

Treasury Committee

Oral evidence: Inflation, HC 1667

Wednesday 5 July 2023

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Members present: Harriett Baldwin (Chair); Mr John Baron; Sir James Duddridge; Danny Kruger; Dame Andrea Leadsom; Anne Marie Morris.

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Witnesses

I: Professor Sir Charles Bean, Professor of Economics, London School of Economics, and former member of the Monetary Policy Committee and the OBR Budget Responsibility Committee; Nina Skero, Chief Executive, Centre for Economics and Business Research; Stephen King, Senior Economic Adviser, HSBC, and author of *We Need to Talk About Inflation*; Dr Sushil Wadhvani CBE, Chief Investment Officer, PGIM Wadhvani, and former member of the Monetary Policy Committee.

Examination of witnesses

Witnesses: Professor Sir Charles Bean, Nina Skero, Stephen King and Dr Sushil Wadhvani.

Q1 Chair: Welcome to the Treasury Select Committee evidence session on the inflation models and the Bank of England. I would like to start by inviting our witnesses to introduce themselves.

Professor Bean: I am Charlie Bean, these days professor of economics at the London School of Economics.

Nina Skero: I am Nina Skero. I am the chief executive at CEBR, the Centre for Economics and Business Research.

Dr Wadhvani: I am Sushil Wadhvani. I have to say that I am here only in a personal capacity. Anything I say does not represent my employer—I am chief investment officer at PGIM Wadhvani—and neither does it represent the views of the Chancellor or the Treasury, because I am a member of the Economic Advisory Council.

Chair: Just remind us of your personal capacity—why we have invited you here. Give us a bit of your illustrious CV, please.

Dr Wadhvani: I am an ex-MPC member.



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Stephen King: I am Stephen King, senior economic adviser at HSBC, a columnist for the *Evening Standard* every so often and an author—but not that author.

Q2 **Chair:** Thank you very much, Stephen. I have actually read your most recent book on the lessons about inflation. Ah, Professor Bean has one there.

We have had the Governor of the Bank of England and some of the current MPC members in quite recently, along with the chief economist, Huw Pill. They have acknowledged that there are issues with the inflation modelling that they have been doing through this period of heightened inflation. I am going to start with a very general, open-ended question for the panel. Are you in agreement that something has gone wrong with the Bank of England's modelling? If so, what?

Stephen King: The answer is yes, in the sense that the Bank of England, in my view, for too long tried to argue that the inflation was transitory, temporary and would disappear in relatively short order. We discovered that there are significant second-round effects that the Bank itself I think had chosen not to acknowledge quite early on. However, modelling is only one part of this story. Models themselves are a description of reality that is no more than a description and by no means a perfect description. As an economist, you have to be aware of where the model's weaknesses lie and where it might go wrong.

What is interesting about Huw Pill's letter, which I have read, is that he says that they estimate the model over the last 30 years or so, since the inflation target first came through. That is all very well, but if you know that the model is estimated over that period, you are almost certainly prevented, when you are using that model, from thinking about alternative scenarios that would not be reflected over that period of time. You might argue, perhaps, that you should look at the data from the 1970s and 1980s. The problem with that is that time moves on. The structure of the economy now is different from how it was back then.

It is important that rather than saying, "The model told us this and that is what we chose to believe," the model gives you a guideline but then afterwards you should say, "Given that guideline, how much of this do we trust? How much do we think we should overwrite and what are the pieces of evidence coming through that might suggest that the model is not as reliable as it might once have been?"

In thinking about the last two or three years, if you go back to 2021 in particular, there were a number of people at that stage, quite early in 2021, who were warning about the possibility of higher inflation coming through on both sides of the Atlantic. You had Larry Summers and Jason Furman in the US and Andy Haldane in his valedictory speech at the Bank of England, who warned about higher inflation. You had Roger Bootle, Martin Wolf and me. There were a number of people who were warning about the possibility.

Chair: This Committee.



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Stephen King: This Committee, indeed. There were a number of people who were warning about the possibility, but at the time it was not properly recognised. Why? Partly because the model itself suggested that what was going up currently would go down, which was a property of what we had experienced over the previous 20 or 30 years, but also because, at the beginning of 2021, I and others saw the first signs of inflation surprising on the upside against a background of seriously weak economic activity. Normally, when you have seriously weak economic activity you expect inflation to surprise on the downside. The fact that it was surprising on the upside, not just in the UK but in the US and the eurozone, suggested that something was changing relative to the history of the previous 30 years.

The second thing I would note is that, if you move away from the model and think about some of the monetary indicators that were coming through at the time—particularly in the US, less so in the eurozone and the UK—there was incredibly powerful money supply growth in 2020. You might say that the relationship between money and the economy is not as strong as it once was. I absolutely agree with that, but when you have that kind of strength coming through, which was really off the scale of what we had seen previously, that strikes me as being a red flag. It is an indicator that perhaps the model, as it was, was not working as reliably as the Bank had suggested.

Q3 **Chair:** Dr Wadhvani, do you also accept that something has gone wrong with the Bank of England's models? If so, what?

Dr Wadhvani: I should say up front that forecasting is always incredibly difficult. We have highly capable people at the Bank. Whenever you are forecasting, you make judgments. Sometimes your judgments work out and sometimes they do not. It is very important that we do not all gang up against them, because you would then deter good people from agreeing to do public service in the future. Having said that, I have believed over this period that perhaps they might have made different judgments.

For example, certainly when I was on the committee, we often cross-checked the results of the model with other things. As has already been said by Stephen, the most obvious cross-check in the last quarter of 2020 was what was happening to the money supply. You had two things in November 2020. One is that money supply growth was high. Secondly, you had these very successful vaccine trials. The one thing you knew was that, if the vaccine worked, lockdowns would end, velocity would normalise and therefore the forecasts the Bank was then producing were not consistent with the money supply growth.

Since we are all in a mood of claiming we saw it all coming, in November 2020 I certainly had a debate with an MPC member where I pointed out this absence of a cross-check. That would be but one example. The other that has also been mentioned is that there was a significant amount of survey evidence that inflation expectations were becoming dislodged.



Q4 **Chair:** What is your source for that survey evidence and when was the survey done?

Dr Wadhvani: For example, there was the Bank's own Decision Maker Panel survey.

Chair: Do you know the date of that?

Dr Wadhvani: I can write to you with the detail, but that would just be one example. I was looking at this evidence internationally. For example, in the US, if you looked at the NFIB survey, by early 2021 it was saying that firms perceived as much pricing power as they had done in the late 1970s. That was truly scary. The reason I look at international evidence is that a lot of these firms are multinational. Therefore, whatever they are seeing in the US they are likely going to see here, even if we do not have the same exact data.

Even if the survey evidence was not robust and could not be believed, it was a very reasonable hypothesis to be looking at. Given the possibility that expectations were becoming de-anchored, it was therefore very important to look at the behaviour of wage and price equations over the 1970s and 1980s. The one thing you knew is that your results from a model over the last 30 years would significantly underestimate inflationary pressure if expectations had become de-anchored.

As Huw says in his excellent letter, there was a very good chance that the estimates from the 1970s and 1980s would overestimate inflationary pressure. You could then do what people like us did in our day job. We produced both sorts of forecast, admittedly for different purposes, and we averaged them. We took a weighted average of the two and argued that a weighted average of those two forecasts would be a better guide than relying on one of them on its own.

Q5 **Chair:** Thank you. That is a great introduction to some of the issues. Ms Skero, I will ask you the same question.

Nina Skero: It is hard at this point to argue that something has not gone wrong, because we are not in a particularly good spot in terms of where inflation is at and the immediate inflationary outlook. There is some room for leniency in terms of what was happening in early to mid-2020. The Bank of England, like a lot of us in the private sector, was looking at a number of indicators and using our modelling framework and best judgment. Things could have gone any number of ways and a lot of the big calls did not go in the direction that the Bank of England thought that they would.

There is also some room for criticism because, following that initial period of a few months, quite a lot of evidence started emerging to suggest that some of the judgments that the Bank of England was making were not really going that way. There was almost a pretty strong consensus building outside of the Bank on things such as the persistence of inflation and the tightness of the labour market. There was quite a lot of reluctance to consider some of those views and perhaps allow for the



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option that some of those calls made earlier in 2020 were, in fact, not correct. There is a balanced view for 2020, but after that there was a lot of opportunity to take emerging evidence into consideration, as I said, on things such as the tightness of the labour market, the impact of the furlough scheme and so on.

Q6 Chair: Professor Bean, do you accept that something has gone wrong with the Bank of England's inflation forecasting models? If so, what?

Professor Bean: I certainly think that it should spend some effort in understanding where the forecasts have gone wrong and how it might have done things better. I would emphasise that this is not just about a model. It is about process and the way the forecast is used by the committee. As others have already intimated, the forecast is not just looking at one model; it is looking at information from a range of sources, possibly forecasts from a range of competing models—things like that.

It is particularly important, in the sorts of circumstances that we have been through in the past few years, to be doing that. We have had the pandemic, which was a once-in-a-century event. We now have a very large external terms of trade shock as a result of the war in Ukraine, larger even than we had back in the 1970s, which was when I started my forecasting career at the Treasury. It was highly likely that models calibrated on the relatively tranquil period since the inception of inflation targeting were not going to speak to the impact of those shocks. Looking at alternative indicators, alternative models and research work that was done back in the 1970s and 1980s was potentially important.

There is some suggestion from Huw Pill's letter to you and speeches by him and Ben Broadbent that at least there was some awareness of this within the Bank. They made a mistake by overly concentrating on the central view at this juncture. Obviously the forecasts have uncertainty bands around them, the fan charts and so forth, but the fan charts are actually not very good at telling stories. Forecasts are quantitative narratives. That is what they are.

When there was uncertainty about the speed of the transmission mechanism from changed interest rates to the impact on demand, the impact of the external terms of trade shock on pay bargaining, which was very important back in the 1970s and 1980s, and the impact of the very tight labour market that we have, it seems to me that it was crying out for the explicit consideration of what the world might look like under alternative views—so, scenarios. I have to say, given the time I spent at the OBR, where we regularly would complement fan charts with scenarios, that I think that would have added to the value of the Bank's narrative.

Q7 Chair: Can I probe the point that Huw Pill makes in his letter to the Committee about the 1970s and 1980s? It strikes us, as laypeople, that there is a recency bias if you just focus on the last 30 years. You are saying, "It has been under control for 30 years. We have been independent. Therefore the logic is that it will remain that way." To us, as



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laypeople, looking back at when there was the last energy shock, it was the 1970s. It seems pretty obvious to us laypeople that you would want to inform your work with that.

I am not clear about Huw Pill's letter—and I would be interested in your interpretation—when he says that they have looked at the 1970s and 1980s. Is that more recently, or would that have been a contemporaneous process that they were doing? It is not clear in the letter.

Dr Wadhvani: I think that I can help you with that. I have very good reasons to believe that in the forecast process in November 2022—as late as November 2022—they still were not looking at the 1970s and 1980s. They were arguing even then that it would be highly misleading to do so. If they have started looking at the 1970s and 1980s in a formal way for the forecast process, it is only after November 2022.

Q8 Chair: It was ambiguous in that letter. We shall obviously ask them ourselves. I thought that that was something you might know about.

There are a range of different mistakes that can happen in forecasting processes. One is a recency bias: that you particularly focus on a more recent period rather than periods that are perhaps more similar to the one you are going through. There is often a bias where there is groupthink where everyone comes perhaps with lack of diversity in terms of their training, their background and their way of looking at the world. It can be difficult, particularly in a committee process like this, to take a dissenting point of view. It can be very difficult for a committee to accept that it has been wrong. Do you think that we have now got to the point where the good news is that they at least recognise that they have been wrong?

Professor Bean: I certainly think that it is true that they recognise it, because they have commissioned an internal review. Actually, the review is not necessarily internal, but it is by their Independent Evaluation Office. That is certainly a valuable step.

You are obviously thinking about groupthink in terms of the MPC. There was a problem of groupthink across the central banking fraternity leading into this episode. The Fed, the ECB, the Bank of England and other central banks, for the past decade or so, have all been focused on how we inject sufficient demand into the economy to get inflation up to meet our targets. You had all these discussions about negative interest rates and other ways of injecting more demand.

Connected with that was the idea of trying to signal that interest rates would stay low for long, and thereby put down the pressure on longer-term interest rates, which is also what QE does. You had all central banks in that mind frame. They were all too slow to pivot to the dangers of a significant increase in inflation and the need to withdraw some of the, in my view, excessive monetary stimulus injected during the pandemic.

Q9 Chair: Do you agree, Professor Bean, that if the Bank of England had been effectively trying to prevent deflation and in fact trying to create



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inflationary pressures, there were not many things that it did not do that would have created inflation?

Professor Bean: It was certainly slow to wake up to the need to be withdrawing stimulus.

Q10 **Chair:** And the steps that it was taking were designed to prevent deflation and actually create inflationary pressure.

Professor Bean: If anything, yes. Personally, I do not think that the quantitative easing that it undertook during the latter half of the pandemic added a lot to inflationary pressures. That is something we can maybe discuss later. Quantitative easing at the early stage of the pandemic, through spring 2020, was entirely warranted by the turmoil in financial markets. Central banks around the world dealt with that very well. My criticism would be that they stuck with it for longer than was appropriate.

If you think about what a pandemic does, it screws down on both demand and supply. It is not obvious that demand is lowered more than supply, so the case for stimulating the economy during that period was weak. It had interest rates at a very low setting. As we went through 2021, it was clear that the economy was rebounding, particularly after the furlough scheme closed, when we basically discovered that 500,000 people had left the labour force and therefore the labour market was much tighter than we expected. At that point, they should have been moving a little bit more swiftly to be changing the stance of policy.

Q11 **Danny Kruger:** That was very interesting. Professor, I would be interested to continue with you on this point about the groupthink tendency. I want to ask you about the human and institutional dynamics at work here and how you think we could improve matters in future. I note what you say about a global consensus among the central banks all leaning the same way. We had it here in London too. The different institutions, from the Government to the Bank, and the commentariat all, naturally enough, align around probably the more risk-averse forecasts and propositions, because they are all friends and colleagues. They interchange roles. One minute you are on the MPC and the next minute you are in a university.

I am not knocking that. That is the way it works and there is great value in having relationships and a common language. You have recognised that there was too much of a consensus and a groupthink. Do you have advice for how we might overcome this problem in the future? You mentioned process. We can discuss the sources of data and so on. Are there things that we can introduce institutionally to invite more diversity of view and enable people to make forecasts where, even if they turn out to be wrong, there is no harm to them? That is what we need.

Professor Bean: The MPC has generally been set up quite well to avoid groupthink compared with some other central banks. Right from the get-go of the MPC, the nine members of the committee were clearly



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individually accountable. My experience on the committee—that was 14 years—was that individual members were very conscious of that.

You should not get the idea that the five internal members all stuck together or anything like that. There are all sorts of split votes. They had the Governor on the losing end of votes from time to time. Even recently, you have had members of the committee voting for no change, a small increase and a big increase, so three-way splits. That sort of diversity is actually quite rare on other committees.

One thing that Ben Bernanke particularly wanted to do when he took over as chair of the Fed from Alan Greenspan was to try to allow for more diversity of opinion to be expressed. He was partly prompted by seeing the way it worked here. Individual MPC members are certainly free to give speeches explaining their own views. The one common thing that is understood is that you should not go out and be rude about your colleagues' views, but you should explain the central view and why you take a different view. A good chair of the committee encourages that. The Governor can do something to foster diversity of debate. As I say, the set-up, in an institutional sense, is actually quite good.

Then there is the separate question of who you get to man or woman the committee. There, you want to make sure that you do not have nine clones and that you have a diversity of backgrounds and skillsets. The skillsets have to be appropriate.

Q12 **Danny Kruger:** Understood. That is partly our job as well, of course. Dr Wadhvani, what is your perspective from when you were on the inside? Do you think that there is enough opportunity for diversity?

Dr Wadhvani: I completely agree with Charlie in the sense that I always felt completely free to express my views, which did not always coincide with the majority view. In fact, when I travelled to visit other central banks, be they in Australia or the eurozone, I was often told that they marvelled at how much independence I had in terms of my ability to express my individual view. It is very important not to lose sight of the fact that, actually, our institutional structure is quite good. Despite that, we had an outcome that we do not like this time.

Q13 **Danny Kruger:** That is the point, isn't it? It is good to know that there is the opportunity for diversity, but if we are not getting an outcome of accuracy, in a sense it does not add the value.

Dr Wadhvani: Anything I offer you would only deepen the puzzle. I noted your remark at the beginning of your question that, because there is this revolving door, everyone thinks the same. The striking thing about this episode to me was how many ex-MPC members were actually worried about inflation and said so.

Q14 **Danny Kruger:** Yes, it was the current members that—

Dr Wadhvani: Yes. And I have not seen that kind of divergence—

Q15 **Danny Kruger:** Is that the implication of what Professor Bean was



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saying: that it is the chairmanship of the committee?

Dr Wadhvani: I don't want to alight on the first simple—

Danny Kruger: You are sticking to the old rule of not criticising. I hear that.

Dr Wadhvani: I don't want to alight on the first simple hypothesis, because this needs further research and thought by people such as yourselves. It puzzled me over these last two or three years how many ex-MPC members came out in public and worried aloud about the inflationary risks, but somehow the Bank did not pay enough attention, perhaps because it thought that we were all old-fashioned and did economics in a primitive way. I have no idea. That is a possible hypothesis.

Danny Kruger: It is often the way, yes. Advice from the old generals is not always welcome.

Stephen King: If you look at the level of dissent on the MPC, it was certainly very high during Charlie's time and Sushil's time. The numbers show very clearly that it drops off from around 2013 or 2014 onwards.

One possibility is that forward guidance played a role, in the sense that forward guidance was designed to illustrate to the public that the central bank had a perfect crystal ball and could see into the future and say, "This is exactly how policy should be. We are going to persuade you. We are going to stick to this particular commitment over a period of time." If you want to stick to that commitment to make it completely credible, it helps if you have a committee that is effectively taking collective Cabinet responsibility. It may be that the level of dissent fell away at that particular point in time.

The second thing I would note is that, when it comes to the forecasting consensus, regardless of whether it is the MPC or any kind of forecasting consensus, one thing I have noticed in my career is that, when you have periods of maximum uncertainty, the consensus often narrows to a very small range. Although the uncertainty is massive, it is safer to be part of the herd. Therefore, you are penalised by being away from the herd, because you might be fantastically right but, equally, you may be fantastically wrong during a period of maximum uncertainty. It may also be that, in 2020 and 2021, the easy thing to do was to go with the herd on the committee without actually pushing for the possibility of something that seemed quite different.

Q16 **Danny Kruger:** I am afraid that that seems to be the inescapable conclusion. Can I ask a more general question about how we got here? We have had inflation for 20 years. It just has not always shown up in the official figures because it has been in assets and house prices in particular. Surely the inescapable conclusion is that this is because the low interest rates and the availability of credit ended up in people borrowing and the money ending up in these assets, particularly since 2008.



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In a sense, it seems extraordinary that we did not predict inflation, given that it would inevitably feed through into more retail goods. Do you accept that straightforward explanation for why we are in the trouble we are in? We have obviously had the shocks in the last couple of years that have precipitated the problem, but underlying it has just been the fact that money has been very cheap for a long time and very available.

Nina Skero: You could make that case. The question would then be at what point in time you would have this problematic period where you see unsustainably high levels of inflation. You could argue that, in the absence of the external shocks, you could have had years and years more without anything significant happening. Perhaps it can seem obvious, but getting the timing right would still have been challenging. That is also not the situation, I suppose, that we ended up in. We ended up in a situation with a number of external shocks. The problem is more misjudgment of how those shocks were going to resonate throughout the economy.

Professor Bean: Can I come in on your story? You sort of have the causality the wrong way, at least as far as the conventional wisdom would run. Over the past 25 years, or something like that, there has been a drift down in the equilibrium underlying interest rate in the world economy and in our economies, driven, essentially, by relatively slow-moving forces: demographics, the ageing of the population, the bulge of saving for retirement, slowdown in growth, which has reduced demand for investment goods, and so forth.

That shift in the savings-investment balance has meant that, for central banks to keep economies operating at potential, they progressively had to have interest rates at a lower and lower level until they eventually hit the lower bound. A natural consequence of having lower interest rates to discount future cash flows is that asset prices rise. The fundamental driver here is not monetary policy. Monetary policy is merely reflecting these underlying real forces. That is the conventional narrative. I happen to have some quibbles with the narrative, which I will not dig into, but certainly if you ask most economists around the world who look at these things, that would be the story.

Q17 **Danny Kruger:** There is a reason why rates have been so low. It is those essential weaknesses that we have, but, fundamentally, I know no one likes calling it printing money in your business, but that is what we have been doing. The result, of course, is that the money has to go somewhere and it ends up where we are now. We have had a fundamentally unsatisfactory monetary policy for the whole of this century, even though we have these causes that you are correct to identify.

Stephen King: There is a peculiarity about the inflation target. There is little discussion currently of whether the inflation target should be raised or whether it is okay to overshoot the target. During the period of the great moderation, when you had these tremendous disinflationary forces coming through from elsewhere in the world, it would have been legitimate, perhaps, in hindsight, to say, "Should central banks have



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deliberately undershot their targets because there are these good deflationary forces coming through from elsewhere in the world?"

Had they done that, nominal rates would have been higher than they actually were, because you would not be trying to force inflation domestically back up again. If nominal rates had been higher, the asset price effects would not have been as big as they proved to be. It is possible to argue that the great moderation led to this period of attempts to steer inflation domestically higher to offset the deflation coming from elsewhere, which then contributed to the asset price bubble that you describe.

However, the difference between that period and what we have talked about over the course of the last two or three years is that that period was not associated with the kind of rapid money supply growth that we have seen more recently. That is a distinguishing feature between where we are now and where we were during that earlier period of bubbles.

Q18 Dame Andrea Leadsom: Good afternoon, everyone. I would like to turn to the situation in the UK specifically. Does the UK have a particular problem with inflation compared with other major advanced economies? If so, what factors are driving that?

Nina Skero: It is not in a unique situation, but there are some factors in the UK that have exacerbated the situation. The tightness of the labour market plays a particularly important role and there have been some unique dynamics in the UK labour market around Brexit. That was exacerbated during covid.

The UK did not see the massive shock in the labour market that some were predicting immediately after Brexit. There were not that many people leaving in any particular industry, as some were forecasting. When covid came about, a lot of workers who were foreign-born went back to their countries of origin and then did not come back. Part of that could be that their personal circumstances changed. Part of that could be the administrative burden at that point of coming back. Because it happened in such a one-off and short timespan, it was not nearly enough time for these other dynamics to change in terms of changing the labour force that is currently in the country.

That is a little bit of a UK-specific situation, partially because of the relatively high share of foreign-born workers in the UK. There is something there that is a UK-specific problem, but the price of energy and the supply chain issues were global shocks. That is why a lot of countries in Europe in particular are seeing rates of inflation that are not that dissimilar.

Q19 Dame Andrea Leadsom: Dr Wadhvani, do you agree that it is the tightness of the UK labour market that makes inflation a particularly sticky problem in the UK?

Dr Wadhvani: Yes. It seems to me that the labour market has played a meaningful role. I agree with you that there is a UK-specific issue here. If



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you go back to the first half of 2022, wage growth in the US was about 5.75%. Depending on which measure you look at, it is now between 4% and 5% in the US. They have different measures of wage growth. Here, of course, we have continued to go higher, not lower, so there has been this striking divergence in terms of wage behaviour between the two economies that is not easily explicable.

A part of it clearly is what happened to our labour supply. It shrunk here because of early retirement and long-term sickness. There is also the Brexit impact, potentially. The US also has not seen incredibly healthy supply growth. If you carry out a back-of-the-envelope calculation, the difference in labour supply between the US and the UK cannot fully explain the difference in wage behaviour. There is something else going on. We do not quite know what is going on.

I will offer a conjecture, knowing that I cannot prove it, if I am allowed to do that. A possible conjecture is that, sadly, while the Bank of England was hiking, each time it hiked it sounded doveish about the destination. The clearest example would be last year. In successive meetings after hiking, they implied that the peak was near, even though none of us knew where the peak was. By contrast, in the US, every time they hiked last year they said that they would keep going and do whatever it takes.

The difference is in terms of the impact it has on the expectations of firms. In the US, I think that firms read that as a reason to be scared. That stiffened their resolve in terms of resisting wage increases. It also made them less likely to dare to push through price increases. Here, if you hike rates and then tell people you are close to the peak, it has a fundamental impact on expectations.

Q20 Dame Andrea Leadsom: That is interesting. Clearly, in the UK we have seen quite significant wage rises. I would like to have your view on whether that is making inflation sticky. By definition, that wage-price spiral, a historic thing that we thought died in the 1970s, looks as if it is back again, yet you are saying that the doveish talk from the MPC encouraged employers to raise wages further. That seems slightly counterintuitive.

Dr Wadhvani: In the US, the message was much clearer. It said, "We will do whatever it takes to bring inflation down." Therefore, if you look at survey evidence in the US, firms got quite worried about the future, because they did not quite know how high rates would have to go to deal with inflation.

Q21 Dame Andrea Leadsom: They felt that they could not afford the higher wages, even if inflation was going to go higher.

Dr Wadhvani: That is right. I want to emphasise that I have no scientific evidence for this. This is just a gut feeling and therefore it is easily dismissed.

Q22 Dame Andrea Leadsom: It is very interesting to hear. Professor Bean, would you say that there is evidence that the shortfall in the labour



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market in the UK is working itself out? Do you think that wage rises are gradually slowing or do we have a sticky problem that we are going to struggle to deal with?

Professor Bean: We have a way to go yet. The crucial issue will be the next pay round, of course. It is too early to know how that will play out, but of course that is how a wage-price spiral operates. We have an external shock, the rise in energy prices associated with Ukraine, driving up prices pretty directly. Workers then, quite reasonably, are trying to get some compensation for that to protect their living standards. They benefit when they get that, but of course their wage rise is just an increase in input costs for whoever employs them and leads to higher prices. Then the process continues.

It is not necessarily an explosive process, but it may take quite a long time to die away. From a monetary policy perspective, the way of trying to get that process to die away faster involves creating more slack. A wage-price spiral will be stronger when markets are tight—and when product markets are tight as well; it should not focus just on the labour market. One thing that marks us out as being different from continental Europe is that our labour market is tighter, partly reflecting this 500,000 people leaving the labour force.

Q23 **Dame Andrea Leadsom:** Is that the 500,000 due to long-term sickness?

Professor Bean: Yes, and early retirements and so forth. In fairness, the Government are trying to put in place policies to reverse that, improving childcare and trying to deal with long-term sickness, but it will take time. In the absence of being able to magic up more supply, you have to rein back on demand, which is why the Bank is raising interest rates.

In terms of the comparison with other countries, which you have been talking about, I would describe it as follows. On the surface, it might look like we all have an inflation problem, but the underlying factors are a bit different. In the US, the story is much more like a conventional, cyclical overheating story, with over-expansionary monetary and fiscal policy. The energy shock there was much smaller, with about a 30% increase in energy prices.

In Europe—ourselves and continental Europe—you have a much bigger energy shock, with prices roughly doubling. Ours is actually a bit bigger: it is about 80% in the euro area and about 110% here. Also our energy shock itself is a little bit more persistent because of the way the Ofgem price cap works. There is a little bit about the shock itself being bigger here. More particularly, in continental Europe you have more slack, so the second-round wage-price dynamics are weaker than they are in this country. We have the worst of both worlds.

Q24 **Dame Andrea Leadsom:** It certainly seems that way. Mr King, we now have core inflation in the UK rising to 7.1% and services at 7.4%. Do you think that we have moved beyond inflation being a global shock issue to



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its being more a UK domestic issue?

Stephen King: Partly, yes. Going back to Sushil's comments about monetary policy and the signalling last year that interest rates each time had possibly peaked, I could use the analogy of a football match with a referee. If a referee says, "I am going to issue one red card in this match and no more," after the red card is issued everyone's behaviour is likely to deteriorate. You need to offer more of those to be credible. Because the Bank focused on the idea of inflation being entirely transitory, it gave the impression each time that rates would go up but would not rise further.

When it comes to the appropriate level of interest rates, there has not been much discussion about the level, as opposed to the rate of change. It is certainly true that the Bank, alongside other central banks, has raised rates a long way compared with previous history, but you are starting from what was effectively a deflationary world. In a deflationary world, of course, interest rates were at rock bottom, because you were trying to deal with a deflation problem.

If you were to think about where interest rates—base rates—are in the UK today compared with the actual level of inflation, you would conclude that real rates, measured on that basis, are still quite low. There is an issue there about how far rates might eventually have to rise. The signalling from the Bank there has not been necessarily that great.

Q25 **Dame Andrea Leadsom:** Do you think that it is still a problem that the Bank is still not setting the right tone?

Stephen King: To be fair, the tone has changed over the last few weeks, because going to a half-point rate increase rather than quarter-point is a clear change of view. It is also fair to say that, having admitted that the modelling and the forecasting had not worked quite so well, there is now a more robust response than there had been. It is still the case that one might ask the question, "If you think you need a more robust response, where do you think interest rates might eventually have to go to?"

Q26 **Dame Andrea Leadsom:** This is a very specific question. Is there some merit in risking overshooting and, in effect, creating a further problem with a recession by raising interest rates too high in order to stamp on inflation, or would that be a very rash direction of travel?

Stephen King: This is a very tricky issue, to be fair. No one wants to cause a recession if they can possibly avoid it. However, sometimes there is a tricky timing choice. It is very easy in the short run to say, "We are not going to have a recession under any circumstances. It is too painful." In the process of not having the recession, in those circumstances, you may allow the inflation to become more embedded. What starts off being regarded as a transitory problem then begins to build over time.

In the story of the 1970s, there is no doubt, particularly talking to UK policymakers who were around in the 1970s, that the view initially was that the inflation was transitory and caused by energy price effects and



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so on. There was a tolerance of inflation and an attempt to deal with it through incomes policies, prices policies and those sorts of things, none of which really worked terribly successfully. It really was not until the late 1970s that there was an admission that you had to work hard on monetary policy to deal with the inflation problem.

I would also note that this is not a political point. The first people to use monetary policy targets in the UK were Callaghan and Healey, so it predates Thatcher.

Dame Andrea Leadsom: Now you are making a political point.

Stephen King: No, not at all.

Dame Andrea Leadsom: The rest of us were all thinking, "Good old Conservatives", but that's fine.

Stephen King: That's your political point.

Q27 **Dame Andrea Leadsom:** It is, indeed. What part do fixed-rate mortgages play in all of this? There is a question as to whether the impact of interest rates is not being felt enough because of the propensity to take out a fixed-rate loan. As a result of that, as you have to remortgage, you get hit massively. Instead of going up incrementally, what was previously a low fixed rate rockets and becomes unaffordable. What impact is that structural change going to have on the whole outlook for getting inflation under control?

Stephen King: The first thing to say, possibly with the benefit of hindsight, is that, if you were worried about the fixed-rate mortgages, that was a case for raising interest rates sooner than they were raised, because you had to get ahead of the game more quickly than would otherwise have been the case. Hindsight is a marvellous thing, but I am simply saying that, under these circumstances, that may be a factor.

Having said that, it is important to recognise that monetary policy does not work just through the mortgage channel. When you are raising interest rates, it has a huge impact on corporate activity, confidence and borrowing through the exchange rate, which we have seen very clearly over the course of the last few weeks. A stronger exchange rate will dampen down demand for UK exports, which will dampen down incomes domestically. There are lots of ways in which the monetary channel works. It is not exclusively about mortgages.

Having said that, it is important to recognise that, having raised rates a long way, there will be a lot of people who will be clearly suffering over the course of the next few months. Whether that is something that monetary policy should worry about is a separate issue. The other way of dealing with it is to provide some kind of fiscal support. If you are going to provide fiscal support, you have to do it making sure you know how you have funded fiscal support. The danger there is that, if you loosen fiscal policy to support people's mortgages, that will simply require



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monetary policy to be tightened even more. You are going round in circles under those circumstances.

Chair: We will come back to more mortgage questions later on.

Q28 **Dame Andrea Leadsom:** As you say, there are many more factors than mortgage rates. Professor Bean, to what extent do you think that there is evidence of profiteering by companies seeing rising interest rates and prices and therefore thinking they can make a quick buck?

Professor Bean: Before I answer that, can I add a little rider on mortgage rates? I have a somewhat different view from what seems to be widely expressed, namely that the increased preponderance of fixed mortgages—two-year, five-year or whatever—is slowing down the monetary transmission mechanism. That could be the case, but it presumes pretty stupid behaviour on behalf of the people who have taken out the loans.

If I have a two-year mortgage that I took out at 1% or something, I know that, when it comes to the end of that time, I am going to be hit with a pretty big increase in my mortgage repayments. I do not have to wait until I get hit by that increased payment before taking countervailing action—cutting my spending back and so forth. I am doubtful that it has slowed down the monetary transmission mechanism quite as much as people think.

It is the case that there is a smaller share of the population with mortgages. It used to be about 40%; it is now 30%. That will mean that that bit of the transmission mechanism is a bit weaker than it was. It is not clear to me that the presence of more temporarily fixed mortgages actually slows it down all that much.

You asked about profiteering, greedflation and that sort of thing. I have not seen any convincing evidence to suggest that this is a widespread problem. That is not to say that it may not be an issue in particular markets. There is obviously a lot of discussion at the moment, particularly in the market for bank deposits, about interest rates on notice accounts not being raised quickly. There was some discussion a while back about whether supermarkets were taking the opportunity to increase their margins and so forth.

It is worth saying that it is quite difficult to get to the bottom of this. When you are looking at the labour market, you can see pretty clearly what is happening because we have data on pay and so forth. When you are looking at the product market side, you need to look at profit margins. There are lots of judgments and data that have to go into constructing that, certainly if you are doing this at a reasonably aggregate level.

Of course, you get cyclical variation in margins. Going back to the banks case, the net interest margin was compressed after 2009 through until recently because the Bank rate had gone so low, so you would expect some rebound in the net interest margin. You need to answer the



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question about whether it looks like margins are growing more strongly than they should be given the state of the economy. As I say, I have not seen any convincing empirical evidence to suggest that this is a significant element in the macroeconomic picture, although it may be important in particular markets.

Q29 Mr Baron: Thank you for joining us. I would like very briefly to look forward over the next few months, but perhaps even further, at what lessons have been learned, what the MPC should do now and, in particular, the risk of over-tightening—something that was picked up earlier. The Bank of England finally admitting that there is something wrong with the system is very welcome. For quite a while now, many of us—Stephen, you mentioned a few of the names—have been saying that it has been behind the curve.

Forecasting is never an exact science, but for the Bank of England to suggest that it is largely down to external shocks, including Ukraine, and to have had interest rates at 0.5% when, prior to Ukraine, inflation was 6.2% and core inflation 5.2%, suggests that it was well behind even before Ukraine. It has admitted that it is now going to have a look at the review and everything. By the way, I never believe that you can forecast shocks, but they were so far behind the curve prior to Ukraine that there was something fundamentally wrong with the system. This is affecting people's lives out there in the real economy.

Looking forward, how would you improve the process? The Bank is now going to have a review. It seems to me that the forecasting process is not an easy task. You have all sorts of new inputs to factor in—the balance between capital and labour, for example. You have supply chains being shortened, onshored, friend-shored or whatever, given the geopolitical situation and covid. Stephen, what would you do to improve the data and the forecasting model?

Stephen King: I will go back to my earlier comments that models are just models. They are not things you can use to predict the future with any kind of precision. Many moons ago, I worked at the Treasury. As Charlie will doubtless remember, one of the big questions of the model was the residual settings in the model. That was the key thing you were being asked about. You had a model that told you X. The error term, which was trending possibly in one direction or another, was the missing information, and you would try to make a judgment about what was in that error term and then fix the forecast based on an assumption about that particular aspect of the model. I do not think that the idea that the model gives you the answer is right.

Q30 Mr Baron: I completely agree with you. That therefore begs the question whether, a month before Ukraine, when you had inflation running at 6%-plus, your target was 2% and interest rates were still 0.5%, there should have been a realisation that something was going wrong—particularly given that inflation was rising very steeply in the months before Ukraine; it was not just that final month.



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Stephen King: To be fair, there were some of us at the time who were suggesting that there was something wrong. You come back to this argument that the model itself and the thinking at the Bank was very focused on the idea that the inflation was effectively transitory. The reason why it thought it was transitory was, effectively, that the Bank implicitly assumes not only that the public understand what the target is and that the Bank is committed to meeting the target, but that the public believe that the target will be met. In other words, it is an implicit contract between the central bank and the public.

Mr Baron: It is managing expectations.

Stephen King: Yes. The point is that if you go through an extended period where inflation is persistently higher than expected and the central bank continuously says, "This is not a problem," at some point the public's view of the central bank may begin to change. It is not that the central bank's behaviour itself has changed; it is the public's reaction to the central bank that begins to change.

Mr Baron: It is about credibility.

Stephen King: You can have a rule of thumb that says, "The central bank tells me that inflation is going to be 2% in two years' time. I have no reason to disbelieve it. Therefore, that is going to be my forecast too." If you have had a two or three-year period where inflation has clearly overshot persistently, it is quite reasonable for the public to say, "You told me it was going to be 2%, but we do not believe you any more. We now have a view that is going to be 3%, 4% or 5%."

This idea of there being an implicit contract is important. The Bank of England perhaps assumed this was a given because they said it was going to be true as opposed to the reality, but if you make a persistent series of errors in one direction, it may then prove not to be true.

Q31 **Mr Baron:** Can I stop you there? I just want to move us on. Time is limited, and I am trying to explore the lessons learned going forward because the future is more important than the past. If you do not mind, Stephen, I will turn to Dr Wadhvani.

It seems to me there is still fundamentally room for error here by the Bank of England. We have talked briefly about over-tightening. They typically look back over a few decades. If you look back over 100 years, say, I cannot think of one period where inflation has gone to double digits and returned to that pre-spike level within two years, yet we still have forecasts suggesting that everything is going to be quite normal by next year.

I grant you that in May the Bank of England increased their inflation forecast from 3.9% to 5.1%, which was big for them, but there is still a real risk of danger of over-tightening going forward. I suggest to you that the sensible thing would be to pause for a moment, given that fixed-rate mortgages now represent something like 90% of borrowing in that market. That lead-in has yet to filter through, and we know that there is



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typically a time lag of nine, 12 or 15 months for the true effect of interest rate rises on the economy to be realised.

Dr Wadhvani: I certainly see the case for worrying about over-tightening. What I would say, though, is that you now have a set of circumstances in which, to be fair to the Bank, not only the Bank's forecasts but the consensus forecast for inflation has been quite wrong again for the last few months.

Mr Baron: That is true for all central banks.

Dr Wadhvani: That goes for wage growth too. Therefore, the Bank now feels under a lot of pressure to be seen to be getting ahead of the curve. That is how I interpret the last 50-basis-point hike, which was a surprise to markets. They feel under pressure because of these errors. They feel under pressure because of daily criticism. The likely reaction now is for them to become hawkish for a while and therefore increase the potential risk of over-tightening.

Now, having said that, I was actually very encouraged by Huw's letter. At least from the outside—maybe I have misunderstood what they have been doing—they have not been doing that much cross-checking over the last two or three years; otherwise, they would not have missed the money supply uptick. They have not been paying that much attention to the period before 1995 because, if they had, they would have recognised the risks of persistent inflation sooner.

The thing to remember is that these are highly capable people who work extremely hard. If they are now beginning to see how they might improve their performance, one has to begin to be hopeful.

Q32 **Mr Baron:** I will move on to you, Nina, if I may. Dr Wadhvani quite rightly raised the money supply figures. Could one of the problems be that money supply figures are no longer included in the monetary policy report and have not been for the last couple of years? When you look at the charts, money supply excess growth—the growth above that required by real GDP—went off the chart in 2020. There was a little bit of a time lag, and then inflation picked up thereafter. Is it an error that the MPC is not attaching the importance to the money supply figures that it should? They certainly seemed in denial about it when we raised it directly with them.

The reason I ask that question is that the money supply figure is now falling fast. That compounds the concern that there may be a risk of over-tightening. Having led inflation up, the money supply figure is now coming back quite significantly. We now have a money supply contraction. Is it an error not to focus enough on money supply?

Nina Skero: There is not one particular red flag that is a missed sign in terms of not seeing inflation coming or its being persistent. It is a collection of misjudgments that have come together, and this could be one of them.



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In terms of the risk of over-tightening, there are softer considerations at play, as we have just heard, around the problem of perception and the misplaced belief that you can overcorrect for a delayed response with further hiking.

Q33 Mr Baron: Does anybody want to come back on this issue about money supply? What we are trying to do, as a Committee, is question what the Bank is doing to improve its modelling process going forward. This is having a real impact on the economy. I am suggesting to you that they were behind the curve, so to speak, as inflation went up. I am suggesting to you now that, while I personally believe that inflation will be stickier and higher going forward than we have been used to in the last decade, there is still a risk of over-tightening. Part of the reason is that they are not factoring in things like shortened supply chains, which are inflationary, or money supply figures, which are now contracting. Can anybody answer me on the money supply figures in particular? It is not an exact science, but we have to try to examine the inputs they are trying to interpret to make sure they are valid and real.

Dr Wadhvani: I can come back to you on the falling money supply figures. It is very important not only to look at recent growth rates in money supply but also the level it has got to. In 2020, we had this very high growth rate and we got to a much higher level. We are now falling from that very high level. If you allow for both the fact that we got to this incredibly high level and the fact that now there is this negative growth rate, it is not as bad on the downside as it was on the upside, if I am making sense.

For what it is worth, the key thing I have learned over years of trying to integrate money supply in one's forecasting framework is that you have to recognise that there were periods where it completely broke down. That is Goodhart's law: when we relied on it for policy purposes, it stopped working. You could conjecture that we now have a reverse Goodhart's law in operation: when we stopped relying on it for policy purposes and when people stopped even publishing it, it started working again. I do not know. This is just another conjecture.

Q34 Mr Baron: There is a bit of a coincidence when you look at the countries that did not expand the money supply. Countries like China, Japan and Switzerland, for example, did not allow the money supply to expand. As a consequence, you could argue—this is certainly what the monetarists would argue—that they do not have an inflation problem.

Stephen King: Can I just make a point on that? Japan has surprisingly had more inflation than expected over the course of the last year or so. You are absolutely right about China, but Japan has followed a pattern very similar to what has happened here.

Q35 Mr Baron: It is not as high as us.

Stephen King: No, it is not as high, but the direction, by their standards, is quite extraordinary. Things have changed there.



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Dr Wadhvani: On China, you have had the little factor that they carried on their zero covid policy for a very long time, which did suppress inflation. It is not just what happened to the money supply in that case. In Switzerland they have had a very high and overvalued currency, which has kept inflation down.

Q36 **Mr Baron:** Professor Bean, last but not least, to what extent is there a risk of over-tightening at this point? Would you pause or would you keep the interest rate rises going?

Professor Bean: It is question of balancing risks. There are risks on both sides. The chance of making a policy error is greater if you are moving interest rates rapidly.

From a monetary strategy point of view, the way you want to be approaching this is, instead of having an Everest, where you jack rates up and then you are forced to reverse quickly, to have something more like a Table Mountain. You get up near a plateau, and then you can afford to wait a bit. As you were suggesting, you can then see how things unfold.

To be able to pursue that strategy, you have to start raising rates early. They are not really in the position to do that. After the previous meeting, they probably thought they were getting near the point where they could possibly pause and see how things unfolded, but we had two very bad sets of inflation figures.

Q37 **Mr Baron:** Are there more rate rises to come?

Professor Bean: They have responded by putting in a chunky one this time. I suspect there may be more, but the key thing is that this has to be data-dependent. Anybody can say that the peak is going to be 5.5% or 6%, but they do not know what is going to happen. As I say, from a strategy point of view, the ideal is to get up to the right region early. Then you can afford to tweak it one way or the other, as the data unfold.

Can I just make one brief comment on the money supply question? Certainly in my day—Sushil will remember this—there was plenty of consideration of the development of the monetary aggregates and so forth. In fact, one of the six divisions I had was called monetary assessment and strategy. That was one of the things they did. I do not know these days whether it gets much attention pre-MPC. It may not have appeared much in the monetary policy report recently. If you were to ask an MPC member that question, they would say that there is certainly a facet of it that they paid a lot of attention to, in that a significant chunk of the increase in the money supply is essentially the deposits that accumulated as a result of the excess savings during the pandemic. That is the £200 billion that households were accumulating because they were still getting paid but did not have the opportunity to—

Q38 **Mr Baron:** It is nothing to do with QE.

Professor Bean: You might say it looks like the QE paid for the budget deficit that was used to pay for the furlough scheme and so forth, but the



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MPC clearly has spent time debating how quickly they think those excess savings would be run down. The fact those savings are there is one of the reasons why demand has been as robust as it has been. Many commentators have been surprised at how well demand has held up, despite the fact that households are having their real incomes squeezed by about 5%.

Q39 Sir James Duddridge: Before probing on interest rates and their impact on the markets, can I return to groupthink? Professor Bean and Dr Wadhvani, you have both expressed in different ways how you were given permission to have different views and advocate for those views. That is a good thing. Clearly, things have not worked out overall in terms of the forecasts.

I want to ask the other two people on the panel whether there is a case for having a designated contrarian within the MPC who does not advocate their own views but is there to challenge others—a kind of red team/blue team catalyst in the middle of a sea of intellects and economists.

Stephen King: I am not sure you need a designated contrarian, but you do need people who are confident enough to express views that may question the existing consensus on the committee and who will express those views in public. It is fair to say that in Charlie's day and Sushil's day there were plenty of people who were prepared to do that.

It is difficult to explain precisely what has changed, but the numbers bear this out. Dissent did fall away quite significantly from around about 2013 or 2014. As Charlie and Sushil said, it has come back quite significantly over the last year or year and a half, which is not surprising given the uncertainties the committee has been faced with.

However, if you are asking what is missing from the committee, it would be nice to have someone with a more monetarist tendency. I am not a monetarist myself, by the way, in case you are wondering whether I have a bias in that direction. It might be useful to have someone who is very much on top of monetary data and who can think about how that world interacts with the model-driven world that is on the committee currently.

The other thing I would suggest—it is a pet thing of mine—is that there should be someone there who knows a lot about economic history. Even though you cannot easily model previous periods, those periods are still incredibly important when it comes to thinking about events in the modern era. For example, if you go back to the global financial crisis, at that time there was not a rich institutional history at the Bank of England about—

Q40 Sir James Duddridge: Can I just pause you there? You mentioned long-term history, but you are actually talking about quite recent events, if we are talking about going back to the 1970s and 1980s, compared with the points you make in your book about looking 100 years in the past. It is proper economic history. It is not just looking back another 10 years, is it?



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Just to complete the picture, I would fully support having someone on the MPC with that experience. From John Baron's questioning, clearly, there is a weakness in monetary advocacy, particularly given Professor Bean saying that his own old department were unsure about the degree to which they had an influence. Do you mind if I pause you there, Stephen? Ms Skero, what are your impressions?

Nina Skero: I certainly do not disagree with the value that diverse points of view bring, but I would come at it from a slightly different angle. There is also some value in having a very strict set of communication guidelines, as we have seen with the Fed in the United States, for example, as compared to the style of communication we have seen from the Bank of England.

When any central bank communicates, it has to keep in mind a number of stakeholders, including the public and the financial markets. The Bank probably has a bit of a problem in terms of its communication strategy with both. On the public side, representatives of the Bank, particularly recently, have said things that were not necessarily incorrect but were probably not going to help with inflation in any way and were probably harmful in other ways.

On the financial markets side, the Fed has now established an expectation that there is going to be very precise language. Market participants pore over every line and every phrase. Compared with that, the Bank of England has a much more relaxed style of communicating its decisions. To the earlier point suggesting that there has been a problem with the very doveish commentary around every hike, I would also say that, to some degree, people were not actually sure what its statements were indicating in terms of the future direction.

Certainly, there is a lot of value in MPC members and others at the Bank being able to express their views, but that also can make it a little harder in terms of setting expectations.

Q41 **Sir James Duddridge:** Earlier we talked about 85% to 90% of interest rates, largely domestic interest rates, being fixed. In terms of other implications, to what degree are interest rates driving down private sector investment, driving up the rental marketplace, both commercial and residential, and driving banks not to pass on interest rates to their depositors in a timely way? It is not even having the benefit of getting people saving more, which will flow through to investment and the capital market in the longer term.

Perhaps I could go to Professor Bean, Ms Skero and Mr King, in that order, to get a better view of the timings of the impacts of interest rates, particularly in the context of it not working domestically.

Professor Bean: As far as investment goes, I suspect the Bank's rate decision is not that critical at the current juncture. For businesses, the more salient issue is the uncertainty in the environment. You could say that the uncertainty around where monetary policy goes is part of that, but the traditional view of thinking that higher interest rates mean a



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higher cost of capital and that feeds through into lower investment probably is not a particularly strong link in the transmission chain at the moment.

It is likely, though, that higher interest rates will have effects on other elements of corporate behaviour, such as things like inventory holdings. There is an incentive for businesses to reduce their inventories when interest rates are higher, if they have to finance them out of borrowing. By the same token, if you are using working capital to pay employees, it may have some consequences for employment as well. Those dimensions may be more important than the fixed capital dimension, but this is one of these areas where there is uncertainty about the strength of the linkage.

If I could just go back to your earlier question about the idea of a devil's advocate, when I was on the committee, particularly when I was Deputy Governor, I always used to lead off the discussion. In those days it was on a Thursday morning. I would be the first to speak, and I would always set it up as, "These are the arguments for action A. These are the arguments for action B." If there was potentially an action C, I would talk about that as well. At the end I would say, "Personally I am inclined to do A rather than B," but I would always be my own devil's advocate.

In my experience, the committee worked better in terms of its internal dynamics when people behaved in that way, putting themselves in a devil's advocate role. It is an inquisitorial approach. You are trying to figure out what is going on in a world where there is a lot of uncertainty and so forth. It worked less well when you had something that was more adversarial, more like a UK court of law, where you are cherry-picking the statistics that support your particular preferred policy.

To some extent, how the committee works depends on the individuals on it, but it also depends on the lead from the chair about how the Governor chooses to run the meetings and so forth. Having some mechanism where the committee forces itself to think about alternative outcomes is important.

I might also mention something else that connects with the point about groupthink. In the year or two before the financial crisis, when Mervyn King was Governor, he quite rightly kept on saying, "Whether we get interest rates wrong by 25 basis points this way or that way is neither here nor there. Where we will lose our reputation is by getting things really wrong. We ought to spend more of our time talking about how things could go really wrong."

For a while, at the end of the first half of the meeting, we would have a separate session where each month one MPC member would spell out a scenario for how things could go badly wrong. A lot of these, it should be said, revolved around inflation expectations becoming de-anchored. That shows the extent to which you are prisoners of your past experience, because a lot of us, in those days, had lived through the 1970s and 1980s. It is interesting. We used to call them our "nightmares". I went



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back and looked at my nightmare from my last MPC meeting. I actually had a financial crisis in it, but it was nothing like the financial crisis in 2008.

Danny Kruger: What year was that?

Professor Bean: This would have been 2006; it may even have been early 2007. It was not long before the financial crisis, but it was nothing like what happened. It was to do with a housing market collapse in the UK. If I had spelled out what actually happened, with the events in the US and how they propagated and so on, I am sure my colleagues would have said, "That is nuts. That could never happen."

That demonstrates the difficulty in thinking sufficiently out of the box, but it is very important that the committee and the Bank's staff try to hard-wire ways of continually self-questioning what they do. Some of this is about going back to history. I really agree with Stephen's point about the value of economic history. That is one place where you can go and look for prompts for how things can go wrong. Having committee members who will also be sufficiently inquisitive to think about alternative scenarios and alternative outcomes is very important.

Q42 **Sir James Duddridge:** Thank you for that. It is very interesting. There seems to be general agreement not necessarily on having a contrarian but on doing something differently, something similar to that which happened previously.

Dr Wadhvani: Definitely do not have a contrarian who is labelled as one, because that will go down really badly. I want to echo what Charlie said. At least when I was on the committee, on the Wednesday the rule was you were not allowed to indicate which way you were thinking of going. What you did instead was you debated the issues. At least when I was on the committee, everyone generally approached Wednesday with a very open-minded approach. We took each issue as we discussed it, and no one was trying to add up issues in a way that would then dictate the way you voted on Thursday.

That type of behaviour earned people respect from their colleagues and implied that they listened to each other. After I left the committee—I do not want to use any names—I did hear anecdotes about there being resident contrarians. People would switch off, even on the Wednesday. They would just stop listening to them. That is very dangerous. You want a set of people who, yes, think differently, but who respect each other and who have a sufficiently open-minded approach to listen to counter-arguments. That is how you earn respect. You help each other get to a better outcome. If you respect each other and listen to each other, you absorb what you have not worked out for yourself.

Q43 **Sir James Duddridge:** I would like to come to Ms Skero and Mr King. I am particularly interested in the question about the impact on corporates of the domestic savings interest rate not being passed on immediately. Will that have an effect on corporate investment, separate to the point



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Professor Bean made? Should we worry that it is not equitable for customers? Perhaps even more importantly than that, is it driving the right behaviours in terms of reinvesting capital in corporates?

Nina Skero: Taking the business investment point separately, there are a number of surveys that ask businesses what they are considering in terms of investment decisions. It does seem that that sort of consideration is relatively low on their agendas. For example, we do ongoing work with the Federation of Small Businesses that looks at its membership. You can also look at surveys of companies of all sizes; the CBI has run one of those, for example. Nobody is really saying that this is a major factor they are considering in terms of their investment decisions. I would agree with the point that there are wider considerations.

Sir James Duddridge: I will take that. I have been told twice that it is not an issue. That is clear evidence, and no one is leaping up to the contrary.

Nina Skero: In terms of the savings rate not being transmitted to customers quickly enough, that is a very important point for other reasons, including issues of fairness since the banks that have passed on those rates are benefiting in other ways.

I do not know whether I would consider it a major factor in terms of the transmission of monetary policy. On that side, how it gets transmitted via mortgages, whether they have seen an increase or consumers are just expecting an increase, is the more important arm, particularly because people with larger savings probably would not have as high a propensity to spend those savings. It is a very important issue to look at, but not primarily from a transmission of monetary policy point of view.

Stephen King: I should stress that, although I do work for HSBC, I am not responsible for their savings rates, just in case you were wondering.

What I would say, though, is that, when it comes to tightening monetary policy, there are always tricky distributional issues, issues of fairness or unfairness, as the case may be. It is equally important to recognise that inflation itself delivers those kinds of problems. It is an arbitrary and undemocratic process of creating winners and losers in terms of both wealth and income.

Moreover, it is also something that creates tremendous uncertainty for businesses. For example, if you are a business and you are thinking about your revenue growth doing X over the course of the next few years, if you want to know what that will mean for your profits, you have to think about what is going to happen to your costs. During an inflationary period your costs are effectively out of your control. You have tremendous uncertainty about what your cost structure will be. As a consequence, you do not know exactly what your margins will be. Without that knowledge, you are more likely to be cautious in terms of your investments.



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Although it is often the case that people think of inflation being a consequence of strong demand, I would suggest that persistent inflation damages the supply potential of the economy. If you have it, you eventually discover that the measuring rod you need to make sensible decisions, which effectively is money, is incredibly unstable. In those circumstances, you might say, "We should not raise rates too far because that is going to be damaging in terms of the inequity within the economy," but the problem of persistent inflation itself is likely to be a bigger long-term problem.

Sir James Duddridge: That is really helpful. Thank you for your evidence. Apologies for disappearing almost immediately to another committee and to other work.

Q44 **Anne Marie Morris:** Stephen, I am going to turn to you, given your ex-Treasury role. One thing that is clear is that, while the Bank is responsible for managing inflation and uses the interest rate as its main but not the only tool to impact that, fiscal policy will also impact inflation. Therefore, while we beat up the Bank for getting it wrong, we actually need to look at both.

For you, what is the appropriate relationship between fiscal and monetary when you are trying to manage inflation? Is what we are currently doing having the right effect? Is it the right thing to do?

Stephen King: First of all, my time at the Treasury was a very long time ago. It was between 1985 and 1988. I do not want to push my experience there too much.

However, it is important that monetary policy has dominance over fiscal policy and not the other way around. Let me explain what I mean by that. West Germany is a very good example. In the 1970s and 1980s, a series of German Governments of different political persuasions wanted to do things fiscally, some of which would have inflationary consequences. The Bundesbank was always there, a bit like the referee, saying, "If you do X, there are consequences in terms of interest rates that you may not necessarily like."

There was no doubt in the German case that they were on top of inflation, first because the Bundesbank was an independent central bank, and secondly because the fiscal authorities knew that, if they were to do X rather than Y, there might be a monetary implication they would not necessarily welcome.

The difference between that and when I was at the Treasury, which was before the Bank of England was independent, was effectively that the Chancellor was making the decisions on both monetary and fiscal policy. The chances of things going wrong, regardless of one's political persuasion, were higher because you did not have that monetary referee operating in the way I have just described.

In terms of where we are currently, ideally what you want is a situation where the Bank of England is raising interest rates to conquer or deal



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with inflation and the Government know that, if they were to do something that was significantly expansionary from the fiscal point of view, the Bank of England may well respond to that with even higher interest rates.

You do not want to make the Bank a political animal that is effectively saying to the Government, "You cannot do this. You cannot do that." Instead, you are trying to say, "Yes, fiscal policy does have inflationary implications at times, but be aware that it is our responsibility as a central bank to deal with the inflation. Therefore, if you do X, we may well respond." Knowing that that response may come through is an important part of the credibility of keeping inflation under control.

Q45 Anne Marie Morris: The second part of my question is about what the current Government have done and their approach to fiscal policy. In many ways, the Government have increased taxation by leaving the thresholds where they are. Is that the right approach? Is there a difference in the fiscal policy you adopt and its impact on inflation?

Stephen King: First of all, I go back to my point that it is the central bank, rather than the Government, that should be responsible for delivering the inflation outcome. The Government may have a role in terms of making sure the distributional consequences of dealing with inflation are different from what would otherwise be the case. There are some distributional things that Governments can do.

As far as fiscal policy is concerned, it has to be secondary to monetary policy. That is the way it works. If it does not work that way, you have a potential problem. Having said that, QE potentially muddies the waters between monetary and fiscal policy. You heard from Charlie earlier about the idea of the furlough scheme being funded by the Government and the Government being effectively funded by QE during 2020.

The issue is that you can reach a situation in which you have rapidly rising Government debt, but you have reached the political limit of how far you can go, either in terms of raising taxes or delivering austerity in terms of public spending. If you get to that point, there are generally only a limited number of options open to policymakers.

One option is default. No one wants to do that. The second option is to regulate the financial system to have some way of manipulating interest rates. Effectively, you distort the system in a way that benefits the Government at the expense of other players in the economy. The third way, frankly, is to tolerate higher inflation. Inflation effectively operates as a tax on creditors and, typically, a benefit to debtors, so long as the inflation rate is higher than the interest rate. The biggest debtor in the economy is typically the Government.

Once you have gone down the QE path and blurred the distinction between monetary and fiscal policy, it might be convenient, if I can put it that way, for a period of inflationary tolerance that would not otherwise have taken place.



- Q46 **Anne Marie Morris:** That is very helpful. Let me turn to you, then, Charles. The water—this clear divide that Stephen is trying to present—has been slightly muddled by the Government's promise to halve inflation. The Government have made a promise to halve inflation and yet, if we follow Stephen's logic, they do not have the toolbox. Clearly, therefore, they think there are things they can do, because to make a statement like that, you cannot just sit on an independent body, the Bank of England, and tell it what to do.

If we take the position that the Government wish, on their own initiative, to take steps that will assist with the inflationary spike, what are the good things they can do and what are the bad things they can do? I appreciate that these things never are just economic decisions for Prime Ministers or Governments; they are also political decisions. Try to take the politics out of it, which I know is difficult, and look objectively at the different tools in the toolbox and what they could do.

Clearly, we could think about public sector spending, public sector wages and decisions about whether or not to increase the minimum wage, which has a knock-on effect right the way up the food chain because people want to keep the differential. There is a lot you could do in that space.

I appreciate that this is even more controversial, but given that one of our problems is our workforce, we could think about where we are on immigration—current Government policy, the impact that has on inflation and the levers it might give rise to.

Then there are direct market interventions. The Government intervened very specifically on energy with a very significant chunk of money. There was debate and discussion about intervening in the food market, from which the Government ultimately have stepped back.

There are many policy areas and many things a Government could do. What should a responsible Government be looking at in terms of the levers? Let us try to take the politics out of it. I appreciate there are all sorts of manifesto commitments about X, Y and Z. What could or should they do?

Professor Bean: I will give you an answer about the principles because, as you say, there are lots of policies. Those are not just fiscal policies; there are structural policies too. If a policy purely affects demand, if it is something that increases demand, it is going to add to inflationary pressure. That will mean the MPC has to set tighter monetary policy than otherwise would have been the case in order to offset that extra demand stimulus to meet the inflation target.

At the current juncture, anything that adds to demand alone is not very helpful to the MPC. Conversely, if you take demand out of the economy, that enables the MPC to run a looser monetary policy.

- Q47 **Anne Marie Morris:** Could you give us some examples?

Professor Bean: Particularly useful things to do at the moment—they are always useful in some sense—would be things that benefit the supply side of the economy.



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Anne Marie Morris: Give me some examples of things on the supply side.

Professor Bean: Some of them are already in the process of being implemented. The childcare measures that were announced in the last Budget should, in due to time, boost the supply of labour from women with younger children and so forth. You could also think about the measures to get older workers and the long-term sick back into the labour market. Again, those are policies that have been announced. We will see how successful they turn out to be, but they are going in the right direction.

You mentioned structural policies and interventions in particular markets. You can try to make those markets work better, be more competitive and improve transparency in them. There is this idea about making it easier for people to know where the cheapest petrol is. That would improve transparency in the market. That is something that is helpful.

On the other hand, there may be other interventions that Governments think of doing, which they think of as being counter-inflationary, such as price controls, which may turn out to be anything but. They may have an adverse effect on supply because businesses become less profitable and stop supplying the goods and services that are affected.

Those are the principles you should apply. There are so many different policies that you might contemplate, but at the current juncture it is unwise to contemplate policies that primarily have the effect of adding to demand and aggravating the inflation problem, necessitating even tighter monetary policy. I would avoid those.

Anne Marie Morris: That is very helpful.

Dr Wadhvani: Can I give you a concrete proposal?

Anne Marie Morris: Please do.

Dr Wadhvani: I agree with everything Charlie has just said, but I just wanted to give you an example. The main risk the Bank of England is currently running is that higher inflation expectations have become embedded and we potentially have a wage-price spiral going on.

As Charlie said, the Government have tried already to be supportive in terms of helping on the labour supply side, but there is another policy that they could potentially consider. They could introduce a tax on excess wage increases. The Government could announce that the baseline reference level for wage increases is 3%. If a firm pays 5% instead of 3%, you charge the firm 100% tax on the difference between 5% and 3%. A 5% wage increase paid by the firm costs the firm 7%, not 5%, which will act as a significant deterrent.

If you apply this to all firms in the economy, it will have the effect of bringing expectations down. In essence, you are helping the Bank of



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England bring inflation down without having to increase unemployment as much as without this policy.

This may be an unfair analogy, but I think about it like this. Suppose you decide that tobacco consumption is a bad thing and you want to discourage it. You can go about that in two ways. You can set the Bank of England a tobacco consumption target, and then they can raise interest rates by enough to impoverish people such that tobacco consumption comes down, or, as a Government, you can help the Bank of England to achieve its tobacco consumption target by directly taxing tobacco consumption, as we already do.

Just as tobacco consumption is harmful, inflation is harmful. Therefore, the Government could be very supportive if they agreed to introduce a tax on excess wage increases as a special measure, perhaps lasting only a year or two.

Q48 Anne Marie Morris: That is very interesting. I have one last question to Nina. We have heard about a juggling between fiscal, monetary and other Government initiatives to try to tackle this issue. Stephen painted it—forgive me, Stephen—rather bleakly, in that the Government direct and the Bank punishes them by shoving up the interest rate. I would like to think there was a bit more communication between the two of them, despite the independence of the Bank of England, which must be preserved.

What should the working relationship be between Government and the Bank of England to make sure we get this right? Given what Dr Wadhvani has said, can the Bank and the Government go too far in trying to deal with inflation, so that they kill off the prospect of future growth? Afterwards, we need to grow. If we take businesses to such a point of pain, will we stunt our ability to recover?

Nina Skero: There are a few different points within that. In terms of how the Bank of England interacts with the Government, you want to be in a place where they are not, at a high level, massively pulling in opposite directions. You do not want to have a monetary tightening cycle along with massively expansionary fiscal policy.

Fiscal policy—this does echo what Stephen said—should not be used to fine-tune inflation either. Fiscal policy is trying to accomplish a lot of other goals in terms of redistribution or shielding some segments of the population. There is also a question of timing when it comes to the things happening on the fiscal side. The initiatives to get people out of economic inactivity are going to take more time than the Bank of England has or would like to have to bring down inflation.

You just want to be in a place where they are not massively pulling in opposite directions, but I am not sure that they are massively pulling in opposite directions at the moment. It is right that the primary focus has been on the Bank in terms of controlling inflation.



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To the latter part of your question, can you get to a point where interest rates rise so much that it stunts growth? You can, but in some sense that could be what they are trying to accomplish, though not deliberately. Monetary policy is sometimes a difficult pill to swallow. In some sense—this came up earlier—the idea of using fiscal policy to shield households from the impacts of monetary policy is very difficult to understand because then it really will not have any purpose.

Can it get to a point where it is hindering growth? Yes, but, while it is certainly not desirable, some element of that is possibly necessary and precisely what they are trying to engineer with a balance.

Q49 Anne Marie Morris: Yes, but can you go so far that it becomes very hard to recover from it? I get what you say. One is trying to dampen demand and effectively stop the growth. You can stop people growing now, but if the consequences of that are business closure, business failure and businesses releasing employees, the result is going to be a much slower comeback.

Nina Skero: It is a balance. That is probably the biggest lost opportunity from not starting this hiking cycle earlier. It goes back to the point raised before. We are now not in this privileged position where rate hikes can be stopped and there can be a period of observation of how that is feeding into the economy, especially without the benefit of having had any significant hiking cycle in the timespan when the structure of the economy was similar enough to what it is now to be able to predict what this degree of tightening is going to do.

Certainly it would be better to be in a different position, but I fear that is probably the biggest cost of some of the missed months and quarters in late 2020 and early 2021. It is now harder to fine-tune things so you are effectively managing that balance between bringing down inflation without tipping the country into too deep of a recession.

Q50 Chair: In closing this session, I want to ask some very quick-fire questions and then draw it together. You have been an amazing panel; we have really enjoyed hearing from you.

We have an open inquiry on quantitative tightening. We have been told by the Bank that quantitative tightening is not an active tool of monetary policy. Can you just give me a quick yes-or-no answer—either, “Yes, I agree” or, “No, I don’t agree”? Is quantitative tightening an active tool of monetary policy?

Professor Bean: It depends on the circumstances. I’m sorry. “Yes” and “no” are not the right answers.

Chair: So it could be. Your answer is not “no”. Nina?

Nina Skero: It doesn’t have the clear—

Chair: Yes or no?

Nina Skero: Um—



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Chair: Could be—okay. Dr Wadhvani?

Dr Wadhvani: QT could be a monetary tightening tool in some circumstances.

Stephen King: It could be, but the signalling is very unclear compared with raising rates.

Chair: Okay. I am hearing a broad consensus there, pretty much.

Danny Kruger: A bit of groupthink, I'm afraid.

Q51 **Chair:** No, we will call that one broad consensus. I am now going to ask you where you think interest rates are going to be on 1 January, just to pull a number out of the hat. We have this expert panel of economists in front of us. I would like you to give me a number for where you think interest rates are going to be on 1 January. Stephen, you are in the business.

Stephen King: Can I choose the year?

Chair: I mean 2024.

Stephen King: I was just checking whether I could choose 2030 or something.

Chair: Sorry, I should have been more precise.

Stephen King: Higher than where they are today.

Chair: Can you give me a number?

Stephen King: Seventy-five basis points higher than they are today.

Chair: So 5.75%.

Stephen King: Yes.

Chair: Sushil?

Dr Wadhvani: I don't know, but 6%.

Nina Skero: 5.75%.

Professor Bean: I believe they will be higher than they are. I am not going to give you a number because I think that is a mistake. It depends on the data, and I believe there is sufficient uncertainty about how things will unfold that it is a nonsense to give a point prediction. Sorry.

Danny Kruger: There you go—you have broken with the consensus.

Q52 **Chair:** My final question is: where will inflation be on 1 January 2024?

Professor Bean: I would say it is about 50:50 whether it is above or below 5%. I have a pretty broad distribution, but my central estimate would probably—



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Chair: Your central estimate is 5%.

Professor Bean: Yes.

Chair: Central estimate, Nina?

Nina Skero: 4.9%.

Dr Wadhvani: 5.75%.

Stephen King: 5.5%.

Chair: Okay. That was extremely interesting. We have spent an enlightening session listening to some of the country's best economic brains. We spent surprisingly little time on the modelling per se, although there was a bit on recency bias and the need to include some monetary information came into it.

We spent more time than I was expecting on some potential decision-making biases that can come into groups if they perhaps do not look at a long enough period of history. That point was made. It can be hard to admit that you have to change direction. That can be a difficult decision to make, if you lose sight of the purpose of keeping inflation at 2% through lots of the different challenges going on around you.

There were some insights into having a safe space for debate and testing potential uncertainty. There was a little bit of information about having a diversity of thought process, which was very enlightening. We also talked about the safe space of defaulting to consensus when times are really uncertain.

We pulled out a lot of really interesting insights from you. Thank you so much for your time this afternoon. Thank you very much for coming in to talk to the Committee.