House of Commons
Treasury Committee

Bank of England May 2013 Inflation Report

Oral and written evidence

Tuesday 25 June 2013

Sir Mervyn King, Governor, Spencer Dale, Executive Director and Chief Economist, Dr Ben Broadbent and Dr Martin Weale CBE, External Members of the Monetary Policy Committee, Bank of England

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The Treasury Committee

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

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Oral evidence

Taken before the Treasury Committee

on Tuesday 25 June 2013

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
John Mann
Mr Pat McFadden
Mr Brooks Newmark
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Sir Mervyn King**, Governor, Bank of England, **Spencer Dale**, Executive Director and Chief Economist, Bank of England, **Dr Ben Broadbent**, external member, Monetary Policy Committee, Bank of England, and **Dr Martin Weale CBE**, external member, Monetary Policy Committee, Bank of England, gave evidence.

Q1 Chair: Governor, thank you very much for coming to see us this morning. This is your last appearance before us and I will say a bit more about that at the end. We have always appreciated the very full and open dialogue and constructive engagement you have had with Parliament over the years. You have certainly always said what you think, which can sometimes be a scarce commodity in public life, and we have all benefited from that. Of course, the announcement has been made that you are shortly to become one of us, a parliamentarian albeit a rather exalted one, and we are looking forward to recruiting you for support up in the Lords for the proposals we have been making on making the Bank of England more accountable. Before we get on to any of those questions, I just want to ask you about the Banking Commission. Do you support the Banking Commission's main proposals on leverage, on remuneration, on recklessness, on reversal of the burden of proof? There are one or two other big issues, not least RBS and the need for a careful examination of the good bank/bad bank split.
Sir Mervyn King: Let me say first I have always appreciated the chance to explain our position and our views to this Committee and I think it has been an admirable example of direct accountability of the Bank to Parliament. That is a thing on which we have always put enormous weight and the theme of much of our work over the past 20 years has always been about transparency. That has been true of every aspect of the Bank's work.
In terms of your Commission and the report, I said last week that I think it is a landmark report. I think it will shape the debate. In terms of capital, leverage and what should happen to some of the banks, I think my views are very well known and I fully support all those recommendations. On some of the newer recommendations, I am entirely supportive of the broad thrust. On the details, in view of a new role I may play in the future, I probably owe it to my new colleagues to listen to all the arguments before I say how I will cast any particular vote in the future, but I am strongly supportive of the broad thrust of all those recommendations.

Q2 Chair: You mentioned capital and leverage there. Perhaps we could get into some of those questions. What lessons do you draw from the process by which an extra £13 billion is going to be raised as capital compared with plans from Britain's banks? When I say "process", do you think that process has been a clear and helpful one? How much lobbying has there been, by whom and were the politicians got at by the banks?
Sir Mervyn King: Let me make three points on that. I think the first one—and it was a lesson that I only came to appreciate in the last few weeks—is that, although the FPC played a crucially important role in making judgments about what should happen to the banking system as a whole, it is only the advent of banking supervision and the powers of the PRA board that enabled those recommendations to turn into reality. What I have come to appreciate even more clearly is that it was the return of banking supervision to the Bank of England that made it possible for the FPC to have some leverage. Merely producing recommendations and reports will have no impact at all without the ability of the supervisor to implement them.

Q3 Chair: "Leverage" is the right term there, isn't it—
Sir Mervyn King: It is, absolutely.
Chair:—because one could argue that you have achieved through the backdoor of the capital requirements demanded by the PRA what you have been denied through the front door on leverage.
Sir Mervyn King: I think the two institutions have worked very closely together and they need each other. The PRA board, focused on individual institutions, needs a coherent, intellectual framework within which to base its judgments on individual institutions and the FPC needs the PRA to make a reality of its recommendations. That was the first lesson.

The second is that the process was not as smooth as it will be in future, I am sure, because the PRA was not up and running until 1 April. All the machinery was in place but the FSA was, understandably, very jealous of its supervisory powers right up until 1 April because it had the legal responsibility for that. It was only from 1 April onwards that we were able to begin the process of assessing the capital needs of each individual bank, of the big eight that we looked at, and it took several weeks to get through that. Meanwhile, we had started explaining to the banks we looked at first what our conclusions were and it would have been better to have been able to get ourselves into a position where could announce the results all at the same time. That will happen in future with stress tests. I think one of the most important developments is the concept of annual stress tests conducted jointly by the PRA board and the FPC and that will be a very important mechanism in future.

The third lesson I draw is that I think banks needs to think very carefully about the relationship they have with supervisors. It is quite clear that things, in their mind, have changed from when the Bank was last responsible for banking supervision. I don't think that banks should conduct conversations with supervisors through the front pages of the *Financial Times* or indeed any other newspaper, and I think it is important that they realise that these conversations are for the supervisor to have confidentially with the bank. It is also important that banks don't leave conversations with the supervisors and feel that the next step is to telephone No. 11 or even No. 10 Downing Street and lobby officials or politicians to put pressure on supervisors to back down on their judgments.

Q4 Chair: Did they make those calls?
Sir Mervyn King: There were certainly calls made to No. 11 and even, in some cases, to No. 10 to try and put pressure on supervisors to be more reasonable in their judgments.

Q5 Chair: Did those politicians or senior officials then respond to those calls by putting pressure on supervisors?
Sir Mervyn King: I think conversations were had and you saw various stories leaked in the press, but the PRA board has been absolutely firm, as has been the FPC, and I would like to congratulate the PRA board members who have served so far. They have done a truly splendid job. I think a very important role of Parliament is to ensure that if you want an effective supervisor—and everyone says, "In the past we didn't have effective supervision and this was one of the causes of the crisis". It is no good making speeches in general saying, "We want an effective supervisor", and then when it comes to an individual bank, asking the supervisor to back down. You need that independent supervisor and you must trust the process.

All the decisions that were made by the PRA board were made unanimously by the PRA board. Every individual consciously and positively voted for the actions that the PRA board has taken. That is the process and I think it is a good process. I think that having the external members of the PRA board and the FPC has shown, as in the case of the MPC, that it is vitally important to have these independent sources of views and thinking represented so that, where they are unanimous, no one can claim that it is just one person or even the Bank of England Executive pushing this line. This is a view that was taken by the PRA board as a whole. It will be very important, I think, and I urge on this Committee to bear in mind the need, yes, to hold the PRA board to account and the FPC account, directly to you, but also to ensure that they are independent and can behave as an independent body.

Q6 Chair: You are saying that politicians and the officials advising them at a senior level in No. 10 and No. 11 have been getting in the way of that process?
Sir Mervyn King: I think they have come under tremendous pressure themselves from banks. They have been lobbied and they feel that—
Chair: They have not resisted that pressure. They have followed it up with—
Sir Mervyn King: They have passed on concerns. It is fair to say that senior politicians have not telephoned me to say, "Change your mind", but various conversations have taken place with others and I think it is very important that people simply should say, if they are lobbied, "Look, the PRA board is an independent supervisor. Don't talk to me about this decision".

Q7 Chair: Have other members of the FPC been contacted by senior officials or politicians?
Sir Mervyn King: The FPC has been out of this for a while. It has been handed on to the PRA board, but certainly conversations have taken place.

Q8 Chair: Have senior members of the PRA been contacted by politicians or senior officials at No. 10 and No. 11 with a view to making points on behalf of the banks?
Sir Mervyn King: At least one conversation took place that I know of and I think it is very important that this not be done. There are several instances where we have seen arguments represented to ease off the views that were taken, which were taken unanimously by the FPC as the general framework for this exercise and then unanimously by the PRA board as applied to individual institutions.

Q9 Chair: You would agree, though, that there is legitimacy to a dialogue between parts of the banking community and our senior politicians?
Sir Mervyn King: Absolutely, and I think it is perfectly reasonable to—
Chair: But what you are saying is that there is a line between that and undue pressure and, on this occasion, that line has been crossed?
Sir Mervyn King: I think it is the subject of the conversation. I think it is perfectly reasonable for senior members of the banking community to talk to and indeed lobby politicians for a change in the framework or a change in the legislation governing the behaviour of banks. But when it comes to individual decisions about individual institutions, that is something that should be conducted bilaterally

between the bank and the supervisor and it is a private conversation. It is hard to make a supervisory framework operate if one part of that conversation feels that going to the newspapers and putting stuff on the front pages—
Chair: Or going to politicians.
Sir Mervyn King:—or even going to politicians, is regarded as part of the legitimate process of the conversation.

Q10 Chair: You are saying that the line has been crossed with respect to both of those in this case?
Sir Mervyn King: I think you can see very clearly it was crossed in terms of briefing to the newspapers—
Chair: Yes, but I am not talking about the one to which I do not have—
Sir Mervyn King:—and there have also been other conversations, clearly. We know that, having had conversations with the supervisors, very often the first response of someone leaving the building is to ring No. 11 or No. 10.

Q11 Chair: That has been very helpful guidance for us. You are agreeing that we are getting a measure of what you wanted on leverage through the backdoor of PRA in its involvement in capital requirements?
Sir Mervyn King: The framework laid down by the FPC was very clear, which is that by the end of this year all banks have to get to a 7% capital ratio, using the definition of "capital" prescribed by the FPC, and if, even having achieved at that level, banks ended up with a leverage ratio in excess of 33:1, then further action would be required to be specified by the PRA board to bring down leverage. That was the general prescription and that is what the PRA board has taken forward.
As of today, with the exception of HSBC and Standard Chartered, every one of those big eight banks has a leverage ratio in excess of 33:1. Now, that will change and all of the banks bar two will have reached leverage ratios of 33:1 or below once they have taken the measures required to reach the 7% capital ratio. Two have not. There are conversations and those two banks have been asked to put forward plans by the end of this week to the PRA board for how they propose to bring down leverage further. The PRA board will discuss that during July and the announcements as to what actions will be taken to meet that requirement will be announced by the banks, having received the agreement of the PRA board, by the end of the July.

Q12 Chair: Those conversations are with which two banks, just for the sake of clarity while we are here?
Sir Mervyn King: It is Barclays and Nationwide and they were named in the table published last week.

Q13 Chair: I would like to turn to what has been described as the beginning of the normalisation of monetary policy. First of all, one aspect of that has been the suggestion that we introduce in the UK forward guidance. Do you agree with that?
Sir Mervyn King: Guidance has always been part of the operation of monetary policy. The lags in monetary policy between when you take actions and their effects on demand, output and inflation are quite long, so you need to give guidance. We have always published our projections conditional upon particular paths of interest rates, so we have always seen guidance as a key part of what we do. If that guidance can be made more systematic and more comprehensive then so much the better and that is the issue that my colleagues, together with my successor, will report back to you and the Chancellor in the August *Inflation Report*. It is not for me to prejudge what should happen. I know that those conversations are taking place and at the August *Inflation Report* and any hearing you hold after that you will be able to discuss where that forward guidance is going, but guidance as a principle is very important to central banks.

Q14 Chair: What we have had is some guidance from Bernanke on another aspect of an organisation of monetary policy that has caused a lot of turmoil in the markets. Should we see that as irrational despondency or "the audacity of pessimism" as you put it in your Mansion House speech?
Sir Mervyn King: I don't think the reaction of the markets was a commentary on the clarity of the communications by the Federal Reserve. Ben Bernanke could hardly have been clearer. The problem is that, when he was clear, Ben Bernanke made it 100% obvious that what the Fed will do "will depend on the incoming data", in his phrase. I think the real uncertainty here and why almost any announcement by central banks causes volatility at present is that no one can know how we are going to create the economic conditions when central banks will choose to raise interest rates. I think this is far and away the most important problem.
I don't think this is an issue of central bank communications. Nobody would sensibly today sit down and say, "This is the path of interest rates that we intend to follow". That would be crazy. The question is it is a contingent path and it is contingent on conditions returning themselves to normal in order to allow interest rates to return to normal. We are nowhere near that yet and I think people have rather jumped the gun in thinking this means an imminent return to normal levels of interest rates. It does not.
To my mind, the big challenge facing not just the UK or the US but the world as a whole, is how to put in place economic policies that are necessary to rebalance our own economies internally and to rebalance our economies externally. This is a challenge not just for us. It is for China and it is also for Germany. Germany cannot carry on with trade surpluses at this level indefinitely. Until these problems are tackled and until markets see in place policies to bring about that return to normal economic conditions there is no prospect for sustainable recovery and, without a prospect for sustainable recovery, markets can understand that it will not be sensible to return interest rates to normal levels. Therefore, I think there is a great deal of uncertainty out there. It is not generated by communications difficulties, it is generated by the underlying economic problems.

Q15 Andrea Leadsom: Sir Mervyn, we have been talking with you about the quantitative easing programme since we took over the Treasury Committee in 2010 and over the years you have talked a lot about the counterfactual of if we had not imposed this new policy, that basically the economy would have been in a much worse state than it has been in. Now, so long after you introduced quantitative easing, do you worry about the consequences of it? Do you worry about the unwind of it? What would your advice be to your successor in terms of dealing with it?

Sir Mervyn King: I think it was the right thing to do and it is rather odd that some of the same people who said that it had no effect on the economy now seem to be arguing that, with the possibility of it unwinding, it is having a very big effect. That the policy was clearly necessary in order to ensure that the broad money supply did not collapse. It did not in this country and it did in some others. That has been helpful in ensuring that we did not fall off a cliff. It has clearly had the consequence that we have gone along with very low levels not just of short-term but long-term interest rates.

I think to have tried to stand out against that would have been possible only with a much higher exchange rate and that would have done enormous damage not just to the tradeable goods sector but to growth as a whole. The low level of interest rates across the world has been responsible for very high levels of asset prices and that is not sustainable. There will be a challenge at some point when interest rates return to normal levels. Asset prices will fall back in nominal terms and if the level of indebtedness around the world has not been reduced by then there will be serious problems of solvency in financial and other institutions. That is why I think it is fundamentally important to get back on the path of solvency for different countries around the world before we raise interest rates to normal levels and before we unwind quantitative easing.

Q16 Andrea Leadsom: Okay, but this policy has endured so far for five years and, inevitably, the longer it has gone on for the higher the risk of the unwind having unintended consequences in and of itself. Presumably you do anticipate that at some point it must be unwound, notwithstanding all that you are saying about the economy needing to recover. How long do you think it might take now to unwind quantitative easing and, specifically, do you accept what Andrew Haldane said to us recently, "Central banks have intentionally blown the biggest Government bond bubble in history" and, "The most significant risk to global financial stability is a disorderly reversion in the yields of Government bonds globally"? Do you agree with him?

Sir Mervyn King: The most important thing to say about this is that clearly the level of interest rates and the scale of asset purchases will have to be unwound and we must return to more normal conditions at some point. That point is not today. When that point is I don't know. I have been very disappointed at the failure of the world to put in place the policies required to create the economic conditions when it would be desirable to return to a normal level of interest rates. I would love to return to normal levels of interest rates, but I think it would be folly to do so before we put in place those policies.

The most important point that BIS made in their report on Sunday was that it is not monetary policy that can create those conditions, it is a whole series of other policies: supply-side policies to raise the profitability of investment by enhancing future incomes and hence returns on investment made today, changes in real exchange rates, changes in trade balances. All of those things will be necessary before we will have the economic conditions when it will be sensible to return to normal levels of interest rates.

Q17 Andrea Leadsom: You are saying that policy-makers have blown the space given to them by central banks by this monetary expansion. They have blown the opportunity to try and put in place measures to get debt down in the economy. Is that what you are saying?

Sir Mervyn King: They have not yet taken advantage of the time that we have created, yes.

Andrea Leadsom: Five years on they have failed to use this opportunity?

Sir Mervyn King: Yes. They have not blown it in the sense there is still time. The right policies can still be put in place, but they have not yet. People will talk about returning to normality and, of course, I would love to be back in that position. I think many people are taking the illogical leap of saying, "Because we would like to be back in more normal conditions let's just get interest rates up". I am afraid if they do that quickly what we will find is that next year or the year after central banks will be easing again because the recovery will have faltered.

Q18 Andrea Leadsom: Would your message to Britain, to the economy, to businesses, to individuals be to get your debt levels down? What would be your message to businesses, families and individuals?

Sir Mervyn King: It is clearly the case that, with the prospect at some point down the road of higher interest rates and therefore possibly lower asset prices, it is not sensible to be in a highly-indebted position. That, of course, is precisely why some companies and many families have been behaving in a way that was consistent with gradually reducing their debt burdens. I am not sure they need my advice to do that. I think they can see that for themselves, but that clearly is part of the transition. This is not something that can be done in isolation.

As a country with a trade deficit we built up debt. As a country we are trying to reduce it, but that requires, for the world economy as a whole to grow, other countries with trade surpluses and large credits to recognise that unless they start to spend more on domestic demand, those assets that they hold as credits will not be worth what they think they are. There will be serious debt restructuring going on in years to come unless we can get a rebalancing of spending in the world as a whole.

Q19 Andrea Leadsom: Dr Weale, you are a macro-economist by background. Do you think economists

understand the implications of the unwind of QE as in if you, as a central bank, sell gilts into the marketplace that has not simply theoretical economic results but very profound impacts on the trading of bond markets? Also, do you think that the Monetary Policy Committee has taken into account sufficiently the potential of the unwind of quantitative easing?
Dr Weale: I think that economists understand perfectly well that if you put a lot of gilts on to the market very suddenly it is almost certain to create chaos.
Andrea Leadsom: That is reassuring, yes.
Dr Weale: Even the anticipation of that would probably create chaos. As the Governor has said, the process of unwinding our asset holdings is some way in the future but I am sure when that point comes the committee will be very aware of the uncertainty and the instability that could be created were it to try and unwind the policy suddenly. Obviously that suggests that you might want to trickle the gilts back into the market rather than have the market facing a wall of sales.

Q20 Andrea Leadsom: Dr Broadbent, do you think that the markets will respond favourably to the central banks en masse dumping Government bonds, even at a trickling pace, back on to the markets or do you think that there will be chaos?
Dr Broadbent: It is important to remember what the Governor just said, which is this is likely to be happening at a point when economies are strengthening; in other words, when, to some degree at least, higher yields would be naturally desirable. Therefore, I doubt or at least I think the chance of a sudden dump in economic circumstances where the market could not tolerate such sales seems very unlikely to me to happen. That said, we are not as familiar over long history with the policy as we are with changing interest rates and that is partly why in fact the MPC has already said in the past that, when it comes to the point where you might want to normalise policy, the first thing we would do is to raise bank credit before thinking of any asset sales.

Q21 Andrea Leadsom: Do you accept that, when simply talk of QE ending in the States causes a massive sell-off in the stock markets and a massive rise in bond yields, selling gilts may have very profound consequences on markets that are very undesirable at a time when the economy is still very fragile?
Dr Broadbent: What I accept is that it is difficult to say with any precision what effect it would have. I don’t think it was predictable, even following what the chairman of the Fed said, that we would have this reaction. What it tells me is precisely what Martin said, which is that one has to be very careful and cautious about the process.

Q22 Mr McFadden: Governor, do you think we are at the beginning of the end of this period of extraordinary monetary stimulus?
Sir Mervyn King: It is very hard to judge. What you see in the United States is that they are still providing more stimulus. The rate at which they are providing more stimulus may be about to suddenly taper, but they are still providing more stimulus. They are doing asset purchases and we are not. I think it is very hard to judge what will happen and I think the reason for that is that it would be a serious mistake to think about what is happening to the UK without thinking about what is happening in the world economy as a whole. We saw the development in the last week or so in China. These are quite significant developments. The euro area still remains a tremendous problem. I think until we know how these problems will work out it is almost impossible for us to judge the speed and the timing by which we may eventually get back to a more normal state of events.

Q23 Mr McFadden: If it is too uncertain to say that we are at the beginning of the end because of all these factors, and what you think are perfectly reasonable comments from Mr Bernanke result in the reaction that Mrs Leadsom described, how do central banks begin to communicate anything about this?
Sir Mervyn King: One thing central banks can do is to make clear that the answer cannot be solely in the hands of monetary policy and that these other problems have to be tackled, and I think Ben Bernanke has been pretty clear about that, too. I think that every time a central bank governor or a central bank official talks about the future path of interest rates it reminds people that there are two distinct issues here. One is what is the state of the economy and the future outlook and how has that changed and, secondly, given that outlook, what is likely to be the path of policy chosen by the central bank?
Everyone is assuming that the reaction of the market was to the second of those two things. I don’t think that is right, I think it is very much to do with the first as well. We are still in uncharted territory. BIS reminded us on Sunday, there is still an enormous amount of debt out there in the world as a whole and, given the imbalances, it is very hard to see how all those debts can be honoured. The process of dealing with that has the potential to deliver many a bump yet down the road.

Q24 Mr McFadden: You said a minute ago that this period of five years or so of extraordinary monetary stimulus, variable interest rates, QE of one kind or another and other measures had created a policy window and bought some time for policy-makers to do other things that had not been done. Could you be more specific? What should policy-makers have done in this five-year window to encourage growth and normality that has not been done?
Sir Mervyn King: There is a very difficult tightrope between pointing out the general direction of policy needed elsewhere, outside the monetary area, and straying into the territory of being too specific on what other people should do.
Mr McFadden: You can elaborate without fear.
Sir Mervyn King: I do think that there has never been a better time to put in place supply-side changes— they do not have any immediate effect, they can take their effect down the road—to improve our productivity, profitability, future investment, education, training. All of these things will pay off in

giving people confidence that incomes in the future will be higher. I think the bigger changes, though, are for other countries outside the UK. In the whole structure of the euro area, they have not yet found a way of bringing about significant sustained corrections to real exchange rate imbalances. There are large amounts of debt out there, some of which have been restructured but I am sure there is more to come.

We are seeing China come to grips now with the challenges of moving from an economy based on exports and a trade surplus to one based much more on internal demand. I do not think we can expect China to do that quickly, it is a big structural challenge for them. In many ways they probably think our problems look trivial in comparison with the challenges that they face. All of these things will be necessary, in my view, to get back to a point where people feel that the world economy as a whole is on a sustainable growth path and, therefore, it can support and live with normal levels of both nominal and real interest rates.

Q25 Mr McFadden: That sounds like we could still be in this position for a long time to come then, that what you are saying is to interpret recent events as the beginning of the end of this period of extraordinary monetary stimulus is premature and we may be a long way from that point. Would that be a fair interpretation of what you just said?

Sir Mervyn King: It may be. I just don't know. There are too many uncertainties here, but certainly the view that we are definitely at the beginning of the end, we are definitely at a point where we need to raise interest rates, I think, is a premature judgment about where we are and no central bank has moved rapidly down that course. The Federal Reserve has merely said that the easing in which it is still engaging may taper at some point, depending on economic conditions. The sheer uncertainty that I have referred to is one of the things that is holding back demand at present. That is why resolution of the uncertainty, taking some of the actions needed, would help not only because they would correct the long-term problems but they would also remove the uncertainty, which is another factor dampening demand at present.

Q26 Mr McFadden: Thank you. Could I ask any of your colleagues if they want to come in on this point about the timing of the winding down of stimulus, whether we think we are near there or whether the public should expect this to continue for some time? How do you manage expectations on this?

Dr Broadbent: As the Governor said, these are extraordinary times and at some point you would expect yields to return to "more normal levels". One thing I think we should point out is that even before the crisis and that much further before policy of quantitative easing around the world yields had fallen, certainly at the long end of the curve, a great deal. In the trough of the last but one recession in the early 1990s 10-year gilt yields were almost in double figures and even when you strip out inflation the real part of those yields was 4.5%. By the end of that decade, despite the fact you were then on the other end of a cycle, they were down at 2% and in 2006 they were as low as 1.5%.

Even saying where the "normal levels" of yields is is quite difficult and I don't think one should alarm people unnecessarily. More importantly on that front, of course, I come back to what we said earlier, which is that the timing is entirely contingent on the path of the economy and, for an open economy like ours, the global economy. I can only echo what the Governor said. I think it would be misleading to say to people, "This or that is going to happen to monetary policy" without mentioning or thinking about the economic developments that ultimately drive monetary policy.

Dr Weale: I certainly share that view and, of course, the whole point of the policy-making framework is that we react to the environment as it evolves. At the beginning of May markets were expecting it to be quite a long time, well into 2016, before there would be the first increase in Bank Rate. That horizon has shortened recently. I should stress this is the market's expectation. It may, of course, extend again depending what happens to the economy. I certainly think it would be quite wrong to try and give any timetable for any sort of return to a more normal pattern of interest rates.

Q27 Mark Garnier: Governor, we have seen in the last couple of weeks the 10-year gilt yield rise from about 165 basis points at a very low level to over 200, so a 70 basis point rise, just on the back of what we have seen coming out of Ben Bernanke in America and the talk about their tapering off. To what extent do you think that the incredibly low bond yields has been a direct result of quantitative easing and to what extent do you think that has been attributable to a flight to quality and an appreciation, if you like, in the Government's policies in terms of trying to resolve the crisis?

Sir Mervyn King: I think part of it has been a response to quantitative easing. Part of it has also been a reflection of people's expectations that, such was the impact of the crisis on demand, it was likely that, even in the absence of quantitative easing, central banks would want to keep interest rates low for quite a long time and that we were not close to the point when interest rates would rise. That has been a real factor, but underlying it we should not forget that we went into the crisis with extraordinarily and unprecedentedly low levels of long-term real and nominal interest rates. This was a reflection of the imbalance between planned savings and planned investment in the world economy as a whole, the imbalances in trading positions and hence capital flows. This was partly one of the causes of the crisis. The immediate response to the crisis clearly is, if anything, to have even lower interest rates to get through the immediate damage, but we only get out of it if we can find a way in which we can raise the long-term level of real interest rates. Not artificially by turning the world into a deep recession, but by changing the patterns of saving and investment around the world such that the equilibrium rate then rises and we get back to the levels of real interest rates we experienced in the past and then central banks can respond to that. That is why I have stressed the importance this morning of long-term real reforms, not just in the UK.

I think we have done more than anyone else. It is in other countries where we need to see changes, too. That would enable the world as a whole gradually to get back to higher levels of real interest rates and central banks would then, naturally, be able, using their judgment to choose the timing, to get back to more normal levels of real rates. To my mind, that is the problem. The question of communication, although it is very important, is a second order problem compared with the question of how we can create the economic conditions so we can get back to sustainable growth all around the world.

Q28 Mark Garnier: One problem that I have advanced on a number of occasions—and a paradox that I can't quite see a solution to and I would be grateful if you could point in some direction on this—is the fact that we have a colossally high level of household debt that is getting on for £1.5 trillion, of which about £1.2 trillion is on mortgages and of which about 40% of that is only on interest-only mortgages with no discernible way of their being paid off aside from selling the asset. Part of the economic recovery will be an increase in household consumption. I think 30% or so of the economy is consumption. We are asking the consumer to do two things. We are asking them potentially to pay off their debt or reduce their level of household debt and, at the same time, spend more money in order to promote consumption at a time when the biggest risk to households is rising interest rates for whatever reason but, if we go back to a period of normal low interest rates, we can still see a two or threefold increase in the cost of financing that household debt. How would you solve that paradox?

Sir Mervyn King: The idea that we are about to return to normal levels of interest rates is premature and one of the reasons why it would not be sensible to get back too quickly is precisely because many households do have high levels of debt. The question is, how was this incurred? I don't think it is sensible to interpret this as British consumers and households going on a sort of credit-driven binge to spend more money. That is not what happened. The economy grew at a very stable rate before the crisis. Low levels of interest rates around the world inevitably pushed up asset prices, including house prices, around the world including in the UK. House prices were already relatively high in the UK because we are a densely populated country.

House prices went up. As the older generation retired or passed away, the housing stock was sold and had to be purchased by the new younger generation. That led to a transfer of wealth to the older generation, which took the form of the younger generation taking out a lot of debt and the older generation having a lot of liquid assets that they got from the proceeds of selling houses. The household sector as a whole wasn't in an unsustainable position, but different generations probably were, if we were to get back to levels of long-term interest rates that were normal relatively soon. The market was pricing in a long period of very long-term interest rates. So far the market has been proved right. If those long-term interest rates persist at very low levels and we do not get back to normal levels for some while then households will be able to absorb those levels of debt. If, on the other hand, there are changes around the world that lead to long-term interest rates going back to more normal levels quickly—I think it is unlikely but if they do go back quickly—then some of those households will find themselves with levels of debt that do not look so attractive given the new lower level of house prices. That will have to be factored into the policy judgments that are made.

I do not think we should think of this as people borrowing to engage in current consumer spending, largely what was going on was people borrowing to finance a much more valuable and expensive housing stock as, perfectly reasonably, the younger generation decided that they too wanted to become homeowners and take on the burden and the attractions of owning a house with the associated debt.

Q29 Jesse Norman: Mr Dale, the Funding for Lending Scheme, if I may just touch on it, has obviously had some role in lowering bulk funding costs but net lending has fallen by £300 million in the last quarter and has been described by commentators as disappointing, what would your evaluation be of it?

Spencer Dale: I think my evaluation would be it is somewhat less disappointing than many commentators would have us believe and although I think its success varies between the housing market and lending for mortgages and what we see in terms of the corporate sector. So in terms of increasing the availability of mortgage lending, allowing households to get on the housing ladder, I think there has been a clear shift in the availability and the cost of borrowing, so many fixed mortgages rates have fallen by over 100 basis points over the past year. Many of those falls have been concentrated in higher loan-to-value ratios, and I think you have seen that starting in terms of an improving housing market. I think that will be an improving housing market, getting levels of activity anywhere near towards levels we last saw prior to 2007 would have many benefits for our economy.

We have seen it far less, however, in terms of the cost and availability of funding to companies. My interpretation is that there has been some improvement but far less of an improvement, which is why we recently extended the Funding for Lending Scheme and gave the security incentive in that way.

When you observe the fact that lending to the corporate sector is still falling, do not necessarily take from that that the Funding for Lending Scheme is not working. There are two points I would make from that. First, my reading of the data is much of the fall in the first quarter in terms of lending to the corporate sector was driven by large companies repaying debt. To the extent that those large companies are switching away from bank lending to borrowing in capital markets, which we saw them do on a considerable scale in Q1, is not a sign of despair, it is an encouraging sign.

Secondly, we had expected this time a year ago for net lending to the corporate sector to be falling very sharply; it is falling far less rapidly than we expected.

To be clear, we want net lending to the SMEs to be growing more than it currently is, which is why we have done the extended scheme, but relative to what we had feared a year ago the lending performance even to SMEs is better than we would have feared.

Q30 Jesse Norman: I am so sorry, we are hopelessly short of time so I am grateful for your brief answers. So quickly summarising that, it has been effective in supporting mortgage growth but the net overall reduction is a disappointment and it has not be anything like as effective in supporting small businesses and business. You do not need to respond, that is just what you said. I am just repeating it. The question I want to ask you, if I may, is this; is it possible for a bank to join the Funding for Lending Scheme and yet not make any net new lending?
Spencer Dale: It is possible for a bank to join the Funding for Lending Scheme and not make any net new lending, but if they do not make any net new lending the ability for them to access funds will be severely curtailed.

Q31 Jesse Norman: But they still do receive some benefit from joining the scheme, even if they do not do any net new lending?
Spencer Dale: Under the terms of the current scheme, they would. Under the terms of the extended scheme, which starts from the beginning of next year, they would not. Their access to funds will be directly related to the extent to which they increase their net lending. So if they do not increase their net lending at all, they can join the scheme at the beginning of next year but they will not be able to borrow any funds from the scheme.

Q32 Jesse Norman: Just for the avoidance of doubt, we have had a scheme and for another six more months we have a scheme in which it is possible for a bank to join, receive some benefit from joining and do no net new lending?
Spencer Dale: That is correct.

Q33 Jesse Norman: That does not sound like a well designed scheme if it is giving banks incentive to join but not incentive to do the net new lending that the scheme is designed specifically to target.
Spencer Dale: Let me explain to you why the scheme was designed in that way. A number of the banks when we designed this scheme a year ago, had made very clear to us they expected to contract their lending book quite substantially and so the incentives were designed to work for two types of banks. One, for those banks expected to expand their lending book to give them incentive to expand it by even more. Secondly, for those banks that were planning to contract their lending books, to contract it by less than they otherwise would have done because the funding costs provided that incentive as well. I think both aspects of that incentive scheme have worked.

Q34 Jesse Norman: The facts of the way the schemes are designed are facts and the other things are counterfactuals and so we can't test them. On the issue of the next six months and the first scheme as announced, have you seen evidence of the banks gaining the scheme by using the incentives that we have described?
Spencer Dale: No, I think if anything we have been surprised by how little banks have borrowed from the Funding for Lending Scheme and I think that in part reflects the success of the scheme. The scheme has helped to bring down funding costs more generally and, as a result, for many banks the cost of borrowing from us via the Funding for Lending Scheme is not materially lower than their costs of being able to access either wholesale or retail funding.

Q35 Jesse Norman: Thank you. Sir Mervyn, the latest data show that some of the biggest lenders, Lloyds, RBS and Santander, had negative net lending in the first quarter. Do these banks benefit from reduced capital requirements under the FLS?
Sir Mervyn King: FLS does not set capital requirements, it provides just the funding.

Q36 Jesse Norman: No, "Changes in lending will not excite a new capital requirement" I think is what you said.
Sir Mervyn King: It will not attract a capital requirement, yes, indeed. But the point about those three banks is that they were clearly planning, for very good reasons, to contract their balance sheets and we designed the scheme in such a way as to give them an incentive to contract it by less, as Mr Dale said. It has been successful in that.

Q37 Jesse Norman: The latest data suggest that Barclays drew £6 million of FLS lending but RBS only £750 million, why do think there is such a disparity between the drawdowns in the case of those two banks?
Sir Mervyn King: You should ask them. They are perfectly entitled to choose themselves how much they draw down.

Q38 Jesse Norman: Is that not a slightly odd reaction, though, because you are designing the scheme based on expectations about their behaviour so I am now asking you what your expectations were about their behaviour and why they are disappointed in it, in your judgment?
Sir Mervyn King: We were designing incentives, how they respond to those incentives is up to them.

Q39 Jesse Norman: Yes, but the incentives are based on expectations. That is the point of incentives, they set expectations in a certain way, they react to certain expectations about how they behave anyway?
Sir Mervyn King: No, they set real prices for the cost of the funding, and that is what it did, it changed the cost of the funding. It was clear that RBS decided to have a strategy that involved much lower levels of lending to the real economy.

Q40 Jesse Norman: Do you think it was a poorly designed scheme that gives the bank an incentive to join and get the benefit without doing any net new lending?

Sir Mervyn King: Not at all. Those other central banks around the world that have looked at the scheme have said it was extremely cleverly designed because it was designed precisely to maximise the incentives to the set of UK banks that we had with two very disparate groups of banks. One group of banks that were lending to the real economy and we wanted to encourage them to lend more, and another group of banks that were clearly contracting lending but there was no point in pretending that they would expand lending, they would not. What we could do was design incentives to encourage them to contract lending by less than they would otherwise have done. That was a very important part of it because those banks accounted for about one half of the stock of lending.

Chair: Final question, please.

Q41 Jesse Norman: So you do not think the low levels of net new lending had anything to do with the poorly designed scheme, and yet it is a design you are changing for the next version of the scheme?

Sir Mervyn King: Not at all, no. The low levels of net lending have everything to do with the individual specific strategies that the banks chose to pursue. I think the incentives that we have designed, both in the original scheme and in this one, were very cleverly calculated to provide exactly the right kinds of incentives. Incentives are incentives. The actions taken by banks are their responsibility.

Q42 John Thurso: Dr Broadbent, can I come to you first and ask you about what has been termed the productivity puzzle? Broadly, since 2010 the private sector has increased jobs by about 6.8%, the economy has increased rather sluggishly by just under 2.5% and productivity has gone down by about 10%. How much do you see that as being a threat, if at all, and what, if anything, should we look for to do about it?

Dr Broadbent: You said 10%, I think it is 10% relative to the trend that we might have expected to occur when we projected forward what had been happening in the, say, 20 years before the crisis. So roughly speaking it has been flat, it fell last year, but since the crisis it has been flat and that is a major disappointment. Productivity is generally, as economists say, procyclical, it tends to fall in recessions and recover again as economies recover. But having said that, I think the shortfall we have seen is much bigger than one would normally expect, even given that correlation over the past.

It is hard to say precisely why that has occurred. The likelihood is there are several things that have gone on. I do think that because this is something you tend to see after financial crises, it is generally the case after financial crises production growth and output growth are disappointing for some time, that my hunch is it is something to do still with the financial system not functioning properly.

Q43 John Thurso: You put forward the other day that it is the zombie companies and that is what I want to test, whether you are still of that opinion?

Dr Broadbent: Yes, I don't think that is the right word, it is a rather pejorative term. What I tried to get across was that the economy is having a hard time adapting to big shifts in demand and putting resources where they belong. A capitalist economy makes these reallocations all the time. Even in the face of a large need to do so, because demand in some areas has weakened a lot and in others it has strengthened, then that will reduce productivity. Those areas of the economy where demand has weakened a lot you might have expected to see more corporate failures but I do not think the companies that are remaining there are necessarily bad, and that is why I resist the use of the word "zombie".

Q44 John Thurso: An alternative thesis could be that the labour market is acting very flexibly, it is pricing itself into jobs and that it will price itself up again as and when the economy recovers.

Dr Broadbent: I think that is quite possible too. Indeed even if we get to a point, and one hopes we do, where we have a better idea and a more precise idea about why this has happened, I don't doubt that there will be several factors that will explain it and I think that is probably one of them. To that extent, of course, you are absolutely right, if, looking forward, the economy grows a little more strongly and productivity with it, then to the extent you have described you would expect to see wage growth being that much faster as well.

Q45 John Thurso: So this conundrum that economists have been arguing about for the last couple of years, and worrying about to a certain extent, may be something that will not solve itself but regulate itself out?

Dr Broadbent: To some degree. Part of this is, in a sense, cyclical of course and it is very hard to know precisely how much.

Q46 John Thurso: Can I come to you, Spencer Dale? In your annual report you note that, "The outlook for growth and inflation is complicated by the considerable uncertainty concerning the extent to which the financial crisis has impaired the supply-side of our economy." To what extent are you confident in the data that leads you to those conclusions?

Spencer Dale: As you well know by sitting on this Committee, for an economist to be confident about the data, one is never confident about the data, so it is quite conceivable that over a period of time the GDP data will be revised and also the employment data will be revised. But the scale of revisions that we would need to see to explain away the entire productivity puzzle would be entirely and utterly unprecedented. So revisions may well change the scale of the puzzle but it will not, in any way, remove the puzzle entirely.

Q47 John Thurso: The reason I ask is there was a rather interesting paper that was put out by the bank recently comparing the first cut of data, which reaches the headlines, with the final revised versions of the data and noting that in actual fact if you look at the first cuts now compared to the first cuts of other recessions, notably early 1990s and 1970s and then you look where we finally were, the conclusion was that the problems we are having now are no worse than the problems we had then and that when you come out the other side they will look remarkably similar. I remember well the early 1990s and indeed in 1970s how bad we thought it was then, and we all think it is very bad now, so I wonder to what extent our judgments are impaired by not appreciating the true level of the finally revised data?

Spencer Dale: I think it is a risk. As you know, when we produce our forecast for what we think will happen to the economy in the future, we also at the same time include backcasts, saying what we think, how the data in the past may well be revised based in part on other types of indicators. So on the MPC we never just wait for the ONS to tell us what the latest estimate of GDP is and say, "Okay, we will take that as gospel", we look at a whole range of indicators in terms of activity indicators but also we will look at the labour market, look at what companies are saying to our agents, and together with those indicators and taking into account that in the past the data has been revised—and there are particular fiscal regularities of how those data have been revised in the past—and we take a judgment to what extent that backdata will be revised. A feature of our backcast data, of our best guess of the economy involved in the past, is the size of the recession was somewhat less than is currently estimated by the ONS. But the big picture, which is that we suffered a very deep recession in 2008 and 2009, is entirely consistent with the ONS.

I don't think our current reading of the data and how it may be revised in any way affects that really big picture message.

Q48 John Thurso: Thank you. Governor, can I come to you? You and I have often discussed over the time I have been on this Committee the question of remuneration in banking and in the wider financial services. The Banking Commission report makes clear the need for remuneration to be related to some form of value but also makes clear that just the total quantum of remuneration is just plain wrong and too much and has no relevance to any other activity in society. As in the famous words of the Rolling Stones' song, for you this is the last time, so can I ask you to reflect on remuneration and tell us what your advice would be to the City in regards to what it pays itself?

Sir Mervyn King: My views on this have not changed at all. There are two aspects that relate to public policy and then there is a third in what banking itself should do. So on public policy I think there are two areas where public policy has a legitimate interest. One is to deal with the "too big to fail, too important to fail" problem. One of the reasons why remuneration is as high as it is, is because of the implicit subsidy that we choose to give the banking sector because it is too big to fail. I don't think you can blame banks if you give them a large subsidy and they look around for interesting ways to spend it. We would all be prey to that temptation. It is up to us to remove that "too big to fail" subsidy and that is a big challenge for public policy, which I talked about at Mansion House last week, and is part of the Banking Commission.

The other is, for public policy, this is more related to the PRA responsibilities, is to ensure that the structure of remuneration is consistent with sensible incentives not to engage in too much risk and to maintain stability in the system. That is, I think, where the Commission's recommendations on deferral of pay make a great deal of sense and it is why Andrew Bailey has also been criticising the European proposals that try to impose rather heavy-handed restrictions on the quantum of remuneration. If you just do that on one part of it, you will divert remuneration into a fixed part, which may not be particularly sensible, and it will be better to have bonuses, yes, but structured in a way that the benefits are deferred until such time as the benefits are truly measured. That is particularly true of much of the trading activity that goes on, where the profits are booked today but the consequences of the contracts may not be revealed for quite a long period of time.

So I think we here are going in the right direction in terms of having a sensible structure of remuneration where we need to put in place the incentives to ensure that remuneration in flexible form is deferred, we need to tackle the "too big to fail" problem.

As for banking itself, that is up to them. We should not blame banking for trying to take advantage if we give them the wrong incentives to pay too much. Within that I would hope that remuneration committees would take a sensible view of what is necessary to pay to get someone to do the job, and that is not always determined entirely by what other banks are paying. But you can see the problem in any one bank, if other banks are paying higher remuneration, it is almost impossible for them to try and break the mould. That happened with Warren Buffett in Salomon Brothers way back in the 1980s, it did not work. You cannot really expect banks to solve this problem alone. There are two areas of public policy to intervene and then we should let the market work.

Q49 Mr Ruffley: Governor, in your information report press conference, you said the recovery was in sight. Yet, you have been in a minority of three every month since February in arguing for more monetary stimulus, £25 billion increase in QE. You voted for that. How do you reconcile those two propositions?

Sir Mervyn King: I think the data show that a recovery is in sight but in my judgment the central view would be that it is too weak to be satisfactory. In our projections we published in May you can see the central projection was basically consistent with flat unemployment over the next two to three years. Unemployment, in my judgment, is well above the level that we could hope to bring it back to and therefore where it was before the crisis, reaching it in a sensible and sustainable way, and it would be sensible to try to aspire to a level of recovery that will bring unemployment back to a sustainable rate over the two to three year horizon.

So I think there is a recovery but I do not think it is sufficiently rapid to reduce my concern that now is time to have a marginal fiscal stimulus.

Q50 Mr Ruffley: Given that Dr Carney will be taking over in a matter of days, there is huge speculation that he will—we do not want to prejudge it—want to increase QE. I am rather intrigued by the

fact that only three of you, Mr Miles and Mr Fisher being the other two, have voted for £25 billion increase every month since February and yet the other members of the MPC have not be persuaded by your argument. I wonder why you think that is.
Sir Mervyn King: As ever with these things, these are marginal judgments, the broad view, the outlook for the economy, is agreed by everyone, I don't think there is any significant difference of view about the outlook—maybe marginal differences here or there but nothing significant—and at the margin the difference is do you do £25 billion more in asset purchase or do you do nothing? These are marginal differences.
But the important point about the MPC, which has been there now since 1997 and I think it is fundamentally important, is that all of us accept there is no right or wrong answer. Each of the nine members of the committee, in the end, is on their own in saying, "I have heard all the arguments, I know that you think we should do and say nothing but in the end in my judgment I would like to do a little bit more".

Q51 Mr Ruffley: I will go straight to the horse's mouth, because we have three members who have been voting consistently against you, Mr Fisher and Mr Miles since February. I hear what you say that this is all marginal, but it might not be that marginal if a new Governor comes in, Dr Carney, and takes your position, Governor, that we need £25 billion more or maybe more QE and yet we have six members of the committee who have consistently voted since February against more QE. I therefore want to go to the horse's mouth, perhaps quickly because we are short of time, Dr Weale, Mr Dale and Dr Broadbent, could you explain to me why you have consistently voted against the other three, led by the Governor? Also whether or not the fact you are voting against the Governor has led you to have any qualms about your decision? Dr Weale first.
Dr Weale: Could I say first of all that I voted with the remit in mind as did the Governor. It has been very marginal but the forecast that we produced in the May report, which showed inflation broadly coming back to target in about two years with the amount of stimulus we have now, seemed to me an appropriate path for the economy. I am very aware that inflation has been above target now for quite a long time and, comparing it with the period before the financial crisis, inflation expectations have become elevated at least to some extent. Now, there is nothing wrong with that. It is perfectly reasonable that you should accept some minor elevation of inflation expectations but the decision is always a balance of risks and I suspect I have been a bit more concerned about the inflationary risks than the Governor has been. Obviously I have listened to his arguments very carefully, given them very considerable thought, as I have done to those from the other members of the committee. They have influenced me but, as the Governor said, I have to make my own decision and the decision that I have made and am happy to defend to this Committee was to vote for no further asset purchases.

Q52 Mr Ruffley: Do you think it was a marginal decision? I am using the words the Governor just used.
Dr Weale: I agree very much with the Governor's view that it is a marginal decision.

Q53 Mr Ruffley: With Dr Carney, an incoming new Governor, the fact you probably would not want to cause him embarrassment, is that something that would ever influence a MPC member's decision like your own?
Dr Weale: I am very much looking forward to hearing the arguments that the new Governor will be making in the context of economic data, which will certainly be different from those that we had in May.

Q54 Mr Ruffley: Mr Dale, you have consistently voted in the majority against the Governor, Mr Miles and Mr Fisher. What were your reasons? In short form.
Spencer Dale: In brief, I have laid out in my report to you the reasons why, and for those who are interested, you can look into that report more. Monetary policy at the moment is trying to balance three types of risks. One risk is that we do not provide enough stimulus to the economy and the economy does not grow sufficiently to make headway into the economic slack that is there, along the lines the Governor sought. The second risk is that inflation has been above target for much of the past five years. I expect it to remain above target for the next couple of years or so, and after some period of time if we keep on stimulating the economy and inflation remains above target, people start to question whether we are committed to bringing inflation back to target. The third is related to some of the points that we have discussed already today—that if central banks keep on pumping more and more liquidity into the system that could encourage excessive risk taking and could be quite awkward when we are trying to exit. All of us are trying to balance those three risks and I think my judgment was, when I was making my decisions over the last three months, when trying to balance all those three risks together, I came out in favour of not increasing more stimulus at the moment.

Q55 Mr Ruffley: Dr Weale and yourself are giving the impression that you are a tad worried about elevated inflation. Dr Broadbent, what about you?
Dr Broadbent: I would say precisely the same thing. Our job is always to balance the risks that Spencer has described, on the one hand, trying to ensure that the slack in the economy, or indeed in the opposite direction when it is operating above capacity diminishes over time and at the same time we want to keep inflation close to target over the medium term. It is a matter of judgment, given the lags with which policy operates, where that balance lies. It is the data and my interpretation of that data that—

Q56 Mr Ruffley: I understand, it is a truism that it is a fine balance, I am just curious that six of you have voted all the same way, obviously worried about elevated inflation, since February, and the same three have voted for increasing QE by £25 billion. I just

think there is a systemic rift there, is there not? It is not you taking different views every month on the balance of risk, six of you have voted one way since February, three the other and I just wondered why?
Dr Broadbent: The data evolve slowly.
Mr Ruffley: You were getting the same data.
Dr Broadbent: But hang on a second, if it were a simple matter and straightforward and the balance of risk were obvious then there would be no point in having a committee at all. Why not just have one person if it is all fairly obvious.

Q57 Mr Ruffley: But you are all taking the same views since February, are you not?
Dr Broadbent: Because the data are slow to evolve. You would not expect people's votes to ping around all over the place over so short a period of time as three to four months. It is not surprising to me. If you look in the past when there have been differences of opinion on the committee, they have tended to persist for some time. That does not surprise me in the least. As the Governor said at the beginning, they are pretty small in the grand scheme of things, differences of opinion. It really is a matter of judgment as to where precisely the balance lies.

Q58 Mr Ruffley: Suppose Dr Carney comes in and wants more QE like Sir Mervyn, would the fact that he is an incoming Governor mean you would want to give him support or would you just look at the data?
Dr Broadbent: I would look at the data and I would also listen to the argument. I said we are a committee, we are not just one person, and I think that is right framework. Many heads usually come to a better decision more often than one single one. Equally we listen to each other and that we do not sit at home and just press a button, we get together and talk about these things. I will listen to the argument.

Q59 Mr Ruffley: I understand that point. Of course you will, I would not expect anything else, Dr Broadbent. I think the point is that six of you have voted consistently since February in a manner that suggests you were a bit worried about the prospects for inflation being above target. Of course it is a fine judgment, we hear that caveat but I think it will be very interesting for Dr Carney to try and persuade you in the way that Sir Mervyn has not.
Dr Broadbent: We have no idea what Dr Carney will persuade us of.

Q60 Stewart Hosie: Governor, in the Stamp Memorial Lecture last October at the LSE on the counterfactual monetary policy, you said that during the period known as the great stability, 1997 to 2007, you wished you had appeared boring. With hindsight, do you think you or the MPC could have done things more quickly, been less boring, been more activist to try and head off what happened?
Sir Mervyn King: We debated it for a while in the late 1990s and I discussed this at some length in that lecture. I think there were two schools of thought at the time, one was recognising the imbalances and that we were at risk of building up an unsustainable level of domestic demand to raise interest rates and take the risk that lower growth but a more balanced economy was a better bet than two-speed growth and a faster overall growth rate. That debate came to an end around 2000, 2001. I did vote 14 times for higher interest rates in that period. There was a fairly active debate. I think what made life difficult was that the exchange rate had gone up by 25% in effective terms in the late 1990s. Far from being a short run phenomenon, that persisted. That was largely responsible for the imbalance in the economy and we ran with this two-speed growth strategy for a long while.
It is impossible to judge, even now, whether it would have been better to have a different policy or not. It would have been a terrible risk to have raised interest rates significantly and persistently to levels above those in other countries. As it was we had the highest interest rate of any G7 country for every month, apart from a few, in 10 years, and despite that we still had an economy that was moving towards a large trade deficit. It would have been very difficult to have argued convincingly at the time that it would have been worth the risk of accepting inflation below target, rising unemployment, weaker growth in order to avoid some potential hazard down the road.

Q61 Stewart Hosie: That is fine, but when the hazard came, it was not a gentle hurdle, it was a cliff.
Sir Mervyn King: Absolutely.
Stewart Hosie: We all went running off. I think in hindsight, if I may ask you the question, and I have asked it before, if you look at the stability reports in the run- up to the crisis, all of the warning signs were there. Credit was too cheap, it was overly available, there was too much dependency on yield from property, it was not different this time, it was exactly the same as all the other times. It was not that there was a lack of information. It was that there was a lack of analysis of what was going to happen. Are the new structures that have been put in place going to allow the right people to understand the warning signs next time?
Sir Mervyn King: Yes, the warning signs were there and, indeed, our own financial stability reports were full of warnings but there was nothing we could do about it other than distort monetary policy against the wishes of Parliament.
I remember coming before this Committee in the late 1990s when a member of the Committee quite rightly said, pointing to one member of the Committee, "Are you seriously suggesting that you should deviate from the inflation target? That would be inconsistent with the mandate that Parliament has given you". It would have been very difficult to defend. As I said earlier, I think the real lesson from this is that you can publish as many financial stability reports as you want, no one will take any notice unless you have the ability to do something about it. The Bank of England now does have the ability to do something about it. It is the Banking Supervisor.
If the degree of leverage in the banking system had been taken seriously, that would have meant almost certainly fighting against what was happening in the international Basel agreement—the move to Basel II turned out to be a real disaster—if the PRA board

had been in existence then and was part of the same organisation as the people writing the reports with the warnings, the outcome might have been different. But what matters is not what did or did not happen in the past, it is what will happen in the future. For me the big lesson in all this is that now the Bank of England does have, in a joined up way, not only the Monetary Policy Committee but the Financial Policy Committee to set out an overall framework for the banking system and the PRA board with the powers to make it happen by regulating individual banks.

Q62 Stewart Hosie: That is the point you made right at the start today and I was going to ask you about because the PRA board are the stick to implement FPC decision making or other things. But you have previously said, "The natural first line of defence against financial crises is macroprudential policy, but the macroprudential tools deal with the symptoms rather than the underlying problems of misperceptions and mispricing." How will the power and authority of the PRA board get around the underlying problem of misperceptions and mispricing?
Sir Mervyn King: I do not think the PRA board can do that except insofar as the misperceptions are those in the hands of bank management. But if it is a market phenomenon then the FPC will need to make very clear what it feels and it may say we think that there is excessive risk taking and that we would have the power in fact to raise capital requirements on particular aspects of activity, whether it be trading activity or perhaps even in the housing market. It feels that the market has got ahead of itself and there are misperceptions of risk and dangerously low pricing of risk in those areas. The FPC does have the power to raise generically capital requirements in that area. That is the FPC's role. The PRA can deal with specific issues related to individual institutions.

Q63 Stewart Hosie: Do you think that the threat of action being taken will add weight to the expectations from the MPC and others where risk is clearly identified but where perhaps actions to ameliorate it were not taken?
Sir Mervyn King: I do. I think the real test of all this framework will come 20 or 30 years from now when the people involved on both sides have forgotten the crisis because they were not directly involved in it, and that will be a test of whether the institutional structure can deliver the results despite the absence of memory.

Q64 Stewart Hosie: Just one final question then on the institutional structure. We have the FPC looking at the macroprudential with the MPC looking at monetary policy, but in a sense they are in the same space. Is there an argument for merging the FPC and the MPC?
Sir Mervyn King: There may be down the road. I would say it is premature to do it, and the reason is my colleagues here. To be effective a committee cannot be too big. My own judgment is that nine is the largest size I would want for an MPC type committee. But if you are going to merge it with the FPC there will be all sorts of pressures to enlarge the committee and if you want to have a range of people with the requisite expertise to cover both MPC and FPC it will be very hard to prevent it becoming too big. I think the informal co-operation we have between the two committees, a lot of exchange of views and information, is adequate for the time being. I certainly wouldn't object to this issue being revisited in, say, five years' time when we have more experience of how the FPC works. But, for the moment the MPC is well tried and tested institution and I think we should not mess around with the MPC. The FPC is more experimental, we are learning about it. It has only been operational in statutory form for a few months. It has not even issued its first statutory recommendations yet, they come tomorrow morning. I think it is going to be important to see how that works. But maybe in five or six years it will be time to come back to look at that.

Q65 John Mann: There is too much liquidity. I want to ask you first, Governor, whether you shared my concern that with 95% of infrastructure spending planned for London that that imbalance is not healthy for the economy?
Sir Mervyn King: I can certainly agree that ensuring adequate regional balance in development and investment is very important. One of the very sad aspects of this crisis and this consequence is that in the 10 years leading from the creation of the MPC and the recovery in the mid 1990s through to 2007, the regional differences in unemployment had been drastically reduced. We have come a long way to reduce regional differentials. Some of that has been recreated as a result of the crisis. I hope with a rebalancing and a shift towards tradeable goods relative to non-tradeable, and an expansion in the output of manufacturing and engineering, that there will be a return now to a better balance regionally over the next five years or so, and it is very important.

Q66 John Mann: Considering the powers that the Governor of the Bank of England now has as you are departing, looking generically at the post, would it be fair to ask the question, are you too big to fail?
Sir Mervyn King: No, because I do not think the powers are vested in an individual. Both internally in the Bank and in the policy-making arenas we have gone a long way to deal with it. I have always said to this Committee, if you are worried about too many powers being vested in the Bank, that is a perfectly reasonable question to ask and if you do not like that then some of the powers should be taken out and put into a different institution. But I do not think the powers are vested in one individual. We have just been discussing it. As Governor I have been in a minority for several months in a row. The idea that I can determine monetary policy myself is clearly false. I am sure Mark Carney is very much more persuasive. He is a very persuasive man. But even he has only one vote out of nine on the MPC, even he will only be one individual on the Financial Policy Committee, and even he will only be one individual on the PRA board. The members of these committees take their responsibilities extremely seriously, not least because they are personally accountable directly to you and

you can talk to them. Any time you want to see them, bring them here and put to them personally the question: why was this the right decision and why did you vote for it? That is to all three of the committees. There is no hiding place for any of them and, therefore, I don't believe that the Governor as an individual is too powerful.

Q67 John Mann: In answer to Andrea Leadsom earlier you used the phrase, I quote, "The failure of the world" in the context of listening central bankers. Some might suggest that the failure of the world has been listening too much to central bankers. Could I quote you at this Committee, you said before the crisis in relation to central bank intervention of a major bank, that is in December 2007 just before the crisis, "That is not remotely likely." You said in a previous meeting with this Committee in relation to a whole series of answers on the US subprime housing market, where you fought to play down the issue describing it as a problem of the credit squeeze, "The real risk is a contraction in the amount available to borrowers." You were asked about capital requirements and regulation and you said existing capital regulation "would be sufficient". You were asked about the seriousness of the initial financial problems with Northern Rock and what you said is, "We are taking policy actions to ensure we do not see a serious downturn of the economy."

Today you have gone on at length about the importance of regulation, but then we asked by Mr Cousins in question 7, 30 December 2007, about the use of regulation you said, "Trying to win the argument is our main weapon." Isn't the real problem that we have listened too much to central bankers who had it wrong in giving advice during the last 10 years?

Sir Mervyn King: You won't be surprised if I disagree with you, Mr Mann, and indeed it wasn't—

John Mann: Not for the first time, Sir Mervyn.

Sir Mervyn King:—me who created the regulatory framework in 1997. I made the point that—as you had made in many Committee appearances—the job of the Bank of England was to work within the environment and the tasks given to it by Parliament, and we did that. We were not responsible for regulation and we did not take it on. We did have the power of argument. That was the only instrument we had, and that is why I think it is so important that banking supervision has been aligned with the work of the Financial Policy Committee. It may be that in years to come people decide that both of those bodies should be removed from the Bank of England and put somewhere else, but the arguments that were made, which persuaded us to take them back to the Bank of England—we weren't enthusiastic—was that there was no other credible body who could put in place both a financial policy committee and organise the supervision of the banking system, and they have been proved absolutely right so far.

I do not rule out in the future there being changes. Maybe you and other parliamentarians will want to make them. But what we have been doing is operating the system that Parliament gave to us, and we have done it to the best of our ability.

Q68 John Mann: Final question. You have been one of those who has been banging the drum for the need for austerity. As you leave, hopefully, to a very long and healthy retirement, looking at the package you leave with, are we rewarding success or are we again rewarding failure?

Sir Mervyn King: Let me explain. I have never used the word "austerity" in terms of it being part of the solution, and austerity, in those countries that have no other instruments of policy to bring about growth, has been a disaster. You see that in the euro area very clearly. The point that I made was that in the context of a 25% depreciation of the exchange rate, and the boost that that will be expected to give to exports—and has given to exports—then it would not be unreasonable to put in place a medium-term plan for fiscal consolidation. You do not need to refer to fiscal outturns in order to understand why growth has been disappointing in the last two to three years. It is very clear and understandable why that has happened. It is a combination of the problems in the euro area affecting demand for our exports directly, uncertainty affecting investment and the impact on bank funding costs, and the increase, in addition, of commodity prices that squeeze real incomes. Those things are more than enough to explain the weakness in growth. There are some positive signs in those areas, which is why it is reasonable to expect a recovery but, as I said before, I don't think we can expect, on the central path as yet, a recovery sufficient to bring down unemployment. So I don't resile from anything that I said in the past, and I think that even you in Parliament will be voting one way or another, whatever happens after the next general election, for some form of fiscal consolidation.

Q69 Mr Newmark: Thank you, Governor. As this is part of your exit interview, it is always worth looking at life in relative terms not in absolute terms, and when I look at our banking system versus our European counterparts, do you think there has been a greater failure to market the impaired assets on banks' balance sheets in continental Europe, particularly France and the southern European countries compared to ourselves?

Sir Mervyn King: Very clearly, I think both the United States and the United Kingdom have been well ahead of the pack in being open and transparent about the problems that have occurred in the banking system. This isn't a question of blaming anyone. These problems in the banking system largely reflect, not just the position before the crisis, but what has happened as a result of the crisis. The important thing is not to get into a blame game but just be open about the state of the banking system and to ensure it has enough capital. I think we have been willing to do that in the way that our American colleagues have also.

Q70 Mr Newmark: Therefore, do you think that with Basel—and I look at Basel III—there should be effectively a more robust regulator that challenges central bankers to look at their own banks' balance sheets on a more like-for-like basis, and is that a weakness in Basel III?

Sir Mervyn King: I am not sure if this can be imposed from outside. The whole Basel process was designed to create a common minimum level for capital and liquidity in banks, a common minimum level. We have seen that the European Union is set on a path of deviating from the recommendations of Basel III, put forward by the whole of the Basel committee and agreed unanimously under my chairmanship at Basel two years ago. That is a very poor example to set the rest of the world. I would not be at all surprised if some of our American colleagues in the regulatory community there argue that they will want a system that also differs from Basel III, but in a way that sets higher requirements. We have seen, certainly on the leverage ratio front, some—

Q71 Mr Newmark: If I can interrupt? It is not the definitions of the requirements themselves, it is the robustness and it is, effectively, the manipulation that goes on by central bankers in other countries so that, if you were to look at Deutsche Bank's balance sheet, for example, you may take a different view of those impaired assets than, for example, the Central Governor there versus the Central Governor effectively of the Bank of France, and the same thing. We all look at the balance sheets in a different way, and that is a weakness in the system.
Sir Mervyn King: It is certainly a weakness. It is not obvious to me that they necessarily take a different view, where there is a difference is in what is said about it publically, and I think the US and the UK have been very clear that the only fair way to deal with this across all banks is to move to a system of stress tests where the results for all banks are made public, after having told the banks in advance so the banks have time to prepare announcements as to how they are going to respond to those stress tests. But I think generally, if we are not open and transparent about the state of the banking system, you will create greater uncertainty in the minds of the market who will require higher interest rates to be willing to lend to banks because of the lack of transparency about those balance sheets.

Q72 Mr Newmark: Dr Broadbent, you were sort of nodding as I was talking. Do you think that there should effectively be a more robust Basel process where there is more like-for-like discipline in looking at assets on balance sheets?
Dr Broadbent: Yes. Of course it is not my responsibility.
Mr Newmark: No, I know that but I am just asking.
Dr Broadbent: No, I think that is plainly true.

Q73 Mr Newmark: Going back to Sir Mervyn, looking at Lloyds versus RBS today, do you think that the Chancellor is right to say that Lloyds is in better shape today for a sale than RBS?
Sir Mervyn King: Yes.

Q74 Mr Newmark: Okay, that is a very clean answer. When Ben Bernanke signalled to the market that he was going to effectively end QE, do you think that it is wrong for central banks effectively to signal to the markets that they are stopping using any monetary tool? Is it best just to remain quiet or is it best to open up and say, "We're going to stop something"? The reason why I say that is that the markets' reaction is almost indicative that the US economy, in particular, has become addicted to QE, because that is what it says. What Ben Bernanke was saying is, "Things are going well now. We're going to stop using QE" and it is though, like a teenager addicted on some drug, the market said, "Hey, what is going on here? We still need to be injected with QE".
Sir Mervyn King: I don't think that is actually what Ben Bernanke was saying. What he was saying was that each month we are doing more and more QE. The extent to which we are going to do more and more may start to taper off, but he certainly wasn't announcing the end of QE, and it may be many years before the Federal Reserve sells the ownership of its assets that it has bought. I think it would be a mistake to infer that he was, in some sense, announcing the end of QE. I think the deeper problem, though, is that it is right for central banks to try to make it possible for markets and other agents in the economy to anticipate what they may do. The fundamental point here is that neither central banks nor the market can know what central banks will do. What they need to understand is how central banks will react to various possible events in the future. So it is what we call a reaction function.

Q75 Mr Newmark: Should he have remained silent then and not said anything?
Sir Mervyn King: No, because that would have given no information. What he has been trying to do is to explain under what circumstances we would start to raise interest rates, in what conditions. That sort of conditional guidance. How explicit you should be is an open question. But what you clearly want to do as a principle is to get in the minds of markets, a deep understanding of how central banks are likely to react to events as they occur. How precise you are about that, whether you link it to particular variables, that of course is going to be the subject of a good deal of discussion on which my successor and my colleagues here today will be reporting back to you in August, so you do not have long to wait now.

Q76 Mr Newmark: If you were to give one piece of advice—and I don't want you to shy away from this now—to your successor what would it be?
Sir Mervyn King: I have no intention of giving public advice, but if you really insist, Mr Newmark.
Mr Newmark: I do insist, I do insist.
Sir Mervyn King: It is very simple, he should be himself. Governors change. It is very important each Governor is true to themselves, and that means acting and behaving in a different way from their predecessors. Everyone is different and trying to fit into a mould does not work. He must—and I am sure he will be—be himself.

Q77 Mr Newmark: So your advice then is "To thine own self be true"?
Sir Mervyn King: Exactly.

Q78 Chair: I have one further question to raise with you about bank notes. You announced that Churchill would appear on the fiver and this generated quite a bit of controversy, one way and another. Do you have anything you want to add or respond?

Sir Mervyn King: I think that there has been a real misunderstanding of the consequences of the announcement that we made. We announced that Winston Churchill will be the next figure on the £5 note—we have a rolling programme of replacing figures on the four denominations that we have—and I don't think anyone has criticised that decision and it has been widely welcomed. The concern, and I understand the concern, is that people think that we might find ourselves in a position where there are no women in the set of historical figures on our bank notes, and I think that is not true. The reason is because, on the date 2015–16, down the road when Winston Churchill notes appear for the first time, it is not the case that Elizabeth Fry disappears the next day. Those notes will continue to circulate for some while, and well before then the announcement of the next historical figure will have been made.

One thing that we are quite determined to avoid is any suggestion that the £5 note in some sense be reserved for women. That would be demeaning. Women are chosen with other historical figures. They are part of the group and we look at them as individuals, and any time we produce a note there are always two notes that we have running in parallel: the figure that we are actually using and a reserve figure, so that, if there are technical problems with the first note, we can run with the second. That second figure often becomes the figure on the following note. The figure that we have been working with for two years—we have said already it is a woman—I can tell you today is Jane Austen. The Jane Austen note has been up and running internally for over a year. That clearly is a candidate for the £10 note down the road to replace Darwin. When that will be I don't know, and it would be quite wrong for me to claim that Jane Austen will be the figure on the £10 note. That has to be a decision for my successor. Let me assure you that there is no imminent demise of Elizabeth Fry on the bank notes, and I think it is extremely unlikely that we shall ever find ourselves in the position where there are no women among the historical figures on our bank notes, and Jane Austen is quietly waiting in the wings.

Q79 Chair: That is very helpful. You have saved some of what I think will be the most interesting remarks for the press right to the end. This is your last outing, Governor, and your tenure has had two halves. The second half has certainly been pretty bumpy and some of the toughest years since the 1930s, and through that period you have played a huge part in managing the crisis. You have been true to yourself. You have been yourself and you have brought enormous clarity of thought and tenacity under fire, and there has been a good deal of that. On behalf of the Committee I would like to say, also, that you are leaving the Bank of England a much stronger institution than you found it, with greatly increased responsibilities and much greater self-confidence, and confidence of others in the Bank about its capacity to fulfil those responsibilities. That is a huge achievement and great legacy, and we would like to thank you for your work on that and also for your wider work as a public servant these past 10 years.

Sir Mervyn King: Thank you very much, Chairman. May I say that this Committee has played an enormously important role in holding the Bank of England to account, and, even more importantly, demonstrating to the people of this country that the Bank of England is held to account? These hearings have always been very important, sometimes enjoyable, sometimes less so, but always fundamentally important in accountability. I think these sessions will continue to be the single most important way in which the Bank of England is held to account. That is a crucial role and you fulfil it. Let me thank you for the way you have done that throughout my time at the Bank.

Chair: Thank you very much. We look forward to recruiting you, as I say, to Parliament very shortly.

Written evidence

Annual Report to the Treasury Committee
Spencer Dale, Chief Economist and Executive Director, Bank of England

Voting Record since June 2012

My previous report to the Treasury Committee was in June 2012. Since then, I have voted to maintain Bank Rate at 0.5% at every meeting.

In July 2012, the MPC voted to increase the size of the asset purchase programme to £375 billion. I voted against the majority decision and instead voted to maintain the size of the asset purchase programme at £325 billion.

Like other MPC members, I was convinced last summer that there was a need to inject more monetary stimulus given the deterioration in the outlook for growth. But the Bank, together with the Government, had just announced the Funding for Lending Scheme which I expected to lead to an easing in credit conditions and so help boost the economy. Given that stimulus, I did not think it was appropriate to undertake an additional round of asset purchases as well. In particular, inflation at the time was close to 3% and I was worried that it would fall back to target more slowly than in the MPC's central projections, and so risk damaging the Committee's credibility.

The MPC's remit provides the Committee with considerable flexibility for it to support output and employment. And since the onset of the financial crisis the MPC has used that flexibility to the full. Over the past five years, it has cut interest rates to almost zero, undertaken a huge asset purchase programme, and launched (and extended) the Funding for Lending scheme. All this despite inflation being above target for the vast majority of this period and averaging well over 3%. But such flexibility is possible only if the Committee retains the widespread confidence of households and companies that inflation will be returned to target in the medium term. Without that credibility, monetary policy wouldn't have the flexibility to support the real economy. The importance of retaining that credibility weighed on my monetary policy decision in July of last year and throughout this period.

In August 2012, I voted to maintain the stock of asset purchases at £375 billion. Although my view of the economic outlook had not changed materially from the previous month, I judged that reversing the decision taken by the Committee in the previous month would create considerable confusion and uncertainty. I made this decision in the knowledge that should my concerns about the inflation outlook materialise, I would have the opportunity in subsequent months to alter my vote. I have voted to maintain the stock of asset purchases at £375 billion at all subsequent meetings.

The Outlook

It looks like we are entering a period of modest, but sustained, economic growth. Business surveys and near-term indicators have firmed since the beginning of the year and some of the headwinds holding back growth in recent years have eased. But the hangover of adjustments and repair left by the financial crisis means that the recovery is likely to continue to be weak by historical standards.

CPI inflation looks set to rise over the next few months and to fluctuate around 3% for much of the summer and the autumn. But the weakness in wage growth means that domestic cost pressures remain well contained, and inflation is likely to fall back to around the 2% target over the next two years or so as the current price pressures stemming from abroad and from recent administered and regulatory decisions fade.

The outlook for growth and inflation is complicated by the considerable uncertainty concerning the extent to which the financial crisis has impaired the supply side of our economy. In particular, the extent to which the puzzling weakness in productivity in recent years stems from the weak demand environment and so may lessen as the economy recovers or whether it largely reflects other factors, such as the damaged banking sector, which might persist even as output recovers. As a result, the short-run trade-off between output and inflation is unusually uncertain.

Monetary policy in the current environment has to balance three significant risks. First, that the Committee does not provide sufficient stimulus to support the incipient recovery and that a further prolonged period of almost stagnant output damages the supply side capacity of our economy. Second, that the sustained period of above target inflation, which I expect to continue for much of the next two years, begins to dent the MPC's credibility, which would be costly for the Committee to regain and would in the meantime constrain the extent to which we are able to support output and employment. And third, that the extraordinary stimulus provided by the MPC, and other central banks, encourages excessive risk taking, which might both threaten financial stability and make it more difficult for the Committee to exit from the current ultra-loose stance of monetary policy as the economy recovers.

All three of these risks, were they to crystallise, have the potential to give rise to significant costs in terms of the efficient functioning of the economy and our nation's welfare. Trying to balance these three risks has been central to my policy decisions over the past year and I expect it to remain so going forward.

Explaining Monetary Policy

Since June 2012, I have delivered three on-the-record speeches, given one interview and written one Op Ed for national newspapers, and made numerous off-the-record presentations to a variety of audiences. These included background briefings on both the extension of the Funding for Lending Scheme and the Bank's new forecasting platform. I have made six regional visits which involved various meetings and events with local businesses and media. As the Bank's Chief Economist, I have extensive liaison with economists in the private and official sectors, both in the UK and internationally.

June 2013

Annual Report to the Treasury Committee
Ben Broadbent, External Member, Monetary Policy Committee

Voting Record

The last year has seen a marked improvement in sentiment in financial markets, a gentle rise in UK economic activity, albeit one that has been obscured by exceptional trends in particular sectors, and rates of inflation that remain above target. It is against this backdrop that I have not voted to expand further the stock of asset purchases.

The improvement in financial markets—particularly marked in the case of banks' funding costs (both debt and equity)—dates from the middle of last year and may, at least in part, owe something to initiatives and statements of central banks around that time. The Bank of England, in conjunction with the Treasury, announced last June the creation of the Funding for Lending Scheme, since extended; in July 2012 the ECB declared it would do "whatever it takes to preserve the euro", and shortly afterwards announced the Outright Monetary Transactions programme (it has since cut its official interest rate as well); in September the US Federal Reserve re-launched its own asset purchase programme and, subject to the stability of inflation expectations, pledged to continue to ease policy until the labour market improves sufficiently.

Some have questioned whether financial markets have over-reacted to these developments, and even whether easy monetary policy has encouraged excessive risk-taking. It hardly needs saying that central banks need to be alert to the dangers of excessive risk in the financial system and, even after the creation of the Financial Policy Committee, that duty extends to the MPC. But I do not yet see any great cause for concern. Equity prices are still 20% below their recent peak in real terms, that much further relative to corporate earnings. Meanwhile, credit extended to non-bank financial companies has stagnated over the past year and continues to fall relative to GDP. So my votes against further expansion of asset purchases are not motivated by a concern that monetary easing has done too much to prices of financial assets (or, for that matter, the opposite concern—much heard in 2012—that it does little to anything).

What is true, however, is that improvements in financial markets have reduced the costs of funding real assets and, therefore, improved the prospects for investment spending, both here and overseas. This, in turn, makes me more confident that the central forecast in the Inflation Report, which envisages a steady improvement in growth—from less than 1% over the past year (to 2013Q1) to 1½% over the next year and 2% the year after that—are reasonable. Even this acceleration in activity is exaggerated by the sharp contractions in oil and construction output last year, declines which are unlikely to be repeated over the next year or two. And current business surveys are, for what it's worth, consistent with GDP growth closer (at an annualised rate) to 2% than 1%.

Though better than the recent past, growth of 1%2% can hardly be described as strong. It is comfortably below the historical average, weaker still than the typical rate three to four years after a recession. So if underlying productivity were also to grow at its normal (2%) rate, and given continued growth of the workforce, the Inflation Report forecasts would imply widening spare capacity and, all else equal, downward pressure on inflation over the medium term. The difficulty for monetary policy is that productivity growth has been very weak, far weaker than one would expect (on past correlations) even given the path of output. It is still not clear what exactly has caused this shortfall and the likelihood is that several things have contributed to it. As I explained in a speech last year, I believe that one significant factor may be the difficulty the economy has had—partly thanks to a still-dysfunctional financial system—in adapting to the significant cross-sectoral shocks wrought by the financial crisis. If so, then it's quite possible that, as the financial system returns to health, and profitable opportunities are again exploited, productivity can again start growing—even, for a period, at an above-average rate. The difficulty is judging when that might happen and there is clearly a risk that, should monetary policy be eased too much in anticipation of such an improvement, inflation would remain above target for that much longer. It is these risks, not a concern with the instrument of policy *per se* (asset purchases as opposed to interest rates), that have persuaded me to vote to keep the monetary stance unchanged over the past twelve months.

The Outlook

I have described how the central forecast in the May Inflation Report envisages a further improvement in economic growth, though not to above-average rates. I also said that part of the expected improvement, at least in the near term, relates to the moderation of the severe rates of contraction seen last year in two particular sectors, oil and construction. I will briefly explain the second point and then say something about wider sources of risk over the medium term.

In 2012, construction output is estimated to have fallen by over 8%, oil production by over 10%. These are relatively small sectors of the economy. But the declines were big enough to knock 0.8% off whole-economy output. Without them, in other words, the economy would have growth by 1.3% rather than 0.5%. In general, one should be wary about simply stripping out the weaker components of growth and assuming that these will correct while the rest of economy carries on growing at a similar rate (the same applies to the faster-rising parts of the CPI). But in this instance there are particular reasons for the severity of the declines last year—maintenance in the case of the North Sea, the lagged effects of reductions in public-sector investment in the case of construction—and particular reasons too for believing that, over the next couple of years, activity is more likely to grow than shrink (oil companies themselves envisage a stabilisation of output; government plans imply moderate increases in gross public-sector investment; there are also signs of firming activity in housing activity, including a rise in housing starts). So it is not unreasonable to expect a less negative contribution from these sources, not to say a slightly positive contribution, over the next couple of years.

More important will be the underlying macroeconomic risks and, of these, the most important still originate from the euro area. It seems to me unlikely that, on its own, monetary policy can unwind the imbalances that built up within the euro area before the crisis or offset the effects of them that have been so plain since. At best, it can buy time for the necessary adjustments to occur and, if this time is to be used profitably, other policy makers need to act too. The shape of a more sustainable euro zone, one that involves a greater degree of risk-sharing in banking regulation and fiscal arrangements, is now detectable. But there are probably further steps to be taken and considerable uncertainty still about how rapidly this will happen. In the meantime, it is hard to see how the euro zone can recover very rapidly (as might be expected in a "normal" cycle) and that will, in turn, continue to act as a drag on our own economy. This is partly why our own forecasts, for UK growth, remain relatively muted and why there is still a downward skew to the distribution.

Domestically, the key areas of uncertainty relate to the behaviour of the banking system and the path of productivity. As I said above, I think these two things may be related. And our forecasts entail a gradual (though unspectacular) improvement on both fronts. I think these are reasonable forecasts. But there's many a slip "twixt cup and lip", and much uncertainty about how these things will evolve.

Explaining Monetary Policy

In the past year I have given three public speeches. The first, last September, was about productivity. I point out that cross-sectoral shocks will lower productivity unless resources are fully mobile in response; I conjecture that slow resource reallocation may help to explain weak productivity growth in the UK (and after other financial crises). The second, last November, discussed the outlook for the construction sector and argued that one might expect to see a stabilisation of output from the spring of 2013. The third, this May, was about forecasting errors. I suggest that people are typically too quick to judge forecasts and too ready to see forecast "errors" as precisely that—someone's mistake. I also gave a seminar (unpublished) at Oxford University, in February, and wrote an article on inflation targeting for an "ebook" published by VoxEU in April.

I have given four on-the-record media interviews (to the BBC, the Northern Echo, CNBC and Bloomberg). I have also had several off-the-record meetings with journalists.

I have made seven Agency visits, to the North East, Great London (both in September last year), Wales, the North West (October 2012), Scotland (February 2013), the South West (April 2013) and East Anglia (May 2013).

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