



Economic Affairs Committee

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

Tuesday 13 June 2023

3.05 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; Baroness Liddell of Coatdyke; Lord Rooker; Lord Turnbull; Lord Verjee.

Evidence Session No. 10

Heard in Public

Questions 156 - 174

Witness

[I](#): Andrew Bailey, Governor of the Bank of England.

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Examination of witness

Andrew Bailey.

Q156 **The Chair:** Good afternoon. Welcome to our hearing on the Bank of England: how is independence working? I am delighted to welcome Andrew Bailey. Thank you very much for joining us, Governor. I also put on the record all our thanks for your and your team's letter and input that you have already sent for our inquiry. We are very grateful. I should also declare an interest, as I always do, as an adviser to Banco Santander.

I always start our oral sessions with a starter for 10, so to speak. It is a very broad question so I would be very grateful if you could try to keep your answer as brief and succinct as possible. It is a very simple question. When you look back to the period since 1998, what do you consider to be the success and failings of an operationally independent Bank of England? I am particularly interested in what you consider might be the failings.

Andrew Bailey: I think that the success in a very broad sense is two things. It is the clarity of the primary objectives and the institutional independence that goes with them; in other words, it is the institutional ability to put those objectives into practice. I will give you one example and then I will go on to the failings. The statement that I have made a number of times recently following the failure of Silicon Valley Bank that the UK banks are safe, they are robust and they can serve the public is important and it is built on that. It does not come from nowhere.

Going to the other side of the question, I would probably draw out two points. One is historical and one is contemporary. Frankly, the historical issue, of course, was that in the pre-financial crisis period we did not have an explicit financial stability responsibility or an explicit financial stability objective. The objective for the structure as a whole was quite obscure. I think that that told, as it were, in the contribution. You could spend a lot of time trying to run the counterfactuals as to what would have happened, and obviously there were important things going on in other parts of the world, but I think that it mattered in the UK, certainly when I compare it to the situation we are in now.

The second thing is contemporary. We are obviously in a situation of very big shocks that have hit the economy. I take the view that this is the point at which those clear objectives and the clear target for price stability is essential as the anchor. As I have said to the Commons Treasury Select Committee, there are obviously lessons to be learned, particularly about how we respond to the scale, nature and sequence of the shocks that we have had. There will be important lessons to be taken from that, no question about it.

The Chair: Can you put a bit more flesh on the bones about what those lessons are?

Andrew Bailey: We are obviously still in it, so I will qualify it in that sense. I think that the lesson for me is that coming out of Covid, so from

the second half of 2020 onwards, we had a series of very big supply shocks. Two of them were international; one of them I think was domestic. The so-called supply-chain shock and the recovery from Covid were global. The war in Ukraine is, obviously and sadly, international, and then we have had a domestic labour supply shock as well. That was domestic. The sequence of those, because it has turned out that there are no gaps between those shocks, and the scale of them has provided a very big challenge. I think that we will have to look at what the right responses to those challenges are. I always have to say, a point I make in other hearings, that it is bearing in mind, of course, what is called the hindsight point, that we do not set policy with hindsight.

The Chair: What would be the processes that you would be looking at when you say that there are lessons to be learned?

Andrew Bailey: Although we have not formally decided yet or announced, I would expect—because it is what we do and we sent you a letter setting out quite a lot of reviews we have done over the years—that this will define elements or that this is something we will do a review on because we would not be doing the right thing if we did not do it, frankly.

The Chair: I am interested in this. You are quite right; you did send a very useful letter that pointed to the reviews you had done in the past. One of the reviews that concluded in 2015, picking up on a review that was done in 2012, the Stockton review, said, “A core theme of the Stockton Review was the need to take steps to introduce greater challenge to forecast conventions and Bank thinking.” It goes on to point to the forecasting itself, which we will come on to in a minute. How much do you feel, though, that that criticism, one could call it, or learning, whatever you wish to call it, certainly a conclusion of this report, has been acted on since 2015?

Andrew Bailey: The point I would make to start with is that I do read, and I have read, some of the other hearings in this review you are doing that talk about the Bank having a model and that the model is not doing well. It is not, I am afraid, like that at all. We do not have a single model. We have something that Lord King introduced, a suite of models that we can put to work. We develop new ones as time goes by.

This is where the challenge comes in and this is where I think that the Stockton review was helpful. I was not on the committee at the time but I do well remember it happening. The job of the committee is to challenge those judgments, introduce its own judgments and form those into changes to the forecast that seem appropriate, given the economic situation we are in. The idea that there is a sausage machine that you stick things into at one end and a forecast pops out the other end—it is really not like that at all.

To illustrate that, there are two things that I would point to in the current situation. First, the committee is, and has been for some time now, making very big adjustments within what we tend to call the modal or the central forecast to the persistence of inflation. Those are judgments.

Secondly, we have the biggest ever what we call upside skew. In our fan chart, the distribution for inflation is at the highest ever in terms of the upside risk. That is again a judgment of the committee.

Q157 Lord King of Lothbury: Mr Governor, welcome. You have been a participant in and an observer of the whole process of setting monetary policy during the 26 years now of independence, indeed right back to the inflation target introduction in 1992. You have been able to observe some parts of it and actively played a role in parts of it as well. Given all that experience, what would you say needs to be improved? Are there things that you think need to be adjusted or improved in the framework?

Andrew Bailey: I do think that we have moved into an era where we have had very big supply shocks operating on the economy and on inflation. Those call into question what the right response is to that at the time. What we will need to review is: did we look at that broadly enough at the time? For me, the biggest challenge there is the labour market in 2021. Although Ukraine, sadly, is possibly having the biggest effect on headline inflation, I am afraid I do take the view on Ukraine—I have read some of the books and it was only in December 2021 that even the intelligence services were saying that this is looking much more serious than previous Russian troop build-ups—that monetary policy will not solve that problem. We have to deal with it.

On the labour market, the real challenge—and this is the difficult one, an issue we spent a lot of time on in 2021—was the furlough scheme, which was extended from April until September. It ended at the end of September 2021. Right up until the last day—I think that there were a million or so jobs on the furlough scheme; more, certainly, than people expected there to be—the question for us was: what will be the consequence of that scheme ending? Are we going to see slack in the labour market in the sense that there are people who will not have jobs to come back to? That was, frankly, as I remember it at the time, the judgment of most commentators. We were probably at the lower end, but we thought that unemployment would rise. We were wrong, frankly.

Lord King of Lothbury: That is about an economic judgment, which can happen at any time. What about the actual framework, the inflation target itself? One area that some witnesses have raised with us, and if you remember it was raised right back when the independence started, is that the Government give the Bank the inflation target. They do not give any explicit instructions about the horizon over which to bring inflation back to target. You cannot bring it back immediately because it is a 12-month measure. You are oscillating between deep recessions and booms, so it is bound to take time to come back. At present the committee makes a judgment as to the appropriate horizon over which to bring it back. Is there any role for government to have a say in that or are there any other aspects of the framework itself that you would like to be able to adjust?

Andrew Bailey: The 2013 amendments to the framework did give us more flexibility over this very point you make about how quickly to bring

inflation back to target. It cast it in the context of a trade-off. It did create more flexibility and it is something that we do, particularly in the current context, spend quite a lot of time focusing on as to how quickly to bring it back to target, accepting all the uncertainty around the judgments we have to make in that.

We have the framework to do that. I think that there is a challenge in there, going back to what I have just said, between how much you explain your judgments about how rapidly you think is sensible for it to come back. As you know very well, the uncertainty around those judgments is substantial, frankly. The fact that we have more flexibility now as a result of the 2013 changes I think is helpful. I have slightly different views on some parts of the 2013 amendments, but I think that will probably usefully formalise something, as you would know better than I would, that was in the minds of people before.

Lord King of Lothbury: A couple of things follow on from that. One is that there were changes to the procedures for transcripts of meetings. If you remember, right at the very beginning when the Bank was independent people tried to make a transcript of the proceedings and could not.

Andrew Bailey: It did not go well.

Lord King of Lothbury: It was not a series of formal statements around the room. It was a genuinely interactive conversation and the transcribers who listened to the recordings could not work out who was speaking. Do you think that the idea of transcripts, which is now embedded into the process, makes a lot of sense?

Andrew Bailey: The first ones will appear next year, in fact.

Lord King of Lothbury: The first appear next year?

Andrew Bailey: Yes, I think so.

Lord King of Lothbury: It is a five-year lag or an eight-year lag?

Andrew Bailey: It is eight. If I am wrong on that, I will correct it, but I think it is eight.

We do it slightly differently from the Federal Reserve. The whole of the FOMC is transcribed. The whole meeting from end to end is transcribed. We have a series of meetings, some of which are taped and transcribed, and one or two of which are not, early on in the process. We have what is called a briefing meeting, the pre-MPC meeting. That has not changed at all. That is not transcribed because the staff are, in a sense, downloading to us what has happened since we last met. Then we have what we call an issues meeting. That is not transcribed and we deliberate quite freely on the issues but we do not reach conclusions on policy. The next meeting is taped, when each of us gives an indicative view. There is a final meeting, which is quite short, where we confirm or not those indicative views. Then we go into the creation of minutes.

I think that it is important to have that mix. I was not on the committee before the transcription process came into being so I am having to judge this from afar, slightly, but I think it does have an effect on deliberation. It is important that we have the opportunity to deliberate without that because the essence of the MPC is that nine people deliberate on the evidence as they see it. Each of us reaches a judgment on that informed by listening and talking and deliberating with the others. If I felt that the deliberation had disappeared out of the process I would be very worried and would want to do something about it. I think that we have managed to preserve that, and I think that you can see this in the FOMC if you go back in time. It does have an effect. If you are on tape, you prepare your remarks. There is less give and take

Q158 Lord King of Lothbury: In your first answer you talked about some of the lessons that might be learned and what you would be doing to discover what those lessons are about why inflation went up. What is your theory of inflation?

Andrew Bailey: Why it has gone up?

Lord King of Lothbury: No, what is your theory of inflation?

Andrew Bailey: It is a balance of supply and demand ultimately in the economy. The economy is hit by all sorts of shocks but ultimately it is the balance of supply and demand. I do take the view—I know a number of people have said this—there is a money impact to that. I certainly do not ignore that and I would be happy to expand on what I think we have seen in recent years on that front. But the balance of supply and demand across a number of parts—it is not just an activity; it is also in the labour market—is key to that.

The challenge we always have is that measuring those things, looking forwards, depends on us essentially reaching views on things that are unmeasurable; for example, on gaps—the gapology in the economy. We have to be very cautious about how we interpret that. Ultimately you can boil it down to quite a lot and you need to do that; we have to keep it as simple as we can.

Lord King of Lothbury: Tell us a bit more about the monetary side of it because it is not easy in the monetary policy reports to see much reference to that. But you said it was still something that you thought about.

Andrew Bailey: This is almost the contemporary example I would give. I will both expand on and qualify some of the things that have been said in previous hearings. Again, if we look back to 2021, say—as a number of people have said—you saw rapid growth in the M4 aggregate. What was not said is that the other aggregate measure of M4, which is M4 lending, was not growing rapidly at all. In fact, it was doing the opposite. It was almost unprecedented that there was this gap opening up between the two.

In the committee, we discuss this a lot, and the rationalisation of this we arrived at but it then posed a question, which I think is still with us, that what we were seeing was quite a strong build-up of saving in the economy. That helps explain the gap between the two measures. It was useful that the monetary aggregates were giving us that picture quite starkly.

We then had to form a view. We had this unexpected build-up of saving that we could rationalise in a Covid context because people were not able to—do you want me to hold that thought?

The Chair: Sorry, Governor. There is a Division in the House. We will return after the vote.

The committee suspended for a Division in the House.

The Chair: We will now resume our hearing. Sorry, you were in the middle of an answer.

Andrew Bailey: Correct me if I am wrong; I think I had just said that the committee was left with an issue that we had a build-up of unexpected saving. We thought the distribution of that was not even across the population, that it was probably more in the sectors of the population that have a lower marginal propensity to consume out of savings.

But we had an issue in 2021 and we still have it to a degree—I will come to that—as to what will be the effect of this build-up of the stock of money. I think we see it now. This is where some of the more monetary-inclined economists fall out among themselves: is it the flow, is it the stock or is it some combination? Certainly, at the moment the flow measures of M4 will tell you it is weakening. But we never know exactly how much is out there. We think the stock has now eroded. In real terms it has eroded but to what extent that stock still has some overhang is a judgment we have to keep coming back to.

I hope that helps to explain how I think about it and how the monetary aggregates do inform that, but it is a bit more developed than some commentators would suggest.

Lord King of Lothbury: It might be helpful to have some of this discussion and ideas reflected in the monetary policy report.

Andrew Bailey: That is a fair point.

Lord King of Lothbury: We looked in vain for references to money and lending, and so on, but the way you have described it, it would be helpful to see more of that.

Andrew Bailey: I think you will see it in the discussion on saving. You are right and it is a fair point that the link back to the monetary aggregates was probably not there.

Lord King of Lothbury: You said earlier that you do not use a model as a sausage machine—assumptions in, answer out. You told the Treasury

Committee that you aim off the model somewhat. One of the problems with a model is—if I remember, I cannot really think it has changed—that it does not matter what you do, inflation in the medium term always comes back to 2%. That bit is what you need to aim off for, clearly. Can you say a bit more about how you aim off?

Andrew Bailey: You are absolutely correct. The problem we have at the moment—it is not just a model, it is models—is that they tend to be highly linear and highly symmetric, therefore. What goes up comes down more or less within the same profile. That is particularly relevant at the moment because, again, if you were to leave the sausage machine to run on its own and take it as it was, the forecast would deliver a very rapid fall in inflation, back to and well below target, driven by this linear symmetry condition that it is in there. We have aimed off that.

That is not our central view; it is a long way off our central view. We think there is more persistence in inflation. Therefore, we have introduced more persistence into it. We have done that in a number of ways. Some of the staff have estimated little new models to try to help us do that and a lot of it is judgment. We have said this is what we think will happen, how can we then reflect that back into the forecast? Of course, as you know, the judgment then on the risk is entirely judgment.

Lord King of Lothbury: The model basically builds in the view that inflation is always and everywhere a transitory phenomenon. It always has to come back to the target. You have to use judgment to override that. Can you say more about the variables or the analysis that you use to decide where inflation will come back to—or maybe it will not?

Andrew Bailey: It will because we will have to use monetary policy to bring it back. Another question is: how much? I point to two things in the current assessment that I would pick up in that respect. One is more structural and the other is more a condition of the times.

The structural points are around the labour market. As this morning's numbers illustrated, we have a very tight labour market in this country. We have had a fall in the supply of labour, which is showing signs of recovering but very slowly. We have our network of regional agents who provide us with a lot of information that informs these judgments. I, as I know you did, go around with the agents a lot, visiting businesses. We have 12 agents and I will spend a day with each one every year.

One of the things that firms pretty much universally say to me, and have been saying to me for a little while, is that they find it so hard to recruit labour in the current market that they will not release labour. There is labour hoarding going on; they will adjust hours if they need to but they will be very reluctant to make people redundant.

We have taken that and again we built that into the judgment on the labour market, and therefore on the tightness of the labour market and how that will get reflected through into price setting, wage setting and

inflation. That is one thing we have done and we have had to come back to that a number of times over the last year or so.

The second one, which we spent quite a bit of time on in the May round forecast, is food. The question that we start with is that the world commodity price level started the chain. Obviously, it was very heavily affected by Ukraine but at the world level, food prices peaked last summer so why is it taking longer in this era than it has in the past for this effect to come through? Our agents tell us this and I hear it—more so from the retailers than the food producers—but we have been told for some time, “No, they have reached the peak, they will come down, the rate of inflation will come down”, then they come back later, saying, “Sorry, we got that one wrong.”

We have had to go back and look very hard at what the underlying drivers are and we have some ideas about that. We still think the rate of inflation will come down but it is taking a lot longer than we expected. We introduced an explicit persistence of food inflation into the forecast in the most recent round.

Q159 Lord Griffiths of Fforestfach: I will ask you a question about groupthink. From one perspective it is very clear that there is not groupthink, and that is on the Monetary Policy Committee: people have different views, they express different views, they vote differently; that is not groupthink. However, as has already been touched on, there is one area where there does seem to be groupthink, and you may say it is a groupthink within the academic economics profession, which is the standard macroeconomic and new-Keynesian model that people are using, and so on, where there is no role for money.

Following on from the last questioner, as I read the detailed reports of the Monetary Policy Committee there does seem to me—I use strong language here—to be a wilful neglect of handling money, despite the fact that in the 18th, 19th and 20th centuries, money has played an important role in many people’s view of inflation, but somehow money is never mentioned. It is one asset among many others and there is nothing distinct about it and there is no urgency somehow about treating money.

It is very interesting that between March 2020, when Covid first hit the scene, and when interest rates were raised by 0.15%, there was unanimity among the MPC. It is one of the few occasions when there has been that sort of unanimity. You talk about—as you did to the last meeting when you were called to give evidence in the other place—the supply-side shocks: Covid, Ukraine, the labour market.

All of those supply-side shocks are outside of the Bank of England but the money supply shock, to me, is something that is under the control of the Bank of England but somehow is not mentioned. It gets lost in all these other assets in the system. Why is there almost a fear of using the words “money stock” as if you then become a monetarist—monetarism as ideology, which I do not think it is. It is simply a proposition that if you increase rapidly the broad stock of money, you will have inflation. It is a long question but that is what I am struggling with.

Andrew Bailey: First, I do not subscribe to any view that there is an ideology. I am entirely with you on this. It comes back to the response I gave Lord King, which is that I think the dilemma we had at that time was between what I call the stock and the flow interpretations. You are right. The flow of the aggregate of money was very rapid. We knew that. We are not blind to that. However, we were seeing a very different picture of credit creation in the economy. If it would help the committee, I would be happy to send you the chart of the two measures. Looking back over a long period—over 40 years or more—I think it is almost unique to see these two measures of money move in very different directions.

I take Lord King's point that we should draw this out more, but we have to try to interpret it. That is our job.

Lord Griffiths of Fforestfach: Something we have heard from witnesses—and which I think is a very fair point—is that there is a difference between being a central banker and an economist working in a central bank. They are two different things and therefore as a central banker, you must make these tough calls. All other central banks had to make the same tough calls and, frankly, you were there in a huge majority. Even for others, who would have placed a stronger emphasis on the money stock in mid-2020, of course it was the right thing to take the brakes off; otherwise, we could have ended up with a great depression.

However, like Lord King, I think that it would have been helpful if some move was made in the monetary policy reports, or at least there was some recognition even in speeches or a paper presented by somebody, to say that money, as opposed to credit, did have a role. Money is something you pay with; credit is when you defer payment when you borrow, so they are different. Credit and money are different things.

Andrew Bailey: Go back to 2020 and the response we had to make then. It is worth remembering that GDP fell by over 20% in a short time. I do not think that others who have appeared here particularly questioned the 2020 policy stance, and I would agree with them. I think 2021 was the hard part, when it became very hard to judge what was going on. I come back to the point about the distinction between the stock and the flow. I hear some people saying—and I disagree—"Well, the economy had a very strong recovery". I think you have to be very careful about the context when you say this. Yes, it is true that in the summer of 2020, GDP having fallen by over 20% and if you only look at that point in time, there was quite a rapid recovery, but the UK economy has not recovered rapidly. Even today, the level of GDP is still marginally below where it was pre-Covid. That recovery was not strong in that sense. The recovery of demand in the economy was not strong. We were then, of course, hit by the supply shocks.

Q160 **Lord Blackwell:** Governor, you said that the recent inflation was driven by supply-side shocks. Given the lessons that we learned over that period, if you could rerun that period with a different monetary policy incorporating those lessons, could the peak in inflation or its trajectory

have been significantly lower?

Andrew Bailey: This question comes up quite often in the other House and I always have to caution that we do not have the benefit of hindsight when we set policy. Historians will come back and look at it with hindsight and that is the right thing to do, but we did not have that luxury. We have to make decisions at the time based on the evidence we have. You can, of course, rerun the real-time evidence. This is another good thing to do and people should do that to see if they were doing the right thing at the time based on what they knew at the time and that is fine. I am happy to do that. But to say, "If you had known a war was going to break out or that the end of the furlough scheme was going to be different, what would you have done?"—although I am cautious because this is modelling, we should be careful about saying is that this type of shock, with its terms of trade component, has had a very big effect on national income. If we had known it was coming and had tried to offset it with monetary policy, we would have to have raised interest rates very substantially in advance of it and that would have had its own consequences.

Lord Blackwell: I was not suggesting hindsight in the sense of being able to know things that you could not have known but you said that you have learned some lessons over this period.

Andrew Bailey: Yes.

Lord Blackwell: So I am wondering how you would have applied those lessons to monetary policy.

Andrew Bailey: One of the lessons that we must go back to is the question of the right path of interest rates. Again, however, we had to base it on what we knew at the time. We were genuinely puzzled by the labour market for much of that period through 2021 and after the furlough scheme ended.

Q161 **Lord Turnbull:** I am a bit troubled by some of the vocabulary that is used. You have an underlying rate of inflation; you talk about a shock and then the word "temporary" comes in and sometimes the shock and "temporary" are equated. I do not think that is helpful. If we throw a small pebble into a pond, the ripples do not go very far; if you throw a rock in, those ripples go on for longer. If you have an explosion, the wave can go on for several years. So the "temporary"—you can have something that is a shock but it could have quite long-lasting consequences. I wonder whether the mentality of thinking that it is a shock means you underestimate its effects going on, rippling through the economy for some time.

Andrew Bailey: That is a fair point. This is a very good question. It goes back to the situation we had in 2021, particularly in the first half of 2021, when we could see the global supply-chain shock, we could see shipping costs rising, some commodity prices rising and disruptions to trade going on at that point. We could see the shift caused by Covid from demand for services to demand for goods, particularly in the US but somewhat here

as well, and the question was how prolonged that was going to be. That was the one thing that we could see at that time—bear in mind that the war had not started and the labour market had not yet evolved to what we subsequently saw. How long was that shock going to go on for? What we know now is that that shock probably peaked a year or so ago. It has now waned substantially. Shipping costs are back to where they were pre-Covid, for instance, and China got to the end of zero Covid much more easily than people had feared. If that had been the only shock, I think would probably be having a somewhat different conversation. Yes, inflation would have gone up but it would probably have come down again. Monetary policy would have responded as appropriate.

I know that “transient”, “temporary” or “transitory”—call it what you like—are not the words to use these days and for obvious reasons because we have had this sequence of shocks and you cannot distinguish between them. There are no air gaps between them so it has now been one very long period of supply shocks. However, when we are looking at one shock it was a somewhat different context.

The Chair: Can I tease this out, Governor? You are saying that the lessons to be learned are not so much from the period pre Ukraine but post Ukraine—is that right? So you would stand by the defence that if we had not had Ukraine, inflation would have been transitory?

Andrew Bailey: It is post when we could see the effects of the end of the furlough scheme, which, given the lag in the labour market data, is November 2021 onwards—so a little bit before Ukraine but not that much.

Lord Davies of Brixton: I want to be sure that I am following this. One of your colleagues, or you, said in evidence to the Commons committee that even if you had had full foresight and you had used every instrument in your toolkit, inflation would still have reached 8%.

Andrew Bailey: We would still have had supply shocks because those things have come from outside. I am not sure about the 8%. I have not used 8%.

Lord Davies of Brixton: Someone did.

Andrew Bailey: One or two of my colleagues have done modelling on this and that has the strength of illustrating the story and the weakness, as Lord King was saying and I was responding, of being overly precise about what had to be done. However, if we had been able to anticipate that we would obviously have had to decide how we would set policy in the Covid era, knowing what was going to happen next. That would have been a very tough call.

Lord Davies of Brixton: Yes, because of the implications of double-digit unemployment.

The Chair: Sorry to labour the point but just to be clear: are the lessons to be learned in the pre- or post-Ukraine period?

Andrew Bailey: It starts a bit before Ukraine because I think the labour-market shock is very important in this respect and that starts to emerge not long before but somewhat before Ukraine.

Lord Griffiths of Fforestfach: It seems to me that you put a lot of emphasis on the labour market shock, and indeed it was a shock, a supply-side shock, and it is a very tight labour market. But if I were to put myself in the position of a trade unionist today thinking of negotiating prices, I would ask, "What is the outlook for inflation likely to be?". If you look at the OBR's predictions on public finances, you find that for this year and the next two years, the borrowing requirement is rising and relative to GDP just comes down in the fifth year. You also see a tremendous demand for public spending on defence, the NHS, social security, and so on. In the newspaper headlines this morning you see the Chancellor talking about tax cuts. I look at these figures and think that if I was the Governor of the Bank of England, I would not want to be accused of creating too much unemployment. With all of this in mind, I would say to myself, "It is a tight labour market but what kind of wage bid am I going to put in?" My question is this. You make a very good point in emphasising inactivity in the labour market but it also seems to me that, given rational expectations and looking forward, there is a very strong case, when you put in a wage demand, for putting quite a big expectation of future inflation into it. I wonder how you balance those things.

Andrew Bailey: That is a very good point. I would say there is another dimension to what you have just said, which is the question, if you are in that position as a wage bargainer, of how you balance what I call backward-looking expectations and forward-looking expectations. This comes back to the question of how fast inflation is going to come down and what sort of probability you put on that. If you use backward-looking expectations and weight it towards recent backward-looking expectations, you will get high inflation numbers. We continue to think that headline inflation will fall this year. It is almost arithmetic because of the annual base effects of energy prices given that energy prices are much lower. We continue to believe that food inflation will come down but it would be rather better to actually see it happen. If you weighted it more towards forward-looking expectations for headline inflation, you would have a lower profile. You can imagine which I would prefer people to use but we have to make the judgment about what we think people are going to do in terms of weighting.

By the way, the monetary policy framework and the anchor of the inflation target are also critical here because we want to be very clear that we are going to bring inflation back to 2%.

Q162 **Baroness Liddell of Coatdyke:** Given the complexity of some of the issues that you have been talking about and have to grapple with, do you think that the remit of the Bank has become overly complex? How do you manage the trade-offs between primary and secondary?

We have heard a belief and argument from a lot of our witnesses that

climate change is not a central bank goal. What do you think of that?

Andrew Bailey: It is a very good question. There are three remits. There is a remit for each of the policy committees: the Monetary Policy Committee, the Financial Policy Committee—the macroprudential committee—and the Prudential Regulation Committee. They all have different remits and they are all different in structure. If you do not mind, it is useful to lay them out briefly.

The simplest is the monetary policy remit because it goes right back to 1997. It is a single objective, a primary objective, of price stability and everything else is hierarchical because it has this language and it is subject to that. I think you were a Treasury Minister so we owe you great thanks for this, and Lord King as well.

That is critical because it is pretty straightforward. Subject to that is that the Government can tell us what their policies are but it is hierarchical. There is no question that the primary objective is price stability.

The other two committees are not in as simple a position. They are a bit different. Let me go to the Prudential Regulation Committee first because it is easier to come back to the Financial Policy Committee.

The Prudential Regulation Committee obviously has primary objectives—safety and soundness; policyholder protection for insurers—but it also has second objectives and “have regards”, the things that we must have regard to. Currently, I think there are about 31 have regards. That will come down a bit when some of the new legislation comes through but it will come down only to about 25, or something like that.

Each time we make policy, we have to assess 25 or 30 have regards and we have to do that as policymakers; we cannot avoid that. There was a judicial review recently on the Stonehenge underpass, which the Government lost because they had not taken the have regards into account properly at the policymaking stage.

The FPC is in the middle and has a bit of both. It has the most complicated job. It has some of the Monetary Policy Committee in the sense that the Government can tell us what their policies are, but the FPC can go rather further than that because it is not as simply hierarchical, and it has have regards as well. So the FPC is the most complicated.

This is where something like climate change comes in. It is not really an issue of monetary policy. You can think about how the economy will evolve in the future and what the climate is going to do to it, but it is not an issue in current policy setting; whereas it is for the FPC and PRC because firms are holding long-term assets that can be at risk from climate transition.

My overarching philosophy here is that we must always view the objectives through the lens of the primary objective. When we have regard to other things, it should be through the lens of the primary objective.

I am sorry, I am probably going to come across as being slightly angular in saying this, but all these objectives come from the Government and, if you do not mind my saying so, this House added an amendment to our objectives last week on nature, which is proposed to be embedded into the climate objective, which, again, is an example of how things—not for the Monetary Policy Committee but for the others—

The Chair: Do you think that politicians are outsourcing too much to the Bank?

Andrew Bailey: I think we have to be clear that these other things have to be viewed through the lens of the primary objectives.

Climate change is a risk, clearly, to financial stability in the prudential world but we must view it through that lens. The Bank of England is not there to make climate change policy. That is other people's job, not ours.

The Chair: Some have argued that the Bank should go further on climate change.

Andrew Bailey: Further in which direction?

The Chair: Further in the sense of being more activist, more interventionist. Where do you stand on that?

Andrew Bailey: I think we must be focused on our primary objective and view everything else through the lens of the primary objective. Climate change is a risk to financial stability and we clearly have to take account of that but it is in that context, not, if you do not mind my saying so, how we can help the world adjust to climate change; that is an objective for other people.

Q163 **Baroness Liddell of Coatdyke:** What dialogue do you have with government about all these remits coming together?

Andrew Bailey: When we get the remit letters we do have a dialogue with government. I have a dialogue with the Chancellor. We have a dialogue with the Treasury. They are not subject to parliamentary scrutiny, I think. They are outside that process, I think, but we do have a dialogue.

There was a proposal on nature a couple of years ago and we did say to the Government—and it was adjusted—“Look, we have a reasonable body of thinking on the relationship between financial stability and climate but I am afraid that on nature, we do not; there is no foundation to build that on”.

Baroness Liddell of Coatdyke: Do you have a dialogue with, for example, the Chancellor, before he signs the letter of remit?

Andrew Bailey: Yes, we do. Yes.

Baroness Liddell of Coatdyke: Do you make these points?

Andrew Bailey: Yes, we often make these points. I often say to Ministers that we must stay focused on our primary objectives.

I think a number of witnesses have said to you that the length of the remit itself has remits. Monetary policy is a bit different. That has not changed that much. But the length of the remits has got longer, yes.

The Chair: Would you like the Government to prune the remit? The ECB in particular is now saying that biodiversity should also become a major focus of its activities. Would you agree? For example, last week, Frank Elderson of the ECB said that tackling biodiversity loss “is core economics”.

Andrew Bailey: It may be core economics or it may not be. We can have that debate. For me, it is not core to our primary objectives as a central bank.

I think you will find that there is a range of views among the central banks as to how far that goes. I am very, very clear that we must stay anchored in our primary objectives, but I understand that Ministers say—reasonably—to us, “But of course you must understand that how you pursue your primary objectives can affect other things”. Competitiveness is a good example. It has made me nervous. My view is that we should, as much as possible, anchor competitiveness—this is in regulation, obviously—in international standards, so in things such as the Basel standards, because they are global. That I understand fully. I am not dying in a ditch on this but we have to put these things in the context of our primary objectives.

The Chair: I am sorry to press you on this, but is the addition of all these “have regards” and so on a distraction?

Andrew Bailey: It certainly creates more work. To take the Prudential Regulation Committee—the PRC—whether it is 31 going to 25 “have regards”, the staff have to spend time on them and we, as policymakers, have to spend time. Otherwise, to go back to the Stonehenge thing, you could find that you could be taken to Court and lose your policy as a result, so it does take time.

The Chair: Does the time spent doing that distract you from other things? Is that what you are saying?

Andrew Bailey: It makes policy-making more complicated; I would certainly say that.

I also want to say this: I am not saying that we should just have a primary objective and everybody should just ignore everything else. Of course there are other things that we have to take into consideration. It is much more of an issue for financial stability; in my view, is not an issue for monetary policy.

Q164 **Lord Davies of Brixton:** Following on from that, how do you think the primary objectives of prices and financial stability work together? Is that

something that the Bank handles well? I am sure you will say yes but is there any inherent conflict there? Is there an issue with managing both price and financial stability?

Andrew Bailey: They clearly can interrelate. I think it is a great strength of our system that we have different committees, different institutions, doing those two things, but we have to make sure that they work together.

One of my jobs as governor, because I chair all the committees, is to make sure that the pieces fit together. Often, monetary policy and financial stability are complements. I would say that they are always complementary but sometimes there are instances—I will describe the most recent one—when you have to think quite hard about how they fit together.

The most obvious recent instance was the pension LDI case last September/October. We had to make an intervention for reasons of financial stability because we perceived that there was a serious risk to financial stability emanating from the gilt market and the LDI pension world. After quite a lot of nights spent with the whiteboard, we concluded that we had to buy gilts; we could not do it any other way in that particular context. That was of course my concern and quite a few people said at the time, "You have just resumed quantitative easing". That is not what we intended to do—or did—but the challenge was how we could design and operate a system where, as a central bank, we could operate in support of both financial stability and monetary policy and not complicate the two.

To describe what happened with the Monetary Policy Committee: we had a meeting where I put it very clearly to the committee that, "The test is not whether you, as the Monetary Policy Committee, want to make this intervention in the gilt market. The test is a different one. It is, 'Do you have—" or do we have, because obviously this is my left brain talking to my right brain at this point—"Do we have the tools to operate monetary policy? Notwithstanding the fact that we are having to make an intervention in another part of the landscape, can you still achieve your objective?'" The answer that I put to the Monetary Policy Committee was "Yes, because, if you want to, you can raise interest rates; you can use another tool". That was the conclusion we came to.

Lord Davies of Brixton: Was it a regular meeting of the Monetary Policy Committee? Did you have to convene one especially?

Andrew Bailey: It was a special meeting because we were out of cycle at that point and it was a different sort of decision. It was not a decision on interest rates; it was a decision on whether it had the tools to do its job.

Lord Davies of Brixton: It was part of the process of reconciling these two things.

Andrew Bailey: Yes. So, we came to that conclusion, and it was very clear that the financial stability intervention—to use the words that we used—should be temporary and targeted and that we should withdraw it as soon as we could. We sold those gilts quite quickly and, interestingly, a number of other central banks have come back to me to say, “I am glad you went first in doing that”. It was quite challenging to work out how to make the parts fit together.

Q165 **Lord Blackwell:** I would like to ask you about the interaction between fiscal and monetary policy. You explained earlier that your model of inflation comes back to the impact on aggregate demand. Obviously both fiscal policy and monetary policy impact on aggregate demand as their means of acting on the economy, but they have different impacts on different parts of society. Ideally, you would think that one would want to optimise a mix of fiscal and monetary policy to get the best result. Ideally, you do not want the Bank of England and the Government’s fiscal policy working in opposition where escalating interest rates and fiscal measures work against each other.

Is there that kind of dialogue to maintain a sensible interaction between fiscal and monetary policy? Assuming there is, how is that different from what went on before the Bank of England’s independence, from 1992 onwards, once an inflation target had been set? You could argue that it was the setting of the inflation target and the Government’s commitment to a new inflation target, that provided that discipline. Even though the Bank of England was not then independent, if the governor at the time had made it clear that he disagreed with what the Government were planning to do, that itself would be a major discipline. Ultimately, they could resign. Is that dialogue happening? It presumably must; therefore, what impact has independence had?

Andrew Bailey: Our approach to setting monetary policy is that we condition our judgments on what we call announced government policies, of which the most important is fiscal policy. We always take announced government policy as the condition. This is a point I made the other day to the Treasury Select Committee. When we talk about our forecasts, they are always conditional forecasts, which is one reason why they change—the conditions change. Fiscal policy is one of the conditions and things such as energy prices are others. We always condition on what the Government’s announced policy is and the effects of that policy. We talk quite a lot to the OBR about what it thinks the effects of fiscal policy on the economy will be. That is important.

I should say what does not happen: the Chancellor and I do not have conversations along the lines of, “If you do this, I could do that” or, “Why do you not do this and I will do that?” That never happens. We do talk about the economy a lot, as I think you would probably expect. We share views on what is going on in the economy and why we think things are happening in the economy, but they are a step back from policy. We do not have trade-off type discussions and that is, I think, a crucial part of our system. We do not co-ordinate policy in that sense. We always condition on what we think fiscal policy is going to be and I think the OBR

always conditions, in terms of monetary policy, on the market part of interest rates.

Lord Blackwell: Is that a missed opportunity, if you are not exploring the trade-offs between monetary and fiscal policy?

Andrew Bailey: I do not think it is. The value of having an independent framework is important and therefore, in a sense, it overrides anything you feel you could get from those conversations. The problem is that such conversations would quickly undermine the value of independence and the value of the framework. But it is important to talk about the economy. When we are trying to work out what is going on in food prices, I am very keen to talk to the Chancellor and the Government and say, "What are you seeing? I will tell you what we are seeing".

Lord Blackwell: One of our previous witnesses pointed out that, since fiscal events are maybe twice a year and the MPC meets many times a year, ultimately the Bank of England therefore has the final word on aggregate demand. Do you think that level of independence is appropriate?

Andrew Bailey: That is a question for the Chancellor. I suppose that the question is: if you set fiscal policy only twice a year, what happens in between? That is one for the Chancellor, not for me. As I say, we have to use a conditioning assumption and I think this is the most sensible one to use.

Q166 **Lord Blackwell:** The lower bound of interest rates is where potentially there could be questions raised about the Bank's independence and its interaction with government policy. Since you cannot use lower interest rates, or have not been able to use negative interest rates, what is the impact of using QE and of raising interest rates on government borrowing? Are these issues that have tested—or, now that rates are raising, will test—the Bank's independence?

Andrew Bailey: At the lower bound, there is a change and it is an important change. When you are not at the lower bound, if, let us say, the Government expand fiscal policy, we then have to decide whether we offset it and how we offset it, if we think that is the appropriate thing to do within the inflation context.

Let us take it as read that at the lower bound you are saying that monetary policy is in some sense constrained. You would then naturally offset fiscal policy less, because you would not want to offset it in that sense; indeed, you would be letting fiscal policy come through more because monetary policy is constrained. I do not think that affects the basic independence structure, but fiscal policy would, which is why people say that fiscal policy becomes more of an issue and has more of a profile at the lower bound. That would be natural, if monetary policy were to be constrained in that sense.

Lord Blackwell: Before I finish, can I go back briefly to the earlier point about rerunning history with the lessons learned? You said, effectively,

that the inflation was caused by the supply-side shocks. Are you saying that those who say that you could have reduced the peak of inflation or reduced the level of inflation through monetarist policy—by not having had such easy quantitative easing or such a long period of low interest rates—are wrong?

Andrew Bailey: I do not take the view that among the contributors to inflation, QE was a significant contributor. I think that these external shocks have contributed much more, I am afraid. I come back to the point that, if we want to go back and rerun policy, we have to consider the consequences of alternative policies, particularly given the impact that the external shocks have had on national income in terms of trade.

Q167 **Lord Turnbull:** You say that you base your actions on announced policy. What do you do when the Government are not following their announced policy, as on road fuel duty? They set that in 2014 and have not put it up, yet you seem to be forced to assume that, against all previous experience, next time they will put it up.

Andrew Bailey: I still think that the most transparent and straightforward thing to do is to take announced fiscal policy as is, and to condition on that. As I said earlier, we always have a debate—and the OBR and the Treasury are a part of that debate—about what the impact is of fiscal policy measures, not monetary policy but fiscal policy. It is a condition of independence that we take what the Government tell us as the policy. You are right: it sometimes does not turn out, but I think it is important in the framework that we do that. I just come back to a point then I made earlier in answer to Lord King. It is important to remember that we do not make monetary policy in a sausage machine. There is always judgment in there.

Q168 **Lord King of Lothbury:** To follow on from Lord Turnbull, one example of this is that the current fiscal framework has the property that, as long as you can claim that you are going to see a fall in the ratio of national debt to national income five years down the road, then that is fine. Then the next year, instead of that promise being changed to four years down the road, which it ought to be, it is still another five years down the road. You end up with Governments who promise fiscal tightening in the future but never get around to delivering it. Is this a challenge and a problem for the Bank?

Andrew Bailey: That is why it is helpful that we have—indeed, we owe this to you—this distribution of risks approach. We can build that up. I should correct what I just said—we do not build up the risks bottom-up; we do not say, "It is a bit of this and a bit of that". It is a top-down view, but we can incorporate a lot of underlying judgments into it. It is a safety valve to accommodate quite a lot of things, of which that might be one.

The Chair: Before I turn to Lord Verjee I want to check one point, bringing together various answers you have given. You say that there is not one model, that there are a number of models, and that you do not just treat them like sausage machines. To come back to Lord Blackwell's

point about lessons learned, are they, as you yourself are saying, more about the judgments made in that period than about the models?

Andrew Bailey: Yes.

The Chair: The judgments made by the MPC?

Andrew Bailey: Yes.

The Chair: When you are looking at the judgments made, therefore, what are you looking at? I am just trying to tease out a bit more about where you will be looking in response to these lessons. Is it the appointments to the MPC?

Andrew Bailey: No, no.

The Chair: What is it?

Andrew Bailey: Let me give you what is for me a prominent example. I remember getting quite a lot of questions in parliamentary committees when we were going through the early Covid period about how much “scarring”—to use that phrase—there would be on the economy. The thrust of the questions at that time was how much capacity destruction Covid would cause. To look back from today, I think this “scarring” is more on participation in the labour force than on companies failing, for instance. That is something that we need to go back and look at and ask, “What could we have seen at the time that might have helped us in that respect?” That is a good question.

The Chair: In that period, a number of people, ourselves included, were saying, “Watch out, we do not think that inflation will be transitory”. In those internal discussions, was there any significant challenge from individuals in meetings saying, “This may not be transitory; it may be persistent”? I pick up on some of the reviews that the Bank itself has done with recommendations to challenge convention more, challenge and avoid groupthink; I am mindful of those thoughts that have been put to you by previous reviews. Was there that challenge?

Andrew Bailey: That challenge built up as 2021 went on. Indeed, I would say I was myself part of that challenging. I remember making a speech in September 2021, saying that I thought the supply chain shock had transitory elements; even by then I was worried about what we were beginning to see. We were puzzled by the labour market at that point.

It is interesting. I am sure there will be many pieces of work done on that. There is a recent paper by Ben Bernanke and Olivier Blanchard that is getting a lot of attention in the US. It is not behavioural; it is accounting. The US of course had a very different pattern of shocks to Europe because the Ukraine effect there is nowhere near what it is in Europe. It still looks like in 2021 it was more the transitory things than the potentially more permanent things that were driving it, but it will be interesting to see what it looks like when this is done for parts of Europe, if it is.

Q169 **Lord Verjee:** Can we shift to the regulatory framework? How confident are you that the current regulatory framework can identify nascent systemic risk? To take Silicon Valley Bank, it is of course in America but there are lessons to be learned from that. In hindsight, it is pretty obvious that, with interest rates going up, there was an obvious systemic risk lurking around there. There are international protocols but then, with Cr dit Suisse, those were pretty much torn up in 24 hours. That is my first question.

My second question is: can you give us some commentary on the tension between monetary policy and systemic risk? Interest rates are 8%. That might be needed for inflation, but it is going to cause real systemic risk. Can you give us some commentary on that tension?

Andrew Bailey: One of the great strengths of our structure is that the FPC and the MPC are separate bodies, which is not the case in most systems. One consequence of having the FPC is that it is much more focused on tail risks. That is its job: to look at the tails of the distribution. Exactly to your point about interest rate risk, we have run stress tests regularly, based on a rates-up scenario—in other words, quite a rapid rise in interest rates usually into some form of recession to create the stress, because you have to create the stress. The FPC structure has been more rigorous in that respect, although I do not want to tempt fate.

The interesting thing with Silicon Valley is that, in many ways, the root of this issue is something that is almost 101 stuff. It is interest rate risk in banking operations. It is not trading; it is banking operations. We have, under the Basel structure, what we call a pillar 2 regime, which is interest rate risk in the banking book. We require our banks to hold capital against that risk.

Lord Verjee: That differed in the US?

Andrew Bailey: Yes, for the regionals. The US structure differs a bit between banks, but I think the mid-tier banks in the US do not hold capital against interest rate risk in the banking book.

The other thing I should say is that—I think this is Europe-wide, not just the UK—the accounting regime means that far fewer of the assets are held at historic value. That is important. More of them are mark-to-market and fair value mark-to-market. That reduces the interest rate risk exposure.

If we put those two things together—the accounting treatment and then, after that, the risk testing for interest rate risk—they have put our system in a better place. We get a more robust outcome in that process by the two policy-making areas being separate, but obviously interacting where appropriate. The FPC is very rigorous on that sort of thing.

On Cr dit Suisse—the second part; I will come to the third part in a moment—where Silicon Valley was a very fast-moving failure, Cr dit Suisse was not. Proximally, it was, but it was a firm that we know had had problems for some time. The critical question now with Cr dit Suisse

in the aftermath is about resolution policy. There has been an assertion by Crédit Suisse that the resolution plans that we have developed ever since the financial crisis for these globally systemic banks do not work. I would say two things on that. Obviously we need to test that assertion, because we cannot sweep it under the carpet. I am sceptical myself; I do not think that case has been made, but I am very clear that we have to test the assertion that the bail-in plan structure does not work. That is an important point coming out of the Crédit Suisse case.

The third thing, to your opening question about systemic risk more broadly, is that we spent, rightly, a large amount of the post-financial crisis period focused on the banking system and, while we still have to be focused on the banking system, as recent events have shown us, we are having to spend a lot more time now on the non-banking world. That is right, because one consequence of the financial crisis, and of the regulation of the banking system following the financial crisis, is a shift in the distribution of intermediation from the banking system to the non-banking system. We should not be surprised at that. Indeed, much of it we wanted because we felt there were assets in the banking system that should not be there—in terms of their characteristics, they were not the right assets to be on the other side of the balance sheet from deposits—but we do now have more systemic risk in the non-bank world.

This is exactly to your point. This is both a global and a national point; we have to do both. The non-bank landscape is very big; it is quite dispersed and we have what I call the breadth and the depth problems. The breadth problem is simply that it is as big as it is. The depth problem is illustrated very nicely by the LDI incident—unfortunately that is the only nice thing about it. There were two sorts of LDI funds: what are called segregated funds, and pooled funds. The segregated funds were the big funds. 85% of the LDI world was the segregated world. A big pension fund is segregated and has its own LDI fund sitting off it. Then we have the pooled world for the smaller funds, which was 15% of it. It was the pooled system that essentially was the problem because it is quite a complicated legal entity structure and those funds were not able to call down the liquidity from their many parent funds in the way that the segregated funds were.

The lesson I take from that, unfortunately, is that we have to get the right combination of breadth and depth, otherwise we will be bitten by things. It is obvious that you should look at the 85%, as surely that is the big part of the system, but then it is the 15% that rears its head.

Q170 Lord King of Lothbury: You mentioned resolution schemes and said that we have not tested them fully. From my experience, and from looking from the outside at some recent events, politicians seem unable to resist getting involved in resolution when it occurs. Certainly, the Swiss authorities decided that it was better to impose losses on creditors than on shareholders, which is the reverse of what would normally be the case. I know that that could not happen in the UK—partly because of the actions of the House of Lords when the resolution legislation went

through—but were you at all concerned when the one bidder for SVB UK managed to get a relaxation of its ring-fencing requirements?

Andrew Bailey: The problem we faced was that the sale of SVB UK to a large bank—there were no other bidders, by the way—would have fallen through otherwise. I am a supporter of the ring-fence but on this it posed the challenge that we would have had to split SVB in two, because you could not put the liabilities and assets in the same legal entity and maintain the ring-fence. That was the essence of it. It was not because it was investment banking; start-up corporate banking was their business. That was a challenge.

The resolution would not have happened if we had tried to split it into two. We would have been faced with the choice of other instruments, putting it into the insolvency procedure—I will come back to that in a moment—or a bridge bank, but the liability goes on to the public purse at that point. That was the challenge we faced. I talked to the Chancellor and the Prime Minister about this; that is a situation where I think it is appropriate that we talk frankly and have quite open discussions about what to do. I welcomed their input.

It was a tough decision. I think it was the right thing, but we have to be clear that this is not a coach and horses through ring-fencing. Once you put a small hole in, the thing just gets bigger and bigger—it is really important that that does not happen.

The other challenge, which is something that we are thinking very hard about—interestingly, this is for small banks, not big banks, and we see this in the US as well—is whether we are at a point where it is acceptable to impose losses on uninsured deposits, or whether the concept of money in terms of commercial bank money and bank deposits means that you cannot do that—you can in the investment world, which is not money but you cannot on this. There was an interesting piece in the *Economist* last week on this. We have to get to the bottom of this question because we do not want to end up—Crédit Suisse aside—having tackled “too big to fail” but now having a “too small to fail” issue because of how we manage these resolution tools and whether you can or cannot end up with uninsured depositors taking losses.

Lord King of Lothbury: Are you attracted by a scheme that would limit the size of these very short-run liabilities so that you could provide adequate liquidity to all the depositors?

Andrew Bailey: On your pawnbroker analogy, may I say two things that go in different directions? Forgive me—tell me if I have misinterpreted it. I think the basic ratio is very interesting and a good one to look at. I take it to be the sum of high-quality liquidity plus the haircut—the value of the assets that they position at the central bank minus the haircut. You learn a lot by getting those ratios out. Where I might differ—as I say, please feel free to answer back here—is that I think, however, that it is not really a substitute for capital regulation. The key in there is then the central bank haircut.

Lord King of Lothbury: Let us not go into that. I take it from what you said on resolution—I do not challenge your decision at all—that you seem to have accepted that, in a resolution, politicians will be involved one way or another if they wish to be.

Andrew Bailey: It is not like monetary policy. I do not think we are going to have independence in that sense, because it is obviously a very high-profile decision to take.

People were lobbying me over that weekend. If we had put it into the insolvency procedure, I do not think, by the way, that they would have lost money, but the problem is that the working capital of these businesses would have been tied up for too long. That was the problem, which I totally accept. People were saying in the biotech world, for instance, that, "You really are going to set back curing disease"—no pressure then.

I say this, because we have to take the lessons from this and think about what it tells us about the regime. This is an area where we need to talk to the Government to say, "We have some choices here". The Chancellor and I were talking quite a lot about this. We were both very interested in the subject and want to get a sensible outcome.

The Chair: Thank you. We are running behind time, I am sorry.

Q171 **Lord Turnbull:** You have four blocks of policy: monetary stability, financial stability, prudential stability for banks and insurers, and financial conduct. After 2010, we split them and dealt the cards in a different way. Conduct went into one organisation and the other three have come to you. From your previous answer, I suspect that you are not going to say, "We did it wrong". I think you probably like that and think that, from a banking point of view, it is probably a good idea. From the point of view of the regulated, they are not so happy with it because they now have two people to have to deal with.

There is then a different question. Within the Bank, there are the three committees. You chair them all—this is probably correct—but you go along with three supporting knights. You have four deputy governors and to each one you take the other three; it is not the same three in each one. There is a very solid caucus of the executive. Now, in the face of that—you are working with the other three day in, day out—you then have the externals. They are not full-timers like you. Do they really stand a chance of making their impact when there is such a solid block of externals, more or less the same for each of these committees?

Andrew Bailey: It is part of my job to make sure that they can. I take responsibility to make sure that they can do that. You had Don Kohn appear before you. Don is someone I have absolutely huge respect for; he was on the Financial Policy Committee until not that long ago and we were incredibly lucky to have him on that committee. He made the point—and I was very interested when he said this—that he felt his job was to challenge the executive and to put them back on the right course when they veered off. I can understand Don saying that. I would say,

having been on the FPC for the whole length of time, that he did a lot more than that. He was one of the movers and shakers of the policies we made. I thought he, in classic Don fashion, understated his contribution massively.

That is what the externals do. It is my job, which I take very seriously, to make sure they can do that, that they get all the information they want, that they are briefed when they want to be briefed and that they can come into the room and advance arguments. The funny thing is that the externals of course have more time than I have to do these things because they have narrower responsibilities. My job, as I said earlier, is to see the whole picture, which is important.

By the way, I should say that the legislation that is going through, part of which you have voted on, will create a fourth committee for financial infrastructure, which I will not chair. One of the deputy governors will do that. Three is as many as I think it is sensible for me to do.

Lord Turnbull: We are going to stick with four deputy governors. How far back in history do you have to go to when there was just one?

Andrew Bailey: 1996, I think. Yes, the 1997 reforms.

Lord King of Lothbury: Technically, no.

Andrew Bailey: It was a year later, was it not, technically?

Lord King of Lothbury: In 1998.

Andrew Bailey: That was when Lord King became a deputy governor.

Lord Turnbull: Do you think you have that right?

Andrew Bailey: Lord King will have a view on this. The responsibilities of the Bank in those days were rather different from now. I think it is essential. Each of the deputy governors runs quite a large area of the Bank and that is important. There are of course important parts of the Bank that are not within the statutory policy. We run part of the critical national infrastructure in payments, for instance, and are replacing it at the moment. There are critical areas that are outside this world as well.

The Chair: Can I quickly come back to the FPC? Paul Tucker, when he gave evidence, said that: "For the FPC, the big thing is to introduce voting in some respects", and that the cost of not having votes is that "we can never really see where the debate is, and that hampers accountability". How would you feel about voting?

Andrew Bailey: The difference between the MPC and the FPC at a basic level is that the MPC has one objective; it has a target, a numerical target, and you can vote on it. I always say that the FPC is a bit like one of these old-fashioned signal boxes where you are pulling all sorts of levers in combination, and I do not think that lends itself to a voting model. I know people say that we could vote on the countercyclical

capital buffer. I prefer to say—I think Don Kohn made this point and I will take this point away as well—that the better debate is that we make sure that the minutes or the records of the FPC set out the different views that are taken within the committee on that. I think that is, frankly, a better way of doing it. The FPC works well on its current consensus basis. That would be my view.

Q172 **Lord Rooker:** Governor, do you believe you are a good communicator?

Andrew Bailey: Well, I try hard. It is a great question. I will pose a challenge. I think it is necessary in the world we live in now, particularly with independent responsibilities, for central banks not just to talk to what I might call expert audiences, not just to financial markets, but to talk more broadly, including more directly to the public. We all have to adjust to that—I know that I have to adjust to that. I think that we have had some times in the last few years when we did not get it right. I respect that. It has been very difficult to communicate the effect that these shocks have had on real income. We are in a changing world; we have to adapt and I recognise that.

Lord Rooker: You have said you have been following our evidence closely. We have had more than one witness suggest that central bankers talk too much, which can cause volatility and uncertainty. Is there a case for more constraint while, I am going to say, “being more open”? There is a contradiction there, but it is not quite so because it depends on which audience you are talking to.

Andrew Bailey: It is a point of subtlety. I have followed the hearings closely and one witness said that we talk more than other central banks. I must say that, when I read that, I thought, “Really? I am not sure”, so I looked up the comparison of the MPC with the Fed board and the ECB governing council. Those are much bigger committees and I therefore did not include the regional Fed members or the national central bank governors because I know we talk a lot less on that basis. Interestingly however, if you just look at our MPC, the board of governors and the governing council of the ECB over the last year, we made slightly fewer speeches than the Fed and a lot fewer than the ECB, which made almost twice as many as the other two.

On monetary policy, I do not think it is a good thing and I do not like it if people “advertise” their votes in advance of the meeting because—to go back to where we started this session—it destroys deliberation. It is our job, however, to explain our votes and explain our decisions after they have been made. That is the underlying philosophy that I hold to.

Lord Rooker: I have three brief questions. Have you, either in preparing to meet us today or during the session, felt any constraint in anything that you have said in answer to the questions?

Andrew Bailey: I am sure there will be people who will pick up things I have said and interpret them. We have to be very careful how we express

things because communication is very important, quite powerful and quite subtle, but I also think it is important we say what we think.

Lord Rooker: A central banker can say, “We got this wrong”, explain why, and still maintain credibility as a central banker. Is that a fair way of putting it?

Andrew Bailey: We have to be open to the lessons learned. If we are not, then frankly we are just not going to make good policy, in my view. Unless we are prepared to learn lessons from experience we are not going to make good policy, all across the board.

Lord Rooker: Finally, I understand your term is eight years. Would it make any material difference to the way you operate if it was four years and renewable?

Andrew Bailey: Luckily, I do not have to think about that and I honestly do not spend time thinking about that. I have enough to think about without having that thought.

The Chair: On the judgment point, when you look back over the last few years, would you identify moments where you would say, “We got X judgment wrong and we are learning the lessons on that”? Maybe you would like to fill in what the X is.

Andrew Bailey: I think we have, particularly in 2021, and a number of witnesses here have made the point. I said to the Treasury Select Committee that we have to look and learn lessons. We have to work out what the lessons are and they have to be based on the decisions we took, based on the evidence and the best judgment we had at the time.

I have to be very robust on this because, to Lord Rooker’s point, I am sure if I say, “We didn’t get this right”, there would be lurid headlines, but the point is that we have to learn lessons. We have to be robust enough. I take your point, but we must learn lessons from the experiences we have, of course we must.

The Chair: We have two sets of questions left, one on the Court from Lord King and another one on CBDCs from me.

Q173 **Lord King of Lothbury:** There is one part of the Bank that most people think has never changed since 1694, but you have seen over many years that it has changed a lot, and that is the Court of the Bank.

Andrew Bailey: Yes.

Lord King of Lothbury: Have you had any discussions with the Treasury about further changes or reforms?

Andrew Bailey: It is interesting. The Court has, I think, been changed three times since the legislation in 1997-98. It became a unitary board in 2016. It was changed in 2009-10, was it not, in your time? Ironically, the Court has probably changed more often than anything else in the Bank.

In my experience, the Court has evolved a lot over time. It is now the governing body of the institution. It is, as near we can get it, a corporate board in terms of many of the things it does, if you look at the finances of the Bank, the budget of the Bank, the risks, the people. I value that. I value the fact that we have a governing body that spends its time on that because it is an enormous help to me, frankly. We look to have people on Court who can add value in those areas. For me, the Court has evolved a lot, which is very helpful.

Lord King of Lothbury: When you change the balance sheet of the Bank to deal with a financial problem, do you have to go to the Court to get its agreement?

Andrew Bailey: Yes, if we are making any major change to the balance sheet. That comes about because the Court has a responsibility for risks to the balance sheet. It can decide whether it accepts, or not, the risks to the balance sheet that are involved in any decisions we take.

Q174 **The Chair:** The final question is from me, on CBDCs. I know full well that the decision has not been taken. In fact, we are soon going to be debating this in the Financial Services and Markets Bill. I know where the Bank is on this. I know that you are doing a lot of consultation on it, put it like that, and that is very welcome.

One of the questions I have is, were there to be a CBDC, what impact do you think that would have on operational independence and your framework for operations?

I was very interested in Andrew Hauser's speech on this. I will quickly read the point. He said that they "could have important implications for the size, composition and risk profile of our balance sheets; for the monetary policy transmission mechanism, and for monetary control". To that one could add, obviously, issues such as privacy, cybersecurity—the whole nine yards. I am very interested to know how you, when you are looking ahead at this—

Andrew Bailey: I start in a slightly different place but it is important to answering your question. I think the first question that we need to answer collectively is: will there be a business need and case for digital money, whether it is for the central bank or not, by which I mean retail, programmable money in the sense that you can take a unit of money and attach programmable instructions to it, on some basis that we do not have today? I do not know the answer to that question, but we need to avoid failure of imagination. My guess is, "Probably yes". Indeed, I think in many ways that was what Facebook was trying to do a few years ago.

Now, if you do answer the question or you think you might answer the question, then I think you have three choices and you can pick permutations of them. You can do it through commercial bank money by creating what are sometimes called "tokenised deposits", which are programmable deposits. You can do it through non-banks, through so-called "stable coins". At the moment some of the examples we have around are neither stable nor coins, but this legislation will create the

regulatory structure in the UK for non-bank stable coins. A third choice is central bank digital currency. I think we need to look at all three.

If you do not mind me saying so, I think that the commercial banks—I have this discussion regularly—need to decide whether there is a case for commercial bank digital money. If we say that the case is positive for digital money, I do not think that the outcome we should look for is that the central banks become the only game in town.

It is important that we are doing the work we are doing, because there may be a case for having a combination of things; there may be a case for having—to use the economics term—both inside and outside money in that world, although I think that is an argument still to be proven. I am very focused on the fact that if we only have central bank digital currency, there are very big questions about its impact on credit creation in the economy and there are very big questions about how it would behave under stress, because it is about access to central bank money.

However, we have to step back first and ask, “Is it right to plan for a world in which there is digital money? In which case, what does that imply?” Central bank money is such an important part, as Lord Griffiths was saying, that we need to be knowledgeable in this area. I am very supportive of the work we are doing but, for me, the jury is out. The banks need to consider this as well, from the point of view of commercial bank money, because that would of course help to preserve, broadly, the monetary system we have today.

The Chair: I hear that. It sounds like it is quite a cold shower for the digital pound; you say that the jury is out in your mind, which is quite interesting. In terms of the operational framework for independence at the Bank, if you go down the digital pound route, as Andrew Hauser spelt out and as our report spells out, it raises a lot of issues. How do you see this impacting?

Andrew Bailey: First of all, thank you for quoting Andrew Hauser’s speech because he is an incredibly thoughtful person on these subjects and on the Bank’s balance sheets. I am very lucky to have him as a colleague. He is right, of course, that in an extreme world, we could end up in a very different world where the central banks’ balance sheet is a very much larger proportion of the monetary system than it is today.

I do not think that is the world we should aim to end up in because it brings all sorts of issues with it, but it depends, if there is a future in digital currency, on what sort of combination of innovations we have. Thank you for asking the question; I would be keen to ask whether we can try to position the debate in that way?

The Chair: Very interesting, thank you very much. I do not know if colleagues have any other questions. We are almost exactly on time, which is fantastic. Thank you very much, Mr Bailey, for answering all of our questions. It was very kind of you to come in.

Andrew Bailey: Thank you.