



Economic Affairs Committee

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

Tuesday 11 July 2023

3 pm

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Members present: Lord Blackwell (In the Chair); Lord Davies of Brixton; Lord Griffiths of Fforestfach; Lord King of Lothbury; Baroness Kramer; Lord Layard; Baroness Liddell of Coatdyke; Lord Londesborough; Lord Rooker; Lord Turnbull; Lord Verjee.

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Questions 241 - 259

Witness

I: Stephen D King, Senior Economic Adviser, HSBC.

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Examination of witness

Stephen D King.

Q241 **The Chair:** Good afternoon and welcome to today's session of the House of Lords Economic Affairs Committee in our inquiry into Bank of England independence. We are delighted to have Stephen King with us. Stephen, would you like to introduce yourself?

Stephen D King: I am HSBC's senior economic adviser. I work there part time, and I was its chief economist for many years. I write newspaper columns from time to time, and I am the author of four books. The last one was called *We Need to Talk about Inflation*.

Q242 **The Chair:** Thank you. I shall start with a general question. We are interested, as you know, in how independence has worked and the strengths and weaknesses of the Bank of England over this period. In your view, has the Bank of England's operational independence been a success, and what mistakes, if any, have been made?

Stephen D King: For the 25 years as a whole, it is difficult to argue that it has been anything other than a success. It has clearly been a success, and you can measure that through average inflation rates over different periods of time.

I took the liberty of looking back over the last 75 years at average inflation rates in quarter-century blocks. The average in the 25 years from 1972 was 4.6%, the average in the 25 years to 1997 was 7.5% and the average in the 25 years to 2022, on my calculations, is 2.2%, so it is virtually in line with the target. To that extent, what we have seen has been pretty remarkable relative to previous history.

I do, however, want to offer some qualifications. First, what we have seen in the UK is part of a global phenomenon. It is not quite correct to suggest that the UK uniquely dealt with inflation in a way that was different from other countries. Again, looking at equivalent figures for the US, the averages were 2.6% for the first 25-year period, 5.5% for the second 25-year period, and 2.5% for the last 25 years. So the same kind of relative improvement comes through. I do not have French figures going back quite so far; I have only the last 50 years or so. But the French figures show an average of 6.4% for the 25 years to 1997, and 1.5% for the 25 years thereafter.

There are a few other qualifications I might mention. The first is that although inflation performance has been very good, economic growth over the last 25 years has been quite disappointing. I am not suggesting that there is a connection between the two. Nevertheless, the pace at which living standards have increased is much slower than in many earlier periods.

The second thing I would note is price stability and financial stability. There have been periods of prolonged price stability, but we have also had, not just in the UK but elsewhere, notable periods of tremendous

financial instability. I also think that possible mistakes or misjudgments of one kind or another have been made. The first of those I would describe as a fear of all deflations being bad. You can perhaps blame JM Keynes for that to a certain degree. You can certainly identify periods in the past of very bad deflations, but, equally, you can identify periods of good deflations, most obviously in the late 19th century. Sometimes central banks and the determination to fight against what might actually have been a good deflation have left monetary and financial conditions too loose, which has contributed not so much to inflation but, rather, to financial bubbles of one kind or another.

The third thing I would note is that, frankly, forward guidance was not a success. I think it led and contributed to elements of almost enforced groupthink. If you are doing forward guidance, you are kind of trying to say that you know something about how the economy will be in the future; you know something about the relationship between different variables. I do not think central banks know any better than anybody else what those relationships might be. In hindsight, the experiment with forward guidance was perhaps not as successful as had been anticipated at the time.

The fourth, rather obvious, mistake is what has happened over the last two or three years—the extent to which inflation has lifted off and the extent to which the inflation performance of the UK now is notably worse than its peers' elsewhere in the world. That now looks to be a situation that has gone wrong.

The Chair: Thank you. I am sure we will come back to a number of those points. Following up on your point about independence obviously having been a success, economists are all taught that correlations do not necessarily imply causality.

Stephen D King: Yes.

The Chair: We have heard a number of people comment that there have been particularly favourable global circumstances around low inflation in most countries over the last 25 years, globalisation being one factor, and it could be argued that the important thing was the adoption of inflation targets rather than independence, which happened in the early 1990s. Inflation actually came down in the 1990s before Bank of England independence. So when you say that independence has been the cause of the low inflation, are there particular things you would point to where you would say, "This would have been different if we had not had an independent Bank"?

Stephen D King: One thought experiment could be to say, "Can you imagine a situation today where the Bank of England was not independent?" I would ask that question, because it seems almost inconceivable today that the Chancellor of the Exchequer would still be in charge of making interest rate decisions because of what happens elsewhere in the world. There is a kind of conformity of behaviour in different parts of the world. So even if Gordon Brown had not made the

Bank of England independent, it seems to me that there is a pretty good chance that it would have been made independent at some point shortly thereafter anyway, just because it became the convention of countries around the world.

A very recent example is probably what happened last autumn with the Kwarteng Budget and the crisis that came through in the gilt market and in pension funds, and the fact that the Bank was able to act almost as a policeman for bad behaviour elsewhere. By acting as that policeman it led to significant changes that perhaps would have been less likely to have materialised as quickly in the absence of its independent role. That is a very good example, in fact, of where the Bank has acted in a way that has changed the dynamics of, in this case, the UK's financial rather than inflation position. Nevertheless, I think it was a significant positive.

Q243 Lord Davies of Brixton: The policy has hinged on the objective of price stability, but do we have the definition of price stability right? Are the ways in which you would want it changed, improved, made clearer?

Stephen D King: I think the definition is quite clear, but it has also bumped into some difficulties in practice. First, there is an active debate now about whether the inflation target should be at 2%—this is not specific to the UK but is a general debate—or whether it should be raised. One argument for that is that if you are at 2% and you are bumping into the zero-rate bound with regard to short-term policy rates, there is a risk of triggering a period of more sustained deflation, which is generally regarded as being undesirable. By raising the actual inflation target, you are less likely to bump into the zero-rate bound than would otherwise be the case.

The problem with that debate is that it might have been reasonable to have had it perhaps six or seven years ago. The problem today is that, with inflation having overshoot so much, to change the target at this point in time would smack of political convenience rather than a sense of proper monetary discipline. Even if one had an intellectual debate about whether it should be 2%, 3% or 4%, today is not the time to have a practical version of that debate.

Secondly, although the target says that it is a target at all times, obviously the Bank has to exercise judgment when it comes to how quickly inflation has to return to target in the light of some kind of deviation from that target. Here I worry that sometimes the timing of that process is unclear: do you do it in a year, two years or five? How quickly do you do it?

I want to give an example not of the UK but of Japan in the late 1980s, which famously had a huge financial and economic bubble. Inflation itself was very low for most of that period; eventually it rose, but for a while it was quite low. In hindsight it would have been better for the Japanese to have raised interest rates sooner to allow inflation to undershoot more than was the case in a bid to make sure that the asset price bubble that was building did not build quite as much. If the Bank had succeeded in

doing that then, when the asset price bubble burst, it would hopefully have been a smaller burst and there would have been less balance-sheet damage to the economy. In those circumstances, the undershoot in the short run might have made it easier to hit the inflation target over the long run. As it turned out, the attempts to allow inflation to go higher in the short run contributed to the very much worse performance over the long run by getting stuck in a semi-deflationary trap.

So sometimes there is a case for arguing that the inflation target itself could be treated more flexibly if the Bank is able to explain why it is being treated that way. I suggest that before the global financial crisis there might have been a case, particularly in hindsight, for interest rates to have been higher than they were. Had they been, that might have reduced the extent to which bubbles were building within the financial system—although to be fair the UK was an addendum to what was really going on in the US. Back in those days, it would probably have been better if the Federal Reserve had had tighter monetary policy; the Bank of England was an afterthought in those circumstances.

Q244 Lord Davies of Brixton: Would it be possible to argue that consumer prices are quite a poor reflection of what is happening in the economy? People have argued for asset prices to be included in whatever metric you choose as your target.

Stephen D King: My difficulty with asset prices being included in part of the target is that asset prices in one sense are a kind of forecast for the future, and those forecasts can change. Sometimes they can be totally wrong and at variance with what is happening. However, I am not sure that a central bank is better than anyone else at trying to work out whether the valuation of the asset market at any point in time is appropriate or otherwise. Having worked in financial markets for quite a long time, I can be confident in saying that trying to value assets at a particular point in time is an art that involves tremendous amounts of guesswork rather than anything that offers more precision.

I could also argue that the whole point of trying to measure inflation is that, in a sense—to turn it upside down—you are trying to get a sense of the value of money. You are trying to work out whether money itself is holding or losing its value over a period of time. So the more assets that you include, the more that you include stuff that looks a bit like money itself. Rather than having an independent, objective measure of what you are trying to do, you are blurring the distinction between measures of the value of money and, separately, the value of asset movements of one kind or another.

So I am not a huge fan of including asset prices in the measure of inflation. However, I am a fan of central banks paying attention to asset prices and balance sheets more explicitly than sometimes happens, because of the issue of the time consistency of hitting the inflation target. In other words, you may find it easier to hit the inflation target in a year's or two years' time by pursuing a particular monetary policy, but in the

process of doing so you can contribute to asset price bubbles that may make it more difficult to hit the target in future.

Q245 Lord King of Lothbury: Our inquiry is about the Bank of England, but in the last two or three years the view that inflation would, always and everywhere, be a transitory phenomenon was one that was held by all advanced countries' central banks. If that is an intellectual failing, what do you think is the cause of that collective groupthink? It is not something that originated in the Bank of England or is unique to it; it seems to be true for all advanced countries' central banks. You have talked—rightly, in my view—of the dangers of forward guidance. That too was something that central banks latched on to. Why did they pursue this intellectual avenue?

Stephen D King: I think there are a number of factors. The first is that there was an obsession with deflation. There was a fear that the West was heading in a Japanese-type direction. To be fair, there was evidence to support that: there were rapidly ageing populations in some countries, high levels of debt and typically high levels of government debt, all of which seemed to be similar to the Japanese experience. There was a tendency to think that what was true of Japan would become true of other countries. I may have written a paper myself at some point arguing precisely that, but sometimes things change and you revise your views.

That is the first point. The second, which is related to it, is that there was a fear that all deflations were bad. To my mind, the great moderation in itself was misinterpreted by central banks. It was very convenient to say, "We have this lovely story of stable growth and low and stable inflation, and that is directly a consequence of our skills as central bankers"—and there were a number of central bankers who argued that at the time. When the great moderation was first being discussed and analysed, most of it was associated with a series of what we might now describe as beneficial external supply shocks—that is, shocks coming through from China and India, basically low-cost producers coming into the world economy with big increases in the effective labour supply of the global economy, which created what I would describe as a deflationary tail-wind for the western world. That also contributed to the deflationary story.

On thinking about inflation itself, a lot of the intermediate targets that people used to look at were thrown out altogether. People were not looking at monetary supply, which I think was a mistake. For a while, partly because it worked well in the US, everyone was addicted to the Taylor rules, which effectively suggested that your interest-rate decision would be based on a view about future inflation based on the output gap and then a view as to how far current inflation had deviated compared with targets, so there is a forward aspect to it and a current aspect. That did not work very well because the current aspect was often just noise; it had no bearing on what was going to happen to the future. So we moved into a forecast targeting model, of which I suppose the biggest advocate was Lars Svensson. Forecast targeting said, in effect, "We have a view about what drives inflation. It's estimated over the last 20 or 30 years; it's worked pretty well over that 20-year or 30-year period when inflation

has been quite low, so we will carry on using it. If we do so, the implication appears to be that inflation will remain low”.

So just at the point when, in my view, evidence was beginning to emerge of an inflationary problem, there was a tendency within central banks to dismiss those warning signs altogether. What is striking, particularly in the early stages of 2021, was that a number of economists external to central banks, such as Larry Summers and Jason Furman in the US and a variety of people in the UK, were warning about higher inflation coming through. However, you did not hear much noise about this within central banking circles.

What is striking about the Bank of England, for example, is that the decision to bring QE to an end—the first votes in favour of doing that—did not emerge until very late in 2021. The first rate increases came through at about the same time. Thereafter—this is a specific point about the Bank more so than other central banks—when the Bank raised rates, the message was always: “We think that inflation has been tackled and is going to come back down again; therefore there isn’t much need to raise interest rates any further”. That messaging was odd; it was almost as if there was a denial that the inflation story had materially worsened.

I should also note that I talk in my book about the four tests that suggest inflation might be a bigger problem than the central banks initially thought. The first test is the deflationary bias. If you are changing institutional arrangements to deal with what you perceive to be a deflation problem alone, you may be slow in spotting the re-emergence of inflationary problems. One of the potential weaknesses of QE, which I do not think has been routinely discussed—most people talk about QE in terms of printing money and creating lots of inflation—is that it effectively distorted bond markets. It meant that bond yields were very slow to rise in the light of rising inflationary pressures. The absence of an increase in bond yields reinforced the idea within central banking corridors that there was not an inflation problem, because it was not priced into markets. But it could not be priced into markets, in part because of the impact of QE. I think there was a bias towards fighting deflation at all times, which was unhelpful from the perspective of recognising inflation when it emerged.

Secondly, frankly, money supply was ignored in a rather foolish fashion. The numbers are not quite so extreme in the UK, but in the US the numbers were off the charts in 2020. For the life of me, I cannot see why policymakers did not look at that and think “This is odd”. You do not have to be a monetarist to think that. I am not a monetarist, but if you look at numbers of that strength you think “This is peculiar”.

The third factor comes back to forecast targeting. I might be quoting your words, I suspect, but it is the idea that you can simply assert that inflation is going to be low in the future because it has been low in the past. That is not good enough. The idea that credibility is the only thing that matters is a mistake. It is pretty clear that, in a situation where inflation begins to overshoot persistently, central bank credibility can be lost extremely quickly which, again, is not helpful.

The final point is the supply-side shocks which have come through and which central banks were slow to spot. There was an assumption that growth comes in steady as she goes all the time. In fact, if you look at the history of economic growth, there are huge variations in terms of supply performance as well as demand performance. The combination of the post-global financial crisis era and, in particular, the impact of the pandemic was damaging to the supply side in a way that I do not think central banks initially recognised; they were very focused on demand rather than supply.

Q246 Lord King of Lothbury: We have received evidence that the Bank of England's models, and most forecasting models in central banks, have the property that it does not matter what you do; inflation always comes back to 2%. It seems very odd to use a model that assumes inflation will come back to 2% to work out what you have to do to make sure it does come back to 2%. That seems to be a serious intellectual failure. Would you agree?

Stephen D King: It sounds like an Alice in Wonderland argument. It is simply saying: "We have a target of 2%; we forecast it will be at 2%; there is nothing that is going to happen in the near term that will change that". To be fair, one of the issues with the inflation-targeting framework is that it is difficult for a central bank to say it is forecasting something other than 2% in two years' time if it has already argued that monetary policy works with a lag of two years or 18 months—whatever it might be.

I would prefer it if a central bank said, "We have these events taking place which means the situation is more puzzling than we had previously thought; there are higher levels of uncertainty and therefore a bigger chance of an inflationary miss than we thought previously". That would be more honest than simply continuously forecasting 2% at virtually all times. If you look at the record of the inflation forecast of the Bank of England's Monetary Policy Committee for the past two or three years, it always returns to 2% in two years' time, or thereabouts, irrespective of what is taking place.

The funny thing I note is that, when it comes to credibility, there is an implicit assumption built into this argument that the public will continue to trust the central bank and what it does. No matter what happens in the short run to inflation, the argument is effectively that the Bank says that the inflation target is 2% and therefore the public will always believe that the Bank will achieve that. The evidence, not just recently but in the past, is that the public tend not to respond in the rational expectations way, but are quite backwards-looking. They look at errors which have built up over the last few years and say "We did not used to have these errors, but now we do. They are all in one direction and therefore we are not sure that we should continue to believe what the central bank says about its commitments".

The issue of how the public think about the institution is as important as the institution itself. You can look back through hundreds of years of economic and inflation history and get the same result. It is not just

about control of the money supply or of fiscal policy; it is about whether the public trust you to continue behaving in a certain way. If you lose that trust, the model itself breaks down.

Lord King of Lothbury: Your book is entitled *We Need to Talk about Inflation*. Many people say that the definition of price stability is when people do not need to talk about inflation, but they clearly do now. Do central bankers talk too much? In your view, what has gone wrong with the communications of central banks?

Stephen D King: There is a danger that the communication is all about defending the current position rather than talking about what might otherwise happen. To be fair, that has changed a bit over the last 12 months or so. You have seen more dissent on the Monetary Policy Committee than there had been for a number of years. For a number of years, there was very little dissent. I think in your time and in Eddie George's time, there was quite a lot of dissent. My impression is that you, at the time, encouraged that dissent and saw it as worthwhile, but more recently dissent has been frowned upon for one reason or another.

This could be either because the forward guidance was not helpful in encouraging dissent or perhaps because, particularly during the early stages of the inflationary pick-up, there was a fear within the Bank that admitting that inflation might be higher would somehow damage the credibility of the institution. There were a series of speeches I would describe as defensive saying, "Don't worry, it's going to come back to 2%". A number of MPC members said roughly the same thing at the same time over quite an extended period, even as others externally were saying something else. A defensiveness has come through, which is different from how it used to be. I personally think that a well-functioning MPC should have people on it who, while not being rude about others—you embrace the collective value of the committee—are confident to say, "Well, actually, I'm worried about this, and I'm worried about that, and I think this will feature in my thinking relative to the views of the committee".

The other thing I would note is that there has been a very strong move in recent years towards a belief in transparency at all costs—that transparency is very important. I can think of a time in a different country where transparency did not really exist but the central bank was quite successful. That was the Bundesbank. I always thought of the Bundesbank as a mystical central bank; you never knew quite what it was doing or why it was doing it. It missed its money supply targets quite regularly, but somehow, by saying very little, it persuaded people that actually it knew what it was doing.

What was the famous movie with Dorothy and the cloak?

Baroness Kramer: "The Wizard of Oz".

Stephen D King: Thank you. That is the one. It might be a "Wizard of Oz" moment when you reveal what is behind the curtain and realise that

it is not quite as coherent as it appeared to be. There are alternatives to being transparent all the time, but if you are going to be transparent you should be transparent in discussing the risks to forecasts and the differing view of the members of the MPC. I think some of that has been lost over the last few years.

Q247 Lord Londesborough: I have a quick observation on the subject of talking too much. I wonder what your reaction was to the Prime Minister feeling the need to talk about inflation—to take the title of your book—at the beginning of the year in some sort of personal pledge to halve the inflation rate from 10% to 5%, at the time when the Bank of England was forecasting 3.9%, I think, at the end of the year and, of course, the MPC was holding a target of 2%. Was that helpful or confusing?

Stephen D King: My personal view was that it seemed at the time to be a very easy pledge to make. To be fair, the Bank of England clearly had credibility at No. 10, because No. 10 was able to make a pledge that most people, frankly, thought would be relatively easy to meet. What we have discovered over the last few months is that inflation in the UK, more so than in other countries, is suffering from these so-called second-round effects. Inflation is clearly stickier than had been anticipated.

The unfortunate thing about the pledge is that if the Prime Minister does not meet it by the end of the year, whose fault is it? If it is not the Prime Minister's fault, it is the Bank of England's fault, and if it is the Bank's fault, we are in a hazy area whereby the Government are implicitly criticising the Bank for what has happened, which, to my mind, is not necessarily helpful to the Bank's independence.

Q248 Lord Griffiths of Fforestfach: Moving on from groupthink, do you think there is a lack of intellectual diversity on the Monetary Policy Committee?

Stephen D King: I do not know all the people on the committee well. I know some of them, but not all of them. I think the general principle of that committee is that committees work well when they have a variety of different skill sets and where the skill sets of some add to and enhance the skill sets of others. It is a general principle that is true.

For me, there are two areas in the MPC that are potential weaknesses. The first is that there is no one there who is passionate about money, in the sense that money matters. If there had been, there would have been at least one person with their head bobbing above the parapet in 2020 or 2021 saying, "Actually, I think there might be a bit of a problem, and here's why". It does not have to be someone criticising the rest of the committee; it simply has to be someone saying, "I've looked at this through a different lens, from a different angle, and my conclusion is a little different from what the model has suggested". That would be a good thing.

A second area, which I mentioned to the Treasury Committee last week, so I am in danger of repeating myself, is economic history. The problem with models is that you can become a slave to the model. The model is

estimated over a certain period of time. It works well precisely because it has been estimated over that period of time.

I am not a model builder myself. I had some vague experience of it in the Treasury many years ago, but I remember my boss at the time suggesting that the equation I had estimated was not working very well, and maybe I should just change the time period by two or three quarters and it might, miraculously, work well. Funnily enough, some of the equations did work better just by changing the time period by two or three quarters. That struck me as not terribly scientific. In other words, you should do the estimate over a number of different periods, and if 29 out of 30 are rubbish but one of them works, the chance is that the one that works is working through luck rather than anything to do with beautiful statistical properties.

If you have a situation where you know that you are model-biased and that the model itself has been estimated over a certain period of time, it would be enormously helpful for someone on the committee to have an in-depth, longer-term knowledge of monetary and financial affairs. Again, you could say, "Okay, this is what the model says, but if you go back to this period in time or that period, didn't we learn from this historical episode that this sort of thing can happen?"

It is not just about monetary policy; it is also about financial policy—for example, the global financial crisis and what happened then. It would be helpful to have a different perspective than the one that is currently there. I was thinking before this meeting about how you would go about doing it, because each person appointed to the committee gets there either because they have a career at the Bank of England that has got them there, or because they have been appointed through the Treasury or whatever it might be. I wonder whether, rather than thinking about individual appointments and asking, "Is this person competent or not competent to do the job?", it might also be worth thinking about whether the person is a good fit in terms of the skill sets that the committee might require and whether they are adding to or simply duplicating existing skill sets.

Q249 Lord Griffiths of Fforestfach: The two points you have made are very valuable. Who do you think should own the requirement to ensure that there is diversity on the committee? Should it be the Chancellor, the Permanent Secretary of the Treasury, the Governor of the Bank, the chairman of the Court, or even an independent appointments body—a House of Commons Treasury committee and so on? Do you have a view? I took all the points you made in the way you answered my first question, but practically, at present, I am a little nervous that there is nobody who says, "This is my responsibility to ensure this" or "It is this committee's responsibility to ensure this".

Stephen D King: I have given this some thought, but I have to admit that I do not know these institutions well enough to be confident in saying how it should be done. In a standard corporate structure, the board makes the serious appointments, and the equivalent of the board

in the Bank is the Court. If you are going to do that through the Court, given that the Court has, I think I am correct in saying, the governor and the four deputy governors on it, you might need to make a decision without those people being involved. Then there is the question of who gets appointed to the Court and whether they are the right kinds of people to make those appointments. That would be the equivalent of what you tend to see in a corporate structure.

I do think that the Treasury has an awful lot of influence in the appointments process in a way that has created an MPC that is dominated by people who were, at some point, at the Treasury. All four deputy governors have spent time at the Treasury, quite extended periods of time in some cases. So although one thinks of the Bank of England as being independent, it is independent but with the Treasury still casting a shadow over it in one way or the other.

On external appointments, rather than the Treasury Committee, for example, simply interviewing the external appointees, might it be useful at times for the Treasury Committee to hear evidence from those who are making the appointments—the people at the Treasury or the external people who come in for the Treasury—to find out what they are thinking about, why they are thinking it and their strategy for shaping the committee over a longer period of time? It is a slightly mysterious process that could be examined more closely.

Lord Griffiths of Fforestfach: I have one short and slightly devious—well, not devious; deviant—question.

Stephen D King: I am slightly worried about this question.

Lord Griffiths of Fforestfach: The Federal Reserve is totally separate from the Treasury. The European Central Bank, set up by a constitution, is totally separate from finance ministries within the euro area. Is there a case for the Bank of England being completely independent of the Treasury?

Stephen D King: The degree of separation elsewhere, even if it is greater legally, is not necessarily that much greater in practice. I shall give two examples. The first is Janet Yellen, who was the chair of the Federal Reserve and is now the US Treasury Secretary. The second is Alan Greenspan, who of course worked in government before he became chair of the Fed. So even if you have separation in a legalistic sense, I still think you are going to end up with people who very happily travel from one institution to the other without a great deal of difficulty.

Q250 **Baroness Liddell of Coatdyke:** When the Governor of the Bank of England appeared before us a few weeks ago, he talked about its remit and the number of issues that he had to have regard to—things like climate change and nature. Do you think there is a risk of central banks in general being politicised or overstretched?

Stephen D King: If I had a Bundesbank hat on, I would say yes. The Bundesbank has consistently argued that the primary job of a central

bank is price stability. Its secondary role is of course as lender of last resort and, depending on the arrangements in a particular country, financial stability may be important as well.

Beyond that, it begins to get a bit awkward, partly because there are obviously trade-offs between the different choices that one might make. Sometimes everything works in the same direction, but not always. A good example of things working in the same direction was during the global financial crisis: we needed interest-rate cuts to prevent inflation from being too low and we needed interest-rate cuts to prevent a financial meltdown, so the financial stability objective and the price stability objective were moving in the same direction.

However, there are other examples in the past where central banks have struggled even with those twin objectives. To go back to the failure of Long-Term Capital Management in 1998 in the US, the Fed cut rates in response to that but in hindsight that was probably an error, given what subsequently transpired in terms of overheating the US economy at the time. There are lots of other examples of that.

These are choices first of all, but this is also a resourcing question. If the central bank does not have additional resources yet is asked to pursue more areas, you are diluting the coverage of what you were doing previously in the existing areas. I have not looked at the numbers, but my guess is that the Bank has not seen a huge increase in personnel to match the increase in responsibilities or objectives that it has been given.

Another issue is that, within any institution, if one area is going swimmingly and appears to be becoming a bit boring then your staff will vote with their feet; they will go to for something else that sounds more interesting. My sense is—although you will have to speak to people at the Bank of England about this because I am not close enough to it—that monetary policy became boring. In one sense, the Bank had been ostensibly too successful: inflation was coming in at 2% each and every year, interest rates were hardly changing and there was no real controversy at all. So a lot of people who might otherwise have focused on monetary policy were looking instead at issues of financial stability, climate change and other things that were intellectually more stimulating at that point in time.

The problem with that is that you might go through a long period of price stability and success, but during that period of success you should always be thinking, "What might go wrong? How might it go wrong? What are we missing at any point in time?" That requires some degree of what you might describe as scenario research, contingency research or whatever it might be—something that is different from simply forecasting where inflation is going to be next year and thinking that there is no need to change rates in one direction or the other. Again, I am not close enough to what the Bank does day to day but, coming to this episode of inflationary overshoot, the obvious questions that would have been asked prior to this would have been, "What are the long-term consequences of QE? Can we be sure that this is going to be entirely consistent with

inflation remaining low for ever more? What are we missing about the peculiarities of QE?" That would have been a reasonable question to have asked.

You could think about supply-side shocks of one type or another, not necessarily a pandemic but supply-side shocks that might have an impact on how you think about the performance of the economy and your likely success in dealing with inflation in the future. You could do work on the history of inflation, saying, "What are the circumstances where it might go wrong? How shall we think about it? What are our contingency plans for those circumstances?" Had that happened, my sense is that the narrative that emerged might have been different from the one that did, because the narrative that emerged was, "Don't worry about it; it's transitory. This will go away." Actually, there are plenty of historical episodes that might have suggested that this would not go away. The lack of a bank of research looking at those historical episodes, trying to put the current episodes into some form of historical context, might have undermined the Bank's ability to deliver when it mattered.

Baroness Liddell of Coatdyke: When Sir Nick Macpherson gave evidence a few weeks ago, he had a copy of the original remit letter from 25 years ago, to which you referred, and the current remit letter, which was vast—about five or six pages. Does it complicate the nature of what you are asking a central bank to do to have such a broad sweep?

Stephen D King: Particularly in situations where there are trade-offs between various objectives, and the Bank feels that it should be trying to deal with each of those objectives, the more objectives it has, the more it is dragged back into a political arena. So the very process of giving the central bank more objectives, when it is supposed to be independent, forces it to make changes or decisions that expose it to understandably greater political and media interest. It would be helpful if one went back to thinking, "What is a central bank for?", and then, "Where are the other important objectives best dealt with?" because that may not be in the central bank. That is not to belittle the other objectives; it is simply to say that there are places where they could be dealt with other than a monetary authority.

Q251 **Baroness Kramer:** I will follow on from Baroness Liddell's question. We have taken evidence from a lot of people who have said that the remit is just too large, it is a distraction and it leads to conflict in the way that you have described. Nearly all of them have assumed that financial stability and price stability should both remain within that central bank remit. You are something of an outlier on this. You have argued in the past that financial stability responsibility should be housed elsewhere. Could you take us through that thinking, because it is a narrowing of the remit beyond what we heard from many other witnesses?

Stephen D King: If you have a situation whereby a central bank is faced with two pressures in different directions, it can lead to bad policy choices. Paul Volcker gave a speech just after he stepped down from the Federal Reserve. It was not quite a valedictory speech, but a retirement

speech, in which he talked about the lessons he had learned on monetary policy and the tackling of inflation. Those lessons included acting quickly and early in response to a pick-up in inflation, and to avoid distractions if you could, because they are unhelpful regarding the inflation objective. He was quite explicit in suggesting that those distractions included issues of financial stability.

I fully accept that, during the global financial crisis, there was a sense that the tripartite arrangement had contributed to making things worse, not better. Of course, the decision made afterwards was to bring financial stability back into the Bank. That strikes me as being an issue of communication between institutions rather than about needing a fundamental redesign of the institutions themselves.

As an example, when the governor was in front of you last year during the Kwarteng Budget situation, there was discussion about whether what the Bank was doing was QE or not. I am pretty certain that it was QE, but the Bank did not want to say that it was because, if you are doing QE to support your gilt market and pension funds and simultaneously raising interest rates because you are worried about inflation, the messages you are giving are incredibly confusing. You are basically pointing in two directions at the same time.

To be fair, the Bank did QE for a very short period. It was time limited, which was probably a wise thing to have done. But, if you have rising inflation and financial instability, having one institution trying to deal with both simultaneously is tricky and confusing.

If you go back in history, an example of where it might have worked, in a weird kind of way, was when the Bank did not have independence at the beginning of the 1970s during the secondary banking crisis. The Bank's job as a financial regulator and a financial stability institution was to try to sort out the secondary banking crisis. Separately, the job of the Government of the day—which, frankly, did not do a very good job in one sense—was to try to get on top of inflation. You had a division of labour, but arguably one that worked reasonably well.

It became easier to say that you can do both things at the same time in the same institution simply because inflation was continuously low and therefore did not seem to be a problem—so, why not give the Bank financial stability objectives? In the current situation, whereby inflation is rising, there is financial instability and you might need to do QE, the messaging is in danger of becoming confused. It is difficult for one institution to give a clear and concise message about what precisely it is up to.

Q252 Baroness Kramer: That leads me to a couple of questions. Is the issue you are raising that, because the Bank has two objectives pulling it in different directions, it may take a suboptimal action in, for example, driving forward the raising the interest rates? Alternatively, are you saying that this may be about perception and general confusion, so it is a communication and perhaps trust issue?

Stephen D King: I suggest that it is a bit of both. I do not think they are mutually exclusive. We got close to it early this year, not so much in the UK but in the US, with the regional banking problems. The markets moved swiftly to price in a very different monetary trajectory to the one they had priced in previously.

As a consequence of how the Fed had behaved in the past, particularly with what became known as the Greenspan put, there was a sense that, if you had financial difficulties, the Federal Reserve would simply cut interest rates and provide support to make sure that the financial system did not implode. As it turned out, the regional banking crisis was not really a crisis, but a very self-contained thing. The regulators moved very quickly to safeguard deposits and there was not quite the run that people had initially feared.

Perceptions matter to a degree and the messaging that you are trying to put across. Separately, by being pulled in two directions at the same time, you can make policy errors.

Baroness Kramer: Just out of curiosity, where would you put financial stability? Does it need to go back into a political context, or is there an alternate independent context where it can sit?

Stephen D King: You could go back to the tripartite arrangement that existed prior to the global financial crisis. That is a possibility. I am not so sure that you would want to go back to a political arrangement because it comes with its own problems.

Q253 **Lord Turnbull:** If we have two institutions—one looking after monetary policy and the other financial stability—we can either reconcile the trade-offs through sharing information inside the organisation or have some other organisation in which the two things are brought together. In the world of government, one department might want one thing and one another, and the Cabinet deals with it.

What we created to bring these two together was the tripartite arrangement, and it proved to be probably the weakest link of the lot. I think that is why we have come to the present arrangement. I am pretty unconvinced by the idea that we should separate them because you then have to provide for where these trade-offs are reconciled.

Stephen D King: I fully accept that. Obviously, in the current arrangements, where the governor chairs both the MPC and the FPC and the PRA is part of the Bank, it is all under one institution. Bearing in mind that my concerns are expressed in the book because they are about inflation, these are concerns precisely because inflation has returned as a problem. If you thought that we were in a world of continuous price stability, in which these trade-offs would not exist, there would be less to worry about.

My concern is that, if inflation has returned and we have some kind of financial difficulty, the Bank will be involved in making judgments about trade-offs that may be difficult for it. In other words, if you go back to

2007-08, imagine a different kind of world where we have the financial crisis and a serious inflation problem—as opposed to no inflation problem. In those circumstances, the tripartite arrangements may have worked differently because you had institutions concentrating on two different challenges. My point is that you now have the potential for two different challenges in a way that was not true back then.

Lord Turnbull: We tend to think in terms of two eras—BC and AD or whatever they are now called. Others have pointed out that we have had three eras. We had pre-1992, when interest rate decisions were pretty shambolic in a way. Then we had the “Ken and Eddie show”, as it was known, where there was involvement of the Chancellor and of the governor but in a very structured way. Then there is operational independence. We have to compare how well we achieved. If we are simply saying, “Oh, it was better then”, about the old Lawson era or about his predecessors, that is not a difficult case to make.

However, the idea of this middle era may be one we need to move closer to. One of the reasons for that is that we now have QE. We have this strange feature where the MPC is treating what to do with government debt as an independent decision that is for it. I find that a very strange position.

Do we need to look at these co-ordination arrangements? They possibly bring the Chancellor in more but not, as in the old era, when he said, “When I want interest rates to go up, they go up”. We certainly want to leave that behind. Would having the two institutions working in a structure with a timetable, a shared objective and the inflation reports, actually be a more comfortable arrangement than what we have at present?

Stephen D King: You are an ex-Treasury official, so you are bound to say that—clawing back power from the independent Bank. I am joking.

There is no doubt in my mind that QE has muddied the waters between what we might describe as independent monetary policy and independent fiscal policy. The fact that it has persisted for a such a long period when it was originally supposed be a very short-term policy may have changed the way in which both the Bank and the Government think about fiscal sustainability.

One striking feature is that over the last 10 or 15 years we have seen the most remarkable increase in government debt as a share of GDP. The only other occasions in UK history where we have seen an increase of government debt on that scale is during wartime, either during the Napoleonic wars or during the First or Second World War, but in peacetime we just do not see it. Although no one necessarily intended that to happen, in the circumstances of the existence of persistent QE and the removal of the bond market vigilantes who used to prowl the prairie of fiscal incontinence—I think I am mixing my metaphors here—once you have almost a guaranteed buyer of last resort for the gilt

market then the temptation to think “We can get away with more and more debt with no immediate cost to us” is very strong.

There is an interesting test now. Let us imagine that we go to the arrangement that you have discussed. One reason to raise interest rates is to get on top of inflation, but QE has effectively shortened the maturity structure of government debt and made it more sensitive to changes in short-term interest rates. If I were the Chancellor in that meeting, I would be saying, “Could you just hold off a bit? It’s not helping us with our fiscal calculations.” I do not know what happens behind closed doors—who knows what is actually being discussed?—but I worry in circumstances where the Chancellor is present for monetary policy decisions, where those monetary policy decisions now have a much bigger impact on debt sustainability than they would have done in the past. There is a danger of fiscal dominance returning through the backdoor.

As a more general principle, looking back over hundreds of years of history, when you have these big increases in government debt or very expansionary fiscal policies, the temptation is always for the Government, the monarch or whoever to find a way to print money to solve the immediate fiscal difficulty. I wonder whether, if we moved back to that institutional arrangement, it would be a slippery slope to ending up with precisely those kinds of conditions.

Lord King of Lothbury: You are not suggesting that fiscal dominance results from the central bank wanting fiscal dominance, are you? Surely it is the other way around.

Stephen D King: No, I am suggesting that if the Chancellor was in these meetings, knowing that a decision to raise short-term interest rates could be costly in terms of the fiscal position, he or she might lean on others in the meeting, saying, “Would you mind not doing what you were going to do? It has this complication for us and there is an election coming up”.

Lord King of Lothbury: And that would make inflation worse.

Stephen D King: Yes.

Q254 **Lord Layard:** I think you have somewhat answered the question that I had but I shall ask a different one. Obviously, a given level of activity and inflation can be achieved by different mixes of fiscal and monetary policy that have very different distributional implications. Who determines that mix? I would guess, and tell me if you agree, that it is the fiscal authority that determines the mix because it knows how the monetary authority will respond to the fiscal position. Do you think Governments think seriously enough about this question of the mix of fiscal and monetary policy and the huge impact it has on the distribution of wealth and income?

Stephen D King: I think they have thought about it less in recent times, partly because interest rates have been at rock bottom for such a long time that monetary policy appears to have had no significant impact on

fiscal plans. There are other things that have a big impact on fiscal plans, most obviously a rather poor pace of economic growth and the impact that has on the shortfall of revenue relative to what Governments would ideally want.

However, we are currently witnessing something that suggests that that relationship will become more important. Raising short-term interest rates is likely to have a large impact on a limited number of people with mortgages, who will be hit very hard relative to others. Of course monetary policy works through other channels, whether through the exchange rate or the impact on corporate behaviour or asset prices, but, to the extent that there are distributional consequences of monetary policy, I argue that the fiscal authority can potentially step in to try to target the most vulnerable in those circumstances.

What you do not want to do, though, is to have a fiscal policy that completely offsets what the monetary institution is trying to do. If the idea is that you are trying to slow the economy down because you have excessive inflation, and you have taken the view that demand is too strong relative to limited supply, if the Government try to offset everything that the Bank of England is trying to do, the implication is that the Bank of England has to raise interest rates even more.

I keep harking back to the Bundesbank, but I recall that in the 1970s and 1980s the one thing that German Governments of all political persuasions knew was that if they were to do X rather than Y, and X was quite stimulative from a fiscal point of view, they would know, as sure as night follows day, that there would be a Bundesbank reaction to it. They would have to anticipate what that reaction would be and then incorporate it into their own fiscal plans. There are some countries that can get away with moving in completely different directions on monetary and fiscal policy, and it really helps if you happen to have the world's reserve currency, which is what the—

The committee suspended for a Division in the House.

On resuming—

The Chair: Welcome back to our session on the Bank of England. Lord Layard, did you want to continue?

Lord Layard: No, I think we had more or less exhausted the topic. I liked Stephen's description of the relationship between fiscal and monetary policy as like the relationship between Richard Burton and Liz Taylor—occasionally separated but destined to reunite.

Stephen D King: They always reunite; it is true.

The Chair: Could I just follow up on that? On the one hand we have Lord Griffiths saying, "Should there be complete separation?"—

Lord Griffiths of Fforestfach: I just asked the question.

The Chair: Yes, it was just a question—and, on the other, Lord Turnbull asks whether there should be more co-operation. The current situation, as the Bank of England has explained it, is that a large part of the inflationary shock came about because of external price pressures. Not surprisingly, real incomes fell in the UK and the response of people in the labour market was to want to recover their incomes through having their wages put up. You would think people would understand that that was not likely to be a temporary measure. The current division, where the Bank of England is solely responsible for inflation and the Treasury is responsible for everything other than inflation, means that only monetary instruments could be used to combat that, whereas there might be other solutions.

I remember that in 1976 Denis Healey, the Chancellor, had quite an innovative policy when he did a deal with the trade unions where they reduced their wage demands in return for reducing direct taxation. The net result was that wages were the same but inflation was lower, and there were various impacts on government spending. That may or may not have been good policy but that kind of co-operation between monetary and fiscal policy, thinking of other ways of tackling the problem, is not possible under the current framework without creating some structure for dialogue.

Stephen D King: Yes. There has been an energy price cap of sorts, so you could argue that that is a fiscal measure that was designed either to smooth out the impact of energy price shocks or to reduce them from what they might otherwise have been.

The tricky thing here is that, if you start off with a given set of monetary economic conditions, whatever they happen to be, and you have a policy of trying to reduce prices in certain areas through fiscal policy, assuming there is no change in your monetary conditions, the chances are that when you lower prices in one area you are going to end up with higher prices somewhere else eventually, because the monetary conditions themselves have not changed. You are playing a game of economic whack-a-mole where inflation pops up somewhere else.

The most extreme example of that is prices and incomes policies. You can see exactly why Governments are attracted to the idea of providing a guideline or legislation to prevent prices or wages rising beyond a certain rate, but the history of them is mostly extremely poor, not least because they are often unfair. Some people benefit while others get left behind. Some wage-earners are left behind but others are not.

The Chair: I was not necessarily advocating price and incomes policy, but both monetary policy and fiscal policy end up bearing down on aggregate demand in the economy and have different distributional effects. Is there not a case for trying to optimise the mix of policy rather than treating them as orthogonal?

Stephen D King: I think my answer is going to have to be something along the lines of "When it has been tried in the past, it has not

necessarily worked very well.” There are different views going back to the 1960s and 1970s. There is the idea of monetary policy being aimed at, say, the exchange rate and fiscal policy being aimed at domestic demand or whatever, but in most cases that tends to break down, partly because fiscal policy is still politicised in a way that monetary policy is not, so there is a co-ordination problem at certain points during the electoral cycle.

Secondly, I argue that the better way in which fiscal policy could work is to say that there are consequences to either tightening or loosening monetary policy that may be undesirable, even though the overall macro objective that you are trying to achieve is the right one. So the Government can step in to alleviate some of that pressure, but I am not sure there are many examples where there has been tremendous success in co-ordinating monetary and fiscal policy in the way you have described. I agree that in principle it might work, but I cannot think of many examples in practice where you could say there had been a proper division of labour and responsibilities that was co-ordinated such that it gave us the right kind of outcome.

That goes back to the issue of time horizons and credibility. When it comes to inflation, you are trying to persuade the public credibly that you can achieve a certain objective over a period of time. As I say, the Bundesbank did it in a kind of mystical way; it did not demonstrate exactly what was going on, and to this day I think people are puzzled as to what was going on. However, by making that longer-term commitment you move away from some of the short-term, fine-tuning, stop-go policies that might otherwise come through.

I should say that one of the other potential difficulties for the Bank over the last 25 years has been that sometimes there has been too much of a stop-go approach. Rates have gone up or down because of near-term inflationary fears without thinking about the longer-term story of trying to be focused on stability over a longer period.

Lord Londesborough: Following up on Lord Griffiths’ question about groupthink, how much of an issue is it that all four deputy governors are ex-Treasury? A number of witnesses have described the Treasury as a prep school for the Bank—an unhelpful type of tribalism, particularly in terms of the culture of independence.

Stephen D King: I was at the Treasury myself briefly, though there are others on this committee who have been there for a lot longer and reached much more exalted positions than I ever got to. I always felt when I was there that it was a very defensive institution and that it thought it knew better than others what was going on. One example of that is that my job—I was very junior—was to compile and publish what were then known as the “outside forecasts”, which are now described as “consensus forecasts”. The word “outside” was important because it gave the impression that outsiders did not know as much as the Treasury.

I look at the Bank from outside, so I have to stress that this is as an outside observer only, but I wonder if that Treasury defensiveness has partly found its way into the Bank too—a reluctance to engage in debate with people outside and a defensiveness about the extent to which the MPC has become, I would say, less diverse of view than was the case previously. So there may be some factors there.

More generally, if you have an institution where everyone is coming from another institution that is the same, so they are all coming from the same place, even if each person is acting with total integrity and honesty, you still suspect that there are hidden biases and so on that will emerge in intellectual thought or approach.

Lord Londesborough: Do you think there is a need for as many as four deputy governors, or is that a bit management top-heavy?

Stephen D King: Part of the reason is that the PRA has come back into the Bank so there is an extra job to be done that was not there previously. I am not close enough to the Bank to make a judgment one way or the other but obviously it is more top-heavy than it once was, maybe for good reasons. I do not have a strong view.

Lord Verjee: To follow up on that, do you think there is sufficient accountability for decision-making at the Bank? If not, how could we improve on accountability for decision making?

Stephen D King: The first thing to note is that all institutions will go through good times and bad. The fact that the Bank has had a more difficult time recently does not mean that the institution itself is broken or indeed that its accountability is necessarily broken.

However, I wonder whether, when it comes to the Bank's appearance in front of, say, the Treasury Committee, the committee should ask more probing questions about the differences of view on the MPC rather than the similarities. I am aware that when you come in front of the Treasury Committee you are talking on behalf of the institution, and that there is therefore a natural defensiveness in discussing what is happening, but at the same time it would be useful if the Treasury Committee or your good selves asked members of the MPC where the differences are and why they exist—and, if there are no differences, ask the obvious question, "Why not?"

In 2020-21, there were plenty of people outside the MPC who disagreed with the MPC about the prospects for inflation. I am not sure at that stage how big the questions were about whether the MPC was missing something. Maybe sometimes the committees to which the MPC is answerable could be open to a broader range of possibilities and possible scenarios to discuss with the MPC members.

Q255 **Lord Turnbull:** In your paper, *We Need to Talk about Inflation*, one of the possibilities raised at the end is that the forecasting mechanism comes out of the Bank. You said it is very difficult for the Bank's own

forecasters to say: "You're not getting there; you're not achieving it". The Treasury solved the problem by basically giving up its forecasts and handing them to the OBR, which can say that it is not hitting its targets or is running it very fine in a way that I do not think the Bank's forecasters can. Is there any solution to this? Could you have a monetary forecaster body that is not so much a part of the Bank's executive?

Stephen D King: That paper was written in 2021, if I recall correctly, or possibly 2022.

Lord Turnbull: It was written in February 2022.

Stephen D King: I was thinking partly about the OBR. What is odd about the Bank comes back to the issue of how you think about inflation two years down the road. The Bank is a kind of judge and jury; its job is to hit the inflation target and its incentive is to forecast that it will hit the inflation target because anything other than hitting the target looks like it has made a policy error.

One way around that is for the Bank to say that it does not think it should hit the inflation target in two years, that the mandate allows it to be reasonably flexible and it thinks there are some very good reasons why, today, it is happy to allow inflation to be higher or lower than the target in two years' time. I have not seen much discussion of that from the Bank. There could be more of that.

If the Bank was unwilling to go down that route, in which case the forecast for two years down the road will always be 2%, there might be a strong case for saying that there should be a separation of the forecasting group from the policymakers. Under those circumstances, it would be an iterative process. You would have an initial forecast to which policymakers would respond and say: "We are going to do this rather than that as a consequence of the forecast". The second round of the forecast would be to say, "Okay, you've done this, but we still believe that the outcome in two years will be different from 2%". The executive, as you describe it, would then have to explain to the public and people like yourselves why they decided that it is the right thing to do. It is not entirely implausible to do something like that. If the OBR works, maybe it could work at the Bank of England as well.

Q256 **Lord King of Lothbury:** You said that the central bank has an incentive to forecast inflation at 2%. Surely its real incentive is to change interest rates so that it really does believe inflation is likely to be 2%, not to say it will be 2% when it does not believe it. That is the real incentive.

Your suggestion of having something other than the Bank making a forecast is a bit like saying that the Bank will take the wrong decisions on interest rates, so we should let another body make the forecast because it is better. In that case, you really want those people to be on the MPC. The incentive of a central bank is to get it right, not to pretend that it will get it right.

Stephen D King: Up to a point, yes, but I think recent behaviour has been very much predicated on the idea that you do not want to admit that you might get it wrong.

Lord King of Lothbury: Is not recent behaviour the result of genuinely believing that the world is described by the model, which tells you that inflation will always come back to 2%? I do not think they sat around saying, "Inflation is going to go up, but we will pretend that it will come back to target". They genuinely believe that it will.

Stephen D King: I am not suggesting that. I am suggesting that, when you have a variety of possible outcomes, the one that you are going to seize upon is the one that is reasonably comfortable.

To make a broader point here, I did some work a few years ago on how consensus forecasts widen out, in terms of the dispersion of the range of forecasts, and then narrow in. Forecasts are sometimes quite wide-ranging and sometimes very narrow. I was surprised to discover that they are narrower during the periods of the greatest uncertainty. The reason for this is because it is comfortable to be in the pack of the consensus; if you are wrong, then you are wrong with everybody else, and no one blames you. However, if you are badly wrong because of the uncertainty then you look completely stupid.

It is worth stressing that it was not just the Bank of England forecasting that inflation was going to be transitory. Virtually every economist in the consensus was forecasting exactly the same thing. The Bank said that it had a model which works in a particular way and the majority of economists said "Well, the Bank has this model which says that it works in this way. Who are we to disbelieve what it is saying? We will forecast the same thing". As inflation moved higher, both the Bank and the forecasting community persistently made the same mistakes—partly because they were persistently using the same model, which had worked pretty well for 20 or 30 years.

This goes back to the history issue. Maybe it is an issue with the teaching of economics at universities. People do not know their economic history, so they feel comfortable with the model. Because of that, it is easy to remain within that comfort zone and not question how the model itself could be wrong.

Q257 **Lord Rooker:** My question has been covered so I will be cheeky and ask a couple of other questions. In your introduction you spoke about getting back to 2% and said that it might be advantageous to hang around at 3% or 4%, but now was not the time to change the target. If my reading of what is planned is correct, this time next year we will be at about 4%. Would that be a good time to look at whether we need go all the way to 2% or is that asking you to forecast something that is impossible to in 12 months' time?

Stephen D King: Let us take the assumption that it will be 4% in a year's time. I would be uncomfortable with the idea of raising the

inflation target at that time. It is moving in the right direction, but that is precisely the sort of thing that was done by the Federal Reserve in the 1970s. Arthur F Burns, who gave a similar speech after he stood down from the Federal Reserve at the end of the 1970s, said that one of the things that it persistently got wrong then was that it was always in a rush to cut interest rates when inflation appeared to be heading in the right direction.

In the process of doing that, the Fed, in effect, allowed inflationary behaviour to become increasingly embedded. Inflation went up, then came down a little bit, and the next upswing went up even further. There were rising peaks and troughs so, although inflation was moving in the right direction, it did not move far enough. Before you know it, you have effectively accommodated a lot more inflation than you were originally expecting.

To be fair, if it turns out that there is an awful lot of economic pain associated with trying to get to 2%, obviously that will be a political discussion. My view is that you should not blast the economy in a way that forces you down to 2% extremely quickly. Have a very careful think about what is causing inflation to be higher, but make it absolutely clear that your intention is to reduce it over the medium term such that you are not accommodating higher inflation.

Go back to the 1970s and there is another mythical story about inflation being caused by the oil shock in 1973. It absolutely was not. Inflation was already roaring ahead in the US, the UK and elsewhere before the 1973 oil shock. The 1973 oil shock was the icing on the cake.

What is important thereafter is that you have different central banks and policymakers responding differently to a global inflationary phenomenon. To put it very simply, the Germans and the Swiss were absolutely focused on getting rid of inflation. The British and the Italians, at the opposite extreme, were focused on trying to support jobs and growth and felt that inflation was a series of external shocks that would simply disappear. If you look at the five years after 1973 and ask which of those groups of countries had a better economic performance, there is no doubt that the Germans and the Swiss did extremely well relative to the British and the Italians.

Whatever the shock is, knowing that you are serious about trying to keep inflation under control is itself very important, because if you do not, you unleash a whole series of additional problems that you did not necessarily anticipate. I wrote the book because I thought that a lot of people younger than most of us here have had no real experience of inflation and do not know the damage it causes. The damage is enormous. It is grossly unfair and redistributes in an entirely arbitrary way. It is not something that society should wish to tolerate if it can avoid doing so.

Q258 Lord Rooker: Thank you. I am not one of those young people, but when the Chair asked the questions about 1976 I went back to how my constituents were dealing with the £6 flat rate, or 27% inflation. It was

an horrendous time that today's generation does not understand. I was amazed when I read one of your papers, because I had not realised until I saw the chart that you produced how Germany had missed out on the inflation in the 1970s, even though I went through it.

I want to be clear what you are suggesting about independence. The way I look at the independence of public bodies, there is no day-to-day control of them by Ministers. That is the situation with the Bank of England and the Food Standards Agency. They are independent but part of the public sector. Do you see any advantage in any of the present arrangements, however they might be changed, going back to giving Ministers some day-to-day control, which they do not have at the moment?

Stephen D King: In terms of monetary policy, with the greatest respect to ex-Ministers around the room, I see no advantages in doing that.

Q259 **Lord Davies of Brixton:** James circulated a link to an article by Peter Sedgwick, who says, referring to independence: "We now have the first real test for that regime. The Bank has reacted slowly, insufficiently and arguably less decisively to the rise in inflation than Conservative chancellors did in the post-1979 era". Do you think that is totally off the wall?

Stephen D King: No, I do not. There is a section in the book that discusses some of this. It tries to rerun history. For everything I have said so far, there is a challenge to central bank independence now that we had not seen until now, at least as far as the Bank of England is concerned.

The big challenge is this. Let us imagine that inflation proves to be quite sticky and that that stickiness requires a tightening of policy that has considerable, material, real economic consequences to the economy. To what extent is an independent technocratic central bank able to enforce those decisions, or even come up with those decisions, knowing that there are potentially very painful consequences involved?

The argument against that is to say that the central bank is credible in the way that the Government are not, so the pain associated with reducing inflation should be smaller. That would be the case for Governments who can be voted out of office and who therefore might not persist with the policies that are required.

Let us ask the question slightly differently and imagine that the Bank of England was made independent in 1980. Would it have succeeded in getting rid of the UK's inflation as quickly as happened under the Thatcher Government? I seriously wonder whether it could have done it, because the costs in the early 1980s were enormous. The one thing that Thatcher could argue for was a sense of political legitimacy, in a sense; she was re-elected in 1983 and again in 1987. It is very difficult for a central bank to demonstrate that kind of legitimacy other than being supported by Governments who themselves may choose, at their

convenience, to blame the central bank for difficulties that might be coming through in the economy.

What I am getting at here is that there are potential limits to central bank independence that would be tested in circumstances where the real economic consequences of pursuing a particular policy prove to be so painful that a technocratic institution cannot go down that path.

The Chair: Thank you. That is a good place to end, because it goes back to where we started, which is: is the causality of low inflation Bank of England independence, or is it low inflation that has made Bank of England independence sustainable? We will not ask you to resolve that here. Thank you for a very useful session.