House of Commons

Treasury Committee

Oral evidence: Jobs, growth and productivity after coronavirus, HC 150

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Watch the meeting

Members present: Mel Stride (Chair); Harriett Baldwin; Anthony Browne; Gareth Davies; Dame Angela Eagle; Kevin Hollinrake; Julie Marson; Siobhain McDonagh; Alison Thewliss.

Questions 323 - 403

Witnesses

I: Lord O'Neill of Gatley; Professor Jagjit Chadha, Director, National Institute of Economic and Social Research (NIESR); Roger Bootle, Chairman, Capital Economics; Ann Pettifor, Director, Prime Economics.

Examination of witnesses

Witnesses: Lord O'Neill of Gatley, Professor Jagjit Chadha, Roger Bootle and Ann Pettifor.

Q323 **Chair:** Good afternoon and welcome to the Treasury Committee and our hearing as part of our inquiry into jobs, growth and productivity after coronavirus. I am very pleased to be joined by four witnesses this afternoon. I am going to ask each of them to just very briefly introduce themselves to the Committee.

Roger Bootle: I am Roger Bootle, chairman of Capital Economics. Thank you very much for inviting me here. I have given evidence a fair few times before.

Chair: You have, and I think you were a special adviser to this Committee at some point in the past, were you not?

Roger Bootle: I was for almost 20 years.

Chair: You have never been forgotten, Roger. If I am correct, Jagjit was also a special adviser.

Ann Pettifor: I am Ann Pettifor, director of Policy Research in Macroeconomics. I have given evidence before, but I do not think I have ever been invited as an adviser.

Chair: There is always the future.

Lord O'Neill of Gatley: This is all very pressurising. Jim O'Neill—Lord Jim O'Neill, no less! At one time in my life, I had a brief period as Treasury Minister, as I am sure most of you know. I have done various other things and still am doing them. It is nice to be here.

Professor Chadha: I am absolutely delighted to be here this afternoon. What a pleasure it is to see everyone in person. Thank you very much for managing to do that. I have to say it is an absolute delight to wander over from Smith Square. I am Jagjit Chadha, director of the National Institute of Economic and Social Research. I am absolutely delighted to have a chance to discuss some of the critical issues facing the UK with you this afternoon.

Q324 **Chair:** Thank you, Jagjit, and welcome to everybody. I will start with an open question to all of you. Inflation is going up to quite a high level by April—7%-plus. The Bank of England has constantly under-forecast where it will go and how persistent it is likely to be. Do you have any thoughts on how well the Bank of England and the MPC have performed in that respect? What is your assessment of where inflation is going and for how long it will persist?

Professor Chadha: The inflation shock is large and worrying. Seven per cent. or more in the first half of this year is far above the inflation target that we have managed to hit throughout the nearly 25 years of the MPC. It leads to concern as to whether that will lead to what economists call second-round effects, which means whether price and wage setters decide to factor that higher level of inflation into their plans for the next couple of years. Inflation far above 2% is not consistent with price stability, which is an important precondition of a strong recovery from the Covid crisis, but also, more importantly, to implement the real-side reforms and progress of the economy that we see.

It is critical, therefore, that the Bank acts to control those second-round effects and to bring inflation down as quickly as possible without inducing excess output volatility, which is economists' language for a recession. That is the clear thing that needs to be avoided. The Bank is facing particular trouble because both public and household debt is high—around the same size as GDP—which means that both these important elements of the economy will be very sensitive to those interest rate changes.

What we would like to see is a gradual increase in interest rates to signal the end of extraordinarily loose monetary policy. Bank rate near zero for over a decade now has been extraordinarily loose. You will recall that we had the emergency cut in March 2020 to deal with the onset of the pandemic, and it was becoming increasingly clear last year that, by this time this year, the pandemic was going to be behind us. In a sense, monetary policy has to be forward-looking, partly because it works with lags. When interest rates change, they affect the economy with a lag of a year to 18 months, so it is important that the MPC signalled its willingness to act last year and continues to act this year.

Q325 **Chair:** Did it act quickly enough? I know it was constrained, as you say, by lockdown and the fragility of the economy to put rates up early, but you think that it was quick enough off the mark to react.

Professor Chadha: There were some unfortunate attempts to engage with monetary policy tightening, in that the mistake—if it is a mistake—that might have been made was to mistake a change in interest rates for the level of interest rates. Even though interest rates have now changed, the level is still very low and offering an expansionary impulse to the economy. Some of the language could have been a bit clearer about that. You can raise interest rates quite a lot at the moment without it bearing down on the economy too much. If we think about where neutral interest rates are, they are probably going to lie somewhere between 2% and 3% at the moment.

Until we get to those kinds of levels, even if they are increasing gradually and slowly, they are not necessarily tight, because they are not above the neutral rate. The Bank may have wanted to be a little bit clearer on that last year, but it has now engaged and started a process of normalisation in interest rates. That is going to be important in order to control the level of inflation and, more importantly, its persistence—how we get it back down to something that is consistent with price stability.

Q326 **Chair:** On this issue of what is happening in the labour market, where we have had very hot areas, and then there has been a question about to what degree that is spilling over into the broader labour market, some of the evidence cited by the MPC through its surveys and agents et cetera, is that there seems to be some indication that the labour market is getting quite hot in terms of pricing increasing expectations on inflation into wage bargaining and so on. Perhaps I can throw this to the rest of the panel, if somebody would like to come in on that. Is there a danger that expectations are getting de-anchored and have moved up quite a lot, and that this is going to feed into the labour market wage-price spiral territory?

Roger Bootle: Yes, this is a very real danger. Often, this issue is slightly misunderstood, in that people concentrate on expectations. Important though they are, an awful lot of wage bargaining is, in my experience, rather about referring to what is happening now or what has happened in the recent past. It is about maintaining real incomes. If we go through a phase when inflation is something like 7% or above, people are going to think, "My pay settlement has to be something significantly higher than it used to be—maybe 7% or so—even to stay where I was". That is without inflation expectations taking off. If there is a danger that they will, the whole thing gets worse.

May I comment on your earlier question about the Bank with regard to inflation, forecasting and reaction? We all know that forecasting is an extremely difficult thing and I would venture to suggest that everyone on this panel has made their fair share of forecasting mistakes, so it is important to bear that in mind. Having said that, the Bank has not covered itself in glory on the inflation issue. It was slow to recognise the dangers. In particular, there were many statements along the lines of, "This is to do with energy prices. It is supply driven. Therefore, monetary policy does not have a role".

I was, frankly, dumbfounded by this, because, in particular, in the 1970s, a large part of two upsurges of inflation in oil prices were supply related, but then the big question was about how monetary policy was going to respond. How monetary policy responded would make a big difference and have a big impact on how interest rates behaved. You had a big contrast between Germany, where monetary policy was very tough, and the United States and the UK, where it was not. Even if it is supplier generated, it is still a key role for monetary policy.

Q327 **Chair:** On that point, do you think, therefore, they should have acted on interest rates earlier?

Roger Bootle: Yes, I do. That is was I was coming to. This is not easy but they were rather slow to act. There was, of course, that unfortunate occasion in November, I think, when they flagged that they were going to put up interest rates but then they did not. It is a very difficult situation, because they want to go gently, not to jeopardise the recovery, as we have heard. There are certain asset markets—the housing market—that are in danger, so you do not want to move suddenly.

At the same time, they look to me as though they are way behind the curve. We have just increased interest rates by a total of 0.4%, when the inflation forecast has gone up by something like 2% or 3%. There seems to me to be a mismatch between the degree of tightening of policy and how quickly the inflation danger is picking up.

Q328 **Chair:** Given the delay in the transmission mechanism of monetary policy—how long it takes to feed through—that sounds like a major problem, does it not? We have this near-term 7%-plus in April that is looming on the horizon, yet we have a lever that has been pulled that might not kick in for up to 18 months in terms of having full effect. Is that a fair concern to have?

Roger Bootle: That is absolutely right. One of the faults of the Bank of England's approach to these issues—as I say, it is very difficult and no one gets it completely right—is that, in my view, it is too mechanistic. Monetary policy is more of an art than a science. The Bank has not communicated clearly enough how tough it may need to be. It has to tried to influence behaviour now, even though the economic effects of rate rises will not come through for quite a while, really.

Ann Pettifor: I do not think that we should be critical of the Bank. I am always usually critical of the Bank but, in this case, this is a global phenomenon. This is a matter of price rises in freight, fuel and the dysfunctional global energy market. The Bank cannot be held responsible for that. Similarly, prices will rise because of international forces, and I do not know that the Bank increasing interest rates can do much about that.

I would like to take up a point that Roger made about the 1970s. For me, the problem is not the Bank of England; the problem is the economic model, which was shaped, first, by the Bank of England and, in August 1971, Nixon unilaterally dismantling the international financial architecture. In September 1971, the Bank of England introduced something called credit and competition control, which everyone knows was all competition and no control.

Basically, what it did then was deregulate lending. Thenceforth, credit rationing was decided by price and not by control, and so whoever was willing to pay the highest price—the highest rate of interest—on credit had credit made available by the banks. Banks could not believe their luck. We had a 72% increase in the money supply—what Dr Needham has called the most intense period of monetary chaos in recent British history, which lasted from 1971 to 1973. Then came the oil shock.

Getting wages into the picture instead of looking at the model of easy money fuelling easy consumption for some, and the fact that we have global markets in energy now, means that these are forces that are beyond the control of the Bank. Putting up interest rates when the economy is still quite weak and business investment is 12% below what it was before the pandemic is not the right way to manage an economy that has still not fully recovered from the great financial crisis. I am perhaps not being terribly helpful but I really think that the Committee should look at the model as such and not blame, if you like, the micro level of decision making that takes place at the Bank.

Chair: Thank you. It is interesting to have a contrary view there.

Lord O'Neill of Gatley: I have some nuances. I should start by saying that this question alone, never mind the other ones, could take days to give a proper answer on, so I will try to be succinct about my nuances on this.

Cyclically—as in where we have come from, let us say, a year ago—it has all been, by standard cyclical economic forecasting models, one of the most predictable that I can ever recall, not least because I managed to think that where we are is where it would be broadly. As Roger intimated, that is not something that one can always say.

Looking at issues now, going forward, I cannot quite recall when there have been so many issues that I know about that have very uncertain outcomes, never mind ones that we do not know about. In that sense, I have sympathy for anybody who has to deal with it as opposed to just talk about it.

However, as touched on by Roger mostly—we might get into this if we have time, linked to some of the other questions—the whole framework for inflation targeting and how the Bank has operated has outlived its sell-by date. Separately, the persistent QE approach, a long time before Covid, had gone beyond its purpose of what it was initially done for. As is topical in the media, and partly why the Governor's comments last week are, understandably, so sensitive, the QE approach appears to have been most influential through what it did on financial conditions, which is perceived as widening inequality et cetera.

One wonders why, so far after the seeming reason for its introduction to deal with the immediacy of the issues of the financial crisis, that still went on. The answer is because inflation was constantly undershooting. It is issues to do with the rest of the world and it became fashionable to want some kind of overshoot. As soon as it shows the first signs of having one, everyone panics, because they do not know how much of an overshoot it is going to be.

There are quite a lot of legitimate uncertainties as to where the inflation profile will go, not least because—I strongly support Roger here—it depends on what they do. If we persist in having staggeringly low what economists or others would call real interest rates, monetary policy alone is not really going to do much to get it under control.

Q329 **Chair:** Just very quickly on QE, is the Bank in the right position where it says, "We have hit 0.5% for interest rates and, therefore, we will passively unwind QE and more actively unwind the bond element within

QE. We will wait until we get to 1% and then start to more actively unwind QE”? Is that the right sort of approach when it comes to quantitative easing?

Lord O’Neill of Gatley: My honest answer is I have no idea. They have created a problem for themselves, linked to how long it has gone on for. We have had a staggering decade of persistently rising bond and equity prices, and with it exceptionally easy financial conditions. As we saw in January, which was the worst month for international equities since 2009, at the first hint of unwinding this stuff, all hell breaks loose.

I spent a long time in my so-called earlier career trying to use these things as lead indicators. If you have a severe tightening of financial conditions, things will probably slow down faster than most people think. In that sense, like so many other things, where people have this understandable but slightly simplistic view of the timeframe of the transmission mechanism, I am not sure that it is 18 months anymore. If we have a few more months of what happened in January around the western world, we will see high-frequency coincident lead indicators slowing dramatically.

Professor Chadha: We are agreed that QE needs to be unwound. We could have been clearer, having ratcheted up QE in March 2020, to have reversed that relatively quickly, once we knew we were approaching relatively normal conditions again. I do not think that it is an easy task to get financial markets to reabsorb £800 billion-plus of sterling debt, and that is the issue that we have to think very carefully about.

That tendency to have the financial markets not have any great appetite for risk, which is something that Jim just referred to, is a problem out there. The bond markets have got used to this very long bull run. Any sense in which QE was going to be unwound leads to this broiling of financial conditions, which may be counterproductive at a time when you are trying to control the yield curve as well as monetary and financial conditions.

That is why we need a bit more clarity about the path of QE, and to take that back into Treasury or debt management control. We have this large amount of debt that, at the moment, the financial markets are not having to hold. We need to manage their reabsorption of that debt in a way that would match their own wish to hold that debt. I do not think that it should necessarily be done passively in that way. It needs to be managed really by the DMO—the Debt Management Office—that has the relationship with those who want to hold Government debt in a particular way, to avoid, first, the issue of extreme sensitivity of bond prices. If you are suddenly going to dump 20% to 30% of debt on the market, there is a danger that forward-looking markets will sell off that debt very quickly.

Secondly, you then have an additional problem that has not been touched upon. At the moment, the QE operation has yielded an overall return to the Treasury from the APF of over £100 billion, because the coupons being clipped have given a higher return than the amount that you have had to pay on reserves. As interest rates start to go to 1% or above, that flow will reverse and we will have a world in which some of those interest payments are going to be coming back to the financial sector.

We are then in a world in which we are not quite sure why interest rates may not be going up. Is it because of inflation prospects or because we are worried about reversing that flow of income? There are a lot of issues out there to discuss as to whether those reserves should be remunerated or not, or whether the DMO might adopt some operations to try to limit the impact on markets from that. Handling that QE thing is an enormous problem for us and it has been in place a bit too long.

I will make a very quick point on wages. What we have at the moment in the labour market are some structural areas of activity in which there is a shortage of labour. People need to move to those areas. In those areas in any market, it is right and proper that wages should go up to incentivise people to move to them. We have some existing and long-lived problems with labour mobility in the country, which have not been helped by the increase in house prices that we have observed in the last few years. Therefore, we have to be careful about talking about an aggregate wage level that is appropriate or not.

There is a lot of—economists' term coming up—heterogeneity; a lot of differences in wages that should be required in different areas, depending upon the shortages, or the excesses that we see elsewhere. It is clear that, following the crisis we have just lived through, there are shortages in many parts of the public sector, whether it is social care and health, education or infrastructure. These are areas that we want to be thinking about attracting labour into. Therefore, thinking about the wage market as an aggregate is slightly problematic at the moment, because we have these structural imbalances that need to be addressed.

Ann Pettifor: This goes back to the economic model. The reason why it is so difficult for the Bank of England to think about unwinding its bond purchases is that the financial markets want those bonds for safety. The reason why there is such a high demand for Treasury bonds is because of the degree of fear that is out there. The degree of fear is related to the weakness of economic recovery since the GFC.

It is a global as well as a British problem. The Bank of England can hang on to those purchases, but if only we could move away from the model of monetary dominance and fiscal quietude—fiscal policy being weak—and instead move into a new model of both monetary and fiscal policy working together to revive the private sector above all else and to revive private as well as public sector investment, we could begin to see economic recovery, which would then limit the degree of fear that there is and the reason why bond purchases have been so attractive to the financial markets.

Q330 **Kevin Hollinrake:** I would just like to revisit this debate about the

Monetary Policy Committee and different opinions. I know that Churchill said, "If you put two economists in the same room, you get two opinions, unless one is Lord Keynes, in which case you get three opinions". Roger, you seem to think that it had been too slow. You cited Germany but, to be fair, is inflation not higher there? You said that it acted more decisively but inflation is higher in Germany than it is in the UK, is it not?

Roger Bootle: That is right. I was referring to the 1970s, when German monetary policy was independent. This time, of course, there is no independence. You are quite right that German inflation is higher.

Q331 **Kevin Hollinrake:** Your view is that the MPC was too slow and should have done something about it more quickly.

Roger Bootle: Yes. I have a general suspicion that the members of the MPC are not as aware of what is going on in what I might term the real world. Thank goodness for the Bank of England's agents, who are plugged in. It seems to have been the reports of the agents recently that have woken up policy setters to how serious the danger is.

I am sure that other people on the panel do this as well, but I talk to quite a lot of businesspeople around the country at various functions, and I do find this a very useful antidote or something to have in addition to what the economic models are throwing out—to talk to people running businesses about what is happening. From a long time ago, it was pretty obvious not just to me but lots of people that we were going to face a significant inflationary danger. You could tell from the pressures that they were under. That is one problem that the Bank faces. It is too dominated by model-based forecasting.

Q332 **Kevin Hollinrake:** Is there groupthink within the MPC? Is there some real challenge in there or not?

Roger Bootle: There probably is, yes. It is a very difficult position to hold and it is difficult to fill those places at the best of times, but I suspect that one could do with somewhat more diverse thinking.

Q333 **Kevin Hollinrake:** Ann, your point was that the economy was only just recovering from the Covid crisis and, therefore, had limited room for manoeuvre. What is your perspective?

Ann Pettifor: It is both from the GFC and the pandemic. We have not recovered fully from 2007, and incomes are certainly still below what they were in 2007 in real terms. Given this world of easy money, QE and deregulated finance, we have very high levels of private and public debt. The reason why the markets panic is that, the minute rates go up, that debt begins to become unaffordable for companies that were borrowing at 0% not long ago but are not making the sales that they need to make in order to be profitable.

Because of cuts in real wages and declines in living standards, we have a cut in purchasing power, which has led to underconsumption and excess production. Companies cannot sell at prices they wish to sell at, because the demand is not there. One of my problems is that the way we look at this is always from the supply side. We ought to look at it also from the demand side. I am a Keynesian.

Q334 **Kevin Hollinrake:** Jim, if you had been on the MPC, would you have voted for interest rate rises more quickly?

Lord O'Neill of Gatley: I would have done the whole of the past year, because, as I said in my first answer, a year ago, for one of the few times in my life, everything seems to have turned out how it looked from pretty obvious standard cyclical forecasting models.

I want to very quickly emphasise again the three underlying issues that dominate what one could call groupthink. Go all the way back to when Mervyn King was Governor—the "nice" decade, as Mervyn christened it. That turned out to be wrong, partly because they were so focused on the inflation targets. Secondly, with that, QE came in to deal with the emergency of 2008 and then to try to be an aid to get to the inflation target. Multiple years of underachieving the target has created this psyche of constant underachievement.

In the middle of this central bank western groupthink—it is a bit unfair to describe it as that but, for the sake of time, I will—the Fed changes its view that it wants to achieve above-target inflation but does not really tell us quite what the hell it means. If you look carefully back to when the Fed did that last August, it started to sow the seeds of some nervousness in the financial markets, because it suddenly went from a general framework around the western world that it had not been achieving, but at least the financial markets knew it, to one where, "We might want higher inflation now but we do not really want to tell you what it is, not least because we do not know".

Surprise, surprise, out of the blue, for the first time in 20 years, inflation comes powering ahead, way above what they dreamt of, and they are like, "Oh my God". That is essentially where we are. I do not think most of them have the slightest idea what has really happened or is going on, because it has all been a lot of very complex forces, but it seems to me quite clear that not just the Bank of England but a number of other central banks should not have behaved in the way they have in the past two years.

At this point, they have to get out of that dilemma, but they now run the classic risk, for those who have been around long enough, that they might end up going too much in completely the wrong way, just to get their own credibility back. It is part of the whole dilemma of greed, fear and financial markets, and these unfortunate central banks in the middle of it.

Q335 **Kevin Hollinrake:** Jagjit, the Bank of England's forecast is that inflation will be back to 2% within two or three years. Is that realistic, based on these forces?

Professor Chadha: Inflation is, of course, the outcome of shocks, the structure of the economy and the monetary policy responses that we see. When you put all that through a range of different models, you get the view that inflation will return to target in 2023 or 2024—that kind of time horizon—with a number of interest rate rises over the next year or so, rising to something like 1.5% to 1.75% by about mid-2023. That is the kind of path that, centrally, people are expecting.

Q336 **Kevin Hollinrake:** You think that we will get back on track pretty successfully.

Professor Chadha: That is the central case. There are lot of risks around that, but let me be clear: the central case looks like that when you run it through a lot of models. We have heard some conversations just now about the extent to which you should believe models, which is why we need to think very carefully about risks. That does look the most likely outcome.

I just want to take a step back in answering the question, if I might. There is a danger that we are asking the Bank of England a little too much here in terms of demand management of the economy. Our view is that the monetary/fiscal mix has been wrong for a very long time, and let me just briefly explain what that means. It means that fiscal policy has been on a path that is too tight, for a decade, which means that, for the Bank of England to meet its inflation target—which, I have to say, it has done on average over the MPC's nearly 25-year existence, which is its purpose—it has to have a more expansionary monetary policy than it would have ideally wanted, had fiscal policy been more stimulatory in this period. It has not been.

Over a long period, what you have is a structural world in which the Bank has had to keep interest rates low to hit its given inflation target. In that process, it has lost some institutional memory about how to deal promptly with an inflation shock and focus on the really important thing for monetary policy, which is price stability.

I know that we might come to this later, but there is a danger of turning to the Bank for too many other things for it to worry about. Let us not have price stability in its mandate. Let us worry about unemployment. Let us worry about net zero. Let us worry about a bunch of other stuff.

Ensuring price stability is the job of a central bank and is the thing that it should be charged with doing. If the members of the Monetary Policy Committee can be encouraged to refocus on that, even in a world of more expansionary, supportive fiscal policy, that is a better outcome than charging the Bank of England with errors.

We might argue a little about whether it should have gone a few months earlier or a few months later. To be clear, we are on a tightening cycle now, and the path that we are on looks more likely than not to yield price stability, which I think is fine.

Q337 **Kevin Hollinrake:** In terms of what the Government could do in terms of fiscal measures, the Chancellor is very keen to start balancing the books and, therefore, is introducing this national insurance rise and the freeze in income tax thresholds this April. Is he right to do that, Jim?

Lord O'Neill of Gatley: Specifically on that measure?

Q338 **Kevin Hollinrake:** Both those measures—national insurance and the freezing of the thresholds—or should we just kick the can down the road?

Lord O'Neill of Gatley: I have strong views on some of the underlying issues. I hope we do have time for it, because I have issues about the framework for monetary policy and the framework for fiscal policy. The standard approach of the past 30 years needs an update. Whether that particular measure on national insurance is right or wrong, from an economic perspective, is neither here nor there.

I would have thought, touching on tricky waters here, that, for the Government of the day, which seemingly get criticised for not really being focused enough, to have a policy that seems quite "wow" and then just drop it because a load of people say they should not do it, would be a bit of a daft thing to do. In the big scheme of things, it is neither here nor there. In the context of the broad approach to monetary and fiscal policy, that particular measure of a 1% change is neither here nor there.

Ann Pettifor: My view of inflation is that it occurs when the economy is operating at full capacity. The economy is not operating at full capacity. It has had an external shock, which is freight, fuel and the market, which is crazy. In order to balance the books—and I have argued this for a long time—the Government just need to use public investment to ensure that incomes rise. What the nation lacks is income. When incomes rise, tax revenues rise. The best way of balancing the books is to increase employment and pay. That may sound wrong to members, but it really is the way to deal with the deficit. It is the way to balance the books. "Look after the employment", said Keynes, "and the budget will look after itself".

Because we do not do that and because we insist on keeping wages down while the 1% are doing very well—and the 1% do not spend; they save, or if they do spend, they waste it on useless products—there is a massive lack of purchasing power in the economy. That is then reflected in the Government's finances when they cannot collect the tax revenues that they need to balance the books.

Q339 **Kevin Hollinrake:** Is the timing of the increase in national insurance right or wrong?

Ann Pettifor: The timing is wrong. I agree with Jim that it does not mean very much, but it also just sends a signal when people are already feeling the pinch and are going to feel more pain, and you inflict even more.

Q340 **Kevin Hollinrake:** Roger, you are on the record as saying the timing is wrong. Is that right?

Roger Bootle: Yes. There are two issues. One is the general question of the speed with which we should seek to balance the books, and the other is the NICS measure. The Government are wrong on both counts.

The question of the speed with which you should seek to balance the books is not a science. It is a very difficult judgment call and I have a lot of sympathy with those charged with the job of doing it, because the numbers are terrifying, but there is an awful lot of nonsense talked about this. If I were charged with advising anyone thinking about this, the first thing I would do would be to get them to read the history books. I would then present them with a chart of the history of Government debt ratio in the United Kingdom.

A lot of people think that it is just appalling and that we are heading for disaster because the debt ratio is 100%. We have been there many times in our history. It was 250% at the end of the Second World War and disaster did not break out. Japan is at something like that level now. We have to be much more nuanced. It is a question of balancing. It is a judgment call. Do we need to proceed quite as fast as we seem to be doing? The answer is no, we do not.

Against that backdrop, what is the position with regard to national insurance contributions? In any case, we all know that it is a ridiculous tax in the first place. It is taxing jobs; it is one of the worst taxes around. If you are going to increase this ridiculous tax, why would you do it at a time when there is a) a cost of living crisis, and b) an inflationary danger? If the public finances were absolutely critically balanced on a knife edge and there was no other way of raising money, it might well be what you do. That is why I began by talking about there being, in my view, no overriding priority to pursue the balancing of books.

Q341 **Kevin Hollinrake:** It is a potential priority. Is there not some politics in this as well? If you want to spend a lot more money on the health system, for example, shouldn’t somebody pay for it?

Lord O’Neill of Gatley: I will bring it up now because I have hinted at it. The past 15 years have demonstrated that, in my view, most of what all of us would have been taught or would have learned from conventional textbooks on fiscal policy is not getting a lot of evidence from the real world. I have been so involved in big international health stuff, as you know from other discussions we have had. This is to do with global antimicrobial resistance. I am pretty aware that things that we have just gone through—and, hopefully, we are going through it—can happen and that this might just be a warm-up act.

Linked to something that is dear to Ann's heart especially, we are coming through another decade of very weak private sector investment spending across the west. This is quite a radical thing, but if we really want the economic model to be a bit like what we have all been trained to believe, we need to have a completely different framework to fiscal policy.

In my view, we need a much more sophisticated version of, dare I say it, Gordon Brown's golden rule, in which public sector investment spending is very publicly and credibly split from consumption or ongoing spending, because you are never going to be able to invest properly, which is the part of public spending that should create positive multipliers, if it is constantly being a subdivision or behind the queue of stuff that is popular, which is public consumption spending.

We bashed through all the conventional levels that the IMF said in 2008. Roger touched on Japan. I know some of these guys will know that the most famous hedge fund names on the planet have spent the best part trying to short Japanese bonds and guess what—they never got anywhere.

There needs to be a shift in the mindset, so that you get out of this rather odd situation—which Roger colourfully and, in my view, quite sensibly said about the national insurance charge. What is the purpose? Why is there such confidence that we need to get the deficit down to some number by whenever and the whole framework for it, and what is it achieving? Do we want to have something that is going to genuinely try to help lift the country's trend growth rates? If so, change the framework, so that you can at least give yourself a fighting chance. It is just as true on education.

Q342 **Kevin Hollinrake:** Are you arguing that investment spending should be a lot higher?

Lord O'Neill of Gatley: Yes, but you cannot do it unless you have a proper framework, because the financial markets will distrust you. The IMF or some big, bold G7 country such as us needs to use the evidence of the past 15 years to say, "Enough of this narrow way of thinking. We need to think differently".

Ann Pettifor: On this point, there is a great deal of unanimity on this table.

Q343 **Kevin Hollinrake:** Jagjit, you have a perspective that, if you had looser fiscal policy, you could have tighter monetary policy. Explain that to us.

Professor Chadha: It is not unrelated to the discussion we have just had. We adopted an approach to sound money a decade or so ago, which incorporated a set of fiscal rules and a fiscal council called the OBR to—you will remember the phrase—mark the Government's homework and report on whether the fiscal balance was heading towards zero at the end of a Parliament. We know that those fiscal rules have been changed nearly every year since then, because they have not been able to be hit.

What it has meant is that we have been constantly focusing on whether a particular budget balance would be hit, rather than asking the broader question of what we need for our economy.

In a sense, it has been mistaking the instrument of policy for the objective of policy. The objective of policy must be about creating the conditions for prosperity, broadly speaking, across the country. That means for anyone who is in a job to have a sufficiently good standard of living so that they can enjoy their lives in a sustainable way. Focusing on a budget balance that is set over a Parliament, which is never going to coincide with the economic cycle, leads to all kinds of errors in fiscal policy.

The budget balance does not distinguish between current expenditure or investment. It does not allow us to think hard about what level of investment we have. There is a question that is often asked—and it goes back to conditions on the golden rule that has already been mentioned, or the Maastricht criteria—as to whether 3% of public net investment is right number or not. It is not. It is a magical number.

It depends upon the state of the economy, the gaps that we have and the extent to which certain regions have been left behind and are behind others, and not only the extent of capital formation that is required but how we identify institutions and structures to deliver it on the ground on a consistent basis, year after year, decade after decade. These will be the questions we have to face.

We looked at some of the numbers before coming along today. Public investment in the UK over the last 40 years has been 1.5% on average. We have gone over 3% only once in that period. We do not have a system to understand the extent to which the public sector creates net worth in the economy, so we are constantly focusing on what I have called the budgetarian flows, which do not help us think about the broader economy.

Q344 **Kevin Hollinrake:** I am out of time but all four economists in this room all agree we should spend more money.

Ann Pettifor: Invest more.

Lord O'Neill of Gatley: On investments.

Kevin Hollinrake: Invest more money, yes.

Lord O'Neill of Gatley: That should scare the hell out of you.

Professor Chadha: Demand management per se is not the answer. It really has to be thought about very carefully and delivered on the ground in a consistent manner over the long run. It is not a question of turning on the taps in a mindless way. It may need a development bank or other structures in place.

Can I just make one very brief point on national insurance? I agree with everyone. There was no need to raise taxes. If you have an established monetary and fiscal settlement, one of the things that you can do is just tax smooth. You bring in taxes when you can later. One of the problems with the national insurance tax in the way that we have it is that it is ultimately a tax on jobs, as has been said. It reduces likely future productivity from those workers, and we have a real productivity problem in this country, so do not introduce a national insurance tax. It is not going to help us catch up the productivity losses we have made.

Kevin Hollinrake: There is politics in that as well.

Professor Chadha: I do not know about politics.

Roger Bootle: I want to comment very quickly on something that has not been mentioned so far. Ann was saying how she is a Keynesian, and she does not have a monopoly on that on this panel. We all are. I have always been a Keynesian. Over the years, I have also become noticeably more Austrian, by which I mean believing in what the long-term supply consequences are of measures when you are just fiddling around with demand.

We have been talking as if you can have a bit of monetary stimulus versus tighter fiscal policy, or the other way round, which is valid up to a point. What strikes me as being absolutely critical here is that we have had interest rates at near zero. That is bound to cause massive distortions in the economy and, in the long run, to inhibit productivity growth. It contributes to the survival of zombie firms and massively distorts asset markets.

One of the factors that policymakers should have in the back of their minds is, quite apart from tinkering with demand and trying to get that right, trying to get monetary policy back to something like a more normal level.

Q345 **Dame Angela Eagle:** Thank you very much for a fascinating discussion so far. I wanted to ask more explicitly about productivity, because clearly it is an ongoing problem. We are at a juncture, are we not, where we have to have an environmental transformation that will encompass a complete transformation in the way that energy is generated and delivered, in the way in which we do farming and in the way in which we use our transport systems?

What is the view of the panel, very briefly, on where we are at this juncture and whether we need a completely different approach to economic analysis in order to deal with what is, in essence, a fourth industrial revolution and the fact that we have to transform our economy, which is going to necessitate vast amounts of investment, some of which is going to be private sector but that may need to be at least guided and backed up by public investment? What is the view? It seems to me that tinkering around with a few skills on the margins is not really going to do the job here.

Ann Pettifor: Thank you for that really important question. We are in a position where we could be like a Government facing war or the possibility of invasion. This is a really urgent task and there is an enormous amount of work to do. It requires public investment, precisely because the private sector is so much of a mass, as Mariana Mazzucato argues.

When it comes to risk, the private sector demands to be de-risked—to have risk removed—so that it can be absolutely certain of either profits or capital gains. That is why it takes the roaring lion that is the state to invest in these big projects and, naturally, the private sector will benefit from that. In pretty much the same way as we have somehow found £92 billion to build HS2, the beneficiaries are mainly the private contractors that are doing the work, but it takes a Government to make that kind of commitment.

We need to do that in order to raise incomes, to balance the books and to improve productivity. On the point on productivity, I would like to quote Andy Haldane: "From 1950 to 1970, median global productivity growth averaged 1.9% per year. Since 1980, it has averaged 0.3% per year. Whatever is driving" it, he says, is global rather than local, and "this global productivity slowdown is clearly not a recent phenomenon". It is a long-term phenomenon. If we think of it as a recent phenomenon, we are not going to find a solution. I am taking us back to the economic model, which is the problem, and we need a new economic model to address this huge crisis that we face.

Q346 **Dame Angela Eagle:** The general view is that rising productivity is linked to rising wages. Do you want to say something, Lord O'Neill, about that as well as my earlier question?

Lord O'Neill of Gatley: As I touched on at the start, we could have had hours more on the previous question. This, in my view, is an even bigger and more important question, and we got a couple of soundbites. I will emphasise simplicity but it is not fair to the issue.

To deal with the climate change issue, which was the prime purpose of this question, is an enormous thing. Slightly controversially, I would like to answer by saying that, for a country with our peculiarities, it is one of many. As we have seen, not just here but around the world, if it becomes the main objective superficially, guess what? You run into issues such as a mammoth rise in energy prices, whereby, unless you are dealing with all the other issues at the same time, as we touched on a bit, you run into immediate problems.

It is a bit fashionable. What I am really trying to say is that it goes right back to the need for a much more substantive rethink as to what the purpose is of fiscal policy, particularly on investment. Unless we can do something about the shocking geographical and many other inequalities, there is absolutely no chance that the focus on climate change will succeed, because of the issues that today's life immediately mean for so many people, just a tiny bit of which we have seen in the past few months.

Q347 **Dame Angela Eagle:** Of course, the big structural issue, just to make this picture even more complex, is the ageing society that we are in.

Lord O'Neill of Gatley: Of course. There are many.

Q348 **Dame Angela Eagle:** Again, it seems to me almost like we have not done enough and, all of a sudden, every structural problem that we might have nightmares about has come over the horizon at breakneck speed and we do not have time left to sort it. What is the way through this?

Lord O'Neill of Gatley: I want to leave one thing on the table here because it is probably not seen by many or not fashionable. The much delayed levelling-up paper is one of the most important things I have seen coming out of a Government Department in a long time. I have joked in the media that it is like a PhD in what one would write on levelling up. It touches on the multitude of issues that are really relevant for the framework of monetary and fiscal policy.

Every Government going forward should probably be tested on the kind of things, as it looks superficially, where the same will be done each of year. You have to deal with all of these things. Just dealing with climate change has absolutely no chance of getting anywhere, unless we are more serious about some of these other issues at the same time, as difficult as it is. The framework for fiscal policy has to be thought of in that context, rather than, "I think we should have a deficit of 3.4% of GDP in another seven years". It is meaningless.

Q349 **Dame Angela Eagle:** Professor, do you have any thoughts on our productivity issues and what we might sensibly do in this complex structural situation of change that we find ourselves in?

Professor Chadha: It is clearly, as has already been hinted, the most important issue facing the country. The underpinning of prosperity in this country in the long run is productivity—how well we can turn the inputs into the economy into outputs. Just to list the issues that we have to address would, as has already been said, take the rest of this session and many more, but let us think about it.

Trade matters. It helps specialisation. It helps learning by doing. Trade has been affected in a problematic manner, let me just say, since 2016. I am choosing my words carefully. Foreign direct investment, and knowhow and expertise of people from overseas wanting to site their capital here and develop industries, as we saw in the 1980s, is a critical part of helping productivity.

There are different types of investment—physical, human and intangible—that we have to ensure flow around the country. Some of it will have positive spillovers from what the public sector does, but much of it will be dependent upon individuals and firms deciding to invest not only immediately but over the medium to long run.

In terms of the extent to which the financial sector is allocating capital around the country, we have, in many areas, a globally excellent financial sector for the rest of the world that can do a very good job of revolving capital that comes into London to the rest of the world, but how good is it at allocating capital around the country? This is not a new problem. The Macmillan gap has been around for a very long time, but it is something that I am not sure we are even addressing now.

The financial sector also asks the question of the zombie firm problem that was raised earlier. If we look at analyses of zombie firm fractions, the fraction of firms in an economy that are near bankruptcy, have low levels of productivity, are carrying too much debt and are not valued highly on stock markets was around 4% to 5% 30 years ago. It might be as high as 15% to 20% on some estimates that we are now seeing, so these firms are not investing. They are certainly not helping their staff to develop their human capital skills, because they are not quite sure whether they are going to be around. They are also more vulnerable. Those firms are more likely to go into bankruptcy or insolvency.

Then we are into the area of skills. How do we improve those skills at both a vocational and an academic level, and in terms of skills that we learn while we work, which are the most important of all, and get firms involved in that process?

If all of that is got right around the country, we can then build up the local agglomeration that we need as well. We cannot have just one part of the country that is globally excellent. That needs to be happening in many other parts of the country in order to retain high levels of human capital up there as well in other parts of the country and to create demand and good levels of jobs. That is a very short list.

Dame Angela Eagle: It is something to be going on with.

Professor Chadha: The counterpart of that long list is that it is long run. It has to be something that successive politicians commit themselves to trying to deliver, so that it becomes a focus of what we try to achieve as an objective at a national level. It cannot be just a hurried paper of some sort or other, or a slogan. Because it has taken 30 or 40 years to create these gaps, it will potentially take 30 or 40 years to offset them, so it cannot be just something that we are setting ourselves a target for the next Parliament or the next year. It really must infuse the national stage.

Q350 **Dame Angela Eagle:** Finally, I just want to bring Roger in to make some comments on all this. In particular, you talked about zombie firms earlier. Do you believe their size is 15% to 20%? I presume that increases in interest rates would bankrupt a lot of those firms quite quickly and you would get a lot of sudden turnover. How could the Government help to sort the outcome of that to make it less terrible for individuals?

Roger Bootle: I do not know what the absolute number is. It depends very much on how you define things, but the key principle is very clear. If you provide virtually free money, you are going to get a lot of it wasted. This is not rocket science. In the past, the credit rationing mechanism has worked reasonably well. Unfortunately, this has the downside that, if you put up interest rates when money has been so cheap, there are going to be quite a lot of firms that go to the wall, but that is part of the process through which you get to a better outcome, because you reallocate resources to other places.

If I could make a general comment on the point you were making about productivity, you are absolutely right. I want to emphasise that this has been a problem for Governments—and not just British Governments—since time immemorial. Even in so-called normal conditions, raising productivity growth is the holy grail and we never find it. To find it in these conditions, when, as you rightly say, we have enormous structural problems—we have the green challenge, ageing and heaven knows whatever else—is going to be very difficult.

We ought at least to try. There are some elements that we should focus on. We have talked an awful lot so far about public investment. I think that is right. We have underinvested in this country in public assets, not least because the Treasury has always focused on the deficit. It is easy, because there are no direct votes involved, to cut public investment. We have underinvested publicly.

Business investment has been too low, for a variety of reasons—incentives and others. People have commented on the skills level, and we have been very bad at bringing people along. The boost to apprenticeships that this Government have brought in is going in the right direction. Similarly, we need to reform the higher education system to make us produce more youngsters who are going to really thrive in high-productivity jobs.

I must say that I agree very much with what Jim O’Neill said about the potential importance of levelling up. I might be more sceptical about how it is going to be achieved as a result of what was in the White Paper, but he is absolutely right that, if this could be delivered, it alone would produce a massive boost to the productivity of the UK economy.

Q351 **Chair:** Ann, can I very quickly put to you this point about zombie companies? To what extent do you buy the argument that, if you have a tighter monetary policy, you shake out what Jagjit is saying is a large proportion of businesses here that are underperforming and are just being kept on life support through low interest rates? Is that, in and of itself, going to be good for productivity?

Lord O’Neill of Gatley: We will find out the answer, that is for sure.

Ann Pettifor: Productivity will improve with higher levels of investment and higher incomes. The demand side is really what is important.

Chair: That is fine. I was just interested in that specific point. You have made your point, and thank you very much for it.

Q352 **Julie Marson:** We have covered such a lot of ground and I want to go back to low interest rates. I am going to try to ask questions that have not been covered, because we have covered quite a lot of ground. Maybe I could start with Roger. We have had near-zero or very low interest rates. Can you see us getting back to pre-financial crisis levels in the foreseeable future?

Roger Bootle: I can see that as being possible. I very much think that we will not get back—I hope we will not—to the interest rates that prevailed in the 1970s and 1980s. Again, history is very revealing here. As with any of these phenomena, I look at the long historical charts. It is jumping out at you when you look at those charts that something went very badly wrong in the 1970s and early 1980s, so we can put that pretty much to one side.

In terms of pre-financial crisis levels, that is possible. It would take a few serious preconditions. Clearly, aggregate demand has to be strong. It has to be fairly resistant to interest rates going up. Confidence has to survive. We have to avoid the financial crash that is possible as interest rates go up.

All that said, the answer is yes. There was a very interesting book produced in the last two years by Professor Charles Goodhart and a colleague, *The Great Demographic Reversal*. It argues that the era of inherently very low inflation and very low interest rates has come to an end, essentially because of demographic factors. This was very interesting. The world is ageing and the labour force in China and elsewhere is falling, which has two implications.

First, it changes the balance of supply and demand in the labour market. It also changes the balance between saving and consumption, which has been so important. Rather than massive over-saving, it tends to flip it the other way. It is a very provocative book and is in danger, dare I say, of being vindicated.

Q353 **Julie Marson:** Is there consensus on the panel in that view?

Ann Pettifor: Low interest rates are a consequence of weak economic activity. They are not driving it but are responding. Central banks are responding to what is, first, a massive overhang of debt, both private and public, and secondly, very low demand. Companies need to be able to sell their products in order to pay their debts down. If you do not enable them to do that but put up interest rates, you will just bankrupt them and turn them into zombies. We need to get the economy going again before we think about raising rates.

Lord O'Neill of Gatley: I have a bit of a nuance. I agree with aspects of what my two colleagues have said there, but I go back to the spirit of what I keep coming back to. When I was just beginning to try to understand the weird world of economic theory, it argued somewhere in there that the so-called real rate of interest, generally speaking, should be somewhere pretty close to the trend real rate of growth. It has got lost in all sorts of weird modern-fangled stuff, including this era of inflation targeting at 2% and nothing else, and the experience of, for a significant part of it, undershooting it.

What the hell do I know about any of this stuff? At the end of the day, it is a social science, but if you stand away from it, it seems to be a bit nuts. There should be, I would have thought, some policy goal to get the real rate of interest back to something like the trend real rate of growth, unless it is negative in this country. As Roger said earlier, interest rates are at a ridiculous level. They are at levels that were relevant when we thought the world's financial system was going bust 13 years ago, and it really does not make a lot of sense.

I do not personally think it is because of weak demand. In fact, getting a bit technically geeky, one of the oddities about everything is that, for the last decade, the UK's average rate of growth was close to the trend rate, but it was completely because of massive labour force growth, despite zero productivity growth. That was completely different from what anybody would have thought in advance, but that is what happened. There has not been a particular weakness in demand. I would not waste time debating that with you. The framework is just weird.

Professor Chadha: We very much hope, on a secular basis, that interest rates will go back to what we think is normal, which is real interest rates of, as Jim has said, around the growth rate of GDP. If productivity rises, that could be around 2%, plus inflation of 4%, so rates could be going back into that 4% to 5% rate. It is not going to happen particularly quickly, and that goes back to the point that Roger was making at one level, and to another point that has not been discussed.

One of the reasons that we have seen a secular decline in real interest rates—the interest rate adjusted for inflation—is that, globally speaking, we have integrated global capital markets. The new entrants into the global capital markets—the Asian economies, the tigers—have had economies in which there has been a very high propensity to save. As the size of the global economy increases, the marginal person entering that market is someone who is a saver rather than a borrower. If you increase the pool of savers, what happens is that the supply curve of savings shifts to the right, and real interest rates fall. Broadly speaking, that is the process that we have seen over the last 30 years.

Then you might ask yourself, "Why have interest rates in the advanced economies fallen so much? Why has our demand for debt not increased those interest rates again?" It is partly because there is a shortage of less risky assets in the world. If people want to hold assets that have low risk, they tend to want to hold advanced economy bonds. What we also need to see is a counterpart to the issues about offsetting the tendency of these new countries to save, which is the development of domestic vehicles for saving in those economies themselves, so the money is not recycled into the advanced economies. That would then start to offset some of the decline in interest rates, because that capital would be held in those countries rather than coming over here.

The process I have just described is not something that is going to happen very quickly. The development of safe capital markets in which those people in those countries who are ageing want to invest domestically is certainly something that the IMF and the World Bank should be encouraged to do in order to help those markets develop, but it is not something that can happen very quickly. Again, it is something that is going to be a 10 or 15-year process, but if we can do that, we are going to see some of those real interest rates rise again. There are two parts to the story—not just the savers but the development as well of more vehicles for people to save in. When that happens, interest rates will start to rise.

Q354 **Julie Marson:** That is fascinating. Thank you. Just to think about another unexpected shock or another recession on the horizon, we talked about quantitative easing starting to unwind. We have low interest rates. How would we cope? Do we have policy levers and options to cope with another shock and a downturn again?

Professor Chadha: Absent the omicron version of the virus we have just lived through—and I am not an epidemiologist—it looks as though we are developing an ability to deal with this virus as we would any other coronavirus. Of course, anything I say, without wishing to introduce a pun into the proceedings, has a big health warning attached to it.

If we think that it is mostly behind us, and that we are going to go through a recovery phase, the question is how we manage that recovery and ensure that inflation is stabilised. That is a question for monetary policy to move as gradually as it can and contain that level of inflation, but also for fiscal policy to continue to provide the stimulus that it requires. We are not, at the moment, thinking about that leading to a recession.

You might then ask what might the causes of a recession be and what are the things that keep economists up at night worrying about a recession. There is the standard set of issues that we would be worried about: a further increase in energy prices that might result from political uncertainty; a world in which monetary policy tightens too quickly might well propel demand into a tailspin and lead to a recession. In that world, if we were there, do we have the instruments to deal with it? In a sense, can we still access capital markets as a Government? Can the fiscal authorities still borrow if they need to? The answer is yes. Can monetary policy do more if it needs to? Certainly, if rates have, by that time, gone up to 1.5% or more, there will be the opportunity to cut interest rates, were a negative shock to manifest itself and require policy levers to be pulled. I do not think that that is the biggest concern for us at the moment.

Lord O'Neill of Gatley: I have three very quick comments. As night follows day, it is going to happen. The notion that there will not be another recession is just for the birds. It is going to happen at some point.

Secondly, your question reminds me, weirdly, of one of the funniest things I ever heard Larry Summers say, which was at Mervyn King's leaving do. The only time you need central bankers is when they have absolutely no training whatsoever to deal with what is going on. That is, you really need something a bit out of the box when the trouble comes out of nowhere. They will have to find something, depending on when it happens. Whether it is conventional or not, time will tell.

The third, slightly more repeated but serious issue is this: let us say that this recession is not tomorrow, that is why we need to have a much more sophisticated, adapted framework for monetary and fiscal policy, so that what policymakers have to do when they do it will not seem so weird, because they will not be thinking about it in such narrow conventional terms as we have all become accustomed to.

Ann Pettifor: We are due another financial crisis, mainly because of the levels of debt, which were $83 trillion back in 2000 and have risen to $295 trillion by 2021, which is nearly double the pace of world GDP growth—in other words, double the growth of income for dealing with that debt. As someone who wrote a book called *The Coming First World Debt Crisis* in 2006, I am particularly conscious of how an overhang of debt can be perturbed or destabilised by a rise in rates. The imbalances are so grave and, it seems to me, central bankers so blissfully unaware of, or blissfully unwilling to correct, those imbalances that constrain them, that we are going to have a financial crisis. I am not at all sure what the Bank will do, but, like Jagjit, I agree that the Bank still has capacity to deal with it.

Q355 **Julie Marson:** To an extent, you are saying that we have become dependent on low interest rates in that sense.

Ann Pettifor: And dependent on debt for getting a roof over our heads or for dealing with the low levels of tax revenues that Governments are collecting. It is that dependence that has to be ended.

Roger Bootle: A recession is going to happen at some point or other, although, again, a look at history does not necessarily bring you to the conclusion that it is bound to happen very soon. It is very striking that, after the Second World War, we went for very nearly 30 years without a major recession. They were extraordinary circumstances, admittedly, but it was not really until the first oil crisis and the aspects of all that hit that we got blown out of the water. We have had several major events since that have come really rather too frequently. At some stage, something will happen. That is the sense in which I have a lot of sympathy for those people who want to get the debt ratio lower in order to be able to let it rise subsequently, but it is a judgment call.

We will have the scope to let the debt ratio rise again. I mentioned the figures before as running roughly at 100 now, and it is going to peak pretty much now, if not very soon. Assuming that a recession does not come immediately, we are then in a position to let it rise above 100. I quoted the historical figures on the Japanese position.

I would rather incline towards that approach than I would towards a massive renewal of QE. QE is a big subject to be embarking on, but my feeling about QE is that it is absolutely the right thing to do in the teeth of a financial crisis. Particularly when you are facing huge liquidity problems in the financial markets, to pump in liquidity the way the banks did was the right thing to do, but I was never fully convinced about using it as a policy willy-nilly to boost demand.

In particular, it has a way of boosting asset prices rather than normally going directly into people's pockets, and we have paid quite a heavy price in terms of inequality and various other distortions for what I suspect is not that large a boost to demand from that particular policy of QE.

If we were in these unfortunate conditions again, although I would want to relieve whatever liquidity crises were in the market, my preferred response would not be to say, "Let us revive the QE programme and inject umpteen squillions".

Julie Marson: One of my colleagues might be talking about quantitative easing next, so you may have led very nicely into the next section.

Q356 **Gareth Davies:** I want to focus on monetary policy, because there have been a number of comments so far about the tools and targets of the Bank of England. Lord O'Neill, let me start with you. You have been an advocate of giving the Bank of England a nominal GDP target. Can you just set out the case for that for us?

Lord O'Neill of Gatley: It links to aspects of what I have said. I have come through it over a long time, slightly by default, but it is also with a bit of realpolitik in mind and some of the issues about the superficially high levels of debt to GDP, at least for our lifetime, but more the real world circumstances of what we want from our fiscal and monetary policy.

We already see central bankers developing views about inequality, issues about climate and the tools, et cetera. As I touched on, on that one specifically, it cannot be a prime goal because it will cause conflicts with others. The crucial thing as to why I have become an advocate is that, because of the power of technology and the advent of its role in data accuracy and usefulness, I do not know people who do it but you could probably have a daily GDP estimate, if you tried hard enough.

Certainly in the days when I was presiding over a bunch of people doing this stuff for me in my endless years of doing this sort of thing, we thought we had one of the most useful monthly indicators of nominal activity in 70 countries in the world. One of the historical criticisms against nominal GDP targeting is that you are targeting something where you would not know what it was until two years after. It was even worse than the time lag on inflation targeting. That has absolutely gone out of the window.

In my view, it would give a better framework for the purposes of monetary policy, including why you are trying to control inflation. As has crept out a bit in some of the discussion already, 2% for the sake of 2% probably led to ridiculous things going on with QE, because the poor old Bank had no other tool at its disposal to try to do it. It is not its fault, in a way. It probably did not raise it; I do not know. That is my core rationale.

There are issues about the number that you would choose and all the rest of it, but it just seems to me that the time has come in this country—Sam Brittan probably being one of the very first advocates of it 40 years ago—for it to indeed be the framework for monetary policy.

Q357 **Gareth Davies:** Thank you for that explanation. In the earlier comments, you said that the inflation target was outdated. Professor, you have advocated for the inflation target to be expanded and raised to 4%, I understand.

Professor Chadha: I do not think I have. I edited a volume in which one of the papers discussed the case for going up to 4%. I do not agree with increasing to 4%.

Q358 **Gareth Davies:** Do you agree with Lord O'Neill? What would you do to the target?

Professor Chadha: I am rather nervous of disagreeing with him, given that I am sitting to his left, but I will disagree with him. Nominal GDP is, of course, the sum of real GDP—the real quantity of goods and services we produce in any year—plus approximately their price level, which is the GDP deflator. Real GDP—that real activity that we have in the economy—is, in the long run, outside of the control of the Bank of England. Through interest rates and monetary control, the Bank of England can control the price level inflation but not real activity.

Going down the route of nominal GDP throws you open to errors that will be caused by things that are outside of your control—real GDP. The clear advantage of an inflation target is that the change in the price level is within the control of the Bank of England. We have hit the target for 25 years, so it clearly is within the control of the Bank of England in the medium run. There will always be shocks that come along on a high-frequency basis, which may mean that the inflation target may not be hit in the short run. The Bank of England's remit is to try to hit that inflation target over its policy cycle, which is what it has tended to do.

If we start to concern ourselves with objectives that are outside the Bank of England's control, such as real GDP, climate change or other issues, we are going to lead to the trade-offs that would make price stability more difficulty to obtain, because we would be asking the Bank of England the question every time, "Do I try to hit price stability without leading to too much output volatility, or do I trade this off against something else?" That is really not what the central bank should be about.

If I could just finish on a point about price stability per se, it is something that people can plan around and understand. It is not clear that everyone understands inflation, but they understand the extent to which prices change in the shops. We had that excellent debate last week, where people were saying, "What is my inflation rate if I am buying particular goods?" People understand that very well, so they can also understand if that is getting out of control and they can ask questions for it to be stabilised. When we get to nominal GDP, it is going to be much harder for people to understand. If we go down the route of high-frequency interventions, that is not the way the central bank should be working.

I have one final point on changing the target. I firmly believe that a 2% inflation target is consistent, broadly speaking, with price stability, so people can plan over the long run. At 2% inflation in a 25-year period, the price level will rise by around 65%, so it is going to be small enough not to matter. If we go to 4% or 5% inflation, the price level over that period would rise by something like 165% or 240%. These are not numbers that are consistent with price stability, which have all kinds of impacts on contracting, planning and people thinking about what they are going to do over the long run, which materially affects investment.

What we have been talking very much about today is that this is a country that underinvests. If we make it incredibly hard for people to understand what their real return will be from investment, I am afraid that that would affect the investment part as well.

Ann Pettifor: I do not think that the Bank should have those as targets. The targets should be prosperity and full employment. That is going to generate the tax revenues and the income that the private sector needs. For me, it is about whether the central bank can work in co-ordinating monetary and fiscal policy. This obsession with monetary dominance has to end, it seems to me, if we are going to have any hope of recovery.

Q359 **Gareth Davies:** Are there other countries' central banks that adopt the same approach that you are advocating?

Ann Pettifor: Are there other countries that do that?

Q360 **Gareth Davies:** Other central banks around the world that you would like the Bank of England to move to.

Ann Pettifor: One of the reasons why we had the prosperity that Roger spoke of between 1945 and 1971 was precisely because that happened. I do not know of central banks that are doing this—perhaps Japan. Certainly in the case of President Biden's programme, it is beginning to happen there. Biden is arguing that wealth is all very well, but work is just as important. We have seen a massive investment in what that means for the American economy, which is doing really well.

Lord O'Neill of Gatley: Arguably, the Federal Reserve Board has a nominal GDP target. It just does not say that that is what it is. It has a mandate about employment as well as inflation.

Q361 **Gareth Davies:** It also has an averaging of inflation.

Lord O'Neill of Gatley: That is a very recent new twist.

Q362 **Gareth Davies:** What do you think of that?

Lord O'Neill of Gatley: As I said earlier, because it has not been very well defined by them, it sowed the seeds of the beginning of the first significant increase in financial market volatility that we have seen for many years. That is part of the problem in the markets right now, because people do not have a clue what the Fed really means.

Professor Chadha: On average inflation targeting, the problem is that, even though, over the very long run, you might think it will deliver the same kind of price stability I have talked about with the inflation target, central banks will, if they adopt an average inflation target, be faced with a very difficult dilemma.

If we have, as we have just had or are living through, a supply shock that leads to inflation overshooting for a short period, the central bank would then have to undershoot inflation for a prolonged period in order to hit its average inflation target. We would have a world in which a central bank, even though the economy has gone back to its previous inflation rate of, say, 2%, would then have to bring about a recession in order to hit its average inflation target.

In the long run, that would severely damage support for price stability, if that were the case. That is why average inflation targeting is not a great innovation compared to what we might call flexible inflation targeting, which is what we have in the UK.

Roger Bootle: I must say that I cannot get worked up about nominal GDP targeting. You may be right, Jim, but it seems to me to be a second or third-order question. I very much agree with what Jagjit said about the public understanding inflation but not understanding nominal GDP, which is very important.

What I wanted to comment on was the broader question behind the questioner's comments about whether the inflation target is fit for purpose or whether it has had its day. Again, one has to understand this historically. Why did we end up with inflation targeting? We did that, surely, because of the high rates of inflation in the 1970s and early 1980s, and the failure of crude monetary targets. That is why we ended up with inflation targets. Have they been pretty good? On the whole, they have.

The major problem, it seems to me, is the age-old difficulty of balancing rules against the need for discretion. You need rules. They provide you with restraints and give you credibility but there are times when you have to be flexible and push the rules to one side. The operation of monetary policy during the era of inflation targeting has been deficient, primarily not because of getting the wrong addition between the apples and pears of real GDP and price inflation. The real problem has been how to deal with asset prices.

We had a period, did we not, before the financial crisis when all the central banks were targeting inflation and went, "Jolly well. Everything is fine, thank you very much", partly due to the influence of China and globalisation. Meanwhile, there was a massive asset bubble building and they were not equipped or incentivised to deal with it. It seems to me that you could have framed the inflation targeting regime more flexibly and in such a way that they would have taken that into account.

Since then, the practice of central banking has adapted quite a lot. They are much more flexible than they were, but I would rather the evolution towards a system where it was understood that, if the pursuit of price stability—i.e. 2% inflation, pure and simple—gave you asset bubbles, central banks would react.

Q363 **Harriett Baldwin:** Thank you, panel. It is terrific to hear you all vigorously agreeing with things that many of us on this Committee have been warning about for a while: that, if you combine a lot of fiscal stimulus, monetary stimulus and quantitative easing, you end up with inflation that no one wants.

We have talked a lot about quantitative easing already, but I wanted to probe a bit further on that and to link it to a theme in our report around productivity. It is the only way that we are going to solve where we have got to, and we need to look ahead, see how we can move on from the monetary, fiscal and quantitative easing stimulus, and try to find our way through to a higher-productivity economy. Can I ask all of you if you disagree with the approach that monetary policy is taking currently on quantitative easing? If you do disagree, how would you approach it differently?

Lord O'Neill of Gatley: My answer would be to reiterate aspects of what I said. Because of being a victim of how they have been given the mandate and approach, we are in a position where they are trying to climb up with their hands tied. We need to change it.

Q364 **Harriett Baldwin:** I would like to understand how. What would you do differently from what they are proposing by letting things mature?

Lord O'Neill of Gatley: I like how Roger framed his opposition to my nominal GDP thing in many ways. They should forget about some of the issues of why they are being so sensitive. It might be a problem with the Chancellor, given the narrowness of the remit, but they should try to get some notion of interest rates back to a sensible level and to stop thinking about all these QE things.

Q365 **Harriett Baldwin:** What is a sensible level for interest rates today?

Lord O'Neill of Gatley: Let us assume that the trend rate of growth is somewhere between 1% and 2%. Aspects of my mind feel it could be higher than is currently conventionally thought—i.e. closer to 2%. If nominal GDP targeting under that was still an inflation target of around 2%, for the reasons that you have said, that means that they should be thinking of a goal of short rates of 4% and constraining their minds by all these things have become so much of a fashion.

Q366 **Harriett Baldwin:** Would you put rates to 4% this year?

Lord O'Neill of Gatley: Not this year. That is what they need to have in their head to get back to normality. The dilemma is that, if we have the same broad approach to fiscal policy, there will be some pretty horrific consequences of that being the only thing that becomes new, if we still have fiscal policy constrained by something about how we have to have a deficit at whatever number it is you want to dream up.

Q367 **Harriett Baldwin:** How much would it cost fiscal policy if you had rates at 4%? The knock-on impact through all of this in terms of interest rates and the deficit is that there would be a lot less to spend.

Lord O'Neill of Gatley: There would be a transitional hit because of the reasons of the debt servicing, but we cannot undo what has happened and we have to get out of this almost jail-like prisoner of circumstances and try to do something to ensure that the trend rate of growth might not keep falling.

Q368 **Harriett Baldwin:** So the No. 1 thing that you would do to improve productivity going forward would be to set interest rates on a trajectory to 4%.

Lord O'Neill of Gatley: No, it would not. That would be for another hearing. We need to have mammoth devolution that this White Paper just began to touch on for the first time in six years. Stop this nonsense of thinking that people in Whitehall know what the skills need is in Barrow versus Bournemouth. It is ridiculous.

Q369 **Harriett Baldwin:** Getting back to quantitative easing, professor, how would you answer my question?

Professor Chadha: It is very interesting participating in this today, and thank you for inviting me along. We have had a lot of discussion on monetary policy and arguably not enough about fiscal policy. That reflects the weight that we put on monetary policy to manage demand in the country, and we need to move away from that. How would we do that? The QE programme has gone on too long and is too large.

Q370 **Harriett Baldwin:** Would you take a different approach to the monetary policy currently proposed?

Professor Chadha: There are a number of things to think about. The way to think about monetary policy and many things is to think about where you want to be in the long run, work out what your long-run objective is, and then work back to your next step. What I am trying to say is that our long-run objective must be to shrink the size of the asset purchase facility, which is 30% of GDP or more at the moment. It should be coming down in the medium term to 5% or less.

Within that, as I already hinted at, there is an enormous maturity mismatch in the asset purchase facility. Its liabilities are overnight reserves, which are subject to any change in bank rate that we have just discussed. Its assets are these long-term bonds that it is holding. That means that, as interest rates start to climb up, the rate of return on bonds is not going to go up to the same extent. Over time, this is going to lead to a cashflow that is negative rather than positive.

Harriett Baldwin: It is going to be horrible.

Professor Chadha: It is a very difficult situation.

Lord O'Neill of Gatley: We just live with it forever.

Q371 **Harriett Baldwin:** Do we just live with it?

Professor Chadha: No, we do not have to live with it. There is a process by which you could take the reserves that commercial banks are currently holding and swap those for longer-term assets—three-month paper or other types—to reduce the sensitivity of that portfolio to changes. You could also start to swap some of the bonds held by the asset purchase facility for shorter-term paper to reduce the maturity mismatch.

Q372 **Harriett Baldwin:** The bottom line is that you would run off the quantitative easing total much more quickly, it sounds like.

Professor Chadha: You would want to think about some debt management operations to reduce its sensitivity to interest rate changes, so that it does not look in any way as though monetary policy decisions are trading off an issue about bond market volatility with price stability. That is really important. That needs to involve the debt management authorities and the Treasury in managing that process. How quickly you do it really depends upon the appetite in the debt markets, which have been affected by not having to carry risk for 10 years or so. We have heard already that any hints that the bull market in bonds is about to end has led to an incredible amount of skittishness in bond markets, which worry about the losses they may face. You might want to run it off more quickly but it might not be possible, because the structures that we now have reflect the policies that have gone for the last 12 years or so.

Q373 **Harriett Baldwin:** I do appreciate how challenging all this is. I am just asking you, as experts, what you would do differently in terms of quantitative easing specifically.

Ann Pettifor: The decision at the time of the great financial crisis to move to a system of monetary dominance and to allow the monetary authorities to address the crisis through the provision of QE has meant that we are now suffering asset price inflation. I am always struck by the fact that Committees like this are obsessed by consumer price inflation.

Q374 **Harriett Baldwin:** I know where we are. I am really asking what you would do from here.

Ann Pettifor: I want to add another dimension, which is that the rise in asset prices has led to a leveraging of additional borrowing. All that borrowing is leveraged against these inflated asset prices. The central banks really have a tough thing to manage here, because there is this massive amount of debt leveraged against assets, so they cannot devalue those assets very quickly.

Q375 **Harriett Baldwin:** How would you do it differently from what is being proposed?

Ann Pettifor: I have some sympathy, although I am very much against QE. The way in which to manage that is to manage the deleveraging and to think about the need to manage the deleveraging. At the moment, central banks leave the deleveraging of that debt to financial markets, and markets are messing about with that. They are not going to do it. It requires intervention to manage that overhang of debt, which, in turn, will lower asset prices and mean that it will be possible to invest more. The central bank will then be able to begin to think about raising interest rates, but we do not begin at this end stage. We deal with what QE has done.

Q376 **Harriett Baldwin:** I am sorry to keep on pressing you, but what would your intervention be?

Ann Pettifor: My intervention would be to begin to take action in dealing with the deleveraging of the massive amount of private debt that there is.

Q377 **Harriett Baldwin:** What would that action be?

Ann Pettifor: It is quite hard to do because the world is currently constructed in such a way that it is beyond the reach of central banks. These are global capital markets that are beyond our reach. One of the tasks for Government policy, it seems to me, is to begin to bring those markets back into regulatory domains. They are beyond the reach of regulation at the moment. I am quite pessimistic about the outlook, precisely because I do not have an answer to your question.

Q378 **Harriett Baldwin:** Even if you were in charge of the world, what I have not been able to hear is what you would do differently. Roger, do you have any ideas of what you would do differently from what the current position of the Monetary Policy Committee is on quantitative easing?

Roger Bootle: First, my prejudice would be in favour of going more quickly in unwinding QE. The most important that I would have to make is that this is a prime area where rules and targets can get you into all sorts of different territory. We have never faced this sort of task before on this scale, and so we simply do not know how it is all going to go down. I would be aiming to go more quickly but I would be prepared to backpedal if the consequences were very serious. We just do not know.

On those consequences, just having weakness of asset markets—and this, to some extent, ties in with what Ann has been saying—is not enough of a reason to backpedal. Given that they have been massively stimulated by QE and other things, if the result of this is higher bond yields and that has an impact on equity prices, so be it. It seems to me to be perfectly reasonable and what we should expect, but we do not want a financial meltdown. That is a very difficult balance to strike, but my prejudice would be in favour of going more quickly.

The second thing I would say is that we heard earlier from Jagjit about the problem with regard to the cashflow on the Bank of England's balance sheet. As he said, the Bank pays bank rate on the reserves that back up its holdings of bonds. As interest rates go up, of course, the rate that it pays out goes up. This is not bound to be the case, and one of the things that needs to be discussed is whether these reserves should be remunerated at all. They did not use to be. For as long as I can remember, until comparatively recently, bank reserves at the Bank of England always received zero, and we are not alone in that.

If we went back to that policy, there would be consequences, because, implicitly, it would be a form of tax on the banking system in order to benefit the state of the public finances. We have to tread carefully, but there are things you can do to ease this. It strikes me as very odd that we have just fallen automatically to this assumption that we reward the banks with bank rate on these reserves.

Q379 **Anthony Browne:** I am not going to ask about quantitative easing or inflation but about the level of national debt and taxation. This was briefly touched on earlier, but I just want to drill down on it. As you will all know, the level of public debt has reached 85% of GDP since the pandemic—by some measures, 100% of GDP, excluding the Bank of England. This is the highest level since the 1960s. The level of taxation after the measures in the last Budget come in will give us the highest level of taxation since the 1940s, at 36% of GDP. We seem to have drifted into becoming a high-debt, high-tax country.

How sustainable is this high level of debt? Is there evidence that it is a drag on economic growth or is it just something that we really should not worry about at all? I want to come to Roger first, because you touched on this briefly, saying that you did not think it was that much of a problem, if I understood your answer rightly.

Roger Bootle: It is not ideal. We would not want to be aiming at that position. A lot of people get overly worked up about it, because they do not understand the difference between the public sector and the position of an individual household—these things are really very different—and nor do they understand the history in their own country and the evidence from others.

I would not want to focus on a particular absolute level. There was a book produced a few years ago by two American economists that suggested that the key level above which you got all sorts of problems with public debt was 90%.

Lord O'Neill of Gatley: Reinhart-Rogoff.

Roger Bootle: That is right—Reinhart and Rogoff. Quite apart from the fact that it subsequently turned out that they had made lots of errors in their various computations, the thing that always struck me as very odd conceptually was that there should be some one level above which problems began. It all depends on the context.

A country that has reasonably strong growth prospects, which partly depends upon demographics, should be able to sustain a higher debt ratio than one that does not. Similarly, a country with a history of not having defaulted, which is our position, and fully functioning financial markets should be able to get through the situation a lot more easily than a country that has a history of default and/or not fully functioning financial markets.

Against that backdrop, that is what I meant when I said that the balance had perhaps gone too far the other way, but do not get me wrong that I would not want the debt ratio to be lower in the long run; I would, but that comes at a cost. In this case, it may come at the cost of higher national insurance contributions, and I would make the judgment somewhat differently.

Q380 **Anthony Browne:** It may not be a drag on growth at the moment, but is it not riskier? Each 1% increase in interest rates is £23 billion in interest payments by the Government. Is it not quite a high-risk game having this high level of debt?

Roger Bootle: Yes, it is risky. As I said before, we would be better off if we did not have that particular issue, but there is no such thing as a free lunch in this subject. You have to balance these different considerations. A lot of discussion of this misconceives the nature of the debt and the dangers that it poses. As and when interest rates go up and/or the debt goes up, and the debt interest burden goes up, a lot of discussion seems to assume that this debt interest disappears into the ether and is gone. No one who we are remotely concerned about receives it. In fact, of course, it is received by other citizens. Broadly speaking, apart from the fact that some of the debt is held externally—put that to one side—it is a distributional question. It is about the fact that some debtholders somewhere are better off at the expense of taxpayers, who have to fork out for it. That is an adverse situation in general, but it is not quite the disaster that people imagine.

Q381 **Anthony Browne:** Ann, when do you think we should worry about the level of national debt? Are you quite comfortable with where it is?

Ann Pettifor: I do not think that we should worry about it. What we should be worrying about is the economy, the fact that the economy is unbalanced and that we lack prosperity. We have not fully recovered. I am against tax rises but in favour of increasing tax revenues. The best way to increase tax revenues to bring down the debt is by creating well-paid, skilled employment and higher investment. Until we see that as the real problem, we are not going to able to deal with the Government debt.

Q382 **Anthony Browne:** That is inevitably true. Higher economic growth leads to higher tax returns. There is not a limit at which you are worried about the level of public debt.

Ann Pettifor: The worry is what is happening to the real economy and the fact that we are so ideologically focused on the Government debt. It seems to me that that is an ideological concern. It is about the state not being allowed to do certain things, but the fact is that, rationally, the really important thing is the state of the economy, both private and public. At the moment, that is the problem that we refuse to address. We are refusing to raise the quality of the economy and the income generated by the economy, which is why we have a deficit and high levels of debt. I am not in favour of high levels of debt, but you only bring them down by addressing the economy.

Lord O'Neill of Gatley: I have a huge amount of sympathy with what both have just said. I would frame mine in the following context: if debt went to 100% of GDP next year as a consequence of us having a proper structural approach to raising education spending, so that we do not have the severe number of people who cannot do what they should do out of our primary and secondary schools, and we have proper preventive healthcare spending, and we fund the devolution that makes us more normal like any other OECD country, I would positively welcome it. We do it as a consequence of this never-ending morass of just rolling in from one year to another. It is exceptionally worrying.

Q383 **Anthony Browne:** Just coming back to a point you made earlier but phrased in a different way, if you invested the money in productive activity—

Lord O'Neill of Gatley: What is different between 85% and 100%, if it is being done for some constructive purpose?

Professor Chadha: I would not worry about debt-to-GDP numbers providing we continue to have a credible monetary/fiscal framework. A credible monetary framework keeps down inflation expectations and the nominal cost of debt issued. A credible fiscal framework, however we define it, is also saying that, in the long run, the Government will raise sufficient revenues to service their debt. It is more important that we have those two things in place than worrying about a particular level of debt to GDP.

You mentioned the impact of changing interest rates on debt service ratios. These numbers are bandied around all over the place in terms of flow income. If you have 100% of GDP and there is a 1% increase in interest service, you are talking about £23 billion to £25 billion. These are the flow numbers, but what matters is to throw in the denominator as well.

What does that do to the payments relative to output in the economy? Debt service costs at the moment are very low historically, even though the level of debt is high. That is, of course, because interest rates are low, but also because we had debt padded across a very long maturity spectrum, which means that changes in interest rates even in the short run do not affect the whole of our debt service structures. It is ultimately very long run.

The issue about a particular shock on interest rates does not particularly matter, as long as debt service ratios are not problematic, which ultimately depends on our ability to raise tax revenues. What really matters over the long run is that it must be right to bring down levels of public debt at the right time. We have done it in the past, as Roger was hinting at, after the Napoleonic wars and after World War I and World War II, without a default and without a credit event. That is a remarkable achievement and says something about the reputation of the UK. That is done in the following way: it is typically done through nominal GDP growth, because that is the denominator.

Anthony Browne: That is the point that Ann was making.

Professor Chadha: Ten years of nominal GDP growth at 5% alongside a balanced budget, when it is right, would reduce debt by 60 percentage points. That is what it would do.

Anthony Browne: This is what happened in the ’60s, basically.

Professor Chadha: It is not something to worry about immediately, providing the frameworks that we have are in place and credible.

Q384 **Anthony Browne:** You do not think that the level of debt in itself is a drag on growth.

Professor Chadha: There is no sense at the moment that people are unwilling to hold UK debt on the margin in their portfolios.

Q385 **Anthony Browne:** The second point of my question is on taxation. There is a relationship to debt. After the last Budget, as I said, taxation is going to go up to 36% of GDP, which is the highest since the late 1940s, which I find quite extraordinary. Is the level of taxation a concern? Does that become a drag on growth and economic activity?

Professor Chadha: I will keep my answer relatively brief. Taxes on investment or labour are ones that, if they go beyond a certain level, are problematic for future GDP growth, because they affect productivity and the extent to which firms want to lay down investment or people want to invest in skills.

One might argue that the shock that we have just had started in 2008-09 as a reflection of an unbalanced economy and one that focused a little too much on the financial sector and had not built up the regions in the way that we might have wanted. We might throw in the impact of leaving the European Union, which is a specific shock to the trade sector of the economy, at least until we have trade deals in place—of course, they may see me out before we have all these trade deals in place. Covid has exposed vulnerabilities and a lack of resilience in many regions and devolved nations, which has caused some problems.

We then have to think very hard about some taxes that maybe lead to a more equitable set of outcomes. One thing that we have been able to observe in the last few years is increasing wealth inequality and increasing income inequality, so it might well be the case that we have to think about taxes to address that, where we can, to make sure that the pain is spread across the country. We have lived through some very difficult times in the last decade or so. There is a sense in which taxes to offset that may be very sensible.

Q386 **Anthony Browne:** So you are not that concerned about that overall level of taxation but more about what it is on and the distribution of it.

Professor Chadha: Redistribution and creating opportunities for people throughout the country.

Q387 **Anthony Browne:** Is it a concern that taxation is 36% of GDP and the highest since the 1940s?

Lord O'Neill of Gatley: I do not know. It is certainly very interesting. Most international economists in the past 20 years would think that the bigger population economies need to become more Scandinavian in terms of higher levels of wealth that is more equally shared. If higher tax is part of a journey to deliver that, so be it. I have that inkling. Linked to what Jagjit said, it is about smarter taxation rather than more. I will throw in an odd one here that people are often a bit surprised to hear me say. Again, it goes back to what is on the tin of economic theory and what happens. In terms of this persistent notion that lowering corporate taxes boosts corporate investment, there has not been a lot of evidence of that for the past 25 years.

Q388 **Anthony Browne:** You were Treasury Minister when that was happening.

Lord O'Neill of Gatley: I tried to oppose it because of the evidence of that being the case. It allows for much more sophisticated balance sheet management but it is not really encouraging more risk-taking from the boards of companies to invest. Within it, they need a much smarter approach to differentiating between dividends and share buybacks and things like this. Conventional thinking has become so out of date and is owned by, "We cannot have any changes to that". It is not resulting in productive investment, but in spectacularly successful balance sheet management. I am not sure that that does much, other than for a narrow group of society.

Q389 **Anthony Browne:** Ann, you said in an earlier answer that you are not in favour of higher taxes in general. What about the level of taxation in the economy as a whole?

Ann Pettifor: The level of taxation is a symptom of the weakness of the economy, just as low interest rates are. I very much agree with what Jim has just been saying. I am repeating myself and you know very well what I am trying to say, which is that we need to increase investment in employment. The problem with the fact that the private sector is so risk-averse is that it has very good reason to be risk-averse. This is a very unstable world that we live in. Investing in speculative activity is far more profitable than investing over a long period in sound, productive activity.

Capital markets are aiming at speculative activity, so we see that they are really not interested any more in investing in the real economy. That is our problem, and that requires the Government and the public sector to intervene and to do that kind of investment. For capital markets, it is far more profitable to gamble out there on whether interest rates are going to rise a bit there or fall a bit there in whichever market they may be addressing. It is that framework, back at the economic model, that makes it so hard to keep taxation as a share of GDP low.

Q390 **Anthony Browne:** Roger, should we be worried about taxation of 36%?

Roger Bootle: The short answer is yes. This is the first significant disagreement on this panel. I may be a Keynesian but I am also a conservative with a small "c". There is a problem, first of all because the state does not, by and large, spend money very well. It is very difficult to get convincing international academic evidence on this, and there is lots of conflicting stuff. Most of it is very ideological. In the stuff I read, someone on the right produces a series of supposed bits of evidence suggesting that high taxation inhibits economic growth. I am never convinced by it. The other side says exactly the opposite.

Part of the problem is that it depends on the nature of the country. There might well be some countries where public spending is managed extremely well and where the type of expenditure, whether there are decent returns on productivity, happens to fall naturally in the public sector, in which case fair enough. It is not always the case that low taxes and low Government spending are a good thing. I just do not think that we are such a country.

The public sector, by and large—I am on very dangerous ground now if I want to get out of the Palace of Westminster alive—operates very badly and extremely inefficiently. In order for it to deliver economically, it has to be put under pressure. It has to be trimmed and pressurised with targets and cuts; otherwise, you end up with a situation where a large part of the economy is operated very inefficiently and you have the private sector not being able to benefit to the extent that it could.

Secondly, I agree with what people have said about smart taxation and the structure of taxation. Over and above that point about the efficiency of spending, there is the question of the effect on incentives. At these sorts of levels, the disincentive effects are very strong and apply at all levels, other than at the very lowest levels, where the last few Governments have done a good job of taking people out of tax, which has done a lot of benefit to improving the relative position of people lower down the income scale.

Other than that, ordinary income-earners face what I think is a ridiculously high level of taxation. At the top, it is bonkers. It has serious adverse effects on the ability of this country to compete. If we tax people at these very high levels, we are not going to be able to retain them. This conjures up images of the past—the brain drain and such like. We should not be in a position where, because of Government action, we risk losing lots of talented people to our competitors.

Anthony Browne: As somebody who is an economic liberal, it is nice to hear someone making a case for lower taxes. I agree with you about the higher marginal rates. I was paying marginal rates of tax of over 70% before I became an MP. I can tell you how that happened.

Q391 **Chair:** It has been a very interesting discussion. There has been a lot of what I would say are fairly unorthodox or radical thoughts going across the panel, and also a lot of consensus, which is quite interesting. If we look at the fiscal targets that the Chancellor has at the moment, it seems to me that you are saying that we are going about this the wrong way in fiscal and monetary terms, ergo we have perhaps inappropriate fiscal targets. Does it matter if the Chancellor misses his fiscal targets? If he goes off and does the things you are suggesting—not worrying about the deficit so much, getting interest rates up in the interim at some point and going for growth—but the targets that he is currently focusing on go out the window, does that matter?

Professor Chadha: They have generally not been hit since we have had targets for fiscal policy.

Q392 **Chair:** If it is quite clear to the markets that the Chancellor has given up on those fiscal targets, does market sentiment matter in these circumstances, as he has a different approach?

Professor Chadha: If you have adopted a target in a particular way and decided to go down the route of an OBR checking the target, you cannot just move away from it without putting another framework in place. The question is what kind of framework we need, which is something we have talked about a lot today, that would give the Ministry of Finance sufficient flexibility to deal with the problems the country faces and raise taxes at the right time, on the right parts of the population, in order to maintain a debt position that was ultimately sustainable. That is the kind of framework we have to get towards.

What might be missing in the middle of all this is a Ministry of the Economy, something that thinks about where the economy needs to go to, rather than necessarily trying to balance the books in that way. The Treasury, by its nature and its very name, is very much about trying to limit expenditure and ensure the books are balanced. As I think we are arguing, the country needs a little bit more than that at the moment. It needs some way of bringing forward investment on a medium to long-term basis to deal with the gaps that we are seeing year after year in the economy. That requires a very different framework.

If that framework was appropriately developed, it would not lead to a problem in debt markets, as you are hinting at, or a world in which there would be a run on sterling or the unwillingness to hold UK public debt. That would not happen if we had the correct framework in place.

Q393 **Chair:** How easy would it be to move to that new framework and new approach without it causing problems in its own terms?

Professor Chadha: The ideal thing would be to publish some form of discussion about where we want to take it, invite evidence and move towards a framework that would lead to some analysis of the different ways it might be portrayed, so we could get the whole of our analysis for the economy on a better footing. At the moment, what tends to happen is that, all of a sudden, as a fiscal event is announced—we might or might not have a Budget next month—the run-up to the fiscal event is dominated by a politician's wish to ensure there is media coverage of it, so there are leaks, particularly of some juicy items.

Then, by the time the Budget comes round and the fiscal event occurs, there is limited further scrutiny of the action. It is really about what taxes were changed, which parts of the population benefit, whether lollipops became cheaper or something else, rather than focusing on the deep problems of the economy. We need a proper analysis of the state of the country and the economy. How is it doing relative to targets? How much levelling up have we actually brought about in the last year or so? How poor are the poorest in the north-west? What have we done for them? How far have we got with building infrastructure?

Lord O'Neill of Gatley: The north-west?

Professor Chadha: I use it as an example because we have done work on that. Surprisingly, it got hit very hard by the Covid crisis. There was a large increase in destitution in the north-west that we noticed in work at the institute. If that was much more the way we did economic policy, with an appropriate state of the economy address that was analysed and looked at, I think that would drive policy in a much better direction than it tends to go through the leaks and the randomness of the fiscal events we currently have.

Lord O'Neill of Gatley: I have three quick things. If you did a random survey of anybody other than the UK economic person, most people would not have a clue what the UK's fiscal framework is right now. I do not think there is a lot of focus on it.

Q394 **Chair:** Not down the Dog and Duck, but maybe in the dealing rooms, the investment banks and the international markets.

Lord O'Neill of Gatley: No, I am not saying it too lightly. I would hazard a guess that it is probably true in a lot of dealing rooms too. Partly it has just adapted and there are games that go on all the while—"Oh, for goodness' sake".

Secondly, I think they could get away with really focusing in on the markets. There is this separate issue that has not come up at all. The UK equity market has badly underperformed many other markets for many, many years. I suspect that, if we had a smarter framework like most of us have been arguing some degree of, it might well be that the gilt market has a one-off adjustment for the worse, but I would have reasonable confidence that our equity market would also be repriced and suddenly become a bit more alive, rather than some kind of thing that just goes round in motion, does not really do much and gets driven by the rest of the world.

Thirdly, something that has always nagged me is that the OBR plays a sort of important role. I used to have to go and stand there at the Dispatch Box. This mad situation where the biggest change in the next year's Budget outcome is simply because three people at the OBR have changed their economic forecast is completely nuts. That sets the framework for our fiscal policy. It is just mad. Sorry.

Chair: No, that is fine. That is a good point.

Ann Pettifor: Capital markets are far more rational than Government Departments or the Treasury. Capital markets do not care a damn about the fiscal framework; they care about whether they can make profits within an economy and whether that economy is prospering. I speak as someone who worked on sovereign debt primarily. I watched as countries like Russia would default on their debts and the capital markets would pile in the next day. Why? Because the balance sheet had been cleared up and Russia had oil. That is all they cared about.

I have seen this happen with other debt cancellations, write-offs and so on. It is very rational, because once the debt has been written off or defaulted on, but there are still assets and there is still income generated, it is a good place to invest. We should learn from capital markets and not rely on these silly ideological fiscal rules. If we have a fiscal rule, it should be to ensure that the economy prospers, but the Chancellor does not have that as a rule, and nor does the Treasury.

Professor Chadha: It is an objective.

Ann Pettifor: As an objective or even as a rule—no, I would want to make it a rule.

Q395 **Chair:** Capital markets do not care about fiscal targets.

Lord O'Neill of Gatley: Personally, I would not go that far.

Ann Pettifor: They care about profits and capital gains, and they want to be able to make profits in markets where there is prosperity. You cannot make profits and capital gains in a deflationary environment, which is what we have had for 10 years.

Roger Bootle: I think it was the Duke of Wellington who said something like, "No battle plan survives first contact with the enemy". He is probably right. Does that mean you should avoid all planning for battle? I think the answer is no. That is the way I regard fiscal rules. With the experience we have had over the last umpteen years, we know they are not cast in stone, and neither should they be. It is right to adapt.

I think the markets would actually be worried about a Government or a Treasury that did not bother about fiscal rules at all and said, "We are just going to borrow whatever we want to borrow". I think the markets would be concerned about that. We would be on the road to a banana republic.

Having said that, I am struck by what I think is a much greater pessimism in the Treasury institutionally about the position of the UK sovereign as a borrower in markets than exists in markets themselves. At the time of the financial crisis, I recall the Government of David Cameron, in which George Osborne of course was Chancellor, made some very strange noises, backing up their very tight fiscal policy, essentially suggesting that the UK could become Greece and that they were worried about the financial markets not having the appetite for British Government debt. In fact, the markets were falling over themselves to buy British Government debt. It is partly because of the nature of British institutions and partly the history.

I would not go mad about the importance of fiscal rules, but the current setup, although it is less than ideal, is probably the right one. That is to say, we have some fiscal rules, everyone knows that they can be changed and every so often, when it looks as though they are wrong, we change them.

Chair: We have certainly been doing that over the years.

Q396 **Alison Thewliss:** I have some questions about net zero and the transition to that. Professor Chadha, the Treasury's net zero review argued that financing additional public spending on net zero financed by borrowing would not be consistent with intergenerational fairness and deviate from the polluter pays principle. You have quite a strong view on this; you called it "balderdash". Can you tell us a bit about why?

Professor Chadha: I apologise for my language.

Alison Thewliss: Not at all—professionally frank.

Professor Chadha: The Treasury's position was that it is the current generation who are polluting and, therefore, who should bear the costs of moving to net zero, but of course it is the future generations who will benefit from net zero, because the planet will be in a better state than it would be otherwise. Those self-same future generations will also benefit from the level of economic growth that we have achieved while we have been polluting, because they will be born and grow up in countries that are richer than they would otherwise have been.

Therefore, it makes absolute sense to lay some of costs on to future generations of the transition to net zero that we are trying to bring around. To imagine that it has to be borne by taxes only on those currently alive fails to understand the benefits that future generations will have from moving to net zero. Because they will be living better lives as a result, they certainly ought to share in the costs of it, so issuing debt in order to meet that is entirely sensible. I just do not understand where that idea has come from at the Treasury.

Q397 **Alison Thewliss:** Do you feel it could be quite manageable?

Professor Chadha: Absolutely. I know there are people to my right who are closer to financial markets than I am, but bonds issued on that basis could be very attractive to investors, as they try to change the composition of their portfolio. If they want to have assets in their portfolio that are green, what could be greener than green bonds issued to try to offset net zero? We are missing a trick by not thinking in that way. I also just do not understand why we would not want future generations to pay for the benefits that they will be receiving. It will not be me; I will not be around.

Q398 **Alison Thewliss:** I saw you nodding, Ann. Do you want to come in on this?

Ann Pettifor: I agree with what Jagjit just said. The Treasury is confusing stocks and flows here. Stocks of emissions have been built up since the Industrial Revolution, so really we need to address that. There is no reason why those who will benefit from a cleaner environment should not also be able to pay for that.

Q399 **Alison Thewliss:** You have written a book on the case for a green new deal. Can you tell us what policy changes you think are required to finance the transition to net zero?

Ann Pettifor: Do we have two hours?

Alison Thewliss: We probably do not, no.

Ann Pettifor: I do not think the Committee wants to hear, because it is a long story, but it goes back to my original comments. The green new deal is about how Roosevelt transformed the economic system in order to be able to tackle a climate crisis, which happened to be the dust bowl. He understood, on the night of his inauguration, that he had to end the gold standard, which was their version of globalisation, in order to be able to empower the Government to invest and to manage both Wall Street and the international economy. My argument, and it must sound utopian to some ears, is that we are going to have to do the same in order to tackle the very grave crisis that is the climate crisis.

Alison Thewliss: Given the scale of what we are looking at here.

Ann Pettifor: Given the scale what we are looking at. The markets are not going to do this. The markets are too risk-averse. The system is out of control. We have a shadow banking system of $23 trillion or so that is way beyond the control of any, even the Federal Reserve. The Federal Reserve is in hock to all of those markets. Until we bring those back down to earth and within regulatory frameworks, it is not going to be possible to tackle what is a global crisis, because the climate crisis is global.

Q400 **Alison Thewliss:** Lord O'Neill, you talked earlier about having to do multiple things at once, changing systems and all the rest of it. Where do you feel net zero fits within these objectives?

Lord O'Neill of Gatley: I winced a little when I heard the latter part of what Ann said there. Maybe I have given a wrong impression. I do not believe that about financial markets. Financial markets get things wrong quite often, but they are typically smarter than the rest of us who talk about them, from my experience. If you give the right overall incentives to financial markets, they will do stuff.

You can look at certain sectors. To take one popular example, why does Tesla have a market cap bigger than most conventional car producers put together? I am sure there are many reasons. There are plenty of others. It might not be the case, given the scale of things that have gone on in the past month, but certainly for much of last year, there was a battery storage producer in the US that had a higher market cap than Exxon. There is a lot changing in that sense, so I do not entirely agree with that.

If policymakers set the right set of conditions to incentivise the private sector—I often argue about things like the northern powerhouse—the private sector will do it for you, if it really believes you are serious. It will save you money. That is the framework. That is part of the fight against climate change that I would prefer to see slightly better understood, rather than this idea that you have to dictate, control and stop. Financial markets do a lot of daft things, but from my experience they are usually smarter than we all are. Andy Warhol is kind of right there.

On your specific question, again on this energy example, we know for reasonably certain that the end of antibiotics is going to cause more damage than what climate change is probably going to do. There are a lot of things like this out there. On energy specifically, a lot of people alive today are not going to be too fussed about supporting a Government that keeps punishing them unless, through the transition, there is affordable energy to keep them from sitting in a freezing house. It has to be done in the context of these other things, in a much smarter way than this narrow "net zero, net zero—and these other issues are not as important". Guess what? They are.

Q401 **Alison Thewliss:** I will bring you back in, Ann. I just wanted to pick up on one particular thing that you said, Lord O'Neill. You said that the markets have to believe that you are serious. Do you think the markets believe the UK Government are serious on net zero?

Lord O'Neill of Gatley: More broadly, there was not really much change in the pricing behaviour of financial markets after the Glasgow summit. There were no new messages that financial markets took on board from that, either here or anywhere else.

Q402 **Alison Thewliss:** Are there more things they need to do, then, to reinforce that?

Lord O'Neill of Gatley: It is for another session, but you probably want to invite one of these people. There is a central bank group—you may have had them here—working on changing capital adequacy risk weightings to make financial markets believe even more that this is central to the future. I would welcome that myself, because it would send pretty clearly, "Here are the rules of engagement". People do endless share buybacks because they are pretty cheap to do and the consequences are pretty good for you if you do it. If you change the risk/reward, they shift. That would happen if you went further down that path.

Ann Pettifor: I just wanted to come back. I made the case earlier about markets being rational. John Kerry appealed to Wall Street to finance the transition in the United States, in particular to big asset management funds like BlackRock. They have just not been able to do so. They have offered some trivial amount for investment. Why? Because it is so much more profitable to invest in oil and gas. Until that changes, it would be irrational of markets to invest, for example, in green energy and clean energy, which is not as profitable as oil and gas. That is my point.

Q403 **Alison Thewliss:** Roger, I have not brought you in on these issues of net zero. Is there anything you want to contribute?

Roger Bootle: I have nothing to add to what has been said, frankly.

Q404 **Kevin Hollinrake:** Professor Chadha, you described trying to pay for mitigation of climate change through taxation as wrong. In fact, you called it "balderdash".

Professor Chadha: Only taxation. You can issue some debt.

Kevin Hollinrake: Yes, that is the point. The net cost of getting to net zero is £320 billion, I read somewhere, and £1.4 trillion gross. There are other spending challenges as well: demographics, ageing population, healthcare, social care, pensions. Are we not going to end up in an unsustainable mountain of debt because of all these different things if we do not fund them through taxation to some extent?

Professor Chadha: We have had a pretty wide-ranging discussion today, trying to understand all the things that are driving debt up. You have mentioned some of them there. The main concern I have is over the country's ability to become more prosperous over time. I will give you a very simple example. If the level of prosperity in this country had increased in the last 12 years at the same rate as it had prior to the financial crisis, we would be around £5,000 per person better off, which would itself fund a great deal of the taxes that you are talking about.

We can certainly add up the requirements for expenditure, but the denominator of that is our income. If we can focus what we do on growing the size of income in the economy, the tax and debt obligations that we have will themselves become affordable.

Q405 **Kevin Hollinrake:** Do you think that is possible? The OBR central projection is that, if we do not change the tax system and, presumably, if we do not grow much more quickly, debt to GDP is 400% by 2060. That is crazy, is it not?

Professor Chadha: You can often come up with scenarios that sound odd, but the idea of projecting such scenarios is to then make some choices as to what we want to do and how we can mitigate against those costs. That is the way scenarios should be treated. They are not necessarily telling you what is going to happen.

It says "If we do nothing". If we do not change the tax system, if we do not address new forms of taxes, if we do not think hard about the expenditures that are required now in order to increase productivity over the medium term, if we do not build up the regions in a particular way, that is where debt to GDP will go. If, on the other hand, we follow a menu of alternative policies, it may not get to those levels. I would think about it within that context, rather than treating it as a deterministic forecast of where we will end up.

Chair: That brings us to the end. Wow, that was a really interesting session. Thank you so much.

Ann Pettifor: It was hard work.

Chair: It was hard work; it should be hard work. You are right. You have held the attention of this Committee pretty well through all sorts of twists and turns of monetary and fiscal policy, and the other things we covered. I always read the transcripts afterwards very carefully. Sometimes I enjoy them a great deal, sometimes rather less so. This one I will enjoy reading a great deal, which probably just shows how sad I am, but there we are.

Can I thank you very much for appearing before us? It has been a great pleasure having you, as ever.