



Treasury Committee

Oral evidence: [Bank of England February 2016 Inflation Report](#), HC 819

Tuesday 23 February 2016

Ordered by the House of Commons to be published on 23 February 2016

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Members present: Mr Andrew Tyrie (Chair); Mr Steve Baker, Mark Garnier, Helen Goodman, Mr Jacob Rees-Mogg, Rachel Reeves

Questions 1-70

Examination of witnesses

Witnesses: **Dr Mark Carney**, Governor, Bank of England, **Dr Gertjan Vlieghe**, External Member, Monetary Policy Committee, **Dr Dame Nemat Shafik DBE**, Deputy Governor, Markets & Banking, and **Dr Martin Weale**, External Member, Monetary Policy Committee, gave evidence.

Q1 Chair: Thank you very much for coming in to see us this morning. Of course, there have been one or two events on the European front since we last met. You will be coming in on 8 March with Jon Cunliffe to see us to discuss the impact of the deal that has been reached and the whole referendum debate, so I don't think we need to linger on it a great deal today. But I would like to open with just one question, which is whether the Bank has modelled what it expects to happen to sterling in the event of a no vote, given what has been going on in the markets in recent days.

Dr Carney: Our approach to forecasting events around the referendum is to take developments in markets and confidence indicator surveys as given, and to feed those through into the forecast. We are not making a judgment about the potential outcome of the referendum—in other words, which side will win—or an assessment of the potential consequences of a leave vote. We are treating this vote exactly how we treat any other political event, which is not to make a judgment on the outcome, and assume the status quo continues. Obviously, we take into account, as I said, the movements in asset prices, such as sterling, as we have seen, and changes in confidence and the potential impact of those changes in confidence, if they manifest, on economic activity.

Q2 Chair: If I came in and took a look at your model, what would I find?

Dr Carney: With respect to the exchange rate, it is a mechanical assumption that it continues to be at spot. We don't forecast the exchange rate per se, as part of the model. I will note, though, that there have been movements in sterling and in the option market as the timing of the referendum has become increasingly clear—and now clear—particularly the sharp increase in risk reversals or buying more downside protection against future falls in sterling around the referendum date, as opposed to upside protection. They have spiked to levels consistent with the levels around the height of the Scottish referendum. They have been particularly concentrated against cable—expressed in sterling/dollar option markets.

Q3 Chair: I would like to cover one important development, which is not directly relevant to the inflation report, and get a reaction from you on it. As you know, there were two commissions on banking reform, one which I chaired and Mark sat on and one chaired by Sir John Vickers. He made a number of pretty rigorous recommendations about what is required to ensure that banks are adequately robust, and that we don't have a repeat of 2008. He has come out saying that the Bank's efforts to secure that extra protection have fallen short of his recommendations. Have you a reaction to that?

Dr Carney: The first thing to say is that my personal view, and the view of colleagues on the FPC and the Bank as a whole, I think, is that the work of your commission, the Parliamentary Commission on Banking Standards, and the Independent Commission on Banking, chaired by Sir John Vickers, is incredibly important work. This provided the framework for the series of reforms that have been put in place. They were rigorous recommendations in the ICB. The Bank has exceeded those recommendations.

Q4 Chair: You are disagreeing with John completely.

Dr Carney: Just to be clear, the recommendation was for a minimum CET1, common equity, for ring-fenced banks of 10%. With the new framework that the FPC announced in December, the recommendation is at least 11%, 11% being higher than 10%, obviously. The recommendation for groups that we have provided—so not just the ring-fenced banks, but the overall group for systemic groups—is 12% CET1, which is obviously, again, higher than 10%. In the ICB, additional layers of loss-absorbing capacity were recommended, and quite rightly so, in my view. There was a range given, and totalling those up the entire loss-absorbing capacity was recommended to be 17% to 20% of risk-weighted assets. For ring-fenced banks, we are out consulting, but we have a framework that has at least 23% of total loss-absorbing capacity. In fact, for most banks, it will be higher than that because there are additional buffers—so-called Pillar 2B buffers—for those institutions.

In addition, we have secured a global agreement on that loss-absorbing capacity—the so called “bail-inable” debt—to make it work cross-border for groups. In addition, we have undergone a fundamental review of the trading book to change the risk weighting and the capital required for the trading book. In addition, we are working in Basel to reduce

excessive variance of risk weighting, to tighten up the standards for the so-called denominator of all of these calculations.

Q5 **Chair:** In a nutshell, John has got it wrong. That is what you are saying.

Dr Carney: Sir John is very able to speak for himself. I think he is, quite rightly, promoting a debate about ensuring that what we are recommending is adequate. I am quite confident that it is. I don't want to speak for him, but he is also drawing attention to questions around the effectiveness of bail-inable debt—in other words, could this extra loss-absorbing capacity actually be bailed in in the event that a bank needs to be resolved? That goes to extremely important work that this Committee has rightly held us to account on, which is making sure the ring fence, as recommended by the PCBS and the Independent Commission on Banking, is put in place; making sure that the common services, the operational structures, are consistent with that ring fence and the resolution of the ring fence; and making sure that that bail-inable debt is held at the right place in the capital structure of the institution.

We see some challenges right now on the continent, where the system is halfway in train and that debt has not been in the right place, so it is not effectively bail-inable yet. It has to be held by institutional investors and those institutional investors have to recognise that they hold bail-inable debt in order to hold the institution to account to provide true market discipline. We are in the process of putting it in place. We always welcome informed challenge, which is what Sir John is giving, on these incredibly important reforms, but we think we do have it right.

Let me just put one figure on the table. Since 2008, the largest UK banks have raised £130 billion of common equity—not of Tier 2 capital, not of CoCos, not of bail-inable debt, but of common equity. On top of that, they have quite substantially reduced the size of their balance sheet—de-risked their balance sheets. They have cut their interbank lending by more than two thirds. They have increased their liquid assets—on balance sheet, not contingent—by four times. These are huge changes and I think we are all aware that, since the start of the year, bank stocks have been under pressure. They have been under pressure on the continent, in the US and also in the UK.

There is a variety of causes of that, but, particularly for the UK institutions, that does not indicate concerns about the resilience of the institutions. The fundamental concerns are about the returns of the institutions. Said another way, many of these institutions have not yet developed the business models that are consistent with a low-growth, low-interest-rate environment and consistent with making returns that shareholders expect under the new regulatory construct. A tremendous amount of capital has been raised. The additional loss-absorbing buffer is in the process of being put in place, and now the institutions have to optimise in order to provide decent returns there.

Q6 **Chair:** That sounds like a pretty detailed and robust rebuttal of a good deal of what John Vickers said. I am not going to prolong the discussion now. The best way to take this forward is not in an MPC hearing, but with respect to the FPC. In the meantime, it would be helpful if the Bank could provide us with a

point-by-point analysis of the points made by Sir John, with the response of the Bank to each of them.

I want to turn to one other subject, which is QE, and I would like to ask, Dr Shafik, what you think the right, long-term size of the Bank's balance sheet should be.

Dr Shafik: As you know, the size of the balance sheet has grown enormously in recent years after the crisis. It used to be about 7% of GDP; it is now about 22% of GDP, and most of that has been because of QE. We have been doing a lot of thinking about what the medium-term size of the balance sheet should be. There are many factors that will drive it and will probably mean that it will be bigger than it was pre-crisis.

First, we have many more counterparties. At the time of the crisis, the Bank had about 30 reserve account holders; today we have over 160, so many more people have access to our balance sheet in order to meet their liquidity requirements. Secondly, regulatory changes have meant that banks have to hold greater levels of liquidity and so their demand for high quality liquid assets has gone up. It is very difficult to estimate what their demand for reserves will be in the future. We know what their current level is. The last time we asked them, "How much do you expect to hold in future?" they said, "About the same as we hold now." But of course, that is an easy answer. I think that over time, we will get a better sense of what demand for reserves at the Bank of England will be.

My expectation is that it will be in the range between 7% and 22% of GDP; it will be at the higher end of that range, given increased demand for reserves. But we cannot give you a precise number now, until we have moved on to a different state of the world.

Q7 Chair: The difference between 7% and 22% is 15%, and you are saying that the lion's share of that is going to be needed indefinitely?

Dr Shafik: No. What I said is that my expectation is that demand for reserves will be significantly higher than it was prior to the crisis. But giving you a precise estimate now would be dishonest.

Q8 Chair: I am not asking you for a single number, but I have asked this question in the past and been told, "We are in a very fluid situation; we are still in a crisis period," and I now feel it is time that we had a somewhat clearer answer and somewhat more guidance on what the Bank thinks the size of its balance sheet should be long term. Would you be prepared to have another go?

Dr Shafik: It would be disingenuous, when banks themselves don't know what their demand for reserves is.

Q9 Chair: They are never going to know for sure what their demand for reserves will be, so that is saying—

Dr Shafik: They will, because in the past—

Chair: That is a symphony of heavenly length; we will never find out. So can we have a slightly more precise answer?

Dr Shafik: Let me give you a bit more. We used to run a system of reserves averaging where we asked banks, “How much reserves do you want?” They would tell us, so they did know. They would give us an estimate and they were required to hold balances on the order of what they had told us. One of the questions we are asking ourselves now is: what is the future monetary policy framework going to look like? Do we want to go back to that sort of system, or do we want to retain the system we have now, which is a floor system, which works very well in a QE sort of world?

Q10 Chair: What is the answer to that question?

Dr Shafik: We are still doing work on that issue. At the moment, the floor system works incredibly well. It delivers market rates that are very near Bank Rate, which is what we need for implementing monetary policy. At present, we would expect to retain our current system for the foreseeable future, but in future we will need to answer this question and we are doing some work on that at this time. Clearly, the demand for reserves is intimately linked to the nature of the monetary policy framework that we have in future.

Q11 Chair: 15 divides by three, so are you thinking that reserves should be near one third, two thirds or nearly all of this current gap between 7% and 22%?

Dr Shafik: It would be very foolish for me to guess, when I have no idea what the state of the world will be in five to 10 years when we have to make that decision.

Q12 Chair: You are never going to know. The Bank has to take decisions on the basis of risk and uncertainty. So we are looking for answers.

Dr Shafik: Yes, but we have a framework now that works very well and will work for the foreseeable future, so trying to predict a hypothetical like that in five or 10 years’ time would be a bit foolhardy.

Q13 Chair: Do you think we are going to make money on QE?

Dr Shafik: It fundamentally depends on the future path of interest rates and the equilibrium level of interest rates. We have looked at many scenarios and there are some in which the net position of the asset purchase facility is a net positive. There are some scenarios in which it is negative, and the key difference between those scenarios is whether you think interest rates will rise in a gradual and limited fashion, which is our expectation. If you expect interest rates to go up very sharply and end up at a very high level, there are some scenarios in which there are losses. Those are the minority of scenarios.

Q14 Chair: It is a very interesting reply, because it is based on the assumption that you know what profit means. It is not straightforward with QE to

establish what the base price is, what the in and the out are, what the comparator would be.

Dr Shafik: That is why we do scenarios. We look at different paths of rates in the future and we look at what might happen.

Q15 Chair: It might be helpful if we also had something on paper about the long-term prospects for making a profit or a loss and the tools that you are using to make the assessment that you have just described. With your agreement, Governor, I can tell you are keen to get in, but it might be helpful if we move on at this point. QE is part of monetary policy. I take it the Bank still holds that view. There was a debate about that question at its inception.

Dr Carney: We absolutely hold that view. I shall make two very quick points if I may, Chairman.

Chair: If they could be made succinctly I would be delighted.

Dr Carney: The first point, succinctly, is that you can look at P&L—profit and loss—in the narrow sense of the APF; you can look at it more broadly, in terms of the overall macroeconomic impact of the policy and the impact on the overall fiscal profit and loss. You absolutely have to do that. The second point I would make, agreeing with Dr Shafik, is that obviously the path of interest rates matters for the flow of that profitability in terms of when the time comes for interest rates to rise. We will determine the path of interest rates as the MPC, consistent with our monetary policy remit, without regard to the profitability of the APF. It will be a result as opposed to an objective, for absolute clarity.

Q16 Helen Goodman: Dr Shafik, it may be the case that, at the moment, the Bank of England does not know whether it is going to make a profit or a loss on QE, but the paper that the Bank published in 2012 on the distributional analysis shows that the wealthiest 5% of households in this country have certainly made a profit on QE, to the tune of about £185,000 per household. Do you think there would have been a way of undertaking QE that would not have produced that distributional effect?

Dr Shafik: The distributional consequences of QE are very complex, because you cannot look just at the impact on asset prices, which is how this type of calculation is done. If QE has a wider benefit to the economy, if it creates greater economic growth, if it creates less unemployment, then many households will benefit from those wider macroeconomic effects, which is the primary objective of QE. The second thing I would say is that monetary policy always has distributional consequences. It is not the best tool to try to address distributional issues; there are many other policy tools, particularly fiscal policy, that are much better suited to addressing income distribution, rather than trying to set monetary policy with distributional consequences in mind.

Q17 Helen Goodman: Of course it is true that nobody expects monetary policy to be the prime policy instrument for making Britain a more equal society.

However, the point about this is that actually it did the exact opposite: it made the top 5% of households £185,000 better off. Do you think that, had you implemented QE in the way that the ECB are doing—they are buying assets from KfW in Germany and CADES in France—we might have had a different distributional upshot?

Dr Shafik: To be honest, I don't think that would have had huge differences in terms of its distributional impact. This was before my time, but the decision that was taken in the UK to buy gilts reflected the availability of a large quantity of assets. I think there weren't many options in terms of buying other sorts of assets, particularly corporate bonds or those kinds of institutions, at the time.

Q18 Helen Goodman: Dr Weale, what do you think?

Dr Weale: I am not sure that it would have made a lot of difference whether we had bought some other securities instead of gilts. The point about QE was that it led to rises in asset prices, and those rises were more general than just rises in the price of gilts. Essentially, we were intervening in asset markets. The routes by which QE operates in the United Kingdom are not as clear as they are in the United States, or at least that is what some recent work that I have done has suggested, but I don't think it would have made a lot of difference had we been able to buy, say, corporate bonds on a large scale instead of Government debt.

Q19 Helen Goodman: Given what you have just said about the desirability of maintaining a large balance sheet, obviously the rollover, which at the moment is running at about £20 billion to £25 billion a year, is going to continue. So this argument is not just a historic argument; it is also an ongoing argument about the kind of assets that you are purchasing. Will you take these matters into account at all in the policy you pursue? Is it your intention to do that?

Dr Shafik: Our current policy is that we replace gilts with gilts. As you say, we have had a series of reinvestments: we have just completed a major set of reinvestments in January; since last September, we have probably purchased around £34 billion of gilts. That system seems to be working well in terms of achieving the Monetary Policy Committee's objectives. At the moment, I don't think there is an intention to look at purchasing other assets. It is impossible to say never and there may be other reasons in the future why we may look at purchasing other assets, but at the moment I think the MPC's view is that we replace gilts with gilts.

Q20 Helen Goodman: The Chairman said that we are not going to ask you about the impact of staying in or leaving the European Union, so I am not going to ask you about that. However, we do have a long campaign period now and yesterday sterling fell quite considerably. Many people think that, over the referendum period, these falls may well continue. I wonder what you think, in the light of that, the likelihood of raising interest rates is. Is it likely to bring that forward or push it back in time? I will ask each of you in turn. We will start with Dr Weale.

Dr Weale: One of the factors that had been holding inflation down was the rise in the exchange rate. Obviously, if you start at a trough, you get quite a good rise, but into last autumn it had been very appreciably up on where it was in early 2013, essentially as the British economy started to spring back to life again. Since then, it has fallen fairly appreciably. It certainly has not unwound the whole of the gain, but there have been some fairly marked falls. Those, though, do have the effect of adding to inflation. I think different members of the committee have different views on the timescale, and perhaps also the magnitude, of that process, but the fall of the exchange rate does weaken one of the factors that had been holding inflation down. In that sense, of course, it is good news because we want inflation to return to its target.

Helen Goodman: It is good for exporters, too. Dr Carney.

Dr Carney: I will first associate myself with everything Dr Weale just said, and I will emphasise a couple of points. First, it does appear that recent moves have been influenced by the upcoming vote. Secondly, what matters for monetary policy is not just a move in the exchange rate but the persistence of that move, obviously, and the reasons behind it. An exchange rate that moves because of differences in the expected path of monetary policy, which is fundamentally driven by different expected paths—for example, the growth and relative slack in economies—is different from one that is caused by rises in risk premia. We have to take that into account.

In terms of our forecast, I just want to re-emphasise that we will take the exchange rate as given. We would expect uncertainty in those other factors, in terms of how they affect real activity, to start to show up, if they do, in survey evidence through our agency networks and in our discussions with businesses across the country. Those will, particularly, have an impact in terms of the forecast, if they materialise.

Dr Shafik: The only thing I would add is that the committee has spent a lot of time looking at how exchange rate changes pass through to inflation. It is actually a very complex process because, first, the exchange rate affects import prices and then it ultimately affects consumer prices. That process can take quite a long time: 18 months before those prices pass through. The near-term effects of current changes in sterling will play out over quite a long time. It is not a mechanical and automatic process. Therefore, the impact on our interest rate decisions would be affected by our judgments about that pace of pass-through.

Dr Vlieghe: I think everything important has been said. I will just reiterate that we don't think about it as just the isolated effect of a weaker exchange rate. Obviously, everything else being equal, a weaker exchange rate boosts growth and boosts inflation, but we have to think, as the Governor said, about why the exchange rate fell. In this case, we think the exchange rate is falling because of increased uncertainty about what is going to happen in the period leading up to or the period following the referendum. It is possible that, at some point, that increased uncertainty of foreign exchange investors also ends up manifesting itself in increased uncertainty on the part of households and businesses, which may or may not delay or reduce their spending.

So far, we have not seen very clear evidence of that, but that is what we are watching very carefully. If that were to materialise, you could then think of the exchange rate as offsetting partly or fully other weakness in the economy due to increased uncertainty. It is

not at all obvious that it is a net boost to the economy; it depends on what else is going on in all the other areas. This is what we are constantly monitoring.

Q21 Mr Rees-Mogg: Governor, you have touched on this in part in an answer to the Chairman, but I wondered if I could ask you a bit more about the drop in bank share prices and the increase of insuring against default. Do you think this reflects the macroeconomic environment or do you think there are other factors at play?

Dr Carney: I think the primary cause is the macroeconomic environment. I have a few comments to support that. First, we saw the intensification and the pressure on bank shares come with a gloomier assessment of the global outlook, which started at the turn of the year. That assessment was occasioned in part by mildly disappointing data in some major economies, but also by greater uncertainty about the policy stance of a number of major emerging markets and advanced economies. There was a renewed appreciation that we, collectively, are in a low-growth, and particularly low nominal growth, environment; and this raised the question of the extent to which monetary policy and other policies would be able to offset those pressures.

That is a particularly difficult environment, as you would know, for banks. Banks are high Beta to the economy in general, but in a low nominal environment it is much tougher to make money. The first challenge to the banking sector has been their ability to make decent returns in that environment and, of course, the track record has not been that strong post 2008. On top of that, there have been some concerns, at least in investing circles, about the impact of negative interest rates on bank profitability. We have seen, particularly in wholesale banking, that bank return on equity has been quite low. Since most negative interest rate policies that have been pursued have been concentrated on wholesale markets through tiered interest rates, that puts additional pressure on their profitability there.

Thirdly, there has been some element, in some jurisdictions, of regulatory uncertainty—interpretations of certain capital rules on the continent. The prosecution, if you will, of bank resolution in Portugal and some questions over how it was going to be pursued in other continental economies raised questions about convertible contingent capital securities, but I would put that last element as the least important. It is mainly macro and it is mainly about the return prospects for these institutions, as opposed to the underlying resilience.

Q22 Mr Rees-Mogg: You think the pressure on the CoCo bonds is ultimately a symptom rather than becoming indirectly a cause.

Dr Carney: Yes. I think it is a symptom. One thing we have to watch—I gave a figure a moment ago for UK banks of £130 billion raised in common equity. The globally systemic banks have raised for the advanced economies almost \$900 billion of equity since 2008 and, in total, about \$1.5 trillion of common equity, once you include the Chinese banks, over the course of the last several years. The resilience is there. The challenge, as you would appreciate, is: what is the earning power? And if the earning power isn't there, the prospect over time of the trigger of a contingent security goes up.

Actually, that is the way the market is supposed to work, because that puts more pressure on bank management to concentrate their businesses, focus on returns and ensure that their balance sheets are appropriately resilient. At this stage, while we have seen, as you indicated in your first question, some increase in bank funding costs, particularly in CDS markets, it has not yet set in, if I could put it that way, and it is more consistent with the generalised risk aversion that we have seen in markets.

Q23 Mr Rees-Mogg: In terms of that increase in funding cost, does it concern you that it actually makes harder the MPC's job of transmitting its monetary policy through the system?

Dr Carney: That is very much on point. There have been a number of developments since the inflation report, as there always are, and some of them have been positive and some negative. On the negative side—negative for inflation, if you will—has been the tightening of credit conditions in global markets. We have to ask ourselves whether or not that is persistent. On the more positive ledger in terms of financial conditions, gilt yields have come down quite markedly. As we just discussed, there has been the movement in the exchange rate, and we had a pretty fulsome discussion about how to treat that. There are some offsets and obviously we have to take that into account.

I would re-emphasise, though, that in terms of the transmission of monetary policy to the real economy, particularly in the UK, we are still in a position where mortgage rates are near all-time lows; credit conditions, in terms of our discussions, our surveys and other indicators, for even small and medium-sized enterprises are as strong as they have been since the crisis; and funding conditions for large enterprises continue to be very strong. So the transmission mechanism is working as we would expect, given the resilience of the core.

Q24 Mr Rees-Mogg: There is an interesting question to be asked on the difference between the MPC and the FPC in these areas, but we tried that when you came here wearing your other hat. I wonder, Dr Weale, if you can follow on from that with your thoughts on the changes in the macroeconomic position since the publication of the inflation report.

Dr Weale: Markets have continued to be erratic. They started behaving erratically in January. We have seen sharp falls in share prices and then, most recently—and internationally, not just in the United Kingdom—a sharp rise in share prices. For me, picking up on what Gertjan said, the key issue will be whether those sorts of movements start to affect the confidence of households and businesses because, of course, what actually matter for the MPC are the spending decisions that people make and the implications of that for inflation. I am looking very carefully to see evidence of that. So far, I have not seen much evidence of it in Britain, although there is some evidence of that happening on the continent.

Q25 Mr Rees-Mogg: Do you think the MPC now has the monetary tools that it needs or has it used up most of its ammunition?

Dr Weale: My view is very much that the Monetary Policy Committee does have the tools that it needs. I referred earlier to some work that I have done on asset purchases, and there we attempted to see whether the second and third phases had less of an impact than the first phase, but it really did not seem to be the case. Of course, that may not carry over, but it does give me some confidence that asset purchases are effective, and not only at a time when markets are severely dislocated.

Another interesting thing that emerged from that work was that it implied that the asset purchases had had more effect on inflation than previous Bank work had shown. Of course, that translates into the possibility—I would say no more than that; I have not followed it through—that the fade in the effect of asset purchases now is one of the things that has been keeping inflation low. That is just an impression; it is certainly not something I could quantify.

Q26 Mr Rees-Mogg: Governor, perhaps you could answer this: to what extent do you think that fiscal policy needs to be adjusted to fit in with monetary policy? The golden scenario, post 2010, was that a tight fiscal policy would allow us to afford a very loose monetary policy, and that that would lead to growth, and it would lead to the deficit going and normalisation returning. To some extent, that hasn't happened. Do you think that fiscal policy needs to be pushing more with monetary policy?

Dr Carney: As monetary authorities, we have tremendous responsibilities and they don't extend to setting fiscal policy, as you can appreciate. So we take the path that fiscal policy is given. As Dr Weale just said, if we were in a position where the economy needed additional stimulus, we do have considerable room. We have conventional policy room. We have made clear that we think we could cut interest rates towards a zero Bank Rate. We could engage in additional asset purchases, including a variety of assets. We could also adjust our policy horizon; in other words, we could shorten the policy horizon over which we wanted to return inflation to target. In the event that we did see a second round of effects materialising, that might be something that made sense. There are a number of things we can do and will do to achieve our remit, irrespective of the stance of fiscal policy.

Q27 Mr Rees-Mogg: Would it be true to say that, the tighter fiscal policy is, the more energetic you have to be with monetary policy, or the more imaginative, perhaps?

Dr Carney: It is true to say that. It is a fact that fiscal policy, broad-brush, at least on the OBR measures, is tightening. Again, broadly speaking, on OBR measures, the reduction in the structural deficit has been about 30 basis points per annum for the last three years, and that is going to accelerate—intensify, if you will—to just south of one percentage point per annum for the next few years. So, yes, it does require monetary policy to be accommodated.

I will finish with this: at the moment, we do feel, or I certainly feel, that monetary policy is providing stimulus. We have quite resilient private domestic demand, including business investment that is running at twice the clip of historic averages and private consumption

growth around 2.75%. The stimulus is being provided and it is pushing against the headwinds from both fiscal policy and, most importantly, a very weak global environment.

Q28 Mr Rees-Mogg: You have brought me on very nicely to my next question, because I wanted to ask about the global environment and the effect that this is having and may continue to have, both for good and ill, and to seek the views of the external members on the current account deficit. Is it possible, or is this wishful thinking, that the lack of foreign inflows going to the emerging markets may actually make it easier for us to finance our current account deficit?

Dr Vlieghe: I would first like to make a few points about the emerging markets themselves, because that is where some of our key concerns are about the global economy. A key development in emerging markets is that, since the financial crisis, they have seen an increase in indebtedness leveraging up, which, relative to the size of their GDP, is bigger than the leveraging up that advanced economies did in the decade before the crisis. Just like in advanced economies, I do not think that, in the emerging economies, that is a sustainable source of growth.

The prospect from here is either significantly weaker growth than we have seen in the past few years or the possibility of a crisis at some point. Frequent reminders of that is one of the things that are keeping financial markets very nervous and going through bouts of very extreme moves.

It is also noteworthy, as I am sure you have seen, that, once we have the full data, 2015 may well be the first year since 1980 that we have seen a net capital outflow from emerging markets as a whole. A reasonable question is: where will that go? I do not want to be too complacent and say, "That is fine; it will come back to the UK." The UK's current account deficit is still very large. My interpretation of why it is there is that, in part, it is a side effect of the economic underperformance in the eurozone. The reason the current account deficit is so large is not primarily because of our trade deficit, but because we are not earning as much on the assets we hold abroad as we are paying out on the assets that foreigners hold in the UK. A lot of the assets that we hold abroad we hold in the eurozone and those returns are lower, and we just don't know what the prospects for those returns are.

We have to be at least open to the possibility that that particular source of our current account deficit is going to persist and, ultimately, in order to offset that income deficit, we will need to run a bigger trade surplus than we would have run in the past. That does mean a weaker exchange rate.

Q29 Mr Rees-Mogg: I want to draw attention to my entry in the Register of Members' Financial Interests, as we have got on to emerging markets and my business invests in emerging markets. Following on from what you were saying about the increase in indebtedness in emerging markets, new local currency loans in China have reached record highs. I imagine, from what you are saying, this is part of the problem rather than part of the solution.

Dr Vlieghe: The Chinese economy has a number of challenges. In general, they are addressing those challenges. They are trying to rotate the economy towards more

sustainable sources of growth and they are trying to deal with the fact that they may have previously stimulated the economy in areas that were not sustainable, and at some point that is going to cost them. That is a very big challenge and dealing with that sets the Chinese economy up for more sustainable growth in the very long run, but a lot of the scenarios involve growth disappointment in the short run. As you are cleaning it up, that is a headwind to growth in the short term. That is what we are seeing. It is not a question of making a mistake; it is a question of the optimal balance between bringing your country to long-run sustainability without endangering the near-term growth path excessively. This is exactly the challenge they are facing and constantly dealing with.

Q30 Mr Rees-Mogg: Governor, if I may ask you one final question, your counterpart, the Governor of the People's Bank of China, has said that he does not think a devaluation of the renminbi is necessary. You have been Governor of a couple of central banks. If you went on to a third, do you think that would be your view? You would have to become a communist to get the job, but maybe that is attractive.

Dr Carney: My chances are very slim. As was just said, a number of structural adjustments are necessary to rebalance the Chinese economy. The indebtedness problem, which you have rightly been discussing and which is much more important than developments in the Chinese stock market, ultimately has to be addressed—that has only just begun—as do the overall rebalancing from external to domestic demand, and overcapacity. Progress in all those regards will be necessary in order to ensure stability on the balance of payments and sustainable growth in China.

I would underscore that the Chinese authorities, including very much Zhou Xiaochuan, the Governor of the People's Bank of China, are absolutely aware of this and are pursuing a set of policies in order to make this happen. They have considerable resources in order to manage that transition. One of the elements of the transition has been, appropriately in my view, to move to an exchange rate policy that more reflects the pattern of Chinese trade and the coming nature of the global economy—in other words, managing against a basket of currencies, as opposed to pegging to the US dollar.

Q31 Mr Rees-Mogg: Do you think any prudent governor of any central bank would ever say, in advance of devaluation, that he thought it was a good idea?

Dr Carney: I am unaware of any instance of that in history.

Q32 Mr Baker: Can I begin, Governor, by just paying tribute to you? Last week, I attended your private seminar with Kevin Dowd, challenging bBnk staff about the stress test. It was a packed seminar; obviously it was private, so I will not say what was said, but it is a huge testament to you and the whole team that so much interest was paid in listening to somebody who wishes to challenge the Bank's thinking. Thank you very much indeed for taking so seriously the Bank's One Bank Research Agenda. It is fantastic.

That said, normal service is about to resume. Dr Shafik, you said monetary policy always has distributional effects. What would you expect to be the distributional effects of negative interest rates?

Dr Shafik: To be honest, it is too early to say because it is still in its infancy. Several countries are experimenting with negative interest rates: Denmark, Sweden, Switzerland, Japan and the ECB. We observe, from that experience, that it has an impact on money markets, so it gets passed on to lower money market rates. But, so far, we do not see it being passed on to deposit rates very much. As I said, it is very early days, so a really good answer to your question about the distributional consequences has to wait until we have more data.

Q33 Mr Baker: Dr Vlieghe, how would you judge the success of a negative interest rates policy? What data would you be looking for in order to judge its success?

Dr Vlieghe: Ultimately, the judge of whether this is successful or not is whether inflation returns to target. In the end, that is our mandate and the mandate of most other central banks. Something I would be looking at and thinking about—indeed, before I arrived, the committee had thought about it extensively—is that, when you lower interest rates and go to the other side of zero, there are some fairly straightforward effects that are unambiguously positive for borrowers and for holders of assets. You lower money market rates, which then gets transmitted to the rest of the yield curve, which then gets transmitted to equity markets as people discount profits at lower interest rates. You create the normal transmission mechanism of interest rates and asset prices. In addition, however, you are putting a lot of pressure on the profitability of banks.

It is a very difficult question to know how to weight those two, because one of them is a stimulus to the economy; the other one obviously is not. It is also very difficult to know how banks are going to respond. How they respond depends on the precise institutional set-up of the banks, to what extent they are wholesale and retail funded and the composition of their assets. That is why you cannot make any blanket statements on the appropriateness or not of negative rates for any country, because it depends on the specific details of the institutions in that country. That is why, a few years ago, the Bank of England took the view that it was not a good idea to take interest rates below 0.5%. Last year, the view was taken that they can go a little bit further down, but we have not yet taken the step of deciding whether or not it is appropriate to go south of zero.

It is precisely those two things: the positive effect on market rates, transmitted into other asset prices, versus the negative effects on the banking system and which of those two dominates for the economy as a whole.

Q34 Mr Baker: The principal piece of data you are interested in is whether inflation returns to target.

Dr Vlieghe: In the end, that is our mandate and everything has to lead to that.

Q35 Mr Baker: What about all those things whose prices change in response to monetary policy that are not in the basket you are looking at: things like asset prices, house prices and so on?

Dr Vlieghe: We care about those for two reasons. We care about them to the extent that they influence overall demand and, via the amount of slack in the economy, ultimately push up on inflation; and we—by which I do not mean the MPC, but the Bank as a whole—care about them from a financial stability point of view. They are not in the MPC's ultimate inflation mandate, so we only care about them as an intermediate step to thinking about whether CPI is going to hit 2%.

Q36 Mr Baker: For the benefit of public scrutiny, could you try to explain in simple language, which perhaps journalists might be able to explain, what you meant when you said that negative rates would put pressure on banks' profitability? What does that really mean for banks and for deposit holders?

Dr Vlieghe: In the simplest terms, a bank balance sheet has liabilities, which are deposits, and assets, which are loans. A bank makes profit by earning a higher return on the assets than it pays out on the liabilities. So far, we have observed that the rate paid on those liabilities is floored at zero, at least at the retail level. Even when wholesale rates have gone negative, no bank has yet taken the step of paying negative rates to households. That may change in the future, but for now let us take that as at least an intermediate threshold.

As you lower interest rates more, the rate of return on the assets goes down and down, but there is no room for the banks to benefit from a lower rate that they pay on the liabilities. The margin that the bank earns is the difference between those two, and you squeeze it and squeeze it and squeeze it, and, at some point, it starts—

Q37 Mr Baker: Sorry to interrupt, but it feels to me like you are saying that we are potentially requiring businesses to be loss-making in their main line of business.

Dr Vlieghe: I am not sure how that follows. I am saying that, the lower interest rates go, the more difficult it is for banks to make a profit. It is the same point that the Governor made a moment ago when he said that, in a low nominal growth environment—which is an environment where nominal interest rates are very low—it is more difficult for banks to earn a healthy rate of return than when nominal growth and nominal interest rates are high.

Q38 Mr Baker: At what point does it become necessary to abolish cash in order to have negative interest rates?

Dr Vlieghe: As I have said before, it is an interesting thought experiment, but it is not one of the tools in the Bank of England's toolkit to decide whether or not people should be allowed to hold cash. We are interested in how low you can bring interest rates and still have a positive effect on the economy, as a whole. That is the only question.

Dr Carney: There have been some estimates of the storage costs of cash in jurisdictions that have very negative interest rates. It tends to be in the 75 to 200 basis point range, so

you can get down to minus 2%. I will just re-emphasise that we have absolutely no intention, no interest in doing that. Secondly, to bring this back to the overall tools, we have conventional room; we have other options. We take very seriously the potentially counterproductive impact on the building society sector particularly, but the financial sector as a whole more broadly.

I will give you one example that I am sure you are familiar with. In Switzerland, interest rates have gone even more negative; they are minus 75 on their marginal rate, and mortgage rates have gone up, despite the fact that 10-year Swiss bonds are flat to slightly negative. They have gone up because banks have tried to square the circle that was just being described and they have added on fees and other charges for mortgages. It is not clear that the domestic transmission has been effective.

If I can make a general point, in my view, what is important from a global monetary policy perspective is that the focus of monetary stimulus, if necessary, is principally concentrated domestically. We are in an unforgiving world; we are in a low nominal growth world. Concentrating policy instruments towards the external channel—in other words, the exchange rate—which is sometimes what can happen if you tier and slice your interest rate so that it affects only wholesale borrowing and wholesale markets, ultimately is far, far less productive for global reflation than policy that is concentrated domestically. That is a safe statement.

Q39 Mr Baker: Dr Weale, what do you think the contribution of negative rates is on market turbulence?

Dr Weale: Well, we don't have negative rates and markets have been turbulent in countries that don't have negative rates, as well as those that do. As other members of the committee mentioned earlier, I suspect one factor in creating turbulence has been precisely the concerns about the impact of negative rates internationally on the profitability of the banking system. If you look back at the letter that Charlie Bean wrote on behalf of the committee in 2013, as far as I remember that was an issue that we had in our mind then and I am sure will continue to have in our minds.

Q40 Rachel Reeves: Following up on some of the points Steve Baker was making, first of all, I do not know much about the banking sectors in the countries that have negative real rates, but the Governor just mentioned the issue of building societies in the UK. I would be concerned about the impact of negative real rates on building societies, in particular because of their business model. In the countries that have negative real rates, do they have equivalents to building societies and have you seen a bigger impact there on the profitability, for example?

Dr Carney: It is early days in the euro area, but certainly there are analogous savings-focused mortgage bank institutions, whether it is the German savings banks or the co-operatives in France. It is at an early stage right now, but one would expect some similar challenges. The ECB has to take a judgment in terms of the instruments it has at its disposal and the need to reflate the economy. If I can quote the president of the ECB, he

said, rightly so, that its mandate is “not exactly” the profitability of the banking sector; it is ultimately hitting the inflation target.

To re-emphasise your point, though, in terms of the focus on the building societies, one thing we have been looking at—and we are well sighted on this, given our supervisory responsibilities—is the ability of those institutions to build an appropriate capital base. Because they had built up capital in the last several years, it is now our judgment that we, if necessary, could lower Bank Rate. It is not yet our judgment that it could go negative, and certainly, as we have been emphasising, if we were ever in a situation that required additional stimulus, we have other options.

Q41 Rachel Reeves: That is what I was going to come on to. Obviously, interest rate cuts and QE are not perfect substitutes for each other, but would other actions like QE perhaps be better in circumstances where you are close to the nominal bounds?

Dr Carney: If we were in that situation where we needed to provide additional stimulus, the committee would look at a range of options and judge what is likely to be most effective. To be clear, I mean most effective in achieving the inflation target, with a secondary concern in terms of supporting the Government’s objective of strong, sustainable and balanced growth, taking into account, in that regard, financial stability considerations as well. We do have options around quantitative easing, as you noted, and the APF can buy a series of assets. We would be very conscious, if we ever extended beyond gilts, of the reasons for doing that, whether it be because of market dysfunction. Or if we purchased other assets, too, it would have to be designed, in my view, in an absolutely neutral way so we were not making distributional decisions across sectors of the economy because, again, that is for Government.

Q42 Rachel Reeves: But you do obviously have a financial stability remit at the Bank, as well. Dr Vlieghe, did you want to add anything on this?

Dr Vlieghe: No. I agree with everything the Governor said about the possibility of further tools. We should not just home in on the interest rate tool, because we have others and we have used them before.

Q43 Rachel Reeves: Governor, in the press conference when you published the inflation report, in the Q&A, you confirmed your view that the next move in interest rates is likely to be up, rather than down, and you said that the whole MPC stands by that. How can you be so confident that that is likely to be the next move?

Dr Carney: We should be clear about what that statement actually says—that over the forecast horizon, interest rates are more likely than not to increase, as we noted in our minutes and in the monetary policy record. Of course, the economy is always subject to shocks, as you know. In fact, in the February forecast, we have a downside skew to our global growth forecast, principally because of issues in emerging markets. We have seen some intensification of those risks, and certainly of the market’s judgments about those

risks, in recent weeks. We have a balance of probability in terms of the orientation. We have given guidance that interest rate increases, when they happen, should be expected to rise to a limited extent at a gradual pace, but we are not on a pre-set course. We are not tying our hands. Of course, if risks were to materialise, if the global situation were to intensify to the downside, that would have implications for the path of policy.

Q44 Rachel Reeves: Do you believe at the moment that the next move is more likely to be up than down?

Dr Carney: The judgment in the inflation report provides a general orientation to the stance of policy. We are operating in a world where there are two broad forces. We have resilient domestic demand. Since the inflation report, we have seen very strong retail sales. We have had another very strong employment report, particularly with hours worked up sharply. Wage growth has come broadly in line; unit labour costs, broadly in line. Core inflation is a tad lower on the core, but CPI is broadly in line with our expectations. Confidence and other indicators have held up all of those positives. We have seen some disappointing data abroad and, overall, a tightening in financial conditions, so we have to weigh the two against each other in taking a policy decision. But I am afraid we are not taking a policy decision today, so I will withhold my conclusions on that until we sit down as a committee later this month—sorry, early next month. I was not announcing an interim meeting there.

Q45 Rachel Reeves: Unless there is something you want to tell us. Dr Vlieghe, in the speech that you gave on 18 January, you said that we should “be prepared for the possibility that real interest rates will remain well below their historical average for a very long time”. How long do you think a very long time is and why do you think that?

Dr Vlieghe: I think that for the three reasons that I outlined in the speech: demographics, debt and the distribution of income. The point of the speech was not that I was going to set out some very precise number saying it is going to be this much lower than in the past for precisely this many years. The point was actually that I don’t know how low and how long, but I wanted to say that there are a few plausible reasons why it might be much more than just a few years; it might easily be a decade. Even if we are not sure, just the possibility, not the certainty, that it is much lower than in the past still has some immediate concrete implications for how I think about policy now.

The two implications that I would draw out is that if the circumstances are right and we do raise rates, I agree entirely with the guidance that the increases are likely to be gradual and limited. I don’t think we need to go very far. Since we don’t need to go very far, I am also not in a desperate hurry to get started and, other things equal, I think a little bit more patience is justified if you think potentially you don’t need to go very far.

The second consequence is that, if we are going to be in this environment where the average level of interest rates is much lower than in the past, there is an asymmetry in policy in the sense that we have more leeway to tighten than we have to ease. We have some leeway to ease, but it is not as big as our leeway to tighten. That asymmetry itself

also, other things equal, makes me a little more patient before thinking a tightening in policy is appropriate. I would like to point out that that asymmetry has implications for the direction of policy, so you want to be a little more patient when you are considering a tightening, but you want to respond a little more quickly when you are considering an easing, given that you don't have as much leeway.

That is exactly the implication that I tried to draw out of that environment. That is the situation that we find ourselves in right now. The outlook is uncertain and we are constantly hit by shocks, but it would be appropriate to respond rather more quickly to a further succession of negative surprises than it would be to respond to a sequence of upside surprises.

Q46 Rachel Reeves: Do you personally think that the next move is likely to be up or down, or do you think it is evenly balanced at the moment?

Dr Vlieghe: In my personal view, in the past few quarters we have seen a sequence of downside surprises to both growth and inflation. My forecast is broadly what we set out in the February inflation report. I do think that the appropriate modal forecast is one where we see resilience in domestic demand that is sufficient to offset the external headwinds. Given that there is little slack in the economy, there should be a gradual upward path for cost pressures. But I have to say that I have relatively little tolerance for further downside surprises and, should they continue, then we would get, relatively quickly, to a point where I would find it appropriate to respond to it.

Q47 Rachel Reeves: It would not take much, basically, for you to consider voting to lower rates again. Is that a fair summary?

Dr Vlieghe: Correct, yes.

Q48 Rachel Reeves: Do you have a view of what the equilibrium real or nominal rate is in this new world? Maybe I should know this. You have suggested it is lower, Dr Vlieghe.

Dr Vlieghe: I suggested it is lower. The best that I can do, and I cannot improve on it yet, is that I suggested it is likely to be somewhere between 1% and 3%, nominal. That is obviously a huge range of uncertainty, but it does at least calibrate it a little bit.

Q49 Rachel Reeves: Mr Governor, do you have a view on that?

Dr Carney: To be clear, are we talking about short-term or longer-term nominal? For longer-term rates, I think you are aware but I will just draw your attention to some research that has been published by Bank staff decomposing the fall in the equilibrium rate or giving one decomposition of the drivers of the fall in equilibrium rate. It is a good piece. In terms of overnight or Bank Rate, it was clearly negative in the course of the crisis. It has probably crept up into positive territory because, in comparing where Bank Rate is relative to the equilibrium rate in nominal space, we do have to take into account the residual stimulus that is provided by the stock of QE. Dr Weale made an important

point earlier, just referencing the fade from past QE. It has been quite some time since we purchased these assets, so it is arguably having a diminishing impact in terms of overall stimulus - in terms of the effective interest rate.

I think it is fair to say that we have been providing stimulus in the last few years, as evidenced by the ability of the economy, to the best of our judgment, to reduce the degree of slack in the economy over time despite very large headwinds from abroad and increasing headwinds from fiscal policy. To my way of thinking, that is all consistent with a very low but positive equilibrium interest rate, and the net effect of where Bank Rate has been, plus QE, has meant that we have been providing some stimulus.

Q50 Rachel Reeves: Do you want to give a number?

Dr Carney: I would be towards the low end of the range just given, but that is being heroically precise about a very difficult concept.

Rachel Reeves: Dr Shafik?

Dr Shafik: You would like a number?

Q51 Rachel Reeves: I would be interested. I will not hold it to you in four weeks' time when you are not here.

Dr Shafik: Exactly. In this case, it is good to give a very long-term forecast because I will not be around. In the UK, historically, Bank Rate has always averaged about 5%. There is some research that, even in ancient Babylonia, it was about 5%. I think we are entering a new phase because of demographics, because of the shift in global savings and investment balances, such that rates will be about half of that going forward, I would say.

Rachel Reeves: Half of the 5%, so about 2.5%.

Dr Shafik: Yes.

Dr Carney: That is a different horizon. We are mixing horizons. That is a 10-year type rate as opposed to an overnight rate. I was referring to Bank Rate. I was referring to relatively short-term rates. Over 10 years, it moves towards that range and then it is consistent.

Q52 Rachel Reeves: You are talking about two years.

Dr Carney: I am talking about Bank Rate. I mean, relative to the policy—the most useful and most difficult is relative to where the policy rate is, which in the end is a judgment we have to make, as opposed to interpolating the whole path.

Q53 Rachel Reeves: Dr Weale?

Dr Weale: If your question turns into asking me for a forecast of where Bank Rate is likely to be in three or five years' time, perhaps I will duck it.

Chair: You used to make a living doing those forecasts. How disappointing.

Dr Weale: I used to, yes. Could I make two observations? First of all, although we think of this as being a low-return world, the return on capital isn't actually low. If you look at the ONS series for the net return on capital stock, it is now at its highest since 1998. How those sorts of contradictions between very low yields on Government debt and what, on the face of it, look like high returns on productive capital will be resolved is not clear. That said, if I were to think of a medium-term range for the Bank Rate, I would place it a bit higher than Dr Vlieghe's range, but not very much higher—say 1.5% to 3.5% or something like that.

Q54 Rachel Reeves: I have one last question, going back to some of the earlier questions about sterling and the recent falls. Dr Shafik, in her answer, talked about the time lags involved in terms of what the policy response would be. Isn't the real issue for the policy response what the source of the shock is and why sterling has fallen? If it reflects a fall in confidence, then it is not clear that the appropriate response would be an increase in rate to deal with a fall in sterling. I just wonder whether you have views on the reasons for the fall in sterling in the last few days and whether you think that will continue. It does affect how you respond as policy makers, doesn't it, Mr Governor?

Dr Carney: A global point is that it is always dangerous to over-interpret short-term moves in markets, and particularly FX markets. I would go back to my answer to the Chairman, which was to note that we have seen a pattern of behaviour in the FX markets, and in particular in FX options, and also in terms of our market intelligence through talking to market participants, and that has all been consistent with the purchase of downside protection against further falls in the currency in and around the referendum date. Particularly, that applies to downside protection vis-à-vis the dollar. I would suggest that the judgment being made is that there could be implications for the euro in parallel, depending on the outcome.

That gives some suggestion as to one of the factors that has crept in to influence the path of sterling. Obviously, it is also and will continue to be influenced by expectations about the pace of growth in this economy and other economies, and the size of our current account deficit. As with all exchange rates, there is a variety of factors, but it is safe to say that there is an element of referendum premium that has come into sterling.

Q55 Rachel Reeves: When Sir Nicholas Macpherson was in front of this Committee a couple of weeks ago, he suggested that, when MPs are out campaigning for the referendum, that might be a time for the Treasury to think about what might happen if people do vote to leave. Do you think that might be a time when the Bank of England might look at that as well?

Dr Carney: If the question goes to contingency planning, I can assure you and the Committee—and now I am speaking not in terms of the MPC but in terms of the FPC and the institution—we are engaged in contingency planning for the referendum, as you would expect. The PRA, in terms of its general supervisory responsibilities, is keeping abreast of the contingency plans of our financial institutions.

Chair: We are going to go into some detail on 8 March.

Q56 Mark Garnier: Over the last two or three years since you have been Governor we have chatted, through these sessions, about the resilience of households and household debt. In your time as Governor, how do you feel households in the UK have managed their balance sheets? Do you think they are more resilient, less resilient or much the same as they were when you first became Governor?

Dr Carney: It is a credit to UK households that they have become more resilient over the course of the last two and a half years. Our most recent Bank of England/NMG survey, which was released at the end of last year, provides quite a bit of detail around this. The number of highly vulnerable households—in other words, those with debt service ratios above 40%—has continued to come down and has reached a relatively low level. The proportion of households who would have potential difficulties, with an economic shock, in servicing their debts has come down, from memory, from around two thirds to around a third. That is quite a marked reduction. The big macro picture has been that the household debt to income ratio has gone down by about 25 percentage points. Part of that is obviously a rise in incomes, although that has been relatively modest. More important has been a pay-down of debt.

The picture is one of improving resilience of UK households. This is slightly more in FPC territory, and I will come back to the MPC in a moment, but we would caution that there are still cohorts of relatively highly indebted households. One of the questions for the MPC, which we have looked at, is the potential impact of those more credit-constrained households. When interest rates rise, could it have a larger than usual impact? In part, as it has been a long time since interest rates have increased, it could have a bigger impact just because of that, and secondly, there is still a relatively large number of relatively indebted households, despite the marked improvement in resilience.

Q57 Mark Garnier: One of the interesting numbers I read recently was that there are 1.8 million households that have never seen a rise in interest rates, which is an extraordinary number. When you look at some of these numbers, you see consumer credit is now increasing faster than secured lending; consumer confidence seems to be going up; and household savings are dropping. Do you think households are getting a bit complacent? Do you think there are still risks out there that they are perhaps getting to live with, and they are now feeling that perhaps the time has come to spend a bit more, have a bit more fun and not worry too much about their balance sheets? Alternatively, do you think this reflects that we have got ourselves back into a good place in terms of household resilience?

Dr Carney: I would say a couple of things in terms of our expectation. First, you are absolutely right in the characterisation. In terms of the overall pace of increase in household debt, it is now tracking the growth of nominal GDP. It is the first time in a long time that in aggregate it is not deleveraging. It may slightly exceed the pace of nominal GDP growth over the forecast horizon, so there could be some releveraging. That will largely depend on what happens in the housing market—in other words, on the scale of transactions in the housing market, more than the price of houses.

In terms of household confidence, you are absolutely right. Household confidence remains quite robust. It is nearly as high as it has been over the course of the last decade. The savings rate has been drawn down. This is behaviour that is consistent with a few things. One is the very strong labour market. For example, the vacancy to unemployment ratio is at its highest level since 2005. It is not just that a large number of people are in work; in fact it is, as I am sure you know, the proportion of the population seeking work in employment, so the employment ratio is as high as it has been since 1971. Also, there are a lot of vacancies, so there are opportunities to change. There is still some slack in the market in my opinion, but there are reasons for confidence.

The other reason for this behaviour is that it can reflect expectations, in the fullness of time, of future wage increases, which would be consistent with both the tightness of the labour market and our expected recovery in productivity. This behaviour is entirely understandable and, I think some households would suggest, overdue.

All of that said, speaking for a moment from an FPC perspective, it is something we have to watch carefully. Despite the improvement in resilience, there is this danger that there could be a sharper upsurge in a low interest rate environment, an environment where almost 2 million households have never experienced a rate increase and, for many others, it is a distant memory and a concept as opposed to a prospect. We have to be careful. We cannot be complacent. It is not about households; it is about the Bank of England not being complacent about this and ensuring that we do not build up pockets of vulnerability that would hurt not just those individuals but be of such a scale that it would hurt the economy as a whole. That is why we have taken some action in the housing market. That is why we are looking at buy-to-let, and that is one of the reasons why the FPC is actively looking at increasing the countercyclical buffer.

Q58 Mark Garnier: This is partly carrying on from Rachel Reeves's question a little bit earlier and the comment from Dr Vlieghe about long-term equilibrium in interest rates. A lot of the discussion we have had this morning has been about what will happen when the confidence comes back, interest rates start to creep up, the long-term equilibrium and all that sort of thing. Part of this discussion has been about surprise shocks. One of the potential surprise shocks that could happen is a crisis in the confidence in sterling. We have not quite seen that over the last few days, but it is illustrated in this slightly febrile moment that some of the most bizarre announcements can have a pretty significant effect on the currency of the fifth-biggest economy on the planet, which will have taken most people by surprise.

Clearly, over the next few months, we will be coming up to a period where there could be some interesting announcements, with interesting opinion polls and, indeed, an interesting result that could result in a sterling shock, particularly if these things come unexpected. Clearly, I do not want to try and put you in a position where you take a specific view on an outcome of a political act, but what troubles me and what I am trying to get your guidance on is whether households will be resilient to what the Bank of England—the MPC—may have to do if we see a sharp fall in sterling. That could be you just trying to defend sterling, which could be a very short-term measure. However, it could be a longer-term, sustained

fall, which could be inflationary, and therefore you would be in a position where perhaps we would see an earlier rise in interest rates—an unexpected rise in interest rates—and potentially, depending on the size of a problem with sterling, the rate could be higher than what most people would now agree is the longer-term equilibrium interest rate.

Dr Carney: In terms of the path of policy, whatever shock we are discussing, whether it is from abroad or domestic, we have to take into account the persistence of the shock, and the impact on the real economy and, ultimately, on inflation. We have to be absolutely consistent in having a stance of adjusting policy to the shocks, if they are going to have persistent impacts, to achieve the inflation target. In doing so, we have to not just fulfil our statutory responsibilities to Parliament but maintain inflation expectations, make sure they are well anchored and ensure that the British people can focus on what matters and not worry about where inflation is going to go.

There are scenarios where that would require interest rate increases. We have been saying for a long time that we think that interest rate increases, when they come, on the basis of the forecast, would be limited and gradual. There are scenarios where it may be a little less limited and a little less gradual. There are obviously scenarios, some of which we have touched on today in some of the questioning, where it might be appropriate to provide additional stimulus. Our job is obviously to make the assessment, set the direction of policy, clearly anchor it in the remit and explain why we are doing so.

Yes, households need to be prepared for the possibility of rate increases. On our latest survey, about half of households expect that to occur over the course of this year, and a higher percentage over a longer period. And we all have to be prepared for the possibility that this economy could be hit by bigger shocks, particularly from abroad.

I will finish with this. The FPC is focused—and the MPC has been kept informed about this—on ensuring that the banks are adequately capitalised for a very large emerging market shock, much larger than we are experiencing at the moment, as was done last year. In 2014, the core of the stress test was effectively a balance of payments challenge. I don't want to use the other "c" word, but it was a balance of payments challenge, with knock-on effects into the housing market and underlying economic activity, with a sharp increase in unemployment. We ensured, to the best of our ability, that the banks have been well capitalised for that.

In terms of our responsibilities, it is at the core hitting the inflation target, but secondarily, and equally importantly I would suggest, ensuring that the banking system and the financial system as a whole will be able to continue functioning if any of these shocks come to pass.

Q59 Mark Garnier: That is very reassuring. Dr Shafik, I would be interested in your views, with you having come from the IMF. We have just heard that households understand what a rise in interest rates means. They understand that it is a possibility. Do you think that they fully understand that shocks could happen to the system, because of certain decisions that are made collectively or otherwise, that could actually bring greater stress to those households? Do you think households have that full understanding, demonstrated by their behaviour,

that they can suffer a big economic shock, which would result in rising interest rates—that is the key thing?

Dr Shafik: It is interesting that there has been an increase, for example, in the proportion of fixed-rate mortgages, which would imply that households are trying to protect themselves for periods of time from rate rises. That is a very good behavioural indicator of people taking the opportunity, in a time of low rates, to protect themselves against future rate rises. I take some comfort from the stress test we did in 2014. The fact that it was a very large current account shock with a housing fall, etc, and the banks were resilient and their balance sheets could withstand a shock on that scale, was reassuring.

Mark Garnier: It is households that I am really interested in.

Dr Shafik: Mortgages, for example, in their balance sheets were able to withstand the kinds of interest rate rises and house price falls that we stressed.

Q60 Mark Garnier: Fair enough, but do you not see the rise in unsecured lending as a slight worry, if we do see a sudden interest rate shock?

Dr Shafik: We have seen an increase in growth in unsecured lending. It is mainly about auto loans. We have done quite a lot of analysis to understand that. It mainly reflects changes in the way people buy cars. Increasingly, people are buying cars on a leased and borrowing basis as opposed to buying them outright. There is collateral against those loans. We have dug quite deep into the unsecured lending market and, because it reflects those structural changes, we are less worried about it than we might otherwise have been if it was the old model of unsecured lending.

Q61 Chair: The implications for the Bank's mandate of a Brexit are something we will have to look at in depth. Just to be clear, we will be going well beyond the effects on sterling that we have discussed today and look at much broader protections that may or may not have been achieved for the euro-outs. Also, of course, we will look at the Bank's fulfilment of its financial stability duty and how that has been affected, among other things. I just thought it important that that be on the record.

As for what you have said about Sir John Vickers, the systemic risk buffer and the resilience of the banks, you have been pretty unambiguous. It will turn out either that you have fulfilled the spirit of the Vickers report or that you have not. We will need to look very closely at that, and possibly before you finalise your decisions on the buffer at the end of May. The next financial stability report is not due until July, I think.

Dr Carney: Yes, July.

Chair: We will be having a hearing immediately after it, so we may need to see you before then. I felt that may need to be on the record. Is there anything you just want to add on those two points? I have one last question.

Dr Carney: I will make one last point. I very much welcome the opportunity to have the discussion; it is an incredibly important issue. As I say, we welcome the debate. The absolutes are clear. The facts are the facts in terms of the overall levels of capital. It is also important to recognise the use of the buffers—systemic risk, capital conservation and other buffers—and how that capital stack is divided up. We will come and explain how we as the FPC have tried to use those buffers to fulfil all our objectives, including the PRA objective to promote competition, provide the right incentives—

Chair: I am sorry to interrupt. This is squarely outside the MPC remit. It was very topical and you needed an opportunity to respond to it, but it sounds as if we are going to need a more thorough examination of it. It sounds as if you are already extremely well briefed for providing it too, so we are looking forward to hearing the rest of not just that sentence, but what will probably turn out to be a disquisition on the subject.

Dr Carney: If I may, Chair, I am not well briefed. These are express decisions of the FPC that we took. We thought very carefully about it for the last two years.

Q62 **Chair:** I did not mean that in any disparaging way. You have thought very carefully about it and come to clear decisions as a collective. We know you always operate by consensus. Dr Weale, were you surprised by the reaction of the markets to the US rate rise?

Dr Weale: Initially, it looked as though not very much was happening. In some sense, the instability we had in January was partly a consequence of the rate rise. I certainly would not say that that was the primary cause of the instability in January. It may have been a factor.

Q63 **Chair:** A minor or a major factor?

Dr Weale: I do not think I am really in a position to judge.

Q64 **Chair:** You are in a better position than most, Dr Weale.

Dr Weale: As I say, it was something that did not come straightaway. The rate rise was advertised very well in advance. In those circumstances, you would have expected the impact to come as the signals were building up that the rate was going to change, and perhaps also at the time of the change, rather than some weeks later. Essentially, the rate rise has interacted with concerns about growth in the global economy, and it is that interaction, rather than the rate rise on its own, that may have been the source of instability.

Q65 **Chair:** It was a mistake, wasn't it?

Dr Weale: I am not making policy for the United States. If you look at their figures for inflation, those different categories of core inflation, then things do look rather different

from simply saying, “The United States is growing slowly.” The United States seems to be suffering from the sort of productivity problem that has been affecting us as well.

Chair: Manufacturing is weak.

Dr Weale: There were some figures this morning suggesting that manufacturing is weak. The United States seems to be suffering from the productivity problems that we have had. To the extent that those are supply side rather than demand side, they affect the capacity of the economy to produce and therefore the risks of excess demand.

Q66 **Chair:** I realise you do not want to make policy for the Fed, but in retrospect this does not look to be a terribly helpful intervention by the Fed for UK policymakers.

Dr Weale: I must say, I do not think retrospect is quite the right way of looking at monetary policy.

Chair: I agree.

Dr Weale: People have to make decisions on the basis of what they see at the time, and not as things look eight weeks later.

Q67 **Chair:** Eight weeks ago, how were you feeling about it?

Dr Weale: I must say that, eight weeks ago, I could understand why people on the Fed wanted to do what they did.

Q68 **Chair:** You were not surprised.

Dr Weale: It was a change that had been very well advertised, so I think I would have been surprised only if I had not been following the news and the economic developments over the previous three months.

Q69 **Chair:** Has the reaction, and the interaction of that with global markets, altered the way you think about the scope for raising interest rates in the UK?

Dr Weale: As I have said, I am aware of the risk that those sorts of disturbances in markets will be transmitted to the real economy, will start affecting business confidence and will start affecting household confidence. Now, whether that will happen or not remains to be seen. Paul Samuelson famously said that the stock market has forecast nine of the last five recessions, and how far this is a good or false signal is not yet clear.

Q70 **Chair:** Have you learnt anything about the merits of forward guidance from this? After all, you have been telling me for the last three minutes that the Americans gave a good deal of forward guidance about this change.

Dr Weale: My view is that the right way to make monetary policy is the way that the MPC does it. We look at the economy at the time and come to our decisions in the light of what is happening in the economy at the moment. Now, it may be possible to put parameters around that, and on occasion we have done. The principle of that, if not the actual specification, I was sympathetic to. But I certainly think it is right, as the Governor said, not to look at some pre-ordained path, but to look at the economy as it is, to come to the best judgment that you can about what is appropriate.

Chair: Thank you very much. Well, there is a lot going on in financial stability policy with respect to the Bank. There is a lot going on in a wider sense, and the Brexit debate is part of that. Today we have been concentrating on monetary policy, but actually there is a lot going on in monetary policy too in the light of international and domestic economic developments. Thank you very much for coming in today. It has been extremely helpful and we will take this debate further quite soon.