Treasury Committee

Oral evidence: Economic impact of coronavirus, HC 271

Wednesday 20 May 2020

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Mr Steve Baker; Harriett Baldwin; Anthony Browne; Felicity Buchan; Ms Angela Eagle; Mike Hill; Julie Marson; Siobhain McDonagh; Alison Thewliss.

Questions 499 – 545

Witnesses

I: Andrew Bailey, Governor, Bank of England; Ben Broadbent, Deputy Governor, Monetary Policy, Bank of England; Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England; Elisabeth Stheeman, External Member, Financial Policy Committee, Bank of England; Jonathan Haskel, External Member, Monetary Policy Committee, Bank of England.

Examination of witnesses

Witnesses: Andrew Bailey, Ben Broadbent, Sir Jon Cunliffe, Elisabeth Stheeman and Jonathan Haskel.

Q499 **Chair:** Good afternoon and welcome to the Treasury Select Committee session with the Bank of England regarding the economic situation and the coronavirus. I would like to welcome our panel to the Committee this afternoon. Perhaps I can begin by asking them to introduce themselves.

Andrew Bailey: Good afternoon. I am Andrew Bailey, the Governor of the Bank of England.

Ben Broadbent: I am Ben Broadbent, Deputy Governor for Monetary Policy at the Bank.

Sir Jon Cunliffe: I am Jon Cunliffe, Deputy Governor for Financial Stability.

Elisabeth Stheeman: I am Elisabeth Stheeman, external member of the Financial Policy Committee.

Jonathan Haskel: Good afternoon. I am Jonathan Haskel. I am an external member of the Monetary Policy Committee.

Q500 **Chair:** Thank you very much. Can I extend a very warm welcome to each and every one of you? Thank you for giving us your time today to appear before the Committee. We have to finish at 4.30 sharp for broadcasting reasons, so I remind members of the Committee that we are restricting questions to 10 minutes per Committee member. Those asking questions will be directing their question typically at one member of the panel. However, if a second or maybe even third member of the panel really wants to say something on a particular matter that the first person has not covered, please raise your hand and I will attempt to bring you in at that point. Bear in mind that you are perfectly at liberty, after this Committee meeting, to write to the Committee with any further thoughts or follow-up information that you feel appropriate.

We are not expecting any votes this afternoon during the time that the Committee is sitting. Should that happen, and votes come early, I will adjourn the Committee for around 10 minutes, just to make everybody aware that that is a possibility, although unlikely. Having said all that, let me now start with our first question, which I would like to put to Andrew Bailey.

Andrew, welcome to the Committee. It is good to see you again. Sir John Vickers has recently suggested that the banks might not be as well capitalised as the Bank of England might feel for the current crisis. One reason for asserting that is his sense that the value of the assets held by banks should be gauged by their share price, rather than the existing approach that is taken, with his approach having the advantage of the immediate and up-to-date nature of that particular valuation. No doubt you will tell the Committee, and you are right to, that the level of capitalisation of banks is much higher than it was back in 2007—I am taking your answer away from you—that you have conducted your stress tests around the *Monetary Policy Report* illustrative scenario, and that your sensitivity analysis and everything else is okay. Is there a chance that Sir John, who after all is a man who knows rather a lot about these matters, might just be on to something?

Andrew Bailey: You are right. We have of course done a stress test. We have done what we call a desktop stress test in the context of the interim *Financial Stability Report* we have just published. I would be happy to discuss that, as would all members of the FPC who are here. Let me start by, in a sense, tackling the point John Vickers makes directly, because it is interesting. It is not particularly a new point for John to make, but it is worth tackling in its own right. As you say, at the root of this, John is saying, "Look, there are two ways to value any firm, banks being an example. One is the market value and the other is what we tend to call the book value". We do the stress tests, as do all other central banks around the world, based on the book value of the assets, but why do we not look at the market value of the assets?

The background to that, and the point John is making, is that, if my memory serves me right, for most of the period since the financial crisis, not just in the UK but across a lot of other countries, banks have typically traded, in terms of their market value, at a discount to their book value. This is often called price-to-book ratio. It differs from bank to bank. Some do not trade at a discount; some do. As an FPC, I can assure you we spend time examining why that is so and have done so long before covid ever came along.

This is what I would say. I will tell you how John will respond to this, but I am going to say it anyway. Had you done a stress test in the run-up to the financial crisis on the market value, you would have been doing it on market values that were trading well in excess of book values. It was not untypical, before the financial crisis, to have market values that were one and a half or two times book value. That would severely have misled you, coming into the financial crisis. You would have concluded that there was no problem. Obviously, you would have been badly wrong.

I know exactly what John Vickers' response to that is: that we should be asymmetric, i.e. that you should only use the market value test when the market value is below one, so below the book value or below par, not when it is above. We could debate that point at length, but I am not going to do that this afternoon. The better question to ask, as we do frequently, is why the market value trades below the book value. Does it tell us something about the assets or something about what I might call the franchise, the business model of the bank and its earnings capacity going forward?

Since the crisis, as a deliberate matter of policy, we have increased the capital that banks are required to hold for a given level of assets or a given level of balance sheet. You often hear banks saying they have to earn their cost of capital. Of course, the more capital they have, in a sense, the more challenging that becomes. That is an adjustment they are all going through. Some business models, frankly, are doing better than others.

We think that the market value tells you more about the business model, its sustainability and the earning power of the bank, rather than the fundamental value of the assets. I do not agree with John, actually, in terms of doing it. Going back to my point about before the crisis, I think we should do stress tests consistently. I do agree with John that, as a financial stability body, we have to ask ourselves, as we do, "Why are they trading below book value? What does it tell us about the individual institutions and the sector as a whole?" It tells us that some business models are having to adjust to the post-crisis world. For some, it has been easier than others. For some, the market still has some concerns about elements of their business model.

That is reflected in the fact that a number of banks have undertaken quite big changes to their business models. For instance, a number have, in quite a costly way, exited investment banking over time, because they are responding to that signal coming from the markets. I do not think that signal is as good a read on fundamental asset values and the book value of their assets as doing a stress test on the book value of the assets using an economic scenario, using all the techniques and tools that we do.

Q501 **Chair:** Can I quickly follow that up? With the *Monetary Policy Report* stress test, you have this sensitivity analysis on the lockdown assumptions and the impact it might have on GDP, and thereby the impact it would have on the requirement for banks and their capital position as a consequence of that. In the absence of any policy differences, and if the world stayed the same, which I know is a huge assumption, how much of an extension of the current lockdown, pre a vaccine, for example, could the banking system sustain, still meeting its minimum capital requirements? How long could it go on, if the Government were to keep lockdown in place, under the model you put forward?

Andrew Bailey: I cannot give you a precise answer to that. Let me explain why. What I can tell you is on the basis of what we published. We published two things. We published our assessment of the banks against the scenario that we used in the *Monetary Policy Report*. Let me just paint a bit of a picture here, if you do not mind. We have never done this before; we have never published a *Financial Stability Report* and a stress test at the same time as the *Monetary Policy Report*. The reason we did it is quite simple, in a way. The *Monetary Policy Report* has in it what you might call a central view of the economy, on the basis of which monetary policy is determined. Financial stability is operating in the stressed tail, if you like, but let us not make any bones about it: we are in a stressed condition. We are in a quite unusually difficult condition at the moment. To our mind, had we published a central view in that stress and not sought to answer the question of what impact it has on the banking system and its stability, it would have been a gap. In and of itself, in the worst situation, it could have caused instability in the banking system by leaving that question unanswered, so we did answer the question.

We then did the second thing, using the so-called sensitivities we developed in the context of the *Monetary Policy Report* for that scenario. We might come back later to why it is a scenario and not a forecast; it is probably best I leave that until later. We used those sensitivities, or you can use those sensitivities, to provide estimates. The first sensitivity is what happens if the lockdown gets extended. How does that affect it? There are then the unemployment effects of the scenario.

However, among the reasons that you cannot mechanically extrapolate this is, first, that there is a lot of uncertainty around the situation. Secondly, one of the two underlying reasons I would pick out for why the stress tests came out somewhat differently to our normal stress tests is that, in our normal stress tests, we do not assume what I call the discretionary use of fiscal policy by the Government. We assume normal fiscal conditions. We let so-called automatic stabilisers operate, but we do not assume that the Government are going to come riding in with special measures. Obviously they have, in my view very sensibly.

Going forward, the answer to your question would have to prejudge the question: not only would the stress continue, but what would the Government response be? You would have to answer questions like that to form a view on the resilience in the banking system. I can tell you that the result of that desktop stress test was inside, as we call it, last year's regular stress test. It means the banks were not as stressed as in the stress test we ran last year. There is margin for further pressure.

This is often thought to be a radical point, but I do not think it is. Underlying your question, there is a point, which I cannot be precise about, at which that resilience comes towards the end. I cannot deny that. We think it has quite a bit of a way to go beyond that stress and there are things that banks can do.

Let me finish with the other big point on the stress test, which I am happy to come back to later. Banks get a better result in that stress, and in our assessment would continue to get a better result, in your scenario, by continuing to lend. It supports the economy better and that rebounds back into the health of the banks.

Sir Jon Cunliffe: I will make two quick points on the price-to-book ratio. There are other indicators of what the market thinks about bank solvency and the quality of their assets. There is the credit default swap spread, which tends to increase when the market is worried about solvency. Then there is the price of the bank debt, particularly the bank debt that gets bailed in as banks get closer to problems. In 2008, we not only saw the share price fall; we saw those indicators go in the other direction, which indicated severe market concerns about bank solvency. That has not been the case this time. Those indicators are not suggesting that the market is concerned about asset quality, in the way it was in 2008. To my mind, that supports that a lot of the share price is to do with bank profitability, as opposed to bank solvency.

If one wants to know how solvent the banks are, and the quality of their assets, in the end there is no alternative but to do a bottom-up test, in the way we have done it, with a cross-check on 85,000 companies to ascertain corporate impairments, and to build it bottom-up in that way, rather than taking broadly what the market says. As Andrew has pointed out, the market has not always been right about the quality of bank assets.

Q502 **Felicity Buchan:** Can I start by thanking you, Andrew, and your team for all your efforts during this very difficult period? I know you have all collectively put in so much. Can I start with a general monetary policy question? Would you now contemplate negative interest rates and buying riskier assets under QE?

Andrew Bailey: I will start. Colleagues may wish to come in, because this question is getting some attention. Let me start with a very general point. We do not rule things out as a matter of principle. That would be foolish. I would follow that up by saying that it does not mean we rule things in either. The MPC has a history, since the financial crisis and the very sharp cuts in interest rates that happened in that period, of keeping under periodic review the so-called lower bound. The Committee has done that several times since the financial crisis, with good reason. Given what we have had to do in the last few weeks, it will be no surprise to learn that we are keeping the tools under active review in the current situation.

I will mention a few things on that. What are we doing, actually? First, we are very keen to observe, and are observing, how the economy responds to the cuts we have made. We have cut rates nearly to zero now, to 0.1%. We are particularly keen to observe that, bearing in mind arguments that are made, and well made, that the effects of cuts weaken as you get nearer to the zero bound and could even become counterproductive. That is an argument that we also have to assess in the context of negative rates.

We are also observing the effects of the measures we can use, and have used, to counteract that weakness of pass-through. In March, we implemented a new term-funding scheme, which effectively provides medium-term funding by the Bank of England to the banks at the policy rate, to reinforce the pass-through as we get down into this zone where the pass-through is weaker if we leave it to its own course.

Next, we are looking carefully at the experiences of those other central banks that have used negative rates. A number of them are publishing quite interesting assessments of that at the moment. If I could draw some overall messages from that, first, the context in which negative rates are used is so important. That is the cyclical context. Secondly, the structure of the financial systems in which they are done is important. Each country has a different structure: the structure of its system and of its banking system. Thirdly, the communication of it, were one to go near it, would be critical. Naturally, if you do not mind me saying so, I think members of the public would find it quite challenging to understand exactly what it is and what it is not. Let us be clear: in countries that have used negative rates, it is quite a nuanced policy tool. It is not a straightforward policy tool.

I would just say that we are not ruling it in, but we are not ruling it out. Now is the right time to review all the tools we are using. We are always reviewing the effectiveness of using quantitative easing and, as you say, we also review the prospects for the use of what is sometimes called credit easing or the purchase of risky assets. Bear in mind that we did innovate there in March, with the introduction of the commercial paper facility, on which we have now advanced about £20 billion to companies. We have some of our own evidence; we have evidence from other central banks. We are doing work on all those tools and will continue to do it, because we know we may have to draw on our toolkit at any point. As you referred to, we have had that experience of having to act very rapidly, so having the whole toolkit under review and assessed as the context changes is important.

Q503 **Felicity Buchan:** Can I ask you about corporate indebtedness? Are you concerned about the level of corporate debt? What effect could that have on the economy and financial stability?

Andrew Bailey: A few minutes ago, Jon referred to the very big piece of work we have done in recent weeks, which was summarised in the interim *Financial Stability Report*. There is also an underlying technical paper to read on how we did it, which really is a bit of a path-breaking piece of work. It looks at a very large number of corporates in this country and assesses their indebtedness, and the risk, frankly, as we go through the shock. We produced an assessment of what we thought the financing requirements of the corporate sector could be, effectively over the year to come. We looked at the requirements and then we looked at the sources of funds.

I would draw a number of things out of that, but let me make one other point, which is very important in thinking about the interventions that have been made. Coming back to the commercial paper facility for a moment, there are two things to note about that. First, bear in mind that the Government take the credit risk on it, so there is a lot of co-ordination on this piece of the patch. We had a cut-off of credit rating pre-covid, saying, "If you were investment grade pre-covid, you have access". It does not matter what has happened post that, because that is a shock that you were not expected to be able to take into account. If you were not, you do not have access. I will come back to that point in a moment. We then lent at the official rates, so in a sense we are taking out the risk premium caused by covid. That is absolutely deliberate.

Going back to the work I referred to on the corporate sector, and looking at the schemes the Government have introduced and our scheme, in the three months up to March, the commercial banks did a lot of lending to large corporates. There were actually record levels of bank lending in the first three months of this year, particularly as larger corporates drew down on their credit facilities in anticipation of a problem to come. If you put all that together and then add in the cash balances that the corporate sector is holding with the banking system, you start with a figure of about £150 billion. You can take a lot of that out, but we think there is a number of about £40 billion or £50 billion that is not filled.

We think some of that has been filled by the Chancellor extending the so-called CLBIL scheme to a wider array of corporate ratings, and extending the amount companies can get under it, but there will still be companies that do not have access. One principal reason for that is their condition before any of this happened. They were over-indebted before covid ever came along, and there are two things on that. First, I am afraid they have to take responsibility, in my view, for sorting that out. Secondly, the need for them, where it can be met, is not debt; it is equity. The answer to that situation is not more debt.

We and the Treasury—the Chancellor and I are in close contact on this—are working on the options for equity. By the way, speaking personally, I hope the first port of call is the market. You have seen companies raise equity in the market even while we have been in this problem, so that is encouraging. It is important and has been reported on by a number of newspapers. I am in close contact with a lot of firms and TheCityUK, encouraging them to say, "Look, we have to have options for equity". Either those companies or some companies that are taking on debt during this period will conclude that, going forward, post crisis, they need more equity. They may need to substitute debt for equity. I would put quite a lot of focus on that as a piece of the picture. We need to be clear that that needs to be addressed.

Q504 **Felicity Buchan:** Do you think that we need a formal scheme, whereby we can swap debt for equity?

Andrew Bailey: I do not know whether it has to be a formal scheme, but we need the tools that allow it to happen. Of course, the market has tools. Do not get me wrong; there are tools out there. The question is whether we need more than the regular market tools, because of the unique situation we are in. Let us be honest: there are going to be questions about how we balance what I might call private interest with public. There will be public interest considerations here about which sectors companies operate in, where they are vital to the economy or society. We have to balance carefully private and public interest. I hope a lot of that can be done by the private sector with influence by the public sector, rather than the public sector having to take the equity up, but we have to have those considerations in mind.

Q505 **Felicity Buchan:** You have said that it is in the collective interests of banks to lend. Do you get the sense that banks are prepared at the moment to use their own balance sheets to lend?

Andrew Bailey: Yes. There are two things on that. First, as I said, lending to large corporates had taken off before we got into the lockdown period. Those are published figures. If you look at lending in the first three months of this year, it was running at something like eight times normal for a year, so it was a very, very high rate of running. A lot of that was corporates drawing down on facilities.

What were slower to take off, as has been well documented, were the very smallest. They are now covered by the bounce-back loan scheme. The bounce-back loan scheme has taken off very rapidly, now it is in place. The Chancellor and I discussed it a lot. It is absolutely the right thing to do, and has been taken up very rapidly, so the numbers are big, in terms of both numbers of companies and now the money. It did require that change to unblock that process.

To be fair to the banks, I will say two things. First, like all of us, they are operating under difficult operational conditions at the moment. Secondly, in the end, it required the switch from 80:20, Government to private, to 100:0. Let me be clear. The Chancellor and I discussed 80:20. I thought it was very sensible, as did he initially, and that it would get the right balance of incentives. The problem was that the number of small companies coming forward was just too big. At 20, the banks were saying, "We are going to apply our tests and standards". That is fair enough. It required that change and it was a sensible change to make.

Chair: This applies to all panellists. Unfortunately, the timing is quite tight in this session. Keep your answers relatively short.

Andrew Bailey: Apologies.

Chair: No, not at all. There is a lot to explain and I totally understand that.

Q506 **Julie Marson:** May I address my question to Sir Jon, please? The Chair started talking about the stress test. I would like to return to that in a little more detail, please. The desktop stress test is called a "plausible illustrative scenario". Each of those words is important. I wonder if you can go back to that and mention why it is a scenario, rather than a forecast. Equally, as a scenario, it is not really a worst case. How much of a worst case is it? If we are really looking to learn and manage these scenarios, do we not need to be more robust in saying what the worst case actually is?

Sir Jon Cunliffe: Let me try to deal with that. First, on this question of a scenario versus a forecast, the scenario comes from the MPC, but the point applies to both committees. In my view, one makes a forecast when one can take a view on the probability distribution of different outcomes around that forecast. It is normal for the MPC to make a forecast and say, "This is our best collective judgment of the central probability", and then to publish the so-called fan charts, a range of outcomes around that. It is then for the Financial Policy Committee to look at the less likely outcomes, whereas the Monetary Policy Committee looks at the central one.

The judgment for both committees was that, considering this pandemic, the way it is playing through the world economy and the UK economy, the public health measures that are necessary to contain it through time, and the chances of a second or third wave, a vaccine or an effective remedy, we do not really have the normal experience of risk to take a risk-based judgment on those things. It is the difference between uncertainty where one is truly uncertain about the outcome and somewhere where you have an experience of things having happened in the past, so you can make an assessment of the likelihood of the risk. Risk assessments are difficult, but you have something to base them on. With uncertainty, one basically does not know.

I have learned through this crisis that epidemiologists find it as difficult to agree as economists, which I suppose is understandable but not entirely reassuring. For us to make a probabilistic forecast of the central path is very difficult. We would be depending on a medical assessment that we cannot easily make. As I say, the health profession is by no means certain. We are also learning all the time about the evolution of the crisis. A scenario is one possible path through all those probabilities. It is a path that has some credibility to it, but it is not necessarily the one that you think is central. Both committees thought it would be misleading to say, "This is our central probability", et cetera.

How then do we deal with your point? Should we not be looking at downside risk and testing the extremes? I do not know where the extremes lie, because I have never seen advanced economies shut down a third of their economy in a matter of weeks before. You do that by sensitivities. It is imperfect, but the way we tried to probe those issues was to look at the sensitivities. In the stress test, banks lose 3.8 percentage points of capital, about 45% of the buffers they hold, before they hit their minimum requirements. We published some mechanical sensitivities about an extra two weeks of lockdown requiring around 20 basis points of capital to absorb the losses. You cannot do the mechanical calculations because, as Andrew says, you have to work through everything else that is happening, but that gives you an idea of resilience.

For the Financial Policy Committee, we normally test the tail of the distribution, but it is very difficult to say how far into the tail we are at the moment and what that tail looks like. That was the reason for both committees doing something that was not their normal practice. As we learn more about the health side of this, and we get a better feel for what it will take to bring this under control, we may be able to go back to a forecast based on probabilities and indicate that. At the time of the interim *FSR*—I am sure Ben will come in on this—and the *MPR*, I do not think the committees felt we could do that.

Q507 **Julie Marson:** I am still trying to get a feel for whether it gives us policy options if we drill down into the absolute worst-case scenario. It is unpredictable, like you say, and there are so many epidemiological and other uncertainties. Tell me if you think my characterisation is wrong, but the scenario looks at a recovery that is maybe not V-shaped, but somewhere between a V and a U. We could discuss that. There are lots of other scenarios we have heard of: properly U-shaped, L-shaped, a swoosh. I have even heard of a square root, a big second peak, for example. How does it shape up with those different scenarios?

Sir Jon Cunliffe: That makes the point. You have to pick your scenario. It is difficult to know. I have heard of W-shaped as well. We could run through the letters of the alphabet. The underlying point here is one Andrew has made clear publicly. No financial system is infinitely resilient. In the end, the financial system lends to and is exposed to the real economy. If the real economy is not functioning for an extended period, the financial system will reflect that. We tried to show, at that point in time, how resilient it was to one path, and then some sensitivities, to give people an idea of the risk if there are other parts. As we go through this, we may come up with a different scenario or a forecast that will enable us to take another judgment.

To make one last point, which I think is the point made in the first question, we also wanted to show to the banks and more generally that it was in their own interest to maintain credit, to roll over credit to the economy and new lending, much of which is Government-guaranteed, because they have the resilience to do that, rather than their natural inclination, which is to pull back on everything. We saw how disastrous that was 10 years ago. This is a way of indicating that they had the buffer space to do that in this scenario. You can then calculate around the sensitivities.

As Andrew said, the banks have responded pretty well so far, but it was an important point to demonstrate. In the end, if this is an L shape with no upward leg, no financial system is infinitely resilient.

Q508 **Julie Marson:** To follow on from that, what would have to happen for the banks to fail the test, if you could not stop them indefinitely paying out dividends, for example, or different scenarios to pack that back into that?

Sir Jon Cunliffe: First, it is important that they generate capital and do not pay that capital out. That was the reason for asking them not to pay dividends both in relation to 2019 and for this year. We will need to see how that evolves further. Secondly, the stress test indicates that they could suffer losses up to £80 billion, which is a very large hit. They use up 3.8% of their capital, but they are still well above the regulatory minimum. If we saw that they were heading towards the regulatory minimum, we would have to take other action to deal with that.

It is better to encourage them not to make things worse by cutting back, because then we really would have a credit crunch and a much worse situation for everybody, and to demonstrate where they are, admittedly on one scenario, but with sensitivities, in terms of their resilience at the moment. The FPC will come back to this in its next series of meetings before the summer break. It will come back to it in October. I am afraid we will have to adjust policy as we learn about the evolution of what is effectively a prolonged natural disaster.

Q509 **Anthony Browne:** I will make the declaration that I made at the beginning of the pre-appointment hearing for Andrew Bailey. When I was chief executive of the British Bankers' Association, I worked closely with many members of the panel. I have one quick question for Andrew Bailey, and I emphasise "quick". I am then going to target my questions at Ben Broadbent. Picking up the point about dividends, you made the unprecedented request to banks not to pay out dividends. That is good politics, but you obviously did it for prudential reasons. Can you imagine repeating that request?

Andrew Bailey: Let me say a few things. First, we asked the banks to consider very seriously the case for paying dividends and they decided not to. Let me make a big point about that. Looking at the stress tests we have published for some years now, we allow banks to take so-called management actions—or assumed management, because it is a scenario—which can be taken into account as an offset to losses in the stress. We are very stringent about what we allow in. We always get some pretty imaginative things suggested and we do not allow them.

Say that a bank has a dividend programme and an established, clear communication that it will reduce dividends, and it has not made anything approaching an unconditional promise to pay a dividend, which it never should do, by the way. It would be a nonsense if it did, but some of them get quite strong in what they promise. Then we allow that to be taken into consideration. It seems only natural to us, as we enter an actual stress, that banks should be very cautious, consistent with that, in paying out dividends. That was, in my view, the right thing to do.

The second point follows on from the last question. When you look at a stress, to pick up Jon's point, where a bank is going down to its minimum capital ratio, it almost by definition would not be earning any return on which a dividend could be paid. The issue of dividends would become entirely academic at that point. There would not be any, in effect, because it would be loss-making. That situation would take over at that point.

You said it was good politics for the banks not to pay dividends. It was more than that. It was very sensible from the point of view of the position of their balance sheets and it gives them optionality. If this whole thing turns out to be much less stressful than we might imagine, and their earnings turn out to be more robust, they will get another chance to consider their dividends as time comes round. For now, in my view, it makes absolute sense that they concluded that the right thing to do was to essentially preserve those dividends as capital, as own funds, and therefore be able to draw upon them if needed.

Q510 **Anthony Browne:** I want to turn to macroeconomic policy. My question is targeted at Ben Broadbent. Sir Jon Cunliffe was answering questions about scenarios. As the Deputy Governor for Monetary Policy, you have to base monetary policy on actual forecasts. You study all the economic data coming in. There is increasing speculation that the bounce-back will be more prolonged; it will not be that rapid. What sort of bounce-back do you think it will be? Will there be a lot of permanent economic scarring?

Ben Broadbent: Good afternoon. As Sir Jon said, there is huge uncertainty about the potential paths. Even given the health outlook and allowing for that additional uncertainty, there is an enormous amount. That is why, as Jon explained, we did not feel able to publish a conventional forecast, because we did think there were sufficient grounds to say, "Here is the chance of this versus the chance of that". I will avoid words like "will" because I just think they are misplaced.

I will just say something about our scenario and where it fits into the projections of some others, and maybe a bit at the end about the very latest evidence, for what it is worth. It is not terribly much at this stage. There is a little bit in the *Monetary Policy Report* comparing our scenario with others' projections and it is pretty much in the middle of the pack on GDP, growth over the next couple of years, unemployment and inflation. There is a wide range, but it is more or less in the middle.

If one is to use a letter of the alphabet, and I have heard a lot about our scenario being V-shaped, it is a pretty lopsided V. There is no doubt that, in our scenario, the recovery is far from immediate and takes place over a longer period than the downturn. As you know, in this scenario, GDP falls precipitously in the first half of this year, by over a quarter. It does not return to that level, in this scenario, until 2022. Furthermore, unemployment does not get back to its prior level until the third quarter of 2022, in this scenario. What happens to unemployment in the space of less than two months then takes well over two years to be unwound, so that does not feel much like a V.

You are absolutely right that one reason for that is that, even though the scenario is based on an unwinding of the lockdown that is done by the end of September this year, the MPC felt that significant parts of consumer spending in particular would continue to be restrained by cautious behaviour on the part of households, cautious because of uncertainty about the economic outlook and because, in the case of what we call social consumption—stuff that requires people physically getting together—there would continue to be nervousness about the virus and the health outlook.

There are many other plausible scenarios. The recovery could be longer or foreseeably shorter. In reference to your question about longer-term scarring, here I think the Committee did feel there were downside risks. There may also be downside risks to consumer spending in the interim, relative to our scenario, but we allowed only for one kind of longer-term supply effect on the economy. We factored in the effect of low investment today and over the next two or three years on the capital stock of the economy and thereby its productive potential.

It is possible that there are other sorts of things that would limit, beyond the scenario, the productive potential of the economy. If there were big shifts in demand, for example, from one type of consumer spending to another, or indeed from consumption to investment, that would require a shift in resources. That can impair productive potential, at least for a time. If the labour market has to reallocate people, that can sometimes raise the natural rate of unemployment for a while. Undoubtedly, these effects could exist, but at the time we made the forecast it was not noticeably different from the average of others. It could not really be described as a V.

Finally, on the very latest evidence, for what it is worth—as a caution, I do not think it is worth that much—in the latest numbers we now have on spending, we look at a wide array of very high-frequency indicators: footfall, travel, payments through the wholesale cash system. In the very latest picture we have for the last couple of weeks of consumer spending, it is enormously lower than it was prior to this. If anything, it is marginally less low than we had in the scenario. I do not think that really tells you much, frankly, about the prospects for the next year and a half. As Sir Jon said, we will simply have to follow the evidence and respond accordingly as we get it.

Q511 **Anthony Browne:** As you say, there are lots of uncertainties at the moment. One of the certainties is that we will end up with a national debt considerably bigger than the one we have at the moment, with speculation that it could go from 80% to 100% of GDP. Traditionally, in a normal economic scenario, you would say that would lead, in the longer term, to higher inflation and higher interest rates. How worried are you about the size of the national debt? What do you think the long-term impact will be?

Ben Broadbent: In every developed country, the fiscal response has been enormous and I agree with the Governor that that has been the right thing. If I can put one wrapper around all of public policy, the effort has been to preserve economic capacity and minimise those scarring effects we were talking about a moment ago. Given that we have switched off potentially a large chunk of the economy, it will result in significant increases in Government debt.

You say that has, traditionally, resulted in inflation; I am not sure that is true. The best way to gauge the market's assessment of those risks is to look at the market's assessment of inflation risks. That we can glean from looking at the bond market, the difference between the yield on conventional index gilts in the UK and similar measures elsewhere. There is not an increase in inflation risk in the opinion of the market; if anything, it is the opposite.

If you look at other jurisdictions and developed economies, those so-called breakeven rates have fallen quite a bit since the beginning of the year, all the way out along the maturity spectrum. In sterling markets, those inflation expectations measures have fallen by less, but they are nonetheless lower, not higher, than they were at the start of the year.

Q512 **Harriett Baldwin:** Can I start by putting on record that I was Economic Secretary when Andrew Bailey was appointed to the FCA and that Elisabeth Stheeman is a long-term personal friend of mine? I am going to direct my questions to Sir Jon initially, about the insurance sector. Our constituents are finding that they are not getting payouts on their business interruption insurance. The Chancellor has said that, indeed, if all those policies were to pay out, the sector would be insolvent. I wonder why the Bank has chosen this moment not to publish the results of the 2019 stress test for insurers.

Sir Jon Cunliffe: There are two separate things here. First, there is the issue about to what extent business continuity policies protect against a pandemic.

Harriett Baldwin: I am quite fine for you not to talk about that, because we have discussed it with the FCA. I really want to talk about the publication of the stress test.

Sir Jon Cunliffe: The decision not to publish the stress test was unconnected with the first issue. The issue was that this was the first time the stress test had included life insurers as well as general insurers. We had run a general insurance test for a couple of years beforehand and it was, to some extent, an exploratory test. When the results came back, it was clear that, in order to get a clear enough message for publication, it was going to require quite a lot of work to go back to the companies, probe how they had done the test and assess it. That is not unusual. We had the same thing when we brought in the first stress test for banks.

That then happened at the start of the crisis and the decision was that the resources, both in the companies and the Bank, would be better spent by doing specific stress tests around what we had already seen in the markets and what could happen to the asset side of insurers' balance sheets. They have been subjected to those tests. Their solvency ratios are pretty strong.

In light of that, there was a statement—we said it in the interim *FSR*—that we had subjected them to individual tests, which have a really big downgrade of credit rating in the economy, as to whether their asset side can deal with that. To get the actual test that we have done to the point of publication would have been difficult and I do not think it would have told us very much.

Q513 **Harriett Baldwin:** Do you not think it looks as though you are trying to hide something by not publishing them now? When will they be published?

Sir Jon Cunliffe: I do not know what we will do about the 2019 test as we go through this crisis, because it may not be very relevant to publish it later on. As I say, it would need considerable effort and work to get it to a point where it could be a reliable guide, particularly on the life insurance side. On the other side, we have the solvency ratios of the companies and they are pretty robust.

Q514 **Harriett Baldwin:** Can you say, on the record, that the stress test would not show that any companies are failing?

Sir Jon Cunliffe: I do not think the stress test would show that any companies were failing. As I say, some of the evidence just needs a lot more work to get a clear message that we could publish.

Andrew Bailey: I am doing this slightly from memory, because I am on the PRC, but it was before my time. For general insurance, the stress test was not a pandemic test; it was a natural disaster test. It was a flood and earthquake test, as I remember it, so it would not tell you a lot about the situation we are in at the moment, if anything.

The point that you raised in respect of your constituents is a very important one. I will leave the FCA to one side. On the prudential side, there is a very important question. The prudential capital framework is calibrated to the risks and the policies that are written. The issue, and this is what the FCA is running a court case on, is that for many policies the risk that is written is clear. For some, it appears not to be as clear as it needs to be and that is why there is a court case.

On the life insurance side, because that has attracted a lot of attention, for a pandemic-style risk, you would have to run a completely different stress test. It is relevant, for two reasons. One is credit risk, as Jon was saying. Already under Solvency II there is what is called a one-in-200; it is a 99.5% confidence limit. When the so-called quantitative indicators were put together, about which I remember the industry complained to this Committee quite vocally a few years ago, they were calibrated around the credit events in the 1930s. That is the basic Solvency II. You can obviously stress that.

Secondly and finally on the stress test for life insurance, this is really sad to have to say, I am afraid. I do not like saying this. You would have to look at restructuring the assumption around the mortality models, because in an annuity business, which is what they are, covid is going to have an impact there, but it will tend to have an impact that goes the other way. All of that needs to be considered, as does the position of your constituents, by the way.

Q515 **Harriett Baldwin:** I appreciate that. I just want to put on record that, from the point of view of Parliament, we would like to know whether the prudential policies that we put have in place, and you have been tasked to put in place, are resulting in insurance firms that are sufficiently capitalised. I would urge you to be transparent on that.

I will come on to a question for Elisabeth, along the same lines as the quote from Sir John Vickers, saying that, if the bank is pausing stress tests for insurance companies as a result of covid-19, those same firms should not be able to pay out dividends. Is it appropriate for Legal & General to be making its £750 million dividend payout at present?

Elisabeth Stheeman: I should just say that the question of the insurance stress test would have been discussed on the PRC, the Prudential Regulation Committee, which I am not an external member of. My colleagues, the external members of the PRC, together with the Governor, who chairs both the PRC and the FPC, would have discussed that, as well as the other Deputy Governors who are members.

To talk about what happened to banks, as was discussed in the hearing a little earlier, this was discussed with banks. The FPC does not get involved in individual bank discussions. That again would be the PRC. Given the work being done on capital and how capital would develop under certain scenarios, based on what the MPC had done, the view was that it was better for banks not to pay any dividends. That is what the scenarios are based on: that there are no dividends being paid for 2019 and 2020.

Harriett Baldwin: Perhaps I will come to Sir Jon on the insurance question and Legal & General.

Sir Jon Cunliffe: As Andrew said, insurance companies were stressed against a one-in-200 stress, which you could think of as a whole single-letter downgrade across half of a diversified portfolio, which is pretty similar to what happened in 1932, which I think was the worst year of the Great Depression. Their capital was resilient to a stress of that sort.

The decision the PRA took was not that all insurance companies should be able to pay dividends, but that it should be a case-by-case approach for the insurance industry as opposed to the more across-the-board approach that banks decided to adopt, with some encouragement from the Bank of England. The reason for that was that one needed to go into the position of every company to see how exposed it was and whether it had the resilience. I cannot discuss individual companies.

Q516 **Harriett Baldwin:** What about generically? On the question of the matching adjustment, do you agree with Sir John Vickers when he says that the matching adjustment is more of a mask than a cushion?

Sir Jon Cunliffe: I spent a long period of my life negotiating the matching adjustment in Brussels. I am pleased to see it is alive and well. I think the matching adjustment simply reflects the fact that insurance companies hold their assets to maturity. While they suffer credit risk, and credit events hurt them, market liquidity risks are not suffered. Therefore, if you were to price the assets that insurance companies hold on their balance sheets at market prices, you would pick up how liquid the assets were, whether you could sell them in stress, et cetera. Given that the insurance companies are trying to match liabilities, they hold those assets to the end of their life. Therefore, that is a credit risk, not a liquidity mark-to-market risk. The matching adjustment was designed to reflect that.

Harriett Baldwin: I am out of time, I am afraid.

Q517 **Chair:** I sensed slight frustration there. You might have valued a little more time to probe. On that basis, we might write to the panel after this session. I would ask members of the panel to respond very promptly to any letter we might send on the issue of insurance and stress testing.

Andrew Bailey: That would be fine. Sam Woods is also an appropriate person to be involved in that.

Q518 **Siobhain McDonagh:** I would like to look at the impact on households and individuals. The Government have introduced a number of measures aimed at supporting workers and limiting job losses. Where are the cracks in the Government's support programmes? Would it be with new starters or those self-employed and paid by dividend? What would be the consequence of support schemes like those for the self-employed not continuing?

Jonathan Haskel: The design of these schemes is primarily a fiscal matter and primarily a matter for the Government, but as a committee we have to try to look as best we can at trying to work out if there are any gaps and so forth. As the Governor mentioned earlier on, these schemes have been tweaked as time has gone by. There have been various changes and so forth to them, quite rightly. We have faced a very difficult crisis and very difficult situation, which has hit very suddenly, so it is right that has been the case. This is very much a moving target.

In terms of small firms, there has been a lot of discussion that originally the small firms found it difficult to absorb these schemes and so on. Again, as the Governor was saying earlier on, I think that situation has improved with the redesign of the schemes, so there is less of a crack there. There is some suggestion, among our agents and from other sources, about the self-employed, as you mentioned.

Q519 **Siobhain McDonagh:** There is concern there will not be another payout in that scheme, so it will end before the furloughing scheme.

Jonathan Haskel: That is a question to the Government and the fiscal authorities, if I may say. Obviously, we have to pay very close attention to the consequence of that, but the design of the scheme is primarily for the fiscal authorities.

You will have seen in our report that we look at the sectoral impact. We have spent quite a lot of time in the Bank doing the work on the sectoral impact. One of the very big sectors that is affected is construction. To your question, there are lots of self-employed people, enormous numbers of self-employed people, in construction, so the health or otherwise of that sector is very important in thinking about how many self-employed people will do. Again, that is a tricky question, depending on when the lockdown might be released and whether construction can carry on under social distancing measures and so forth. That sectoral mix goes to your question and is another way of asking who is going to be the most exposed to this.

Q520 **Siobhain McDonagh:** Yes, which neatly brings me on to my next question. The impact that the pandemic has on household incomes varies greatly, as you suggested, between sectors, industries, classes and income levels. You are projecting a more than doubling in unemployment to 9%. Where do you expect we will see the greatest losses in income? Who will come out of this with perhaps an enhanced financial position? What impact do you think this has on the economic outlook as a whole?

Jonathan Haskel: My starting point would again be the type of sectoral work we have done. As we have just discussed, one area that has been hit very hard is the construction sector. The construction sector disproportionately employs self-employed people, as we have just been mentioning, so their incomes are going to be hit. The other obvious sector that is going to be hit very hard is hospitality, restaurants and hotels. What are the types of workers who are typically employed in those sectors? The answer is they are young and unskilled workers.

To your question, if we ask where the incidence of difficulty is going to occur, I think it is going to occur most readily under those various types of workers. You will have seen in our report that we cross-checked those types of projections, which we necessarily had to do, before the full extent of the shock was apparent. We cross-checked those projections with the agents. Our Bank of England agents are a very good source of understanding that sectoral impact. If that helps, that is the first part of your question around the income incidence.

If I understood correctly, the second part of your question was about what the consequences of the economic outlook were going to be. It seems to me at least that one way of thinking about this is the following. To the extent that this economic shock hits relatively well-off workers who can borrow, have a stock of savings and can therefore somewhat smooth their way over this recession a little bit—the Governor has used similar types of phrases as well—that would make for a relatively more mild recession.

However, those workers who may be strongly affected are those who are self-employed, young and unskilled, typically do not have many savings and often do not have access to capital markets. That gives a much more Keynesian flavour to the recovery. That is to say that there are many more disadvantaged workers who may not have access to that borrowing and those types of credit. That means the overall stance of monetary and fiscal policy is going to be incredibly important in understanding how we are going to pull out of this recession. The fortunes of those types of workers are going to depend very strongly upon aggregate demand in the economy and whether it is sufficient to pull us back to the inflation target that the MPC is charged with.

Q521 **Siobhain McDonagh:** I am not sure who is the right person on the panel to answer this one; it may be you. It is about the housing market. We can see that it is slowly reopening, with record numbers of first-time buyers registering with estate agents. What short and long-term effects do you think we will see on the housing market? Who will be the winners and the losers?

Jonathan Haskel: Let me say a few words and then maybe others can come in. We talk in the report about the outlook for the housing market. Activity has been so low—more or less non-existent—that you will know that the Office for National Statistics has actually stopped publishing its house price index. It is an incredibly uncertain area. If we do not even have an index of transactions at the moment, if the market is so impaired that we cannot measure what the various sales are, it is going to be very difficult to know how it will come back again. That would be one thought.

Another quick thought would be that it fits in with what Ben was talking about earlier on about the long-term structural change. If it is the case that more people start working from home, there is a change in the demand for inner-city office space and all that, there might be some long-term structural changes that would affect the housing market and the commercial real estate market as well, but that is much more speculative.

Elisabeth Stheeman: Perhaps I could make a few points about the commercial real estate market, which Jonathan has already touched on. He made a really good point that there may well be a structural change in the market. If you think about how people work now compared to three months ago, a lot of companies and industries would not have thought that they were going to pretty much all remote working. Take the Bank of England as an example. There are very few people there physically, and I have certainly seen that talking to people in other industries.

There will be a period where companies will reassess their real estate needs and think through how much office space they will actually need. Prime office in central London will always be high in demand, but, if you look at secondary or tertiary locations, much less will be needed. If you think of areas such as retail, and especially retail malls, there have been retail outlets that have already had issues, especially in secondary and tertiary locations. There is quite likely to be some readjustment.

Q522 **Rushanara Ali:** My first question is to the Governor, picking up on the points Mr Broadbent made about the V shape that does not sound like a V shape, and perhaps he might come back and say which letter would be a better exposition of the scenario that has been painted. Also, Professor Haskel's vote for an increase in quantitative easing seems to reflect a greater pessimism towards the economic outlook. Taking all of that into account, and what, Mr Bailey, you have already said to our Chair around the stability of the banking sector, potential for extended lockdown, rising unemployment, scarring, regional inequality, which we have not touched on, and of course the B-word, which has had fewer mentions more recently, in terms of Brexit and a potential deal at the end of the year, which may still mean not frictionless trade, and possibly even a no-deal Brexit, what does it mean for banking stability and the economic outlook? Are we still looking at a V shape or are we looking at some other shape?

Andrew Bailey: To be honest with you, I am not very much taken with using letters to describe this, but I know it is a convenience that gets used. To draw on some points that have been made, there are a number of things that drive the up leg of the scenario that we have. First, there is obviously the timing and period of lifting the restrictions. When and at what pace that happens will have a big effect. This is different. If there is any such thing as a standard recession, this is different. People will start doing things. We are already seeing some evidence of that. By the way, we see that in China, which is obviously further ahead in terms of coming out. You see a recovery of activity and quite interesting differences in China in what is recovering more quickly and what is not, but you see a recovery as the restrictions get lifted.

The second thing is that we, as Ben said, included in the scenario a period of what I would call natural caution by choice, i.e. even when the Government say you can do things, consumers will be cautious about what they do.

Q523 **Rushanara Ali:** Governor, can I probe on the specifics? What does all this mean for our constituents? People are very worried. We are all very concerned. What does it mean for banking stability if the scenario is much more pessimistic going forward, which it could well be, as some of you already alluded to? What does Brexit mean towards the end of the year? People are beginning to get worried about that again. We need to have a sense of where we are heading. The country is looking to you and your team to give us some sense of direction.

Andrew Bailey: We have given you as much direction as we can. We discussed this earlier. We discussed at length the stability of the banking system. We have made the point. Jon has made the point very clearly. I made it earlier.

Q524 **Rushanara Ali:** What about Brexit?

Andrew Bailey: As we always do, we conditioned the scenario and all the analysis we did around the reports on Government policy. Government policy is that this process will be completed at the end of the year and there will be a trade deal. We will obviously follow that very closely. We are assisting where we can in terms of the work on financial services equivalence. I have to be honest with you: at the moment it is not the dominant issue; the dominant issue is covid, to be clear.

With your constituents, I would say that we are doing everything we can. We have responded very rapidly and with, frankly, a lot of firepower. I have said it a number of times and I will say it again: it is crucially important that, within the framework of our policy, within the inflation target, we are doing everything we can to support the economy. We have done a record amount of QE in volume and we are doing a record amount of QE in flow, and that is deliberate. One of the big things we are doing is keeping the cost of borrowing down, because that feeds through into the state of the economy.

Q525 **Rushanara Ali:** I want to probe you further on this point. What you have done is very welcome, absolutely. As you have heard from Siobhain and others, there are major gaps in terms of the Government's response, such as new starters, the hundreds of thousands of people who are in seasonal work in the restaurant, catering and hospitality sector and so on. Many of those people are getting very little help. Lots of them do not qualify for welfare, which is the Government's default. You then have the spectre of a million unemployed young people and another lost generation. The issue for us is how we can make sure that long-term scarring effect does not have the knock-on effect on the economy, which all of you are familiar with. What else can be done to address those gaps? I appreciate it straddles into policy but where do we go from here to address those gaps?

Andrew Bailey: Let me say two things. It does straddle outside of our responsibilities. The job retention scheme is a very sensible policy. One of the reasons we have a faster recovery than a "normal" recession is because we believe it will enable people to come back into work faster. To my mind, it is a very sensible policy in that respect. The Chancellor has to take some important decisions. He has made an announcement about timing, but he has some important decisions to take on this point about the employer's contribution. That is for him, but I strongly support that as a policy. It is helping people. That will help to reduce scarring because, as Ben was saying earlier, one of the causes of scarring is having higher long-term unemployment.

Secondly, there is the whole set of measures around supporting firms and supporting firms to survive through this shock. There are the various lending programmes, of which we are operating the commercial paper facility. There is about £20 billion outstanding now. Many of those companies are companies that employ a lot of people, and a lot of low-paid people as well, I can assure you. One of things I am absolutely determined about is we are going to publish the names of firms that have borrowed, because it is important that we do for transparency. I want people to understand that the rationale behind this is to support employment and the livelihood of people in this country, your constituents. I am sure I will get told that I should have applied a green factor to it or something, and I am very supportive of that, but the clear and present need at the moment is to support people's livelihoods and thus support the economy.

Q526 **Rushanara Ali:** Sir Jon, I have a question for you. In the last session we talked about supply chains and the international dimension. There are lots of arguments about globalisation and so on. What do you think will be the impact of a retreat from globalisation? Also, in terms of supply chains, there is impact on certain countries because of the behaviour of some of our companies, sometimes for reasons to do with distress that they face and other times because they have decided not to pay up for contracts for ready-made garments, for example, which I mentioned in the past. What do you think will be the impact on the wider international markets, maintaining those supply chains and protecting workers in some of the poorest countries in the world, where we need collaboration? Do you think enough has been done to protect lives globally and make sure this pandemic response is one that is comprehensive but also that the economic response globally is comprehensive enough?

Sir Jon Cunliffe: If I start with the supply chain, there has been a lot of damage to supply chains already. Ben talked earlier about what has been happening in China. In China, activity is back but their export orders are much lower than their general industrial activity. That illustrates the spill-over effects that we get between countries. It is difficult to gaze in a crystal ball, but you can see that most countries want to have more resilience in their health systems and in the way they will deal with pandemics in future. Some of this will go to freedom of movement globally and the way in which that is managed.

I think it is inevitable that, having experienced a shock like this, we will be in for a period where the emerging markets and advanced economies—all countries—think about those issues: "How do I deal with risk that comes from abroad and how do I ensure resilience?" It is important that we recognise that globalisation exposes you to risk from other countries, but, in an integrated global economy, also allows you to share risk with other countries.

Q527 **Rushanara Ali:** Does it have a knock-on effect on our ability to do trade deals with non-EU countries in this context?

Sir Jon Cunliffe: At the moment I do not know how this will play out in terms of trade policy. Countries will want to think about how they control risks that could come from abroad. The key is that, if we go for what I will call responsible forms of self-reliance, it does not lead to a more general unravelling of globalisation and global supply chains, for some of the reasons you mentioned. First, because it is a way for us to share risk.

Secondly, because it has been a very important motor of lifting large sections of the world out of poverty, which benefits us all. Thirdly, if we want the health systems in less developed countries and emerging markets to be capable of dealing with this sort of health crisis in the future, bearing in mind that we are connected to them, we have to have a system globally that allows them to grow and have the resources to do that.

On the second part of your question, about whether enough has yet been done for less developed and emerging market countries, we do not yet know how the health crisis will play out in those countries. It is clear they will be hit by so-called spill-overs from advanced economies. Remittances will be lower, trade will be lower, their exports will be hit, and then of course they will have to cope, to an extent we do not yet know, with the actual pandemic itself. The next stage of this, bluntly, has to be considering again how we support those countries through this crisis. It is ultimately in our interest to do that. The world has become so connected that one cannot simply say, "Let us put up the barriers", and do that. It is in our long-term interest to do that as well.

Q528 **Alison Thewliss:** I want to pick up on the point that some others have begun with around the switching from a forecast to an illustrative scenario. By changing the label from "forecast" to "scenario", are you acknowledging that you have very little idea of how to weight the risks you are seeing and the different outcomes? Are we now in the scenario of suspending the usual fine-tuned policy interventions in favour of judgments and hunches?

Andrew Bailey: Jon and Ben have said earlier on in the hearing that there is risk and uncertainty in this. The level of uncertainty, as Jon was saying, is so high at the moment that it makes it very hazardous to attempt to do a forecast in the right meaning of the sense. The question was how the scenario drives the policy decision. I will come to that. The reason the scenario is important, which you rightly put your finger on, is we still need to have what I call an organising framework for the economic judgments we make; otherwise, ad-hocery can creep in without noticing it sometimes.

As we said, and I will not go over it, there are some really key judgments in there. There are some key judgments about timing of measures and scarring. There was a very important discussion at the Monetary Policy Committee about what proportion of the people who are on the furlough scheme will actually be looking for jobs while they are on the furlough scheme. They either can see they are losing their job or they will think they are going to lose their job, and thus they are competing in the labour market. That comes through to downward pressure on earnings.

If you are truly furloughed, in the sense you are sitting tight and just waiting to return to your job, you are not going to put pressure on other people's earnings because you are not competing. We made an assumption, and you just have to make an assumption about it. It is something we discussed a lot on the committee. Having a model and a scenario enables you to have an organising framework. It creates some consistency, frankly. That is important.

You rightly put your finger on this. How does that link to the policy judgment? By the way, that is true in a forecast as well. If you go back in time, I know members of the Monetary Policy Committee and indeed some of my predecessors as Governor will have said very different things about this at times. It is a matter of judgment. The forecast is a judgment that you apply. It is true that the scenario is, I would say, more remote in that sense, in terms of the link between that and the judgment on policy, but I do not want you to think we are then just making it up as we go along in a random fashion.

It drove a lot of our thinking. It pointed a very clear way ahead for us, but then we had difficult judgments. I would also go back to the question that was asked earlier about tools as well. We are in all sorts of slightly uncharted territory here, in terms of what effect the tools have as well. Yes, there is a lot of judgment, and more so than would usually be the case.

Q529 **Alison Thewliss:** One of the judgments you were making was around the Coronavirus Job Retention Scheme and your assumption that it was going to reduce the number of jobs lost. That assumption is based on companies not topping up wages. If it is now going to be the case that companies are going to be asked to top up wages from the end of July, does that change that assumption altogether?

Andrew Bailey: There are two different things in there. The job retention scheme pays 80%, up to a limit. There is a question today of how many companies are actually paying the remainder to get the person back to where they were before. We have some data on that. Our agents are very helpful on that because they talk to a lot of companies. We do not think a very high proportion are doing that. Some are, but not that many.

You pointed to the second thing, which will come in the future. The Chancellor has to take a decision, when he seeks to get a contribution from companies and in a sense starts to reduce and phase out the economic effects of it, on how he structures that. That is a decision for him to make. I am sure he will give us as many clues and hints as he can. I talk to the Chancellor a lot, so I talk to him about what his thinking is on that. When we come to do our next round, which is coming up in July, we will factor that in as best we can at the time.

Jonathan Haskel: I was trying to find the number the agents have told us of the fraction of firms that, as the Governor was saying, are topping up. It is a very small number. I apologise that I cannot immediately find the exact number.

If I can amplify those remarks a little bit and go to the thrust of your questions, this is indeed a moving target. As well as making these types of judgments that the Governor has just talked about, we are trying to be very transparent about the judgments we have made. We are trying to use the best available evidence that we can to look at those judgments.

There are at least two dimensions to that, which I will mention very quickly. One is the use of the agents, which we have talked about. The other is our very close contact with the Office for National Statistics. The other side of the judgments that we have to make are the judgments that statisticians have to make about how you measure the output of education when you have a large number of schools that are closed. You mentioned about whether we are just feeling our way in the dark. These are difficult economic circumstances and difficult to do from a measurements side and a forecasting side. We are doing everything we can to make sure we can feel our way through less darkness than would otherwise be the case.

Andrew Bailey: Can I add to what Jonathan said? We are expecting there to be more noise around the data releases coming up. I should say that the ONS are doing a terrific job. We all spent the afternoon with them last week, being taken through all the things they are doing to try to overcome the restrictions they are facing. It is excellent, but, honestly, we are going to have a period where there will be more noise around the data.

Q530 **Alison Thewliss:** The MPC report highlights that covid is now a larger source of uncertainty than Brexit, but Brexit has not gone away. Do you think it is something that people have forgotten about just now? Is the risk of a no-deal Brexit something you are still factoring in?

Andrew Bailey: No, Brexit has not gone away, as I was saying earlier, but covid is a much more dominant source of uncertainty at the moment. There is no question about that.

Jonathan Haskel: That is another area where, through the agents and our work on, for example, the DMP—the Decision Maker Panel—we are placed to try to find a little bit of light in this darkness. You will know from our previous interactions on this panel that we spend quite a lot of time asking firms about, for example, how much time they are spending on Brexit, the nature of their preparations and so forth, through the DMP and the agents. We have a good chance of attempting to nail down those types of effects with some hard evidence on the ground, gathered in a timely fashion, so we can get a much better handle on all this.

Q531 **Alison Thewliss:** It would certainly be useful to get more of that data as you get it as well. Could I ask about the estimates of initial collapse in output? How do you calibrate that when nothing like this has ever happened before?

Jonathan Haskel: I mentioned earlier on in the discussion about the construction sector; we have these sectoral indicators. There has been a lot of work, in conjunction with the ONS, that tries to build bottom-up ways of attempting to size this downturn by looking at things such as the input-output tables. For example, those data would tell you that, if the restaurant sector closes, that cascades down to lower demand from the farm sector, lower demand to accountants that are auditing the restaurant and all that kind of thing. In answer to the question of how we have managed to try to size that initial GDP shock, that is based on quite a lot of very thorough bottom-up work, using the structure of the economy and trying to figure out what those various cascade effects are. Maybe that helps as a little bit of background.

Andrew Bailey: To add to what Jonathan said, and coming back to the point, there will be a lot of noise and uncertainty around even the data that we are receiving. To give you an example, the release of Q1 GDP was actually stronger than we had in our scenario. We were weaker in our scenario. That may well be right and it may well be that it did not fall as much as we thought it would, but, just to give you an example, the critical period in that first quarter was the last few days of March. You could have a one or two-day difference in terms of the timing of the lockdown coming into effect in our scenario versus the way the ONS are constructing the estimates. That is perfectly reasonable, given what was going on. It could easily happen. You can account for all that sort of difference and that is just the world of uncertainty we are living in.

Q532 **Alison Thewliss:** Lastly, do you expect to make a forecast in the next quarter, rather than an illustrative scenario?

Andrew Bailey: That is something we are beginning to discuss on the committee. There are a lot of issues there as to whether we feel confident enough. We want to go back to forecasting. Do not get me wrong. It is the first time the MPC has not published a forecast in its lifetime. You have to go back into the pre-MPC early-90s periods, when there were inflation reports produced before independence and the MPC came into being. You have to go a long way back not to have a forecast and a fan chart. To be clear, we want to get back to that, but this reflects the uniquely unusual uncertainty we have been facing.

Ben Broadbent: On monitoring the economy right now, we have a lot of high-frequency information on different areas of consumer spending.

Q533 **Ms Eagle:** The Monetary Policy Committee minutes document states, “In the current circumstances […] monetary policy is aimed at supporting businesses and households through the crisis, and limiting any lasting damage to the economy”. That is not a surprising statement. It is actually quite a comforting statement. Governor, is that your way of conceding that the inflation target is currently suspended?

Andrew Bailey: No, it is not. The inflation target is not suspended at all. It is a way of saying that, given where we are today, we think we have scope—and you can see the inflation profile we had in the scenario—to put emphasis on what are the following objectives that we have, once we are sufficiently confident about the inflation targets. We have a sufficient degree of confidence around the inflation target. At the moment, as you can see from the scenario we published, the challenge for us is getting inflation to return back up to target. As we said in the *Monetary Policy Report*, we are expecting inflation to go pretty near to zero.

Q534 **Ms Eagle:** It has halved, has it not, month to month, from 1.5% to 0.8%?

Andrew Bailey: Yes. I am going to be writing a letter to the Chancellor next month and I will be writing a few more letters based on the scenario we have. By the way, a big part of that, as you will know, is that we have had a very big fall in oil prices.

Q535 **Ms Eagle:** Especially given the huge effect of oil prices on the inflation basket, and how quickly it has gone down in what is obviously a global shock, an exogenous shock, do you think deflation is now a bigger threat than inflation? If so, what do you think the Bank could actually do about it?

Andrew Bailey: We are, not for the first time in the last decade, in a period where we are going to have very low inflation.

Ms Eagle: I am wondering whether you are worried about deflation.

Andrew Bailey: No, I am not worried about what you might call the pernicious sort, which is debt deflation. I am not worried about that at the moment. It requires us to target monetary policy at returning inflation to the target. It always does that, and of course the job for us is to get it back up to target at this point. A lot of that, as the scenario illustrated, will of course depend upon the path of recovery of the economy and what that does to slacken the economy, in terms of the balance between demand and capacity in the economy. As we hopefully illustrated already this afternoon, there is a very large amount of uncertainty around that. That will be something we will learn a lot about. It explains why we have been very aggressive in the use of the policy tools that we have. Over the last period since March, since Mark Carney's last Monetary Policy Committee meeting and my first several, we have been very aggressive in terms of these tools.

Q536 **Ms Eagle:** Governor, given what we have seen from the quite astonishing jobs market data published yesterday, do you think you are likely to be able to use your normal tools in any kind of normal way for quite a long time? If we look, wages are shrinking. In the experimental statistics, it looks like the number of hours worked is down 25% in quarter 2. We have had the fastest rise in unemployment claims since 1947 and the sharpest fall in vacancies since 2001. We are now not, Chancellor included, expecting that to bounce back quickly, partially because of the uncertainties created around the virus and the fact that social distancing is still going to affect the way our service economy works. Where does that leave the tools you have in the box?

Andrew Bailey: I will take you back to the discussion we had earlier on in the hearing, which was prompted by the question on negative rates. My answer to that was that we certainly do not rule anything out. We are not specifically ruling things in at the moment that we are not using, but now is the time to examine the toolbox, to review all the tools we have and also look at, as I said, what tools we might have. That is absolutely the right thing to do and is what we are doing.

I remember at the last hearing, the pre-appointment hearing I had, a member of the Committee asked me a question that followed on from some questions Mark Carney had had about the headroom that the Monetary Policy Committee had. Mark had set out an assessment of the headroom and I have to say that seems rather like ancient history now. The world has changed around us and we have had to consider how we innovate around that sort of headroom calculation a lot. No doubt we will have to go on doing that. We are fully geared up and have our staff working very hard on that stuff.

Q537 **Ms Eagle:** If you are thinking about negative rates—I appreciate you have not ruled them in or out—that is a shift from what you said during your appointment hearing in another age ago, as you rightly pointed out, even though in time it was not that long ago. Would the effect of having negative interest rates not mean that you were saying to the banks, "You have to lend even more"? Would that affect financial stability? Would you be worried about that?

Andrew Bailey: Of course, yes. Lending is part of the incentive there. That is why we have the committees. It is not just a judgment for the Monetary Policy Committee. It is also a judgment for the other two committees, the Financial Policy Committee and the Prudential Regulation Committee. All of them will have to be part of and are part of that assessment. Although the MPC will have to take the decision at the end, the assessment of the other two committees will be fed into it, and that is extremely important. One of my jobs, as chair of all of them, is to make sure that happens, and I can assure you it will happen.

Q538 **Ms Eagle:** Finally, Governor, is it now possible to argue that the independence of the Bank is actually a chimera? You are working so closely, hand in glove, with the Treasury that there is not very much independence left.

Andrew Bailey: No. Thank you for asking this question because I want to push back very hard on this, if you do not mind. Let me start by saying I think that we could only do what we are doing at the moment, in terms of the pace, scale and aggression of the Bank's action, if we were credibly independent. The credibility of the framework and the independence of the Bank is absolutely at the heart of what we can do. Many commentators have written about so-called monetary financing, although it turns out that everybody has a different definition of the term. They have written about inflation risks. They have written about other countries that have had hyperinflation in the past.

My answer to that is a big part of this is the independence of the Bank of England and the credibility of the framework. In my view, we can only do this because we are credible. That is the benefit of it. We can use those tools, going back to your first question, which was absolutely right, to the benefit of the people of this country. That is what we can do and that is what I am committed to doing. I have to tell you that I think this is where the independence of the Bank is really showing its strength, in that we can do this.

Chair: At the mention of the words "monetary financing", I can feel Steve chomping at the bit.

Andrew Bailey: I can predict who is coming next.

Q539 **Mr Baker:** I must refer to my registered shareholding in Glint Pay. As you know, I have talked about monetary issues since my maiden speech so of course I am very grateful to come in on this. At this time of uncertainty, one thing we can be absolutely certain of is you are doing QE. Can I pick up on this issue about the gilt yields in March and the concerns that a primary gilt auction might fail? Sir Jon claimed that it was a liquidity issue emerging due to a dash for cash. I will come to Sir Jon in a moment. Could I start with Elisabeth Stheeman? Do you think we are in a position where there was a reason to fear that a primary gilt auction might fail?

Elisabeth Stheeman: I would answer this question more broadly in terms of what happened, if we look back at the middle of March, when there was a huge push for liquidity in the system and what is referred to as the dash for cash, with investors looking for liquidity and moving from less liquid to more liquid holdings. There were certain parts of the investment spectrum, such as money market funds, high-yield funds and equity investments, that were less looked for by investors than more liquid areas. Investors wanted to go into investments that would give them a greater part of liquidity and being able to monetise on that at short notice.

Q540 **Mr Baker:** To put that into plain language, that is about investors wanting to hold things that they can subsequently sell easily. Is it not the case that the Bank has stood behind those gilt auctions and said to people, "If you buy gilts from the Debt Management Office, you will be able to sell them easily to us, the Bank of England"?

Elisabeth Stheeman: At this point, I would like to refer this question to members of the Monetary Policy Committee.

Q541 **Mr Baker:** I know the Governor wants to come in and I want to bring in the Governor, but I have referred to Sir Jon. Sir Jon, can I put that to you? Is it not the case that the Bank has now said to the bond markets, "We will buy those gilts that you buy from the Debt Management Office"?

Sir Jon Cunliffe: If it helps, I am very happy to talk generally about that move to liquidity, but it was actually a move to safe haven assets, which one would think is normal. You saw Government bond prices go up, gold go up, et cetera. Somewhere around about the middle of March, it switched into a dash for cash and quite disorderly markets, and not just in the UK; this was global. We could talk about what lessons we learned from that, and I think there are some lessons we should indeed take from that about what caused that flip into a dash for cash, where people started to sell the safest assets they had because that was the only way they could get liquidity. That is what caused those market conditions.

The Monetary Policy Committee was faced with a tightening of financial conditions because the yield curve rose as Government bond prices went down. At a time when the economy needed more support, to see financial conditions tighten because of disorderly markets required central banks generally—the ECB, ourselves, the Fed—to step in. That is a monetary policy action.

Coming in to prevent monetary conditions tightening is the inverse of coming in to loosen monetary conditions. That is a monetary policy action. Does it have an impact on the market for Government debt? Yes. What is important here is the motivation for this and whether you can explain it in monetary policy terms. This gets to the argument about if it is monetary financing or monetary policy.

Q542 **Mr Baker:** I want to bring the Governor in next. Governor, to contextualise it, can I put to you a quote from Sir Robert Stheeman at the Debt Management Office? He said of the gilt market, "It has got used to the notion that there is one large seller in the primary market—us—and in the secondary market there is one very large source of demand—the Bank. That has established an equilibrium that has given market makers the confidence that it is now a safe market in which to operate". Is this not an extraordinary position to be in: that, according to the head of the Debt Management Office, it is the Bank of England that has made the gilt market safe?

Andrew Bailey: That is a question for the head of the Debt Management Office to answer. The head of the Debt Management Office will see this from the perspective of the responsibility and objective that he has. I want to emphasise what my colleagues have said. The cost of borrowing in this country is, obviously, a major piece of the transmission of monetary policy. It is of course the case at the moment that the major borrower is the Government. That seems to me to be a product of the entirely appropriate role the state is taking in dealing with this crisis that we are in and, therefore, the consequence of that in terms of debt financing.

It is not the Bank of England's stated objective to finance the Government. That is why we are doing all this in the secondary market. I wanted to say that because the channel is through the cost of borrowing. It so happens at the moment, as we all know, that the major borrowers, for obvious reasons, are the Government. That is the way we look at it from the point of view of monetary policy. I can well understand that if you are heading the Debt Management Office you look at it through a different lens. That is perfectly appropriate.

Q543 **Mr Baker:** Can I pick up on something you said there about what other colleagues have said? What I am driving at here is that it is not a question of your motives. Your motives are clearly in the public interest. I am trying to make sure that, on the record, we all understand what is going on and why. I will quote to you another of your colleagues, Dr Vlieghe. He said this extraordinary thing: "If we were the central bank of the Weimar Republic or Zimbabwe, the mechanical transactions on our balance sheet would be similar to what is actually happening in the UK right now". He of course was making the point about the independence of the Bank. Would you accept that what is going on right now is really quite extraordinary in terms of the monetary history of the United Kingdom?

Andrew Bailey: We are in quite an extraordinary situation in terms of the economic history of the United Kingdom. People refer back to 1709, but we are not really that sure what happened in 1709, except that the Bank of England did do quantitative easing; I can tell you that. It is an entirely appropriate response to the condition we find ourselves in. Let me make one big point. I am avery aware of what Jan Vlieghe said and I know why he said it. As you say, you know why he said it. It is a point about a balance sheet. As Ben Broadbent and I have certainly said in the last few weeks, there is one very big difference: you cannot inflate public debt away in a world where you pay interest on reserves.

Q544 **Mr Baker:** Let me put this point to Ben Broadbent, because I think it is the heart of the matter. We say that what enables you to use these tools is the independence of the framework and the independence of the Monetary Policy Committee. What I understand to be inherent in that, and what I am asking you to tell the public, is that, if the situation arose that inflation was rising and it was necessary to stop engaging in QE and raise interest rates to control inflation—and you are nodding, for the record—you would do that, even if that meant a gilt auction failing. In a sense, I am asking if the Monetary Policy Committee's remit stands though the heavens fall, in terms of Government finance.

Ben Broadbent: That is absolutely the critical question. The answer to it is yes. Let me make two points in reference to particular things you have said. The first is about whether this has happened before. Yes, it has happened before—the coincidence of a large Government deficit and the launch of QE. It happened 10 years ago, or 11 years ago now, in 2009 and also in 2010. More generally, it is not a coincidence, and has happened very often, that you should find the Government deficit rising at the same time that monetary policy is being eased. That is because they are both cyclical. It is almost always the case that you will find monetary policy being eased, whether by means of conventional or so-called unconventional policy, at the same time that the Government are issuing more debt. It is not one causing the other. It is simply that they are both responding to the economic cycle.

The point Jan Vlieghe made is a very important one. Transactionally, if I write down, in purely accounting terms, that coincidence in time of a Government deficit and monetary easing, it looks exactly the same as if I tried to write down what some people call monetary finance, but it misses the crucial distinction, the only distinction that really matters. That is the one you alighted on, which is who is doing what and why.

The reason we eased monetary policy in March is because we were concerned we had to meet the inflation target and we otherwise might fall short of it. That is the reason. One of the means of transmission of that policy is that, as the Governor pointed out, borrowing costs get easier. Costs of borrowing get easier both for the private sector and for the public sector, but that is not the objective of policy. It happens along the way. The objective is and will remain the inflation target.

You are right that, were we to have some other source of inflation, we could not ease policy. As I say, it is very often the case that you will find that, when the Government deficit is rising because the economy is weak, in those circumstances we will usually want to ease policy. Were we to be in the rare circumstance where inflation was going up a lot and the Government were also borrowing a lot more, we would be more likely to tighten policy. The purpose of our policy is to meet our inflation remit.

Mr Baker: Thank you very much. You have made that very clear. The Governor is nodding.

Jonathan Haskel: I am going to be super-quick, just to emphasise what Ben and Sir Jon have said. The thing we did not want to happen is for monetary conditions to get tighter. We absolutely did not want to say to desperate firms attempting to do the best they could for their suppliers, customers and workers, "We are going to make things tighter for you". We took action to ease monetary policy in order to hit the target. That is why we did it.

Andrew Bailey: I agree. We have no objective to make sure all gilt auctions succeed. If a gilt auction fails, a gilt auction fails. It is not a part of the objective of the Bank of England to make all gilt auctions succeed.

Q545 **Chair:** I am going to squeeze in one very final question to the Governor. One of the more interesting issues that has surfaced in this session has been around negative interest rates. You seem to have shifted a bit from your other hearing with us where we discussed this matter, to be more leaning in that direction, if I could put it that way. You used terms like "active consideration" and so on, albeit that you also caveat it by saying in principle you would not have any tool off the table. Given that, could you tell us very briefly what criteria would need to be met in your mind for the Bank to take a decision to go for negative interest rates?

Andrew Bailey: I have changed my position a bit. That is because in that ancient history period back in early March, before we got into this situation, it all seemed a long way away. As I said earlier, in this situation we have to review our tools as a matter of regularity. We have to keep them under consideration. I say that in the spirit of ruling nothing out and ruling nothing in.

To briefly the answer the point you made, there are a lot of considerations. In my view, it is not a linear move from where we are today to a negative rate. There are a lot of issues around, for instance, how it would affect the structure of the financial system, how it would feed through into the stability of the financial system and what the pass-through would be. I do not think we can assume that pass-through would be linear, i.e. that you just put through a cut and it will go through as if you were cutting in the positive range. All of those things are a good reason to think that the pass-through would be different. It could be weaker. We will have to consider all of those things, as well as what I said earlier about any measures we would take alongside it to counteract those things, if we thought it was the right thing to do.

Coming back to a point I made earlier, it is interesting to look at what other central banks have written and considered about it, about their financial systems and the cyclical context in which they did it. There are some pretty mixed reviews of it.

Chair: On that note, we are out of time. Thank you to everybody on the panel for your contributions this afternoon. We have covered a wide range of questions. As is inevitable perhaps, because of the nature of the matters we are discussing, it has raised a large number of questions as well. It may be that the Committee, as I said earlier, will want to write to you with some follow-up questions.

Andrew Bailey: Of course, yes.

Chair: Thank you, Andrew, for your positive response to that. If we could ask for a fairly quick response to any questions that we send through, we would be very grateful. Finally, there are clearly, at this very difficult time for our country, a number of actors who are working very hard to get us through this—economists, politicians and even epidemiologists, which I do not think I could even pronounce a few months ago. Certainly right at the centre is the Bank of England and each and every one of you, and we are grateful for all that you are doing to help support the economy at this very difficult time.