



Economic Affairs Committee

Corrected oral evidence: UK labour supply

Tuesday 22 November 2022

4.05 pm

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Members present: Lord Bridges of Headley (The Chair); Viscount Chandos; Lord Fox; Lord Griffiths of Fforestfach; Lord King of Lothbury; Baroness Kramer; Lord Layard; Lord Livingston of Parkhead; Lord Monks; Baroness Noakes; Lord Rooker; Lord Skidelsky; Lord Stern of Brentford.

Evidence Session No. 1

Heard in Public

Questions 1 – 15

Witnesses

I: Sir Paul Tucker, research fellow/Harvard Kennedy School, and former Chair, Systemic Risk Council; Erkki Liikanen, Co-Chair, Systemic Risk Council.

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Examination of witnesses

Sir Paul Tucker and Erkki Liikanen.

Q1 The Chair: Good afternoon and welcome to this meeting of the Economic Affairs Committee where we are looking at financial stability risks. As we will be touching on financial regulation, I should remind everyone of my interests as an adviser to Banco Santander. Let me begin by asking our two witnesses to introduce themselves.

Sir Paul Tucker: Thank you very much, Chair, for inviting me to give evidence to you. I am a research fellow at Harvard Kennedy School. I am a former central banker, and perhaps I ought to disclose that I am a member of the main board of Swiss Re, the global reinsurance company.

Erkki Liikanen: Among other things, I chair the European think tank Bruegel and the Helsinki Graduate School of Economics today, and then I am also the chair of the IFRS Foundation Trustees. I am also co-chair of the Systemic Risk Council, which is American and European.

Q2 The Chair: Thank you both very much for joining us. There is a lot of terrain that we wish to cover, so I will start by asking a very broad question to try to set the scene. We are exiting an era of cheap money and ultra-low interest rates. I have just been reading the OECD outlook, which is pretty gloomy and depressing. When you take a bird's eye view of where things lie at the moment, what would you say are the greatest sources of risk to the global financial system? Could you briefly set the scene for us?

Sir Paul Tucker: As interest rates rise in the United States and the euro area particularly, but also in the UK of course, there will be greater or lesser deleveraging across the financial system, particularly outside the banking system. The greatest sources of risk, frankly, are that excessive leverage and liquidity mismatches have built up outside the banking sector. The authorities in all the main centres, not just the UK, have essentially neglected that, partly through their efforts to work together and finding it difficult to work together. We can see the recent LDI pension fund thing in the UK, which became global market news, as just one example of what might lie ahead.

I have a further comment. I do not know whether this is true, but the newspapers report that these pension fund vehicles were subjected to a stress test in and around 2018 of what would happen if interest rates—the yield curve as a whole—moved up by about 100 basis points. I would say that this was obviously a wholly inadequate stress test. It was set when interest rates around the world were essentially zero and expected to be zero for a long time, but also when the authorities thought that what economists call the neutral interest rate was around two percent. You would at least want a stress test of going back to two. But bad things also happen in the world, so you would want to stress test rather more than two. I would probably have chosen 300 basis points, but a reasonable person might have chosen 250. I do not see what reassurance anyone could have got from 100 basis points since that would have been

a state of affairs well below normal. I do not want to lay that on too much, but it somehow captures the extent to which people have been overly relaxed about leverage outside the banking system.

Secondly, I will quickly add one other point. I would prefer not to name the firm, but we have seen one very large continental European global bank stumble horribly in recent months with imprudence on a scale and of a kind that is almost unfathomable given what happened in 2007 and 2008. I say that not to have a pop at them but because it is easy to conduct these discussions, and more importantly for policymakers to do so, as though everything in the banking sector must be hunky-dory and none of the carelessness in the run-up to the 2007 crisis could possibly be recurring. We have evidence in at least one case that that is simply not true.

Erkki Liikanen: Yes, I mainly agree with Paul. I left central banking in summer 2018, and the last report came from BIS, which I have not forgotten. It said that low market rates for a long time could have implications for financial stability as well as for the health of financial institutions. That could be seen very clearly.

Of course, now the outlook for financial stability has worsened as inflation remains high and the macroeconomic forecast deteriorated. We have the rising interest rates and energy costs, as well as for the economy debt-servicing capacity of sovereigns, corporates and households confronts its first real test. As the risk appetite in the financial market decreases, the price of risk-taking grows and getting funding from the markets might be hampered, which can cause surges in volume, the cost of funding and demands for collateral.

That is my general comment but I mainly agree with Paul. I can come back to some interlinkages later because you have some other questions to ask us.

Q3 **The Chair:** Thank you very much. Erkki, when you look at the reforms that have taken place to the world's financial regulatory architecture since the GFC, do you think that they are working, have prepared us and made the system more resilient? If I am right, Sir Paul, I am hearing from you that there is still reason for concern in the banking sector per se. We will come on to NBFIs, but I am interested the extent to which you think the reforms since 2008 have worked.

Erkki Liikanen: My assessment is moderately positive. At the time we set the increased requirements for capital and, in that area, these new regulations have been followed. Of course, since then, when the situation becomes more difficult, it is extremely important that the regulatory authorities keep this line so that there is trust in the financial system. In that general aspect I think that it is moderately positive.

As to other aspects, you know well about ring-fencing, which is an area I also worked in. Its impact has mainly been positive but now, today, it may be that we must focus not only on ring-fenced but non-ring-fenced

financial institutions because these interlinkages are working over this border. What was done at the time was right, but now one needs to go further.

Sir Paul Tucker: I will add two things very quickly. It is not that I know that there are problems in other banks; I do not remotely know. However, what happened in this massive SIFI, as it is called—a systemically important financial institution—means that there is no room for complacency. I think that what the regulators ought to do is to not take the word of the big banks that they are okay and to find the areas of discomfort.

The other thing I would add—this may take us too far astray—is that, on the retail banking side, the changes over time in the way that customers are treated will have eroded customer trust. That increases the fragility of the banking sector when bad things happen. I have a little bit of experience in this now, which I do not want to go into at all, but I do not think that the way that people feel about their banks is anything like the same as when I was a young man or even a middle-aged adult.

Q4 **The Chair:** Sir Paul, before I hand over to Baroness Noakes to go into NBFIs, do you feel that the mindset is one where we are regulating for the last crisis? Have we caught up with how the world has transformed—you may not think that it has transformed that much; I think that it has transformed quite a lot—since 2008? Is there a danger that we are regulating via the rear-view mirror and not looking ahead, or do you think that is wrong?

Sir Paul Tucker: Yes, somewhat, in particular in this area of inattention to risk outside of banking. Erkki referred to a quite recent report. Those of us around the table—including, of course, Erkki—in 2010, 2011 and 2012 knew that reregulating banking would push banking-like activity outside the perimeter of banking. We did not know that interest rates would stay so low for so long, but it is completely predictable generically that there would be excess leverage and illiquidity outside of banking, though not precisely where it would turn up, and there were plans to deal with that. It was G20 policy to follow up on what is called shadow banking, which did not happen. That is somewhere between the rear-view mirror in the sense that there was a good forward-looking view and somehow people lost interest in it or got bogged down or obstructed, I cannot know which.

Erkki Liikanen: I think yes and no. It was a tremendous financial crisis for our generation. The basic reforms were correct but, today, what we have of course learned is that it will be important to somehow regulate and supervise equally both banks and non-banks. That will be a challenge. In an ideal world, we should aim to move from an entity-based approach to an activity-based approach, because whatever the institution it will be activity based.

The Chair: I am sorry to cut you off, but I want to bring in Baroness Noakes, who may want to get into this precise topic.

Q5 **Baroness Noakes:** Yes, I want to shift on to shadow banking. As you have both indicated, this is an issue that has been recognised for some time. Sir Paul, can you set the scene for us by identifying where in the non-banking financial institutions sector we see the greatest risks? Can you explain why we should be concerned about those and then perhaps say what you think should be done? In a seminar recently, you noted that there is more talk about shadow banking than action. If action is to be taken, what is that action to be?

Sir Paul Tucker: The first thing to say is that I am pleased that you are using the expression "shadow banking". There has been this move to calling it "non-bank financial intermediation". I do not know whether you know—I have this from pretty damn reliable sources—this was an initiative partly of the Trump White House to change the words and partly embraced by officials. Big asset managers absolutely wanted to shift away from the expression "shadow banking" because they saw it as pejorative.

I and others talked about this in 2010 and 2012, while I was still in office, and in 2014 and 2015. It is of no interest whatever that I happened to talk about it myself; the point is that this was foreseen.

It manifests itself always in different ways. In the run-up to the 2007 crisis, it was money market mutual funds, asset-backed commercial paper conduits, structured investment vehicles, in some respects monoline insurers, parts of the AIG insurance company. Precisely where it is now, I am not in a position to know, but the Bank, the Fed and others are. It is not hard to find out where it is. You essentially do two things: first, you wander around the market talking to people about what is going on, what is interesting and where innovation is; and, secondly, you ask the big banks and broker dealers where they are extending leverage and which are the growth areas for extending leverage to the non-bank financial sector. That will give you pretty good clues.

It matters because when a financial entity has liquidity mismatches or leverage, in bad states of the world there can be runs on it or an inability to roll over the debt or meet collateral calls, as we saw in the pension thing. What then happens is that there are forced sales of assets. That pushes down asset values and pushes up market interest rates. That increases the cost of capital, it reduces wealth, and so hits spending in the economy. The macroeconomy-financial system linkages feed upon themselves, pushing the economy on to a lower equilibrium path, and more and more firms of financial intermediaries into default or near default.

What should be done? I have three things. First of all, please do not, as the UK Parliament, give the Prudential Regulation Authority a competitiveness objective. Someone would only do that if they really disliked the City of London and wanted to damage the City of London in the long run. It is not just that it would be bad for the British public and bad for the UK; it will be bad for the City of London to give the PRA a competitiveness objective. I can summon the ghosts of Eddie George and

George Blunden in assuring you that the City does not always know its best interests over the medium to long run. Of that I am confident and I really am summoning their ghosts.¹

The second thing is that the Financial Policy Committee, which curiously does not feature in national debates nearly as much as Lord King and I might have expected a dozen years or so ago, can use the tools that it has. It can increase minimum margin requirements in some derivatives markets. It can increase minimum excess collateral requirements in lending markets, which all sounds terribly complicated but it amounts to introducing a leverage cap on traded positions in traded markets. I thought that that should have happened from around 2016-17 when it became obvious that QE was going on, it seemed, for ever.

More generally, there needs to be delivery on this clear international intention back in 2010, 2011, 2012 to have a general policy for shadow banking. I have argued since shortly after I left office that if you try to tackle one piece of shadow banking at a time only when it becomes a tangible threat to stability, by then it will be so big that it has lobbying power—particularly in the country I am sitting in, and particularly in the city I am sitting in, Washington DC—and, therefore, will be able to obstruct any regulatory measure. A strategy of follow the growth and respond when it is very big is absolutely doomed to failure when policy meets politics and the politics of money and donations.

I do think that it would be possible to have a general policy. It would essentially say something along the lines of, “If you are overleveraged and taking a lot of liquidity risk, then you must take out liquidity insurance with a central bank and you must pre-position collateral with the central bank”, and the central bank’s collateral policy will then effectively put a cap on the amount of leverage that can be adopted by these firms. All that could have been done; it still should be done. I think that it will be quite difficult to do it internationally and, therefore...I think you are referring to a Bank of England event, which both Lord King and I were at; it was Chatham House so, peculiarly, although my slides are public with the consent of the Bank, I am not allowed to speak about the event itself. I can say that these ideas have been circulating for a while, one version from Lord King himself, one version rather similar in many respects from me, and I think they should just do it.

Baroness Noakes: That is pretty clear. Is there anything that you would like to add, Mr Liikanen?

¹ I should have added the following concrete point. Imagine the UK had set higher capital standards for banks during the early 2000s. There would have been huge complaints and lobbying from the banks (and, no doubt, ministers). But the benefits to the standing of the City would have been enormous if, alone among its peers, Britain’s banks had not failed in 2007-08. London would have been the banking centre the rest of the world could trust to be safe. Banks’ true interests were exactly the opposite of what they lobbied for under the regime of “light touch regulation”.

Erkki Liikanen: Yes, I will come back to the terms that were used after John Vickers's report on reform, when I was still involved with these issues in Europe. We spoke about ring-fenced and non-ring-fenced. The UK's advantage is now that you are very far in the resolution mechanism. The Bank of England has announced that banks are resolvable. At the same time, people know that this non-ring-fenced part is also systemically very important and critical. For resolution authorities it will be a challenge to be able to also handle that part properly in the future. As I said before, perhaps there will be need for more of this activity-based approach in the future, not only entity-based. That is the challenge: progress in resolvability but challenge on the non-banking side.

Baroness Noakes: Do you believe that action should be taken by national authorities rather than globally or regionally, as Sir Paul suggested?

Erkki Liikanen: You do not change legislation in one go, but if you look at how it is now and what the authorities have—if you look at the UK situation—for you the ring-fencing gives some clarity to the markets, which is clearer in many other areas. It can happen. It will be helpful there, but in the long term I think we should have this activity-based analysis and measures globally because banks are operated globally.

Q6 **Lord King of Lothbury:** I should declare that both witnesses are former colleagues and, indeed, friends. Sir Paul, greetings; Erkki, hyvää päivää.

Sir Paul Tucker: Oh, my goodness.

Lord King of Lothbury: What I would like to ask you about specifically is the episode recently in the UK when the Bank of England intervened directly into the gilts market. The fact that pension funds might have to meet cash margin calls if gilt prices fell was identified by the Financial Policy Committee of the Bank, I think, four years ago. It is pretty obvious that if any one pension fund were going to have to put up cash margin calls while gilt prices as a whole fell, then the same problem would afflict all pension funds in that situation. The fact that it was a systemic problem that arose could hardly have been a surprise.

I would like to ask first Sir Paul and then perhaps you, Erkki, to comment on how you would have thought about this and approached it in putting in place in advance a method for handling the problem when the events of a fall in gilt prices materialised, and whether you think that there were risks involved in the Bank directly intervening in the gilts market. You know more about this than almost anyone else, Sir Paul, in your former career, so give us the benefit of your experience and wisdom.

Sir Paul Tucker: One would like to think that ahead of time, with colleagues, there would have been a response to say "you do not need to lever up the whole of your pension fund to enhance the yields. You do not have to be almost infinitely levered". And there could have been steps in advance to try to influence the banks and dealers, which the FPC

certainly has powers to do, on the terms on which leverage was provided. Imagine that for some reason one knows about the risk but does nothing. Just imagine that.

Then there is another thought experiment. What one would really want to do is to provide liquidity assistance to the pension funds against their illiquid collateral so that they do not have to sell their gilts. That would be, I think, the best swift response.

If one did not do that for whatever reason and gilt yields are going through the ceiling as forced selling spirals around the world and commentators are coming in and saying there is a "moron premium" and it is incipient sovereign debt prices—which I do not believe it was, by the way, but if that takes grip—I can see there are circumstances where one briefly wants to step in as, as it were, a market maker of last resort to stabilise gilt prices. But one wants to get out very quickly.

One wants to do something else in those circumstances. It is absolutely vital to distinguish the market maker of last resort exercise from quantitative easing (which is trying to stimulate aggregate demand). That is easily done, as it happens. I can think of five ways of doing it, which I will not bore you with, but as one buys the gilts and pays central bank money for them, one wants to drain that extra central bank money from the market. The Bank of England did not do that and I think this was a mistake—quite a big mistake, actually. Andrew Hauser, the markets director, not a member of any of the policy committees but a man who, in some respects, might be in charge of certain parts of the Bank of England these days, more or less said in a speech recently that they were very concerned that their operation was mistaken for QE. I do not think it needed to be at all. It does not matter how small the amount; if you create reserves via a non-monetary policy operation, you must remove the reserves from the system, however small they were.

There is a governance point here, which may take the committee too far astray and I apologise if so. There is a suggestion that the Monetary Policy Committee informally approved of, or acquiesced in, this money creation. I do not understand what that means. There either was a Monetary Policy Committee meeting to discuss it or there was not. If there was, we should see the minutes of the emergency meeting. If there was not, there was not formal approval from the MPC and that money should certainly have been drained.

I will not repeat the points I have made, but there are various stages where, in an ideal world, the forced selling would have been prevented. Then in a less than ideal world, the response would have been lender of last resort against collateral to the pension funds, directly or via their banks—it does not much matter which. Later on, there was such a facility via which the Bank lent, I believe, £5 million. The number was announced last Thursday, I think. Then, if you are rocked back to acting as market maker of last resort, you must distinguish that from quantitative easing in what I will describe as the obvious ways.

Lord King of Lothbury: Your first preference in dealing with the event would be the provision of liquidity through the application of the general principle that you enunciated before, which is that the central bank would stand ready to provide liquidity against pre-position collateral.

Sir Paul Tucker: Yes, and this links to Baroness Noakes's previous question on shadow banking in that central banks are partly in the business of providing liquidity insurance to the private sector. Historically, that was thought to be the banks, but if things that are not legally banks do banking-like things and are big, they will end up needing liquidity insurance as well. It is best to recognise that in advance rather than scuttle around. As I say, if they do not do that, and this is a government bond market after all, given where they eventually found themselves and given the sequence of sins of omission, I then think that they did the right thing in a tight corner, but then did not implement it as it could and should have been.

Lord King of Lothbury: Erkki, looking at this from afar, did you have any reaction or response to how this was handled?

Erkki Liikanen: I followed it as one incident, which is a type of incident that can be more frequent in these uncertain times, but I do not want to go into details. I have not been able to follow it so closely.

Q7 **Lord Livingston of Parkhead:** Sir Paul, this question is probably for you. Is this a case where you are looking at a number of regulated entities but, unfortunately, some are not regulated by people who have systemic financial risk on their list of things that they either know about or have a requirement, so the pension regulator, and that we have a regulatory gap in that people who are creating the systemic risk do not fall within the net? It is an extension of the shadow banking problem. It was a regulated sector and, in fact, we have to understand better the way that the regulatory topology, if you want to call it that, operates in the UK.

Sir Paul Tucker: No and "a bit, yes," is my answer. If the Financial Policy Committee did not exist, the answer would be yes, there would be a gap, but the Financial Policy Committee is part of the apparatus to fill that gap. It has a right to make recommendations to absolutely anybody, including the Pensions Regulator, the Treasury, and anyone it wants, really. Let me speak more carefully. The Pensions Regulator is not in the position of the PRA or FCA in relation to the FPC. They are in the position that if the Bank of England FPC makes a recommendation to them, they must comply or explain. They have a statutory duty to comply or explain. The Pensions Regulator and others, including the Treasury, are under no statutory duty to comply or explain, but if the FPC said in public that it thought that the Pensions Regulator ought to do something, the Pensions Regulator would probably find itself in a position of needing to explain or comply, with a small "e" or small "c". That is the first thing to say.

The second thing to say is that the legislation that created the Financial Policy Committee gave it a responsibility of reporting --- I think each year

--- to the Treasury on whether the perimeter of regulation needed to be changed to help preserve stability or there needed to be a reshuffling of responsibilities between regulators to help preserve stability. Those are recommendations from the FPC to the Treasury. I do not know whether it still happens, but while Lord King and I were there we set up a process whereby the FPC would be briefed on perimeter issues, if I may put it like that, so as to ensure that it adequately fulfilled the responsibility bestowed on it by Parliament.

This throws into an interesting light, one might say, the point that Lord King made that the FPC did discuss the risks from the pension sector in 2018. The big point here is that if you go back to 2007, the Bank of England and others had predicted lots of things that went wrong in 2007 and 2008. I do not by any means want to defend everything during our period of office, but we did identify lots of things, including all the overleveraged structures that I mentioned earlier, but we—I was then part of it—had no powers. The point of the FPC was to get beyond excellent analysis to analysis with powers. If you have powers and you exercise your powers, your analysis becomes an action in itself, where people start to take notice of it because you may follow up the published analysis with action or recommendations to others to take action. I am very sad about this, frankly, because I suppose I am one of the architects of the FPC. I am very sad that the expectation from Parliament, the public and the media on FPC has not developed in the way that I and others expected.

Lord Livingston of Parkhead: You are saying that the architecture exists. The risk was known about. A hundred basis points, I think, as we all sit here, seems a strangely small number when you compare it to the assumptions used in bank stress tests and asset manager stress tests and other things. Basically, the operation failed rather than the architecture. That may be an unhelpful distinction, but is that broadly what you are saying?

Sir Paul Tucker: Yes. On the facts I have, which are pretty limited, for goodness' sake—I might change this conclusion if I looked into the matter very carefully—the regime looks okay and does not need to be met with legislative reform or anything, but I do think that there is a question of us—citizens, you on our behalf—demanding more from the FPC.

Q8 Lord Griffiths of Fforestfach: Sir Paul, your comments have been very helpful. As I listen to them, and having read the Industry and Regulators Committee report, it seems to me that the evidence we have on the LDC is that there are a whole lot of people there who are really not on top of their jobs. It was a very disparate group of regulators, who were not talking to each other. No one institution had taken ownership of it. That is one thing. Secondly, there are other areas within the shadow banking system where there could be trouble ahead. From the point of view of this committee, if you agree with those two facts—you might not—what is the best contribution that this committee could make on what you mentioned as the role of Parliament or the general public?

Sir Paul Tucker: I think that it is to argue for a different dialogue in Parliament with the Financial Policy Committee. "What are you doing?" Not, "What are you saying?" but, "What are you doing about the things that you have identified?" I was greatly struck...there is an asset manager, who I will not name and I do not know him—people seem to think he is quite good—and he ran one of these Twitter polls, asking "Who do you blame for this LDI crisis?" He listed a whole bunch of people, trustees and regulators. I think that "blame" is the wrong word, but the FPC was not included. To the extent that there was not a threat to stability I completely agree with that. If there was a threat to stability, then it was the job of the FPC to take action.

My criticism is not of the FPC members and so on and so forth. It is that somehow—I do not know quite how this happened—after it was created in 2012, people did not realise that we now have a body that is taking charge of ensuring that there is stability wherever the threat is coming from. I am surprised because, in the short time that Mervyn and I served on the formal FPC, that is what we were trying to do, but obviously we did not succeed.

The Chair: I am sorry to jump in, Sir Paul. I will bring in Lord Fox because we have quite a number of questions that we still want to get to.

Lord Fox: I am slightly over-egging on this area, but it seems that the lack of activism from the FPC is the point you are making, given that it had the ability to do things. You said that perhaps the dialogue and the nature of the dialogue from government to the FPC should change. What form should that—

Sir Paul Tucker: Not government, Parliament.

Lord Fox: I beg your pardon, yes, Parliament. Would one way of signalling that be to increase the number of regulators that come under the statutory aegis of the FPC? If it is not that, what other messages should Parliament be sending the FPC to show that it expects a higher level of activism than is currently forthcoming?

Sir Paul Tucker: The approach you have aired is definitely worth thinking about, putting more regulators under the "comply or explain" thing so that it is clear that the FPC has responsibility. I think it has responsibility even where regulators are not formally under it in that sense.

Something else I would do relates to the Treasury's remit to the FPC—I will get the numbers slightly wrong—having grown from around eight pages during Mervyn's and my time to about, I do not know, 20-odd pages now. Anyway, it has more than doubled. Those in power should have a look at deleting everything that has been added since 2013 and go back to the beginning and say, "Could we live with that?" Do not urge the FPC to cure problems of regional disadvantage, inequality or climate change or lots of other social ills. Say, "Preserve financial stability and we can articulate your remit as clearly as the MPC remit can be articulated."

There are two men, David Aikman and Richard Barwell, who run a blog called Macroprudential Matters. They have been arguing this for two to three years and it has not made a jot of difference.

Q9 The Chair: Can I just jump in, Sir Paul? I want to ask one specific question before I turn over to Baroness Kramer. Coming back to risks in shadow banking, looking at the risks—and, as you say, the FPC is now meant to be analysing the risks and taking action—a straightforward question: we have had the experience of LDI; what are the other pockets of risks that you think that the FPC should be, first, identifying and, secondly, if it has identified it, taking more action on if it is not taking sufficient action at the moment?

Sir Paul Tucker: I cannot know where it is, but there will be other pockets of excess leverage and it ought to be urging the supervisors—the regulators—to get these people quietly deleveraged without destabilising markets. Then it ought to be using the powers that it has to raise margin requirements and minimum haircut requirements—basically, reduce the amount of leverage in the system. Executing that, given where we now find ourselves—it would have been much better done in 2016, 2017 or 2018—is harder now, but still somehow needs to be done. Or not doing it needs to be explained and defended in the way that the Monetary Policy Committee has to explain and defend itself. It is meant to be a committee of action, so inaction is doing something and maybe inaction has been completely justified.

Q10 Baroness Kramer: Sir Paul, I am mindful of a comment that you made a little earlier, which I paraphrase as: in the shadow banking sector, if a new activity arises that seems to be growing, it is wise to put in place a regulatory framework early before it gets so big that it can fight back. I have the crypto question. The question to you and to Erkki is: is this a sector now where we have to be concerned about a new systemic risk—I am mindful of the words of Sir Jon Cunliffe—and it is not just a protection of vulnerable people regulatory issue?

Erkki Liikanen: In recent days, this has been very much in the news. As early as January this year, the Systemic Risk Council wrote to the American authorities, saying that the already complex payment, clearing and settlement activities within the meaning of the law and the rapid growth over the past year in the area of stablecoins means that they are likely to become systemically important. The problem is that the sector has been unregulated and underregulated in the United States.

The Financial Stability Board later this year gave an opinion that the crypto assets market could reach a point where it represents a threat to global financial stability through its scale, structural vulnerabilities and increasing interconnectedness with the traditional financial system. In Europe, there have been steps forward in that area. The EU adopted in October a broad regulation of crypto assets as one of the major distributed ledger technology applications. On the one hand, the EU emphasised that there is an opportunity for economic growth and a new employment area but, on the other hand, it is possible that it can be a

critical issue for financial stability. For that reason, at the EU level, legislation has been adopted, which is a dedicated harmonised framework to provide specific rules for crypto assets.

The UK has taken a slightly different view and introduced in June the legislation to bring stablecoins within regulatory parameters. I am sure that those opinions that we stated in January—that they need regulation—have proved the right ones and now the sense of urgency is growing. It is good to be balanced: still support the possibilities to give innovation to the financial system, especially to the payment area, which these technologies can do, but on the other hand be very careful about the risks that the crypto assets can bring to financial stability.

Baroness Kramer: Sir Paul, could I ask for your comments on this with this thought in mind? Is this just a stablecoin issue or is this a much broader cryptocurrency issue? When I talk to people in this area, they all say that the answer is we must have global standards because of the way that crypto is so fungible across borders, but China has made it very clear that it will not play in that arena. What tools do we have that could be effective if you think we need to put something effective in place?

Sir Paul Tucker: I think there is an absolutely enormous issue of principle and prudence here that Parliament really does need to debate actively. If one thinks about pure crypto—so not the so-called stablecoins that are backed by central bank money or by other portfolios of reasonably good assets but pure crypto—one can make a pretty respectable case for not regulating them at all so that there is no question of the state coming in and rescuing people. I think Andrew Bailey has struck probably exactly the right tone on pure crypto for some time, which is that it is very likely to be a puff of smoke. Of course, there are networks that are sustaining it longer than most people would have expected, but I am really worried that if one starts to regulate pure crypto, and if it is purely a bubble, then the state, whether the US state or the UK state, will find themselves needing to protect and compensate members of the public if they lose out.

Having said which --- that, I think, is a respectable argument and where I am for the time being --- I do not know where I would end up if I was involved in thinking about these things carefully. There is one crypto exchange, I believe—I will not name it because I have probably slightly misunderstood it—which is domiciled in one place and managed from another and has operations elsewhere. When someone said this to me, I said, "Oh, my goodness, that is a crypto version of BCCI". Some of you are old enough to remember the BCCI thing. It was both a crisis and a scandal: domiciled in Luxembourg, owned from a Gulf state, managed by somebody who was on a plane or nowhere very much and, of course, it was all very bad.

I do not think the reflex should be to give a veneer of not just respectability but of the state somehow having your back if you go into

this regulated thing. It could not be more different from a pension or a current account deposit. There are things here that go way beyond technical issues, and I have felt for some time, whether on digital central bank currencies or this broader crypto stuff, that policymakers are a bit too fascinated by the techy stuff and not quite seized enough of the high-level questions. That may not be very helpful.

Lord King of Lothbury: I wanted to ask Erkki whether he agreed with Sir Paul, because I very much agree with what Sir Paul said, which is that crypto and stablecoins are two very different animals. On crypto we would like people to fail—to lose money—without any pretence that someone else should bail them out. Stablecoins are pretending to be backed by central bank currencies and the regulation that is required is to make sure that indeed they are backed by central bank currencies because they are very much like Scottish banknotes, where we allow our Scottish banks to print their own notes, but only if they are backed one for one by Bank of England notes.

Sir Paul Tucker: All the time.

Lord King of Lothbury: All the time, and that is what stablecoins should be made to do.

Erkki Liikanen: Lord King, this was exactly the reason that we wrote in February the letter to authorities on stablecoins and that is also where the Financial Stability Board has been moving on. I will just add one element. Right now there is global consultation organised by the Financial Stability Board to find consistency and comprehensiveness in this area of regulation and to find recommendations that could create global oversight of a global stablecoin. If there is an area where global co-operation between authorities, internationally and domestically, is important, this is the area. That is why I say that the Financial Stability Board, as you know better than anybody, had a critical role when we went through the reforms to lessen inflation. I think its proposals for consultation solutions are something I support.

Sir Paul Tucker: May I just say one sentence about that? It will be terribly difficult to get global co-operation, given the role that digital stuff plays in the geopolitical contest.

Viscount Chandos: When we looked at a CBDC in an inquiry about a year ago, it was quite hard to fathom what the rationale for it was. We certainly heard suggestions privately that it was essentially defensive. Do you think that regulation of stablecoin is all that needs to happen, or is a retail CBDC that is likely to put commercial stablecoin out of business a better way of creating the financial payment system of the future?

Sir Paul Tucker: It is a better way. It is a better way of doing it, but it is tremendously important that if central banks do this, these are tokens rather than accounts at the central bank. I think all citizens banking at the central bank has the nightmare scenario for the liberal west of no banking secrecy from the state, a route to social control, and state allocation of credit. Of course, if one was sitting in Beijing, one would

think all those things were fine, and this gets to why the digital currency thing will be very hard in terms of international politics.

Domestically, if the world is becoming digital, then we want a digital equivalent of a cash Bank of England note. The episodes in the 19th century in the United States and elsewhere, when private banks issued their own pieces of paper and they were not 100% backed by Bank of England notes or guaranteed by the US Treasury, were a problem. This all revolves around safety. When we, individuals and households, treat something as safe, it does need to be credibly safe in the sense that it is ultimately backed by a central bank that can create money—the final means of settlement.

Q11 Lord Rooker: Good afternoon. Sir Paul, I was going back in memory there. In its heyday I used to drive into Parliament past the offices of BCCI in its glory days.

May I ask about sovereign credit risk? Is there an increase in this and, if so, where might it be focused? How could the UK possibly be affected by its impact?

Erkki Liikanen: It is a very important question now, when we have had very low interest rates and inflation risks are high. We have rising interest rates and, of course, there will be pressures for the fiscal side. My personal opinion is that, in these circumstances, it is very important for the Governments to have very prudent fiscal policies that are well targeted, well assessed, and, if they somehow promise investment, that will be helping the green transition for climate change. This prudent fiscal policy where the Governments can be trusted and their policies can be respected is the best way to avoid major risks. Of course, these issues can be quite important, especially in some emerging economies or developing economies, which have been indebted in recent times.

Lord Rooker: Do you think there will be an effect on the eurozone in forthcoming years in terms of stress?

Erkki Liikanen: We will see, but I do not make forecasts here. Sometimes in the euro area you will see that those countries that have a high debt level are able to have primary surplus in their budgets so their capacity to roll the loans has been taken care of. It depends, of course, on what that is, but still I would say that it is very important to have clear rules that Governments respect and which are transparent and measurable and will help avoid problems with the sovereign risks.

The Chair: Sir Paul, do you have anything that you want to add on either of those points before I hand over to Lord Stern?

Sir Paul Tucker: I do not think so, no.

Q12 Lord Stern of Brentford: Thank you both for joining us. My question is about zombie companies that are getting by surviving on essentially zero-cost money. Now, of course, it is not zero nominal cost any more. How do you see the future for these companies? Not very good, I suppose is the

answer. What do you think that the implications would be for systemic risk?

Erkki Liikanen: Could I take this question because when I heard it before, I went to research literature and there was an interesting paper by Acharya, who was deputy governor of the Bank of India earlier, which gave a nuanced view on this issue. He said that on the basis of the evidence in Europe, the effect of distressed firms having stayed afloat thanks to cheap credit in a low-interest environment has been disinflationary. This disinflationary mechanism is that zombie firms can create excess production capacity, putting downward pressures on mark-ups, prices and productivity. It is interesting and it is a research paper written by very serious people. It is not counterintuitive but this other view can also work here. There are other difficulties but, for inflation, the impact can be disinflationary.

Lord Stern of Brentford: You believe their results?

Erkki Liikanen: I must say Sir Paul Tucker also knows Acharya, and Lord King knows him well. They are very serious research people and I should have to work more to be able to challenge their comment.

Lord Stern of Brentford: If those zombie firms whose capacity was helping in the sense of being disinflationary no longer survive, what then happens?

Erkki Liikanen: They will go out of market, but the question was whether the impact is inflationary. It depends on how much new capacity we will have, but the logic is that these companies, for their part, bring new capacity also in the market. That way gives more supply space and puts prices down, not up.

Lord Stern of Brentford: If they were disinflationary and they disappear, would the effect not be in the opposite direction?

Erkki Liikanen: Of course.

Lord Stern of Brentford: Thank you very much, Erkki. Sir Paul, do you have anything on that?

Sir Paul Tucker: It will depend in part on whether stagflation persists. If stagflation persists, I think the companies you are describing and many levered companies held in private equity portfolios and elsewhere will go through a very difficult time indeed. Doing a stagflation stress test is tremendously important. Let me make this concrete. One of the values of having external members on the Financial Policy Committee is that their duty is to you and to the Commons and to their mandate. They should be saying, "I know that the MPC says that it is all under control and it will all be fine, and I hope that the MPC is right, but we demand a stress test that assumes it will not be fine and there will be a recession and interest rates will be high for a while and then they will be jacked up as the MPC chases after rising inflation expectations. What would the stresses be then?" One hopes that one would want to do that, even if one were on

both committees. It would be quite an interesting thing to do, but the external members of the FPC should be doing that.²

What I want to do is to nest your question about zombie companies in a broader question about who gets carried out with the tide if stagflation persists. People have invoked Paul Volcker a lot over the past year or so, in a slightly peculiar way, because they have not tightened monetary policy that much in the United States. Paul had to tighten it a lot, and so they should do a stress test of, "We have lost credibility. What happens to the economy and to the financial system if we have to reassert it?" Your zombie company question would be a subset, or one sector, if you like, that would be very adversely affected in those circumstances.

Lord King of Lothbury: If zombie companies are the less profitable and less productive companies and they now start gradually having to contract, restructure their debts and so on, that would release resources that could then flow to more productive and more efficient companies. That would raise productivity growth over a period. Would you agree with that proposition?

Erkki Liikanen: Absolutely, I agree. I have these research papers. There is another, by the way, by the Bank of Finland. At first sight they are counterintuitive but if we go deep they go to the direction of what Lord King just said.

Q13 Lord Griffiths of Fforestfach: I would like to ask Sir Paul a question. To the extent that you put more emphasis on the MPC, by contrast to the FPC, to what extent do you think there is the possibility of monetary policy drifting into fiscal policy, which is to do with the allocation of resources rather than the overall objective of bringing inflation under control?

Sir Paul Tucker: I think that there is that risk. I do not think that it is to do with the FPC. Between fiscal policy and monetary policy there is essentially a sequential game; for the technicians, it is a Stackelberg game. A fiscal policymaker moves first. If the fiscal policymaker chooses to do very little to support the economy, as during 2012, 2013, 2014, 2015 and so on, monetary policy has to do more.

Further, something profound happened. I did not really notice it at the time, probably because I did not want to during the last crisis, which is that the political classes across the western world reached two views. First of all, this inflation thing was really easy and you did not need the embodiment of Paul Volcker in the United States or wherever to maintain

² Since I have said it elsewhere, I should have added that there needs to be more focus on the accountability of individual FPC members. When it was decided to try to make decisions by consensus where possible, it did not occur to me that there would never be any minority votes. The committee would perform better if each individual member expected that, in the event of instability or actions to contain instability, they would have to defend why they had not voted for pre-emptive action. Minority votes would enhance public debate on the use of the FPC's powers.

low inflation. They became a bit relaxed about that. Secondly and crucially, because central bank balance sheets were used to do so many things—the Funding for Lending scheme in the United Kingdom that Mervyn and I were part of creating, with Charlie Bean and others, and similar things in the United States and the euro area—I think the political classes thought that if they (the central bankers) can use it to do that, they can use it to do all sorts of other things. They can help steer the supply of credit to places that would be helpful, to steer it away from places we do not want it to go to. Over time, there has been this—this is not quite the right word—creeping politicisation that has acted, at the very least, as a distraction from the core mission, which is price stability and banking stability. As Mervyn’s predecessor used to say with great eloquence, “Stability, stability, stability”.

- Q14 **Lord Monks:** I was going to ask about what the UK authorities could do to mitigate the impact of the risks created in the shadow banking system, but I think you have answered that, so I will pose a question to Erkki. What can the UK learn from other countries on how we manage systemic financial risk? I am sure that Finland has some good lessons; it usually has on quite a lot of things in my field. What about in this area?

Erkki Liikanen: Thank you very much for the question but I am very shy to give advice to others. I learned a lot from Lord King and his analysis at the time I was governor. I remember his one famous sentence that the banks go abroad to grow and they come back home to die. Sir Paul Tucker was also a critical player in that.

As I said at the start, the UK has it right that you now have a resolution system that works and the resolution proposal has been properly done. That is one issue. I also think that the discussions about ring-fencing fundamentally were right. The challenge you will have is how to supervise perhaps the regulated non-banking side—the non-ring-fenced side—but that issue is equally difficult in other countries, too. Of course, your difference is that the banking sector is so much bigger in your country. Its role is bigger. We are all learning from others so I do not want to give any detailed advice.

Lord Monks: Okay. Sir Paul, do you have anything to add to that?

Sir Paul Tucker: I will just add one thing, which goes back to your preamble. The first best is nearly always an international agreement. Officials naturally—I was no different—strive and strive and strive to get international agreements to address these various issues. The point I have raised is how you pursue that without falling into drift, where you drift on for years and years and nothing is happening internationally and you do not do something domestically. It is very difficult to say that we will go it alone, but sometimes you have to. There is now a whole series of things. Erkki mentioned clearing houses. Nothing has been done on the resolution of clearing houses over the past decade. I will not elaborate, but that is terribly dangerous, notwithstanding efforts in the international community. I think the UK faces this challenge of when you go alone without signalling hostility to international efforts. I think it is important

that one should be willing to do so and there are a couple of areas where perhaps the UK should do so.

- Q15 **The Chair:** Sir Paul, just as a final point, what I am hearing consistently, though—correct me if I am wrong here—is that you feel that the FPC has the tools and has the remit but it is not really doing its job properly. Is that too blunt a portrayal of your position?

Sir Paul Tucker: It is too blunt. My concern is with expectations of the FPC, if you like. I want to transform the expectations of the FPC, or rather I want you to transform the expectations of the FPC, back to where they were at its foundation. Its expectations have slipped into it being a very high-quality analytical shop. I would say this, wouldn't I, but we were that before we had the powers. The point was to get the powers and, therefore, give point to the analysis.

No one should have any doubt that if the FPC had acted on the various things that I and others have described, it would have been very unpopular and, unlike price stability, where you can track inflation coming out at 2% on average during Eddie and Mervyn's period, with this it is things that do not happen. It is the absence of crises, which on the whole people do not celebrate. I think this requires, if I may say so, your committee and the Treasury Committee in the House of Commons to ask how you incentivise—they are only men and women—the FPC to be unpopular when it needs to be. Ultimately, that is why central bank independence is worth while.

The Chair: Thank you very much indeed for that. Erkki, do you have anything that you wish to add right at the end? I am sorry, we are well over time, which is my fault entirely. If not, thank you both very much indeed. That was a very interesting and insightful session and we are all very grateful to you.