



Treasury

Oral evidence: Bank of England November 2013 Inflation Report, HC 825 Tuesday 26 November 2013

Ordered by the House of Commons to be published on Tuesday 26 November 2013

[Watch the meeting](#)

Members present: Mr Andrew Tyrie (Chair), Mark Garnier, Stewart Hosie, Andrea Leadsom, Mr Andrew Love, John Mann, Mr Pat McFadden, Mr George Mudie, Mr Brooks Newmark, Jesse Norman, Teresa Pearce, Mr David Ruffley, John Thurso

Questions [1-137]

Witness[es]: **Dr Mark Carney**, Governor, **Charles Bean**, Deputy Governor, Monetary Policy, **Spencer Dale**, Executive Director and Chief Economist, and **Dr Ben Broadbent**, External Member, Monetary Policy Committee, Bank of England, gave oral evidence.

Q1 Chair: Good morning. Thank you very much, Governor, and all of you for coming to give evidence this morning. We have quite a lot of ground to cover, and that might occupy most of the morning. We will see how we go. It has been augmented by an exchange of letters, which has just been put online and which I saw about five minutes before we went into private session, between you and the Chancellor on leverage. Can you just say for the benefit of those who have not yet read those letters what they are telling us?

Dr Carney: Yes. As the Committee is aware, in fact, the first time I was before this Committee, the Committee asked questions about the leverage ratio and the powers of the Bank, specifically the FPC, over it. The exchange of letters proposes and, at least from our perspective and my perspective, agrees to a review conducted by the FPC in an expedited fashion of the implementation of a leverage ratio for banks in the United Kingdom.

There are several aspects of this. You are well familiar, but I will just review quickly. The first is to have a leverage ratio, and our view, the view of the FPC, the view of the Bank of England and my personal view, is that a leverage ratio is an integral part of the capital framework of banks, so it is absolutely necessary. As I say in the letter, if I could pick out one element that was essential to the performance of the Canadian banking system during the crisis, it was the presence of a leverage ratio. The first point is that it is integral to the capital framework, so we need to come to ground on the actual definition and calibration of the leverage ratio.

The second point is how the leverage ratio should vary with changes in the risk base capital framework. As you are well familiar, there are two aspects of this. The first is with respect to ring-fenced banks, the Independent Commission on Banking recommendations,

and the second is, if the FPC was to apply its powers of direction over a counter-cyclical capital buffer, would the leverage ratio move in a proportionate fashion with those adjustments? Our view is it should. In the absence of those movements, there will be incentives to game the system. Again, the leverage ratio is complementary to the risk base framework.

The third aspect of the letter is to give a sense around the timing, and I will finish with this if I can just say a word on the timing for the review. There are a couple of important inputs before the FPC finalises its recommendations about how to implement the leverage ratio. The first is in January, in Basel, we would expect the governors and heads of supervision who oversee the Basel Committee to come to an agreement—an international agreement—on the definition of the leverage ratio and recommended minimum calibration of that leverage ratio. Obviously, knowing how it is defined internationally is important domestically for a level playing field. Secondly, internationally, as part of the agenda of the FSB, very much supported by the Bank and the Treasury, is to define what is called gone-concern loss-absorbing capacity—in simpler terms, although I confess it is not that much simpler, bail-inable debt, something we have discussed at this Committee on numerous occasions—and the interaction between that bail-inable debt. The third element, which is the finalisation of the Recovery and Resolution Directive of the EU and its application here, is important for the questions around the calibration and application of a leverage ratio for the ring-fenced bank as well. The structure of that inter-group debt is relevant there.

All of those factors should be finalised over the course of the coming, I would say, three-quarters. The resolution aspects will take a little longer than that international definition. What we intend to do as the FPC is to work in parallel with that, come up with an evidence-based and well-reasoned recommendation to implement the leverage ratio, and we welcome the Chancellor's indication that he would, on that basis, give the FPC powers of direction over the leverage ratio.

Q2 Chair: You used the word “expedited”. You are expecting that the FPC should be granted this power when?

Dr Carney: We would expect that it would be granted in this Parliament.

Q3 Chair: You cannot be more precise than that? Are we talking about somewhere in June 2015?

Dr Carney: Given the international agenda and the timetable for that, the expectation would be that we would provide our report, our assessment, by as late as this time next year, because I think particular—

Q4 Chair: Within a year?

Dr Carney: Within a year, but we would expect very quickly thereafter we would be granted that power.

Q5 Chair: Are we talking about before the end of 2014?

Dr Carney: Yes. It is in control of Parliament. Yes.

Q6 Chair: Yes. That is the timing question. Then there is the substance, which I will just take in two parts. The first question is what this review is intended to do. You are saying in your letter that this review is about how to operate the leverage ratio. That is, it is about questions such as definitions and about the application of the leverage ratio to ring-fencing, largely.

Dr Carney: Yes.

Q7 Chair: There are other issues, but those are the two major ones, from what I can tell from what you have just said and also from the letter. Your letter nowhere indicates that there might be a possibility you could conclude that you should not be granted this power. On the contrary, your third paragraph makes clear you think this is absolutely crucial, and you have more or less paraphrased that part of the letter in your first reply to me. Am I right in thinking that as far as the Bank is concerned, the transfer of this power is a done deal?

Dr Carney: You are right in thinking that—

Chair: Subject to parliamentary approval.

Dr Carney: Thank you for the caveat, yes. Yes. We see that this power is consistent and in fact necessary to properly implement a robust capital framework in the United Kingdom.

Q8 Chair: If I can take you to the Chancellor's letter and you to, on my copy, page 2, this does not seem to be what the Chancellor is saying. Correct me if I am wrong, and I can only repeat that I have only just seen these letters only a few moments ago, but this letter says at the top of the first full paragraph on page 2, "This is now an appropriate time for the FPC to consider whether it needs additional powers". That is not what you have just been telling me, is it?

Dr Carney: It is the appropriate time for us to consider whether—and the view of the FPC, I expect, certainly my personal view—we should have these additional powers. We will undertake an evidence-based review. We will make the recommendations according to that, and I am fully confident that the very broad weight of evidence will support—I am confident that other independent members of the FPC will come to similar conclusions as I have just stated.

Q9 Chair: Just clarify this point. There is a gap between these letters, is there not? One is about whether as well as how, and the other is just about how.

Dr Carney: One is written—I can speak best to my letter and the opinions expressed therein, and the question is how.

Chair: I will not ask you the same question all over again because I can tell I am not going to get further detail to the answer.

Q10 Mr McFadden: Good morning. This idea of a leverage ratio, as you have just been discussing with the Chairman, would be, in simple terms, what most people would regard as part of making banking safer.

Dr Carney: Yes.

Q11 Mr McFadden: Yes. I am thinking about the speech you gave to the FT anniversary conference about a month ago, where you talked about the size of the City and so on, and the thrust of that speech was we do not have anything to fear from a bigger financial sector, as long as we can make it safe. What else, other than the leverage ratio, is needed to make it safer?

Dr Carney: Thank you. I appreciate the emphasis on the second part of the speech, which is exactly that point. There are certainly advantages to the financial system, but it has to be made safer; it has to be made more resilient. In addition to the leverage ratio, I will highlight two other aspects. There are more. The first relates to a series of measures around ending “too big to fail”. They include implementing elements of Recovery and Resolution Directive, but, very importantly, changing the capital structure of the largest banks, so that the cost of failure is borne first by the shareholders and the management, but then by the debtholders in ascending order up the capital structure, so that institutions can be recapitalised through the debt structure, so that they can recover without recourse to public funds, and also without creating a series of knock-on effects on other institutions in the sector.

The second aspect, which is somewhat technical but we think equally important, is to ensure that the functioning of core markets, core markets for funding banks, core markets in derivatives and core short-term money markets, all of those markets are resilient. What happened in all of those markets during the crisis was that they stopped functioning. The equity market, in contrast, did not stop functioning. We did not necessarily like the prices in the equity market, but you continued to be able to trade and realise a price. These massive other markets ceased functioning. There are a series of reforms that are working to ensure that those markets will be continuously open. There is a common element to a number of those reforms, which relate directly to the responsibilities of the Bank of England, and that relates to collateral and the use of collateral to reduce risk between counterparties to provide greater liquidity in these markets and ensure, when there is a shock, these markets remain open.

What I tried to emphasise in the speech is the importance of collateral and ultimately the importance of the interaction between the Bank of England and markets in collateral themselves, and that is why we have made a series of changes led by my colleague, Mr Bean, to the functioning of what is called our sterling market framework; basically, the way that we provide liquidity when there are shocks to markets.

Q12 Mr McFadden: This is diffuse and complex, isn't it? If you are being asked by the person in the street, a lot of this requires international agreement, a lot of it is work in progress rather than work that has been completed, whereas the reality, having been through the movie of seeing a big financial sector tip over as very real, these things on the other side of the ledger about making it safe are far less real. What would you say to a member of the public who said, “Well, how much confidence can I have that these things can make it safe?”

Dr Carney: I think the first thing is, on “too big to fail”, there is a fundamental question of fairness about accomplishing this objective. Irrespective of the impact on the size of the City, it is fundamentally a question of fairness to ensure that if an institution makes a mistake, just like if a small businessperson makes a mistake or is hit by adverse trading conditions, that institution bears the full consequences of that. We do need to do a number

of complex things in order to make that statement true, to really end “too big to fail”. Ending “too big to fail”, making these changes with capital structure, other aspects, it happens that that helps to improve the resilience of the financial system, but the motivation for it—and I think this Committee has helped lead this—is first and foremost rooted in questions of fundamental fairness in bringing, if you will, capitalism to the capitalists.

The second aspect—this question of markets and ensuring that markets continue to work—I accept absolutely that it can seem quite esoteric and arcane, but the fact is these markets are measured in trillions of dollars. They stopped functioning, and it was the seizing up of these markets that led to the knock-on effects through the financial system. For what it is worth, I would go back to my example of the equity market. The equity market remained open, so what are the characteristics of the equity market that we can translate into these other markets, and how else can we buttress these other markets? Part of that is the responsibility of the Bank of England. It is plumbing, to some respect, but it is our responsibility, and we have made quite substantial changes that draw on the lessons of the crisis to help ensure that that is the case.

If I can just circle back to what I believe was the original motivation of the line of questioning, it is absolutely true that if we are not successful in implementing these measures, it will have consequences for the size of a sustainable financial system, the size of the financial system that can be sustained in this country.

Q13 Mr McFadden: I want to ask more about the size. You talked in your speech; I think the figures were that at the moment the financial sector is worth about four times UK GDP, and you talked about this potentially becoming nine times UK GDP by 2050, I think. Do you see any downsides in that? Some commentators have said that a financial sector that grows too big sucks in energy and creativity away from other economic activity, perhaps manufacturing, perhaps creative industries, and other forms of activity. Even if it can be made safe, is it healthy? Is that a healthy vision for the future of the UK economy to have such a massive, dominant financial sector?

Dr Carney: Let me go directly to the question, and then if I may add one other point. The UK financial sector is about 10% of GDP, as you are aware, and about two-thirds of the jobs in the UK financial sector are outside of London, so there is a distribution of those jobs across the country and that could be further enhanced. The benefit of the financial sector for the broader UK economy should be—again, properly organised—access to credit on competitive terms, and I am sure we will talk about aspects of that. Secondly, it can help UK business penetrate export markets in terms of financing, but also in terms of reciprocity of access to those markets. I think it does help our creative industries in building new markets as well. It is a major export of this economy, and this is an economy that does have a notable current account deficit, so the export of financial services is important.

If I may make my related point to that, the very simple calculation that you rightly referenced was based on the following. Where is the relative share of UK GDP likely to go in the global economy as emerging markets grow—there is China, Brazil, India—as a share of the global economy? First element. The second element is what is the likely size of the financial sector in those economies—the so-called process of financial deepening in

those economies? What historically has been the share of the UK in cross-border financial flows between economies? One of the strengths of the UK financial system has been to stand in the middle of flows between economies, so between the US and Europe historically and vice versa. Increasingly, there is the opportunity to play a role through capital flows from and to and between major emerging markets. That plays to the strengths of the UK financial system. If UK institutions just keep their market share of those international flows, one ends up with that calculation, and the question becomes, “How can that be done safely?” as you alluded to, and if it cannot, what would then have to be done to restrict the growth, which would be a change from a competitive position that has developed over centuries here? That may be the will of the people in Parliament, but it is a very big decision.

Q14 Mr McFadden: Where I think most policymakers are is that they appreciate the value of the sector, which you outlined, but they also know this gives certain characteristics to the UK economy. Of the lending, over 50% of it goes to property in one form or another; 1.4% goes to manufacturing. The interpretation of your speech has been that the UK cannot escape a finance and property-led economy. Are you comfortable with that interpretation, or do you think that is a mistaken interpretation of the picture that you painted?

Dr Carney: I would say that is a mistaken interpretation. The financial sector is an important sector in the UK economy. It is one of the competitive strengths. It has the prospect of growing if we reorganise it properly, but that is not foregone, and there are many other strengths in this economy. I do not believe, again, properly organised, that the success of the financial services sector comes at the detriment of other important sectors of this economy.

Q15 Chair: Governor, this same speech to which Pat McFadden has been referring has a remarkable change of tone from that of your predecessor, does it not? You have said, for example, “It is not for the bank to decide how big the financial sector should be”. He might have said that, but then virtually the whole of the proceeding page is saying, “A vibrant financial sector brings substantial benefits. Being at the heart of the global financial system broadens the investment opportunities for institutions that look after British savings, reinforces the ability of UK manufacturing and creative industries to compete globally”, and so on and so on. You were intending a change of tone, weren’t you, Governor?

Dr Carney: I think the speech follows on and the approach follows on logically from a number of measures that Lord King put in place as Governor, along with colleagues, and I will give one example. I referenced to Mr McFadden the sterling market framework changes. Those were initiated as a result of the Winters Review, and that was initiated by Lord King. In many respects, they—

Q16 Chair: But these are not references to the sterling market framework, are they? These are broad-based points you are making here.

Dr Carney: There are two elements. In terms of how to successfully do this, in our opinion, the changes to the sterling market framework are very much part of this, and those are changes that draw on measures and innovations that were put in place when Governor King was in my current position. They are necessarily for those resilient markets.

For the broader point, if I may, and not to over-aggrandise it, there is a fundamental issue in terms of the orientation of this economy. The UK is admired around the world for being an open economy and being an innovative economy, and there are pressures in the global economy to make both the financial system and the trading system more fragmented, to put up barriers. I would argue that that is not in our interests. It is not ultimately in the global economy's interests. Getting the UK financial system right, particularly, the outward-facing aspects of the UK financial system, making it resilient, ensuring it has integrity, with those, subject to being innovative, is important, and that is why we have referred to this system as a global good, as well as a domestic asset.

Q17 Chair: The question was, “Was there a change of tone?” and we got an answer to a slightly different question.

Dr Carney: It is an evolution of tone.

Q18 Chair: I think the answer would have been yes, had you not felt a little embarrassed to say so. Is that right?

Dr Carney: I feel no embarrassment about my answer.

Chair: About saying so or denying it? I am not sure which. We will move on.

Q19 Mr Newmark: Forward guidance. In the November inflation report, the Bank forecast unemployment to be 7.7% in the third quarter of 2013. The official statistics from the ONS show that the unemployment rate fell by 0.2 percentage points to 7.6% between Q2 and Q3. Is this faster than expected reduction in unemployment and an indicator that unemployment may reach 7% sooner than you expected?

Dr Carney: It is, as you rightly note, the welcome news that more jobs were created. It was a strong unemployment report driven by both high participation and strong employment growth and high-quality employment growth. Let me first state, so none of us are in any doubt, that is welcome news. The exact timing of when that 7% threshold will be achieved is subject to uncertainty. We do our best to give our estimates of that uncertainty. Two-fifths probability by the end of 2014 and three-fifths probability by the end of 2015 is what we have there, and one month's employment figures does not have a material change on those likelihoods, no. It does not, but it is welcome news.

Q20 Mr Newmark: Anything that does not move in a linear fashion—as confidence builds, people hold back and hold back, and suddenly they start employing people, and that leads on to wage inflation, which I will get to in a minute. The last quarter was good and better than expected, but in fact if you go further and you look at the recent month figures, the single month figures by the ONS show that unemployment fell to 7.1% in September, so it looks like unemployment is declining faster than expected, just above the forward guidance threshold. Is this an indication that rates may need to be increased far sooner than the Bank expected?

Dr Carney: No, it is not. I would not draw that conclusion. We go in some detail—

Q21 Mr Newmark: You said threshold.

Dr Carney: A couple of points. First, in terms of the sampling for the LFS, we use the three-month average of LFS figures for a reason. We go through in some detail—I am sure you have reviewed it—in the report on page 29 in terms of how they sample, and you see that saw-tooth pattern, which has been consistent to the monthly figures of the LFS. I would not over-read a 7.1% any more than I would over-weight the 8% one-month figure the month prior.

The second point, which I think at this stage I just want to re-emphasise, which the Committee re-emphasised in the report and was clear in the minutes and in our press conference, is that 7% is a threshold. It is not a trigger. It is a question of, what are the conditions in the economy when that is achieved, and what do we learn along the way between now and when we arrive at that point?

Q22 Mr Newmark: Let me push you further, because I want to touch on something you mentioned a couple of seconds ago. The revised unemployment figures in the November inflation report show that there is a 40% chance, which is I think your two-fifths point, that unemployment will fall below 7% by the fourth quarter of 2014. This is nine months sooner than reported in the August report. How severely do you think this has impacted the Bank's credibility, and is forward guidance dead on arrival?

Dr Carney: That is a total failure of logic, Mr Newmark. What guidance is doing is giving businesses, households, financial market participants and parliamentarians perspective on the conditions that are necessary to exist in the economy before the MPC would begin to consider adjusting monetary policy and tightening monetary policy; in shorthand, raising interest rates. Let us put this in context, and let me preface it with good news is good news. The rate of inflation is falling. This economy is the strongest major advanced economy in the world at present. The rate of growth is just under 4% as we sit here today. That is not our forecast on year-on-year, but the economy is picking up sharply. About 60,000 jobs are being created a month, and these are high-quality jobs. They are in the private sector, and they are mostly full-time.

With that backdrop, I would also say, in terms of questions of business confidence, that you are seeing a marked improvement in business confidence as well. In that context, in the absence of forward guidance, the conversation would be, wrongly, about an immediate tightening of monetary policy and an immediate raise of interest rates. That is not the conversation. That is not the market expectation. That is not what businesses expect, when all of us go around the country. Charlie was at a meeting with businesses just yesterday. I have met with over 200 businesses in the course of the last several months across the country. They understand forward guidance. They understand that, given the slack in the economy, given that the recovery is relatively new, what the Monetary Policy Committee is not going to do is to pull the rug out from under the recovery just as it gets going. We are going to learn as we move towards that 7% threshold, and then we will take stock.

Q23 Mr Newmark: Yes, but you are the one that has come in. You have set this new forward guidance, so you cannot suddenly slightly say, "Well, it is forward guidance, with several caveats". What we have had now, as you quite rightly point out, the Chancellor has created the right environment for more jobs to be created. There are more men and women in work than ever before. Unemployment continues to drop. People are being pulled out of

short-term temporary employment to more full employment. All that is good news. It is also good news that we are going to hit this 7% bogey that you set. I am going to get to Spencer in a minute on wage inflation, which is likely to come back, because as unemployment drops and there is greater demand for jobs, you start getting wage inflation. You could have, effectively, a combination of falling below your 7% threshold and seeing inflation pick up, particularly wage inflation. When that happens, are you saying to me you are still going to sit on your hands and say, “We are still going to keep interest rates at this 200-year low.”?

Dr Carney: Let me say a couple of things. The first is we have been absolutely consistent since August, when we put forward guidance in place. The 7% has always been a threshold, not a trigger. It has always been about this fundamental question of, once the recovery gets going, what happens to productivity in the economy and what happens to supply in the economy? Wages are more likely to be determined by how productive workers are than short-term dynamics in the labour market. I would remind you that there are a very large number of workers, who have jobs, who want to work much more than they are working today, and I would not underestimate the extent to which there is slack not just of people looking for a job—

Q24 Mr Newmark: You see the slack not, as I say, between those out of a job and wanting a job; it is really the difference, the delta, effectively, between those in short-term temporary employment versus full employment?

Dr Carney: We would see the slack in both of those aspects. There are still a million more people out of work today who were in work before. If you look at part-time workers who cannot find full-time work, it is 4.8%, versus 2.2% average prior. If you look at broader measures of unwilling part-time workers, it is at historic highs, certainly as measured. There is a lot of slack in this market. The good news is, because we are having the recovery, that slack starts to be taken up. The big issue in association with that, in parallel to that, is what happens to productivity alongside.

Q25 Mr Newmark: Why don't you refine your forward guidance to include the difference between effectively part-time work versus full-time? I guess that is really what you are saying. There is still some room for manoeuvre because of the difference between those in part-time work versus full-time work.

Dr Carney: I think, Mr Newmark, it is constructive to have the discussion of the broader elements of slack in the labour market, but we are at a stage in the recovery, with the degree of slack in the labour market and within companies, that it is much simpler than that. We do not even have to begin to make that assessment with respect to the stance of monetary policy, in our view, with the guidance we have put in August, until we see the rate of unemployment get down to 7%. We clearly—and we stated this in August and we have re-emphasised it since—will look at very broad ranges of measures of slack, both in the labour market and within companies, to set the stance of monetary policy. Again, to keep it simple, we do not have to start doing that, and we will not start acting on those assessments. We will talk about them ad nauseum, I can assure you. We will talk about them, but we will not starting acting on them until that threshold has been achieved.

Q26 Mr Newmark: If I can just quickly speak—

Chair: We have to move on. One very quick question, and then we will have to move on.

Mr Newmark: It is to do with wage inflation. This is to Spencer. The recent KPMG/REC permanent salaries survey indicated that, in October, wages grew at their fastest rate since 2007, which is the point I was making to the Governor. Is this a sign that in the coming months wage inflation could pick up more rapidly than the Bank expected? What are the implications of that?

Spencer Dale: We are looking at surveys. It is quite interesting. Over the last couple of years, the surveys of pay pressures have consistently pointed to stronger pay growth than we have seen in the national data. Exactly what strength of signal we should draw from that I think is unclear. The point I would just reiterate is the point that the Governor made. When we are thinking about wage increases going forward, there are good wage increases and bad wage increases. The type of wage increase we want to see is that fuelled and paid for by increased productivity. We have seen significant pay squeezes on people's real incomes over the last few years, which is because productivity has been so weak and wage growth has been so weak. If, as the economy picks up, we see stronger productivity growth and that feeds through into wage growth, that is a good news story and does not pose threats to inflation. It is only if we see wage growth outstripping productivity that it becomes more a source of concern.

Mr Newmark: The impact on forward guidance means what, then?

Chair: We are going to move on now.

Q27 Jesse Norman: Thank you, Mr Chairman. Mr Dale, you gave a speech on 16 October 2013, where you were assessing past monetary policy in the context of where it is developed with forward guidance. If I may, I am going to quote from that briefly. You say, "The focus, the public emphasis that we as inflation targeters place on outcomes of inflation can be a double-edged sword because it can create the false impression that inflation is the sole focus of our monetary policy". Then you say, "In fact, over recent years, nothing could have been further from the truth. Indeed, inflation has been above target for the vast majority of the period since the financial crisis". That has been blindingly obvious to anyone who has looked at the numbers or the bank. Why on earth did you not just say that at the time? Why have we been going through this charade of pretending we had an inflation-targeting policy, when, in fact, as you say, nothing could have been further from the truth?

Spencer Dale: What I said in the speech was the thing that could have been nothing further from the truth was that the thing we solely focused on was inflation. The primary objective throughout this period, and continues to be, is to hit the inflation target, but we need to do that with due regard to the impact that has on the rest of the economy.

The judgment we made over this period of time—and there are countless speeches that I made and other members of the committee made during that period of time—was we felt that there was a series of temporary shocks driving up the price level. The only way in which we could bring down inflation more quickly would be tightening monetary policy when our economy was already incredibly weak and generating an even deeper recession. We made the judgment that that would be a bad thing to do, and that domestic inflation

pressures remained well contained, and that inflation would fall back to target as long as that remained the case, and indeed that appears to be turning out. As the Governor just recently said, in the most recent data, inflation now has fallen back to 2.2%, so inflation has fallen back down, and at the same time monetary policy has continued to help support jobs and employment and help to bring the economy out of the recession.

Q28 Jesse Norman: Do you not think it would be more honest to say, “Look, we do have this inflation target, but frankly we are ignoring it for the time being because we are trying to protect the economy”?

Spencer Dale: No. The point of the inflation target is to make sure that we set policy in such a way as is consistent with bringing down inflation in the medium term. That has always been our objective, and I think that is what we have done consistently throughout this period of time, and it remains a key part of the forward guidance. If we felt keeping interest rates low at the moment threatened that, we started to see inflation expectations pick up, we started to see our outlook for inflation being consistent with that, we would respond. That is a clear feature of our two knockouts.

Q29 Jesse Norman: The importance of forward guidance from your point of view, then, is that it increases certainty, and it does so by putting in a rule-based framework rather than a purely discretionary one. Is that right?

Spencer Dale: Yes.

Q30 Jesse Norman: I see the Governor nodding, so I am hoping that is right.

Spencer Dale: It provides greater clarity about how we are setting monetary policy. I do not think it changes the way we have been setting monetary policy over the last few years, but it provides greater clarity and articulation of the way we have been trading off, this very difficult trade-off we have faced in this country, when in fact inflation has been above target but our economy has been very weak.

Q31 Jesse Norman: So, greater clarity and articulation. When you originally announced it, you expected that you would hit the employment threshold in the middle of 2016. Now, we are looking by the end of 2014. In other words, a drastic change in the effect of the policy as a result of this financial target of 7% unemployment threshold. Do you think that has increased clarity and certainty?

Spencer Dale: I think when we announced the target we suggested that—now it is in the forward guidance—the forecast for unemployment is highly uncertain. We had a central projection, which is that we would hit it towards the end of 2016, but we made clear there was a significant range of uncertainty around that. We now suggest, on the basis of market interest rates, we are more likely to hit it towards the end of 2015.

As the Governor said, I think the key thing we are keen to stress is the uncertainty around there. There is a 40% chance that we could hit it by the end of 2014, but we also assess and make very clear that we think there is a 30% chance we will not hit it until beyond the end of 2016. Trying to predict with precision exactly what will happen to unemployment is a very difficult thing to do. The key thing of our forward guidance is that it should not

be judged on whether we know exactly when unemployment will reach 7%. The thing is that people understand, and certainly businesses understand, that the point at which we will raise interest rates will be a point where we have seen a period of strong, sustained growth and the economy is strong enough to sustain a rise in interest rates.

Q32 Jesse Norman: All right, but what has actually happened is you have lashed yourself to a threshold number, and as the UK economy has strengthened, that threshold number has caused you to change your views fairly drastically. In other words, it has increased the fluctuation and uncertainty, rather than diminishing it.

Spencer Dale: Sorry, I do not recognise at any point we have committed—as the Governor again said, we made very clear in August, and we repeated again in November, that the 7% unemployment is a threshold, not a trigger. At no point did we say we would definitely have to do it. My experience of speaking to businesses—I was up in the north-west at the end of last week—was they understand this. They understand and take comfort from the fact that we do not know precisely the date at which we can raise interest rates, but the fact that they know that when we will raise interest rates it will be against the backdrop of a stronger economy, an economy that can withstand a rise in interest rates, I think they draw comfort from, and it helps uncertainty in terms of their planning.

Q33 Jesse Norman: In your view, therefore, it is preferable to have a system that one could describe as follows. There is a 7% threshold on unemployment, subject to three knockouts—one on price stability, one on inflation expectations and one on financial stability—and that is overall a more clear and certain system than a fairly statement that you want to support the recovery by keeping interest rates low until you see some strong growth?

Spencer Dale: I think it provides a greater articulation of what we mean by a stronger economy, yes.

Dr Carney: If I may interject—

Q34 Jesse Norman: Sorry. I am going to come to you in a second if I may, Dr Carney. I just want to get the facts of Spencer Dale on the table. What everyone else might regard with some justification as extremely complex, you regard as clear and articulated. If that is the case, why are you moving away from the idea that unemployment is the best indicator of slack in the economy?

Spencer Dale: Just to clarify, I am not sure, and I have been speaking to businesses. They do find this highly complex. The idea that the Bank is stressing that we have started recovery, but the economy remains very weak and we need to see a sustained period of strong growth before we raise interest rates, so do not worry that we are going to raise interest rates very quickly, but we are only going to raise interest rates once we have seen that and the economy is strong enough to stand that. I do not think they find it as confusing as some people in the bubble of London appear to do.

Q35 Jesse Norman: I will just ask the question, then. If unemployment has been a great proxy for you for slack in the economy, why are you moving away from it?

Spencer Dale: I do not think we are moving away from anything. What we said was we thought unemployment was a good measure of slack to use as a point where we stop and provide assessment, and this relates a bit to Mr Newmark's question. In the past, if firms do have considerable spare capacity within their own companies, if they have existing workers who do wish to work more, they will tend to use those workers and say, "Work full-time," before they go and increase their labour force. For that reason, you would expect to use up that spare capacity before you see unemployment falling, and for that reason unemployment seems a natural measure to use. The whole key point is, at the point we hit 7%, we stop, we assess what is going on in the economy, and then we make a judgment from that point onwards.

Q36 Jesse Norman: All right, that is helpful. Governor, earlier this month there was a Reuters poll of economists, which concluded with more than 50% of those polled—that being a number of 29—taking the view that the handling of forward guidance has hurt the Bank of England's credibility. Do you accept that?

Dr Carney: I am not familiar with the poll. Our credibility is grounded in our ability to achieve the inflation target—that is fundamental—and to achieve it in a way that avoids—the jargon is "excessive variability in unemployment and output", but in effect in a way that is consistent with a sustainable recovery. That is what we have done with forward guidance.

Let me give you another Reuters poll, another Reuters snap poll after the inflation report, which is 75% of respondents expect that there will be a space in time between the achievement of the 7% unemployment threshold and the adjustment in monetary policy. They understand that it is a threshold, not a trigger. I am going to ask my colleague to reference, because I think we should flush out who is really confused about this. I have to say, a couple of hundred businesses that I have talked to, we do not see it. When we survey businesses, we do not see this confusion. When we see the reaction of businesses to the developments in the economy, we do not see this purported confusion.

Let me make one other point, if I may. This is important, because you referenced strong growth, quite rightly. We are seeing strong growth, the strongest recovery of the advanced economies right now. We are not seeing an adjustment in short-term expectations of interest rate moves, as both my colleagues to the left can purport in more rigorous fashion. That historic relationships would have fully priced in interest rate moves, given the strength of this recovery right now, and even in the case of the revision of the Bank's forecast.

Q37 Jesse Norman: That is interesting. In order to make that contrast work, Governor, you are going to have to show that those businesses you have been talking to have not been accepting my verbal description of your policy, which is keeping interest rates low until you see some strong growth in employment picking up. They are accepting the detail of the policy you are putting to them. When you talked to these 200 businesses, how many of them have mentioned or talk about these three knockouts that you have mentioned, or understand the interactions between any of those three knockouts?

Dr Carney: They understand. What businesses understand is that we are operating this policy without taking risks with price stability and financial stability. That is what they need to know.

Q38 Jesse Norman: They understand the detail of the policy. They understand the verbal description I have given you. But that is not my point.

Dr Carney: They understand the core thrust of the policy is that there is going to be exceptional monetary stability—

Q39 Jesse Norman: We are in agreement. That is the language. That is what they accept. That is what they understand. That is what I am suggesting.

Dr Carney: That is what they need to understand, because that is the reality of the policy.

Q40 Jesse Norman: The technical jargon and these knockouts and the complexity are irrelevant to what they think of the policy. That is the point I am making.

Dr Carney: But the technical aspects of those knockouts are relevant in terms of disciplining the policy, and of course we are held to that standard, the standard of the technical, as opposed to something that is more descriptive and higher level. We disciplined this policy, which was the right decision. If there is time, I would invite my colleagues to—

Q41 Chair: The businesses are getting the mood music, and you are giving us the detail. That is what you are saying.

Dr Carney: We are giving everyone the detail, but yes. The businesses are getting the core, the mood music, and they are correctly interpreting the policy.

Chair: We are moving on now.

Q42 John Thurso: Can I come to Charlie Bean, please?

Charles Bean: I was feeling left out.

John Thurso: I noticed that. It has been a long time since we last met. I want to really look at the questions around productivity and spare capacity. The MPC has practised a period of exceptionally loose monetary policy, and that is pretty much underpinned by the assumption that there is a significant spare capacity in the economy, which will be eroded gradually due to an improvement in productivity. Is this the key judgment that the committee is making at the moment?

Charles Bean: Certainly, the key issue that faces the economy is how much spare capacity there is. Spare capacity comes in various guises. There is spare capacity in the labour market, which we have been talking about, unemployment, workers who may be part-time rather than full-time, as they would prefer. There may also be spare capacity within companies that they could run at a high level of utilisation. The big unknown that we are faced with, and this ties into the design of the policy guidance, is why productivity growth has been as weak as it has been over the past five years. If you just compare the level of

productivity now with the naive extrapolation of the pre-crisis trend, it is about 15% below that. I am not going to suggest we can get back to that 15% trend, but we can probably get some of the way back there.

There are lots of different hypotheses for why productivity has been weak. Some of these imply that as demand picks up, so you will see productivity analogously responding. There are others that suggest that that productivity may have been permanently lost or pretty persistently lost. That would be particularly the case to the extent that it is associated with weak past investment in the past, workers not having the opportunity to learn by doing because the activity was weak, and to the extent that capital has been misallocated as a result of the problems in the banking system.

We, and many other people, have been trying to get to the bottom of the relative importance of the various causes, but the honest answer is that we do not really know how much productivity will come back as growth proceeds. Something we will learn about over the next two or three years, assuming the recovery continues—

Q43 John Thurso: What are the key things we should be looking at? That uncertainty comes through in your section 3.2 report. We have talked a bit about the labour side. What are the key things that we should be watching and asking you about in this regard?

Charles Bean: The most obvious thing to look at is the behaviour of productivity alongside the other measures of slack. The key thing for us will be: is productivity picking up at the same time as unemployment is falling, or has productivity growth remained pretty moribund as growth proceeds? Unemployment under those circumstances will fall relatively faster.

I think it is plausible to argue that businesses are going to take advantage of the opportunities that they can to expand productivity, rather than taking on lots and lots of new workers, so I think it is plausible that the sequencing here will not involve unemployment falling before we see any rebound at all in productivity. We certainly want to be looking at the joint behaviour of productivity and measures of labour market slack and, for that matter, measures of capacity utilisation in businesses.

We probably also want to be looking at the behaviour sectorally and digging down in a little bit more detail. Indications say that liquidations might pick up in the recovery. It might be an indication that some of the so-called zombie firms are going out of business and capital resource is being reallocated to better ones. There are a number of areas that you might be looking at for clues. As I say, we should learn quite a lot in the next couple of years on this point.

Q44 John Thurso: In two years' time, we will be able to say to you, "What a brilliant judgment!" or "Didn't you half get it wrong!"

Charles Bean: No, obviously, in terms of our central projection, it embodies a particular assumption about what happens to productivity, but the key thing across the committee, although different members might put different weights on the various hypotheses, we would all agree we are extremely uncertain about this dimension. It is the biggest single puzzle—if I can just finish this—that we are faced with, and it is why it makes sense to describe the policy guidance not in terms of some measure of the output gap, which we

have no idea how big that is, but in terms of a measure of slack that we do have some idea about how it behaves, and its behaviour is likely to be linked to this unobservable productivity gap.

While I have the floor, can I just make one important correction to Mr Norman's statement, when you said the essence of our guidance is that we will not tighten policy until growth picks up? You are right that in some sense the big idea of the guidance is to get across that we are not in a rush to tighten policy, but the key thing is it is not before growth picks up. It is until there has been a material reduction in the degree of slack in the economy. In other words, you need a sustained period of growth to generate it.

Q45 John Thurso: My question is going to bring in Dr Broadbent, because of course you are the external who is before us today. This is a very big judgment that has been made, and it is clearly one that within the Bank has taken a great deal of thought. To what extent are you as the external looking at this, and to what extent do you concur with this, and to what extent do you think that there is a trade-off in this judgment against possible inflationary pressures? If we get this wrong, there could be quite big inflationary pressures coming through.

Dr Broadbent: I signed up to the policy lock, stock and barrel, so I do support it, and there is built into it, as we discussed earlier, a set of safeguards to protect against the material rise in inflation expectations or price and financial stability on top of that. In my judgment, those are sufficient to deal with any potential problem from that area. On top of that, I would agree with Charlie. It is precisely because we are uncertain about productivity that it is right to focus policy on measures in the labour market, and I see this framework as robust to that biggest single uncertainty we face, which is about how productivity will develop through the recovery.

Q46 John Thurso: In answer earlier, the Governor to, I think, Pat McFadden raised the question about the right skills as between the financial sector and other areas of the economy, and the implication is that, if all the bright people go into the City, they are not in industry. I visited Rolls-Royce recently, where they told me that had it not been for the recession, they would not have been able to employ the 700 engineers and scientists and other people they needed to do their current, very interesting, forward-looking work. The question from that is, when we are looking at labour, rather than looking at labour as one whole, also to look at the segments. Are the right people going into the right areas to create the forward productivity that we will need? Is that an issue that you are looking at?

Dr Broadbent: It is certainly not an issue that monetary policy could ever hope to deal with. The only thing I would say is that of course it is utterly critical as a source of growth, as a source of good levels of economic well-being, that skills in the economy improve throughout the economy. You might have asked me that question 100 years ago, and in fact people have been asking it for about that long.

Q47 John Thurso: The point is that we did not have the MPC 100 years ago, but—
Dr Broadbent: The point is that the MPC is not in a position to—

John Thurso: The point is that we are looking at labour and the labour market as pretty much a proxy for the output gap. Therefore, having the right labour in the right place to

take up the slack is an absolutely fundamental part of the judgment that you are being asked to make. Therefore, I am asking, how do we assess externally what you are doing, whether you are getting it right or whatever?

Dr Broadbent: No, that is true, and I would say a couple of things. First of all, I think that if there was a serious mis-match in the labour market, either regionally or across sectors, you would see structural unemployment be higher, and the degree of slack would be that much lower. In the end, you would see wage inflation pick up earlier, and that would have some bearing on these other knock-outs if it came to that. That is not my view of what is happening, I have to say, and you can look for evidence independently of labour mis-match or wage inflation. I do not think there is much evidence there that that is happening, but that would be the root via which one would assess this.

John Thurso: Thank you.

Q48 Chair: Obviously, there is always going to be a lot of uncertainty surrounding productivity and the output gap, but the greater certainty you are all going to want to inject with forward guidance is only going to be as good as the data that is being collected. Can I ask you, Governor? You have come fresh from another central bank. Do you think the ONS is delivering you the data you need to do your job?

Dr Carney: We can always improve, and the ONS is not exempt from that. I can give you some initial reflections in terms of a few—

Chair: It will be very helpful if you do not talk in code, so we can get straight to the point.

Dr Carney: Just adjusting to the question. There is a point. There is always a point. It may not be well expressed, but let me try. There are a couple of areas, I have been struck, where the current status of the data in the UK provides some challenges for policy. One of them at present is how investment is calculated. There has been an adjustment in the last six months or so to the deflator used to translate from nominal to real investment, and the consequences of that have been that the picture of investment both historically and at present has changed quite substantially, and the path of investment in the UK is now much more volatile, apparently, than it is in other major advanced economies.

We have put cautionary language in our reports both in August and in November in terms of how much weight we are putting on that data. We are not putting full weight on that data, and it has to be said that it does not entirely feel right that investment is measured falling at a time when we see continued strengthening in investment intentions. I think there is some—

Q49 Chair: Do I have that right?

Dr Carney: We are not putting the weight we would like to put on it. Of course, the shift, to go back to Mr Thurso's line of questioning, one of the things we look for, if you take a step away from just measured productivity and other aspects that Charlie spoke of, is what happens to investment. That is one example. Another example, which is related to the MPC but goes to the Bank's broader responsibilities, is the flow of funds data here. There is a work plan in place, is my understanding, at the ONS, to improve the flow of funds.

This tells us the movement of debt by sector, by household, across the whole economy. It is incredibly important, as you would appreciate, for the conduct of the Financial Policy Committee's responsibilities, but also for some of the issues around the sustainability of the recovery of monetary policy. There is a lot of work, it would appear, that needs to be done to bring flow of funds data here up to the international standards and the level we need. There is room—

Q50 Chair: That is quite a serious criticism. You are saying that the quality of data you are getting is not up to snuff.

Dr Carney: I was saying that there is room for improvement, and that does extend to some pretty important classes of data of which we are important consumers, and it affects policy judgments.

Q51 Chair: Was it better in Canada?

Dr Carney: I was much more comfortable with the data in Canada.

Q52 Chair: The answer is yes. Have you anything you want to add?

Dr Carney: Given my limited experience, the answer is yes.

Q53 Chair: Do you have anything you want to add, Mr Bean? This is very much your field.

Charles Bean: Yes. The first thing to be said is that issues of data reliability have always been with us, ever since I joined.

Q54 Chair: But the Governor is saying it is worse than in other countries.

Charles Bean: I obviously have less direct experience of Canadian statistics than he does. I would say, if you go back some years—

Q55 Chair: Not just Canada. He has been talking about investment statistics in other countries generally.

Charles Bean: The Central Statistical Office, now the Office for National Statistics, used to have a reputation of being one of the best statistical agencies around the world. It may well be that you could somehow compare different agencies. Maybe it is not quite such a strong relative performer. Some of that must reflect the fact that it has been squeezed in the resources it has. It has a lot of demands put on it.

Q56 Chair: Why don't you drop us a line, Governor, on where you would like to see some improvements?

Dr Carney: Sure. I will consult with my colleagues and do so.

Charles Bean: Can I just make one quick interjection there?

Chair: If it is quick. We have lots of people wanting to get in.

Charles Bean: We do have an annual meeting with the Office for National Statistics where we have an opportunity to feed in to them what our—

Q57 Chair: This has gone on for years, has it not?

Charles Bean: Absolutely, absolutely.

Chair: I have quotations here from senior Bank sources—which may well be you, Mr Bean; I do not know—saying that you have long-standing concerns about all of this. It is a question of competence, of getting quality data in a timely fashion. In other words, they are incompetent and you are not getting them in time.

Charles Bean: I can guarantee that was not me that said that.

Chair: I have not heard anything contradicting the sentiment this morning.

Q58 Mr Ruffley: Good morning, Governor. Just sticking with productivity, a lot is riding on this, as we all can see. The faster productivity recovers, all things being equal, the more downward pressure on inflation. The faster productivity recovers, the more slowly we will hit the 7% unemployment threshold. There is a lot riding on this. What do you see as being the major driver for recovery of productivity, and when do you expect a significant increase in productivity to kick in?

Dr Carney: The first aspect of the recovery in productivity is the recovery; the recovery in demand and just the ability of firms to use their resources more effectively and to a greater extent. What has just begun happening over the course of the last quarters, in our view, is a necessary condition to see this pickup in recovery. Now we have to start seeing it in the data. It does not look like we really will see it in the Q3 data. We are looking for, when we get into 2014, a pickup in labour productivity to around 1% or so on a measured basis, so it is on the come still but—

Q59 Mr Ruffley: Is that because the capital labour ratio is getting better?

Dr Carney: According to the ONS, it is not, but we would—

Q60 Mr Ruffley: Where is this productivity going to come from, if not more business investment?

Dr Carney: If I may, Mr Ruffley, that is the second element. The first element is just that you have businesses that have slack, and we can think of it in two simple metrics. They are economies of scale and production. They are not producing at optimal scale. The more demand there is, the more they can produce at optimal scale. That is the first element.

The second element is learning by doing. It is a very fundamental point, but the more you produce, the better you get at things, and you end up—back to Mr Thurso's question—having people move from firms within industries that bring knowledge from best performers to less-good performers, and that improves overall productivity. It is that dynamic first. That is one.

The second dynamic, as you rightly point out, is the improvement in the capital labour ratio, the reigniting of business investment. All surveys and other indications suggest that we are close to that point, and in fact, in our forecast, when you go into 2014, consistent with that forecast is really a handover towards business investment and a pickup in business investment.

The third point is a point that Mr Bean emphasised, which was related to the recycling of capital in the economy, so it is poor-performing firms exiting, but very importantly new firms starting up at the same time, so the birth and death of firms. We will look to those types of figures as well to get a sense of whether productivity is coming back.

Q61 Mr Ruffley: Many commentators, economic and political, say that the recovery that we are seeing is overly dependent on consumer demand, and we know that real wages are falling a lot more than real take-home pay, but let us just stick with average real wages. Is this recovery sustainable at the moment?

Dr Carney: I guess a couple of elements. First, to put some numbers around your commentary, the core of the forecast, if you look at our forecast over the course of the next year, growth is about 2.9% for 2014. About 80% of that comes from household spending, between consumption and the strength in the housing market. As I said, towards the back end of 2014 and into 2015, we do see a pickup of investment.

When thinking about the sustainability of the recovery, we need to think about the life cycle of the recovery. Recoveries are very seldom, in this country or other countries, led by business investment. There needs to be a source of demand that then generates the need for that business investment and the confidence for that business investment. If you look at the situation the UK is in right now, that demand is not going to come from outside our shores. The eurozone has improved somewhat, but it is still very weak and growing roughly at 1% a year—effectively a stagnation—and that is our largest export market, as you know. The question is the extent to which domestic demand can provide the initial lift that will bring that rebalancing towards business investment. That is what we are seeing now.

What is important is that all of the elements are in place for business investment to pick up, and that means reducing unnecessary uncertainty. Our contribution to that is forward guidance, providing stimulus, again, the stance of monetary policy, but making sure that the transmission of that stimulus is as effective as possible to businesses, and that means ensuring that we finish the job on fixing the core of the financial system here, fixing the banks and major building societies, and a lot of progress has been made there. It is those elements that help put in place the conditions—demand and stimulus. They put in place the conditions for that recovery in business investment, but we still need to see it.

Q62 Mr Ruffley: You have mentioned business investment and also the contribution that exports would make to a sustainable recovery. The OECD revised downwards its global growth forecast for 2013-2014. Could you give us your forecast as to when the external environment trade will be an element in British economic growth?

Dr Carney: It is a sorry history. For the last five years, whether it is the OECD, the IMF, the Bank of England or indeed the Bank of Canada, where I was previously, about this

time every year we were capitulating on our forecasts of global growth and having forecasts where there would be a modest improvement in global growth the following year. This year is no exception, global growth coming in around 3%. The Bank's expectation is global growth will pick up to about 3.5% in 2014; the IMF would be slightly stronger, about 3.75%; the OECD, I think, somewhere around there.

The question is, why would it be different this time, and will we see that actual benefit? Importantly, the reduction of some of the tail risks in Europe help reduce some of the downside risk to that global forecast. The very large swing in the fiscal impulse in the United States from very large drag to less of a drag in the US helps us, as does the improvement in balance sheets in the financial system in the US. The UK helps. As an example, if you improve your financial system, you get much more traction in terms of stimulus. Consumer balance sheets have improved. We have seen the dynamic here.

The downside risks to that improved forecast relate still somewhat to the eurozone, where there is tough execution around a series of structural reforms, and secondly, across a range of emerging markets, where they are going through an adjustment at present to rebalance growth. On that last point, if I may, we have taken that into account and we have substantially marked down the prospects for emerging markets into 2014 such that, in effect, about 70% of the improvement in global growth is being driven by the improvement in the core of the advanced economies, which is different than any other time in the recent past.

Q63 Mr Ruffley: Final question: if business investment continues to be weak, if there is no immediate prospect in 2013-2014 of export-led growth in the UK, how long could the consumer safely prop up economic growth, as it is doing now?

Dr Carney: In that environment, the British consumer is more likely to consume directly—well, as is consistent with our forecast, to consume out of income. Income growth is modest. Just to go back to an earlier exchange, wages pressures are actually extremely weak in the UK. They have been for some time, and you referenced it in your earlier comments. We would see very modest growth in income, and we would see growth proceeding at a level below any reasonable estimate of potential, which could continue to mean a recovery, but a very modest one.

Mr Ruffley: Thank you.

Q64 Mr Mudie: Governor, I want to take you back to something you said to Pat McFadden, which is about the figures that were indebted to Martin Wolf for putting into the public arena. August 13, loans outstanding to UK residents from banks, £2.4 trillion; 34% of this went to financial institutions—34%—42% went to housing, went to households secured on dwellings, mortgages and loans; 10% went to real estate and construction; 1.4% went to manufacturing. The point that there is real concern about your FT speech was this lauding of the City and banks and how you wanted the financial institutions—your job was just to regulate, and so on. In the rebalance of the economy that we have spoken about since the crash, how seriously do you take it? If you take it seriously, doesn't this description of the distribution of loans, of money, show that we are going down the same old roads as we were before the crash?

Dr Carney: We take rebalancing of the economy across sectors seriously. We take the importance of sustainable credit growth very seriously. It is understandable in the teeth of the deepest recession in this country's history that there has not been a sharp growth in loans to manufacturing businesses, quite reasonably, I would suggest, from the businesses themselves, going back to the investment discussion that we had earlier. What manufacturing has been able to do, and it has been an impressive performance, as a whole—there are obviously individual challenges—is they have been able to maintain positive profit margins, which have put them in a position to take advantage of the recovery as it proceeds both here and abroad.

I will hand it back to you, Mr Mudie. It is important that we have a financial system that serves all elements of the British economy, that serves manufacturing, very importantly, and that serves the service sector, which is far and away the largest component of the economy and employs the vast majority of our people.

Q65 Mr Mudie: If it is important, you said the growth of this financial sector was not detrimental to other sections. If it is feeding itself a third of the loans—its own institutions, its own sector—and only passing 1% on to—it is not only manufacturing. Manufacturing have their own funds. It is the bigger manufacturers that have their own fundraising procedures. It is small businesses and medium-sized businesses that we all have paid lip service to wanting to see grow. The figures are now clear, thanks to Martin Wolf—1%. We are under the impression that the Bank wanted this rebalancing, and they have wanted it for three or four years. Now, the figures after three or four years after 1.4%—I would have thought the Bank should be worried that their efforts are either just faint-hearted or they are being ignored. Would you not think, if we want to rebalance the economy, and you think the Bank agrees that it is very important not to have an unbalanced economy with finance such a big factor, we are not going to get that rebalancing if the investment is as low as this.

Dr Carney: I can answer this question in two ways, and I am going to give you one element, which you may not like, but it is going to be the statistics behind it.

Q66 Mr Mudie: I am used to that with Governors.

Dr Carney: At least, I am warning you that you are not going to like it—which is around the statistics, that it is not a surprise given the value of housing in this economy, and given that mortgages, when one borrows against a house, it may not be 90% loan to value, but it is going to be 60% of mortgages right now and the flow are about 80% loan to value. The level of leverage you have against a house is materially higher than the leverage one property runs a manufacturing business, and—

Mr Mudie: No, but Governor—

Dr Carney: There is a statistical question in terms of the sizes of the relative borrowing demands from these various sectors. That is the first point. The second point, though, which is to go to the heart of what you are addressing, it is important. It clearly is important that there is a robust financial system, robust banks that are there through the cycle, that are out there servicing all the elements of the real economy, and that is not just manufacturing.

Q67 Mr Mudie: They are not, and we are accepting they are not.
Dr Carney: We are seeing improvements.

Q68 Mr Mudie: Where?
Dr Carney: We are seeing improvements in terms of there has been—

Q69 Mr Mudie: This is August this year.
Dr Carney: The question is the cost of funds and the availability of funds, because there is a demand element to this equation. It is not a question of showing up at a door, knocking on a plant and forcing somebody to establish a loan in order to meet a quota. It is a question of whether firms in this country can access credit at competitive terms, and the answer to that is it is true to a point. Very importantly, it is not fully true for medium and small enterprises across the range there. That is where there does need to be further improvement, which is why the Bank of England has focused, through the PRA and others, to ensure that the core of our financial system is adequately capitalised, because those conversations do not even begin.

Q70 Mr Mudie: That is the point. That is the point, Governor. You refer to it in one of your answers at your press conference. The lad asked you about loans to SMEs, and you ended up saying—it is fair enough we have to get the core right, but then you refer, and this is in the context of speaking about SMEs, “And then they will get to the periphery”. “The periphery” is how you described SMEs.

Dr Carney: No.

Q71 Mr Mudie: Yes, you did. I have the words—
Dr Carney: I was referring to—I misspoke, if I did. The periphery; I meant the core of the banks first and then the periphery. We hit the core banks that have the biggest impact on the supply of finance because of market share and because of importance to the economy. That is where we focused, so that is what I intended to say.

Q72 Mr Mudie: FLS. That is your scheme, Funding for Lending.
Dr Carney: Yes.

Q73 Mr Mudie: A lass from the *Times* asked you a question, and you passed it to Paul Fisher. Why is the money that was going into the Funding for Lending Scheme, which is going down to mortgages and small and medium-sized enterprises—why are you not doing something? It seems to be going to mortgages and not SMEs. His starting answer was, “Well, we did not have any specific sectors in mind. It was just to be of help to the banks, to enable them to lend”. In other words, here is a scheme that we have sat in the Treasury Committee and thought, “Well, there is a scheme here. We have been worried about the transparency; we have been worried about the distribution, but early days, early days.” A year on, we are now discovering SMEs are getting less money.

I really just say to you, it is your first time and you have a lot to catch up with, but in one of your answers you said you were doing something. Jon Cunliffe and someone else, Andy Haldane, were doing some work on securitisation and so on. Are you taking this seriously? If you are taking it seriously, can you tell us, not now, but can you give us a list of the tactics, the ideas and the initiatives that they are working on? More importantly, after three years, and with the banks only lending 1.4% of their money to small businesses, a timetable. We have been flannelled now for four years, and one of my colleagues is going to discuss RBS with you, who send out press release after press release about how they are lending to small businesses. All the banks do, and yet the money goes down. If you are taking it seriously and you have Andy and Jon working on this, can we have an agenda and timetables? Also, it would be very helpful if you gave us some objective of where you thought you would get to over a period of time.

Chair: That was a quick question and we would be grateful for a quick reply.

Dr Carney: It is an important question.

Chair: Dr Broadbent, we will start with the Governor, and then I noticed that you also scribbled something down, so we will find out what that is in a minute. Governor.

Dr Carney: I am very interested in this. I would rather hear from him. In terms of the agenda on capital, I will start there. All major banks and building societies have had to have a capital plan to bring them to 7% risk-weighted and 3% leverage ratio, proving the value, if I may, of the leverage ratio. We have seen major capital raises in recent weeks for some of the largest banks. The largest building society is in the market with an innovative capital instrument as we speak, and there is progress. We will talk about RBS and what they need to do in order to get them in the right position, so I will not go on on that.

We are working on credit registers as one way of improving, in a variety of ways, information in the SME market, so that competitor banks can come in and supply credit or compete for SME business. We are doing a lot of work, including with the European Central Bank and at the Financial Stability Board, on recasting securitisation. I am more broadly, in terms of agenda, going to please FPC purdah and welcome you to read our FSR that comes out on Thursday. Thank you.

Q74 Chair: Dr Broadbent.

Dr Broadbent: Thank you, Chairman. I have only a couple of points I wanted to make in relation to Mr Moody's question. One is that, as I see it, rebalancing is really about shifting the economy from non-tradable stuff to tradables, rather than manufacturing per se. As the Governor reminded us earlier, a lot of services—including financial services—are highly tradable and important for our exports.

The second point was about these numbers on debt, on credit to various sectors. I am not sure one is comparing like with like there. There is this large pool of bank credit to other financial companies. Virtually all of that is short-term liquidity provision. It is not debt for expansion. Indeed, if you add up all the companies in the financial sector in this country, whether it is banks or non-banks or insurance companies—most of them are outside London—that number is smaller than the share of manufacturing in the economy, so this is

not debt for expansion. It is more liquidity provision, so I am not sure it is the right way to measure any sort of bias of the banks.

Q75 Mr Mudie: Are there any figures you care to put on the table?

Dr Broadbent: I am just saying I am not sure that is the right one. I have not thought about what is the right one yet, but I am not sure that is it.

The final point is just again a question of measurement and what you can learn from the data. As far as the corporate loans are concerned and the total stock—you are right that it is still declining—but a lot of that, I suspect, and I would certainly hope, is banks slowly winding down bad loans. I absolutely agree with you that it is critical that we see an increased supply of credit to good companies—indeed, companies as yet unborn—and that has been a real problem. It is always a problem for any credit crunch. But I would not be surprised if that went on, if that were to improve, we would nonetheless still see the total stock of bank loans to the corporate sector declining, or at least not growing much, because there is a chunk of that that is not much good and will inevitably be wound down.

Q76 Stewart Hosie: Dr Broadbent, you said in your September speech to the London Business School that the surprisingly low level of firm exits in and since the recession was not an unmitigated good. I presume you meant by that that there were zombie firms and debit firms servicing the debt but not doing anything else and not exiting the market, simply sitting there, treading water.

Dr Broadbent: Yes. I think that is possible. Yes. Nor is it an unmitigated bad, in the sense that it may well also be the case that banks are forbearing on firms that do have a long-term viable future.

Q77 Stewart Hosie: Have you been able to quantify, then, what these zombie firms have prevented in terms of capital allocation or labour moving to more productive businesses? Is there a number we can put on that in terms of productivity or growth that has been suppressed because of these businesses?

Dr Broadbent: I have had what I would call an extremely heroic attempt, which is to say probably not very good, at doing so in that speech when I looked at changes in relative prices, and if you measure it in those terms, there is likely less than half, certainly, of the shortfall in productivity that Charlie referred to earlier, at best.

Q78 Stewart Hosie: Even a figure of 20% or 30% of the shortfall is still calculable and significant.

Dr Broadbent: Yes, as are a number of other influences, including ones that as the Governor alluded to one would expect to be eaten up just as a result of faster demand growth. The reason I do not want to be too precise is I am just not sure we can be too precise. We have seen this exceptionally weak productivity growth. My guess is that no single thing can explain it all or even a majority of them.

Q79 Stewart Hosie: Indeed, but I want to focus on this for a particular reason, because it is calculable. It is probably significant in terms of the total shortfall in productivity, and in terms of monetary policy has the loose monetary policy approach, in your view, allowed businesses to stay in existence treading water when otherwise they would not have had and we would have had more churn in the economy more quickly?

Dr Broadbent: Let me say first that the overall effect of loose monetary policy is undoubtedly positive. If we learnt nothing else from the experience of the 1930s or, indeed, the experience of Japan in the 1990s, it is that you should not delay or be modest about the degree of monetary easing after a big financial crisis. The costs of doing that are very severe. It may well be at the margin that the process that you described does matter in some cases. Equally, it will have saved viable businesses that one would hope would not have gone to the wall. It is possible that effect is at work, but I would certainly not therefore want to conclude that we should have higher interest rates or should have had higher interest rates.

Q80 Stewart Hosie: I am certainly not suggesting that, however, in terms of the recovery phase, if the Adam Smith Institute is correct and there are over 100,000 of these firms, perhaps 108,000, what potential does that have to create drag on recovery? If they are that heavily in debt and if they can afford to service the debt at very low interest rates but they cannot invest and are not growing, if those figures are correct and there is 100,000 plus of these zombie firms, what impact do you think that would have on the speed of recovery, particularly productivity recovery?

Dr Broadbent: If anything, I would have expected the processes of all the normal reallocation that goes on in an economy, where firms fail, others are born, people move jobs, would improve as the economy improved. It is a kind of backward-looking measure, in a way. I do not know. We none of us know. As Charlie said earlier, we are highly uncertain about the way these things will evolve, but if anything I would have thought, just giving another point from which to start, I would have expected faster if anything than average productivity growth through this recovery. Indeed, that is why I am happy with the forecast in the November inflation report that has precisely that central path.

Q81 Stewart Hosie: Governor, you concur with that sentiment generally?

Dr Carney: I do. I think that as the recovery progresses, though, the opportunity cost of not redeploying those resources goes up, and that can be a drag, but that also is a catalyst for doing so, and so one would expect to see some of this unwound. I would make the further point, which was implicit in Dr Broadbent's answer, that with the employment that has been maintained in this process and firms that are viable in the depth of the toughest recession in the UK's history, their viability may well change as demand conditions improve. That is important; that is good forbearance.

Q82 Stewart Hosie: I would agree with that. Let me turn to the other side of the coin. We talk about these heavily indebted zombie firms treading water. There was a report yesterday on the banks in general, RBS more particularly, that would seem to suggest and certainly alleged that viable businesses were being driven to the wall during this downturn in order for assets to be recovered and sold at a different price to make a profit for the banks. I

am just wondering if those allegations were true and if this was significant, if there is a view the Bank has taken? Presumably, driving viable businesses to the wall has a far more profound impact on productivity than simply allowing zombie companies to tread water. Has the Bank seen the report, and has it taken a view on this sort of activity?

Dr Carney: Certainly, we take the view that the behaviours documented in both reports—because, as you know, it is also referenced in Sir Andrew Large’s report—are both deeply troubling and extremely serious, and first and foremost in these matters, it is the direct responsibility of the FCA to conduct an appropriate investigation. I know the institution itself is conducting their own investigation, but authorities need to be involved and that is absolutely necessary.

I do not want to downplay it at all, but if I may go to the macro-economic level, yes, that would have an impact on productivity. What we have seen, though, which is why we are in part having the broader discussion about forbearance, is that there has been evidence of quite substantial forbearance during the recovery, so this behaviour is cutting across it in a different way. That is absolutely in no way, shape or form, to undercut anything I said at the start. This has to be tracked down to the fullest extent of the law, but it would not appear that the scale of this has been on the order of magnitude that has had the impact that would affect the overall figure.

Q83 Stewart Hosie: We certainly hope it has not, and I am sure the regulators will investigate this fully. One final question, in terms of the impact on monetary policy in another crisis—bearing all of these points in mind—is there an argument now looking at some of this behaviour to say that the asset purchase scheme should have focused at least to some extent more on non-gilt assets to allow viable businesses to sell equity or debt or other assets to the Bank to sustain themselves and not be reliant on very weak banks during a financial crisis?

Dr Carney: I was not here, so I do not want to make judgments, and the strategies that were pursued have put us in a position that we are now having this recovery, so I will speak in absolute general terms, if I may. In the pursuit of extraordinary monetary policy there is a question of targeting the stimulus as effectively as possible. That has to be twinned with the fact that it is inappropriate for the central bank to be the allocator of credit in the economy, to make fundamental credit decisions. There has to be, in the design of any credit-easing type policy, the type you reference, a way to be absolutely neutral in the allocation of that credit across firms and indeed, to a large extent, across sectors. There are deep design questions, but there are certainly circumstances that one can imagine, and we may have seen, across the major economies in the course of this crisis where credit-easing-type policies have been, and would have been, particularly effective. That is my view.

Chair: We had eight colleagues coming in. We have five more and I am intending to carry on without interruption unless you would prefer otherwise?

Dr Carney: That is fine.

Q84 Mark Garnier: Governor, can I just carry on with one question, if I may, about this RBS report yesterday from Lawrence Tomlinson? It is more of a sort of general comment on what is going on with the banks in terms of their behaviour, and in particular with the

requirement for banks, particularly RBS, to reduce the size of its balance sheet. When you look at where it can reduce its balance sheet, clearly it needs to reduce the number of loans in order to do that.

You can characterise businesses in three different types. Those with strong balance sheets and strong cash flow who of course are desirable businesses for all banks, and nobody would want to lose those. You can then have the so-called zombie businesses where they have very bad-shaped balance sheets, but also they have problems with their cash flow, and those are businesses where perhaps the debt is far in excess of the assets that the business has. Therefore, foreclosing on that business would be a significant loss to the bank because they would not be able to cover the assets they needed to cover the debt. The third shape of business is those with a strong balance sheet, so a loan-to-value ratio that is very comfortable by anybody's measure, but with some problems with cash flow that could cause a credit event that would be maybe missing an interest payment, or a slight slip in the loan-to-value ratios. If you were a bank trying to reduce the size of your balance sheet, you would need to look to those areas where you could get your money back and it strikes me that this area specifically where you could do that is where you have exactly this type of business that has been described by Lawrence Tomlinson in his report yesterday, which is where you have businesses that are slightly stressed but have strong balance sheets.

Do you think, and I am getting to the question, that it is possible that by requiring the bank to reduce the size of their balance sheet they have been put under pressure to go into the grey area of behaviour that is being alleged by Lawrence Tomlinson?

Dr Carney: No, I do not, is the short answer. I think the idea or the defence is that there was some form of predatory restructuring, which is the activity that is described in Mr Tomlinson's report, which was the consequence of getting banks to be adequately capitalised. In effect, if true, this behaviour is fundamental violation of the integrity of the banking relationship. That is my first point.

There was a need for a number of institutions including RBS to reduce the size of their balance sheet, but the big material areas where balance sheet reduction could make the biggest difference, I would suggest, were concentrated on their investment banking and their international activities, as opposed to their core UK activities, and I would say that we welcome the renewed focus of the new RBS senior management on its core retail and UK commercial business. They will have to prove that they can execute that strategy, but at least they appear to be concentrating on the right things.

Q85 Mark Garnier: It is very early days with this Tomlinson report, but presumably you see this as seriously as we do?

Dr Carney: We do see it as serious. I have had discussions with Sir Andrew Large, who also raised the issues. They have been brought to the attention of the appropriate authority, which as you know is the FCA, and they are taking it extremely seriously as well.

Q86 Mark Garnier: Thank you. Can I turn to Spencer Dale? You have been a bit quiet for a bit. Can I talk to stressed households, and the problems we are getting with stressed households? We have heard a bit earlier that 60% of GDP comes from household consumption, and we have recently had a report that has been published by the Centre for Social Justice called *Maxed Out* that looks at household debt and household problems where

it notes one or two things. Only Ireland has a higher ratio of personal debt to GDP among European countries than the UK, which obviously puts us in a very bad position. How dangerous do you think this high level of household debt is to the recovery in the future?

Spencer Dale: I think it reflects an increased vulnerability to economic shocks. The balance sheet of the household sector as a whole is relatively healthy, but within there are distributions where some people have very high levels of debt and others very high levels of savings. The vulnerability is with the people who have the high level of debt. To a very large extent those increases in debt are a counterpart to the increase in house prices we saw prior to the financial crisis, where what we saw were young households having to take out mortgages to pay for their houses. The recipients of that were old households who then saved that money, which is why the balance sheet as a whole was relatively strong but where we do have these pockets of vulnerability associated with high levels of debt.

Q87 Mark Garnier: There was another report that was out during the summer where it looks at the financial buffers that households had, and the financial buffers for those households between 24 and 44 years old is just an eight-day buffer, whereas as you so rightly said pensioners, I think, is a 175-day buffer, but then of course you would expect that because they have their savings and their pension. Clearly, we have this colossal amount of household debt at a time when interest rates are at a super-low level, and we can see them going back to a low level of interest rate with a three, four, five, six-fold increase in the base rate. What sort of effect do you think that is going to have on the recovery?

Spencer Dale: The level of household debt as a proportion of income has fallen over the last few years, so it has come back a little bit but still remains high.

Mark Garnier: Yes, it has come from 175%—

Spencer Dale: The levels of arrears and defaults at the moment are also at very low levels. The issue is when interest rates start to rise the implications that will have, and I have a somewhat nervousness at some of these studies. They always say, “If interest rates were to go up tomorrow that would have very significant implications.” Yes, it would, and that is the whole point of forward guidance. We are not going to raise interest rates tomorrow. We are going to raise them at a time when the economy is significantly stronger, employment levels are higher, when incomes are higher. My hope is by following that the household sector, along with the corporate sector, will be in a better position to withstand a rise in interest rates when we do so. We are very aware of this issue when raising interest rates, and we will make sure that we take that into account in terms of the pace and speed with which we raise rates.

Q88 Mark Garnier: One of the interesting things is if you look at the nominal numbers, in the decade leading up to the crisis in 2007 household debt in nominal terms rose from about £500 million to £1.43 trillion, which is a pretty colossal increase. That also coincided, interestingly, in the same decade leading up to 2007, with household savings ratio dropping from 10% to practically zero. On a statistical point, are these all mixed in together? Are household savings also taken into account in repayment of debt? They are? There is nodding around the table.

Dr Carney: Yes, repayment of debt is the same.

Q89 Mark Garnier: On a wider, philosophical economic point, we have seen this exponential rise up until 2007 of household debt and household vulnerability coincide with a colossal bubble that was based on, as you so rightly say, house values going up. Since then we have seen a marked increase in the savings ratio, but now it is sort of levelling off at around 8%, and dropping back to about 6%. We have also seen a flattening out of the level of increase in household debt at around the £1.43 trillion level, and corresponding with that is a level of pretty much flat economic movement. Is it fair to assume from this that in order to get any sort of economic growth that what we need is economic activity to be driven by an increase in the leveraging of households, or is that an assumption too far?

Spencer Dale: No, I think it relates to the reply the Governor gave earlier. For sustainable growth, what we need to see is stronger investment and stronger productivity growth. That is what we need to see. For a period of time, what we have seen is the level of household savings rise quite sharply. Some of that is related to uncertainty and fear about their job prospects and so on. As that confidence returns, we may see some flattening out in the savings ratio. That is what we have seen over the last year or so, but for long-term sustainable growth, we need to see increased investment, increased productivity, and then that increased productivity will pay for higher wage growth and that will help to underpin the recovery.

Q90 John Mann: Thank you, Chairman, and good morning. You mentioned Sir Andrew Large and your discussions with him. When was the first time that Sir Andrew Large's work with RBS was raised directly with anyone in the Bank of England?

Dr Carney: The first indications Sir Andrew had around the possibility of something like this, and I can revert to you with the exact date, coincided with the publication of his first draft report relating to the lending practices of RBS. Forgive me; I will say a month or six weeks ago. He also communicated that, in my understanding, to the FCA at the same time.

Q91 John Mann: There was no earlier date going back much earlier when—

Dr Carney: Not to my knowledge. Not to any of our knowledge.

Q92 John Mann: Your approach to answering questions on this Committee, Dr Carney, is it that your role should always be to give, other than when there are issues of purdah involved, full, frank and comprehensive answers?

Dr Carney: Yes, yes.

Chair: That is the easiest one so far.

Q93 John Mann: What political ambition do you have?

Dr Carney: None, thank you.

John Mann: None whatsoever?

Dr Carney: None whatsoever. Thank you.

Q94 John Mann: I have had three stints on this Committee, and I observed for the first time group speak from the Bank's representatives, with people using exactly the same phrases. I have never heard that before. When the previous Governor was here—I think it was my question, but I may be wrong on that—he was asked about recovery. He said, “I do not want to underestimate the gravity of the crisis facing the world economy.” This morning, you gave, and I had to adjust when you said it, you described the UK at the moment as, “The strongest economy in the world.” You were exaggerating when you said that, weren't you?

Dr Carney: The strongest recovery among the major advanced economies, so that is the strongest recovery from a very weak base. So we are still 2.5 percentage points, as you are well aware, below where the economy was in 2008, but the rate of growth in the United Kingdom as we sit here today is stronger than that of the United States, Germany, Japan, France, Italy, Canada, Australia, in all other major advanced economies. That is the fact. It is a long way back from where trend would have been, or any reasonable estimation of where trend would be, but as we sit here the rate of growth is stronger.

Q95 John Mann: According to the IMF and the OECD, it is less than China, India and the US.

Dr Carney: Neither China nor India are advanced economies.

Q96 John Mann: And the US?

Dr Carney: No, the rate of growth as we sit here today is stronger in the UK than it is in the United States.

Q97 John Mann: That is not according to the IMF and the OECD.

Dr Carney: I cannot help what the IMF and the OECD might have said, but I suspect we are talking about different times. As we sit here today, the rate of growth in the United Kingdom—

Q98 John Mann: The projections for next year are also higher for the US and India and China than they are for the UK.

Dr Carney: I do not believe that.

Charles Bean: Not for the US. It is true for India and China; but generally speaking, emerging markets do grow fast to catch up.

Q99 John Mann: The OECD's November estimates for the US 2.9%, UK 2.4%.

Dr Carney: Our estimate is for UK growth in 2014 of 2.9% so call it a draw vis-à-vis. We will see. It will be revealed. That is a forecast in each case, but there are two differences. There are two elements here. One is the question of rate of growth, where the rate of growth has picked up quite significantly, and the conversation, if I may allude to it, related to the rate of growth and expectations of interest rates in the market and the effectiveness of forecasting.

Q100 John Mann: So we are now saying the rate of growth. So what you are saying is that we are coming out of recovery later than everyone else and therefore now we are catching up.

Dr Carney: Well, that is without—

Q101 John Mann: That is mathematically going to be a higher rate of growth. Can we come to the real economy?

Dr Carney: Sorry, Mr Mann, please. That is true, but others are coming out of the recovery late—France, Italy, Spain—and they are not growing at the rates in the United Kingdom. There is a long way to catch up.

Q102 John Mann: What worries me is that you are sounding more like a politician than a Governor.

Dr Carney: No, I am making sure that the record is accurate.

Q103 John Mann: Two members of the panel in front of us both use the terms, “Don’t worry,” but if we look at household indebtedness, it is going up, isn’t it?

Dr Carney: The rate of household indebtedness has come down a little more than 20 percentage points as measured against income. There is a prospect though—

Q104 John Mann: Now, it’s going up.

Dr Carney: Well, the prospect—

Chair: Do go ahead, sorry.

Dr Carney: Thank you.

John Mann: I will ask my question.

Chair: I just want the Governor to complete his answer.

John Mann: No, no. Thank you, but I will ask my question.

Chair: John, I would like the Governor to complete his answer to the question on household indebtedness.

John Mann: It is going up now, isn’t it?

Chair: John, you are going to be called to order unless you let the Governor answer the last question.

Dr Carney: Thank you, Chair. The rate of household indebtedness has gone down. What I was going to say is, with the recovery in the housing market and the increase in house prices, over time, there is the prospect of the rate of household indebtedness going up relative to income, as mortgages turn over from people who have either no mortgage or low mortgages on their house to first time buyers.

Q105 John Mann: When you say that the rate of household debt has gone down what is the timescale that you mean by that?

Dr Carney: Since 2008, the level of household indebtedness relative to income has gone down by at least 20 percentage points. I believe it is about 24 percentage points.

Q106 John Mann: Between 2010 and now, 2013, it has gone up, so you have picked figures from 2008 to now, but from 2010 to now unsecured and secured debt has gone up.

Dr Carney: It has gone down as measured relative to income, and income growth has been quite weak, as you know.

Q107 John Mann: I am using analysis of your figures. Let us take private sector investment.

Dr Carney: I am highly confident in the figures. I am happy to circulate our figures directly to the Committee after this meeting.

Q108 John Mann: Private sector investment—biggest fall in the last quarter in the last two years.

Dr Carney: As measured by the ONS, and we discussed earlier some issues around that, but fundamental to the recovery will be the recovery in private sector investment. There is an inconsistency at present with measured private sector investment and investment intentions—

Q109 John Mann: It is a significant drop, isn't it, minus 2.3%?

Dr Carney: It is a significant drop.

Q110 John Mann: Compared to the last two years?

Dr Carney: It is a significant drop, if that indeed is the drop.

Q111 John Mann: Households are borrowing more, both secured and unsecured debt, businesses are investing less, and yet you are there saying we are the world leader among comparative economies.

Dr Carney: I am saying the following things. First, that the rate of growth in the United Kingdom is the strongest rate at present relative to other major advanced economies. This is relevant in the context not just of what is happening on the ground in this economy, but it is relevant to the effectiveness of forward guidance and what interest rate expectations are. There is not a discussion as we sit here today. I think, consistent with your line of questioning, there is not a discussion about the prospect of the removal of monetary stimulus because the recovery has not broadened out to business investment, so I am saying that.

Secondly, we have a different view—and as I say I am highly confident in mine—of where household indebtedness has moved relative to income in this economy over the course of the last several years.

There is the possibility, and I will speak to it on Thursday with the FSR release with my colleagues, with Charlie and other colleagues in the FPC, of an increase in household indebtedness in the medium term because of what is happening in the housing market, and that is a broader set of issues.

Q112 John Mann: My concern is you also said, “This is the toughest recession in UK history,” and I suspect historians might want, even over the last century, to take issue with that. My concern is the contrast with the approach of your predecessor and you, in that you are rather more selective on the timelines that you are giving in order to present a rosier picture, and I am trying to work out why. Are you not in danger of being too close to the Chancellor and acting as a politician rather than as a Governor of the Bank of England?

Dr Carney: First off, I am more than mildly offended by the thrust of the question. The facts are that my predecessor helped put in place the conditions for the recovery we are now seeing, but what my predecessor went through over the course of his five-year term was inflation persistently above target. Now inflation is 2.2%, a contraction that for the path of GDP—very importantly not for unemployment, but for the path of GDP—was deeper and more prolonged than the Great Depression and anything else experienced in the last 100 years. So that is what he has been through. Entirely fortuitous, what I am here today describing, along with my colleagues, is inflation at 2.2%, jobs being created that are in the private sector, an economy that is growing from a weak base, but is growing at the fastest rate among the advanced economies. I fail to see why that is not relevant to either the stance or monetary policy.

We have spent the vast bulk of our time, appropriately so, on a number of issues, whether it is the health of the banks, the rebalancing of the economy, the role of the City, household indebtedness, what happens in the housing market, a wide range of issues that are challenges to the durability and sustainability of this recovery, but the fact is there is a recovery under way.

Q113 John Mann: Final question. You said—

Chair: Is it a quick question?

John Mann: It is a quick question.

You are singing the virtues of doubling the size of the financial sector within the economy. Do you think it is appropriate as your role as the Governor of the Bank of England to be singing the praises and prospects of one sector as opposed to other sectors?

Dr Carney: I was not singing the praises and prospects. I was alluding to the possibility of the increase in the size of the financial sector, relative to the size of GDP, but at the same point making it very clear that the job of the Bank of England is not to pick the size of the financial sector. That is an issue for yourselves and is ultimately determined therein, but it is the job of the Bank of England to make the financial sector resilient and to make it safe, and there are a lot of very important things that we still need to do in order to have accomplished those goals.

Q114 Chair: Can we take you back to John Mann’s first question about RBS lending? He asked you when Mr Large first became aware of these problems at RBS, and you said it was about a month ago. Do you recall that exchange with John?

Dr Carney: Yes.

Q115 Chair: We, as MPs, have been inundated with complaints about this for years—not only about RBS, but often about RBS—but told that this was not so, that there was no supply constraint, that their customers were being treated reasonably. Do you not think it is shocking that these manifest weaknesses and maltreatment of RBS customers has not been picked up much earlier by somebody, either by the RBS board or by regulators or by UKFI?

Dr Carney: I think if these activities proceeded on any sort of scale it is remarkable.

Q116 Chair: Do you think it is shocking?

Dr Carney: Okay, it is shocking. I will use the same word.

Chair: Just to be clear what we are looking at—stripped of diplomatic baggage.

Dr Carney: These issues, as I said earlier—I apologise, Chairman.

Chair: The reason I raise that is that it is a failure of governance, even after we have been told that the governance is being sorted out, isn't it?

Dr Carney: It is a failure of governance. I think you are aware that it is the view of the Bank and the PRA that reforms, including of the senior persons regime, are essential to reinforce governance within institutions themselves, but there are broader issues of governance and responsibility.

Q117 Mr Love: Governor, can I take us back to the issue of the durability of the recovery, which you have touched on in a number of answers? In an answer to Mr Ruffley when he suggested that business investment was unlikely to improve non-net trade—how long could we sustain the recovery on consumption?—you said that the limiting factor would be income growth, and indeed I think Mr Dale also reflected that. In a later answer, you also suggested that house price rises may have an impact. How important do you feel house price rises are in sustaining consumer expenditure?

Dr Carney: We go into some detail in the report, Mr Love, on exactly this issue. Our view is that it is not house price rises that are the primary driver of consumption. Quite often you get house prices moving up at the same time or slightly leading or slightly lagging increases in consumption, but that in our view, and analytically we have done some work and Mr Dale can speak more to it, to disaggregate the moves and show that really what is happening here is the expectations and improvements of incomes cause two things—one, to consume more at present, but also to extend more in terms of house price purchases. That helps move them in parallel fashion.

There is an important collateral channel, though. As house prices go up, it is easier to borrow against those houses. What I was trying to distinguish in the previous exchange is in terms of what has happened, which has been a reduction in debt relative to income over the course of the last five years, with what we expect is central to our projection in terms of the next three years, which is basically households consuming out of income. So income growth is the limiting factor and what matters is where productivity and wages go, and we have

relatively modest, with a medium term out 10 years, out 20 years, perspective of what happens if house prices move up over the course of the next several years to certain levels and what that does to the level of mortgage debt that will naturally occur as houses are sold from people who have lived in them a long time and paid down their mortgages to first-time and younger buyers who have to mortgage up heavily. This is something we are going to detail a bit in the Financial Stability Review that is coming out on Thursday that you will not have time to watch, but we will talk more about it as the FPC.

Q118 Mr Love: I do not want to encroach on that as it is an important occasion, but I just wondered how you would characterise the state of the housing market at the moment. Housing supply is very muted; there appears to be price rises occurring but not uniformly. In some areas, it is occurring much faster than others. How would you characterise it?

Dr Carney: I think you have caught many of the elements. There is momentum in the housing market. We expect that near-term momentum will be sustained for a period before ultimately house price growth is more consistent with normal income growth. There is much stronger price pressure and price performance in London and the south-east. It is broadening across the country, and we are seeing positive house price growth in most parts of the country, with the exception of Northern Ireland, as we sit here.

Q119 Mr Love: I notice the figures for mortgage lending in October had gone up to £17.6 billion, which is the highest level in five years. Is that causing you some concern?

Dr Carney: The overall level of mortgage applications, mortgage lending, housing transactions, there are a whole variety of figures that are still running at around three quarters of historic averages, so it is still not back to where those averages were before. There is some room. It is important—and, again, I apologise; this moves into questions of financial stability—that underwriting standards are maintained, and there is quite strong evidence that underwriting standards, as you would hope, have substantially improved over the course of the last several years. Again, that is something we will talk more fulsomely on, on Thursday.

Let me make one other point if I may, because you alluded to housing supply. Private housing starts are still running at about 117,000, I think, on an annualised basis, which is the most recent figure, so well below pre-crisis levels. When I look at housing supply here, I apologise that I put it in comparative context with Canada, but there is roughly half as many people in Canada. Housing starts are roughly twice as high in Canada, around about 200,000 than they are in the UK and the UK demographics are slightly younger than they are in Canada, so it gives a sense of the scale of the supply issue. Obviously, there is a lot of space in Canada and it is slightly easier to do housing starts, but the supply and demand dynamic that a number of people have raised is quite fundamental.

Q120 Mr Love: There are a lot of people taking a rather optimistic view that demand will increase supply, yet we all know the institutional barriers that there are to cranking up supply very easily. It is not like the Canadian market, and certainly not like the American market. What confidence do you have that if we see this increase in demand and house price rises that will trigger a significant increase in supply? Supply is at the lowest level almost since records began.

Dr Carney: Yes, supply has been extremely low. It has picked up about 50% to that 117,000, but it is still low relative to history and relative to what one would expect

demand would be. Housing is important in the near term. Contribution from dwelling investment, whether it is new supply or home improvement or even transactions, is important to the forecast, as I referred to earlier at present and into the first half of 2014, but we see it coming off in relative terms. We do not see a marked improvement in the supply of new homes, in part for the reasons you cite—whether it is planning, whether it is supply of bricks, whether it is people who have shifted out of construction. There are a variety of impediments that exist at present. Improvement in prices will reduce some of those impediments, but it is unlikely that they will solve them.

Q121 Mr Love: Let me ask you one final question, and that is in relation to this vexed question of borrowing. Mark Garnier quoted from the report *Maxed Out*. Let me quote from it. It says, “Debt is rising at an alarming rate”, but in answer to questions in relation to the inflation report, you have said that there has not been a sharp uptake in borrowing. How do we square those alternative views, or is this politics versus economics?

Dr Carney: I will stick with the economics. I am afraid I have not read *Maxed Out*, but we look at borrowing relative to the ability to service those debts, certainly from a macro perspective as the Monetary Policy Committee. There has been this reduction that I referenced earlier. I think reasonable people would have different views about whether that reduction has gone far enough and whether that reduction with the current levels of debt relative to income are sustainable in the absence of real income growth in future years. I personally have some concerns in that regard.

When we go to the Financial Policy Committee and think about our financial stability obligations we look at it not just at an aggregate level but by cohort and by type of borrower, and those particularly more heavily indebted borrowers who pay a very high proportion of their income on debt service, even though interest rates are low. That is where we have the greatest concern.

Q122 Teresa Pearce: Good afternoon.

Dr Carney: Good afternoon.

Teresa Pearce: As it is afternoon, I will keep my questions relatively short. We have talked about stability in the housing market and one area where there is very little stability for families is in the private rented sector. In the private rented sector, short-term tenancies are the norm, and one of the reasons for this is because the major banks put restrictions on the loans they give to landlords, where they give a limit of a 12-month tenancy that is allowed to be given as landlords. The Nationwide has recently changed that, where they allow 36 months, which is in line with many European countries, where private rental agreements are normally two or three years. HSBC have two years, but the other major banks—Lloyds, Barclays, Santander, Royal Bank of Scotland—have 12 months. This is a restriction on stability in the rental market, in my opinion. Do you think that restriction is fair or reasonable?

Dr Carney: I believe that it is a judgment for the institutions. I would say that I am encouraged that there is a difference in approach with institutions, and the judgment that has to be made is to what extent there is encouragement, highly speculative, but there are two sides to what you are saying. One is of course the tenants’ perspective, which is to

provide greater certainty for the tenant, which is obviously in their interest; but also from the landlord perspective, it makes the certainty of servicing any underlying mortgage that much higher if you have a longer-term tenancy. I can see the arguments just from a management perspective to not have shorter-term restrictions, but I do not want to micro-manage financial institutions who take decisions in broader context.

Q123 Teresa Pearce: The Government have recently stated that they are going to hold a mortgage lenders' summit to understand these barriers and to see what could be done. Do you think that would be a sensible way forward?

Dr Carney: I will just take a pass on that. I will be frank, it is not an issue—down to that level of detail—on which I focused in my first five months; my apologies.

Q124 Teresa Pearce: For some of the families in my constituency, whose children have moved school four times in five years because of short-term places—

Dr Carney: Because of that.

Teresa Pearce: It is a massive subject. It is just something I would like you to bear in mind when you are talking to the banks about the way they lend and whether these restrictions are necessary, or they are just there because they have always been there. Thank you.

Dr Carney: Okay; understood. Thank you.

Q125 Andrea Leadsom: Good afternoon. I would just like to ask you, Mr Bean, going back to forward guidance for a moment, in your October speech you said that it might be worth looking at changing the unemployment threshold for forward guidance. Can you just expand on that slightly? What sort of scenarios were you thinking of and what sort of level?

Charles Bean: Let me be accurate. I was not saying that we would change the guidance that we provided. What I was saying is that as we approach the threshold, clearly there would be—

Q126 Andrea Leadsom: Sorry, can I just remind you exactly what you said? You said there was scope for, “resetting the unemployment threshold to a new lower level”.

Charles Bean: Yes, I will expand on it. It is not resetting it now, but as we get to the threshold, there will be a question about what comes afterwards, and there will obviously be debate going on in the markets and possibly this Committee and so forth about, “Are we going to raise interest rates?” or whatever. We will have learnt quite a lot over the journey to 7%, as the Governor said earlier on. I would expect, as the committee gets close to that 7% threshold, it will feel in a better position to give some indication about what is likely to happen next, whether that will involve raising bank rate or possibly it may well be the case that because productivity has recovered, inflation pressures remain low, that it will look as if it is plausible and sensible to keep the bank rate where it is at the moment. It will be perfectly possible for the committee in that case to issue new guidance once it has hit the 7% to say that they expect to be able to maintain it until 6.5%. It is worth

emphasising I am not saying changing the existing guidance, but it is about there may be guidance that comes after where we are.

Q127 Andrea Leadsom: Thank you. Dr Broadbent, as the external policeman of the MPC, if I can call you that, can I ask you, do you think that forward guidance was in part driven by a desire to avoid a potential collapse of the bond markets following what happened in the States, when they talked about perhaps slowing down QE and there was a big run on the bonds? Certainly, Governor King came to this Committee and made very clear it is a long time before we start raising interest rates. Was forward guidance in part simply to calm the nerves of the markets and therefore is there a risk that we, as the Treasury Committee, should be concerned that you may keep moving the goalposts in order to keep the markets calm because of the risk that, in raising interest rates, you have to start to address the unwinding of QE and thereby spark a run on the bond markets?

Dr Broadbent: There are several aspects to that. I would say to some extent, yes, I certainly hope that guidance would prevent premature excessive increases in interest rates. Indeed, I think they already have, measurably so. As the Governor said earlier, not so much to calm the markets—it is not always out of control—but you would normally have seen in response both to stronger direct evidence of growth, and indeed the upgrade in our own growth forecast, a slightly higher rise in forward interest rates. Clearly, it would not be desirable to present something that was wholly unwarranted, whether it is what happened in June in the United States of this year, or indeed 20 years ago, 1994, when the bond market reacted very adversely to the first rise in interest rates.

When it comes to the point when the Asset Purchase Facility starts to be wound down, I can see guidance of some description; in other words, a little more precision about the conditions under which it would happen and how we would do it would be desirable. Of course, we are a long, long way from that.

Can I just caveat all that by saying that we could not and certainly would not seek to micro-control interest rate markets beyond that. Guidance should not be mistaken—and I tried to point this out in the speech, but I think a lot of the coverage still misses this point—as an unconditional promise. It was never that; it is not that; and we are not seeking at all points in time to control the entire yield curve regardless of economic conditions. That would be foolish.

Q128 Andrea Leadsom: I understand, but can I just ask you a further question then, because it does concern me that when we get to the point where we are unwinding the asset purchase programme then inevitably there is suddenly a big seller of gilts in the market, so what that inevitably means is a change in the yield curve, a change in market sentiment and so on. Can forward guidance be used? Are there any means at your disposal to be able to control the impact on the markets?

Dr Broadbent: Let me just challenge the word “inevitable”. It is not going to happen arbitrarily. If I had to guess about the circumstances under which the unwind would happen, it would be an environment in which the economy was growing more strongly, in which the demand for liquidity was falling, in which the Government borrowing requirements were also falling, and all those things would tend to go in the opposite direction; they would tend to depress gilts. We would be not suddenly deciding

whimsically, “Now we are going to get rid of it all.” We would be doing it at a time in which I think the economy could absorb these sales of gilts. The demand for gilts would be going up and the supply from the Government would be falling, so it is not inevitable.

Having said that, the example you raised earlier of the United States in the summer of this year—just a suggestion not even of a sale, but a slight change in the rate of purchase—that was instructive and it is clearly important to communicate very clearly as best one can the conditions under which this would happen and how it would happen. It is, as I say, some way away yet. Remember that we have said we would not countenance reducing the size of the facility at least until interest rates start to go up, so it is some way off yet, but I—

Q129 Andrea Leadsom: But can I just remind you—you will recall Governor King specifically said how it would be unwound is there would be a 0.25% rise in base rate and then the Asset Purchase Facility would be unwound?

Dr Broadbent: I do not think he did say that.

Andrea Leadsom: He said that in this Committee some years ago.

Charles Bean: Yes, I was going to say he did not say it would be a quarter of a point increase and then we would immediately start—

Q130 Andrea Leadsom: No, not immediately. No, he said the next step, there would be a change in direction by a small tightening, perhaps 0.25%, and afterwards, instead of further tightenings of interest rates, the Asset Purchase Facility would be unwound. It is etched in my memory, but we can check the record.

Dr Carney: Can we etch something else in your memory?

Charles Bean: Yes.

Andrea Leadsom: Yes, please do.

Charles Bean: Certainly, the vision here is that we would not embark on sales of the gilts until it was quite clear that the economy was on a sustained recovery path where we needed to keep on gradually tightening the stance of monetary policy. Now, that might well not happen when we just raised by 25 basis points. You might wait until the bank rate had gone up a few notches before we felt that things were sufficiently tranquil and well-entrenched to make a steady sale at a reasonably slow pace back to the market of the gilts sensible.

Q131 Andrea Leadsom: Okay, thank you. Mr Dale, as the economist to the Bank, can you just comment? In the eurozone, Mr Bean in his recent speech—I do not want to ask him again, because I have not given you a turn—he said that a lot will depend on the ECB’s stress tests of the European banks as to how well they are able to sustain their recovery. Obviously, we all agree that their fate is very much tied in with our own, since there is a huge amount of trade between us, yet Mr Bean also made the point that the eurozone remains a huge risk to the UK economy. Can you comment on to what extent can the eurozone ever

reduce the risk that it is to the UK economy until it achieves proper banking union? Is it feasible that the risks can be lowered without them moving to their end game of fiscal union?

Spencer Dale: I think you can reduce the risk. They can do all sorts of things to help reduce the risk in terms of putting infrastructures in place like the stress tests, which increase confidence, by the countries in the periphery undertaking some of the adjustments and gradually doing the rebalancing they need to take place. Charlie should speak for himself in terms of his own speech, but my own view is, under the best possible case, the euro area is going to grow pretty weakly over the next few years and will not help and not be a driver for growth for our economy. Whatever they do, there will be a significant risk over that period of time of worse outcomes, and so we should think of the euro area as a persistent drag on our economy for a sustained period, but that does not mean the risk cannot get less as they gradually go through that adjustment process.

Q132 Andrea Leadsom: Following on from that, do you think that you can have a successful currency without a common fiscal policy?

Spencer Dale: I think there are many different ways that you can structure that; and ultimately, they are political decisions rather than economic ones.

Q133 Andrea Leadsom: Yes, but as an economist, can you tell us whether you can have a successful single currency, the euro, unless you have a shared fiscal policy over the medium to long term?

Spencer Dale: I think there are circumstances in which you can and circumstances you cannot; and ultimately, they are political ones rather than economic ones.

Q134 Andrea Leadsom: Governor, just bearing in mind today that the Scottish Parliament have come out with their proposal that they can continue to keep the pound but have two entirely separate fiscal policies, what is the central thinking of the Bank of England about how to cope with two openly and very deliberately different fiscal policies, while trying to squeeze into the one-size-fits-all pound?

Dr Carney: As you can appreciate, the release of, from my understanding, 600 or 700 pages of documents occurred during this Committee. I have been riveted in my attention to the Committee, so I would at least ask leave to read the documents.

Q135 Andrea Leadsom: But you must have some thoughts on this. It is not new.

Dr Carney: I would say there are many lessons from the crisis period that reinforce attributes of the most sustainable currency unions, and it is difficult in the fullness of time to have a currency union, and I speak from the Canadian experience, without some element of fiscal federalism. My personal view for the eurozone—and I will speak only to the eurozone—is that there will be a requirement of some form of fiscal federalism. I will use that term—there are politer terms—but the banking union that you referred to, which shares liabilities and exposure, is a form of fiscal federalism, but I suspect that ultimately in the fullness of time that will have to be reinforced by some element of sharing, potentially through the labour market, potentially through other mechanisms, in order to have a fully viable euro.

Chair: We can only take one last very quick one.

Andrea Leadsom: I have to choose then, don't I? I am going to choose the question that is going to get me into a lot of trouble with the Chairman.

Chair: I know what it is, and you will not be in trouble.

Q136 Andrea Leadsom: Governor, in your five months in the job, have you concluded—as no doubt your colleagues must have done—that half the population has no role in the senior leadership of the Bank of the England, or would you like a list of 100 brilliant, senior, experienced and capable women to consider to take on some of these senior posts?

Dr Carney: We would welcome any recommendations for people, for anyone to reinforce the human capital of the Bank of England.

Q137 Andrea Leadsom: But do you think having no women is an issue specifically?

Dr Carney: We are looking to enhance the gender diversity and overall the diversity of the Bank. This will take some time, but we are in the midst of a strategic planning exercise. I fully expect, subject to agreement of colleagues, that such issues will be central to our priorities in the coming years.

Chair: We have ranged very widely what was this morning, now this afternoon, and we are very grateful to all of you for answering our questions so thoroughly. With that thought in mind, we look forward very much to seeing you, Governor, I think in mid-January to discuss another of your responsibilities, the FPC. Thank you very much indeed.

Dr Carney: Thank you very much.