



Treasury Committee

Oral evidence: Bank of England May 2015 Inflation Report, HC 314

Tuesday 14 July 2015

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Members present: Mr Andrew Tyrie (Chair), Steve Baker, Bill Esterson, Mark Garnier, Helen Goodman, Stephen Hammond, George Kerevan, John Mann, Chris Philp, Jacob Rees-Mogg, Wes Streeting

Questions 1-53

Examination of Witnesses

Witnesses: **Dr Mark Carney**, Governor, Bank of England, **Sir Jon Cunliffe**, Deputy Governor, Financial Stability, Bank of England, **Professor David Miles**, Member, Monetary Policy Committee, Bank of England, and **Ian McCafferty**, Member, Monetary Policy Committee, Bank of England, gave evidence.

Q1 Chair: Thank you very much for coming to give evidence to us this morning. Of course for you this is business as usual but for us it is the beginning of a new Parliament and a new Committee and we are very eager to hear what you have to say. We have a double-header, which is hard work for us all today and hopefully we will be able to get back into a more normal rhythm very shortly. Could I begin by asking a question that I have asked the Bank of England before in public session: do you think Greece can recover economically at current euro exchange rates?

Dr Carney: Thank you, Chairman, and thanks to the members of the Committee for having us and for your patience over these two sessions. I would say the following. Obviously the statement by the euro group leaders—a statement not an agreement by euro group leaders—on Monday morning is an attempt to craft a programme that will allow exactly that to happen, that Greece would be able to return to sustainable growth under current euro exchange rates. I would observe that what is embedded in that statement requires Herculean efforts from all sides, not just the Greeks, in terms of—

Chair: Do you think even Hercules can pull this off?

Dr Carney: The labours of Hercules? Well, it will be tested. The scale of structural reforms, the scale of fiscal adjustment that is required, the scale of privatisation that

ultimately will be required, all of these are significant. In addition, there is an observation about the necessity of smoothing the debt profile but that is another major effort that will be required at current exchange rates, implied exchange rates within the euro, in order to return to sustainability. I would say one other aspect, if I may, which is that the process by which this agreement was struck, the nature of the agreement, the scale of the challenge, underscores the series of institutional shortcomings that still exist within the European Monetary Union. That is something that is not just my own opinion and the opinion of colleagues at the Bank, but is the opinion of the five presidents, including the president of the European Central Bank. This is still unfinished business.

Q2 Stephen Hammond: Governor, thank you for those opening remarks. Can I ask about two things? One is the viability of the deal, given what the Greek people have always said in terms of the ability to find €30 billion of assets. Does the Bank have any view on the potential viability of the deal at all and, secondly, the ramifications of this particular deal in comparison to some of the discussions about other deals and what their impact might be on the UK economy?

Dr Carney: In terms of the first question and specifically with respect to privatisation, I would make a couple of comments, if I may. The scale of privatisation that is required is large, although the scale of state assets is equally still large in Greece. Secondly, depending on the future of the financial system, the banking system in Greece and potential recapitalisation of that system, that does create a series of assets that ultimately would be sensibly privatised in the fullness of time. Thirdly, the actual timetable around privatisation and the deal—at least as I understand it and obviously we were not in the room in striking the deal—is phased, in terms of the letter of what is a statement not an agreement, consistent with the profile of debt repayments. As you can appreciate, the profile of debt repayments is quite elongated so my understanding is it is not a forced immediate privatisation. All of those factors give some support to the prospects of executing what is a very large privatisation programme relative to the size of that economy. Those are mitigants, if you will.

I would say that again on an external reading of the deal, or rather the statement that could become a deal because ultimately it has to become a deal for financing from the ESM, it would appear that the privatisation programme is necessary to add to the path of growth, the productivity potential of the Greek economy in order to improve debt sustainability. All of that said, eyes wide open on this, there are big execution risks on all sides, including execution risk around the profile of the debt that in the judgment of the IMF—and I believe other authorities and we would share those judgments—is not sustainable in its current form.

Q3 Stephen Hammond: You made a comment about the judgment of the IMF. You will have seen considerable comment in journals about, first of all, the relationship between the IMF and the eurozone and how that has worked and how the leadership of the IMF may or may not have been affected by the membership of the eurozone countries, and also the actions of 2010 and the IMF not giving greater debt relief being fatal for the implications of what we are seeing now. Would you care to comment on that at all?

Dr Carney: It was apparent in 2010, and it is certainly absolutely clear now, that the IMF programme at that point stretched to the absolute limit the financing capacity of the fund. It was done under a special provision that was justified not on relative country size but on potential systemic consequences of the absence of a deal. It clearly stretched the ability of the Greek economy to finance, ultimately pay back the debt. One of the assumptions in the original programme was that Greece would move from being the least productive member of the eurozone to the most productive member of the eurozone, that there would be that improvement in the flow of productivity, not the absolute level of productivity obviously. That has not happened.

I will say one thing though, in 2010 the judgments about having an agreement for Greece were made in very different circumstances where the ECB had not specified additional tools to protect the integrity of the euro, circumstances where there was quite large European banking exposure to Greece and where there was much less confidence about the ability of the euro as a whole to weather the potential exit of one of its members. The situation is very difficult now, particularly for Greece. There is some risk of contagion; that is why defences are in place. But it is a very different situation today, which is why we can discuss this in a very calm, reasoned fashion and our session, I am sure, will not be dominated by Greece because we will quite rightly focus on a number of other issues. My point is—maybe I am taking too long to make it—that steps taken in 2010 did serve a purpose. That said, it is 2015 now; there are facts on the ground that have changed substantially. This statement of the euro group is an attempt to address those very difficult facts and the task of execution will be extremely difficult for all parties involved.

Q4 Stephen Hammond: A question to Sir Jon, if I may: you told the Treasury Committee that there was a very strong political will among euro members to keep the current euro together in December, and that has clearly been shown. Given what we perceive or we are told are now tensions between various leading members of the euro group and given that the Governor has just said we need to be eyes wide open in the execution risk of this deal, are you confident that the political will that is held through this would hold if the execution risk was such that the deal failed?

Sir Jon Cunliffe: I think the political will to hold the euro together has been pretty tested over the last few weeks. They managed and they stayed throughout the night on Monday to come up with not a deal, because it is the precursor to a negotiation, that everybody could sign up to. Given the different positions, I think that in itself was a pretty Herculean effort. To me, that is test of the will to do that, but it has been tested and I think for the first time also the idea of a time-out for Greece appeared in those negotiations, which would be some form of suspension. So it is clearly under a lot of strain. I think this is now a process where we have to see what is on the Greek side and then what is on the creditor side to see if they can keep it together. The message I took from the weekend and the events was that there was still an awful amount of political capital invested in the euro and a will to keep it whole and not to lose—

Chair: We might come back to it in the next hearing, which is financial stability implications as well and there are huge implications with respect to Greece. Could both colleagues and attendees at this meeting all turn off their electronic devices so that we

don't have these pings and other noises, which tend to get picked up more by microphones than they do in the room?

Q5 George Kerevan: Good morning, gentlemen. Good morning, Governor. I should preface this by saying that you will see in my declaration of interests that I was previously a journalist and I may on occasion have taken your name in vain, for which I do apologise, and I hope all is forgiven and we can move on.

I am interested, across the panel, in probing what the Bank feels and the Monetary Policy Committee feels is the sensitivity of the economy, consumers, firms, mortgage lenders, to a rise in interest rates. We are at quite a benign inflation number this morning but at some point interest rates must rise—we will not speculate when—and when they do it will be after a very long period in which they have been flat, unusually flat. Has that changed what you think, has that changed sensitivities to whatever the rise is when it comes? How would that therefore impact on the committee's response to, say, an American interest rate rise, how fast it would come, how much it would go? So, sensitivities.

Dr Carney: Thank you, and the slate is wiped clean if you also forgive me anything I have said in the past that may have caused any offence to you.

There are a lot of important points in your question. Let me start it this way: the point at which interest rates may begin to rise is moving closer, given the performance of the economy, consistent growth above trend, the firming of domestic costs, counterbalanced somewhat by disinflation that we are importing from abroad, in part because of the strength of the currency, so this initiation point is moving closer. There will inevitably be shocks and adjustments and there are lots of caveats around that statement. In thinking about not just the timing of the first adjustment, a decision we have to make individually, we also have to think about the impact of precisely your question, those adjustments on the UK economy, given—as Mr Garnier and others have raised in the past—the heavy indebtedness of UK households.

Let me give two points of context: the UK versus US, and then I will talk about UK households in a second. The first is that if you look at historic rate cycles in the US relative to the UK, the average US rate cycle raises interest rates by about 3 percentage points. That was then, this is now, and things are a bit different now. The largest UK rate cycle since the adoption of inflation targeting is an upward move of 150 basis points, 1.5%, much less than the average in the US. There are a few reasons for that but one of them is the greater sensitivity of the average UK household to interest rates because mortgages are principally floating rate in the UK, they are principally fixed in the US. It also relates to the relative openness of the economy and the impact on the exchange rate. That is a point of context that means that your question goes to the heart of the issue.

We look at this quite closely and we have been looking at this over the course of the last several years, both as the MPC and as the Financial Policy Committee. We look not just at the overall level of indebtedness of households, which to give broad-brush numbers has peaked at a little more than 165% of income and has come down by about 20, 25 percentage points over the course of the last few years as people have paid down debt and incomes have just begun to grow. We also look at the distribution of that debt and the cohort of heavily indebted households and their potential reaction to rate increases. We do

that in a variety of ways. We can model it out. We did that when we were constructing protections in the housing market as the FPC; we did it about a year ago. We also use survey evidence. There is a Bank of England NMG survey that looks at how people expect to adjust to changes in cost, including changes in interest rates, and that does show a heightened sensitivity, albeit a reduced heightened sensitivity to what it was a few years ago because households have been making progress in reducing their exposure.

So it is one of the reasons why once rates begin to adjust we expect those adjustments to move at a gradual pace and to a limited extent. We will learn about the sensitivity as rates begin to adjust. We will watch it very closely because ultimately our objective is not to have inflation at 0%. We are absolutely symmetric in our views on inflation, as you know, and our job is to bring inflation back, our stated objective as a committee is to bring inflation back to that 2% target within the next two years.

Q6 George Kerevan: Could I move a little further? I appreciate all of that but, given that it would be unusual to have an interest rate rise suddenly after a long period, and many younger people might not have experienced that if it has gone on for five, eight years or whatever, do we have any evidence, have you looked for any evidence that the initial shock value might have an impact on behaviour? Would that then feed back into how the committee might approach changes in interest rates? If, for instance, you felt that people might overreact, would that then dissipate how far you would raise interest rates, other things being equal?

Dr Carney: I would say a couple of things on that. One is that there are survey expectations of what will happen to interest rates, what people expect to happen to interest rates. Secondly, we use opportunities like this, the Inflation Report, regional visits, speeches and so on, to get across the expected or potential paths of monetary policy and as a broad-brush message that the economy has been performing well. It has been growing faster than its historic trend now for a few years, give or take the odd quarter, but that is effectively what it has been doing. There has been a big increase in employment, wages are beginning to grow, interest rates are at exceptionally historically low levels, and so households should begin to manage their finances with the expectation that there would be some upward adjustment in those interest rates. At the same time, we are cautioning that all the news is not in the first adjustment. It is really in the likely path of interest rates. There are a variety of reasons, and I will not repeat them here, why one would expect the increases in interest rates to, as I said, proceed at a much more gradual pace and to a much more limited extent than in the past.

I accept your basic point, which is that for some people this will be the first time since they took out debt that rates have gone up and it will have an adjustment. In fact, we saw some element of this—and it is hard to be precise about this—in the spring of 2014 where a variety of things happened. The FPC took action to protect against excessive borrowing in the housing market but at the same time speculation about the possibility of rate increases increased and we saw a bigger adjustment in terms of housing activity possibly as a consequence of that.

Q7 Chair: Mr McCafferty, were you one of those two members on the MPC, mentioned in the minutes, who feel that policy remains finely balanced between voting to hold or to raise the bank rate?

Ian McCafferty: Yes, I was.

Chair: Why?

Ian McCafferty: I think there are a number of factors that are influencing my decision at the moment. As you are well aware, I was voting for a rate raise up until the end of last year and then changed my vote back to continuing to maintain current levels of policy. The proximate reason for that was of course the sharp fall in inflation triggered by the collapse in oil prices and in particular the risks that that posed that a period of close to zero inflation—and we are, as we saw from this morning's data, still in that period—would lead to—

Chair: We are at zero.

Ian McCafferty: We are at zero exactly.

Chair: We are at zero and you are writing letters again, Governor.

Ian McCafferty: We will, yes. But essentially that period of low inflation would in itself bring about possible behaviour change, that either employers would offer lower wage rises than would otherwise have been the case, that employees would either accept or operate on the basis of lower wage rises, and that would lead to a risk of more persistent low inflation than simply the one-off effect, as a result of the fall in oil and commodity prices and the rise in sterling, was due to bring about. That is not the only reason why I changed my vote but it was the proximate reason.

In addition to that, I think we have learnt a little more about the economy over the course of the last year in terms of why wages have been so low and the amount of labour supply that is available, both of which have suggested that we have been able to allow the economy to run a little longer than would have been the case had we not had that additional labour supply starting to come through. But at the same time I think the balance of risks that we face is shifting as we look over the course of the forecast. The near term risks to inflation have, therefore, been on the downside because of that risk of persistent low inflation because of behaviour change. As I look out towards the end of the forecast, my perception of the risk starts to change towards the upside, that as we start to see wages pick up and the labour market tighten we may well get to a point at which the rise in unit labour cost becomes less consistent with the 2% inflation target. Therefore, there is a balance to be struck in terms of where we pitch policy and I think that balance is quite fine at this stage.

Q8 Chair: The Bank is symmetrical between 2% below, 2% above target, but do you think that the risks associated with deflation are greater than inflation, that is from a policy perspective from acting upon it? We are now at 2% below but suppose we go to minus 1; are you equally happy dealing with minus 1 as you are dealing with plus 5?

Ian McCafferty: I think the chances of us going to minus 1 are quite slim, unless we were to see a further similar fall in oil prices, the halving that we have seen previously.

Q9 Chair: But what is your answer to the question: are you indifferent between minus 1 and plus 5?

Ian McCafferty: No, I am not indifferent between minus 1 and plus 5. Minus 1 is only 3 from the target; plus 5 is more than that. I beg your pardon, my arithmetic is a bit off. No, I think the risks of very low inflation—

Q10 Chair: We provide all sorts of services on the Treasury Committee. Just reminding people of these things is one of them. I would like to clarify this point. Perhaps I will ask Professor Miles on the point while you are thinking things through. It does seem to me that all the evidence suggests that the tools available to you on the low side, on the deflation side, are much trickier to deploy although we have had a lot of experience at it now than on dealing with traditional inflation, normally hit by higher rates. Do you now think that policy can be symmetrical?

Professor Miles: In terms of the risk, I do think it is pretty symmetric. On your question about minus 1 or plus 5, which is worse, in September 2011, I think it was, the inflation rate was at 5.25 and that felt a very tricky position to be on the MPC at that time. I think there was a real risk then that inflation expectations would move higher and people would not think that we would get back to the target. What strikes me about the recent experience, when inflation has turned out lower than we thought a year or so ago, is people's inflation expectations seem quite well anchored, two or three years down the road when you ask people where they think inflation will be, to the target. Even when inflation was marginally negative, I don't think there was much evidence at all that people thought that we would descend into more and more negative inflation. In fact, people thought that inflation would get back to 2% a couple of years down the road.

Q11 Steve Baker: Good morning. Have we entered a period of secular stagnation, Professor Miles?

Professor Miles: I am sceptical as to whether we have. Larry Summers, who is a great economist, thinks that this is a real risk. He thinks it is a risk because he believes that maybe the level of investment at any particular interest rate may be a lot lower than it used to be and maybe people's desire to save at any particular level of interest rate is higher than it used to be, and that is a problem because you start running out of demand. There is more saving and not enough investment and that, in a nutshell, I think is his version of secular stagnation.

I have to say in the UK I am not convinced that this is a particularly good description of where we are. The savings rate in the household sector in the UK is unusually low. It just went beneath 5% on the latest Office for National Statistics numbers. We have had relatively weak investment over the last few years, but my own view about that is that it is not a long-term downward shift in people's desire to invest. It is that we have been until very recently in a very deep recession. Companies have probably had more capacity than they needed and it is not surprising that in that environment they don't do much investment.

My short answer to the question is that within the UK the low level of interest rates has been a sort of rational response to a very sharp downturn, but to my mind it does not tell you that we need very low interest rates really as far ahead as you can possibly look.

Q12 Steve Baker: Since you mentioned Larry Summers, the BBC has reported that he has said—it is not a literal quote, it is a quote from a BBC article—that, “Growth over the last few decades has been increasingly reliant on a series of financial bubbles, whether in tech stocks or housing, to generate enough investment to achieve full employment”. Do you think that Larry Summers might be on to something there?

Professor Miles: Some of that I think is particularly relevant to the US where the dotcom boom was a big story and there was a lot of investment driven on the back of that. I am not sure that it was such a big driver of investment in the UK. The level of interest rates between 1997 and 2007, which we seem to need in the UK to keep things roughly in balance and unemployment relatively steady and inflation at target, was not an unusually low and falling number. It was about 5% pretty much the whole time.

Q13 Steve Baker: Thinking about that, thinking about the new normal, the Committee staff have very helpfully given us the path of bank rate back to 1973 and there are clearly three normals here: a period until 1992 where interest rates were in a band broadly between 8% and 14%, then between 1993 and 2009 where they were, as you say, around 5%, and then the pedal really hits the metal and stays there from 2009. But from what you have just said, I sense that you don’t see a corresponding change in people’s propensity to save that corresponds to these interest rate shifts, these three normals.

Professor Miles: I think where we are right now with extremely low interest rates is we are still dealing with the thankfully fading after effects of the terrible crisis of 2008 and I don’t think that is a guide to where the new normal for interest rates will be. It may be that the new normal is a little bit lower than Bank Rate at about 5%, but I don’t believe for one minute the new normal is extremely low interest rates near the zero bound where we are right now.

Dr Carney: Let me say a couple of things, if I may. First, secular stagnation means a lot of different things to different people, as you know, so I will concentrate in on what I think is the most helpful bit of the debate, which is where you are headed, which is where savings and investment equilibrate. Larry Summers’ thesis is that that has been steadily falling globally and in fact it is negative and that was consistent with central bank policy. I would say that is entirely consistent with the policy of major central banks, including the Bank of England. The reason for £375 billion of asset purchases is because the judgment of the MPC was that interest rates had gone to as low as they possibly could go and they needed to go negative, and effectively the way to create a substitute for negative interest rates was to purchase assets and adjust overall financial conditions as a consequence of that. The challenge for us today, to bring it to the MPC today, is where is that so-called equilibrium interest rate today, where is it headed tomorrow and how should we judge our current policy stance relative to that equilibrium interest rate. That is a very complicated judgment to make.

I do think that there are a variety of factors that mean that the new normal, certainly over the policy horizon over the next three years, is substantially lower than it was previously. I said in response to a previous question from Mr Kerevan that I thought that the point at which interest rates would begin to adjust up is moving closer, but over the policy horizon there is no question in my mind. I see no scenario in which they would move towards historic levels.

Q14 Steve Baker: I do want to move on to inflation targeting and alternative policy tools, but before I do I just want to drill into something implicit in what you have said and this idea of negative interest rates. It seems to me there is a logical contradiction in it. Usually we expect to pay people to save and people to pay a charge in order to invest but negative real interest rates seem to suggest that we are paying people to invest and charging people to save. Why would any saver be prepared to pay a fee to save?

Dr Carney: We are speaking conjecturally so I am not advocating this, but the issue is that if there is an equilibrium where there is excess savings relative to investment—there could be a variety of reasons for that. People could be saving more because they are more concerned about the future or because of where they are in the demographic cycle. They could be saving more globally because they are an emerging economy that is intervening in the foreign exchange market and building up reserves to manage things. Relative to investment, and investment could be falling in part because capital intensity of investment has been falling, in part because of uncertainty, in part because of financial headwinds that Professor Miles just referred to, which are now fading, all those factors could mean exactly the scenario you described. The question is: why would a saver accept effectively what is a tax on their savings, giving up money? You have to be extremely risk averse in order to accept that because you have alternatives for your savings, and your alternatives for your savings are to take more risk and buy equities or buy property or invest directly in a business. It is an uncomfortable position to be in without question, which is why one of the contributions we can make to this whole issue is, first, fix the financial system, which is the topic for the next session, as you know; secondly, make sure that people's expectations are that we will do our job to get inflation back to that 2% target so that the real interest rate is lower and that spurs activity in business and ultimately helps bring up this equilibrium interest rate; to make sure to validate those expectations by achieving that.

Q15 Steve Baker: I am sorry, Governor, the Chairman has asked me to move on. I want to pick up on this term “expectations”. I think we should be congratulating you on your second anniversary this month of joining the Bank and I am conscious that policy has not actually changed for some years. When did monetary policy last change?

Dr Carney: Well, it has changed. The last time interest rates changed was March 2009, six years ago—make sure we get our maths right. After we turned off our devices it is really difficult, Chair. So it is six years when that last changed, but of course in the subsequent years there were huge changes in monetary policy because of asset purchases.

Steve Baker: Which stopped in July 2012, did it not?

Dr Carney: Exactly. When I arrived there was an understandable split in the committee where some three members were still voting for additional asset purchases. We shifted

policy from that to an expectation of no more asset purchases, not beginning to think about raising interest rates with forward guidance. Now we have been moving towards the point at which policy may begin to normalise. Different members of the committee will have different views on when that point should be. That is a shift in monetary policy.

Q16 Steve Baker: As ever, I find myself with vastly more to ask you than I have time for, but the point I am making is that during the time you have been Governor surely the main contribution to monetary policy of the committee has been in managing people's economic expectations rather than changing monetary policy itself.

Chair: If you can answer that in a sentence, you can provide an answer.

Dr Carney: Yes, but the dramatic changes to the health of the financial system over that period have also provided a much improved transmission mechanism for the monetary policy that has been in place and as a consequence of that monetary policy has become more accommodative over that period.

Chair: See how well we do. Very good indeed.

Q17 Bill Esterson: Good morning. Can I ask you about the so-called productivity puzzle and why is productivity in this country so weak? A range of views, please.

Dr Carney: There is a range of views and colleagues certainly have done a lot of work on this and I would encourage you to solicit their views as well. Let me keep with the previous line of questioning and add one element that we think is beginning to come off so it is relevant to what we see over the forecast horizon as a pickup in productivity, which is the health of the financial system and the functioning of the financial system. We had a period post-2008-09 where, as we are all aware, the UK financial system was not functioning well. Credit was severely constrained and in addition it is not just credit was constrained but there was a great deal of forbearance of existing loans. Part of productivity is births and deaths of companies. People are starting new companies and putting old companies to bed; there is a reallocation of capital; new jobs are put in place; people move to more productive jobs. That is absolutely essential to the build of productivity. On all those metrics in the years following the recession there was a sharp fall in the number of new companies created, and importantly about 40% below historic averages during the recession of the number of companies that went into liquidation. It seems like an odd thing to advocate but it is a good thing for companies that ultimately are not productive, ultimately are not going to make it, to cease and capital and resources to move over.

In part that was a product of the weakness of the financial system. It was a financial system that could not withstand that level of liquidation. What has happened since—I will try be quick—is the rebuild of capital in the financial system, the increased resilience, has meant that we are seeing a pickup. First, in the labour market, people shifting jobs is now back to historic averages of job churn; people are willing to take chances and go out for a new job. Secondly, we are starting to see a pickup not just in company formation but in company liquidation, which is a good thing. So we expect that through this channel we will see part of the productivity puzzle be removed, but I have only given you a sliver of the answer to a much broader question.

Q18 Bill Esterson: Other views, anybody?

Ian McCafferty: I think there is no single factor that has driven the productivity puzzle. The factors that have depressed productivity were different at the depth of the recession than have perhaps held productivity back more recently. In addition to the ones mentioned by the Governor, including capital allocation and forbearance, I think we have to look at this in a microeconomic sense as well as in a macroeconomic sense because there are very significant differences in productivity performance by sector. Just under half, about 40% of the productivity puzzle can be explained by reference to three specific sectors: the North Sea, the financial services sector and the utilities sector. I think the causes of their shifts in productivity performance are not always specifically linked to the crisis but are very specific to those three areas.

In addition to that, we have some evidence that through the course of the deep recession we had a reallocation of labour within firms. A number of firms have reported to me, for example, that they have had to spend more time searching for business rather than necessarily completing it and that will change their output relative to their intensity of labour. There is also the composition of the labour force. The fact that over the course of the last year or so we have seen more than proportionately that the creation of new employment has been in lower paid and probably lower productivity jobs means that, while the individual productivity of an individual worker may not be suppressed, the average is therefore suppressed across the whole economy.

So I think there are a whole series of factors which have changed over the course of the last six years from those that perhaps initially caused the dip in productivity to where we are now.

Q19 Bill Esterson: Just to explore this point that people are working longer, what are the tools that you would advocate to ensure they can work smarter, if that is a way of phrasing it?

Ian McCafferty: One of the things that we are starting to see is, of course, a recovery in business investment. Over the course of 2014-2015 we have seen quite a sharp rise in business investment and as the data matures it has become clear that that pickup in business investment has been stronger than was initially suggested. To that extent, I think some of the initial causes of the productivity weakness were to do with the collapse of investment that we saw at the time of the recession and that is starting to be reversed. As the Governor has suggested, as we start to see interest rates and monetary policy normalise, we may well see some of that reallocation of capital start to feed through, which will also help productivity.

Q20 Bill Esterson: Is public sector investment strong enough?

Ian McCafferty: It is clear that the latest Budget does suggest that the Government are paying a great deal of attention to ensuring that infrastructure is an important part of improving productivity.

Q21 Bill Esterson: What do the rest of the panel think about public sector investment?

Professor Miles: There may be some glimmer of the light at the end of what has been a very long, dark tunnel in terms of productivity over the last few years. I think I am right in saying that the latest figures for the growth of productivity per hour are something like close to plus 1%, up to the first quarter of this year. That is a little bit more like a normal number, having had many years where it was either negative or zero.

Sir Jon Cunliffe: I think most of the main factors have been identified and we may never be able to do the arithmetic to solve the puzzle. One thing I would say, and it picks up on what the Governor said, is that if the credit cycle gets out of control or the financial sector gets out of control, there is a lot of evidence that it misallocates resources in the boom and then it is unable to function as the brain of the economy, directing resources to the most productive use in the recovery. That is one of the reasons, I think, why recoveries from recessions induced by financial busts are so long and so painful. Also I would associate myself with David's comments on secular stagnation. That is probably what we are seeing, a painful recovery. The kind of average time is given as seven or eight years and I think that is where we are. It is also one reason why if you want to have stable sustainable productivity growth you need a stable financial sector. These two things are not opposed; they are complementary.

Q22 Bill Esterson: Is part of the answer that we need to redress the imbalance, if that is what it is, between manufacturing and the service sector?

Sir Jon Cunliffe: My point was more we have to ensure that the financial system does its job on allocating resources, which is a vital job for a modern economy, and does it in a way that allocates resources efficiently and does not respond to the wrong incentives.

Q23 Bill Esterson: But what about that question? Does anybody want—

Chair: It will have to be very quick, a sort of yes or no, otherwise we are going to run very behind.

Sir Jon Cunliffe: Some of the productivity that Ian mentioned that we lost in the financial sector was probably illusory productivity because the financial sector had grown too large and been stimulated by the credit cycle.

Q24 Chris Philp: Just developing further this question about the role that bank finance plays in stimulating productivity by allocating capital to the more productive sectors, the sort of process Schumpeter would approve of, what action has the Bank of England taken to encourage lending banks to make sure that zombie loans are liquidated and that there is proactive new lending to operating businesses? In particular, do you think that trying to get the tier 1 capital ratios up, which has successfully been done to 11% over the last three or four years, may have actually inhibited the process of getting banks to lend to the productive sector and maybe that has been a little bit procyclical rather than countercyclical?

Dr Carney: Thank you for the question. I will preface it this way, which is just clarity on committees. The MPC takes a view on how well the financial sector is functioning, actually and prospectively, and then sets monetary policy accordingly. Some of these challenges are one of the reasons why monetary policy has been as it was: extremely low interest rates, asset purchases, other factors. It is more the responsibility of the FPC and the PRA in its supervisory role, those arms of the Bank, in directly addressing your concern.

In terms of forbearance, the first part of your question dealing with, your term, zombie loans, I distinguish between that which we can directly address, so these are loans that effectively have gone bad and that they are only refinancing because of a compounding lending to the entity, so the lending is being paid back to service the loan. In terms of the individual bank's responsibility, there are supervisory responsibilities obviously we are right on top of and we are not seeing, and you would not expect to see, a big surge and there is not a big pool of these types of loans in PRA-regulated institutions. A more subtle issue, though, is what Mr McCafferty and I were touching on, which is that given the low level of interest rates, there are loans that firms can service but they can't service at more normal levels of interest rate, so they have a period of time to improve their own productivity or to make a decision to exit their business and move somewhere else. The process of as interest rates begin to move up, it is not just households whose expectations will adjust but it is also businesses' expectations will adjust and that is part of what helps to drive an improvement in productivity. That is one of the channels we were alluding to. By the way, I would agree with everything else that was said in terms of overall add-up on productivity and prospects for some improvement.

I would reject the second part of your question, which is the idea that somehow by ensuring that financial institutions are adequately capitalised it makes them less likely to lend to productive sectors. In fact, if there is a lesson from the differential performance of the United States, Canada, Australia and now of the United Kingdom relative to the performance of continental Europe, one of the core lessons is you recapitalise your banking system transparently and effectively early on. That banking system will then have the confidence to write off zombie loans, the ones they should, and go out and look for new business and find new business. We have seen a steady improvement in availability and terms of credit over the last several years following the action of the Financial Policy Committee, action that really preceded my arrival so I am not taking credit for it, that ensured that these banks moved in a timely fashion to appropriate levels of capitalisation. So it is the exact opposite. There is a limit to everything. It doesn't go on for ever, but it has been achieved.

Q25 Chris Philp: On the question of low wages or low wage jobs, which I think Mr McCafferty touched on a few moments ago, there is some suggestion by some economists that when employers can take on employees on low wages—for example the minimum wage currently at £6.50 an hour—it acts as an disincentive to invest in IT, plant and machinery or indeed training because they can simply hire low wage staff as an alternative to making those investments. In that context, do you think that the fairly significant increases in the minimum wage contemplated in last week's Budget might act as a stimulus towards companies

investing more heavily in those areas, staff training, IT and so on, and might that therefore have an indirect effect in stimulating productivity growth?

Dr Carney: It is a very important question. Two things. First, Mr McCafferty in his earlier answer alluded to an important point, which is that the composition of the labour force, recent job growth, has been more heavily weighted in lower wage jobs and jobs where there is a mismatch between people who don't yet fully have the skills for the position they are filling. We expect that effect to go away and that is part of the recovery in productivity that we expect over the forecast horizon. To your general point, yes, on the margin changing wages will shift the balance in terms of firm investment, either into capital or into human capital, training and the like that you referenced, and should on the margin have some effect on productivity.

As you can appreciate, the changes to the national living wage have just been announced. We are, as a committee, in the process of analysing them and their impacts on not just productivity but the prospects for inflation in the UK and we will report on that in the August Report. On a personal level, I take note of the OBR's analysis that from an inflation perspective this is a very modest impact. I also take note of historic moves in the minimum wage in the early 2000s, which cumulated to about a 31% increase over four years, similar orders of magnitude, that there was no discernible impact on inflation at that time. But we will do a comprehensive analysis of these issues and bring them back to our remit, the impact on inflation, in the August report.

Q26 Mark Garnier: Governor, household balance sheets. We are seeing household debt increasing and although it is a very small portion of household debt, unsecured debt is up 7.2% over the last year. Are you worried about rising household debt, notwithstanding the household debt in terms of the household income ratio on which I appreciate your point? But are you worried about the general trend on household debt, particularly the unsecured element of it?

Dr Carney: I would say that it is something that both committees watch closely and that we have some expectation over the medium term that this reduction in overall household debt to income will bottom out and start to move up, not least because of the generalised rise in housing prices. As older people sell their homes and the older people have smaller mortgages, the purchaser inevitably has a bigger mortgage and as a consequence there is this drift associated with house prices that is there. Your question is specifically around unsecured lending, which has picked up. It has picked up after quite a low period. It is something we look at and we look at specifically on a cohort basis as opposed to across the entire population to look for pockets of vulnerability. To use the dashboard terminology of my colleague, it is not yet flashing red on the dashboard. When we have a chance to talk about the risks for the FPC, it is not one of our core risks, but it is something that we watch closely, yes.

Sir Jon Cunliffe: Unsecured lending to consumers is growing at 7% to 8%, which is higher than it has been in the past. Pre-crisis it was growing at about 12% to 13% and the overall stock I think now is about £160 billion, £170 billion. It was well over £200 billion before the crisis, which is not to suggest it is not something you watch, but it is about a fifth of all household debt so one has to bear it in mind.

Q27 Mark Garnier: Put it into context, yes. I do appreciate that but there are interesting threads coming together on all of this. The household savings ratio has now dropped below 4.9% and for quite useful reasons. If you are a risk-free person your risk-free return is so small, more now in a helpful way it is pushing money to those who are slightly higher risk where you can get into equity and that is investment. We then put investment into the wider economy. But equally so, we require household consumption to help drive the economic recovery and you are seeing savings ratio very low and you are seeing household debt going up. Is there not a risk that with very low interest rates you are now seeing people being pushed into blowing their money or indeed even just going off and borrowing more money to buy stuff? The economic picture is so uncertain in terms of equity investment, your risk-free rate is so little there is no point in saving. You may as well have a bit of fun and buy that Aston Martin you have been looking forward to, or a flat screen TV, depending.

Dr Carney: The one risk we are not worried about is that hand-to-mouth consumers are about to purchase an Aston Martin.

Mark Garnier: I used hyperbole to make a point.

Dr Carney: In our May forecast—and as you know we are in the process of updating our one for August—the principal driver of household consumption over that forecast is the recovery in wages and the pickup in wages. The recent wage data that we have seen through April is consistent with that, if anything a touch firmer—it depends on how one looks at bonuses— than we had expected in May. For our purposes, to achieve the inflation target we need to see that wage growth pick up towards 4%, a bit above 4% on an annualised basis, over the course of the next few years. Assuming it does, and that is our forecast, it is more that dynamic than a reduction in the savings rate and a pickup in unsecured household borrowing that is driving consumption. We can achieve the inflation target, we can use up the excess slack in this economy and continue to grow at trends rate consistent with that. Embedded in that forecast is an upward adjustment in interest rates. We happen to use the market interest rate curve, as you know, as the assumption, but consistent with that is an increase in interest rates and we would run greater risk with household borrowing but importantly for our mandate, for our remit, with inflation if we were to not make an adjustment. That in essence is what the forecast says.

Q28 Mark Garnier: That is very helpful. On a slightly different subject, has the mortgage market review been a good thing or a bad thing? Has it created strange pressures in terms of where people are trying to borrow money? Do you think the mortgage market review has achieved its objectives?

Dr Carney: I will just say a few words and, Chair, with your leave, Professor Miles may want to add, because he has thought a lot about this. I think broad brush it has achieved its objectives in terms of bringing underwriting standards up to levels of common sense, documentation of borrowers, minimum tests for serviceability. I think it has done that. It has had a noticeable impact on the performance of the housing market as there was an adjustment from the old way of doing business to the new way of doing business and it may have had a longer tail. Certainly relative to our forecasting expectations for the housing market as part of our inflation forecasting—this is going back, say, 15 months or so ago—it had a bigger impact for a longer period of time than we would have expected.

Professor Miles: I think it has been a good thing. To my mind, the main thing it has done is make all lenders—and many did this anyway—ask some pretty searching questions about whether mortgages would be affordable if interest rates were to rise 2% or 3% over the next few years, maybe more than they will but at least ask questions as to whether people could deal with that. It comes back to Mr Kerevan's question about how worried one might be in the current environment about the first rise in interest rates, which clearly is coming and is not a bad thing. I think I feel more reassured this time round that we can deal with that without too much pain, partly as a result of the mortgage market review. I think it has been useful.

Q29 Jacob Rees-Mogg: Can I move us on to the current account deficit and your thoughts on whether we should be concerned about this, whether there is some point at which people suddenly switch from being entirely relaxed about the current account deficit to suddenly panicking about it? Historically it used to be politically of great importance but most people no longer think about it very much. What are your concerns and do you fear that there might be a change in sentiment or do you think this is old-fashioned mercantilism and we really should not worry?

Dr Carney: I welcome the question and, as Sir Jon knows, this is one of the risks that the FPC has identified as one of the top risks to the UK economy. So let me go through reasons to worry about it, the reasons to take some comfort and then what does it mean for policy.

In terms of reasons for concern, as you pointed out it is at an historic high, 6% of GDP. Ultimately one is relying on the kindness of strangers in order to finance a current account deficit. If that kindness goes away, there is a sharp adjustment that is required of the economy. You basically have to reduce spending and investment. The FPC used that as a motivation for a stress test of the banking system last year. It is a stress test, so it is an extreme scenario, but you can see the channels where there is a pullback of financing, an impact on sterling, an adjustment on interest rates, a big adjustment in the housing market, a big adjustment to bank balance sheets, a three-year recession, doubling of the unemployment rate, and so on. All of this is in the public domain. There are channels that can go there and it is our job to worry about some of these things.

Why would one be slightly more sanguine about this current account deficit? The first reason is that it is largely at present financed by longer-term flows, foreign direct investment, equity investment flows, so it is a good financing mix. It is not short hot money. Secondly, those flows are denominated in sterling and so there is no mismatch. It is in the right direction. It is not associated, despite the conversation that we have just had, with accelerating household borrowing. There is not a domestic boom that is associated with this current account deficit. In fact, one of the big counterparts is the fiscal side, the fiscal deficit.

That leads to what one does about it. Taking it at the highest level, the optimal policy mix to address a current account deficit over the medium term would involve several things. One is tighter fiscal policy, fiscal accommodation. The Government has set out their plans and you will be debating them. Accommodative monetary policy; again anchored relative to the inflation target but monetary policy - independent of the stance of fiscal policy, the tighter fiscal policy - is again to achieve the inflation target. We would adjust accordingly.

Thirdly and importantly, and this is something the Bank can do now, is to run tighter macroprudential policies, so be aware that in an environment of very low interest rates for a long period of time, whether it is in the household sector or in financial markets, risks may develop and we may need to take steps to adjust accordingly. My last point is to pick up on near where you finish, which is to underscore the importance of maintaining the attractiveness of the UK as an investment destination, so that means sound macro policy. It means being open to trade and investment, as it always has been.

Q30 Jacob Rees-Mogg: Investment follows on from that. Sir Jon, you may be the expert on this considering your previous role. Are you concerned about investment in relation to our position in Europe and the discussions over our membership of the European Union?

Sir Jon Cunliffe: So far we have seen, in the investment numbers and investment intentions, no particular sign of that and we saw no sign of that in the run-up to the election. Investment intentions are strong and business confidence is strong, and the forecasts for investment going forward reflect that. That has not been seen. Of course there will be a referendum and this is something one needs to watch quite carefully on the way, but at the moment there is no sign that it is having an effect.

Q31 Jacob Rees-Mogg: Moving on to sterling, the June minutes noted that, “The past appreciation of sterling had the potential to impart a somewhat more persistent negative impact on inflation, however”. The thing about sterling is it is both a cause and effect of how you set monetary policy, isn’t it? If you put interest rates up sterling rises and that helps reduce inflation, but if sterling is high that helps reduce inflation too and therefore may encourage you to reduce interest rates because of the result of sterling and vice versa. What is your view? Do you take a view; do you have any formal or informal targets on sterling or any discussions with the Chancellor about where sterling ought to be in terms of your approach to monetary policy?

Dr Carney: Thank you for the question. It is an important one. First, to be absolutely clear, we do not take a view on the level of the exchange rate. There is no informal target let alone a formal one. One of the strengths of the monetary policy framework in the United Kingdom has been not just inflation targeting but a commitment and a demonstrated commitment to a freely floating exchange rate. This is a very open economy, as you know. It helps us adjust to shocks. It is relevant to the previous discussion we just had about the current account and part of the reason why one can take some comfort given the scale of the current account. What is important with sterling, in my opinion, with respect to monetary policy is that large moves of sterling have in the past, and it appears to be in the present, had a persistent impact on inflation. In other words, the pass through has not been immediate. It has shown up over time and it shows up, including over the horizon of monetary policy, so the horizon over which we can affect inflation. If there are large movements, and there is evidence of persistent pass through, it is harder to just look through those adjustments. That said, that does not equate to reacting to short-term moves and in no way would one expect tightening financial conditions because of the strength of sterling to remove the need for some adjustment in interest rates at this juncture.

Q32 Jacob Rees-Mogg: Although a sharp fall in sterling could lead to a rise in interest rates, that would not be because sterling had fallen. It would be because of the inflationary consequences of a sharp fall in sterling.

Dr Carney: Let me answer it this way, which is we did a scenario, as I referenced, for a stress test last year that had some of that dynamic. We overrode the usual reaction function of the Bank of England, which would have been to look through most of the impact of this, in order to generate a bigger test of the banks, basically a sharper adjustment of interest rates and therefore the housing market, and so on. So it does not necessarily follow that we—certainly there is no mechanical relationship between the two because I would underscore the importance of the persistence of the move and in the fullness of time persistence of moves in exchange rates reflect fundamentals. They can deviate for fundamentals for some time but ultimately they reflect fundamentals. What is important is that market participants and businesses and households understand our so-called reaction function, that we are going to set policy to achieve that inflation target in a timely fashion and that we explain, as we tried to do in that report, where we see the impact of sterling.

To put it into context, and if I may put it into the current context, we have had a very large movement of sterling since its recent trough. In the last two years it has moved 17% up on an effective basis, so that is a very large move, but it will be more than counterbalanced by the firming of domestic costs, wages, relative to productivity over the course of the forecast horizon. That is what we effectively say in the inflation report and we will update that in August. So, even with the large move, it matters but it is not the dominant factor in terms of the outlook for inflation.

Q33 Wes Streeting: I want to turn back slightly to the issue of productivity and also to link into wages. Governor, in your Q&A following the inflation report you implied that the issues we have had in terms of productivity are cyclical and that some of the issues we have had around low productivity, low skill jobs, will correct themselves but the effect is going to last a little longer than we thought previously. How confident can you be that these are cyclical pressures and that the impact of the banking crisis has not led to a structural alteration to the economy that has placed us on a lower productivity path?

Dr Carney: It is an important question. I will say several things. First, I associate myself with Sir Jon's earlier answer that the tail from a banking crisis, from a financial crisis is very long. It does, because of the channels we have been discussing, tend to be associated with a lower level of productivity for some time, and that is what we are seeing. Even though we see in the May report a pickup in productivity to around 1.75% by the end of the forecast horizon, that is still well below the historic average of 2.25% and it is not making up any of the ground that we have lost. So even that recovery needs to be put in context. Some of the reasons why one would expect that pickup to occur, and we expect it to occur, partly is because of the investment pickup that we are seeing in actual investment and investment intentions. Part of it is what Mr McCafferty was referring to earlier in that when we look at the composition of jobs that have recently been created, they have tended to be either lower skilled or, as I said earlier, people are over filling jobs initially and gradually they will move into the right slots with more productivity. We do think that effect is going to tail off. We only find that data on a quarterly basis, so I am not more up to date on that information than we were when we put the report out. In addition, there are these financial channels that we have been discussing, that we do think that with a path of

gently rising interest rates there will be some of these positive dynamics of churn of capital between businesses failing and thriving, new and thriving businesses, which will help with productivity.

Q34 Wes Streeting: At what point would you expect to see a more significant improvement in productivity to give that reassurance that this is cyclical and that we are going to correct the position? The concern would be that if it has taken a lasting hit and the economy has less spare capacity to grow without generating inflationary pressures, then interest rates will need to rise earlier. How are you determining the pace at which you would want to see productivity improving in policy terms, particularly around setting interest rates?

Dr Carney: A couple of comments. The first is that we have seen a pickup in productivity subsequent to the publication of the May report. We received the revisions for Q1 data, which meant, as Professor Miles said, that Q1 productivity was substantially higher than initially reported. It came in I think at about 0.8, just less than 1%, so that is more consistent with what our expectations would have been. Secondly, I would agree with your point, and it is a point we make, that in the absence of a pickup in productivity consistent with the forecast, then there would be an adjustment to the pace of increases. If productivity growth was slower, then all things being equal there is less spare capacity; monetary policy would have to normalise to a greater degree. But there are two-sided risks here. Productivity could be stronger. It is a puzzle for a reason. It has been surprisingly weak for a period of time, irrespective of all the explanations we have been giving for it, and as the expansion progresses we could see this picking up more rapidly. So it is one of the key variables on which we have to stay on top.

I will say though that none of the bigger measures to improve productivity, the types that are being debated through a productivity plan and debated in the House—their impact on productivity really affect the medium and longer term productivity. It is to the great credit of the House to debate those issues because it is well beyond the usual horizon of certainly monetary policy but ultimately essential to improve living standards over the longer term.

Q35 Wes Streeting: Briefly on wages, did the Chancellor consult you prior to the announcement of the so-called national living wage announced in the Budget?

Dr Carney: I have regular discussions with the Chancellor on a variety of issues and I think it is best in order to ensure it does continue—

Chair: Was that a yes, Governor, or did I detect a no? I think that was a yes, wasn't it?

Dr Carney: This is right there with confirm or deny on nuclear submarines and stuff like that.

Wes Streeting: You should consider standing for election, Governor.

Dr Carney: When the Chancellor formally consults there is an exchange of letters, I think is the best way to—which end up in the public domain.

Chair: I think that is a yes.

Wes Streeting: I will take that as a yes. Going back to the productivity dimension, do you think the pace at which we see an improvement or otherwise in productivity has any bearing on the pace at which the Chancellor wants to increase the minimum wage in the timescale announced in the Budget?

Dr Carney: I am not privy to the Chancellor's thinking on that. I refer back to the previous discussion in that there should be some—and I wouldn't overplay this and I don't think the OBR has in its estimates—improvement in productivity as a consequence of adjustment in the national living wage. The orders of magnitude to the individuals are probably quite significant, but from the economy-wide perspective should be relatively modest. We will refine our estimate of that for the August report.

Q36 Wes Streeting: What impact do you think the increase will have on the labour market? Do you expect there to be regional differences? Do you expect it to impact on migration?

Dr Carney: Again, I would refer to the August report, keep it in our remit, if I may, for a moment. The order of magnitude adjustments could be up to around 0.3 percentage points on the level of wages, overall level of wages, not for those who get the direct benefit, over the four-year horizon over which this is phased in. Labour costs are about 50% of overall costs, and not all of that is necessarily passed on to the consumer. One starts to see that the orders of magnitude are quite modest in terms of overall impact on inflation over that period. That is just the level of prices, it is not ongoing.

In terms of regional impacts, we do not do regional analysis at the Bank. We care about what is going on in the regions, and we visit the regions and see the data, but we do not do regional forecasts. Of course, it would be a product of the proportion of workers who are at the minimum wage. Importantly, and this is one of the key questions, is those who are just above the minimum wage and what happens to pay differentials as the national minimum wage comes into pass.

Q37 Wes Streeting: I really do welcome any increase in the minimum wage. Finally, there is a risk that what the Chancellor has done is circumvent the Low Pay Commission, which has been a really important structure for bringing all of the relevant and interested parties around the table to talk about the potential impacts or otherwise of increase in the national minimum wage. What action will the Bank be taking in terms of asking the Bank's agents to take soundings from industry about the effects it might have, and does the Bank take a view on what might happen to employment trends in the labour market?

Dr Carney: One of the things we do as a committee every quarter is that we set the questions for the agents to ask their business contacts and then we get those survey results back. This is on top of the regular discussions that our agents have. So it will not surprise you that the committee has been very interested in investment intentions. It has been interested in broad-brush impact of small political risk on investment intentions. It has been interested in developments in the labour markets and tightness in the labour market. Undoubtedly that last interest will endure as the national living wage comes into being. But I would be surprised, under the control of colleagues, if we would be as specifically focused as that, as opposed to overall labour market conditions, tightness of labour market,

difficulty hiring, wage intentions, and so on, and how this, among other factors, play into those conditions.

Wes Streeting: Do any other panel members have a view on that? Thank you.

Q38 Mark Garnier: Governor, just a very quick one on this. One or two organisations representing small businesses have expressed concerns that where you have a small business, which is a low-wage employer, so the hospitality sector or the retail sector, that will put pressure on that business. Should they be worried? Is it not the case that if one shop suddenly discovers the cost of their wage has gone up that is mitigated by the fact that the staff of the shop next door is spending more money in their shop? Does it not accelerate the circulation of money within the system and, therefore, any worries that the low-wage employers may have just gets worked through the system relatively quickly?

Dr Carney: I will answer this, and it will not entirely satisfy you, but why change at this stage? We will look at this in the round. What is the overall impact on the outlook, obviously for inflation, but economic activity? There is an element of this, as you say, that is without question, which is that greater disposable income for a larger number of people does circulate in the economy. There is an art and some science to picking the right spot for that. At this stage, this is a personal view; it is an important initiative for the individuals directly affected. In terms of overall economic impact, whether on inflation, or activity, or productivity, it will modestly move all of those up, modestly but not materially. That is an initial personal read as opposed to a committee read.

Q39 Helen Goodman: Thank you very much. Governor, you have said that wage growth is one of the most significant things in your forecast. To use a very old-fashioned term, when we joined the European Union and we agreed to the free movement aspects we were, in a way, internationalising the reserve army of the unemployed. I wonder if you could say what you think the impact of migration from the EU is and will be on wage growth, assuming we stay in the European Union.

Dr Carney: Just to give a bit of context to an important question, I think that the dynamics of the UK labour market over the last several years have been characterised by a very large, positive labour supply shock. There has been a big increase in the numbers of people seeking work, and we see that in much higher participation, particularly among people in their 50s and early 60s. Women in their 50s and early 60s are one cohort where there is much higher participation in the labour market than historically. If you just brought forward historic participation, again we see this positive increase. It is a little harder to measure with precision, but we have seen an increase in the desired hours of individuals as well.

That big increase in labour is one of the reasons, broad brush, why wage growth has not picked up as rapidly. It is one of the reasons why there has been more spare capacity, as Mr McCafferty said, than we would have thought previously. It is one of the reasons why businesses have substituted labour for capital, and one of the reasons, by extension, that productivity has been a little slower. I am coming to immigration in a moment. Even a big labour supply shock runs its course in time, and we have seen steady employment growth and a steady fall in the unemployment rate.

The reason I raise that is that it is important to look at the impact of immigration in that context, in terms of what has happened up to this point. Relative to what we would have expected a few years ago if we just brought forward historic participation rates, that increase in participation rate and the increase in hours worked, relative to trend, the combination of those two in terms of UK nationals supplying more labour to the labour market is, on order of magnitude, about 10 times the increase in immigration relative to trend over that period. So we have seen a sharp up-movement in immigration in the last few years, but it has come from relatively low levels, past historic averages, and they are supplying more immigrants, more net migration to the country.

Relative to the increased willingness of people in this country to work—and I use “willingness” carefully, because in many cases it is not willingness, it is need. It is need because of changes to pension arrangements, or need because of the burden of past debts. But the fact is they are supplying labour. Those are the orders of magnitude.

You asked, perspective, what does this mean going forward? My long introduction there was about an increase in labour supply that is being used up, and increasingly used up. On the margin the level of net migration will be increasingly important to incremental labour supply going forward, as it was in the early and mid-2000s in this country. It is something that we will be watching closely, because it does have an element of the reserve army, as you say.

Q40 Helen Goodman: So what you are arguing is that the significance of migration from the EU on the labour market will become more significant in the future. Do you have any thoughts on how significant that will be if the eurozone area falls back?

Dr Carney: Two things. Part of your question goes to the core of the dynamic. What is important for the supply of labour, particularly from the European Union, is the relative performance of the two economies. The UK, as we all know, has outperformed continental economies in recent years. Now, Greece apart, we see an acceleration in the recovery in the euro area. It has picked up. The banking system is finally being repaired. The ECB is providing significant stimulus, and they are being helped by broader improvement in conditions elsewhere, including the UK.

So there is some reason that that differential may begin to close, which on the margin, going back to Mr Rees-Mogg’s question, will help on the current account. As you know, part of the driver of the current account is poor investment performance on our UK investments abroad, more than it is in the UK. I would draw attention to this, which is that our forecast in May, and we will update it shortly, is that, even with these dynamics—relatively strong growth in the UK, relative to Europe, prospect of some increase in migration—wage growth continues to pick up over the forecast horizon to start to approach historic levels of north of 4%, which is necessary. We are seeing that in wage growth now.

Professor Miles: May I make a very brief observation?

Helen Goodman: Yes, Professor Miles.

Professor Miles: If you had said to me 15 or 20 years ago, “The scale of net migration to the UK will be this large, what do you think will happen?” I would have said, perhaps rather naively, “It will drive the level of real wages down quite significantly”. It turns out, having read quite a lot of studies on this—not having done the research myself, but just read people who I think do serious studies—that these real wage effects appear to be really very small, which in a sense seems very puzzling. Why should it be that such a large inflow of labour into the UK should apparently have quite a small impact on real wages?

I think the answer is the obvious one, and maybe it is kind of blindingly obvious, but it took me a while to think it through: that when a large number of people come, they do not just add to the supply of new labour. They add to the demand for labour as well, because they end up spending most of what they earn in the UK. So you get an increase in the supply of labour that is, roughly speaking, matched by an increase in the demand for labour, and it does not do a whole lot to real wages. I would not have thought of that before, but I think that is probably the answer.

Q41 Helen Goodman: Do you not think it might be different in different sectors?

Professor Miles: I could believe it would be, and you could affect relative wages in different sectors. I think if you stand back and ask the big picture questions, “What has it done to the overall level of real wages?” as I say, my reading of a lot of studies is surprisingly little is the answer.

Q42 Helen Goodman: The MPC minutes said in June it was likely that fiscal consolidation would continue to weigh on growth for some time. Following the Budget, do you still hold to that view?

Dr Carney: Two things. We will update our forecast with the next report. But the Budget has smoothed the pace of fiscal consolidation; it has not changed the overall quantum of it. There are some changes, as you know, in terms of the composition of the spending reductions relative to the March Budget, so we will have to work through that. It is one of the issues we will work through. But broad brush, I would start from the point that the UK Government have had the announced intention in Budgets in place for a sustained fiscal consolidation over the course of the next several years for some time.

That is one of the headwinds against the economy. It is known, and we take it into account in our forecasting. It is one of the reasons one would expect the level of interest rates, when they do rise, to rise to a more limited extent than previously, because there is a monetary policy offset. But order of magnitude, in my personal view I did not see anything in the new Budget that would materially shift the forecast as a consequence of the new Budget. If anything, on the margin, by smoothing the path of consolidation, it is marginally helpful.

Q43 Helen Goodman: What about the long-term implications of having a charter to lock in a permanent budget surplus?

Chair: Come on, Governor.

Dr Carney: If I may, I will speak from a Canadian experience, which is there is—

Helen Goodman: No, no, no, you are the Governor of the Bank of England.

Dr Carney: It is instructive, I think, because there is value in having a broad political consensus around managing public finances to balance or slight surplus in times of full employment, in so-called normal times. There is value to having the political consensus around that. How that is enacted, specific legislation, obviously is entirely out of my responsibility.

Q44 Helen Goodman: I know there is a value in having consensus on many long-term issues, but the question was: is locking in surpluses as a permanent feature of the way we manage the public finances, in your view, going to have a deflationary impact on the economy?

Dr Carney: Our view is that the Monetary Policy Committee, present and future, will always take fiscal policy as given, and will adjust monetary policy appropriately. In my personal view, I am pleased that Parliament will have the chance to debate these important issues fully.

Q45 Chair: We have had quite a few of these policies, haven't we? We have had the MTFS, we have had the code for fiscal stability, we have had the temporary operating rule, the charter for budget responsibility, and now we have this new one coming in. They do tend to come and go, don't they?

Dr Carney: I have seen many variants in many different jurisdictions, yes.

Q46 Chair: But do you still think they have some value?

Dr Carney: I think there is a question about the value of the management of fiscal policy. I am, maybe not clearly enough, declining to opine on specific legislation or loss that—

Chair: No. That is a reasonable decision for a Governor to take when he is not the Chancellor, and that is Chancellor's business. Your business is monetary policy. Chris Philp wants to come in and then Bill Esterson, with quick rejoinders, and then we must adjourn.

Q47 Chris Philp: Thank you. Just returning to the question of the current account deficit that Mr Rees-Mogg alluded to earlier, I would be interested in hearing Professor Miles' view on this, as well as the Governor. You mentioned before that clearly if there is a withdrawal of foreign direct investment, which is plugging the gap, that will cause a painful transition. Laying to one side that question, if this current account deficit persists—and it is the highest level for the 70-year period covered by your chart—and we continue to finance that with, essentially, foreign investors purchasing UK assets, both physical assets, companies, and making stock market investment, won't we have a situation in 10, or 20, or

30 years' time when an enormous proportion of assets, whether they be physical assets or financial assets, will be foreign owned? While that might be financially acceptable, is there not a point at which there is a national interest question that starts coming into play? I would be very interested to hear Professor Miles' view on that, and also the Governor's.

Chair: I think we will just have to have one reply, and it will have to be a quick reply, and then Bill with a quick question and reply, because John Mann also wants to chip in.

Professor Miles: One of the reasons why the current account deficit has grown so much is not so much that there has been deterioration in exports from the UK relative to imports. It is largely because of deterioration in the net income we get from overseas assets. I think that is one of the things that make the recent history of a very large current account deficit somewhat unusual.

Something else unusual has happened, which is that even though the UK has been running these extraordinarily large current account deficits, when you then step back and value the stock of assets that the UK owns overseas relative to the assets that the overseas sector owns in the UK, it has actually improved slightly. We have made a whopping great capital gain. This is crudely speaking. We have made a very big capital gain on the assets that we own overseas, although we have not earned very much income from them, which is why you simultaneously get a current account deficit and, strangely enough, a slight improvement of the net asset position of the UK. It is a very puzzling period.

Chair: It is very interesting. We will have to explore on another occasion.

Q48 **Bill Esterson:** What are the risks of running a surplus in normal times? Governor, you sort of avoided that question.

Dr Carney: From a monetary policy perspective they are entirely manageable. What we have to do is understand the stance of fiscal policy and its impact on the economy, and then adjust monetary policy appropriately to achieve our remit, the 2% inflation target. There are broader issues in the stance of fiscal policy but, as the Chairman has indicated, it is not appropriate for us to comment on the stance of policy.

Q49 **John Mann:** Mr McCafferty, I am finding from employers skill shortage being the critical issue. That is spreading to the public sector far more now than it was, but is very much the issue in the private sector in my area. Is that out of kilter with your experience and feedback?

Ian McCafferty: I think the issue of skill shortages, as I understand it from my conversations with businesses around the country, is focused in a number of key skills and a number of key areas. It is not as if it is particularly widespread across every type of employment at this stage. I think this is an issue that has been a problem for the economy for a very long period. I have been listening to employers talk about skill shortages in areas such as IT, engineering and so on for over 20 years. To that extent, while some of these issues are acute, they have been acute for quite some period. They are as much structural as they are cyclical.

I think it is an issue that, as the labour market starts to tighten, will lead to the increase in nominal wages that the Governor has discussed earlier, and we do have to watch that that increase in wages comes through at a pace that is still consistent with the inflation target.

Q50 John Mann: Sir Jon, if we take people of working age, what is the skill profile of those who have emigrated from the country in the last 12 months as opposed to those who are new immigrants to the country?

Sir Jon Cunliffe: I could not tell you how the exact skill profile of those who have left. If you wanted a precise answer, we would have to look it up.

John Mann: No, I want a general answer.

Sir Jon Cunliffe: My feeling is we do not have that much data on many of the people who leave the country. When you are counting net migration it is quite difficult to know who has left and who has gone abroad for what reasons. What I would say is if you look at the composition of the flows into the labour force in the UK, the compositional point that Mr McCafferty was making before, that has been skewed over the last two years, if you like, to the lower skilled. So you would assume there has been an inflow into the UK in that area, as well as in the highly skilled area. I do not want to mislead you; I do not have the information on flows out.

Q51 John Mann: Are you going to have the information at your fingertips, Governor, in the near future with your research?

Dr Carney: Two things. In terms of the flows, the skill set of immigrants into this country on average is higher than the resident labour market. We can provide you with the figures that are otherwise in the public domain if that is desired. But I believe that is the case, that while it is more readily tracked, who is coming in, nationals who leave is less tracked, and what is better known is the “stock” of skill set of people who are here.

Q52 John Mann: With respect, on that, that the very high skill level people move more, your answer could be misinterpreted in that in certain sectors, banking for example, if people of a high skill level are moving in and moving out regularly, then by definition there will be more people of an above-average skill level moving in. The question is in relation to the overall picture. In your answers to Helen Goodman you talked about against trend. Some people fear that what is happening is there is an increasing tendency for low skill, and that the Chancellor may well have increased that further—free childcare, £11,000 non-taxable income—to encourage from within the European Union an even greater flow of low-skilled workers in.

At the same time there seems to be a dearth of information about people leaving the country. As an example, I believe a third of the Teach First programme of the top teachers have emigrated since its inception, which is a hugely significant number if that is true. It is on the data. What are you going to do in terms of the data? I have employers who are saying we have skill shortages because they cannot get the labour that they want from around the world,

but at the same time we are seeing a potentially increasing number of low-skilled migrants from the EU.

Dr Carney: I will make two comments. First, a specific one in terms of the skill set of net migration into the country. I am sure you are well aware that half of the net migration is from outside the EU. Half of migration into the country is from the EU. On average the skill levels are higher across the skill spectrum, measured skills, and these are imperfectly measured but at least as the data are calculated. But we will provide you with the data that is around. I think the question in terms of the quality of statistics is one that obviously is best directed first to the ONS, but also through our former colleague Sir Charlie Bean, who is, as you know, about to conduct a review of the national statistics. Issues such as these that become relevant to monetary policy and broader policy are relevant.

Q53 John Mann: I have a final question. It is also, is it not, very much a question to be directed to yourselves, because part of the monetary policy puzzle may well be that we are having to rely on, and are getting, increasing numbers of low-skilled people into the country when a lot of skilled people would appear, having been brought up here, to be leaving the country? That has some worrying longer-term consequences for our productivity if it is at all true. Therefore, do you intend to ensure that your data are far better than that of your predecessor, who repeatedly told this Committee that there would not be this inflow of mass numbers of low-skilled migrants from across the European Union, and clearly was wrong when he informed us of that?

Dr Carney: The question of the data is we rely on others for the data and analysing them. There is a factual question in terms of what that data show in terms of the relative skill levels of net migration into the country. I will write to the Committee with the data that we use, which are supplied by others, so that we are on the same fact level and we can jointly judge the relative utility of that. I will make a personal observation—you have made one as well—that this is a very attractive environment for high-skilled labour as well, because of the opportunities, the tax regime, rule of law and a variety of factors. I would be surprised if the country were net losing high-skilled workers. But that is, as you quite rightly point out, a question of data and fact, and we should investigate.

Ian McCafferty: I think there are two points in the debate if we step one pace back in terms of this issue of low skills. The first is that much of the increase that we have seen over the last year in the lower skills, lower-paid jobs, is simply an unwinding of what happened during and immediately after the recession. At that stage, back in 2008-2009, it was the young, the less skilled, who lost their jobs disproportionately as the economy started to decline. They are now being brought back into the labour market and, therefore, that is part of the reason why over the last year, year and a half, we have seen this disproportionate level of lower skilled employees come back into the market.

The other potential explanation, at least for part of this—and it is something that I am still waiting on the data for before I can look at it in even more detail—is that we have seen a significant increase, as far as I can tell, in the number of apprenticeships that have taken place over the course of this recovery. Those are deemed to be low-skilled jobs at the outset, because you are taking on people who are low skilled and training them up within the labour force, but to the extent that they do not stay as low skilled, they will, over time,

increase their skills. Therefore, I think there is a definitional issue here as to what we mean by low-skilled jobs.

Chair: Thank you very much for coming to see us this morning, which is now this afternoon. We are only stopping for a brief while, because you have important commitments later on this afternoon. So we will be beginning in exactly half an hour. I am sorry that it is such a brief adjournment.