

Treasury Committee

Oral evidence: [Appointment of Sir Charles Bean to the Office of Budget Responsibility's Responsibility Committee, HC 642](#)

Thursday 8 September 2016

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Members present: Mr Andrew Tyrie (Chair); Mr Steve Baker; George Kerevan; Chris Philp; Wes Streeting.

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Witness

[I](#): Professor Sir Charles Bean.

Written evidence from witnesses:

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Examination of Witness

I: Professor Sir Charles Bean.

Q1 Chair: Thank you very much for coming to see us today. You are very well known to this Committee and to Parliament, with various hats on, over many years.

Professor Sir Charles Bean: It is nice to be back.

Chair: Your decision to go on to the OBR is an interesting one. The two main tasks of the OBR, as we see it—and we had a hand in its creation, as a Committee, six years ago—were to demonstrate independence from political interference and to get across to a wider public the fragility and unreliability of forecasts. The one thing you know about them is that they will be wrong. They are a little bit better than nothing, but that is all. You have these numbers because public policy requires them, not because it is a blueprint for how every aspect of public policy should be conducted. It seems that, on the first, the OBR has had more success than on the second. I would just like to explore those issues with you briefly, and then I will hand over to colleagues.

How do you think the OBR's independence should best be entrenched? Were you at all concerned by the exchanges that took place between the Treasury and the OBR in the run-up to a recent forecast, which appeared to be an attempt to influence it?

Professor Sir Charles Bean: Well, as far as that side goes, obviously the OBR has to interact with the Treasury and other Government Departments, because the actual evaluation of spending and tax measures is done within the Departments. The OBR relies on that quite heavily and acts as a critic before taking on numbers. Inevitably, some liaison is necessary.

When it comes to the Budget, a lot of Budget decisions are taken very late on in the process. Even quite close to the wire, there is going to have to be quite a bit of interaction. It seems to me quite reasonable for the OBR to show the Treasury its documents in the draft stage, to check facts and things like that. It would certainly not be feasible to say, "Complete separation: the OBR lives on a separate island." That is not viable.

Nevertheless, obviously from the outside you will have a suspicion that the Treasury may try to nudge things in a particular direction, or whatever. The key thing is that members of the Budget Responsibility Committee, and the OBR more generally, are resistant to that where it is inappropriate. It is obviously perfectly appropriate to take on board corrections of fact, but, if they are actually being pushed in an inappropriate direction, the first line of defence has to be people who will be robust and say, "No, I am not going to take that on board."

I guess the thing you can do to buttress that—and I have to say I do not



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know whether this exists at the moment in the OBR or not—is to have a pretty clear memorandum of understanding.

Chair: There is one, and it has been improved and revamped as a consequence of pressure from this Committee to deal with the allegations that were made recently—so yes.

Professor Sir Charles Bean: That is eminently sensible, in that case. Often with these things people do not realise up front that there might be an issue; something happens; then they think, “We have to codify this.” Having a clear MOU about what is acceptable, what is unacceptable, timescales of when documents will be submitted and all those sorts of things help to limit any worries about interference.

Q2 **Chair:** Well, we might come on to that in a bit more detail. One of my colleagues may ask you some questions about that.

What about the other role, where it seems the OBR has not been very successful, in convincing the public and the press that they should not take too much notice of the forecasts or, particularly, blame the OBR or the Government if events do not develop in the way the OBR had forecast: in other words, getting a degree of realism about what you really can achieve with a forecast? What could be done there? Do you have any thoughts on that?

Professor Sir Charles Bean: This is an issue, of course, which we grappled with at the Bank, I have to say, not totally successfully. Governor King in particular was very strong on the argument that the future is unknowable; you have to take forecasts with a pinch of salt; you need to look at the whole distribution of possible outcomes; it is not the central projection that matters.

We introduced the fan charts to try to get that across, which is obviously something the OBR have followed. Despite that, outsiders would nevertheless get their rulers out, measure exactly where the central projection was and say, “The Bank of England is predicting growth next year of 2.6%” or whatever, completely ignoring the wide range of uncertainty.

One needs to talk more explicitly in probabilities about risks and try to bring home just how uncertain projections are and how it may be quite plausible for the world to turn out very differently from the central projection.

Q3 **Chair:** You are intending to do that, if you take this job.

Professor Sir Charles Bean: One of the very good things in Dave Ramsden’s review is that it recommends the OBR to pay more attention to risks to the public finances. Certainly, if I join the OBR, if you take me on, I would like to see whether there are ways we can do more on that front than is the case at the moment to try to bring home the uncertainty.

Of course, it plays back into policy decisions. If you think about fiscal policy decisions over the past year or so, the OBR had a slightly more



buoyant forecast at one point, which led the Chancellor to take a more relaxed view on fiscal policy. Then, in the following forecast, that was moved in a more negative direction, and there was very strong feedback to current policy, looking for ways to change things to meet the fiscal rules. There is something deeply unsatisfactory about having policy moved around a lot by variations in a central projection, which is very uncertain.

We had the same problem, it should be said, at the Bank, where if you changed the central project for inflation that would translate back into some implication for what the appropriate setting of bank rate should be. Very often, the grounds you had for shifting the forecast out in the medium term were pretty weak. It is something that I have not quite come to think how to deal with in terms of policy, but there is clearly something unsatisfactory that has a very tight link between the policy setting now and a pretty flaky forecast some years ahead.

Chair: That is very helpful, and we will remain very interested in that area.

George Kerevan: Good morning. Under the present memorandum of understanding between the Treasury and OBR, the Treasury has an exceptional right of access pre-publication to final reports, such as the Autumn Statement or whatever. Is that justified?

Professor Sir Charles Bean: It pretty much has to be, because the forecast is a key element of framing the fiscal judgment. I do not really see how, on Budget day, the Chancellor can stand up and give a coherent Budget picture without having had an appropriate preview of what the OBR document is going to say.

As I said at the outset, it is important that that pre-release access is governed by clear protocols and things like that, but having the pre-release access does not worry me.

Q4 **George Kerevan:** Just for clarity's sake, I accept the point that the Chancellor cannot stand up in the Chamber not having seen what the forecast is, but, practically, what time span is the Chancellor or the Treasury given between the pre-publication and standing up to deliver in the Chamber?

Professor Sir Charles Bean: I have to say anything less than 24 hours is pushing it, because it is a substantial document; it needs time to digest. It is not like pre-release access to ONS statistics, where you can argue for much shorter pre-release access times than actually obtain. Here, given the nature of the document, you just have to give the Treasury more time to absorb it—at least 24 hours.

Q5 **George Kerevan:** Let us have a hypothetical situation. Let us suppose that, during the exceptional pre-release reading by the Treasury, a civil servant contacts OBR and says, "My Minister does not like some of this phraseology. Can I suggest something different?" Is that an appropriate intervention?



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Professor Sir Charles Bean: This would be a case where the OBR would say, “I hear, but I do not listen,” to quote Wim Duisenberg. It would be entirely inappropriate to take on board something like that. If somebody pointed out something that was factually incorrect, yes, it might be appropriate to make a last-minute change, but not to say, “Can you change the tone of the wording here?”

George Kerevan: If a Minister, through a civil servant, said, “The use of the phrase ‘freeze on departmental spending’ could be softened”, that would be inappropriate under the memorandum.

Professor Sir Charles Bean: If it is anything other than factual, it is inappropriate to be taking on board.

Q6 **George Kerevan:** That is not a hypothetical example; that is exactly what happened in the run-up to the 2014 Autumn Statement. However, what became apparent after probing by this Committee was that that suggestion was not logged initially, because it was deemed internally not to have come from Ministers, because it had been relayed by a civil servant. Even then, there was the need to tighten up.

Professor Sir Charles Bean: It seems appropriate to me that, at that stage, you are logging requests or suggestions, wherever they come from.

Q7 **George Kerevan:** We now understand that change has been made, but does that suggest that we need to keep the memorandum of understanding constantly under review?

Professor Sir Charles Bean: You should keep all MOUs constantly under review, not just here but anywhere, to see whether they are still appropriate.

Q8 **George Kerevan:** The Treasury’s 2015 review of OBR recommended that the memorandum of understanding was reviewed by September 2016, so we still await that, it now being September 2016.

Professor Sir Charles Bean: Well, it is not the end. I would hope that Robert and his colleagues will be producing something soon.

Q9 **George Kerevan:** Could you suggest any other institutional safeguards that could be put in place to prevent—maybe we are being ungenerous to the Government—Government potentially trying to unduly influence OBR? Are there any other institutional arrangements you might consider?

Professor Sir Charles Bean: I have to say there is nothing that immediately springs to mind that you would want to do. As I said at the outset, the key thing is having individuals who are robustly independent in this space. That is the first line of defence. Then you need clearly understood processes and protocols, which is what the MOU governs. If you wanted to strengthen it, I suppose you could always go beyond an MOU to something that has more legal force or something like that. To me, that looks a bit unnecessarily heavy-handed.

Q10 **George Kerevan:** Would it be appropriate in this procedure that, if, say,



the oversight board felt there had been undue attempts to persuade or influence, it could report that to some other agency within Government? At the moment, it seems to me that it remains internal. If such a process of undue influence or probing had taken place, it is difficult for this Committee or the public to find out that it has happened; it tends to be internal. Is there any way you could make that process more open?

Professor Sir Charles Bean: It may be appropriate in the first instance for it to be internal and for the oversight board to liaise with the relevant Department, Minister, civil servant, whoever it might be, and make clear that this was unacceptable and must not happen again. If there was serial infringement, it seems to me that this is something the board should go public on: name and shame.

George Kerevan: That would be your view.

Professor Sir Charles Bean: That would be my view, yes.

Q11 **George Kerevan:** That is good to know. OBR currently has a staff of around 21, but there are equivalent bodies elsewhere, in Holland for instance, where the staff is of many orders of magnitude greater. Is the current staffing of OBR, which ultimately means it relies on other Government Departments like the Treasury to feed in, sustainable or should OBR have an expanded operation?

Professor Sir Charles Bean: It is obviously linked to what you want the OBR to do. Clearly, if you expand its remit and ask it to do more things, it would need more people. Then there is a question about whether it has all its staff in house or whether it relies, essentially, on input from other Departments. You can see different ways of setting this up.

You are absolutely right that, in some other countries, the corresponding bodies are much bigger. The CBO in the US is something like 300 people, but they do much more of the costing of measures and so forth in house. I am sure they still have some liaison with the relevant Departments and so forth.

I would want to reserve judgment until I have actually been inside the OBR and been through a few rounds to see how well the process works. If, for some reason, it looked like it was not working well, this model of relying on input from other Departments, then I might feel this is a case where you need to shift some of the resources out of those Departments, into the OBR. I suspect it is not really a case of shifting but of duplicating, because those resources are probably also needed in the originating Departments. There will be a net cost overall to the public sector by expanding the function in that way.

George Kerevan: That is appreciated.

Professor Sir Charles Bean: Come back and ask me in a year's time.

Q12 **George Kerevan:** We will gladly take up that offer. It is just that the greater the in-house ability of the OBR to generate statistics of its own, the less reliant it is on others to assist it.



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Professor Sir Charles Bean: Indeed.

Q13 **George Kerevan:** It protects the independence of the OBR, which is our principal interest here.

A follow-up on that general line of inquiry: to what degree should OBR and ONS have access to statistics in Government Departments of their own volition?

Professor Sir Charles Bean: Both of them should have access to the statistics they need to do their job. There should be a presumption of right of access. Of course, this was something that I argued quite strongly for in my statistics review. The reason that the ONS does not make as much use of administrative data as is done in many other countries, such as Scandinavia and Canada, is partly because the gateways for access are so cumbersome and sometimes there is an excessive degree of caution on the part of the data owner in providing that information to another Department or, in this case, the statistics agency.

Subject to the appropriate privacy safeguards and things like that, there should be a presumption of right of access for the ONS and the OBR to the information they need to do their job properly. Now, in my understanding, the OBR has that right of access to the tax information and so forth that is needed to do its job, and what I basically want to see is the ONS given the same right of access.

Q14 **Wes Streeting:** Good morning, Sir Charles. Thanks for coming in to see us this morning. I just want to begin by reflecting on the previous Government's fiscal rules, which have all been ditched. If you had to advise the Treasury on the contents of a new fiscal framework, what would your priorities be?

Q15 **Professor Sir Charles Bean:** Well, of course, the OBR does not advise on the framework, as I understand it, so this is going beyond the OBR's responsibility. Here, I am merely talking as an independent academic economist.

I am of the view that the excessive reliance on monetary policy to control aggregate demand that we have had over the last few years is becoming less appropriate. We are in a world where the monetary policy instruments have possibly less traction and, clearly, we are approaching the lower bound on interest rates, but there are also questions about the effectiveness of asset purchases and concerns about some of their collateral consequences.

It is quite likely that the present world—and I do mean “world” here, not just the UK—is characterised by a relatively low real interest rate, what economists refer to as the neutral real interest rate, which has basically emerged over the last 15 years. If you go back to the late 1990s, the underlying real interest rate was about 4%; it is now down to about 0%. This is nothing to do with the financial crisis. It has been an inexorable shift down, associated with high propensities to save, particularly in Asia,



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with demographics and with a reduced propensity to invest, which may partly be associated with a slowdown in productivity growth. It may also be connected with the changing nature of growth: that it is less intensive in physical capital and more dependent on human capital. There have also been changes in the supplies and demands for safe relative to risky assets, and a shift in relative demand towards safe assets.

Those three things together have been driving down the underlying real interest rate, and that is partly responsible for putting us in the position where there is much less scope for using monetary policy in the way we used to in the late 1990s and the early part of the 2000s. That inevitably pushes you, then, towards saying that other policies need to take up more of a burden. That is structural and fiscal, obviously, and that covers a huge range of things.

Most economists would say that, at the current juncture, with very low real interest rates, public sector infrastructure looks more attractive than it would if interest rates were higher. When it comes to thinking about fiscal rules, it makes sense to be thinking about a world where there is more room for countercyclical fiscal action than perhaps we worried about 15 or 20 years ago, but which still ensures that things remain sustainable in the longer-term. You do not want public debt exploding or whatever. That is saying more room in the short term but still something that pegs it down in the longer term. That leaves open lots of different fiscal rules you might follow, but they are the generic characteristics the Government should be considering.

Q16 Wes Streeting: Presumably, especially given more recent experience, you would caution against too much rigidity in those rules as well.

Professor Sir Charles Bean: Absolutely. In defence of the rules as they have been, they are sometimes portrayed as rather rigid. In fact, the Chancellor has allowed the automatic stabilisers to work. The way they have been operated has actually been quite flexible, but it is important that there is that short-term flexibility, even if there is a longer-term anchor that ensures sustainability.

Q17 Wes Streeting: Thinking about the remit of the OBR, the Opposition opened up the debate in the last Parliament about whether the OBR should be involved in costing the policies of political parties' manifestos, ahead of a general election. Do you have a view about the desirability of that option?

Professor Sir Charles Bean: Ultimately, it is an issue for Parliament. As I understand it—and correct me if I am wrong—it would require legislation, would it not?

Wes Streeting: A change in remit.

Professor Sir Charles Bean: If Parliament wants to do that, fine. I would want to say that it is not a small change. Certainly, the way the OBR is set up at the moment—I guess this comes back to the question we were discussing earlier—means it relies on other Departments for



input. We would be moving to a world where the Departments would be carrying out work not just for the Government of the day but for Opposition parties. That would be quite a significant change in principle. There is no reason not to do it, if that is what Parliament wants to do, but it is important to realise that it is quite a fundamental change of principle.

The other thing that is self-evidently true is that, if you go down this route, you would need more resources in the OBR to do it—fine. I guess you would need to have some pretty clear protocols about when this could be done and how many parties can ask for it. Is any party in Parliament entitled to ask for it? Are parts of parties able to ask for their particular programme? Those sorts of things would need addressing.

Chair: These can all be addressed.

Professor Sir Charles Bean: No, they can, but I am merely pointing out what might seem like a small thing—

Chair: Everything worth doing has the odd obstacle.

Professor Sir Charles Bean: Yes, yes. If it is thought through and it is Parliament's will, I do not see any reason why the OBR should not do it, but realise that it is a significant change.

Q18 Wes Streeting: In addition to thinking about the desirability of costing manifesto policies before an election in terms of public benefit and trying to remove the usual to-ing and fro-ing about figures in an election campaign, so voters can think about the facts and the substance of the argument, there is also a challenge, which we have already seen in this Parliament, that the absence of pre-election analysis means Governments are not properly held to account in a timely way for fiscally incredible manifesto pledges.

For example, we had the Government policy—well, I will be careful about my language, actually—the manifesto commitment of the extension of right to buy for housing associations, which the Conservative Party probably did not imagine would see the light of day if they were in coalition. As a result of that, we now have a policy that is on the face of the Housing and Planning Act that has received Royal Assent and is still uncostered.

Because there is an issue about the remit of the OBR in terms of looking at firm policies, if Governments do not classify policy positions as firm policies at an appropriate juncture, it means that significant areas of Government policy, potentially costly areas of Government policy, go through this place and into the legislation without proper scrutiny. Does there need to be some tightening up of the remit in relation to this issue of firm policies?

Professor Sir Charles Bean: There is a question here as to whether it necessarily has to be the OBR that is doing that. It does seem to me, when it comes to parliamentary scrutiny of a particular policy, it is reasonable for Opposition parties to demand appropriate evaluation of costs and things like that, which could just be the originating Department



producing it.

I guess what you might want is the OBR acting as a policemen of, "Are the numbers that are being produced by the Department reasonable?" There is clearly some merit in that. What happens at the moment is that outsiders, people like the Institute for Fiscal Studies, might well step in and provide that discipline. However, I would not have any problem with the OBR having its remit extended to include these sorts of things.

- Q19 **Wes Streeting:** Finally, I just want to turn to the challenges thrown up by the result of the referendum and the uncertainty about the direction on Brexit. We were asking the Governor of the Bank of England and members of the MPC about the challenges it has thrown up for the Bank of England's forecasting. Following the referendum, the OBR cancelled its July fiscal sustainability report on the basis that the ability to produce long-term projections and a medium-term forecast would be affected by the trade arrangements the Government decide to pursue.

We are now in a position where the Government are trying to work through the tension of needing clarity quickly but also needing to define a negotiating position before triggering Article 50. We potentially have some time, and certainly an undefined amount of time, before Article 50 will be triggered. How meaningful, in that context, will OBR forecasts be? How do you foresee the OBR trying to work through some of those challenges?

Professor Sir Charles Bean: This is a serious issue, and it is obviously alluded to in the submission I prepared for the Committee. When you are thinking about the medium to longer-term consequences of Brexit, there are a lot of unknown unknowns, to use Donald Rumsfeld's phrase. It is not something where we can look at past experience and form a judgment about the likely statistical distribution of outcomes or whatever. It depends on political decisions not just in this country, but also in other countries—obviously, there are 27 other member states—and, looking further ahead, if we are talking about free-trade agreements with other countries, how willing they are to do them and what those free-trade agreements might end up looking like.

On top of that, it is quite important when you are thinking about consequences of Brexit that it is not just the trading regime and the migration regime that matter. It may have consequences for other policies that are very difficult to see now. If you are thinking about forecasts of what the world is going to look like, you really are in territory where it is very difficult to take a view about a statistical range of outcomes. The only way to really think about this is probably to talk about some possible scenarios, just to give broad orders of magnitude.

One other thing I would say, which maybe goes a bit in the other direction, is that we need to keep this in context. Clearly, Brexit could end up having quite a significant impact and potential outcome further down the road. There are estimates out there of the consequences of different trade regimes at the moment. One can argue about how



reasonable those numbers are.

Remember, though, there are lots of other uncertainties out there, and of course one of the biggest—this Committee has talked about it with me in my former role on many occasions—is the uncertainty about productivity growth. A change in productivity growth of half a percentage point accumulated over 10 years is 5% of GDP, or actually a bit more with compounding. That is the same order of magnitude of some of the bigger numbers that you get for the impact of Brexit. Do not forget that there are these other big uncertainties that the OBR has to grapple with as well.

Q20 Wes Streeting: Finally, taking that all into account, there is a risk of some conflict with the Government, if your analysis indicated that the Government's proposed relationship with the EU following Brexit would lead to a deteriorating economic or fiscal outlook. If that were to be the case, are you prepared, if necessary, to publish OBR reports that conclude the Government's Brexit policy would be economically detrimental?

Professor Sir Charles Bean: When you say "detrimental", that might be going a bit further, because that is a broader judgment about whether it is a good or a bad thing. The role of the OBR is obviously to talk about its impact on the public finances. As I understand it at the moment, the way the OBR does its forecasts is to recognise, if there is some policy that is introduced, that it may not be 100% effective or whatever. It allows for those sorts of things. That is part of the judgment about the impact of policy.

I guess the tricky thing would be if the Government declared, just for the sake of argument, that they wanted to remain a member of the single market in goods, services and capital but control migratory inflows, and they stated, "That is our policy. That is what we are going in to achieve in the negotiation." Now, we know that is not acceptable to the other 27 member states. The OBR would then be faced with something that is stated Government policy, which looks very unlikely to be achievable.

Chair: I do not know about that. The first bit is true; I am not so sure the second bit is true.

Professor Sir Charles Bean: Very simply, I am saying we would keep three of the four freedoms and we decide—

Chair: I am sorry to interrupt. It is "very unlikely to be achievable" that I reacted to.

Professor Sir Charles Bean: I see what you mean. I am premising this on the other 27 member states saying, "You cannot have the single market à la carte, just the bits you like." The essence of my point is that the outcome depends not just on what the Government say, but also depends on what you can achieve in a negotiation.

The only way the OBR can deal with that would be to say, "Well, this is what will happen if the Government are successful in achieving their



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negotiation; in considering risks, this might be the consequence," and then have something that is a less favourable outcome. That seems to be the only way you can really think about that sort of case, where you do not really know whether the policy will be achieved or not.

Q21 **Wes Streeting:** Indeed. I have a final question.

Chair: It is a final, final, final question.

Wes Streeting: Yes, final, final, final. I referred to my final line of questioning. This is definitely my final question, I promise. Let us assume that you are correct and it is unlikely that Britain would get an arrangement where we are in the single market and do not have to sign up to freedom of movement, and there is a sharp decline in net inward migration, creating additional fiscal challenges.

One of the problems with the immigration debate at the moment is that this is a heart issue, and lots of communities across the country are legitimately feeling the pain of globalisation and feeling that other parts of the country are benefiting, but the overall net impact on the UK is positive. Is the economic analysis fundamentally correct that, all other things being equal, reduction in inward migration will be bad for the UK's economy and, as a result, bad for all households? Should we be more robust in taking on the economic argument for immigration?

Professor Sir Charles Bean: An awful lot depends on what the migration regime is. It is impossible to answer that question without knowing how it operates, exactly what the objectives are, how efficient it is and, therefore, the consequences for the location of businesses.

It would be perfectly reasonable to say, "We want to reduce the inflows of relatively unskilled labour but keep the inflows of necessary skilled labour," because clearly the UK economy and UK businesses benefit from being able to get skilled workers to relieve domestic bottlenecks and so forth, and that enables you to run the economy at a higher level of activity and it actually reduces overall unemployment. It is perfectly possible to envisage a migratory regime that keeps the benefits and does not have too much cost. However, you might well have one that is introduced that is not very efficient.

Q22 **Chair:** You have used very careful language there when you said "does not have too much cost". You said, "It is perfectly possible to envisage a migratory regime that does not have too much cost."

Professor Sir Charles Bean: Well, I am saying I could envisage one. This is a relatively high level of abstraction. You start getting into, "How does it actually operate? How bureaucratic is it? How efficient are the civil servants policing it? How much leakage is there?" All these sorts of things start playing into whether this deals with the issue you are concerned with.

Bringing the whole thing full circle, it comes back to a question you raised earlier about the OBR saying whether it is a good thing or not. I pushed back on that and I said it is not the OBR's job to say whether it is a good



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thing or not. That is very much because, as you say, people worry about more than the economics. It is how it affects them, their local societies and their perceptions of that. They may be perfectly happy—my view is that this is essentially what they voted for in the referendum—accepting that there may be some overall economic cost by leaving, but they are prepared to bear that for other gains: the ability to control their lives and a limit on migration. That is fine, and the OBR should not be in the position of saying, “That is an incorrect judgment.” The OBR’s role is simply to work out the consequences of whatever is chosen for the public finances.

Q23 **Chair:** I could see your train of thought moving off into an interesting siding for a while, and you are now back on mainstream OBR.

Professor Sir Charles Bean: It is a temporary deviation.

Wes Streeting: It is very welcome.

Chair: It was a temporary deviation, which did not go quite as far as Sir Stephen Nickell’s on the same subject when asked pretty much the same question.

I would like to clarify the point about party costings, which I have been a supporter of for nearly 30 years. In fact, it was my attempt to raise this in the House that ended up resulting in a conspiracy of the Front Benches to table the very amendment to the Budget Responsibility and National Audit Bill that now prohibits it, which did not exist until I raised the subject. You can see the lack of influence that I had, at least initially, on this subject.

Professor Sir Charles Bean: It is counterproductive to raise difficult issues.

Q24 **Chair:** I have persevered, however, and there seems to have been some sort of damascene conversion in some quarters. Just to clarify what you said on it, you are agreed, are you not, that all these administrative problems should be capable of resolution; that where there is a will there is a way; and that there may be public policy benefits from having a well-constructed system in place that could improve the quality of public discourse during an election?

Professor Sir Charles Bean: Oh, yes. It is clearly feasible because, as I understand it, that is essentially what the Congressional Budget Office does.

Q25 **Chair:** The Dutch have a system, and other countries have various—

Professor Sir Charles Bean: I do not actually know how the Dutch operate. It is clearly achievable, if Parliament wants it. There are issues of principle that you just need to recognise you are crossing or raising and there are practicalities. So long as those practicalities are dealt with, I think it is perfectly feasible.

Q26 **Chair:** I would just like to take you back to another point that



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Wes Streeting raised, which was about the effects of Brexit. You may not wish to take your comments very far on this, but I should at least give you the opportunity. Were you relaxed about the approach taken by the Bank of England and the Governor in the run up to 23 June with respect to the possible impact of Brexit on the economy?

Professor Sir Charles Bean: Let me talk a bit about principles. I should also say I was abroad for a good part of the campaign.

Chair: All the better, to have a good sense of perspective on it.

Professor Sir Charles Bean: However, it also means I was not around for some of the discussions and I do not know everything that the Bank said on this topic and so forth.

Chair: If you feel you do not have much to say on it—

Professor Sir Charles Bean: I will just make a few comments about the principles involved. People say that the Bank should have been completely silent and said nothing; that is not only wrong, but inconsistent with the legal obligations of the Bank, the MPC and the FPC.

Chair: I made that point on behalf of the Committee before 23 June.

Professor Sir Charles Bean: Clearly, the responsibility of the FPC is to assess the risks to the stability of the financial system as they see them and to raise those publicly so that financial institutions are appropriately forewarned. It was clearly appropriate for the Bank to undertake contingency planning for measures to ensure that, if those risks crystallise, they can be mitigated, and that is exactly what the Bank did on the financial stability side.

As far as the Monetary Policy Committee is concerned, clearly, if this is something that is a material risk to the outlook over the three-year horizon that the MPC is using for setting monetary policy, it must be willing to talk about it. These sorts of issues do crop up from time to time. Whenever you have an election looming and Governments have different fiscal policies prospectively, you have to take on board the fact that the world may look different depending on who gets elected and you put something in the minutes that reflects your discussions around those risks and so forth. However, it is appropriate for the Bank to be circumspect in any commentary beyond its remit. It should stick to its knitting, if you like.

Q27 **Chair:** I am not going to push you any further on that, but I am going to pick you up and ask you a question on something you said yesterday to what I think was the European Sub-Committee in the House of Lords.

Professor Sir Charles Bean: That is right.

Chair: You said, I think, that the City wants access to the single market by means of equivalence, while accepting that this means they would not have any say over the rules. The rules would change over time and may not be to our advantage. That is only one of the problems with



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equivalence, is it not? There is another, which is that equivalence does not cover quite a lot of economic activity down the road: it does not cover wholesale banking, insurance or a number of other things at all.

Professor Sir Charles Bean: There was quite a lot said during the session yesterday, but the gist of my remarks was that we were unlikely to be in a world where we could preserve the passporting arrangements that we have at present, and passporting allows a right both to establish a branch in another EU member state and to sell services across border. As far as I can see, unless it was negotiated as part of a one-off deal whereby we could keep passporting rights if we were willing to adopt the Norwegian model of being part of the European Economic Area, anything else would probably involve losing those passporting rights.

However, EU regulations regarding third-country financial institutions do at the moment allow cross-border sales providing the regulatory and supervisory regime is regarded as sufficiently equivalent in some areas. You are absolutely right; it is not universal. The bit that you caught probably would have been me saying that it looks unlikely that we will have passporting, in which case the next best to go for is probably equivalence. Financial institutions that do not presently have subsidiaries but want to deal with retail customers in other EU member states will have to set them up; that means they will be subject to local supervision.

Q28 **Chair:** I am a bit depressed by your lack of optimism on these negotiations, on the idea that single markets should be so inviolable—it is something that might be negotiable—and, hereto, the mutual interest in trying to support something on passporting might mean that the ability to keep it going should not be taken off the table at this stage. Do you not think so?

Professor Sir Charles Bean: I am less optimistic than you. I am certainly all for trying to get the best deal that we can. Basically, as I said yesterday, we should aim to minimise the costs of leaving and maximise what we get out of the opportunities of leaving. Of course there is plenty of scope for the City of London to try to increase its profile on a global scale. Being realistic, plenty of other member states will not want to play ball on this issue, because they see it as a way of attracting financial activity to their particular markets.

Chair: Or a great deal of it to America and Singapore.

Q29 **Mr Baker:** Good morning, Sir Charles. I will resist the temptation to bang on about Europe and instead ask you to explore three areas directly related to the work of the ONS. The first one is the output gap. It seems, every time we visit it in this Committee, to be something of a vexed concept. Could you explain your perspective on how important you think the output gap is to the work of the ONS and how accurate it is as a concept, or otherwise characterise the output gap in your view?

Professor Sir Charles Bean: When I was at the Bank, I avoided talking about the output gap successfully for 14 years, precisely because it is



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such a slippery concept. It is something that only makes sense in the context of an economic model where you can talk about some well-defined concept of potential output and then output relative to that concept of potential. Potential output is not something that we observe in the real world. It is hard enough to measure actual GDP, let alone potential. All one has are proxy measures for slack in particular markets: unemployment in the labour market—there are various different concepts of unemployment—measures of capacity utilisation within firms, things like that.

I have always taken the view that, while it is a useful theoretical concept for thinking about the way economies work and for economies playing with models, it is not an operational statistic in the same way as GDP or something like that is; it is fraught with all sorts of assumptions you have to make about the nature of potential output, what determines it and so forth. For that reason, I quite deliberately have always preferred to talk about slack or something like that, precisely because people have this mistaken view that there is some very precise measure of the output gap out there that everybody would agree with.

Q30 Mr Baker: How important is the output gap to those forecasts that the ONS is producing? How critical are these numbers?

Professor Sir Charles Bean: The degree of slack will be, because essentially you have to be asking yourself the question of how much more output can rise before the pressures within particular markets lead to inflation taking off. Those judgments have to be made; you cannot really avoid making those judgments. One of the good things about the OBR, relative to the Bank—for the Bank, it is really pretty central, because it is a key driver of inflation—is that, because of the slightly longer-term focus of fiscal policy, you perhaps do not have to worry so much about slack, but of course you still have to worry about this nebulous notion of potential output.

Q31 Mr Baker: Would you agree with me—just to try to nail this down, because I think you agree with me, but I want to be sure—that, in the output gap, we have a figure that is really unknowable and yet is actually quite material to the numbers that come out of the forecasts?

Professor Sir Charles Bean: That is quite a good way of putting it, yes.

Mr Baker: That is a relief.

Chair: It is an understatement, is it not: “quite material”?

Professor Sir Charles Bean: Yes. The one thing I really want to stress is that potential output is a concept within an economic model. It is not something that is there in the world that you could, in principle, think, “Let us go out and measure it,” whereas, in principle, difficult though it is, you can talk about measuring GDP. It is very difficult—that is what my statistics review was all about—but at least you know what it is. However, potential output is a concept of an economic model.



Q32 **Mr Baker:** This brings me on to the second set of areas that I wanted to touch on. Yesterday, in my exchanges with the Governor, we touched on this idea that coarse aggregates do not act on one another. In this particular exchange, it was the concept that tracking M4 does not allow you to mechanically draw conclusions about inflation. I personally think that is a real problem. Just thinking about the output gap and potential output, would you agree that it is the case that, when GDP changes, the productive capacity that might be lost in a recession is not the same productive capacity that is restored when economic growth comes back?

Professor Sir Charles Bean: Quite possibly, yes. Hysteretic effects, they would be called. Yes, absolutely.

Q33 **Mr Baker:** There are structural changes in the economy as that capital is allocated.

Professor Sir Charles Bean: That is exactly what some of my research in academia before I went into the Bank was all around, particularly hysteresis effects in the labour market, but I also did some work on hysteretic effects in product markets, too.

Q34 **Mr Baker:** I will make a point of having a look. That brings us on to a quote I used yesterday from Hermes, which made the point that quantitative easing might now be, as they particularly say—and it is an allegation I agree with—introducing distortions into the economy. Now, in your testimony earlier to Wes, you said that there would be collateral consequences to this current expansionary monetary policy. Would you mind explaining what you think those consequences are?

Professor Sir Charles Bean: Let me precede an explanation there by noting that the real underlying problem here is not monetary policy per se, but it is the point I made earlier about the underlying real interest rate in the world economy being at unusually low levels. Essentially, if the monetary policymakers around the world want to keep output somewhere near our mythical potential and inflation stable, they have to be setting interest rates that are consistent with this underlying neutral real interest rate. As I said earlier, there have been deep tectonic forces that have been driving that underlying natural real interest rate down over the past 15 years.

Chair: It is the demographics, productivity, growth.

Professor Sir Charles Bean: It is the demographics, productivity, change in the nature of growth, shifts in portfolio preferences.

Q35 **Chair:** What did you mean by “shifts in the nature of preferences”?

Professor Sir Charles Bean: There are a number of things going on here. Partly, post crisis, it is people shifting out of risky assets into safe assets—so liquidity preference—but it is also changes in supply such that, for instance, ahead of the crisis, mortgage-backed securities were viewed as being relatively safe; they were AAA-rated in the US. They turned out to be anything else but safe, so overnight, with the crisis, people



suddenly realised a load of what they had previous thought were pretty safe assets were not. It is the same as eurozone periphery debt, about which, until the eurozone debt crisis broke, people said, "Government securities are safe," then they realised Greek debt was not safe.

- Q36 **Mr Baker:** This is an area where I always struggle to reconcile what I am hearing from professional economists with what I think I know about the world as it actually is. When you say, "underlying real interest rates," are you talking—as I think you are—about the aggregate time preferences of the public—in other words, the extent to which people have reduced the price that they associate with deferring consumption? When I think about underlying interest rates, I think of the price that somebody demands in order to defer their consumption from today, so I think somebody on the whole prefers a loaf of bread today to a loaf of bread in a year, but by how much? That is the interest rate, to be simplistic.

Professor Sir Charles Bean: In principle, if that changed, that could drive the phenomenon that I am talking about; however, I would not associate it with individuals' changes. The reality is, of course, that you have people at different stages of their lifecycle and we have gone through a period where there has been a big bulge of middle-aged people who are doing lots of saving for their retirement. It is particularly pronounced in China, it should be said, and there you do not have safety nets, so people largely have to self-insure. You have this bulge of savings partly being driven by the demographic features. As the demographic structure changes, aggregate savings will change, but you do not necessarily need changes in individuals' saving propensity.

- Q37 **Mr Baker:** It is who we are talking about. Some of us get the impression that people prefer to bring their consumption forward.

Professor Sir Charles Bean: One of the consequences of the way it has all worked out in equilibrium is precisely that, as the interest rate is driven down at the aggregate level, that encourages people to bring forward spending. That is the natural process of how the market works and gets back into equilibrium.

- Q38 **Mr Baker:** To try to synthesise this a little bit, there are interest rates that people pay to borrow and receive when they save. Do you think there is scope for a considerable debate about cause and effect: whether the demographic effects, etc., have changed people's aggregate preferences and therefore the underlying rates or whether actually central banks have substantially developed?

Professor Sir Charles Bean: I am not saying that people's individual preferences have necessarily changed here; it is the changing mix of people at different stages of their lifecycles, as far as the demographic part goes. This is an area where there is quite a lot of debate going on at the moment because some people put the weight on the saving story. Ben Bernanke's savings glut was one of the important initial contributions here. There are other people who place much more weight on the



weakness of the demand for funds to invest because of changes in technology, or lack of change in technology, in the case of Robert Gordon, who takes the view that productivity growth is permanently lower. Personally, I do not find that view very persuasive, but you can make the argument about changes in the nature of production where you need less physical capital and more human capital.

- Q39 **Mr Baker:** We are having a very interesting exchange, but I am slightly conscious of the time and where I meant us to be going. One of the most definitive factors in the economy right now is this enormous monetary policy intervention that has just been announced and is now taking place. Really, the heart of what I am trying to get to is to what extent you think this extraordinary monetary intervention will have real effects in the economy, in particular on the structure of capital investment and the structure of prices, and what the real consequences of all that will be.

Professor Sir Charles Bean: It is certainly true that the lower interest rate world—and this is monetary policy reflecting what is happening to the underlying real story—certainly has significant consequences.

- Q40 **Mr Baker:** I am sorry. Just to pick you up on that point, surely it is very difficult to justify the latest round of QE with shifting preferences and demographics in the real world. That is a positive choice by the Bank to try to stimulate the economy.

Professor Sir Charles Bean: Just let me finish the train of argument and I will come back to this. What I do believe to be the case is that one of the consequences of this low real interest rate environment that has been validated by monetary policy is that it most obviously makes it more expensive to save for the future. People who already have assets are better off. For people who do not have assets—the younger people—it is much more costly to save for their retirement, so there are big distributional effects. It obviously has the consequence of pushing people who want to try to find ways of getting a better return into riskier assets. That of course is what QE is designed to do; that is how it works. The worry is that it ends up pushing people too far and creating financial sector vulnerability. This is something, of course, that the Bank for International Settlements has been quite vocal on.

My own view is that the longer we are in this world, the more you need to worry about those sorts of consequences and the more it makes sense to be looking for other policies to try to pull us back to a world where rates of return are at more normal levels.

- Q41 **Chair:** Back to the point you started with.

Professor Sir Charles Bean: Back to the question about monetary policy action, the concern about doing more in this space is that there is more of this collateral damage and distributional consequences, so while the Bank does not have a remit to worry about distributional consequences Government clearly ought to. I also worry about the effectiveness of the monetary instruments, where we are now.



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Q42 **Chair:** Just take us through that, looking at the main ones, briefly. What you are basically saying is that they have more levers they can pull, but they might not be attached.

Professor Sir Charles Bean: The Bank can do more in a technical sense. It has a bit more room to cover: bank rate, if it wanted, before it leads banks to substitute wholesale from bank reserves into cash. I prepared a note for this Committee shortly before I left the Bank on where the Bank thought that the technical floor was—and it was somewhere between minus 0.5% and minus 1%—before that substitution would occur.

Even before you get to that point, you would have been asking questions about how effective a bank rate cut is. Going back to 2009, we stopped at 50 basis points because we thought going further would be counterproductive in terms of its impact on the economy. This was both because of concerns about financial stability and also because of the impact on banks' profit margins being squeezed, because of the reluctance to lower deposit rates into negative territory at a time when a lot of their mortgage books were being linked to bank rate coming down. Squeezing profit margins was not going to encourage them to be extending more credit.

We took the view at that point that it was not sensible to go below a half because it would have counter-productive effects on aggregate demand. Obviously the Bank has revisited this; we revisited it while I was there, to see if our calculus had changed. The financial stability concern is probably less now because banks are much better capitalised, but there was still a concern about the impact on banks' profit margins and that, as I understand it, is why they introduced this term funding scheme. The term funding scheme is all about making sure you get the full 25 basis points working.

I think we should put this in context. People think that the Bank has done a huge amount of monetary action here: 25 basis points is a nudge on the tiller.

Q43 **Mr Baker:** But the QE is not—

Professor Sir Charles Bean: I will come to QE in a minute. You have the supplement of the QE. It is still a relatively modest amount; remember, we bought £375 billion of assets while I was there so it is a bit more. It will have and indeed has had some significant effect on the yield curve and the consequent effects on bond yields are precisely the sorts of distributional things I have talked about. Then you ask yourself, even if you are having an impact on the interest rates, how much impact it will then have on aggregate demand, because that is really what matters.

Q44 **Mr Baker:** I am so sorry to cut you off slightly. It is a fascinating discussion, but I know the Chairman is going to cut me off and I am



determined to ask you one question about the practical work of the ONS. In terms of the work of the OBR, the point that I am driving at, really, overall with this set of questions is this: we have ended up with the output gap, a concept so flawed you have avoided talking about it for however long. We have reached a conclusion about it. The output gap is fundamentally about what we produce, but I think we are also agreeing—talking about these distributional effects—that the Bank of England’s QE programme will change the structure of prices in the capital markets and therefore the allocation of capital. You are nodding, for the record.

Professor Sir Charles Bean: Yes.

Mr Baker: Therefore, it ought to change the structure of the economy and the way we produce.

Professor Sir Charles Bean: Yes.

Q45 **Mr Baker:** Thank you. I am genuinely thrilled we are agreed thus far. I am trying to get to the bottom of where, in a nutshell, you think the Bank of England’s monetary policy will connect to the work of the OBR through that key concept of the output gap.

Professor Sir Charles Bean: In principle, you would hope that the effect on yields would encourage more investment, boost the capital stock and raise potential output. That is the classic channel. Then there may also be ancillary channels operating particularly through the exchange rate. You would expect QE to put some downward pressure on the exchange rate. That affects the composition of demand, but may also have consequences for the supply side of the economy, depending on exactly how labour supply responds to the consequent change in real wages, the allocation between different sectors, between the tradeable and non-tradeable sector, and so forth. There may be a transmission channel through there, but the primary channel is supposed to be through investment.

My question at the moment—which is why there is perhaps a little bit of reluctance to be thinking monetary policy is the solution here—is that we already had very low safe yields. It is very difficult to believe that a further reduction in safe real interest rates is going to have very much of a boosting effect on investment.

Q46 **Mr Baker:** My really final question is to just put to you—

Chair: You are joining the Wes Streeting club.

Mr Baker: This really is the final question. I wanted to just put to you a quote from your report. You said, “One challenge is that the near-continual succession of unsuccessful change programmes”—this is in the ONS—“over recent years has left many in ONS weary of change altogether.” I am just wondering, in the context of this conversation we are having, whether the problem at the ONS is not so much that they are not organised the right way but that they might be trying to carry out an impossible task. Do you think that elements of the work of the ONS are



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simply impossible—in particular, questions like establishing the output gap? I think we have agreed that some of these aspects are simply impossible

Professor Sir Charles Bean: Fortunately, the ONS is not asked to establish the output gap. Statistical measurement of the economy, in general, is very difficult. A lot of us take GDP as though it is a nice hard concept: you can weigh it. It is not like that. The more you get into it, the more you realise how many compromises and judgments you have to make in trying to construct statistics and collect proxies for different things. When you think about it, in a complex economy with loads of different sorts of goods and services, extended supply chains across countries, it is not surprising that it is difficult. I have every sympathy with statistical offices, to begin with, about how difficult the challenge is that they have been set, and it has been getting more difficult with the digital revolution. That is the basic task that they have been set.

On top of that, there is a legacy, as far as the ONS is concerned, of things like failed technology projects, the disruption of the move to Newport and the loss of a significant chunk of staff. All those things together have not been helpful for the efficiency of the operation, although I have to say that current management are very impressive in the way that they are trying to tackle the challenges and turn it round.

Mr Baker: You make very good points, but we have drawn out what I needed to cover. Thank you.

Chair: Sir Charles, we have learnt a lot this morning. Thank you very much for coming along. We now need to go into private session and I bring this to an end. Thank you very much indeed for coming to see us.

Professor Sir Charles Bean: Thank you very much.