House of Commons

Treasury Committee

Oral evidence: Bank of England Monetary Policy Reports, HC 419

Tuesday 19 November 2024

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Watch the meeting

Members present: Dame Meg Hillier (Chair); Dame Harriett Baldwin; Rachel Blake; Chris Coghlan; Bobby Dean; John Glen; Dame Siobhan McDonagh; Lola McEvoy; Yuan Yang.

Questions 1 - 92

Witnesses

I: Andrew Bailey, Governor, Bank of England; Clare Lombardelli, Deputy Governor for Monetary Policy, Bank of England; Dr Catherine L Mann, External Member, Monetary Policy Committee; Professor Alan Taylor, External Member, Monetary Policy Committee.

Examination of witnesses

Witnesses: Andrew Bailey, Clare Lombardelli, Dr Catherine L Mann and Professor Alan Taylor.

Q1 **Chair:** Welcome to the Treasury Committee on Tuesday 19 November 2024. Today, we are delighted to welcome the Governor of the Bank of England and members of the Monetary Policy Committee to give evidence to us as one of their regular outings in front of us. Of course, there has been a recent rate-setting event and there will be another one in December.

I am delighted to welcome Andrew Bailey, the Governor of the Bank of England, who is a regular visitor to this Committee. He is joined by Clare Lombardelli, the deputy governor for monetary policy and a member of the MPC. They are joined by Dr Catherine Mann and Professor Alan Taylor. A special welcome to Professor Taylor because he became a member of the committee just after we were all elected, so has not had the normal meeting in front of us on his own. This is a chance, Professor Taylor, for you to get to know us, and for us to get to know you and to hear your thoughts on all these issues.

I want to dive straight in, if I may, with those of you who voted to cut rates. Dr Mann, I will come to you in a moment. What tipped the balance for you in terms of cutting rates?

Andrew Bailey: The starting point for me was that the pace and progress on disinflation, on bringing inflation down, has been faster than we expected it to be. That has been true not only over the last year but in the intervening period between our August report and the November report. We were starting at a point where we were lower than we had expected to be, which is obviously good news. That influenced my thinking, but you then have to get behind why that is happening and what the risks around it are, so I would put it into a little bit of context if you do not mind.

We cut rates but also, as you may have seen in the language, emphasised the word "gradual", looking forwards. On the one hand, my vote was very much reflecting the progress I thought we had made over the recent period, but against that we had to balance two things, which I no doubt will come back to.

One is the fact that, if you look at the components of inflation, the more domestic component, particularly services, is still above a level that is compatible with us being at target on a sustained basis going forward, once some of the shocks that are still affecting things such as energy wind through, so we have to watch that very carefully. That quite clearly reflects developments in the labour market, which no doubt we will also come on to. That is the first thing.

The second thing is that there are a number of risks out there, which we will also no doubt come on to, so I will not say much about them at this stage. UK import prices have been stronger than would be indicated by world export prices, which has put some upside on. Then we are looking at things such as the impact of the Budget, which no doubt we will come to, and developments in the world at large.

Putting all that together, I felt that the progress that we had made and what we were seeing in the inflation outturns justified us taking another step. Obviously, it was our second step. We made the first one in August.

Chair: I am interested in the word "gradual", which I think I will come back to in a moment.

Clare Lombardelli: The dominating factor for me was what we have seen in the data on inflation, following the disinflation that we have seen, and, perhaps more importantly, the drivers of inflation. We are seeing, and have seen, a fall in services inflation. We are seeing, and continue to see, a fall in wage settlements. If you take that together on top of what has happened to goods prices, that suggests that the drivers of inflation are less strong than they have been in the past, but similarly to the Governor—and perhaps we will come on to this—I see risks on both sides.

It felt right to slightly lift the level of restrictiveness of monetary policy at this time, while looking very carefully at the data that we are expecting and in particular what we are expecting to get over the coming months. For example, our agents will be talking to businesses around the country and doing their pay survey, which we will get the results of early in the new year. I have a similar set of motives.

Professor Taylor: Thank you for your welcome. I am broadly in agreement with what the Governor and Clare Lombardelli said. There has been progress. There was reason to be cautious six months or a year ago, but the unfolding data is in line with historical patterns if we look at the evidence across countries and across time. I am doing some research now with my team at the Bank. There is a general pattern, which is that energy shocks will feed in very quickly to some sectors, such as cool goods and food. They will feed in more slowly and peak later when it comes to services and wages.

In the broad scheme of things, the pattern is unfolding as you would expect. It is not abnormal, but you want to see some reassurance as you go through those phases to see that it is proceeding normally. You are worried about the case where inflation maybe persists longer and you would be worried about expectations becoming unanchored. We will get back to the cases later. There was reason to put quite a lot of weight on that probably six to 12 months ago, but, as the Governor said, the numbers keep coming in a little bit below where we thought we would be. In my mind, that was shifting weight, even before I joined the committee, towards a more normal scenario. That gave me reassurance to think that it is okay to continue with the gradual pace of cuts, which had started in August.

Q2 **Chair:** I am hearing the word "gradual" a lot. Dr Mann, you did not vote with your colleagues at the table. What gave you pause?

Dr Mann: Thank you very much, Chair, for the opportunity. We all look at the data very carefully and I look at the data in a slightly different way. I agree that the 1.7% CPI headline inflation was below where it was expected to be last August, but that was principally, almost entirely, due to changes in the energy conditioning assumption. If we look at the underlying components, whether it be goods, services or wages, we missed by quite a bit less. In fact, we underestimated wage dynamics in our August MPR.

I look at that and then add on the observation from our decision-maker panel, which, looking forward, gives us a steer on its expectations for prices one year ahead. For consumer-facing firms, it is still over 4%, where, for historical comparison, it needs to be at least 2%. Similarly, for consumer-facing firms wage expectations are 5%, and this was before the Budget.

It is also the case, looking at our decision-maker panel, that there was deceleration in both forward-looking prices and forward-looking wages for

a number of months earlier this year, but, for both of those categories in general across all firms, there has been no continued deceleration for four months. In other words, these forward-looking prices and wages have been flat above target consistent or historically consistent rates for four months. I take that as indicative of a concern about the persistence of embedded inflation lasting for longer.

Household inflation expectations also have ticked up, not in an unanchored way, but nevertheless ticked up as opposed to continued to decelerate. For the Citi expectations it has been ticking up for four months, and for Ipsos it also ticked up in the Q3 data print.

Finally, I take a steer from financial markets. From their point of view of inflation expectations, at the current pace, associated with the conditioning assumption that we have in the forecast, we would not get to a sustainable 2% headline inflation within the forecast horizon.

I also incorporated two aspects of the Budget in my consideration, which of course was incorporated in our projections as well. I took the consideration that it was front-loaded on demand and geographically dispersed throughout the economy. All that is a good thing from the standpoint of the pace of economic activity in the economy, but it also offers the opportunity for firms to realise the price increases that they have in expectation going forward. Again, those are inconsistent with a 2% target. We can discuss other elements of the Budget with regard to the national living wage potentially coming from the low-pay conditions.

Q3 **Chair:** What account did you take of the increases in wages in the Budget for national minimum wage and then a potential increase in some of the employer national insurance contributions?

Dr Mann: In my analysis of labour market conditions, as it is reflected through current wage developments across different types of firms, and on expectation, as I noted, from the decision-maker panel and from our agent meetings, there is a residual or legacy effect of the two increases in national living wage over the last two years. Even before the Budget, firms were struggling to incorporate that and deal with that, in the sense of a wage compression problem throughout the ranks of their firms. They were deciding how they were going to handle that fact.

Q4 **Chair:** You are talking about differentials here.

Dr Mann: Yes, differentials across different job categories within a firm.

Q5 **Chair:** There was an inflationary pressure up the chain.

Dr Mann: They were going to have to figure out how to deal with that because there was wage compression based on two years' worth of uplift in the national living wage. It is not a bad thing to have an uplift in the national living wage, but it creates this situation facing firms of wage compression and how they are going to deal with it. That is accentuated

by the prospect of a higher than inflation increase coming from the Low Pay Commission remit in April next year.

There is also the increase in national insurance contributions that firms will have to address. We talked about this in the Monetary Policy Report. There are a number of different ways that firms can adjust in the face of national living wage or national insurance contributions. They can pass it through to prices or try to do that. They can just keep wages and make that be the manner in which the adjustment is made. Those have different implications for profit margins. They can also have the margin of adjustment of reducing the number of people they employ, or they can engage in investment that would be productivity enhancing. Those are all different ways in which firms can meet these challenges within their overall budgets and their objectives around what they want going forward. My view was that, since these are all upside risks to inflation of both wages and prices that were already stagnant at target inconsistent rates, we needed to wait and see how these were going to materialise going forward.

Q6 **Chair:** Can I go back, perhaps, to Professor Taylor first? A lot of you have talked about gradual approaches. How quickly do you think rates are likely to fall and how fast would you see the pace of cuts?

Professor Taylor: That is the question on everyone's mind. "Gradual" is one of those words that mean different things to different people. One view in the market is that "gradual" means a cut every other meeting and "aggressive" means a cut every meeting. In the course of a year there are eight meetings and we do not only have the choice of doing zero, four or eight, so there is a wide range of possibilities going forward and that depends on how the data unfold.

My view is that, going forward, for some of the reasons we have alluded to, the key is going to be the labour market and what we see there. It is going to be very important to keep an eye on that. We do not necessarily have the best statistics there, which we will probably come back to. We are going to have to take a lot of reads from different sources, including, crucially, our agent network.

If you ask what "gradual" means right now, it is aligned, in our case too, closely with the market curve. That would be in line with about 100 basis points over the next year. To align with the conventional interpretation, we should try to stick to that, but that does not mean to say that that is what will unfold. If conditions are weaker—and my own views skew to the downside risk now versus the upside risk of about a year ago—we could go more quickly.

Q7 **Chair:** Ms Lombardelli, what market conditions would you need to see go more quickly?

Clare Lombardelli: It is not really market conditions as much as, in terms of financial markets, the broader picture for the economy that I am

looking to, in particular—it is very hard to judge these things—the level of demand and potential supply in the economy, what that means for firms' ability to raise prices, what we see on costs and the pressures we are seeing there, and what is going on on the supply side of the labour market in terms of capacity. There is a lot of uncertainty around all that, but those are the sorts of things we would look to.

As I mentioned before, I am particularly interested in things like what we are picking up about expectations for next year on pricing and cost drivers, particularly in the services sector, where, as others have said, we have seen and are seeing inflation coming down but to a rate above target. Those are the sorts of data I will be looking to in making those decisions.

Q8 **Chair:** How long do you think it will take for some of these things to feed through? It is snowing today. There are lots of other international things, as the Governor mentioned.

Clare Lombardelli: We are making policy by thinking about how the economy is going to evolve over the coming months, year, two years or three years. It is important. You are right: it is snowing today and the weather plays a factor, but I would not put too much weight on the very short term. I think that we will get quite a lot of information early next year on what is happening in the labour market. There is a lot of uncertainty, as others have said, for a whole range of reasons. Some of that is about policy, but actually a lot of that is about how the labour market is responding to the big shocks we have had over recent years, particularly covid, but there are others, and what is going on cyclically in the labour market.

We will be looking quite carefully at the data we get from our agents around wage expectations for next year and what we are hearing from businesses around the country about how they will respond to things such as NICs and the national living wage. Certainly, when you go around the country and talk to businesses, what happened last year on the national living wage is a pressure, as Dr Mann says, that comes up probably more than any other issue. I think that we will get quite a lot of information early next year in particular around what is going on with some of those uncertainties, but there is a lot of uncertainty out there. I have no doubt that next time we will say that it is all very uncertain.

Q9 **Chair:** Governor, I am sure you have some comments there, but another issue is of course that some of the Budget policies will not have an impact until April next year. When you talk about "gradual", presumably you are playing those factors and when policies will hit the labour market into your thinking.

Andrew Bailey: Yes. I agree with a lot of Catherine's assessment, by the way. There is some evidence of some loosening going on in the labour market at the moment. Our agents tell a slightly different story to the decision-maker panel, but you are right. Catherine laid it out. One

important element of the Budget for us is how this increase in the cost of employment then plays through. This is the most important part of it, I would say.

As Catherine said, it can play through in a number of ways and let us be clear that they are not mutually exclusive. We could have higher inflation, clearly. We could have lower wage increases than would have been the case otherwise. We could have some loss of employment, so some degree of reduction in employment to reduce the cost of employment. We could have a squeeze on profit margins. We could have an increase in productivity, though that tends to be rather slower. All those things could happen. We, so far, have not made any strong conclusion on that. We really want to see the evidence. In the forecast we did, we made some pretty neutral assumptions about that, as did the OBR, so we need to see how that plays through.

Chair: We are getting a sense of why it is going to be gradual, I think.

Andrew Bailey: Yes.

Q10 **Lola McEvoy:** Good morning, everyone. I want to probe on your agents and the pay survey specifically before I move on to my next question. With your pay survey, how comprehensively does it cover low-paid sectors that are quite hard to reach but that will be positively impacted by the actions taken in the Budget around investment in construction and infrastructure, and the rail settlements? In a previous role I worked with quite a lot of low-pay data and it is sometimes very difficult to get to some of the supply chain sectors and the harder-to-reach ones. I want to know a bit more about your process around that.

Andrew Bailey: It is a good question. I will start; I am sure that colleagues will come in. We construct the agents' contact sample, if you like, quite carefully to make sure that it has a properly weighted sample of the economy in it, because that is important. We do not want to have a biased sample. If you put all 12 of them together, it is quite a big sample as well.

I can also tell you that—I spend a lot of time with the agents—in the sessions I do with their contacts, the national living wage is a very prominent subject of discussion. I can tell you that it is clearly on the minds of the companies that they and we see. It comes through very clearly. If anything, our staff, when they do the overall macro assessment, say that the passthrough of the national living wage is possibly a bit less than the level of comment we get would suggest, and we have to weigh those things. We spend a lot of time in the MPC with that weighting issue, as to how we think about those two things.

By the way, to give you an example, the agents' sample includes a full weighting of services firms, and parts of the services sector have more low-paid workers than some other parts of the economy. We are pretty reassured that the agents' contact sample picks that up.

Dr Mann: I note that you mentioned the agents, but there is the decision-maker panel, which is a different set of firms surveyed through a different formal survey on a monthly basis. We are getting these steers from two independent sources but at the firm level. That is a very important way of getting confirmation, or a little dissonance, in samples that are designed explicitly to be representative of the economy. Then the macroeconomic is, in some sense, the aggregation of all that, although, again, there is independent data that comes from the ONS on prices, wages and so forth.

Clare Lombardelli: I was going to make a similar point, which is that the agent survey is one of many sources of data that we try to use in this space. We have the decision-maker panel, as Catherine says. We also use HMRC and DWP data, in so far as we have it. We may or may not come on to the labour force survey, but that is another source. We also have a lot of information through credit data and the like that looks at people on lower incomes. We are putting all this together.

As you have heard, at the moment we are hearing slightly different things around some aspects of the labour market. In particular, the decision-maker panel has wage expectations at a slightly higher level than what we are sensing from our agents. That is why we are looking, as far as we can, at all the sources of data in the economy, trying to cross-check them and work out what they can tell us, what they cannot and where the uncertainty is. We put a lot of effort into trying to understand, as you say, the lower-pay end of the labour market as well.

Q11 **Lola McEvoy:** You are confident that the lower-pay representation from the agents is not focused solely on the hospitality and retail sectors.

Clare Lombardelli: No.

Lola McEvoy: I suppose that is what I was getting at.

Clare Lombardelli: It is comprehensive. There will be a lot of them in it, because they are big employers across the country, but we do everything we can to think very intentionally about how we put that sample together and keep that under review.

Q12 **Lola McEvoy:** Moving on to mortgages, we saw last week that, although the interest rate has come down, the mortgage rate has actually gone up for a lot of the big lenders on the two-year fixed-term mortgages. That is going to have a huge consequence for my constituents in Darlington and all our constituents across the country, who are hard-working and trying to get by in a difficult climate. What thought was given to that? Is that what you expected to happen? What is your feeling about why that has happened?

Andrew Bailey: Mortgage rates have come down since August. If we look at the period since the August Monetary Policy Report to now, mortgage rates have come down. There has been passthrough of the cut

that we made in August. It is too soon, by the way, to talk about the cut we made last week. That takes time to come through.

To put that into perspective, the majority of mortgages in this country—quite a large majority now—are fixed-rate mortgages. They are not variable-rate mortgages. They are priced off the swap curve in the market according to the duration of the mortgage. They are usually four, five or seven years. Mortgage pricing, therefore, reflects the swap curve and how that responds. That will be influenced by what we do, but, whereas variable-rate mortgages are much more directly affected by decisions we take on Bank rate, they are now intermediated more through swap curves.

The curve rose. We have had quite a lot of event risk recently. There were two things that have moved the curve around. First, there was a reaction to the UK Budget. Secondly, there has been quite a reaction to the US presidential election. We have seen some rise in the curve. It has not, by the way, reversed all that we have seen since August, but you will see some increase. Your point about mortgage pricing reflects the fact that the swap curve has risen somewhat and so banks price off that curve.

Q13 **Chair:** You think that the US has had more impact.

Andrew Bailey: They have both had an impact. Obviously, they are slightly different timings. You had an immediate impact in the UK. But if you take that week, by the Friday of that week, it was the expectations of the US election and then the US election itself that had more driven it. It is not unusual for our rates to be moved around by the US curve, by the way. That is not at all unusual. We have seen that quite a bit this year, for instance. More recently, the strengthening of the US curve has been the thing that has done it, although this morning they are both off, actually, so we will see where they go to.

Q14 **Lola McEvoy:** To pick up on that point, and then I will let somebody else talk, you said it is too soon to talk about the current reduction in the rate. When would you anticipate mortgage rates to be more reflective of that?

Andrew Bailey: No, I was talking about general passthrough, including deposit rates, for instance. Mortgage rates will move rather more quickly because the curve moves rather more quickly and so banks or lenders tend to reprice their mortgages rather more quickly. To get the whole passthrough story, including deposit rates, you have to wait for a bit to see that.

Q15 **Chair:** Earlier, when Professor Taylor talked about inflation, he said his views were skewed to the downside. I wonder whether each of you could tell me whether you see it downside or upside.

Dr Mann: In my comment on my decision to hold in November, I outlined a variety of reasons associated with pricing behaviour of firms, or strategic pricing by firms, strategic wage setting within negotiations

and the potential risks associated with national insurance and national living wage. All these are upside risks, to my view. The only downside risk that I can think of in the current context is global pricing of goods coming out of Asia. Other than that, I can see only upside risks.

In addition, it is important to know, or to take into account, when inflation has an upside bias to it, that firms and workers both react to that by upward bias. There is downward rigidity and upward ratchet. That is an important consideration in my decision making.

Clare Lombardelli: I would distinguish between the risks and the consequences of those risks. I see the risks to inflation as broadly balanced. I take seriously and share some of the concerns Catherine has about the upside risk that inflation might be higher because of some of the structural changes we might have seen in the economy. However, I also see that there are some downside risks to inflation. We might see a slightly softer outlook for the UK economy. I see the inflation outlook as broadly balanced.

I am more concerned about the upside risk—the structural change—because the consequence of it in terms of the cost to the economy would be higher if we were to see inflation being slightly entrenched at a higher rate. I would separate out the probability of something happening and the consequence of it happening when I think about this.

Q16 **Chair:** Professor Taylor, do you want to add anything?

Professor Taylor: Yes, I want to add something there. The Bernanke review was excellent in getting us to move away from the central forecast and think about scenarios and risks around that forecast. We may to talk about that some more. We are going in a good direction. I want to emphasise that my probability on case 3 is not zero. It has gone down, but it is not zero and so I share some of Catherine's concerns. I just think that the evolution of the data has pushed me to a different position than six or 12 months ago.

In terms of what the headwinds are, the point about mortgages was a good one. The curve has moved around for lots of reasons, as the Governor has said. If you had taken a bond trader, put them to sleep three months ago and woken them up today, and said, "What is going on with UK gilts? The yields have gone up," the first thing they would ask you is, "What has happened to US 10 year?" They have gone up. They have marched up together, which reflects global sentiment. There has been risk on for equities and bonds have gone up due to mainly global factors. In the short run, that is going to weigh. It is going to weigh on mortgage pricing, for reasons that are external to the UK. There could be other global risks ahead, which we may talk about.

Even before that event—I think that there was an FSR chart about this—because of the staggering of mortgage pricing and the resets coming, we were going to see debt service ratios rising over time. That is another

force that is weighing on the consumer. Another thing that shifted my view is that vacancies have been coming down. That has been normalising.

Also, because of problems in the data and the uncertainty around the outlook, I put a lot of weight on what the agents are saying. I made my first agency visit to Scotland in October. I intend to do a lot of those, despite being based in New York. I am going to Leeds in January and to Bristol in February. What I heard there, and it is consistent with other agency feedback we are getting, is the kind of "wait and see" attitude that is prevalent. You see that in firms. They have been saying for a long time, "We are going to invest. I think that rates are going to come down and the economy is going to improve." Then the agents will go back weeks or months later and get the same response. It is rolling forward.

There is a similar phenomenon in the way households are behaving with respect to saving. It is maybe precautionary or because of other motives. Historically, that is symptomatic of what happens after big crisis events, such as the great depression. I listened to my parents telling me about how their thinking evolved. If you think about covid, a pandemic or a global financial crisis, people take on maybe a slightly different view of spending and saving. All that is, to me, weighing on the economy. NICs, for the reasons that the Governor mentioned, are going to possibly dislocate the labour market. There are a lot of factors making me very worried now and wanting to focus on that labour market view in the weeks ahead.

Q17 **Chair:** We are going to come on to whether the Budget has maybe begun to move the dial in a moment. Governor, which way do you lean?

Andrew Bailey: I am very close to where Clare is, actually. I have risks on both sides. To be honest with you, if you had asked me this question a month or so ago, I would have probably been a bit closer to where Alan is. The structural argument, as Clare says, has to be given weight. I put weight on that argument because it is harder to counteract the structural. We would have to lean harder and for longer.

I go back to the point I made about the impact on employment costs of the Budget and the way I set out those channels through which it can transmit. This could be either upside or downside for inflation. You could get higher inflation, but you could get quite a weakening of the labour market and downside pressure on pay.

Q18 **Dame Harriett Baldwin:** Ms Lombardelli, we have heard about the Bernanke review. It was done after central banks around the world, and the Bank of England, had a poor forecasting record through the last inflation crisis. I know that you are in charge of implementing the 12 recommendations that he set out. I think that I could detect some subtle signs in the latest Monetary Policy Report of some change, but could you summarise where we have got to in terms of the implementation?

Clare Lombardelli: Thank you for asking me and giving me the opportunity to talk about it. We have started the process of implementing the response to the Bernanke review. This will be a pretty big programme of work. As you know, his review was comprehensive and wide-ranging. We are, as a result, looking at pretty much every aspect of the way in which we do monetary policy. That includes our processes around the way we structure the committee's time, what we use that for, and the technology that we have. He brought out a lot of the issues around the technology that the Bank currently uses, including our models and what models we use.

Q19 **Dame Harriett Baldwin:** The COMPASS model.

Clare Lombardelli: Yes, but not just that. He recommended that we have a wider range of models and, in particular, models that can help us with structural and supply-side shocks to the economy. There is the way we think about data in the context of our policymaking. There is what I call policy strategy, which is how we think about these questions of, "How should you set policy under uncertainty?" and the things I talked about before about being not just the probability of outcomes but the consequences. If you are in one world and you set policies, what could that mean if you were in another? There is also how we communicate.

There are a whole range of things there and they are all interrelated. One of his big recommendations was to focus less, as Professor Taylor said, on the central forecast and use it less as a communication device. If you do that, it raises a lot of questions about what you put in its place, how you think about that communication and how you do that in a way that is clear. In a sense, all of these things are interrelated.

As you say, there was a hint of it. We began some tentative steps in that direction in this round. We changed the way in which the committee used its time. We spent more time talking about how the economy might evolve and what the implication of that would be for policy. You can see the result of that in the cases that we set out in the box.

Q20 **Dame Harriett Baldwin:** The cases are the scenarios that he described, are they?

Clare Lombardelli: Yes, that was us thinking about different ways in which the economy might evolve. All of them, in a sense, are consistent with the data as we see it now, but the question is, going forward, what is going to happen next. That is sharing how we thought about different ways in which, from here, we might see the economy. There is uncertainty around that. We spent more time in this round talking about those possibilities, how the data stacks up against them and how we assess the likelihood of them. How do we think about what policy would mean in that space? We have set out a box that talks about that in a bit more detail.

That is a small start. There is a lot more to come on Bernanke. This is going to be a big reform programme. It is going to take a long time.

Q21 **Dame Harriett Baldwin:** How long is a long time?

Clare Lombardelli: At this point, I do not know. It is going to be years, not months, to reform our whole process.

Q22 **Dame Harriett Baldwin:** Will we be able to see small, incremental differences every time, would you say?

Clare Lombardelli: I do not anticipate that we are going to go away, sit in a bunker and then, after three years, go, "Ta-da, here is our new policy." I think that we will be gradually testing approaches. We are going to have to learn as we go because this is quite different, so you will, and I am sure that we will talk about it again. It is a big programme of work, but we are starting that now.

Q23 **Dame Harriett Baldwin:** Governor, the central scenario shows inflation rising to 2.8% next year and an over 40% chance of us having inflation go back up to 3% next year. If you were required to write a letter to the Chancellor about the 3%, do you not feel that that would be a bit of a failure and that the British public would feel pretty let down that inflation was back up to 3% again?

Andrew Bailey: I also have to balance that with the fact that the forecast brings inflation back down to its target sustainably at the horizons and of course that is what we look at. Then we have to ask the question of how much tightening we should do or how much more restrictive we should be with that profile of inflation in mind, given that there is a cost to being restrictive. This is the whole element of what we call the trade-off—that is language that is in our remit—and that is a judgment we have to make. It is obviously a much smaller judgment than some of the judgments we would have had to make in the past, given where we have been.

I would much prefer that inflation did not go up to that level, but this gradual approach towards taking restriction out will allow us to adjust as we go along to the evidence we see. To make the point again, the evidence we have seen recently is that the outturns have been lower than we thought they would be. We do not know whether that is going to continue, but we will see. That is part of the relevant picture for judging our response to that forecast.

Let me make a point that has been made many times before: there is not a mechanical relationship between the forecast and the policy decision. That is important. The forecast informs the policy decision. As Clare has set out, in the way we are developing it the use of the cases informs it even more, but it is not a mechanical decision. We have to make those judgments and I think that it is an appropriate judgment for this point in time.

Q24 **Dame Harriett Baldwin:** You mentioned in your annual report to us, and you have mentioned in your evidence today, these four different ways in which firms can pass on the extra cost of employing people. I wonder whether you could tell us whether you fed into your model that only one of those routes was going to happen, so, for example, reducing employment was the only way in which things adjusted. Does your model tell you how many jobs that represents?

Andrew Bailey: We did not do that because we did not make an assumption that there would be only one reaction.

Q25 **Dame Harriett Baldwin:** If you were to put that into the model, what would it—

Andrew Bailey: We would have a sharper rise in unemployment. Actually, we have a pretty flat profile for unemployment now in the central case. I would hazard to guess, without having done it, that it would be a bit higher if you made that assumption.

Q26 **Dame Harriett Baldwin:** The Office for Budget Responsibility has a figure for that. It says that employment is going to be 50,000 lower as a result of the measures in the Budget. You will have seen the letter from the British Retail Consortium this morning as well.

Andrew Bailey: Yes, I have.

Q27 **Dame Harriett Baldwin:** I wonder whether you think that that sounds plausible.

Andrew Bailey: I know, because we talked to the OBR about this, that it made pretty similar assumptions to us about the way in which this will pass through. If I could add one other point, the passthrough in terms of the allocation between these channels does not have to be constant over time. Indeed, I doubt that it will be. Probably, initially there will be more pressure on firms' margins, because it takes them longer to adjust, and then they will probably rebuild those profit margins. That is over time. I would expect that. It can change over time.

The OBR made a pretty similar set of assumptions to us. It put more on a combination of some increase in inflation, wages being somewhat lower than they would have been and something on profit margins. Yes, I saw the BRC's letter and it is right. There is a risk here that the reduction in employment could be more. Yes, that is a risk.

Q28 **Dame Harriett Baldwin:** Similarly, if it were to feed through exclusively through inflation, what impact would that have on the economy?

Andrew Bailey: That would be, again, a rather larger effect than we have factored in, because we factored in some labour market effects and wages being lower than they would otherwise have been. At its peak, the contribution of the Budget to the inflation profile is half a percent. It would be a bit more than that if you made different assumptions on the

passthrough. I would caution that I do not think it is sensible to load it all on to one of these channels.

Q29 **Dame Harriett Baldwin:** No, I am just wondering whether your model allows you to tease that out.

Andrew Bailey: No, I know you were not doing that, but I would just caution that I do not think that that is a sensible way to do it.

Dr Mann: I have to add here that the fundamental driver of the decision of firms to make adjustments on any one of these margins depends on the demand conditions that they face. That is intimately related to the outcome on labour market tightness, wage developments, prices or even investment in productivity. The underlying demand status is the primary factor to be considered when making these other assessments.

Q30 **Dame Harriett Baldwin:** I accept that it will feed through in potentially more than four different ways, but I just wondered whether your models allowed you to put in, if the adjustment were all through this mechanism or that mechanism, what the impact would be.

Andrew Bailey: Yes, we would be able to do that in principle.

Dame Harriett Baldwin: Could you share it with the Committee?

Dr Mann: If we had the labour market flow data, we could make some judgments. We have discussed the absence of that flow data before and may discuss that again.

Q31 **Dame Harriett Baldwin:** Could you share that with the Committee?

Andrew Bailey: We could look at something and write to you, yes, although Catherine is right. There is uncertainty around the labour force survey. It is a little bit abstract, but we can put that through. We can make some assumptions about it, certainly.

On the point Catherine made, the only caveat I would add is that one thing firms have said to us quite a lot over the last few years is that there has been some of what I call labour hoarding. I do not want to be pejorative about this. It was a perfectly sensible reaction, particularly during covid. If that is still the case, it might be rather easier for them to shed cost than if it was not.

Q32 **Dame Harriett Baldwin:** Do you mean by letting people go?

Andrew Bailey: Yes.

Q33 **John Glen:** Governor, could I ask you about the Trump policy on tariffs and what assessment you have made about how that will affect the UK economy? Credible sources say that it will see a reduction of GDP by 0.8%. It will inflate the cost of exports into the US and we would see a reduction of £22 billion. There is a whole world of politicians responding to that, and there is speculation over where it would take effect, but if the imposition of the 20% tariff was the case, how would that affect your

thinking about the impact on the UK economy?

Andrew Bailey: I should say first that, although we were able, as colleagues have said, to incorporate the impact of the UK Budget into what we did, we were not able to incorporate the impact of the US election result, because it literally came on the day we were taking the decision.

John Glen: You can be forgiven for that.

Andrew Bailey: I can be quite transparent that that is not in there. I also want to be very clear that it is very important that we wait to see what the Administration actually do. To borrow a phrase from one of my colleagues, we wait to see when all is said and done. We have seen the said bit, but we have not seen the done bit. US elections do not quite have the same tightness of tie to what I would call the manifesto as I think British elections tend to do. Let us wait and see what they actually do, because that is really important, and that is what we will be doing.

Q34 **Chair:** How long do you think that will take to feed through to your rate setting?

Andrew Bailey: It will be quite a while.

Q35 **Chair:** Yes, exactly. You are thinking that it would not be until next summer.

Andrew Bailey: It depends on the speed at which they take decisions. They do not actually take office until late January, so let us see what happens. To your point, though, Mr Glen, we would need to know and take views on quite a lot of other things. Those other things are not just the tariffs that are implemented by the US but what the tariffs are implemented on, what the reaction of other countries is to those tariffs and how that feeds through to exchange rates, because that will affect the relative cost of doing business. I am very cautious about jumping to conclusions about what the effects of tariffs are.

I would be very clear that fragmenting the world economy is not a good thing. Quite clearly, I have to say that. There could be different tariffs against different parts of the world. We should also accept that the UK has a larger share of services in its trade than other countries do and services are different in that sense. Tariffs do not work in the same way in the services world. We really would need to see all of that before jumping to a conclusion.

Q36 **John Glen:** I respect that, but people will be looking to you for wisdom on the relative choices that a Government face. We are in a situation where you referred to the implications of Brexit in your speech last Thursday evening and the Government have stated their objective to reset that relationship too. There will be trade-offs in that, in terms of the impact if you remove some of those frictions. What would that mean in terms of greater freedoms of movement with young people potentially,

for example? We also look to China—the Prime Minister met with the President yesterday—in terms of the uncertainty around how it will stimulate the economy.

For us, trying to scrutinise your analysis, how do we determine what your judgment is about the best course of action for the Government? It seems to me that there are trade-offs in a situation where we are subject to the negative impact of those tariffs and there are consequences of a reset of the relationship. You will of course say that these run on certain pathways, but what would you say is most desirable for the UK economy?

Andrew Bailey: Let me split it into two parts. The first part is that we will be very transparent about the analysis we do and the judgments we reach, and we will be happy to share that analysis with you when we get to a point where we can do it. There is no question about that whatsoever.

You referred to points I made last week. Let me make two comments on that. I described myself last week as a dyed-in-the-wool free trader, and I am. Free trade is not about choosing one area over another. That is not in the history of this country. We should approach all areas of the world as places we trade with. We should therefore be in an active dialogue with the Trump Administration on those policies as they affect the UK. Likewise, we should be in an active dialogue with the EU as well.

I will say one thing on that, if you do not mind. As you know—you have spent a lot of time on this—we have spent the last eight years implementing Brexit in the financial services world. I would like to say that so far—it is never over—the outcomes have been better than we feared they would be back in 2016 and 2017. One reason for that is that, as I said to my colleagues back in 2016 at the start, we have to maintain an open dialogue and open relations with the European Union because it has to trust us with financial services. We have done that. We have put a lot of effort into that.

I find it hard to understand people who seem to say that we should implement Brexit in the most hostile fashion possible. I take no position on Brexit. I never have, but I have always said that it is my job to get on and do it, and I will do it in the best way possible. Having a relationship with the European Union is the better way to do it in that sense.

Q37 **John Glen:** Can I push you? I agree with what you have said. We have spoken a lot when I was a Minister.

Andrew Bailey: We worked together a lot on it, very constructively.

John Glen: There is an impression out there that the Government will have to make a choice between them. We know that the instincts of the new President are perhaps to see things in more of a binary fashion about the direction that the UK Government wish to go in. We are trying to draw out where that hard moment actually crystallises for the UK economy. There may be choices that mean that you can carry on that

dialogue both across the Atlantic and with Brussels, but you have to make choices. As a Committee, we are asking you when that moment crystallises.

Andrew Bailey: It crystallises only once we have a much better idea than we do today of what the Trump Administration intend to do. I do not think that we can make that judgment today, because we literally do not know what their intentions are. We have heard things that were said during the election campaign. As I said, we will be happy to come back and give you our assessment of our responsibilities—obviously the Government have many other responsibilities—once we know that.

Dr Mann: How firms choose to respond to whatever the policies might be is a key ingredient to the outcome. Potentially, once there is some clarity about the policies being put into place, we can add questions to our decision-maker panel, as was the case during the Brexit negotiations and so forth. We can get an impression about what UK firms are doing in reaction to whatever policies are put into place. Until we get the policies, we cannot ask those questions. We can get a lot of insight from our firms, which are ultimately the ones that are going to make the adjustments one way or another.

Q38 **Chair:** I wonder whether, Professor Taylor, as you are based in New York, you have any perspective on this.

Professor Taylor: I do not know whether that gives me any extra wisdom or insight on this.

Chair: "Wisdom" is clearly going to be a repeated word.

Professor Taylor: My take on this is, as the Governor said, that we need to wait and see what actually transpires. The range of uncertainty that we face now is magnified considerably by that. The lessons of economic history and economic theory are clear. If you are a large country, you may be able to use trade policy to your advantage. For a small country, that is very difficult. The world just goes on and most of the costs, if you impose trade barriers, fall on you. That is point one. Point two is that, if you were to get into a trade war with lots of retaliation, that would raise the problems to an even higher level.

Chair: The Chancellor said very clearly that she was not keen to get into a discussion about tit-for-tat tariffs and that she wanted to be a free trade nation. That was on the record to us a couple of weeks ago.

Q39 **Chris Coghlan:** Thank you, Professor Taylor, for your comments. Building on that, of course a trade war is in nobody's interest, but during the first Trump Administration Vietnam and Germany were major beneficiaries from displaced trade due to the US-China trade war. Is it possible that there is a similar opportunity for the UK in the event of an EU-US trade war? If so, how should the UK think about being positioned?

Professor Taylor: It is a very standard piece of trade theory and something that is replicated in countless studies that interventions in trade policy will cause trade diversion. If you are the party imposing the barriers, your trade goes down, but water finds its level and trade flows will reallocate. If we see major changes in trade policy around the world, it is going to redirect trade flows, for sure.

Q40 **Chris Coghlan:** Governor, building on your comments on Brexit, which you also spoke about in your Mansion House speech, are you able to tell me what the Bank's best estimate is of the impact of Brexit on UK inflation in the short term, and on investment and productivity in the long term?

Andrew Bailey: We have produced assessments in the past on the impact on investment and productivity. We have said that we think that it would have an initial negative effect. The reason—as I said last week and I have said a lot of times before, including to this Committee in the past—is that, if you reduce the openness of an economy, it has those effects. The evidence we have seen so far largely supports the judgments we have taken in the past on that front. I would be happy to send that again, if you would like, for the Committee.

Q41 **Chris Coghlan:** Ms Lombardelli, many are advocating seizing the $300 billion in frozen Russian FX reserves. Has the Bank done any analysis that you can share with us on the potential impact of that on global capital markets and the risk premium to G7 debt, and therefore what the potential economic benefit or cost could be to G7 economies?

Clare Lombardelli: I am afraid that I am probably not the best person to answer on that one because it is not my area of responsibility.

Andrew Bailey: Very little of it is actually in the UK, I should say. That $300 billion number was a product of where the Russian reserves were at the point when the events happened. We have very little of that in the UK. I have obviously spent quite a bit of time in the G7 with fellow Ministers and governors. It has been discussed a lot. The best thing to say is that it remains frozen for obvious reasons.

Q42 **Rachel Blake:** It is good to meet you. I want to ask and probe more about inflation indices. You have talked a bit about your overall assessment in your decisions earlier this month, but we have seen overall inflation stabilised. I wonder whether you could talk about some of the indices that we might not be focusing enough on, so the other contributory factors to that. Then I am going to come on to the distributional impacts of inflation.

Clare Lombardelli: Our remit is clear that we are responsible for CPI, and that is what we focus on. In thinking about that, we spend a huge amount of time looking at the different components of inflation. You can see in our analysis that we set out lots of detail on what is happening to goods, services and what we consider core—stripping out volatile—and looking at those aspects. In different ways, these all feed through into

the overall inflationary pressures and they move in different ways. We spend a lot of time looking at how those movements feed through into the overall impact.

When we are doing things like stripping out volatile elements, we are very aware that those are very important to people. One thing we saw in inflation over the last two years was, in particular, that it was energy and food prices that shot up. Of course, that is extremely painful for people, particularly people on lowest incomes, who spend a much higher proportion of their income on those sorts of goods and have fewer resources and ways to manage through that. We look at all those measures, but we keep a very firm view and are very clear that our remit is for overall inflation across the economy. We spend, like I say, a lot of time looking at the different components of that and the different ways it affects different groups of people.

Dr Mann: One of the reasons for looking at these disaggregations, whether it be in different indices or looking at different income groups—by the way, if we look at the contribution of mortgages to the middle income category, each group has a different basket, so they have a different behaviour in their real income purchasing power and will save or spend differently depending on that—is to evaluate the dynamics of consumer behaviour over time. Those things have changed, so you cannot just look at the macroeconomic data. It becomes a very important ingredient in informing our decisions. It also has implications because of the way in which various policies, for example the energy price guarantee, filter through different groups in different ways.

Q43 **Rachel Blake:** Building on those points, I understand that you are focusing on CPI, but you take into account other indices. You have acknowledged already the experience of high food costs. How do you think that experience of high food costs will be affecting demand, to the point that Professor Taylor was making earlier?

Clare Lombardelli: Building on what Catherine said, when we are thinking about demand, we think about, if you look across the economy, different groups of people in the economy and what their propensity to save and consume is. It is obviously the case that people on lower incomes consume a higher proportion of their income, but their income is lower so they constitute less of, if you like, the demand in the economy. That disaggregation is one of the many ways in which we think about demand in the economy.

For example, when Catherine was talking earlier about the impact of the Budget, she highlighted that a lot of the spending at the front end, because it is through public services, will be distributed across the economy geographically more than other forms of spending might be, so you see how that plays through into demand geographically. That will be one example of how we think about the way in which different groups of people, whether that is by income, sector or geography, will be consuming and saving, and therefore how that all adds into demand.

Andrew Bailey: Our staff do quite a lot of work, as do staff in other central banks, on what shapes people's perceptions of inflation. There is a difference between perceptions and expectations. Expectations are what people think inflation is going to be in the future; perception is what they think it is today.

The reason I say that is that the results tend to suggest that people's perceptions are shaped more by the things that they buy more frequently. It is not a great surprise, really. Of course, food and energy have therefore quite a high weight in those perceptions.

Q44 **Rachel Blake:** To follow on from that and your analysis of demand, we have an analysis of the impact of inflation and interest rates on mortgage holders most recently. When you are looking at that income distribution and how people are affected by inflation, how are you balancing an understanding of mortgage holders with perhaps people who are not mortgage holders and their perception of inflation?

Clare Lombardelli: We have lots of data on who holds mortgages. Of course, it is a subset of the British population. Some people are homeowners without a mortgage. Some people have mortgages. Some people are renters or, indeed, are in a different set. We do think about that.

The other thing to bear in mind with mortgages—we touched on this a bit earlier—is that, because so many are fixed rate, there is a real distribution in the rates that people are paying. You still have some people who are on very low rates reflecting fixing a while ago. You have some people who are on much higher rates because they have changed. We will think about that in thinking about what their disposable income is. We think about their income after their mortgage costs and therefore their ability to spend.

Again, this is another way in which we cut the data to understand the position that households are in now. We also think about how that is likely to evolve because that is critical to us understanding how demand is likely to evolve. Consumption is, by far and away, the biggest portion of demand.

As Catherine says, that is absolutely critical to what we will therefore see in pricing behaviour because firms will be thinking about how much demand is out there when they are setting their prices, which feeds directly into inflation. These are all ways in which we are trying to understand the current situation in terms of what is happening and how that will evolve going forward.

Q45 **Rachel Blake:** I have one final question. How concerned are you about volatility in that demand given perceptions of inflation?

Clare Lombardelli: The overall GDP data moves around. We had quite a bit of weakness at the back end of last year. There was strength coming into this year. That strength is easing off now.

In a sense, we try to look through the volatility and think about what inflation will be in the future, and therefore how we set interest rates now. But we are monitoring all this data to try to pick up whether there are trends, how much of it is volatility in the sense that it is noise and how far it gives you a signal about what is going to happen in the future. We look across the piece, including, as I mentioned earlier, at some of the data we have in the credit space, how much demand there is and what we are seeing in terms of households and their position.

Q46 **Chair:** It is interesting that you mention credit. We have talked a bit about mortgage holders, and you mentioned renters. My constituency could be broadly divided into people who could afford to work four days a week and those who work four jobs over seven days.

Professor Taylor, you talked about going and visiting agents. Credit to you for talking to people on the ground, but do you gather any data about those people who are having to work multiple jobs on low wages? That will have an impact on their disposable income. The confidence is different in that bracket. The danger is that we tend to look at the top tier and perhaps not understand the impact lower down.

Andrew Bailey: As part of the agency visits, we do two other things. We do what we call community forums, where we meet people who are not typically running businesses but are more the type of people who you have just described. We also meet, in a separate programme, people largely from the charitable sector, who are dealing with the issues.

I was in Shrewsbury last month and I did a session in Shropshire with people in the charities that support those sorts of people. We find that very helpful in giving us the feedback that we will not, as you rightly say, get from the normal agency context.

Q47 **Chair:** How do you use that feedback?

Andrew Bailey: It all goes into the pot, as it were, very deliberately.

Q48 **Chair:** Professor Taylor, have you done some of these visits too?

Professor Taylor: Yes, and I also listen to what other members of the committee bring back from their visits. As Andrew says, it goes into the pot and we talk about it together. There are more formal surveys that the agents are doing throughout the year as well as the timely year-end survey that they are doing now, which is on a bigger scale and is really going to help us.

Yes, it is really important, especially at turning points, to listen to what the agents are saying and what is happening on the ground. You cannot just sit in Threadneedle Street and think you understand the entire economy.

Q49 **Chair:** I am glad to hear that. The carpets are very thick and the men in pink jackets are very genteel, but it is a long way from the streets of south Hackney.

Professor Taylor: You want to get a sense of what is not in your model sometimes. We have a model of saving. If interest rates rise, people have an incentive to save more, but, if we look backwards over the last 12 or 24 months, saving is quite a bit higher than what the model alone would predict. You want to get behind that and talk to people about why saving is high. Similarly, you want to know why firms are not investing as much as you would have expected, given your model. That is the vital information you get from the agents and from getting out.

Clare Lombardelli: I would add that we run surveys specifically on this to collect the data systematically, in particular around household finances. That gives us a picture and we can break that down by different income levels and different household finance levels. Again, we monitor that to see whether there are new signs or new evidence of trends or particular positions that households are finding themselves in.

It is undoubtedly the case that some of the people you refer to and some people who are in particularly precarious positions, whether that is employment or financial, do not tend to be picked up as well by a lot of the surveys or the agency visits, as much effort as we put in. That is why it is important to continue to put the effort in to make sure that you are doing the best you can to capture those parts of the labour market and those parts of the country. It is something that we are conscious of.

Chair: I am glad to hear that it is on your mind and you are trying to capture some of that. I am sure there is always more to be done.

Q50 **Yuan Yang:** I would like to turn now to quantitative tightening and what came before QT. Thank you, Governor, for your correspondence with the Chancellor over the asset purchase facility arrangements, which the Committee has seen. As part of those arrangements, as you know, the Treasury is now effectively paying out interest payments to commercial banks for the reserves that they hold with the Bank of England via the facility. How much do you expect the Treasury to pay out over the next Parliament? How fiscally significant is this payment in terms of constraining what the Chancellor can do with the Budget?

Andrew Bailey: I cannot give you a figure for the next Parliament, I am afraid, because that will depend on a lot of assumptions. The reports are published quite regularly, but they depend on a lot of assumptions.

I can tell you the current balance of cash, if you like, in terms of cash flow. The Bank paid over to the Treasury £124 billion during the phase when quantitative easing was going on until interest rates started to rise. Currently, that number remains plus £70 billion. Essentially, £54 billion has come back the other way in terms of cash payments from the Treasury to us. There remains plus £70 billion on that level of accounting.

Q51 **Yuan Yang:** In the last financial year, the Treasury paid £20 billion or £30 billion to the Bank.

Andrew Bailey: Yes. It depends on a number of things. It depends on interest rates and where the curve is. As you rightly said, quite a bit of this comes from the difference between the price that we paid for the gilts, and therefore the discounted income flow on that, and what is now being paid, as you said, by us on the reserve accounts. By the way—you may want to come on to this—that is not a link that we make closely. The remuneration that we pay on reserve accounts is done for other reasons. You can make that connection in our balance sheet.

It will depend on the curve. It will also depend upon the timing of sales that we make, but let me be very clear on that. That is, in a sense, all about the timing of these cash flows. For a given curve, it would not affect the overall cash flow over the life of the thing.

Q52 **Yuan Yang:** For the current Parliament, what matters are the in-year budget constraints.

Andrew Bailey: Yes, but, if you do not mind me saying so, you really need the Treasury to talk about how that feeds through into the fiscal arithmetic, which has changed in the Budget in terms of the way in which the fiscal rule is set up.

Q53 **Yuan Yang:** Right now, over the last year, you are looking at something like £20 billion to £30 billion in transfers from the Treasury back to the Bank.

Andrew Bailey: The cash is flowing the other way, yes.

Q54 **Yuan Yang:** Are there better means, technically, of ensuring better value for money so the Treasury has to make fewer payments of that kind?

Andrew Bailey: Can I make another point about what distinguishes us from other central banks? In many other central banks, you are not seeing the cash flow happen, even though they essentially have very similar positions to us.

The reason for that—I am sorry; I am going to do some slightly abstruse accounting at this point—is that these central banks are able to book deferred assets on to their own accounts. Why are they able to do that? I am going to put to one side the fact that they have different accounting standards. The reason is that they retain the profits they earn from the note issue and then pay them out to their Treasury by some process, usually an annual agreement or whatever.

Therefore, they have an income stream, which they can offset against the cash flows. Of course, it means they will not be paying over the money that they would otherwise be paying over as the profits of the note issue. Because of an Act passed in 1844 by Sir Robert Peel, we do not have that. In fact, what is called the seigniorage, the profits of the note issue, is paid over immediately. For the last year, we were probably paying over about £5 billion a year. We cannot do that piece of accounting because to do that piece of accounting you have to have some income. You cannot

book a deferred asset and have no income in the future to offset it against.

Economically, I am afraid it makes no difference at all. However, optically it does. I recognise that we are in a situation where these cash flows are having to come back. All I would say is that there is another cash flow going the other way, which will be going the other way permanently, which other central banks are using to offset. We cannot do that. It looks different in this country.

One benefit of our arrangement is that it is more transparent. I have to be honest that it is slightly painfully transparent, but it is a more transparent system.

Q55 **Yuan Yang:** That is one channel that is closed off to the Bank. You mentioned the importance of that interest payment on reserves for other means. I presume you mean the monetary transmission mechanism. The Bank made technical preparations three years ago to introduce a tiered reserve system to see whether that was possible. Of course, the European Central Bank has done so previously. Is the infrastructure in place to implement such a system?

Andrew Bailey: The European Central Bank has a somewhat historical minimum reserve provision, which goes way back to when it was doing monetary targeting. It is very small, I should say; it often gets exaggerated in the telling. That minimum reserve requirement is very small as a proportion of reserves. In our system, we do not have that. Could we introduce a tiering structure? Over time, yes, we could. It would require us to do quite a lot of changing of our systems, but we could do it.

Can I just say this from the point of view of the substance of the issue? That is not at all necessary for us to do to pursue our objectives of either monetary policy or financial stability. Indeed, I would argue—I have said this in previous commentary—that it is somewhat inconsistent with our monetary policy objectives because we pay the policy rate on reserves. That helps us to anchor the interest rate curve at the policy rate, which is critical to the MPC's pursuit of its objective.

Q56 **Yuan Yang:** I take that point, but value for money is a consideration for the Treasury as well as for the programme and pace of quantitative easing. Is there any value-for-money consideration in that arrangement?

Andrew Bailey: It depends on what you mean by value for money. If you look at value for money in the context of what we have done over the last 15 years, you have to look at the overall economic effects of quantitative easing and the quantitative tightening that is now going on. The cash flows do not answer that question for you. I just need to be very clear on that: that question is not answered by the cash flows. That is an economic question. That is the appropriate way to look at value for money.

If you then come to the question of tiering—I am going to be quite blunt about this—it is a tax on the banking system. It is not something that is needed for our objectives. It does not enhance the value for money of our objectives at all. It would be a fiscal decision, not a financial stability decision or a monetary policy decision.

Q57 **Dame Harriett Baldwin:** It sounds as though you have been asked to do a lot of work on this by the Government.

Andrew Bailey: No. We have looked at the question in various ways in the past, but there is no big work programme going on. Let me assure you on that.

Q58 **Yuan Yang:** Similar to Dame Harriett's question, you have previously spoken to the Lords Committee and told it that the Bank could not act to change that arrangement of paying interest on the reserves on its own. What partnership would you need from other parts of Government? What conversations have you had with them on this issue?

Andrew Bailey: First of all, I am very clear—I have said this before—that this is rightly a decision for Government. It is not a decision for us. We do not need to do this to pursue our objectives. In fact, I would argue it is contrary to our objectives. It is not a decision for us. It would require a decision from Government to do that. They would have to be the takers of that decision.

Q59 **Yuan Yang:** I will move on to ask Ms Lombardelli about distributional impacts. What is your latest assessment of the impact of QE on inequality? Is QT undoing any of that impact? Is there a risk of a ratchet effect where it is much easier to increase rather than decrease the level of inequality?

Clare Lombardelli: We have done work in the past on the impact of QE on distributional outcomes. Linking a bit to what the Governor was saying, you have to take an overall economic perspective about what QE did and does in supporting the economy. When you look at that, you see that it supports everyone across the economy. Of course, those people on low incomes come within that.

The Bank has done that analysis in the past. The Bank has not done specific analysis of the distributional impacts of QT. We have done quite a lot of analysis on the impact of QT, which shows a very small impact from quantitative tightening. That is completely consistent with all the academic literature out there.

There is limited available evidence because QT programmes have only been going for quite a short period of time and they tend to have been smaller. That evidence seems to suggest, if anything, a very small impact from QT. You would not expect it to have particularly changed the broader conclusions about QE. It shows the sorts of things you would expect. Obviously, QE is implemented in a different environment. Quite often, it is a time when you are facing a shock. The QT programme is

particularly designed to be very stable and in the background. It is just happening; it is not an active policy tool. It is not in response to a shock, if you like.

You get slightly different results, but the overall economic impact of QT—as I say, all this evidence is emerging and we will know a lot more about QT in a few years when more countries are doing it and more of it has happened—is quite small.

Andrew Bailey: Can I just come back on Dame Harriett's question? I would not mind putting this question to rest. You referred to work that was done three years ago. I just want to be clear on what that work was because it is relevant to Dame Harriett's question.

Three years ago, I remember we were looking at the question of whether we would and could introduce negative interest rates, believe it or not. It sounds like a different world, but we were. Other central banks that had done negative interest rates did them through a system of tiering their reserve remuneration. They did not move to negative interest rates on the whole of their reserve stock. That is what occurred to me. That is what you are referring to.

You are right that we did work at that point to ask, "If we were to move to negative interest rates, could we tier remuneration on reserves?" You are right, Dame Harriett; we did do some work on that question.

Q60 **Dame Harriett Baldwin:** That was not with the new Government.

Andrew Bailey: This goes back to the previous Government.

Dame Harriett Baldwin: Yes, not since 4 July.

Q61 **Lola McEvoy:** I have another question to probe a bit further on the global impact, the other approaches that big central banks globally have taken, and any potential economic advantages to those economies because of their different approach. Has there been any work done on that or do you have any thoughts about it?

I know it is not within your remit, as you have outlined, to make the decision, but I would be interested to hear the opinions of other members of the panel, maybe Dr Mann, on the impacts of the approaches that other central banks are using.

Dr Mann: I would agree with what the Governor said, which is that the nature of accounting for the profits or losses associated with holdings of different assets has not affected the conduct of the central banks' decision-making. The two are separate to the extent that there are fiscal considerations—for example, in the US, there are not because of this deferred asset, and in Europe, the complexity of the different sovereigns on the balance sheet creates its own challenges. These are accounting issues.

The financial markets have looked through this. If there is a conduct issue and we think that there should be a different choice of monetary policy because of these accounting strategies, the financial markets will seize on that pretty quickly. The fact is that they have looked through it because they separate out what the monetary policy authorities need to do for their jurisdiction, and then this accounting thing is on the other side. It is not affecting the decisions that are relevant to the jurisdictions on which they are basing their monetary policy decisions.

Clare Lombardelli: If I can add to this, in my previous role at the OECD, I wanted to do some work on the international comparisons of these things. You very quickly find you cannot because, while the UK is very transparent, lots of other countries are a lot less transparent. It is quite difficult to get comparable data on these things, which can be quite frustrating when you want to do research.

Q62 **Lola McEvoy:** Can I bring in Professor Taylor? Wearing your hat as an economic history guru, could you tell us whether there are any examples of a differing approach having a beneficial outcome for an economy?

Professor Taylor: Central banks have been experimenting with different kinds of intervention for 500 years. That is a very rich history. As the Governor mentioned, all kinds of interesting laws were passed at various times that we are still living with.

As it pertains to the last 10 or 15 years, that history is still to be written. The judgment on QE will be that it is a tool that needs to be there in extremis. In those crisis moments, as Clare Lombardelli mentioned, it may be the only tool you have that can avert a major financial breakdown in markets and avoid the counterfactual of an even worse recession.

In normal times, you may want to unwind that. That is what QT is about. It should proceed more smoothly because it is not being implemented in the same dramatic fashion. There is a move now towards a repo-based system of providing liquidity through borrowed reserves, which takes away a lot of the interest rate risk questions that have arisen. We are moving in a healthy direction there and hopefully we are learning lessons from the past.

The most interesting conversation was about the accounting. It seems obscure, but that is just a quirk of the way we do our accounting here. As the Governor said, that is optically interesting, but in terms of the underlying economics maybe not as much.

Q63 **Lola McEvoy:** Yes, you will forgive us because it feels like quite an expensive quirk annually. I know it is not, as you have explained.

Professor Taylor: It is also maybe not so much the choice of the Bank, but if one wants to change the accounting, okay.

Q64 **Yuan Yang:** Can I just clarify something, Governor? You previously said

that tiering reserves might run counter to your objectives when it comes to increasing value for money on QE. In what way would it be counter to your objectives?

Andrew Bailey: We do not need to tier reserves to achieve our objectives.

Q65 **Yuan Yang:** Would it be counter to them?

Andrew Bailey: From the point of view of monetary policy, by far the simplest system is that we hold reserve accounts and we pay the policy rate on the reserve accounts. We do not pay some mixture of different rates. If we did pay a mixture of different rates, at the margin that could have some effect on the transmission of monetary policy. That is really my point. The simplest system is the one that we have, which is to pay the policy rate on reserve accounts.

This goes to what Alan was just saying. Moving to a system where we use repo to fund the reserve accounts, which is something that I set out in a lecture I gave at the LSE earlier this year, to my mind is the most attractive system we can move to because it means that the interest rate risk is taken off our balance sheet. In other words, we essentially have the Bank rate on either side of the calculation. We are in the middle, but we are not taking interest rate risk.

That would not get away from the question of, "Would you do quantitative easing in the future?" In a sense, through quantitative easing we are deliberately taking that risk on to our balance sheet. It is a policy choice to do that. In normal circumstances, I would like us to move to a world where we do not have that risk on our balance sheet; that risk is left out in the banking system.

Q66 **John Glen:** Could I turn to the overall impact of some of the Budget decisions on inflation, interest rates and growth? Could I ask you, Ms Lombardelli, about the assumptions made about the stimulus effect and the crowding-out effect? There seem to be some differences around how the OBR has assessed the effect of the national insurance increases. That will play out and decision making from your panels and others will indicate how that goes forward, but could you explain what fiscal multipliers you used and why there is a difference between the OBR's assessment of the NICs impact on behaviours and what you have decided?

Clare Lombardelli: The big picture is that the way in which we have assessed the Budget and the way in which the OBR has assessed the Budget are very similar. We have the impact on growth by the end of next year as 0.7%. The OBR has 0.6%. On inflation, the numbers are very similar.

There are some differences, like you say. They derive from two things, really. One is around the way in which we look at the multipliers. Again, we both follow the totally standard economic approach. When certain

spending happens, we ask the question, "What proportion of that feeds through into demand?" For some things, it might be 100%. For some things, it might be less.

The OBR has slightly different numbers from us. There are two reasons for that. First, we both look at the literature and there is a lot of uncertainty in that. There is a range of views. We both ground our numbers in the literature, but they might be slightly different. We both basically take the type of spending, whether it is capital investment, welfare or tax, and think about the time—over the first year, second year, third year and so on. We have slightly different numbers, but they are not big differences. You could argue about them; the literature does. Neither of us is doing anything that is particularly unusual in that space.

The other way in which they are different is that the OBR embeds in its multipliers changes to interest rates, exchange rates and other things. We do not because we take those separately from the market. The OBR thinks about the impact of Government spending and says, "There will be all sorts of consequences from that, including on interest rates and exchange rates." We just take those from the market. Those are just different modelling approaches, which should get you to the same answer theoretically. You might get slightly different numbers because of the way in which markets have moved.

You have a difference in the multipliers. The other thing going on that is slightly different is our judgment about the amount of spare capacity in the economy. Again, I would not over-interpret the differences here. Both of us basically believe that at the moment the economy is broadly in balance in terms of demand and supply.

At this point, I will say that it is very hard to make judgments about spare capacity, the output gap and all those sorts of things. It is really hard to know. It is hard to know now; it is hard to know what they will be in the future. Frankly, economists find it hard to know what has happened in the past. The output gap is really difficult to judge, but for lots of reasons we think that broadly in balance seems about right. Unemployment is quite stable. Vacancies are coming down. It does not feel like there is a huge amount of excess capacity in the economy.

You have those things. Now, over our forecasts, we think some spare capacity will open up in the economy in response to monetary policy being tight. Fiscal policy will tighten in the later years. We think there might be some spare capacity that emerges in the economy. The OBR takes a slightly different view. It has more of the impact of the Budget in the near term, so its multipliers are higher in year one than ours are, for example. It has a bigger impact and thinks there might be excess demand in the economy.

That is why the OBR has crowding out in the traditional sense of whether there is more competition for resources. Because we think an element of slack will open up, we do not have that traditional sense of crowding out.

But we do think that demand will be higher next year and the year after because of the Budget, and therefore inflation will be higher. Sorry, that was quite long-winded.

John Glen: No, that is very helpful.

Chair: It was very helpful.

Clare Lombardelli: Big picture: they are not massive differences, but there are some differences in the detail.

Q67 **John Glen:** Could I ask the Governor about the Budget impact? You predict a near-term increase in inflation and GDP, but the Bank is less clear about interest rates. The guidance in September was different. The OBR says that there will be an effect and that interest rates will go up by 0.25%. Can you explain the Bank's thinking with respect to interest rates? Why is there no clarity over the expectation of interest rate effects?

Andrew Bailey: As a matter of course, we do not take a view on what interest rates are going to be. In our forecast, we condition it on the market curve. The market curve did move—interestingly, it moved around the Budget by pretty much what the OBR is putting in, about 25 basis points. If you look at the market's profile of what it thinks we are going to do, it moved by about 25 basis points—you are right. We factor that into our forecast, but we do not take a view ourselves going forward on what interest rates are going to be. Going back to what we have been discussing and what Clare was just saying, my guess is that that will change over time anyway.

Q68 **John Glen:** Perhaps I could turn to Dr Mann and Professor Taylor then. The September guidance was that a gradual approach to removing policy restraint remains appropriate. Can you talk about the interaction between that guidance and your expectation of how expansionary the Budget would be? Can you give us an assessment of how that guidance could evolve?

Professor Taylor: We did not know all the details of the Budget ahead of time.

John Glen: A lot were aired in the media.

Chair: There were quite a lot of trails.

Professor Taylor: A lot of things were heard, but we did not know for sure. Bank staff received information that week. Talking of spare capacity, there was no spare capacity there. I need to thank the Bank staff for doing an amazing job in giving us some guidance with updated forecasts, which have been incredibly informative.

In the November round, we were looking at the changes from the Budget and the changes from all the other things that have been happening that

we have talked about. The inflation numbers were coming down. We also had a sense that savings were elevated and there were lower demand pressures than we otherwise would have anticipated. The update in November reflected all of that as a whole.

That was the basis for the November decision. There were lots of offsetting factors. The actual effect in terms of demand pressure from the Budget is in chart B on page 29. The demand pressure is only really about half the story. A lot of the inflation deviation is in year 1 and 2 due to other Budget changes, various one-time tax changes and a certain path of fuel duty, which is not ineluctable. It is assumed here to follow a given path.

Q69 **John Glen:** Is that wise, though? On the fuel duty point and the 0.2% effect, why is that—

Professor Taylor: It is just what we do.

John Glen: I get that, but it is a policy decision that has kept rolling over. Should the default setting not be that it will be rolled over rather than the other way around?

Andrew Bailey: Can I just come in on that?

John Glen: I thought you would.

Andrew Bailey: We condition on announced Government policies. I take your point that this is a stated policy that has not happened for a long time now.

Chair: To pick up on Ms Lombardelli's point about economists not always being able to tell based on what has gone on in the past, in this case that would be rather a good indication.

Andrew Bailey: I will tell you what my concern is here. That would put us on a slippery slope towards making our own judgments on what policy was going to be. We really do not want to go there.

Chair: That is a question better directed at politicians, yes.

John Glen: Personally, I think that is reasonable.

Professor Taylor: To come back to the question about what it means for inflation, if I look at the blue bars in chart B, which are about the demand pressure, that is what you feel, as an economist, is the underlying inflation impact that is happening in a sustained way as opposed to one-time tax or price measures. You may or may not believe those, but we have to factor them in.

Where you put the weight in terms of the driver of underlying inflation would be on the blue bars that are working through demand in the economy. They are up about 20 to 25 basis points. They have been offset in the overall forecast by declining price pressures elsewhere. Our

demand judgment is changing because we have seen more savings and other effects. That is one way to read that chart.

Dr Mann: The committee uses this "gradual" language. I do not, but it is a committee document, and that is why it is there. I have taken the view that a more activist strategy is superior. This is for a couple of reasons, a number of which I have already outlined with regard to the underlying inflation pressures.

I start by noting that the restrictiveness of monetary policy is less, in my view, than has been incorporated into our models under the standard assumptions. That is principally because the starting point for the hiking cycle was not zero or the effective lower bound; it started at about negative 3.5%. That is one reason why it is important to hold as opposed to pursue this gradual strategy.

The second aspect with regard to the degree of restrictiveness of monetary policy is where we think we are going to end up in the longer term. My view is that this so-called r-star or the neutral interest rate at which the economy will be in balance is much higher than is incorporated in our models, hence the current stance of monetary policy is not particularly restrictive.

How does that translate into not being a gradualist? There are a couple of other elements that are important. First, as I said, it allows more time to evaluate whether the upside risks to inflation that I have outlined materialise. That is an important thing to consider because of the upward bias and the ratchet effect that we have in the inflation process.

Secondly, I will not hold forever—I have said that publicly before, so no news there—but, when I do cut, it will be more aggressive because I will have received the signal that I need from the data, whether it be demand, supply, prices or wages, that an appropriate stance is to cut by a larger amount.

The rationale for doing that is multiple. First, the research shows that firms do respond immediately to a strong signal from the central bank that the decision has been made based on information coming in. That strong signal and immediate response of firms, which our research shows, is a different type of channel for the transmission of monetary policy than the common view, which is that it takes a long time for it to filter through. Some of it does take a long time, but there is also an immediate response, which means that monetary policy has more traction in the near term than some models would incorporate.

Secondly, these days, with the frankly larger movements, the signal is clearer. We are definitely making a change based on information. In today's climate of volatility and financial markets moving around quite a bit, that clear signal cuts through the noise of financial market behaviour.

My last point on gradualism is that, frankly, in my view, it allows the persistence that we have been struggling with to drag on for longer. Why do we want that?

John Glen: Thank you for your clarity.

Q70 **Chris Coghlan:** Governor, in your Mansion House speech, you spoke about the vital importance of improving UK productivity. You said that that is linked to capital deepening, that the UK has continually been at the bottom of the G7 league table for investment since the 1990s and that public investment is the foundation of business investment.

In the Budget, UK public investment remains flat as a share of GDP. Therefore, how can we expect the Budget to improve UK productivity? I would be interested in other panel members' views as well.

Andrew Bailey: That is a question for the Chancellor to answer. What I would say is that that flat profile of investment was against what was a very challenging Budget from the point of view of the overall budget position. You would really have to ask the Chancellor how she made that judgment, but I would just make that point. It has to be assessed against the overall outcome.

It is sensible that the fiscal rules have been amended to put a sharper relief on investment and potentially create more headroom for it.

Dr Mann: There are two channels through which the Budget could have productivity enhancing outcomes. We have already talked about one in the context of how firms might respond to the change in labour costs. One strategy is to undertake productivity enhancing investments that would be supportive of the higher real wages that are part of the equation here. That is one way in which you get investment and productivity growth.

Secondly, let us suppose that this demand factor really has traction throughout the economy. Again, the research that we do looking at firm-level data shows so-called sales surprises. If I am a firm, I do a forecast looking forward a year and I think my sales will be a certain amount. When the Budget comes in, however, it is demand driven, front-loaded and widely distributed throughout the economy. That is a sales surprise. When firms get a sales surprise, they respond with higher investment. Again, that is a productivity enhancing strategy. Those are two channels through which you could get a productivity gain.

Q71 **Chris Coghlan:** Presumably that is much less than if more of the Budget was aimed at public investment versus two thirds of it being on current spending.

Dr Mann: Those are incorporated in the multipliers already.

Clare Lombardelli: Let me add a couple of things. The Budget is one part of the Government's policy, and the Chancellor will talk more widely

about that. There are the things that were announced at Mansion House last week; there are others, such as planning and the like.

There are a few things that I would mention from our perspective. As you say, productivity is a huge challenge for the UK. It is relevant to monetary policy in so far as it determines how quickly the economy can grow in a non-inflationary way. Of course, it is the only long way to drive up real incomes.

Productivity depends on a whole set of things. Public investment is one. Private investment is an area where the UK has also lagged behind its counterparts. That is absolutely critical. If you think about every worker and how efficient they are being, it is about that.

The other thing that is really critical is skills and human capital. As economists, our understanding of the importance of human capital has really changed over the last few decades. If you look forward to how economies are changing and evolving with technology and all of that, you can see an even greater role for that. The Budget covered some of this, but I am sure the Government will think more broadly about it.

Professor Taylor: In the long run, productivity is everything. The central bank and monetary policy can try to provide the foundations for that through a credible nominal anchor and financial stability. The UK has special problems, but it also has some of the same problems as many advanced countries. Trend growth has been slowing. Demographic trends and other trends have been a headwind. The UK seems to have been at the bottom of the pack, as you say.

There is a broad range of questions there. Again, from talking to the agents I got a sense that firms are concerned about skills and education, as Clare Lombardelli mentioned. That can be addressed through a broad range of Government policies, but it will not just be what the Budget says. The planning revisions may also help.

There is scope for upside. At the same time, we are coming out of a lot of uncertainty shocks, which were very negative shocks for the economy. If we could have a quiet decade, maybe things would suddenly look up. I would not bank on it, but we would like that.

Q72 **Chris Coghlan:** As we have been discussing, the Budget is forecast to be inflationary. Given that, to what extent does it make sense for the Bank to be increasing interest rates to respond to that Government-induced inflation? If that does control inflation, is there a risk that that will then hamper growth and productivity, given the cost of borrowing for firms?

Andrew Bailey: The response of interest rates should take into account whether we think inflation is going to be sustainably at our target. It goes back to the earlier question. Yes, it has had the effect of putting something more on to this profile. We had this profile before, which is really to do with the unwinding of some of the shocks that we have had.

Our judgment is not really aimed at that; it is aimed at whether we think, based on the interest rate we have and the path of interest rates that the market thinks we have, there will be sufficient restriction in the path of interest rates to bring inflation sustainably back to target. That is the judgment we have to take.

You have heard different views. Catherine has set out a different view on that, but in my own view, yes, it will be sufficient to bring us back to target sustainably.

Q73 **Lola McEvoy:** Before we move off this topic, Dr Mann, for the less educated in economic policy, could you just explain a bit more about your sales surprise approach and what that actually means? Can you elaborate more on the productivity aspect of that one?

Dr Mann: We can send you the research paper done by Bank staff. We have already talked about the DM panel. One of the questions they ask is, "What do you think your sales growth is likely to be over the next year?" Since it is a time series panel—we have asked that question multiple times over the years—we can compare what they thought they were going to get in terms of sales with what they did get as an outcome.

There is a distribution of surprises from what they thought they were going to get versus what they did. When there is a positive sales surprise, we can factor that in. How do you react to that? Do you make investment? Do interest rates and the cost of finance matter? The sales surprises dominate the investment decision. Financial conditions are not relevant, which is also something we see in the macroeconomic analysis as well. That is what I mean by sales surprise and how firms react in terms of undertaking investment.

Chair: We would love to see that paper. That is really interesting.

Q74 **Bobby Dean:** I would like to move on to the labour market data. I apologise in advance to the Governor because I know he preceded his comments on the Mansion House speech with "oh dear". That was his phrase when we were talking about this section.

Before we get into the data issues, can you just explain to me more broadly what impact the labour data has on your forecast and how integral it is to what you write?

Andrew Bailey: It is. Just to be clear at the start, we are talking here about the quantity side, not the pay side. The pay side is a different survey, which does not have the issues that the labour force survey does.

It is integral because we take a number of things out of it. One is employment. Another one is unemployment, which is people who do not have jobs but are seeking to have jobs. The third one, which historically tends to get less attention but is very important at the moment, is what is called participation, which is people who do not have jobs and are not seeking to have jobs.

Just to give a bit of background on this, during covid—this was quite common across many countries—there was an increase in so-called inactivity or non-participation. The UK was not unusual in that respect. What is more unusual is that most other countries have seen that reverse as covid has largely gone away. If you take the UK labour force survey at face value, that is not the case in the UK. Participation has not reversed its path. That is very important because that is a big signal on what we call the tightness of the labour market. When people are not seeking to work, they are not putting pressure on the labour market in terms of competing for jobs.

However, the problem we have at the moment is that we do not know whether that is a good read or not a good read. It is particularly an issue with participation. Our staff can proxy unemployment through other data series. We think we have a reasonably good idea of how that has behaved and we can compare that with the labour force survey.

There are just not the same alternative measures of participation, so we are much more dependent on it. You can use substitutes. There is the vacancy-to-unemployment ratio, which is not measuring the same thing, but it gives you a measure of the tightness of the labour market. Without confidence in that participation data, that really is an issue.

Moreover, underneath that is the second set of questions that the ONS asked people in the sample, which are about why people are not participating in the labour market: "What has caused you to become inactive?" Again, the story is that there has been an increase in long-term ill health. You may say, "Well, that is consistent with increasing NHS waiting lists," but we do not know whether that is correlation or causation.

It is an important issue. That is a long way of saying that it is very important. It is not just important for us, of course. It is important for other aspects of public policy as well.

Dr Mann: Can I add one additional aspect of this? There are three different states that people can be in. They can be employed, unemployed or not participating. The flows across these three different states are very important to our understanding because you can have an increase in unemployment as people come from inactivity into unemployment on their way to getting a job. That is positive because they are drawn into an expanding economy with more jobs. You can also have an increase in unemployment because people are becoming unemployed and then maybe they will become inactive. That is a bad signal for the economy.

We do not have those flow data. As a result, when unemployment changes, we do not know which way it is going, whether it is in the good direction or the bad direction.

Q75 **Bobby Dean:** Yes, I understand that point well. My dad was a scaffolder.

He is out of work at the moment awaiting treatment. He would love to get back into the workplace, but he is not able to. Equally, we hear stories about GPs who have built equity in their homes, decided to move to the south coast and have no intention of returning to the workforce.

You are telling me that we have no steer at the moment from the survey data about what proportion of those types of people there would be. Is that right?

Andrew Bailey: You get a steer from the LFS. People answer the same questions in the LFS, but the sample is now so small that it is not a statistically representative sample. We do not know how much faith we can put in it. That is the problem.

Q76 **Bobby Dean:** My final question is about the policy levers that we have to address it. We will not know which ones to pull if we do not have the data, but could you explain to us what policy levers there are?

Andrew Bailey: The ONS is responsible for this. We are working very closely with the ONS; we have a very good working relationship with the ONS. You may have seen the letter that our chief economist Huw Pill wrote, which was released recently. That also set out Catherine's point about the flow data.

The ONS is doing a lot of work to try to correct this. It has increased the sample size, trying to get more people into the sample. It is looking at different ways of operating the sample. It is working very hard at this.

It is interesting. As I said in the Mansion House speech, I have talked to my fellow central bank governors and other countries have versions of this, but they do not have such an extreme a case of it as we do. Why the UK has an extreme case I am afraid I cannot answer. It just seems a bit odd to me.

The ONS is working very hard. It would probably be better to ask the ONS about what it is doing, but it is working very hard at this. There is no question about that.

Q77 **Bobby Dean:** Just going back to my point earlier about the potential reasons people might be doing this, would the early take-up of pensions have a big effect on participation? That is people not just having equity in their homes but taking their pensions early.

Andrew Bailey: Yes, it is one of the candidate explanations. We have an ageing population now, but the trend in non-participation goes above and beyond what you would expect even for a given level of ageing of the population because we can broadly factor that in.

Having said that, there is another point that needs to be tackled in the labour force survey, which Huw covered in his letter. It needs to be updated to use the most recent population numbers. However, we have a reasonable idea about the ageing population.

One explanation during covid always seemed to me to be that people were deciding to go into retirement a bit earlier than they would otherwise have done because of the impact of covid. That did not seem unreasonable at all. The puzzle is why the UK has then behaved differently from other countries.

Q78 **Chair:** Is it having gold-plated pensions for a certain cohort? They have taken pensions and those pensions are enough to live on compared with other countries.

Andrew Bailey: It is possible. The problem is that we just do not know the answers to these questions. I should also say that it is certainly the case that the long-term sickness argument comes through strongly. By the way, when I talk to people in the health service, they say that it does accord with some of the things they see. It is not totally surprising in some sense.

Q79 **Lola McEvoy:** There are myriad different issues that are contributing to our lag of covid bounce-back. It might be gold-plated pensions for the very lucky few, but it is more likely that the low-wage economy in certain areas combined with ill health outcomes and additional care responsibilities means that we are seeing a problem.

In terms of economic inactivity and the measures that the Chancellor has taken to try to get people back to work through health spending, I would be interested to know the panel's view on how quickly that will have an impact on getting people back to work with the reduction of waiting lists, earlier neurodiversity diagnoses and the additional care support that we are giving. I will go to Dr Mann first, with your productivity hat on.

Dr Mann: I am not a health economist. I would totally hesitate to try to answer any of your questions, honestly.

Clare Lombardelli: Let me have a go. Just to be completely transparent on this, we have not done an analysis of the specific details and nor would it be for us to do that. These are public policy issues. They are not directly in monetary policy.

There are a few things that we can say. We do know some things from different sources of data. There is clearly an issue about long-term sickness. In particular, you can see some real changes there around younger people and mental health. The numbers that we have seen there, in terms of the level of change, are incredibly high. There is clearly an issue around young people and mental health.

There is clearly, as the Governor said and as you have alluded to, an issue around the ageing population, sickness and ill health. It is the case that a lot of that spending on health will go to people well beyond pension age, so you might not expect to see huge returns, for perfectly sensible public policy reasons. That is a good thing, but it might not help the labour market that directly.

There are a set of things that we know about the history of active labour market policies. The UK really has a good history here. We know a lot from the evidence. It can take a long time for someone with ill health to rejoin the labour market. If you are economically inactive because of ill health, you have the health barrier and you then have a lack of work experience. It can take a lot of intervention and time just to bring someone from economic inactivity to unemployment, and then from unemployment to working again. With the changes in society around reasonable adjustments in the workplace and all of that, this is going in the right direction, but some of these barriers are huge. You would not expect very fast changes.

On the question about pensions, again, we just do not know and it is quite hard to know. Is one of the reasons that the UK is different because of that? It possibly is. The challenge, as the Governor says, is that there are lots of hypotheses for what could be behind this. If we had better data, we would be able to distinguish them a bit more. Some people have tried. The IFS and others have done some good work in this space, but it is very hard to know.

Q80 **Lola McEvoy:** It is interesting that you mentioned the mental health element because there has been quite a lot of work on that separately. Essentially, there are quite a lot of differences in the mental health statistics. Again, it comes back to the data and the story that we can get from the data.

Some of the mental health statistics are double counting causational mental health while someone is on a waiting list for another issue. I had somebody in my constituency who had worked for 40 years and was asked to go back to work in a job that was not appropriate for somebody with the disability that she had, so it is about appropriateness in getting people back to work. A whole new approach is needed.

The impact of health spending in the Budget might be long felt, but there are some things where we could intervene early to prioritise this group of people specifically.

Clare Lombardelli: I am not a health economist either. The health spending in the Budget will have been for wider public policy and health reasons. There may be a knock-on benefit to the labour market. We can be pretty confident in the direction. It is going to be better for the labour market if you have a healthier population, but those transmission mechanisms are going to be pretty noisy and pretty lagged. You would not expect to see a huge immediate dividend, not least because of the age of the population that they will mostly target.

Chair: We heard similar from the OBR.

Q81 **Yuan Yang:** To the Governor, we have a situation where the UK has an unusually low participation rate and people are unusually unlikely to participate in the labour force survey. What needs to be done to solve this problem? Who needs to do it? Is the Bank doing any work to solve

this problem as well?

Andrew Bailey: First of all, we think we have a low participation rate. That is the question. By the way, if we have a higher participation rate than we think, the productivity statistics are even worse than we think they are.

Chair: Whichever way, it is not good.

Andrew Bailey: As I say, we think that. We are, as Huw set out in his letters, supporting the ONS. We are obviously not the ONS, but we rely on the ONS. They are the experts in data and data collection. We cannot do that for them, but we participate very closely with them. We provide them with all the support and assessment we can. We have our own team of labour economists who work very closely with them. I just do not want you to think that we are standing on the sidelines throwing rocks. We have actually said to them, "We understand there is a problem. We understand why this problem seems to have happened," although I find it puzzling that the UK seems to be a bit of an outlier in this respect. We are totally supportive of getting this thing sorted out.

Q82 **Yuan Yang:** How confident are you that the ONS can solve this problem? By when do you expect that to begin?

Andrew Bailey: I do not know when, because they have a lot of work to do. There is still a question of what it will take to get this sample response rate up. I could not put a date on it, frankly, but there is a great deal of work going on. They have, I know, been given more budget within the Budget, in that sense.

Q83 **Chair:** The Monetary Policy Report highlights that credit card borrowing has gone up. Do you have any sense of the distributional impact of that, given we have seen savings rise as well?

Clare Lombardelli: We have not seen a very sharp change in the very low end, if you like, which we have been looking for in that space, but you are right. We have seen uses go up overall, but it does not look to be disproportionately at one point in the income distribution.

Chair: That is helpful.

Dr Mann: It is also important to make a distinction between usage and holding balances. In fact, I have been very carefully looking at holding balances for exactly the reason that this is a way in which consumption is being maintained, but it creates a vulnerability going forward. The balances have not changed. The usage has changed relative to pre-covid, but, again, we can think of that in terms of contactless payments being more convenient and that changing the behavioural use of a credit or a debit card.

Q84 **Chair:** At the moment, you do not have data for whether balances are being paid off regularly or people are holding balances on credit cards.

Dr Mann: No, we do have that data.

Andrew Bailey: Can I just put an advert in? We will be publishing our next six-monthly Financial Stability Report at the end of next week. We always cover the debt situation. We already have a date for a hearing here on that report.

Chair: Yes, we do. You are back again very soon.

Andrew Bailey: We can obviously answer those questions in the context of the Financial Stability Report as well.

Q85 **Lola McEvoy:** I had a question about stocks and shares ISAs and the use of them. In the Mansion House speech, the Lord Mayor talked about the lack of use of stocks and shares ISAs in the UK. I wondered what your expert opinion would be on the potential impact of growth if there was more use of stocks and shares ISAs.

Andrew Bailey: I made a bigger point in my Mansion House speech, which is that we have to look very seriously and work very hard at changes and reforms that can encourage—I use that verb carefully and I will come back to that—greater investment in the real economy. Again, going back to some of the discussion we were having earlier, the UK has a poor record in this respect.

I made the points in the context of UK pension funds, and I have said this a number of times, not because we should force pension funds. We should not be dictating to pension funds where they invest. However, the question does not go off the table for that reason. The rate of investment in the real economy—in risk taking and things that will create growth in the real economy—is very low. We do have to address these questions. It is not really for me to say, "We should do this," or, "We should do that," but we have to take this seriously.

By the way, it is something that Mr Glen and I worked on a lot in a previous life in the previous Government in terms of long-term investment. It is been a subject that has been around for some time. As I said last week, I am afraid this is just a lot of heavy lifting, this work, but it needs to be done.

Q86 **Lola McEvoy:** Can I add a follow-up question on that? In 2018, the FCA said that 33% of consumers who had drawn out their pensions early as part of the previous Government's policy were leaving them as cash and not investing them at all. Do you think that was a potential missed opportunity for growth in the economy? Do you think there could be something done about how to support people who draw down their pensions early to give them confidence in some of the other investment opportunities?

Andrew Bailey: I was chief executive of the FCA at the time so, yes, I do remember that one. The purpose of that work was to ask how we could improve the advice that was given to people on how, within what I call reasonable risk management, they could get a better return on their pensions, because there seemed to be too much of it being allocated into

cash. I would have to go and look at what the consequences of that were. I do not carry it around in my head. You are right. It is another aspect of the same issue.

Q87 **Chair:** Sometimes people have accused you of being overly pessimistic in your forecasts. It is noticeable that your 2026-27 forecasts are below the average, despite previous forecasts being proved to be pessimistic. What would you say, Governor? Is the Bank being too pessimistic?

Andrew Bailey: I would say some of the outturns have not been far off where we thought they would be.

Q88 **Chair:** You are out of step with some other forecasters.

Andrew Bailey: Clare made a point earlier that, if you compare us with the OBR, it has a faster transmission in its assumption on fiscal measures than we do. On the other hand, that is a question of speed of transmission, not overall scale of transmission so much. We do have differences. The OBR takes a more positive view on the net trade contribution to growth than we do. I have to say net trade has not been strong in recent times. I would defend our view, in that we have not been particularly far off in terms of outcomes.

Q89 **Dame Harriett Baldwin:** A year ago in your November report, you forecast that growth this year would be zero. What has it actually been?

Andrew Bailey: It has been positive.

Q90 **Dame Harriett Baldwin:** Can you state what the number was? We have 1.7% in front of us. Is that correct?

Clare Lombardelli: For 2024, we have 1%, but of course we are not finished yet with 2024. We will see what the Q4 number looks like. I would say we are not pessimistic. I am relatively new to the Bank, but the judgments we make are realistic. The OBR is more positive about the speed with which the Budget will affect growth in the short term. It is more positive about trend growth and trend productivity than we are. We have 1%; the OBR has 1.2%.

The difference is that the OBR still puts some weight on productivity growth pre-financial crisis. Maybe we will see a return to some of that, when we saw very high manufacturing productivity. We are not expecting the economy to return to its pre-GFC levels, but who knows? There are all sorts of things. We could have a long conversation about technology, AI, all those sorts of things.

We take a very data-grounded approach, as does the OBR. These differences are not huge, I would say. You may think there is group-think among all economists, but I would not say it is particularly in one part or the other. We all take quite similar approaches and come out with numbers based on the data and on the models that are broadly realistic.

Dr Mann: I will make the note, however, that I have been here for three years, and we continually forecast an output gap opening up, as we have in this forecast as well. That has not materialised.

Q91 **Chair:** I wonder, Governor, if you have any comment on how quickly rate cuts are passed through. It has been slow in the past.

Dame Harriett Baldwin: Unless you are a saver, Chair.

Chair: Have you any comment for both savers and borrowers, or any message, really, for what you expect the banks to do?

Andrew Bailey: We do expect passthrough to happen. If I take the savings side, on the way up, the passthrough was faster on fixed-term deposits than it was on sight deposits. As I said before, it did not particularly surprise me because, for another reason in our world, we changed the liquidity regime for banks in the aftermath of the financial crisis, and we weight far more, to the banks' credit, as it were, in the liquidity calculations for fixed-term deposits, because they cannot run as quickly. We did not have a liquidity regime before the financial crisis; we do now. We do give more weighting for that. It does not surprise me that the banks put more value on fixed-term deposits than they do on sight deposits in that context.

We cannot judge what we did last week because it is too soon. If you go to what we did in August and look at the passthrough so far into sight deposits, about half has come through. In other words, the banks have not yet passed on half of the cut. That is still with depositors. Fixed-term deposits have come down more. Again, that is interesting that they are more responsive on fixed-term deposits. On mortgages, we were saying earlier that they are now essentially priced off the swap curve far more. They are not so much priced off our position.

Q92 **Chair:** You are not worried with how it is passing through.

Andrew Bailey: We monitor it very carefully. I gave a speech at Loughborough University earlier this year, where I also made the point that I am not surprised that, as we have moved away from near-zero interest rates, we have also seen banks adjust what I call their net interest margin. They have actually reverted much more to what they were pre-financial crisis. When we took the official rate down to nearly zero, effectively, the banks did not take their deposit rates all the way down. The relationship between our rate and their rates inverted, almost, from traditionally them being below us to being above us. That actually squeezed their net interest margins. I am not surprised that we have seen that, as we have moved rates back into what I might call the more normal territory of pre-crisis.

Chair: They are recouping that.

Andrew Bailey: If you look at their net interest margins, last time I looked, they are now pretty near to where they were pre-financial crisis in terms of net interest margins. That does not surprise me, really.

Chair: Thank you very much indeed. It has been a very interesting session and very useful for us to understand your thinking, especially with the next rate-cutting meeting coming up very soon. We have learned that, while inflation is falling more quickly than expected, risks still remain, particularly relating to inflation in services, which all the figures bear out. Following this month's rate cut, future cuts are expected to be gradual, as you have all really highlighted. We also heard that there are mixed signals on conditions in the labour market, which has been quite interesting and a knotty issue for us all to grapple with.

We have also heard a range of views from you about the upside and downside risks to inflation, but it is great to hear these arguments and discussions played out in public, so we thank you for that. We also learned that, of course, there are problems with data, making it difficult to understand the labour market, something that this Committee is committed to investigating further. We heard that the great global trade fragmentation is not a good thing, but the Bank will wait and see what the new US Administration do, which very much aligns with what the Chancellor was saying to us a couple of weeks ago. Can I thank you all very much indeed for your time?