HOUSE OF COMMONS

Treasury Committee

Oral evidence: Jobs, growth and productivity after coronavirus, HC 150

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Harriett Baldwin; Anthony Browne; Gareth Davies; Dame Angela Eagle; Kevin Hollinrake; Siobhain McDonagh; Alison Thewliss.

Questions 404 - 462

Witnesses

I: Charles Goodhart CBE FBA, Emeritus Professor of Banking and Finance, London School of Economics; Adam Posen, President, Peterson Institute for International Economics; Kristin Forbes, Professor of Management and Global Economics, MIT's Sloan School of Management.

Examination of witnesses

Witnesses: Charles Goodhart, Adam Posen and Kristin Forbes.

Q404 **Chair:** Good afternoon and welcome to the Treasury Select Committee and our final hearing in our inquiry into jobs, growth and productivity. We are very pleased to be joined remotely by three witnesses this afternoon, each of whom has given evidence to this Committee in the past. We thank you for that and welcome you back. I wondered if you could each, very briefly, introduce yourself to the Committee.

Charles Goodhart: My name is Professor Charles Goodhart. I am an emeritus professor of banking and finance at the London School of Economics. I am currently residing in your constituency, Chair.

Chair: That is incredibly disarming, Charles. I will be very gentle on you in every way. I am delighted to welcome you here this afternoon.

Kristin Forbes: I am Kristin Forbes. I am a professor of global economics at MIT Sloan School of Management. I wish I could say I was in the UK right now, but I am in Brookline, Massachusetts.

Adam Posen: I am Adam Posen, president of the Peterson Institute for International Economics. I was on the MPC from 2009 to 2012 and I am currently in my office in Washington DC.

Q405 **Chair:** Welcome to all our witnesses. Thank you for attending. Charles, inflation is very high and predicted to go still higher. There is talk of a fairly narrow path here in terms of monetary policy: putting up interest rates, this balance between taming inflation on the one hand and not damaging the economy too much on the other. I know you have written some interesting things about demographics and changes in the labour force, et cetera, and the implications that that has for that kind of debate. I wondered whether you could tell us a bit about how you see that narrow path and what you think the MPC and the Bank of England should be doing going forward.

Charles Goodhart: The present provides the most challenging set of circumstances that the MPC and the exercise of inflation targeting have ever had to address. It is a major supply shock, with energy and food prices going up very sharply. It is much more difficult in the UK and Europe than it is in America. The reason for that is that we are large-scale importers of both foodstuff, grain in particular, and energy. The US is not only self-sufficient; it is actually a net exporter of both of those. The adverse income effect in the UK and Europe is much more difficult.

There is also the threat, which I do not think is insignificant, that gas might get turned off, either because we turn it off on our side or because the Russians decide to turn it off to make life more difficult for western Europe. In that case, the income effects would become even greater.

Given this problem of very adverse income effects and very sharply rising inflation, the question is what you do when there is particularly huge uncertainty about the future. A lot of my colleagues on the shadow MPC argue that the central banks in particular, and the Bank of England especially, are so far behind the curve that they ought to be raising interest rates more sharply, as least as quickly as the Fed is now expecting to raise them, i.e. 50 basis points every meeting. Given the additional uncertainties and the adverse income effects in the UK, I think that this would be a bit dangerous at the moment.

Although I am normally on the hawkish side, at the moment, given these uncertainties, particularly about war in Ukraine, the present policy of the Bank of England of slow and steady, of 25 basis points every meeting, is probably just about as good as you can get in these incredibly difficult circumstances. It cannot stop raising interest rates, given the enormously negative real interest rates, the massive increase in inflation and the expectation that it will go up into double figures by the autumn. For the time being, 25 basis points every meeting is probably about right.

Q406 **Chair:** We have the pressures on inflation that you cited there of foodstuffs, grain, energy and so on. Then there are the pressures in an overheated labour market. Could you tell us a bit about your thoughts on the labour market in particular? Are we moving into a position now where we are looking at a wage-price spiral potentially there, with inflationary expectations very substantially de-anchored from the Bank of England's ultimate target here?

Charles Goodhart: The answer is yes. The wage-price spiral has already started in the US. It is going merrily there. It is beginning in the UK. It will not actually probably get cut back until the very tight labour market—not quite as tight as in the US, but still very tight—weakens somewhat. The prospects of a soft landing are not zero, but they are certainly, in my view, a lot less than 50/50. The likelihood is that we are going to have to have, at the very least, a mild recession and unemployment rising. The question is what is necessary to bring that about and at what speed.

Q407 **Chair:** I am going to go to Kristin, please, with the same basic question. Do you agree with this going slightly softer on the interest rate rises for the reason that Charles has given, or are you thinking you really want to slam the brakes on now a little bit harder, so that we do not have to unravel it all later at even greater cost?

Kristin Forbes: Before I directly address your question, let me back up a bit to the narrow path you started with that Charles mentioned, that Governor Bailey has been talking about and that other central bank governors have also been focusing on. I fully agree that this is an extremely challenging period, possibly the most challenging since the Bank of England has been independent. I would actually say that the challenge facing it is even worse than a narrow path.

When you say "narrow path" and when central bank governors use that term, it implies that the path is fixed and that they know where the endpoint is or where they are going. Even if central banks choose the right policy path right now, given economic circumstances right now, they are going to likely be hit by surprises. We do not know where energy prices are going. We do not know what is happening in Russia and Ukraine. The optimal path for monetary policy is going to keep changing, based on what happens in the rest of the world. It is the external shocks that are making their job very difficult.

I would worry about pre-committing to any path, given that what happens next is largely outside the control of the Bank of England, in terms of these external shocks. Also, when you talk about "narrow path", it implies you know where that end rate is, where interest rates would be when everything is neutral, inflation is at 2% and the labour market is at full employment. Central banks do not know what that point is.

I have been thinking that a better analogy than trying to walk down a narrow path is that it is as if central banks were trying to hit a golf ball down a very long, very narrow fairway, with water to one side, woods on the other, gusts of wind that could blow the golf ball off course, even if they hit it perfectly well, and they cannot even see where the hole is at the other end until they get closer. The task is much more difficult than just a narrow path. They are going to be buffeted by shocks, by wind, even if they hit the ball perfectly, and they are not going to know where the end point is until they get closer.

Having said all that in terms of what the Bank of England should be doing right now, I agree that more tightening is going to be necessary. Not only are wages being ratcheted up to meet higher inflation, but firms feel very comfortable raising prices because of higher costs and higher inflation. Inflation expectations are uncomfortably high in the United Kingdom. The top priority needs to be bringing inflation down and that is likely to mean continued increases in interest rates.

I also worry that growth could slow. It is unclear how much interest rates will need to be raised, but I would support more aggressive tightening earlier to show that the central bank is going to bring inflation down, bring down these ratchet effects of higher inflation feeding through into wages and price setting. Then, if the economy slows more sharply than expected, if the Bank of England needs to adjust, it could lower rates in the future as needed.

I would prioritise, moving forward, raising rates each meeting, as Charles said, maybe even by 50 basis points in a meeting or two, if growth and the labour market hold up, to tackle the imminent issues around inflation. If growth slows, you will adjust accordingly.

Q408 **Chair:** Are you seeing the distinction between the 25 basis point increase, as opposed to the 50 basis point increase, around the need to bear down on expectations and the cost of labour issues, so wages going up? Is that the nub of what that decision is largely about, in your view? Are those the expectations that are being managed there, or are there other aspects to that?

Kristin Forbes: I agree that most important is the labour market. The labour market looks extremely tight right now. Unemployment is at 3.8%. The Bank of England is expecting it to fall to 3.6%. That is well below any level I thought was consistent with stable inflation, so the labour market is very tight.

Much of the reason why inflation is so high now is because of temporary factors: high energy prices, high traded goods prices, shifts in spending patterns related to Covid. Many of those will fade, but that means inflation will come down from the 7% plus it is now, and even higher it is going to, down closer to 2%, but it does not mean inflation will get to 2%. Getting it back to 2% will mean getting the labour market back closer to an equilibrium level.

There is one caveat with the labour market, which is going to be a challenge for the MPC. Even though the labour market looks extremely tight right now—firms cannot hire enough and vacancies are very high—there is a pool of workers who have dropped out of the labour force and have not come back in. If those workers started to come back into the labour force, that would provide more of a cushion and allow the Bank of England to move more gradually on interest rate hikes. Whether those workers come back is a big unknown right now. That is why I think that the MPC should maintain flexibility, watch the data, especially the data on the labour market you mentioned, and then adjust the path of rate hikes accordingly.

Q409 **Chair:** Adam, you are, it seems to me, leaning on perhaps a more assertive monetary policy, in terms of putting rates up. I am quoting you here as saying, "The central bank has no choice but to cause a recession when a broad range of prices are rising at such a strong pace". Could you talk us through your thinking on that, please, and some of your thoughts on what is happening in the labour market, labour supply and Brexit, and the implications of that for the debate we are having just now?

Adam Posen: Yes, I am, unusually, one notch more aggressive in what I think the MPC should be doing in tightening, compared to what my colleagues, Charles and Kristin, have said. Therefore, I want a higher terminal rate and a faster move to that point than is currently priced into markets, let alone what the forecast says.

You were kind enough to quote from my interview with the *Guardian.* My basic thinking is as follows. Since I am not an official, I am allowed to be blunt. I recognise that this would cause a recession in all likelihood, if there is to be a rapid rise further in interest rates. I am not saying that that is nice, but it goes to a point that Charles and Kristin have made. You can have wages rising insufficiently quickly to keep up with nominal developments but still contributing to inflation. It is not a perfect coincidence.

We are in a situation in the UK, like the US and other places, where wages are rising at a probably unsustainable pace compared to where productivity is and where we want inflation to be. At the same time, for a large number of workers, maybe not all, but particularly low-income workers, they are not keeping pace with the general rate of inflation. The whole point of the MPC having an inflation target that is fixed at something above zero but low, like 2%, is that you do not have this perfect coincidence that, to some degree, the MPC's modal forecast seems to put in place.

Another former MPC colleague, David Blanchflower, talks about that. If you have sufficient slowdown in real incomes, inflation will automatically come down. The whole point is that you are intervening with monetary policy precisely because you are not going to have that perfect self-regulation. It is not to say that either of my colleagues were suggesting that, but it is very clear to make that explicit.

Then comes the question of how you get the inflation down. If you are in an environment where there are some inflationary momentums, some de-anchoring of inflation expectations, you have to do more to bring it down than you did in the past, when that was not the case. That is why I am speaking bluntly about the Bank of England. The MPC would, essentially, have to raise rates enough to reduce labour market pressure, meaning raise unemployment. I am very happy if there turns out to be a narrow path or a welcoming fairway with a skilful drive, but the sad reality is that there is going to have to be an economic slowdown in the UK, beyond what is already on the cards, in order to get inflation sustainably back to target.

As you mentioned, I have made reference to Brexit. The reason for doing that is not to score political points, but it is analytical, so that the public, you on the Committee, and the Bank, I hope, understand why they have to be more aggressive. If we look at the euro area, the UK and the US, on two counts the UK did better than the US in recent years in terms of policy choices that are more like the EU.

First, the UK did not have the huge spike in unemployment and drop in labour force participation that the US did, because the UK wisely, like most EU countries, put in place furloughs, subsidies and part-time programmes, so that people were not separated from work to get benefits the way they were in the US. Secondly, the UK, like the EU, did not engage in an excess fiscal stimulus. It engaged, rightly, in large-scale fiscal stimulus over the course of 2020, but it did not, like the US, put on this extra, very large burst of stimulus in a short time period at the start of 2021.

For those two reasons, you would think that inflation should be looking like it looks in the euro area. There should not be a general wage inflation, because you did not have this excess boost to consumption on people’s balance sheets and you did not have the disruption that forced workers to rematch and re-bargain the way we did in the US. Instead, as Governor Bailey said in a speech a couple of weeks ago at the Peterson Institute, you have a labour market that looks a lot more like the US, with wage inflation. You also have more food inflation.

To me, that tells you that this is something idiosyncratic to the UK about how the same inflation shock of Covid reopening, of energy prices out of Ukraine, is being transmitted in the UK. In line with things I had said a few years ago, and others have more recently pointed out, I think that a large part of this is Brexit. You do not have the flexible labour supply of migrants coming in from Europe who can add to the labour supply but also go in and out of work as needed.

Labour is a differentiated good in econ speak, meaning that it was not like suddenly you did not have Polish or Romanians to pick the strawberries in European fields, maybe in Devon where you and Charles are coming from. You did not have that, but you could not suddenly get your British, native workers to do that. That is one particular example, but there are many such examples where, over time, the British labour force might adapt to the needs, but you are not going to overnight replace all the EU workers who are no longer here in those sectors and in those fields, literally and figuratively.

Additionally, I would argue that the anchoring of expectations about inflation is somewhat weakened because the UK is inherently a smaller economy, more on its own in the face of shocks. It is less buffered than it was when it was integrated more with the larger European Union.

For these two reasons, even though the UK successfully avoided the mistakes the US made, the same shocks that are hitting everybody have resulted in higher, earlier and probably, in my view, more persistent inflation in the UK than they have in the euro area. This is not about scoring points about Brexit. Brexit is Brexit. It is a reality. For me, this points to the Bank of England having to look back to the 1970s, not all the way back to there, but having to be more aggressive to re-establish low inflation than it has been in the recent past.

Chair: That is a very interesting analysis there, Adam.

Q410 **Gareth Davies:** Adam, I am going to pick up where we just left off, because your comments have been widely reported. In Bloomberg, it said that Brexit explains 80% of UK inflation. *City A.M.* just yesterday ran a story saying that most of the UK's inflation is a direct result of Brexit. Did you say that 80% of the UK's inflation is as a result of Brexit?

Adam Posen: Thank you for the question. Let me be very clear, for the record. I said it. I was wrong to say so. I offhandedly responded to a Bloomberg reporter's question in a way I should not have. It was sloppy. It might be 65%. It might be 78.2%. By 80%, I was loosely indicating that I think a substantial majority of the inflation differential for the UK over the euro area is due to Brexit, through these transmission mechanisms I mentioned. The 80% has been reported and it is fair because I said it, but, for the Committee, let me be very clear: that was me being sloppy. It is just that the major portion of the differential, in my view, is due to Brexit.

Q411 **Gareth Davies:** To further clarify, it is not that overall inflation is being caused by Brexit. It is the differential and the time lag between the eurozone and the UK. That is what you were talking about.

Adam Posen: Exactly, yes. Thank you for allowing me to clarify that. Again, it is my fault for having been sloppy, but that is what I meant. There was a certain amount of inflation, like Europe, that the UK was going to get from energy and food prices as a result of Ukraine, a certain amount of inflation that everybody was going to get from reopening after Covid. It is the share of why it is so much higher than just that that I was trying to explain.

Q412 **Gareth Davies:** Thank you for that clarification. In that case, let me move on to what you just mentioned. I think you touched on it briefly in response to our Chair. The OBR and the Bank of England have made clear that they believe the key drivers of inflation have been and are goods and energy. Can you elaborate a little more on what is underpinning this inflationary drive from goods and energy?

Adam Posen: There are particular idiosyncrasies—to put it nicely—to the UK natural gas market and they showed up very strongly in recent months. The fact remains that, whenever you are looking at how inflation comes about, there is an impulse and then a shock. Then there is how much that gets amplified and transmitted out into the economy.

The idiosyncrasies of the UK natural gas pricing, for example, get too much emphasis for two reasons. On the overestimation side, it is that the energy dependence of the UK on external energy is much lower than, say, Germany, Italy, the Netherlands, Austria, in particular with respect to Russian or Ukrainian energy that is being disrupted. It is not a uniform market. It is partly the UK not being part of the purchasing group that is the EU and being off on its own that makes it bad. It is not just the regulatory structure.

The second point is the persistence. What is going to be interesting to see, and I may be wrong, is that, in the UK structure, there should be a certain amount of the inflation dropping out because of the times from the last natural gas rate setting. The important issue is whether that affects the trend inflation or not. My contention, which may be proven wrong, is that, in the euro area, they are going to be able to wait out most of the price shock. They have not had wage inflation. They have had very little general inflation. The vast majority of their inflation is directly attributable to energy prices, so they are not going to have to be as aggressive, in my view, because, once that drops out, it will drop out.

My forecast or contention on the UK is that, even when this initial impulse drops out, it is still going to be there in the overall inflation trend. I hope I am wrong, but that is my belief.

Q413 **Gareth Davies:** Kristin, can I ask you to contribute to that question? Also, given that you are in the United States, a lot of people have commented that one of the drivers of the US inflation is fiscal stimulus and overgenerous policies perhaps by the Administration. Can you comment on that and whether you think that applies to the UK as well?

Kristin Forbes: Let me first tackle the question about what is driving inflation in the UK. Then I will touch on stimulus. When I think about inflation in any country, I like to think about it as being driven by six factors particularly relevant for the UK. First is energy prices. That is obviously high everywhere around the world. That is why headline inflation is high everywhere around the world. It is above 7% or 8% in most countries, but that is not what worries me and what worries most central banks, because high inflation should pass through.

Focusing on core inflation worries me more. In the UK, core inflation is now at 5.7%, probably going higher. That is the inflation that worries me the most, because that will tend to be more persistent. What is driving that, even if you take out the energy prices effects that have driven up inflation around the world? Driving core inflation partly is movements in the exchange rate. In the UK, movements in sterling pass through and have a meaningful effect on inflation. Sterling has been weaker than other currencies, especially than the dollar. The fact that the Bank of England is raising rates at a slower pace than countries like the US is contributing to inflation a bit.

Another factor independent of movements in sterling is other goods prices. That has also been contributing to inflation and that is partly related to supply chain disruptions and shifts in spending related to the pandemic. People are buying more things and fewer services. Those effects should fade over time, but they have persisted longer than expected.

Another factor contributing to inflation is lagged inflation, where inflation has been in the past. This is where the situation is different for the UK than the US or the euro area, something that has not been touched on yet. The UK has had inflation averaging around 2% since the global financial crisis, so over roughly the last decade. That is quite different than in the euro area, where inflation has been well below 2%, and even in the US, where the US has struggled to get inflation back to 2%. That means the UK is coming into this period with inflation that has been higher and more volatile, so people are faster to adjust prices and inflation expectations.

Another factor, related to that, that feeds into inflation is inflation expectations. In this also, the UK has a greater risk than other major economies. Inflation expectations in the UK have gone up quite a bit. They have gone up everywhere short term, but medium and longer-term inflation expectations have gone up more in the UK. In the UK, they are quite a bit uncomfortably above where you would like to see them, consistent with 2% inflation. You have not seen that sort of move in medium-term inflation expectations in the US and euro area. That is also feeding through into these wage-price spirals.

The final factor feeding into inflation, which is also high in the UK, is slack. The UK has a very tight labour market and this is similar to the US economy, but some other economies, such as the euro area, may not have quite as tight a labour market.

Going through all those factors—I just went through them quickly—there are about six factors that feed through into inflation and the UK hits every box, where it has inflationary pressure coming from all six areas. Other economies do not have that pressure coming from all six areas. Yes, they all have inflation pressure from energy, but the euro area does not have pressure coming from having lagged inflation and inflation expectations as high. The US also does not have the same history of higher inflation recently and inflation expectations moving up the same way, for example. The UK has the additional pressure from sterling weakening that is not an issue in the US.

Bottom line, put it all together, you see why this is a particularly difficult challenge for the UK and why inflation could hit even 10% by the fall of this year and is unlikely to hit those sorts of numbers in other countries. That is my quick analysis of what is driving inflation in the UK.

I agree with Adam that the role of fiscal stimulus is important. In the US and UK, and other economies, fiscal stimulus was very important to get countries past the acute phase of Covid. The UK undertook a big stimulus and that was very important in helping families when they were told they could not go to work and when businesses were told they could not operate. That helped the economy recover so quickly, so that we are now in this positive situation where output is back around where it was before Covid hit. Other countries have not hit that level yet, so stimulus was important.

It is also important not to overdo a stimulus. In the US, some of the later stages of the fiscal stimulus were not needed and pushed the economy to an overheating state, which is making the job quite difficult for the Fed. The UK was not as aggressive in the later stages of Covid with stimulus, so that is not contributing to overheating to the same extent as in the US economy.

Q414 **Kevin Hollinrake:** My questions centre on the permanence of inflation or whether it is transitory. Professor Goodhart, you seem to think that, because of the demographics and tightness in the labour market, it might be more permanent than perhaps Professor Forbes. I would be really interested to hear your view on how permanent you think this high inflation environment will be.

Charles Goodhart: You are absolutely right. Indeed, I wrote a book about this not so long ago. One of the key features of recent decades is that China has actually been dis-inflating the world. That is going to end because the Chinese working age population, having been rising very rapidly, because of the one-child policy is now going to tank very sharply. China dis-inflated the world by bringing down goods prices very sharply as it became the workshop of the world and Chinese labour was very cheap, relative to labour elsewhere, in Europe and in North America.

It also meant that there was a valid, credible threat that employers could use against their workers in manufacturing and other sectors, where they could move their production offshore. There was a huge shift from manufacturing to services, particularly in the US, and labour is far less well organised and far less unionised in the service sector than it was in the manufacturing sector, with the result that labour bargaining power virtually everywhere got trashed. It collapsed and that meant that it was terribly easy to keep wages down, because, effectively, labour supply was coming out of everybody’s ears. There was masses of labour.

There was another factor, which was the decline in the fertility rate, combined with availability of consumer durables, washing machines, freezers, refrigerators and so on. That meant that you did not have to have one of a married pair staying at home, usually the woman, to do the housework, which did not add to GDP. Over the decades up until now, there has been a huge shift of women out of housework into the labour force.

For all these reasons, the availability of labour hugely expanded and there is now a reversal of that. The working age population is actually going to decline in China, much of continental Europe and Russia. It is only held up in the US and the UK by immigration. As Adam and Kristin have said, immigration has been reduced by Brexit and may get reduced in the US as well. Without immigration, the working age population in the US and UK also will be declining.

With the geopolitical problems with China and Russia, there is a shift from offshoring for cheap production to onshoring in order to make sure that your production and inputs are safe. All that is going to mean that labour power over the next three or four decades is going to be recovering, and recovering really quite sharply.

There are, of course, obvious possibilities of ways of dealing with that. The one area where there are going to be a lot of workers available is Africa. The question is going to be whether we can make use of the massive available workforce in Africa. Technology can help. If more of the old, like me, can go on working and do not get the diseases of the aged that have not yet been cured by medicine, that would be a great boon. The underlying structure of the availability of labour is going to be going from huge oversupply to considerable undersupply. Therefore, inevitably, by simple supply and demand, labour in general is going to become more expensive over the next decades.

Q415 **Kevin Hollinrake:** The Bank of England is predicting that it can get back to the 2% inflation target within two or three years. Where do you think that it will be in two or three years?

Charles Goodhart: They will be pushed to get it down much below about 3%. In order to get it down and bring it down to 2%, they will have to have higher unemployment rates. The stronger the labour bargaining power, unfortunately, the higher the natural rate of unemployment has to be. As labour bargaining power strengthens and remains high over coming decades, the level of unemployment to reach and maintain 2% is going to be somewhat higher than it has been in the past.

Q416 **Kevin Hollinrake:** Professor Forbes, what do you think about all that? Do you agree with all that?

Kristin Forbes: Charles's work on some of the structural changes that are affecting the economy is extremely important. These structural changes will determine where growth settles, where unemployment settles, wage growth, where interest rates settle et cetera, if we ever reach some sort of equilibrium.

I would push back a little bit that this means we will have higher inflation. Where inflation settles will depend on what the Bank of England does. If the Bank of England follows through on its commitment to return inflation to target, to do whatever it takes to get there, it can bring inflation down to 2%. That might be in acting more aggressively than it has been. I wish it had started the tightening cycle earlier. If it persists in raising interest rates to bring inflation down, inflation should be able to settle down, maybe not exactly in two years' time, to about 2% within three years. It might take some difficult decisions and an increase in unemployment, as has been discussed.

Q417 **Kevin Hollinrake:** I think that Adam Posen suggested that might require a recession to get back to that level. Would you agree with that, Professor Forbes?

Kristin Forbes: I would not go so far as to say that it implies a recession. Exactly what the Bank of England does will determine what is required. If it acts more aggressively now and shows it is committed to bring inflation down, and really convinces the public and companies that it is going to bring inflation down, that could, in itself, dampen some of these inflation expectations and wage-price effects that worry all of us. Again, it is really reiterating, "This is the priority. The Bank of England is committed to bring inflation down" and not wavering. Then you may not need to create a recession. You may not. It is not guaranteed, but you may not. It will be less likely to be necessary.

Q418 **Kevin Hollinrake:** Mr Posen, what do you think? You seem to think that a recession is required to get inflation back to target.

Adam Posen: I hope I am wrong. If you take Kristin's list of the six factors bearing down on UK inflation, it is a pretty damning list. If you add in what I way saying, consistent with some of the things Kristin was saying, in that the expectations are less well anchored than they once were, the ability to just get it back down by acting tough in the short term, versus having to repeat some of the things that were done in the 1980s, is lower.

Maybe it will be a small rise in unemployment and what we call a growth recession, so not actually two quarters of negative growth. We can still hope for that, but it is very likely that we will need a recession. The Bank has to be prepared to do that.

The final thing is vis-à-vis Charles's comments on long-term demographics and all the old jokes about long-term world debt. It is important that he pointed out, for example, Africa and more of the continued work, which I hope he continues doing, of older people. Demographics are not destiny. If they were, Japan would not be in deflation right now. There are a lot of factors that go with the demographics, so I would not take solace or hope either way from long-term demographic projections.

Q419 **Kevin Hollinrake:** You think that it is possible to get back to the pre-pandemic fairly permanent low-inflation environment.

Adam Posen: Yes, I do. I just think that it is going to be painful to get there.

Q420 **Kevin Hollinrake:** Professor Goodhart, you covered Japan in some of your comments—the fact that Japan has also benefited from the China effect, the low-wage effect, or cheap goods, in keeping its inflation down. Do you not buy the argument that Japan is a good example of the demographics that you are talking about in a country that has not seen high inflation?

Charles Goodhart: No, Japan was an open economy in a world that was swimming in labour. The Japanese corporates took full advantage of that and shipped their production abroad. The Japanese economy went from a manufacturing to a service sector, frequently part time, and all the global pressures that were reducing inflation worldwide had their effect in Japan. It could not buck the worldwide trends. The worldwide trends are now reversing and going in the opposite direction.

Q421 **Kevin Hollinrake:** To get inflation under control, yet avoid a recession, do you think the Bank of England's target of 2% is too low?

Charles Goodhart: I would be against changing the inflation target, because, once you change it, it is clear that you can change it again. Once you start changing it to suit current conditions, people will stop believing that this is something you are credibly going to achieve over the longer term.

Rather than change the target, I would tend to be less exacting about trying to say what is a success. The achievement of inflation in the euro area and the US of slightly over 1% from the great financial crisis to Covid was actually a great success. If we had inflation running at 3% rather than 2%, it would not be a bad thing. We get paranoic about relatively small changes in inflation relative to target. Considering the fluctuations and shocks that have occurred, we should be much more prepared to be relaxed if inflation deviates from target by anything up to about 1.5%, rather than screaming about failure once it leaves target by about 0.5%. We ought to widen the bounds, rather than change the target.

Q422 **Dame Angela Eagle:** I am not sure that, Charles, widening the bounds, rather than changing the target, would make any material difference if people felt that the bounds had got wider and the Bank had more leeway. Why would that not affect how seriously policymakers and decision-makers took the target in the first place?

Charles Goodhart: We have massively exaggerated the failure of having inflation below 2%. As a result, the central banks undertook unduly expansionist policies. They undertook and maintained QE for far too long. They drove nominal interest rates, in many cases, negative, and they still are negative in the euro area. To have negative interest rates at a time when inflation is 7% is rising is just plain crazy. If you have inflation running at 3%, you might need to have interest rates sufficiently high to keep unemployment at a level that is undesirable and unnecessary.

Q423 **Dame Angela Eagle:** In terms of the changes to the labour market and the worries about there being wage inflation caused by this inflationary shock we have had, in a tight labour market another way of dealing with the issues there surely is to increase labour productivity, so wages can go up. Nobody has talked about that as a solution at the moment. Listening to all of you, you are all saying that we have had stagnant if not falling wages for the last 10 or 12 years, and, as soon as labour becomes scarce in the economy and therefore the price of it goes up, we now have to ensure that the percentage of reward to wages stays low again by changing the terms of the debate.

In those kinds of models, do those who work for wages rather than own assets ever get anything but a bad deal? Is that not why populism is on the rise, threatening democracy across the world?

Adam, you are saying that, in order to keep inflation down, we have to have a recession. If you are a wage earner on a modest wage, you have already seen real decreases to your living standards, earning less in real terms for quite a while now and expected to work harder for less. Now we have to have a recession to prevent inflation getting completely out of control. In those circumstances, what is in it for the wage earner?

Adam Posen: Nothing. That is why I said it the way I did. I stated the same facts that you did. I said the same facts about the real wage decline. If you want labour to have a bigger share of the economy, it has to be done through legislation that you and your colleagues in Parliament can pass, rather than counting on the brief periods where you get a shortage of labour demand and trying to take advantage of those. They end up backfiring on many of the workers you are talking about, because you get inflation instead.

Q424 **Dame Angela Eagle:** What measures are you talking about, Adam? Are you talking about minimum wage legislation or higher levels of in-wage benefits?

Adam Posen: I am talking about several things.

Dame Angela Eagle: What are you talking about?

Adam Posen: I am talking about all of the above. You do things to improve the bargaining power of unions across the economy in all times of the economy. I am talking about putting in a higher minimum wage that is a one-time shift and is not inflationary but gives everyone better bargaining. I am talking about better benefits so people are more willing and able to change jobs and therefore, irrespective of whether it is a downtime or an uptime in the economy, you have workers having more power.

I am in favour of greater regulatory interventions to make sure that workers are getting the benefits they are supposed to get. I am in favour of higher profit taxes on corporations and higher taxes on corporations more generally, with the distribution going to other people. I am in favour of changes in the tax code in the UK that do not favour the City of London against other forms of activity.

There is a whole bunch of things that Labour and the Lib Dems have talked about through the years, and that people who are non-partisan have talked about through the years, that Parliament can and, in my opinion, should do to increase the labour share of the economy. All I am saying is that the sad realities are as you describe them, but that shows why counting on tight labour markets due to the business cycle is not a good way to address labour's small share. You need to do something that structurally enhances labour's share of the economy in a way that is not subject to ups and downs of the business cycle.

Q425 **Dame Angela Eagle:** Kristin Forbes, how would you do what Adam has just said, if we wanted a wider share of the income generated in an economy to go to the labour side? What would be your policy solutions to that?

Kristin Forbes: I am not sure I follow the details of UK policy to comment on some of the specifics, but I want to agree with your opening comment—the importance of raising productivity growth. If you want to bring inflation down in the UK, higher productivity growth could go a long way towards bringing inflation down and still supporting strong wage growth.

I just taught my last class at MIT and my big focus of that class was on raising productivity. If you have higher productivity growth, that can solve so many problems. It can bring inflation down, bring standards of living up across the income classes, make debt more sustainable and so on.

The problem for the UK is that productivity growth has been weak even before Covid hit. According to OECD statistics, the productivity growth was decent in UK in 2015 and, since the Brexit vote, it has fallen and not come back. In the US, productivity growth has started to come back and, in 2019, was the highest it had been in a decade. We have not seen that sort of recovery in the UK, even before Covid. It is a top priority to get productivity growth back in the UK.

On a positive note, Covid may offer some opportunities. Covid has forced companies to rethink how they operate. It has forced individuals to think about how they work. Maybe they do not need to be in the office every day. This restructuring of how people work, how they shop, how companies operate, could be an opportunity to move forward on productivity. I have heard from a number of companies I meet with in the US statements such as, "Covid forced us to adopt new technology. We adopted more in 10 months than we would have done over 10 years, because we were forced to change so quickly".

I am positive on productivity growth moving forward. That could be very important. The UK has a double challenge of coming out of a period of very low productivity growth, lower than in other comparable countries, and Brexit causing another shift in how production and trade are happening. There are real challenges there. If you and your Government can overcome some of those hurdles, that could go a long way towards addressing inflation.

Finally, the reason I did not mention this before, and others have not, is that there is very little that Bank of England can do, in terms of raising productivity growth. That onus is more on the Government and central banks cannot do very much.

Q426 **Dame Angela Eagle:** If the Government wanted to increase productivity, which, to be fair, all Governments have said they want to increase, even as it has plummeted in the last few years, what sorts of things should they be doing? For example, we have just had the super deduction over here. That paid firms to invest and has not caused there to be a huge increase in investment, probably because of Brexit and other uncertainties. What would you suggest the Government should be doing in order to increase the productivity of the labour force that is there and try to deal with this inflationary issue without having a painful recession and an even bigger squeeze on people's living standards?

Kristin Forbes: Again, I do not know as much about some of the specific policies in the UK, but I can mention a couple of broad policies that I would suggest. One, which unfortunately would not provide benefits for quite a while, is education. Strong education improves productivity in the longer term, but that will not have a short-term boost. Shorter term, I would focus on trade agreements, facilitating trade as the UK has shifted away from being so dependent on trade with the euro area, when it was part of the European Union, to how it can facilitate trade to have access to cheaper inputs and more efficient production patterns around the world. That is one thing I would prioritise right now.

Q427 **Dame Angela Eagle:** Charles Goodhart, what do you think we ought to be doing, from a policy point of view, to try to ensure that the proportion of reward that goes to those who earn wages, rather than those who own assets, increases rather than decreases?

Charles Goodhart: I think that it is going to go that way anyhow. The last 30 years have been a wonderful time for those who had assets, whether it was human capital, financial capital or real capital, and a lousy time if you were in unskilled labour. That is now changing. The rise in unit labour costs that I see coming along will lead employers to invest more at home, as will the onshoring that will occur as people flee China. That will raise investment.

The productivity per worker in the UK is likely to rise quite sharply, while, at the same time, the rise in interest rates we are going to have is going to mean that asset values generally will decline, as they are at the moment. One of the subtitles of our book was "waning inequality". Inequality within countries increased dramatically over the last 30 years. Because of the demographic and other factors, that is going to reverse. I think that what you want, more equality within the UK, will actually come about as a result of the underlying trends in our economy.

There are, of course, other things that can be done. I would like to see a shift of taxation away from incomes and investment to, for example, carbon and land. There are a whole series of things that can be done on the fiscal side that would be beneficial to provide greater returns, both to labour and to investment.

Q428 **Rushanara Ali:** Good afternoon and thank you. I have further questions on interest rates. We have seen a long-term trend downwards in terms of interest rates and near zero rates since the financial crisis, notwithstanding the more recent rise. Can each of you talk us through what you see happening to interest rates going forward? Adam Posen, I know you were talking about the need for raising interest rates. What should citizens expect to see going forward, given where we are now? In the UK, with the risk of 10% inflation by the end of the year, what sorts of rates are we looking at this year, next year and the coming years?

Adam Posen: The nominal interest rate, the short-term rate that the MPC controls, is going to have to go up at least 250 or 300 basis points from here. I believe that the market has priced in roughly 175 and the latest MPC report is roughly saying it will go up to 1%, and then it will decide and see where it goes from there. I believe that the short rate that the MPC controls is going to have to get into the mid-threes.

If we think about a worse scenario than I expect, but a possible scenario, that the inflation momentum is really there and so, unlike what we have all talked about, the idea of inflation expectations being strongly anchored, the Bank has to do a lot to slow inflation expectations, you have to move towards positive real interest rates. When inflation is running at 7%, 8% or 9%, that is a very big number. I am hopeful and do not expect it will have to do that, but I think it will have to go beyond what the MPC members currently seem to think is what they call neutral. They have been very careful not to specify what neutral is, perhaps in response to the kinds of uncertainties that Kristin and Charles were talking about.

Q429 **Rushanara Ali:** What would you say is neutral and what would you say is the higher end, if you were to hazard a guess?

Adam Posen: Neutral right now is a 2% inflation target, plus a 0.75% real growth productivity trend. That would get you a neutral of 2.75%. I am very bearish right now on the productivity growth trend and the demographic trend. I think that most people would put neutral in the UK at 1% to 1.25%.

Q430 **Rushanara Ali:** You were saying that the real interest rate could be much higher. What sorts of numbers are we talking about?

Adam Posen: Nominal neutral is going to be something below 3%. If it raises rates past that, I expect that that will slow grow, raise unemployment and reduce inflation. If it turns out that it needs to go further, then it truly is playing catch-up and we do not know. My very strong expectation is that it would not have to go much further, but we do not know.

Q431 **Rushanara Ali:** Can I bring in Professor Forbes and then Professor Goodhart on this? Do you agree with that response, or want to add to it or disagree?

Kristin Forbes: Let me start with my usual caveat. There is always quite a bit of discussion about neutral. Everyone wants to know where interest rates will go or settle when everything is in equilibrium—2% inflation, unemployment at the stable rate. I do not think that we have any idea where that is. It moves around a lot. I worry about people who think they know exactly where that endpoint is. That can move based on what central banks do. It can move based on all the structural shifts that Charles has talked about.

I did an analysis for a Jackson Hole conference in the US a couple of years ago on different estimates of the neutral rate for the UK and US, and the error bands were bigger than the actual interest rate. We just cannot estimate this. That is during normal times. Then you get a shock like Covid or Brexit and that makes it even harder to know where it is going to go.

Q432 **Rushanara Ali:** In our case, we have had both shocks, unlike other countries. Most countries have had one. Given that, Adam Posen talked about policy interventions that Government could take. We are getting quite a lot of resistance in terms of Government intervention to take the edge off for those with fixed incomes or low wages, where inflation is outpacing their ability to keep up, in terms of the cost of living crisis. Given all that, is there not a real risk that we could end up in a situation that is much more difficult for the UK? We cannot rely on the central bank to fix this. We need Government to play their part. If they are not prepared to do those things and introduce further policy interventions, we could be looking at these scenarios of much higher interest rates.

Kristin Forbes: That is important. Even though I cannot tell you where the interest rates will go, it is important to be very public about the risk that they are going up and they could go up quite a bit, so people can prepare. That squeeze is likely coming and anyone who is buying a home or might have a variable interest rate on a credit card needs to be aware that rates could go up to the 3% type level that Adam has mentioned.

I worry that, in the Bank of England's latest monetary policy report, it signals with its different graphs that there does not seem to be a sense that interest rates will go up much more. There were even some members of the committee who sounded like they were not sure if interest rates would have to go up at all any more from the 1% where they are right now. I find it very hard to see scenarios where that will play out. Given that inflation is going up to 9% next month, maybe 10% by the end of this year, interest rates are going to need to go up quite a bit above the 1% level they are now. Markets expect 2.5% or so on average. People need to start hearing those numbers and being ready for them.

Q433 **Rushanara Ali:** We also heard from the Bank of England in the recent past that inflation was transitory, as was said in the US context as well. With Ukraine and external factors, all that has changed. Would you say that there needs to be a very different approach, in terms of what Government do and how they work?

Are there lessons to be learned from the way in which, in our case, but also in other countries, the central bank worked much more in tandem, if you like, with Government responding to the pandemic? There were lots of positives around that. That is not happening now. It is back to old ways of working. It feels like that anyway. Are there lessons to be learned from thinking about these particular sets of challenges and responding to them with a similar sort of approach?

Kristin Forbes: I could take a few lessons from what we have learned over the past few years. When Covid hit, there was a large monetary stimulus from the Bank of England and a large fiscal stimulus from the Government. That made sense. Both were working in the same direction. There was some talk and concern that there was actually too much co-ordination. I know there has been criticism that some of the QE programme done by the Bank of England was to finance the Government deficit.

It is important to make clear that, especially now as we are switching to the next phase, the Bank of England is not there to buy Government debt. The Bank of England is there to meet its mandate, which is the inflation target. That is the prominent concern. Being aggressive, raising interest rates now to fight inflation and unwinding the balance sheet would go some way to making that clear. That is going to be important going forward, to show that the Bank of England will not hesitate to fight inflation, as it is sticking to its mandate.

A second lesson that we have learned this time around is that central banks around the world, not just the Bank of England, were, in a sense, fighting the last war. The lesson after the global financial crisis was that probably central banks and Governments could have provided more stimulus. The recovery took a number of years. The labour market took a long time to recover and inflation was very low in most countries. There was a sense that it is better to wait to remove stimulus, wait to tighten interest rates until the recovery is well ingrained and unemployment has fallen quite a bit.

Central banks probably waited too long around the world, because they were fighting that last battle, but Covid was different. The recession was much faster. The recovery was much faster. Central banks should not have waited so long as they did after the global financial crisis. Being able to pivot quickly and adjust, because each period is different, is a very important lesson that will hopefully persist going forward.

Then a third lesson was more from the US, which we have talked about. It is that the Bank of England should stick to its mandate, which is inflation. Then the Government need to stick to their priorities. If inflation is the prominent concern as the Government think about policies, they should be cognisant that if they adopt more stimulus, or adopt more spending, that will make the job more difficult for the Bank of England. Again, each needs to do what makes sense for its focus, but in the US the sense is that the Government doing the additional stimulus has made the job harder for the Fed. That is just another lesson learned from this experience.

Q434 **Rushanara Ali:** Professor Goodhart, it is over to you. Also I have a supplementary for you, which is about if interest rates do go up and up. Do you have any reflections on the implications on the housing market and homeowners? For a very long time homeowners have become dependent on low-interest mortgages. Should we expect to see shocks to the housing market that, historically in the UK, certainly in the late 1980s housing market, were pretty painful?

Charles Goodhart: You are absolutely right. I would go further and say that we will not start to get inflation down until the housing market starts to weaken quite significantly. That will take considerably higher interest rates than we have now. Incidentally, the concept of neutral interest rates at this juncture, when inflation is as high as it is and real rates are as low as they are, is a confused and nonsensical idea, as Larry Summers said in a very excellent presentation that was given last Friday at the Hoover Institution conference, which is well worth trying to get hold of.

My own forecast, for what it is worth, and it is not worth very much, is that it will probably take nominal interest rates well above 4% to start having a significant effect on the housing market and thence on inflation. My bet would be that we will go over 5%. The idea that you can get inflation down, given the kind of investment rates we have, with real interest rates still massively negative, is optimistic beyond belief.

Q435 **Rushanara Ali:** What should we expect in terms of the scale of repossessions and the hit on the housing market?

Charles Goodhart: I would very much hope that the regulatory authorities in the Bank of England start tightening up on the constraints on new borrowers, because it is new borrowers who have to take out very large loans and then find that the value of their house suddenly after they have bought it starts going down. I would tighten up now on loan-to-value and loan-to-income ratios to try to ensure that only really strong first-time borrowers are able to enter the housing market at this stage. Otherwise, we will have a lot of really significant despair in the housing market.

Q436 **Rushanara Ali:** Just on that, there will be existing borrowers who are on much more fixed incomes where income is not rising. If their mortgage costs rise when they are switching from fixed rates to variable rates and so on, their costs will go up as well. Do any of you have a sense, if we are looking at those sort of numbers, of what percentage of repossessions and so on in the housing market should we expect?

Charles Goodhart: Remember that housing prices have been rising really dramatically quickly over the last few years. It is only recent borrowers who are going to be really in bad trouble. People who have borrowed at very low rates and found the housing prices have been shooting up are not going to be in desperate straits. It is the new borrowers that I am particularly worried about. Anyhow, I have spoken too much on this, so over to Kristin and Adam.

Kristin Forbes: I will just bring one quick point. There was some nice research done on this by the Federal Reserve Bank of Boston during the global financial crisis for the US, not the UK. It found that, for people who are most likely to default and not be able to afford the mortgage, the most important factor is whether they keep their job. This does stem down to what happens to the labour market. If we can keep unemployment from rising too much, that will help as the housing market weakens.

Q437 **Chair:** Can I just pick up on one obviously correct thing that you said, Kristin, which is that the central bank is not led by Government debt? It has of course done an awful lot of that. It is going to start reversing that as we go forward, but it has done an awful lot of it. We have been discussing how inflation has ripped ahead in recent times and is going to go still higher. Do any of our three witnesses think at the back of their minds that the Bank of England, in terms of monetary policy, might have been slightly too accommodative of the Government and their desire to raise debt finance in the markets, or do you think it has been absolutely scrupulously independent at every turn? Are there any doubts?

Adam Posen: I have none.

Charles Goodhart: They have been scrupulously independent and at the same time wrong.

Q438 **Alison Thewliss:** I have some questions about monetary policy. If I could ask Adam Posen first, you said that the 2% target, which you co-authored arguments for 40 years ago, has outlived its usefulness. Can you tell us a bit more about why you feel that?

Adam Posen: When Ben Bernanke, Ric Mishkin, Thomas Laubach and I wrote a book called *Inflation Targeting* that came out in 1999, we stressed the idea initially that the inflation target should be changed as the economic conditions changed, not just the whims of the Government or the whims of the policymakers on the committee, but when there is real structural change. If you go back to the discussion that Charles and particularly Kristin just had about why you cannot directly measure or even easily estimate what neutral is, or demographic shifts like Charles is talking about or Brexit as a regime shift, it is unreasonable to think that the target that was set for a variety of convenient reasons, mostly having to do with everybody else picking the same number in 1992, is necessarily the right target.

Additionally, as you are probably aware, there has been a lot of discussion over the last 10 to 15 years about what is called the effect of the zero lower bound on interest rates. Charles and I may disagree on this, given his last comment about overdoing things. Because the economy has a low fundamental interest rate and we kept being in a low inflation world, which I expect us to return to, the central banks do not have much space to stimulate the economy or react before they hit zero. Then they have to do quantitative easing or negative interest rates, which are probably less effective and have more distortions.

There are a bunch of reasons why a higher inflation target would be right for the UK right now. If it turns out that getting inflation back down is less painful than I expect, requiring less of an interest rate rise, less real interest rate rise, less recession, it would be more reasonable for Parliament and the Treasury to discuss with the Bank whether it should stop at 3% rather than 2% and raise it going forward.

To go with some things my colleagues have said and things we wrote in the book 25 years ago, or whenever, if the central bank does not have much credibility, or alternatively the central bank has credibility but the economic regime it is in does not, because the country is smaller and less credible or able to commit to discipline, it is more important that the central bank sticks with the target, whatever it is. It is contingent.

If I were in the abstract and we were not in this inflationary period, I would say it would be good for the Bank of England to have raised its inflation target for a few years, subject to subsequent review, to 3%, say, from 2%. If we were in a situation where bringing down inflation proved difficult, I would be more worried about making that shift. Whether or not that is persuasive, does that make sense as a statement?

Alison Thewliss: That is useful, thank you.

Kristin Forbes: This is one area where I have a different view than Adam, so I just wanted to highlight it. The 2% inflation target for the Bank of England, especially when it is 2% inflation out two years from now, has actually worked quite well. It has given the Bank of England quite a bit of flexibility to adjust when it is hit by external shocks, whether inflation is too low or too high.

Right now, when inflation is so high and so above target, is not a time to talk about raising the inflation target. While there may be academic arguments or other arguments for thinking about whether 2% is the right number, now is not the time because even by just talking about raising that inflation target you risk further undermining inflation expectations, having people expect higher inflation going forward and making it harder to end this spiral you are on the verge of hitting right now in the UK.

Let me give you a couple of numbers I just pulled out last night. Since independence, since the second quarter of 1998, quarterly inflation has been 2.0% in the UK. That is despite a number of major external shocks. That is despite inflation being negative briefly at some periods and inflation being 7% today. It has averaged over the period of independence exactly 2% inflation two years forward. That is pretty good performance.

In comparison, the US average inflation has been 2.3% over that period. The euro area has been lower, at 1.7%. The numbers say something. There have been a lot of external shocks the last 15 or 20 years, and the inflation target has given the Bank of England flexibility to manage those shocks and get inflation back to average 2.0% exactly on a quarterly basis over the period. I would be very cautious fiddling with that right now.

Then a final point where the Bank of England's mandate also works quite well is that it does not have an explicit unemployment component or growth component as the US does, for example, which is the dual mandate of inflation and employment. Since the inflation target is two years forward, with some flexibility for more time if needed the UK, that means you are implicitly assuming that you have to set inflation to have equilibrium in the labour market and in growth. That means you do have to support the labour market and support growth to get inflation sustainably at 2% in two years' time.

It is a very nice way to have a target that gives flexibility. That lets the Bank of England incorporate what is going on in the labour market, in growth, while it focuses on inflation, but also is very clear to communicate and to talk about to the public. Sticking to that should make it easier to bring inflation down. Muddying the waters by putting anything else in there would make it less effective.

Alison Thewliss: That is interesting, thank you. Charles, do you have things to add to this?

Charles Goodhart: I agree entirely with Kristin. I would add, though, that the inflation target is not set by the Bank of England. It is set by Parliament. Can you imagine what news commentators would say if the Chancellor of the Exchequer got up and said, "I want the target now to be 3% rather than 2%"? What the commentators would say is, "That is because he is frightened that otherwise interest rates will have to go up higher", and it is all politicised. Partly for that reason, as well as everything that Kristin said, for the time being we have to leave it at 2%.

Also, Alan Greenspan said that when an inflation target is working is when nobody worries about inflation. Because of the improvements in quality, a 2% target when hit is effectively one that is largely ignored by everybody. A 3% or certainly anything about 3% would not be ignored by people and would automatically tend to lead towards a wage-price spiral. I am entirely with Kristin.

Adam Posen: Just for the record, I am on this point entirely opposed to my two colleagues. They are focusing too much on the short-term optics versus the substance. They overestimate the reaction of the average people. They underestimate the benefits that would come. The fact that the Bank of England through sheer luck had perfectly 2.0% has not resulted, over a 25-year span, in improvement in productivity growth. I am not sure that there is some compelling argument that it is doing what it should be doing.

Finally, in terms of the external affairs, since I believe the UK continues to have an over-valued exchange rate given its productivity trend since roughly 2010 and now given Brexit, having a higher inflation target than some of the other countries might not be a bad idea. I am sure they both completely disagree with all those points.

Q439 **Alison Thewliss:** It is perfectly fine for you to disagree. That is helpful for us as well, to get a range of views here. Could I ask this, just as a point of difference? In the United States the Federal Reserve has adopted an inflation averaging approach. Can you tell me a bit more about that and if there is any relevance to that approach, if the UK were to take something similar?

Kristin Forbes: There are different aspects of the average inflation target. One is that, if inflation undershoots, you are basically committing to have inflation overshoot 2%, so that average inflation is around 2%. What is an important part of this new framework, which has got the Fed into a bit of trouble, is that it also pre-committed not to act as pre-emptively if the labour market tightens, not to raise interest rates as far in advance as it would have, because of uncertainty about how low unemployment can go, how quickly inflation will pick up, and less concern about overshooting the inflation target.

While that shift made sense if you were worried about inflation being too low, and made sense given the past decade where inflation was too low, the timing was not very good to adopt this right before inflation picked up sharply. Actually, I gave a talk at Adam's Peterson Institute, where we talked about new frameworks more in the context of the ECB, but I raised four concerns with this shift to a framework such as this that is less pre-emptive. It assumes that the Phillips curve is flat. In other words, it assumes that, even as unemployment falls very low, inflation will not pick up quickly.

I have worried about that because of work I have also done with people at the Peterson Institute, showing that these relationships are nonlinear. When unemployment falls too low, inflation can pick up quite quickly. I worry the average inflation targeting regime could miss those risks. Also something like an average inflation targeting regime where you can act more slowly when inflation picks up assumes that inflation expectations are sticky and do not adjust quickly. We have just seen that they can move quite quickly. That worries me about this sort of shift.

This shift also assumed that the neutral interest rate was lower. As we have just talked about, we do not really know where that is. Then finally, these shifts assume we know where labour force participation will settle and some other assumptions that, again, are very hard. My big picture takeaway from this is that I do understand the logic of shifting the target in the US or shifting the framework where inflation had been low for a period, but the timing was very unlucky. I do worry, now we are in a higher inflation regime, that these changes do not make sense when you are in an environment with higher inflation, where unemployment is so low, and if anything can make the job harder for central banks to bring inflation back down.

Again, I hope the Bank of England is not encouraged to head in that direction. The Bank of England should not need to because of the flexibility already built in that I just talked about. In the US, there was not an inflation target out two years as explicitly as in the UK. By having the inflation target out two years, that gives the Bank of England more of the flexibility that the Fed did not have and may have pushed it more towards this average inflation targeting framework.

Alison Thewliss: Charles, do you have anything you wanted to add to that?

Charles Goodhart: The average inflation target is dead. It was introduced to deal with what was perceived as a specific problem in 2019 and the beginning of 2020. Events have made it perfectly clear that it was a wrong decision and the sooner we all forget about it the better.

Q440 **Alison Thewliss:** Thank you, that is very clear. The MPC has in its toolkit interest rates, quantitative easing, corporate bond purchases and, newly, negative interest rates. Are these adequate to the task of tackling future downturns, particularly in a world where interest rates remain or are at near zero?

Adam Posen: I believe it is adequate. I believe that there has to be a flexibility that, when a crisis or a financial interruption hits, the central bank, in this case the Bank of England, is able to intervene in specific markets as needed. We saw that in 2008-09. I had at the time advocated for purchases of bonds, which were denied but I think would have helped. They would not have changed the world. We saw two years ago, in the initial impact of Covid on the economies, that the central banks have to be prepared to make specific types of lending programmes and specific kinds of purchases of assets.

An emergency facility or something similar to the older version is right, like article 13(3) of the Federal Reserve Act, which gave them the right to do that and which de facto the Treasury has given to the Bank of England. That is about specific interventions and specific circumstances.

In general, the combination of interest rates, including negative interest rates and quantitative easing possibilities, is sufficient. I would note there are separate issues about whether their macro prudential tools are sufficient to deal with things like real estate bubbles and so on, but that is an issue for a separate day. If I understood your question correctly, we do have adequate tools, with this important exception that in a financial panic they can adapt as needed, obviously with Treasury or parliamentary oversight.

Kristin Forbes: After strongly disagreeing with Adam on the last one, I will second what he has said. I agree. The toolkit of the Bank of England is quite sufficient now to deal with downturns. I would actually add to your list another tool, which is programmes such as the TFS, the subsidised lending to banks, or the subsidised lending to banks to promote lending to small and medium enterprises that was adopted recently. It is worth noting that in this previous decade before Covid there was a lot of soul searching among central banks and economists about not having enough tools to get inflation to target or deal with the next downturn.

The events over the last few years have shown that there are a lot of tools in the central bank's arsenal and they can be quite effective at not only stabilising the economy but dealing with different disruptions in financial markets. Having said that, the central banks do now have a large toolkit. It is important to keep those tools, keep them available if needed in the future, but that does not mean they can get inflation down right now without some pain and adjustment. These are tools that are more helpful in a recession, in a slowdown, during periods of market disruption, during periods like today when inflation is so high, partly due to large external shocks. There is only so much that the Bank of England can do.

Q441 **Alison Thewliss:** Charles, are there any further tools that you think the MPC should have, or is this adequate?

Charles Goodhart: No, I agree with my colleagues. My worry is not whether they have enough tools but whether there are self-imposed constraints on using them.

I note that, when there is a deflationary crisis, as with the onset of the great financial crisis and when Covid struck at the beginning of 2020, the central banks were prepared to drop interest rates by a large amount, more than 100 basis points, in some cases 200 basis points or more. There seems to be, at least among certain central banks, the constraint that you do not raise interest rates by large amounts when there is an inflationary crisis. There is an asymmetry developing in which central banks are prepared to cut massively but not prepared to increase massively when you get into a real inflationary crisis. That may need to be reconsidered, but the tools are there.

Q442 **Alison Thewliss:** Just briefly, I want to talk about the latest remit letter from the Chancellor, which says the Monetary Policy Committee's secondary economic policy objective includes support for a "structural reform to level up opportunity in all parts of the UK and to transition to an environmentally sustainable and resilient net zero economy". Are these things that monetary policy can do?

Charles Goodhart: If you are asking me, in terms of levelling up, the answer is no. The interest rates are nationwide and I do not quite see how you can deal with that. One of the concerns that people have had recently is that the central bank has taken on so many objectives, including helping with climate change, et cetera, that perhaps it is losing its focus on what its primary aim ought to be, which is the maintenance of price stability by achieving the inflation target.

Adam Posen: I agree. We have seen repeatedly that levelling up, whether in unified Germany, in the diverse US or in the UK, is a very difficult challenge. Even policies directed right at it do not seem to work. Monetary policy does not have any effect on it. Similarly, on climate change, this relates to the answer I gave earlier about how to deal with worker bargaining power. At some point, it is up to the elected legislatures, the Governments, to do these things and monetary policy cannot substitute, not because monetary policy is sacred and they cannot be asked to do this or not because they are not accountable, but because it will not work. If the UK wants to do something about its contributions to climate change and its response to that, do something about levelling up, do something about the low bargaining power of workers, it has to be done through legislation.

Kristin Forbes: I also agree with this. I actually have some additional reasons. Not only are the tools of central banks not terribly effective for many of these other worthwhile goals, but I worry that, if central banks' mandates are expanded, they will be less effective at accomplishing what is of primary importance, which is keeping inflation down around targets, whatever they are. If central banks are pushed in different directions, it is hard to communicate what they are focused on. It is harder to get the message across. People may question whether they would take some of the very difficult steps needed to get inflation down. We have been spoiled in some ways over the last 20 years or so, in that inflation has not been such a big problem. As Charles mentioned, the best inflation is one we do not think about. We have not had to worry about inflation as much, and that has made it easier to think that central banks could do other things, because keeping inflation around targets was not seen as such a big concern or such a big challenge. The last year has reminded us it is still of primary importance. We need central banks to focus on this goal and this target. Keeping their mandates very narrow so they can accomplish that is important.

Alison Thewliss: Thank you all very much. That has been really interesting.

Q443 **Harriett Baldwin:** After the financial crisis 13 years ago, central banks reached for quantitative easing as an additional tool, because they had reached the limits of what they could do with interest rates themselves. Recently, the House of Lords described quantitative easing in a report as a "dangerous addiction". Obviously, the Bank of England has had nearly £900 million of quantitative easing cumulatively. Can I start with Professor Forbes? You have called, now that we are in a tightening phase, for central banks to prioritise quantitative tightening. Yet we are seeing the Bank of England primarily using interest rates to combat inflation. It has really only unwound any QE passively. Can you expand on that for us, please?

Kristin Forbes: Quantitative easing was an important addition to central banks' toolkits. When interest rates were down as low as they thought they could go and you needed more stimulus, this is now an additional tool, even though we would rather not use it; we would rather just adjust interest rates. It can help stimulate the economy, get jobs back, get growth back, raise inflation. I will admit I had initially been sceptical about how well it would work. I did not know if QE mainly worked because markets were disrupted and dysfunctional, and it just eased market functioning. We learned in the UK after the Brexit vote, when markets were functioning well, the Bank of England did QE and it did provide stimulus as expected, that this is an important tool.

Having said that, it is also important to unwind it when not needed and not to overuse it. For example, I worry that the last round of QE that the Bank of England did was probably not all needed. It could have been cut back sooner as the economy recovered. Now, going forward, I will give the Governor Bailey and the Bank of England very substantial credit. They have been way ahead of other central banks all around the world in talking about the importance of unwinding balance sheets, doing quantitative tightening and selling the assets that were purchased during emergency situations.

Governor Bailey gave a very long, detailed analysis of this about a year and a half ago at the Jackson Hole conference in the US. This is well before the US Fed, for example, was talking about this. They deserve credit for talking about it and giving guidance before any other central bank on how they would accomplish it. They specifically said, when interest rates hit a certain level, they would start the automatic unwinding of assets on the balance sheet. Then they said, when interest rates hit 1%, which they just did at the last meeting, they could actively discuss asset sales. Other central banks are still figuring out how to communicate this and how to move forward. The Fed just barely announced how it is going to move forward.

The Bank of England has been ahead of everyone in communicating it. That is probably why it has gone off smoothly, as it has started some of this automatic unwind ahead of other central banks. They should get credit. Having said that, I also would now like to see them continue to move forward. They now have hit this 1% hurdle, where they could start to discuss active sales and not just letting this automatic unwind of assets happen, which would be very slow, very chunky and mean the balance sheet would not shrink very much for years.

They have now reached the hurdle where they could do more. In the last meeting, it sounded like they had not even started the process of how they would do that or did not have a concrete plan. While it makes sense to move cautiously, because you do not want to disrupt markets especially given the volatility recently, I hope that the Bank of England will continue to move forward. It has been a leader around the world in this. There seems to be some more caution now at the Bank of England in terms of tightening more, and unwinding the balance sheet could be a very useful complement to tightening.

Q444 **Harriett Baldwin:** Can I just ask you to elaborate on the complement to tightening? Are you saying that you would like to see the unwinding happen before they shift base rates again? Do you want to see both happening?

Kristin Forbes: As the MPC has said, adjusting bank rate is the primary tool, the main way they should tighten. That makes sense. We know how adjustments in interest rates work. We know how the affect the economy. We know roughly how that will affect inflation and growth. When they shrink the balance sheet, we really do not know what those effects would be. They just could be modest; they could be tiny. Doing it in the background at the same time could help or might not have much effect, except that it gets the Bank of England out of the business of owning a large share of Government assets.

Q445 **Harriett Baldwin:** You started by saying you thought that, when they used quantitative easing at the start of the pandemic, that itself should now be unwound, because you felt that was more of a response, was more mission creep, as it were, for quantitative easing in terms of tackling liquidity. Are you saying you are rowing back from that now and you think that they should be slower to unwind quantitative easing?

Kristin Forbes: There is this asymmetry, which is a big challenge. When central banks do quantitative easy, we now have a rough idea of how much that stimulates the economy, raises inflation and jobs, helps markets unfreeze. We do not really have much idea of what happens when you unwind the balance sheets and sell them, partly because no one has done this except the Fed during a very brief window when a lot of other things were going on. Unwinding the balance sheet should be done more slowly and cautiously than when QE was done.

Q446 **Harriett Baldwin:** That is just because we have never done it before.

Kristin Forbes: We have not done it before. The channels for why we think QE works are things such as signalling that interest rates will stay low for longer. If you are doing QT now, it is not clear that that signals anything, so it may just not have much effect. Again, we just do not know, so we need to be very cautious. There I fully support the Bank of England's efforts to be very cautious. Still being cautious, I would like to see them continue, as they have been, setting precedents and moving forward around the world.

Q447 **Harriett Baldwin:** Professor Goodhart, the Office for Budget Responsibility has described to our committee how the rise in the bank rate feeds through directly into the cost of interest rates on the public debt, obviously. You suggested in evidence to the Lords Committee last year that the Bank could stop paying interest to commercial banks. Can you elaborate on why you think that might be needed and whether it would be practicable?

Charles Goodhart: It would be difficult. One reason why QE was done far too much and was long hated, apart from its beneficial effects when there were liquidity fears, which were considerable at times, was that it shortened the duration of the public sector debt. Those of us who did not believe that inflation was going to be lower forever, and that nominal interest rates were going to be virtually zero forever, thought that the past years up to 2020 were a period in which we should have lengthened the maturity, the duration, of Government debt in order to go on paying low interest rates forever. In fact, what QE did was actually shorten the duration, so that it means that the increase in interest rates will have a much greater effect on the interest rate costs of the public sector immediately. Now, that is quite largely because all these payments are being made to the commercial banks on their reserves. You deal with that by simply not paying the interest to commercial banks. That would be, in effect, a tax on commercial banks and it would have a number of adverse side effects. It would mean that there would be an incentive to shift intermediation out of banks, which are relatively well regulated and relatively efficient, into the non-bank financial intermediaries, which are less well regulated and probably less efficient. It would also shift business abroad rather than at home. It is a rather extreme response to the interest rate cost, but it is one that could be—

Q448 **Harriett Baldwin:** You are not advocating it. I am not hearing you advocate it.

Charles Goodhart: No, it is a possibility, but it has to be appreciated that, if interest rates go up, including eventually the interest rate on bank deposits, paying zero on a large, required base effectively would be a tax on banks. It may be that a tax on banks is regarded as a relatively easy mechanism for trying to relax the fiscal problems, which are likely to remain very considerable over future years. It would have to be seen, perceived and accepted as a specific tax on the banking system.

Q449 **Harriett Baldwin:** Can I change the subject slightly and just ask each one of you this? Obviously, a rise in interest rates is going to be another cost that households, our constituents, are all going to have to pay, especially on their mortgages. Could you list for the Committee the one thing that you think the UK Government should do to reduce the cost of living shock for constituents and for households. It is slightly outside the scope of the wider remit but very topical and important to constituents. Who wants to start with that one?

Charles Goodhart: The cost of living is going up particularly because of energy and it will go up particularly because of food. The problem is about the grain prices going up, fertiliser prices going up, so the harvest is not going to be that good over the next year. Food and energy are particularly heavily represented in the consumption of the poorest. My answer to the cost of living crisis would be to focus as much as possible on providing support to the poorest, not only those who are getting very low wages but those who are not getting any wages at all because they are unemployed, old or for other reasons that they have very low incomes. Focus the support on the low-income sectors of the economy.

Q450 **Harriett Baldwin:** Professor Forbes, what one thing would you do?

Kristin Forbes: This is a difficult question, as many of the things that I would suggest doing so you do not end up in a situation like this again will take time and not help much today, like diversifying energy sources.

If I had to answer something right now about what could make a difference immediately, this is not very glamorous, but I would actually come out and reiterate that the Bank of England mandate is 2% inflation and nothing else. They need to focus on that and make sure you really reiterate that the Bank of England can take tough measures to bring inflation down. Hopefully that would help bring inflation expectations down, help them fight this wage price spiral and ratchet effects, to get people to realise inflation is coming down. That could help address the cost of living. If inflation comes down more quickly than expected, that could go a long way towards addressing the cost of living crisis.

Adam Posen: I agree with most of what Charles said. Aid should be focused on the lower-income families. I would not do anything to subsidise people with their mortgages, since they had the benefit of capital gains, and they generally are people who are better off. That would feed inflation in other ways. It would draw out how long the disinflation process would be and impose more of the disinflation process on people who do not own houses. I would avoid that and I would do a lot more subsidies to the poor, both working and non-working, including very targeted income-tested energy subsidies.

Q451 **Anthony Browne:** We talked earlier about the tools that you have and the toolkits of central banks. I am going to talk about a tool that is in the Chancellor's toolkit, which is fiscal policy, and the balance between fiscal policy and monetary policy, and whether it is in the right place. We did touch on this earlier when we talked about the fiscal support that was brought out in the UK and the US during the Covid crisis. I am thinking going forwards, now we are out of the crisis. Professor Jagjit Chadha from the National Institute of Economic and Social Research, who we had for evidence earlier, said he thought the balance between fiscal and monetary policy was wrong, in that tight fiscal policy had continued keeping interest rates close to zero. Do you think the balance is right between fiscal and monetary policy?

Charles Goodhart: It is not an easy question. At the moment, the main worry for why I did not agree with my colleagues Adam and Kristin about tightening monetary policy more sharply than is being done at the moment is because of my continuing concern about the availability of gas to Europe. If that gets resolved, I would have joined them and said that monetary policy should be tightened more sharply. If monetary policy is tightened more sharply, with a continuing short-term rise in energy and food, it is necessary to undertake more fiscal support for the poor. I would like to see greater expenditures for that, which will drive the public sector deficit even further into the red.

Taking the longer term, which the OBR does, the rise in the number of old who need care, who need medicines and who get pensions, all of which end up in the public sector, and the decline in the proportion and sometimes absolute decline in the working age population, who pay the income tax and much of the other taxes as well, mean that the public sector position is, as you can see from the OBR's figures and the CBO's figures in the US, is getting steadily and consistently worse. As John Cochrane keeps on arguing in the US, the public sector position is worsening steadily. Ultimately, that means either that you are going to have massive inflation or that you are going to have to default, which would itself lead to massive inflation, neither of which you want.

At some future stage, not tomorrow, not next year, we are going to have to have much higher taxes, given what is happening to democracy. The question is how we can introduce higher taxes without this having adverse effects on our economy and on productivity in particular. We are going to have to do a lot of thinking about what kind of additional taxes we are going to need. I have some ideas. Other people may dislike them. I would like to go much more for a land or property tax. I would like to go much more for a carbon tax. At some future stage, we are going to have to work out what additional taxes we are going to need, because otherwise the situation actually is unsustainable at some point.

Q452 **Anthony Browne:** Adam, do you think we have the balance right between fiscal policy and monetary policy, or do you support a looser fiscal policy?

Adam Posen: Generally, yes, as I said in my response to the opening questions, the UK avoided some of the mistakes that the US did make in this fiscal cycle. The response to the 2020 initial onset of Covid and its economic implications was right. We are not way out of whack in the UK. Distributionally, a number of choices that have been made over the last couple of years in fiscal policy have put too much burden on the poor and people without capital assets, and too little burden on the reverse. That is the dominant issue right now for UK fiscal policy.

I am less worried than Charles or Cochrane about long-term fiscal sustainability, but I agree that, over the long term, the more one can build up essentially automatic stabiliser taxes that go up and down with the business cycle more aggressively, the better it is for stabilisation of the whole economy and the less monetary policy has to do. When I was on the Bank of England MPC, which is now a long time ago, I advocated for basically cyclical real estate taxes. There is room to do things like that as well as substituting carbon taxes and property taxes for other forms of taxation. If you are asking me simply the macroeconomic policy mix right now, fiscal-military balance is broadly right.

Q453 **Anthony Browne:** Kristin, do you think the balance is right or would you advocate more fiscal activism, as it were?

Kristin Forbes: I will admit that my former training as an MPC member still makes me reticent to talk about fiscal policy. It was so drilled into our head.

Q454 **Anthony Browne:** You are a free agent now. You can say what you like.

Kristin Forbes: I know, but old habits die hard. I will be brief. There is a role for fiscal policy today in the UK to target specific sectors of the economy that are under severe stress, such as low-income households, and there is room for fiscal policy to target things such as raising productivity growth, which is incredibly important to tackle all these issues we talk about, including debt.

Having said that, when you think about overall stimulus, though, I would much rather see adjustments to stimulus done through monetary policy in the Bank of England, and no additional stimulus done on the Government side, because of the issues Charles raised. The UK has a high debt level. It is at this point manageable, but the more debt is taken on, the greater the risks go in the future. Demographics are not working in your favour. Productivity growth has not been supportive. Given the risks of adding to the current debt burden, I would be very hesitant to do additional stimulus through the Government and instead would like to see any additional stimulus, at least for now, done through the central bank.

Q455 **Anthony Browne:** Presumably with interest rates rising, which they are now, that will be more possible, to just rely on monetary policy for stimulus than fiscal policy. When interest rates are incredibly low, the temptation would be to use fiscal policy more, presumably.

Kristin Forbes: It would be very nice to be back in a world where most adjustments to the business cycle and your normal ups and downs are just addressed through changes in bank rate without having to resort to the other tools.

Q456 **Anthony Browne:** Do you think there have been any downsides to relying on monetary policy so much, as we have done, since the financial crisis?

Kristin Forbes: I did worry that, over the decade up until Covid, the reliance on monetary policy seemed to basically be in one direction, just that the central banks stepped in, lowered interest rates and lowered interest rates, did QE, and in the UK never unwound the QE and reduced the size of its balance sheet, and was very hesitant to raise interest rates. Back to Charles's point, when they did it would only be 25 basis points, then wait a while and very slow and gradual, which meant you were creating an expectation that, when things went wrong, the central bank stepped in and eased, but they would be very slow to tighten.

That led to an asymmetry of risk assessment, and people were probably more willing to take on debt, more willing to invest in financial markets, because it seemed that most of the actions went in one direction. What has happened in the last two years, though, has changed that. Now the world is seeing that central banks do unwind balance sheets. They do raise interest rates. That should hopefully reduce the risks around the one-sided expectations that were beginning to build up in the past.

Q457 **Anthony Browne:** Charles, can I follow up your comments? You are worried about the long-term fiscal sustainability of all advanced countries for demographic reasons. Presumably that means you see less scope for fiscal policy in terms of economic stimulus and you would end up relying purely or more simply on monetary policy.

Charles Goodhart: No, I wanted to shift the basis of taxation to a form of tax that has a less adverse effect on effort, on incentives to work and on incentives to invest. A shift to a carbon tax, which would have the benefit of improving climate change, and a shift to a property tax, particularly a land tax, because that has zero effect on the incentive to work and to invest, are actually necessary. It is not so much a question that I want to reduce the deficit now. I do not. If anything, I would be happy to have a slightly higher deficit focused, as Adam said, on support for the poor. We have to have a serious discussion over the longer-term trends and what that means to the structure of taxation in our economies.

Q458 **Anthony Browne:** The Chancellor has just announced his new fiscal rules, requiring public debt and the current budget to be in balance within three years. Do you think that is overly fiscally tight, then, from what you are saying?

Charles Goodhart: I shall be very surprised if he achieves it. It is always a desire. It is like St Augustine: "Dear Lord, make me chaste in future but please not now".

Anthony Browne: We did do hearings on this earlier and had similar amounts of scepticism from a range of economists.

Q459 **Siobhain McDonagh:** My questions examine whether the economic cycle, a protracted recovery from the financial crisis and low interest rates may have played a part in reducing the UK's long-term growth potential. If so, could stronger monetary or fiscal stimulus help raise long-term growth prospects?

Because I have come last, I know that some of these topics will already have been touched on. I would just like to ask all the members of the Panel this. The UK has suffered a particularly bad productivity performance since the financial crisis. Did a protracted recovery and sluggish investment weaken the UK's long-term growth potential? If so, is there a role for monetary and fiscal policy in improving productivity growth by running the economy hot?

Adam Posen: It is a very profound question, in terms of both its public implications and its intellectual implications. My bias during the financial crisis was towards a point of view that there was hysteresis, as the economists call it, that if you let a bad outcome occur and persist, and you underutilised particularly people, there would be workforce scarring and it would have ongoing effects as well as missed investment.

Fortunately or unfortunately, the data does not really support that. Even though it seems intuitively right, it has not turned out that way. Several years ago my colleagues, Olivier Blanchard and Larry Summers, with a host of younger econometricians tried to look for the evidence of hysteresis and these kinds of effects across a range of high-income economies, including the UK and the US. They could not find a support for it.

More bluntly, this is what Chair Powell, for example, at the Federal Reserve talked about in helping to justify the aggressive stimulus policies, both fiscal and monetary, that were undertaken in response to Covid, which I support. The fact remains that we have seen in country after country, including the UK, that the number of people dropping out of the workforce or being scarred permanently and not able to get back into labour force participation is quite small. For at least a share of those who have remained out, it is voluntary. It is not because something terrible happened to them.

As much as I would like to believe that monetary policy and running the economy hot would have that benefit, the last 20 years of evidence does not support that as a claim. We should not be taking it into account.

Kristin Forbes: I can jump in on this. I agree with Adam's comment. There are intuitive reasons why it sounds like running the economy hot could bring more people back in the labour force, raise productivity and growth, but the evidence is very weak. When I was on the MPC a while ago, I worried about another aspect of this: if you had very low interest rates for an extended period and ran the economy hot, could you actually be hurting productivity growth? You could be making it easier for inefficient firms to keep operating, for example, and then taking resources to inefficient companies that could hurt overall productivity growth. I looked at that in quite a bit of detail.

Actually, I gave a speech I called "Low Interest Rates: King Midas' Golden Touch?" We all love low interest rates initially. They do help the economy. King Midas loved his golden touch when everything he touched turned to gold, but when it is around for too long the costs built up. King Midas did not like it then. His food turned to gold; his daughter turned to gold. The costs grew over time. I worried about whether, with low interest rates, running the economy hot would lead to bigger costs over time, such as more inefficient companies, making the economy more inefficient.

Also, although the argument is intuitive, the evidence is very weak. There might be some effects. Andy Haldane at the Bank of England did a similar sort of analysis. You might get some small negative effects, but very tiny and far outweighed by the boost to the economy.

The bottom line, after spending a lot of time looking at this, is that the arguments make intuitive sense, but there is not much evidence that running the economy hot does boost growth. It may not hurt growth very much also, but it does not provide much benefit. If anything, it could lead to more risk, as we are facing now, of it getting harder to bring inflation back down. The arguments are not there, or the arguments might be there but they are not supported by the facts.

Charles Goodhart: I agree with both of them.

Q460 **Siobhain McDonagh:** Unanimity—great.

The United States embarked on a very large fiscal and monetary stimulus last year. It is now the only G7 economy that the IMF forecasts will experience stronger growth than it had expected pre-pandemic, but it also has the highest inflation in the G7. Does this show the potential or limitations of running the economy hot?

Charles Goodhart: Yes.

Kristin Forbes: Yes.

Adam Posen: Yes.

Q461 **Siobhain McDonagh:** It is a one-word answer. Charles, you have noted the potential impact of demography on the UK's economy going forward. Should we be looking at policies to increase the supply of labour pool?

Charles Goodhart: I think the world will change in the sense that, when labour becomes stronger, wages are rising and asset markets are not so frothy, the previous general political dislike of immigration, which we saw in both the UK and the US, may weaken and even at some point reverse. There will be an increasing belief that there are at least some groups of people, of immigrants, whom we should welcome with open arms.

I am particularly glad to see that the UK is welcoming a large inflow from Hong Kong. I wish we had done much more to ease the way of Ukrainian refugees into our country. The inability to issue visas to Ukrainians coming into the UK was a significant failure of the Home Office. Within the next decade or so, public attitudes to immigration may well show a sea change.

Q462 **Siobhain McDonagh:** Interest rates have been held at near zero since the financial crisis. To what extent could the UK's productivity puzzle be explained by a population of zombie firms with limited prospects but able to survive thanks to easy financial conditions?

Kristin Forbes: I can jump in on that. That was what I referenced earlier that I did some work on, a number of years ago, granted. I found that there may have been a small increase in less efficient firms because of low interest rates, but the number was probably quite small. I do worry right now, though, that that number may have jumped. Look at bankruptcies. This is not just an issue in the UK. If you look at a number of countries, bankruptcies have been abnormally low since Covid hit. That is because of the very substantial support, not just from low interest rates but from all sorts of different subsidised lending programmes.

Some of those companies will not be efficient and will not be profitable as things normalise. It also is very hard to know during the peak of Covid which companies will be profitable going forward or which will not. We do have an important adjustment that will need to happen going forward around the world, not just in the UK. The fact that some of these companies may have been supported during Covid does not suggest interest rates were too low. During Covid when the Government said, "You have to stop; workers cannot come into work; you have to shut down", companies did need some support. Now we need to let natural market forces sort out which of those companies should be solvent going forward.

Adam Posen: Can I complement Kristin's remarks? I read her speeches about this topic in the UK. They are applicable. Additionally, I have done a lot of work through the years on Japan. There was this constant yammering from many people, some serious scholars, some pundits, about zombies overtaking Japan because you have very low interest rates and all kinds of cosy arrangements. What I argued, starting in 1998, which I and others have documented, is that that does not seem to be an issue. There may be individual firms, but it is not clear that low interest rates on average increase the number of zombie firms in a meaningful way.

If you look, Japan's per capita growth rate has been near the top of the G7 and has actually gone up over time. That is not due to low interest rates by any means, but the lack of hiking and low interest rates did not prevent that. The direct evidence is that, just as Kristin said, we do not know which companies are going to be profitable or losers in the future. Essentially, if you think interest rates are a way of determining who is a zombie and who is not, you are basically saying it is all a question of who has liquidity at a given moment. That is not necessarily a good measure of future prospects or productivity. It is actually very arbitrary. I do not view this as an issue.

Siobhain McDonagh: Charles, did you want to add anything?

Charles Goodhart: I am with Kristin on this. What was worse than low interest rates was the 100% credit guarantee by the Government, which was more or less a standing invitation for anyone who wanted to borrow, sometimes and quite frequently fraudulently, to continue in business at the Government's expense. The 100% credit guarantees for small and medium-sized enterprises, without any kind of check on creditworthiness or profitability, was an error. I have been writing with others an article to argue that point, which is rather similar to the low interest rate argument.

Chair: We started to drift into an area there, Charles, that the Committee is also looking at, when it is coming to fraud around Covid.

Can I thank you all very much indeed for appearing before the Committee? There has been a broad level of agreement on many things. There was one moment during the last round of questions where you all replied "yes" simultaneously, in unison, which for a group of economists together is almost unheard of. There was a lot that you agreed on and also a lot that you disagreed on, actually, but we all agree it is going to be a very tough future ahead for the Chancellor and the Bank of England. There were lots of thoughts on monetary policy, on the future of interest rates, lots of good analysis on inflation, both its causes and some ideas around what we should be doing about it.

For those who like to follow our proceedings, rather like a soap opera, we have the Governor of the Bank of England and three members of the Monetary Policy Committee before us this coming Monday. It is worth watching for anybody who would like to tune in for that. Could I finish by thanking Kristin and Adam from the USA? It is a very special country for us. Thank you for joining us, and what could be more special than Central Devon, Charles, my constituency? Thank you very much indeed for joining us from Devon too. That concludes this session.