HOUSE OF LORDS

Economic Affairs Committee

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

Tuesday 6 June 2023

2.55 pm

Watch the meeting

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

Evidence Session No. 9 Heard in Public Questions 136 - 155

Witnesses

I: Charles Goodhart, Emeritus Professor of Banking and Finance, London School of Economics; Raghuram Rajan, Former Governor, Reserve Bank of India.

Examination of Witnesses

Charles Goodhart and Raghuram Rajan.

Q136 **The Chair:** Good afternoon and welcome to this hearing of the Economic Affairs Committee. We have two excellent witnesses this afternoon. Could I ask you to introduce yourselves, please, for the record?

Charles Goodhart: I am a retired professor from the London School of Economics.

Raghuram Rajan: I am a professor at the University of Chicago's Booth School and a former governor of the Reserve Bank of India.

Q137 **The Chair:** Thank you both very much for coming in. I will ask a starter for 10 and a scene-setter question. It is very simple, really. Do you consider the Bank of England's operational independence a success? That is the core question we are trying to answer. If you want to frame briefly what we may come to touch upon, that would be good.

Charles Goodhart: It was superbly set up and has been remarkably successful as an institution. It has also been a success in operation, although perhaps not quite as central to the low-inflation period that we had since it was set up as some central bankers themselves might think.

Raghuram Rajan: Amplifying that, the period of success after the setting up, which was entirely appropriate, was one in which inflation around the world came down. There were common factors driving that. A lot of central banks that adopted an inflation targeting framework during that period, especially in industrial countries, were quite successful at bringing inflation to levels at which it did not really matter, which is where we want to be.

The challenge, at times like these, when inflation gets out of all control, is to try to make sure that it is brought within the target range in adequate time before it gets entrenched. That is why, for many central banks, the test of the system will be now, rather than during the period when inflation was relatively low. They did it well.

The Chair: That is interesting. Do you feel that we have not really tested independence up to now?

Raghuram Rajan: Let me not be so dramatic. There was success initially. We were at high inflation in the late 1990s. It came down, and collectively the central banks contributed, but, as Charles said, it is very hard to attribute the success just to the central banks. There were other factors. Globalisation was a factor that played out.

The Chair: Charles, do you think independence has been tested up to now in the way Raghu has just said? Do you feel that we have had ample time to test it?

Raghuram Rajan: The test comes when you have a spurt of high inflation, like the current one, with lots of things happening.

Charles Goodhart: The central banks around the world were not enormously successful in bringing inflation back to target during the very disinflationary period between the great financial crisis and the onset of Covid. They struggled. They tried various measures, but were not particularly successful.

My view, in retrospect, is that they in some ways tried too hard. Considering the disinflationary pressures that Raghu explained very well, with the massive increase in the availability of labour worldwide, particularly with the offshoring to low-wage economies, it would have been better had the central banks actually been a little less concerned about hitting 2%. They overemphasised the dangers. There came to be an expectation that inflation might actually be negative for a time and they worried about that excessively. If they had just been happy with inflation rounding at about 1.5% or 1.7% rather than struggling to get it back to 2%, that would have been better.

Q138 **The Chair:** That is a very neat segue to ask my supplementary. Do you think that the Bank's price stability objective is suitably defined? Does it require any changes at all?

Charles Goodhart: I was involved in the first ever operational target for the Reserve Bank of New Zealand. We chose 2% for rather sensible reasons, partly because we thought that there was a bias. Quality changes were not taken sufficiently into account. We were also worried about the floor to nominal wages and prices. It would be very difficult for them to go down. We wanted something that protected us against a bit from the zero lower bound and we thought that 2% was a reasonable level that would satisfy Greenspan's definition of inflation, which was that people would not notice it. So I think 2% ex ante was an appropriate number. Ex post, with the benefit of hindsight, considering the extent of disinflation, we would have done better had we set it even lower, at 1% or even 0.5%.

My own view, as you may know, is that the next few decades will be much more inflationary and that growth will be slower anyhow, for a lot of reasons. In some ways, it might be better in future to set it at 3%. That said, this is exactly the wrong moment to try to change the target. Given that the central banks are struggling with the issue of credibility and have not yet quickly and smoothly managed to return inflation to target, if they were to change the target at this point, it would have a devastating effect on credibility.

Raghuram Rajan: There are issues of what level to set it at, but, now that it is set at 2% across the industrial world, let us not meddle with it. The big issue to me is what band you allow round it. The band at which the governor is supposed to write letters, plus or minus 1%, seems to indicate that this is the tolerable level beyond which we start getting anxious.

This is where I would entirely agree with Charles. Central bankers know how to deal with high inflation, but much less how to deal with low inflation. The real worry with low inflation is galloping deflation. We have not really seen that, except during the depression. Not even in Japan have we seen galloping deflation. The question is whether we can be more relaxed on the lower bound—in other words, a slight bit of asymmetry. You do not want it too explicitly introduced into the framework, because then you might entrench expectations falling off, but you do not want to insist that, when you are slightly below 1.7% or 1.5%, you have to strive to reach 2%. Raising inflation, especially in a deflationary environment, is tough.

The Chair: Would you have this debate now? Would you start to change it now?

Raghuram Rajan: I would not have any debate now. I would say, "Get it within target and then let's see". Central banks know how to do that. It is much easier for them to do that.

Charles Goodhart: Raghu is much younger than I am and he does not remember the 1970s in as much detail as I do. If you were in the 1970s and you asked a central bank, "Is it easier to raise inflation or to lower it?", there is absolutely no question about the answer you would get. It is extraordinarily difficult, as Arthur Burns, for example, would have said, for political and other reasons, to raise interest rates and adversely affect employment to a degree and at a speed that will lower inflation. They would have said that any central banker can raise inflation; all you have to do is raise the growth of the money supply.

Q139 **Lord Davies of Brixton:** I have a question prepared, but you have answered it to a large extent in what you have said already. To narrow it, you have described how central banks have done over the last three or four decades and gave a sort of measured B-minus. Am I being unfair? The issue before us is to what extent operational independence played a role in that outcome.

Charles Goodhart: It played quite a lot of a role. Independence is always qualified. What one Government does, another Government can take back, except in the case of the ECB, which is protected by treaty. The appointments are always made, effectively, by Governments, so independence is always qualified.

That said, the fact that independence has been introduced and supported through Parliament means that there is a greater likelihood of interest rates being adjusted for economic reasons, rather than to suit the political objectives of whatever Government it might be at that time. It has helped and it does help.

Raghuram Rajan: I have operated a central bank when it did not have a specific mandate. The political pressures on you at that time to do whatever the political establishment wants can be considerable. Having a specific remit and a Monetary Policy Committee that is independent, rather than a governor on whom all the pressure can fall, is useful.

Alongside the transparency on how that policy committee thinks and sets its policy, all those things contribute.

Here I get a chance to respond to Charles for a second. At that time, we did not have this kind of structure. That is why it was really hard to fight high inflation; the political backing to do what it takes was simply not there. With the remit and with the independent committee, there is no question. Yes, there are people who will complain about interest rates and how this is hurting ordinary people, but central banks can say, "This is what we are tasked to do". That gives them a substantial ability to do the job.

Lord Davies of Brixton: What do you think would have been different in the UK through the first decade and a half of this century? What would there have been political pressure for the Bank to do that it did not do?

Raghuram Rajan: As Charles said, it was a period of disinflation across the world, partly as a result of globalisation. There were lots of pressures in the 1970s and 1980s. They dwindled over time as the disinflationary pressures took hold across the world. We cannot run that experiment again, but, arguably, it was a relatively easy task at that point, which is why I keep saying that the challenge is now, as opposed to during the period of disinflation.

The Chair: Charles, you wanted to mention something about inflation and the measurement of asset prices.

Charles Goodhart: I am concerned not so much about the target but about how it is measured. It is a great pity that housing does not enter into the CPI and the target. Housing is very important as part of the CPI and, I believe, the PCE in the US. It has been introduced into the target by the ECB in the EU. It is highly important that it should be in the target.

It would also make the job of the central bank considerably easier. Remember that monetary policy and interest rate changes operate very largely through the housing market. As the Bank of England is now trying to get inflation down, you probably saw the headline about house prices declining at the fastest rate over the last 14 years. That would show that monetary policy was working.

Equally, in the period between 2010 and 2020, housing prices were rocketing up. That was partly due to the expansionary monetary policies. If housing had been included in the CPI, I think there would have been less pressure for such expansionary policies as were entertained at the time. I would very strongly want to see housing included in the CPI for the purpose of managing the target.

Lord Davies of Brixton: Is that just a question of using CPIH instead of CPI, or is it more fundamental?

Charles Goodhart: No, CPIX is correct, because you do not want the impact of interest rate changes themselves to come back on to the target. When you push up interest rates, you do not want that to appear to be inflationary as such. Housing prices, excluding the interest rates, ought to be in. The ECB has done some very good work, in my view, about how that should be undertaken. Housing—rented accommodation and the housing itself—plays a considerable role for the Fed.

Lord Griffiths of Fforestfach: The ONS publishes a number of measures of inflation. You have one: the CPIH. Are you saying that the way that is produced at present does not meet the criteria that you have just mentioned?

Charles Goodhart: I am not sure that I know about CPIH. I will pass on that. What the ECB has done, or is doing, for the measurement of housing in the EU is something that the Bank of England should think very seriously about introducing in the UK.

Lord Turnbull: If the reduction in inflation has been attributed to central banks but actually they did not achieve as much of it as they may be getting credit for, are we on the other hand getting a bonus, in the sense that this belief that central banks have been very successful has helped to moderate inflationary expectations? To lose that bonus is very disadvantageous, which makes it more important to re-establish at least the belief that there is someone at the wheel who really cares about inflation, even if it is not really all their work.

Raghuram Rajan: This is very important. You are talking to the issue of central bank credibility for low inflation. Once that is lost, at least the belief is that it takes a fair amount of time to restore it. It also implies a much harder fight against inflation during the period that credibility is lost. I agree entirely with you.

There is a very big issue of how much time it will take to bring the inflation of this current period back within the norms that you want. The longer it takes, the more likely it is that you lose that credibility, expectations get entrenched and the fight is harder for longer. That, to some extent, is the argument for doing it quickly rather than doing it later.

Lord Rooker: I declare an interest in that I was in the Commons from February 1974, so I well remember inflation rates of 27%. I know the effect of that on my constituents and I know the arguments, even though they were a Government of whom I was nominally a supporter. Well, I was until 1997.

I want to ask a bit on the housing, because I cannot quite figure it out. I do not know much about Europe, but we have a very unequal housing structure price-wise in this country. There were times when places like Sunderland had thousands of empty properties. You could buy and sell houses in pubs, and this was happening, at a time, for a few thousand pounds. By putting housing in, how do we go when we have a very unequal housing structure? Our geography is very unfair in this country. It is unequal, rather than unfair. One follows the other, but it is very unequal. How would you incorporate housing into the structure?

Charles Goodhart: The world is unequal, the UK is unequal, in many ways. The normal response to that is that you try to take a representative house. I admit that that is not entirely easy, but then again the basket of goods or food, for example, that your constituents would buy if they were in Sunderland would be quite different from the basket that somebody in Surbiton would buy. It is not just housing where the issue of inequality and the implications of that for a price index occur. It is much more general. It is generally handled, in so far as it can be, by trying to look at a representative consumer in the country as a whole.

Q140 **Lord Griffiths of Fforestfach:** I have two questions and they both relate to the theme of groupthink. We have taken evidence from a number of witnesses and they have raised this issue of groupthink. They have mentioned is that the MPC appointments seem to be of a similar category of economic thinking. The four deputy governors of the Bank of England have all had experience in the Treasury and three of them were Treasury officials. There seems to be a neglect of money in the way they construct a model of the monetary economy.

First, to what extent do you think the view that there is groupthink is justified? Secondly, if you felt that it was justified, to what extent do you think the concept of inflation having been considered to be transitory was the result of groupthink or of poor models that had no real role for money?

Raghuram Rajan: There is a certain amount of groupthink that comes from backgrounds and a certain amount that comes from recent experience. It is sometimes a little hard to parse those two, but let me try in the following sense. There is a certain macro monetary view that prevails in central banks and is associated with the DSGE models, which rarely have a role for a financial sector, rarely have a role for money and have become the prevailing go-to models. There are a whole variety of them in that basket.

Lord Griffiths of Fforestfach: Why do you think that is?

Raghuram Rajan: Partly, it is what is taught in PhD programmes in US and UK schools. That is where people learn it. They join the research departments of central banks or they join the research departments of universities and are then pulled into central banks.

One is the economics profession itself and how it has started thinking about this. As you know, 2007-08 was a big wake-up call to the profession: "Hey, you guys, you didn't even think about the plumbing of the system and it's backed up". The plumbing has to do with nitty-gritty issues like incentives in the financial system and what they are doing out there. This was taken as something that would work, except when it stops. That is one issue.

There are a variety of sources of expertise in the economics profession also. It may make sense to mix it up a little once in a while and have a labour economist, who understands monetary economics but is not wedded to the same models, or a financial economist, who may pay more attention to the financial sector—or a layperson; I think Chair Powell is a layperson, and he initially questioned a lot of the received wisdom, but he has imbibed much of it now. That is one set of possibilities.

The other thing is experience. You mention that they said it was transitory. We had not really experienced high sustained inflation since the early 1990s. It had been coming down significantly from then. The war that central banks were fighting was too-low inflation. They have pivoted and said that the problem now is too-high inflation. As you know, the Federal Reserve changed its monetary framework, taking into account the low inflation and throwing out of the window the old mantra that when you see inflation in the eyeballs, it is too late. No, they wanted to see inflation and ensure that it was sustainable before they acted. In that kind of environment, where experience and the problem you have been tackling have been so different, it is tempting for a little while to say, "Wait, we have time. This will probably go away. It has gone away every time in the past couple of decades". Then it did not.

Charles Goodhart: Raghu is absolutely correct. The groupthink is primarily among central bankers as a group. That is led particularly, if you like, by groupthink among economists. If you ask, "Why did the monetary aggregates fall out of favour?", it was for a variety of reasons. The demand for money functions did not perform very well when they were tried in the early 1980s. If you remember, Governor Bouey said, "We didn't abandon monetary targets. They abandoned us".

Monetary aggregates were dealt quite a severe blow, because the monetary base increased by a factor, I think, of about 10 in the United States in the great financial crisis. Quite a large group of American monetarists effectively said, "This will lead to hyperinflation very quickly". Of course, it did nothing of the kind. That was a fairly devastating blow, particularly in the US, which tends to be the leader of thought in this field.

That said, an increasing number of people, for example Borio in the BIS, think that relatively small changes in money within a normal range are not very important. If you get a really large change in broad money—a 20% change, as you had in the US—and very large changes out of the ordinary in the UK and some other advanced countries, or consistent and persistent declines in broad money, at least you should take notice. The central bank should ask itself, "Does this have any meaning?" Simply ignoring this and saying, as I think Chair Powell did, "We have to unlearn everything about monetary aggregates", was wildly overstating it.

Q141 **Lord King of Lothbury:** Raghu Rajan, you talked about the importance of experience here in creating groupthink. Fundamentally, what was coming from the academic world to central banks was the view that we could abandon Friedman's maxim that inflation is always and everywhere a monetary phenomenon, and replace it with models in which inflation was always and everywhere a transitory phenomenon. Whatever you simulated, inflation always came back to the target. Does that not look like an extraordinary error now?

Raghuram Rajan: It does. What you said is absolutely true. I used to be at the IMF and we used to run our models there. There was nothing monetary policy could not cure. There is a huge shock, cut the interest rate a little bit, everything gets smoothed out and big shocks become little blips. All I can say is that, yes, I agree with you. We need to revisit these models in the light of experience.

There is also the big unexplained issue in many of these models of expectations. They are core to the model, but how they are formed and what drives them is a complete black box. As the central bank, how do you influence that? What are the channels you have for changing that? It is taken as a given that your policy statement is completely credible, everybody believes it and, therefore, you can influence expectations whichever way you want. In practice, it is not so easy and we know very little about it.

Q142 **Lord Londesborough:** Charles, you have been quoted as describing central bankers, and I think economists in general, as behaving like sheep. They tend to revert to flock mentality. I was interested as to whether there are any central banks around the world that you think have avoided the flock and whether there is anything we should learn from them in so doing.

Charles Goodhart: There are certainly central banks around the world that have avoided the flock, but not necessarily for the better. I am thinking of Turkey and Argentina, to take simply two. Particularly when the politicians impose their views, they are sometimes, indeed frequently, much worse than the kinds of errors about expectations that Raghu was, very correctly, talking about.

In terms of those who have done better, I never really understand quite what happens in Japan, but it is always slightly different. Our society and economy are very different from those in Japan and I am not certain that we can learn very much from them.

Q143 **The Chair:** In terms of practical steps that can be taken at the Bank of England to address groupthink, Raghu, you mentioned the models. It is the models that need to be addressed. Could you put a bit more flesh on the bone about what you think should happen? The other thing is diversity of view and thought and what should be done. I am interested in practical ideas, rather than the problem. I want to think about the solutions here.

Raghuram Rajan: Models are harder. We want models that are easy to use but that embrace a wider set of issues in the world. One big issue that we simply do not tackle well is liquidity. We know it matters, but we do not know how and in what ways. One argument in recent days is that the increase in asset prices in the US is being driven by plentiful liquidity because the Treasury has not been expanding its account or its holding of reserves. This sounds like Greek to many people in this room, but it is also Greek to central bankers. How does liquidity operate in affecting a whole bunch of other things? That is an issue that has to be thought of.

On the backgrounds, you have the possibility of the central bank having people from outside. Four members, I think, are from outside. Perhaps more variety could be brought in with those four, not choosing just professional economists. You do a little bit of that, perhaps more of those different backgrounds, maybe even laypersons who need to be convinced. No central banker likes to convince a layperson, because they ask annoying questions, but it is important that you try to explain how you are thinking and somebody can say, "I think you are missing this. I think you are missing that".

Charles Goodhart: It is probably fair to say that the Bank of England, particularly the Monetary Policy Committee, is more diverse than any other central bank in the world. It is probably also true to say that there have been more dissents in the Bank of England than there have been in any other central bank in the world.

The ECB, for example, is in a rather different condition, because it has governors of the individual national central banks. We never know whether there is any dissent at all. After the decision has been made, even though central banker members of the governing council disagreed, usually—not always—they hide their disagreement. Dissents in the Fed are pretty rare. In many countries, it is very rare for anyone to dissent from the governor. We are remarkably diverse.

The Chair: Where does the groupthink emerge in the Bank?

Charles Goodhart: The groupthink is at the level of central bankers as a whole and the level of economic theorists as a whole. It is not at a level of the Bank of England.

Q144 **Lord Griffiths of Fforestfach:** One thing that people giving evidence have said is that the Monetary Policy Committee had greater diversity when it was set up—and, I think, when you were a member of it—than it has today. Would you say that that is a fair judgment?

Charles Goodhart: Admittedly, there is nobody who puts that much weight on the monetary aggregates in the committee at the moment, but there are two of them who have dissented, I think, continuously for about the last 12 or 15 meetings. There is Jonathan Haskel, from business. There is Catherine Mann, an American from the OECD. There are two ladies who dissent—one is Silvana Tenreyro and I cannot pronounce the other one so I will not try—who are specialists in particular macro fields, not, I think, monetary specialists, and who have very diverse views of their own.

The diversity at the moment may not involve the inclusion of some people with views that you would prefer, but it certainly includes people with very differing views—much more differing, in my view, than you will find in almost any other central bank. This argument about groupthink and diversity is very fair, but I do not think you ought to apply it particularly to the Bank of England.

Q145 **Lord King of Lothbury:** Since the financial crisis, the central banks, and the Bank of England in particular, have been asked to do more things than they were doing before. Some of that is in the area of financial stability and banking regulation. The remits that are sent by the Chancellor each year to the Bank have been getting longer and longer. It is asked to take more things into account, with a lot more secondary objectives. Do you think there is a risk that the Bank is being asked to cover too much ground and that it is overstretched? The risk is taking your eye off the ball of the main objective of monetary policy. What is your reaction to this expansion of responsibilities that the Bank has been asked to take on?

Charles Goodhart: There is a risk, but a relatively small risk. The Bank of England's mandate makes it clear that its leading objective is to achieve price stability. If it fails to hit the inflation target, as is the case at the moment, it gets an enormous amount of flack. Therefore, I think it will, inevitably and rightly, focus on that much more than on any secondary considerations.

Having financial stability as a concurrent objective is actually sensible, because you cannot have price stability without financial stability. The two are complementary. Beyond that, I have very considerable doubts about the value or worth of including other objectives, like green, hitting net zero or, I am afraid, inequality. That is very important, but it ought to be dealt with by another body, not by the Bank of England. I do not think that the risk is terribly high at the moment, but I agree that there is a risk. It is wrong and unfortunate to load too many subsidiary objectives on to the Bank.

Raghuram Rajan: I agree with Charles that, relative to other central banks, the Bank of England is very diverse. In that sense, let me associate myself with his remarks.

On the issue of these objectives, I found it interesting that this letter is sent once a year, reiterating the price stability objective but then adding a whole bunch of others. I wonder whether there is some value to keeping the price stability objective fixed for a number of years but maybe altering the other ones. That is what happens in practice, because you really cannot, in some sense, deal with fluctuating price stability objectives.

I absolutely think that price stability and financial stability are joined at the hip. It is hard to separate those two. Do you need to add more? I would think probably not. I agree entirely with Charles. Part of the problem that central banks have is that they are being tasked with too much. Unfortunately, they are accepting a lot more than they can deliver, which is also hitting their credibility.

The Chair: Is that their choice, though? They are sent the letter. Should they be pushing back?

Raghuram Rajan: Some of it is theirs. Again, going back to this issue, when you find it really hard to push inflation up—we have found that even printing a ton of money does not help—you try more and more aggressive things to move it up. In that process, you may impinge on your financial stability objective in an attempt to reach your price stability objective. That is the sense in which it should be kept simple and limited. There could be a conversation between the Government and the central bank about what the Government are trying, but the central bank delivers best when it delivers these two.

Lord King of Lothbury: That was very clear. Thank you.

Q146 **Baroness Liddell of Coatdyke:** The trend of discussion we have had so far is very interesting. It would be very useful to look at the specifics of central banks around the world. Who is doing it right? Who has something to learn and how can we learn from that, either what is good in what other central banks are doing within their remit or what we should avoid doing in setting the remit of the central banks? Compare and contrast.

Charles Goodhart: All central banks have quite a lot to learn. The problem is not with the central bankers but with the economists. The mainstream modelling, as Raghu was saying, has largely failed. At any rate, it has failed in the last few years. We need to improve our models and our economic understanding of the way the world works. It is an economic problem, not a central banking problem.

Baroness Liddell of Coatdyke: What about the remit, though? Should the remit of central banks be altered?

Charles Goodhart: The remit to achieve price stability is fine. They failed to understand, particularly in the summer of 2021, that inflation was likely to be worse and more permanent than they had understood. That failure in 2021 got horribly reinforced by the horrible event, which they could not have foreseen, of the invasion of Ukraine.

Raghuram Rajan: On this, you saw a bunch of emerging-market central bankers raising interest rates way before the developed countries. That was because they had far less credibility, to the issue you talked about earlier, than the industrial country central banks. They had far less confidence that if they let inflation move up they would be able to bring it down. They simply did not hope that it would be transitory. They had to act, even if it would have been transitory. It is a difference in position. They acted earlier because they did not have the confidence or the credibility that industrial-country central bankers enjoyed, not really because they had different remits.

Charles talked earlier about not changing remits at this point and about a central bank that was not doing it well: Argentina. One reason why it lost control over inflation was because, right in the middle of very high inflation, it decided to change the inflation target and move it up, because it could not achieve the lower inflation target. Then it completely lost credibility and the Government were turned out, based on the fact that the whole anti-inflationary programme simply collapsed.

Baroness Liddell of Coatdyke: You do not think there is anything we have to learn from other central banks' remit.

Raghuram Rajan: I agree with Charles. It is fine. If there is one thing I would look at it is whether we really need to specify the price stability target every year. It changes infrequently. Maybe revisit it every five years and see whether it is appropriate. If you have a tradition of reiterating the same target every year, maybe you achieve the same thing. This is a minor issue, not a central issue.

The Chair: Charles, you said that the problem is with the economists. On the remit, is the problem not with the politicians writing longer and longer remits. First, do you agree with that statement? Secondly, Raghu, do you think that we should therefore get out the secateurs and prune the remit right back to some basic points?

Raghuram Rajan: I do not see why all the rest has to be in it.

The Chair: Your answer is yes, we should try to cut it out.

Raghuram Rajan: Why not focus on the two main ones, price stability and financial stability? The Government can perhaps talk about how they feel on both these issues, but restrict it to that.

The Chair: Charles, do you want to add anything on that?

Charles Goodhart: No. I agree entirely with Raghu.

Q147 **Lord Layard:** Maybe we could go back to those two things, price stability and financial stability. At the moment, we have a separate committee for each, and each has its own instrument, aiming at its own target, but obviously each instrument impinges on both outcomes. Is this decentralisation approach really sensible? We have had evidence from Paul Tucker and from the national institute suggesting that, because of the interrelation between these two objectives, there should simply be one board, rather than two separate committees that are looking at the impact of any decision on both outcomes. What is your view on that?

Raghuram Rajan: I have written about this. There is an illusion of separation, which you referred to just now. That is very convenient. While setting monetary policy, we worry about price stability; financial stability is a very peripheral concern that the FPC, the regulators and others will take care of.

Typically, that is okay, but there are times when you are pushing really strongly on the monetary accommodation accelerator, keeping interest rates really low, doing all sorts of quantitative easing and other ways of lending, and you find that financial stability is increasingly a concern, but that is not a time when you are paying attention to it. Eventually, you have to pay attention.

When you are doing this, it is very hard to get supervisors to do the right thing. There are so many ways in which the financial system can take risk at times like this, when monetary conditions are very accommodative. The problems really start emerging down the line. That is what we see nowadays. As you are raising interest rates in the United States, you are finding that people have taken undue risk. Where were the supervisors? They were looking at it, but not as closely as they should have been.

These things come together. It is important to have some commonality in the two committees, which I think there is. It is important to understand that monetary policy has to be set keeping financial stability in mind. It is useful to keep it separate because at least they can spend more time each on their specific expertise, but they should not think of themselves as being entirely separate.

Charles Goodhart: The present set-up is just about right, because the issues that you are dealing with are very different in the two committees. Monetary policy is straightforward macroeconomics. Financial stability is a much more complicated area, where there are no models and there is no target. There cannot be a target other than avoiding a crisis.

You have one clear instrument on the monetary policy side, which takes effect immediately. You have a whole series of differing instruments on the financial stability side. You have very little idea what the effect of them will be on the financial stability side. In most cases, they take a long time to take effect. If you are changing the capital ratio, you cannot expect the banks to adjust absolutely immediately, while the interest rate takes effect instantaneously.

It is a very different set-up in the two fields. Putting the two fields together in a single committee would actually overburden that committee and make it far less easy for the judgments to be achieved adequately. The extent of overlap in the membership provides all that is necessary in the form of co-ordination. I would leave it exactly as it is. As I was saying, the institutional set-up at the Bank of England is absolutely superb and has stood the test of time very well indeed.

The Chair: We are very struck, Charles, by what you have just said. Just on the point of the committee membership, you think it is good having the overlap. Others have said there is a downside because, coming back to our issue of groupthink, it could entrench groupthink. Just for clarity, you think it is a good thing.

Charles Goodhart: Again, I have been very impressed by the external members of the Financial Policy Committee. It has had people like Donald Kohn and Anil Kashyap, who are really experts in the field. If they say there is a problem, any sensible member of the Bank of England’s executive would take it very seriously. The externals, particularly in this field, play a very important role and have done very well.

Raghuram Rajan: The commonalty is very important. You want some of the thinking in the FPC to transmit to the MPC, and vice versa. I agree with Charles that this is a great structure, but if you kept them entirely separate you would have problems, because then you are not taking into account what is happening on the financial stability side while setting monetary policy.

Q148 **Lord Rooker:** Given what you have said in the last few minutes, I will rephrase my question. Are you saying that you are confident that the Financial Policy Committee is up to spotting emerging, new-born systemic risks? The question would have been about how confident you are, but you seem incredibly confident that they are. Is that the case, or I have misunderstood what I have heard?

Charles Goodhart: No one can ever say that they can spot every risk within the financial system. It is simply not within human powers. You will never quite know how much the FPC has actually succeeded in heading off risks because, in so far as they have identified a risk and taken measures to deal with it, it will not come to anyone's notice. You see things happening only when something goes wrong, and there will inevitably be cases where things go wrong.

This is an area where I do not really know, but I cannot remember whether the FPC was aware of the problem that might arise with the pension funds and LDI. The difficulty here was that the Pensions Regulator was not under the control of the FPC. It was managed by members of the pension fund system itself and did not do a good job. It would have been very difficult for the Bank of England and FPC actually to have overturned the Pensions Regulator, under the arrangements that were then in place, to have improved the situation before it went wrong. Lord King probably knows the story of that much better than I do.

Lord King of Lothbury: No. The FPC did identify potential problems of the kind that occurred. It identified them in 2018, and it came up with a possible solution in 2020. You are absolutely right that it had no ability to instruct the pension regulatory bodies to change their regulations, which was the cause of the problem.

Lord Rooker: Is there scope for improvements to the regulatory framework in this area?

Charles Goodhart: The fact that the Pensions Regulator was not properly set up was a problem. I believe, but I am not sure, that change there is under consideration. One of the difficulties here is that the financial sector is always developing, innovating and changing. It will be difficult for the regulators always to be able to keep in touch with all changing progress.

The crypto area is one in which I have no real capacity, but it clearly needs regulation. At the same time, I understand that the Government want to make the UK a crypto force, and it worries me whether the regulation will be applied sufficiently strongly to deal with problems that might develop in that area.

Q149 **Lord Londesborough:** Can we get your thoughts on QE and the size of the Bank's balance sheet? As we know, it rose to above a third of our annual GDP, which has now been reversed, at some cost to the Treasury.

My question is broken into two parts. First, to what degree do you think such levels of QE have compromised the Bank's independence, blurring the lines between monetary and fiscal policy? Some critics have put it as a thinly veiled scheme to finance the Government's deficit. Secondly, how much do you think QE has impacted on the Bank's credibility in its fight against inflation, in the eyes of both the market and, indeed, the public? The Bank seems to be arguing that QE has had a marginal impact on the rate of inflation.

Charles Goodhart: QE was initially a superb instrument for dealing with liquidity problems. I particularly applaud Lord King because I believe that he was the first to introduce it in, I think, March 2009. As a mechanism for dealing with liquidity problems, it is unrivalled. It protected many of our economies from disaster several times over, not just from the great financial crisis. It was used when there was a liquidity crisis in the US—in March this year, I think, or maybe 2022; my memory is going. They reapplied QE and that was absolutely splendid.

The problem was that QE got extended not just to deal with liquidity problems, but to try to bring about general monetary expansion. It did so in the pursuit of trying to lower long-term interest rates, given the effective lower bound to short-term interest rates. It did have some effect on long-term interest rates. The best estimates are about 75 basis points. In order to do that, it effectively shifted the duration of outstanding public sector debt just enormously from long term to short term.

If you believe, as I believed and as I think actually happened, that the interest rates that we were all facing from about 2009 through effectively to 2022 were extraordinarily, historically and exceptionally low, shortening the duration of debt was just crazy. It was exactly the wrong thing to do. If interest rates are historically as low as they can ever get, you ought to lengthen the duration of debt. That was, admittedly with the huge benefit of hindsight, one of the great mistakes that has ever been made.

It does have a particular effect on the central bank, but not in the case of the UK because the profits and losses from the fund where the QE effectively is placed have always gone to the Treasury. It has less effect on the Bank of England than it has elsewhere, where the losses of the central bank—or central banks, in the case of the ECB—will be seized upon by populists to attack the central bank. It was a two-edged sword in the sense that QE was the right answer for dealing with liquidity problems. Dealing with general issues relating to a monetary expansion at a time when interest rates were historically low was the wrong answer.

Raghuram Rajan: One of the primary rules of central banks is those temporary infusions of liquidity and to liquify the system when it is illiquid. The semi-permanent infusion has very different consequences.

Charles spoke about the effect on the fiscal. There is a very separate effect on the banking system because somebody has to hold the reserves that the central bank is putting out. What happens, again, is that because the banking system has really liquid reserves on its assets side, it issues really short-term liabilities on its liabilities side, so it, too, shortens maturities. In the US, we see time deposits come down over this period and demand deposits go up. Many of them are uninsured demand deposits. When you ask what is happening at Silicon Valley Bank and why it had 94% uninsured demand deposits, it is not entirely unrelated to the QE that happened in the pandemic.

We have to recognise that the expansion of the central bank balance sheet is also accompanied by an expansion of the commercial bank balance sheet. That is harder to move up and down without something breaking in the middle. If you are not achieving a lot in terms of affecting interest rates through quantitative easing, perhaps one should be worried about the financial stability consequences of moving these things up and down in semi-permanent ways. You have to come in when there are liquidity shortages that you need to deal with.

On the issue of compromising independence, it depends on when it is done. If it is done when the Government's fiscal is very healthy, no; you are buying an asset that is not necessarily making it easier for the Government to finance. But over the course of your expansion in the balance sheet, things may change, as they have changed. If the Government's fiscal situation is very different now, then of course the central bank has to always keep thinking. If I do shrink my balance sheet, am I forcing a lot more pain on the Government, because somebody has to buy the government debt that I sell, and the Government are also selling. Who will hold duration at this point? It is a big question that we will have to start asking when central bank balance sheets are so expanded.

It is a place you do not want to go to too lightly, and we should certainly examine our experience with QE to see whether costs are greater than the benefits, or vice versa.

Lord Londesborough: Coming back to commercial banks, you have described QE as something of an addiction to the drug of stimulus. You are suggesting that there may well be further bank failures and crises in sectors like commercial property, with the advent of aggressive interest rate hiking and QT.

Raghuram Rajan: Just separating a few of those things, there is a natural consequence of rising interest rates, which is that your long-term loans look a lot less valuable. That will happen every time you raise interest rates fairly sharply. The question is how much of your long-term assets in the banking system were built up because you had this avalanche of deposits coming into the system that you did not know how to deploy.

A number of banks basically said, "We have a lot of money coming in. Let us pick up a little bit of spread. Let us invest in long-term securities". That spread will be a sizeable profit for us. Interest rates have not gone up for a long time, implying that they probably will never go up and we make the spread. That was a mistake, and clearly we are seeing the consequence of that.

The problem for many mid-sized banks is that they have financed not with the core deposits, the homeowners and householders who do not really look at the interest rate every week, but with much more runnable money. That money is moving. It is saying, "Pay me 5%, which is what the money markets are asking for, or I move".

The bank cost of funding is moving up quite a bit, which is making it very hard to absorb the losses that they have incurred on their long-term assets. That is where the commercial real estate comes in. That is one example of the losses that have to be absorbed. That is why there is a slow-burning problem in the banking system in the United States—I cannot speak for the UK—that will be fixed through mergers and a number of banks closing. It will happen over time, but it may not happen overnight.

Q150 **The Chair:** Can I just come back to the point about the relationship between central banks and their treasuries? I do not want to make this UK-specific, but Charles may wish to. Given the QE experience and where we are now, do we need to look at that relationship more clearly in terms of accountability, scrutiny and transparency, if for no other reason than to ensure that the bank's independence is seen to be guaranteed, and so that it is seen not to be doing deficit financing, et cetera. Raghu, I do not know whether you feel that it is necessary for that to be clarified in some shape or form.

Raghuram Rajan: I agree with the need to clarify. Many central banks got away from financing their Governments in the 1970s, 1980s and 1990s at great cost. There was a political battle, and eventually there was a way in which it was done. Charles Plosser, a former Fed president, has written about this issue of expanded central bank balance sheets. Yes, you are saying that you are holding government securities, but what happens if they say, "Why don't you finance this or that public sector project that is coming up? After all, you have plenty of assets on your hands"? In that sense, it does make central banks vulnerable to suggestions.

The Chair: Sorry to press you, but what do you think should be done about that?

Raghuram Rajan: This is an additional cost of expanding your balance sheet. Therefore, we should do it only in pretty extreme circumstances. It should not be done lightly. It makes much more sense to do it only in a temporary fashion rather than as a permanent expansion. I do not think the benefits outweigh the costs. That is a view that could be studied. This remit of being allowed to do QE can be withdrawn or contained.

Charles Goodhart: I am more worried about the Government's overall fiscal position. I am not speaking specifically about the UK; I am really speaking about all advanced economies. Once you get the debt ratio going significantly over 100%—and the projections of the OBR and the CBO are that will be rising effectively exponentially from now under present policies—you are getting into a stage where an increase in interest rates affects the overall fiscal deficit so much that Chancellors are bound to be increasingly sensitive.

You are getting into the kind of world in which hyperinflation may follow along the lines that economists like John Cochrane are talking about. Look at the scale of the overall fiscal deficit and the projections of the deficit, the effect on Ukraine and our requirement to raise defence, the effect on the need to spend money to green the economy and the massive increase in the number of old and incapacitated old. There was a piece in the *Times* today that said that the increase in the number of old will increase the number of those getting cancer by 30%.

If you take the existing projections, the debt is effectively becoming unsustainable in all our countries. If the debt is going to become unsustainable, monetary policy is likely to become almost impossible. There is a huge underlying fiscal position. The problem with a democratic society is that it does not have to be tackled immediately, which means that any Government are likely to say, "Let the next Government, whoever it is, tackle it rather than us doing it now".

Q151 **Lord Griffiths of Fforestfach:** Charles, I very much agree with what you have said. I am trying to write something at present on inflation. The way inflation took off in the 1970s and the way it has taken off recently here, you can easily see that because of the debt problem the thing could really jump up again sharply. However, if you mention the phrase "hyperinflation", people think you are in a different world. Hyperinflation is Germany in 1923, Argentina, certain less developed countries and so on. It is not part of our tradition in the G7, the West and so on.

The question that has come to my mind, given that you are right and given that there will be enormous pressure on the central banks to monetise their process, is what actually you put in place. I was having this discussion with Andrew Turnbull today at lunch. We at present have an overall ceiling of government debt to GDP, but is that enough? Keynes, back in 1946 in the *Economic Journal*, said there should be a limit of 25% in the percentage of government expenditure to GDP. He said that it could not be verified in any way scientifically. I am just interested. Given that you have raised it, what fiscal constraints would you recommend to kill it?

Charles Goodhart: You should not think of fiscal constraints. You actually have to think of fiscal actions. You really have two alternatives. Either you can be much less generous to the old and raise the retirement age fairly considerably or you have to raise taxation. The question then is what kind of tax you can raise in a world that will grow much more slowly anyhow. If you raise income taxes on labour or capital, it has effects on the incentives. If you raise it too far, you get migration.

Consumption taxes lower the real incomes of workers. They will undoubtedly react to that, and it has temporary effects on inflation. As I wrote in the book with Manoj Pradhan, I would like to see the introduction of a significant carbon tax and of a land value tax. Both of those would be a means of raising taxation sufficiently to deal with the fiscal problems that I see coming down the road. That is essentially a fiscal issue. It is slightly far away from our discussion this afternoon.

The Chair: Raghu, if, as I do, you buy Charles's analysis of the rising debt problem, and therefore the pressure on central banks of inflation going up but with the countervailing pressure of raising rates from the Government, is their independence safeguarded? Do you feel that they have the wherewithal to take action, as things currently stand, or will the pressure become so great that they feel they cannot withstand the political pressure and not raise rates?

Raghuram Rajan: If the mandate is clear, which it would be if it is just the price stability and financial stability, they have nowhere to hide if they cannot achieve price stability. That is part of their mandate. Can enough pressure be brought some day that they will cave? Yes, but it will be transparent to all, and it will be that the country wants it. What can you do against that? You cannot do anything.

Q152 **Lord Turnbull:** I want to come to the unresolved problem of accountability, which you can divide up into bits: there is the metric you use and the performance against it; to whom that is reported; and what sanctions there are, if any, if these remits are not being hit. We have the letter in this country, but a lot of people think it is pretty flimsy.

An alternative of dismissing a central bank governor raises all sorts of things about the genuine independence of a central bank governor. I do not see any prospect of using money or any bonuses, as you would have in the corporate sector. Are we simply left with the name, shame and blame of the remit letter, or is there something else we could do to sharpen accountability?

Raghuram Rajan: There is a sense within the central banking fraternity that you do not want to be the governor who let inflation go through the roof. The name of Burns in the United States is mud. Nobody wants to be a Burns. Everybody wants to be a Volcker. Volcker is a hero for bringing down inflation.

The people you get as governors are not doing it for the money. They are doing it for whatever personal reasons, but I think they want to leave with their reputation intact. They do not want to be Burns. You do not need to increase those incentives. It is pretty clear when they fail on the job. The number of letters they write does not matter. It is what the public think about the inflationary situation. Did they leave with too high inflation?

I am not sure that is an area you need to worry too much about. The incentives are embedded in the central banking fraternity.

Lord Turnbull: There is only one mechanism. People are appointed for eight years. That can be renewed. Renewal can be denied. I cannot think of anything else.

Raghuram Rajan: Eight years is long relative to other central banks. That is something that you could think about. You have typically had governors who have served for a very long time. Montagu Norman was just four or five central bankers ago.

Q153 **Lord King of Lothbury:** He was the first one to be the governor for more than two years. He stayed for over 20 years, which was quite an impressive achievement.

My question is about one aspect of this question of accountability. The Bank has a Court, which is an oversight body. Charles, you will have seen Court evolve and change quite significantly during your various spells in the Bank. I want to put the question first to Charles. It is a question that is specific to the Bank of England. Raghu might give us a comment on other central banks and equivalent oversight bodies; the Fed does not really have one.

Charles, what do you see as the purpose of and role of Court? It sets salaries and the budget and protects the interests of the external members of the various policy committees, to which those members can appeal if they feel they are not being given the resources they want. You have seen the Court change so much over a number of years. What do you think of Court as an institution? Have the changes been in the right direction? What do you think the role of Court should be?

Charles Goodhart: The changes were in the right direction. We have effectively set out what it does now. It is a local oversight body. Who else was going to do it? You certainly do not want the politicians to do that. You do need an oversight of its domestic management.

It also plays another role. It is a number of very senior, experienced people. If anything goes really wrong in the relationship between the Bank and the Government, having members of the Court onside who can support you is an important protection for the Bank. I do not think you mentioned that. It is one of the issues that I would see the Court undertaking.

I was never senior enough in the Bank to have any role with the Court myself. You know far more about the relationships between the Bank and the Court than I do.

Lord King of Lothbury: But you are the witness, Professor Goodheart.

Charles Goodhart: Inevitably, and rightly, given the need to maintain policy as secret until it is enacted, they play very little role in the policy discussions of the Bank, or in the discussions in which I took part. Again, the institutional set-up of the Bank is exceedingly good. The Court plays a rather minor but nevertheless important and useful role in the activities of the Bank. I stand ready to be entirely corrected by you, because your knowledge of this particular aspect is infinitely better than mine.

Lord King of Lothbury: Professor Rajan, the Fed does not have an equivalent for the board of governors. Individual reserve banks do. What was the position of the Reserve Bank of India? Was there an equivalent?

Raghuram Rajan: No, but it was very important to have a parliamentary committee, in the same way as the Fed chairman gives his Humphrey-Hawkins testimony, for the reasons that Charles mentioned. You want to first communicate to the elected representatives what you are doing and why you are doing it. Having a regular presentation would be a good thing, but you also build some allies in case you have to take certain actions and they have to be explained more widely. Hopefully some of these elected representatives will be on your side in that case.

I do not know anything about the Court so I will not talk about it, but in the case of the Fed, it is useful for the Fed chairman to have regular contact with Congress. Increasingly, given that central banks are seen as elitist and one of those pointy-headed guys who are doing things against the popular will, it is quite important to communicate what you are doing in clear language. This is one way to do it. The Fed has started community meetings and so on to also spread the message, but this is a way of getting it out loud and clear.

Q154 **Lord Layard:** I wanted to go back to the point that both of you, especially Charles, were making about the models used by the Bank, which are quite central to the operation of the Bank. You were saying that the model currently being used is really not adequate. Do you think this is an area where there should be some review? Could this committee play any useful role, like suggesting that there should be a review of the model that is being used?

Charles Goodhart: I doubt whether any parliamentary committee would be the right committee to look at detailed—

Lord Layard: I was not saying that. I was saying to identify the need for a review, not to conduct a review.

Charles Goodhart: I am quite sure that there will be reviews of the models. It is clear that this has to take place, not just in the UK. We are not alone in all these problems. Exactly the same problem has been occurring in the United States, and indeed in Europe with the ECB. Philip Lane’s models have come under just as much criticism as the models used by the Bank of England, if not more.

Again, none of this is specific to this country. There is a need for the economic professions to look again at the kind of models that they are using. It is not just central banks either. What has gone wrong with the models is common to the entire macroeconomic profession as it stands.

Q155 **The Chair:** May I just tie together some of these questions? Over the last

25 years, we have given our central bank and other central banks enormous powers and authority to take decisions that have an enormous impact on our economies. At the same time, the complexity of central banking has grown. We have seen unconventional tools, like QE, become conventional.

Given that complexity, plus the critical role that a central bank plays, how can we marry that up with effective accountability and scrutiny in a democracy? The excellent and able people who there are down the corridor in the House of Commons are not central bankers. They do not understand these terms. How do we tackle that challenge?

Raghuram Rajan: You ask questions: "Why did you fail on the job?"

The Chair: Is Parliament here asking a sufficient number of questions to hold the Bank of England to account, for example?

Raghuram Rajan: Asking these pointed questions and asking for an answer that makes sense is part of what makes central bankers embarrassed: "Yes, we did fail. We went to 10% inflation when our target was 2%, and we stayed with high inflation for a couple of years". I am just talking aloud about possibilities.

If we have to explain the great inflation to Parliament, we also have to explain what we are doing to make sure that it does not happen again. This means that you have to look at your models, and you have to ask why those models miss it and how we can ensure those models will not miss it. Just asking the questions is enough to embarrass the central banker and to make them look at what happened and why.

Charles Goodhart: They are very embarrassed already. There will be a need for a huge rethink in this field.

The Chair: Do you mean of models?

Charles Goodhart: Yes, of models. Again, I point the finger not at central banks as such, but at the economic profession and the models it is currently using.

The Chair: Thank you, both, very much indeed. We have covered a lot of ground. It has been a very useful session.