



Treasury Committee

Oral evidence: [Quantitative Easing](#), HC 902

Tuesday 16 July 2013]

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Members present: Mr Andrew Tyrie (Chair), Mark Garnier, Stuart Hosie, Andrea Leadsom, Mr Andrew Love, John Mann, Mr Pat McFadden, Mr George Mudie, Mr Brooks Newmark, Jesse Norman, Mr David Ruffley, John Thurso

Questions [279-398]

- Witnesses: [Paul Fisher, Executive Director of Markets, Bank of England, and Robert Stheeman, Chief Executive, Debt Management Office

Q279 Chair: Thank you very much for coming to see us this morning, and it still is this morning. Can I begin with you, Mr Fisher? We have seen a lot of volatility in response to the tapering announcement by the Fed. Is that a harbinger of what we might see when the MPC decides to unwind QE?

Paul Fisher: I think it has been quite an instructive episode, although not exactly the same as would happen in the UK case. Among the things that it demonstrates is, first of all, the pre-eminence of US dollar markets in financial markets generally, so when there is a risk off scenario like this, you see assets being sold off across the board, so it was not just interest rates but equities, emerging market assets and so on. So, those spillovers from the US to the UK mean that I suspect we will continue to get volatility as the US exits from its QE. I do not think we would get the same spillovers to international markets from the UK. It demonstrates some other things: first of all, the importance of communication. I think the US markets had got very much one way round of what the US would do, so it demonstrates that you do need to be clear and transparent about what your policies are going to be.

In fact, volatility has not been particularly high over the last couple of months. It has come up from what was a very low compressed level to something that across markets, across those couple of months, has been about average, and so we could easily see more volatile periods than this in the months to come. It also illustrates the way that the financial markets are forward-looking, so small bits of news about policy can cause quite sharp reactions. So, I think all of those points are very instructive about what exit might be like, but I shouldn't think we would get the same international spillovers.

Q280 Chair: Could you speak up, Mr Fisher? So, were the markets right or wrong?

Paul Fisher: I think the markets had it wrong prior to the statements by the Chairman in the US. I was in New York in early April, and I was quite struck how everybody was one way round. They all thought the exit from QE would be very smooth and that the Fed would tell them everything that was going to happen well in advance. Nobody was hedging the possibility of upward movements in rates because they had all lost money trying to do that over the previous couple of years. So, I was quite struck. It occurred to me then that the market was ripe for some volatility to occur when news came in. Of course you cannot predict what or when that news will be, so it was quite interesting how much it moved just on the back of Bernanke's comments.

Q281 Chair: Just to be clear, your reply is the markets incorrectly priced the yield curve, prior the announcement, by suggesting that yields were lower than they should have been?

Paul Fisher: Lower for longer, yes.

Q282 Chair: They were right to adjust, which has been an adjustment of what, about 100 basis points?

Paul Fisher: Yes. I wouldn't say I am sure the current level is in the right place. I think it will take a while. What happened was we saw a big unwind of positions from leveraged money, hedge funds and the like, who had taken these lower for longer positions. That caused a general risk-off scenario. We are now seeing the market starting to try to find new levels for financial market prices. I am not sure that adjustment has fully worked through yet, but they were right to re-price and we will have to wait and see whether or not they get to a more sensible level. My contacts are saying this is a sensible correction, to put some two-way risk back into the market.

Chair: Mr Stheeman, do you have anything you want to add or disagree with, if you want?

Robert Stheeman: I agree very much with a lot of points that Paul made, but I would also say that I do not believe that the markets are necessarily right or wrong. I think it is always unwise to ascribe to markets any particular wisdom or lack of wisdom. They react purely to news that they have out there in the open, which is why Paul's comments about communication is so key for the future. It could easily be that the markets are not doing what one would expect them to do, but I am always a little bit cautious about saying, "The market is wrong and therefore we have it right, but we are being misunderstood". I always think that that is slightly sort of dangerous.

Q283 Chair: You gave the impression that you agree with most of what Mr Fisher says.

Robert Stheeman: Absolutely.

Chair: So, there must have been something you disagree with.

Robert Stheeman: The markets had indeed brought yields across the globe down quite a bit, certainly here in the US, in particular in the major liquid Government bond markets. For that to have happened, there was a consensus of view that also the economic conditions, the reaction functions of central banks were such that it necessitated very low yields. I think that that was arguably at the time perfectly justified, but where I completely agree with Paul is that the recent move—although it was a very sharp move, and I would say quite an unpleasant move for many market participants—is one that seems to reflect the current conditions much more appropriately.

Q284 Mr Newmark: This is to Robert. Are you worried that when the Bank starts to unwind QE, the market might be flooded with gilts and you will struggle to issue?

Robert Stheeman: It is extremely hard for me to envisage exactly the situation we are going to find ourselves in when the Bank decides to unwind. That worry would be greater if I knew now that the Bank would do so in a very forceful, potentially even uncontrolled fashion in a non-programmatic way. Then I would be seriously worried. I have always felt that the market is deep and liquid enough, or should be deep and liquid enough, to be able accommodate sales certainly by the Government, but also potentially by the Bank, if necessary, at the same time. Having said that, we can't offer any guarantees that that price adjustment process would be smooth. I think that the events in markets over the last few weeks underline the point that just the merest hint in the US—not even the UK, but the US—what they refer to as “tapering” can mean that price movements are going to be exceptionally sharp and they can cause volatile markets.

Q285 Mr Newmark: Do you think the US has perhaps taken the sting out of the tail by seeing the reaction, and has that adjusted the way you are going about your scenario planning and messaging then, given what you have said?

Robert Stheeman: As far as taking the sting out of the tail for markets, quite possibly, yes, it may well have done. Again, it is worth noting that the market movements over the last few weeks have been driven by the US. The US remains the leading Government bond market and it is instructive just how correlated our individual bond markets really are. In terms of our own behaviour as a result of that, nothing changes. It is in the nature of debt management, and it is in the nature of our strategy and operations, that we stick to the plans that were in existence at the time of the Budget when we received our remit. So, we are not changing anything.

Q286 Mr Newmark: You might have to change something if yields become unsustainable, and I guess is there a yield at which selling does become unsustainable? You can have all the plans in the world, but if the markets give you a different message, there may be a price at which you will change your decision. Have you thought that through at all?

Robert Stheeman: In terms of debt management strategy, there are a number of points during the year that we can change, with Ministers' agreement, elements of the debt management strategy that was set out at the time of the Budget. The *Autumn Statement* is the obvious one. In general, we try to have long-term plans to which we stick, and, when you say that yields might become unsustainable, if yields have to rise, if yields rise as a result of even expectations around QE sales, let alone the sales themselves, that could be a positive for us in terms of being able to sell what we have to sell, because it will draw in

buyers at higher yields. Effectively, that is the market efficiently pricing in our issuance as well to take that down in an orderly fashion.

Q287 Mr Newmark: Paul, you are going to have to speak up because I have a bad head cold, so I cannot hear anything. The MPC has said it will raise the Bank Rate before it unwinds QE. Once it begins raising interest rates, how will it decide at what point to unwind QE?

Paul Fisher: I should say this is not a commitment that is what we will do. This is our presumptive plan at the moment. We think it is most likely that we would increase interest rates first and then we would look to return our system to reserves averaging, although that is a decision under review. Then we would start to sell assets but, first of all, it would have to be consistent with what monetary policy we wanted to achieve. For example, we wanted to tighten conditions. We would only start when we thought we could maintain a programme of sales for a good long period. What we do not want to do is sell one month, stop, buy some more, sell another month, so we would want a good long programme of gilt sales. We have suggested perhaps six months' worth at a time—although it would take us a lot longer than six months to unwind—but that is really the conditions where we could set out a programme of sales to give the market some certainty to try to maintain orderly conditions.

Q288 Mr Newmark: But markets are smart and, when they see that happening and they see the signal come, they will respond accordingly, and you could get a movement in the market that doesn't necessarily mean you end up effectively getting a reasonable market price, because it will have anticipated that move.

Paul Fisher: This is why it is a presumptive plan. First of all, we would give the signal that policy was going to be tightened through changing interest rates. You would then see what the market reaction was. That may give you quite a tightening in monetary policy, and so you may then want to delay asset sales for some time. If you thought you needed to do more tightening, then you would have two instruments you could play with, in terms of interest rates and sales. Our presumption is that the active instrument of policy would be interest rates, and we would try to get asset sales on to a sustained platform over a period of time to give some certainty to the market about how much would be sold back into the market over that period.

Q289 Mr Newmark: Robert, what are your thoughts on that, particularly what effect will the decision to raise the Bank Rate have on your ability to issue those gilts?

Robert Stheeman: I wholeheartedly endorse the notion of a programmatic, rules-based approach to any sales. It is the same thing that we do in our own sales when we are selling gilts and it is the one that the market finds the easiest to prepare for, to adjust accordingly in order to avoid unnecessary volatility as much as possible. So, I wholeheartedly endorse that. Exactly what is going to happen when rates do rise is incredibly hard to predict, but I would also agree with Paul's premise, namely the chances are that, even before the Bank Rate itself is raised, you will have seen a movement in yields. If you look at what has happened in the US markets again over the last few weeks, that is a classic example of the market discounting well in advance of an event that has not yet happened. They are trying

to assume what is going to be the case when it happens, and I think the same applies here. My guess is that before the Bank raises rates, you will have seen yields move up.

Q290 Mr Newmark: But didn't you see it as slightly ironic that Bernanke was effectively saying, "Hey, things are going fairly well economically. We are going to issue less, be doing perhaps a little less QE", and that is instructive for us as well, because, as the economy begins to turn here and growth begins to come back, you will be signalling—perhaps in a slightly different way then, but you will be signalling nevertheless—that the unwind is going to be beginning. There is a risk, at least at that point, given the historically low cost of Government borrowing, there could be a sudden spike in yields demanded by the market when QE is unwound. It is getting that balance right that is going to be your big challenge, I suspect.

Robert Stheeman: I do not disagree with any of that. To be clear, I would not want to leave the Committee with the impression that I don't think that there is a risk there. There is a real risk, but I would also say that rising rates are not necessarily only a bad thing. As you have implied, they are a sign of potential growth in the economy, that the market expects that. Also, that growth environment is normally associated—this is not a prediction; it is just looking at the past—with better public finances, which themselves could potentially hint at a smaller borrowing requirement by Government, so all of those things work together. But is there a risk? Absolutely, and I want to acknowledge one point: the events of the last few weeks suggest that the withdrawal of the stimulus by monetary policy authorities globally, that process, the associated market movements are going to be uncertain. The consequences of that are very uncertain, and I don't think we should pretend otherwise.

Q291 Mr Newmark: If I just finish on my last question, I like to make sure that whatever we do on the Committee relates to our constituents, so that ordinary people understand that, a lot of times we do a lot of technical talk and jargon. But if there is a spike, it is going to affect mortgage-holders, people who have borrowed at extremely low rates; it will affect people in small businesses in my constituency, who again have benefited from a long-term process of QE where we have had artificially low interest rates as a result to help try to boost the economy. As interest rates become more normalised—and as I said, there could be a sudden move up in yields—do you share my concern that those of our constituents that have been sucked into buying houses with relatively low mortgages, who have ended up borrowing at fairly low rates to keep their businesses going, could be hurt by this?

Robert Stheeman: Absolutely. In a rising rate environment, the entire economy, including savers, including mortgage holders, will be affected.

Q292 Mr Newmark: How do we prepare the public for this? Because effectively, since 2008, we have lived in an artificially low period of very low interest rates. On the one hand the one message we are giving is encouraging them to buy houses, and the Government has a process there, yet at the same time we are saying, "We must say to them, 'Beware, because interest rates aren't going to be low forever'". I think the messaging, particularly, that you guys give is going to be very important in the lead-up to that.

Robert Stheeman: I accept the point. I would just say the messaging specifically coming from the Debt Management Office is going to have to be, and should be, business as usual.

We have to continue to raise the funds that we need to raise at the market rate at what we hope is in the most cost-effective fashion possible.

Q293 Mr Newmark: Okay. Paul, just a final question to you: what would you see as the effect of such a spike?

Paul Fisher: If it is a spike, of course, that implies that rates go up and then come down again and that will wash through quite quickly. If you observe the banks, it takes about a year or so for a bank to fully pass through changes in its funding rates to lending for businesses and households. That is one of the reasons why the Funding for Lending Scheme is taking so long to have its full effect work through. So, if there is just a spike, I don't think that will affect businesses and households very quickly. You are right, people have to be aware that in the longer term—

Q294 Mr Newmark: To be clear, when I was talking about “a spike”; I was talking about a spike up, not necessarily a spike up and down.

Paul Fisher: Yes. But we will be changing policy—and I should stress I think this is still some way off in the future, we are talking about potentially years in the future here—and at that time we would be wanting to tighten policy because output growth is growing, unemployment is falling and inflationary pressures are starting to build. Those are the conditions under which we would want to tighten policy. We would want to slow credit growth down in those conditions, and so hopefully the conditions under which we would be doing this are ones where those effects will be desirable.

Q295 Mr Newmark: So, the implication of your answer, then, is it looks like this unwinding is unlikely to happen at least for a couple of years. What you are saying is it is some way off. So, you are seeing interest rates really remaining low for at least the next 24 months, if I was to pull out a figure?

Paul Fisher: The current yield curve in the markets has the first rise in interest rates not priced in until the middle of 2015. As you know, we are currently going through a process of discussion around forward guidance and thresholds, which we are going to report back on in the August *Inflation Report*, which will go precisely to this sort of point.

Q296 Andrea Leadsom: Good morning. The scandal of the LIBOR rigging is still very fresh in people's minds. So, Mr Fisher, I would like to ask you whether you consider that—along with now an investigation into potential oil price-fixing—there has potentially been rigging of gilt auctions. Specifically on 10 October 2011, an auction of gilts was cancelled because of fears that the price was moving in some manipulated way. Do you consider that there has been manipulation of gilt-edged auctions?

Paul Fisher: No. In all our operations, we think very hard about how the market participants might behave and we try to design operations to account for that. We spend a lot of time looking at what happens and talking to market participants afterwards, and we always reserve the right to not complete an operation if we think something untoward has happened. On that particular occasion, the auction wasn't cancelled, the auction went ahead, but we did not allocate any purchases to one particular bond that was being offered

to us, whose price had gone up very substantially in the market that morning against the run of the market trend. On that occasion, our methods demonstrated that there was something to be concerned about and we took the appropriate action and the market generally welcomed that. But we do pay a lot of attention to those sorts of market moves. That was taken as a shot across the bows. But, yes, I agree with you, the scandals around the rate rigging have been very distressing.

Q297 Andrea Leadsom: Just to go to the nub of this, you are saying that the Bank of England dealt with it with, as you say, a shot across the bows, so are you saying that there was an attempt to rig a gilt auction?

Paul Fisher: We don't know. We are not an investigative authority, so we could not drill into exactly what had happened; so, we have passed all those details across to the investigating authorities, and it is with them.

Q298 Andrea Leadsom: That was the FSA at the time and is now the FCA?

Paul Fisher: It was at that time the FSA, yes.

Q299 Andrea Leadsom: So, what progress have they made with their enquiries, and to what extent do you follow it up?

Paul Fisher: I have followed it up. I cannot comment, and they would ask me not to comment, on any investigations they may or may not be running.

Q300 Andrea Leadsom: Does this run the risk then in a few years' time perhaps of being investigated as akin to the day when the US regulators talked to the Governor of the Bank of England about potential LIBOR-rigging, and the Governor of the Bank of England simply passed it on to the BBA to look at and the BBA did not get around to looking at it? Is this similar to that? If you suspect there is—

Paul Fisher: No, the BBA are not an investigative authority, and the FSA/FCA are.

Q301 Andrea Leadsom: So, you are saying that they have a statutory duty to investigate whether—

Paul Fisher: Yes. They can go in, for example, and look at telephone records and email records and things like that, which I can't. All I can see is what happens in the operation, in the market prices, and I can take the appropriate action to protect public money. But I can't follow that up, I can't go into a firm and see what they are doing. I can ask them, but they can tell me what they like.

Q302 Andrea Leadsom: So, will the FCA be reporting back to you on their findings and will there be appropriate action taken? What would you expect to happen as a member of the Bank of England?

Paul Fisher: I really can't comment, because it is sub judice.

Q303 Andrea Leadsom: But you can tell me whether you expect to ever hear from them again on the subject or not?

Paul Fisher: Yes, I would.

Q304 Andrea Leadsom: You will hear from the FCA again on whether auction has been attempted to be rigged?

Paul Fisher: Yes.

Q305 Andrea Leadsom: Do you consider that the processes around the gilt-edged auctions are sufficiently robust, bearing in mind the very blatant rigging of LIBOR and the possible suspected rigging of oil prices? Do you consider that the measures around the gilt-edged auctions ought to be investigated and tightened or changed?

Paul Fisher: No. We have examined it regularly as we went, well before that particular incident in 2011. Part of the design of the operation was that rather than buy one gilt at a time, we bought from a selection of gilts. So, on that particular one there were 10 gilts, and we know it is possible to squeeze one gilt in the market in that fashion—if that is what happened—but it is not possible to squeeze 10. So, it was very obvious to us here what was happening. One gilt was moving not just inconsistent with the market, it was moving in the opposite direction to all of the other gilts in the market. So, there was a clear signal. The design of the operations was done intentionally to show up that sort of adverse movement.

So, we have looked at it. We had never seen anything like that previously; we have never seen anything like that again. There have been other instances where we have wondered about people's behaviour, so we call them in and we have discussions about them to see if we can understand what they are doing. What usually happens then is they don't do it again, even if it was a perfectly legitimate thing for them to be doing. So, we have a lot of discussions going on in the background, but this was the first case where we had seen something where I was sufficiently concerned not to proceed with allocating against that particular bond.

Q306 Andrea Leadsom: So, your belief was that the market was being deliberately manipulated?

Paul Fisher: There was that risk. I did not have the information to conclude that. All the evidence we have we have passed across.

Q307 Andrea Leadsom: Presumably you do accept, as the Bank of England, that since QE was largely designed to flood the market with liquidity following the financial crisis it would be quite astonishing if banks were then seeking to manipulate the market that was designed to bail them out at a time of great crisis. It would be an ultimate irony not to mention a public outrage, if that were the case.

Paul Fisher: I could not accept that QE was designed to bail out the banks. It was designed to get the economy going again, or rather to stop it collapsing, which it was doing at the time when we started.

Q308 Chair: Also to bail out the banks, because without bailing out the banks, we could not get the economy going.

Paul Fisher: QE was originally intended to work around the banking system. We were trying to get money out into the economy as a whole, and in fact it was designed in a way to avoid the banks.

Q309 Andrea Leadsom: Yes, I understand that. But my point is would it not be utterly outrageous if an auction were being rigged when the whole point of QE was to try to undo the damage ultimately caused by the banks themselves?

Paul Fisher: If that is what somebody was doing, it would be thoroughly reprehensible and the appropriate action will follow.

Q310 Andrea Leadsom: So, you would expect to see significant action? This would not be swept under the carpet? If individuals or banks were found guilty, you would expect to see action taken?

Paul Fisher: Yes. I do not have all the evidence, because I am not the authority that has access to the relevant records.

Q311 Andrea Leadsom: Bearing in mind that you do not have the access yourself, but if wrongdoing was found to be the case, would you expect that to be in the public domain and very serious consequences?

Paul Fisher: Absolutely, I would. Yes, that is usually the case with these sorts of investigations.

Q312 Andrea Leadsom: Thank you. Last question to Mr Stheeman: did you think or did you consider or worry about the fact when the QE programme was instigated—since clearly the Bank of England was now the biggest buyer out there of Government gilts—that there would be the potential for front-running rigging, any form of malpractice, as a result of this very specific one-way only Bank of England as a big purchaser?

Robert Stheeman: Not specifically. I suppose we regard reverse auctions as carried out by the Bank as similar to our own operations, which by their very nature are competitive. I think Paul made an interesting point when he said that their reverse auctions, as opposed to our direct auctions, are fundamentally different in that a whole array of stocks can potentially be offered. I would also point out though that the ability exists to reject some of those offers, if that was felt correct, and that is exactly what happened. But to go back to the point, the auction process by definition is a competitive one. I am talking now about our own auctions and it is a relatively transparent one, where effectively we—and the Bank does the mirror thing—put into the market a block of paper to be sold to primary dealer gilt-edged market makers all at one time at 10.30am, and there is a competitive process whereby no bidder knows what another bidder is doing.

Q313 Andrea Leadsom: You think; you assume?

Robert Stheeman: We think, we assume; you are right. We can only assume that, but I suppose the strongest argument against collusion is not just obviously the whole legal sanction, but it is also the fact that competition would suggest that people are very desperate to make sure that they themselves are the one with that leading advantage.

Q314 Andrea Leadsom: But clearly that collusion was a key point about the LIBOR rigging, so the assumption that competition means there is no collusion does not hold true, does it, in the banking system?

Robert Stheeman: I am not quite sure whether LIBOR there is exactly the right parallel because, as I say, an auction is us effectively inviting bids, commercial bids, whereby we are asking people to put their money on the table. LIBOR was something fundamentally different. It was about fixing—to use the parlance—a specific rate, noting a specific rate at a given time, asking for specific quotes. That is not the same as the competitive commercial imperative that exists behind an auction.

Q315 Andrea Leadsom: So, then are you saying that the gilt auctions can't be rigged by the nature of the design?

Robert Stheeman: I wish I could give you a complete cast-iron guarantee along those lines. I can't. What I am saying is that we have absolutely no evidence that our gilt auctions are in any way subject to any sort of—what I call—bad or even illegal market practice at all. We feel that the presence of a number of primary dealers in competition with each other reduces the possibility of that.

Q316 Andrea Leadsom: So, you are confident that there will not be any evidence of wrongdoing when this inquiry draws its conclusion?

Robert Stheeman: No, I am not saying that, because I am talking specifically about our auctions, and the reverse auction situation that Paul referred to seems to me a fundamentally different operation. That was clearly something where I believe at the time the Bank identified a certain specific behaviour around a single stock, among many, that they felt that they could reject. There is one thing—again, a parallel that we have—which is important. That is that when we sell gilts in our auctions, we also have an element of discretion. That discretion is, if necessary, if we felt that we were receiving bids that were somehow in any way of not good quality but were somehow tainted—for want of a better word—we would look at that very carefully, in the same way as the Bank did with their reverse auctions. But again, nobody can offer cast-iron guarantees. I don't know what the outcome of this particular situation with the Bank was, but it was not the entirely same process as our own auctions.

Paul Fisher: Can I just add one point, which is that the difference with LIBOR is that the LIBOR rates were not observable. Essentially the Banks were making the rates up to put them into the LIBOR submissions. In the gilt market prices are continuously available, so the advantage we have is we can observe how the pricing is changing. If we think the pricing going into our operations isn't fair, we can then take action about that, so it is much more transparent than the interbank lending market.

Q317 Andrea Leadsom: I would have to disagree with that. I think LIBOR is observable. There are always interbank rates being bid and offered to each other among banks. I accept what you are saying is that gilt prices are very closely pursued, but I think LIBOR is as well.

Paul Fisher: No, there are far more transactions in gilt markets; far more.

Q318 Andrea Leadsom: I think the issue of collusion, Mr Stheeman says that because you are competitively bidding at the same time that collusion isn't possible. Of course it is if you know that there is a big buyer out there, you can all of course put the price up a bit, can't you? Without even talking to each other, you all know which way the market is headed. So, I think collusion is perfectly possible.

Robert Stheeman: I should add I don't think I said that it is impossible. I think it is unlikely because of competitive commercial pressures, but I cannot rule it out.

Q319 Chair: At the beginning of that set of answers, Mr Fisher, you said this was sub judice. Has anybody been charged?

Paul Fisher: Not yet, no. I was trying to find some term, but it is—

Q320 Chair: I do not think it is sub judice and, of course, a very different set of rules apply to something that is. Therefore you are able to comment on this, and I think it is important that we should be clear that that limit to what you can say, it is not—

Paul Fisher: To be fair, I don't know if somebody has been charged.

Q321 Chair: As far as we are aware here on this Committee, nobody has been charged, and therefore it is not sub judice. If it were, I would have informed the Committee before we started the hearing.

You have said that you have informed the investigating authorities—I think was the initial phrase you used—which you then explained was the FCA. Might it have been the SFO?

Paul Fisher: I don't think so on this occasion. I spoke directly to the FSA, and they were happy that it was within their grounds of competence. They seemed to be—

Q322 Chair: That was not my question, though. It is whether it is also within the grounds of competency of the SFO.

Paul Fisher: I don't know.

Q323 Chair: But you did not consider that as a possibility?

Paul Fisher: No.

Q324 Chair: When you found out about the possibility of manipulation, did you put any additional market monitoring processes in place?

Paul Fisher: No. The market monitoring process we had had worked, so they had shown up the event and we had dealt with it. We looked back to see whether or not we could have missed anything previously. We have not found anything of a similar nature before or since.

Q325 Chair: So, there have been no changes at all to your market monitoring process?

Paul Fisher: Not as a result of that incident, no.

Q326 Chair: What reporting mechanisms are there in the Bank for people to escalate suspicions when they may become aware or suspicious of cases of manipulation?

Paul Fisher: It comes straight up the line, so it came straight to me on that particular occasion.

Q327 Chair: When you say “straight up the line” just give me a feel for what this line looks like between the person that is monitoring it and the person who then takes a decision—which is you—to hand this to someone else to look at.

Paul Fisher: We have an open plan dealing room with the desks who are carrying out the operations. There is a head of division who sits right by them and there is me, and the most senior person available in the dealing room at the time on the spot would have to make the decision.

Q328 Chair: All right. In a moment you come back, by all means, Andrea. Before notifying the FCA, did you consult the Governor?

Paul Fisher: I alerted the Governor to what had happened on the day of the event, but no, the decision to pass it across to the FCA was directly from me. As it is, this is not the first time I have passed across information to the FSA.

Q329 Chair: In the terms of reference of your job, do you have executive responsibility for taking that decision to tell the FCA or does that lie with another individual or group?

Paul Fisher: Any market participant has a responsibility to pass information of a suspicious nature across to authorities, so I do not need it as part of my job.

Q330 Chair: That is technically an entirely correct reply, but I am asking about the way the Bank operates internally. I am trying to get a feel for the way the Bank operates.

Paul Fisher: It would be understood that this is the responsibility of myself or my heads of division. It is always done from one of us to the FCA or FSA, yes.

Q331 Chair: Okay. Have you given any consideration to whether a civil action might be appropriate?

Paul Fisher: I really do not have enough evidence to take any sort of action. All I have is the evidence of the price moves on that day, so it is very difficult for me to know that this was a result of some normal market behaviour or not. It looked on the surface of it not, but I do not have access to the evidence that would tell me whether or not somebody was really doing something they should not have been, and so I am not in a position to make that judgment.

Q332 Chair: The evidential hurdle is lower for a civil action than for a criminal action, as you know.

Paul Fisher: It is.

Q333 Chair: So, you would have had to form a view. When you are holding the information that you did have, you took a view that this is something that you should bring to the attention of a criminal authority. So, you took the view that it was sufficiently serious to warrant a criminal investigation?

Paul Fisher: The hurdle for us passing information to the FSA or FCA is very low. If we hear anything at all suspicious, any rumours that might have foundation, I will always pass those across to our colleagues in the market abuse authorities. I do not have to sit and think for very long before deciding to pass that sort of information across, because they may be receiving similar information from other sources. If they can put all the pieces together, they can form a view, which I can't. On this occasion, I had hoped that other participants in the gilt market might have reported the incident, that the firms involved themselves would have reported it after their internal investigation, so my passing it across—I would have hoped it would have been just one part of a bigger jigsaw.

Q334 Chair: Have you at any time considered taking a civil action in a case like this?

Paul Fisher: No. I am not a lawyer, and I would have to take legal advice on whether or not that was appropriate and my legal unit of course were involved in this from the outset.

Q335 Chair: Therefore the question is doubly pertinent. You took legal advice, they told you to hand this to the FCA or they advised you to hand this to the FCA, and I am now asking whether you also asked whether civil action might be appropriate.

Paul Fisher: My understanding of the civil law is that it would not be, but I would have to go and check that. I mean, we have not suffered any damage as a result of this action. In fact, it was quite helpful, in some ways, to put a shot across the bows of the market and remind everybody that we had the right to reject offers. So, it was quite beneficial to us. I am not sure I have suffered some damage that would justify a civil action.

Chair: Yes, but you are now beginning to answer the question as if you were a lawyer. My question was whether you considered this decision, and you told me that you had not considered it and that you have not consulted the lawyers on that point.

Paul Fisher: I have not consulted the lawyers on that point. Our standard procedure, if we hear any suggestions of market abuse from any quarter, including our own operations, is to pass that across to the market abuse authorities.

Chair: Andrea Leadsom has a quick rejoinder.

Q336 Andrea Leadsom: Yes. It is just in the immediate aftermath of the LIBOR scandal, I was quite astonished to see Sir Mervyn King quoted in a newspaper as saying he was amazed that anyone would manipulate LIBOR for the sake of a couple of basis points, which to me showed a fundamental lack of understanding about how the money markets work, because clearly that amounts to a significant sum. You mentioned, Mr Fisher, that in this instance it was staring you in the face; that here was one line of gilts that was moving in the opposite direction to how it should be moving. So, it was a glaringly obvious either manipulation or something very strange going on that was absolutely right there in your face. So, my question is this: bearing in mind the Bank of England has been a big buyer all the way through, is it not entirely possible that far, far smaller manipulations have been going on under your nose all the time and the only time you could spot it is if there was something as glaring as you have just referred to on 10 October?

Paul Fisher: Of course you can never be absolutely 100% certain there aren't small things going on. We have looked hard at the movements of prices around our operations, compared that with movements around the DMO's operations, and we think we are broadly in line, but you can never be absolutely sure that somebody isn't doing something at the margin. I am not sure how you would.

Q337 Mr Mudie: Mr Stheeman, the last time you were before us I felt very sorry for you, because I thought you were being treated very shabbily or offhandedly by the Treasury and the Bank of England. That is me saying that, but it seems it is continuing. When you were answering questions, you were not able to say there is anything set up; there were no agreed procedures; it is when they pick up the phone and tell you, you will roll. Is that the situation?

Robert Stheeman: Following that meeting to which you referred, you are probably aware that we sent you a note at your request, which described the institutional setup in some detail. If I can just very briefly refer to that, because I think that is the basis of the answer of the question. We are legally part of the Treasury. We are an executive agency. We operate at arm's length, but we are just a fundamental part of the Treasury and we receive, as you are aware, every year a gilt sales remit. We can give comments to colleagues in the Treasury and we can, when we meet with—I do quite regularly, often on an informal basis—colleagues in the Bank of England. We can offer views on a number of things, but of course where those views cut across, for instance, issues of monetary policy, they are—and that is the institutional governance framework that we have—quite rightly the preserve of the Bank of England and the Monetary Policy Committee.

Nothing has changed there. You are absolutely right, that is still the case, and particularly in relation to QE, there will be times when we have said certain things to the Bank. They may agree with what we say; they may disagree, but we respect the fact that the final decision about the implementation of what is ultimately a monetary policy tool lies with the Bank.

Q338 Mr Mudie: Did you say, “They may say this”, or “have said this”, when you finished that sentence, the Bank of England? Do they invite you to discussions? What are the governance arrangements? Is it you, the Treasury and the Bank of England? Do you meet regularly? Even if you are only sat at the end of the table speaking about operational matters, are you at the table?

Robert Stheeman: In some discussions, as I say, but it is an informal process. We will meet. However, it is important to understand that the institutional setup has been created in such a way as deliberately to keep debt management and debt management policy implementation separate from monetary policy. So, to a certain extent, there is a conscious and deliberate decision in the setup under which we have to operate to keep those two areas apart. That does not mean that we will not talk at times about operational issues, which we have any number of them, but there is no formal process. To answer your question directly, there is no formal process for us to give views directly on specific activities of the Bank.

Q339 Mr Mudie: It is just that we had an expert in on the Spending Review last week, and he projected us hitting 92% of debt to GDP. It is over £1.2 trillion. You have a huge job on your hands, and whatever the Monetary Policy Committee may think—that they are the king of the castle—what you do, and the problems they may cause you, could be very important for the economy. But they seem to see you as just someone they will give orders to and expect you to do it. With the sensitivity and importance of it, that does not seem to me a good arrangement. It did strike me last time, that is why I felt sorry for you, but it seems it is continuing. Can you sleep at night?

Robert Stheeman: Amazingly I can. I understand what you are saying. If I may make one point about the institutional setup, about the separation and about the fact, arguably indeed, that we do not have any influence ourselves on how monetary policy might be implemented, is that that separation is part of the credibility of the overall framework. That credibility is incredibly important to the markets. Because if the markets felt that—and I think this is key in relation to the size of the task that we do indeed have—actually to be nice to us, the Bank of England, the Monetary Policy Committee, would make decisions, for instance around QE, which might be beneficial for Government finances, then all sorts of wider questions around the credibility, around perhaps some kind of underhand monetary financing of Government, could in theory arise. That is why I think, in order to avoid that, the current institution setup is actually rather a good one. It does not allow that to happen. We derive benefit from the market as a result, because the market believes that there is no collusion between ourselves and the Bank around monetary policy implementation.

Q340 Mr Mudie: If that expert was right, he then projected it further forward and thought the markets would turn and we would have terrible trouble raising cash, and very expensive trouble. Do you see any problems, or are you prepared for problems like that?

Robert Stheeman: I don’t have a crystal ball, and one of the things that I try—

Q341 Mr Mudie: Do you do any forward-planning?

Robert Stheeman: A lot of forward-planning. One of the things I did try to make clear at the beginning is a lot of this is hugely uncertain. I think I may have said this to the Committee previously but I repeat it. We cannot force people to buy gilts. For that reason, all the debt management strategies that we employ are designed to facilitate the sale of gilts as much as possible. The gilt market is a very open one, it is a very deep one, it is a very liquid one, therefore all our strategies have to be aligned to that market structure; they have to be designed to support market liquidity as much as possible, which we believe is the strongest guarantee that we will be able to fulfil our remit of raising the cash that we need to raise to fund Government.

Q342 John Thurso: Can I come to you, Paul? During the course of discussing QE on various occasions, a number of colleagues have asked various representatives of the Bank what the impact is on the ordinary citizen. Broadly speaking, there have been a bit of winners, a bit of losers. The Governor explained on one occasion that those who had financial assets were doing better than those that needed them and so on. Has the Bank undertaken any formal assessment of the impact of QE on citizens generally, or does it confine itself to looking at the impact on the market?

Paul Fisher: We focus on the impact of QE on economic aggregates as a whole, so output, inflation, unemployment, and that is our main focus in terms of setting out monetary policy. Of course we did produce for this Committee a review of the effect on pensions, as that was a particular issue. It is always the case that monetary policy changes have distributional impacts. You are moving income and incentives between savers and borrowers. That is what monetary policy does when we change interest rates.

I think what you are seeing here is that sometimes there are things, which are second or third order effects of the operations, that become important when the operations are just so big. The size of the QE programme, setting interest rates at zero—these are historically very significant operations. So, some things that would normally be small are now being seen in larger scale, and you are seeing those distributional consequences come back from different pressure groups who feel that they will particularly suffer.

Q343 John Thurso: Broadly speaking, the answer is that the Bank does not look more generally at individual citizens or groups?

Paul Fisher: Only if we think it is affecting the monetary transmission mechanism.

Q344 John Thurso: The follow-up question is to ask, as I am looking at the exit from QE, whether or not it would be your intention to make any assessment of the impact of exit or maintaining the strategy of just looking at the broad economic impacts.

Paul Fisher: We would again focus on the broad economic impact on output and inflation. There is nothing in our remit that means we should go and look at distributional effects. We can do that if somebody particularly asks us to, subject to resources. Where we do dig down a bit is we do look at what happens regionally, through our regional agents' network. We do look at what happens to different sectors of the economy, because that can have a big impact. So, those things where we think it may affect the overall macro economic impact, we are digging down into the details. For example, you have to look at what happens to household debt, to assess what happens to household income and

expenditure. We know different groups within that will be in different positions. So, there is a certain amount of digging down you have to do, but it is all funnelled into getting that overall assessment of what is going to happen to inflation and output and unemployment.

Q345 John Thurso: When he came before us, Andy Haldane used the phrase that the Bank has “intentionally blown the biggest government bond bubble in history”, which I am sure you all enjoyed as much as we did. How confident are you that decisions on Bank Rate, and the eventual unwinding of QE, can be made in such a way as to avoid the sort of problems that were experienced in the 1994 global bond market crash?

Paul Fisher: It will be a big challenge. This has been the biggest recession in the UK economy since at least the Great Depression, and so we have had the most extraordinary macro policy measures to deal with that. So, of course it is the biggest challenge we will have had for 50 or 60 years. I am reasonably optimistic we can get this right, if we are clear and transparent about what our intentions are. It is possible forward guidance may help. We will consider that for our August report.

Can I say there is not a risk of some disturbances? No, of course I can't, because you have seen what has happened just on a small bit of news from the States.

Q346 John Thurso: If I may just link these two points together that I have been asking you about, there is huge degree of uncertainty about how this is going to be done, when it is going to be done, what the conditions will be like and what impact it will have on the market. We don't really know how it affects citizens, although we have some ideas, so we will be going into an unwinding with some considerable but unforeseen impacts. It would seem to me, that could move the decision-making from being a purely independent Monetary Policy Committee decision into being something of a political decision. So, the two-edged question is: is it right that the MPC should be involved in taking what are quasi political decisions? It may be, it may not be. I ask for your views; secondly, whether or not at that stage the Bank has any discussion with the Treasury over how it is going to do it?

Paul Fisher: On the latter first. Of course, we have the remit from the Government that sets out what they expect us to do and how they expect us to do it, and that has recently been revisited and expanded somewhat. So, I think that is something we just have to get on and do. Making monetary policy is always political, with a small “p”. What it isn't anymore is party-political, and so we should not be put under pressure to change interest rates for party-political reasons.

But of course it affects people's lives. That is the whole point about monetary policy, you are trying to improve the economic outcomes for the country in terms of keeping inflation low, employment up and unemployment down. That has to be political. But the decision has been taken to delegate the technical decision of setting monetary policy to the committee, subject to the remit from Government. We think that is the right way to do it. The remit from the Government is very important for us to give us that political legitimacy, and the accountability before this Committee is very important, so we have to come and explain ourselves and what we are doing and the various measures of transparency we have.

Q347 John Thurso: If you refer back to the answers you gave to Brooks Newmark and the questions that he was putting, it is very much about: what is going to happen to the small business? What is going to happen to the individual mortgage holder? It seems to me that there is a potential risk that, when we start unwinding QE, the market reactions are a bit more complex than we perhaps envisage and the effect on the economy is not quite what it might have been. The net result is it puts people who have a lot of debt, in those circumstances, under a degree of pressure that might not have been foreseen. In that circumstance, it seems to me that there is an open invitation to the Chancellor of the day, and the Government of the day, to reassess that. Has any thinking has been going on in that regard?

Paul Fisher: I think the important thing is they have to set the remit annually and they have to set it publicly. If the Government want us to change tack on policy, they can tell us but they have to do so publicly, and there would be consequences for that if they diverged from a remit that had inflation as its primary goal.

Q348 John Thurso: If we look at the pre-crash days where you had your remit, which was an inflation target, and you had interest rates as the basic weapon and the interest rate moved to achieve the target. That entire process, once the target for inflation had been made, had been totally outsourced and was independent and the best academics came to the view. So, we got where we wanted without—as you rightly said—the party politics taking place. If we are now in a position where what you are saying is it is no longer that simple, and there are sufficient impacts that you may need to change your remit on an annual basis, has not the independence of monetary policy been, at least in part, repatriated to the Treasury?

Paul Fisher: I think the remit we have—it was fit for purpose before, and it has been improved—gives us the flexibility to do what we need to on the exit strategy. It can't be in the interests of the UK economy to suddenly put a shock into the system, which means that people with large debts all go bust and their firms or households suddenly become completely broke, because you would kill the economy in your tracks. So, you do want to have a relatively smooth path for policy. However, we can't predict what the reactions in the markets might be, so some of this will be to do it and feeling it as we go along. We can put interest rates up. If there is too big a reaction, we can take interest rates down again. Unwinding asset sales is a bit more problematic than that. We would want to do it on a smooth basis, but we will have to suck it and see a bit on the exit strategy for monetary policy, depending on what the reaction is. Our focus will be on maintaining steady growth and low inflation, and if we saw the economy start to slow down disproportionately, we would have to take action to prevent that.

Q349 Mr Ruffley: Mr Fisher, I would like to have some questions, to have another go around the block on the subject of: might there be a loss when we get to unwinding? McLaren and Smith in the Q1 *Quarterly Bulletin* this year paint a picture that is eminently plausible. I am going to read out for the record, to explain why there could well be a loss, and I am quoting from them, "Because the price of all the gilts held is assumed to fall when gilt sales are announced", i.e. the unwinding, "the gilts are sold for a lower price (over and above the extent to which this would occur anyway as a result of the gilts being purchased 'above par'). HMT makes transfers to the APF to cover this shortfall. Again, where possible, cash in the APF is used to make up this shortfall, with the remainder being transferred from HMT. But because the portfolio gets smaller as sales continue, the amount of coupons received also

starts to fall, and therefore so does the amount of cash available to make up the shortfall: that is why the size of the transfers from HMT increases over time. This continues until the entire portfolio is sold”. That is the end of the quote. They come to the conclusion on their major scenario that the cash transfer from HMT to the Asset Purchase Facility could amount to £8 billion. Now, isn’t that a loss to the public sector?

Paul Fisher: No, I don’t think so.

Q350 Mr Ruffley: Why not? HMT is covering a shortfall that is not covered by coupon or anything else.

Paul Fisher: I am not sure we have that quite right. What happens with asset purchases is we have built up a very substantial portfolio and a very substantial mark to market positive position. Some of that is in the form of cash, which has been given to the Treasury to manage. But that cash will be due back in the APF as the thing unwinds. As we unwind that positive position will get rundown, our central expectation is at the end of the Asset Purchase Facility we are more likely than not to end up with a positive position overall. The cash transfers between the Treasury and ourselves do not really affect that overall profit and loss position on the QE portfolio. It is just a cash management issue.

Q351 Mr Ruffley: Is it? What you are saying is that the coupon, which is being transferred before Christmas, when that is rundown, suppose that isn’t sufficient to cover losses?

Paul Fisher: It is possible that at the end of the day we could have a negative position.

Mr Ruffley: That is the point, it is possible.

Paul Fisher: Yes, you can draw out all the different scenarios. Most of the scenarios we can draw out have us ending in a positive position. Of course, you can take an extreme view and find a scenario in which case there is a negative position.

Q352 Mr Ruffley: With the greatest of respect, it is not extreme. I don’t know if you have read McLaren and Smith in the *Quarterly Bulletin*, which is why I took the trouble to read out a scenario where it is perfectly clear that there will have to be cash transfers from HMT, which in most people’s view, you say “cash transfer”—

Paul Fisher: They will have to transfer the cash back.

Mr Ruffley: Let me just finish. There is a view that that would have to be shown up as a loss to the public sector. I am asking for your comment on that, and you are telling me it is not possible. It is possible, is it not?

Paul Fisher: We will have transferred—

Mr Ruffley: Sorry, it is possible, isn’t it?

Paul Fisher: Which is possible? It is possible for the overall Asset Purchase Facility to end up with a negative position, yes. It is possible.

Mr Ruffley: Thank you, you are conceding that?

Paul Fisher: Yes, it is technically possible.

Mr Ruffley: Thank you, fine. Well, I am getting mixed messages.

Paul Fisher: It is not probable; it is not very likely but it is possible.

Q353 Mr Ruffley: It is possible, but if that eventuality occurs, is that a loss to the public sector or not?

Paul Fisher: It is a cost to the public sector. Whether or not—

Mr Ruffley: It is a cost to the public sector.

Paul Fisher: —there has been an overall profit and loss on the Asset Purchase Facility depends on a whole of other things.

Q354 Mr Ruffley: Well, hang on, a whole range of other things. This is a simple question: is it a loss to the public sector or not?

Paul Fisher: In the extreme case of the—

Q355 Mr Ruffley: In whatever case it is, is it a loss to the public sector?

Paul Fisher: I would not call it a loss because I think the public sector will have benefited hugely from the Asset Purchase Facility in the meantime, and to work out whether the public sector has had a profit or loss you need to take everything into account. It would be a negative cash position.

Q356 Mr Ruffley: It would be a negative cash position—

Paul Fisher: It could be.

Mr Ruffley: —in other words a loss. But what you are importing is something else, and this was the thinking of the Governor when he was asked about this I think by Andrea Leadsom, first of all, in this Committee. I am recalling here, I think he used the words, “It’s a wash”. We took it to mean that he meant by that that the social utility of avoiding a depression was sufficient grounds for believing QE was a good thing and there couldn’t be any negative. But you have used the words “openness” and “transparency”, which is why I want to get back to this concept of whether or not there could be a loss. Could you explain why you don’t think it is probable? Let’s just get back, you are saying it could happen but you think it is not probable.

Paul Fisher: We are currently sitting on a positive position of well over £40 billion up, so there is quite a long way to burn through before we get into a position of there being a negative position at the end of the portfolio. We have mapped out a variety of scenarios for the exit from QE, for different paths of interest rates. Most of those paths—even taking quite extreme assumptions—give you a positive position at the end of the thing. But it is a scenario, there are probabilities attached, and you can certainly take possibilities in the tail that would give you a negative position. That is just the distribution.

Q357 Chair: Are you prepared to send us those scenarios?

Paul Fisher: They are published in the article. But why I don’t call it a loss—let me just explain. Robert does a very, very good job at the DMO and makes decisions with the

Government all the time about how to fund the Government's debt. Those decisions have different cost implications and they result in different cash flows to and from the public sector. We don't think of changes in those decisions as generating a profit and loss. It is just the different cost of funding the Government debt. It happens all the time in a regular way. Effectively, what we are doing is something similar to that. Potentially there will be a cost involved but you would not think of it as a profit and loss. The question is: does it benefit the public finances? I would say it will be a huge benefit because we will have generated more tax revenue and cut unemployment spending by boosting the economy.

Mr Ruffley: Understood.

Q358 Chair: It is really a case of debt management?

Paul Fisher: There is an aspect of this which is close to debt management. I actually published a report on this myself for the Committee on the Global Financial System, which I would be happy to copy on to you. There are certainly interrelationships between monetary policy, which have always been there.

Q359 Mr Ruffley: The OBR 2012, the economic and fiscal outlook, one of the principal forecasts is that the net fiscal impact of the treatment of APF cash flows could be a gain of £55 billion for the Government. So, if that is described as a gain, it must logically be the case that losses could be scored in a different scenario.

Paul Fisher: Yes, we prefer not to think of it as profit or loss. The IMF paper—if that is the one I am thinking of—had some odd things in it because they were not considering coupon income.

Mr Ruffley: Sorry, can you say that again?

Paul Fisher: The IMF paper. Which one was it you were referring to?

Mr Ruffley: The OBR.

Paul Fisher: The OBR. So, that is fine.

Q360 Mr Ruffley: A final question, Mr Fisher. Has there been any discussion at the Bank or with the Debt Management Office about holding the gilts to maturity?

Paul Fisher: No. We will need to be able to reverse our monetary policy position, which means doing two things. Taking the cash out of the market, putting securities back in and changing the maturity structure back to the way it was. So, ultimately we will need to reverse the process of asset purchases. We can do that in a variety of ways. Some of them we could allow to runoff to maturity. Most we would expect to sell back, but there are some other things we could do as part of that exit strategy if we wanted to.

Q361 Chair: You are doing a bit more than a little tweaking of the old debt management, aren't you? I mean that is stretching it quite a long way.

Paul Fisher: It is a very large impact on the Government's debt market, yes.

Q362 Chair: Why don't I ask the same question again, you are doing a bit more than a bit of debt management, aren't you?

Paul Fisher: Yes.

Q363 Chair: Therefore, the accounting treatment, which leads you to say that we should think of this as a debt management cost, just like any other piece of debt management, to say the least, is a questionable accounting approach, something that might be subject to debate and controversy.

Paul Fisher: I think if you—

Chair: Sorry, was that a “yes” or “no” to that question?

Paul Fisher: I am not sure I really understand the question. I think one has to say, “What is the question you want to answer here? Is it what is the impact of asset purchases on the fiscal position?” We can answer that by taking a range of things. Do you want to look at the cash flow implications of the asset purchase? We can consider that. I am arguing that the profit and loss concept does not really fit in this discussion.

Chair: Well, at that point I will bring in Mark Garnier who is struggling to keep quiet.

Q364 Mark Garnier: I am struggling to get my head around what you are saying. You have two very, very simple elements to this asset purchase scheme. You have the capital side of it and the interest side of it. The interest side of it washes itself through because, of course, the Government is currently paying out 229 basis points gross redemption yield, which is then coming into you. You are then paying it, so that cancels itself out effectively.

Paul Fisher: No, it is coming to us instead of going to the market.

Q365 Mark Garnier: Yes, okay, so it is coming to you but it is an income to you. The Government has got it out. But effectively the big picture thing washes itself through. The capital side of it, though, so the purchase of the capital—so ignore the gross redemption yield, just take the capital side of it—you buy gilt when you are trying to reduce interest rates, so you are buying a gilt at, say, 300 basis points yield. Sorry, you are buying gilt to push up the prices, so you are buying it at the lower yields and when you are unwinding it you are selling it at the higher yields, therefore it is lower capital prices. So, on the capital alone you have to have a loss, otherwise QE has not worked.

Paul Fisher: We would expect to get a loss on the capital part, yes, but—

Q366 Mark Garnier: On the capital side. We agree that for the QE to have worked the capital side—excluding all the dividends—would have made a loss. Agreed, yes?

Paul Fisher: That is a central expectation. There are certainly some scenarios where it comes out positive—

Q367 Mark Garnier: Sure. It is a central expectation. You are holding gilt prices high because you want to keep cheap money. When you are unwinding it you are now allowing price to go, so you have to make a loss. Then even if you were to take into account

on your book that you have the dividend coming in, it is still only around anything between 160 and 240 basis points, so it is not very much. That is really unlikely to cover the losses. But the important point is that the Government is paying out this interest anyway, so the only bit that is relevant to this is the capital, which—

Paul Fisher: No, the Government does benefit from the coupon payments because it would have paid those out to the market and not got them back. If it pays them to us it essentially gets them back, and that is a direct saving to the Government on its outflows, so the coupon is very much part of the profit.

Q368 Mark Garnier: Yes, which is why I say it essentially works itself out.

Paul Fisher: But it is not small. Even taking account of the funding charge, the accrued interest is currently about £37 billion. It is very large.

Q369 Mark Garnier: Then I completely take your point. Nonetheless, to say that you have a saved cost, I mean essentially it is dividend out, dividend back and they become dividends going within the system. The capital is the only thing that has an effect, and as you say the capital has a net result.

Paul Fisher: That £37 billion would have been paid out to the private sector and the Government would not have got it back, so that is a £37 billion cash saving to the Government.

Q370 Mark Garnier: Yes, sure; so, £37 billion out, £37 billion back. Therefore, zero.

Paul Fisher: Relative to—we are saving the Government £37 billion. They would have paid that out to the private sector holders of those gilts. That was a direct expenditure by the Government, which they are not now making because it comes back via us.

Q371 Mark Garnier: It is a bit of a moot point, I think it—

Paul Fisher: No, it is very clear, this is part of the saving for the Government. This is money they would have had to spend effectively. They would have had to have raised more debt to pay for the £37 billion coupons than they would have under this arrangement.

Q372 Chair: You told us that there is only a remote chance that a loss will be recorded, is that right?

Paul Fisher: It is not likely. It is in the tail of the distribution.

Q373 Chair: Give us a feel for where in the tail. Give us a probability.

Paul Fisher: I can point you to the scenarios that are laid out in the paper, which give you a range of scenarios. That is how we have done it, rather than do a probability calculation. We have taken stress scenarios for previous increases in interest rates and worked those through.

Q374 Chair: You said even when subject to high-stress scenarios, earlier. That would imply a remote probability, without giving me a number.

Paul Fisher: Yes.

Chair: That the probability is remote.

Paul Fisher: It is unlikely.

Q375 Chair: When are we going to discover this?

Paul Fisher: At the end of the programme, for sure.

Q376 Chair: You never know for sure but, as a guess, roughly when do you think we will start to get a feel for this?

Paul Fisher: The longer time goes by before we unwind the more likely it is we end up with a profit at the end rather than a loss, to use your terminology. The scenario on which we would have ended up with the most negative position was one where we did QE and then quickly unwound it. The longer we are going on the more we are building up this endowment of coupon income, funding it at 0.5% and earning the gilt rate. So, the longer we go on the bigger the buffer we have.

Q377 Chair: Give me a rough feel for the number of years that will elapse before you feel reasonably confident to make this kind of judgment.

Paul Fisher: I am a lot more confident now than I was, enough to say that the central expectation and the probabilities may come.

Q378 Chair: But you are not already confident, I am just trying to get a feel. Are we talking about another five years, another 10 years?

Paul Fisher: You never get 100% confidence, so I am not quite sure how to do it. We are certainly getting more confident all the time that that will be the outcome. I should say this isn't something that we are worried about or spend a lot of time doing, other than because you are interested in it. We don't think this is an interesting question, even.

Chair: I think we have noticed that.

Paul Fisher: We were looking at it because you asked us about it.

Chair: We do listen to the answers, you know, Mr Fisher. We have noticed that.

Mr Ruffley: I wouldn't say it was sneering condescension, but it was pretty close.

Chair: No, I do not think there was any sneering condescension. You are just making a point to us and we are making a point to you, but can you give us a feel for how long this is?

Paul Fisher: I feel reasonably confident now that we should end up with a positive position, and I am getting more confident each year that goes past. I had expected by now we would have been unwinding the QE programme when we started. But we are not, we are still talking about whether or not we should have more stimulus.

Chair: Pat McFadden.

Mark Garnier: I haven't finished my questions.

Chair: Sorry, Mark.

Q379 Mark Garnier: I haven't even started my questions yet. What I want to talk about is the relationship between QE and the movement of the base rate. Many central bankers describe them as being functionally similar. By way of example, Adam Posen said that, compared to changing the Bank Rate, QE "acts on quantities instead of prices that, in basic economics, are just duals of one another". Paul Fisher, would you agree with that?

Paul Fisher: Yes.

Q380 Mark Garnier: The interesting question—coming back to when you were talking to Brooks Newmark a little bit earlier, about the order in which you are starting to tighten monetary policy—is how you go about doing it. As I understood it, when talking to the Governor of the Bank of England and some of your other colleagues in previous sessions, once you run out of space with the base rates you then have to have something that comes in alternatively. That is where QE really takes effect, and that is working on the yield curve. Why would you work on the base rates first rather than on QE?

Paul Fisher: The main reason is it is much easier to be activist with interest rates than it is with gilt sales when we come out, because of the risk of causing disorderly reactions. With interest rates we would be able to move them up, we would be able to move them down. We would be able to stop one month, not do anything for three months and restart again. With gilt sales we really need to be programmatic, so it is just a question of which can you change with the most frequency? It seems to us that it would be better to give the signal with interest rates first.

I come back to the point I made earlier. This isn't a commitment. This is a presumptive plan that the committee have had. In future there will be different committee members. We have a new Governor now. That plan could change, but the expectation is still that we would change interest rates first to give the signal, and then we would sell gilts when we could do so in an orderly fashion.

Q381 Mark Garnier: This also comes back to Brooks Newmark's point about forward guidance and trying to warn people what is going to go on. It is quite interesting when it comes to unwinding the QE process, because you are obviously managing the increase in the debt for the Government. Then, of course, at some point you are going to be competing against the Bank of England who will be pushing gilts into the marketplace. If the Bank is deciding to do it at a certain part of the yield curve, is that going to completely cause a nightmare for your debt management?

Robert Stheeman: If the Bank decided to make sales at one single part of the yield curve, I would argue you would see a distortion in that particular part of the yield curve. You would see a significant move upwards in that part of the yield curve. I am trying to imagine the scenario of why they would want to target a very specific part of the yield curve. I would imagine—and I have to be careful because I am not trying to give the Bank advice here on monetary policy, but this is purely as an observer—that the Bank would be looking, when it comes to any programmatic sales to be doing something quite similar to

what they did on the way in. In other words, they would look across the entire yield curve and probably not want necessarily to target any one particular part.

That is a personal opinion. For instance, I am aware in the United States that things would be done differently. There could be scenarios where the MPC decides to choose otherwise. I am giving you purely a personal opinion on that one.

Q382 Mark Garnier: Paul Fisher, Mr Stheeman has been very, very gentle in his advice. In fact it is personal opinion. He does not want to give any formal advice. But it is a very important point. To what extent are you taking advice from the DMO, in terms of what you will be doing at some point in the future when you are unwinding QE?

Paul Fisher: We would always value the input and knowledge of the DMO in designing and influencing what we do. Robert has the responsibility of ensuring an orderly gilt market. Although we do not have that responsibility officially the Government's debt market is part of the transmission mechanism for interest rates, and it is not in our interests, either from a financial or monetary stability point of view, to have a disorderly Government debt market. So, our interests are very much aligned. I always value Robert's detailed input, from him and his team, on how we should be doing things.

But ultimately, I have to design operations that deliver the monetary policy requirements of the MPC, so that is my primary goal. If in doing that I can take input from the DMO and make sure we do it in an orderly fashion, then that will be the ideal.

Q383 Mark Garnier: My final question, if I may, do you anticipate any scenario where you will just simply allow the gilts to run to maturity and allow them to—

Paul Fisher: We have some very long-dated gilts, so I can't quite see that.

Mark Garnier: It would be a very passive measure to take.

Paul Fisher: I don't think it will work like that. We have injected something like £280 billion extra reserves into the system. There were £36 billion of reserves at the start of doing QE, so there is an awful lot of cash we need to unwind. I suspect, going forward, the banks will be required to hold much bigger reserves portfolios than they did before as part of their reserve buffers. So, there will be a certain amount of cash we will absolutely have to take out of the market, and we will then have to back those reserves with something. That could be gilts or it could just be our lending operations. We haven't decided that yet.

So, I could imagine a situation in which a certain proportion of gilts remained on our balance sheet to back a high level of reserves, and we could do that as part of the unwind, but that is very speculative at the moment. The starting point would be that we should expect to unwind the monetary impulse that we have put in, and that will certainly involve selling off at least a substantial proportion of the gilts, probably most of them.

Q384 Mr McFadden: I won't detain you long; I think we have reached the end of this. I want to take you back to where we started. Mr Fisher, I am a bit confused about the replies you gave earlier about your response to the Ben Bernanke tapering signal. If I remember rightly, when we started this session you were saying something along the lines of

injecting that kind of uncertainty into the market is not a bad thing. Yet after the recent meeting, the MPC appeared to not like that reaction by saying that expectations of interest rates going up any time in the near future were not warranted. Can I ask you, within the Bank was the reaction to Ben Bernanke's tapering announcement that it was welcome news or that it was not warranted? It can't be both of these things.

Paul Fisher: What I was saying about the US is very much a personal view rather than a Bank view, but the US economy is much further advanced than we are in terms of the rate of growth and its general levels of activity. So, what is right for the US is not necessarily right for the UK, and that is what we were saying in the MPC statement. We did not think there had been enough changes in the UK data or the outlook to warrant the change in gilt rates that we had seen as a result of the US announcement. That does not mean to say that what happened in the US wasn't appropriate, given where US policy is.

Q385 Mr McFadden: Since we have had a dry run—if you want to call it that, a little bit—through this Ben Bernanke experience, what other discussions in the Bank on how to communicate the beginning of the exit to QE, how confident are you that you can signal the exit without shouting “Fire!” in the theatre?

Paul Fisher: It will be a great challenge. I should say that all of the discussions we are having at the moment are more about whether we should be giving forward guidance and using thresholds; whether we should be giving more stimulus rather than discussing what the exit strategy will be. We will no doubt get to that when we get a bit closer to the exit. I think people have looked very hard at what has happened in the US and will be absorbing that, in terms of what our reactions in future might be. One of the messages I personally take is that it is dangerous if you let the market get so one way round in their expectations that things have become a one-way bet in the market. That is essentially what had happened.

By being transparent, you should be in a position where there are risks on both sides all the time. If you are setting policy correctly, there should be a risk that you need to tighten or a risk that you need to loosen, and the market had got itself into just one angle of that that it was just going to stay looser for longer.

Q386 Mr McFadden: You have used phrases in this session—and I don't mean just you personally—the way this is talked about is the exit should be on a smooth basis that it should be programmatic and so on. It is not the way these markets work, is it?

Paul Fisher: No. The operation should be trying to keep smooth and programmatic. We can't control the degree of volatility in the markets. As I said at the start, the markets will be forward-looking. They will get a little bit of news and they will move quite a long way. That will happen as we get up towards the exit point. Probably before we have said anything the market will react and be starting to move in that direction. Most of the time when we change monetary policy we are validating a move that has already been in the market. Only rarely do we shock it with something it wasn't expecting.

Q387 Mr McFadden: So, your communications challenge on this is quite a big one, isn't it?

Paul Fisher: Yes, and we will need to address it in speeches, articles and communications, over quite a long period over the next few years in that run up, as to how we are thinking about what the exit strategy will be, so that people understand their reaction function in an even-handed way and not just get one-sided.

Q388 Chair: Mr Stheeman, near the beginning of the session you described the DMO's status as one of operational independence, if I am not mistaken.

Robert Stheeman: I said we operate at arm's length—I think that is what is in our so-called framework document—from the Treasury. But we are accountable to Treasury Ministers, and I have reporting lines directly into the Treasury, yes.

Q389 Chair: This arm's length decision-making process means that you are left alone to get on with the job, totally, of managing the debt?

Robert Stheeman: It means that, in terms of the actual remit, which we receive every year at the time of the Budget, once that remit is set within the parameters of that remit we have operational freedom to do what we think best. That remit, for instance, constrains us in terms of how much we are issuing in different maturity buckets, shorts, mediums, longs; how much inflation-linked debt. All that has to be agreed and signed off by Ministers. That is a ministerial decision. It is based on—

Q390 Chair: At the beginning of each year?

Robert Stheeman: At the beginning of each year.

Q391 Chair: From then on you are on your own, you can do it as you like?

Robert Stheeman: For want of a better expression, I always regard the remit as our marching orders. We take that away. We will then talk regularly, formally and informally, with the market on how best to deliver that and we will make a series of calendar issuance announcements throughout the year.

Q392 Chair: If you felt that that operational freedom within the envelope of the annual remit was in some way compromised by other interested parties leaning on you to do a particular thing, what would you do about it?

Robert Stheeman: In the first instance, I would probably talk to colleagues in the Treasury. In the first instance.

Q393 Chair: That is officials?

Robert Stheeman: Officials in the Treasury, yes.

Q394 Chair: And then?

Robert Stheeman: I would talk to them a little bit more. I would raise it and, ultimately, I have the ability if I want to raise it directly with Ministers.

Q395 Chair: The reason I am asking this question is that, to some degree, the credibility of the DMO hinges on the fact that you have that operational autonomy, freedom or independence—whichever word you want to use—does it not?

Robert Stheeman: It does.

Q396 Chair: Therefore, the exchange we are having now is not irrelevant to the way the markets perceive your operations, to put it mildly.

Robert Stheeman: I accept that point. I completely agree, and I think that is true. I would just say that the nature of the independence that we have is, for instance, a different one to the nature of the Bank's independence, which is statutory. As I said at the beginning, we do not have any legal existence of our own. So, arguably, I would say that independence is not quite as hard, for instance, as it is in the case of the Bank of England. That does not mean that we would not defend it robustly if, for any reason, we felt that it was unnecessarily being threatened.

Q397 Chair: If you were official, your port of call to protect yourself would be first of all to a senior official and then to a Minister, if you could get any change, and then finally if you wanted you could take it to the Cabinet Secretary to force a discussion with the Prime Minister. But in your case you have another point of call, don't you, which is to discuss it publicly?

Robert Stheeman: Yes.

Chair: And it is understood that you would have that opportunity?

Robert Stheeman: Yes. I can't think of one occasion, in the 15 years that the DMO have existed, where we have felt the need to engage in a public discussion to emphasise our independence in the face of something that might undermine that. I am not aware of that.

Q398 Chair: I just want to clarify, at the moment everything looks wonderful on the debt management front, because after all quite a number of them get swept up or have been swept up over the last few years, gone out of one door and come back through another. When that goes into reverse, your job might get quite tough. I am sure it is not easy now—I am very pleased you sleep at night. But there may be quite wide implications for the economy as a whole, and I want to be clear on what you are going to do about it if you feel you are being unreasonably leaned on, for any purpose whatever that may be. I want to clarify that you will be prepared to speak up publicly if you feel it appropriate.

Robert Stheeman: I would.

Chair: That is what I want to hear. Thank you very much indeed. Thank you for the very interesting evidence we have had; exchanges that sometimes have seemed like ships passing in the night and at other times been extremely informative, and we are very grateful to you.

