TUESDAY 24 NOVEMBER 2009

Present

Best, L
Eatwell, L
Forsyth of Drumlean, L
Hamwee, B
Kingsmill, B
Levene of Portsoken, L
MacGregor of Pulham Market, L
Paul, L
Tugendhat, L
Vallance of Tummel, L (Chairman)

Witnesses: **Mr Mervyn King,** Governor of the Bank of England, **Mr Paul Tucker,** Deputy Governor, **Mr Paul Fisher,** Executive Director, and **Mr Andrew Sentance,** External MPC Member, examined.

Q1 Chairman: Welcome to the Economic Affairs Committee. This meeting will begin with one of our occasional series of hearings with the Governor of the Bank of England on the Economic Outlook. The second part of the meeting will be the sixth public hearing of our inquiry into private finance projects. As usual copies of members' entries in the register of interests and interests declared as relevant to this inquiry are available to the public and to the witnesses. Governor, Deputy Governor, Mr Fisher and Mr Sentance, welcome; thank you for sparing time to come along. As ever we would be grateful if you could speak reasonably loudly and clearly for the benefit of the stenographer and indeed for the webcast. Perhaps I could start with the first question which is a general one. The Bank has upgraded its forecasts for recovery and growth over the next two years. There has been a certain amount of criticism from some commentators that perhaps the figures are over-optimistic. How would you respond to that?

Mr King: Good afternoon. I feel a lot hinges on what you mean by "optimistic" and I think, if you look at the inflation report we published a couple of weeks ago, we tried very hard to show the same outlook for the economy in two ways, one is the more conventional way of looking at growth rates and the other was in terms of levels of activity, levels of GDP. In terms of growth rates I think some people have looked at the fan chart for growth rates and said there are pretty rapid growth rates, is it back to business as usual, but what we wanted to do was to show the consequence of the very sharp fall in the level of output that has occurred over the past year, particularly at the end of last year and beginning of this year. If you have the inflation report, if you look at pages six and seven, you will see there that chart one is a chart for growth rates which may have given rise to this view that we have a rather optimistic outlook. Chart two is the implication of that very same outlook for the level of output and you can see that after the sharp fall in output at the end of last year/beginning of this, that the level of output is expected to be below the level it would otherwise have been expected to be at really for the indefinite future. We just do not make up the lost ground that we have experienced as a result of the financial crisis. That is really very marked. I would caution everyone against looking at individual numbers here but the darkest part of our fan chart is the most likely outcome but there are downside risks in our view to activity. If you take those into account then the growth rates in 2010 and 2011 – the calendar year growth rates – are really not much more than 1.5 per cent in 2010 and three per cent in 2011 which is much closer to the consensus. That is the expected growth rate in the economy, the mean of the distribution. I think those are not quite so apparently optimistic. One reason why we believe there will be some recovery is because we do think that the actions we have taken in terms of asset purchases – what some people call quantitative easing, injecting money directly into the economy - will have an impact on the economy and it will stimulate spending and ultimately feed through to activity and to inflation. We do believe that the policy actions we have taken will have some effect. If other people for one reason or another have not factored that into their outlook, then they will not surprisingly have somewhat more pessimistic forecasts. However, as I say, no-one can possibly know the number; there is enormous uncertainty. That is why we published them as a fan chart. It is the impression that you get by looking at the shape of the picture that matters; very sharp downturn at the end of last year/beginning of this year; signs of flattening out; then a recovery. That will go forward but will still leave the level of output well below the level that one might have expected to see had we continued on the growth trend that we were experiencing over many years up to 2007.

Q2 Chairman: We will come back to quantitative easing a little later but as you raised it perhaps I could ask you if you could tell us a little bit about what the underlying assumptions were with respect to quantitative easing over the next two years in your growth forecast.

Mr King: We condition the forecast always on a path for monetary policy. This is an arbitrary path for monetary policy, not a path that we necessarily expect to follow. We do it always in two ways, one for the market expectation of bank rate and the other for constant bank rate right through the forecast horizon. When it comes asset purchases there is no obvious observation of market expectations of the scale of the assets that we will continue to hold as a result of our purchases so we have assumed that the pictures that we generate in our fan charts are conditional on the one hand on the market path of the bank rate which is for it to pick up and to recover over the next two years, back to around three per cent, but for the £200 billion of asset purchases that we agreed at the last meeting to be maintained, to have reached that and hold that fixed right through the next three year period. The other forecast is one conditioned on a constant bank rate of 0.5 per cent but the same £200 billion worth of asset purchases. These are different angles, if you like, of getting a view on the same outlook; we have the same view of the economy, we are just conditioning it on slightly different assumptions about how stimulatory monetary policy will be, so it gives you an extra way of trying to triangulate the view that the Committee has on the state of the economy.

Q3 Lord Forsyth of Drumlean: I was quite struck with the minutes of this month's (November) Monetary Policy Committee minutes where your chief economist, Spencer Dale, said that further substantial injections of liquidity might result in unwarranted increases in some asset prices that could prove costly to rectify, complicating the task of meeting the inflation target in the future. The week previously, at the inflation report press conference, you said it would be peculiar to worry about asset prices at this particular point. That is quite a spread of views.

Mr King: It is a spread of views but I do not think they are as far as apart as that, after all Spencer Dale did vote for maintaining asset purchases at £175 billion; he was not arguing that we should reverse that and I was not arguing that we should go more than £200 billion worth of asset purchases. I think it is a relatively small difference of view. Everyone on the Committee accepts that if we were to continue with asset purchases month in, month out and to do that without limit then inevitably not merely would asset prices rise, actually consumer price inflation would rise to well above target. No-one is suggesting we do that. The real challenge facing the Committee is to know at what point to reduce the extraordinary amount of stimulation that we have injected into the economy and that is something that we will judge month by month. The strength of the MPC is that there are differences of view on it. These can reflect differences of judgment about the outlook for the economy. No-one has a monopoly of wisdom. We think it is better to aggregate our views and we believe in what comes out of that as a majority is the best way of reaching the decision. We have always done that. At various times all of us have been in the minority; I am sure that will continue to be the case. The most important thing is that people argue for what they really believe to be the case. That, I think, is the strength of the MPC process. The differences of view are small.

We have had three ways differences of view on monetary policy before when it came to levels of bank rate, so the fact that that should be true for levels of asset purchases I do not think is particularly surprising especially at a juncture where we are, perhaps close to a turning point, at least in terms of growth rates.

Q4 Lord Best: Governor, what do you see as the likely consequences for future inflation and monetary policy of this burgeoning fiscal deficit? In particular, do you see an economic case, perhaps temporarily, for adopting a monetary policy that allows inflation to increase in order to reduce the value of debt in real terms which many governments before have done to reduce the government debt burden?

Mr King: I think if the deficit were allowed to run unchecked indefinitely then this would undoubtedly make the task of monetary policy much more difficult, it would lead people to doubt the credibility of the commitment of the UK as whole to low and stable inflation and indeed to macro-economic stability in general. However, I do not believe anybody is suggesting that. There may be differences of view about precisely when and precisely how the deficit would be reduced, but I think everyone is agreed on the need to reduce the very large fiscal deficit and to start on that pretty soon. I think there is a broad agreement on that front. The idea of trying to use higher inflation to solve the problem of the deficit is mistaken because the deficit itself is not going to be eased or helped by having inflation. It may be that you believe mistakenly that over a period you can solve a problem of a stock of debt by allowing inflation to pick up and erode the value of that stock of debt, but that does not help with the deficit problem; the deficit still has to be closed. In the long run what we saw in the periods you referred to in your question was that once you have given away the idea that you are prepared to allow inflation to rise well above target to solve the fiscal problem, it may be extraordinarily painful to convince people that you are serious about bringing inflation back down again to a reasonable target. We have never found it easy to bring inflation down from high levels to close to the target, so since we have got an inflation rate in the vicinity of the target I think it would be extremely unwise to abandon our position and give up the pursuit of the inflation target. We certainly will continue, as long as that is the instruction given to us, to us to set monetary policy in order to meet the inflation target.

Q5 Lord MacGregor of Pulham Market: I have some questions on quantitative easing. How successful has it been so far, not least in encouraging bank lending? How long will it continue? I think you have partly dealt with that but I think I heard you say that your judge month by month, and in answer to another question you seem to imply that you would be holding the position over two years. Perhaps you could just clarify that. How do you back out of it or run it down, and what is the likely cost to the taxpayer?

Mr King: I think there are about half a dozen questions there.

Q6 Lord MacGregor of Pulham Market: Four I think.

Mr King: Let me try to deal first with the very precise point about the assumption about the scale of quantitative easing. We judge it month by month; we do not decide now what scale of quantitative easing we will carry out in one month or three months' or six months' time. The virtue of the Monetary Policy Committee is the flexibility we have to revisit our decisions each month and we do that. The forecast is conditioned on an assumed path of quantitative easing. This is not a statement about what we will expect to do ourselves; it is merely a very precise statement to you, the viewer, to tell you from what angle you are looking at this forecast. It is a photograph of our views about the outlook for the economy; we want you to know from what angle you are viewing this outlook. That depends on the conditioning path for monetary policy, both bank rate and the path of quantitative easing.

Q7 Lord MacGregor of Pulham Market: We should not read any more into it than that?

Mr King: No, you should not read any more into it than that. I think it has been successful. We have injected a large amount of money into the economy. I know to many people this will seem rather strange because for the last 50 years most of the time the central bank has put its efforts into trying to withdraw an excessive amount of money creation in the economy in order to bring inflation down. This is a very unusual situation. I think the extraordinary damage done to the banking sector has meant that the great powerful movement to deleverage the banking sector which is underway is creating an enormous monetary squeeze on the economy. Even the injection of money that we have put into the economy has not been sufficient wholly to offset that. I think we have largely offset it and I think the economy would have shrunk much further and faster had we not injected the money into the economy that we did. How does it work? We buy assets; primarily we have been buying government gilts because this is an asset that is completely safe from the taxpayers' point of view. It does not involve our making judgments about private credit instruments and which parts of the economy should receive credit. We injected the money into the economy and then what happens – this is the more conventional part of the monetary transmission mechanism - the people in the economy who sold assets to us (primarily the non-bank private sector) will then normally wish to diversify their portfolio to buy other assets to replace the gilts that they sold to us. That means an entire range of financial and, in some cases perhaps, even real assets. That will push up the prices of those assets which, other things being equal, one might expect to lead to higher spending by the private sector, and it will also lower the yields on those assets which, in the case of those instruments which are used to finance companies – for example corporate bonds – reducing the yield of corporate bonds will lower the cost to companies of obtaining finance and that in turn will act to stimulate the economy. In many ways this is a rather conventional part of the monetary transmission mechanism. Now I think, as I said, what has proved difficult for us in this period, is that unusually we are doing this at a time when the banking sector has been very badly damaged, where the banking sector is trying very hard to reduce the size of its balance sheet, which means that although our actions can stimulate the demand for lending it cannot directly do anything to increase the supply of lending and indeed quantitative easing itself does not and is not and never was thought to be an instrument designed to improve the ability of the banking sector to provide more lending. That would have to be achieved more directly. Of course to the extent that we can get the economy to grow a little faster than would otherwise be the case or to come out of the sharp downturn that we have experienced, that will make it easier for the banking sector to achieve its desired deleveraging and will bring forward the point when the banking sector will be back again in a state of health where it would be able to finance lending normally. We are not in that position at present. I think quantitative easing has worked. How will we continue to do it? I think that is something that we will judge month by month. We have a programme of asset purchases which we announce as a plan for three months so there is some presumption that we will take this programme to the end of January and think again at the February inflation report Monetary Policy Committee meeting. We can always change our mind and do something earlier if we wish to do that but certainly next February we would have another decision to make and we would make it at that point with all the information available to hand then and we certainly would not dream of making it in advance. It is much better to wait, with all the information, the new forecast, the new inflation report and we will be able to form our judgment then.

Q8 Lord MacGregor of Pulham Market: What about the question of backing out and running it down?

Mr King: I think it is relatively straight forward in principle and technically in that what we would do is a combination of raising bank rates and selling the assets that we purchased. I see no technical impediment to either. We have had a long history of both buying and selling assets and also raising and lowering bank rates. We know how to do it. The really difficult part is the judgment about when and by how much to tighten monetary policy. Indeed at this stage I think we cannot even rule out doing more asset purchasing; that will depend on the state of the economy so we are waiting until we get there. The most difficult challenge for the Committee over the next couple of years is that we know we start from a position of quite extraordinary monetary stimulus; we are clearly not going to want to stay here indefinitely and at some point we have a very substantial degree of tightening to undertake. The timing of that and the path along which we tighten policy will be one of the most difficult judgments that the Monetary Policy Committee will ever be called upon to make. I think it is the judgment that is going to be difficult, not the technicality of doing it.

Q9 Lord MacGregor of Pulham Market: You seem to suggest, just on the effects so far, that one of the main effects in these purposes was to enable banks to restrengthen their balance sheets and overcome some of their own problems before they then started to lend substantially again whereas government ministers have given the impression that the whole purpose was to encourage the banks to start lending.

Mr King: The purpose of quantitative easing was to inject more money into the economy and stimulate private sector demand. It was to operate on the demand side of the equation, on money and the demand side, not on credit and supply.

Mr Tucker: In some respects it bypasses the banking system. By buying the gilts and putting the cash out to non-bank financial institutions it is precisely trying to sidestep the difficulties with bank intermediation that we find ourselves with.

Q10 Lord MacGregor of Pulham Market: I do understand that. I think that government ministers have sometimes given a rather different impression. You do not think that one of the consequences has been to produce extra demand for assets like equities and a lot of it has gone into that area which would not immediately have the same effect on the economy.

Mr King: The whole point is to inject money into the economy so that the institutions or agents who sold the assets to us would then buy other assets which might well include equities but that is part of the conventional transmission mechanism of monetary policy; you ease monetary policy and that normally leads to a rise in asset prices, precisely by how much and which asset varies and will depend on the preferences of those investors. Trying to increase asset prices was indeed one of the objectives of quantitative easing because that is part of the way in which monetary policy can help us stimulate the economy.

Q11 Lord Tugendhat: I believe we all have reason to be grateful to you for the way in which the quantitative easing programme has been conducted and I would hope that you would not end it prematurely. Having made that point, I wonder if there is anything you can tell us about what changes have occurred in the composition of other holders and buyers of gilts as this programme has unfolded?

Mr King: Perhaps I can ask Mr Fisher to comment on that.

Mr Fisher: It is quite difficult to know the counter-factual. We know that we have bought around £180 billion of gilts that would otherwise have been held principally by the non-bank financial sector. That would mostly be insurance companies, but actually a lot of insurance companies and pension funds delegate their assets out to asset managers and it is the asset managers who make the active decisions. We know that during the course of this year so far, corporate bonds have been issued at what I believe is a record pace, a much higher rate of issuance than in previous years, and equity issuance has also been high. So we know that those assets have been in very high demand from the asset managers. It is very difficult to give anything very precise in terms of the composition.

Q12 Lord Tugendhat: In terms of overseas holders of gilts, has there been any significant change in holders and indeed purchasers?

Mr Fisher: My information from contacts is that the overseas holders are continuing to buy gilts. In the first two months of the operation of the asset purchase facility the data we have - which is fairly meagre - did show proportionally some sales out of what were supposed to be overseas holders of gilts. But those overseas holders of gilts might just be funds which are registered overseas but are operating in London so it is not clear really where the location is. Over the £180 billion of purchases so far it has been predominantly those classed as domestic institutions who have been the sellers of gilts.

Q13 Lord Eatwell: When you were talking about the unwinding of quantitative easing you related it very carefully to the state of the economy at the time. You did not similarly qualify the issue of when the deficit might be reduced which you just said was quite soon. Should that be related to the state of the economy too?

Mr King: Absolutely. Forgive me for giving a misleading impression. I spoke in another place this morning and was very, very clear that whatever path is taken to reduce the fiscal deficit – I think it is important to have a clear, credible plan to do that - it needs to be contingent on the state of the economy.

Q14 Lord Forsyth of Drumlean: I do not want to go over the ground you have just gone over on quantitative easing. Perhaps I am being a bit stupid but having read all the stuff when we started the programme of quantitative easing the objective seemed to be to increase the money supply. What is not clear in my mind are what are the specific objectives that you are trying to achieve by your programme of quantitative easing?

Mr King: Our specific objective is to try to meet the inflation target and to do that in the short run by injecting more money into the economy because the scale of both broad money and total nominal spending was substantially below where they would have been had we not experienced the financial crisis and in order to get back to a path that was going to hit the inflation target we needed to expand the total level of nominal demand. To do that we injected money directly into the economy and calibrated that by the scale by which we thought the amount of money needed to be increased, so it was done directly in those terms. Of course what we do is not the only influence on the amount of broad money in the economy. The banking system has a major influence on that and the banking sector has been trying reduce its leverage – the size of its balance sheet – which, other things being equal, is going to shrink the amount of money in the economy. These two factors have been working against each other. I think that since the banks would undoubtedly have been trying to shrink their balance sheets even if we had not injected money into the economy, we have managed to prevent the amount of money falling faster than it would otherwise have done and in that sense stabilised the growth rate of money and indeed some signs that it is beginning to pick up. It might have been better had it picked up a bit faster – that would have been better - but we are going through a quite extraordinary downturn in the world economy where every county is experiencing something very similar and I rather doubt that any path of monetary policy would have found it easy to get the path of nominal demand back to its ideal level very quickly. We are certainly trying to do it; you can see it in our projections and forecasts. We aim to get inflation back to target at the end the horizon. If we can get it back before that then undoubtedly we will try to do so. The path of the economy in the short run is very heavily dependent on what is happening overseas and not just on the actions that we take. We have been through the most extraordinary downturn from which I am glad to say the world economy appears to be slowly and gradually emerging.

Q15 Lord Forsyth of Drumlean: In terms of deciding on the scale of quantitative easing and when to stop it and how to stop it, where does responsibility for lie as regards the Bank and the Treasury and Parliament? The supplementary question I am going to ask you is, where is the scope for parliamentary scrutiny of this?

Mr King: The decision lies with the Monetary Policy Committee as do the decisions on bank rate. It is true that because we are buying assets we have an indemnity from the Treasury so I always discuss this and the chancellor gives me an indemnity so that the Monetary Policy Committee can take its decision. However, at no stage has the chancellor ever sought to influence or second guess the decisions of the MPC on the scale of quantitative easing. That is a matter for monetary policy and the Monetary Policy Committee. As far as scrutiny is concerned, the two main fora for scrutiny of this is this Committee and the partner committee – the Treasury Committee – in the Commons to which most of us here attended this morning, so we do have clear Parliamentary scrutiny of that.

Q16 Lord Forsyth of Drumlean: Because of the blurring quantitative easing creates in policy between monetary and fiscal policy, effectively no-one knows what the consequences of the quantitative easing will be ultimately. Parliament has been effectively circumvented. Throughout our history Parliament has been involved in determining spending and borrowing, now the Bank, as you have explained it, appears to be able to decide these matters pretty well without proper scrutiny, and where we have had quantitative easing in the past in our history – I think on three occasions - there have been special vehicles established in order to control it because of the consequences, if quantitative easing goes wrong, for the wider savings and health of the economy.

Mr King: I do not share that view at all I am afraid. Quantitative easing is another form of increasing money supply. That is something which central banks around the world do provided parliament gives them the authority to do it. Parliament has given the Monetary Policy Committee the authority to set bank rate which is another way of deciding how much money supply there will be in the economy. This is just another vehicle for doing it. We do not determine borrowing or spending in the economy; that is entirely a fiscal matter for the chancellor. We determine the amount of money that we inject into the economy and one of the reasons why we have conducted most of our operations in terms of government gilts is precisely to avoid the Monetary Policy Committee making judgments and decisions about the allocation of credit between particular sectors of the economy or particular companies which ought properly to be taken by elected politicians. Everything that we have done has been done within a very clear remit given to us by Parliament.

Q17 Lord Forsyth of Drumlean: To finish that point, the quantitative easing policy in itself will add substantially to the national debt, will it not? You have set up an off-balance sheet vehicle which I suppose must be the government's biggest creditor; these are quite innovative changes which will have a long term effect on the amount borne by the taxpayer and the impact on the economy surely?

Mr King: We are not having direct effect on the amount of public debt and anything that we do - the assets we buy – one day we will sell back into the market.

Q18 Lord Forsyth of Drumlean: At a loss.

Mr King: We buy them from the private market and sell them back to the private market. What we are doing is influencing the amount of money in the economy. Of course the effect of that is uncertain but that is true of all monetary policy and we would not dream of doing this had we not got a clear remit from Parliament to set monetary policy to meet the inflation target.

Q19 Lord Forsyth of Drumlean: Are you saying the effect of the quantitative easing policy will not add to the national debt?

Mr King: It will not add to the national debt, no.

Q20 Baroness Kingsmill: Governor, I wonder if you could help me a little as to why we seem to be so particularly dependent on quantitative easing and why, for example, the US Fed and ECB seem to express scepticism about this. What is the explanation for these differences of opinion?

Mr King: To be honest I do not think there are anywhere near as big differences of opinion perhaps as the question might suggest. All three central banks have seen a very large expansion of the size of their balance sheet both in absolute terms and relative to GDP - in fact a rather similar rate of increase in the size of the balance sheet relative to GPD - precisely in order to deal with the most extraordinary financial crisis. The types of assets which have been purchased by the three central banks have been rather different but that I think represents different circumstances. The United States has bought a significant amount of private sector assets; they have also bought a very large amount of quasi government assets, that is instruments guaranteed by or issued by what are effectively now government agencies in the mortgage market. They have bought extraordinary amounts of that; that is very similar to our purchasing government gilts.

Q21 Baroness Kingsmill: You mean the toxic assets.

Mr King: No, not the toxic assets. Mortgage assets guaranteed by the Fannie Mae, Freddie Mac and so on or, indeed, instruments issued by those organisations to finance themselves. They have been purchased by the Federal Reserve. In the case of the European Central Bank I think it would be almost impossible for them to buy government bonds because whose government bonds would they buy? It would be very, very difficult to purchase equi-proportional issues of each country in proportion to GDP for the same maturity (they have different structures of government debt). I think we are in a much stronger position; I think our policy is a lot easier to implement than theirs. What the ECB have done is essentially to be willing to lend to the banking sector for a much longer period to guarantee them an interest rate at which they will lend and re-purchase the instrument a year later at the interest rate which they are setting today. They are finding other ways of injecting money into the economy. I think we are all doing the same type of operation, which is finding a way of injecting money into the economy in order to stimulate total private sector domestic demand. The scale of it, if you look at the balance sheet of central banks, is actually not dissimilar across the three major central banks. I think the differences are actually much smaller than the similarities and that is the most important thing. I think if that were not the case it would be very odd because we all face the same problem.

Q22 Baroness Hamwee: Can we turn to financial regulation, the UK's Tripartite system? What is your current view of the need for change?

Mr King: I always find this debate rather unhelpful. If you go back people said that no-one knew who was in charge of the Tripartite system. What was very clear at the time when the crisis started and we got into the problems with Northern Rock was that all three members of the Tripartite knew exactly what their responsibilities were. The real problem was that none of the three had the powers or ability to resolve a failing bank. We knew what our responsibilities were but nobody had been given the responsibility for the resolution authority to resolve a failing bank. We were the only G7 country that did not have that system. It had been discussed that it was in the process of being analysed and debated and I think in a couple more years we would probably have had it in place, but that was not to be. Once that was the case, once there was the absence of a resolution authority, then I think it did not matter what the Tripartite said to each other; what was missing were key instruments that the authorities needed collectively. Interestingly, exactly the same problem arose in the United States when trying to deal with Lehman Brothers. They too had no legal powers of resolution of Lehman Brothers and they were put in a very difficult position. If you look at almost all aspects of the regulatory system that have failed the question that is worth asking is "What powers should somebody have had that nobody had?" and not "What did X do that Y might have done instead?" I think this is true of deposit insurance where we needed to change that system. It was true of liquidity regulation; we did not have adequate liquidity regulation. We did not have a resolution authority. These are things that I mentioned at the very first Treasury Committee hearing we had on the Northern Rock issue. As we have gone forward we have introduced a banking bill which has introduced a resolution authority; we have corrected a system of deposit insurance. Now I think the really big question is to deal with this too important to fail question and to ensure that whatever regulatory system we have and whoever is responsible for operating it, the most important question is: do we have a structure of the financial system and a structure of financial regulation that means that no institution can believe that it is too important to fail and that if it fails and makes a mess of things it will be allowed to fail. One of the real tests of successful regulation is a regulatory system where the regulator has the confidence and will not be criticised for allowing an institution to fail that deserves to fail because it has made a mess of things. That is true in every other part of the economy and it needs to be true in the financial sector as well. In all of these areas I think rather than wonder is it the Tripartite, should it be somebody else, the real question is: what powers are needed to deal with the financial sector? What kind of regulation should we have? I do not think you can answer that without thinking quite deeply about what structure of the financial sector we should have as well.

Q23 Chairman: The Bank published a very interesting discussion paper over the weekend on macro-prudential policy. What do you see as being the next steps there? I know it is a discussion paper, but in order to get that focussed into action rather than discussion, what would happen and who would trigger it?

Mr King: We are trying to generate a debate on this and I am sure that we will succeed in doing that. In many ways a very important aspect of that debate is the international debate among the regulatory communities, not just regulators but central banks as well. Paul, my colleague, is chairing a key working party in that international debate. Let me ask him to explain how we are going to carry this debate forward.

Mr Tucker: It is exactly as the Governor says; there will be a domestic debate with our Tripartite partners but also I hope with the banking system. The two great debates are about too big to fail and market discipline, what happens when everything goes wrong. The other one is about whether we can slow the credit cycle just a bit to make it less likely that things go wrong. If we cannot cure those problems then the levels of capital and liquidity that the banking system will have to hold will be higher. This is not just an official sector perspective; the banking system has a pretty compelling incentive to work with the authorities first to make it easier for banks to escape distress in an orderly way and secondly for the authorities to take the punchbowl away when it needs to be taken away. The international dimension to this is vital for two reasons. First of all on resolution plans it is vital because so many banks operate internationally and insolvency laws are immensely complex in every country, they are even more complex when they interact. The idea that any country can sit in its own capital and decide that it will resolve a distressed bank in a particular way with indifference to the rest of the world is utterly fanciful and it is partly for that reason that we have so many banks in state ownership or quasi state ownership around the world. The macro-prudential international dimension is subtly different. Imagine that there was over-exuberance in the mortgage market in this country at some date in the future and that the UK authorities made UK domicile banks hold more capital or more liquidity against lending to the UK mortgage market. That would probably make the UK banking system more resilient than otherwise but it would not necessarily stop households in the UK borrowing excessively from abroad. Indeed it would be a very massive step indeed to decide that we wanted exchange controls to block that. One would hope that in the example I have given that authorities overseas – in

Paris, Frankfurt, Washington or wherever - would say. "The UK authorities think the UK mortgage market is getting out of control, we ought also to be requiring our banks – German banks, French banks – to put more capital or liquidity aside against those risks". So at the very least I would hope we can get to a position where the information we share with each other in this field can influence each other's actions, which is just how monetary policy works in a world of floating exchange rates. Beyond that would be something more ambitious where we actually coordinated and I think we need to go one step at a time. The core of this - certainly the macro-prudential element - will be a debate about whether we can do this by rules alone or whether it requires an element of discretionary judgment. We start off doubtful that it can be done by rules alone. If we were good enough at writing rules we would write a monetary policy rule and not have the MPC meet each month. Once you introduce discretion then you need to put a framework of discipline and accountability around that so that it is not just faceless bureaucrats deciding what the capital ratios and liquidity ratios of banks are if whoever it is – we, the FSA, Treasury – decide that things are getting out of control. There is a lot to be debated here. I think the key debates will be in Basel and in this country amongst the Tripartite.

Q24 Chairman: I take your point that the chances of getting international agreement across the board for coordinated effort are relatively low in the short run and I think, from a reading of the report at any rate, there was a possibility that one might do something unilaterally as a first step in the UK. If that were the case then who would decide to do it? Is it within the Bank's purview to do it?

Mr King: That would depend on how the chancellor decided to allocate macro-prudential powers and responsibilities. That is something which the chancellor would have to decide.

Q25 Chairman: It seems to me that you have got quite close to developing potential instruments for exercising macro-prudential supervision, which is a big step forward, and therefore what you are saying is that if you buff these up and they became solid and not just a hypothesis then you would be ready to go if you got the nod from the chancellor?

Mr King: I do not think it has to be us; I think there are other bodies that could do it too. I do not want to make any pitch at all for any turf or territory. I want to make it clear that what we are doing in this discussion paper is contributing to a debate to try to get beyond the generalised assertions that macro-prudential powers would be a good thing and to work out what it would actually mean in practice, what the benefits might be and what the challenges and potential difficulties might be. I am sure that the discussion paper has not got to the bottom of it completely and that is why we have put it out to involve other people in the debate so that that debate can continue before the UK and Parliament decide what sort of macro-prudential powers it would like to be exercised in the United Kingdom. Once that has been decided and only then does it seem to me sensible to decide who should exercise them.

Q26 Chairman: That is fair enough, but you are getting quite close to a blue print as to what the macro-prudential instrument might be.

Mr King: I think there is a lot more to discuss but nevertheless we want to put this down in writing and get the debate going.

Q27 Lord Eatwell: When Jacques de Laroisière was here several months ago focussing on exactly this question he expressed a concern that macro-prudential regulation was akin to fiscal policy and was in the same decision making dimension, if you like. You said just now, Governor, that we do not determine borrowing or spending, but taking away the punchbowl is doing exactly that.

Mr King: There is a difference and I think there is a good question to ask about whether or not these powers are to be exercised in terms of general expansion of credit or whether it is to be in respect of particular markets. Paul gave the example of the mortgage market and it is certainly the case that if somebody is going to be called upon to make a judgment about whether there is too much exuberance in one market rather than another, that is something that gets much closer to the political level of decision taking than is conventional for central banks. This is why I do not think that these are easy questions to answer as to what kind of regulation we should have and who should then exercise it. There are big questions here.

Q28 Lord Eatwell: The report says that the judgments required to set macro-prudential policy would in kind be not unlike those required to operate monetary policy. That seems to me to be wrong.

Mr King: I do not think it is if it is in terms of credit as a whole. Let us suppose, for example, we take a counterfactual which said that in 2005-2007 when the MPC was raising bank rate, it was very conscious of the fact that it did not seem to matter how much we raised bank rate, mortgage rates were not going up, margins were being squeezed. Let us suppose that the MPC had been setting macro-prudential margins on mortgage lending at the same time. You could have argued, I think, that we would have got back to the point where the mortgage rate too would have risen and in that example it looks more like monetary policy. I think it does depend very much on the example one looks at. In the area of the linkage between financial institutions and whether you want to impose an extra capital requirement on institutions that have particularly important linkages with the rest of the financial sector, that is really neither monetary nor fiscal policy; that is much closer to regulation. That is why I think the macro-prudential area is both very interesting but it has aspects of all these different components of policy and I do not think therefore it is obvious how you reach the conclusion as to who should exercise it.

Q29 Lord Paul: I would like to come back to when you mentioned the banks being too big to fail and you think large banks should be broken up. If this policy were adopted how should the banks that are too important to fail be identified? Would adoption of the policy imply that no bank was too important to fail?

Mr King: I certainly think it is vital to get to a position where no bank or financial institution is regarded as too important to fail. From that point of view what I think is very clearly the wrong way to go is to try to move towards a situation where some institutions are either explicitly or implicitly identified as having a guarantee from the state and are too big to fail, even if they are charged a price for that. I think there is no price you can take easily if you are willing to give an absolutely unconditional guarantee. I do think it is very, very important that if we are going to have any hope of having a credible system of regulation of our financial sector that no institution can find itself in a position where it knows – and its creditors know, particularly its wholesale creditors know - that if things go wrong the state will actually underwrite it. There are many ways of getting to that point but the most important thing is to recognise that we just cannot allow institutions to continue if it is believed that they have that too important to fail guarantee. I think there are several different ways in which you can try to alter the financial structure in such a way as to mean that no institution is too important to fail and therefore they can be left to fail safely. It is a bit like a three-legged stool where you want to rest on three different legs, not just one. One is capital and I think we at the Bank feel quite strongly that contingent capital - that is capital which banks raise which, when the bank starts to run out of money automatically converts to equity – is a very important part of the capital structure of the banking sector going forward because it does provide a way in which we are much less dependent on some regulator working out precisely what the right Basel ratio is; there is a big cushion of capital that can be converted to equity when necessary and the people who supply that – the creditors – will know that there are circumstances when they would bear the burden and would not just be bailed out by the government. So capital is one leg. I think resolution is another, that is that banks cannot be allowed to become so complex, so systemically crucial to the system that no one can contemplate their disappearing. In other parts of the economy we have learned how to devise frameworks for regulation that maintain the continuity of service to consumers without guaranteeing the continuity of the private sector provider of that service, whether it is transport, telecommunications, electricity or whatever. We must do the same in financial services. We must distinguish between the individual company that provides the service and the kinds of services and continuity of service that government wants to guarantee. If institutions simply are too complex the regulator must have the courage to say, "I am sorry, you are too complex; you will have to change your structure so that we can indeed believe that you are an institution which we can allow to fail if you mess things up". The third thing is structure. There are certain kinds of depositors that government clearly does want to protect: we have given a hundred per cent guarantee now to retail depositors up to £50,000. That makes sense in order to enable ordinary people to run bank accounts and take part in the payment system without having to worry what kind of crazy investments the banks in which they put their deposits are engaging in. If we are going to guarantee those deposits we cannot allow those institutions to say, "These deposits are guaranteed, why do you not take them away and invest them in all kinds of exciting and very risky activity?" That cannot be right. There have to be restrictions on the activities which insured retail deposits are allowed to finance. These are three different legs: structure, resolution and capital which I think come together as an important agenda for the international regulatory system but what they all have in common is that the final resting point of this system has to be one in which no-one says "Very sorry, we have some institutions here which are just too big to fail; we will never be able to let them go." That is not a situation you can reconcile with a market discipline of a free market economy. We have heard a lot in recent months about banks and banking either being socially useless or doing God's work on the other hand. Frankly it does not matter whether they are doing either of those. Why should we decide? The market should decide. What matters is a very simple proposition which is that the market discipline that applies to the rest of the economy – to manufacturing and every other sector of the economy - has to apply to banking as well.

Q30 Lord Paul: I agree with you but, on the other hand, that assumes that the bankers knew what they were doing and the way some of these have failed is because they just lost track of what they were doing.

Mr King: Banks do make serious mistakes from time to time. In a private sector economy you can't stop people or prevent people from making mistakes, but the rule of a market economy is that if you make a mistake and your company fails, it fails. It does not get bailed out by government. The rest of the economy has come to learn that that is in fact the best route to prosperity and has come to accept that market discipline. What seems wholly wrong is that manufacturing, agriculture, construction and the rest of the economy understand that if their firm cannot find customers it fails; if you work for a company who cannot sell its product you lose your job and you have to find another one. That market discipline applies to everyone apparently except banks. That cannot possibly be right. It will distort the incentives for the monitoring of risks by banks of creditors who fund those banks. If they think they are not lending to the bank but lending to the government then of course they will not bother to monitor the risk which banks are taking. This is a very obvious common sense point and it is not about the sophistication of regulation; it is about you not being able to have a market economy unless banks are never going to find themselves in a position of being too important to fail. The big objective for regulation is that we should not expect regulators to stop banks from making mistakes that banks themselves feel are ones they really want to pursue. There is a limit to what regulators can do. If we really believe that the regulators are so much cleverer than the banks themselves, that they can not only monitor what the banks are doing when the banks are behaving sensibly, but they can also step in and tell the banks to stop it when they are not being sensible, then why on earth the regulators are not running the banks in the first place I do not know. That must be the right thing to happen, but that is not the way of the world. People will make mistakes and the important thing is that the banks and those who finance the banks – those who provide the funding for banks - recognise that many activities are risky, some will succeed and some will not. If they do not then the losses are made by the people who provided the finance, not by the taxpayer.

Q31 Baroness Kingsmill: Fundamentally, Governor, would you agree that there is simply not sufficient competition between the banks and that possibly it is a competition regulator that should be taking a very good hard look at these institutions?
Mr King: I do not think that is the essence of the too important to fail issue, although I do accept that what has happened as a consequence of the too important to fail development of the banking sector is that competition has been reduced. I think it would be healthier if we could go back to a more competitive banking system. The damage that has been done to the banking sector in the last two years has been such that that will not be an easy route for us to follow. For the UK as a whole it is very important that gradually and over time we try to chart our way back to a more competitive banking system.

Q32 Lord Tugendhat: You have said that banks will make mistakes and there will be failures; that must be the case, history demonstrates it. You have also said that you would like to see a situation in which the regulator has the authority to allow an institution to fail and not to be criticised for so doing. I think the not being criticised may be a hope rather than an aspiration but, looking at those two statements, do you feel that if the same body has the ultimate responsibility for deciding on whether a bank fails is perceived by the public to be the body that decides whether a bank fails is the same as the one which has responsibility for monetary policy that there is a danger that problems in the regulatory area, which are bound to be controversial and bound to create political discussion, will contaminate the authority in dealing with monetary policy?

Mr King: In principle yes, although I must say that my experience of the past two years is that the fact that the Bank of England had no responsibility whatsoever for banking did not seem to stop many people from criticising the Bank for what actually happened in the United Kingdom.

Q33 Lord Tugendhat: It has not contaminated your authority in dealing with monetary policy.

Mr King: No, but it might not do otherwise. I think it is very hard to say. The way in which these things are allocated around the world varies from one country to another. Let me assure you, I have not come here to argue for more powers or responsibilities at all; I have more than enough work on my plate. What I care most about is that in the debate about regulation we start from the position of saying what is the right structure of a financial sector? We then say, given that structure what should the regulation look like, what kind of regulation does the UK need? At that point we then ask who should do it and that is a matter for Parliament to decide.

Q34 Lord Eatwell: Now for something completely different. I wonder if we could just turn to the notion of a tax on financial transactions which has been proposed by the government, suggested by the head of the FSA and Mr Strauss-Kahn now seems to have come into line as well that this might be a good idea. If there is negative externality associated with financial transactions would it not be desirable to price that negative externality?

Mr King: I think the way you pose the question the answer can only be yes because you have assumed that there is a negative externality. The point I would make in this debate is that the argument that was used originally when Tobin talked about the Tobin tax and the earlier debates which you know very well took place, the concern was that prices in these markets were just too volatile and that was the main source of concern. I have to say, I do not really see that as being a major concern at present. Indeed, if I were to say what is my biggest concern about volatility of asset prices in the world economy, it is not the high frequency movement of asset prices that worries me, it is the low frequency, potential long term mis-pricing which continues for many years and then suddenly reverts. We have very low long term real interest rates in the world economy at present. I do not know whether these will persist or not. If they do not we will see a big fall in asset prices at some point in the future. If they do then I think many people's concerns about the current level of asset prices is probably misplaced, but no-one can really know that and I do not think a tax on transactions is relevant to that. For me the two biggest issues facing the policy makers in the world economy that come out of the financial crisis are firstly the too important to fail question, and secondly, the imbalances in the world economy and the need for reform of the international monetary system. Those are the two big questions.

Q35 Lord Eatwell: There has been, has there not, an enormous expansion of the volume of financial transactions related to any given real underline?

Mr King: That is the scale of financial transactions.

Q36 Lord Eatwell: That seems to be the stuff that did not trade, all of the securitisations.

Mr Tucker: It was the leverage loan stuck on their books which rendered them bankrupt, not the position that they could trade in reasonably liquid markets. Yes, they lost money on it but they were able to contain their losses because they could trade out of them. As the Governor says, the slow moving risks are the most potent because people are very slow to appreciate how damaging they are, whether it be in the official sector or in the private sector. What I would add on the imbalances issue is that if we cannot resolve the structure of the international monetary system in some way – which should be the big priority – then that plays into the macro-prudential debate that we were having earlier because it would mean that our financial system, not only here but elsewhere, needs to be more resilient than it would otherwise be because there is this slow moving monster underneath.

Q37 Lord Eatwell: The imbalances issue has not been resolved since the first emergence of the German surplus back in the late '60s.

Mr King: I agree and the reason why it became so large and has become so important is because the country with the deficit is the country with the reserve currency and one very large economy on the other side. The scale of the problem is becoming so big now that if these imbalances re-emerge we will have further problems down the road. My feeling is that the debate on the Tobin tax, while you point to some perfectly reasonably issues here about the scale of transactions and the issue of many of these instruments, I do not myself think that they are central to the debate about why we had the financial crisis and what we need to do to get out of it.

Q38 Lord Levene of Portsoken: Governor, you have been quoted as indicating a preference for greater separation of the banks between commercial and investment banking activities. What sort of separation do you have in mind and how do you think it might be made to work?

Mr King: As I said, I think the most important thing is to recognise the objective here which is to have no institution that is too important to fail. There are three legs of the stool on which I would rest this: capital, resolution and structure. If we find that capital and resolution are not adequate then I suspect we will need to take steps to limit the diversity of activities which can be engaged in one institution. I will give you two examples, one is the institutions that take retail deposits from households which are going to be guaranteed up to £50,000 per household at one hundred per cent. To guarantee by the state a hundred per cent guarantee of liabilities means you have to have a pretty close eye on what is being done with those liabilities, what assets they are financing. That is very hard to do within the conglomerate institution. I think having more separation at that end may turn out to be inevitable. At the opposite end of the spectrum you have propriety trading where one of the great joys of hedge funds in the past two years has been precisely because they have been separate from other institutions they have failed and been allowed to fail without anyone worrying. Our continental partners used to keep going on and on about hedge funds between 2007 and 2008; actually people really have not mentioned them very much in the last 12 months because the problems have been at the heart of the banking sector where there has been a problem with the implicit guarantee. Over 2000 hedge funds have failed in the last two years. I do not rejoice in the failure of any institution but I do rejoice in a framework which allows people either to be successful or to fail without getting in anybody else's way. That has been the great benefit of having separation of that propriety trading in hedge funds. I do not know the right answer in all this area; I think we have to feel our way towards it. What I do feel is absolutely irresistible is the logic behind the proposition that we must get away from the situation in which we say to ourselves, "Look, let's be worldly and realistic; these institutions are just too big to fail". That is a recipe for disaster because we will be giving guarantees; people will know that the institutions will not be allowed to fail and the people providing credit will not monitor the risks the banks are taking. We have to get away from that. I spelled out a three legged stool structure for trying to do it. All of these ideas need to be explored but with the objective of getting to the point where there is no institution that is too important to fail. One last point on this, I think it is something which the UK can do on its own and take a lead on it because we do not have the luxury of waiting for everyone else to come up with the answer. In terms of international banking sectors we have a very successful financial centre, as you know more than anyone else. The City – London – as an international financial sector is a whole lot more than some of those banking activities that have got us into trouble. It is a much wider range and variety of activities. The only hope we have of retaining an international banking sector is if we can get away from the position in which the taxpayer and people around the world who buy UK government bonds stop worrying about the fact that the UK government might have to stand behind a banking sector that is five times GDP. The Americans have a big advantage here; it is a simple comparative advantage. They can afford to let too important to fail go on because their banking sector is less than one times GDP. It would be a serious mistake for us to rely on the rest of the world solving this problem because in the end, if we do not solve this problem, people who buy government bonds around the world will say that that the UK is a bit of a risk because at some point or another, we have no idea when, there is a big risk that the UK government and the UK taxpayer might once again have to pick up a massive fiscal burden because the banking sector is so large relative to GDP. We can be a highly successful international financial sector and a highly successful international banking sector, but the best way to achieve that is to ensure that the UK taxpayer does not have to stand behind the banking sector in order to give it some solidity, that the banking sector itself provides that.

Q39 Chairman: That seems as good a point as any to stop. Thank you very much indeed, Governor and your colleagues, for giving us your time; it has been very useful.

Mr King: Thank you very much.