HOUSE OF LORDS

Select Committee on Economic Affairs

Uncorrected oral evidence: Quantitative easing

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3 pm

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

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Witnesses

I: Lord Macpherson of Earl's Court, former Permanent Secretary (2005-16) at HM Treasury; Rt Hon Ed Balls, Professor of Political Economy at King's College London, former Chief Economic Adviser (1999-2004) and Economic Secretary (2006-2007) at HM Treasury.

Examination of witnesses

Lord Macpherson of Earl's Court and Rt Hon Ed Balls.

Q164 **The Chair:** Welcome to this session of the Economic Affairs Committee. Our witnesses are Lord Macpherson of Earl's Court, former Permanent Secretary to the Treasury, and Ed Balls, Professor of Political Economy at King's College London.

Lord Macpherson, in 2017 you said that it was "time to move on" from QE and compared it to heroin, arguing that it needs "ever increasing fixes to catch a high", while the "negative side effects increase". Do you still think that is the case?

Lord Macpherson: I think I was certainly right to say that in 2017. Unbeknownst to me then, we have just had a monumental pandemic, which has had quite a significant effect.

Let me explain what I meant in that statement. First, quantitative easing was very successful when it was developed by the Bank of England and put into practice back in 2009. At that time, long-term interest rates were reasonably high: my recollection is that they were around 4% to 5%. I think that QE had a real impact. Fast forward to more recently, and long-term interest rates have been very low indeed. To have an effect, you have to do even more QE. Once long-term interest rates are below 1%, as they were last year, you have to buy a great deal of debt to have any impact at all.

The negative effects are reasonably well known. I hasten to add that these are not issues that are the fault of the Bank of England. In its own terms, QE makes perfectly good sense, but one of its impacts is to push up asset prices, if not consumer prices. That tends to benefit the haves over the have-nots. Indeed, if you push up house prices—and that feeds through to rents—the have-nots may well face higher costs of living. In a sensible world, the finance ministry—in our case, HM Treasury—would implement tax and benefit changes to offset some of those effects. Having recommended to Governments of all persuasions that it was time to do something about capital taxation, I have been very struck that none of them ever really do. You have to go back to Nigel Lawson in the 1980s for someone who was prepared to do something quite radical on capital gains tax.

As I say, this is not the Bank of England's fault, but we are currently living with the consequences of higher asset prices.

The Chair: Mohamed El-Erian told us that there is an unhealthy co-dependency between central banks and markets, as well as a widening disconnect between markets and the real economy. Do you agree?

Lord Macpherson: There is definitely something in that. I observed it more in the United States in the Fed's relationship with the markets; I think that the relationship in Britain has been rather different.

I see some risk in central banks being seen to be the organisations that prop up markets as a last resort. There is nothing wrong with intervening to ensure that markets are actually operating or to provide liquidity, as the Bank of England has, but you need to be careful. It is not the central bank's job to prop up equity markets—nor do I think the Bank of England has done that.

The Chair: Ed Balls, do you want to comment on that last point? I do not expect that you will want to comment on what Lord Macpherson said in 2017.

Ed Balls: There is no doubt, as Nick said, that QE had an important impact, led by Lord King at the Bank of England and Alistair Darling as Chancellor, in the financial crisis, and there was a marked fall in long-term interest rates. There is no doubt that—as Nick also said—during a period in which long-term interest rates have been much lower, QE necessarily has to do more work and finds it harder to do so.

I find it very hard to criticise what the Bank of England did with its acceleration of QE last March. We can debate more widely in another committee the wider approach that the Government have taken to the pandemic and the decisions that they may have made in health policy, for example, but the way in which the Bank of England and the Treasury have worked together in macroeconomic policy over the past year has been very effective and impressive.

I agree with the Governor of the Bank of England when he says that a year ago, at a time when it did not really have other instruments in its locker, scale and speed of QE were very important. You only have to look at the trouble that the president of the ECB got into by being behind the curve and appearing to doubt the importance of central banks playing a role in stabilising dysfunctional markets to see how important was the way in which the Bank of England engaged.

I make one further point, which is very striking. The Bank of England was made independent in 1997 on a particular model that was unusual globally—for the Government to set the inflation target to a point, and with independent members. The degree of transparency that Lord King had established at the Bank of England before 1997 was enhanced with the decision, for example, to attribute votes to individual members. It is quite unusual in government to have a reform that, 24 years on, is fundamentally operating in the same way and that, I would say, has been very effective over the past year.

I have some wider concerns about the current regime at the Bank of England, but I think that the monetary and QE response over the past 12 months has been excellent, and that has been possible because the Bank is independent.

The Chair: My question was about Mohamed El-Erian, who told us that there was an unhealthy co-dependency between central banks and markets. Are you saying that there is a co-dependency, but that it is healthy, or are you rejecting the fact that there is a co-dependency?

Ed Balls: Of course there is a co-dependency, because the Bank of England has been stepping in to play a number of roles to make otherwise dysfunctional markets work better and more effectively, and to support aggregate demand. The reality is that, for the past 10 or more years, markets have been quite dysfunctional. In these circumstances, without the role of the Bank in QE, in my view, they would have been substantially more dysfunctional.

I can agree with Mohamed and at the same time say that the counterfactual would be much worse. Thank goodness we have had independent central banks operating the way they have done.

The Chair: Do you agree with him that there is a widening disconnect between markets and the real economy?

Ed Balls: It has been very hard to have a period of slow productivity growth and very low long-term interest rates. For some sectors and for some companies, it may be possible to use debt to sustain otherwise unsustainable operations. I would say, more generally, that we have kept the market economy functioning because of the way in which the Bank of England has intervened in markets to make them work more effectively. In more recent times, the Treasury has played its proper role in supporting aggregate demand through fiscal policy. The Bank and the Treasury working together in the past year in a co-ordinated way has been hugely effective. Without that, there would have been a much more negative co-dependent relationship between the Bank of England and markets.

Q165 **Lord Skidelsky:** My question is to both witnesses, and it arises directly from a remark that you made, Ed: that the Treasury and the Bank of England have worked together during the pandemic remarkably successfully. Has QE, on this scale and for this length of time, changed the relationship between the Treasury and the Bank of England as it was initially conceived?

Ed Balls: I think that the Treasury-Bank relationship has changed over the past 10 years as a result of the global financial crisis and the reforms put in place in 2010. Perhaps we will come back to that, as there are some issues, flaws and dangers in the broader status quo. But the overriding reality for the Bank-Treasury relationship has been a pandemic—a massive global shock. Of course, that is a very different experience for the Bank and the Treasury, but, fundamentally, no, I do not think it has changed the relationship. I see no evidence that the Treasury has instructed the Bank to act in any way that would take it outside its remit. Everything that it has done, it seems to me, has been rightly driven by its mandate for the inflation target and, more widely, to support financial stability in the economy.

The reality is that there are times—perhaps good times for the economy—when there is an inevitable tension between an independent central bank and a Treasury, and there are times when they work really closely together and when more co-operation is needed, and this has been one of those times. So it has been a different relationship, but has it fundamentally changed the relationship between the Treasury and the Bank of England? To put that another way, has central bank independence in the UK been undermined in the past year? I would emphatically say no.

Lord Skidelsky: In other words, the fact that the central bank's debt-buying policy has tracked, very remarkably, the growth of the government deficit since the start of the pandemic is a coincidence, is it?

Ed Balls: I think that it is a very good piece of policy-making by the Monetary Policy Committee in response to a massive demand shock and the Treasury's correct fiscal expansion. In 2007 to 2010, similarly, we saw the Treasury and the Bank working in the same direction. I would say that between 2010 and 2015 was a much harder period, because fiscal policy and monetary policy were acting in a different direction.

Over the past year, it was totally right for the Treasury to use fiscal policy in the way that it has done. I think that the Bank of England looked at its mandate and the inflation target and judged, beyond the immediate action to make markets work effectively, that QE, in this way, would allow fiscal policy to play that role in a way that was stabilising, not destabilising, for the economy. If inflation was above target or if we had had resignations of independent members from the Monetary Policy Committee, that would be a different story, but it has not been, and we have not.

I take at face value the MPC's view that its mandate has allowed it—and actually required it—to support the economy in this way. That, I think, has eased the path for fiscal policy, which seems to me to be a good thing; it is what happens when you have a mature relationship between a Treasury and an independent central bank. In an immature relationship—let us be honest: it has been much harder for the ECB, because it has a much more complex political structure, and it is newer—the reality is that it has often had a much harder time. I think that the maturity of this relationship has worked very effectively.

Is the fact that the Bank has played its role in QE a sign that it has been dominated by the Treasury or fiscally directed? I would say absolutely not. That does not mean that there are not challenges to come in the next few years but, so far, this is what you would want from an independent central bank operating effectively in a good relationship with a Treasury in a pandemic.

Lord Skidelsky: Putting it into simple English—at any rate, the English that I am more familiar with—you are saying that the Bank's support of the Treasury in this pandemic has required the monetary financing of the deficit. That is what it means, and we are not used to that. Does that not also blur the distinction between fiscal and monetary policy?

Ed Balls: I do not think that is the case, and that is not what I said. I do not think that we have seen a monetary financing of the deficit. We have not seen a textbook creation of non-interest-paying reserves by the Bank of England. We have seen the Treasury issuing gilts and, separately, the Bank using QE to make markets function and to buy debt. But it is not helicopter money, not monetary financing, and it has not been mandated by the Treasury to do so; it has chosen to do so because it judged that it was necessary for its monetary policy mandate.

This is one of the big questions always with an independent central bank. I remember these debates in 1997, when people who opposed our reform said, "The problem with an independent central bank is that you will not have effective co-ordination of fiscal and monetary policy". It is true that, sometimes, you can have ineffective co-ordination of fiscal and monetary policy. In my view, that is what happened between 2010 and 2012. In the past year, we have had effective co-ordination of monetary and fiscal policy, fully consistent with the Bank's monetary policy mandate. This is the system working well in a very difficult circumstance.

Lord Macpherson: I will comment very briefly, as Ed has covered much of the ground. I should mention in passing that I thought that co-ordination between the Treasury and the Bank of England was positive, not just between 2007 and 2010 but also from 2010 onwards, until I left in 2016. So I would not draw the same distinction as Ed, but I recognise that he has different views on fiscal consolidation from me.

The one point that I would make is that the orders of magnitude have certainly got much bigger in the past year. I do not know whether it was coincidental or planned that the level of QE matched the fiscal expansion, but the one thing that we do know is that the deficit has not risen as much as expected because the economy has recovered more quickly than expected. Ex post, the QE is probably rather greater than the funding required by the Government, which probably means that the QE goes on for longer.

I would point to what happens from here on if the economy carries on recovering. Sorry—at the beginning I should have declared an interest as executive chairman of C Hoare & Co, a small private bank. The interesting thing—as is already being signposted by developments in the gilt market since the turn of the year—will be when it comes to the Bank of England deciding that it is time to tighten policy. That is where the true test of Bank independence will come.

In one sense, this has been the easy part. Many of us expected, back in 2009—indeed, I can remember discussing this with Lord King—that the so-called asset purchase facility would start making losses reasonably near into the future from that time. Here we are 12 or so years later, and that prospect is finally coming into view. That will be an interesting test.

The logic of the system set in place is that, through this period, the central bank, which is indemnified by the Treasury, starts losing money in its immediate holdings or the value of those holdings, and that will feed through. Just as the Government were happy to take advantage of the gains in the early stages, this will start being a hit to the public finances.

I have seen some people appearing before your committee advocating at this point that you should simply change the rules of the game. I would be worried about that. Credibility hinges on maintaining—

The Chair: I think we are going to come on to that later, Lord Macpherson. I know that one colleague wants to raise the asset purchase facility. Two colleagues wish to come in with quick questions: Lord Bridges and Viscount Chandos.

Lord Bridges of Headley: I have a quick question for Ed Balls. I am very interested in your answers today, and thanks for joining us.

I want to clarify what you think and what the perception is. In my view, the perception is key. I come back to what we have discussed at previous hearings—the perception in the City. You will have seen the *FT*'s survey that came out in January, which "found investors believe the central bank's quantitative easing programme is a thinly veiled attempt to finance the Government's deficit to keep its borrowing costs down".

Do you agree that this argument is in some ways academic, because it is that perception that we now need to tackle, and it is therefore the point that Lord Macpherson was just coming on to, which will really be key? Do you agree that it is a matter of perception and that we should be worried about that? If so, what do we need to do about it?

Ed Balls: There are some broader perceptions that we have to worry about. Independence is under threat more broadly and globally and—as we will come on to later, I am sure—there are some real risks and vulnerabilities in the UK system.

A year ago, financial markets were very fragile, liquidity was suddenly at a huge premium, and spreads were opening very fast. The Bank of England's swift and decisive QE programme signalled, first, that the markets would operate and liquidity would be provided; and, secondly, that the policy would be looser, not tighter, and that monetary policy would support fiscal policy through this period.

From a City point of view or from a growth point of view, if the Bank of England had been fighting against fiscal policy in the past year, that would have been very bad for the UK. Alternatively, if the Bank of England had been trying to do all the work with QE and the Government had been unwilling to respond with fiscal loosening through the furlough scheme and everything else—which, without wanting to go over the past, is what happened in a number of countries after 2009—it would have been much tougher.

From a UK economy point of view, the co-ordination of monetary and fiscal policy in this period has been important and positive, but I do not think that it is right to say—I do not think that we have any evidence to see anywhere—that the Treasury overrode the Bank's mandate.

Independent members of the MPC were not required by the Government to vote for this. They were not told, “Monetary policy is subordinate to fiscal policy and inflation is now downgraded as an objective”; they did it because they thought it was necessary to meet their objectives for growth and, more widely, employment and the stability in the economy.

Of course you will hear some people saying that in the City, and of course it is the case that what the Bank has done in the gilts market has helped the Government to sell record numbers of gilts because of the size of the deficit. That is a good thing, and it was an act of monetary policy supporting fiscal policy in the same way as, in other times, fiscal policy can support monetary policy.

Viscount Chandos: As you say, the Government have been able to sell record amounts of gilts, and at very low rates, but those low rates are illusory because, through the workings of the AFP, the Government have entered a giant interest rate swap. It seems to be a matter not of principle but of degree. Would it not have been better if QE had been a few hundred billion pounds less and the 10-year gilt yield had been 50 basis points higher? Would that not have been better and just as supportive for the economy?

Ed Balls: All these debates are hard, because they come back to the tricky counterfactuals—to what would have been. From the beginning, when QE began, Lord King and the Bank of England were clear that they did not have a balance sheet that would allow them to absorb this degree of financial risk. Therefore, there was a Treasury guarantee. If it had not been for the Treasury guarantee, this arm of monetary policy could not have been effective.

In your scenario, the Bank would probably say that it could have led to higher interest rates and more uncertainty across the yield curve, and the Treasury might say, “It would have been more expensive and harder for us to get our gilts away during a period when we needed to finance a huge deficit”, both of which would have been negative to the economy—but we do not know.

That is one of the things that comes over from reading all your testimony. You set in place structures and transparency, which have to be robust in hugely uncertain times, when people do not know what the counterfactual is or will be, or what is actually going on in the economy. Bad systems collapse in those times, and good systems are robust. I think that the system is robust. That is not to say that there are not debates—there are lots of debates about central banking at the moment—but, fundamentally, it feels to me as though the MPC has made the decisions that it thought were right for the economy, and I am not sure that I feel in a position to second-guess it on that.

The Chair: Okay, Ed Balls, you have made that point several times.

Lord Macpherson, do you want to comment on either of these two points? I think that the question from Lord Bridges was pretty much focused on perception and the impact of the perception.

Lord Macpherson: Perceptions do matter; equally, doing the right thing matters. There is a trade-off there.

As for Viscount Chandos's point, there is not a huge amount of science yet in QE. It is very difficult to know the precise impact of an extra £10 billion or £20 billion of asset purchases. Given what we know now, quite possibly the Bank should have done less, but I think that it probably entered into the judgment last year in good faith.

Q166 **Lord Monks:** I have a question, first, to Ed. We have been looking at a paper that you co-authored for Harvard in 2016. You have been complimentary about the recent record of the Bank and the Treasury, but in that paper you were opening up the prospect that we had reached "peak"—I think that was the word—central banking independence. You had one or two ideas for what might be done in the future. How much have your views changed following the pandemic? Where does it leave us after this massive crisis?

Ed Balls: The answer, Lord Monks, is that I do not think that my views from that 2016 paper have changed. I think that there are two different meanings to the word "peak". Around the world, central banking independence has been put under pressure. There was Trump's criticism—look at India, and look at Brazil. There have been concerns about the Bank of England's comments on Brexit, and there have been some debates about QE. Experts have not been popular politically in the past 10 years, and that has included the Bank of England, and there has been some pushback against the idea of independence.

In the UK context, I do not think that, in monetary policy terms, there has been pushback in independence, and the pandemic has shown that, although these debates about QE are material. More widely, what has clearly happened in Britain and in many other countries since 2010 is that central banks have taken on a much wider role, and the Bank of England plays a much wider role in our economy. It has brought more powers into itself, and it has taken on the whole of prudential regulation.

The worry that I have, which we set out in that paper, is that, while the strength on monetary policy is the clarity of the inflation target set by the Chancellor—with monthly meetings with clear votes in the MPC and accountability for bank decision-making related to that objective—when you move more widely into financial stability and macroprudential policy, it is much more opaque. We have a much less clear definition of what the Bank's objectives are. The FPC does not publish votes, and I am not sure that its minutes are as widely read as those of the MPC.

My worry is that quite a lot of the risk for broader financial policy-making has been moved from the Treasury down to the Bank of England. That is okay in comfortable times, but the Bank has known financial policy difficulties even before the financial crisis—think of Barings, Equitable Life and the BCCI. In those circumstances, if all the power has been moved to the Bank of England, that leaves the institution much more exposed if things go wrong.

I think that we should be asking: what is the counterpart, in broader financial stability policy, to the Chancellor clearly setting an inflation target? I do not think that we have that at the moment, and that is a concern. It is quite comfortable for Chancellors. If I were the Chancellor, I might see attractions in this—but, for the Bank of England and for wider economic policy, having so much power now in a less accountable Bank of England, without a clear objective set by the Treasury, is a concern, and that is why we propose solutions to that.

Lord Monks: I have a quick question to Nick Macpherson, primarily, although Ed Balls might have a view. Do you think that the extension of the central bank mandate into climate change will affect its operational independence—the stretching of its mandate in that direction?

Lord Macpherson: I have been trying to understand this new mandate. I read it last night, but I could not work out whether it was a substantive change or not. Clearly, the Government briefed it as such. I listened to a very good speech by Lord King in the Budget debate, and he seemed to have concerns about it.

It relates slightly to Ed's point. I think that, if we overload the Bank with objectives—bear in mind that it only has so many instruments—we risk dragging it into political areas where it will be criticised unnecessarily. It is important that, for each objective, the Bank has clear instruments. The environment matters—I totally respect that—but there are limits to what you can offload on to the Bank of England. As Lord King pointed out, if you want to do something about carbon, it is probably sensible to tax it, rather than expect the central bank to make strange decisions on which assets it will buy and so on. It is not wholly clear from the remit itself; it is the way it was briefed that worried me.

Q167 **Baroness Kramer:** I wonder whether we could take this conversation a little further, particularly looking forward. Ed Balls, you talked about the wider role that has gradually crept up on the Bank of England, giving financial stability and various other examples. Lord Macpherson, in referencing climate change, talked about offloading more responsibilities on to the Bank of England. Do we need some mechanism that would allow the policy committees to refer what they identify as politically sensitive decisions to the Chancellor, which would help them to protect their independence and prevent them from taking, for example, an industrial role?

Ed Balls: Any action that the Bank of England takes will always have a distributional consequence. If it raises interest rates, some people will win and some people will lose. If the Bank gets into a situation where it is making decisions and is discriminating between different classes of people with different levels of interest rate or different types of borrowing allowance or those kinds of things, that takes it into a much more politically sensitive realm. My advice would be that those are the places where you would rather have the Treasury and the politicians making the overarching decisions, rather than the Bank of England. It is good for the Bank of England to have a voice on climate change, and of course it will have a view about financial risk and climate risk over the next 30 years. But, frankly, handing power to the Bank of England to make decisions over taxes for carbon would take it way beyond what a sensible central bank with unelected leadership should be doing.

My worry, looking more narrowly at macroprudential policy, is that, as the Bank now has tools that allow it to make decisions about credit availability and decisions more widely, we start to take it into some much more sensitive distributional areas. The proposal that I made in the paper back in 2016, to which Lord Monks referred, is that, if you cannot specify the financial stability objective as clearly as an inflation target, the better thing to do would be to have a committee, chaired by the Chancellor, with the governor and deputy governors on it—perhaps the conduct regulator as well—in which the Chancellor sets out the mandate for the next six months for financial stability, what the concerns are and what needs to be done, then allows the Bank operationally to get on and do that work, without it being second-guessed by the Treasury, but clearly with a remit that gives it the political cover to do that. If not, and it goes wrong, there is a big danger at the moment that the Bank would suddenly be very exposed.

Once you start talking about lending schemes where the Bank itself, not as an agent of the Treasury but as an independent decision-maker, is deciding which companies to support and which not to—I think that Lord King took the same view a few years back with Funding for Lending—you are drawing the Bank of England into a place that it really should not be. Independence is a good thing, but not if it is abused, and you must not allow the Bank to take on politically sensitive responsibilities way beyond its remit or where it makes sense to have an unelected leadership. In those cases, rather than having a committee to refer it back to, it would be much better if the decisions were not being made by the Bank of England in those circumstances at all.

Baroness Kramer: Nick, you were nodding.

Lord Macpherson: Yes. I would like to reinforce that point. Perhaps I am being sentimental but I think that this country can be quite proud of its economic institutions. They do have a certain credibility, especially the Bank of England. Therefore, they need nurturing by the political class, because you tamper with them at your peril.

Ed mentioned the Funding for Lending scheme. I remember being involved in discussions with Lord King on that. I also remember discussions around corporate bond purchases at a time when the Government were very keen that the Bank bought rather more. Over time, I was definitely persuaded by the argument that, if you were expecting the Bank to intervene on a very large scale in the corporate bond market, it could well have to discriminate in a way that would bring it into the political arena. We just have to be careful about this.

I partly agree with Ed on the point about decisions having been made to extend the remit of the Bank of England considerably since the financial crisis, and I would be very cautious about adding anything further to its remit.

Q168 **Baroness Kingsmill:** I think that the previous discussion has probably given me an indication of how you are going to respond to the question that I have been assigned. Do you think the Bank of England should be able to use QE formally as a means to be a market maker of last resort? We have discussed this to some extent in previous responses, but what would you say to that? Should it have a formal role as a market maker of last resort?

Lord Macpherson: I would—

Ed Balls: I think—

Lord Macpherson: Shall I go first?

Ed Balls: After you, Nick.

Lord Macpherson: I will be brief, Ed, and you can then improve on my answer.

The Chair: And be brief.

Lord Macpherson: I do not think that it is the role of QE to be market maker of last resort. I think that the Bank of England has a role in maintaining reasonable liquidity in the financial markets, ensuring that they do not seize up altogether. The Bank has always had that role, and it has played it. Lord King intervened in very sensible ways back in 2008 and 2009. I am not sure that you need to bring QE into that process.

Baroness Kingsmill: It is part of its general remit to maintain financial stability.

Lord Macpherson: Yes, its role is to maintain stability, but not to make life easy for the Government in terms of cheap borrowing.

Ed Balls: I agree with Nick. I think that we should be clear: that is partly what the Bank of England was doing last March when it intervened. As Paul Tucker said when he gave evidence, it intervened in the first instance to keep markets functioning. I think that is an important role for the Bank of England, and I think it used QE for that. I am not opposed to that.

My concern is that the Bank's job is to deliver price stability and, each year, the Chancellor confirms the inflation target, defined in a particular way, at 2%, for which the Bank is then accountable. The Bank's job is to deliver financial stability, but how "financial stability" is defined year to year is opaque. There is not the same Chancellor-Bank dialogue over the financial stability risks month by month or six months to six months in the public domain, and I think that that leaves the Bank of England very exposed in normal times because, if it is making decisions without political direction in the sense of the target or the objective and things go wrong, independence suddenly starts to come into question.

In a more challenging time, you really need the Chancellor working very closely not just with the governor but with the deputy governor for monetary policy and for financial stability and with the PRA. At the moment, I do not feel as though those relationships are happening in the regular way that we want. We need to do more and to give more direction on financial stability. If the Chancellor had been doing that a year ago, he undoubtedly would have been saying that it is very important, in this unstable time, that the Bank intervenes to keep markets functioning. When it did, it would have done so with that chancellorial blessing. That feels to me like a gap at the moment.

Baroness Kingsmill: Are you arguing for more transparency?

Ed Balls: I think that transparency is much stronger on the monetary policy side than on the Financial Policy Committee side. There is much less scrutiny, and votes are not attributed.

In America, they have a committee called the FSOC, chaired by the Secretary of the Treasury, with the Fed and other regulators, which is there to give overall direction. What they do not have in the US is proper independent powers in macroprudential policy for the Fed to act. We have those macroprudential powers for the Bank of England, but, at the moment, we do not have an FSOC-style, Chancellor-chaired body that sets the remit. I think that would make life better for the Bank of England and give it more political support and cover, and it would also be better for the Treasury at a time of crisis. The transparency, the good decision-making and the robustness flow from the structures. On the monetary policy side, we have good structures. I do not think that we have fit-for-purpose structures on the financial stability side quite yet.

The Chair: I am hoping to get three more questions in over the next 15 minutes.

Q169 **Lord King of Lothbury:** I start by thanking both witnesses for being so clear about the importance of limiting the remit of the Bank of England. I think that that is very important.

You were both involved, in one way or another, when QE was set up, and you will clearly remember that no one at the time imagined that QE would still be functioning 12 years later and on an even bigger scale. Do you think that the particular structure in which it operates through the asset purchase facility is still appropriate? Would you make any recommendations for change after such a long period, or do you think that that particular mechanism still works satisfactorily today?

Lord Macpherson: I think that it works well enough. I simply do not know whether, had we known that it would go on this long, we would have designed it differently. I see risks in redesigning the process, particularly for the Bank of England, if those changes seem to suggest that, in some way, the Government are being let off the hook in terms of the interest rate bill. I am not close enough to the detail now to have a firm view on how better to design it.

Ed Balls: I do not think that QE could have begun without an APF-style mechanism. It works and it has sustained independence partly because of its existence. If we are going to move into a new phase now, it will be tougher because of the scale of the deficits in the past year. On some of the questions that have been raised by other witnesses about whether independence can survive this, I do not agree, for example, with Charles Goodhart’s pessimism. I do not think that we will or should see the Government overriding independence when it comes to the fiscal consequences of rates rising. It will be a good thing if interest rates go up in the end because the economy is recovering strongly. It would send a terrible signal now to depart from a regime that has functioned.

Lord King of Lothbury: I have a small follow-up for Lord Macpherson. At the time when the debt indemnity was given by the Treasury to the Bank, that fact was made quite clear publicly, and it has been clear ever since. It is argued that the technical deed of indemnity has not been published. Do you recall whether that is true? If so, why?

Lord Macpherson: I saw some reference to this, and I was quite puzzled. I seem to remember that, at that time, we were pretty focused on being as transparent as we could be.

Lord King of Lothbury: All the letters between Chancellor and governor were published, yes.

Lord Macpherson: I would hope that, if we forgot in some way to publish it, we could publish it, because it will add to the sum of human knowledge and therefore create a better debate about these things.

Lord Haskel: Ed, it is good to see you.

Ed Balls: It is good to see you, Lord Haskel.

Q170 **Lord Haskel:** You have always been a champion of Bank of England independence, but you have also spoken of scrutiny and oversight, particularly of systemic risk. In November 2020 you proposed the creation of a Treasury-Bank of England oversight committee. What exactly was the rationale behind that proposal, and what form would it take? In response to the last question, you mentioned an American committee. Was that a model that you had in mind?

Ed Balls: You have to make a distinction between accountability, oversight and scrutiny on the one hand and the objective setting for financial stability and crisis management on the other. In the case of the former, it seems that the Treasury Committee, the House of Lords committee, Parliament more widely and the media do a very effective job of scrutiny and accountability, particularly on the monetary policy side. I worry that we do not have the same degree on financial stability. The FPC is less scrutinised and its minutes are less discussed. Votes are not made public, but that would be an easy enhancement.

The proposal that I am making is a bit different from scrutiny; it is about how you ensure that the objectives of the Bank are owned by the Treasury, that the Treasury provides the political cover for the Bank of England to get on and do what are more complicated and sometimes more controversial things—and that, in a time of crisis, the Treasury, which, in the end, will be the balance sheet that has to take on risk, has all the information flowing back from the Bank of England.

It would be good if the Chancellor heard regularly from not just the governor but the different deputy governors, with different, sometimes overlapping and sometimes contradicting, responsibilities. It would be good if the Treasury, with that group, was setting a more detailed financial stability remit, six months by six months. By doing so, you would create the body that, in a time of potential crisis, would come together, where information would already be flowing freely, where people would know each other well and where you would start to make the decisions that are sometimes made in a rather more ad hoc way in a financial crisis. That is what I proposed.

It is not the same as the American model—it is very different—but America does have an FSOC chaired by the Treasury Secretary. I do not think that it is hugely popular in America, partly because it does not have the powers that it should have, and nor does the Fed. I do not want to overdo it. I am sure that, when you hear from Don Kohn, he will throw his hands in the air and say, "You don't want our FSOC". The reality is that we have a better-functioning central bank when it comes to financial stability, but I think that the US has moved further towards political ownership of financial stability objectives, and that is where I think our gap is.

If I had been Chancellor in 2015, I would have been discussing with the Permanent Secretary, Lord Macpherson, how we made sure, fully consistent with the Bank's operational independence, that we did not leave it as politically exposed as I believe it was and still is in financial stability. At the moment, if there was a crisis in a year or two's time, it would all be laid at the Bank of England's door, and that is a dangerous place for the Bank to be.

Lord Haskel: Lord Macpherson, do you have a view on this oversight committee?

Lord Macpherson: I do not have as well developed a view as Ed. I always struggle with this issue. You want to ensure that the Bank of England is asking hard questions of itself and learning lessons, but you also want to ensure that, by the Government vacating space, it is not being forced to occupy territory that is more political.

Crisis management did interest me. I recall George Osborne, I think, as Chancellor, agreeing quite a good memorandum of understanding to answer the question of who was in charge in a crisis. That is a really important point; there needs to be clarity and understanding on each side. Ed's solution might be the answer, but I am now too far away from this to have an advanced view.

Ed Balls: The problem with that MoU is that it is too personalised, simply on the person of the Chancellor and the person of the governor. If the deputy governor for monetary policy has one view and the deputy governor for prudential stability has a different view, it seems important that the Chancellor hears both views, rather than that being funnelled through only the individual person of the governor, because that puts the governor in too big and exposed a position. That is why you need something more formal than what felt to me to be very ad hoc in that MoU, and it is still that MoU that functions today, I believe.

Q171 **Lord Fox:** Should the Bank set out an exit strategy now? If not now, under what conditions should it consider setting out an exit strategy? Let us go to Lord Macpherson first. You mentioned that you thought the scale might make QE go on for longer. What do you think about an exit?

Lord Macpherson: It clearly cannot set out the precise exit strategy, because that will depend on events, but I think that setting out a framework is useful. Certainly, the last governor set out a view of when QE would begin to be withdrawn, compared to rises in interest rates. That is important to understand, too. It is always open to the Bank to revise that reaction function. Creating clarity around how you would exit QE would encourage a better debate and result in greater understanding. Transparency in this space is really important.

Lord Fox: What are the risks in doing that?

Lord Macpherson: I suppose that the risks are that, when the exit strategy comes—who knows: it could be next week or it could be in 50 years' time—the previous strategy is obsolete in some way. But, provided the Bank of England is charged with updating it, that does not have to be in massive detail. Understanding precisely how this will play out—there are implications for the Debt Management Office's gilt auction programme—is useful. Maintaining that dialogue will result in better policy execution.

Ed Balls: When you think of what QE does, it may have an impact on the term structure of interest rates immediately; it may have an impact on portfolio balance. Fundamentally, it is also a signal about future policy. How you use those signals and when you use them is so important. If the Government or the Bank were to indicate now that there will never be an exit from QE, that would de facto be the announcement of monetisation, on which Lord Skidelsky would feel vindicated, but I think that it would be a bad signal for the credibility of the Bank of England and the wider UK fiscal state. If, on the other hand, the indication now was, "We're getting ready for it", the signal would be, "We think we're out of the woods, so prepare for a tightening of policy". That does not seem to be where we are at the moment, and it would send the wrong signals to markets at a delicate time.

The right thing to do is to say that we will, at the right point, set out an exit strategy, but not to do it until we are really sure that it is the right time. When others have tried to set out these exit strategies over the past few years, it was quite destabilising, including in the US. Perhaps that is because, in retrospect, they started to exit a little earlier than they should have done. That is a debate that we can have. The answer is: yes to an exit strategy, but not yet.

Lord Bridges of Headley: A number of our witnesses have discussed whether the Bank should return to paying zero interest on its reserves, were rates to rise, in order to make debt management more sustainable. What do you make of that proposal? Would you tweak it? Would you accept it?

Lord Macpherson: I think that it is dangerous. I should remind you of my interests again as, obviously, banks would be impacted by this.

It is important that the rules of the game on QE are symmetric. If you change the rules at the point where it starts costing the Government something, you damage the credibility of the framework. That is important. If the Bank of England concludes, for wider monetary policy reasons, that it wants to have a different reserve system and just remunerate marginal reserves or whatever, I do not have an objection to that, providing it is framed in monetary policy terms, but in the current environment I think that would be risky and dangerous. It would effectively represent a tax on the banks. There is nothing wrong with taxing banks—as a Treasury official, I designed many a tax of that nature. But it comes back to the point that I was making in relation to Lord King, the environment and the mandate. If you want to tax banks, tax them, but do not just change rules for fiscal reasons that are operated by the monetary authority. Once you start doing that, you really are undermining the policy framework.

Ed Balls: I agree with Nick. These things are about signals and the robustness of the system. If the Bank moves from making a monetary policy decision to having a fiscal policy decision imposed on it, which would be very damaging to its credibility and wider credibility, we would all lose from that.

We have to accept the reality of what has happened in the past year, and in some ways celebrate it. I was thinking about this earlier when Lord Skidelsky was speaking. I am not trying to reopen the debate about 2010 to 2012, Nick will be pleased to know, but imagine if, last March, when the crisis began, the Treasury had said, "Fiscal policy is going to continue to be driven by a balanced budget rule, we are not going to use fiscal policy actively, and we want the Bank of England to do all the work". That would have put the Bank of England in an impossible position. There is no way in which QE could have dealt with that pressure, and at that point the Bank should have said and would have been right to say to the Treasury, "No. You need to act". That was not where we were, because the Treasury acted—great.

The consequences have to be dealt with, and they include fiscal consequences for our country, which may take 50 years to deal with. When I was Economic Secretary in 2007, I announced the last repayment to Canada of the war debt that we had taken on at the end of the Second World War. That is the nature of these once, twice or three-times-in-a-century events—that generations bear that pressure. That will happen for decades to come. If the Treasury suddenly started to play fast and loose and tell the Bank, "We will want you to claw back for us the fiscal consequences of the correct fiscal decisions we made", that would be a very bad signal. You have to have confidence in what you have done. It has done the right thing, and it should stick to it.

The Chair: That concludes this first session, and it has been absolutely fascinating. I began to think at one point that it might make an episode of the BBC's "The Reunion" programme. It is also great to hear that phrase, "I agree with Nick", appearing so frequently in our political discourse again.

Lord Fox: Speak for yourself.

The Chair: It has been really helpful, and I am very grateful to Ed Balls and Lord Macpherson. Their evidence has been really helpful to the committee. Thank you for making your time available.