HOUSE OF LORDS

Economic Affairs Committee

Corrected oral evidence: Governor of the Bank of England—annual scrutiny session

Wednesday 14 February 2024

3 pm

Watch the meeting

Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Burns; Lord Griffiths of Fforestfach; Lord Lamont of Lerwick; Lord Layard; Baroness Liddell of Coatdyke; Lord Londesborough; Lord Razzall; Lord Rooker; Lord Turnbull; Lord Verjee; Baroness Wolf of Dulwich.

Evidence Session No. 1 Heard in Public Questions 1 - 38

Witness

I: Andrew Bailey, Governor of the Bank of England.

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Examination of witness

Andrew Bailey.

Q1 **The Chair:** Good afternoon and welcome to this session of the Economic Affairs Committee. I am delighted to welcome Andrew Bailey, Governor of the Bank of England. Before I go any further, I should register my interest as an adviser to Banco Santander in Madrid.

Governor, it is very good to see you here today. Interesting figures came out this morning undershooting inflation forecasts. How would you describe it? Is it good news?

Andrew Bailey: Yes. In fact, we slightly overshot last month and slightly undershot this month, so it pretty much leaves us where we were.

If you look under the surface, there is a bit more to it than that, which is the encouraging bit. We were expecting a small tick-up in inflation this month because of the so-called annual base effects, which are in the arithmetic because they are basically a mirror image of what went on a year ago. They were there and nothing has changed on those. That means that there were other things going on that were putting more downward pressure on it than we expected, so that is good news. As far as I can tell, looking at it this morning, that amount of downward movement was pretty broad based, with a bit of it in energy, some of it in food, but a little bit in services as well. That is quite encouraging.

As I say, that leaves us broadly where we thought we were going to be, but that is encouraging relative to where we could have been.

The Chair: Huw Pill said earlier this month that "that moment at which Bank Rate cuts might be possible is still some way off". Do you think that what we heard today and yesterday in particular changes that?

Andrew Bailey: I do not think that broadly it changes the picture from where we were with the February monetary policy report. These are pretty small numbers in terms of differences. To reinforce what Huw said, and I made this point at the press conference two weeks ago, the big change is that we have moved in a sense from facing the question of how restrictive we have to make policy to get back to target sustainably to how long we have to maintain this policy stand for to achieve that. That is an important and significant change. Today's numbers leave us exactly in that position.

Q2 **The Chair:** To go a bit more deeply into this, when you are looking at persistence, what data are you looking at in particular? Can you say a bit more about what you are looking at on wages, on the jobs market, and on services? Those seem to be the three categories.

Andrew Bailey: Yes, there are three categories. Services inflation has the highest domestic component in it. Just to give the background on that, we have seen inflation coming down very rapidly, which is really the ending of the global shocks to inflation that we saw a year to two years ago. We were always putting interest rates up. Sadly, we cannot use

interest rates to deal with the consequences of the Ukraine war, but what we can do, and were doing, is to stop the second-round effects to domestic inflation.

These three things are trying to capture those second-round effects. The first thing, services inflation, is important, because it has a much bigger domestic component. It is still above 6%, which is not compatible with a 2% sustained inflation target. It has further to go. However, we have started to see signs of it coming down.

The second thing is pay earnings. Again, we are seeing signs of it coming down. Yesterday's earnings numbers were billed as slightly disappointing. There was quite a marked reduction in pay growth yesterday, but just not as far as we thought. We are seeing that coming down, but we need to see more evidence of that to be convinced that we are on track for 2% sustainably.

The third thing—this is the one for which we are finding the data most challenging at the moment—is the quantity side of the labour market. We had a very tight labour market for some time. The problem we face is that the ONS uses the so-called Labour Force Survey—the LFS—to measure it, and the LFS has had serious problems with the sampling.

The Chair: We will come on to that.

Andrew Bailey: It is affecting more for us the identification of unemployment and inactivity. There are other things that we can use to proxy employment, in a sense, and our staff use anything, frankly, that we think is a decent proxy. There are fewer proxies of unemployment, particularly for the split between unemployment and inactivity. That is the third and more challenging thing at the moment.

The Chair: Are you looking for all three sectors to see persistence easing, or are you looking at one more than another?

Andrew Bailey: In the best world, all three would move consistently. If they do not, we will have to dig under the lid and see what is going on.

Q3 **The Chair:** I read with interest that Swati Dhingra, a member of the MPC, has warned that you may be underplaying the downside risks for the UK economy and has voted for immediate rate cuts. What would you say in response to that, given the figures we have seen in the last 48 hours?

Andrew Bailey: On the growth question, we will see the GDP number on activity tomorrow, which is the third one of the week; it is a big week for data. My sense is this. Last year, GDP was flat overall. We will find out whether we had a so-called technical recession or not, depending on what the fourth quarter number is. In our February monetary policy report, it was in the balance, frankly. We did not have a recession in the forecast, but in the view we took it is at best flat. It would not take much to tip it either way, frankly.

An important point to make underneath that is that if you split that overall GDP number into what we call the market economy and the government economy, the market economy was negative last year and the government economy was positive. By the way, the quite big GDP revisions we had were really all on the government economy—things like health and education.

However, as I said in the speech I gave on Monday—and this is more significant in some ways—we are now seeing signs of the beginning of a pick-up in some surveys, for instance. Certainly the view we took in our February report published two weeks ago is that we have a modest pick-up this year that will continue thereafter. That is being helped by the fact that we have a lower yield curve, and one of the big changes between the November and the February reports was that the yield curve has come down quite substantially.

The Chair: Thank you. Lord Burns will ask about other aspects of this.

Q4 **Lord Burns:** Good afternoon, Governor. First, I should declare my interest as an adviser to Banco Santander in Madrid.

Some commentators have argued that the Bank paid too little attention to the rapid expansion of broad money in the early stages of the pandemic and the danger of overheating that that implied. More recently, broad money growth has been very weak, as set out in your report, and even negative at times. Some of the same commentators are now saying that the Bank may be paying insufficient attention to this. We would like to hear your response to that.

Andrew Bailey: We certainly do pay attention to it. The thing I tend to pay most attention to at the moment, and we had a chart of this in the report, is the relationship between the stock of broad money and nominal income or nominal GDP. That gives you a sense, I think, as to whether there is an overhang or an underhang of money. You can see that it is just now back to the pre-Covid trend line. There was an overhang during Covid. No great surprise there. We know that story without having to go back over it. What we have seen in the last year or so, or a bit more now, has taken that ratio back to its trend line.

The question is what happens next on that front. The change in the broad money measure is that it is becoming less negative now; it is trending back to flat. We will watch that carefully. That is a better indicator than the month-on-month change. The problem with the month-on-month change is that our staff always come in—you may remember this—and there is always something involving non-financial institutions of some sort or other, or some other financial institution, and it gets quite cloudy. That ratio is not a bad indicator of what is going on.

Lord Burns: You also showed that ratio for the domestic sector in the report.

Andrew Bailey: Yes, the household sector.

Lord Burns: The story was much the same there, as I remember, which is that although there has been a deceleration—and, indeed, some negative movement—we are now back to what might be described as—

Andrew Bailey: Yes. If you draw a trend line pre Covid, we are back to that trend line.

Lord Burns: So, in the end, this will be a debate between rates of change and the extent of getting back to levels, and we will learn about this in time.

Andrew Bailey: Yes, and in a way we should. If you take the view—obviously, this is quite highly disputed—that there were extraordinary circumstances during the Covid period, those extraordinary circumstances have now gone and we should be back there, in a sense.

Q5 **Baroness Liddell of Coatdyke:** I want to take you back to the labour market. What confidence do you have in labour market statistics at the moment? I got the impression from what you said earlier that there is a degree of uncertainty.

Andrew Bailey: There is quite a degree of uncertainty. Obviously, it is done on a sample. The completion rate of the sample, or the sample size therefore, was declining before Covid. During Covid, the ONS necessarily used to do a face-to-face interview; it would go to see members of the sample and ask them these questions. On things like inactivity, of course, there are a lot of follow-up questions about what is causing you to be inactive and so on. It obviously could not do that face to face during Covid, so it switched to telephone. The problem is that generally as a nation we do not answer the phone if we do not know who is on the other end, and the sample size has gone down.

The ONS did some things to supplement that such as putting more people on to that work during Covid, but we have observed the sample size going down. We have also observed for a little while that the numbers were becoming more volatile in the short term. These are numbers that you would not expect to be particularly short-run. They will have trends in them, obviously, but you would not expect short-run volatility going both ways.

The ONS has now also published a so-called experimental statistic. I have to be honest: our staff have advised us that whether unemployment is currently 3.8% or 4.2% is pretty hard to judge. The ONS is now working on a new method that it will release later this year. So it is a problem. It is also a problem because the split between inactivity and unemployment has become much more important, particularly the underlying reasons for inactivity and whether we think they will be permanent or temporary. That is a challenge for us. Our staff do a lot of things to proxy. Our regional agents spend a lot of time asking firms for their side of the story. So we try to build it up as best we can. It is easier to do that on employment than it is on unemployment, because it is easier to talk to firms that have employees than it is to talk to people who are not in jobs.

Q6 **Baroness Liddell of Coatdyke:** It is quite interesting. Whenever you look at what is happening with inactivity in the labour market, it breeds considerable uncertainty. The figures out today look a bit scary. How much agreement is there in the MPC on wage dynamics? Immigration is now aimed more at the skilled market, and the wage dynamic is quite important there.

Andrew Bailey: It is. My colleagues have set out their own views in speeches and it is in the minutes. If you take the views of people who vote in different ways, it features quite strongly in the reasons why they have a different view. That is looking forwards at how pay will evolve.

Another challenge for us—this is in a number of reports that we have published—is that we have a number of models, plural, that estimate wage equations, none of which, frankly, has performed well. We have a chart that shows essentially that the committee is setting a path of wages looking forward, which, I have to be honest with you, is entirely judgment; it is not model-based at all. When I say "judgment", I should say that we get a lot of input from our agents, who do a survey every year; they have just done one on what firms think their settlements will be this year. So we obviously use a lot of information. However, that is the other area that has become problematic for the forward-looking view.

The Chair: This is quite worrying, though. You may not be flying blind, but it sounds as though you have serious challenges.

Andrew Bailey: It is one reason why I was so keen to get Ben Bernanke to come, and I was delighted when he agreed. I know there is a difference of view on this. To me, it is not that we are blindly following a model. It is that we have a number of models, and some of them, frankly, are delivering outputs that we do not have much confidence in. Some outputs are fine.

The Chair: We will come on to the models. I am also thinking about inputs in terms of the ONS data. It strikes me, from what you are saying, that you and the Treasury are facing quite a big challenge.

Andrew Bailey: The inputs shape the outputs, so yes, it is a challenge. What is also a challenge—to your question—is the exact reasons for inactivity and what, from those reasons, we deduce might happen in the future.

Q7 **The Chair:** I think I am right in saying that the ONS is now saying that it will not get the new LFS up and running until September. How confident are you from your conversations with it that that will happen?

Andrew Bailey: I do not know, to be honest, because I do not think we are close to the detailed work on the sample and how it is going about it. I was not surprised when it was delayed, because it struck me that it may require longer to put this thing in place, given the deep-seated problem it faces as to how you collect this information.

The Chair: So that we can peel away the problem, I was also struck by

the actual immigration population statistics. Is that also an issue? I am just trying to scope the problem that we are facing here.

Andrew Bailey: There were problems in the population data and in some underlying elements of the labour market data. Until recently, up to the last year or two, the ONS had assumed that the population was no longer ageing, which, unfortunately and sadly, we all are. It has corrected that. We are not particularly well qualified to judge the immigration statistics as they are. We take those as given, to be honest.

Q8 **Lord Blackwell:** Governor, I do not expect you to comment much further on short-term interest rates, but I would like your views on what the long term might hold. We have had a period of very low interest rates. The rate of 5.25% is now regarded as high, but that is after a period when, for a decade, real interest rates were negative. Your predecessor espoused the view that there was a permanent excess of savings in the world economy that was depressing interest rates, so we could expect continued low rates. If you look forward, the one-year gilt is just below base rate, but the 10-year gilt and the 15-year gilt are still above 4%, which if you assume 2% inflation is a 2% real interest rate and would not suggest much of an opportunity for a fall in rates from where they are now. In your view, what might an equilibrium rate look like in the long run?

Andrew Bailey: I will divide this up into what I call the long-term equilibrium rate and the shorter-term more cyclical one, because they are importantly different.

The long-term equilibrium rate for an open economy like the UK is a global thing; it is shaped globally. The point Mark Carney was making about saving and which is reflected in that assessment is that the world has an ageing population, and older populations save more, which determines the supply of saving. We have also had very weak productivity growth globally since the financial crisis, and certainly, if you look at the UK, weak investment. That determines the demand for investment, and the interest rate is the equilibrating price of those two things. That is the argument for why it came down.

If you follow that line of argument, those things are very slow moving, because the world's population does not stop ageing quickly. However, there is now a second and possibly more important element: what we tend to call the shorter-term cyclical equilibrium rate. There are good reasons to think that that has gone up a bit, particularly given what we were discussing about the labour market. Whatever the numbers really are, the labour market is clearly tight. We have a restrictive monetary policy at the moment that is pushing down on demand. Inflation is coming down and unemployment is not going up. That is a good thing, of course; I do not want to come across as decrying that in any sense. However, it is interesting that we are in that situation.

I deduce from that that the shorter-term equilibrium rate has gone up. I cannot give you a number, but if you asked me where I thought it would

settle at some point in the not too distant future, in the medium term, I doubt that we are going back to zero. It will be lower than it is today because it is restrictive today. It will be somewhere in the middle.

Lord Blackwell: A positive real interest rate?

Andrew Bailey: Yes.

Q9 **Lord Blackwell:** Can I follow up one point about the tightness in the labour force? You and others in the Bank have been making the case for moderation in wage demands in order to control short-term inflation and to keep interest rates—

Andrew Bailey: I have to be careful what I say about that.

Lord Blackwell: We are in a period of labour shortage and, given the points you just made about an ageing population, there is probably a permanent shortage of working-age labour. Without continued massive immigration that is likely to continue. I am not a historian, but I was struck when reading about the time of the Black Death in 1350 when the population halved that there was an attempt to control wages by law, which failed. Real wages grew significantly, and in the 50 years after that it was one of the fastest growth rates in GDP per head until the Industrial Revolution because of the pressure on productivity. I am not trying to draw exact analogies, but do you think we need to adjust in the medium term to a higher wage economy?

Andrew Bailey: A book came out recently that covers a number of the big supply shocks in history, of which that is one. It is quite interesting. I read it just before Christmas.

We do have a tight labour market. By the way, I was in the east Midlands yesterday. When I go around the country, it is very clear, and it has been very clear for the last two years. Companies have told me that they would retain labour even if there was a downturn in activity, because they were concerned about how to rehire labour if and when they needed to. We have certainly seen that going on.

On pay, we are seeing, and I expect to continue to see, that as headline inflation comes down—people understandably have to be convinced that it will stay there and come down further—that feeds through into inflation expectations, which will feed through into wage bargaining. We are starting to see that. I will be very clear. That is not me preaching something. That is the mechanism that I would expect to see.

You are right, of course, that it will be shaped by how tight the labour market is. We have just done our annual supply side stocktake, as we call it, of the various components of the supply side, and we certainly see a tight supply of labour in that sense on the supply side.

Q10 **Lord Londesborough:** Governor, I would like your views specifically in relation to productivity, which as we know remains stubbornly low in the UK and has done since the financial crisis. How much of a concerning

factor is productivity in the thinking of the Bank and the MPC when assessing the labour market and wage dynamics? I am thinking in particular about the actual cost of labour in relation to its output. Employers in a market economy, which you were pointing out was particularly struggling last year, are paying almost 7% per annum when productivity is below 0.5%. What are your views on that?

Andrew Bailey: You are right that we have had very weak productivity growth rate since the global financial crisis, which is not limited to this country. This country has been quite a pronounced case, but it is not by any means limited to this country. That is a problem.

The issue for us, of course—it is why we do these supply side stocktakes—is that monetary policy is the balance between demand and supply. We have to have regard to the growth of the supply side of the economy, and the supply capacity growth at the moment is very weak. I have been following your hearings on public debt. Of course, it is an issue there as well. If we are going to adjust debt levels, growth of the supply side and productivity growth are important there. It is significant. It is interesting looking back to the post-Second World War period on this. We came out of the Second World War with a lot higher public debt level than we have today. It was adjusted down over time. There were primary surpluses, but there was also stronger productivity growth than we have now. It is a very important issue in that sense.

Q11 **Lord Turnbull:** I am slightly confused. You said that older people save more, so if we have an ageing population, savings will be higher.

Andrew Bailey: Yes.

Lord Turnbull: I would say exactly the opposite. Older people do not save more; they draw on their savings. We have more people who are about to become old. They may be saving more. I think you said that you did not expect long-term rates to go back down to the levels they were at. On the one hand, you are with the Carney view that there is an excess of savings and, on the other hand, you are saying that interest rates will not go down to the levels they were at before.

Andrew Bailey: I was saying—it is the so-called lifetime savings hypothesis, the Modigliani hypothesis—that people over their lifetimes move from being in a net debt position to being in a net asset position. They do accumulate more saving and assets as they get older. We typically pay our mortgages off, for instance.

Lord Turnbull: Then you reach a point when you start to draw on those savings, as some of us around this table know.

Andrew Bailey: That is an interesting point. You are right. The theory is that at that point you start drawing down your savings, but the evidence suggests that none of us do so to anything like the degree that people think they will. In a sense, what has been observed is that that process does not happen to the degree it is assumed it will. You can attribute a

number of reasons to that. One is that we want to bequest wealth to our offspring.

Q12 **The Chair:** Trying to pull all this together, to use Huw Pill's analogy we are on Table Mountain. We are on the plateau. Base camp is higher than it was as to where rates might settle.

Andrew Bailey: Yes, policy is restrictive at the moment in that sense.

The Chair: Yes, policy is restrictive. Picking up on what Lord Turnbull was saying, Charles Goodhart, in his writing, clearly takes a slightly different view. I think I am right in saying that rates have averaged 9% since the 1970s. You are saying that they will be lower than they are now. How long is the period you are covering that for?

Andrew Bailey: I was talking about the medium term, so I can talk about five or 10 years or so. The long-run argument that I think Mark Carney set out would suggest that nothing has changed, in a sense. We will come through Covid and all these things and still be in the position of having an ageing population. It would be nice to think that we have faster productivity growth, but we have no evidence of it yet. The point I was making is that I, and I think quite a few people, think that the shorter-term equilibrium, which in the end is the thing that determines the next few years, has gone up. That means that we will not come back down to where we were pre Covid.

Q13 **Lord Rooker:** My colleague just mentioned the productivity gains after the end of the Second World War. I had real work in the 1950s and 1960s before I came into Westminster. I was involved in engineering and manufacturing on the shop floor and in management. The economy is not like that now. We had the potential to do things after the Second World War, in terms of productivity, that we do not have now. Is the way the economy has changed a serious problem for us? It is now heavily dependent on services.

Andrew Bailey: There is potential now. AI is potential. It brings its own risks with it, but it brings a lot of opportunities as well. At the Bank of England, like a lot of organisations, we are trying to work out what to do with it and how we can improve productivity with it. There are opportunities. They can be harder to measure, because they are often in what are typically called the intangibles. I think that a lot of the post-Second World War was in tangibles—manufacturing and so on. There are opportunities, but it has been elusive for the last 15 years, certainly.

Q14 **Lord Lamont of Lerwick:** I declare my interest as an adviser to the Official Monetary and Financial Institutions Forum.

Governor, I want to ask you about QT and why the Bank of England is pursuing what some might call a slightly more aggressive policy in QT terms than other central banks. I appreciate that you start from a position with a larger balance sheet, because you held at least 37% of government securities at one point. However, you seem to be the only major bank selling securities in this way. Other central banks are holding

to maturity—a more passive approach. Is there not a danger that you will create a vicious cycle whereby prices are driven lower, and a lot lower than when they were purchased, there are huge losses, and you have to issue more gilts in order to fund the losses?

Andrew Bailey: I can think of at least two other central banks that are doing the same thing as we are doing: the Swedish central bank and the New Zealand central bank.

Lord Lamont of Lerwick: Not the Fed or the ECB.

Andrew Bailey: The Fed is in a different position, because the US debt stock has a very short maturity. The Fed is holding a very short maturity of assets on its balance sheet, so it can rely on run-off to achieve the same thing. The UK debt stock is longer maturity on average. Going back to 2009, we bought throughout a representative set of the UK debt stock, so we have much longer-term assets on our balance sheet. If we relied on passive run-off, it would be 50 or 60 years before we saw it all go off. That is an important consideration.

I would also say this. If markets are efficient, the cost of passive run-off is the same as the cost of active run-off. It is either a carry cost or a sale cost. Those two things will equilibrate if markets are efficient. I hear it said sometimes that if only the Bank of England would hold these assets, the losses or the cash flow would go away, but that is not the case. I would just enter that caveat.

Secondly, we monitor market operations and market efficiency daily. At the moment, we see no evidence of a problem in the gilt market in that sense. In fact, this year, not just in the UK but globally, the demand for debt from investors has been very high, probably because they think interest rates will come down. There is no problem selling gilts at the moment, I would say, but we will have to keep watching that carefully.

Finally, and this is important for how our thinking goes forward, there are two parts to this story to do with how our balance sheet works. The total size of our balance sheet, which is coming down, will be determined by the demand of the banking system for reserve assets. We will have to see at what point that demand for reserve assets hits steady state. I said at a lecture I gave on Monday that it will be higher than it was pre crisis, and lower than it is today, but I know that is not a very helpful answer because there is a very big gap between those two numbers.

That is really not QT. QT is about what assets we hold on the other side of our balance sheet to match those reserves. When we get to the point where we hit this steady state reserve level—as I said on Monday, I think it will be higher than we thought it would be—the question then is: do we continue the QT, which will allow us to adjust the assets on the balance sheet and to remove interest rate risk from the Bank of England's balance sheet and put it back out into the market? That is what I think we should do. It is a genuine decision to take at that point. We will have to take that decision and to expose the thinking behind it to full scrutiny.

Q15 **Lord Lamont of Lerwick:** Could I ask you about the macroeconomic effects of QT? When you appeared before the Treasury Committee with David Ramsden, it was explained that you needed QT, first, to give headroom space for likely future interventions and, secondly, to correct distortions in the market. The impression was given that there was no macroeconomic effect from QT. When it was put to you, I think by the Chair of the committee, that this was something of a leap in the dark into unknown territory, you said yes and it is why you keep it under review. Have you had any further thoughts from that review? Is it not odd, if you introduce QE in order to achieve certain macroeconomic effects, to argue that QT, an almost opposite policy, does not have any effects?

Andrew Bailey: I understand the point, but the reason is as follows. First, we monitor it constantly. We published an updated assessment of QT in the August monetary policy report last year, and I expect we will do the same thing again in the August report this year. We do it every year, and at that point in the year, because that is when we decide what we will do for the 12 months to come.

They are different, because when we were doing QE we were not altering bank rate; we were using QE as the monetary policy tool because we had hit the lower band. Today, of course, we are using bank rate as the primary tool. We are not using QT as a monetary policy tool. The point I made to the Treasury Committee that you are recalling is that we set bank rates based on the yield curve that we have, and that yield curve will take into account the impact of all the things that go on, including the impact of QT. In other words, when we set bank rate we are taking into account any impact from QT, whatever that might be. We can do that, and we are using bank rate as the primary monetary policy tool, so altering bank rate is what in a sense draws the distinction between QT and QE.

Q16 **Lord Lamont of Lerwick:** Thank you. I would like to ask you about the fiscal consequences of QT. The OBR estimated that, based on market expectations for the bank rate and gilts, the cumulative net loss that might be realised would be about £126 billion. Before you remind me, I acknowledge that you had profits on the other side of the transaction when QE was implemented. David Ramsden told the committee at that session that the MPC decisions about the scale and composition of QT will not be affected by value for money considerations. Surely somebody has to be considering value for money considerations.

Andrew Bailey: I will make two points on this. First, those cash flow numbers move around quite a lot. The number we published recently was £40 billion or £50 billion lower because the yield curve has moved. Those numbers are quite volatile. More importantly, I do not think that the cash flows are a measure of economic value for money, because they are only a measure of cash flows. They do not measure the impact of QE and QT in terms of the economics. It is more QE in that case. In overall economic value for money, it is a much broader consideration than just the cash flow. As I said earlier, in an efficient market the cash flow numbers will be the same whichever strategy we employ.

Q17 **Lord Burns:** Could I widen this discussion on the fiscal costs of QE and go back to the whole exercise of QE followed by QT? I was also disturbed by the notion of seeming to rule out the consequences for fiscal costs of some of the action. When you embarked on that whole policy, was consideration given to the potential fiscal costs, given where interest rates were?

Andrew Bailey: When we embarked on—?

Lord Burns: In the pandemic, the latest round of QE, who decided what scale of fiscal cost or fiscal risk could be incurred? Was this a Treasury decision? Was it a joint decision?

Andrew Bailey: The MPC decided on the amount of QE to do, but the Treasury has to take the decision to adjust the indemnity that the Bank has. It is interesting to reflect back on it now. We were in a state of crisis at that point and, to be honest, the decisions then looked very different to how they are sometimes considered now. If you do not mind me saying so, there was a bit of, "This is a crisis. We've really got to act". We had a crisis in the markets at that point, but we also had an economic crisis. The cost-benefit considerations looked very different at that time.

Lord Burns: Hindsight is a wonderful thing, and I am not questioning that so much. I am questioning who took that into consideration. Quite a large fiscal risk was going to be involved with it, which may have come out positively. As we have seen, we have had a very large negative.

Andrew Bailey: It was very hard.

Lord Burns: I am just puzzled. Once people make statements like, "We don't take fiscal cost into consideration", it rings alarm bells, as you might expect given my background. I am trying to pin down where that decision was taken.

Andrew Bailey: The decision was far more about what I would call the economic cost-benefit. You are much more skilled in this than I am, but I would say that that on its own obviously has big consequences for fiscal policy. The consequences of what would have happened if we had gone into a prolonged recession in Covid would have been very different. Those were the considerations. It was not so much the cash flows. The cash flows, of course, were inherently hard to model, because we do not know what the curve will be going forward.

Q18 **The Chair:** Can I pick up on a couple of points that have been made, Governor? The first was made by Sir Charlie Bean, who yesterday or the day before suggested that a new lower interest rate ought to be paid on commercial banks' deposits created under QE, reflecting similarly what the ECB is doing with the policy of tiering payments on reserves. What do you think about that proposal?

Andrew Bailey: Let me explain something about the ECB. The ECB still has in place a policy of minimum reserve requirements. We do not have a distinction in our system of two sorts of reserves. All our reserves are the

same, so it would be hard to make that change. I have said before—and it is a slightly blunt thing—that that is a tax on the banking system. I do not think that the Bank of England can decide to do something like that on its own. It would be wrong for us to do that. We would certainly have to do that with the Government. Also, that system of paying bank rate on reserves anchors the implementation of monetary policy. It anchors the short end of the curve at the official rate. We would have to be very careful how we implemented anything like that. That is a pretty substantial change and not one that I would currently advocate.

Q19 **The Chair:** The second issue is the deed of indemnity, which comes back to what Lord Lamont and Lord Burns were talking about. I am a bit mystified about what the Treasury is saying to us on this. The Chancellor has written to the committee and once again is saying that the Treasury will not publish the deed of indemnity. I will quote what he writes in his letter: "It is in line with HM Treasury's risk assessment, given market sensitivities related to the document. A disclosure of operationally sensitive information relating to QE, including details relevant to the Government's cash management operations, could have an adverse impact on the Debt Management Office operations".

I find that odd, because you said to us back in 2021 that there is no mystery about this document, and Lord Macpherson has also said that it should be published. He said, "I don't think it contained anything interesting at all". Either it contains something that is of great interest, which is what the Chancellor seems to be saying, or it is meaningless. I take it that you are standing by your view that it is no mystery to us at all and it could be published.

Andrew Bailey: Lord Macpherson should know, because he probably wrote it. I read it, as I said, back in 2021. You are right. It is not a short document, but it is a pretty straightforward indemnity. It is not in the Bank of England's power. That is a government decision. It is not one for us.

The Chair: Can I gently try to probe you? Does it have this point about market sensitivities in it?

Andrew Bailey: You have to ask the Chancellor or the Treasury that question.

The Chair: No doubt we will.

Andrew Bailey: I am sorry.

The Chair: We will write to the Chancellor and see where he gets to on that.

Q20 **Lord Lamont of Lerwick:** Do other central banks have a deed of indemnity?

Andrew Bailey: No. Other central banks tend to have the arrangements set out in a rather unusual way, and the reason is as follows. The UK is

unique. We have to go back to the Bank Charter Act 1844, I am afraid. In 1844, Sir Robert Peel split the Bank of England into two parts, the issue department and the banking department, as is on our accounts. There is only one thing that is the liability of the issue department and that is the bank notes in issue. They are obviously non-interest-bearing assets.

We invest the proceeds of the notes in interest-bearing assets, and they earn what is called the seigniorage. What is unique about the UK is that all the seigniorage is paid straight over to the Treasury after we deduct the cost of printing the notes and so on, but that is very small compared to the seigniorage. The seigniorage has gone up because it is unhedged interest rate exposure. Annualised, it has gone up from about £200 million a year to something like £4 billion a year currently, because there are about £80 billion of notes in circulation.

I make this point, because other central banks—taking the Fed as an example—essentially book a deferred loss on to their balance sheet for the QE and offset it, as I understand it, by future seigniorage income. We do not have any future seigniorage. We could not do that because we just do not have any income to offset, so that would not work. That is one reason why the indemnity has to exist. At the end of the day, you could say that these things are all the same. Economically, they are probably all the same. If the US system did not have that deferred asset, the Fed would be paying more of its profits over to the US Treasury, but it is not going to for some period of time. We are doing it from an indemnity but, as I understand it, that is why we have a different system here. You can thank Sir Robert Peel for that.

Lord Lamont of Lerwick: Yes, but the indemnity is a modern invention.

Andrew Bailey: Entirely. The indemnity is separate, yes.

Q21 **Lord Razzall:** Governor, in your detailed answers to Lord Lamont you may have answered my question, but let me ask it anyway. Clearly, a number of Governments throughout the world are looking at and have the need to finance through the issuing of bonds. We have falling bond prices. Do you see a problem with appetite for UK bonds, or do you think we are okay? Will there be any changes?

Andrew Bailey: We have falling bond yields. We have rising bond prices at the moment. As I said earlier, demand for debt across markets has been very strong since the start of this year. You see that in the gilt market, both in the auctions that the Debt Management Office is conducting for new issue and in our own auctions under the QT programme. The cover rate on the auctions is high at the moment. I would say that at the moment there is no issue about the ability to sell debt. We have to keep that under constant watch, though. That is important.

Lord Razzall: You do not see any problems in the medium term.

Andrew Bailey: Not at the moment. In the meantime, we have to keep it under constant watch.

Q22 **The Chair:** I think you put the preferred minimum range of reserves in 2023 at £325 billion to £480 billion.

Andrew Bailey: Yes.

The Chair: Is that roughly where you are still?

Andrew Bailey: Yes. I would probably lean towards the upper end of that number. Bear in mind that it is in the upper 700s at the moment. By the way, it was about 10 to 20 before the financial crisis, but we did not have any financial stability protection in there. I would probably be at the upper end of that range.

There is, by the way, another element to this that will work its way off in the next two years, which is nothing to do with QT and is our so-called TFSME lending programme to banks during the Covid crisis. That will come to its end during the next two years. That will take reserves down as well.

The Chair: Very good. Moving on to another aspect of this, Lord Layard has a question on the national debt.

Q23 **Lord Layard:** I wanted to ask you about the sustainability of the national debt in the medium and longer term and how important it is to reduce the debt-income ratio in the coming years. Yesterday, we took evidence from various international parties. We heard that the UK has the lowest debt-income ratio in the G7 bar Germany and the tightest fiscal stance in the G7. Do we really need a still tighter fiscal stance to reduce our debt-income ratio?

Andrew Bailey: I should say that it is for the Office for Budget Responsibility to offer its views on sustainability. For me, there are two things that I offer as framing comments, if that helps. The first is that this goes across countries. We have seen some very big shocks in recent years, Covid being one, Ukraine being another. Arguably, climate change also falls into this category, because it is about intergenerational investment. Those have put a strain on government finances, so the question arises: what is the sustainable position on government debt? Of course, it is hard to know what shocks we will face in the future. The last four years have not been very encouraging in that respect.

Secondly, I go back to the point about post the Second World War, which I find quite interesting to look at. We have done a bit of work to try to plot what happened. We came out of the Second World War with a debt-to-GDP ratio in the upper 200% range, I think. It came down quite a long way over several decades. Inflation has a complicating effect on the story, but there seemed to be two underlying parts to why it came down. One is that the UK up to the 1970s was running primary surpluses on the fiscal side. Secondly, going back to the earlier conversation, stronger growth and stronger productivity growth were part of that adjustment story. It is very good that you are holding these hearings. I follow them all, and I followed the one you had yesterday, because these underlying questions about what the right pattern of primary balances is and how

growth in the economy and growth on the supply side of the economy can contribute to this is important.

Lord Layard: There is obviously the argument that when the sun is shining you mend your roof.

Andrew Bailey: Yes.

Lord Layard: The obvious question is: is the sun shining at the moment? It is a time of a lot of difficulty in funding the social services and so on, and it would be helpful to us to know from the Bank's point of view how important being responsible for financial stability in this country is in order to reduce the debt-income ratio now.

Andrew Bailey: I do not know about the sun shining. As I say, it is not really for us to judge that. One thing I would say is that the pressures on government financing are pretty severe at the moment. You rightly point to another consequence of an ageing population. It is a very important issue for Governments around the world in thinking about how they manage these demands on government finances, it seems to me. That is why it is very good that you are doing this inquiry.

Q24 **The Chair:** On the vulnerabilities we face, as you were saying, compared with the post-war period we have tailwinds that have become headwinds. In terms of demography, you mentioned one. Can you talk a bit about how you see the vulnerability of our debt, its short-term nature, the maturity of it, and more of it held by foreign investors? Should this be troubling us, or is it more the medium to long run when we are examining the sustainability of our debt? Will some of those features dissipate over time?

Andrew Bailey: I understand that QE complicates this while it is still in place, but the UK made progress over the years to lengthen the maturity of its debt stock. It is longer than other G7 countries, if I remember rightly. It is certainly longer than the US debt stock now. You can always say that it is a reserve currency, so they have that luxury, but the UK has done a lot to lengthen the term of its debt stock over the years, and that was a sensible thing to do.

The Chair: How concerned should we be about the vulnerability of our debt as it currently stands when we are considering this issue of debt sustainability?

Andrew Bailey: Again, I make the point that we are an open economy. Yes, we have tended to have a higher proportion of overseas investors. There is another source of demand from domestic pension investment. There is a genuine question there now about the pattern going forward. The Government have, rightly, put on the radar what the role of pension funds should be in so-called productive investment in the economy, because this goes back to the productivity question. That has to be worked through as well.

Q25 **The Chair:** Are we overreliant on what Mark Carney called the kindness

of strangers? Richard Hughes said that international investors might be fickle and flighty. Should we be concerned about that from your perspective?

Andrew Bailey: We have to have an eye on it. I do not think the evidence suggests that it is quite as volatile as that might suggest, but we have to have a fairly careful eye on it.

Q26 **Lord Griffiths of Fforestfach:** Governor, thank you very much for coming.

In your response to our report, you dealt with the problem of groupthink. You make the point that there is clearly diversity in the Monetary Policy Committee. There is no doubt about that. People take different positions. They vote differently on what to do with interest rates. The *Times*, in commenting most recently on our report, said that one of the members of the MPC describes himself as a very convinced monetarist. From that point of view, there is no question that there is diversity.

The person who captured our concern was Raghuram Rajan in his evidence to us. He said that over the last 20 or 30 years there had been a change in fashion in the academic world of how they viewed inflation and the causes of inflation. They put more emphasis on expectations and central banks influencing expectations than on central banks creating money and so on. That is a change in fashion that started in the academic world. Those graduates do PhDs and go to central banks, and before you know it the whole of your economics department is coming out with almost a revolution in the way it thinks about inflation. Of course, most of these people were very young during the early 1970s inflation. What is your current thinking on diversity and the way you are managing it?

Andrew Bailey: It is a very good question. I will start by reinforcing the point you made first. We have just had a three-way split on the voting at the committee, the first time since 2008, so there is no lack of diversity in the MPC's voting. By the way, it is important that we are transparent about the views of the committee. It is obviously important that we reach a decision, and we do, but it is important that those views are set out. Obviously I take one position, but reasonable people can take different views on these things. That is always important to bear in mind.

You have had much more experience of this than I have. I do think that the academic community has a certain tendency towards herd-like behaviour at times. The expectations point that you make is interesting. I am probably in the group that is quite sceptical about forward guidance. That is part of trying to guide expectations. I am quite sceptical about it. We are doing it only in the sense that you are always expressing a view about the future. We are not doing overt forward guidance. It is easy to get into it and really hard to drop it once you have it. It overstays its welcome, and we have had these discussions in the MPC. So I am fairly sceptical about that. There clearly was a body of opinion that thought that that was a tool of monetary policy that you could use to make your job easier. You did not have to move interest rates around as much, and

recent years have not been very promising on that front. Let me put it that way.

It is interesting how you shape that thinking in the academic world. Central banks have to engage in the academic world, and we do. Raghuram has been in both, so I think he is right to make that point about the danger of these things sometimes becoming quite embedded.

Lord Griffiths of Fforestfach: Presumably that is something that Ben Bernanke will take into account in his review of the whole issue of forecasting.

Andrew Bailey: Yes. The backdrop to why I was keen that we had Ben Bernanke do this work is, as I said earlier, that we are having to use a huge amount of judgment at the moment. Putting it like that, you would say, "Of course you are. That's what you're there to do", and you might ask what we would expect if there are supply shocks like pandemics and wars. I take that point in some ways, but the tools have not served us particularly well. I am delighted that Ben Bernanke is doing this work, because I am sure we will learn a lot from it both about the tools and how we use them in policy-making and presenting policy.

Q27 **Lord Lamont of Lerwick:** I was very interested in your remarks about forward guidance. I think the scepticism is well justified, but do you think that in the past—in the great moderation, particularly in the late 1980s/1990s—central banks have overestimated their own influence through words and underestimated effects like China?

Andrew Bailey: That is a good question. China has had a big effect. By the way, it is one of the things that we look at at the moment, because, going back almost to the Chair's first question, if we look at the components of inflation and what balance of components gets us to an overall 2%, we need to be a bit careful about looking back into the great moderation period, because clearly China's entry into the world economy was shaping certainly goods prices at that point. China is currently back in deflation again. Structurally, it will probably be a different story going forward. That is important to bear in mind when we think about the situation we are in today.

Q28 **The Chair:** Can I pick up on one point in our report and what Lord Griffiths was talking about, which is the focus on the money supply? It comes back to the first bit of this entire conversation. A number of us were concerned about this. The witnesses pointed to a sense that there was not enough focus on the money supply, and we make this point in the report. Stephen King, who is an adviser at HSBC, said that the money supply was ignored "in a rather foolish fashion", which is quite strong words. Since then, Tim Congdon at the IIMR has been pointing to the largest one-year drop in the modern statistical record in M4 and Amex. To what extent is that a real focal point in your discussions as you look ahead? We were thinking that it should be more reflected in your reports. I do not know whether you sense that that criticism was unfair.

Andrew Bailey: It is, but I go back to the point I made earlier. Stephen and Tim may not agree with me on this, but I would look more, as I said earlier, at the relationship between the stock of M4 and nominal income. I know there is a bit of a philosophical divide in that world between whether you look at rates of change or stocks and levels. I think the virtue of looking at that stock ratio is that you really get to the question of whether there is a money overhang or an underhang. As I said earlier, we are sort of back on the trend line again at the moment.

The Chair: Right. There are quite strong words. I think Julian Jessop, for example, goes on to say that it is signalling a severe recession.

Andrew Bailey: I know this is touchy ground, but monetary theory is excellent in the way in which it grounds the whole thing. It is not a great forecasting tool, as history would tell us.

The Chair: You are saying that these concerns are overblown.

Andrew Bailey: They are right to say that you should always be looking at it and you should always be concluding. We have a sectoral money model amongst our models and always have done. On its own it is not as good a forecasting tool as some of the commentary sometimes makes out.

Q29 **Lord Rooker:** Governor, my question, like Lord Griffiths', is based on our report. Thanks for being so open with us. I want to give you another chance to be really open with us. When you came to give evidence on the report, we had a long discussion about the primary and secondary objectives. You clearly made the point that the secondary objectives are not without cost, they create more work, and they make policy-making more complex. So when we said in our report that the Bank may be doing too much, we took those points, which we heard from other witnesses as well, into account. Yet you rejected them. You rejected our report. Why?

Andrew Bailey: There are two levels to this, and if I misunderstood I apologise. At the higher level—I will go back to the pre-financial crisis world for a moment—it was a mistake to separate financial stability and prudential regulation of banks and insurers from the central bank in the way that happened. I am afraid we learned that one the hard way in the financial crisis, and putting them back together was the right thing to do. That increases the responsibilities of the Bank, and this is what lay behind my response. That does make our life more complicated, but it is a complication that is inherent in being a central bank and we just have to take it on. I have a management team who can do that.

The second point is the one you make and is about the secondary objectives. By the way, this is really about financial stability and prudential regulation. It is not so much about monetary policy. The monetary policy framework is still more straightforward. They have grown. I understand that there are very proper debates about things like competitiveness, but the size of those remits has grown over time, which

makes our life more complicated because we have to take them very seriously. When we are given them by government and by Parliament, we do not just toss them to one side and say, "I'm not going to do that". We do take them seriously. I said what I said because I do think it is important not to overburden the remits in that sense, because it makes our life much more complicated.

Lord Rooker: Now that the Chancellor has proved the objectives by pruning the climate change issues, how does that affect the Bank?

Andrew Bailey: Just to be clear, this is on the financial policy stability side and not on the monetary policy side. Activity, climate is still included in the remit. The Government state in their remit what they regard as the key policies that we should have regard to. They took out the things that they had in there related to climate. They have not taken climate risk out. We are doing this at the moment; we have had to sit down and say, "What does that mean?" We still have to look at what the climate risk is for financial stability. There is a financial stability risk in this, so we have not ignored that. But it does mean that we do not have quite such a precise regard for government policies in that area because they have taken them out of the list of government policies. We tried to slim it down in that sense and have somewhat reduced our resources in that area as well.

The Chair: I was going to ask you that. So have you reduced resources on climate as a result of this?

Andrew Bailey: We have somewhat reduced our resources, yes, and we are currently reviewing it again at the moment.

The Chair: You have talked about the number of people you have devoted to it and what they are doing. Do you think you will still be focused on keeping up the momentum on this? I see that Positive Money has said that "climate change no longer seems a priority". Is that the mindset you are in: that it is no longer the priority it was before the FPC remit was reset?

Andrew Bailey: No. It is very much still in the set of financial stability responsibilities. In so far as the Government have changed their focus, the remit says that we should have regard to the Government's focus, and we have changed in that respect.

The Chair: Are there things that you were planning to do that you are not going to do now?

Andrew Bailey: The depth and breadth of work that we do will be trimmed back. As I say, we will focus on what I call core financial stability risks.

The Chair: Does that make your life easier?

Andrew Bailey: Unfortunately, there are plenty of other risks that are coming down the track. Sadly, there is no shortage of risk. There is

always an issue for us about relative priorities; we are, for instance, having to put more focus on operational risk and yet more focus on cyber risk in that world.

Q30 **Lord Turnbull:** In our report, at paragraph 124 onwards, we highlighted concerns about financial modelling and how those models were used. Interestingly, before our report was published, you had already appointed Ben Bernanke to review this field. So clearly you too had spotted shortcomings in this area. Can you tell us a bit more about what you thought were the problems there, and what solutions you hope Ben Bernanke might come up with?

Andrew Bailey: As I was saying a few minutes ago, I know some people have said the Bank is obsessed with one model. That was not the case. The problem is that we have a suite of models, but we were in a situation where that suite of models was not really giving us what I call the guidance and assistance that we would like to have. As I said earlier, a lot more judgment has to be applied by the committee and by the staff to help us through these things, and wage equations are a pretty good example of that.

One of the origins of the Bernanke report was to say, "Look, we really do need to take stock of this and decide other things that we could or should be doing that we're not doing but really ought to be doing in the future in that world". There are at least two other parts to it. One is how we in the Bank organise ourselves—how the modelling and the data work is organised. Again, we have other things like AI coming along, as I said.

A big thing for us is how the committee present that. That is something that I have also encouraged. We have had the fan chart ever since the beginning of the MPC, so for over 25 years. Is it still the right way to convey uncertainty and risk with scenarios? Would that be a useful thing for us to do? In the way we do it, we put more weight on the forecast in presenting policy than other central banks do. That has pluses and minuses. We try to give our best view of the moment, but I am always conscious, as I said the other day, that all the forecasts that we do are conditional on yield curves, energy prices and fiscal policy. I am afraid that, once they get into the outside world, they are treated as unconditional immediately. Are we putting too much weight on a central case, for instance? These are the questions that I am very grateful to have Ben Bernanke looking at.

Lord Turnbull: What is the timescale? Has he started work?

Andrew Bailey: Yes. He is well into it. In fact, he is busy writing, as I understand it. I think it will appear some time in the spring. I am not sure exactly when because he is busy, hard at work.

Q31 **Lord Layard:** Would it be correct to say that, up to about 20 years ago, the central model was focused on the wage-price barrel, that was then dropped and is now something that you want to reintroduce? Is that the right way of thinking about it?

Andrew Bailey: This may not be the right answer. Tell me if it is not. There is always a variety of Phillips curves in there. At the heart of most of these models, there is always one of those or something like that in there. There is a variety of ways of getting to it, but they have not changed that much.

Lord Layard: Wages being a more central issue than they were in the model that you have been using for the last—

Andrew Bailey: I think I am right in saying that this is the chart we have used a few times. I have used it. I think we have three wage equations, and we produce what we call a swathe, which is essentially the output of those three equations. Then we show this line above it, which is actually where the committee is setting the path of wages. These three equations are telling us something, but they are clearly not telling us the answer in that sense.

Q32 **Baroness Wolf of Dulwich:** Could I come back to the point you made earlier about forecasting and that the Bank does more than any other central bank? You said earlier that the wage models were not working very well, and we know that the financial model has not been working very well. I have two questions. First, is anything working well? More seriously, surely you all have to have some sort of modelling going on. Is the difference really in the way you make decisions, or is it more in the fact that the Bank goes out into the world and lets it know what the forecasts are, and is that helpful?

Andrew Bailey: That is a great question. All central banks do it in a slightly different way. The Fed has so-called dot plots for each member. We produce what we call a best collective judgment forecast. I perfectly understand that some members of the committee are more signed up to it than others. You can tell that from the way they vote, obviously. In some other central banks, the staff produce a forecast, and you can try to work out to what extent that is passed through into the policy-making judgment. It is obviously an input to it, but the policy-making judgment is more described in words than in forecasts.

There is no great common ground. There is no uniform model for how central banks tend to do that sort of thing. People have said over the years that we are more of an inflation target forecasting institution sometimes; I am not sure who used that term first. The forecast has always sat in the middle of it. But it is challenging at the moment.

We have not thrown the theory of the models out. That still drives the committee, and you have to have a framework. I would also say that we have a central model, because ultimately things have to add up. The component parts of GDP have to add up to the total of GDP. Those are simple errors, but you have to avoid them. So there is a framework sitting in the middle of it. We have had to go out of the models but hang on to the theory to come to these judgments. As I say, we use a lot of information from our regional agents, for instance, to inform the judgments that we make.

Q33 **Lord Burns:** Could I return, Governor, to the opening points that you made about today’s inflation rate and the whole question of uncertainty? One of the things that struck me, looking at it relatively quickly, was that we seem to have moved to a position where many of the special events seem to have come out of the numbers. So many of the different definitions now look within quite a narrow range, when one looks at groups of prices and that whole period of saying that this has all been affected by energy prices going up, or by energy prices coming down, or by food prices. Is there a danger that we are going to get stuck with inflation at around this rate of 4% and that the last part of the journey will become much tougher than it has been so far? How much appetite will there really be to get back to this final stage?

Andrew Bailey: The forecast in the report that we published two weeks ago indicates that it will come down to about target by spring. One reason for that comes back to energy again and that, in today’s number—this is a slightly strange thing to say—there was a bit of an upside from energy, in the sense that the latest Ofgem reset has meant that it was not falling quite as fast as it was. However, I think I am right in saying that the Ofgem period ends next week, so we are well through the observation period. The next Ofgem reset looks like it will have quite a drop in it.

By the way, we were wrong on one thing back in November, although I defend why we were wrong. A month on from the terrible events in the Middle East, and drawing on history, predicting back at the beginning of November that oil prices will not go up and gas prices will come down substantially, given what was going on, would have been quite hazardous, but that is what has happened, for a variety of reasons. It looks like we are going to have quite a further leg down between now and spring, April/May, time.

On what we published a couple of weeks ago, we think that that will stay around for the summer, but the base effects will start to go into reverse. Just to be clear, because it is important to put this into perspective, I think we had it going back up to just under three again, so it is not back to where we were, fortunately. We then have the task of getting that sustainably back down to target. That is why we have taken the view—and I slightly take the view—that the issue now is how long we have to be restrictive. It is that leg of it that matters. What happens in the spring will not be the thing that determines the stance of monetary policy, in that sense, because we have to hit targets sustainably.

Q34 **The Chair:** I was reading an interview that Isabel Schnabel gave at the ECB about two weeks ago. She said that we are past the peak of transmission. Would you agree with that in terms of the UK?

Andrew Bailey: That is an interesting question. Back at the beginning of November, we spent a lot of time on the transmission mechanism, for good reasons. Our staff told us that they thought that we were about 50% of the way through the transmission of the rises that had happened. When we did the February report, they said that we were about 70% of

the way through. That is for two reasons. One is because obviously more time had passed, but, more particularly, it was because the yield curve had come down so much. If you like, the denominator had changed. In other words, there was not going to be as much tightening. Therefore, the tightening that has happened is a bigger proportion of the eventual tightening. So that is the reason. As I say, staff estimated about 70%.

Q35 **Lord Blackwell:** Could I raise a different topic related to the excellent speech you gave the other day on banks' profitability and valuations? In that, you raised the prospect that bank valuations may be affected by a higher risk aversion, a higher risk premium, in the discount rate applied than historically, which would seem counterintuitive in some ways given that they are all holding that much more capital against those risks. Do you have a view on the extent to which that is rational because of the perception of externalities, like cybersecurity and wars and so on, or do you share a perception that the years of low interest rates have left the banks with loans that may be difficult to maintain in the high interest rate future?

Andrew Bailey: That is a very interesting question. I have to confess that I ended up in that speech saying, "There is still a puzzle". The UK banking system is in a very sound condition. It has come through these major shocks well. We are saying that there is a bit of a tick-up in impairments, but this is nothing compared to some of the standards of history.

As I set out in the speech, net interest margins are now broadly back to where they were pre-financial crisis—in other words, going back to the previous time when our interest rates were in more normal territory, the adjustment happened when the official interest rate was near zero, when the banks were paying rates above our rates; normally they pay a bit below our rates. In a sense, that has reverted back to its normal relationships and net interest margins are a bit wider. Obviously, we have more capital in the system but, as I said, that does not determine the risk in the system, so the puzzle remains.

You may be right. Maybe there are externalities out there that the market is valuing. It remains a puzzle to me, and it is something that we have to do more work on with the banks, because there is a puzzle out there. The system is fundamentally in good health. Dividend payouts are now back to pretty solid territory. So the valuation question remains a puzzle.

Q36 **The Chair:** Can I pursue a thought related to the competitive growth objective that Lord Rooker was asking about? That objective is now coming in, or is being enacted. What difference is it making in practice?

Andrew Bailey: Very much like I said in answer to Lord Blackwell's question, and as I deliberately said in my speech on Monday, we are now, believe it or not, 15 years on, coming to the tail end of the post-financial crisis capital regulation and liquidity regulation, the so-called Basel 3.1 package, and now is the time to say, in the spirit of that competitiveness objective—it will not be exactly the same in every

country, because we have different local arrangements and different local structures—"Do we think it is broadly in the right place from an equivalence point of view?"

Q37 **The Chair:** Right. In terms of the debate over equivalence—I am thinking here about the EU and where we go in that—

Andrew Bailey: That formal equivalence, you mean.

The Chair: Yes, that sort of equivalence. When you mention those words, it triggers a thought in my mind and brings back those Brexit days. Do you feel that, as we move ahead into a post-Brexit world, we have a clear path and strategy for the City on competitiveness and that we should be diverging or aligning in certain areas?

Andrew Bailey: I have always said that I do not take any position, per se, on Brexit. I am a public official. I should not, and I do not. But obviously we have to get on and implement it and do it in the most sensible fashion. I think we have made good progress on that front in financial services. I have been very clear about this since the day after the referendum, funnily enough. I said to staff, "It's important that we do not become isolated and isolationist", and I do not think we are. We are very active in the international agenda. We have kept good relations with our EU counterparties. Things like the Windsor Agreement help in that respect and in the background mood music. It is important, because on the whole there is every reason on both sides for us to co-operate.

The other big thing I would stress here is that it is often presented that this all goes one way: that the EU has a huge dependence on the City of London. Obviously, a lot of EU business is done in the City of London, and things like the clearing debates emphasise the benefits of concentration, in a sense. But if you look at something like the LDI issue, you see it the other way around. We have dependence on the EU as well, so almost none of those LDI funds were domiciled in this country; they were domiciled mainly in Ireland and Luxembourg. We have good relations with Ireland and Luxembourg, so it is not a problem there, but I always point out to them, "Look, this is a two-way street, so we need to get on, because frankly the dependencies go both ways".

Q38 **Lord Verjee:** Governor, could we switch to central bank digital currencies? Could you give us your current thoughts on where we are on them? It seems that the Europeans have their foot on the accelerator, whereas the Americans are a bit reticent. Also, could you tell us where China fits into all this?

Andrew Bailey: I think you are right and that the Americans are a bit more reticent. The Europeans have their foot on the accelerator, but, as I read it in places like the European Parliament and so on, there is a bit more questioning going on now about just how it will work. The Chinese have introduced one. I am not sure that it has had that much of an impact, though. It is quite interesting to look at. It does not seem to have made that much of an impact, but they have introduced one, and many countries are obviously looking at it.

So where are we? We and the Treasury put out a response to the consultation and got 50,000 responses, which is the most we have ever had by a very long way. I will give you my view on it. The most important question is not about central bank digital currency. It is about digital currency. You can say, “What do you mean by digital currency?” I think it is about using greater programmability in the payments’ world in particular. I am talking about retail now. Wholesale will happen. It is a different world. To what extent can we take advantage of that in terms of outcomes? I do not claim to be an expert in this field, but with things like late payment could you make real progress if you could have greater programmability of payments? If I deliver that service to you, I will program the payment to arrive when it should arrive, not a month later. I think the technology could help there, for instance.

I am talking to the banks a lot at the moment. I have said to them, “Look, this is not about central bank currency. It is about using digital technology”. I do not want to disturb the balance of central bank and commercial bank money in the system—in some ways, it goes in parallel with things I said on Monday in the speech in Loughborough on liquidity regulation—because that starts to disturb credit creation in the economy, and we do not want to do that.

To put it a bit more bluntly, I have said to the banks, “Look, I don’t really want us to be left as the only game in town on this front”, and doing it because, if we do not do it, it is not going to happen, and there is a case for doing it. So we are talking to banks at the moment about it. Those are important conversations. I do not know where they will go to at the moment. Then we can decide, in the light of where we get to that on that, whether there is a case for central bank digital currency, or not. We may say, “Actually, we don’t need it”.

You have challenged us in the past, quite rightly, saying, “What problem are you trying to solve here?” Once we have identified issues that can be solved this way and how they can be solved, we can answer the question that you have put to us that I agree with, which is: does it require central bank digital currency or not to do that? We will get to that answer, and we will be very transparent. I am happy to come along to discuss that at any time.

The Chair: Governor, thank you very much indeed for covering a great amount of ground.