HOUSE OF COMMONS

Treasury Committee

Oral evidence: Bank of England May Inflation Report HC 450

Tuesday 24 June 2014

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Watch the meeting

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

Questions 1-103

Witnesses: **Dr Mark Carney**, Governor of the Bank of England, **Sir Charles Bean**, Deputy Governor of the Bank of England, **Professor David Miles**, Monetary Policy Committee Member, and **Ian McCafferty**, Monetary Policy Committee Member, gave evidence

Q1 Chair: Governor, thank you very much for coming to give evidence this morning, and thanks to the rest of the team for coming in as well.

Can I begin by saying something about Sir Charlie? If I may call you Sir Charlie, unless you decide at this moment to call yourself for ever more—and it will be in Hansard—Sir Charles. You have been a top-flight public servant and a top-flight economist for the Bank and for the country and we owe you a lot. You have always managed to blend loyalty and independence, not an easy mix at times. Thank you very much indeed for your public service.

Sir Charles Bean: Thank you very much for those kind words.

Q2 Chair: Now, no friendly remarks at a public hearing would ever be appropriate without some sort of sting in the tail, and on this occasion, the sting in the tail is that we, as a group, have the considered view that it would help public discourse and public policy if the most senior people in the Bank, when they left, produced some sort of valedictory note on what they feel they have picked up as lessons for their successors. We recognise that a small part of it—we hope a very small part of it—may need to be released with a delay for one reason or another, but perhaps my first question to you, Sir Charlie, is are you minded to have a go at one of these?

Sir Charles Bean: I would be happy to produce something like that. I think it is appropriate to have a little bit of an air gap between me finishing and me producing something like that. That is for two reasons: first, to be fair to those who are coming in and taking my place, and secondly, it is also valuable if I can just have a little bit of a period of reflection, a little bit from afar, if you like, before I do so.

Q3 Chair: How long would you like?

Sir Charles Bean: A year. Is that reasonable?

Q4 Chair: I think we can cope with 12 months. Does this approach have your full support, Governor?

Dr Carney: Absolutely.

Chair: Good.

Sir Charles Bean: The one other thing I might mention is that it may be useful for me if you highlight any particular themes that you might like me to dwell on in such a report at a suitable time. Obviously you do not need to do it now, but at some future juncture.

Q5 Chair: We will drop you a line.

Governor, on the substance, can I begin by asking you whether you think any of your reservations about the quality of data and the difficulty in any case of getting high-quality data has a bearing on the explanation of the productivity puzzle?

Dr Carney: Yes. We have done, with respect to staff, the MPC as a whole and individual members of this Committee, as you know, a fair bit of work on this productivity puzzle. I will summarise it, but certainly invite, with your leave, colleagues to come in on it.

If we look relative to pre-crisis trends, the productivity gap, as we sit here today, is probably about 16 percentage points. Staff published a recent article in our quarterly bulletin, estimating that about a quarter of that, or 4 percentage points of the gap, could be represented by mis-measurement. There are a few aspects of that and I will touch on them briefly. The first would be just mis-measurement of output. Some of that subsequently we would expect to be with revisions of final data that would come in, but some are more substantive. An example that is about to be fixed by the ONS would be the treatment of R&D, which is treated as intermediate consumption as opposed to investment, so that is a secular underestimation of output, which as I say, we expect to be adjusted in the revisions that are coming out to methodology in the fall.

Other challenges on estimate of output and productivity value added by sector: financial services is a famous one that the Bank has done work on; capturing value added in financial services and capturing value added more broadly in the services sector is quite challenging. As you are well aware, 70% of output roughly is from the services sector, so this fairly fundamental. It is less likely that there is mis-measurement around the labour input component. That is more readily measured.

The last point I will make in terms of these estimates is that when I quote 16%, I am obviously quoting relative to a pre-crisis trend and some things have changed subsequent to the crisis. One example would be in financial services, one of the toughest areas to measure, but another example that is relevant is North Sea oil output, which has been on some secular

down-path, and so that would affect it as well. Just to summarise, our best estimate of that issue is about a quarter. It is a material amount, but it certainly does not explain the majority of the productivity puzzle.

Q6 Mr Love: Governor, was the latest labour market data published on 11 June stronger than you had anticipated in the May Inflation Report?

Dr Carney: There are many aspects to that data. In terms of the pace of job creation, it continues to be strong. As you are aware, employment growth is still running at a record pace, but what was weaker and notable was that the average weekly earnings, the wage data, in effect, was softer than our expectations and adds to a run of hard data around wages—actual data around wages—that has been softer than we had expected. That is important for the forecast, because our expectation is that there will be an acceleration in earnings in the second half of this year, into 2015, which would help support consumption, so taken together, that data presents some cross-currents for the outlook.

Q7 Mr Love: Let me ask you whether this data materially affects your judgment of the level of spare capacity in the economy.

Dr Carney: Taken in isolation, which is always dangerous, the continuation of development on the wage front suggest to me—others would have a different opinion potentially—

Mr Love: I am going to ask them just in a moment.

Dr Carney: Yes, it would suggest to me that there has been more spare capacity in the labour market than we previously had thought, all things being equal, but of course—and this is extremely important for me to say—all things are not equal. What has also happened is that the economy has performed a little bit better in terms of actual out-turns, but in terms of momentum, forward indicators, it has more momentum than we would have expected, so the combination of the two are greater momentum in the economy and prospectively greater momentum into the second half of this year. We have to balance that against the possibility, in my opinion, that we would have had more spare capacity to begin with, but that spare capacity is beginning to be used up.

Q8 Mr Love: Mr McCafferty, what is your view on spare capacity in light of these figures?

Ian McCafferty: I would say that I still believe it is very risky to be over-precise in terms of the level of spare capacity. We have suggested that there is a range of existing capacity of somewhere between 1% and 1.5%. I do not dissent strongly from that, but as I said in a recent speech, there are ranges around that in terms of the level of uncertainty. That is why I think that in addition to looking at the quantitative measures of spare capacity, we need—and it is agreed by my colleagues as well as my having said it in public—to continue to monitor the price indicators of the absorption of spare capacity, those areas of potential price stress that start to emerge as the economy starts to approach full capacity.

Q9 Mr Love: Professor Miles, what is your view on spare capacity?

Professor Miles: I think what is happening in the labour market is an indication that there remains a significant degree of spare capacity. Wage settlements are coming in

consistently lower than I thought likely, given the headline unemployment number. That reflects a collection of different things: there is a degree of hidden unemployment among the self-employed; there is an unusually large proportion of people who would like to work more hours than they are working, and they do not get measured as unemployed, they are working but they would like to work a bit more. I think there is a significant amount of slack there. I am probably at the upper end of the range that we have talked about, 1% to 1.5%. It is quite plausible that there may be more spare capacity than that even.

Q10 Mr Love: Sir Charles, can I ask you whether it affects your judgment about how long it will take to absorb that spare capacity?

Sir Charles Bean: The first thing I will say just on spare capacity is that there is a real danger of spurious precision here. The Governor has already referred to some difficulties of measuring GDP. Spare capacity is GDP relative to some unobserved counterfactual of what output would be once all wages and prices had adjusted. It is a real mistake to think this is an area where you can get concrete numbers. That is just by way of background.

As far as I am concerned, my central estimate is 1% to 1.5%; it is a thick point with considerable uncertainty either side of that. The wage data: certainly that is consistent with there being more slack in the labour market. Of course, pay growth may be lower for other reasons than slack, there are lots of things that determine pay growth and there are some indicators that go in the other direction. If you look at some of the survey information on pay, the REC survey, for instance, also some of the intelligence from our agents, there are signs we are seeing some skills bottlenecks starting to emerge, and you might expect that to be associated with some upward pressure on pay further down the road.

I would not want to say it is a completely unalloyed picture in one direction. The whole name of the game of policy-making is weighing up a number of different indicators together. Personally, I would still expect to see pay growth edging up during the second part of this year and into next year reflecting the gradually tightening labour market and the reduced availability of spare labour.

Chair: We are going to have to move on, unless you have one further question, Andy.

Q11 Mr Love: That was in a series of questions, but I take your point, Chair.

Perhaps I can just ask about the medium-term equilibrium rate of unemployment. Will that be materially affected by the new job figures?

Dr Carney: Again, I absolutely associate myself with colleagues' comments about the dangers of spurious precision here and relying too much on one data point. Looking across the job performance though, there has been evidence that the longer-term unemployed have been finding work more rapidly than they had previously, which suggests that the medium-term equilibrium rate of unemployment could be lower and could be coming down. Our dynamic, our current estimate as a committee, is that that measure is somewhere between 6%, 6.5%, and by the end of the forecast horizon would fall to in the range of 5.5%, 5.75%, something in that range. Another colleague, Martin Weale, has done some work on this using the wage data, which suggests—and he did not come to this conclusion; he was very careful in not coming to this conclusion—some support that it could be lower at present as one explanation, only one possible explanation. There are

other possible explanations, as Sir Charles said—Sir Charlie, I am sorry—for why wages have been as soft as they are.

Q12 Mr Newmark: The employment data seems to go from strength to strength. I think now we have something like 30.5 million in work, which is close to effectively the 73% that was at the high peak in 1974. The total number of people in work has gone up 780,000 year on year, which is the largest increase in 25 years. Jobseeker's Allowance claimants are down 27,400, which is the 19th monthly collective consecutive decline and youth unemployment is dropping. With all this good news that is out there in the market, there does seem to be coming down the road a challenge with capacity. Are we going to reach a point, in your view, at which it is going to be tough to find people to fill jobs or do you not really see that as a challenge coming soon at all? I appreciate that obviously unemployment is still 6.6%.

Dr Carney: Yes. Let me say this, that—

Mr Newmark: I am trying to square the circle of all the good news that is coming in on employment—unemployment is still at 6.6%—but when I speak to people in my constituency, there seems to be not just a skills gap, but it is already beginning to be tough to find people to fill those jobs.

Dr Carney: There are always going to be skill shortages in certain areas and some of those exist today, but let me bring it to the general on where we operate policy. The best collective judgment of the MPC, which I share, is that there is additional spare capacity concentrated in the labour market that can be absorbed further before we would look at beginning to normalise interest rates, in other words, raise interest rates.

Q13 Mr Newmark: Just so I understand what you are talking about: can spare capacity also be filled with people who were full-time and went part-time, back to full-time and things like that?

Dr Carney: That is exactly right, Mr Newmark, and we outlined this in some detail in the May report. As colleagues just mentioned, it is partly people who want to work full-time, and importantly people who want to work full-time, more hours than they are working currently. It may be some of the self-employed, certainly by no stretch all.

Q14 Mr Newmark: But self-employment is not necessarily a bad thing. That is how you get entrepreneurs and people starting businesses.

Dr Carney: It is absolutely a good thing and to be encouraged, but there are cases where work has been outsourced; there are other aspects that could be picked up, and we don't rely heavily on this in our estimate. In fact, we do not rely on it in our band of estimate of the 1% to 1.5% of spare capacity in the labour market, around which there are bigger confidence bands. But that is a possibility, that there is spare capacity there. The point I would make, and you are putting your finger on one of the central challenges we face as a committee—and we are as upfront about this as possible—we are looking to manage monetary policy to achieve the inflation target in a way that supports a durable expansion.

In doing so, we are looking to use up—make sure the economy absorbs is a better way of putting it—what is wasteful spare capacity and spare capacity concentrated in the labour market, so that it is absorbed over the forecast horizon. We think, and this is the guidance we have given, that that will require the start of normalisation of interest rates, in other words, increases in interest rates. The exact timing of that will be driven by the data, but the most important aspect of the guidance that we are giving is that our view is that the increases in rates over the forecast horizon, in our best estimation, will be limited and gradual.

Q15 Mr Newmark: But you said a bit earlier that there has been an acceleration in earnings. That is, to my view, a good thing. That deals with some of the cost of living issues that have been talked about, so there must some pressures in the system. If there is a lot of capacity, you can keep earnings down, but clearly there has been an acceleration of earnings, and an acceleration of earnings now over inflation, so I am trying to deal with that tension there as well.

Dr Carney: Just to be clear for the record, we expect that there will be a pick-up in earnings growth, and in our forecast, the latter half of this year—which of course has not happened yet; we are still in June—into next year we expect earnings to pick up and there to be real earnings growth. There has not been an acceleration in actual earnings in the measured data that has been produced yet. Since 2008, there have been only six individual months in total where average weekly earnings have been above inflation, just so we are clear.

Mr McCafferty rightly referenced, as did Sir Charlie, that there was some survey data and other indicators that suggest that this could be about to happen, but it has not happened as yet.

Q16 Mr Newmark: I totally get that, but let us look at this year. I look at velocity, and if you look at velocity, would you say that if we just took a snapshot of January versus a snapshot in June, you are already beginning to see that earnings increase or not?

Dr Carney: No. What we have seen, if you take a snapshot of January and a snapshot of June, is that momentum in the economy as a whole, activity has been maintained. On a forward-looking basis, there is reason to expect that it will be maintained into the second half of the year faster than we had previously expected. But if you look at earnings of workers, there has not been an acceleration, whether you take a snapshot of January or June, February or May and so on. We have not yet seen it.

Q17 Mr Newmark: Again, I want to understand, if there has been pretty much a flatline, if you want to use that expression, then between the two data points I have given you, what is driving your analysis to say, "In the second half of this year, you are going to suddenly begin to see that with these earnings"?

Dr Carney: There are a few things. The first is where you started, which is that there is a tightening in the labour market, more people are working, that is a good thing, and people are working more hours, that is also a good thing, so that is positive. Secondly, we do

expect —and we are starting to see the first signs of this—this productivity growth, the first topic we started with, to pick up and pick over the forecast horizon, and both those factors would support a pick-up in earnings. That is an expectation. The timing of when it happens, the degree to which it happens, remains to be seen and that is one of the challenges for the formulation of our policy.

Q18 Mr Mudie: Governor, where do you feel we are with the target we all embrace of a balanced economy, a rebalanced economy? From the outside, it looks as though we have the financial sector, service sector, household consumption driving the growth. Now, business investment is slightly up, but construction is down, but what seems not to be happening is any movement on manufacturing and exports. Are you as gloomy as I am about the rebalancing, because we have been speaking about it for four years?

Dr Carney: It is an extremely important question. The durability of the expansion turns ultimately on having greater balance in the economy. You have picked up sectors: I go first to the overall internal and external balance of the economy, so what we were just discussing is a question of internal balance, in other words, how much spare capacity is in the economy, and to have balance we need to use that up, first point. So we are making progress there, but there is more to be done.

The external imbalances are significant. The current account deficit is near a record high. There are reasons for that, driven in part, importantly, by weaknesses abroad, and when I turn back to where you started on the sectoral side, the components of growth, so how much of it is household spending, how much is business investment and how much is housing, there are signs that there is more balance in the recovery than previously. This started out as an increase in consumption. This recovery started out as a sharp increase in consumption driven by or financed by a fall in the savings rate, and the initial signs of life in the housing market. What has happened subsequently is that business investment has picked up. It is contributing about a quarter of the growth right now. We expect that to continue for a variety of reasons, so that has provided more balance. The question of where wage growth goes though is fundamental to the sustainability of consumption growth over the medium term, so we do need to see that move.

Then the last component I will highlight is on the export side, where the data is a bit choppy and one has to look through individual data points, but there are still reasonable challenges there, given the weakness of demand abroad and the recent strength of sterling, which has not yet—not yet—been supported by improvements in productivity and competitiveness.

Q19 Mr Mudie: That still does not answer the question about manufacturing and exports, if that was a condition of the rebalancing, a specific condition that we would grow the industrial sector and it would be reflected in exports, which would help the trade gap. Are you content about where we are at this moment in time then, and if not, where do you see us moving to in your tenure?

Dr Carney: In terms of the management of monetary policy, as you know, we do not target specific sectors. We do need to see ultimately balance in the expansion. Have we seen sufficient growth in productivity to rebalance externally? The answer is no, not yet. Have we been disappointed by productivity performance? Manufacturing productivity has picked up, but broader services productivity, as measured, has not.

Q20 Mr Mudie: You are doing a great job dodging it, but I am really talking about taking up a greater share of GDP, productivity and so on. That was what we all envisaged and all wanted and still pay lip service to, a growing manufacturing base with a growing export. Now, it is not happening and I am just saying are you content with that? Secondly, if you are not content, where do you see us going with that sector?

Dr Carney: Ultimately, the competitiveness, the effectiveness, the job creation in the manufacturing sector is determined by a variety of factors.

Q21 Mr Mudie: No, I know that, I know that.

Dr Carney: But the Bank of England, as far as—

Mr Mudie: But are you content with where we are and do you have a target in your mind for where we would want to be to increase the GDP share in that sector?

Dr Carney: We do not have a target—

Mr Mudie: You do not?

Dr Carney: —of GDP for manufacturing. What we do is put in place conditions of price and financial stability that affect a financial sector so that entrepreneurs in the manufacturing sector or the service sector can get the capital they need and have the confidence that they need to invest, to become more competitive, to help rebalance as a whole the British economy.

Q22 Steve Baker: When you are considering rebalancing spare capacity, to what extent do you consider the fact that neither labour nor capital are homogenous? Perhaps, Governor, you could—

Dr Carney: That is a fact, and there are friction costs in terms of rebalancing movement of resources, whether different types of labour skill shortages we discussed, different types of capital between labour and capital. There are those frictions in the economy that are part of the functioning of the economy and ultimately we have to take those into account in a macro sense in terms of appropriately calibrating monetary policy to achieve the inflation target.

Q23 Steve Baker: But do you recognise that during a rebalancing process, the transformation from one form of capital to another will take a considerable period of time?

Dr Carney: Yes.

Q24 Steve Baker: So you would expect that to affect productivity?

Dr Carney: Absolutely, and if I may, Mr Baker, one of the explanations for the productivity shortfall is that that process of shifting capital has been less aggressive, less rapid than in a normal recovery, in part we think because of, for a period of time, the weaknesses in the financial sector. One simple example: the number of births and deaths of companies has been unusually low relative to previous experiences, which suggests a slower rate of recycling of capital, and as a consequence, a lower rate of productivity growth.

Q25 Steve Baker: Isn't that a sort of reduced rate of creative destruction a deliberate consequence of policy?

Dr Carney: No. The reduced rate of creative destruction in the example I just gave is becoming less relevant because of the repair of the financial sector, but is a consequence of a financial sector that was under-capitalised, there was an excess of forbearance and there was not recycling of capital. It was also a consequence of a quite understandable lack of confidence in economic prospects, so entrepreneurs were not taking risks, not to the same extent. Certainly people were taking risk, but not to the same extent, pursuing a Schumpeterian ideal.

Q26 Steve Baker: Before I move on to Charlie, have you found, during your long tenure at the Bank, that this phenomenon has been considered in adequate detail, this phenomenon of the heterogeneity of capital and labour?

Sir Charles Bean: Yes. As the Governor has already suggested, it is, we think, one of the reasons for the productivity shortfall, that the process of creative destruction has been less powerful than it would be in a normal business cycle downturn, and that is associated with both the fact this is a recession in which interest rates are relatively low, it is associated with banks showing forbearance for both good and bad reasons. It is easy for people to slip into the error of thinking, "Oh well, if we have slowed down creative destruction, that is a permanently bad thing". The important thing is whether the resources that are trapped in the less productive businesses or sectors get released sufficiently rapidly as the economy starts growing strongly to move where they can be better utilised. So that will be important over the next few years, that we do see the process of reallocation accelerating.

Q27 Steve Baker: Thank you. If I could just turn to the press release on the Inflation Report*,* Governor, you identified three key elements of the MPC's judgment that the economy was returning to normality: a move from consumption to investment; a move from falling to rising real wages, and a move from employment growth to productivity growth. Could you just say something about the interconnectedness of those three factors and could you explain which of those factors you are least confident about? Perhaps I could ask the other panel members to touch on it as well.

Dr Carney: Spot on question. Maybe I will try to take them together. The shift from consumption to investment we are seeing, as was referenced in my earlier answer with respect to that. Clearly that investment growth pick-up will be associated with an increase in productivity, an increase in labour productivity. Over time, it should be associated with a rise in real wages, which is necessary for the rebalancing. As we sit here today, what we have been discussing has not been the lag, but we have not seen the movement in real wages and so we are balancing, individually and collectively as a committee, an economic outlook where we have momentum in the economy, the economy growing above trend, currently growing near 4% on an annualised basis, and with forward-looking indicators suggesting that that momentum will continue into the second half, whereas in our central forecast, it could continue into the second half. Our central forecast has it decelerating as this rebalancing happens. We are balancing that against some indications, particularly on the wage data and price data, of the potential that there was more slack to begin with, so slack being used up more quickly because of momentum, but there potentially being more in the economy than we had previously thought.

Q28 Steve Baker: Could I ask others where perhaps you are most confident?

Chair: A quick response on that, if it is possible.

Professor Miles: On the overall issue of rebalancing, I think it is a case of glass half-full, glass half-empty, really. On the investment side, the signs are fairly encouraging, lots of forward-looking surveys look quite strong there, so I am fairly confident that investment will rise quite strongly and that it will increase as a share of GDP.

Where it has been very disappointing is the export side. It is partly that we went into the financial mess for many years in a situation where the biggest export market for the UK is the rest of Europe. The rest of Europe hasn't had a recovery and that has not helped us at all. The fast-growing—

Q29 Steve Baker: I am sorry to interrupt. The Chair has indicated I am running out of time. Can I just ask one quick follow-up to the Governor?

You mentioned this rebalancing from consumption to investment. Shouldn't that be associated with a shift in interest rates as we adopt a different point on the production possibilities frontier?

Dr Carney: I personally would not reduce the decision around timing to adjust interest rates to just the shift between consumption and investment. It is the overall balance between activity, capacity, actual and prospective. I would underscore that the decision around the first move in interest rates will be driven by the evolution of the economy. In other words, it will be data-driven, and I would underscore further, particularly with respect to the entrepreneurs and business people, on which you rightly focused, that is what is most relevant for those individuals, as it is for households, is not the timing of the first interest rate move, but the expected path of interest rates over the medium term, which in the view of the MPC, reconfirmed again in June, is that those increases will be limited and gradual.

Q30 Chair: Professor Miles, have you, in that interval after you were cut off, been able to concertina what you might have said into a couple of sentences?

Professor Miles: Simply the point that it takes a long time, and longer than I had thought, for UK companies to orientate themselves to export to the fast-growing bits of the world, which are in the Far East. That is a process that will take many, many years, so that element of rebalancing is going to happen over a long period.

Chair: That is helpful, thank you.

Q31 John Mann: Governor, you keep stressing data-driven. Of course, data is historical, with a time lag. Most private sector pay increases are still based on the financial year rather than the calendar year, aren't they?

Dr Carney: The pay cycle tends to be in the first quarter of the year, yes, whether it is end of the year or first quarter of the year, so yes. Obviously I think most businesses manage, as you suggest, it through their financial year.

Q32 John Mann: Introduced from April rather than from January, so April to April.

Ian McCafferty: In terms of the data, the month in which we see the greatest number of pay settlements is January, followed by April, but many of these are applied immediately rather than according to the fiscal year.

Q33 John Mann: What are your agents saying? Your agents are out there. What are they saying about private sector pay increases that have been agreed and are about to be or have been implemented this year? How much are they saying the private sector is increasing its pay this year?

Sir Charles Bean: First, I think it is important to distinguish between settlements and pay, because there is an important element on top of settlements, which as you have correctly diagnosed, are already largely set for this year, because the bulk of them are either in January or April. The element on top of that, which economists sometimes refer to as "pay drift", reflects the pressures of the need to get extra workers in at short notice and so forth. The leading indicators of that are the surveys that I referred to earlier, and our agents are suggesting that in some areas where there is a lack of labour at the moment—so construction is quite a good one, but also some other particular skill sectors—those shortages are starting to appear and they are being met by selective higher pay awards. They are not widespread enough to have much effect on average earnings in the economy as a whole, but there are the first signs certainly, I would say, from the indicators that we have, including the agents, that there is some upward movement in pay.

Q34 John Mann: How much?

Sir Charles Bean: You are talking about—

John Mann: Companies tell each other. They want to know what everyone is doing.

Sir Charles Bean: But the thing is, these are for particular workers or for particular subgroups of their workforce, so the effect on the overall pay bill of the company might be quite small, but they are paying 5% more or something particularly to these workers.

Q35 John Mann: Is there any reason why my area should be any different from the rest of the country? It is not particularly a high skill—

Sir Charles Bean: No, not at all, not at all. I would imagine—

Q36 John Mann: So when the Chamber of Commerce with me gets together all the large employers, and we are talking very large employers and quite a lot of them, they all say that the pay increase being brought in from this April is averaging 3.6% to 3.7%. That is a huge increase compared with the last three or four years. Is that out of kilter with the rest of the economy?

Dr Carney: It is higher than what we are currently seeing in the increase in average weekly earnings, which is 1.7%, 1.8%, but we expect it to move up. It is more consistent with survey evidence and some reports from agents that Sir Charlie was just mentioning that indicate that for new hires, for example, pay increases are moving towards—with the REC survey and others—about 4%.

John Mann: But this is for existing as well.

Dr Carney: But for existing, your constituency, the claimant count unemployment is 3.5%, 3.3%, something like that. It is relatively low relative to national average, so it may be—

Q37 John Mann: No, it is not. It is above national average in terms of unemployment and it is relatively low pay, but the increases in large private sector organisations, of which there are lots, are very significantly bigger for this year than they have been for the last three or four years, and people identified the reason for that: skill shortages and need to compete. If that is the case in my area, and my area is not unusual, then that is going to be the case across most of the country. If pay is increased from virtually no increase to 3.6%, that is above inflation; that is a big increase. In calculating what you are going to be doing, how much attention are you paying to that or are you purely paying attention to measured historical data that will be time-lagged?

Chair: I am afraid we will just have to take this reply and then we will have to move on.

Sir Charles Bean: Okay. We have a very big pay settlement databank, so these settlements that you are talking about will be part of that databank. The one thing that is worth picking up on in what you say is there is a distinction between the private and the public sector and we have seen more signs of pay growth picking up in the private sector, whereas pay growth has remained extremely muted, as there is obviously continuing downward pressure, on public sector pay. The generic point is that pay growth has been

picking up in the private sector, maybe not quite as much as the particular firms that you have been speaking to, but as a generic point across the economy. I think that is a fair characterisation. It is still relatively modest though.

John Mann: Chairman, I have just one question on the paper that—

Chair: You will have to be extremely quick and very quick reply.

Q38 John Mann: Governor, on the paper that—

Chair: You have to be quick, John.

John Mann: —you submitted to us on regional disparities, chart 4 shows the net growth in the number of firms across the UK. What it demonstrates is that in London, there is a large increase in the number. Everywhere else there is no increase in the number of net firms being created in the UK. Is that not a significant problem in terms of how we might come out of a recession with London growing, but the rest of the economy not growing?

Chair: We have the point. It is the regional disparities point.

Dr Carney: Yes, the persistence of this, with the challenges of the durability of the expansion, some of it would be down to concentrations of tech and other lightly-capitalised activities in London, but your basic point I absolutely accept.

Q39 Chair: Governor, in your Mansion House speech, you said that rates could rise sooner than expected. Is that your view or the view of the MPC?

Dr Carney: It was my speech, so it was my view.

Q40 Chair: Did you consult members of the MPC?

Dr Carney: We had been through a June MPC round. We had discussions in taking policy, discussions that were faithfully recorded in the minutes that subsequently came out, and noted that the MPC found it somewhat surprising that market expectations of timing of the first interest rate move in 2014 were relatively low.

Q41 Chair: These remarks seem to have been interpreted as a statement by the Bank rather than just a personal view of one member of the MPC. Did that surprise you?

Dr Carney: I must say that it was my speech, but it was a speech that was consistent with the discussion of the MPC. The fact is that there are various ways to measure this, but market expectations of an interest rate increase for the latter half of this year into the early part of next year were relatively low, juxtaposed with a run of quite strong data with respect to economic momentum in our underlying forecast. Now, may I just be clear that in saying that, I said, “could be sooner”? The decision on timing of any rate increase will absolutely reflect the evolution of the economy. It will be driven by data—

Q42 Chair: We will get into the substance in a moment. I just want to be clear on the procedure, but at the time you made this remark, you were expecting it to be seen as a personal remark, and obviously it is

for others to judge whether it is consistent with what is being published by the MPC up to this time.

Dr Carney: Yes. I am clear in terms of when I say the MPC's best collective judgment or when I make a statement, I make that distinction.

Q43 Chair: Okay. Mr McCafferty, this "move markets", were you consulted?

Ian McCafferty: Yes.

Q44 Chair: Do you feel you should have been consulted?

Ian McCafferty: Yes. We had a very full discussion during the course of the early June MPC round, before the speech, about the state of markets and the state of the economy and it was also my view that there is more uncertainty about the timing of the first rate rise than was indicated by some of the market statistics. As we discussed earlier, there is still a great deal of uncertainty, not least because of some of the big issues such as how fast productivity will recover. It was clear from the market data at the time of our early June meeting that the probability of a rate rise before the end of 2014 was only 15%. I personally felt that was rather too low, given the inherent uncertainty about where the economy might go over the second half of the year.

Q45 Chair: There is some merit in members of the MPC, all members, making clear whether they are talking in a personal capacity or not perhaps.

Professor Miles, is there anything you want to add on the procedure by which this market moving event took place? You may have nothing, but if you do, please enlighten me.

Professor Miles: I thought it was clear that it was the Governor's speech and the Governor was speaking as an individual, rather than giving a collective judgment.

Chair: Okay, that is fine. We will move on to the substance now.

Q46 Jesse Norman: Thank you, Chairman. Governor, do you think that market moving views like this are better expressed formally in the MPC minutes and the Inflation Report or do you think it is better for them to be expressed via obiter dicta of the kind that you have described?

Dr Carney: There is a variety of communication vehicles that the MPC uses, from Inflation Reports to statements on occasion around meetings, the minutes and individual speeches and at various times at various junctures, any of those vehicles—and there is evidence in all cases—any of those vehicles can have market-moving implications or not. It is sometimes a product, particularly in short-dated markets, short-term sterling markets, sometimes the product of how markets are positioned, the extent to which markets adjust to a statement that comes out through any of the vehicles, so there is no one best vehicle.

Q47 Jesse Norman: It is entirely appropriate, from your point of view, to be able to use the Governor's speech, speaking in a personal

capacity, to move the market or to say things that could move the markets?

Dr Carney: I have been a G7 Governor for seven years and I would be surprised if that were not the case. That has always been the case.

Q48 Jesse Norman: Sure, I understand. So you foresaw the reaction of there being the tightening that there was as a result—

Dr Carney: The observation was that the adjustment in rates could come sooner, and that observation was motivated by analysis presented to us, a discussion among the MPC that observed that despite the run of data and despite the other communications, the market expectations of when the first rate adjustment might happen had been relatively invariant, had been relatively constant over a period of time. Now, I will hand back to you, but I just want to re-emphasise: what we have emphasised as a committee and as individuals is that we understand the speculation around when the first rate move might be. What is most important, in our view, for achieving the inflation target and for businesses making investments and for households making major decisions, is the medium-term path of interest rates, and in our view, that is likely to be a limited and gradual adjustment.

Q49 Jesse Norman: But the point is, as Mr McCafferty said, essentially there was a view in the MPC that the market had not properly understood your view or expectations, and therefore you were trying to bring them forward slightly in your speech.

Dr Carney: Really what we are trying to do, I will make it absolutely clear, is that we would like to see the market adjust to the data, just as our opinions are updated, and there are across—

Q50 Jesse Norman: They had not adjusted and you were trying to get them to adjust, that was the point of your speech?

Dr Carney: We were surprised that it had not. There were many other items in the speech, but that was one of the points.

Q51 Jesse Norman: Okay. So you intended the speech to shift market expectations and you also intended the slight tightening that occurred as a result of that?

Dr Carney: A short-term market for expectations of a bank rate that moves around with the data, whether it is stronger activity or evidence of higher spare capacity, is a healthy thing. Volatility—

Q52 Jesse Norman: But that is all I am saying: the data is changing and you wanted the market to tighten slightly to reflect the data?

Dr Carney: Yes, and if the data changes again, as it undoubtedly will, we would expect the market to adjust to it.

Q53 Jesse Norman: Sure. But it was an intended consequence is what you are saying?

Dr Carney: Absolutely.

Q54 Jesse Norman: Okay, that is helpful. Do you think that in general it has been a positive development in the last 15 years in monetary policy that we have moved away from a framework of discretion towards one of rules in monetary policy? Is that a generally positive development?

Dr Carney: I would say the evidence of the last six years has been it has been very fortunate that the MPC, prior to my arrival, did not follow a simple monetary rule. If they had followed a Taylor rule, for example, there would not have been the large adjustments in interest rates and the substantial other measures that were taken to provide necessary stimulus to lessen the impact of the recession.

Q55 Jesse Norman: In other words, the discretion the MPC has exercised has been a valuable one; that is the point you are making. This seems to me potentially a return to the old-fashioned smoke and mirrors, because what you have if you look at just what has happened today, if interest rates are supposed to be determined in this very direct way by data, then as soon as the data changes, the MPC's view changes, you make a speech and the monetary policy changes. How can that be a sustainable piece of monetary policy?

Dr Carney: We are grounded first and foremost in achieving the inflation target. That is the remit given to us by Parliament and we are resolute in conducting monetary policy to achieve the 2% inflation target while supporting a durable expansion, first and foremost. Secondly, our view is, as we sit here today, there is room for additional spare capacity to be used up further before we move rates, but we will see the evolution in the economy. Thirdly, we have provided guidance, something we had not done in the past, of the likely medium-term path of interest rates, limited and gradual. We have provided guidance, which was augmented in the May Inflation Report on asset sales, on our approach to asset sales. We have also provided guidance consistently about the interplay between monetary policy and macroprudential policy, with monetary policy being the last line of defence against—

Q56 Jesse Norman: Okay. I have a question for Sir Charlie, if I may. By the way, just for the record, I do not regard that as a disagreement with the position I have outlined, Governor. Sir Charlie, first of all, let me associate myself with the remarks made earlier by the Chair about your status as an adornment of our public services. Thank you.

Sir Charles Bean: Thank you very much.

Q57 **Jesse Norman:** What was your view of the Governor's remarks in the Mansion House speech? Do you think they were advisable? Do you think it was a sensible idea to make these obiter dicta as a way of reflecting monetary policy quite so—

Sir Charles Bean: I am not going to comment on whether they are advisable or not. The Governor is entitled to say whatever he likes in his speeches, as are all members of the committee. The one thing I do want to stress—

Q58 **Jesse Norman:** Would you have done it if you had been in that position, Charlie, put it that way?

Chair: What was the one thing you were going to say?

Sir Charles Bean: The one thing I was going to say is that the analysis, if you like, behind the sentence that got so much attention was something that had had quite a lot of attention in our internal discussions at the MPC meeting and so forth. We were all struck by the high degree of certainty that market participants seemed to have about the timing of the first increase in interest rates. This is not about the expected date; it is about the degree of precision that they seemed—

Jesse Norman: I am really asking about the advisability of the intervention rather than the content that you are describing.

Chair: Can we have an answer to that?

Sir Charles Bean: Just let me extend this. There is a general point at the moment, I think, which market participants in our view underestimate the extent of uncertainty that is out there. Implied volatilities on a range of assets seem to be unusually compressed. They are below pre-crisis averages and that does not reflect the degree of uncertainty there is—geopolitical risks, economic risks and so forth. Putting into the public domain the fact that there is that uncertainty about the environment, which has an immediate carry across to monetary policy decisions, I think was important to do.

Q59 **Chair:** Okay. In this MPC meeting, was there unanimity on that point?

Sir Charles Bean: I think we all thought it was a puzzle why—

Chair: But there was?

Sir Charles Bean: Yes.

Q60 **Chair:** In that case, why didn't the MPC decide to make its own statement?

Sir Charles Bean: Well, I do not think it was so significant a thing that we would think, "Oh, we must put out a statement to say that this one particular feature of the world needs correcting" but it seemed perfectly reasonable to me as part of the narrative of monetary policy for the Governor to make the remark he did.

Q61 **Chair:** Why have markets misinterpreted the public data?

Sir Charles Bean: If I can put it in technical terms, it is about the second moment, not the first moment of the distribution. It is about the degree of certainty that they hold. It is a subtle message, but that is the answer. Market participants underestimate the uncertainty of the environment that they and we are operating in and that has—

Chair: Well, they can have the benefit of your advice from the outside to help them with these subtleties shortly, Sir Charlie.

Q62 **Mr McFadden:** I would like to begin on this point about unanimity. Governor, if we could go back to the initial Forward Guidance issued by the Bank shortly after you took up your post last summer, can you remind the Committee: was the MPC unanimous at that time in its view that the time of the first increase in interest rates was likely to be 2016?

Dr Carney: There is a very important distinction here. The committee adopted the first phase of Forward Guidance, which was a state-contingent Forward Guidance. In other words, plain language, it meant that we were not even going to begin to think about raising interest rates until we saw the unemployment rate get to 7%. That was not couched in terms of time but in terms of an outcome in the economy.

In terms of unanimity on the committee at that time, there was one member of the committee, Martin Weale, who had a different view from the rest of us about the appropriate level of the so-called inflation knockout and dissented on that basis and made it clear. He subsequently made it clear that he would manage his decisions in the context of the Forward Guidance adopted by the committee, which is what he did.

Just to re-emphasise, what the committee adopted in August was state contingent. It was focused on an outcome in the economy and it was, in our view, an easy decision. In other words, there was not a prospect, absent some extreme tail event, of needing to raise interest rates until we saw the unemployment rate get down to 7%, at which point we would re-evaluate.

Q63 **Mr McFadden:** There was no date mentioned? Where did people get the idea of 2016?

Dr Carney: Where people got that is we provided at that time our best estimate of the path of unemployment given the path of the economy, and we were obviously wrong.

Q64 **Mr McFadden:** So there was a date?

Dr Carney: No, there was a forecast. We provided a forecast of unemployment with a very wide confidence band around it. With the wisdom of hindsight, what we got wrong there, and you are always going to get things wrong in the forecast, we were at the upper end of expectations for growth. We were more right than most on growth, the strength of the economy, but we expected productivity growth to pick up much more rapidly than it has and, in fact, has added in some respects to the productivity puzzle. The consequence of

that has been a welcome increase in employment but it meant that the unemployment threshold was breached in February of this year.

Q65 **Mr McFadden:** Okay. Where we are now with the Mansion House speech is a very significant change in timing expectations since last summer. You know the quoted sentence, "It could happen sooner than markets currently expect and markets are currently expecting quarter 1 or 2, 2015". Your latest forecast or latest signal is that it could be even sooner than 2015. Is that a fair summary?

Dr Carney: The timing of it will be determined by the data and I think we have got across the point to the market to watch the evolution of the data closely. We will see those market expectations move around as the data moves around. The economy, the labour market, has performed better than expected. There is less spare capacity in the economy than we had expected in August of last year, largely for good reasons. I would just refer back to my previous answers of what we are trying to balance in terms of our current view of the momentum in the economy, the likelihood that that will be maintained, versus some indications to some of us that there may be more spare capacity than we would have previously thought, albeit that that spare capacity is being used up as the economy progresses.

Q66 **Mr McFadden:** The purpose of guidance is to achieve clarity of expectations among households and consumers. If you take collectively the statements made by the Bank over the last year, do you think clarity of expectations has been achieved?

Dr Carney: I have in the last year personally—colleagues would have done the same—been out and visited 1,000 businesses across the United Kingdom. The messages of Forward Guidance have been very clearly received. Forward Guidance 1 was absolutely clear to businesses. We provided—you do not have to take my word for it—survey evidence conducted by agents, surveys by private sector firms that have confirmed that, and it has had consequences. It has had positive consequences for hiring and investment according to the firms not just that I have met but that have been surveyed.

In terms of Forward Guidance, the current guidance we are giving is to focus attention on what really will matter for businesses and households over the medium term. If you are taking out a mortgage, what matters? Does it matter the teaser rate you get today or where bank rate and potentially mortgage interest rates are going to be in the medium term? If you are making an investment, is it the rate today or is it where interest rates are going to be in the medium term, recognising that half of business borrowing is floating rate and another 25% gets repriced every year? In other words, it is the medium term that matters for the viability and we are giving our best collective judgment that as the economy progresses the time to normalise interest rates is edging closer. It is coming closer, but what is most relevant is, in our view, that those adjustments will be to a level of interest rates through a gradual process that is likely to be materially lower than historic averages.

Q67 **Mr McFadden:** In terms of this point about clarity of expectations, you say you think you have achieved that. We have had a

lot of different signals. We have had a signal that rates probably would not rise until 2016. We have then had a market expectation that rates would go up in 2015. We then got a speech saying now that might be an underestimation. It strikes me that the Bank is behaving a bit like an unreliable boyfriend, one day hot, one day cold, and the people on the other side of the message are left not really knowing where they stand.

Dr Carney: Mr McFadden, what has happened with guidance is that particularly businesses understood the first phase of guidance and acted on it. Many of them acted on it with hiring and investment. That reinforced the strength of the recovery and the balance of the recovery. It is not the only factor but it reinforced other factors and has given us momentum and, in fact, more momentum than we would have thought in August. The second phase is looking towards the medium term because we do need—obviously, we all want—a durable recovery. We do not want business decisions taken today, personal decisions taken today, borrowing decisions for investment or for housing or for consumption, that are based on expectations of interest rates that are unlikely to transpire.

Now, one danger is that people assume, having lived through six years of interest rates at their rock bottom level, that they are never going to go up. We have to dispel that and I think that is understood. The other extreme is that people assume that they are going to go up to historic levels and historic rates. Go back to the markets. Currently, the expectations in markets is that the pace of interest rate increases on a quarterly basis are about half the rate of previous tightening cycles in the UK and less than half the rate of the previous tightening cycles in the US, for example. The market expectation is that over the medium term interest rates will go to levels that are about half of historic averages. With that speech, the one thing that did not change was either of those expectations. Limited and gradual has gotten through to the market. Limited and gradual, when I go around this country and meet businesses—and I will be in Northern Ireland on Friday and do the same thing—they understand that and they can make decisions on that.

Chair: We have had quite a bit of Forward Guidance and not always the same in the last 18 months, to put it mildly.

Q68 **Mark Garnier:** Governor, I want to carry on with interest rates but can I ask a purely hypothetical question of you first? You said in your speech, "To be clear, the Bank does not target asset price inflation in general or house prices in particular". My question is this: had asset prices or house prices been included in inflation targeting prior to the crisis, do you think the crisis might have been averted and the house pricing asset bubble would not have been created?

Dr Carney: I do not think so to the same extent. I think it would have been a mistake purely including asset prices or house prices in the CPI.

Mark Garnier: Housing costs?

Dr Carney: Well, user costs of housing would have helped in terms of a fairer representation of what we all consume as individuals. It is a fair representation of that and we know the ONS has developed a CPI measure that may address that. When I look to causes of the crisis, the causes of the crisis on the public side more have to do with failures

of regulation and absence of macroprudential policy. I would start with failures of regulation and supervision and absence of macroprudential policy. It is those policies that would have needed to be used. I apologise; if you want to pursue it I would slightly defer to Sir Charlie, who has experience during this period of inflation targeting, having house price rapid movements and the limited ability, at least in my estimation, to use monetary policy to address a financial stability risk while simultaneously meeting the core remit of Parliament.

Q69 **Mark Garnier:** Just to finish off on that particular point, you reckon the Financial Policy Committee is there to deal with the macroprudential policy?

Dr Carney: That is the remit of the FPC, yes, to promote financial stability.

Q70 **Mark Garnier:** That is fantastic, thank you very much. Back to interest rates, there is talk about interest rates going up. There have been a number of predictions about what might happen to households and we have talked about this in the past. The OBR, interestingly, have come up with one comment where they say if mortgages were to rise by 250 basis points by Q1, 2019, in line with the central assumption for the bank rate, "The effect on borrowers could be more significant, with 24% of mortgagors changing behaviour." However, the OBR makes a huge assumption that the interest rate spread between the base rate and the mortgage rate is going to narrow as the base rate increases. Are you confident that that is going to happen?

Dr Carney: Let me say two things. First, with respect to the narrowing of that spread, no. There have been a variety of changes to the amount of capital banks need to hold, the amount of liquidity they need to hold. The spread between mortgage rates and base rates was too tight, in my estimation, prior to the crisis. Professor Miles is better suited than I to talk to that specific point.

The second point I would make, though, is that this sensitivity to debt of households, we recognise the sensitivity to rising interest rates given the indebtedness position of households, and that is one of the reasons why we think that the path of interest rates is likely to be limited and gradual. If it were significant and rapid, the impact would be that we would not return the economy to balance. We would not keep inflation at target.

Q71 **Mark Garnier:** This is the baby steps argument, isn't it? You take a little step and see what happens and if everything is okay you take another little step. I am very interested by your answer or the first part of that answer, which is that you are not convinced that the interest rate spread is going to narrow.

Dr Carney: I have not looked at the specific study to which you are referring, but the consequence of that would be larger, obviously, than the 24% of individuals who would have to change their behaviour because their mortgage costs would be higher.

Q72 **Mark Garnier:** This is slightly outside the remit of this hearing, but do you see the FPC would be possibly coming in to try to do something apropos that interest rate spread if there is anything it can do, if there is a significant effect on households?

Dr Carney: Obviously, it being under FPC purdah I cannot comment directly on FPC actions. I would say that, first and foremost, to the extent there are structural changes that we expect to persist over the medium term in the cost of borrowing relative to the risk-free rate, that has implications, particularly if there are sound reasons for it. Banks have to carry more capital because they did not carry enough prior to the crisis, for example. If there are sound reasons for those higher spreads, it is the MPC that has to take that into account in the setting of the risk-free rate such that the economy will operate at full capacity and inflation will remain on target.

Q73 **Mark Garnier:** To carry on the questions that Mr Baker was asking a bit earlier about forbearance, of course, irrespective of the interest rate spread between what the banks are lending and what they are borrowing at, there could be—or, rather, we do not necessarily know how many households are being offered forbearance because at the moment the cost of forbearance to the Bank is just 50 basis points. Clearly, if interest rates go up to, say, 75 basis points, the cost of forbearance for the Bank has now gone up by half as much again. How much work have you done in terms of looking at what is going to happen to those vulnerable households?

Dr Carney: What I would say is within the Bank a lot of work has been done and I would perhaps defer that discussion to the discussion of the Financial Stability review, the FPC session we are having in a few weeks, if I may, because it is an important question but it would be best—

Mark Garnier: But you cannot do it now, that is fine.

Chair: We understand.

Q74 **Mr Ruffley:** Governor, much is made by commentators and some on this Committee about the way in which phase 1 of Forward Guidance has been replaced by phase 2. Isn't it the case that with your opening position, which is that there would be no rate rises until 2016, you were, in fact, giving a boost in confidence to the consumer, the house buyer? Presumably, there are no regrets at all. You should not need to apologise.

Dr Carney: I have no regrets about the implementation of Forward Guidance 1. With respect to the specifics, though, about suggesting—not that you are but that as some have—that it was a specific time, no, it was a state. It was a state of the economy, 7% unemployment; that was the threshold. The point I have made consistently has been we want to see jobs, incomes and spending really growing. We are seeing jobs, we are seeing

spending; we have not yet seen incomes really growing. We expect that to start happening and that would be consistent with a durable expansion.

Q75 **Mr Ruffley:** Could we just go back to the answer you gave to Mr Norman, this Mansion House speech statement that rates would be raised more quickly than markets might expect? You explained very clearly that you are achieving two things. One was that you wanted to correct the market impression that there was only a 15% chance of rates rising this calendar year, I get that, but also you said to Mr Norman that, yes, indeed, it was quite explicit in your thinking that there should be some market monetary tightening as a result of your statement. The fact is that it has taken quite a long time for everyone to understand that. I think people on this Committee only really understood it for the first time today. Lots of people in the press, *The Financial Times*, have different views. I have seen market notes from Goldman Sachs, your old employer, saying they were not quite sure whether it was both, one or neither of those two interpretations. Don't you think there is an argument for making statements like that in an inflation report where it is clear and explicit and very formal so that people do not have to guess? What do you say to that argument?

Dr Carney: Let me make two points if I may. First, just a point of clarification: it was not more quickly but it was sooner.

Mr Ruffley: Sooner.

Dr Carney: Yes, so just, again, limited and gradual persists. In terms of vehicles of communication, can we periodically review how we communicate, the vehicles we use, the balance between the Inflation Report, the minutes, public speeches, the relative merits of a statement, with meetings? Yes, we can. We have a review of one aspect of communication, the aspects of the communication for the medium term. Kevin Warsh is reviewing potential publication of transcripts of the MPC meetings. He will report towards the end of the year and I am sure this Committee will take an interest in what he says. He will also look at whether there are other forms of changes to communication. It is not a comprehensive review but there could potentially be some suggestions that come out of that process. I would personally welcome the views of the Committee. If there is a view that we should make regular statements following MPC meetings that is something I am certainly familiar and comfortable with, but that is a decision for the MPC as a whole.

Q76 **Mr Ruffley:** Thank you. In the May report, we see the news that asset sales would be deferred, "At least until bank rate has reached a level from which it could be cut materially". Is this intended to be an additional phase of Forward Guidance?

Dr Carney: Well, it is guidance with respect to asset sales, as you rightly note. It is consistent with the discussion we had first around this table or a similar table at the TSC prior to that report where we discussed this point, individual views about the merits of using conventional monetary policy—bank rate in other words—as the marginal

instrument of monetary policy going forward. It crystallised that discussion in the Inflation Report.

Q77 **Mr Ruffley:** When you refer to, "Until bank rate has reached a level from which it could be cut materially", presumably that means from greater than 1%?

Dr Carney: My personal view—I do not want to get, if you do not mind—

Mr Ruffley: I am just trying to parse what these words mean.

Dr Carney: Yes, exactly. Not being pinned down on exactly a number, but I would expect it personally to be higher than 1%, yes.

Q78 **Mr Ruffley:** Higher than 1%. My final question is on the market-led tightening, you have made it quite clear that the way you want the outside world to view your intentions is by looking at the data. You will look at the data; the market should look at the data month by month. I totally understand that. But when you make a statement of the kind you did at the Mansion House—there was a market-led monetary tightening—do you measure in the Bank what the effect of that tightening is? You might be looking at currency. You might be looking at the steepness of the yield curve and market rates. How do you quantify what tightening effect that statement made?

Dr Carney: Well, the short answer is yes, we look at a broad range of financial conditions to estimate monetary conditions more broadly. Persistence matters and it is also persistence relative to our expectations. In part, there is a question of where markets were, where volatility was and will be prospectively relative to our expectations. We would expect, all things being equal, that there will be some increase in volatility as interest rates start to normalise. There is a variety of reasons for that. There is a very important technical reason, which is once you start to move off the zero lower bound, the lowest level that interest rates can be, then you have two-sided risk. You start to have two-sided risk on interest rates because they could, again, be lowered if the need presented itself.

Q79 **John Thurso:** Can I come to you, Mr McCafferty, first, just to go back to some remarks you were making earlier? I was very taken by your recent speech and particularly the sectoral analysis on productivity. I quite get the point that it is the relativity and not the absolute nature of the data that is really important to look at. Given we are short of time, could I ask you to encapsulate for me what you think is the real lesson from that work for policymakers going forward?

Ian McCafferty: I think there are a number of lessons. Probably the most important and what I was trying to capture in that speech was to take a look at what the likelihood is of productivity recovering as demand recovers across the economy naturally and semi-automatically. We have had to make an assumption about that in terms of our forecasts. It is a very important element of the forecast in terms of the pace of absorption of slack and

the time period over which the output gap might, therefore, reach closure. The most important element of the speech was to say there is an element of productivity, which is likely to recover naturally and semi-automatically as demand recovers but that is only—

John Thurso: That was the 40%?

Ian McCafferty: That is the 40% of the gap that I identified. It is a slightly different measure using slightly different data than the 16% that the Governor mentioned before. That is relative to implied trends. I have simply looked at an absolute gap between 2007 and 2012, but we come to similar conclusions. Essentially, what that says is that part of it will recover semi-automatically or naturally as demand recovers, but not all of it. That is not to say that it is permanently lost but that it is due to factors that are not specific to the cycle, not specific to the previous weakness in demand, and it may, therefore, recover only more slowly. We, therefore, have to take a cautious view. As I said in the speech, that is what we have already taken within the Inflation Report forecast about quite how fast productivity can be expected to recover.

Q80 **John Thurso:** Two of the observations you made that I saw, one was the relative continuing decline in oil because it is getting more costly; the other was the introduction of regulatory changes in the financial sector, both of which have fairly permanent impact. This clearly is very important work. Will you and the Bank be doing more on this to develop how this can help us going forward?

Ian McCafferty: Certainly, I would hope to, not only personally but also I think the Bank is very closely looking at this subject because I think it is so central to how the economy will behave over the next couple of years. My colleagues on the MPC as well as the Bank staff will continue to look at productivity from all sorts of different angles as a way of trying to reduce the degree of uncertainty that currently exists.

Q81 **John Thurso:** I look forward to returning to that. I am now going to change the subject completely and come to you, Governor, if I may. What is the current thinking on the MPC regarding exit from QE?

Dr Carney: We have detailed in the May report our current thinking. The first is the most simple—the guidance that we put in place in February we have subsequently reaffirmed—which is that we will continue to reinvest all proceeds of the asset purchase facility as they mature at least until the first bank rate increase. For the time being, we are reinvesting, and then we would take a decision subsequent to that and we would provide the clear signals to the market. Secondly, we view conventional monetary policy, as we just discussed, as the marginal instrument initially, so we would look to raise bank rate to such a level from which it could be materially cut if we needed to provide stimulus. That is the second element of the guidance. Then we would look over time to manage the asset purchase facility down to a more appropriate level.

Q82 **John Thurso:** Because we are under time pressure from the Chairman, I am going to encapsulate several questions into one and not go to the particular people who I would like to. It seems that there is a

general view that we have to get out of QE at some point and this is important, yet Professor Miles, in a speech he made recently, observed that when markets are functioning properly the purchase or sale of assets does not have a great deal of impact. Sir Charles or Sir Charlie—which one is it?

Sir Charles Bean: I do not mind.

John Thurso: All right, whatever then—observed that there were potholes and bumps along the way. The question is this: would it be true to say that it is the movement in the stock of assets that is the important thing rather than the quantum of assets held? Therefore, is there an argument to say that having done a great movement to achieve where we are we do not need to do another movement, i.e. an exit, and we could keep that as a weapon when we need to go in the opposite direction at a future stage? In other words, exiting itself may be more of a danger than holding on.

Sir Charles Bean: The first thing I should say is that my potholes remark in the speech referred to the whole process of normalisation of policy. It was not just asset sales; it was also returning interest rates to a more normal level. The fact that the world is uncertain means that there is bound to be bumpiness on that road. It is part of the point I was making earlier about market participants needing to realise that that uncertainty is inevitable.

Now, do you need to unwind the asset purchases? In principle, we could keep the asset purchase facility sitting there. What it is, essentially, is a change in the composition of the liabilities of the state. We have taken out some long-dated debt and replaced it with essentially short-dated debt in the form of bank reserves, which pay our interest rate. You would only start worrying about that set-up if there were signs that the banks having a lot of reserves on their balance sheet was leading them to do something undesirable, in which case you might want to suck them out of the system. One way of doing that, but not the only way, would be selling some of the gilts back into the market.

Chair: Do you have a quick question?

Q83 **John Thurso:** I would just ask the Governor if it is worth the MPC doing some work simply to analyse whether, if it is movement—and you have referred, Charlie, to the temper tantrums and so on—in fact, just holding the status quo for quite a long time may not be a preferable option rather than the received wisdom, which is we have to as quickly as possible get rid of it?

Dr Carney: Well, I can assure the Committee and you, Mr Thurso, that we have been doing this work. We will continue. One of the areas on which Minouche Shafik, the new Deputy Governor Markets, is going to focus is precisely around these issues.

Q84 **Stewart Hosie:** In a similar vein then, Professor Miles, you said in your February speech to the Mile End Group some interesting things

about the Bank's balance sheet. You were speaking about the bonds that had been purchased as a part of QE. You said a number of them could be retained to bank the reserves that banks would demand in the future in relation to leveraging rules in particular. Can you explain what you mean by that a little more and how that might work?

Professor Miles: Yes. On the eve of the financial mess, the commercial banks that held reserves at the Bank of England were holding very small levels of reserves relative to their balance sheets, minuscule in many ways; £25 billion, £30 billion. They are now holding close to £300 billion. It may well be that the commercial banks decide it is prudent for them to hold many more reserves at the Bank of England. If that is what they decide, the overall balance sheet of the Bank of England will stay much larger than it was before the financial mess. There is a question then about—as Charlie was saying—what is the composition of the assets that the Bank of England will hold against much bigger liabilities? It may be that it makes sense to hold quite a substantial part of that in the form of gilts, government bonds, in which case the Bank overall will end up not selling more than some part of the assets that we purchased under QE.

Q85 **Stewart Hosie:** Well, let me ask you about that. I take it there is no practical difference between holding 100 billion of gilts as part of asset purchase, part of QE, and holding the same 100 billion of gilts to back up commercial banks' demand for reserves. I take it there is fundamentally no difference there?

Professor Miles: I think in terms of the economics of it that is probably right. Institutionally, it may get put in a different pot, but the economics of it are as you say.

Q86 **Stewart Hosie:** Which makes it slightly interesting because when QE was first posited to us all, the argument was that it was different from just printing money because that new electronic cash would ultimately be withdrawn from the system. That is what gave us the comfort that it was not going to be hyperinflationary because it was designed to for a purpose and then the cash would be withdrawn. What has changed?

Professor Miles: What has changed is that it may be that the commercial banks decide in their own commercial interest that they want to hold many more reserves. That would not be inflationary because those reserves would be sitting there and it would make sense then to keep the Bank of England balance sheet bigger than it had been before the financial mess.

Q87 **Stewart Hosie:** I understand that that makes sense. There is a final question, because I am conscious of time, to the Governor. Governor, when you were first before us, in answer to the question from David Ruffley, "What does unwinding QE mean?" you said returning the Bank's balance sheet to its pre-crisis position. All the indications now are that that will not be the case, so can I just ask a simple question? Is this a policy change or is it simply a pragmatic tweaking in relation to the Bank's need to hold reserves in relation to new liquidity rules?

Dr Carney: Right. I would remind you, Mr Hosie, members of the Committee, that I was under strict instructions from Mr Ruffley to answer in everyday language in a single sentence and I was under immense time pressure, so that was the shorthand that I used.

I would define, picking up on what colleagues have said, the pre-crisis position as a position that is consistent with the normal course liquidity requirements of the banking system. Obviously, I was not here in the initial discussions that set up the QE, but what has changed to the good in terms of the banking system here is that through regulation and supervision we have put much more responsibility on the banks themselves to hold liquidity to manage liquidity shocks and, as a consequence of that, their demand for reserves in steady state can be expected to be higher. The further consequence of that is that the balance sheet of the Bank of England will be larger than it was prior to the crisis, but it is not there to perform another purpose. It is not there to perform a monetary stimulus purpose, this aspect of unconventional policy. It is not unconventional policy; it is policy to support the effective functioning of the financial system.

Q88 **Stewart Hosie:** It is banking policy as opposed to monetary policy, no change?

Dr Carney: Yes, to simplify. To simplify, yes.

Q89 **Teresa Pearce:** Dr Carney, do you think there is a growing housing crisis in London?

Dr Carney: I am afraid from a monetary policy perspective I have to plead FPC purdah comments about the state of the housing market and potential measures again as a—

Q90 **Teresa Pearce:** As a Londoner, as a person who lives in London?

Dr Carney: Well, I happen to be one of 10 Londoners who is a member of the FPC so that restricts my ability to comment on it. I can comment on the underlying housing outlook that affects the stance of monetary policy.

Q91 **Teresa Pearce:** Okay. Well, would you agree that if there is a growing housing crisis in London it is down to supply and price?

Dr Carney: We would agree that the dynamics in the UK housing market are complicated, very much affected by the limited new supply of housing relative to natural demographic demand.

Q92 **Teresa Pearce:** Okay. I think it was in March when we had a discussion about the London housing market and you said there were two housing markets in London. One part of the housing market was the cash buyer, which the Bank of England has very little tools to do anything about. Do you agree that is what you said then?

Dr Carney: Well, certainly, again from a monetary policy perspective we have none, no tools, and from a financial policy perspective I cannot comment. Well, I should not comment but I think it is evident that—

Q93 **Teresa Pearce:** From a supply point of view, I think you were on Sky Television in May and you talked about the fact that in Canada twice as many houses were built for half the population there is in the UK. You also said, quite rightly, that the Bank of England is not going to build a single house. The Bank of England has very little influence on supply; that is true as well, isn't it?

Dr Carney: That is correct. From a monetary policy perspective, our influence on supply is the price stability and appropriate stance of monetary policy to encourage investment, which at the moment we have stimulative policy to encourage investment. Ultimately, that helps.

Q94 **Teresa Pearce:** In May, when the Prime Minister said the Government has given the Bank of England the duty to make sure that bubbles are dealt with and they have all the powers they need to do that, do you think you have?

Dr Carney: I think that I am going to—

Teresa Pearce: In London, which is different from the rest of the country.

Dr Carney: We have the tools necessary to achieve our inflation target, which is the primary responsibility of the Monetary Policy Committee. The Financial Policy Committee, about which I cannot comment because I am in purdah, has a wide range of tools to address financial stability risks. How they deploy them and the adequacy or inadequacy of those tools would be best discussed in the broader session, if I may.

Chair: Well, you will be back in three weeks.

Dr Carney: Exactly.

Chair: We can have a canter round there.

Teresa Pearce: That is fine.

Q95 **Chair:** Could I ask Sir Charlie, since it is his valedictory appearance, are wages now the most important bellwether of spare capacity?

Sir Charles Bean: No, productivity is.

Q96 **Chair:** There has been no change of emphasis from unemployment to wages?

Sir Charles Bean: No. The underlying key factor that will determine how much the economy can grow will be the extent of the recovery in productivity. That really is the be all and end all and other things follow from that. The primary reason unemployment fell faster than our central expectation when we introduced Forward Guidance a year ago was basically because productivity did not recover. The Governor has talked about the

desirability of seeing pay growth pick up and that would help to sustain consumer spending, but you can only have a sustainable pick-up in pay growth if productivity growth picks up. I would identify that as the really central thing that will determine how fast the economy can grow without generating inflationary pressures.

Q97 **Chair:** Governor, since you came on the scene, indeed prior to your appointment, we have had a discussion in the UK triggered by remarks by you about nominal GDP targeting. We have had Forward Guidance 1. We have had Forward Guidance 2. Then we have had this May's Inflation Report and we have had the Mansion House speech; quite a lot of guidance, Governor, not all of it pointing or seeming to point in the same direction. At the end of this hearing, is there anything you want to add to that description?

Dr Carney: I think we as the MPC have been absolutely consistent in our approach. We have focused monetary policy on achieving the inflation target while securing the recovery. When I first arrived, it was the early stages of the recovery. It was not yet clear whether that recovery would have legs, so we focused Forward Guidance to provide a simple, clear message to businesses and households to help secure that recovery. In my personal opinion, and supported by survey and other evidence, it reinforced, it was not the sole factor, but it reinforced that recovery. Partly as a consequence, we have seen very strong output growth, the fastest growth in the G7, fastest job creation on record, in a manner that maintained inflation expectations well anchored and, as the MPC had rightly seen through past shocks, inflation returned to target and then slightly below.

The subsequent guidance that we have given has focused, in our opinion, my opinion, rightly on the medium term because now as we shift from recovery to expansion that is the most important horizon for businesses and for households. Interest rates are going to start to normalise at some point. We cannot tell you today exactly when that is going to be. It will be affected by the data. It will be determined by the evolution of the economy. We have to watch the data for when that comes, but the first interest rate increase is not the most important thing. It is where the path of interest rates are set over the medium term. Our best judgment is that the increases in rates are likely to be limited relative to history and the process is likely to be gradual in order to ensure that what has now been a successful recovery is turned into a durable and balanced expansion. That is the guidance we have given and that, in our opinion, my opinion, has helped support outcomes—helped support; not solely responsible by any stretch of the imagination—that have been the strongest in the G7 over the course of the last year.

Q98 **Chair:** Given that historically we have often looked at inflation targeting on a two-year view, when you talk about the medium term, are you talking about a longer period and, if so, what?

Dr Carney: Yes. Our view in terms of where interest rates are going to settle out, if you look out to a three-year horizon, my personal view is they will still be materially below historic averages—that is materially below the 5% historic average—because there are huge forces that are still operating on this economy, from the weakness in Europe, the repair of public balance sheets, the weight of debt on private households, and the changing

financial system, as the discussion with Mr Garnier noted, in terms of the changes, for one example, on mortgage spreads. All those factors will influence the medium-term level of interest rates. Our job is to take into account those factors, set bank rate today and tomorrow and in the medium term on a path that is consistent with achieving the inflation target and a durable expansion.

Q99 **Chair:** In our first hearing with you after the Mansion House speech, which certainly was perceived to contain some news or which the markets interpreted as news on monetary policy, I am sure it is well understood that our questions have focused on what you said. Before we finish, I just wanted to check whether there is anything that Mr McCafferty or Professor Miles came here thinking ought to be put into the public domain.

Professor Miles: Can I say something very briefly about Forward Guidance? It seemed to me, and it stills seems to me, that the main purpose of Forward Guidance, was to head off the risks. When we saw some clear signs of a more sustainable recovery and GDP looked like it was growing at maybe 3%, maybe a bit more than 3%, a year, there was a risk that that would trigger a sharp increase in the yield curve because people might expect that monetary policy would get back to normal quite quickly, and normal might have been a view that interest rates were 5%. I think what Forward Guidance has done is allowed the recovery to get under way to build up some head of steam without that risk playing out of medium term two, three, four, five-year interest rates moving up quite sharply. That is the big aim of Forward Guidance and I think it has been quite successful. The noise around whether people think the first interest rate rise will come in December or February or March is, I think, largely noise.

Ian McCafferty: I would just add—

Q100 **Chair:** I will come on to you in just a moment. You began that by saying the main purpose of Forward Guidance "was", but you still think it has a purpose?

Professor Miles: Well, was and remains. The risk of that happening has become much reduced because the message has got across. I think that was a real risk.

Q101 **Chair:** A diminished need for Forward Guidance but some residual need for Forward Guidance, is that what you are saying?

Professor Miles: Yes, you could put it like that.

Chair: Okay.

Ian McCafferty: I would just add one small point, which is that it is human nature to always crave certainty. Unfortunately, the economy is inherently an uncertain place and, as such, we have always couched guidance in terms of the evolution of the economy and have avoided calendar dates. It is, I think, an unfortunate element of the interpretation of what we try to do that people continually pin dates on when interest rates will change.

Q102 **Chair:** Sir Charlie, this is your last opportunity in a formal capacity to address us. Is there anything you would like to add?

Sir Charles Bean: Well, I can only endorse what my two colleagues have said.

Chair: As you have been doing for some years.

Sir Charles Bean: I think they put it very well what the big point of Forward Guidance was. It was to be clear about the nature of our reaction function and that we were not going to be raising interest rates simply because growth had come back and that that guidance was state contingent. People keep on saying we said that we would not think about raising interest rates until 2016. We never said that and it is a misrepresentation of what the guidance was and is.

Q103 **Chair:** Thank you very much, all four of you, for giving evidence this morning. We have run to time and we look forward to seeing you in three weeks' time, Governor, with a different cast and a different subject.

Dr Carney: Different subject, thank you.