



Select Committee on Economic Affairs

Corrected oral evidence: Quantitative easing

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3 pm

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Members present: Lord Forsyth of Drumlean (The Chair); Viscount Chandos; Lord Fox; Lord Haskel; Lord King of Lothbury; Baroness Kingsmill; Baroness Kramer; Lord Livingston of Parkhead; Lord Monks; Lord Skidelsky.

Evidence Session No. 13

Virtual Proceeding

Questions 125 - 138

Witnesses

I: Anjalika Bardalai, Chief Economist, TheCityUK; Richard Butcher, Chair, Pensions and Lifetime Savings Association.

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Examination of Witnesses

Richard Butcher and Anjalika Bardalai.

Q125 **The Chair:** Welcome to this session of the Economic Affairs Committee. We have two witnesses: Richard Butcher, chair of the Pensions and Lifetime Savings Association, and Anjalika Bardalai, chief economist at TheCityUK.

Perhaps, Anjalika, I could start with you. Is there a case, as Charles Goodhart has suggested in his evidence to the committee, for the Bank of England to return to paying zero interest on its reserves or for different tiers of interest payments? Perhaps you could indicate what you think the effect would be on the banking sector.

Anjalika Bardalai: Good afternoon, and thank you very much for the invitation to appear in front of the committee today. One of the key issues in the wider debate on quantitative easing is the idea of intention. I suspect that we may return to that aspect several times in the discussion this afternoon.

With regard to the specific suggestion put forward by Charles Goodhart about the possibility of non-interest bearing reserves, if the intention were, for example, monetary stimulus, the impact and the effectiveness would depend on several things: for example, whether the perceived insufficient bank lending was because of liquidity constraints on the willingness to lend, or whether the problem was a lack of demand.

The Chair: I am sorry to interrupt you, but I think the intention would be to prevent the Treasury having to pay large sums as interest rates went up.

Anjalika Bardalai: In that case, if the intention is essentially a debt management solution, my concern is the potential impact on the credibility of UK institutions in the long term, because it could be argued that the policy would be perceived as a form of off-balance sheet accounting, in effect.

I understand that zero interest rates on reserves were the norm prior to the global financial crisis, when commercial banks adjusted reserves based on interest rates, but, very obviously, credit and liquidity conditions were very different then. Now, the reserves held are sizable and the interest paid on them is designed to help the Bank of England to influence liquidity conditions. If the reserves paid zero interest, the Bank of England would have to change the implementation of its monetary policy, if, one day, it wanted to raise interest rates above zero.

In short, the practical challenges of such a policy should not be underestimated.

The Chair: You are not against it because it would just be a stealth tax for the banks.

Anjalika Bardalai: No. That is a very good segue into the second part of your question, which I believe was what the impact would be on the banking sector. If banks received zero interest on reserves, they could do one of two things: they could choose to lend more, in which case they would be taking on more balance sheet risk; or, if the level of risk aversion was high, they could choose not to lend, in which case they would face losses in real terms on their reserves.

If the banks were lending more and there was a concern about the potential inflationary impact of that, there would have to be a consideration of second-order policy implementation, such as higher capital ratios or reserve requirements, to offset that. The impact on banks would essentially be a financial penalty, because they would be prevented from earning interest on the reserves and from increased lending, presumably at a profit.

In his own evidence to this committee, Charles Goodhart acknowledged that the policy would in effect act as a tax on banks, so I think our views on this are basically aligned.

Q126 The Chair: What about William Allen's proposal for a compulsory swap of banks' reserve balances for short and medium-dated fixed-rate gilt-edged securities?

Anjalika Bardalai: This is a very interesting proposal, because it provides quite an elegant way of addressing the issue of the interest rate risk associated with the Bank of England's holding of bank reserves, which is now fairly significant—it is approaching £1 trillion. At a philosophical level, it is almost quite radical, if I can use that term, in the sense that it would represent a reversal of the trend that we have seen over the past several decades of financial liberalisation.

In the policy paper in which William Allen put forward this proposal, he noted something that is quite important to call out, so I hope you will not mind if I read a very brief extract from it. It is important, because the language is quite striking. He wrote, "The proposal is for an act of financial repression. The argument in favour of it is that some form of financial repression is unavoidable, and that the operation proposed here is less harmful than possible alternatives. It would not eliminate the need to reduce the primary deficit if interest rates rose, but it would allow the Government more time to make the necessary adjustment".

In short, compared to the previous proposal that we were discussing of non-interest bearing reserves, this would still represent a loss of interest for commercial banks, but just on a lesser scale.

Q127 Lord Livingston of Parkhead: I have a question on the second point about a compulsory switch. Are there any other possibilities, using the markets, such as the Bank of England itself taking out fixed-rate to floating-rate interest rate swaps, effectively in order to avoid this future challenge if rates were to rise? Is there a capacity in the market to do that? Would it offset all the other Bank of England interventions? Are

there other instruments that it could take out to mitigate this problem?

Anjalika Bardalai: It is an interesting question. I would probably want to spend a little more time considering the universe of alternatives and possibilities, but the key part of the way you posed that question was in the use of the term “offset”. All this is part of a wider debate about something that we have now come to term unconventional monetary policy, so it is a question of unintended consequences and one policy offsetting another.

The overall point I would make is that we need to be really careful about the net impact of market distortions. The more we go into alternative policies and layering one policy over another, the more we go, potentially, into market distortions.

The Chair: Anjalika, I do not want to be rude, but you have described two of the two suggestions as interesting and not really said whether you are in favour of or against them. Perhaps you might drop us a note if you have an opportunity to talk to colleagues and think about it.

Q128 **Lord King of Lothbury:** Since QE is, effectively, a compulsory swap of gilts for banks’ reserve balances, do all these suggestions not basically come down to the idea of just undoing QE?

Anjalika Bardalai: On the question of undoing QE, there is a lot of debate about timing, extent and mechanism. So, yes, I think it is fair to say that some of these proposals could be seen as a partial undoing or unwinding of QE, but in a more nuanced way than what we normally think about when we have a debate about unwinding QE, which is normally confined to just looking at the flow of asset purchases or reducing the stock held.

Lord King of Lothbury: If the Bank of England has responsibility for QE, should the Government or others therefore have responsibility for undoing QE through other proposals of this kind? Does that not seem to cloud the governance of QE?

Anjalika Bardalai: QE is ultimately an example of where monetary and fiscal policy are acting in concert. Monetary policy remains independent, but it is a very strong example of where co-ordinated monetary and fiscal policy was necessary and highly appropriate, because the policy was rightly introduced in response to an unexpected and severe crisis, and then expanded in response to repeated unexpected and severe crises.

Q129 **Lord Skidelsky:** We have wandered heavily into macroeconomics. What is the impact of quantitative easing on debt sustainability and the public finances in the current environment of very low interest rates, and what will its effect be if interest rates go up?

Richard Butcher: This is a little out of my remit, so I would be happy to hear Anjalika’s comments and then add anything. My evidence will be circumstantial here.

Anjalika Bardalai: Very obviously, at the most basic level, QE helps debt sustainability because it lowers the cost of sovereign debt. That is a fairly obvious statement. The context is that the Bank of England's balance sheet is indemnified by Treasury, but Treasury also receives the Bank of England's profits. A rise in sovereign bond yields would, of course, increase the Government's debt service obligations, but the Bank of England, as the bondholder, is a beneficiary, and those interest payments go back to the Treasury.

In the absence of QE, debt service costs would be higher than they currently are. This is the issue of the counterfactual. It is also worth emphasising that, if the Bank of England released bonds into the secondary market as part of an unwinding or looking at the impact, there would be a risk of more interest rate volatility, because you would have multiple buyers and sellers in the market, rather than the bonds just being held on the central bank balance sheet. Plus the interest payments would not necessarily be returning to Treasury.

This, in turn, would have implications for the Government's fiscal sustainability and the wider debate about how quickly to return to balanced budgets. At this particular time, that is quite a nuanced debate, because it is a time of significant economic uncertainty. The timing and the position in the business cycle would be critical in determining what the impact of a rise in rates and reduced spending would be.

Lord Skidelsky: The question of a return to a balanced budget depends partly on the impact that QE has on the demand side of the economy. To the extent that it causes output to be greater than it otherwise would, there is an automatic shrinkage in the debt-to-GDP ratio, the sustainability of the government deficit and so on. QE would then unwind automatically, to some extent, there being less need for it. What is your view on that? Is QE producing, or will it produce, the kind of stimulus that would allow the automatic unwinding through the growth in output and in the denominator?

Anjalika Bardalai: This might, in the first instance, come across as an unsatisfactory response, but it is a very typical response from an economist: it would be very difficult to isolate the impact of QE per se. This is partly returning to the point I made earlier that we are seeing and have seen fiscal and monetary policy acting in concert. If we eventually see robust and sustained increase in demand—or, if you like, robust and sustained GDP growth—that helps to facilitate a tightening of monetary policy, particularly given the starting point of where we are now in 2020 and 2021, it will be quite challenging to precisely unpick the extent to which that would be attributed to the very loose monetary policy of the past decade-plus or to the extraordinary fiscal policy that we have seen over the past 15 months.

Q130 **Lord Monks:** We now come to Richard Butcher's territory and pensions. We have had a clash of evidence presented to us so far about the way QE has affected the viability of different types of pension schemes, defined benefit in particular. I would like your view. In what ways has the viability

of pension schemes been affected by QE? What do you think of the Bank of England's view that there is not much effect? The NAPF, your predecessor organisation, took a different view some years ago, but what is your view of the current situation?

Richard Butcher: We did take a different view. Thank you for having me along and for asking me a pensions question, as opposed to an economics question. The committee will be aware that there are different types of pension scheme, and QE has affected them in different ways. You mentioned defined benefit schemes, so let us start with those.

The most common form of defined benefit scheme is what is called a final salary scheme. You may also have come across CARE schemes. In a defined benefit scheme, the benefits are defined in advance, hence the name, but the costs are not. The trustees or managers of the pension schemes hire an actuary to help them model the future costs of those liabilities. The actuary will calculate the values of the current liability and project them forward to a future date. They will then capitalise them—"What sum of money do we need?"—discount that to the current date, aggregate the results for all the members, adjust them for a couple of other factors, and that gives us our result.

In that model, there are a huge number of assumptions. The gilt yield is one of the critical assumptions. As it is a large component part of the investment return, it affects the discount rate. QE has pushed up the value of gilts and reduced their yield. As a consequence, it has made the assumed rate of interest lower and so pushed up the value of the liabilities. Quite simply, it has made defined benefit schemes appear more expensive.

There is lots of evidence for that, but I will cite one example, the Pension Protection Fund purple book. The PPF is the lifeboat for pension schemes. It calculated back in 2002 that a 0.1% reduction in yield would increase DB liabilities by about 2%, but their assets by only about 0.4%, hence they have become more expensive. This can be mitigated in part by schemes having their assets and liabilities well matched. Matching was quite rare back in 2007 to 2010 but it is more common now. In any event, matching is not a flawless concept; there is no perfect match for a DB liability.

The cost comes in two parts. We have future service costs for schemes that are still open to future accrual. If you reduce the yield, it pushes up the future service costs. It is common sense to argue that, if it is more expensive, it is less affordable. Therefore, that has affected the viability of a defined benefit scheme, leading more of those schemes to close. There is evidence of that from the Pensions Regulator, which publishes a report every year. The most recent iteration of its report last month showed that, between 2012 and 2020, the number of open schemes reduced from 13% to 10%. It also found that the number of schemes that were closed to future accrual increased from 28% to 47%, so a lot of these schemes are now legacy.

We also have past service costs. This is where we have not saved enough money to cover the liabilities that have already accrued. If you reduce the gilt yields, you increase the value of the liability. Therefore, there is an increased chance of a funding deficit or having too little money, and the size of that deficit also goes up. That has to threaten the viability of the scheme as well as of the employer. That deficit is a debt due from the employer, which it can avoid only by becoming insolvent, and that is rarely part of a corporate's business plan.

What is the evidence for this? We did some survey work with our members about 10 years ago and found that about 75% of schemes were in deficit in 2007. That increased to 87% in 2011. We found that 25% of schemes were in surplus in 2007, which reduced to 13% by 2011. The Bank of England's own analysis in July 2012 showed that a model scheme that was neutrally funded, so had exactly the right amount of money, but not matched would go from having no deficit and no surplus to having a £33 million deficit between 2007 and 2012. Similarly, a scheme that already had a £30 million deficit would go to a £65 million deficit in the same period. It just increases deficits. That affects a company's ability to spend and invest money, and to pay dividends and give pay increases. It also affects their ability to pay into a DC scheme.

There are only two statutory exit routes for employers with DB schemes. One is that they pay all the benefits until the last of the members have died, and the other is that they buy their benefits out with an insurance company, using a wholesale insurance product called a buyout product. Buyout products are priced using gilt yields as well. QE has increased the cost of a buyout, which means that fewer employers have proceeded to buy out, which means more employers have these things still hanging around their neck, acting as a drag on their economic activity and potentially weakening the security for members.

In DC schemes, it is a little less clear. DC schemes work in the opposite way to defined benefit schemes. In these schemes, the costs are identified and defined, but the benefits are not. QE has not affected the viability of DC schemes per se, but it has affected the viability of their objective of providing an adequate income in retirement.

It has done that in a couple of ways. QE drove up the cost of annuities. We use annuities in DC schemes as well, but they are more of a retail product in this context. Prior to the pension freedoms of 2015, buying an annuity was the way most members went when they got to retirement, so increasing the cost of an annuity made it harder for somebody to buy an adequate income in retirement and made annuitisation much less attractive. That created a counterdemand for annuitisation and may have been a factor in the Government's decision to introduce freedom and choice.

That means that older savers are much more exposed to a different set of risks: investment risks for longer; having to make complex decisions much later in life, as cognitive decline kicks in; the risks of overspending and underspending; and the risks of living a long and healthy life and

running out of money. On the flip side, it is quite complicated, but it is probable that younger savers have benefited from QE in defined contribution schemes, because it has pushed up asset values.

Lord Monks: DB schemes have been in trouble for years, and that predates any QE being heard of or thought about. There is a range of factors here that are working against DB schemes. I am trying to get to where QE comes in that list. We have had low growth and low interest rates. The problems that you talked about with DB schemes could have been there without QE; in fact, they probably were there. The evidence seems to point to the problems that mainly affected the underfunded schemes rather than the well-funded schemes. Without QE, what would be different?

Richard Butcher: There are probably three principal factors behind the death of defined benefit schemes. One is creeping government legislation from the mid-1980s that improved that quality of defined benefit schemes. A second is increasing longevity—people living for longer. When I started in this industry, we expected people to live for about 18 or 19 years beyond retirement; they now live 30 years beyond retirement, which is a 50% increase in liability, roughly speaking. Gilt yields are the other key component to that, and that is because of the impact on funding.

In a sense, when you create a deficit, it is a paper deficit. It is an assessment of costs in the future, right up until the point in time where you ask the employer to cover the cost of that deficit. Those employers have been living with larger deficits, which can affect sentiment as well, for a longer time.

More importantly, going back to a point I made earlier, one of the two statutory exit routes for that employer is to buy out those benefits. The cost of buyout has gone up significantly because of reduced gilt yields. That has made it less likely that they have been able to wash their hands of those DB schemes, so they have had to live with them. They are, inevitably and undoubtedly, a drag on the ability of an employer to invest money elsewhere in its business.

The Chair: Can you quantify the extent to which people have lost out as a result of QE?

Richard Butcher: I might copy Anjalika and say that it is almost impossible to isolate the impact just of QE; there are so many other moving parts in this.

Q131 **Viscount Chandos:** Following up on Lord Monks's supplementary, the estimates of the extent to which QE has pushed longer-term rates down are pretty modest. As you have acknowledged, changes in life expectancy and in the capital markets that are not related to QE are, surely, overwhelmingly more important than QE has been to the valuation of pension schemes. The industry also creates its own problem, does it not, through the methodology that is so heavily based on long-term gilt yields

as a discount rate? There are, it seems to me, quite compelling arguments that you can look at different discount rates to avoid excessive net present value of future liabilities.

Richard Butcher: Many schemes do use more complex discount rates. For a long time, the Pensions Regulator urged schemes to use a gilt yield discount rate as part of their discounting, so they had less flexibility and choice over that. At the moment, we do. You have two periods in which you measure your discount rate: pre and post-retirement.

Pre-retirement, we tend to allow for growth assets within our portfolio, so the discount rate is higher, and therefore the value of the liability lower, because we can take into account these other factors.

Post-retirement, we tend to use a more gilts-based discount rate, because that is reflective of the investments we are holding, so the discount rate should match the assets you are holding, and you use gilts post-retirement.

Viscount Chandos: That is rather a circular argument: you base the discount rate on the type of assets you hold. But I hear what you say about pre-retirement discount rates. It still seems to me that the Bank of England's argument that it has not been a significant issue in increasing the net present value of pension fund liabilities is quite convincing. I guess I am concerned that the industry has turned to QE as an explanation for problems that are under its own control or inherent to the way the industry operates.

Q132 **Lord Livingston of Parkhead:** I want to carry on with this issue of the impact of QE. We have had low interest rates for a long period, in which QE is only one part, but we also have seen within DB schemes a movement towards gilts, because, as the membership ages, that is the natural thing. The regulator is also pushing in that direction.

Has there been any impact of QE and low interest rates more generally on the asset mix held by pension schemes? How have they responded? Have they got riskier or less risky, or has it had no impact on what they hold?

Richard Butcher: It has had little impact on what we hold. Around the margins, it might have done. A number of factors have contributed to more sophistication in the investment model. I suppose there are a number of different things to throw into this. Deficits per se are not a driver of increased investment risk.

Lord Livingston of Parkhead: At least, they are not in this country. In some other countries, that is not the case.

Richard Butcher: Yes, possibly. When we have a deficit, the expectation is that we ask the employer for more money or we ask it to pay money for longer, as opposed to just gambling more money on the next horse at the horse race. It is also worth noting that the fiduciaries are obliged to take a prudent approach, so they cannot just take increasing amounts of risk.

The other factor is that the majority of schemes, as I have already mentioned, are closed to future accrual and are not bringing in new members, so the average age of membership is going up and the average investment horizon is coming down. That all lends itself to gradual de-risking of assets, so more gilts-based investment than other things.

That said, in a low-yield environment, we have tended to make the portfolios a little more sophisticated and tried to make them more efficient. We might have a chunk of assets that are low risk, but a small allocation to assets that are relatively high risk, to try to drive some return. There has been some interest in private equity, illiquid investments and other things, but it is not really as a consequence of quantitative easing. In DC, again, there has been an increase in the level of risk within an investment portfolio, but it is due to factors other than QE as opposed to primarily because of QE.

Lord Livingston of Parkhead: On the point on DB schemes, I understand why there has been no movement in asset mix, which is partly a regulatory environment issue as well. Could the Pension Regulator say, "We recognise that gilts are an incredibly expensive way of funding schemes at the moment and that there are other non-correlated areas, such as infrastructure investment"? In this environment, where you have gilts paying, effectively, negative real interest rates, should the Pensions Regulator have said, "We need to be a little more creative in in this environment and maybe find more productive routes to invest at least part of the scheme"?

Richard Butcher: The Pensions Regulator has played a good game in this respect. It has shown flexibility and willingness for schemes to be created within the boundaries of prudence. Ultimately, what we can do is defined by the legal term "prudence", so trustees have to do what they believe is appropriate and take the level of risk that is appropriate.

There are other investment tools available to us. The Government are spending a lot of time thinking about productive finance at the moment, for example, so more infrastructure investment, but the difficulty with that, particularly for DB schemes, is the time horizon. Infrastructure investment is highly illiquid, whereas a lot of DB schemes are on the journey plan now where they will reach buyout over five to 10 years, which is just not consistent with long-term illiquid investments.

Q133 **Lord Fox:** You mentioned that, for DB schemes, businesses have had to increase their contributions to pension funds. This has been exacerbated by the Pension Regulator's insistence on yields. Would you agree that, by doing that, businesses are taking capital that could have been invested to grow their business at a much higher percentage rate than any kind of return they are going to get from gilt yields? Coincidentally, this has also been a major restraint on potential growth and productivity, particularly within the more established businesses in the United Kingdom.

Richard Butcher: It is more established businesses, but it is lots of businesses, generally those that are a bit older and which therefore have

a defined benefit scheme. My day job is as a professional fiduciary. I have had that negotiation with a great many employers, where they have been trying to balance keeping the money invested in their business or putting it into the pension scheme. Nearly always, they think they can generate an extra return within their business.

The trouble is that we are in a negotiation with them and trying to get as much money out of them as we can, so it is a question of trying to find that balance between what is going to produce a successful return in the business, because ultimately we would rather have a sustainable employer that is going to be around for longer to pay the contributions, and what we need in order to secure those members' benefits.

It is an incredibly difficult balancing act. My own experience is that employers have had to pay money into the pension scheme at the expense of being able to reinvest it in their own business.

Lord Fox: The best guarantee, surely, is for the parent company to be profitable rather than to break itself investing in a pension fund.

Richard Butcher: Yes, I completely agree. The difficulty, though, is judging what is going to be a profitable investment or reinvestment, and that is the challenge in renegotiations.

Q134 **Baroness Kramer:** I want to come at this from a slightly different angle. If we accept part of your argument that says that, at the very least, there has been some destabilisation of pension plans as a consequence of QE, what could mitigate that? Are there other ways in which the Government could take steps to follow through on their monetary policy that would not have such knock-on consequences from your perspective? I know that is a hard question, because a lot of minds have been roving around it and we have not heard very many suggestions, but I wondered if there was anything that your industry has come forward with, either at the macro level or, indeed, as an additional step for mitigation.

Richard Butcher: I would love to give you an answer, but I am afraid we do not have one. We have had these discussions. We are not aware of any solutions that have been found. As I say, I am not an economist and this is probably way above my pay grade. We believe that quantitative easing has been a positive policy. We understand the reasons why it was introduced. On the whole, it has been positive for pension schemes, because, in many cases, it has provided lower-cost credit to companies that might have otherwise struggled, so it has maintained and supported employers who might otherwise have gone bust. I cannot give you a magic solution, I am afraid.

Baroness Kramer: As we go forward to look at winddown and those kinds of things, are there any particular things we need to keep in mind for the pension industry?

Richard Butcher: If QE is maintained at its current level, it will continue to give us the problems that we have had to deal with in the past. If it is wound down, the flipside of those problems will become apparent. We

can probably manage that winding down, if it happens, as long as it is done in an orderly and controlled way. The biggest worry for us would be if it were done in an uncontrolled way.

Q135 **Baroness Kingsmill:** The markets have become very accustomed to QE. It was introduced as an emergency measure but now seems to be the status quo. The Government and the Bank of England have increasingly become co-dependents in relation to QE. Is there a risk that they will never get out of it and that there is, in fact, no likely exit strategy?

Anjalika Bardalai: "Co-dependents" is not a term that I have heard before in this context, so I will certainly note that. This inquiry has been ongoing for a few months, and previous witnesses have commented on the possibility of no exit and the uncertainty about the extent, timing and mechanism of any possible unwinding. I would echo those concerns.

In particular, some of the compelling evidence that has been presented was in the session on 23 March and the discussion about how QE unwinding, as I was saying earlier, could refer to flow or to stock. This is important because, back in 2013, we had a very obvious example of how markets could react strongly and in a very volatile fashion to indications around changes to flow. I am referring to the so-called taper tantrum induced by the Fed's statement. In the event, the Fed did not start unwinding until 2017-18.

Here in the UK, QE has only been expanded. There has been no move yet towards unwinding. That means that, at the most basic level, we need to ask the question about 'No Exit', so to speak. It is noteworthy that, exactly as you say, this was launched as a temporary measure and is still in place 12 years later. It is also worth highlighting that it was introduced, in the first instance, as a response to a financial crisis, but maintained and then expanded in response to other economic shocks, including Brexit in 2016 and the pandemic last year.

Depending on your point of view, you could take this as evidence that unconventional monetary policy, as it was called at the time, is becoming more conventional or, indeed, has become conventional, depending on your time horizon.

Baroness Kingsmill: "Co-dependency" is a term that is used in cases of addiction. The risk is that we have become addicted to QE. Has this had, or does it risk having, any impact on financial stability?

Anjalika Bardalai: In terms of financial stability, I would highlight two things. One, at a very macro level, is the potential for misallocation of capital, if the cost of credit is being kept extremely low for an extremely long time. The other, possibly more specific, one is about the wider environment having triggered the so-called search for yield. That has, in many cases, encouraged flows into riskier assets, by which I mean, in terms of asset classes and geography. The financial stability risk associated with that is the risk of asset bubbles potentially bursting if QE is unwound too quickly or, as Richard said, in a disorderly fashion. If

policy was tightened or if market sentiment changed, owing to a belief that underlying asset values were being artificially supported, and if you saw severe or sudden declines in asset values, that would, of course, have knock-on effects in the real economy.

Baroness Kingsmill: Yes, indeed. It would have to be a very measured exit for that not to occur. It does not look as if it is likely to happen any time soon, though, does it?

Anjalika Bardalai: There are few indications, particularly given, as I mentioned earlier, the current economic uncertainty, that any significant unwinding of QE will happen in the very near term.

Q136 **Lord King of Lothbury:** In answer to Baroness Kingsmill, you talked about the general economic risks from exiting QE. Could I ask you both to talk about whether there are any very specific risks particular to pension funds or the banking sector that might come from the unwinding of QE?

Richard Butcher: There is one particular risk, but generally speaking the unwinding of QE for a DB scheme would be positive. It would reduce the value of the liabilities and the price of doing a buyout with an insurance company, so it would allow employers to exit in a safe way and to provide security to their members.

There is one particular risk. As gilt yields come down—I will not attempt to describe this—a lot of asset and liability matching has been achieved through buying derivative contracts, and they require some leverage. As gilt yields go up, there is the risk of significant cash calls on pension schemes. A lot of pension schemes have set aside prudent levels of cash to meet those cash calls, should they occur, but, if it happens at a rapid rate, the level of cash call could be beyond their prudent reserve, which would require them to disinvest from elsewhere. That would be disinvesting in a disorderly way, which may not be the optimal outcome. That is the major risk for a DB scheme.

Lord King of Lothbury: Do you want to say anything on the banking sector or stick to pension funds?

Richard Butcher: I am going to stick to pensions, if you do not mind.

Lord King of Lothbury: Anjalika, are there any specific risks to the banking sector that you would identify from an unwinding of QE?

Anjalika Bardalai: Yes. I would return to the example I used a moment ago: the risk of asset price bubbles potentially bursting in the event that market sentiment changed or that QE were perceived to be being unwound in an inappropriate or disorderly fashion. A decline in asset prices would have an impact on the real economy through the consumption channel.

The impact on banks in particular would be twofold: generally, through slower economic growth, which would, all other things being equal, lead

to a rise in bank non-performing loans; but also through banks' balance sheet weakness, because the fall in the price of the assets backing the loans would reduce banks' ability and willingness to lend. You have, in a worst-case scenario, the possibility of a downward spiral and self-reinforcing prophesy.

Q137 Lord Haskel: We have discussed the effect of QE on gilts. To what extent has the Bank engaged in direct monetary financing during the pandemic? Is there a case for banks to do this during a crisis?

Anjalika Bardalai: Because QE has operated through the secondary market rather than with the Bank buying government debt directly, I would strongly argue that it is difficult to say that the programme has constituted direct monetary financing. This is an area where, again, I would come back to the point about intention. It is a really important consideration in this question. Monetary financing typically occurs with the goal of financing a budget deficit, whereas, in the UK, the Bank of England's QE programme has really had the goal of stimulating the economy in response to the three shocks that we have touched on repeatedly.

That said, there is a little bit of nuance here. Notwithstanding the importance of the intention, the end result, you could argue, has been the same. That end result, as we have discussed, is a lowering of the cost of sovereign borrowing. If you look at it through that lens, you could argue that QE has, in effect, been an unofficial deficit monetisation, but I cannot emphasise enough how important the intention aspect of this is when you try to distinguish between the two approaches, even if that is a "soft" characteristic beyond the technical aspect and implementation.

Lord Haskel: Richard, you told us earlier that QE had pushed up the value of gilts and made returns lower. To what extent has the Bank been engaged in direct monetary financing?

Richard Butcher: That is a question of political judgment that is well beyond our remit. We do not have a view on this. It is certainly helpful that the Government and the Bank of England take whatever action is needed, within reason, when there is a crisis, and we are grateful that they did.

Lord Haskel: How would the buyers of government gilts have responded, if the Bank had openly and transparently announced that it would directly finance the Government's deficit spending during the pandemic and in a time of crisis?

Anjalika Bardalai: You could make the argument that there was a general market awareness that QE has had the effect of indirectly lowering sovereign borrowing costs. Therefore, if we accept that the market knew that already, it is possible that a more direct approach might have had a relatively limited impact on government bond yields, although there might have been an impact on the perception of the credibility of UK institutions in the long term.

Coming back to the issue of what the impact would have been, looking again at the metric of yields on sovereign debt specifically, it is important to mention that we cannot view QE in isolation. Sovereign debt yields are affected by lots of factors: general market sentiment, political conditions, trends in other asset classes and trends in other countries.

Focusing for the moment on trends in other countries, another very important factor is that other major central banks—the Fed, the ECB and the BoJ—have all been engaged in QE. If the Bank of England openly announced that it was engaging in direct financing of the deficit and it were the only major central bank to do so, the market reaction would be quite different than if general conditions made it such that major central banks were all engaged in this type of policy simultaneously.

The Chair: You appear to be saying that the amount of QE being raised matches the Government's need for expenditure. Are you saying that, if that were the reason, it could not be made explicit, because other banks might be doing the same thing and it would be bad if people knew the truth of the matter, or are you saying that this is not happening at all and it is merely a coincidence that these numbers seem to match?

Anjalika Bardalai: It would be beyond my remit to say that the close match between the amount of government borrowing and the amount of QE and bond buying indicates direct deficit financing.

The Chair: What do you mean by your remit?

Anjalika Bardalai: It would be speculative, because I am not aware of any strong evidence either way to say that.

The Chair: I asked you about what you did say, which was that, if it were happening, it would be a mistake to say so, as other central banks were engaged in the same activity. Did I misunderstand what you were saying?

Anjalika Bardalai: To clarify my comment about other central banks: when QE was introduced, it was described as an unconventional monetary policy. Its unconventionality was mitigated by the fact that the Bank of England was not an outlier in embracing this approach. As I said, all major central banks implemented the policy at around the same time, and continued with it.

Were the Bank of England to suddenly say openly and transparently, "We are engaged in deficit monetisation", which it has not, market reaction would be different if the Bank of England were the only central bank in the world saying that, than if multiple central banks were doing so.

Q138 **Lord Skidelsky:** Why are people so reluctant to say that the Bank of England has been acting as the agent of the Treasury? You have circled around this point, Anjalika, as have other witnesses, and yet that is what it says. I guess the argument is that, if that were openly acknowledged, the Bank would lose its credibility as an independent institution. Is the truth of the matter not that the Treasury just said to the Bank, "This is

what we want you to do"? Why not admit it? You are not here as a witness to reassure the markets but to tell us what has been going on.

Anjalika Bardalai: First, I definitely do not feel well placed to comment on discussions that may or may not be happening between the Treasury and the Bank of England. Secondly, you referred to a very important point, which I have touched on more than once in my comments this afternoon. That is the question of institutional credibility, which, in the UK, is extremely high and is one of many factors that influence sovereign debt yields.

Institutional credibility with regard to monetary policy is, indeed, predicated partly on central bank independence, which is an enormous question that is possibly beyond the scope of the comments this afternoon. If I could refer to just one thing in that regard, it would be the recent speech that Andy Haldane made, looking at central bank independence. Of course, I would not be able to summarise his entire speech here, but the key point is that it is a much more multifaceted and complex question than it appears at first glance.

The Chair: We will have the Governor and the Chancellor before the committee, so we can ask them that question. That brings us to the end of this session. Richard Butcher and Anjalika Bardalai, can I thank you so much for dealing so ably with the questions and resisting the temptations from the committee to lead you into dangerous territory?