



Treasury Committee

Oral evidence: Bank of England February 2015 Inflation Report, HC 1056

Tuesday 24 February 2015

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Written evidence from witnesses:

- [Martin Weale's Annual Report to the Treasury Committee](#)

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Members present: Mr Andrew Tyrie MP (Chair), Rushanara Ali, Steve Baker, Mark Garnier, Stewart Hosie, Mike Kane, Mr Andrew Love, John Mann, Jesse Norman, David Ruffley, Alok Sharma, John Thurso

Questions 1-84

Witnesses: **Dr Mark Carney**, Governor, **Dr Ben Broadbent**, Deputy Governor, Monetary Policy, **Professor David Miles**, and **Dr Martin Weale**, Members, Monetary Policy Committee, Bank of England, gave evidence.

Q1 Chair: Good morning, Governor and fellow members of the MPC. Thank you very much for coming to give evidence to us this morning. We have quite a lot to get through, so I think we should get under way. Like the weather, the eurozone crisis seems to have come back and, just like the weather, too, rather changeable day by day. How serious a problem is this for the UK economy and for conduct of monetary policy?

Dr Carney: Chair, it is a serious issue. It is our largest trading partner and largest investment destination. The challenges that are currently facing Greece are material for the Greek economy. The Greek economy itself is not that important for UK exporters. The exposure of the UK financial system is quite small to the Greek economy. For example, for the major UK banks, the exposures are less than 2% of common equity.

Chair: Yes, but it is a contagious crisis.

Dr Carney: The issues are more about other channels of contagion, not direct channels of contagion, as you indicate: implications for confidence in the eurozone as a whole; potential financial market contagion.

The situation today is quite different than it was in 2012, the last time the weather or the eurozone crisis was with us, in that there are quite distinct differences in the track records of the other so-called peripheral economies. Ireland, Portugal and Spain have superior track records in terms of performance relative to Greece. They are off programme. Secondly, the

toolkit of the ECB has been enhanced, both with quantitative easing and with open market transactions. There is a demonstrated willingness of the ECB to use those tools, in fact a unanimity of the ECB with respect to quantitative easing, so that makes a difference as well. In addition, the exposure of the private sector as a whole—I am not talking about the UK private sector but the private sector as a whole—to Greece has been substantially reduced. For example, for sovereign exposures, only 20% of that exposure to the Greek sovereign is to the private sector.

There are a number of differences, but personally and as a committee we would not downplay the risks. There are risks there. If there were to be a disorderly exit of Greece, we would expect that that would have ramifications for asset prices more broadly and potentially for confidence. Then those improvements in the institutional structure in the euro area would need to be used to reduce that.

Q2 Chair: You have talked about a disorderly exit. Can the Greek economy recover at current exchange rates?

Dr Carney: Yes. The question is the strength of the recovery and that will be a product not least in terms of how diligently and comprehensively and quickly the Greek authorities implement the reform package that they are in the process of agreeing with the European authorities.

Q3 Chair: Other colleagues might come back to Greece in a moment; it is an important issue. A key document in front of us today is the Inflation Report. The first question I ought to ask you is how long we have to run with current policy before you decide that it needs to be called the deflation report. How serious is it that we are now running into a period, at least, where we are going to have prices falling? Do you think we should think of being below target as exactly symmetrical with being above target in potential level of harm?

Dr Carney: Let me start with your last point, which is the treatment of the target. It is absolutely symmetric. We care as much about inflation being below the target as we do about having inflation above the target. In treating deviations from target, we have to take an assessment of the nature of the shock—why is inflation below target, in this case—and the time horizon over which to bring inflation back to target.

The predominant cause of inflation being as low as it is, 0.3% on its most recent reading, are food and energy prices, principally energy prices. In fact, it was two-thirds at the time when I wrote the letter to the Chancellor and we published the Inflation Report, and the most recent reading is that three-quarters of the movement relative to target is caused by food and energy prices. Those are one-off price changes, a one-time fall in the oil price—one of the largest falls in the last half century—being the principal driver.

We have to make a choice, but we have the ability, as you know, to look through deviations from target, whether above or below. The committee, prior to my arrival, looked through a series of one-off shocks when inflation was above, rightly so in my judgment—I did not take those judgments, but rightly so in my judgment—in order to not cause undue

volatility in output; said differently, to not cause excessive increases in unemployment at a time when the economy was very slow.

We are in a situation today where we have these one-off moves in oil prices—energy prices more broadly—and food prices that are principally driving inflation down and will likely bring it further down towards zero and possibly below zero. We can look through that provided that we do not see signs, more generalised signs, of disinflation or deflation.

Q4 Chair: What are the key indicators? Wages? Savings?

Dr Carney: Given that we have an inflation target, the first thing we will look at is the components of inflation, so we look at the various diffusion indices. An important point is when we look at the CPI components today—and it is embedded in the letter—on a weighted basis it is exactly the same proportion of components that are above zero, so have positive inflation, as was the case during the period of 1997 to 2007, the period at which inflation was broadly at the 2% target.

We look at diffusion indices. We will look at wages and other principal causes of inflation. As you are aware, as the committee is aware, at present average weekly earnings are growing, so real incomes are growing more strong in this case.

The other suite of indicators that we are very vigilant at looking at is estimates of inflation expectations, both survey estimates and market estimates. The conclusion of the committee with respect to the last—

Chair: Or in this case deflationary expectations.

Dr Carney: In the short term, yes, but in the medium term and over the relevant policy horizon, the expectations are for positive inflation. The conclusion of the committee, which I share, is that those expectations are broadly consistent with the 2% inflation target. But we will continue to be vigilant in monitoring those indicators because those are the type of indicators that—

Q5 Chair: I want to bring in the externals at this point to see if they have anything they want to add to this. Professor Miles?

Professor Miles: I think the expectation story is one where over the next year expectations clearly are low. Our own expectation on the Monetary Policy Committee is that inflation is pretty close to zero for much of this year. Beyond that, households and companies and financial market expectations of inflation look to me pretty consistent with inflation moving back to the target level. They do not seem to me to be pointing to an expectation of ongoing deflation at all.

Q6 Chair: Dr Weale, there is not much talk in the Inflation Report about the effect of a period of deflation on consumer behaviour and, in particular, consumers deciding to save to buy the same goods next year and, therefore, for there to be a pickup in the savings ratio. The

central forecast, in fact, is for some modest fall in the savings ratio and for it to be considerably below where it was in the average of the previous 10 years. Are you happy with that assessment of savings?

Dr Weale: Yes, I am broadly happy with that. I think that at least the evidence I have seen suggests that the behaviour of quite a lot of people is influenced by money interest rates at least as much as real interest rates. What people are seeing at the moment is that their cash outgoings are going down rather than up and their feeling is that this is giving them a bit more money to spend. So I think the cash-flow effects are quite important. More generally, the sort of example I give is: were there many people who put off visiting friends and relatives at Christmas because the petrol was going to be cheaper in January or they thought it might be cheaper in January? I do not think we see much evidence of that.

Q7 Chair: It is the wrong sort of price falls to pick up that effect—is that what you are saying?

Dr Weale: Yes, indeed.

Chair: It is not white goods, it is petrol.

Dr Weale: No, but even with white goods there has been a long-term tendency of white goods to become cheaper and improve in quality and so on. We notice that all the time, but people go on buying them.

Q8 Jesse Norman: Welcome, Governor. I have a couple of earlier quick questions if I might. Governor, can I ask if you have viewed the video of the Grabiner testimony to us?

Dr Carney: No, I have not.

Jesse Norman: You have not viewed it. Thank you for that.

Chair: I should explain for members of the public that we are having a session on this next week so we will be looking at it in more detail then, and you will be coming together with the Chairman of Court.

Q9 Jesse Norman: Perhaps I could request that you look at it before our next meeting, Governor. In the Bank's guide to your employment it says, "We aim to be courteous in our personal relations, both externally and internally". In particular, "You, the employee, are: expected to perform your duties diligently and punctually; to behave to the public and your colleagues with courtesy and consideration". Do you think, based on a reading of the transcript, if you have not yet seen the video, Governor, that Lord Grabiner's testimony to us was up to the standards of the behaviour expected of the Bank or do you think it fell below it?

Dr Carney: Lord Grabiner was contracted by the Oversight Committee of the Court. Lord Grabiner is not an employee of the Bank of England. I would stress again, as I pointed out in my letter to you, Mr Norman, that Lord Grabiner has been contracted by the

independent directors of Court, chaired by the Chair of Court, Anthony Habgood. That is the arrangement, so I am now answering as a member of Court but not as a member of the Oversight Committee. I think it is important that we make that distinction—given the amount of time and thoughtfulness and effort that this Committee has spent on the governance of the Bank, that we are clear about how the governance arrangements have been put into place and how independent investigations have been conducted.

With that context, with the second point of context being that Lord Grabiner was contracted by the Oversight Committee—he is not an employee of the Bank of England—I am not going to venture an opinion on his conduct.

Chair: You had a second question, Mr Norman.

Q10 Jesse Norman: I did. So you do not think that the Bank’s standards of behaviour should extend to its public contractors, those making enquiries into it? That is what you have said.

Dr Carney: That is not what I said. I said I was not going to venture a judgment.

Jesse Norman: You have a private opinion but not one you are going to share with the Committee?

Dr Carney: I do not have a fully formed view. As I noted, I have not viewed the video, as you pointed out. In part, as I should add, Mr Norman, in that we are having a session on this next week.

Q11 Jesse Norman: I have a final question, which is has Lord Grabiner apologised to you or any other member of Court for his behaviour in front of us?

Dr Carney: He has not apologised to me. I have not asked for an apology from him and I do not know what he has said to other members of Court.

Q12 Jesse Norman: Thank you very much, Governor, for those comments. In your speech in Dublin recently, you said that the eurozone needed a plan that, “Should include what every other successful currency union has at its heart: mechanisms to share fiscal sovereignty”. Central bankers normally think about monetary policy rather than fiscal policy, so I am wondering why it was you chose to make public comments, possibly criticisms, of eurozone Governments on matters of fiscal policy.

Dr Carney: Part of the answer to that question is the first question of the Chairman of this Committee, which is that it is relevant to the British economy, the developments in the eurozone. As I said, it is our largest investment destination; it is our largest trading partner. Clearly, the judgment, including the judgment of the President of the European Central Bank, is that European monetary union is “unfinished”. The question is what is necessary to finish that monetary union. My comments in Dublin were anchored in that, answering that question, and also answering it in light of the experience in this monetary union,

issues that we have discussed at this Committee over the course of the last year and a half with respect to sterling monetary union.

The basic point is that it is necessary to have both private and public risk-sharing mechanisms. A banking union, the effort that has been the focus of European authorities for the last several years, is very welcome. A capital markets union, which is the new focus, is also welcome and also necessary, something that will extend across the European Union, so something the UK will benefit from and we can inform. Lastly, making the point that it is necessary also to have some form of public risk-sharing, as is the case in other successful currency unions, which brings into the fold fiscal arrangements.

Now, to be absolutely clear, my conclusions, or my arguments in that speech and the conclusions in the speech, relate to the structure of fiscal policy, the structure of monetary union, and they are also conclusions that were the conclusions of the President of the European Central Bank, the President of the European Council, the President of the European Commission and the President of the Eurogroup, as demonstrated in the four-president report, which I quote in that speech.

Q13 Jesse Norman: You said in your Inflation Report press conference that you had had discussions with counterparts, obviously possibly some of the people you have just mentioned, prior to the speech and subsequently to it, both in central banks and ministries. You have said they were supportive. Were there any countries or institutions that were keen for you to speak out on this issue from outside the eurozone as you are?

Dr Carney: The short answer is yes, but I am not going to go into which ones.

Q14 Jesse Norman: I understand. That is very helpful. So there was a feeling that it would be a constructive contribution to the debate for you to flag to eurozone Governments the importance of sharing fiscal sovereignty and risk-sharing of the kind you have described?

Dr Carney: Yes, and I would say that I have received no comment to the contrary from any European authority since the speech.

Jesse Norman: That is extremely helpful. I do not have any further questions.

Q15 Mike Kane: Good morning, Governor and committee. Given that in the autumn statement the Chancellor welcomed lower inflation, and given that it was below target, were you surprised by his statement?

Dr Carney: The Chancellor can speak for himself. From our perspective, what we have been at pains to stress is the causes of that very low inflation, and I will just refer back to my previous answer with respect to the predominant causes being movements in food and energy prices. We have also been keen to stress that that is temporary. It is a one-off development. As these move through the inflation numbers, they will dissipate after a year. Thirdly, we have been at pains to stress that we will do our job, our job as the MPC, which is to bring inflation back to the 2% inflation target, that we will do so in a

reasonable horizon. The unanimous judgment of the committee was that that horizon, given the nature of the shocks that are hitting the economy at present, should be within the next two years, and that we not only have the responsibility to do that—we have now provided the clarity about the time horizon—we also have the means and very much the will in order to do that. We recognise that this is a temporary situation and we will look to bring inflation back to target promptly.

Q16 Mike Kane: But in terms of the MPC's efforts to anchor inflation expectations, haven't the politicians, when they make statements like that, altered the goalposts on the Bank and the Monetary Policy Committee?

Dr Carney: I would note that our remit was confirmed within the past several weeks; the remit confirmed a 2% inflation target. I appreciate the line of questioning because what is important is that workers and businesses and people in general understand that this is a temporary phenomenon. Yes, it does mean more purchasing power at the moment. Yes, it will provide some support for the economy as a consequence of that, but at the same time the MPC will conduct policy in order to bring inflation back to target promptly, as I say, within two years. That should inform people, particularly as they are forming judgments about appropriate wages in this economy.

Q17 Mike Kane: Did any of the members of the MPC raise with you what the Chancellor said in his autumn statement, or do any of the members have concerns when politicians do not reflect the target that has been set?

Dr Weale: I think the key point is that, as the Governor said, what everyone is welcoming is that real incomes are rising. That is, in part, a consequence of much lower oil prices, but it is the increase in real incomes that is good news for everyone.

Mike Kane: Any other views?

Professor Miles: What would be worrisome is if there were signs that inflation expectations of households and companies were building in an expectation of extremely low inflation, well beneath the target level, for many years into the future. But that really is not the situation as far as I can see.

Q18 Mike Kane: Governor, you are Canadian. If I can use an American analogy in terms of some insider baseball here, were any of the other members involved in writing the letter to the Chancellor after inflation had fallen below 1%?

Dr Carney: Yes, we went through several drafts of the letter. All members commented on the letter and members knew the contents of the letter prior to its being signed and sent to the Chancellor. It is paramount that the letter is consistent with the Inflation Report, with the MPC's forecast and its expectations and judgments around the appropriate time horizon to bring inflation back to target.

Q19 Mike Kane: Can I just ask a quick question of follow-up, Dr Carney, from last time? We talked slightly, if you recall, about our exposure to the situation in Ukraine and you were saying the banks' exposure was not that great. I am still quite worried. I met a major manufacturer in my constituency yesterday who has tens of millions tied up there and they feel quite exposed to the situation. Do you think it has deteriorated or got better in the time since you were last in front of us?

Dr Carney: Obviously it is fast-moving—the circumstances on the ground. The geopolitics overshadowed the economics at this stage. There are tentative positive developments in terms of the ceasefire that has been agreed. The scale of the IMF programme is also a positive development since we last met. But the economic situation in Ukraine and the economic situation in Russia, to which a number of—there will be individual companies who have exposure and we also have indirect exposure through other economies to Russia. The Russian economy is in recession and will be in a relatively deep recession this year, in part as a consequence of the hostilities.

Q20 Stewart Hosie: Professor Miles, in your speech recently, “What can monetary policy do?” you argued that in the UK the Government have accepted that any fiscal consequences of the setting of monetary policy to hit the inflation target are something they will need to adjust to. Isn't it a legitimate concern that when the time comes—and it may be some time in the future—to unwind QE, that acceptance you talk about will be lost?

Professor Miles: I don't think so. I think whatever the fiscal implications of the QE operation are, which to date have been net positive in the sense that we have earned more income on the assets than the cost of the funding, which is linked to Bank Rate, but whatever the long-run implications are, they will flow through to the fiscal balance and will feed into the overall fiscal strategy, whatever that is, of a future Government.

Q21 Stewart Hosie: So you have little or no concerns that if the Government take a decision to unwind QE, we would still learn the lessons and accept there would be fiscal consequences, whatever they may be?

Professor Miles: There will be fiscal consequences. It is a bit hard to judge at the moment whether they are net positive or negative over the long term. It will depend what the situation is at the end of the operation when you have unwound it all. It may well be—this is another part of the speech, actually—that the Bank of England's balance sheet will remain much larger well into the future. So it is not obvious that the great majority of the gilts that have been bought by the Bank of England end up being sold, even when you have got back to a neutral monetary policy.

Q22 Stewart Hosie: I will come back to that point slightly later, but you also said in the speech, “Some people seem more keen than I think is wise to move away from the centrality of the inflation target”. Which people were you thinking of?

Professor Miles: I think there are quite a lot of commentators around the world, not just in the UK but more widely. There are a lot of academics who say the lesson of the last few years is that having an inflation target is too narrow and you need a broader set of targets for monetary policy; you need to take into account financial stability issues, what is happening to income inequality—a whole range of things that some people want to add to the list of things that a monetary policy committee needs to try to address. My own view is that that is not the most coherent way to go—that if you give a monetary policy committee several different targets you may end up not hitting any of them.

I also take the view that actually hitting an inflation target by no means involves ignoring what is happening in the real economy and being very concerned about unemployment and slack. I don't think there is a conflict between trying to hit an inflation target and worrying about the efficient utilisation of resources. I think they are complementary, really.

Q23 Stewart Hosie: That is helpful. Governor, on that point, Professor Miles also argued in his speech that, “Flexible inflation targeting is not inconsistent with attaching significant weight to short-term fluctuations in output and employment”, which you have just described. “But having some target for growth or employment over the medium to longer term as part of the remit for the central bank is a different matter. I think there is little to be said in favour of that”, which we have just had paraphrased. Do you agree with that?

Dr Carney: I do agree with that and I think it is very well put. If I can bring it to the current circumstances, we have a situation where part of our judgment about the path to return—how to respond to—I will simplify it—to the oil price shock is a determination of whether we could lean against that to bring inflation back more promptly to target. The fact is there are lags in the effectiveness of monetary policy. Peak impact somewhere between 18 to 24 months is our experience. That oil price effect, maybe not in the underlying economy but in terms of CPI, will have washed through over the course of a year. So we would look at the short-term variability and take that into account.

Q24 Stewart Hosie: You described earlier in the hearing the way you would look through certain short-term hurdles, and I understand that. Obviously, you agree with Professor Miles and it is good to have that consistency. But you do have the unemployment knockout, which allows you to reconsider the forward guidance. Are these things absolutely compatible?

Dr Carney: They are compatible. If we go back to the first phase of forward guidance—and to be clear, that no longer operates because we went through the knockout—the point there was putting in guidance as the recovery was just beginning to gather steam and to provide perspective on a necessary condition for the consideration of potential tightening of monetary policy, in other words raising of interest rates. We used that as an indicator, as a knockout, to say that we were unlikely to even begin to think about tightening monetary policy until unemployment had reached that level. It was a means to an end that provided guidance.

Q25 Stewart Hosie: Professor Miles made a point about perhaps holding more of the gilts than had previously been the case. The words of the speech were, “It was very likely that the Bank of England balance sheet may stay very much larger than it was”, not because of a failure to unwind QE but because banks would want to hold short-term reserves. You have alluded to this before in answers to me and to John Thurso, but that is a much more concise way of putting it. Is this now where the Bank is moving to—basically a tacit acceptance or a public statement that even if QE is all unwound, the level of gilts held will be substantially higher for the reasons given?

Dr Carney: Let me build up the answer. The first point is that historically the Bank had not backed all of banknotes in issuance with gilt holdings, so currency in circulation had not been backed. The Bank had taken a decision prior to the crisis that we would move gradually to a position where we would back all the currency in issuance with gilts. It is a sensible thing to do. Given our holdings of gilts, it is sensible—Dr Broadbent oversees it—that we would move to that position. That in and of itself will leave a higher standing state balance sheet, a higher holding of gilts on the Bank of England balance sheet. That is the first point.

The second point, to which Professor Miles was referring in the speech, is the question of liquidity management at private banks. They have new regulatory requirements but also, I would add, perhaps a new appreciation of their responsibilities to manage their own liquidity and not be wholly dependent on a central bank safety net. That will mean holding more liquid securities and potentially more bank reserves, which again is consistent with a bigger resting—equilibrium size of the Bank of England balance sheet, said different ways. But the precise question of how we manage reserves in the system has not yet been determined because we have not begun yet to move interest rates off these very low levels.

Q26 Stewart Hosie: Just one final question then on that issue of liquidity cover, from memory I think the Basel rules insist that that moves to 100% over the five-year timeframe or something like that. Do you think the public are aware that the banking system is becoming safer specifically because there will be, effectively, 100% liquidity cover?

Dr Carney: I think public awareness of the considerable improvement in the resiliency of the banking system has been overshadowed somewhat by continuing problems with conduct of those institutions. There is a recognition that the system has moved back from its very fragile state in the wake of the crisis, but probably not a full appreciation of the extent to which the system has built resiliency both in terms of capital and liquidity. That is entirely understandable given the headlines people are faced with every day.

Q27 Chair: Dr Broadbent, do you think these conduct issues are reaching the point where they are inhibiting banks from supporting the economic recovery?

Dr Broadbent: They have certainly gone on for a depressingly long time. I would mainly echo what the Governor has just said. I think the more important impediment to the supply of credit has been the weakness of their balance sheets and that is why the improvements we have seen in the strength of those balance sheets over the last five years is extremely

welcome. Without it I doubt we would have had the recovery we have enjoyed over the last couple of years, for example. But probably at the margin, yes, it is at the very least a distraction to—

Chair: But it is marginal not central?

Dr Broadbent: I do not think it has prevented a recovery in the supply of lending over the last couple of years.

Chair: We would have had a less strong recovery than we would have otherwise had. You are saying it is a marginal effect, whereas you are saying what has gone on with balance sheets has been much more important.

Dr Broadbent: I would imagine that is more important, which is not to underplay the importance of conduct issues.

Chair: In their own right. I am just trying to get the economic impact in perspective.

Dr Broadbent: Yes, indeed, more important.

Q28 Alok Sharma: Dr Weale, just turning to the latest set of MPC minutes that have been published, with regard to the base rate it notes, “For two members, the immediate policy decision remained finely balanced: given the outlook for inflation beyond the short term, there could well be a case for an increase in Bank Rate later in the year”. Were you one of those members?

Dr Weale: That is my view, that things are finely balanced.

Q29 Alok Sharma: Why is that? Given what the Governor has said about inflation and general expectations in the market, why do you think this is so finely balanced?

Dr Weale: My sense is that the labour market is getting fairly tight. Unemployment has continued to fall fairly rapidly. Average weekly earnings growth has picked up certainly faster than I was expecting. It is a volatile series and it may go down again, but the sort of pressures I had thought we might see in the labour market towards the end of this year, perhaps are starting to show earlier. Of course, we have a target for CPI, we do not have a target for wage increases or a target for domestic costs, and the effects of rising wage costs on CPI are attenuated through things like the import content that is not directly affected by wage growth. My concern is that the labour market is tightening and that eventually that is likely to prove a limit on our ability or the desirability of keeping interest rates as low as they are.

Q30 Alok Sharma: Dr Broadbent, I saw you nodding when Dr Weale was speaking. Does that mean that you were the other member of the MPC who shares a similar view?

Dr Broadbent: No, it doesn't. Was I nodding? I must be very careful with my head.

Q31 Alok Sharma: Just to return to this point, the minutes also note, “All members viewed it as more likely than not that Bank Rate would increase over the next three years; for one member, the next change in the stance of monetary policy was roughly as likely to be a loosening as a tightening”. Is the member who had that particular view present today?

Dr Broadbent: Can I just say that we assign individual names to the most important things in the minutes, which is the vote. There is, at any point in time, typically a range of views about all sorts of things in the economy and at times about policy itself.

Q32 Alok Sharma: Let’s cut to the chase. Let me ask you, Dr Broadbent. Dr Weale has been very clear in terms of what he thinks may happen in terms of the base rate. What is your view? Do you have a three-year view on this, a two-year view, a one-year view?

Dr Broadbent: The clearest way of seeing what the collective view is is to look at the forecast. In the forecast, a moderate rise in interest rates is necessary to produce inflation rising back towards the target within the kind of horizon that we think is appropriate at the moment. Therefore, that is also my view, I would say, that roughly speaking we need a moderate rise and, therefore, it is more likely than not that the next move is up.

Q33 Alok Sharma: Professor Miles, could you just comment on that? And when do you think this likely modest rise is going to come?

Professor Miles: I was very happy with the statement in the minutes, which was the collective judgment that over the next few years the most likely outcome is the Bank Rate gradually moves back up off where it is at the moment, back toward a more normal level. It probably does not get back to the old normal but moves back in that direction at least.

My own view is that the outlook at the moment means that we should not be in a great hurry to be normalising policy and moving up the Bank Rate. The inflation outlook for the very near term is that it stays very low. Looking beyond that, and as is reflected in our forecasts in the Inflation Report, if one were to leave the Bank Rate unchanged in those projections in the Inflation Report, the central expectation then would be inflation would start moving above the target and would end up materially above it two or three years down the road. I think that is a sensible judgment and that says that at some point, probably not immediately, the Bank Rate does need to go up.

Q34 Alok Sharma: Governor, could I turn to the housing market with you? Could you give us your current views on the—

Dr Carney: You are not interested in my view on the—

Alok Sharma: We are always very interested in your views on everything. If you would like to give us those views we would be delighted, but perhaps after you have given us those views you could give us your views on the housing market.

Dr Carney: No, it is all right. I was nodding and shaking my head at the same time.

Chair: Is there something you are desperate to say, Governor?

Dr Carney: No, but I just found it amusing that I was not asked. As Professor Miles and Dr Broadbent said, if you look at the forecast, inflation gets back to the 2% horizon within two years, which is the stated objective of the MPC given the shocks that are hitting the economy, in this case, and it goes a little bit above 2% farther out in the horizon. That is a forecast that uses the then market curve, which is consistent not with any cut in interest rates but with modest increases in interest rates. That is, in my judgment, what is likely to be the case at the current juncture.

Q35 Alok Sharma: Okay. Just turning briefly to the housing market, what do you think is going to happen over the next 12 months in terms of house prices?

Dr Carney: We have, as the MPC, a view that house price growth nationwide will decelerate relative to the levels in the previous year, that broadly the growth will be consistent with income growth, so in the range—I have to be careful here given that real incomes have moved more sharply—of 5% or 6% on an annualised basis. There will be substantial regional variation on that, but I would not bet my house on that.

Q36 Alok Sharma: A final question on the Help to Buy scheme: I think it was reported in October that you and the FPC have taken the view that the Help to Buy scheme does not pose a material risk to financial stability and is not contributing materially to house price growth. Do you continue to share that view?

Dr Carney: The FPC does continue to have that view because the FPC has made it clear that if the view were to develop that the Help to Buy scheme posed risks to financial stability, it would make those views public and it would alert the Government to that fact, and it has not.

Q37 Alok Sharma: It would alert the Government to that not at the review point of every September but—

Dr Carney: The Government has expressed a desire for a review every September and we will acknowledge that, but if there is any policy or set of circumstances that are contributing to risk to financial stability, we have an obligation, if they are policies of the Bank of England, to adjust those policies; if they are policies of the FCA, to alert the FCA, make judgments; and in this case, if a policy of the Government, to alert the Government, and we would do so, yes.

Q38 Chair: Just for clarity's sake, who was this member who viewed the stance of monetary policy to be roughly as likely to lead to a loosening as a tightening?

Dr Carney: I think it is up to the individual to reveal that in due course and the rationale behind it. Just to put this in context—

Q39 Chair: Perhaps you could provide a bit of context by telling us whether that person asked for his view to be added to the minutes.

Dr Carney: Well, of course, everything that is in the minutes—

Chair: Whether he specifically asked for that view to be added to the minutes.

Dr Carney: This is dancing on the head of a pin. This is an important point because I don't think there should be any confusion coming out of this worthwhile set of issues. It is a nine-zero vote to keep policy the same, first point. There is nuance provided around that vote. Some members think it is finely balanced; one member has that view. The rest of the members do not hold those nuances.

The next point is that every member of the committee's judgment is that rates are more likely than not to be higher at the end of the forecast period than they are today. The next point is that the best collective judgment of the committee, consistent with the forecast, consistent with the letter to the Chancellor, is that modest increases in interest rates will be necessary to achieve the inflation target.

Q40 Chair: That is helpful. It was not you then, was it?

Professor Miles: There was some speculation in the press that it was me. I just wanted to say that it was not me.

Chair: Okay. So it is four down and five to go. We will move on to Andy Love.

Mr Love: Maybe next week we should have four other members of the Monetary Policy Committee here.

Dr Carney: Here is my slight concern about this discussion. It is worth enunciating. I would not want a member of the general public or market participants or others to misinterpret the discussion. The best collective judgment of the committee is that the next move is likely to be up, that modest increases in interest rates are consistent with achieving the inflation target, that we will do what is necessary in order to achieve that inflation target. I appreciate the nuance and the salami slicing, but in the end what matters is the weight of opinion on the committee and the decisions that are made.

Q41 Mr Love: Governor, may I come back to the risks of deflation? The Bank's forecast for inflation later this year is that it will enter negative territory. You have explained that this morning in answer to questions from the Chairman as being primarily related to reduction in energy and food prices, but how likely is it that price or wage-setting decisions will be affected by a period of negative inflation?

Dr Carney: The first thing is that we expect very low inflation for most of this year, possibly negative inflation. That determination of the latter will be largely—not exclusively but largely—determined by the evolution of oil prices, petrol prices and other energy prices. The prospect of that influencing wage setting is in part, in our view, determined by inflation expectations and the extent to which individuals and companies expect inflation to return to target in a timely fashion. It is also obviously a product of the relative tightness of the labour market and, through the fullness of time, a function of productivity growth in the labour market.

Q42 Mr Love: How extended a period of negative inflation do you think is necessary for negative inflation to feed through to prices and wages?

Dr Carney: One of the things we do identify in the report—and if you are a keen reader of the fan chart in the CPI, as I know you are, Mr Love—we have a slight downside skew in the near term of the fan chart to inflation. That is because of the possibility of greater persistence of low inflation, so the possibility that low inflation breeds further low inflation for a period of time. There is some possibility of that. That is not our central expectation but there is some possibility of that and we tried to incorporate that in our risks around the inflation forecasts.

We do view, when you get to the two or three-year horizon, the risks around the inflation forecast to be evenly balanced, not least by some of the points that my colleague Dr Weale has made.

Q43 Mr Love: Were you surprised that the survey carried out by the Bank's agents showed that inflation expectations was the most cited factor likely to bear down on labour cost growth in 2015, the very scenario that you are saying might not happen?

Dr Carney: I would not say we were surprised by that; it is an important piece of information. I would add, though, that the wage-setting survey by those same agents of those same companies is consistent with wage growth of about 2.5%—that is the information from the survey. That is corroborated by other surveys, some of which suggest even stronger wage growth, certainly for new hires, than that. In the end, even though companies were taking into account the prospect of lower inflation and lower other costs associated with that, their expectation on average was what I would term solid wage growth. Again, Mr Love, to put this in context, historic average wage growth would be around 4%; something consistent with an economy operating at equilibrium would be around 4% annualised wage growth.

Q44 Mr Love: Japan has had experience of deflation for some considerable time. Are there any lessons to be learnt from the Japanese example?

Dr Carney: There are numerous lessons to be learned, and many of them have been applied. The first is the need for vigilance against deflation and the possibility that deflationary expectations would set in. I would say in terms of the vigilance and the

responsiveness, monetary policy did respond very rapidly and forcibly here post-crisis when there were concerns about the prospect of very low inflation. We have kept an accommodative stance of monetary policy. In fact, we have forgone the tightening of monetary policy in part because of these risks.

Another lesson from Japan is the paramount importance of fixing the banking system early so that the natural capital reallocation process functions, so that companies that should die, die and those that can be born can access that credit. It took a bit of time here but by 2013 the core of the banking system was substantially recapitalised. I think one of the core lessons of the stress test that the Bank conducted last fall was that the core of the system is resilient, and resilient to another downturn. It will retain an ability to lend to the real economy in another downturn. That is the judgment of the FPC of the Bank of England.

Those are two core lessons that have been applied. We are vigilant towards risks of persistently low inflation. We care just as much about inflation below target as above. That is why we are watching inflation expectations closely. That is why we have the policy stance that we do have. Even though it is consistent with modest rate increases, they are quite modest and they are quite gradual. That is in the context of an economy where the labour market is tightening, the economy is continuing to grow above trend and can be expected to do so over the forecast horizon, at least in our view.

Q45 Mr Love: I assume that you have seen *The Daily Telegraph's* front page of Friday 13 February. The title of the article is, "Enjoy low prices while you can". You are quoted as saying, "Families should take advantage of cheap petrol and food as take-home pay rises". Do you have a strategy to boost consumer expenditure? Is this something that the MPC—

Dr Carney: No, with respect to the changes in food and energy prices, one should recognise where they came from. By and large, they are exogenous effects. They came from outside the UK. That is less true for food because part of that is a product of intense competition in retailing and much of the food consumed is domestically grown. But certainly, in the case of energy prices these are dramatic falls in the price of, particularly, crude oil. It is a one-time effect. It helps boost real incomes. It is not a strategy; it is something that has happened, and the question is how we respond.

As we have been discussing, rightly so, our view is that we look through that effect. It has the consequence of boosting real take-home pay, particularly if wage settlements are anything like the expectations of the companies that our agents have been surveying, the companies we have been meeting across the country as we go around, the companies that have been reporting into other surveys such as the REC survey. There will be a boost that helps support relatively strong growth in consumer expenditure without a material drawdown in household savings over the near term. But this is a temporary phenomenon, so enjoy it while you can because it is not going to last. Petrol prices are not going to continue to fall; food prices are not going to continue to fall.

Q46 Mr Love: I think the point that *The Daily Telegraph* was trying to make was that in this period when prices will be falling, consumers may be incentivised to withhold expenditure.

They were suggesting that the MPC was alert to that process and you were, as the spokesman, suggesting that people should keep spending.

Dr Carney: I understand your point now. I will associate myself with Dr Weale's comments, and Professor Miles made them in a different context, which is that we don't see a lot of evidence of deferred consumption in this country, in the past or at present. I think the greater risk from deflation or persistently low inflation, the reasons we have a 2% inflation target, relate to the functioning of the labour market and financial contracts. Long-term mortgages are taken out with certain assumptions of what the wage and price inflation would be and if we go off target then it will be inconsistent with the economy functioning well. The term that I have used is that a little bit of inflation greases the wheels of the economy. That is true; that is why we do target some inflation.

Q47 Mark Garnier: Obviously, I appreciate everything you have said about the fact that this very low inflation rate is a temporary thing and is probably going to pick up again. May I take a range of views across the panel? Perhaps we will start with Dr Broadbent. In the event that you are wrong—not that I am suggesting for a moment that such great minds would ever get this sort of thing wrong, despite what Robert Chote keeps saying about economists—and there has to be a further loosening of monetary policy, would you prefer a lowering of the Bank Rate or would you prefer more quantitative easing?

Dr Broadbent: We don't have to take that decision yet. As we set out in the letter, however, we have changed our view slightly of what is the effective lower band in the UK for the official interest rate. Previously, the judgment was that any cut, should that be thought necessary, below $\frac{1}{2}$ a per cent. might have perverse effects by damaging the margins, profits, balance sheets of certain financial intermediaries. Because those balance sheets are now stronger, we no longer think that is the case.

Q48 Mark Garnier: Is that not why quantitative easing came in in the first place, as opposed to cutting—

Dr Broadbent: Yes, partly. Let's be clear: if one was to try and translate the one into the other, the effect of quantitative easing was much bigger than the sort of margins on Bank Rate we are talking about. But I don't think we have reached any judgment as to whether we would use one in preference to the other because, of course, as we have spent the last several minutes discussing, everyone on the committee thinks interest rates are likely to end up higher by the end of the forecast period, not lower.

Mark Garnier: But on a hypothetical thing, if you were pressed—

Dr Broadbent: I understand, but what I am trying to tell you is that it will be a judgment of the committee as to which we use. I do not think we have in advance any prejudgment as to which of those instruments we would use.

Q49 Mark Garnier: Is that the same for everybody? Rather than going through, does anybody have any strong feelings one way or the other?

Dr Weale: No, I think it is a purely hypothetical case and should the need arise the right thing to do would be to look at the circumstances at the time and see what is the most sensible decision.

Dr Carney: Yes, I agree with my colleagues. Once one gets into hypotheticals—you can have many hypotheticals. Certainly, where we started this hearing on euro area issues and contagion and broader crisis channels might merit a certain response, but a more conventional slowdown and persistent disinflation might otherwise. Let me underscore, though, that it is quite handy that we have the ability to use conventional monetary policy if we were to need to, and that helps inform the stance of the policy at present.

Q50 Mark Garnier: One issue of this, were it to come to this hypothetical situation of conventional monetary policy or QE, obviously the Treasury has a view in this because the Government is underwriting the QE book, as I understand it. Have you had any discussions with the Treasury about this and what their appetite would be to any further quantitative easing?

Dr Carney: The short answer is no, and if we ever were to come to a case where the view of the MPC was that additional stimulus would be required—and I would remind you that we vote on this each meeting and it is entirely possible that a vote could go in any direction—those are the decisions of the MPC. The asset purchase facility is in place, the indemnity is in place, and those decisions would be the decisions of the MPC.

I think this is the point, though, in the discussion—and you have been very careful to say this is hypothetical—where I am duty-bound to again insert into the transcript that this is hypothetical. It is not an act of hypothetical discussion at the committee, just to be clear.

Q51 Mark Garnier: No, I appreciate that but it certainly came up at the MPC press conference and Robert Peston was pressing you quite hard on this particular area. In fact, this comes to the next bit, which is potential negative actual interest rates as opposed to negative real interest rates. This is something that does come about under extreme conditions and we have certainly started seeing this in parts of the eurozone. Do you think—again completely hypothetically—that it is possible that we could see negative actual interest rates in the UK? Is that something that is conceivable or is it simply not going to happen?

Dr Carney: I think the judgment of the committee, as expressed in the letter specifically, is that because the resilience of the banks and building societies has increased, we are in a position where we could, if necessary, cut Bank Rate towards zero. That is towards a level that is still above zero. We have not specified a specific level. We have not had to. We are not having the active discussion about it because the focus of policy is towards timing and degree of tightening when appropriate.

Both the ECB and other countries in Europe, but not as part of the euro area—Switzerland, Denmark and Sweden as an example—with the exception of the last, in all of those cases the

negative interest rates have been applied not to their core policy instrument but to the rate paid by the central bank on effectively deposits at the central bank that are excess reserves of the banking system at the central bank. It depends on the relative size of those excess reserves relative to reserves, the extent to which those negative interest rates start to translate out into actual deposit rates, rates that individual savers would see. That has not always been the case or that has not yet been the case in some of these jurisdictions but it will be over time.

Mark Garnier: It has had an effect in Hong Kong, if I remember rightly.

Dr Carney: Yes. There are other systems, systems that have excess reserves that have used this so-called stepped-floor approach, laying a negative interest rate on some of the reserves. We do not have that system; that is the first point. We also have only taken a judgment about the ability to move Bank Rate towards zero if necessary and we, of course, disclose that as part of the process of writing the letter to the Chancellor to explain why inflation is below target when our strategy is to bring it back. Again, I am repeating myself but I think it is necessary to do so. Our strategy to bring it back, as best as we can tell at this point in time given the shocks that have hit the economy, is consistent with modest increases in interest rates over the forecast horizon. In other words, the Bank Rate is more likely than not to be higher than it is at present at the end of the forecast.

Q52 John Thurso: Can I come to you first, Professor Miles? I want to talk about productivity. How concerned are you about persistent below-trend growth in productivity and what analysis, if any, have you made of that?

Professor Miles: I think it is concerning. I had been more optimistic a couple of years ago, or even a year ago, that we would now be seeing more normal rates of productivity growth. We have seen some productivity growth over the last couple of quarters in the latest data, but it is still below what we used to think of as normal rates of productivity growth. I thought that as unemployment came down and we got back to more normal rates of¹ growth we would see more normal productivity. I have become a bit more pessimistic on all that and, on the back of that, slightly more pessimistic about how much slack there is in the UK economy.

Having said all that, I do think that there is a case to be made for the most likely outcome being that you gradually do get back to something that looks a bit more normal: 1.5% to 2% increases in labour productivity year on year. As a long-run place that the economy may get back to, I think that remains pretty plausible. It is just that the process has taken far longer than I thought.

Q53 John Thurso: When Professor Nickell came before us from the OBR in December, he took a similar view that although it has been going on for six years it is not yet the time to say there has been a change to the long-run rate. At what point do you suppose, six years having gone by, one actually says the long-run rate has changed, and what implication might that have for our thinking?

¹ Note by witness: “output” should be inserted before “growth”.

Professor Miles: One answer to that would be when you had got back to a situation where all the slack had been used up: unemployment had fallen to an estimate of its sustainable rate; when people said that they were working on average the right number of hours, as opposed to the situation at the moment when more people than not say they would like to work more hours. If you took that as one's yardstick of a normal equilibrium position for the economy, which to my mind is still a few years off, if at that point and beyond there was still no sign of productivity growth beyond the low numbers we have seen recently, I think I would start reducing my estimate about the long-run sustainable rate of productivity growth. But it is still a few years off, I think, that point.

Q54 John Thurso: But the key to all of this is an understanding of what is really happening in the labour market?

Professor Miles: Yes, where our understanding remains very imperfect.

Q55 John Thurso: There is some disagreement on the committee, is there, about the labour market—how big a gap there is?

Professor Miles: I think there is a range of views. I would not say it was enormous at the moment, probably less than it has been in the past. I am probably toward one end of the spectrum in thinking there is a bit more slack or spare capacity than the middle of the pack, but those differences are shrinking.

Q56 John Thurso: Perhaps, then, I can come to Dr Weale. In your report to us, commenting on your voting record, you said, "Underlying this voting is a view that there is less spare capacity in the labour market than the committee's collective judgment has suggested". Why do you think that is the case? Where I am going with this is what impact you think it has on our reflections on productivity.

Dr Weale: There are a number of factors. One is that the people who moved from unemployment or, indeed, from non-employment into work are typically paid appreciably less than the average wage. I do not want to get into concepts of what fair wages are and so on, but they also seem typically to be less well qualified and have lower levels of educational attainment. That is likely to mean that you get less than average output from them. That is not overall a large effect but it is a material effect.

Another issue arises from the way in which you interpret people saying that they want to work more hours than they do. There are two measures of this. The one that attracted more attention was some work that David Blanchflower did looking at the number of hours people said they wanted to work and looking at how that had changed. I looked through those numbers fairly carefully and found that if you take people in one month, they say they want to work, say, 10 or 12 hours longer. A year later, the people who said they wanted to work longer are no longer saying that, or many of them are no longer saying that, but actually they are only working four or five hours longer. So there is a question of how we should interpret those numbers.

The other measure of an hours gap is given by people who are working part time and say they want to work full time. I suspect that the same phenomenon may be present there. I also suspect that one of the factors behind working part time when you would like to work full time, or say you would like to work full time when you only work part time, may be having a partner who is out of work. So, with a general sense of economic recovery, my suspicion is that that component of the gap is likely to decline to some extent of its own volition.

I should also say or perhaps stress that the committee collectively, as the Governor mentioned, wants to do more work on the supply side and we will all have studied it in more detail in time for the May forecast round.

Q57 John Thurso: It remains the big conundrum, does it not, for all economists—OBR, yourselves, everybody—that nobody quite understands why productivity has been below trend for so long? The thinking that you are doing around the labour market is potentially a partial explanation of that, is it not?

Dr Weale: I am not sure that it is an important explanation of low growth in output per hour worked. What I have noticed is that it is something of an international phenomenon. It is true that by the international standards Britain is nevertheless a relatively poor performer. We have had some specific factors that Ian McCafferty mentioned last summer, like declining oil output. We may be more sensitive to movements in the productivity in the financial sector, but in aggregate that is not terribly important.

I suppose one reason why I share the view that productivity growth is eventually likely to pick up to more normal levels is that for quite a long time, certainly since the Second World War, Britain has been tending to catch up with the high productivity countries, typically France and the United States. Even if world knowledge is advancing less rapidly, we do still have substantial scope for catch-up there.

Q58 John Thurso: Dr Broadbent, any comment on those two answers on this question of productivity?

Dr Broadbent: No, except to say, supporting what Martin has just said, that I think it is an issue that goes beyond the labour market. My own view is that weak productivity may affect the rate at which unemployment falls but the explanation is not simply to be found in things that have changed in the labour market. There is something deeper going on. I would also point out that my own instinct is that the fact of the financial crisis through some mechanism may have had some bearing on this because we have seen weak productivity growth after other financial crises as well. But you are right to say that we do not have a very deep understanding.

Q59 John Thurso: Governor, can I come to you and ask a different question but related to the same subject? It is around the outlook for investment. The Inflation Report notes that, “In the central projection, annual investment growth remains robust, reflecting support from low interest rates and the past easing of credit conditions, the gradual recovery in global demand

and domestic demand conditions. Within that...investment by extraction companies, which accounts for 7% of business investment, falls by more than 40% over the forecast period". Can the rest of the economy make up that gap and how worried should we be about the non-extraction side of investment seemingly below that which we would like?

Dr Carney: In terms of the extraction sector, as you will know, in Scotland there is a fairly substantial adjustment that is under way. It has begun; it is under way. We have adjusted our forecast because of that and, as you rightly know, a 40% adjustment is significant. Partly as a consequence, the path of investment is somewhat lower than it was in our November forecast, but it is still robust investment growth as a whole and that does reflect the factors that have been listed.

There are a number of risks to that forecast, not least the external environment. There are declining risks from the domestic financial system—financial environment, so that drag has been reduced, but certainly anything that would impact confidence domestically or externally can impact it. We are not yet picking up in our surveys and our discussions anything material in that last regard.

Q60 Steve Baker: Good morning. Before turning to eurozone quantitative easing, could I just return to the least controversial part of Mr Norman's questions, which was eurozone fiscal union? Who would have thought it? Professor Miles, you made a magnificent speech on what monetary policy can and cannot do. Under the heading, "Fiscal and monetary policy: symbiosis and consistency", you quoted Cochrane. He said, "We can read the inflation target equally as a commitment by the Treasury to fund debt at the targeted level of inflation, as it is a commitment by the central bank to target that level of inflation via interest rate policy". Could you just be clear that you are saying there is a tight, symbiotic relationship between monetary policy and fiscal policy?

Professor Miles: Yes. I think in the long run you cannot have a situation where the fiscal authority, in order to be sustainable and keep rolling over the debt and pay the interest, needs an interest rate set at a very low level and that that was inconsistent with the central bank's view of the interest rate you need to hit an inflation target. So if there is a tension between those things, something has got to give in the longer run. I think that is the sense in which they have to be consistent.

Q61 Steve Baker: Dr Broadbent, is this a common view among economists in your field of work?

Dr Broadbent: Yes. The circumstances David is describing, I would say, do not necessarily apply at all times. There is some constraint ultimately, but that does not mean that from day to day we have to co-ordinate with the fiscal authority at all, because I think we are a long way from that constraint. One way of putting it is that, certainly in history, very rapid rates of inflation, hyperinflation, have been fiscal events ultimately, but they have been fiscal events because the fiscal authority has lost control of borrowing and because that dominates the monetary authority. That is not remotely the position we are in anywhere in the developed world today, certainly not here.

Q62 Steve Baker: Dr Weale, are we all nursing up to the intellectual leadership, which the Governor has expressed, by calling for a more complete eurozone fiscal union?

Dr Weale: I suppose I have asked myself, can I imagine other ways in which the euro area could function? An alternative approach that would not give the same sense of a single entity for the Governor's proposals would be if each nation state managed to regenerate for itself a substitute for the interest rate tool that it has lost. This was one of the issues that was discussed in the work that was done on euro membership in 2003: how would you limit consumer debt growth and credit growth if you had lost control of the interest rate? Certainly, no one has tried that; there are very good reasons for not rushing into it. I can certainly see that if the euro area wants to turn itself into something that is much more like a federation, then it will need to go down the path that the Governor described.

Q63 Steve Baker: Governor, would you recommend to the nations of Europe that they adopt a more integrated and federal structure?

Dr Carney: Well, I don't think it is necessarily a question of a formal federal structure. What I noted in that speech, and consistent with some of the observations of other European authorities, has been that there could be a twinning of labour market reforms, which are necessary, and unemployment insurance flows across jurisdictions. The advantage of that is clearly these are flows from individuals and companies to individuals as opposed to Governments to Governments and then dispensed by Governments, so it reduces the political element to that and potentially the leakage in that. It does not necessarily have to be federal, but in my view there is a need to recreate that. There are dangers to try to recreate domestic monetary policy within a currency union, obviously. I will leave it at that and let you continue.

Q64 Steve Baker: We could talk about this for a long time, I am sure. How has eurozone QE changed all of your outlooks for the world economy and particularly for our economy?

Dr Broadbent: I think it is a very welcome development, frankly.

Q65 Steve Baker: So as long as we keep on creating new money and giving it to wealthy holders of assets until the cost of living picks up for ordinary people, everything will be well in due course?

Dr Broadbent: I would not describe the transmission of QE quite in those terms, but what is clear is that the eurozone economy is one that was short of potential—clearly, there is significant slack where not just headline inflation, but underlying inflation, even stripping out those more volatile components, was well below the level consistent with the ECB's remit—and that therefore there was a case for easing monetary policy. Two things in particular were welcome about the ECB's announcement: first, the very fact that it was now recognised that this was a legitimate tool of monetary policy, and secondly, the fact

that it was made conditional on the things that the ECB really cares about, namely inflation. I think both those were welcome, and at the margin they added to our central forecast of growth in Europe and, to the extent it affects our own economy, growth here as well.

Q66 Steve Baker: I realise I deliberately caricature the transmission mechanism, but is this not, in the end, a reasonably close caricature? The Bank has explained that asset prices are lifted, both in bonds and equities, about equally by quantitative easing. We know that there is a distributive effect. That has been explained again by the Bank of England. We know that different income levels experience inflation differently. We know that we are looking at a temporary fall in food and energy prices, which will be very welcome, particularly to those on lower pay. I think we also know that the Bank has said very clearly that you will take whatever action is necessary to return to the inflation target. It feels to me like a very welcome fall in the cost of living will be fought, if it goes on for too long, by the Bank engaging in, perhaps, quantitative easing, which will again help the wealthy. Although it may seem I am caricaturing what you are doing, I am only relying on your own papers.

Dr Weale: Could I make one point? It is important to distinguish changes in a monetary phenomenon, the inflation rate, from the sort of factors that have pulled the price level down recently. The price of oil sometimes falls, it sometimes goes up. When the price of oil falls, that is good news for people who buy petrol, people who buy domestic fuel, and so on. It is that phenomenon that is largely behind the current fall in the rate of inflation. One could have imagined a situation—it is perhaps a bit hard to imagine—where some other prices and wages had picked up just as the price of petrol had fallen. That would have delivered the same impact on the living standards of working people, but inflation would have been closer to target.

Q67 Steve Baker: I care very much what the Governor thinks about this issue, but I do just want to reply to you by saying I remember Friedman's stricture that "Inflation is always and everywhere a monetary phenomenon". In the Bank's letter about inflation rates it compares a period—I will find it again—in table 1, the 1997 to 2007 average inflation compared to December 2014. I printed out a chart for quantity of M4 outstanding. You can probably see from there, since I have highlighted it, that during the period of historic inflation, 1997 to 2007, the quantity of M4 outstanding doubled in an accelerating rush, whereas in the period since the crisis M4 outstanding has been broadly stagnant.

Dr Broadbent: Inflation was higher since the crisis than before, so that—

Dr Carney: Yes, in fact, that is exactly right. If Professor Friedman were here today he would have a case to answer, because that shows the exact contrary of your point. What it does show, and it is a point you have made in the past, is the importance of looking at broader monetary aggregates, not least from a financial stability perspective. Because what a closer scrutiny of M4, its components, what was happening in the financial sector at the time, might have indicated is some of the problems that were to manifest subsequently.

If I can go back to your basic point, I marvel at your jump from the ECB and the situation in Europe, which is quite different, to the situation in the United Kingdom and the Bank of England's policy. I just want to correct a few things, if I may. The first is: why do we have the 2% inflation target? Why is it important for us to get inflation back to that 2% target? The very first point on that is it is not even for us to ask because it is a mandate of Parliament. We have a remit. We have operational independence how to get inflation back to target, but we do not have goal independence.

The reason Parliament, in its wisdom, has set this remit is that a little bit of inflation does help the economy function. If you think about less well-off constituents that you would have, fellow citizens across the country, they have debts, a disproportionate amount of debts, debts taken out in certain expectations of inflation rates and wage rates. Those will be harder to service in the event of persistently low inflation—or deflation, much harder to service in that case. So their real standards of living will very rapidly decrease.

Also, we want the labour market to function well. There is downward wage rigidity, even though this is a very flexible labour market, and a little bit of inflation helps wages adjust, helps people move to jobs. Among many other reasons, that is why we have chosen² that target.

To get back to the logic train you had there, it is not our strategy, it is not our intent—as I think we have made clear as we sit here today representing the MPC—that we would engage in additional quantitative easing. That is not our expectation. Our expectation is that to achieve the inflation target in a timely fashion would be consistent with modest increases in interest rates over the forecast horizon.

Q68 Steve Baker: Of course, I do not mean for a moment that you are operating policy to harm the poor. I know that you are not. What I am trying to do is challenge the intellectual consensus because I think there is something wrong with it. Professor Miles, in that marvellous speech you indicated that there is a disconnect between the way that theoreticians see the operation of monetary policy and the way that practitioners like yourselves see the operation of monetary policy. You explained that in any other field that would be seen as really quite worrying. Are you worried about that theoretical disconnect from the practical world and what it means for the lives of ordinary people?

Professor Miles: Yes, I am in a way. It is partly a reflection of how economics is taught in schools, and particularly at universities. The models that are used are a bit stylised and do not reflect the structure of a modern economy. In fact, one of the senses in which I think it is unhelpful, in some ways, the way economics has gone. Coming back to the issue of quantitative easing—I think I am in a slightly different place from you. There are a lot of clever theoretical models that say quantitative easing can't work and it will be a waste of time or possibly harmful. I think they do not quite reflect the reality of the situation for the periods when we on the Monetary Policy Committee were actively buying assets. 2009 was the year in which we bought more assets than any other year—£200 billion—and that was a period in which the financial markets were largely dysfunctional, particularly the corporate bond market. I think one of the impacts of our asset purchases then was to bring

² *Note by witness:* the word “chosen” should be deleted.

down corporate bond yields, which made life much easier for companies that could issue in that market. I think that did have an impact on their ability to get through that terrible year, 2009. I do think without that unemployment would have been significantly higher—it would have risen by even more. That would not have helped people on low incomes. So I do question the argument that with QE, you are buying assets, you are driving up asset prices and it helps³ the rich. I come from a different position on that one.

Q69 Steve Baker: I am just quoting Bank papers. I know I absolutely must stop, Governor, but if I may, I would just like to ask you one tiny question just for the record.

Chair: It definitely is the last question.

Steve Baker: For the record, could you just confirm that the Bank of England does not participate in the CME Group's central bank incentive programme?

Dr Carney: If I may, Chair, two things: I can confirm we do not. We do not participate in that. Secondly—

Chair: If this “secondly” is very short we will take it, Governor; otherwise we will have to move on.

Dr Carney: Yes. It is linking theory and practice and research, and I want to make a plug for our new research strategy, our research conference, which is tomorrow led by Dr Broadbent and—

Chair: Right, okay.

Dr Carney: But it gets to this very important point about bringing back theory and practice. Mr Baker will be pleased to know that one of the legs of our research strategy is around disruptive technologies, currencies, and implications for monetary stability.

Q70 Rushanara Ali: I will not subject you to any graphs, Governor.

Dr Carney: Thank you.

Rushanara Ali: I wanted to focus on wage pressures. The Bank of England's Inflation Report forecasts a 3.5% growth in wages over the next year and potentially higher subsequently. What are the factors driving that optimistic figure?

Dr Carney: As Dr Weale and others have indicated, and it is detailed in the report, there has been a tightening in the labour market, in all measures of slack in the labour market. Whether it is unemployment, the participation gap or the average hours gap, the so-called involuntary part time, all of those factors have tightened. That is supporting modest growth in wages. This is a return to modest growth in wages. We think there will be an acceleration as the labour market continues to tighten.

³ *Note by witness:* The word “just” should be inserted after “helps”.

Q71 Rushanara Ali: How much are bonuses accounting for that prediction?

Dr Carney: In the economy as a whole we do not make a distinction between the two. I can tell you that the growth of the most recent figures is in the order of 2.1% economy-wide of total pay and about 1.7% economy-wide for regular pay, thereabouts, so it is significant. Bonuses are not exclusively in the financial sector, as you would appreciate.

Rushanara Ali: Yes.

Dr Carney: I might add as well there has been some shifting, which is hard to parse in real time, but there should be some shifting in the proportion of financial sector compensation that is paid as bonus versus as regular pay, because of regulation.

Q72 Rushanara Ali: Yes. Can I just turn to the special report released last week by agents from the Bank of England that showed no trend of the kind of wage growth of around 3.5% and how much account has been taken of this? Perhaps Dr Weale could also respond to that and your reflections on the differences and how much notice the Bank of England is taking of that report.

Dr Carney: Yes. We commissioned it and certainly took note of it and discussed it in the run-up to policy. It is one of many indicators of the prospect for wages. We supplement them with other surveys. We supplement with the underlying measures of slack in the economy and our expectation for the path of the economy, which in some cases may be stronger than the companies surveyed, not least because of an expectation that real incomes will grow more rapidly than they had in the past because of the added benefit in the short term of the fall in energy prices.

Q73 Rushanara Ali: At the lower end of the market, new entrant unemployment is beginning to go down. What are your reflections on the lower end of the market?

Dr Carney: For less skilled employment—and you are drawing out an important compositional effect as well—what we had seen over the past year, and is now tailing off, is that more of the job growth had been in lower-skilled jobs. As a consequence, there has not been wage growth in those jobs. That has meant that in aggregate the growth in average weekly earnings has been slower than it otherwise would have been. It is a good thing because there are jobs, but that has had the compositional impact of lowering average weekly earnings. As the mix adjusts there is that impact as well on wages.

Dr Weale: Could I just say that it is quite helpful to think of wage growth as being a combination of wage settlements and wage drift? The sense certainly I get from the businesses that I talk to is that the information that we have from the agents is the best information we have on settlement, but the story on wage drift seems to have been changing quite a lot. People at the businesses I have visited are talking about how they need to offer pay rises to retain people. They may need to offer pay rises to attract people. The sense certainly I have been getting is of a rather different picture from the story I was hearing a year ago. That is how I reconcile the forecast with what we are hearing from the agents.

Q74 Rushanara Ali: You are very confident it is going to go up? Because in the last year, between 2013 and 2014, it was around 1.4%, so it is quite a dramatic shift. Obviously, it will be welcome, but there is some scepticism about the projections that are being made.

Dr Weale: Forecasts are forecasts and there is obviously, as we at the Bank have been at pains to stress, a margin of uncertainty around all of them. We only show the uncertainty for the key components, but obviously around these projections there is a margin of uncertainty. What we are also seeing is that if you look at average weekly earnings growth—not over the last year but, say, over the previous three months—that is erratic but it does seem to have settled at a rather higher rate, sometimes a bit below, sometimes a bit above 4%. That is certainly an encouraging sign about pay growth that I have taken into account and, indeed, one of the factors that has made me think that perhaps pay growth is picking up a bit faster than I was expecting.

Q75 Rushanara Ali: Finally, there are discussions about increasing the national minimum wage. A recommendation has been made by the Low Pay Commission. Do you have any reflections on that, on increases at the bottom end?

Dr Weale: I have not done any particular work on the effects of changes in the minimum wage, but obviously people everywhere welcome increases in their living standards.

Q76 Rushanara Ali: Would you suggest it should go up?

Dr Weale: We have the Low Pay Commission whose job it is to answer those questions, and they have delivered an answer. Our job is to produce forecasts in the light of the decisions that bodies like them make.

Rushanara Ali: Thank you very much.

Chair: I would say that is a very straight bat, Dr Weale. I think you encountered the ball as it was coming towards you.

Q77 Mr Ruffley: Dr Broadbent, we have already heard from Dr Weale why his view as to the amount of capacity is less than, perhaps, the collective view of the MPC. He helpfully describes, in his written evidence to us on 16 February on his voting record, the hours gap point, which he has already alluded to today, that the ONS labour force figures, “suggested to me that a measure based on what people said they wanted was likely to be misleading”. How misleading do you think that is? You obviously do not think it is quite as misleading as Dr Weale.

Dr Broadbent: Yes.

Mr Ruffley: I just wondered why that was.

Dr Broadbent: Let me come at it from a slightly different angle, which is wage growth itself. As Martin explained, the very recent figures show slightly faster growth than over the past. But what struck us over much of 2014 and, indeed, 2013 was that wages grew less quickly than we were expecting given our estimates at the time of slack in the labour market. That evidence is relevant, too, I think.

What Martin has described are his views about the way we construct our estimates of spare capacity in the labour market from the bottom up, as it were. What is also true as you look at it from the other end, from what you might expect to be affected by that level of slack, wage growth, you might come to a slightly different conclusion and think there seems to have been more of it, for some reason, than we were expecting. I put weight on both those, and the fact that wage growth was weaker than we were expecting certainly in the last part of 2013 and the first half of 2014 makes me think that somewhere—whether or not we can identify it in the precise numerical terms that Martin talks about—there has been spare capacity in the labour market and that to a degree we will allow that to continue to pull down on wage growth relative to the normal figures that the Governor was talking about. It is a balance of things. I do not think it is possible to come at a definitive answer from any one bit of information.

Q78 Mr Ruffley: No, and that is helpful. In his written submission to us, Dr Weale also says, “I was also concerned that the Committee was more willing to raise its estimates of ‘full participation’ when actual participation rose than it was to reduce them when the participation figures fell”. What is your view on that statement?

Dr Broadbent: What is true, broadly speaking, is that participation in the labour market is significantly higher than would have been the case had averages within age groups stayed constant. To put it another way, the process of ageing of the labour force might have been expected to push down on aggregate participation quite significantly over the last two or three years. That is not what has happened, and therefore there has been something else going on to offset that. The judgment we have to make is how much of that is structural and how much is cyclical. There was a range of views about what that split should be, and we will revisit that judgment periodically. We are going to do so again ahead of the next and in the next Inflation Report. I also refer to the answer I gave a moment ago, which is that the fact is that, for whatever reason, wage growth through much of 2013 and 2014 was lower than we expected. That makes me think that even if we cannot specifically say where it exists, there was spare capacity in the labour market.

Q79 Mr Ruffley: When you say “for whatever reason”, what would your educated guess be?

Dr Broadbent: We ventured some suggestions, which you might expect to see reflected in participation—

Mr Ruffley: Which is the market leader of all these possible explanations?

Dr Broadbent: I think it is true there are various forces that might have persuaded people to stay in the labour market longer than people of the same age did some years ago. For

example, maybe they do not expect to have the same income. They think they are going to be forced to stay in the labour market simply to earn the extra income they need to maintain current levels of consumption. There have been various changes in benefits that may have encouraged them to stay in the labour market. There might be several reasons why a person of a given age approaching retirement, or even beyond conventional retirement age, is now deciding to stay in work, whereas the equivalent person 10 years ago did not.

Q80 Mr Ruffley: That is helpful. In the 12 February Q&A session you had accompanying this report, you talk about a lot of people who lost their jobs as a result of the recession who, rather than looking for work and being counted as unemployed, instead sort of dropped out of the labour force, but would be able to come back relatively easily. Could you put some numbers on that? Is that a weighty factor—people just coming off the claimant count?

Dr Broadbent: That is precisely what I meant when I talked about the judgment as to how much of the changes in participation is structural and how much is cyclical. It is always likely to be the case, to some degree, that there are people who lose their jobs in a recession and who do not formally count themselves then as unemployed, but who with only a little encouragement, and in particular only a small increase in wages, would none the less seek to return to work again. That is what one would call cyclical non-participation.

One route to that judgment is the questions that are asked in the labour force survey to which Martin was referring but, as he says, it is probably not the case that one can take those answers completely at face value. We have to have other judgments about how you make that split. As I say, we will be returning to this in May, but it is not straightforward in the sense that if I give you a precise answer I do not think that—

Q81 Mr Ruffley: Is it a very significant part of the spare capacity in the labour market that you—

Dr Broadbent: Currently, yes, that is our view. As I said at the beginning, my own view is that you have to have some explanation as to why wage growth was weaker. That, for me, is the bottom line. It seems to me the natural explanation is that there was spare capacity in the labour market, even if allocating that slack is not entirely straightforward.

Q82 Mr Ruffley: That is very helpful. My final question, Dr Broadbent, is on the dip in productivity in the last three months. It has been broadly a story in the past few quarters of a revival in productivity growth. What is your assessment of productivity growth in the next 12 months, the short-term productivity levels?

Dr Broadbent: We have learned to be careful about these forecasts. My hope is certainly that I see continued growth. As David said, the experience has been disappointing, less so relative to other countries but certainly pretty disappointing relative to pre-crisis trends. We have been marginally encouraged by the fact that productivity does appear at least to

be growing somewhat. I would describe our forecasts—even if I share the medium to long-term optimism expressed by David and Martin, which I do—as relatively cautious, I would say. We have a forecast in which growth exists and picks up gradually, but even by the end of the forecast period it barely gets back to the sort of average rates that we saw prior to the crisis. I don't think our forecast is unreasonable and there might be various reasons, to do with repairing the scars left by the financial crisis, why you should expect marginally faster productivity growth than we have had to suffer over the last five years.

Q83 Chair: Governor, earlier in the session we had some exchanges and you have had exchanges with other members about the identity of this one person who does not agree with the other eight about that likely direction of tightening of policy that he or she thinks is as likely to be a loosening as a tightening. You gave a good explanation for why you think it would be important not, in each case, to identify the person. But in this case, don't you think there would be some good explanatory value for the public if, in due course, that person were to set out in a speech why there is such a different view held by that person?

Dr Carney: Yes, I think it would be logical that— All of us, as members of the committee, have a responsibility to explain our views. This is a nuanced view and that individual can explain it in due course.

Chair: Fine. Maybe it is not as stark as it appeared in the minutes, but I am not going to ask you to elaborate now. You have given me the response that I expected and hoped for, which is that you see merit in giving an explanation.

Dr Carney: Yes. I will not repeat, trust me, Chairman, my previous answer—

Chair: We try to avoid repetition.

Dr Carney: —but I will refer to it to put this in its proper context, which is that—

Chair: I am sure that will happen.

Dr Carney: —I think we spent more time on it in this hearing than it possibly merits.

Chair: Okay. Well, we don't know, do we? That is why we have been asking the question.

Dr Carney: Well, I know what I think.

Q84 Chair: Just to go back to the deflationary expectations exchanges that have taken place also between you and me and a number of members of the Committee today, is the biggest deflation risk the eurozone?

Dr Carney: The biggest potential shock, yes. I would agree with that, yes.

Chair: Therefore, we have a huge vested interest, as a country, in seeing the eurozone crisis resolved as speedily as possible rather than this continuing, as I put it at the beginning, as variable weather.

Dr Carney: We have a huge interest, yes, in a more sustainable evolution in the eurozone.

Chair: That is a polite way of putting it, yes.

Dr Carney: Of course, the member states have an even greater interest in resolving this.

Chair: Okay. Thank you very much for coming to see us on what is now almost this afternoon, still this morning. It has been extremely interesting and we are very grateful to you. We will see you next week on a much more detailed subject, which we will discuss for more than the two or three minutes that were allocated to it today.

Dr Carney: Yes. Thank you very much, Chairman.