HOUSE OF COMMONS

Treasury Committee

Oral evidence: Appointment of Sarah Breeden as Deputy Governor for Financial Stability, Bank of England, HC 1814

Tuesday 12 September 2023

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Watch the meeting

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

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Witness

I: Sarah Breeden.

Examination of Witness

Witness: Sarah Breeden.

Q1 **Chair:** Welcome to the Treasury Committee's evidence session on the appointment of Sarah Breeden as deputy governor for financial stability at the Bank of England. Can I start by asking you to introduce yourself?

Sarah Breeden: I am Sarah Breeden. I am executive director for financial stability strategy and risk and a member of the FPC at the Bank of England.

Q2 **Chair:** This appointment would take effect on 1 November and you would be taking the role that Sir Jon Cunliffe has been taking up until now.

Sarah Breeden: That is correct.

Q3 **Chair:** Can you help the Committee understand how your existing responsibilities will shift on 1 November when you take on the additional responsibility of having a seat on the Monetary Policy Committee?

Sarah Breeden: I will continue to be a member of the FPC. That is unchanged. What will change is I will become a member of the Prudential Regulation Committee and a member of the Monetary Policy Committee; I will be the chair rather than a member of the FMI Board; and I will become a member of Court. I am in the process of recruiting a successor for me in this role. That will be an important thing to sort before 1 November.

Q4 **Chair:** What are the things you will not be doing from 1 November onwards?

Sarah Breeden: I will leave all of my responsibilities as the executive director for financial stability with my successor. They will become the person responsible for all of the analysis that goes to the FPC, running the directorate of financial stability. They will become a member of the FPC and a member of the FMI Board.

Q5 **Chair:** You are a career Bank of England person. Can you talk about when you have had experience of monetary policy during your career? What experience of monetary policy do you have?

Sarah Breeden: I have been very closely engaged in the outlook for the UK economy from my current seat as member of FPC and executive director for financial stability. It is the basis of our financial stability assessment, about which we come and talk to you regularly. In the current environment, with interest rates rising, in that role I have been more conversant with the live monetary policy debate then perhaps my predecessors have been.

In that role, we have undertaken a deep analysis of where interest rate risk arises in the financial system. We had the LDI episode.

Chair: That was the last time we saw you in front of this Committee.

Sarah Breeden: That is right. That involved both the FPC and the MPC. I have given a speech on the links between monetary policy and financial stability. I am familiar with the current economy and how financial stability and monetary policy interlink.

I would add that my experience over the years means that I have a deep expertise in financial markets and banks. That is important on the Monetary Policy Committee because it speaks to how monetary policy decisions made around the MPC table are transmitted through financial markets and banks into the actual financial conditions that are faced by businesses and households. The deep expertise I bring on the transmission mechanism will bring a valuable perspective to the MPC table, particularly at the moment.

Finally, I would highlight that I have spent the last two years on the FPC and previously in supervision as a financial policymaker, not a monetary policymaker. That is relevant because, as you take those decisions, you are dealing with uncertainty and you are making trade-offs between different ways of achieving your objective. You can deliver a safe financial system with the stability of the graveyard, as we have sometimes talked about with this Committee.

Balancing those trade-offs, dealing with uncertainty and making judgments based on multiple sources of data will also stand me in good stead to be on the Monetary Policy Committee.

Q6 **Chair:** The Governor has acknowledged to this Committee that there have been some lessons to be learned in terms of the process of monetary policy over the last period, in particular around the fact that inflation has become quite deeply embedded in terms of the second-order effects, as he put it, that the Monetary Policy Committee was trying to avoid.

One of the things we have done is assemble a panel of experts who have given their views as to what did not work. I know the Court has commissioned an independent assessment from Ben Bernanke. One of the things that has come up as a point is around groupthink. As a career Bank of England person, how can you reassure this Committee that you will not bring additional groupthink to the Monetary Policy Committee?

Sarah Breeden: I totally understand your concern. It is an obvious question to ask somebody who has worked at a central bank for 30 years. I suspect the Chancellor was also worried about that when he appointed me. I want to emphasise that independence of thought is important to me personally. It is not something you should be unduly worried about. I will highlight the internal and the external aspects of that, if I may.

Within the Bank, I have worked with a vast number of colleagues, including five Governors. I have never been afraid to present a strong view. There is no one I have uniformly agreed with. I welcome challenge, and I create a safe space for people to challenge me as well. That will not change as I take up my new role.

I also have a track record of external challenge, as I hope my CV shows. All the roles I have held have been externally facing at senior level. That naturally comes with challenge. I do not assume that I have all the answers. I listen because I might learn something. That includes the accountability here, citizens' panels and talking to businesses and households.

I take this so seriously because the decisions we make are too important to the people of the United Kingdom for us to get them wrong. Open debate, where we seek to challenge each other and be challenged, is the best way to get there. I have a track record of that. I am happy to offer some examples if that would be helpful.

Q7 **Chair:** Yes, please. Could you give us some examples of when you have challenged existing thinking within the Bank?

Sarah Breeden: Within the Bank, perhaps I might point to the LDI episode. There were two things where I showed challenge. First, as the issue was arising, I was a strong voice for quick action despite the uncertainty that there was in the situation. Secondly, I was an early advocate of the need for there to be greater resilience in the LDI sector. I gave a speech in early November, well before the December recommendation.

When Russia invaded Ukraine, within the Bank and the FPC there were a range of views on how the impact of that might be relevant to the FPC's responsibilities. What role did we have in commodities markets? How did that dovetail with our remit? As things have progressed, it has shown that we were right to be focused on those issues and the financial stability benefits of money funds being able to borrow in a stress. It is a really trite example perhaps, but you can see in the record of that meeting that some members thought one thing and other members thought another, and I was the one who was pushing for money funds to be able to borrow.

I have some examples of external challenge too, if that would be helpful.

Q8 **Chair:** We may bring those out. I can see you have come very well prepared for all the potential questions we might fire at you. I shall continue to try to coax out some additional information.

You have also given us a lot of information in your questionnaire, which we will be publishing alongside this session. In reading your questionnaire, it struck me that you were quite defensive about what would have happened if the Bank had raised rates more aggressively. You cite a rule of thumb that I would like to know more about. Do you appreciate just how painful the level of inflation in this country has been for people, and particularly for the very poorest?

One of the things you highlight is this rule of thumb. You think that, if we had done more, the economy would have suffered much more. Can you talk us through those trade-offs in the case of the Monetary Policy Committee and the implicit view that you have in your questionnaire that everything has been fine and we made all the right decisions at the right time on monetary policy?

Sarah Breeden: If I created that impression, I have overstated my view. I will try to explain it but, as I do so, I want to make three important caveats. First, monetary policymakers inevitably make policy in real time. I have the benefit of hindsight when I look at what they have done.

Secondly, the series of shocks we have faced has been truly extraordinary: a once-in-100-years pandemic and a war. It is not a surprise that our approach has been tested severely.

Q9 **Chair:** Do you think there been a recency bias on the Monetary Policy Committee, then?

Sarah Breeden: What is clear is that over time the MPC has realised that its understanding of the economy, the persistence of inflation and the resilience of demand, even as it has put interest rates up and we have suffered this great external price shock, has been wrong. Its understanding of how that would impact the economy and inflation has been wrong.

And it has in its more recent forecasts of what is going to happen to inflation and the economy overlaid extra judgments about what it thinks will happen. Given the errors in the past in its understanding of what is happening in the economy, it has looked to learn from those errors and bring these new judgments into its forecast from here.

There are lessons to learn about how we use our models and how we incorporate a broader analysis of the economy at a time of very large changes and unprecedented, out-of-sample episodes of stress. The MPC has learned these lessons. Its approach to taking judgments on the future path of inflation in the August Monetary Policy Report is very different from previously. By definition, we have learned.

Q10 **Chair:** You were going to tell us a little bit more about this simple rule of thumb. You say that inflation would have been around three to five percentage points higher if the Monetary Policy Committee had not increased the Bank rate. You also have another rule of thumb that says how much the economy would have suffered if they had gone faster. Can you talk us through your rules of thumb, please?

Sarah Breeden: This is about the transmission mechanism of policy that we routinely use to forecast forward what happens to the economy as we increase interest rates. The sorts of channels through which it is operating are things like the exchange rate. Had we not increased interest rates at a time when lots of other central banks were, sterling would have been much lower. That would have increased the price of imports. That would have led to a very serious increase in inflation. That is what is doing most of the work when I say in the questionnaire that, had the MPC not increased interest rates, the exchange rate would have been lower and prices of imports and therefore inflation would have been higher.

Q11 **Chair:** Is this rule of thumb a formula that you use?

Sarah Breeden: It is the transmission mechanism, yes. It is our understanding of that.

Q12 **Chair:** Can you explain it a bit more in plain language that the British public might understand?

Sarah Breeden: As interest rates stay the same while interest rates in other countries are increased, our exchange rate falls. That means the price of things that are coming into the economy will rise. Fuel is a really good example. Fuel is priced in dollars. The sterling price of that will rise, and that leads to higher inflation. That is the best example I can think of as to how to make real the transmission mechanism.

Q13 **Chair:** This is not a rule of thumb that is attached to you personally. You imply in your documentation that it is your rule of thumb.

Sarah Breeden: That is a fair challenge. Apologies for that. What I want you to know is I did not write that without speaking to the team who model and challenge the transmission mechanism. I had that discussion before I put that in there. It was not just parroting out what the team told me. We went through all the channels of the transmission mechanism for inflation. Like I say, the exchange rate is the one that happens most immediately because the price adjusts quickly, but it also affects demand and the output gap. That has a more medium-term impact on inflation.

Q14 **Chair:** You looked at the monetary policy team's formula for the transmission mechanism and you agree with it.

Sarah Breeden: That is right, yes. It is important to say that what I want to do when I am in the role is make sure the transmission mechanism remains the best reflection of what is happening in the economy.

It is relatively easy to understand the impact on the exchange rate. That is quite a direct and observable feed-through. It is much harder to think about how changes in interest rates are affecting the behaviour of savers and mortgage holders. Those aspects of the transmission mechanism take longer to come through and we rely on them on to bring inflation down in future. We need to make sure we are on top of those. We need to check that our model of the world continues to reflect what is happening in practice, if that makes sense.

Q15 **Chair:** Going back over the period since Russia's invasion of Ukraine, given that you are taking Sir Jon Cunliffe's seat on the Monetary Policy Committee, can you give us an example of where you think you would have voted differently from Sir Jon?

Sarah Breeden: I honestly think that is really hard to do. The MPC faces a vast quantity of data. It deliberates for days. These are all balanced judgments. I was not around the table, so it is very hard for me to be able to answer that question.

What I can say—it comes back a bit to the answer I gave you in response to your question about groupthink—is that, as I am sat around that table in future, I will be challenging. I will be wanting to understand what our models are telling us and what we are assuming. I will be talking to businesses and banks and trying to understand in practice how monetary policy is affecting the economy. I will not be reliant on the output of models.

As I said, that is one of the things I will bring: an understanding of how the transmission mechanism operates in practice.

Q16 **Sir James Duddridge:** I am new to the Committee. When Sir Jon came along, I thought he was the deputy rather than one of the deputies. Politicians are obsessed by candidates and leaders getting run over by the Clapham omnibus. If the Governor were to be run over by the

Clapham omnibus, who would be in charge?

Sarah Breeden: I think our chair of Court, David Roberts, would look to put arrangements in place. All of the deputy governors have individual responsibilities. Mine is for financial stability; Ben's is for monetary policy; David's is for markets and banking.

Q17 **Sir James Duddridge:** The chair of Court would be in charge.

Sarah Breeden: Let me be clear: I do not know the answer to that question. I imagine that the chair of Court would put arrangements in place involving the combination of staff.

Q18 **Sir James Duddridge:** Thank you. We may come back to that. I was curious. It is not perhaps a question for today, but certainly the public need to know the answer to that.

Turning to communications, in the past some of the media pronouncements coming from the Bank have been a little problematic. Two examples of that would be Huw Pill telling the public they need to accept being poorer and the Governor requesting that workers do not ask for higher wages because this would only fuel inflation. Were these examples of poor messaging? If so, could the messaging from the Bank be better?

Sarah Breeden: I and we recognise that this is a difficult time and that many people are struggling. As the MPC, our focus is on the conditions in which decisions about wages and prices are made. That means we need to have an interest in the level of wage inflation. We do not have a role in individual wage or pricing decisions, but we do have an interest in the aggregate impact of those.

Because we set the environment in which those decisions are made, it is important for us to communicate how we are thinking about those issues. We need to explain how delivering low inflation will support the poorest in our economy. We have complex and nuanced messages to deliver. It is important to make sure we deliver them simply to those who are affected.

If I may just take us on a slight tangent and then come back, one of the issues in financial stability for which I was responsible was the review of our mortgage market measures. As you may know, we placed some limits on household indebtedness in order to stop a build-up of indebtedness that might lead to a bust in the housing market.

As part of that review, in addition to talking to the banks about how they would react, I also spoke to debt charities and social landlords. I tried to ensure that the reason for our measures was understood by those as well as the technocrats. That is our challenge. We are technocrats and we need to deliver technocratic messages that make sense to the CROs of banks, but at the same time we need to be really clear on why that matters for individual businesses and households, and they need to understand what our decisions mean for them. There is continual work that we need to do to improve that.

Q19 **Sir James Duddridge:** I was interested to hear the reports of the Governor's comment to us around interest rates nearly reaching their heights. Clearly, evidence to the Committee is important as a form of communication to the market.

Sarah Breeden: Yes, it is.

Q20 **Sir James Duddridge:** It is a pinch point. Are there any new forms of communication that could carry that nuanced message to the markets while still reaching the constituent in Southend or the person on the Clapham omnibus?

Sarah Breeden: We have to use a variety of media. We are increasingly adding to that media. 10 years ago we wrote long speeches and put out long reports. We now complement those with short video clips.

I did one after the FSR. If you look on the Bank of England website there is a 90-second clip of me trying to explain the FPC's judgments on financial stability. I know the Governor did an equivalent one for the Monetary Policy Report as well. We are increasingly using social media, such as LinkedIn and X, as it is called now, to try to make our nuanced and complex judgments simpler and more digestible.

There is obviously still a role for important formal communications as well, because that is where we can set out the range of our views. I hope they help you hold us to account better.

Q21 **Sir James Duddridge:** You have talked about the Bank of England not operating in a vacuum in relation to a comparison of central banks. What best practice do you see in other banks? In particular I am thinking of Fed, where members are asked to look at interest rates in the future rather than just taking a snapshot.

Sarah Breeden: You mean publishing the dot plots, as they call them.

Q22 **Sir James Duddridge:** I was interested in your view on that but also, much more broadly than that, is there anything that you have seen elsewhere around the world at other central banks that we should be doing as well?

Sarah Breeden: Let me take the example of our outreach programme. We go out and hold citizens' panels, where we ask people from Southend or wherever to come and talk to us about their experience of the economy. I have done half a dozen of those and they are incredibly valuable. I think we copied that idea from the Fed, but we have expanded it and made it relevant to our objectives.

On communications, the ECB is doing a lot on podcasts. That is something we might do more of. It is something we have talked about in financial stability. The aim is to roll it out across all of the Bank's operations at the same time. Those would be the two examples I would give you.

Q23 **Sir James Duddridge:** Could you comment on this issue of taking a longer-term view as to where interest rates will go rather than where they should go today?

Sarah Breeden: It is not something I have looked at in detail, but what I can tell you is that it comes with costs as well as benefits because small changes in those are in danger of being overly focused on.

My guess is that these sorts of issues will be picked up in Ben Bernanke's review. As you know, our way of communicating at the moment is through the fan chart. That is the best collective judgment of all of the MPC members. I suspect that what Ben will consider as part of his review is whether that is the right way of communicating when there are differences of views. Dot plots may be a part of that.

Q24 **Anne Marie Morris:** Ms Breeden, there seems to be a mixed view as to whether a recession would be preferable to higher inflation. Indeed, the Chancellor certainly thinks that getting inflation down is more of a key target than the risk of a recession. Do you agree with him and why?

Sarah Breeden: The important thing to say up front is that the best contribution the MPC can deliver to growth is to return inflation to target sustainably. Everybody agrees on that. Of course, that is what our statutory objective requires us to do.

There are two points about the remit that are relevant to your question. First, errors on both sides matter. It is not only a problem if inflation is too high. It is also a problem if inflation is too low because the economy has been put in recession unnecessarily and there has been some over-tightening. That is really important to remember.

The second thing I focus on in the remit—I explored this a bit in the questionnaire I sent in—is that there is a choice the MPC can make about the pace at which it returns inflation to target. We need to get inflation to target, but, if getting inflation to target quickly would lead to undue volatility in output—a recession, so to speak—we have the flexibility to take our time and not to react so quickly.

The challenge right now, Anne Marie, is that wages are high and rising. There is a real risk that the second-round effects mean that this inflation becomes embedded. That is something I will focus on, as I am thinking about the challenge that you put in front of us.

Q25 **Anne Marie Morris:** You talk about the pace. Have we over-tightened too quickly, effectively? It is clear that, whatever we do—whatever you do—there is a lag and a lead time. There are not going to be immediate results, if you like.

Sarah Breeden: It is certainly the case that there are lags in monetary policy and there is an awful lot of tightening that is to come through. Indeed, it is the effect of that tightening that is expected to bring inflation back down to target.

We are not forecasting a recession. You talked with the Governor and others last week. It is not our intent to cause a recession, and the MPC will be careful as it takes its decisions. After November, I will be very careful in balancing those two factors: the risk of inflation becoming embedded and more persistent through these second-round effects; and the impact of tightening coming through. That is the careful balancing act we have to do. Andrew described it last week.

Q26 **Anne Marie Morris:** You are absolutely right, Ms Breeden. My concern is that you said earlier that we got it wrong, as in the direct link between inflation and the interest rate. Something is obviously not right, and clearly that is being reviewed. Nonetheless, it is the current financial or economic indicator that you still continue to use.

You have said that what has been done in the past cannot be the model for the future because, clearly, it is not working. Today, wage growth of 7.8% was announced, which is the highest on record. That includes the one-off payments made to NHS staff and civil servants, which clearly has to, it seems to me, temper what you think of that. The unemployment rate from May to July has now started to move and has risen by 0.5%. Despite the fact that, after the rectification of the figures, growth seems to be happening, nonetheless confidence seems to be going through the floor.

Given all of that and given that you have said the existing formula does not work, how are you going to make that decision? What is going to have to happen to make you vote to cut the Bank rate?

Sarah Breeden: You are absolutely right in your articulation of the monetary policymaker's challenge. We are looking at the extent to which wage and price inflation—it is important to look at both—is expected in the medium term, not just now. What are today's observations about wages and corporate pricing behaviour telling us about what might happen in the future? We are weighing that against the further tightening that is coming through.

There are a lot of mixed signals. As you said, we have high wages, a labour market loosening and inflation coming down. How those combine to help us come to a medium-term judgment about what is happening to wages and pricing will be what I will be looking at when I am looking at interest rates in November.

How would I go about doing that? I am not a monetary policymaker yet. I am observing the September round before participating as a voting member in the November round. I will be really getting to grips with the UK data and, importantly, understanding the consistency between the signals we are getting now and the judgment the policy has been made on—the policy the MPC had in mind when they took their decisions.

It is not the spot observations of these data now that matter. It is whether that was taken into account when the MPC took its decision about the policy stance. I have not observed the September round and I have not been a part of the November forecast yet, so I cannot answer that question, but that is the process I will be going through.

Q27 **Anne Marie Morris:** That is helpful on process, but there are a number of factors that will impact the decision that is made about what happens to interest rates. Of the many factors, some are clearly more important than others. What is the one single thing that, if it were to change in the direction that would show you that economy were getting back on track and we were getting inflation back under control, would lead you to vote to reduce the rate?

Sarah Breeden: The thing I will be most focused on is the balance across two factors. I cannot give you a single factor because it will be how things combine. It will be the balance of the outlook for persistent inflation, wages and pricing intentions alongside the impact of existing tightening coming through and the impact that is having on freeing up capacity in the labour market. It will be how those two balance out.

Q28 **Anne Marie Morris:** It is very hard to predict the future.

Sarah Breeden: There is an awful lot of data that is going to come out between now and then. As I say, we will combine it in a forecast. In an environment where there are mixed signals, as we have talked about, you have to look at all the data and come to a judgment in the round as to where the balance is. Is the balance such that inflation will persist? Is the balance such that the monetary tightening that has happened so far is going to free up capacity in the labour market and bring inflation down naturally? Those are the two questions I will be asking.

Q29 **Anne Marie Morris:** As you have said the current model is not working, given the challenge of trying to understand the speed of the consequent impact of the change, where are you going to look for additional thoughts, information, statistics and economic evidence to enable you to make a decision? You already say the current model is broken.

Sarah Breeden: The model is the start, but we absolutely need to complement that. The sorts of things I will be focused on are what we are hearing from the businesses our agents are in contact with. We issued the Decision Maker Panel survey last week. There was some interesting data in there about what businesses' intentions were for pricing in the future. That is the complement to the model-based data that will be important as we make that decision.

The way I characterise it is that you can look at the models or you can look at the world around you. Looking at the world around you in these uncertain times will be really important. I am off to Northern Ireland next week and I am off to Nottinghamshire in October. I will be hearing from businesses and understanding what our agents are telling us. That will be a really important complement.

The other thing, in terms of how existing tightening is feeding through, is that we are getting some interesting data and intelligence from the banks. My perception is that people react very differently to coming off a five-year fixed mortgage than if they have a floating rate and their interest rate goes up a little bit each time.

The intelligence we are getting through—we have some data to support this—is that, rather than having the payment shock of refixing at current rates, people are extending the term of their mortgage so the hit to their income is less. That means the transmission of monetary policy is different. Some other people are using savings to pay off their mortgage. That is another important area. We are really deeply trying to understand the transmission of that policy in practice and whether it is as we were expecting.

Q30 **Dame Andrea Leadsom:** Good morning. Just following on from that, at MPC level, do we potentially need to rethink forecasting, taking into account the extent to which households and businesses now try to fix for longer periods of time and therefore the transmission of monetary policy is now much more difficult?

Sarah Breeden: Let me take a step back. We have models, we look at wider data, we take judgments and we make our policy decisions. The models are only a part of our discussion, though they are the important start.

Those models do take into account the fact that people are coming off fixes. The fact that 85% of the mortgage market is now on fixed rates rather than the 20% it was in the past is a part of our modelling. What is not in the modelling is the behavioural response that I tried to illustrate with the example to Anne Marie.

That is an example of where Dr Bernanke's review will be helpful because it will be saying to us, "How do you use the output of those models? What other data do you need to see? What do those models capture well? What are they missing? How do you bring in those other factors and ensure coherence?" The data-based aspects of this are in the models, but the behavioural responses are not. That is where Dr Bernanke's review will help.

Q31 **Dame Andrea Leadsom:** That is a really helpful answer. In your own response to the questionnaire, you have stated that you will have a particular focus on developing a deeper understanding of how the forecast is constructed and what it does and does not capture. You have said that what you really think it does not capture is the behavioural aspect, although it does capture the reality of longer fixings.

Can you just explain that a bit more? Does it capture everything that households and businesses fix, so long-term energy contracts, long-term price fixings for food supplies and so on? Is it weak in that regard? In terms of behavioural activities, do the Bank's forecasting models seek to look at whether in fact people will scrap their gym membership today even though their mortgage does not come up for another eight months? Does it seek to identify those sorts of behavioural changes?

Sarah Breeden: I am not incredibly close to this, so I will give you my best guess on the answer to that.

My understanding—again, I have had a briefing from staff to help prepare me—is that we have a suite of models. We have a core model that ensures that the economy adds up; it ensures the coherence of it. We then have lots of other models that sit outside that, which we look to bring in. We also have some conditioning assumptions, where we say, "What are we going to assume about interest rates? What are we going to assume about the price of oil or the price of energy?"

What the team does all the time to support the MPC is look to augment the assumptions and the suite of models in the light of what we are learning about the economy. For example, the MPC made a big change about 12 months ago—I think it was in August—on what assumption to make about energy prices. Similarly, there has been a lot of work on food inflation and how falls in producer prices might feed through.

There has also been work on something else. We have done energy. I had another example in mind. I am sorry; it is gone.

The team tries to use the experience of the real world to recognise where the models need to be enhanced. Dr Bernanke's review will aim to take a judgment on what we have done so far and see whether there are other things we need to do and whether there is a better framework we can put in place. As you can tell by the way I have told you about what happened, it is a bit ad hoc: "This went wrong so we did this. We learned something about that so we did the other". Dr Bernanke's review will help us put a better framework in place to do that.

Q32 **Dame Andrea Leadsom:** There is always the old saying that all economic forecasting is bound to be wrong, by definition. Most economic forecasts prove to be wrong. In terms of forecasting, would you say your inclination is to perhaps use 30% of what the forecast is telling you from the modelling point of view and 70% your own judgment? You have talked a lot about the use of agents, the importance of understanding transmission and talking to people out there. Do we on this Committee set too much store by the amount you as MPC members take forecasting into account? Is that an issue for us?

Sarah Breeden: It is helpful to think about those different stages. The suite of models produces a number. We bring in other models and overlay our judgment. That gets us to our expected path for inflation, and then we take a judgment on the risks around that. That is what leads to the policy decision.

It is not like the model spurts out an answer and that determines the policy response. All along the way, what I will be doing, and what my colleagues on the MPC have done, is seeking to understand what of what is happening in the economy is captured well in our models and where we need to bring in extra information.

Energy is a really good example of that. As you said, we need to bring in the Ofgem price cap. We need to think about what energy costs businesses are going to face. We used to just do what we call a random walk, a straight line, and assume that today's price continues. When gas was the equivalent of $600 for a barrel of oil, that was clearly not the right thing to do, so we adapted our forecast.

I want to emphasise that it is not a straight output from the model to the policy decision. There is lots of judgment along the way. We try to be transparent about those judgments in the Monetary Policy Report and in the minutes. We look to learn when we have got those judgments wrong.

Q33 **Dame Andrea Leadsom:** To what extent is it a problem that the forecasting models only focus on the experience of the last 30 years, i.e. since the MPC has been in operation? Is that something you expect will change?

Sarah Breeden: I know that was a topic of debate last week. It is really important for your main model to be calibrated or determined with reference to the policymaking environment—the framework that you are in now. The objective of the Monetary Policy Committee is to deliver inflation at 2%. Relationships in the economy to inflation are very different when you have that Monetary Policy Committee in place. For that reason, it is right to calibrate the model on the last 30 years.

However, we need to recognise that what we have seen is extraordinary. The sorts of shocks we have seen have not happened in that 30-year period. That is where we need to bring in judgments and learn from history, for example. I would not recalibrate the model, but I would look to learn from history. Perhaps that is the short answer to your question.

Q34 **Dame Andrea Leadsom:** Have you seen any examples of good practice elsewhere in the world? Are there places that have done it better than we have here?

Sarah Breeden: Again, I am not close to this. I am coming to this role from the financial stability side, not the monetary policy side. My sense from the seat I have been in is that everybody has been struggling with this, not just central banks but also forecasters more broadly.

One interesting question for us all—it is something that we have done, for example, in our climate work—is to consider whether more use of scenario analysis might be useful. Rather than picking a single forecast, could you do some "what if" scenarios and publish a range? In a way, that comes back to some of the communication challenges we were talking about before. It is not all pros. There are some cons to it.

Certainly, it is important to think about what we can learn from history, to consider what scenario analysis might help better inform our judgments and to look out of the window as well as at the models.

Q35 **Dame Andrea Leadsom:** Coming from the financial stability side, would you say financial stability always trumps the monetary remit?

Sarah Breeden: Absolutely not, no. I would say that both our statutory objectives are important. Indeed, I like to think of them as two sides of the same coin. If you do not have financial stability, you will not have monetary stability. If you do not have monetary stability, you will not have financial stability either. They are symbiotic.

Q36 **Dame Andrea Leadsom:** Did you back the Bank deciding to delay the start of quantitative tightening as a result of the LDI crisis?

Sarah Breeden: I was not on the MPC, so it was not my judgment to make.

Q37 **Dame Andrea Leadsom:** What was your personal view?

Sarah Breeden: I thought it was necessary, on financial stability grounds, for us to stabilise the yield curve, which is what our intervention did. Once we had managed to build resilience in the funds that had caused the instability in the gilt market in the first place, we could stop intervening on financial stability grounds and allow the monetary policymakers to continue with their sale.

Q38 **Dame Andrea Leadsom:** That suggests you think financial stability trumps the monetary policy remit.

Sarah Breeden: They are two halves of the same coin. Through our interventions, we sought to stabilise the market, rather than leave it at a dysfunctional level, and then to build resilience so that the Monetary Policy Committee could carry on tightening.

I am trying to think of a better way of explaining it. The interest rate curve that would have existed had the FPC not intervened would not have been consistent with delivering monetary stability because interest rates would have been very high. Our interventions were stabilising dysfunction in the market, which then enabled the FPC to continue.

Q39 **Chair:** Just on quantitative tightening, you imply in your questionnaire that quantitative tightening does have a tightening impact on the real economy. Can you elaborate on that? We have never been able to get anything out of the Bank on that before.

Sarah Breeden: The way I would describe it is that, as we sell bonds back to the market, the shape of the curve changes. There is a small increase in the term premia between short-term rates and long-term rates as a result of that.

Q40 **Chair:** What is "small" for you?

Sarah Breeden: I do not have the data; I have not been a part of the work. In fact, I think am right in saying that an estimate has not been published.

Chair: No, it has not. We are dying to hear it.

Dame Andrea Leadsom: Yes, we are.

Sarah Breeden: It is relatively small, as I understand it.

Q41 **Chair:** Are we talking about one basis point or are we talking about 25 basis points?

Sarah Breeden: I honestly could not answer. I am sorry.

Q42 **Chair:** It is not zero.

Sarah Breeden: It is not zero. There is an impact on the economy. What is clear is that the main monetary policy instrument is the Bank rate. Of course, as you change the Bank rate, as we have seen with the 10-year curve recently, that has an impact on longer-term rates as well.

What I would say is that it is the changes in Bank rate that are having a greater impact on term premia than our quantitative tightening programme of sales.

Q43 **Chair:** How do you know that if there is not any analysis that you can share with us?

Sarah Breeden: That is based on my reading of how the market has changed. When longer-term interest rates move, they have reacted as news about inflation has come out and the short end of the market has moved.

Q44 **Chair:** None of the announcements on quantitative tightening have had any market-moving impact. Is that the implication?

Sarah Breeden: I know my colleagues have been really careful to ensure that we engage with the market and the DMO and that our announcements and actions about quantitative tightening are predictable and prudently scaled in order not to create extra uncertainty in the gilt market.

Q45 **Danny Kruger:** Good morning. I want to ask you about crypto, central bank digital currencies and related topics, if I may. You have answered questions from the Committee before on this, but I just want to get your personal view on how things stand at the moment.

We all recognise that crypto assets and cryptocurrencies represent an alternative payment mechanism. In that sense, maybe they are a good thing for financial stability because they provide a more plural market in finance and payments. Does that advantage currently outweigh the risks that crypto represents to financial stability, or is your current position more that the risk outweighs the benefits?

Sarah Breeden: When answering that question, it is really important to split crypto into its constituent parts.

Danny Kruger: I mean unbacked crypto-assets.

Sarah Breeden: Unbacked crypto is very different to stablecoins. We have been very clear, as the FPC, that unbacked crypto is an asset that has no intrinsic value, and the price of it could go to zero, and therefore investors should be prepared to lose all of their money. That megaphone about the risks of crypto has been consistent and very clear.

However, that technology has the potential to bring benefits to the financial system. In March 2022, just as the war came out, we put out a Financial Stability in Focus report on crypto. What we set out there was how, although unbacked crypto came with risk, there were benefits from the technology, and therefore it would become increasingly used by the traditional financial system. Therefore, as crypto becomes connected with the traditional financial system, that is when you need to regulate it, and it might become a financial stability risk in future.

Q46 **Danny Kruger:** That is interesting. The potential development of the technology, in a sense, is positive, from your perspective. As the technology develops, you think that it could get safer rather than less safe?

Sarah Breeden: The way I would describe it is that this crypto technology and the use of distributed ledgers and blockchains enables two things to happen. The first is about things that currently have to be done across multiple ledgers. If I was sending money to you, I would have to tell my bank, which would have to tell the Bank of England, which would have tell your bank, which would have to tell you. All of those steps involve cost and risk. Crypto technology enables us to be able to do that on a single ledger, with multiple people able to access that ledger and see it. The opportunity to increase efficiency and reduce cost in the processing of financial transactions is there.

The other thing that you can do as this technology develops is, because it is easily accessed, you can do it on ever smaller things. It is cheaper and so you could do micropayments. My judgment is that the technology can fundamentally reshape how we do financial intermediation. That is why we have done the work at the Bank of England on stablecoins and why we are innovating with RTGS with the RTGS renewal programme. We have the digital securities.[1]

Q47 **Danny Kruger:** Explain the RTGS. What is the RTGS?

[1] The witness later clarified that she meant to say: "the Digital Securities Sandbox".

Sarah Breeden: RTGS is the main wholesale payment platform; it is the real-time gross settlement payments platform.

Q48 **Danny Kruger:** That is about the potential for wholesale.

Sarah Breeden: That is right. That is for wholesale.

Q49 **Danny Kruger:** That is great. So far I have not heard anybody object to the wholesale use of this technology; it is the retail and it is the private citizens.

Sarah Breeden: An example I can think of is that when you buy something off Amazon, you might be able to have your payment be transferred only when it has arrived in your house, rather than you paying earlier. There is a greater functionality.

Q50 **Danny Kruger:** What you are describing is that the reduction of friction and disintermediation itself poses potential huge dangers. Friction is almost a means of ensuring some safety in the system.

Sarah Breeden: I totally agree with that.

Danny Kruger: It is great to hear that recognition.

Sarah Breeden: To be clear, I recognise the risks as well. From a financial side, we are very focused on those as well.

Q51 **Danny Kruger:** We recommended as a Committee that crypto should be regarded and regulated as a form of gambling rather than financial services. Are you in agreement with that?

Sarah Breeden: I agree that crypto poses risks and brings consumer harms. I agree it should be regulated, but where I am in a different position to the Committee is in terms of how best to achieve that. Our approach is with an eye to this technology being increasingly adopted, as I just described. My judgment is that this will become an important part of what you and I would think of as traditional finance. With that in mind, it is better to have it within the financial services regulatory perimeter rather than gambling. What the financial services regulatory perimeter will enable us to do is to deliver the same risk and the same regulatory outcome, in terms of custody and the transparency and the fairness of the market. There are conflicts of interest in being able, as we saw with FTX, to hold somebody's money or hold somebody's coins but then use it for your own aims.

All those things are captured by the financial services regime, and so, rather than regulators for gambling, the right thing to do is to bring that activity into the financial services regulatory perimeter, whilst at the same time keeping on the megaphone about, "Unbacked crypto has no value and you should be prepared to lose all your money."

Q52 **Danny Kruger:** That is very interesting. Thank you very much for that. There is lots that we could explore more but we might reflect on that ourselves.

Lastly on crypto, before moving on, do you think the view that you just expressed there—that it is best to treat them as financial services that should be regulated alongside other ones—is shared among central banks globally? Is there a need for a global framework and a consensus across the world? Should we all do this in the same way?

Sarah Breeden: There certainly is that need. In his current role, Sir Jon has done an awful lot to promote the international debate. That slogan of "Same risk, same regulatory outcome" is one that the FSB, for example, has shared. It was actively debated, as part of the recent Indian G20 presidency, as to whether that was the right thing to do or whether you should ban it completely, but the FSB, as the international regulatory standard and the international board that is relevant in this space, has come up with that same slogan.

Q53 **Danny Kruger:** The last set of questions is about CBDC, the digital pound. From what you have said there, given what you think about the development of technology, its potential benefits and the importance of regulating it rather than leaving it outside the regulatory regime, can I assume that you are supportive in principle of the development of a digital currency for the UK?

Sarah Breeden: Let me emphasise that no decisions have been taken yet. It is a discussion paper. We have had an awful lot of responses. We will publish a summary of those, I hope, before the end of the year. On the back of that we need to start a national conversation, actually, because, while I am supportive of that technology, as was apparent in the responses that we got to the discussion paper, there is a lot of concern about privacy. Analytically, it is the right thing. I can see a case for it. We are at the start of the debate on how you manage the privacy challenges and the role of the state.

Q54 **Danny Kruger:** I will come on to that in a second. You are going to publish a summary of the responses. That is very good to hear. It sounds like the responses have been perhaps more than anticipated, and more concerned about privacy than was possibly perceived?

Sarah Breeden: I did not have a prior on that, so I cannot answer, but what I can say is that I would have expected there to be a lot of interest.

Q55 **Danny Kruger:** I agree about the national conversation. It is very helpful. That is why this Committee is looking at it. On the timeline, when do you expect to come out with the actual response to the consultation?

Sarah Breeden: We are hoping to summarise those and publish that before the end of this year.

Q56 **Danny Kruger:** That is just a summary response, but what about in terms of an actual response to the process?

Sarah Breeden: I do not have a date in mind for the next step.

Q57 **Danny Kruger:** The Bank and the Treasury are doing this together, so there is presumably going to be a combined response that the British state comes forward with.

Sarah Breeden: Yes, absolutely. I have not been a part of the discussions yet, so I do not want to give you a date.

Q58 **Danny Kruger:** That is understood. Before we get on to privacy, you said you understand the analytic case for CBDC. I would quite like to understand what you think the advantage is of it or what problem it is trying to solve. In answering that, can you also address one of the main anxieties, aside from privacy, which is for financial stability? What if there is a run? This is a huge incentive. It is a massive "run here" sign over this new function, which would potentially destabilise the banking system very dramatically.

Sarah Breeden: Let me outline what it is for, and then I will come back to the financial stability risk. As I look at the, "What is it for?" question, I have two perspectives. The first is foundational, philosophical or whatever you want to call it. A digital pound would be the anchor for all money in the digital world. We now have bank notes as the anchor for money in the economy. The bank note is the thing that gives you confidence that your pound in Barclays and my pound in Lloyds can be exchanged.

The digital pound would make sure that all pounds are exchangeable for other pounds in a digital world, and so it would support trust in digital money, like taking a bank note out of an ATM supports trust in money today. That matters a lot to me as a central banker, but I suspect it does not resonate with many others. It is important for us not to put that anchor role at risk.

Q59 **Danny Kruger:** What is the implication for cash? You are essentially saying it is replacing the role of cash.

Sarah Breeden: No. Let me answer that question with reference to my children. My children do not do bank notes. I find it hard to imagine that their generation does not have access to a form of central bank money. To be clear—and it is helpful to iterate this here—we will ensure that cash is available as long as it is demanded. We will ensure that the cash infrastructure in the financial system is there as long as it is demanded. Cash and digital money are choices.

Q60 **Danny Kruger:** They are choices influenced by the availability, so it is not just demand. The supply of the form of money also influences the demand. Do you think that the introduction of a digital pound would influence the demand for cash in the economy, or do you think it is unrelated?

Sarah Breeden: I do not have great insight on this. My observation, based on the data I have, is that it is almost bimodal. There are two camps. There are some people for whom cash is incredibly important, and there are some people for whom cash plays no role whatsoever.

Q61 **Danny Kruger:** The increasing availability and impetus towards digital transactions means that cash is being driven out of the economy, because it is so much easier for retailers to say, "No cash", and therefore the use of cash is just going to become increasingly niche because of the drive towards digital. It is not as if these are neutral choices that people are able to make.

Sarah Breeden: I certainly agree that how merchants approach the use of cash is an important debate to have. Parliament is the natural place to have that.

Danny Kruger: Can I just ask a last question about privacy, Chair? I have taken too much time. I apologise.

Sarah Breeden: I have not even answered your question. I am sorry.

Q62 **Danny Kruger:** Nobody in this country wants there to be a programmable digital currency like in the Chinese system, where the Government can basically look at what you are spending and determine what you can spend it on. Can you give assurances that the technology will not allow that in due course? How can we ensure that there is a sufficient firebreak in the tech to ensure that we are not empowering the state beyond the point that any of us would wish to go?

Sarah Breeden: We have not yet got to the point where those issues have been raised. We are at the technical design point. What I can say is that I recognise these privacy concerns about programmability as real concerns. What we need to do, working with Treasury and with Parliament, is reassure the public on how privacy is going to be delivered. Terms and conditions will be set in legislation. We must not assume trust in practice. We need to demonstrate that whatever it is that Parliament has decided is the right boundary for privacy is the one that we will deliver.

If I might just add one point, these issues are important in the world of private digital money as well as the digital pound, so I hope there is an equal focus on that.

Chair: The reason I was keen to hear your answers to Danny's questions is that we will be looking at the central bank digital currency issue in greater depth, so it was helpful to have this opportunity to get your replies on the record.

Q63 **Sir James Duddridge:** Turning to the housing market, the FPC dropped its requirement to stress-test mortgages at 3% above a standard variable rate. Clearly that now seems unwise. I am concerned that the FCA now only tries to stress-test plus one percentage point. What would you do, and how concerned are you that people are actually getting mortgages that they potentially cannot afford?

Sarah Breeden: I can assure you that we looked at that issue in great detail in December 2021, when we took the decision to retire the FPC's affordability test and instead to rely on our flow limit, where high loan-to-income mortgages need to be limited to 15% of the stock of mortgages, while the FCA also continues to stress every single mortgage appropriately.

I can reassure you, Sir James, that we did a lot of analysis before we retired that test. That analysis showed that we got the benefits for financial stability of ensuring that people were not overindebted through the use of just the LTI tool. We had two tools—the LTI tool and the affordability tool—that were doing the same job, and therefore it was simpler to just have one and instead to rely on the FCA's tool.

Q64 **Sir James Duddridge:** Can I just probe you in terms of hindsight? I can totally see why that was the right decision at the time. Equally, I see it as pretty obvious, given what we have now seen, that it would not have been what you would have done if you could have rewound. I am probing you not so much on the decision then, but do you still think it was the right decision now?

Sarah Breeden: I really do, because our interest is ensuring the aggregate stock of indebtedness and the tail of very indebted households is limited. We do not have to intervene as a macroprudential authority on every single mortgage. The FCA does, through its responsible lending. It has its requirements there. We felt the combination of the FCA's responsible lending and our other macroprudential tool gave us a simpler, more proportionate and more predictable way of managing indebtedness in the housing market.

If I might throw it back the other way, had we not retired that tool your constituents would be being stress-tested today at interest rates in double figures. Given that we can get the financial stability benefits without stressing every single mortgage to that level, we thought it was the proportionate policy response to retire it.

Sir James Duddridge: That makes sense on a macro level. We will take up the micro, individual constituent implications with the FCA.

Sarah Breeden: That is exactly right. Had the FCA not got a responsible lending regime, perhaps the judgment would have been different. It was the combination of the FCA's regime and our macroprudential one that we felt delivered the right approach.

Q65 **Anne Marie Morris:** Can we briefly touch on the Edinburgh reforms? What do you think the impact of those reforms has been, for either monetary or prudential policy? I am particularly interested in your thoughts on the changes to ring-fencing.

Sarah Breeden: Ring-fencing is fundamentally helpful because we have an international financial centre on our doorstep. As a consequence of having an international financial centre, we are exposed to shocks from abroad. SVB is a really good example of that. Similarly, Credit Suisse problems overseas can flow back to the UK. What ring-fencing does is ensure that UK businesses and households can rely on the provision of financial services regardless of what is happening globally.

There is an opportunity to review it. Thresholds are always worth reviewing as time has gone by, so I am personally supportive of a review to see if there is tidying that can be done. UK businesses and households benefit from the fact that there is a firebreak, if you like, between the City and the provision of financial services to them.

Q66 **Anne Marie Morris:** You say you understand and accept that there needs to be some discussion about the loosening of this firebreak. Where do you think the line should be?

Sarah Breeden: The proposals are being worked on. Bank of England staff are a part of that, so it is work in progress. What I have heard of the likely changes is not something that would worry me.

Q67 **Anne Marie Morris:** What is your view on the senior managers regime changes? Do you think increasing accountability is going to encourage financial stability?

Sarah Breeden: I absolutely agree that we need to maintain the SMCR. I was in supervision when it was brought in and I saw that the introduction of that regime made people take their responsibilities very seriously. That can only be a good thing in producing safer and sounder financial institutions. I am sure there are opportunities to look at it and see, in the light of experience, whether we can do it in a more efficient way. I know there have been some issues with processing of applications. Are we doing it in a proportionate way? Fundamentally, I agree that it needs to be maintained.

Q68 **Chair:** Sarah, this is your opportunity to bring up anything else that you have not covered in either your questionnaire or in your oral evidence to us.

Sarah Breeden: No. We have covered it well. Perhaps the only thing I could say is that Jon's shoes are very big shoes to step in. I am excited about the role, but in no doubt about the importance of the responsibilities that go with it.

Chair: Thank you very much for your evidence today. I am going to declare that the evidence session has concluded, and we are now going to meet in private.