



Economic Affairs Committee

Corrected oral evidence: Bank of England: how is independence working?

Tuesday 7 March 2023

3 pm

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Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Davies of Brixton; Lord Griffiths of Fforestfach; Lord King of Lothbury; Lord Layard; Lord Londesborough; Lord Rooker; Lord Turnbull.

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Questions 1 - 20

Witnesses

I: Professor David Aikman, Professor of Finance and Director at Qatar Centre for Global Banking and Finance at King's Business School, King's College London; Professor Frederic Malherbe, Professor of Economics and Finance at University College London; Professor Jagjit Chadha, Director at National Institute of Economic and Social Research.

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Examination of witnesses

Professor David Aikman, Professor Frederic Malherbe and Professor Jagjit Chadha.

Q1 **The Chair:** Good afternoon and welcome to this first evidence session of the Economic Affairs Committee inquiry into the Bank of England: How is Independence Working? I am delighted to be joined by three eminent academics who have been studying this subject and I will ask them to introduce themselves, but before I do that, I should declare my interest as an adviser to and shareholder in Banco Santander.

Could I start with Professor David Aikman; could you introduce yourself, please?

Professor David Aikman: I am the director of the Qatar Centre for Global Banking and Finance at King's Business School. I am also a professor of finance in the department there.

Professor Jagjit Chadha: I am the Director of the National Institute of Economic and Social Research. I am delighted to be here this afternoon. Thank you for inviting me.

Professor Frederic Malherbe: I am a professor of economics and finance at UCL and the director of the UCL Centre for Finance.

The Chair: Thank you all very much for coming. It is great to have you here.

Can I start with a scene setter? Taking a few steps back, we have set ourselves a very big but very simple question, which is: how is independence working? If you had to answer that, trying to summarise it, what would your main points be as to the strengths and weaknesses of the current system, just as a starter for 10, to give us some sense of your thinking? Could I start with Professor Aikman?

Professor David Aikman: From my perspective, independence as a headline thing works extremely well. I would ask you to imagine how the QE programme around 2020 and the Bank's operations this last September would have worked if it was the Treasury in control of monetary policy in the UK. The other point I would make is that the general problem that policy is trying to deal with is making short-term costly decisions that are in the long-term interest of our society and I think an independent central bank is still the best way of dealing with that trade-off.

Professor Jagjit Chadha: Clearly, central bank independence in pursuit of an inflation target set by the Government with instrument control has worked very well. The Monetary Policy Committee of the Bank of England, up until the inflation crisis, largely but not only brought about by Putin's invasion of Ukraine, has managed to hit its target over that period. To that extent, independence has worked very well in the realm of monetary policy.

There are questions to consider in terms of financial policy, the operation of the Financial Policy Committee and the PRA, but we will probably come to that a bit later on.

It is important to separate these bits of independence and of course there are a number of areas of interdependence between monetary, fiscal and financial policy where some of these matters are probably muddier than we would like them to be and might ultimately require some institutional reform—but I will keep my response brief.

Professor Frederic Malherbe: I agree with David and Jagjit. Overall, independence for central banks is very important. We want to insulate the people who have to take the painful decisions in the short term from electoral cycles and the short-term pressures that the Government may face. From that point of view, I think it is working very well.

However, as Jagjit Chadha said, it is true that things are more interdependent than we would like them to be and perhaps some clarification is needed and some improvement may be possible. But overall, I think it is working well.

The Chair: Can I press you on which points of clarification, just to give us some sense of where you think we should be looking?

Professor Frederic Malherbe: When it comes to monetary policy and financial stability, as we have seen recently, sometimes the same tools are used for different purposes and perhaps some clarification is needed there.

Independence is great but it goes with accountability and transparency and perhaps in that dimension, we could reflect and see where improvements are possible.

The Chair: Professor Aikman, are there any areas of weakness and clarification that you think we should be looking at?

Professor David Aikman: I would also highlight issues around financial stability, the precision with which the Bank's mandate is specified in terms of financial-stability goals and whether the Bank could do more to be accountable in that area. I think it works better on the monetary policy side.

The Chair: That is a very useful scene setting. I will turn now to Lord Blackwell.

Q2 Lord Blackwell: I want to ask about the objectives of the Bank of England. As we know, the first objective, price stability, is subject to supporting the Government's objectives for growth and employment. The next question is about the independence, whether those things can truly be independent. In addition, the Bank through the FPC has responsibility for financial stability, the PRA is also part of the Bank of England and has objectives to do with competition, SMR, ring-fencing and so on and the Bank also has goals around achieving net zero not just for the Bank itself

but for the wider economy. Do you think that the proliferation of objectives and goals is compromising the Bank's ability to be laser-like in its focus on inflation and financial stability?

Professor David Aikman: I am not sure I would use the word "compromised" but I agree with the general points you are making. There has been quite a marked change in the way the Bank's financial stability remit has been written since the initial letter from the Chancellor in 2013. Far more weight has been placed on secondary objectives, which you just listed, and I think that raises two problems. It could risk diverting the Bank's attention from its primary mandates and I think that is an additional problem in this case because we do not have a very clearly specified financial stability goal for the Bank. In contrast to the 2% inflation target, which is crystal clear, the objective of protecting and enhancing the resilience of the financial sector is open to interpretation. So, yes, I do think it is problematic. I do not think it has compromised the Bank's policies to date but it is an area of concern.

Professor Jagjit Chadha: If we go back 25 years, I think the perception, which was the right perception, was the Bank was solely in charge of inflation targetry and the Bank had been streamlined through a number of reforms with banking supervision and debt management obligations removed from the bank and I think in some sense—and of course they were simpler times; the past often looks as if it was a simpler period—it looked like a good way of approaching the problem of ensuring price stability with an independent committee able to set a set of instruments that we think could control inflation. The danger—and with David Aikman, I am not sure that the dangers have fully materialised—is in at least one's mind's eye that the Bank may now be thought to be in charge of not only inflation but macro-financial matters, micro-financial matters, the competitiveness of the City of London, net zero, a range of issues that we may be concerned as to whether it has the instruments at its disposal to deal with, whether it has the resources to deal with them and whether it might detract and lead to trade-offs where pursuit of the inflation target is in some sense, not through design or competence or anything, put under jeopardy by the number of things being asked.

I think most dangerous of all is that some of these issues are inevitably political in their nature. We might come to that a bit later. There is a political element to financial stability and financial regulation.

We also, I think, could accept that no matter what regulations and regimes we set down, there will be crises and things will go wrong in the future. When and if they do, that may damage the Bank's ability to pursue its primary goal and that is one of monetary stability. I am concerned that we may be asking the Bank to do too much and that might mean that others are running away from the responsibilities for doing those things.

Lord Blackwell: Professor Aikman, would you say it is more a concern then? Have you seen evidence of that causing problems?

Professor Jagjit Chadha: I do not want to say “evidence”. We have not had a financial crisis but whenever we read reports, there are concerns out there that there are financial risks at stake. I very much hope that we do not have another financial crisis but it would be wrong of me to come to this committee today and not point to concerns that I have as someone monitoring these things and thinking about them regularly with colleagues.

Professor Frederic Malherbe: I would like to build on that and focus on a specific area.

As I think is widely accepted, Governments have an inflation bias when it comes to monetary policy and I think that Governments tend to have a credit-supply, credit-provision bias as well. More credit, in many cases, is good but it can lead to imbalances and it can also be the case that too much credit is given. This is something that can still be good for the economy, or apparently good for the economy, in the short term. It will boost GDP and boost economic activity but in the medium to long run, this can be bad. Just think of credit provision to people to build bridges to nowhere. These are decisions that are hard to take in the short term. To try to cool them down, politically this is very difficult. And one of the challenges and the difficulties I think we face, when we ask the Bank to respond and to take into account every year the new priorities of the Government, is to put too much weight on the short term. Ideally, we would like the Bank to put weight on the medium and long term. That, I think, would be safer.

Professor Jagjit Chadha: Exactly. The way I always think about central banks is as something that is trying to extend the time horizon of policymaking so we care about the long run. It is one of the institutions that we require that function from, to think about the long run. So much of politics, media and comment is based on what has just happened and what should we do next. We do need institutions out there that are thinking about the very long run, if I could just amplify Professor Malherbe.

Q3 The Chair: Before I turn to Lord Davies, may I ask two quick questions?

I was very struck, when I was comparing and contrasting the letters from successive Chancellors to the Governor setting out the remit, by just how much that remit has grown.

First, on accountability and scrutiny of Chancellors as they have been changing this remit, I would like to get your sense of how much there has been and what role you think Parliament has had in that.

Secondly, if we could take a step back and put this in some international context, how has the changing remit been seen, or not seen, in the role of other central banks?

As Lord Blackwell was speaking, what sprang to my mind was what Jay Powell was saying a few weeks ago about his perceived role of the Fed in climate and whether or not we are alone in this morphing of responsibilities in terms of the remit.

Professor Aikman, maybe you could comment on one of those.

Professor David Aikman: I will comment on the first point about expansion in the remit letter.

I do not think you asked specifically about whether there has been sufficient scrutiny from Parliament of these letters but I do not think there has. That is my sense. I did some research on this, just looking at questions from your colleagues at the Treasury Committee for instance, specifically on this issue. I do not think it has been an area that has received the attention it deserves.

Just as you say, my sense is that there has been a very large increase in particularly the secondary objectives specified in the remit.

The Chair: Anything else on either of those two questions, accountability and international perspective?

Professor Frederic Malherbe: You mentioned for instance climate change. I think this is of course extremely important. On the other hand, it is hard for me to think of this being a natural mandate for a central bank.

There are two aspects to that. First, there is climate change risk; it may be that, because of climate change, we will have financial stability risk. But that is something that is already in the remit of the central bank. Or, the other way round, using central bank tools to, for instance, accelerate the transition. It is an interesting proposition but it seems to me that it is likely to interfere with the primary goals and also—and this is something I have done some research on—the tools used for financial stability are very blunt when it comes to industrial policy. For instance, if you change capital requirements, you affect the average funding costs of banks. But where it affects them at the margin and where it affects the allocation of capital, this can have very weird, very subtle unintended consequences. So, I think these are not the best tools and it is probably blurring the mandate so I think we should be very careful about this.

Professor Jagjit Chadha: It is difficult to get this point across as clearly as I would like but I think there is a danger—not only because we seem to have a lot of Chancellors these days—that we are missing the chance to cross-examine and think very hard about the Chancellor's economic objectives and the instruments he or she may use to bring them about and, as well, cross-examination of senior Treasury officials as to the advice that is given in pursuit of those objectives. It seems to me we are not addressing that to the extent that we ought.

We have argued at the institute for some time that the Chancellor ought to be setting out an annual state of the economy address in some detail. Not the expression of some statement about aspirations and objectives, which is very welcome, but a very clear outline of where the economy is strong and where it is weak in a way that we can track year by year. Alongside that, if the Chancellor could commit to dates well in advance for fiscal events then that would allow more full and direct analysis by the

OBR that would be used as a way of examining whether the Chancellor could meet his or her objectives over a reasonable timeframe. I think these things are missing. I am not quite sure how we solve them but that extent of scrutiny of the Chancellor's objectives—that are, of course, reflected in the remit letter—would be very, very important additions.

Q4 Lord Davies of Brixton: Of course we now have 25 years of experience in how this system is running, which gives us the benefit of hindsight. Do you think there was insufficient attention given initially, and subsequently, to the relationship between monetary and fiscal policy? There has been some comment over the last year or so about the two areas of policy being operated in conflict with each other. Should what the bank does fit in better with fiscal policy?

Professor Jagjit Chadha: I will start briefly but I am absolutely sure David and Frederic will have much to add.

That monetary and fiscal policy both affect aggregate demand is obvious. That is the kind of thing we teach undergraduates and we all understand. I think the extent to which the Monetary Policy Committee meets regularly, at least 10 times a year, and is able to condition its projections for inflation, its view of the monetary transmission mechanism and the range of monetary and financial conditions on its understanding of fiscal policy—that level of co-ordination is probably achieved through that.

What is, in fact, very important that we have—and this is one of the lessons we learnt from the mini-Budget of last Autumn—is that both monetary and fiscal policy ought to agree upon the medium or long-term objectives of policy, which is something I was talking about a minute or two ago, not set a growth target that is unattainable, and also share plans very clearly. One obvious route is to ensure that plans are shared through the OBR. It is also to ensure that if there are going to be radical changes in fiscal policy they are shared in a timely manner with the Monetary Policy Committee of the Bank of England so that either interest rates can be set conditional on that or, indeed, some form of communication can be offered to understand what might happen in the event of different types of fiscal interventions in the marketplace.

All of that can be managed with a better set of explanations from the fiscal policymakers, rather than necessarily asking the bank to take on formal roles for co-ordinating monetary and fiscal policy.

Professor David Aikman: I agree with everything my colleague has said. The extra point I will make is around the occasions where we are at the zero lower bound, where interest rates are very, very low and the Bank of England does not feel it has the tools to boost aggregate demand, to deal with an aggregate demand shortfall. In those states of the world there is perhaps more case for co-ordination between monetary policy and fiscal policy to ensure we can deal with that aggregate demand issue. Exactly what form that would take I am not entirely sure but that strikes me as a state of the world where more co-ordination would be desirable.

Professor Frederic Malherbe: I think the Act of 1998 got the principle absolutely right. Then, over time, new tools and new kinds of shocks arose. There is always room for better communication and, for instance, making sure that one another knows the plans. In the case of the zero lower bound, indeed, it makes sense then to have the Treasury stimulating the economy. I do not think it goes at all against the fundamental principles that were set in the Act. Therefore, generally speaking, with hindsight, I think that things were set right in the first place. That does not mean that at the margin we cannot improve some of the communication but I would not revisit the old principles.

Lord Davies of Brixton: I am worried about the possibility of some sort of feedback loop on how fiscal policy is being set. You stated fiscal policy is inherent medium to long term so the field is left clear for monetary policy in the short term.

Professor David Aikman: That is the normal operation. I would think about fiscal policy taking longer-term decisions—worrying much more about social insurance, providing public goods—and the MPC dealing with the business cycle. That is how I would describe the set-up that we try to create at least.

Lord Davies of Brixton: I am a bit worried about the business cycle as a model that still works.

Professor Jagjit Chadha: You are quite right; no business cycle is the same as there are different shocks and different economic structures. I think you have in mind short-term fluctuations in the economy so we still would maintain the distinction that fiscal policy should be primarily focused on distributional matters and, where possible, to help the supply side of the economy. That is inherently a medium-term objective. Monetary policy can manage the level of short-run nominal demand in the economy in order to snap it back, hopefully, in line with the level of supply. That kind of dichotomy I think continues to work.

I take David's points, and I agree with him, on QE. However, of course, the quantum of QE was not something that was set by Treasury. It was asked for by the Monetary Policy Committee as a substitute essentially for not being able to lower interest rates below the zero lower bound. It was very much an operation to try to sustain the level of nominal demand and prevent a much deeper recession than would otherwise have been the case in its absence after the financial crisis.

Whereas I agree that when you hit the lower zero bound then fiscal policy has more impact, I did not see QE primarily as a fiscal operation. I saw it as a monetary operation and I am sure that is what you meant.

Professor David Aikman: Let me clarify, I also do not mean QE actually.

Professor Jagjit Chadha: Forgive me.

Professor David Aikman: We are still a little unsure how effective QE as a stabilisation tool is. I think there is a case, when monetary policy is at zero lower bound, to think about using fiscal policy more aggressively as a stabilisation tool. That is my point.

Q5 **Lord King of Lothbury:** You have all set out very clearly the framework under which monetary policy operates, with fiscal policy going first and then the Monetary Policy Committee going second and meeting eight times a year, much more frequently than the fiscal interventions. With a predictable reaction function of the Monetary Policy Committee, the fiscal authority and the Treasury can anticipate what the Bank is likely to do. That is a very clear framework. It is designed to prevent fiscal dominance in which the fiscal authority pursues a policy that makes it impossible for the Bank to achieve price stability. However, that is a capability of the Bank to respond, it does not guarantee that the Bank would respond. Obviously there were comments in 2020 and 2021 to the effect that was it just a coincidence that the amount of QE was very close to the deficits that were being run?

I wonder if you would like to comment, not so much on the remit that permits the Bank to act as an authority achieving price stability, but whether you think there is an adequate safeguard to ensure that it does in fact do that.

Professor Aikman. I find it hard to think of David as Professor Aikman but I do.

Professor David Aikman: It happens.

Lord King of Lothbury: I know. It is quite disturbing.

Professor David Aikman: I think the Bank does receive a lot of scrutiny in this particular area from market analysts, from yourselves and from your colleagues. Therefore I am not worried that there is a lack of scrutiny over its decisions in this area. You are raising a very important point but I think it is a point that is widely discussed.

Professor Frederic Malherbe: I think, very shortly, especially compared to functional stability, the very clear target of 2% inflation helps anchor the discussions and the scrutiny. This is something that is extremely useful as well. We will probably come on to the financial policy part, which is more complicated. However, when it comes to monetary policy, I think the system is pretty good.

Professor Jagjit Chadha: It is a very interesting question, whether after the fact or even in real time it looked as though the quantity of QE that was being carried out during the Covid period was very similar to the level of deficits being run by the Government. There is a question asked by some people as to whether that was in any way directly financing government expenditure.

You know very well, and this committee knows very well, the level of debt incurred or sold to primary markets by the Government is a result of a fiscal policy measure and QE is the repurchase of that debt from the

non-bank financial sector. They are very separate operations in that sense. I did not see it as directly monetary financing. It was not the case of the Bank of England directly buying that debt from the Treasury. It has started fortunately, and at last, a quantitative tightening programme to reduce the stock of QE.

While all that was going on the Bank was continuing—as Frederic and David said—to present its own projections as to where inflation will go and continuing to make statements at least to try to convince people that interest rates will be set at a level appropriate to bring inflation back down to target over some horizon. It has been clear since the inflation shock that we are currently living through that that horizon has been extended. Depending upon the weight you want to put on output in your reaction function as opposed to inflation, the extension of that horizon might well be thought to be optimal. So in that sense I think the Bank has continued to work within the framework, use QE as a way of establishing a greater level of nominal demand than would otherwise have been the case, and yet also at the same time make statements that inflation will return back to target given a sequence of interest rates that it will choose. I do not think in that sense it has been seen or perceived by anyone who follows these things regularly that that process was anything other than continuing to manage nominal demand in a way that was consistent with the level of supply in the economy and ultimately price stability.

Whether mistakes were made because of the macroeconomic models that we had, or the narrative, or the judgment as to whether Covid was affecting more the supply side or the demand side of the economy, is a matter that you and I have discussed in the past as I know other members of this committee will be thinking of, as will David and Frederic. It is very true that mistakes may have been made at that time that have contributed to the inflation or cost of living crisis we are currently seeing. However, I think it would be very hard to make the case that they were a direct result of wishing to primarily finance directly government expenditure through an expansion of QE.

Lord King of Lothbury: This inquiry is not trying to look at individual policy decisions, whether they were right or wrong, but is about the process. We might come back later to the question of who should decide on the horizon over which inflation should be brought back to target; should it be the Bank, should it be the Treasury, should there be some discussion? I think that is a question that was not clear in the original remit and has been slightly vague ever since. Perhaps we can come back to that later.

Q6 Lord Griffiths of Fforestfach: The 1998 Act was a complete overhaul of regulation. We replaced the Financial Services Authority with three new institutions, the PRA, the FCA and the Financial Policy Committee. A number of questions arise from this. The first is: do you think that it would be different if those bodies had existed in 2008?

A second question: after having been at the coalface in this area for a

number of years in an investment bank, my feeling is that we dropped a slab of concrete to crack a nut. We created a new industry of financial regulation. I do not know what the number of people in these three bodies is today compared with what the number of people employed in the FSA would be. I would be very interested in that statistic. My second question is: do you think we have really gone overboard and is there not a case for slimming down some of the regulation that we have?

Professor David Aikman: Two very interesting questions. Would it have made a difference? I think that was your first question. I would break that up into three sub-questions. The first is: could we have spotted the build-up of risks in the system in real time with this new set-up? Do we now have the tools to deal with the vulnerabilities that we may or may not have spotted? Lastly, but importantly: is there the political backing of these bodies to actually use those tools quite aggressively?

Lord Griffiths of Fforestfach: Sorry, when you say “political backing”, what do you mean by that?

Professor David Aikman: I mean we would have had to have increased capital and liquidity requirements quite substantially. The discussion we had about secondary objectives a second ago—it would have potentially created issues for the perceived international competitiveness of UK banks. That is what I mean.

Would we have spotted the risks? You can go back to the Bank’s published financial stability reports for 2005-06. You will see a discussion of overvaluation in house prices, build-ups in household debts, reliance on complex structured products of funding. Many of the things that went wrong are listed there. The thing that we completely misunderstood, in my view, is how poorly capitalised the banking system was, so the metrics we were looking at turned out to be completely worthless. That is a harder problem to deal with.

I do think we now have the tools in terms of the regulators to deal with the issues that went wrong at the time. However, I do worry about whether those tools could have been used aggressively enough to have dealt with the problem. I would be mildly encouraged that we would get a better outcome in dropping the new architecture on the issues that we faced in 2005-06.

Very briefly to your second question about the proliferation of the number of people working in this area, I do agree with that.

Lord Griffiths of Fforestfach: And the overregulation.

Professor David Aikman: I would cast it in terms of the complexity of regulation. I do think that is a major issue. The reason we have so many people employed on both sides is a reflection of how complex the rules we have built are.

Professor Jagjit Chadha: It is an interesting observation that we have gone from light-touch regulation to such an extensive panoply of

regulations. David has already listed some: Basel III, the necessary increase in capital and liquidity requirements at bank level and across the whole industry, the ring-fencing proposal, the idea for resolution and living wills for individual banks. In the middle of all of that is clearly the Bank of England. The Financial Policy Committee, the FCA and the PRA are these new institutions that we have in place. It seems to me we have gone from a world that was underregulated to one that is more heavily regulated.

The way that a financial crisis impacts itself on an economy is manyfold. It is important that as far as possible we try to limit those risks. It is damaging to the country at large through the importance that we place on finance in the City of London and also to households and individuals who will find themselves in severe trouble if a bank goes under or, as we discovered as recently as last autumn, if they cannot raise finance in the way they would want to. So it is incredibly important that this thing is regulated properly.

However, I see some merit and attractiveness in the point raised that maybe it has become a little bit too byzantine, a little bit too complicated and a little bit difficult for people to see exactly what the different committees do. There are broadly two ways we might want to think about that. One is whether there should be both an MPC and an FPC at the Bank. This is something David and I have talked about a bit but we do not necessarily agree. The extent to which some elements of macroprudential interests—whether because they have a macroeconomic impact, whether it is loan-to-value ratios or loan-to-income or, indeed, countercyclical capital buffers—should be part of a broader decision about monetary and financial conditions such as we see at the FOMC. Colleagues of mine at Glasgow, Charles Nolan and Alfred Duncan, have separately argued that because issues to do with financial policy and regulation are so broad and inherently interact with many other parts of economic policy—even if it is housing, regulation, we could list a tax, there is such a broad number of areas—that it should arguably be a separate institution in its own design. I am not here in front of this committee to say it should be one or the other. However, it seems to me we are not quite in the right place on this and we might want to reconsider how these things are configured.

The Chair: Sorry, is that because we are just not clear what it is for and have not answered the very basic question of what it is we are trying to achieve?

Professor Jagjit Chadha: Yes, because if we think about the market failures or rigidities out there, we cannot consider their solution without at the same time thinking about the appropriate institution that we need to look after that.

I think there is a thread of discussion this afternoon that perhaps the Bank has too much to do. If that was what we agreed we might want to think about either streamlining some of its activities through combining committees or asking ourselves whether financial policy ought to be

housed in a separate institution or political institution with political backing. Financial policy will occasionally go wrong. There will be crises I am afraid; I do not know when and I do not know where. However, there will be and it is not always the case they ought to be handled, it seems to me, at the central bank.

Professor Frederic Malherbe: I would like to add one thing to the question of whether the financial sector is overregulated. I would like to say no but with a nuance. No in the sense that the overall tightness of regulation I do not think is too high. Perhaps, yes, things are too complicated and there are things that could be simplified. However, overall, the truth is that financial institutions and financial markets benefit from safety nets from the Government and from the taxpayer, ultimately. That distorts incentives. It gives an incentive to take on too much leverage. We have seen that recently in the LDI industry but there are other pockets of leverage going up and up. That does not strike me as a world in which financial institutions are so regulated that they can no longer take too much risk and take advantage of those safety nets. However, I am very sympathetic to the idea that sometimes we perhaps go too much into the complexity of regulation and sometimes blunter tools could be more efficient in the sense that they would simplify things; compliance for instance.

Q7 Lord King of Lothbury: I would like to build on Lord Griffiths' question and ask you about the organisation of these different responsibilities within the Bank, just within the Bank.

When Eddie George was governor, if you went into his office, you would see two in-trays on the desk, one on monetary policy up to here and one on regulation up way beyond I can reach. What happened was that the urgent drove out the important. Now the governor has three in-trays, Monetary Policy Committee, Financial Policy Committee and regulation.

The question is: what is the role of the governor and other senior members of the Bank with respect to these three different responsibilities? One line of argument that has been made is that the governor should not sit on all three, no one should sit on all three. There should be some specialisation, partly to enable them to do the job rather than just rushing from one meeting to another. The other line of argument is that certainly the governor will be held accountable for everything that happens in the bank so he is not allowed to turn around and say, "It has got nothing to do with me, I do not sit on that committee". That does not seem very credible. Of course, we saw last September that there were issues that arose then that were very difficult to distinguish between the respective responsibilities of FPC and MPC. You could argue they involved both and, indeed, it might well have turned out to involve PRA as well. There are these different arguments about how the internal management of these three different areas should be handled.

Leave to one side the question of whether all three should be in the Bank or not, assume they are: what is your view as to how the organisation

internally should be managed?

Professor David Aikman: I do feel the governor needs to sit on all three of the committees for the reason you gave. It is not obvious to me that all the deputy governors need to have so much cross-membership as there is. To give a concrete example: should the deputy governor for monetary policy be a member of the PRC? I can see there is a case for it but is it an absolute necessity for the reason you gave in terms of giving people time to work on the thing we want them to focus on? I think you could make a similar argument perhaps for the deputy governor for markets sitting on PRC and FPC. Of course there is a case but it is a question of priority.

I would personally favour reducing the size of the committees, I think they are too large. I think there are 12 people on FPC, 12 on PRC and nine on the MPC. These are all very large groups to coalesce into making a decision. Therefore I think there is a case for stepping down as a formal member of a committee. You could still have your staff contribute to the briefing and input that way.

Lord King of Lothbury: Would you have fewer deputy governors?

Professor David Aikman: I probably would, yes.

Professor Frederic Malherbe: I do not know the internal structure and how things work within the committees as well as David but what he says sounds sensible to me.

I definitely think there is a case for having overlap, to have the governor, for instance, sitting in all highest-level committees simply because one needs to aggregate the information and also be accountable. I will stop there because on the small details of the organisation I do not feel I am qualified enough to comment.

Lord King of Lothbury: To go back to the assumption on which I based the question: would you want to change the responsibilities of the Bank in respect of these three? Would you want to move any of these responsibilities outside the Bank?

Professor Frederic Malherbe: I do not think so. FPC and PRA should go hand in hand. For micro and macroprudential regulation the overlap of skills, expertise and information is too important. It would be quite inefficient to separate them.

As to whether we want to have that block and monetary policy together—I should say we may want to discuss that—given that both face the short-term versus long-term incentives that we have discussed before, there is a natural case to put them together because both Financial Policy Committee and MPC decisions will affect one another. Whether it is a completely clear-cut case and there could not be another model that would work as well, that is conceivable. However, I do not see a very big need to separate them. I think there is a case to put them together.

Professor Jagjit Chadha: Getting a sense of how the Bank organises itself is difficult and is perhaps easiest for David to talk about as a more recent leaver.

Clearly the governor ought to be chairing the key decision-making bodies of the Bank, which would mean the MPC, the PRA and the FPC. For as long as they are at the Bank, he ought to be involved in that. I would certainly be concerned if the same people were at every committee meeting, the governor and the four deputy governors. There ought to be more separation of that. Whether an individual deputy governor should be assigned for one area—let it be financial policy, monetary policy or prudential regulation—and take the lead in bringing together the analysis and the policy proposals: that might allow for some streamlining and release some resources for deeper thinking on the issues in other areas for those individuals who are no longer involved. Whereas I understand large and unwieldy committees are not helpful, this is a large committee but certainly not unwieldy and it can work.

Where I do worry about the composition of externals is to do with the FPC and the PRA. I am not entirely sure that the representation is that broad. It seems to be very much based from people who have worked in the City or close to financial institutions rather than a broader pool of people who might lead to more interesting decisions. I have not seen that many experts or academics being involved. That is not a case for us being involved in that, I am simply saying that there are people out there who would have a stake in some of these issues, as well as consumers and others, who do not seem to have been involved in these committees in the way I would have anticipated. At the same time that I am in favour of streamlining committees, the external membership is not quite as broad as I would like it to be.

Q8 Lord Turnbull: On smaller committees, you seem to be suggesting that we cut down on internal members, who must be thinking that if it is room 4 it is the MPC and if it is room 5 it is something else. They do overlap a lot. However, they each have about five externals. Would you want to cut those down or would you say “Well, we’re very happy with five externals but we’re not sure we have the right kind of five”? Do we want people who have more of a finger on the pulse of what is going on in markets? If we were having them smaller, I would not want to reduce the external input if the external input were properly constituted.

Professor David Aikman: I quite agree. This may be slightly controversial but there might be a case for considering having a majority of external members on committees to avoid issues around groupthink. It would be a big change in the structure of the Bank. When I was talking about smaller committees I was thinking about fewer internal members. It would end up being a majority of external members.

There is a question about whether we are able to attract the right people as external members to these committees. It is a very hard job to go against the tide of thinking within the organisation. I also think the external members of the FPC could have more staff supporting them in

the way that the external members of the MPC do. There are internal things that could elevate the status of the external members.

Professor Jagjit Chadha: I very much agree with David on that remark. If I am wrong about this I apologise, but I suspect membership of these committees is done through the public appointments process and there are a number of people working within this square mile who are concerned about the way the public appointments process has been working recently, with very long delays and an inability to reach out to all possible constituencies. That might be something this committee might want to consider. If, in the end, we think that there should be a broader representation at these committees, that then requires us to think about whether the public appointments process is working in its current frame. In other areas it has come up a number of times as an issue.

The Chair: It is very interesting. When you say "broader representation", can you just define what you mean by that?

Professor Jagjit Chadha: There are a number of things here in terms of ministerial choice and names that are put forward, but also to ensure that at the point of advertising jobs, the people asked to encourage applications reach out to a sufficient number of people. It seems to be an ongoing issue here. Maybe it is related to the special nature of the skills required, but there is nothing wrong with reaching out to a broader set of people who would be affected by financial policy and regulatory policy, and giving them sufficient time to learn about the issues and contribute actively to the committees.

Professor Frederic Malherbe: Again, I am not well versed in the internal dynamics of the committees but I would like to say something about the FPC. Contrary to the MPC, where there is a huge body of knowledge and some consensus at least on the most important building blocks of the frameworks that people think are relevant to making the policy decisions, this is not really the case and this does not really exist yet for the work of the FPC. Therefore, I think having the input of academic experts would be extremely useful. That is something that could probably be improved.

Lord Griffiths of Fforestfach: Can I just ask you how you would respond to the following? We have two deputy governors. The governor chairs one committee and the deputy governors chair one of the other committees, with the governor having the right to sit and attend all committees.

Professor David Aikman: I do not have a strong reaction to that. It seems like a sensible proposition from my perspective. The governor then has the choice.

Lord Griffiths of Fforestfach: Yes or no?

Professor Jagjit Chadha: Just to be clear, you are suggesting that for all the committees there would be a deputy governor chairing and the governor could—

Lord Griffiths of Fforestfach: That is right. A governor or deputy governor would be the chair of each committee but the governor would have the right to sit on all committees so he would not be ruled out of knowing what was being said, the idea being that you are trying to cut the size of the bureaucracy down. It is just one idea. I am sure there are many ideas.

Professor Jagjit Chadha: I am absolutely sure you could make any of the configurations work that you want. It is important for me the governor, as he has done and will continue to do, is aware at very close quarters about the set of issues that are affecting the different committees. The question is whether that is best and most efficiently done by him chairing or in some other capacity. At least, having to chair it, he will definitely be there.

The streamlining might be better done elsewhere in the organisation so that the deputy governors are maybe mandated to provide specific reports in their area alone and not necessarily go to the other meetings. The question is: how many different meetings do they have to contribute to and play a part in? It could be that. As David and Frederic said earlier on, if nearly all the deputy governors go to all these key meetings, where is the chance for some time to do other bits of work that are in your area? It might increase the possibility of groupthink if that were happening. Some separation is helpful.

The Chair: On that point, groupthink, we can come on to oversight, the Court of Directors, and Lord Layard.

Q9 **Lord Layard:** We were talking about the role of non-execs. At one time there was the oversight committee, which was only non-execs and had some oversight of how everything else was going. In 2016 that was rolled up into the Court, which also includes the governor and some deputy governors. Do you think the rolling up of the oversight committee has worked well or was something lost there?

Professor David Aikman: Unless you are very close to this process, I think it is impossible to gauge. That is my honest view. It would be a question you should ask former governors and former deputy governors, about how well that process works.

More generally, the Bank also set up this independent evaluation office to provide oversight of its policy functions. In my view, there is a case for having more external scrutiny of what the Bank is doing. There are a lot of inside committees and activities providing that assessment role and I think it is very hard to do that if you are an insider. There is a case for more external scrutiny.

Professor Frederic Malherbe: I think it is even harder for an outsider to comment on that, so I will not add anything.

Professor Jagjit Chadha: The question of the Court is also something for us to be considering in terms of public appointments. Clearly, there were some issues last year with the public appointments to the Court in terms of delays. Whether it is holding Bank decisions to account in an appropriate manner is, as I think Frederic and Dave said, very hard for us to tell, particularly whether it is an improvement over the oversight committee. We have had so much noise in the British economy in the last six or seven years it is very hard to understand whether policy might have been better with different levels of oversight.

The independent evaluation office again has been a good innovation. As David has said, its work on the quantitative easing exercises has been useful. However, it did seem to be—and this is a phrase that a number of people have used when I have asked them about the Bank and its operations—a little bit too much like marking their own homework. If we believe that the OBR is a way of marking the Treasury's homework, we might want to think of different institutions or processes whereby the Bank is prepared to be examined by external bodies more obviously than it currently is. That is not to say that we think it is necessarily doing a bad job, but if you are continually marking your own homework there is a danger that your mark might, over time, slide up.

Lord King of Lothbury: You talk about marking your own homework. The Bank seems to have 60 million people marking its homework and a large number of professional economists, of whom you account for three, writing all the time and commenting on it. You said earlier, Professor Aikman, that you thought there was a lot of scrutiny of what the Bank did in respect of QE and whether it was monetary financing or not. What is missing from this very high degree of public scrutiny where everyone has an opinion? What do you think is missing at present?

Professor David Aikman: I think 99% of that scrutiny is on the monetary policy side and there is very little scrutiny, in my view, of the decisions of the FPC and the financial regulators because it is a very technical task. That is what is missing, I think.

Lord King of Lothbury: Perhaps I could just comment to Lord Layard about the question that was raised. I do not think whether there is an oversight committee or a Court of Directors is the big question. The big question is: can Court meet and sit without the internal members of it? The big decision in that respect was when the governor was no longer chairing Court. That was the big decision, because then Court met regularly for part of every monthly session without the internal members. Then it could exercise oversight or have a frank discussion about what was going on in the Bank. That was the big step. Whether you call that an oversight committee or a meeting of the Court without the internal members is neither here nor there; what matters is that it can take place.

Professor Jagjit Chadha: Obviously, the actions of the Bank of England are heavily scrutinised by the media and households across the country, and quite rightly too, but as David said, much of what it does seems to fall below the radar in terms of financial policy and regulation. It is

important that we find fora for those things to be discussed more openly and clearly, if only so that when any new Chancellor decides to change financial regulation there is some sense of a constituency of people out there who are also thinking about that.

There is also another point. Whether it is a failing in this country or more broadly, we are so focused on the here and now, the last bit of news, that there is a danger that scrutiny is mostly about the very last decision. Sometimes it is a bit like being a football manager, you are only as good as your last game. We may be missing secular trends or things that are happening over time because there are no obvious fora for those things to be discussed. I should compliment David here for his work in setting up the Bank of England Watchers' Conference last year, but that is one of many things that we ought to be doing.

If I could just give one brief example, the Bank of England produced a very helpful report on the impact of QE on wealth inequality but I cannot help thinking that—even if I had myself come to the same conclusion—it would have been a much stronger report had it been written by an external body with appropriate funding, to try to understand not only how QE had potentially raised asset prices and increased financial wealth inequality but had possibly also, by stimulating aggregate demand, prevented a much deeper and longer recession than might have been the case, which would have also affected many households. It would have had a more powerful resonance in the economy had it not been written by the Bank of England itself. There is a communication point here as well. By demonstrating independence of scrutiny you are able to demonstrate better the effectiveness of policy than if you write that paper internally.

The Chair: Before I turn to Lord Turnbull, another question about groupthink. We have talked about structure and you have mentioned appointments and broader representation. I am interested in diversity of views and range of views. Do you think that over the 25 years of independence, there is becoming a bias towards people of a certain view or is that just an impression that might be made by some critics? Do you think that enough effort is made to seek out those who have a different point of view from the consensus on matters of policy and have internal challenge, or is this not an issue in your mind at all?

Professor David Aikman: Do you mean specifically MPC there, or are you talking generally?

The Chair: I am thinking MPC but I am thinking generally as well, among the members of the MPC but also just within the Bank and its own teams, to try to ensure that there is always someone kicking the tyres and asking, "Are we sure we're on the right track overall?"

Professor David Aikman: That is a good question. On the monetary policy side there has been a convergence of views about how monetary policy works. Maybe that is being blown apart as we speak, given the issues we have been grappling with.

I can probably see, in terms of the internal staff training that people are getting who are working on these issues, that maybe that issue is—

The Chair: What do you mean by that? I am sorry, I am not sure I understand that.

Professor David Aikman: People are joining the Bank having done master's degrees in economics and finance or PhDs in the same thing. They are not joining with very heterogeneous views about how the economy works or how the transmission mechanism of monetary policy works. Equally, I am not sure what you would do to fix that issue. You are raising an interesting point. I think there is less of that on the FPC side.

The Chair: Less?

Professor David Aikman: Yes.

The Chair: Interesting. Would either of you like to comment?

Professor Frederic Malherbe: A piece of research just came to my mind. There is evidence that external members tend to dissent more at the beginning [of their term] and then, after a few years, tend to vote in a way that is closer to the internal members. It may be a good and a bad thing. It is interesting, per se. Definitely, internal members have more detailed knowledge of all the nitty-gritty details that are relevant. Externals can bring a different point of view. I guess as externals sit in the committee longer, they learn about more of the technicalities but perhaps they also get absorbed in something that could be closer to groupthink. But given that there is some turnover there, I am not too worried, actually.

Professor Jagjit Chadha: Lord King, in a famous speech, wrote, "Divided we stand, united we fall", and the idea there is that even if we have the same or similar economic framework about the things that affect demand and supply, our judgment in real time might lead to us having a different view as to where interest rates should sit, if not today, in a sequence or as a path. That is an entirely reasonable position to have. That said, it seems to me and the people who have studied these things that the fraction of dissenting votes, the number of votes that we have had that have not been in line with the consensus, has been very low over time. Given a tribe of economists who, it is generally thought, do not agree on things, there seems to be a large degree of consensus.

Is it not possible then to argue that people are having a serious discussion during their meetings where they might come in with a different judgment but because there has been a robust exchange of views, they have converged to a particular view or judgment about the state of the economy? It is not clear to me that that is not the answer. That could very well be the process that is going on: there is divergence, there is disagreement, but in the course of the meeting there is some agreement as to what should be done.

- Q10 Lord Griffiths of Fforestfach:** I would like to ask you a question on this diversity. I got a researcher to do a word check on the monetary policy reports since the beginning of 2020 in connection with the word “money”, because it has a section headed, “Monetary conditions”. Basically, for 13 reports they could not find one which had any term “money”, “money stock”, “growth of money stock” and so on. You can be an ideological monetarist but you can also be a pragmatic monetarist. Given what happened with broad money growth in 2021 it does seem to me there is a case that there has been a lack of diversity in the discussion and, I suspect, among the economic directorate as well. If I put that up as a proposition, could you comment?

Professor David Aikman: It does not surprise me, what your researcher found, because that is the direction that the academic literature has moved in terms of the way monetary policy affects the economy. There has been less weight placed on monetary aggregates, rightly or wrongly, and more weight placed on interest rates. The Bank’s publications are a reflection of that, I would say.

Professor Jagjit Chadha: As far as I am aware, there is a monetary analysis undertaken before every MPC meeting. The money numbers are analysed. Whether they are used as an exact lodestar as to the inflationary pressure in the economy, it would go the same way as for any other quantity; I am afraid, in economics, it depends. It depends on what has driven the increase in money supply. The real question is: what has driven the shock that we have seen? The fact that money has gone up is not itself an inflationary problem. People spend a lot of their time trying to understand why particular prices and magnitude have moved, rather than using anything as a perfect indicator. That would not be the right way ahead, it seems to me.

- Q11 Lord Turnbull:** In the original 1998 framework, monetary policy was assigned to the Bank and it had control over its main lever, interest rates. Fiscal policy was effectively assigned to the Treasury so that it decided on the size of the borrowing requirement, and all the decisions about how it was funded—which the Bank was, in a sense, doing before that—were transferred to the Treasury, into the debt management office and cash management.

When we get to QE we suddenly find that these two institutions are on the same territory and there is a key decision: do we want to expand or reduce the extent of QE? It is unclear whose call that is. If, as I suspect, it cannot be assigned to one or other of these institutions, do we not need some framework or concordat on how that decision gets reached that is then published, so that when we come to argue about whether QE should be going up or down faster than it is, we know to whom we should address that question?

Professor Jagjit Chadha: That is a very good question, thank you. I think it would be helpful, after well over a decade of QE, for the Bank’s Monetary Policy Committee to set out exactly what it thinks it has achieved with the different bouts of QE that we had. There were the first

couple of rounds of QE that were a direct response to the financial crisis, another bout following the referendum on remaining in the European Union, and yet another bout during Covid that, at the peak of QE, led to a stock of debt held by the asset purchase facility approaching 40% of GDP, which was a huge amount by historical standards and relative to my expectation a decade or so ago. That is where I would start.

To move on to answer your question, in my understanding and in explanations I have had, it has always been a case of manipulating the stock of QE to help bring about a level of nominal demand that is in line with expected supply, so that there is not a systematic or sustained move away from price stability. It is surely about nominal demand management. Now, in your question you seem to be suggesting that it is somehow intimately connected with fiscal policy decisions and may have changed the fiscal policy choices.

Lord Turnbull: No.

Professor Jagjit Chadha: No? Forgive me if I have misinterpreted.

Lord Turnbull: I was implying that what looked like a fiscal decision turned out not to be a fiscal decision after all. You use the phrase, "What it has achieved". Who is "it" in this? I think you are meaning, "What the Bank or the MPC has achieved".

Professor Jagjit Chadha: Yes.

Lord Turnbull: You are answering my question, "Whose call is it?" and saying that it is the Bank's call. It is using this as a replacement for the interest rate decisions that it cannot take because interest rates have bottomed out.

Professor Jagjit Chadha: Yes.

Lord Turnbull: Is that a satisfactory basis? If it is, would it be helpful if it was then set out for Parliament and the people so that they could see better who is making these calls and make them accountable?

Professor Jagjit Chadha: There are question marks as to whether QE should have been, if I can use the phrase, reignited to the extent to which it was either after the referendum or during Covid, or whether other interventions might have been deployed, for example, in March 2020 through the deployment of a lender of last resort in the gilt markets, which had gummed up in that month. It seemed to me over time that QE was increasingly being turned to as the option of first resort rather than last resort and I think those questions need to be thought about, but I also think that it was deployed continually as a method of managing nominal demand.

Q12 **Lord Turnbull:** It is a slightly different question. Lord Griffiths and Lord King have highlighted the number of institutions we have. After 2008 we changed the FSA and we left conduct management and, basically, consumer protection outside the Bank. That looks to me like a sound

decision because the Bank does not really want to be involved with small institutions, building societies, financial advisers and so on. That makes quite a lot of sense. You then have these two, the Financial Policy Committee and the PRA. One of them is looking at the financial strength of individual institutions and one of them is trying to look at the financial strength of the system as a whole, but you find out about the second by aggregating the first. Do we need both?

Professor David Aikman: Yes, I think we do. The FPC's mandate is to look across the whole financial system to start with. It is a much broader mandate. One of the lessons from the period leading up to 2008 was that we were focusing on individual firms but not doing the adding-up exercise, which is the FPC's job.

There is a question about exactly how the FPC should function in this set-up and how it should see its role. You mentioned that they are both in the same institution, which is very good for fostering co-ordination, and there are lots of good examples I could give you for how they have co-ordinated well. One question in my mind—slightly controversial as well—is whether the FPC is trying to co-ordinate too much with the micro-prudential side and whether it should be trying to play a role that is a little bit more of a policeman for the micro-prudential regulators; rather than rubber-stamping their decisions, actually kicking the tyres a little bit more than it is doing. There is a question about how we could engineer a bit more tension between micro and macro. That is the direction I would like to see things moving.

Q13 Lord Londesborough: My question connects to the comment you made earlier, Professor Chadha. I think you said, "Perhaps the Bank has too much to do". Taking into account the successive additions to the Bank's responsibilities since 1998, including the Acts of 2012 and 2016, to what extent is there a risk that the Bank is being asked to do too much? Do you think the balance is about right or reflects the increasingly challenging and complex economic landscape, or do you feel that the Bank is in danger of losing its primary focus?

Professor Jagjit Chadha: I have some sympathy with the view that the Bank is being asked to do too much. There is great benefit from clarity of mission for a central bank and if that vision and mission is about price and financial stability we ought to think very carefully about how the Bank should be reconstituted to do just that. If we move more broadly into the area of financial policy, kicking the tyres, or the broad set of issues in which financial policy operates, they impinge quite strongly in other areas of economic policy and there are ultimately some political issues that will matter. If you have to tell a young couple who are both at work that they cannot afford to buy a house and it is the Bank of England's fault, that strikes me as something that we must think very carefully about, because the Bank at the same time is also setting the interest rate that they are paying on their mortgage. I am concerned that we are not in the right space.

I do not have an answer for you this afternoon. I am very happy to go away to think about it more, but that sense of increased responsibility—more jobs, more meetings, the whole tone of our conversation this afternoon is the sheer quantity of the things that we are asking the Bank to do. That is notwithstanding the extent to which, and we have not discussed it this afternoon, the Bank is also acting as economic adviser across a large number of issues outside of monetary policy to the rest of the Government, because there is not sufficient experience or skills. Let me be clear there are some quite excellent people working as economists in government, but there are not sufficient numbers of people to answer all the questions. When the Bank is being asked that as well, I worry that the sheer number of things that are being asked will lead to trade-offs or inefficiencies that we need to address.

Professor Frederic Malherbe: I would like to put together a few bits that we have already mentioned. I broadly agree here. I think especially that times are not very easy. The Bank faces a lot of challenges. Strengthening the focus on the primary objectives could be a useful thing.

As Jagjit Chadha just mentioned, there can be distributional issues, distributional consequences when we take financial policy or monetary policy actions. Those consequences should be thought in the medium to long term; I would say in terms of the charter of the Bank: the Bank should be acting for the good of the people of the UK. The role of the Bank is to be there to ensure that we have macroeconomic stability, to ensure prosperity, something important. If we want to phrase this into secondary objectives to qualify why we have those primary objectives I think it is very good.

As I have mentioned before, if the secondary objectives are fine-tuned according to the last news, the last shock, the last event, the last priority, that is something that is not necessarily useful, can be a bit damaging for credibility and also, ultimately, for accountability. So, I would be cautious about that.

Professor David Aikman: My perspective is the same as what you have just heard, so I will stop there.

- Q14 **Lord Rooker:** My question relates to the legislation since 1998 and the changes affecting the balance between the Bank of England's transparency and operational independence. I picked up in answer to the very first question from Lord Bridges and I regret to say I did not list who it was, but one of you gave a quite negative point about transparency. That is what I picked up. I wrote down "transparency" with an exclamation mark—it was something that I picked up as negative. Could you explain this to me? I do not know about these things. How does transparency feel with all these committees that we have been discussing for almost an hour and a half? Do any of them meet in public? How does transparency form? Does publishing minutes the day after count as transparency? Does transparency in the way that it operates strengthen or constrain operational independence?

I have a thing about operational independence because the structure of the Bank is a mystery to me, but I have always taken operational independence of government bodies as being no day-to-day control by Ministers. You have a remit, get on with it, but there is no day-to-day control. I once chaired the Food Standards Agency. The board meets in public and by law there is no day-to-day control by Ministers, but it is a government department. What is the effect of the legislation on the balance between transparency, good or bad, and operational independence?

Professor Jagjit Chadha: I will give a brief answer on best practice. Providing we have a societal consensus for an objective, let us suppose it is price stability, and that societal consensus is reflected in the political imperative given from the Chancellor in the remit to say, "I reflect society's preferences and as Chancellor I want inflation to be 2%, more or less, and people to plan on that basis, on a forward-looking basis", then he or she is reflecting those preferences of society.

The Monetary Policy Committee of the Bank of England in the period of independence will be setting its instruments to try to bring that objective about. Not everyone will have sufficient time to sit through all the meetings and sift through all the data in the way that the Monetary Policy Committee would do, or the individuals who work at the Bank would provide that support for—or the academics outside the Bank may interact with them as well. There is a huge and rich flow of information required.

We may not fully understand the decisions that are made at any moment in time. In that sense, that is where transparency and accountability come in. The elements of transparency here are that we know who voted for what. We have the minutes that we can examine and there will be speeches made by individuals to try to help us understand the judgment that they formed. All of that is very important for us, because we cannot know in expectation whether the inflation target will be hit or not hit. We do not know because we are not there whether the decisions were made on the right basis or the wrong basis. This set of transparency interventions helps us understand that decision-making process and is an intimate part of the accountability.

Whether all of that then carries through to the way that the financial policy and regulation works I am not so sure. I think it is obviously more complex, more opaque and even more difficult to understand than monetary policy. I am a simple guy. I stop at monetary policy. I think those elements of transparency and accountability are not fully developed on the financial policy side. I could be wrong.

Professor David Aikman: There is no voting, for instance, on the FPC over policy decisions, so that is one area where financial policy is less transparent than monetary policy. You asked specifically whether any of the meetings happen in public. No. I do not think that would improve transparency. The Fed has a model where they occasionally do meet in public and those are scripted meetings as a result, so improving transparency is not a completely straightforward thing. I think the Bank

is probably as transparent as any other financial regulator on financial policy. It could do more.

Professor Jagjit Chadha: I guess I am saying it is a systemic issue with financial policy. One thing I would like the MPC to do is to have its meetings around the country, not just in Threadneedle Street—but that is a separate matter.

Lord Rooker: If they are behind closed doors, what is the benefit of moving it around the country?

Professor Jagjit Chadha: During the process of the week or the meetings there would be interactions with individuals at local level, so it would not just be one individual MPC member visiting Leeds, for example. The whole shooting match, if that is the right phrase, would go up and lead to interactions with a number of people over the course of that week. It is all about helping people understand the nature of decision-making and policy-making and I think that would help—but I guess it is marginal.

Q15 **Lord Blackwell:** The reality is that a lot of these meetings are shrouded in secrecy and indeed purdah because of the fear that their discussions are going to influence the market and this all has to be kept closeted. When you talk about public accountability, it is very difficult. The governor can always hide behind the fact that he cannot answer that question because what he says might be market sensitive.

Professor Jagjit Chadha: I believe it is called the “quiet period” now. They have adopted a different phrase to “purdah”. Clearly in the run-up to a decision on interest rates or bank regulation, that is intensely market sensitive, so it is not something that I think would be sensible to have people speculating about too much based on an individual comment by a member of the MPC. But after the fact there is quite a lot of communication about decisions. There is a panoply of speeches given by individuals and they interact and explain their judgment. That by and large works. I would not expect the decision to be filmed in real time so that people can see the different arguments put forward. In the end, if you have too much transparency, that might also limit the discussion that occurs. There is a live debate about whether minutes should be published in full, and the danger of that is that then people are saying things with posterity in mind, rather than the current decision at their disposal. There are ultimately limits to transparency. We do not want to go all the way to 100%.

Lord Blackwell: The point I was trying to make is it maybe reinforces the need for internal accountability mechanism and scrutiny, rather than relying on public.

Q16 **Lord Londesborough:** This question is about international comparison or standing. Given the reforms since 1998, have they replaced the Bank of England among the top tier of central banks, in terms of best practice in relation to governance and policy decision-making? While we are talking about best practice, in your view what are the key areas or the

fair areas for drawing international comparison?

Professor Frederic Mallerbe: I am not aware of well-accepted rankings of central banks so I can just give you my thoughts about that. I think overall the Bank is doing pretty well and is definitely, on many dimensions, a model for some other central banks. I may be wrong about that, but I think on the monetary policy side a lot of the best practices have come from the US in the first place, from the Fed. That was the pioneer a few decades ago, and then things have been shaped in different ways. The processes that the MPC follows are definitely high in terms of transparency. I think it is quite high.

On the FPC level it is so hard to compare. The way different jurisdictions approach financial stability is very different, the way those bodies are structured is different, so comparisons are very hard. The truth is that the economic body of knowledge is not as developed as the one on the Monetary Policy Committee, so the conceptual benchmark against which we could make those assessments is much more blurred—so it is hard. Overall, I think it is doing well, but it is hard for me to be more precise than that.

Professor David Aikman: I do not have much to add. I would say one big strength of the UK's framework is the fact that it has instrument independence but not goal independence, so the fact that Parliament provides the goals I think is a distinct benefit compared with the Fed model or the ECB model.

Professor Jagjit Chadha: One of the curses of being the director of the National Institute is that we have a chance not only to look at fiscal policy but broadly monetary policy, economic policy, and the state of the nation, in a world in which I think it might be fair to say the country relative to our main trading partners and peers has taken a great step back in the last decade. That does not look like it is the case for the Bank of England. It continues to be very highly regarded in international circles. It is one area in which we have not as a country taken a big step back.

Q17 **The Chair:** Is it fair to say, listening to the three of you speak in the last hour or so, and I totally understand what I hear you say just now, that there is a slight question mark over the FPC and certainly its objectives? Is that a fair summation of what you are all saying on that?

Professor Jagjit Chadha: I think that is right. Unlike with monetary stability, it is very hard to come up with a definition of what would constitute financial stability across a range of financial institutions in a way that we could monitor it and target it. The absence of that definition makes it very hard for the Financial Policy Committee or associated committees to operate in the same way as the Monetary Policy Committee.

Lord King of Lothbury: To make that even more explicit, the Monetary Policy Committee votes on interest rates and QE, and if they are debating interest rates people might say, "Well, I think it should be 4.5%" and others say 4.25%, others say 4%. You can have a vote on that and there

is a document that explains, because you are voting over a single number, how you would reach a decision as to which compromise number is supported by a majority. With the FPC the problem is that there is no single variable that you might want to use to bring about a degree of financial stability, so you could end up with each member of the committee saying, "Well, this is my ideal package of measures" and there is no basis on which you can vote to decide which one is better. You need a conversation in which people agree on what seems to be the most sensible thing to do. That, I think, is a fundamental difference between FPC and PRA on the one hand, and the MPC on the other.

Professor David Aikman: Could I respond to that? That is exactly the case for why the FPC was set up in the way it was, on the consensus model. My sense from having watched the discussions in practice is I think you could have voting over quantitative decisions that the committee needs to take.

Lord King of Lothbury: Voting was never ruled out. Indeed, there have to be votes over the measures that the committee agrees on, so they do have votes. They typically tend to be unanimous, but they do not have to be, and there were situations where there was a clear majority in favour of an action and a minority that disagreed with it. You can have votes, but it is not anywhere near as simple as a voting procedure on the MPC, where you can write down the procedure that guarantees you reach the decision.

Lord Turnbull: Maybe you can explain this. Is the FPC's main job to try to spot where danger is coming from and then point to someone and say, "That is your responsibility. Would you do something about that?" rather than having a series of instruments of its own?

Lord King of Lothbury: Well, it does have some instruments of its own and that was one of the big issues that was discussed when the FPC was created. The problem before the FPC was set up was that the Bank had some vague responsibility for financial stability, but absolutely no powers whatever to bring it about. The difficulty with that is if you write a report saying, "There is a disaster about to come in this area. Somebody else ought to do something about it" the immediate response is, "Well, what are you doing about it?" I think that you do not want to separate some powers at least from the ability to create warnings. The FPC does have powers in respect of various decisions on mortgages and other parts of the financial system.

Q18 **Lord Griffiths of Fforestfach:** Two questions. The first is, if I can come back to where the Chair started this afternoon on independence, 25 years ago the Bank of England was granted operational independence. From reading, and I may be wrong, I think in the Fed it is the President and Congress who choose the objectives, rather than the Fed itself. My question is, I sometimes feel, and this may be an impertinence to say it, that the Treasury treats the Bank like a dog on a leash and if you read the Act and the way it acts, it lets it go out so far and run round the park, but at the end of the day the fist is clenched and it knows it really has the

authority. For example, I find it odd that it is the Treasury that appoints members of the MPC. When it comes to giving extra work and responsibilities to the Bank, it is the Chancellor who says it is in his rights, and the Treasury has reserve powers. Neither the Fed nor the ECB face this kind of approach. To what extent do you think there is a case, given that the Bank has operational independence, for it to be given more operational independence along these lines?

Professor David Aikman: I would strongly oppose that personally. I think the huge strength of the current setup is the fact that it is the Government who set the objectives that the Bank, as an independent body, tries to meet.

Lord Griffiths of Fforestfach: I am not suggesting that the Government should not. I think in a democracy it is absolutely right that the Government, and therefore the Chancellor, set the objectives or that Parliament sets the objectives. What I am concerned about is operational independence and whether it should be given more operational independence from the Treasury.

Professor David Aikman: It is not clear to me it needs more. It has the tools. Maybe that is what it comes down to. Does it have the instruments at its disposal to meet the objectives it has been given? My sense is it does. It is not clear to me there is an issue with the operational independence of the Bank.

Lord Griffiths of Fforestfach: It is like saying, "Well, we'll choose people to play in a football team who can kick a football around but we are not able to name the players". If I was a manager I would find that an invidious position to be in.

Professor Frederic Malherbe: I guess as we have discussed before one important dimension is the frequency with which objectives are discussed and reviewed. If those objectives are stable, not reviewed every now and then, then I think that gives a lot of independence to the Bank to do its job. If indeed as you have mentioned not only the players on the team are picked by the Chancellor, but on top of that there are messages about the tactics that come all the time, then there is a problem. In my personal view I would be in favour of decreasing those interferences. Ultimately, of course we want the Government somehow to be in charge of the objectives in the long term. What is the best way to anchor those objectives? I do not know but, clearly, I would tend to push them towards longer term than shorter term.

Professor Jagjit Chadha: If we take the football analogy a bit further, it is whether there is enough scrutiny of the Chancellor, going back to the question that we started with earlier. Clearly, the decisions of the Chancellor to appoint people to the MPC are subject to a form of hearing, probably not quite the right word, with the Commons committee, but I wonder whether there may be more scrutiny of the Chancellor in the decisions that he or she passes through to the Bank in terms of what they are doing. It seems that might be the thing that is missing here.

Maybe this committee and the Treasury committee should act as referee a little bit more than they are currently doing.

- Q19 **Lord Blackwell:** I was going to ask about the role of external members on the committees, but I think you have addressed that quite a lot and the basic view is there should be stronger representation. Unless any of you want to add to that, with the Chair's indulgence I do have a couple of other questions I would like to ask.

First, the Bank's mandate as the primary authority on controlling price inflation rather than the Treasury works to the extent that, as you have explained, given monetary and fiscal policy both impact on aggregate demand, then when you have a demand side led inflation the Bank of England can counteract fiscal policy if necessary. It is less clear to me whether this framework works when you have a supply side inflationary shock, when the problem is not excess demand but in fact the supply side shock may have reduced aggregate demand. Is it clear how the Bank has the tools and is the appropriate mechanism to respond to a supply side inflationary shock?

Professor Jagjit Chadha: This is clearly something we have all been thinking about a lot in the last year, as a result of the increase in energy prices following Putin's invasion of Ukraine. You are right to ask the question as to whether we have the monetary policy tools to deal with a large shift to the left of the supply curve, which is a one-off increase in the price level and the temporary inflation. One answer might be you have to do nothing at all; you just let it happen. But with such a large increase in inflation to double digits in the way we have not seen for 30 years or more, it is incredibly important that the Bank is seen operating in a way to reduce the extent to which that will lead to more persistent inflation, or what economists call second-round effects, as they get dragged into the planning and expectations of those setting prices and wages beyond the horizon of the next year or so. That is why interest rates must rise in the first instance to try to demonstrate that inflation will indeed come back, because those second-round effects will not obtain, but also to remember that if this is a permanent impact or crimping of the supply side of the economy we are going to need a smaller amount of nominal demand in the economy than we did in the past, because supply is also lower. To that extent, interest rates have to go up. So the direction of interest rates is clear. Where the discussion and judgment evolve is very much about the extent or the horizon over which you want inflation to come back.

Ideally, if you care about employment and output in the economy and output volatility you probably want to do as little as you can, in order to bring inflation down without generating a recession. In fact, it is entirely possible because this is a shock to income, real income, for us to go from a higher income, full employment equilibrium to a lower income full employment equilibrium without there being any increase in unemployment at all, if we could get that glide path just right. That has been the debate of the Monetary Policy Committee, where some other members have been saying that what we need to do is immediately raise

interest rates to a very high level to bring inflation down, if not only because of its impact through exchange rates but also by sending a signal that we are serious about it.

I do think through careful communication of the reasons for interest rates to go up and careful communication of the fact that with this kind of shock it is entirely appropriate to lengthen the horizon, we do have the tools at our disposal to deal with this.

Q20 Lord Blackwell: A second quick question. Without getting into monetary policy theory one could view that one of the primary routes that monetary policy affects the economy is through the volume of credit influencing demand, in which interest rates are an influencer but not the sole influencer. Although interest rates now seem to be the general mechanism, the US used to put more emphasis on controlling reserves. Do you think there is any role that we have missed in terms of use of volume of reserves as a mechanism for monetary transmission?

Professor David Aikman: In a sense that is what we are doing with quantitative easing over the past 10 years. When nominal interest rates have hit the zero lower bound we have moved towards more emphasis on the Bank creating central bank reserves, central bank money. So, no, I do not think we have lost that.

The Chair: Thank you all very much. Does anyone have any final question? No? I am conscious we have gone well over time, which is my fault entirely, but there has been a lot to cover. Thank you all very much for coming in. It has been a very useful first session.