Treasury Committee

Oral evidence: Financial Stability

HC 143

Tuesday 24 May 2016

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Watch the meeting

Members present: Mr Andrew Tyrie (Chair); Mr Steve Baker; Mark Garnier; Mr Jacob Rees-Mogg; Rachel Reeves

Questions 1 - 100

Witnesses: **Martin Taylor**, External Member, **Donald Kohn**, External Member, and **Richard Sharp**, External Member, Financial Policy Committee, Bank of England, gave evidence.

Q1 Chair: Thank you very much for coming to see us this afternoon, and at relatively short notice. We are particularly grateful to you for coming, and to you, Donald Kohn, because I think you have come from abroad and have had to reschedule one of your trips a little.

We are eager to look primarily at the issue of the Bank's involvement and the FPC's involvement in the judgment on the referendum. We are also keen to hear your views as three individuals of the FPC, notwithstanding the desire to speak with consensus on financial policy matters as far as possible. We have decided as a committee that we should try to take views from the externals without the internals present, not as the norm, but as a practice from time to time. This seems a very good opportunity to go further down that road.

Can I begin by just reading what Mark Carney said on 12 May? He said that the risk posed by the EU referendum is "the biggest risk in the judgment of the independent Financial Policy Committee—10 members; it's the biggest risk in the judgment of the independent Monetary Policy Committee—nine members". He is referring, of course, to the risks surrounding the referendum. He goes on to reiterate the point and reinforce it. I will not read out everything he has said. He said that on 12 May, but you had not had a meeting to discuss it since 23 March. Is that correct? Perhaps I should start with Martin Taylor.

Martin Taylor: That is almost correct, Mr Chairman. We had our policy meeting on 23 March. When the record of that meeting was published, we said, and I have it in front of me, "The committee assesses the risks around the referendum to be the most significant near-term domestic risks to financial stability", so the Governor was more or less quoting from the record, it seems to me. We did have a meeting together with our MPC colleagues in early April.

Chair: This was a joint meeting on 6 April.

Martin Taylor: That is right. It is referred to in the inflation report. Since then, we have not met as a committee. We have obviously had individual meetings with staff. We are about to go into the second quarter round.

Q2 Chair: You have not had a chance, as a group, to look at the material that is in the inflation report.

Martin Taylor: No, we have just received it, as you have.

Q3 Chair: When you made that assessment as a group, were you all of one mind?

Martin Taylor: We all felt it was a pretty uncontroversial thing to say "the most significant near-term domestic risks to financial stability". One looked at the domestic financial picture and there was the referendum looming. Obviously the uncertainty is the result. If the result turned out to be leave, the uncertainty is as to how things would pan out thereafter. I think there was no question that it was the most significant domestic risk on the horizon. We said little more than that, except that we would be following up on monitoring the channels of risk closely and supporting mitigating actions where possible, and so we have been talking to our colleagues in the Bank and at the PRA about what contingency planning they had done, as you would expect.

Q4 Chair: In everything that he said, was he speaking for you, Mr Sharp?

Richard Sharp: In everything he said in relation to the FPC, yes.

Q5 Chair: What about in relation to Brexit? I have the transcript of the Governor's remarks here in front of me, and I am sure you have looked at it.

Richard Sharp: Wearing his FPC hat, yes. As Martin said, we do not sit on the MPC. One of the key judgments associated with the MPC comments is based upon the modelling that the MPC has received. There are some issues I have with some of that modelling, just based upon certain assumptions. In making models, one has to make assumptions. You interrogated Dr Broadbent this morning, for example, on the benefits of forecasting. Obviously, if you vary assumptions, you can come up with different outcomes. We have not met as the FPC since this last inflation report but, having looked at some of the modelling and the assumptions that went into the report, I might have a slightly different nuanced view of some of the risks associated, coming out of that discussion.

Chair: Perhaps you would like to elaborate.

Richard Sharp: For example, one of the issues is associated with the risks of external capital flows and the requirement for the UK to have external capital flows. The UK is a thoroughly investable economy and it would remain a thoroughly investable economy, whichever way the vote goes, by any global standard. I am an external member. In my other capacity as an investor, I discuss with international investors and I have seen significant flows coming into the UK, unaffected by concerns about Brexit, coming out of the US—US endowments for example. Where I might disagree with the Governor is that I do not think it is the kindness of strangers. I think strangers make a calculated risk/reward assessment, and they would continue to view the UK as an extremely good risk, by any global measure.

Q6 Chair: You have given that as one example. Do you have others where you would like some nuance?

Richard Sharp: The different parties in the debate draw on different comments that are made. One thing I would emphasise is that the Governor has not made any longer-term comments on the longer-term stability. Clearly, that is an issue where we have to have some concerns, as the FPC. If we see long-term instability, we will discuss that. As I said last time I was here, I am quite in agreement with the Governor that it represents a short-term source of instability.

The comfort I take, and I know he does too, is that the foreign exchange market is a very efficient mechanism as a shock absorber, which would diminish the effects that would otherwise take place in other markets, bringing instability. It is short-term instability, but the foreign exchange market is a very strong shock absorber. Although markets sometimes overshoot, they can settle.

The uncertainty is a different issue. The uncertainty is around the markets now with respect to which way the vote goes. You see and you had a discussion today about how that varies and affects the options market, but also there would be uncertainty with respect to the negotiations, were there to be any Brexit. Again, those are political considerations and reasonable people can differ as to the anticipated outcome of that.

We at the FPC have to look at the parameters of risk associated with failed negotiations and satisfy ourselves that, in the longer term, they can be accommodated without any significant problem for stability. We have satisfied ourselves. We have the benefit of the stress test that we subject the banking system to. The banking system is significantly more robust than it has been in the past and, therefore, we will get to discuss that, but personally I am very comfortable with the financial stability issues associated if there were to be a Brexit vote.

Q7 Chair: This is quite a different tone we are hearing. You called it a “nuance” in your opening remark, which I also picked up on. I would not say this is relaxed, but you are certainly reasonably confident that the UK can absorb this shock, that markets will act efficiently and that the turbulence is manageable.

Richard Sharp: Yes is the short answer. It is not without issues. There are going to be issues to the financial services industry, but there is also the counterfactual, as you have discussed here many times with people like Andrew Bailey and others, associated with remaining part of the EU. This is where people can have longer-term views about the costs and benefits of being either in the EU or out of the EU, but I do not regard that as a financial stability issue.

Q8 Chair: Mr Kohn, I have two questions for you, but the easy, short question is: have you anything to add to what you have just heard from your two colleagues?

Donald Kohn: I would like to add that I was in full agreement with the opinion of our committee, the Financial Policy Committee, on 23 March that the referendum constituted the most important domestic risk to financial stability. I am perhaps a little less relaxed than Richard is about this. I agree that the banking system is quite strong and getting stronger all the time, importantly because of measures that the interim and Financial Policy Committee have taken over the last five years to build capital and liquidity, and because of measures the PRA has taken to make sure risk management is improving in these institutions.

There are a lot of unknowns and uncertainties about this, as Martin emphasised. Asset prices will change. It is most likely that there will be a different relationship, if the UK votes to exit, between the UK and the EU. No one knows what that new relationship will be. There is a lot of uncertainty, and how markets react to that uncertainty is very hard to tell. It is most likely that there will be some risk premiums built into asset prices, were that to happen. As to how that feeds through the banking system, I am comforted by the high levels of capital in the way they came through the 2014 stress tests particularly, but there are some unknowns there. Then there are things outside the banking system. What is going to happen to the sterling bond markets and corporate bond markets, for example? Are extra risk premiums built in there? What happens to the property markets? How does that feed through? I do see this as an important risk factor here.

Can I just clarify one nuance? We did see the inflation report box that reported on our 6 April meeting. We had an opportunity to comment on that box before it went into the inflation report, so it was not totally new to us, from that perspective.

Q9 Chair: Was there a consensus when discussed at that meeting?

Donald Kohn: Yes.

Q10 Chair: You were all happy with that box. Was it therefore effectively signed off by the MPC, although informally?

Donald Kohn: Everybody had a chance to comment. I presume that whatever comments were offered were incorporated into the box. I joined by telephone, but in that meeting the Governor was very careful to make sure everyone had an opportunity, not so much on the box, but the contents of the meeting and the various risks that were discussed.

Q11 Chair: I have it in front of me here and it touches on some of the issues you raise, Mr Sharp. Did you raise any of them at that meeting?

Richard Sharp: Yes, I think I did raise them.

Q12 Chair: But you were still happy to sign off on it.

Richard Sharp: Yes.

Q13 Chair: Mr Taylor, did you have any views on this when it was signed off?

Martin Taylor: No, I thought it was a fair description of the meeting. It was not a policy meeting.

Chair: Sorry, I am talking about this box.

Martin Taylor: No, I had nothing to add to the box. It was interesting to learn how our MPC colleagues were thinking of their modelling and how they viewed it. Equally, I hope they were interested to hear what we felt about the banking system.

Chair: This is very much more than an academic exercise, though, is it not? It must have been very clear to all of you, all 20-odd or whatever it was in the room, that you were having a discussion about something that was of acute political significance and was going to cause a considerable amount of controversy.

Martin Taylor: Yes.

Chair: But you felt that the economics in it were robust enough for you not to raise qualms about it.

Martin Taylor: I had nothing to add to the box.

Q14 Chair: Mr Kohn, you have spent much of a lifetime working with the Fed Reserve and being involved in US monetary policy. How is this issue, with its implications for the stability of global financial markets, being perceived at the Fed? Will it in any way influence any decisions that are being taken by the FOMC? I am not asking you to lift the veil on any secret information. I would not expect you to have any secret information, but there are few people on the outside better informed than you about these things, after the lifetime experience you have had. Can you offer a view on that to the Committee, please?

Donald Kohn: To be very clear, I have no inside information. Various members of the Open Market Committee have discussed this issue as a potential risk to financial stability. Some of them have put more emphasis on it than others. The FOMC is meeting just a few days before the vote. There are people in the markets who are wondering whether the nearness of the vote and the associated potential for market turbulence would not be one of the factors that the FOMC considers when it decides whether or not to take the next step in raising rates. We have not had a clear signal from FOMC members on that, but the fact is that the markets and people observing FOMC behaviour have raised that issue, because of the concern about market reactions to a potential vote to leave.

Chair: This decision may have implications for monetary policy in the United States. That is what you are saying essentially.

Donald Kohn: At least for the timing of monetary policy in the United States—that is really what the focus has been.

Q15 Mr Rees-Mogg: Thank you, gentlemen, for coming in this afternoon. Mr Sharp, I wonder if I could follow up on what the Chairman was asking you. Looking directly at the Governor's answer and its precise wording to a question from Faisal Islam on 12 May, he says, "This is the biggest risk in the judgment of the independent Financial Policy Committee—10 members; it's the biggest risk in the judgment of the independent Monetary Policy Committee—nine members—to the achievement of their remits". Now, I do not think that is quite what the minutes of the meeting of 23 March were saying. They said it was an important short-term risk, not the biggest risk to the achievement of your remit. Is that fair?

Richard Sharp: The FPC statement speaks for itself. It explicitly lays out that it is the single greatest domestic financial risk.

Mr Rees-Mogg: Risk to your remit is surely rather more than a domestic risk.

Richard Sharp: Yes, it is. We look at long-term and short-term risk as well. He has also said to this Committee in the past that he is not making any comment on the longer-term issues associated with it.

Q16 Mr Rees-Mogg: The "remit" phrase is important, because your committee works by consensus. Obviously, in trying to achieve a consensus, people on the committee will accept that not 100% of their view will be stated. Then it is very important that the chairman of that committee sticks rigorously to the consensus and does not push it any further. Do you think that is fair?

Richard Sharp: Yes.

Q17 Mr Rees-Mogg: When you gave evidence to your reappointment hearing, you very importantly did not list Brexit as a major risk. I just wonder to what extent you may feel that you have co-operated in the desire to achieve a consensus and then, having co-operated, what you are saying is that you are being pushed a little bit further.

Richard Sharp: The committee has not commented on the longer-term financial risks of Brexit. It has not highlighted Brexit as a longer-term financial risk. It has highlighted it as a short-term domestic risk, and we have seen volatility in foreign exchange markets that reflects that. I do not think the Governor has gone beyond that.

Q18 Mr Rees-Mogg: Even when he says it is the biggest risk to your whole remit of financial stability, do you not think that is going beyond saying that it is a short-term domestic risk?

Richard Sharp: There are other longer-term risks that have uncertainty associated with them; for example, a Chinese hard landing would have global repercussions. You see discussions on the scale of Chinese debt and concerns about that. Those would have very serious global GDP issues. The probability factor of those may be very slight, and so I take it that he was really talking through a calculus of probability and visibility.

Q19 Mr Rees-Mogg: What do you think the biggest risk to your remit is, in your own personal opinion—not just domestic?

Richard Sharp: Our remit is long-term financial stability, so the biggest risk that we addressed in the short run and we continue to address is the vulnerability of the global financial system, measured in two strong areas. One is the capitalisation of the banking system and the risks of contagion through that. Second is the great difficulty of liquidity in markets associated with the narrowing of capital that is provided for large-scale transmissions of capital through a market. Those are two issues we have spent a lot of time focusing on.

Q20 Mr Rees-Mogg: You are being very generous in your evidence about the press conference given by the Governor, because it seems to me that you think, in the consensus that has come out from the FPC, that the biggest risk to your remit is actually slightly different from the one your chairman put forward.

Richard Sharp: It is included within it.

Mr Rees-Mogg: It is part of it, but not exclusive.

Chair: It is included within what?

Richard Sharp: The short-term domestic risk of Brexit is included within the remit, as well as the longer-term issues.

Q21 Mr Rees-Mogg: It is a very important difference. What I am trying to get at is that it is very difficult to have committees that reach consensus. We are facing this within this committee at the moment, discussing our own report on the consequences of leaving the European Union. It inevitably means that the consensus you come up with is not 100% satisfactory to anybody, but that is particularly difficult if the chairman then briefs it in a way that is not very strictly in accordance with what has been agreed in the consensus.

Richard Sharp: I am comfortable with what he said. I take your point that he could possibly have used more words, but I am very comfortable with what he said, because our remit does include scrutinising short-term risks and that was really what he was addressing there.

Q22 Mr Rees-Mogg: You are very generous; that is the point I would repeat. The next question I would ask is whether the FPC has considered or whether it is in your remit to consider the risk to the reputation of the Bank of England from appearing to be partisan in so political and sensitive an issue, when it is so cautious in general elections. Has that been a discussion that has been had?

Richard Sharp: No.

Q23 Mr Rees-Mogg: The political consequences of the Bank of England expressing a clear view were not part of the FPC's consideration.

Richard Sharp: What is clear is that the Bank of England and the chairman of the committee, whichever committee he is speaking for, are really addressing the remit of that committee with respect to their objectives. If from that are taken judgments about the political implications, those are judgments that are taken from whatever is said, acting in his capacity as chairman of that particular committee. He speaks differently when he is acting as the chairman of the MPC and as chairman of the FPC. It is very helpful that it is the same person, but we do not address issues from the point of view of any political perspective.

Q24 Mr Rees-Mogg: In a general election, you would be very careful not in any way to appear to take sides, even if you were quite worried about the financial consequences of an opposition manifesto.

Richard Sharp: Yes

Q25 Mr Rees-Mogg: You had no discussion to consider whether this was similar to a general election and whether or not you should be similarly cautious.

Richard Sharp: I do not think you will agree with me, but I do not believe the chairman is taking sides. He is expressing his views on the implications of Brexit, with respect to the judgment of the committees that he represents when he speaks that way.

Q26 Mr Rees-Mogg: For the purposes of this question, let me accept what you are saying, for the millions listening to this as it is broadcast around the world. I do not, but, for the purposes of the question, if you accept that he is merely discussing the consequences and has not taken sides, surely in a general election context there are potentially very sizable financial stability considerations from an opposition manifesto. It is inconceivable that the FPC would opine on those in the run-up to a general election.

Richard Sharp: Yes, it is.

Q27 Mr Rees-Mogg: That is what I am trying to get at: there has been no discussion within the FPC about whether these two were similar and the same rules should be followed. Therefore, it has been the Governor's decision that he should make the statements he has made, in light of the thoroughly fair discussions you have had, on the economics underlying it.

Richard Sharp: Yes. What he is doing, however, is having press conferences following the discussions that we have had as a committee. Those press conferences are reflecting a consensus.

Q28 Mr Rees-Mogg: You may well have had a consensus. I would be very surprised if you had a consensus that said you thought Mr Corbyn's latest policy for a new economics abandoning austerity was absolutely the bee's knees and would be wonderful for the country or that, if you did, you would actually say it. That is the point that I am getting at: this very damaging politicisation of the Bank of England seems to come directly from the Governor, not from the committees, because they have not discussed it.

Richard Sharp: He has a duty, and this is for you to judge as a committee, to fulfil his obligation as the chairman of those committees. Brexit is an immediate issue that has a direct bearing on the MPC's decisions and, therefore, needs some explanation.

Q29 Mr Rees-Mogg: I expect I can predict your answer, but do you not think that a wise chairman would have at least had a discussion with his committee about how they should approach something so politically sensitive, so that they are at least all fully accepting of the political controversy that they may be entering into?

Richard Sharp: We sit on the FPC. I do not sit on the MPC. We have approached the discussions of the FPC purely from the position of financial stability. We have also been advised to avoid getting involved in any of the politicisation, which is what we have endeavoured to do.

Q30 Mr Rees-Mogg: The Governor has done that bit for you. I was just going to move on, if I may, to what you said about sterling, because it is a fundamentally important point, acting essentially as a shock absorber or automatic stabiliser. The Bank of England does not normally make statements expressing where it expects sterling to go. It normally takes it from market expectations and puts it into its forecasts. As an experienced banker, are you used to central banks speculating on the decline of their own currency?

Richard Sharp: I think you will find that the comments made this morning and the comments made earlier in relation to sterling follow the reporting of what has happened in the market and—Dr Broadbent made this point—are trying to analyse the correlation between an expectation of a vote for Brexit and how the markets are performing. Sterling depreciating is a form of easing and therefore has direct bearing on what the MPC should consider, because it can look at the calculation and assess what the markets are telling it with respect to the potential outcome. You should see it as a commentary on the relationship and, therefore, a way to communicate to the markets what would be expected to happen and to give assurances with respect to the Bank of England's position, in terms of monitoring, comfort and maintaining stability, in the event that those were to happen.

Q31 Mr Rees-Mogg: It is the reverse of what Dr Broadbent said they normally do, and he went through this, which was not to forecast financial prices, because they are fundamentally unforecastable, so you are better off taking the market's expectation. It is quite a change. If I can move on slightly, do you think forecasting a sharp decline in sterling is helpful to financial stability?

Richard Sharp: At the beginning of the year, in January, there was a consensus among major investor banks and major investors that the euro would decline sharply against the US dollar. By early February, most people had to reverse their views entirely on that point. Forecasting in foreign exchange is a highly treacherous area, which is why the analysis is really looking at a mechanistic analysis of what the markets are saying now. For example, it is entirely possible that markets would overshoot and bounce back. The Bank of England is not in the business of making forecasts, in that sense. It is saying that this could be an expected event arising, with a shock, and as a result of that this is how the MPC may then behave.

Mr Rees-Mogg: What you are saying makes a great deal more sense than what the Governor has been saying, but perhaps I will leave it at that and pass it back to you, Mr Chairman.

Q32 Chair: Has the Governor strayed from his remit into the political arena or taken the Bank there, Mr Sharp?

Richard Sharp: No.

Q33 Chair: There is a nuance between some of the remarks you have just been making and that very generalised and very firm conclusion you have given me, I think you would agree. He has certainly moved pretty close to it.

Richard Sharp: It is unavoidable if he is to speak at all on this matter, given you have confirmation bias from parties on either extreme, leaving aside the people who are genuinely uncertain, who will pick on comments that are made with respect to the economy and draw them into their own analysis to promote their particular point of view.

Martin Taylor: Mr Chairman, might I comment on what has just been said, continuing, if I may, the committee's tradition of generosity? You used the word "normal" many times and one of the difficulties we have here is that this is not a normal situation. It is an extremely unusual situation.

Chair: We were going to get into that, but do carry on.

Martin Taylor: Rather than taking the general election as an analogy, I would take the Scottish referendum, where the Bank did speak about the currency issue in particular. It was generally felt, not by everybody, that it was right to do so. We knew that our record would refer to the referendum, so I do not think we can put all this at the Governor's door. We felt, and certainly I felt as a committee member, that we could not duck this issue. For the Bank of England to have remained silent throughout the referendum campaign, pretending that it was not happening, would have put us in an impossible position. There would have been endless speculation.

Q34 Chair: Not least in trying to give any evidence to this Committee, a point that I made this morning to the Governor.

Martin Taylor: You would have kebabbed us, Mr Chairman, and it would have been impossible. I do not think we could have kept silent. If I may just pick up on one thing, I agree with Richard and not with the Governor, in that I do not believe this is a threat to the FPC's remit. I suspect, although he is not here to speak for himself, that he was concerned about the MPC's remit and about the particular issue that, certainly on the MPC's forecasts, a leave vote could give you a decline in GDP and a burst of inflation, which makes policy-setting extremely difficult. I suppose that is what he was thinking of.

Chair: He will be able to speak for himself.

Donald Kohn: Mr Rees-Mogg, you implied that the Governor got out in front of the committee and made a decision to call attention to this, but it was a committee decision to put in our record and in our announcement after our meeting that this was the greatest near-term domestic risk.

Mr Rees-Mogg: I was implying something slightly different.

Donald Kohn: I wanted to make that clear. Secondly, with regard to remit, an important part of our remit, and it is in the legislation, is to identify risks to financial stability. At least in my view, there was a risk—not a certainty, not the most likely outcome, but it was a risk—that financial instability would necessarily flow from a vote to exit the EU. It is an unusual event and a large enough risk that we, within our remit to identify risks, were appropriately identifying that as a risk to financial stability.

Q35 Mr Rees-Mogg: To your first point, the implication I made was that, after your committee meeting at the press conference on 12 May, as I heard from Mr Taylor, the Governor essentially misspoke and meant the MPC and included the FPC in it. Therefore, there is an appearance of saying more than the formal minutes agree to. That was the point on that. On the second point, this comes back to the general election issue that there is inevitability a significant stability risk if you move from a middle-of-the-road Conservative Government to a quite left-wing—Ms Reeves will not deny this—economic policy led by the Labour party at the moment. It is inconceivable that the FPC would put out statements saying that this was a major financial risk, even though it would have risks about it.

Chair: We have had quite a run around this point.

Mr Rees-Mogg: Indeed, but Mr Kohn mentioned this point specifically, so it is important to bring it in.

Chair: I am going to give Mr Kohn an opportunity to respond again if he wants to, seeing as he is after all the witness here.

Donald Kohn: I just see this as a different type of event. It is a discrete event on a particular date, with a major change that has never happened before, so there is very little history to base it on. It is very different from changing Governments, where new policies might or might not come in; they might come in over a long period of time; manifestos might or not be implemented. I see this as a different event.

Chair: Mr Taylor, you opened up an area which, in any case, Mark Garnier was going to pursue in some depth.

Q36 Mark Garnier: If I may just carry on with what you were saying, surely the difference between the event that is happening on 23 June and a general election is that a general election, as you so rightly say, is a run-of-the-mill event. It happens every five years now and is very much a political choice that is being given to an electorate, which has a multiplicity of outcomes, given the fact that we can potentially have coalition Governments. This is a very different thing. This is a constitutional issue, which is something that has a binary outcome and looks at the structure and relationship that our country has within its constitution, within the different parts of the world. Is that alone enough to justify that the MPC and the FPC should, as part of their remit, be required to highlight the fact that, because it is constitutional, not political, it has a risk outcome to it?

Donald Kohn: Our thinking was that it was a big enough one-time event—I am not sure about the difference between constitutional and political here—that we had an obligation to highlight our concerns.

Q37 Mark Garnier: Martin Taylor mentioned the example of the Scottish referendum. Again, at the time it was interesting, because there were similar types of debates going on within this Committee. The SNP made identical points to those the leave campaign is making with reference to the comments by the Governor and the MPC. One of the interesting points that struck me with the Scottish referendum was that many of those comments were happening in the close run-up. I remember we had a Committee session where at least three of us, if not four of us, in the week before the referendum, were trying to get him to make political points and he was studiously being very resilient.

Chair: You would not have been trying to lead the witness like that, Mark.

Mark Garnier: Not half, Chairman. I think we all were, if I remember rightly, including you.

Martin Taylor: There was a period of purdah.

Q38 Mark Garnier: Exactly. I think it was within 10 days. The interesting point is that the Governor came out very early on, so some time ago, in order to try to get well ahead of the bow wave. That is something that has been learned as a result of the Scottish referendum. Is there anything else that you can look to, which gives us an example of what lessons have been learned?

Martin Taylor: We felt as a committee that we should refer to the matter early. The Bank's decision to announce the repo operations early fell into the same category. We on the FPC were very conscious that our next policy meeting would take place the week after the referendum, so if we wanted to say anything we had to get it out early, and I think that was helpful. We have not said anything since. We have rested on this. I am sure that the purdah period will be very strictly observed.

Mark Garnier: Mr Kohn, would you like to add anything to that? You were nodding a bit earlier and I am very interested in your view.

Donald Kohn: I agree with Mr Taylor. Remember that the date of the referendum was announced in February, so this was our first and really only opportunity to make our views known, at the 23 March meeting.

Q39 Mark Garnier: Looking at it from the other point of view, would the FPC be almost negligent if it were not to raise its concerns about risks to the economy?

Richard Sharp: What we have actually said can be overstated. What we have said is that, in the short term, it is the biggest domestic political risk. Fortunately, the euro environment is taken care of externally. Domestically, we have taken actions. We have taken actions in the property market. We have taken actions in the banking market. You have to look at that situation against other things that could be domestic sources of risk. We have not made a comment about it with respect to the longer term. We have satisfied ourselves as a committee that any risk to stability can be well absorbed. As I said, we have had stress tests that make us very comfortable that this is not a threat to longer-term stability, so you can also overstate what we have said.

Q40 Mark Garnier: Can I stay with you on the currency thing? You were talking a little bit earlier about the currency exchange rates acting as a shock absorber. One of the interesting things from the OECD that came up in its policy paper on Brexit is that the negative economic impact of Britain leaving Europe could have a negative economic impact on the EU, which may in itself lead to a decline in the euro against the US dollar. The net effect of that, of course, would be that the sterling and the euro may decline at the same rate, in which case the exchange rate does not change at all between those two currencies. Given the fact that 54% of our imports come from the EU and 44% of our exports go the EU, that shock absorber effect will be minimal, given the fact that our main trading currency will be unchanged. Do you have any thoughts about that?

Richard Sharp: The UK represents 17% of the exports from the EU excluding the UK, so we represent a significant exporter of goods from the EU ex-UK; hence a failed negotiation on trade has implications for both parties.

Q41 Mark Garnier: I am thinking more of the shock absorber effect in the short term.

Richard Sharp: That would be part of the uncertainty. Secondly, there could be a political dynamic associated with a Brexit, with respect to the EU and the strength of the EU as a community. That could also have a negative effect. Set against that, the ECB is standing in a very strong position to support the euro capital markets.

Mark Garnier: You are saying that, actually, in the event of the shock spreading through Europe, the euro is more likely to hold up against sterling than perhaps my analysis came to.

Richard Sharp: As I said, the very smart minds have been completely wrong on the euro, the yen and the dollar this year, so far, so why should they not be wrong on sterling as well?

Q42 Mark Garnier: Have they ever been completely right? Actually, that is an incredibly important point. We are speculating ad nauseam. One of the interesting points about some of this speculation is that sterling has already fallen 9% since November. There is an expectation that sterling will fall 12% if we come out. It is very difficult to put a figure on it and of course it is complete guesswork. You were an investment banker: is it not the case that markets hate uncertainty, but actually they like some sort of certainty? The fact is that, were we to vote to leave, although we do not know what the process of renegotiation would be, at least there is a little bit of certainty, because we now know what the outcome of the referendum is. To then assume that there would be a continuing 12% decline on the back of that result is probably overegging the pudding.

Having said that, of course there is a great deal of uncertainty that could subsequently happen, as trade deals may or may not come off. That could lead to drip-feed uncertainty. Is seeing the 12% decline after a no vote too much of a heroic assumption, Mr Sharp?

Richard Sharp: I have no unique view on that.

Mark Garnier: Does anybody have a view on that?

Richard Sharp: I would expect some decline and some overshoot, but markets have a way of adjusting.

Donald Kohn: I have no idea what the number would be. I think the uncertainty that would follow a leave vote would be very, very substantial about what the configuration of the UK's relationship to the EU would be two years hence. It would have great effect on business models and on the valuation of various assets. One reason why the Bank, for example, has said that 4 or 5 percentage points of the 9% decline that you cited is from Brexit referendum uncertainty is that they are reading this from the options markets. They are reading this from their own index of uncertainty. They also see that it has responded to increases and decreases in polling, betting, et cetera, about whether leave or remain will win the vote.

One reason why it has been as small as it has been is because at least the markets seem to be thinking that remain has larger odds than leave at this point. It has shown a sensitivity and the sensitivity is that, when remain looks like higher odds, sterling has tended to appreciate a little. I am not comfortable at all with the number, but I am pretty comfortable with the direction of change, were leave to win the referendum. At least the markets are telling us that is what would happen.

Q43 Mark Garnier: Nonetheless, a betting odd is an asset price in the same way that a share price is. All it is merely doing is reflecting everything that is known by a market at any given moment. That could change over time, and so could the other things. Can I look at the Treasury's analysis of the short-term effects of Brexit? The Treasury came up with the analysis that GDP will decline by 3.6%, compared with the baseline, in the two years after a vote to leave. Have you done any analysis of that, Martin Taylor? Do you agree with that?

Martin Taylor: We are not a forecasting committee. That is one of the glories of the FPC. We leave that to the MPC. The first casualty of war is truth, as they say, and the forecasts being made at the moment cannot possibly all be right, because they differ so much. I have nothing to say on the Treasury forecast. To your earlier question, and here perhaps I will stick my neck out, it seems to me that a pretty sharp fall in the exchange rate is the least controversial consequence of a leave vote. As to the rest of it, I am not competent, but I would expect that.

Mark Garnier: There is the greatest risk of currency movement.

Martin Taylor: I regard it as the least speculative of the conclusions.

Q44 Chair: All three of you are saying that, are you not? That is my impression.

Martin Taylor: If I may, Mr Rees-Mogg commented, and I understand his comment, that it was a strange thing to do for a central bank to point out threats to its own currency. People have said that the Bank is shouting fire in a crowded theatre. Actually, I think the Bank is pointing out to the audience where the fire exits are.

Mark Garnier: That is a very good analogy.

Martin Taylor: In the case of a leave vote, there will be changes to trade and the terms of trade will have to adapt.

Q45 Mark Garnier: One of the assumptions in one of the analyses by the Treasury is that households will stop spending money in a post-Brexit environment, in anticipation of a worsening economic outlook, which those of us in the in camp would think is fairly normal. Quite an interesting viewpoint on this is that, if households vote to leave, and the assumption is that they are not necessarily voting to make their lives worse but are voting to make their lives better, does that not mean that more than half of the electorate who turn out are more optimistic? Has that analysis not been completely turned on its head?

Richard Sharp: There may not be 100% turnout.

Mark Garnier: No, it could be a 70% or 60% turnout, so it could be that at least 30% to 35% of the population get the response they want. They could go out on a massive, jolly spending spree.

Mr Rees-Mogg: I am planning it.

Mark Garnier: You have the money, Jacob. It is an interesting point. The assumption that everybody is going to view exit as a bad thing fails to take account of the fact that a lot of people would have got the vote they wanted.

Martin Taylor: We as a committee have to be very careful about this. This is not our job. Our concern about the risk is the danger that exit could amplify already-existing risks, which we have talked about previously. The current account is the most obvious, hence my remark about the currency. There would need to be a quick reset to encourage inflows to continue. Beyond that, it is very dangerous for FPC members to get into the minutiae of forecasting, although perhaps Don wants to do that here.

Mark Garnier: You look enthusiastic to say something.

Donald Kohn: One thing we need to think about is that people might vote for leave for reasons other than the net present value of their future income. They could vote to reduce their future income because they are getting more utility from some other dimension. I do not know, but I do not think you can assume that, just because they voted to leave, they think their income will be higher in the future. There are just too many factors at play here.

I guess I would be a little more concerned about businesses than I was about households and the effect of uncertainty there, because I am concerned that, for example, risk premiums will rise in securities markets, particularly corporate bond markets. I know that corporations, for their capital spending, import a great deal of the capital equipment that they use. I think it was 40% or 50% of investment spending. That equipment would be more expensive than it otherwise would be. There is a lot of evidence over the years that business investment does react negatively to uncertainty. There is an option value of waiting and most businesses are sophisticated enough to understand that. They would wait to see how things would turn out.

Q46 Mark Garnier: That is really helpful. Reading between the lines, you do not have any problems with the Treasury's analysis that there could just be a slowdown in demand.

Donald Kohn: I do not have any problems with the general idea that GDP growth would be slower. I have no view on the exact number either to the left or the right of the decimal point, but it would be slower.

Q47 Mark Garnier: I have one last question. A commentator for the leave campaign made a fairly firm statement about possible outcomes. The Treasury has suggested you could see rising inflation and, at the same time, falling house prices. The commentator said it would be completely impossible to see inflation and deflation happening in two parts of the economy at the same time. Would you like to make a comment on that? Presumably it is possible, if you see a fall in currency and you are a net importer, that your cost of goods goes up. You try to respond to that, as the MPC, which means you raise interest rates to get more interest in your currency and, as a result of that, you tighten liquidity and, therefore, you see a decline in the property market.

Donald Kohn: That was exactly our 2014 stress test. It was a loss of confidence in the inflation target that caused a drop in sterling, a sharp rise in interest rates and a sharp decline in real estate prices. At least at that time, and I still agree, we thought that that was a coherent story.

Q48 Mark Garnier: Those 2014 stress tests are very interesting because, if I remember rightly, they used a significant decline in the confidence of the British economy as a result of productivity figures failing to get better. If you take out productivity failure or disappointment and replace it with an economic shock, such as a very disappointing result for the outcome of this thing, it could precipitate that type of scenario. I am not trying to suggest that it would precipitate exactly that scenario, but it is that type of shock that would cause the role play that the 2014 stress test had. For the stenographers, you are all nodding. Are you nodding as well, Mr Sharp?

Richard Sharp: No, I do not think I am. I got a bit lost in your argument.

Mark Garnier: Mr Kohn and Mr Taylor were keeping up, I think. You are nodding now.

Martin Taylor: It was a balance of payments crisis, followed by a steep fall in the exchange rate, a rise in inflation because of the cost of imported goods, a sharp response by the Monetary Policy Committee—by raising interest rates sharply—and then a fall in house prices.

Q49 Mark Garnier: That was seen as a plausible outcome.

Martin Taylor: Yes.

Richard Sharp: What do you mean "a plausible outcome"?

Mark Garnier: It is a plausible outcome from Brexit, if there is a shock.

Martin Taylor: One could imagine the world develop like that. I would not say it was the central outcome.

Mark Garnier: It would be wrong to say that it is a probable outcome, but it is one of the outcomes that could come as a result of it, among many others.

Martin Taylor: It is conceivable.

Mark Garnier: It is a conceivable outcome.

Q50 Rachel Reeves: We are going into the referendum with a historically and internationally high level of our current account deficit. It is obviously financed by a substantial portfolio of foreign direct investment inflows. In the May inflation report, it says that one existing vulnerability that could amplify the size of the impact of a vote to leave the EU is the elevated UK current account deficit, so I just want to explore why it is a risk and what the implications might be. If we were to vote to leave the EU, how would you expect investors to respond to that in terms of portfolio and foreign direct investment, Mr Taylor?

Martin Taylor: Mr Sharp knows more about this than I do, but I am happy to have a go. At the moment, you are seeing some signs of wait and see by investors, both domestically and from abroad. You see it in the commercial real estate market in particular and, indeed, with a binary event just a few weeks out, why would you not wait before committing yourself? I suppose that, if there is a vote to leave, as I said before, things will rebalance at a lower exchange rate and the exchange rate will fall until people come back in again.

Q51 Rachel Reeves: I recognise what you are saying, that at the moment there is a wait and see approach. In the event of a vote to leave, you think that there would be a reduction in those investments, but as a result sterling would fall and it would be cheaper to invest.

Martin Taylor: I feel very timid talking to an economist like you on these subjects. You know much more about this than I do. There would be a fundamental reset, a shaking of the plates and then life would carry on, at a different level of exchange rate and a different level of activity perhaps. As Richard Sharp said earlier, I believe that foreign investors would not be put off the United Kingdom permanently; they would come back when they decided the exchange rate had fallen enough. I might be completely wrong about that.

Richard Sharp: No, you are completely right.

Chair: Consensus has broken out in the FPC.

Martin Taylor: And generosity.

Q52 Rachel Reeves: One of the reasons that some people say the UK is seen as a positive place for foreign direct investment is because we have access to the single market. I recognise what you say, that it would just rebalance at a lower level of sterling, but presumably that would have some real effects. Mr Sharp, would you like to comment?

Richard Sharp: Yes. You will see external forecasters talk about lower growth and, clearly, the new trading relationships that need to be established will cause people to price the capacity of the domestic economy and the companies within the domestic economy to grow. Obviously, we are home to a lot of global companies as well and uncertainty adds an element of a risk premium when global investors have choices about where they put their assets. However, we have so many other strong things going for us that we should not ignore: the rule of law, governance, the political institutions that we have; plus we have a strong economy going into this situation.

Q53 Rachel Reeves: Obviously, in the end, everything has to balance and the current account deficit has to equal the capital account surplus or they could even switch around. Ultimately, if we still have a current account deficit, we would still have a capital account surplus, we would still have those inflows, but we would have them at a lower value of sterling, a lower growth rate and greater uncertainty, which has to be compensated, I guess, by a lower value of sterling.

Richard Sharp: Correct, which is why the discussion has been as to whether you get some increase in yield, as required, to bid the money in. Fortunately, again, we are in the era of zero global rates or negative rates in some parts of the world, so the potential cost of that may not be so great.

Q54 Rachel Reeves: It goes on in the inflation report to say, "An abrupt decline in capital inflows could pose a major financing difficulty for the UK particularly if it were also associated with investors attempting to reduce their existing holdings of UK assets". Obviously this is the MPC rather than the FPC, but how worried are you about an abrupt decline? The Governor says it is "likely to result, if not a sudden stop—I wouldn't necessarily go there—but in higher risk premia on a range of sterling assets". What sort of decline do you think we would see and are you worried about "a major financing difficulty for the UK"? It sounds like you are not, but I wonder.

Richard Sharp: I am not worried about a major financing issue for the UK. If you look at the maturity of government debt, it is well funded; it is broadly held. We are a very strong credit, as I said at the outset. There may be some price adjustment for uncertainty in terms of the yield, potentially. That will be mitigated if the currency itself has depreciated, but I do not see an issue there. They said "could" in that statement.

Martin Taylor: It is important to distinguish what might happen in the very short run after the referendum. Suppose there was an unexpected vote leave when the market had concluded that there was going to be a remain vote. You might see some gapping if that were to happen and people would not know where they were, but all this could be handled.

Donald Kohn: We have worried about the illiquidity of some of these markets. That has been a major thrust of our study at the FPC over the past year or so. To Martin's point about gapping, that is definitely possible, and then you could get overshooting in these prices due to the uncertainty, because of the gapping that unleashes some different dynamics. I agree with my colleagues that, basically, the UK financial system is sound and should be resilient to this. That is what the stress test in 2014 said, but there are all kinds of uncertainties and risks out there once the process begins.

I have one thought to add to yours about the decline in sterling and the capital inflows. When sterling declines, the current account deficit will shrink, because imports will decline and be more expensive. Exports will increase to some extent, though it could take a long time for the exports to respond given the uncertainty about the trade agreements. There will be a decline in the current account deficit, but that will come at the expense of a lower standard of living for UK residents relative to the baseline, because they will be paying more for imports. There are consequences to the decline in sterling even though the UK will remain a very desirable place for investment for a number of reasons, as Richard has outlined.

Q55 Rachel Reeves: Mr Sharp, I want to clarify something you said. You spoke about a price adjustment. We have spoken about how the depreciation of sterling would encourage investment to come back in. By "price adjustment", do you also mean changes in interest rates?

Richard Sharp: Yes. There could be a steepening of the yield curve, for example. There will be a debate about how much. People, right now, can make different assumptions in their models.

Q56 Rachel Reeves: Sure. One of the possible implications of a vote to leave, as well as sterling falling, would be to encourage those portfolio and FDI flows to keep coming in, and interest rates would be higher to encourage that.

Richard Sharp: Yes, it could be, exactly, particularly longer term.

Q57 Rachel Reeves: Why particularly longer term?

Richard Sharp: The Bank of England, through its MPC, may choose how it wants to behave in the shorter term. That is for them to decide, but the longer term tends to be driven by the markets.

Q58 Rachel Reeves: Yes, so the bank rate might stay where it is or even fall if there is a shock, but along the yield curve you would expect—

Richard Sharp: As you discussed with the MPC members, there is a range of possible outcomes that they wanted to flag for you.

Q59 Rachel Reeves: Finally, the answer may well be nothing, but in the event of the scenarios that we have just talked through, is there anything that the FPC could do or would want to do in terms of helping this adjustment or ensuring a soft adjustment to this new world?

Richard Sharp: Not by commission. What we have checked is that any areas of potential instability are well protected; that there is resilience in the system; that the Bank of England has the tools at its disposal to ensure that, whatever the decision is, the economy functions and there is financial stability. We have satisfied ourselves of that.

Q60 Rachel Reeves: What sort of tools might you need or what sort of tools have given you reason to be satisfied?

Richard Sharp: As Mr Taylor mentioned, there has already been an announcement with respect to the liquidity facilities, for example.

Rachel Reeves: The additional auctions.

Richard Sharp: Exactly.

Q61 Rachel Reeves: Anything else?

Donald Kohn: The Bank has also said that the PRA is working with the individual companies, with all the banks, to make sure they have considered the risks and have plans in place.

Q62 Rachel Reeves: From your perspective, those risks would be about ensuring adequate liquidity.

Donald Kohn: Adequate liquidity, which the Bank can supply, but the banks should do it first, and risk management and knowing what their exposures are and managing those exposures—liquidity, capital, et cetera— to potential adverse events.

Q63 Rachel Reeves: These are things that are happening now to prepare for a possible leave vote. When you meet quite soon after the vote—

Martin Taylor: We meet before the vote. Our policy meeting is after the vote. We have several meetings in the run-up to the vote. You remember how this works.

Q64 Rachel Reeves: We did not have an FPC when I was there, only the MPC, and I worked in monetary analysis, so I am not a financial stability expert—not that I am a monetary policy expert either. You have talked about what you are doing at the moment to ensure banks and businesses are well prepared. Is there any thought about additional actions you might take in the event of a vote to leave? The answer might be no, you are not concerned or you have not thought about it yet, but I just wondered.

Martin Taylor: Apart from asking the questions that we have asked of the other parts of the Bank about their preparedness, which we are satisfied with, I would imagine we will be discussing this during the round that is coming up.

Q65 Mr Baker: Can I just take stock for a moment? I was just thinking back to your reappointment hearing, Mr Sharp. If I was to paraphrase—and it is a paraphrase; I am looking for you to correct me—we concluded that the risk here is that there will be some volatility in the market around the vote and some downward pressure on the exchange rate. But what I have heard you say again today is that, in the medium to long term, it will all adjust and things will go on just fine. Provided that the Bank provides the necessary liquidity around the vote, that is the long and the short of the currency risk. Is that about right? Perhaps you would summarise the events you expect to happen in your own words, because we have had quite a canter around this, but it is not quite what I think you said in your reappointment hearing.

Richard Sharp: What I said in my reappointment was that there could be some short-term stability issues, but I was not concerned by any long-term stability issues, and that remains what I believe and the words that I use.

Q66 Mr Baker: Yes, so we are expecting some downward pressure on the currency, but we are not sure how far or for how long.

Richard Sharp: Do not forget that, in the realm of medium to longer term, there are a huge number of possibilities that come to bear, as we have already discussed, including issues with respect to an aftershock. There is not zero risk of an aftershock with respect to the whole EU community and the political reaction there, for example.

Q67 Chair: Do you mean a shock, a response, in the EU to the UK?

Richard Sharp: Yes. In the medium to long term, you cannot rule out a wide spectrum of possibilities, including some extreme. Also, there are counterfactual issues. In the event of remain, as the IMF flagged today, there is an unresolved Greek issue and there are other issues that challenge the European system. We would not exist if the world was predictable and we could just put in place something that would be permanently stable. We have to react to events.

Q68 Mr Baker: Thank you. We have got to where I wanted, which is that we know there is quite a considerable degree of unpredictability around these events. Mr Taylor, you stuck your neck out, as you put it, and you said you felt that, in the Treasury report, the least speculative elements were the claims about currency movements.

Martin Taylor: Yes.

Q69 Mr Baker: That seems to imply considerable criticism of all the other claims, so could you perhaps expand a little on what you meant when you said it was the "least speculative", because that must mean the others are more speculative?

Martin Taylor: I simply meant that we are not a forecasting committee. I am not competent to do economic forecasts. I consume a large number of them. I have been doing that for a very long time and I am aware of their deficiencies, as you are. All these forecasts, whether it is the MPC's forecast, the Treasury's forecast or those of many outside economists, have some things in common; they do not all agree. One can talk about directions and quantities calibration. I will not go near the calibration.

It seems very likely that sterling would fall sharply in the short run, certainly, in the event of a leave vote, which is why it is not perhaps as happy a picture as you were painting with Richard Sharp. There would be a cost, in the short term at least, in lost output and higher unemployment, but I am not competent to calibrate that. Some forecasts look and feel hard to me. The most certain of these elements, to me, is the fall in the exchange rate, because one can already see the way the market is behaving.

Q70 Mr Baker: I felt the mood of the room change with your point about pointing to the fire exits. I feel pretty sure we are going to see your face on a leaflet with your point about the fire exits on it.

Martin Taylor: A leaflet?

Q71 Mr Baker: Yes. I hesitate to go there again, but in the course of things you said the Bank of England was indicating the fire exits. Can you explain a bit more exactly what you were trying to convey there?

Martin Taylor: I was explaining how a rebalancing would take place.

Q72 Mr Baker: You are not suggesting that the Bank is pointing which way the public should go.

Martin Taylor: No.

Q73 Mr Baker: Thank you. Just to turn to some of the other risks, you and the Governor—I was just looking at his Q&A with Faisal Islam— have all been quite careful to say that Brexit is the biggest domestic risk to financial stability. The others might be: China; the European Central Bank has just accelerated QE to €80 billion a month; Mr Sharp, you just mentioned European issues. Could you put in context how much more significant some of those international risks are compared to the Brexit risk? I am leaving it open to whoever flinches first. Mr Kohn, perhaps you would like to go for it. Can you contextualise those international risks compared to Brexit?

Chair: Or put them in a hierarchy, for instance, for us.

Donald Kohn: It is very hard to do that. There are different kinds of risk, as Mr Sharp was emphasising earlier, and I agree with him. These global risks are with us and are going to be with us for quite a while. The referendum risk is a near-term risk and we will know on 24 June which way that might go. I would resist saying one is bigger than the other. They are just very different and both, in my view, are material to financial stability in the United Kingdom.

Martin Taylor: We have tended not to rank risks in order, because to do that—we are back to forecasting again—you have to have some estimate of the probability of the risk crystallising, in one form or another, and the impact that it would have.

Q74 Chair: Yes, but you need to make those assessments in order to make an overall assessment of financial stability, Mr Taylor, so I hope that you are doing that work.

Martin Taylor: No, you do not have to calibrate them as precisely as that, because these risks could break in all sorts of ways, from the very serious to the marginally serious. We live with all these. I do not agree with the suggestion put forward a moment ago, perhaps I misunderstood it, that by leaving the European Union we escape from the eurozone risk.

Q75 Mr Baker: I was not suggesting that. I was asking you to place those risks in a hierarchy.

Martin Taylor: They are three big risks. We have major risks and minor risks. Those are three major ones. They have different time horizons.

Q76 Mr Baker: I am quite surprised by the conversation we have just had about likelihood and severity. I wrote down "likelihood, severity"; you used other terms. When I used to manage aero-engine risk, in order to know where we should be prioritising our actions and, given scarce resources, where effort should be applied, we were very careful to look at likelihood and severity. Are we really saying we do not look at these risks and categorise them in some hierarchy in order to understand where the committee should be placing its effort?

Martin Taylor: No. I am talking about the game of saying, "Here are the five biggest risks". I think you can say intelligently, "Here are the five biggest risks we can identify". Unless one of them is stupendously bigger than the others, I do not think that getting into the business of ranking them ABCDE is particularly useful. Take problems in China or problems in the eurozone; there are so many possible outcomes with different degrees of severity that it becomes a parlour game and we do not advance our work very much by going down the parlour game route. We advance it by trying to understand whether our financial system is resilient enough to stand up to these things going wrong.

Q77 Chair: I am very surprised by what you are saying. Priorities for action must derive from a hierarchy of risk, an assessment of what they are and an identification from them about what you most feel you need to do, Mr Taylor.

Martin Taylor: That would be the case if it were within our power to solve these problems.

Q78 Chair: No, no, no, it bears no relation at all to the issue of the extent to which you can directly affect, for example, a banking crisis in China. What you do want to know, though, is what the likelihood is. If you consider it to be extremely remote, you are less likely to put priorities to thinking through that problem—the scarce resources that Steve Baker has just referred to, the scare resources of the staff who think about these issues and collect data on them—than you would be if you concluded that it had a high risk.

Martin Taylor: We are a tail risk committee. That means that, on the whole, the things we are concerned about have relatively low probabilities and relatively high impact.

Donald Kohn: It is fair that, when we construct our stress test scenarios, we think about what you and Mr Baker are talking about. When we did this at the end of 2013 for a 2014 stress test, we thought that property markets in the UK and an interest rate snap-back were probably the most important risks that we wanted the UK banks to be resilient to, so we constructed a scenario that had rising interest rates, declining house prices, declining commercial real estate prices. When we constructed our scenario at the end of 2014, we thought the global risks were the greatest.

Chair: Now Mr Baker is quite reasonably asking if you could give us some context, some sense of the hierarchy of risk among the three that you have just cited.

Mr Steve Baker: While you think about that, I just want to put this before you. The *FT* has compared the shock scenario with others. To give you an indication, their shock scenario, compared to other recessions, has a very quick recovery; it is virtually a flat line. Their severe shock is broadly equivalent to the 1990 to 1992 recession. The 2008 to 2010 and the 1979 to 1981 recessions are very considerably worse. When we know that, even in my own lifetime, we have lived through very much more severe shocks than the one that is the worst case predicted by the Treasury over Brexit, it is important to have some kind of hierarchical understanding of the things you are worrying about. It seems to me that, even by the Treasury's own worst estimate, the risks are not that great compared to realistically foreseeable risks that you must deal with all the time.

When I reflect on the evidence this Committee took recently from Dame Clara Furse—correct me if I am wrong, Chairman—she did not mention Brexit risk in her reappointment evidence, which was a matter of surprise to the Committee. You did mention it, Mr Sharp, but in a way that felt, to me, quite moderate. The Governor, when he previously came before the Committee, needed to be drawn to the subject, whereas now it is occupying all our time. I cannot help thinking that this risk is looming over us so much because the certainty of the referendum date is there, a month away. I cannot help wondering if, the day after the referendum, we will suddenly be worrying about China and the eurozone as far more significant risks, which would be backed up by this chart in the *FT* showing that, in real life, things can be vastly worse than the Treasury is forecasting around Brexit. I am looking for a sense of perspective on these relative risks.

Donald Kohn: It is the case that the Bank, consulting with the FPC, has made contingency plans for a vote to leave, so it is fair to say that the energy of the Bank is now focused, with FPC consultation, on the near-term risk of what happens on 23 June. But it is also the case that we did an annual cyclical scenario for the banks for the stress tests. In that annual cyclical scenario—and those stress test results will come in in the third or fourth quarter—we had a bigger shock to global risks than we did to UK risk. We have not prioritised one versus the other, but we have certainly concentrated in the near term on this and longer term on that, and that, to me, lines up with the way the risks are.

Q79 Mr Baker: I had better move on, because I have a fair bit more ground I want to cover. Mr Sharp, in your earlier evidence, I took from what you began to say that you feel it is in everybody's interests to conclude a trade negotiation fairly quickly.

Richard Sharp: No.

Q80 Mr Baker: You were talking about the size of the UK market in comparison to—

Richard Sharp: Clearly there are interests on both parties where there is a common interest in a successful negotiation. However, there are political issues and you have had political voices. Lammy, for example, has talked about the difficulties of trade negotiations and the fact that there would be a need to make them difficult pour encourager les autres—or décourager les autres. History has a lot of experience of failed negotiations, despite the fact that both parties would have benefited from a successful negotiation.

Q81 Mr Baker: That would mean bad faith on the part of an organisation that claims that it is set up to avoid economic nationalism, because it knows that economic nationalism can lead to war.

Richard Sharp: These are speculative areas. What we have to look at, as a committee, are the parameters of risk associated with worst-case outcomes.

Q82 Mr Baker: Moving on to house prices, I was just looking at an E*vening Standard* report. “The stampede to escape George Osborne’s new ‘landlord tax’ has sent London property prices spiralling to new all-time highs. The average price of a London home leaped £30,000 in March—one of the biggest monthly jumps on record”. Does that put any additional context in terms of financial stability risks around what the Treasury is saying about house prices?

Donald Kohn: It is very hard to interpret what is going on in the property markets today, because you have these two things: you have the new tax regime that came in on 1 April and then you have this referendum risk. As the Governor mentioned, having to do with economic data more generally, there are things going on now, including the referendum risk, which make these data hard to interpret. I do not follow the logic that because of this jump in March to get ahead of the tax increase somehow—

Q83 Mr Baker: The point I am making is that the housing market has an awful lot going on in it, which mitigates against any kind of sensible forecast about what might happen.

Donald Kohn: Yes.

Q84 Mr Baker: You are all agreeing, thank you. Just to turn to the Treasury’s model, do you understand it to be predicting a fall in house prices compared to today’s prices or do you understand it to be predicting a slowing in the rate of growth so that, at a point in the future, house prices are lower than they might have been? In other words, is a reduced rate of growth being dressed up as a loss?

Richard Sharp: We were not involved in any way in the Treasury model. We have looked at any analysis as the Bank. The commentary, as you will have seen, is that it is a reduction from an increase and therefore it is broadly flat. You will have seen that commentary.

Q85 Mr Baker: Thank you. That is what I understood: broadly flat. We are talking about broadly flat house prices in an environment where a policy from the Chancellor can push them up by £30,000 in a month, which is an interesting context.

I think you have confirmed that you have not done any of your own analysis of the likely impact of a Brexit vote on lending and house prices. Is that the case?

Richard Sharp: No, there has been, from the Bank of England, monetary policy analysis that we have had sight of; that is not being shared with the public.

Q86 Mr Baker: How does it compare and contrast?

Richard Sharp: It is not being shared with the public.

Q87 Mr Baker: Are you able to share it with us privately?

Richard Sharp: You will have to talk to the Governor about that.

Chair: I do not know whether we will be asking for it.

Q88 Mr Baker: If the Treasury's predictions are accurate, what is your assessment of the consequences of financial stability if house prices were to increase by that reduced rate and be 10% to 18% lower than they might otherwise have been in two years? What does it mean for financial stability in two years if the Treasury is right about that house price forecast?

Martin Taylor: Is the Treasury also right about its inflation forecast? Does it have an interest rate forecast in there? You have to look at all the variables. It is not only one thing that is moving in the Treasury forecast.

Q89 Mr Baker: Finally, I would like to ask Donald Kohn about a very interesting speech you made at the Brookings Institution in September. I will refresh your memory with one short paragraph and then intimate what is in the others. You said, "Europe has been subject to a couple of stress tests in the last five years […] the eurozone crisis and then the refugee crisis of the last couple of months, and it's revealed some real problems with where Europe is now. And I worry that, both politically and economically, you're not in a stable place". You then talked about a lack of democratic process to turn the ship around. You talked about clunky crisis management, resentment building up, time for a stocktake, where citizens will go and so on. You said, "If this union is so fragile that, if you don't keep moving, it's going to fall over, it's going to fall over eventually anyhow". That was your speech that you made.

Donald Kohn: Yes.

Q90 Mr Baker: What does all of that mean for financial stability?

Donald Kohn: I do think, as Mr Sharp pointed out, the incompleteness of the eurozone is a risk to economic stability and financial stability.

Q91 Chair: That was a specific reference to the eurozone, was it—this creature that is moving along in a very fragile form?

Donald Kohn: Yes. That was a specific reference to the euro area and an objection to the bicycle metaphor that one often hears, which is that, if you do not keep moving forward, you will fall over. I thought that was not a good way to do cost-benefit analysis, so, if it was not worth taking a step, you should not take a step. The eurozone needs to continue to move towards banking union; it needs to have more shared risk, public and private, to make it a coherent place. As I noted in that speech, it needs to make sure that the democratic accountability matches up somehow with the greater shared risk and shared union. I worry that it is an incomplete project right now.

Q92 Mr Baker: You are raising some quite profound political and economic factors there. Thank you for nodding—just for the record. Where do you think the eurozone will be in five years?

Donald Kohn: My best guess is that they will continue to move towards greater union within the eurozone and make it more cohesive and coherent, but by no means am I 100% certain of that. There are risks on all sides of that.

Q93 Mr Baker: If they were to fail to achieve a fiscal and a banking union, for example, what would be the consequences for the currency then?

Donald Kohn: It would be much harder to hold the currency union together. We have already seen the stresses from having national banking systems depend on national budgets. They have gone towards a shared resolution system. They need to complete that with a shared insurance system. If they fail to move forward on this, it will put the union at risk eventually, but there is a lot of will to do it. I am constantly surprised that even public polls of Greek populace say that what they are going through is horrible, and it is, but they support being part of the euro. It is a little hard for an outsider—and I am an outsider, not only here in the UK but even more so in the eurozone—to downplay the will of the people inside to make it work.

Q94 Mr Baker: Mr Sharp and Mr Taylor, do you have anything additional to add on this subject of eurozone risk?

Richard Sharp: You have heard from the IMF today, obviously encouraging a clean resolution of the Greek situation. The Greek Government recently voted through greater austerity.

Q95 Chair: Talk about the pot calling the kettle black, bearing in mind the advice they have been giving for a while on the Greek crisis.

Richard Sharp: As Mr Kohn said, the logic has to be pooled fiscal governance and a willingness to provide inter-zone transfers. Without that, you are going to have extraordinarily high social costs.

Q96 Mr Baker: If wealthy Germany will not agree to pay for the costs of a struggling south, what will that mean for the eurozone? Will it not break apart?

Richard Sharp: It creates tensions and, as we have seen, they can be pushed quite far without breaking the eurozone, particularly given the power of the ECB to paper over them. It creates difficulties, though, and it is significantly suboptimal.

Mr Baker: I will resist the temptation to talk about that papering over by the ECB.

Q97 Chair: I will end by asking Donald Kohn one question, only because I am going to vote him, for these purposes, senior man on this panel. Do you think the IMF should avoid coming over here and offering a view a week before the referendum, with its Article IV assessment?

Donald Kohn: I do not have a view on that, Mr Chairman. They have already expressed their view or at least the managing director has expressed her view, which presumably is the view of the institution.

Q98 Chair: Your colleague here, Mr Taylor, said how important it is to observe purdah strictly. You used the word "strictly". It strikes me as about as clear a breach of the spirit of that principle as it is possible to get. I suppose one could do it 24 hours before the vote. But you have no view.

Donald Kohn: That is correct.

Q99 Chair: I will just see if Mr Sharp has a view.

Richard Sharp: The word "maladroit" comes to mind.

Q100 Chair: Mr Taylor?

Martin Taylor: The IMF should be very careful what it says, if it says anything, at such a time.

Chair: That is very helpful and slightly more guidance than we got from the Governor, who went very silent when asked the question this morning, as some of you may have noticed. Thank you very much indeed for coming to give evidence; it has been extremely interesting and we have one or two points we will want to come back to in future sessions. Thank you particularly, Mr Kohn, for coming.