem and the potential deleveraging, or indeed just slowing down of leveraging, has to be absolutely crucial to any economic recovery.

***Gavyn Davies***: Yes. Absolutely without question that is right. I think what Richard Koo pointed to was why it would be so difficult for Japan to recover through economic policy changes. I think he proved to be right on that because the deleveraging of the economy in the private sector occurred at a pace that the public sector could not offset. It became almost impossible for the public sector to increase its budget deficit sufficiently to offset that deleveraging, and that was one reason they got stuck. By the way, I agree with Stephen; there are lots of other supply side issues too in Japan, but it was certainly one reason that they got stuck.

It is absolutely an explanation of why the problem is difficult to solve. Whether it has the policy prescription effects that Richard thinks, I am not so clear. Richard basically says that, in a situation like this, fiscal policy is the only thing that you can do and you should do it pretty early and in scale. For a country like ours, where we have done some fiscal easing—at least, in 2009 and 2010—and where we have a very large budget deficit and a quite high debt ratio, I am not a great enthusiast for dealing with this balance sheet issue mainly or solely through fiscal policy. The monetary policy that we have pursued has been better at dealing with this issue than many other people think. I don’t think it has been a complete failure by any means. On the whole, it has been moderately successful at dealing with a really big problem.

***Roger Farmer***: If I may jump in, I agree with a great deal of what Gavyn just said. In particular, I would like to come to the fiscal issue, and relate it to the debt overhang. The notion that we need a very large fiscal stimulus now to get out of this crisis, and that is what Japan needs, is being widely voiced. If you were to ask the question, “Would a massive increase in the size of Government spending get us out of this recession and get people back to work?” I think the answer is: absolutely, yes. But it is much easier to increase the size of Government than it is to reduce it. If you take the comparison with how the US got out of the Great Depression, there was an increase in the size of Government, from around about 15% before World War II. The Government was basically running 50% of the economy in the middle of World War II, and when the size of Government shrank at the end it did not come back down to 15%. It came back down to something like 22% or 23%, or 30% if you also throw in welfare and transfer programmes.

The way that that fiscal stimulus was supposed to be working was through the Keynesian theory of the multiplier. That said that if you get people spending, more people will have jobs. As their income goes up, they will spend more, consumption will go up and there will be a virtuous cycle. I believe the problem with that view is—one of the things we learned in the post-war period—that consumption spending depends not so much on income but on wealth very broadly defined, including expectations of future wealth. At the moment, there is an enormous amount of debate in economics over not a particularly stellar amount of data, but my reading of those facts is that, to the extent that there is a spending multiplier, it is probably less than one.

A lot of the evidence is that the private sector shrinks when Government increases. That is certainly what happened in World War II, although there may have been other causes for that. If you put all those pieces together, and to tie this back to the debt deleveraging, what we saw was an enormous collapse in wealth, post-the Lehman Brothers collapse, and that drop in wealth led to a drop in consumption spending. I believe the additional uncertainty also led to a reduction in investment spending. We are now left with an economy that, when it was running at full employment, could easily have maintained the level of debt that was out there, but now, when the economy is running at half pace, the debt is too much. We can wait for 20 years for that debt to come down, or we can try to get the economy moving in such a way that the amount of debt that is outstanding can be serviced by putting people back to work.

**Q137 Mark Garnier:** Isn’t that a massive punt, though? I completely accept that if your Government has 43% of GDP and you increase your expenditure on the Government by, let us say, 10%, then you are going to get what amounts to a 4% or 5% increase potentially in GDP over that period, just as it comes through one to one. I do not disagree with that. But doesn’t Keynes require that, in order for a Keynesian cycle to work properly, first of all you put money aside when you are the peak of a boom and you recognise that you are at a boom? You put money aside, so you have that money to invest into your Government during the down cycle if you are getting it right.

Notwithstanding that, isn't the other colossal risk that is facing us that, if you have this huge Keynesian stimulus and if you say, "Okay, we are running a big budget deficit, but we will increase that budget deficit; we will increase debt hugely in order to go in and spend more money on the economy", you then run a very, very significant risk of future downgrades, of an increase in the yields we have to pay in the bond market? That currently remains at 163 basis points, which is the lowest I have seen it go, but that could easily go up. Not only would that then completely stifle Government spending because, of course, with this very, very high level of Government debt it is costing you more to issue the increase in debt; much more importantly, the social impact of doing that would be to run a locomotive through households, smashing them to pieces with this very high level of debt. £1.47 trillion worth of this debt is a very, very large amount. It is at super-low interest rates at the moment, so households are now used to this low-interest rate environment. We have a very, very dubious property market. Not many people that we see coming before us genuinely believe that the property market is worth what it is, so people don't necessarily have that feeling of being wealthy, and a lot of the boom we saw was people feeling their wealth was increasing as their property was going up, so they were mortgaging more. Of the £1.47 trillion worth of household debt, £1.2 is in mortgages but, of that, 40% is on interest-only mortgages, so there is no repayment plan.

**Chair:** I was just wondering whether you were working up to a question.

**Mark Garnier:** I am working up to a question.

**Chair:** It was just an idle thought of mine.

**Mark Garnier:** I have got this off the chest. This is the key point. The key question is: if you increase the size of Government, is the risk to households an unacceptably high risk?

***Roger Farmer***: Yes. You may have misunderstood the point I was trying to make. I am totally opposed to a massive fiscal increase of the size that would be needed in order to restore full employment, partly because of the reasons you are discussing and partly because I believe it would lead to a permanent increase in the size of Government that may be difficult to remove in the future.

I do believe that the problem is demand-driven. I believe that there are not enough people out there buying things, and there are not enough people out there buying things because there are not enough people employed earning the money to do it. Where I differ with Keynes is that we have had new facts since World War II, and those facts have to do with the determinants of consumption spending. The determinants of consumption spending, which we learned in the 1950s with the work of Milton Friedman, have a lot more to do with wealth than they do with income. The problem is in the financial markets. It was a collapse in the value of paper assets in the financial markets. While the value of those paper assets stay down, people will not be working in order to generate the income to generate the return to the financial assets. So, the problem is in the financial markets; I believe the solution is in the financial markets.

**Q138 Chair:** Mr King wanted to come in at several points. Perhaps I will give him a quick question, and then he can say whatever he wanted to say. Do you think fiscal policy is about right, too tight or too loose?

***Stephen King***: I think we expect too much of policy in general, if I can put it that way.

**Chair:** Have another go. That wasn't the question.

***Stephen King***: I would not be an advocate of loosening fiscal policy significantly from where we are currently. I think there are some—

**Chair:** So it is about right?

***Stephen King***: About right. There are some reasonable arguments in favour of doing specific infrastructure spending, and perhaps redistributing the source of spending towards infrastructure and capital.

**Q139 Chair:** I am going to come straight back to you, because we have been around that circuit already once. What is your answer to the question, Mr Davies? You have had more time to think about it.

***Gavyn Davies***: Yes, I have. I am going to go for about right as well.

**Q140 Chair:** That is good. Mr Farmer?

***Gavyn Davies***: Can I just add one thing?

**Chair:** Only if you have to.

***Gavyn Davies***: One thing, and I do have to: it is about right as long as we really can do more on the monetary side when inflation permits.

**Chair:** Can we do more on the monetary side?

***Gavyn Davies***: Yes.

**Q141 Chair:** Yes. All right, so the answer does not need amplification. Mr Farmer.

***Roger Farmer***: Broadly speaking, I am in agreement with both of those positions. Can we do more on the monetary side? I would say—

**Q142 Chair:** That was not the question. Mr King, you have the floor.

***Stephen King***: Thank you very much, Chairman. Just a few comments that go back to Roger Farmer’s remarks about wealth effects; I think there is something that is rather peculiar about the UK experience in recent years, and it is comes back to your question about deleveraging within the household sector. There has been a very significant redistributional effect that has come through from QE. If you happen to be financially asset-rich, you have done very well from QE. If you are someone who depends on a nominal wage and have not much in the way of financial assets, arguably, you have done worse from QE, to the extent that the fall in the exchange rate anticipated QE and may have been locked in by the impact of subsequent QE. The consequence of that has been that real wages have been hit very hard over the course of the last few years, probably the biggest squeeze we have seen since the 1920s. If it is the case that you want households to deleverage, it is much more difficult to do it if your real incomes are coming under constant pressure, so I think there is a distributional aspect that is important to mention.

The second factor on the fiscal position—and this goes back to what fiscal position we were in before the crisis struck. I want to emphasise here the difference between where we are today and where Roosevelt was when he came in, in 1932 or 1933. The deficit in the US under Hoover was about 2% of GDP and it rose to 9% of GDP by 1935 or 1936, so it was clearly a very significant fiscal stimulus, but the starting point was fundamentally different from where we are currently.

The final comment is this: I think there is a potential trap with QE—and this comes back to the issue of Japan and Richard Koo’s thesis—which is that if it is the case that as a consequence of continuous fiscal stimulus there is perceived to be, whether rightly or wrongly, a risk of subsequently higher bond yields, it make it very difficult then to exit from QE. If you believe that QE is the reason why bond yields are kept under control during a period of fiscal stimulus, if the fiscal stimulus doesn’t work very well, which really was the story in Japan over the last 10 to 20 years, then can you ever exit from a model that basically gives you continuously low interest rates and continuously expanding budget deficit? In Japan’s case, in one sense it is fairly clear there is a kind of trap there. The only difference is that in Japan, because they have had deflation, real rates are a bit higher than you would like, but overall I would say that there is a concern that if you persist with QE and it allows Governments to justify further Government borrowing as a consequence of QE, they are never ever really faced with the market consequences of that Government borrowing.

**Q143 Chair:** That is extremely interesting. Have you read the CBR's view about the relationship between long-run borrowing costs and the possible fiscal stimulus?

***Stephen King***: I have read a number of views. I am not sure if I have read that particular one, but—

**Chair:** We are very interested to have your view on that as well, if you are prepared to give us that in due course.

**Q144 Jesse Norman:** Mr Davies, when QE was originally announced, there was a lot of hot air from different economists and analysts suggesting this was going to lead to hyper-inflation. Why hasn't that happened?

***Gavyn Davies***: I think it was the wrong inflation mechanism, which many people had in their minds. The inflation mechanism that some people definitely had in their minds was from the monetary base, narrow money, to broad money, and from broad money to prices. Each of those links turned out to not apply in these circumstances. To be fair to them, the central bankers did not expect those links to apply. So, when they increased the size of their balance sheets, they did not increase their inflation forecasts anything like commensurate with that, and they turned out to be right. Looking back on this, I guess the reason was that the demand for liquidity by the banks, and by other people in the economy, at that time was so great that accommodating that demand for liquidity at the central bank did not have the consequences for broad money and for inflation that we would more normally have been accustomed to.

Mr Norman, I believe that if we keep our central bank balance sheet as big as this, and we do not exit at the appropriate moment, we will still see the inflation that the monetary base expansion may produce. I believe that we have to see the central bank balance sheet increase as temporary and connected to an increase in the demand for liquidity, which one day may reverse, and, as that happens, we have to reverse the QE.

**Q145 Jesse Norman:** So, once the private sector gets to the end of the process of deleveraging and starts to split up the source of funds, you might expect to see a parallel kick in inflation if there is not?

***Gavyn Davies***: Yes. I would expect to see the central banks then exit, and I think that will be politically tricky. I don't think it is going to be as easy—

**Q146 Jesse Norman:** Why is that?

***Gavyn Davies***: The exit will mean a couple of things. It will mean selling Government bonds back to private asset holders, at a time when the Government is also selling probably newly-printed Government bonds at the same time. You can see that the Government may not be too thrilled when the central bank says, "We have to reverse this, and we may be selling more bonds in the next 12 months than HM Treasury is selling in order to reverse QE". You can see that that could be tricky.

Secondly, and I think Stephen was alluding to this earlier on Japan, to the extent that our financial system is exposed to bond risk, the exit process that must push bond yields higher through time is potentially going to cause trouble for our financial system. If it is done at an appropriate pace, and is expected in advance and so on, it probably can be handled. But you can see how a process which damages the financial system and makes it harder for the Treasury to sell gilts is going to be politically trickier than the reverse process.

**Q147 Jesse Norman:** So, you have a gilt market potentially under those constraints, with a lot of new supply and yields potentially having to go up quite quickly in order to keep bidders at the table?

***Gavyn Davies***: Yes. The good news is that the demand for those gilts should also be going up as the banks and other financial institutions reduce their holdings of cash at the central bank. Technically, you can certainly produce a path for the exit that looks just like reversing the entry and doesn't cause any trouble whatsoever. But I just feel life is not really like that, and this entry will prove to be a lot more palatable to our Government than the exit will be.

**Q148 Jesse Norman:** Thank you for that. Mr King, obviously QE is emergency therapy. It came in, in response to the prospect of imminent or potential deflation. That was the original guiding political rationale for it. Just developing some of the thoughts that you were hinting at earlier, do you think there is any evidence that it could have depressive effects on spending and, therefore, on consumption because of the anticipation of long-term uncertainty, a protracted recession with real wages already being stagnant?

***Stephen King***: I would argue that, on a cost-benefit analysis, policymakers have generally focused entirely on the benefits and have chosen to push to one side some of the costs that may be coming through as a consequence of a sustained adherence to QE. To continue with the medical comparisons, I would suggest that perhaps at first QE was seen to be an antibiotic. It is now more of a painkiller. It does not actually cure the problem. It makes it easier to live with the problem that has accumulated.

There are a whole host of issues that I think at least have distributional effects on the economy. I have already mentioned the issue of the squeeze in real wages, associated with a softer currency, the fact that those who are financially asset-rich do quite well, so it is distributional impact from that perspective that may have a negative consequence to the economy if you assume that the marginal propensity to consume of those on wage income is higher than the marginal propensity to consume of those who are very much more dependent on financial assets. I think there is an empirical question to answer.

There is the issue of the impact on under-funded pensions, which is a familiar issue, of course, by now. I don't think that was being talked about very much when QE was first adopted. It is important to stress here that QE is not the cause of larger pension deficits in itself, but QE may make those deficits still larger, as a consequence of the impact on the net present value of the future liabilities of the pension fund relative to the impact on the assets. To the extent that that leads to changes in behaviour from other institutions or individuals, then that may have a negative effect on the economy. For example, if a company, which in normal circumstances might use its profits to invest in physical capacity, chooses instead to put some of that money aside to plug into its pension fund, it basically implies an increase in corporate saving. For households, it is clear that there is a shift away from DB schemes to DC schemes, or some other kind of reduction in pension entitlements. Again, that may increase household saving to a certain extent.

You have the rather bizarre situation in some local authorities, or particularly US state governments, whereby the legal protection for pensions, and the widening of pension deficits as a consequence of QE, for example, has led to teachers being let go to fund the pensions of retired or soon to be retired teachers, which is a strange allocation of resources.

I also add to this the fact that, on a global level, I think one of the unexpected consequences of QE was a sustained increase in commodity prices. That was not just that people thought they should invest in commodities because money was increasingly unsafe, but also because the parts of the world that were not deleveraging quite so heavily were those in the emerging world, which just so happened to have a disproportionately high demand for commodities. So, as QE led to a rotation of global growth away from the West towards the rest, I think it led to a change in relative prices, which may have contributed to a further squeeze in real incomes in the West.

**Q149 Jesse Norman:** That is a very interesting and long reply. Picking out a couple of elements to it, you are agreeing that there may be depressive effects on the other side of the stimulative effects, and that these have been somewhat underplayed.

***Stephen King***: Yes.

**Q150 Jesse Norman:** Among the other things you have pointed to, you are pointing to a particular impact on those at the bottom half of the income spectrum whose real wages cease to rise. I am slightly adding words, but I think it is in line with what you are suggesting, because real wages really ceased to go up after about 2004 or 2005. Therefore, you are picking on particular sets or groups of people who happen to drop into, for example, annuities during the QE period and have, therefore, almost by accident found their incomes significantly lower, and some of them will have wealth effects compensating. I do not think I am putting words into your mouth. Those were all aspects.

***Stephen King***: No.

**Q151 Jesse Norman:** Thank you for that. What we have here, then, is a policy that is essentially emergency treatment but becoming a painkiller. We have a policy that—as Mr King suggested earlier—has the effect of ignoring or leaving out small- and medium-sized enterprises. You have a policy that is known to be stimulative of inflation, up to a point. You have one that has redistributional effects that we are only discovering, but which are clearly marked to certain segments of the population, and it appears somewhat addictive. Is that a fair summary of some of the drawbacks to this policy, against which the bank has to make a decision about its overall value? Let me start with you, Mr King.

***Stephen King***: Given that you have paraphrased what I have just said, I think it is a fair summary, yes.

**Q152 Jesse Norman:** If I may suggest, I think there are elements that have been added: the point about inflation; and the emergency treatment, the change in the politics from that of emergency to that of "steady as you go". You are accepting that. Can I ask Mr Farmer?

***Roger Farmer***: Again, can I hop in there? I believe we are moving in some way to think about exit strategies. The notion of a painkiller suggests that we may never be exiting. I think what many central bankers have been hoping for is that the stimulative effects would have come in faster and the economy would be growing by now.

**Q153 Jesse Norman:** But you are not demurring from the description that I have just given?

***Roger Farmer***: No, but let me add something. I think it is interesting to ask the question: what would happen if we were to try to withdraw from QE right now by raising interest rates right now? The immediate impact of that would be to depress wealth and to make the level of real economic activity depressed, which is why people are not doing it. However, once you recognise that there are two dimensions to this policy—one is the monetary aspect we have been talking about, inflation, the size of the balance sheet and nominal rates; and the other is relative asset prices, which we have now learned can be independently targeted through changing the risk composition of the balance sheet—it becomes possible to think about exiting sooner, while at the same time ameliorating the potential downside of raising rates, by active intervention on the risk composition of the balance sheet. I think that is something that is a really interesting idea to think about going forward.

**Q154 Jesse Norman:** That is helpful. Mr Davies, do you want to add anything to that?

***Gavyn Davies***: Yes, Mr Norman. I did not disagree with any element on your list, but I think it is important to point out that there is an alternative list of benefits—

**Jesse Norman:** Yes, of course.

***Gavyn Davies***: —which in my opinion have probably dominated the list of disadvantages so far. Those include that the policy has reduced interest rates and made it easier for debtors to cope with their debt. It has increased asset prices, which has been an enormously important part of the recovery in the United States, I would argue, and to some extent here as well, and it has brought forward spending. The Mervyn King example about intertemporal substitution, meaning with interest rates lower we have a tendency to bring forward spending from the future: as Mervyn has said, that is a good thing as long as you think there will be some spending in the future to cope when you get there. He is saying now, of course, that may not be so clear. But I think all of those things have prevented what could have been an enormously worse situation. We must really remember this. In some ways, this is an example of policy succeeding not failing, because it has prevented something worse from happening.

**Q155 Jesse Norman:** I suspect there will be widespread agreement with that, but just with a concluding question, though, picking up that point. The issue—that I and I suspect the Committee certainly are going to focus on—is not so much whether or not the original rationale was well grounded but whether it should be continued and, if so, on what terms. So, the question I want to end with finally, which picks up the point you mention, Mr Davies, is the one thing we have seen obviously is a flattened yield curve that, in a sense, deliberately artificially distorts investment horizons. There is a sense in which QE has suspended the business cycle in part, because natural processes of working through have not taken place in the environment of ultra-low interest rates. Therefore, do you think in some sense QE may now be slowing down recovery?

***Gavyn Davies***: I don’t think it is slowing down recovery, but it may well be dampening some of the natural market effects that we normally expect to happen. On the whole, being a supporter of markets most of the time, under most circumstances, I do regret that, but I don’t think it is slowing down recovery, no.

**Q156 Jesse Norman:** That is helpful. Could I just ask—

**Chair:** Very quickly.

**Jesse Norman:** —because it is a rather crucial question: is there an effect, either now or potentially on the horizon, of it slowing down recovery?

**Chair:** Just a quick reply if you can manage it.

***Stephen King***: I worry about the possibility of zombie companies, companies that perhaps should not survive that do survive. As a consequence, the profitability of other companies is lower or alternatively other companies cannot get finance in the first place.

**Jesse Norman:** Thank you.

**Q157 Mr Mudie:** One of the things that I was surprised at in your evidence is the recent answer that you are all satisfied with fiscal policy. As I see fiscal policy, the debt is growing. The deficit is staying at the higher level, and it is going to be at that level for three years. The deficit is 50% higher than the Chancellor said it would be this financial year. I can't remember where you got the reference to recovery. It is hard to see where there is a recovery. All that amounts to is the strain goes on to monetary policy, which you are suggesting. The conventional wisdom and the conventional wise man, the Governor of the Bank of England, say monetary policy cannot take that strain. Can you give me a response to that?

***Roger Farmer***: With respect to fiscal policy, there are two ways of thinking about how fiscal policy has helped ameliorate business cycle volatility since World War II. One is what we think of as automatic—

**Q158 Mr Mudie:** We are stuck for time. Can we just do fiscal policy from 2008, say?

***Roger Farmer***: From—

**Mr Mudie:** 2008.

***Roger Farmer***: Yes. There is an automatic component of fiscal policy, and much of the increase in the deficit that we have seen has been the consequence of the drop in tax revenues coming from the fall in economic activity. Then there is the question about whether you respond to those deficits by austerity, by lowering spending, by trying to raise taxes. There is a sense in which that is defeatist, in the sense that I think there is a danger that you might recognise lower growth and higher unemployment as a new normal.

To the second part of your question about are we trying to put too much of a burden on monetary policy, I would say very much so. On traditional monetary policy, the answer to that question is yes, but I don't think that we should be looking through the same glasses as our ancestors. There is an opportunity here to think about a different way of conducting fiscal policy in the future, and that is the second dimension of what I call qualitative easing, acting on the risk composition of the consolidated balance sheet of the Government.

***Gavyn Davies***: Mr Mudie, may I add something on this, because over the last four years, generally speaking, I have thought we should have a medium-term programme for fiscal consolidation with pretty aggressive monetary easing. So, in my own mind, I have not been very far away from the policy that we have pursued. Over the last couple of years, I would say that the evidence has not been exactly supportive of my prior beliefs in a couple of ways. I think monetary policy has turned out to be harder and to have more defects than I perhaps expected, and the Keynesian multiplier has turned out to be higher than I thought it would be, too. We have evidence from other countries that the risks of a financial crisis, coming from our high-rate of borrowing, are perhaps less than I thought.

I understand where you are coming from. However, I haven't changed my basic posture, which is that when we are running a deficit, which was over 10% of GDP with a debt ratio of 80% or 90% of GDP in the forecast, some form of medium-term fiscal consolidation was necessary. Whether we timed it correctly, I am not so sure. I would say this: that when I look at the alternative proposals that are being made by others in the political system and in the economic fraternity—the Paul Krugmans and others—they tend to be not really dramatically different on fiscal policy; not different enough to really change the path of the economy dramatically. I think if we made a fiscal change of that size, I wouldn't like to predict that all of the stuff I have said so far will continue to apply.

**Q159 Mr Mudie:** I think if we go to the extreme, yes, I would agree with you. But are you all telling me that some fiscal stimulus spelled out, if we did not have plan A and we did not have a loss of political face and we were saying, "Look, that has run for three years now and the results are pretty bad", Mr King, do you not think if we had a fiscal policy and a monetary policy working together, with an aim to get the economy going, some stimulus, getting people back into work and so on, with other things—except I am not saying this is the only answer—the market would be that frightened of a change of policy?

***Stephen King***: I think the honest answer is we don't know for definite. There are two sources of concern. The one that I think people tend to focus on is probably the wrong thing. That is the idea that somehow, as a consequence of fiscal stimulus, there will be a sudden spike in gilt yields, which is the southern European model. That isn't going to happen.

**Mr Mudie:** Yes. I am thinking more in confidence terms.

***Stephen King***: I understand that. But the other financial market reaction is possibly on the currency rather than on the gilt yield. I would argue that, if you have a fiscal authority with an independent central bank that can work together, if there is a significant fiscal stimulus associated with significant monetary stimulus, the risk is not the gilt yield but it is the possibility of sterling falling quite a long way. That comes back to some of the difficulties we have seen over the last three or four years. Can we guarantee that the fall in sterling is a good thing for the economy or, as it has turned out in recent times, a more questionable thing for the economy? So, I think that is an issue that is worth noting.

***Gavyn Davies***: Could I add to what Stephen has said?

**Q160 Mr Mudie:** But also when it falls, as it did, and there is no corresponding rise in exports, it tells us something about the urgent need to rebalance the economy, doesn't it?

***Stephen King***: It tells us something about the structural supply-side performance of the economy. If that is weak, it does not matter what you do with macro policy; you still have a problem. In one sense, I think that is the difficulty that Japan has faced. It has had these periods of stimulus and, focusing purely on macroeconomic policy, people have said, "Don't worry, it is going to be all okay", and it hasn't been.

One other thing, I mentioned before this idea that the US budget deficit was very small in 1932. I think it is important to stress how much fiscal positions had deteriorated before the onset of the financial crisis. The amount of fiscal stimulus already in the bag, say, between 1999 and 2005. We should not forget that in 2001 and 2002 at the time when the dotcom bubble had burst and when there was 9/11 and so on, there was a terrible panic among policymakers we could be facing a Japan-style lost decade. So the consequence was we had a huge amount of monetary and fiscal stimulus. In hindsight, I would argue that some of that stimulus actually contributed to the bubbles that subsequently led to the difficulties we are now living through today. There is a risk, in terms of stimulus that actually creates distortions that makes life more difficult rather than less difficult over the medium term.

***Gavyn Davies***: Mr Mudie, the other thing I would like to add—and I understand the frustration that we keep telling you there are difficulties with solutions—is we need to be aware of and worried about what is called fiscal dominance over the central bank. At the moment, I think we are probably monetising about half of our budget deficit. That is roughly right, isn't it, Stephen? If we were to really change the fiscal stance, in a way that would change the path for output in the near term—and I think it would boost output in the near term—the pressure on the central bank to buy those gilts would be enormous. I bet you we would end up monetising a bigger proportion of our budget deficit.

The first thing I did in Government in the 1970s was I was sitting in No. 10 and observed the rising inflation to 26% in the UK in 1975. No one saw that coming; no one. When I arrived in No. 10, in March 1974, I think the Treasury forecast for inflation a year later was 9% and the outturn was 26%. What I am saying is I have lived through a very big inflation; I know how long it took to reverse.

**Q161 Mr Mudie:** Gavyn, we had the situation then where wages were automatically updated with inflation. It was just madness.

***Gavyn Davies***: And commodity prices.

**Mr Mudie:** We are far from that.

***Gavyn Davies***: We are absolutely far from it, but please don't let us go back in that direction.

**Q162 Mr Mudie:** No, nobody wants to go back to that. If you are all saying this about fiscal stimulus then on monetary stimulus—and it seems to be a consensus again that it is diminishing returns and so on—if we are looking at other monetary initiatives, can you each suggest one separate one because we had the Monetary Policy Committee before us about a month ago; they are bereft of ideas as well as ambition.

***Gavyn Davies***: There are at least three options, none of which I currently recommend.

**Mr Mudie:** Tell us what you recommend.

***Gavyn Davies***: I recommend the Funding for Lending Scheme being increased, and I recommend sorting out the problem in the banking sector.

**Q163 Chair:** Just give us the three you do not recommend.

***Gavyn Davies***: The three I don't recommend—and I don't recommend them because of inflation, Chairman—are we could buy foreign exchange and set an exchange rate target. I also don't recommend that for reasons Stephen said. Secondly, we could do helicopter money as suggested by Adair Turner; we could monetise an increase in the budget deficit. Thirdly, we could buy equities, which is what Roger says. We are not out of options, but whether we should pursue them is a completely different matter at this point.

**Q164 Mr Mudie:** Stephen, what is the one thing you would do, not the things you would not do?

***Stephen King***: I would offer more help to SMEs through the Funding for Lending Scheme.

***Roger Farmer***: I would set up a sovereign wealth fund that was paid for by issuing debt. I would create an index fund in the stock market, and I would work against financial volatility, which I think has been the cause of this crisis.

**Q165 Mr Mudie:** In view of your answers, positive answers, are any of you interested in being nominated for the Monetary Policy Committee?

***Gavyn Davies***: No, too busy.

**Q166 Chair:** Mr Farmer, you haven't had a fair crack of the whip there in the last quarter of an hour; do you have some points you want to add more widely? I noticed you flinching a little.

***Roger Farmer***: I would simply re-stress the single point I have been trying to make through all of this, which is that there are different ways of thinking about fiscal policy other than purely a spending programme. The Bank of England has been criticised by some for moving into fiscal territory; I think there is a sense in which buying risky assets is moving into fiscal territory. Moving forward we should recognise that not only is it moving into fiscal territory but that an alternative to discretionary fiscal policy would be to recognise that the immense financial volatility, which we see in the financial markets, is dangerous. It is not efficient. It is something that a co-ordinated Treasury/Bank policy could potentially reduce, with the goal of attempting to prevent the deleterious effects of financial crises.

I would add one piece to that. The reason I think that financial markets are not doing the job that as economists we think they should be doing, is that almost all of the people who are adversely affected by financial crises are not yet born. They are our children and our grandchildren. School leavers, whose first job occurs in a boom, can be 15% or 20% better off than their peers whose first job occurs in a recession. I believe the reason for that is that those people—our children and our grandchildren—are unable to participate in the financial markets that would smooth out those fluctuations if they are were able to. I think there is a real failure here of markets, and it is one of the very few instances where there is a potential role for Government to help out.

**Q167 Chair:** I am going to bring John Thurso in in just a moment. But there was something Gavyn Davies said a moment ago about inflation, which, for those of us who are old enough to remember those days, rings true—do you think that any of the flexibility that is being put into the remit carries risks of that type?

***Gavyn Davies***: It carries some risks, Chairman. However, I am happy, as long as the MPC is left to be independent and the independent judge of how to operate under the remit.

**Q168 Chair:** But are they being left independent, or is this the beginning of political interference?

***Gavyn Davies***: There are one or two little signs like, for example, the exchange of letters that can now take place between the Monetary Policy Committee's decision and the publication of the minutes. We may now see Governor-to-Chancellor and Chancellor-to-Governor letters in that period. But, let's face it, the mandate is the Treasury's to set, and in my view they are democratically entitled to do that.

**Q169 Chair:** That is a different point. That is the legitimacy of it; I am asking you about the effect of it.

***Gavyn Davies***: Yes. As long as the MPC is really independent and allowed independently to set policy, subject to the mandate, then I am happy.

**Q170 John Thurso:** In the Chairman's opening comments, he said there were only four questions around this policy, the fourth of which was the exit strategy. That is basically what I want to ask about. Before I do that, can I come quickly to you, Gavyn, and ask you about something you said earlier regarding the banks. You particularly drew attention to the difference between the US recovery and the UK one, and singled out the fact that the US authorities had been more realistic and tougher in sorting out the bad debts. This very much mirrors evidence that was given to us by Adam Posen, both on the Committee and on the Banking Standards Commission, where he said that the fact that we had not sorted out our banks in this country to the same degree was a bigger drag. At the moment, the thinking is that we could do something by looking at the state-owned banks, particularly RBS, and creating a bad bank/good bank scenario. Would that be something that you would therefore favour?

***Gavyn Davies***: I would favour exploring that, Mr Thurso. I don't feel myself to be sufficiently expert to tell you it is the right thing to do, but I do listen to what the outgoing Governor has to say. I think it is a little bit fashionable nowadays to ignore him because he is the outgoing Governor, and to spend all out time looking at the incoming Governor, which is an understandable human-being reaction. But perhaps we should listen to him, because he is now free to say what he thinks. I am impressed by what he is saying on the banks at the moment.

**Q171 John Thurso:** Thank you. Can I just go one further? At the moment the thought is around obviously those banks that have been semi-nationalised. However, is there also a problem in the other banks that are not owned by the state and some mechanism should be developed to offer them the ability to get rid of their bad assets? Bearing in mind that what you said was the American experience was once the state said it would do it if nobody else would, the private sector did it.

***Gavyn Davies***: I think personally that the private sector is capable of doing almost all of this itself, as the Governor has said. I would also think it likely that, because the two big publicly owned banks were in such trouble that we had to take them over into the public sector, that is probably where the biggest problems lie.

**Q172 John Thurso:** Thank you. Let me come to you, Roger Farmer, first, if I may. Hopefully one day we will arrive at the happy point where we can unwind QE. There are clearly a number of issues around that. Nobody has ever done it before. Timing and method come to mind. What would be your concerns and/or advice?

***Roger Farmer***: There is clearly an issue about what is sold off and when it is sold off. There are a number of ways of ensuring that QE is unwound, without generating a large potential increase in the size of not just the monetary base but the broader measures of the money supply. One way of doing that is to continue paying interest on reserves as the monetary base is unwound. The other is to sell off long-term gilts into the market. I think the concern is precisely that the current very large size of liquidity in reserves leaks out into an increase in domestic credit. I am not particularly concerned. I have looked at the statements that have been made by both the Fed and the Bank of England on how they would propose to unwind the policy. I don't see any particular difficulties with any of the strategies that have been laid out, either by the Bank of England or by the Fed.

**Q173 John Thurso:** In your view, to what extent is it one of the most important points that—as you have just said—there is credibility that it will be unwound? In other words, if anybody for a moment thought that they might not, that would almost be a bigger problem than the method by which you choose.

***Roger Farmer***: I agree with that completely, yes. There is a very real element in determining the effects of monetary policy, of expectations of what the money supply will be in the future, so yes. I think that is the whole point of maintaining credibility of an anti-inflationary regime.

**Q174 John Thurso:** Stephen King, can I put the same question; concerns or advice?

***Stephen King***: First of all, I would like to say I think it will be a long way ahead before we start to exit from QE, because I suspect that the growth rates we are going to experience over the next two or three years will remain pretty weak. The combination of a monetary policy with both costs and benefits, alongside the lack of any kind of obvious fiscal stimulus, will effectively lock in low growth. I can't see any easy way out of the current process of adopting QE, because there is nothing else available.

The obvious concerns include consequences for the financial system if there was to be an unruly, undesirable spike in gilt yields. If you look at the IMF's Global Financial Stability Review, which came out the other week, there is a chapter in there talking about exiting from QE. While they did not talk so much about the UK, they did talk about the fact that, in general, banks hold a large amount of government paper that might leave them vulnerable in the event of a sudden rise in yield. They make most of their comments about Japanese banks, particularly Japanese regional banks. So, I think the disorderly aspect of it is worrisome.

The other aspect I would say is this—going back to my earlier comments about financial assets in general—I would say across a whole range of different asset classes globally, investors are increasingly buying stuff, not because there is necessarily a lack of risk but rather because they are desperate for returns. A search for yield that has come back, which we last saw prior to the financial crisis—that desperate search for yield is all very well, but, of course, if you then turn the tap off, then the risk factors become more important, and at that point you may get some financial disruption. We should not lose sight of the fact that a whole range of different asset classes may be increasingly influenced not by economic reality but by the simple fact that the central bank is constantly providing extra, almost free, money.

**Q175 John Thurso:** You said something interesting at the Centre for Policy Studies' lunch, "The health of the banks appears to be critically important to enabling a recovery. The irony is that QE is masking a weak banking sector and attempting to exit QE may lead to a round of bank failures". How much do you feel that is a danger that we should be concerned about?

***Stephen King***: Of course, if you were a sensible policymaker, you would not exit QE until you felt that there was no risk of a bank failure. But that creates a trap of staying in QE for longer than might otherwise be the case. It is important to stress that my remarks are not focused specifically on the UK banks; they focused on QE in general. It goes back to the IMF report that came out a month or so ago. The only other thing I would note is that QE has made banking business itself more difficult, in some ways, because banks often make their money through a positively sloped yield curve, and that has not been the case as a consequence of QE. Of course, one argument in favour of exiting is that if the yield curve becomes more positive again, that is helpful for banks, but at the same time I would suggest that the potential losses built into the exit from QE might be sufficiently large to create financial disturbances more generally.

**Q176 John Thurso:** Can I come to you last; the same question?

***Gavyn Davies***: Yes, Mr Thurso; thank you. The one thing I would like to add is this risk of fiscal dominance again. Olivier Blanchard, the Chief Economist at the IMF, published a paper last week on the future of macro policy; pretty interesting, actually. It showed how uncertain all of this is. But on this particular subject of the exit, the thing he said and warned about is this: that as we entered QE, from the Governments' perspective, it was very easy to allow central banks to be independent because they independently chose to do exactly what Governments would have preferred anyway. I think Stephen has written about this in the *FT* as well. When the exit comes around, independent central banks may choose to do things that Governments do not like. At that point it becomes much more probable, I think, that Governments will seek to direct their central banks. We came extremely close to that in Japan. If we didn't cross the border, they were right on the border of fiscal dominance over their central bank. My fear is that all of the gains we have had from independent central banking could come under threat if the exit process is long and difficult, which I think it will be.

**Q177 John Thurso:** What you are saying is the unintended consequence is not around financial policy as much as it is around a re-politicising of central banking?

***Gavyn Davies***: I am getting a little worried about the politicising of central banking. It is coming from the overload of the burden that has been put on them, forcing them into an arena that should be for politicians, and not allowing them to pursue the exit in the technical way that Roger says is feasible—which I completely agree with—but is not as politically easy as the entry.

***Stephen King***: If I could just add that the language of central banking is increasingly about trade-offs. Prior to the financial crisis there were no obvious trade-offs. The idea was that if you delivered price stability and low inflation everything else would naturally fall into place. You can have trade-offs about growth, inflation, financial stability and so on, and it is not difficult to imagine that; because those trade-offs, effectively, are in many ways political choices rather than straightforward technical choices, it is inevitable that politicians will want to take a much bigger role in examining what central banks are up to and perhaps influencing their choices.

***Gavyn Davies***: Mr Thurso, I don't think we are very close to this in the UK. For example, I do not think the coupon transfer was an example of fiscal dominance. I think that became clear in the debate on the subject, including at this Committee. So I don't think we are close, but I don't think we are not in the zone where it becomes a real problem.

**Q178 John Thurso:** But the point you are making, which I think is pretty critical, is that while not close it is a very good time for the debate about where the policy implications lie to be had. So, one of the things that this report should be doing is kicking that debate off, to ensure that the policymakers are thinking about the consequences before they become a reality.

***Gavyn Davies***: It is very clear to me that the Federal Reserve is doing this. If you look at the minutes of the FOMC, last year and again this year, they are clearly thinking carefully about how the exit should be handled. I am sure we are doing the same thing, but it is not quite as visible to me.

***Roger Farmer***: Mr Thurso, if I might add, it is often thought that the exit from quantitative easing would simply mean a return to business as usual in what was happening in the period, say, after 1980 in the western world. I would like to continue to add that I think we learned something from the whole exercise. The part of quantitative easing that involved trading in the asset markets I would like to see stripped away from standard monetary policy but not necessarily abandoned once we move back into a more normal monetary regime.

**Q179 John Thurso:** Some of this might become tools in actual financial stability rather than—

***Roger Farmer***: That is exactly correct. That is what I would like to see, and I think it should be recognised that that is essentially a fiscal operation as opposed to a monetary operation.

**Q180 Mr Ruffley:** Gentlemen, I have enjoyed your evidence very much. I just have one or two sweeping-up points. First of all, Mr Davies, you talked about the list of monetary actions that you would not want to see. I wonder would you add to that list something that Paul Tucker referenced, which was negative interest rates, penalties for banks holding cash at the central bank. If you think it is a bad idea, why?

***Gavyn Davies***: I think it is a small idea, and, therefore, I am not particularly hyped about it in either direction, Mr Ruffley. It might move interest rates 0.25% to 0.5% maximum, with a whole panoply of new measures needed to achieve that. It may cause more dysfunctionality in the money markets than we see already. That might all be worth it if we could make a big difference, but I don't think that kind of cut in rates will make a very big difference. The FLS scheme—and I know I keep coming back to this—is easy in a sense, but it has made a much bigger difference to banks' funding costs than a small move into negative territory on rates.

**Q181 Mr Ruffley:** But it is not a serious runner, so far as the City is concerned.

***Gavyn Davies***: I think there are some supporters, but I haven't seen it being seen as a big solution.

**Q182 Mr Ruffley:** The second point is on FLS, and this is to confirm something that I suspect. I presume there is no technical problem to ensure that the banks lend to SMEs rather than, as it appears at the moment, skewing their lending to residential mortgages on the grounds that it is less risky.

***Gavyn Davies***: Defining SMEs may not be straightforward. People may masquerade as SMEs if they believe that they are going to get a better deal from the bank. It is the same with all control mechanisms; people try to get around them. But it should be doable to a degree. One of the ways I think the Government is considering is to make the scheme applicable, outside the commercial banking system, to entities that more normally make trade credit lending, invoice credit lending, so probably they are going to have customers that are SMEs. So, I think we can do it to some degree.

**Q183 Mr Ruffley:** Finally, Mr King, there were scenarios played out in Mr Norman's questioning of Mr Davies on exit. I want to give you an alternative scenario, and perhaps all three of you could tell me the answer to the question I will pose. The alternative scenario is that we might want to be exiting when the economy is growing to trend, it is bumping on nicely. That might also be associated with inflation ticking up, and there might be a need to tighten monetary policy. If that be the case, you might expect bond yields to go up, and we might expect gilt prices to be lower; that leaves us in the position where the selling back into the market—the unwinding—is at a loss, because the bank were purchasing at a higher price. That question of loss: does that matter at all?

***Stephen King***: Personally I do not think it does.

**Q184 Mr Ruffley:** I will be precise. Are there any adverse economic consequences of a loss being posted in the scenario I have given? There are lots of different scenarios, but that is certainly one of them and that is one that this Committee put to Mervyn King last year. I just wonder on that specific question, are there any obvious adverse economic impacts of selling at a "loss" in the unwinding?

***Stephen King***: Again, personally, I think there are not huge consequences.

**Q185 Mr Ruffley:** Are there any consequences of an adverse nature?

***Stephen King***: There is certainly a fiscal consequence of it. Gavyn is nodding his head; he wants to add more.

***Gavyn Davies***: The question of whether central banks can run with negative equity, Mr Ruffley, which I think is what you are asking, this is all very opaque to most people in the country, and that may well be a good thing. I think central banks can run with negative equity, but if they get to a point where they are essentially funding their negative equity by more monetary creation, then I think the credibility of the central bank can come under question. I think it is highly improbable, but I think it is not impossible.

**Q186 Mr Ruffley:** You think it is improbable that there would be negative equity?

***Gavyn Davies***: I don't think it is improbable they would have negative equity; I think it is improbable that it would be big enough to cause inflation expectations to rise. Again, the Fed has been discussing this to some degree, and apparently what they are thinking of doing is creating an account that is future seigneurage income. It has not been earned yet, but is there as a plug for any negative equity that takes effect. What that then means is they will give less seigneurage income to the Treasury over time.

***Roger Farmer***: I would add that to the extent that there is an issue it is a political issue. For a period of time, when the Fed and the Bank of England were buying these assets, there had been an enormous transfer, which in the US is automatically returned to the Treasury and here has recently been returned to the Treasury. When the position is unwound there will be a flow in the other direction. One possibility would have been simply to have accumulated that as a balance on the bank's balance sheet. Again, I stress the issue is not so much economic—because I agree with Stephen—it is a political concern that there could be a period of time when there is a flow from the Treasury back to the bank.

***Gavyn Davies***: The power to create money is such a crucial and important power that messing about with it does worry me. I am sorry, but it does worry me. Having a central bank in negative net worth could, under some circumstances, undermine confidence in the currency and in inflation. I could not point you to an example of this, except possibly the Bank of France in the mid-1920s. There aren't many examples of this. It does not mean it is impossible.

***Stephen King***: Could I just come back to the negative interest rate argument? Gavyn has already mentioned that the chances of a negative nominal interest rate having much of an impact is pretty low, but of course the other option is to have a substantially more negative real interest rate. This comes back to the helicopter money story. I think in Adair Turner's speech he was suggesting that helicopter money would not necessarily create inflation, because the output gap was very large. I would disagree with that. I think you can create inflation with a very large output gap if the monetary institution is somehow undermined through the fiscal dominance that Gavyn has already mentioned. A classic example, which is a good kind of inflation, was back in the 1930s where Roosevelt had no difficulty creating inflation, even though the output at the time must have been absolutely massive because, effectively, he adopted a price level target that allowed prices to rise quite rapidly.

So, I worry about the debate about negative rates, not just from a nominal rate perspective but also from a real rate perspective and the implications it carries for monetary instability.

***Roger Farmer***: I would agree completely with that position. I think that the notion of an output gap or a natural rate of unemployment, which is a related concept, is outdated and unhelpful and we could very easily recreate inflation at a time of depressed economic activity.

**Chair:** You have said so many interesting things. I want to pick up several of them, but instead of doing that I think I will just bring the session to an end by thanking you all very much for coming. You come from diverse backgrounds in many respects. We have ranged very widely and, quite remarkably, you appear to agree on almost all issues. This is very helpful for us in one sense, except that, as we know, when three economists agree they are usually all wrong. We hope that isn't the case with your evidence. Thank you very much.