

Treasury Committee

Oral evidence: [Autumn Statement 2016](#), HC 837

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Members present: Mr Andrew Tyrie (Chair); Mr Steve Baker; Stephen Hammond; George Kerevan; Kit Malthouse; Mr Jacob Rees-Mogg; Rachel Reeves

Questions 198 - 289

Witnesses

I: Dr Andrew Lilico, Executive Director and Principal, Europe Economics; Jonathan Portes, Research Fellow, National Institute of Economic and Social Research; Professor Martin Weale, Professor in the Department of Political Economy and School of Management and Business, Kings College London.

II: Professor Simon Wren-Lewis, Emeritus Fellow in Macroeconomics, Merton College Oxford; Professor Philip Booth, Professor of Finance, Public Policy and Ethics, St Mary's University.

Examination of Witnesses

Witnesses: Dr Andrew Lilico, Jonathan Portes and Professor Martin Weale.

Q198 Chair: Good morning. We have three high-powered witnesses in front of us, and thank you very much, all three of you, for coming in. I would like to begin with a question. Maybe I will go from left to right, as I am looking, and I will start with you, Dr Lilico. From a purely economic perspective, are the UK's interests best served by staying in the single market, by maintaining a high degree of access to it or by leaving it and relying on WTO rules?

Dr Lilico: If one could secure an arrangement in which one stayed in the single market, there would be quite a strong argument for doing that, from a purely economic point of view. I think it is really a non-starter for a number of reasons. From the UK's perspective, it would be important that we put to bed the immigration question. I think politicians should become more accountable for their immigration judgments, which I think



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would lead to them arguing for more immigration than they have done in the past, which would probably have some economic benefits as well.

From the EU's perspective, it is very implausible that they would allow us to exercise a power of reservation, which you would have as a member of the single market, which would effectively act as a veto. Obviously it would be quite beneficial to us in some ways, being able to exercise a de facto veto over certain regulations we did not like in the single market. I do not think the rest of the EU is going to grant us that power.

We should expect to have preferential access to the single market. That would be the right path to take, with some new trade agreement with them. It is probably easier to get one in respect of goods than in respect of services. My preference would be for one that did not involve remaining in the customs union.

Chair: I am going to come on to that in a moment, if I may.

Dr Lilico: Obviously you could be a member of the single market and be able to make your own trade deals. Some other single market members are able to do that. If one were going to stay in the single market, then I would recommend that path rather than another.

Q199 **Chair:** I have just one point of clarification. When you say it is a non-starter—and I ask the question from a purely economic perspective—do you think it is a non-starter because the kinds of qualifications to the relatively free movement of labour currently available under the single market would not be negotiable? It is not an economic objection on your part; it is a political objection.

Dr Lilico: There are two kinds of objections. First of all, one should understand that the single market just is an area of free movement of goods, services, capital and labour, so there is no such thing as being in the single market but having restrictions on free movement. That is not in the nature of the beast. That is not merely a political commitment; that is to understand what a single market is from an economic perspective. A single market is the free movement of products and services—goods, the outputs of production—and of the factors of production: capital and labour. That is what its nature is. Those things are indivisible really.

Q200 **Chair:** Would you agree, Dr Lilico, that all of those are heavily qualified as it is? The idea that they are complete in any of those areas, except possibly trade, would be to misunderstand their status. To take services, for example, it would be very difficult to argue that there is a free market in services. In capital, there is a huge amount of regulation, some of which has been put in recently, some of it at national level, some at international level, which is restricting capital in one way or another.

Dr Lilico: I would say that there is an important distinction in the European Union between things that are accepted in principle as



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curtailable and matters where you are committed to the principle that all the barriers should be removed.

Q201 **Chair:** That is a direction-of-travel point, is it not? It is an aspirational point and we are talking about where we are now, not where we might be on some other date.

Dr Lilico: Of course. It would be very difficult for the European Union, for example, to say you can be in the single market but you are allowed to restrict imports of cars. I do not really see a distinction between saying I am allowed to restrict imports of cars, but I am going to stay in the single market; and saying I am allowed to restrict inward migration of people, but I am allowed to stay in the single market. I do not think that either of those ideas makes any sense.

Chair: It is only because I am moving left to right, as I am looking, Jonathan Portes, and then Professor Weale will have to try to say things that have not already been said.

Jonathan Portes: There is no question that there is a lot of economic evidence to say that the UK has benefited from the degree of economic integration with the rest of Europe—however you want to call that, the single market or anything else—in terms of trade in goods and services, reductions in barriers to mobility and factors of production and migration. Up until now, the UK has benefited substantially from that.

It therefore follows that it is at least a logical conclusion that any reduction in that will have negative economic consequences for the UK. From that point of view, yes, we would be better off staying in the single market, however you want to define it, maintaining the maximum amount of access, however you want to define it.

The counterbalance from that of course is that the past does not necessarily predict the future. It is at least in theory possible that leaving the single market in some form will allow us to expand openness and economic integration with other parts of the world. There is economic evidence of the fact that distance still matters a huge amount for trade, not just of goods but of services. This myth that distance is less important than it used to be has been thoroughly discredited now, in the empirical evidence. It is improbable, given the data and the empirical evidence, that we would be able to expand our degree of integration with the rest of the world in such a way as to make up for the likely losses from leaving the single market or from reducing our access to the single market. The answer is broadly that, from an economic perspective, as far as I can tell, it is highly probable that we would be better off by preserving the maximum degree of access or indeed membership.

Q202 **Chair:** Rather than hold things up now, would you send from your institute the empirical evidence to which you have referred there, in due course?

Jonathan Portes: Certainly.



Professor Weale: I share the view that Britain's economic interest would be served by remaining in the single market. Economists have talked for centuries about gains from trade and the empirical work that has been done, some of which Jonathan alluded to, shows that there are indeed gains from trade. Those are more than just the short-term gains of giving people a wider range of choice. There is a suggestion that openness to trade has a positive impact on productivity performance.

That said, when I looked at the study of the estimates of the size of this, my sense was that, in terms of leaving the single market, they provided a sort of fuzzy upper limit, rather than a clear guide or clear best estimate. One of the reasons for this was that they talk about the effects of openness to trade on competition. Now, Britain has some of the most effective competition laws in the world and those presumably will remain, even if we do not stay as a member of the single market.

Chair: It is a presumption that this Committee will examine, but I think it is quite a big presumption you have made just then, not least bearing in mind some of the things the Prime Minister said in her speech at the party conference. In fact, UK law is not really UK law. It is just a replication or a very close assimilation of the law that currently pertains at EU level.

Professor Weale: If we maintain the competition laws that we have, then that will be less of a hazard than perhaps if we were to go back to the way that we operated 40 years ago. Another argument for easy trade is that it is not worth establishing a trading operation but, when you remove barriers, it becomes worthwhile. Well, of course, we already have trading arrangements. Firms already have export networks to continental Europe and those will not necessarily disappear, at least rapidly, even if people might be less keen on setting them up. Some of those sorts of advantages are certainly likely to remain but, nevertheless, I think leaving the single market would have adverse impacts on Britain's economic performance and most probably on its level of productivity.

Q203 **Chair:** Dr Lilico, you more or less answered this question, but I want to just come back to something you said and then give your two other colleagues on the panel an opportunity to comment as well. The Prime Minister is talking at every opportunity about how important it is to be a global leader in free trade. Most people take that to mean that Britain is going to negotiate its own trade agreements, as opposed to relying on trade deals negotiated at EU level, which means leaving the customs union. Do you think that is in the UK's long-term interests? I got the impression from what you said that you thought we should certainly leave the customs union, but correct me if I am wrong.

Dr Lilico: No, I think it is very clear that we should leave the customs union. If it were feasible for other reasons, you could imagine having a customs union in respect of particular things, like cars or something like that. Of course, WTO rules tend to mitigate strongly against those sorts of very partial sectoral deals, so it is difficult to see how that is a practical



possibility. If there were some way of making that a practical possibility, it could be argued that you could stay in there in respect of very narrow sectors. As a broad reality, across the vast swath of activity, it is going to be much better for us to seek our own new trade deals outside the EU's customs union.

Q204 Chair: Rather than now, but later, if you have the substantive supporting evidence to show the difficulty of doing sectoral deals at WTO level from outside the customs union, it would be extremely interesting to look at. Jonathan Portes.

Jonathan Portes: From a purely economic perspective, leaving the customs union will have some costs. There will be some transitional costs, because we will have to work out whatever the new system is for border controls between the UK and the remaining European Union, and there will be ongoing costs, because there will have to be some checks at borders. It is not clear what they will be. Those checks do not appear to be terribly costly or damaging, in terms of trade between, say, Switzerland and the European Union or between Norway and the European Union, but they do exist and there must be some costs. Arguably, given the UK's physical position and constraints, things might be rather more difficult for us.

Andrew is of course right that there are also the opportunities gained by leaving the customs union. It is at that point that the economics sort of break down. There are clearly economic disadvantages to leaving the customs union. The economic advantages of the new trade deals depend entirely on what you think the political and economic feasibility is over the medium and long term. If you said to me, hypothetically, "Would the disadvantages of leaving the customs union be outweighed by free trade with China, India and the US?" the answer almost certainly would be yes. From a political economy point of view, we know that that is not going to happen. Your judgment on whether those advantages outweigh the clearly existing disadvantages of leaving depends entirely on your political economy judgment of to what extent you think it is likely that the UK will make not just any old free trade deal, but meaningful trade-promoting deals with the rest of the world, in the medium to long term.

Chair: It would be interesting to know what President-elect Trump has in his back pocket, in that respect. Professor Weale.

Professor Weale: Customs unions have the effect of trade creation and trade diversion. Trade diversion is a cost of belonging to a customs union; trade creation, with the other members of the customs union, is the benefit. If one were to think about leaving the customs union, the argument would have to be that, somehow, we expect to gain more from the undiversion of the trade had been diverted than we would lose through the loss of trade with the existing members of the customs unions. How far that actually happens will depend on the practicality of negotiating arrangements with other countries.



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Chair: It is the same point Jonathan made, but I am asking you for a judgment. He gave a clear view. Dr Lilico gave a clear view.

Professor Weale: My judgment, like Jonathan's, is that that is not going to be easy and it would be a major risk.

Chair: Just to be clear on the answer, your answer is we should try to stay in the customs union.

Professor Weale: Yes.

Q205 **Mr Jacob Rees-Mogg:** Gentlemen, good morning. On the OBR itself, can I take it that you all agree that its forecasts are fair and objective, and that it has set out its judgment assumptions and the uncertainty that lies behind them as transparently as can reasonably be expected? Is that fair? Does everyone accept that?

Professor Weale: Yes.

Jonathan Portes: Yes.

Dr Lilico: Yes.

Q206 **Mr Jacob Rees-Mogg:** I then wanted to lead on to the assumptions that they are forced to make. As you know by their mandate, they have to accept not that government policy will work, but that government policy will at least be attempted, which makes it quite difficult in a vacuum of government policy. For very good reasons, the Government have not expressed their policy around Article 50 and developments therefrom. Without leading the witnesses too much, is it fair to say that these forecasts have a particularly high level of uncertainty around them, Professor Weale?

Professor Weale: Yes, we are obviously looking at a situation that neither we nor other countries have faced before, so people have to make the best judgment that they can. I in the past have been resistant to saying that things were particularly uncertain at the moment; forecasters tend to say that all the time. By now, it is actually true. The OBR has made assumptions about the impact of uncertainty on investment, which are perfectly reasonable assumptions, but of course they are no more than that.

Q207 **Mr Jacob Rees-Mogg:** Is it particularly difficult for the OBR, because they are so constrained, under both their statute and the mandate that derives from that statute, in the assumptions that they can make? They cannot make political assumptions about what may be likely to happen; they can only make assumptions on the basis of what the Government tell them they are thinking of doing. It is even harder for them that it might be for you to make a forecast.

Professor Weale: The reality is that, if I was producing my own forecast and asking myself about the uncertainty surrounding Brexit, it has to be very high. It is likely to remain high, at least for the duration of the



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negotiation process, because of course any eventual deal has to be approved by 27 countries, some of which have more than one Parliament. The uncertainty is going to be very great. I must say I find it hard to see that that could have a positive short-term effect on economic performance.

Jonathan Portes: I agree with Martin. I do not think, in this case—sometimes it is, but in this case—it is particularly the OBR's mandate or the rules it is following that is making it more difficult. It is the objective circumstances.

Mr Jacob Rees-Mogg: It is just very difficult. Dr Lilico.

Dr Lilico: There are a couple of areas that one could highlight where this is relevant. There is something a little peculiar about being in a situation where you are changing the way in which you make policy and then assuming that has no impact on your policy. A couple of the instances where I think this is relevant are that they say they do not make any assumptions about additional trade deals in the future, say with the US or anything like that, and they do not make any assumptions about how it might change the way in which we devise our own regulations and any of the gains associated with that.

There are other things that they do not assume. I would assume that European policies, particularly in respect of the eurozone, would improve the way that they dealt with that, allowing the eurozone to grow faster. I would also assume that the union might be more robust, so the internal cohesion of the United Kingdom would be better. It is very difficult for the OBR to have made any of those sorts of assumptions. I am not saying that they ought to have done anything different, but somebody probably ought to have a go, at some official level, at quantifying what some of the impacts of Brexit will be from the perspective of assuming that leavers, the people who won the argument with the public, have the right assumptions rather than, as has always been the case up until now in all of the official assumptions, assuming that the assumptions of the remainers are correct. It seems like an odd situation to be in, where government policy is assumed to be wrong.

Q208 **Mr Jacob Rees-Mogg:** Thank you very much. I want to move on and slightly back actually to what the Chairman was asking about openness to trade. The Bank of England, Treasury and the International Trade Secretary say that openness to trade improves productivity. The OBR assumes that trade openness declines, but then does not assume that this causes a decline in productivity, because the link was not well understood. Perhaps, Dr Lilico, as I went to you last, you could start on this one, please.

Dr Lilico: I do not agree that you should necessarily assume that, at least over the longer term, you get a reduction in trade openness. I do not see that as a likely consequence of Brexit. I think that you should naturally assume that things about net out at a global level. We gain as



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much from dealing with what will, by about 2030, be two thirds of our trade with the non-EU world as we lose on the EU trade. I do not think that assumption is correct.

I do think, though, that you should think it plausible that there is some kind of connection between lower trading and productivity. These things are difficult. It is complex and it is not very clear what the relationship is, but it is natural to suppose that there is at least some.

Q209 Mr Jacob Rees-Mogg: If we were to go for unilateral free trade, do you think that would increase productivity or decrease it? If we just opened our markets completely to everybody, not worrying about trade deals, not putting in lots of border controls, actually getting rid of customs officers rather than adding more, do you think that would increase or decrease productivity?

Dr Lilico: I would probably not favour doing it, but the likely consequence of it probably would be increased productivity. The experience of countries like New Zealand, which exposed themselves in particular markets very greatly to international competition, was that it led to some boosting of internal productivity.

Q210 Chair: Sorry, Jacob, to interrupt, but why would you not recommend doing it?

Dr Lilico: There are a number of reasons, but trading agreements are very often connected to geopolitical agreements. You seek some partners, some mates, in the world and you want something that you can offer your mates that you do not offer to everybody else. It can be advantageous to hold something back that you give to particular people. I think that that is probably more important, but the other kind of reason that people mention is that it gives you something to bargain with to create opportunities for your exporters, as well as your consumers. Your consumers clearly gain, but I would say that the first impact is the more dominant one. Trading agreements are political in nature. Certainly you have a core set of central ones. The European Union, for example, is not ultimately or mainly about a trading relationship. It is a trading relationship that goes with the geopolitical partnership.

Q211 Mr Jacob Rees-Mogg: Are you saying that New Zealand has no mates?

Dr Lilico: I am not saying it does not have any mates. It does have some, but it does not need geopolitical partners in quite the same way that the UK does, because it is so small.

Q212 Mr Jacob Rees-Mogg: On the other part of opening markets for your exporters, essentially if you go down the bargaining route, are you not only threatening to damage your consumers?

Dr Lilico: I agree that that is a key thing that you do. I do not think that that would be enough alone. I am just saying that it is a secondary factor. The primary factor, in my view, is that you have economic



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agreements as part of geopolitical partnerships and you want to hold something back.

Jonathan Portes: It sort of depends what unilateral free trade means, because a lot of trade is in services and things that are constrained not by tariffs, but by non-tariff barriers and regulation. We cannot simply remove all our non-tariff barriers. We either have the same emissions standards for our cars as the rest of the European Union, which we do now, or we have the emissions standards that prevail in India or the United States. We cannot have all three at the same time, right?

The unilateral removal of tariffs and that sort of approach would certainly improve productivity in, say, agriculture because some low-productivity agriculture would be wiped out. Some low-productivity agriculture in the UK would be wiped out and the competitive pressures on the rest of British agriculture would increase. This is the standard way. Would that increase productivity in the economy overall? That depends obviously on whether the resources that were released by the destruction of low-productivity agriculture were redeployed efficiently elsewhere. In the UK context, given that we have relatively flexible labour and product markets, the answer is very probably yes.

Chair: Prices would fall in the shops.

Jonathan Portes: Yes, they would.

Mr Jacob Rees-Mogg: We could, if we wanted, accept emissions standards from India, America and Europe. There would be no contradiction in that.

Jonathan Portes: We could in principle have no emissions standards at all.

Q213 **Mr Jacob Rees-Mogg:** We would say, "If it is good enough in India, we will accept it here." There is nothing to stop that happening.

Jonathan Portes: We could. If we went down that route as a general thing, if we simply said that we would not impose any regulatory constraints on any goods coming to this country, the risks of negative spillover that would reduce productivity, as well as a lot of other things that we tend to care about, would be very high.

Q214 **Mr Jacob Rees-Mogg:** We could take it a very long way. The American emissions standards are probably higher, in some cases. I accept that we are not going to allow dangerous toys to come in from China. We do not want to see those sorts of risks, but there is a very long way you could go.

Jonathan Portes: We could certainly go a fair way, but I think we would find that the complications and difficulties that mounted up would quickly become quite considerable.



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Professor Weale: Could I add a couple of points to that? First of all, I must say that I do not see New Zealand as a good example. Measured by the OECD, their living standards are now thought to be not terribly difficult from those in Slovakia. Whether you should believe those data is a separate issue, but New Zealand is the country that supposedly has done all the right things, in terms of openness and deregulation, but it has not really helped it.

On the issue of free trade, of course this has been tried before. In the late 19th century, Britain abolished tariffs on French goods, in the hope that the French would abolish tariffs on British goods. I am not sure whether they actually did or not. As Jonathan has said, there would be gains in productivity, but you must not lose sight of the so-called optimal tariff argument that, if a country imposes tariffs on imports from Britain, it tends to move the terms of trade in its favour and that is an income cost to the United Kingdom. There is no reason to think that those sorts of effects have disappeared.

Mr Jacob Rees-Mogg: If I may, I will move on, as time is relatively short, to immigration and the free movement of people.

Chair: Briefly, if you could, Jacob. It is very interesting. It is only that we have two sessions this morning.

Q215 **Mr Jacob Rees-Mogg:** I will shut up in the second session if that helps, but I think this is so important to the whole debate. From a purely economic standpoint, would any of the three of you want to impose any limits on the free movement of people?

Jonathan Portes: Do you mean within the European Union or outside?

Mr Jacob Rees-Mogg: I mean within the European Union but, if you want to answer more broadly, do by all means.

Jonathan Portes: No is the short answer. There is now a reasonable degree of empirical evidence on the impact of free movement on the UK labour market. There have been quite a few studies. None of them have suggested any significant adverse effect on the employment of UK workers. While there probably have been some wage effects, particularly at the lower end, these are pretty modest compared to other factors that affect low-paid workers. Certainly the poor position of some low-paid workers in the UK economy is not driven by migration from the EU.

Moreover, there is an increasing body of empirical evidence, again very similar to the trade arguments, on the wider productivity-enhancing impacts of openness to migration, in particular an important analysis published by the IMF, in the October World Economic Outlook, on the productivity-enhancing impacts of migration, not just high-skilled migration, but also low-skilled migration, on advanced economies.

Q216 **Mr Jacob Rees-Mogg:** You mentioned the effect, even though marginal, on wages for the lowest skills. Is that something, if we move on from



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economics to politics, that ought to be a more considerable concern?

Jonathan Portes: Absolutely. I think it is, as the Government's policy on the national living wage and the national minimum wage demonstrates. The right policy levers to deal with issues around low-paid workers, whatever you think of the specific policy the Government are pursuing, are issues around tax credits, issues around the National Minimum Wage and issues around regulation in sectors where workers are at the risk of exploitation or illegal conduct.

Chair: We are going to have to move on, Jacob. I will allow just one very brief further question, as you are pregnant with it.

Mr Jacob Rees-Mogg: I must say I have two more really.

Chair: You can have one.

Q217 **Mr Jacob Rees-Mogg:** I will just ask Dr Lilico. You are quoted as saying that it would "be ridiculous to design the UK's post-Brexit global political and economic relations [...] on the basis that, whatever we do, we have to keep immigration below 100,000". What are the consequences of trying to do that? Could the other two gentlemen say if they agree that this is a ridiculous target?

Chair: Very cleverly, Jacob, you have probably got in both your questions.

Dr Lilico: I think that many of the various Governments' commitments on that sort of topic, made over the past decade or so, and those of the Conservative party in opposition before that, were predicated on the notion that you would not be able to do it. One of my thoughts is that the promises that politicians make when they have no capacity to do so are foolish things for them to think that they should do once they do have the capacity to do so. I would say that you need to have a new set of promises now, for the new environment, which you can actually keep. One of the big benefits of restricting free movement is that then politicians will change their promises and make ones that would be more sensible to keep. That is connected to the notion that you may have a short-term undeliverable promise, and then you back-engineer all of your subsequent trading arrangements globally in order to meet a promise that you should never have made in the first place. That would be ridiculous.

Jonathan Portes: I am on record as saying that I think that targeting net migration has no economic basis whatsoever.

Professor Weale: I must say I agree that adjusting your policies to meet an arbitrary target is not the way I would choose to run the country.

Chair: I should tell you that, in private session, the Committee decided that it would be pretty crisp and brief on each of these two sessions, to



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make sure that the second session had a reasonable hearing. But, as you can tell, there is a great deal of interest around the table on this subject. With that in mind, we must give Rachel a bit more latitude as well.

Q218 Rachel Reeves: Thank you very much, Chairman. Just returning to the earlier theme of Mr Rees-Mogg's questions, what do you think the impact would be on the steel industry in this country if we had an approach where we unilaterally allowed imports into this country without tariffs and without any reciprocal arrangement overseas, Mr Portes?

Jonathan Portes: Unilaterally, at the moment, there would be a serious risk that you would see closures of what remains of the UK steel industry. It is possible that you might see the productivity-enhancing effect. That is, the spur of competition would force manufacturers here, which of course have invested a lot of money here and there are still workers here. They might invest more in an effort to raise productivity even higher and keep at least some of the operations viable, or they might find themselves forced to close down entirely. I do not know the answer. I am not a steel expert, but there is certainly a risk that the industry would close entirely, yes.

Professor Weale: Mr Portes made a comment about losing a lot of the agricultural sector. That would probably also apply to substantial parts of manufacturing, with the consequences that, even though free trade on average may lead to gains, it would tend to depress the earnings of the people working in the sectors that are now exposed to the stiff wind of competition. Opening up free trade in the way that was suggested has distributional effects, as well as effects on average income.

Dr Lilico: I would say that one of the reasons why markets and free trade in general are quite attractive is that it is very difficult for people to guess, without all of the signals that are provided by the price mechanism, exactly how the dice will fall in a very complicated world. It is natural to suppose that you would have some increase in UK steel productivity and probably some diversion of activity to other parts of the world for steel. Who knows how much of the steel might survive? It is by no means certain. These things are very complicated. If we were trading, there would be some change in the comparative advantage. Once we did that, it could be that something else would leave from the UK to be done much more elsewhere in the world and we would get more steel. It is very difficult to guess in advance.

Q219 Rachel Reeves: You do not know how the dice are going to fall but, if they are stacked against you, you have a pretty good chance of not getting a result that would be good, either for this country or for people who work in particular industries. Do you think that the productivity of people who are working in the steel industry today would be higher if they were working in producing steel or if they were claiming unemployment benefits, Mr Portes?



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Jonathan Portes: That relates to the point I was saying earlier about adjustment costs. Leaving steel aside, if you want to apply this in general, if you want to cash the productivity-enhancing gains of free trade and open markets for the country as a whole, you need to have adjustment mechanisms that allow the resources, including the human resources that are released as a consequence of change, to be redeployed efficiently. That applies to change whether it is driven by trade or by technological change. Remember, people lose their jobs because of technological change in the UK probably far more than they do because of trade actually.

Sometimes we have been good at that in the past; sometimes we have been quite bad at it in the past. You can see the legacy of failed or not particularly successfully adjustments still in some of our northern communities. Equally, you can see areas or sectors elsewhere in the country where we have been quite good at redeploying resources, but that is primarily a matter for domestic government policy.

Q220 Rachel Reeves: Professor Weale, you made the point, in answer to an earlier question, that, if we were unilaterally to get rid of tariffs without a reciprocal arrangement, it changes the terms of trade and has an income effect on the UK, presumably because of the reduced attractiveness of our exports compared to imports. Could you just elaborate a little more on what you mean?

Professor Weale: Yes, it is essentially that for countries that buy Britain's imports, because they have tariffs on them, it not only means that they pay higher internal prices; it also means that the ex-tariff price at which we sell our export is lower than it would be in the case of bilateral free trade. This is an observation that has been around for 70 or 80 years. Other countries, by imposing tariffs on British goods, can exploit their market power as consumers of British goods.

Rachel Reeves: Without reciprocal arrangements, it makes Britain less competitive, compared with our competitors.

Professor Weale: Not necessarily compared to our competitors, but it puts us at a disadvantage relative to the access that we give countries that are supplying us.

Q221 Rachel Reeves: Moving on to the issues on immigration and specifically on the OBR forecasts for net migration, the ONS say that, because of the data, without the referendum result they would have revised up their estimates of net migration, but because of the referendum result, they have decided to stick with the March projection for net migration. Do you think that that is a reasonable assumption to make? Net migration is running at around 330,000 as it is now, falling to about 185,000 by 2020. Do you think that that is a reasonable assumption, Dr Lilico?

Dr Lilico: It seems perfectly sensible to me, as the latest estimate. I would probably not have deviated from it very much at all.



Jonathan Portes: The OBR would correctly say that forecasting migration is extremely difficult. It is the job of the ONS to do it. They take a view on whether the ONS's judgments are reasonably plausible. The OBR would say that this is just a stylised assumption: "Do not take it too literally, but we had to put something in."

I am intending to publish very shortly what I hope will be a slightly more rigorous attempt to quantify the impact of possible Brexit scenarios on net migration. I am doing so reluctantly, because migration forecasting is extremely risky and the risk of getting egg on your face, as has happened to previous economists who ventured into this area, is quite significant, but I think it is incumbent on me to have a go. I have been doing some econometric analysis of the determinants of migration to the UK and will be publishing that relatively soon. I will let the Committee have it when it is ready.

Q222 **Rachel Reeves:** Thank you, Mr Portes. You have said previously that you think, even before there is a deal, you would expect net migration to fall for a variety of reasons: psychological effects, exchange rate effects and relative employment prospect effects. Not to pre-empt your work but, even before we leave the European Union, probably in April 2019, would you expect net migration to be falling towards that 185,000 level, where the OBR expect it to end up?

Jonathan Portes: I am not sure about the 185,000 area, but certainly I would expect it to be falling, yes. I would expect to see it fall from now on.

Q223 **Rachel Reeves:** Do you want to give us any numbers, Mr Portes, or will I have to await your paper?

Jonathan Portes: We are literally running and re-running the numbers now, and they change every time, as you know—you have done this before yourself—so I would rather not, but I undertake to send them to the Committee relatively soon, in time for you to take them under consideration for this.

Q224 **Rachel Reeves:** I look forward to seeing that. Professor Weale, do you also think that these assumptions are sensible ones? Are we likely to see a fall in net migration, even before we leave the European Union?

Professor Weale: I think that they are perfectly sensible. I would not say that forecasting migration is difficult, but it is certainly inaccurate. The ONS has historically tended to under-predict net migration, so the OBR's observations are perfectly reasonable.

Q225 **Rachel Reeves:** Just quickly to go back to you, Mr Portes, and we look forward to seeing your paper, but on the transmission mechanism by which you think that net migration is going to fall on its own volition—I mentioned a few of the ways in which that might happen—for the Committee's sake can you elaborate a little, without the numbers, on why you think it is going to fall anyway?



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Jonathan Portes: Yes. First of all, some of the upsurge in net migration, particularly from the European Union in the last few years, has been driven both by the general weakness of the European economy and labour markets in particular countries. The eurozone is not exactly booming, but it is doing somewhat better. There was also a very sharp rise in net migrations from Bulgaria and Romania when we ended transitional controls on those two countries, on 1 January 2014. At some point, you would think that that is going to slacken off. Then there is an exchange rate effect. To the extent that people, particularly from other European countries, may at least think they are coming for relatively short periods, they will translate what they are likely to get here into their home country salaries and see that wages here have now fallen significantly in euro terms.

Finally, and this is something we are trying to quantify, but it is very difficult to quantify except in a stylised sense, there is simply the psychological broader impact of the Brexit vote. Even before there are any changes of law and policy, people may feel less welcome here. Even though they are still perfectly free to come and work here, they may feel that their long-term prospects, their long-term security should their spouses, children and so on be here, are going to be less promising. Certainly there is a reasonable amount of anecdotal evidence in some sectors, for example the university sector, that that is already beginning to have some impact.

Q226 **Rachel Reeves:** Just briefly on the economic impacts of lower levels of net migration, the OBR makes a judgment that the skill mix and the demographic mix of future migrants will likely mirror the existing stock of migrants already here. Do you think that that is a reasonable assumption or would you expect that to change in the wake of Brexit, Mr Portes?

Jonathan Portes: It is very difficult to say how the skill mix would change. We do know that, at the moment, EU migrants on the whole have higher skills or are better qualified than UK natives, but tend to work in relatively low-paid jobs. What the impact on the skill mix will be, without knowing what the new immigration system will look like, is difficult to say. What I would say, though, on the idea that we are going to have this new system that will allow in only the workers we want, the very highly skilled ones, and exclude low-skilled workers entirely, is first of all that immigration systems do not work that way. You cannot centrally plan labour markets that way. Second of all, any new system that imposes restrictions will lead to a reduction in highly skilled and skilled migration as well as low-skilled migration.

Q227 **Rachel Reeves:** If we did have a system that the Government could engineer in a way that our migrants were of a higher skill mix than they are currently, finally from the three of you, do you think it would have a positive effect on productivity or does it not matter?

Jonathan Portes: It might.



Professor Weale: It has to depend on what the migrants actually come to do. If at the same time there are more jobs suitable for them, rather than more graduates coming to work for a few months in London to improve their English, then it could have a positive impact on average output per person. As Jonathan suggested, actually delivering that would seem to be rather difficult to say the least.

Rachel Reeves: Does anyone want to add anything or shall we move on?

Chair: Move on. Stephen Hammond.

Q228 **Stephen Hammond:** Thank you. Good morning, gentlemen. You are obviously all aware of the significance of the financial services sector to the UK economy. I just wonder if you could give us your views. You will be aware that a number of those participating in the various sectors of the financial services world are looking for transitional arrangements. I wonder if you could say how long you think the UK will take to make final arrangements, whether or not the transitional arrangements will be of benefit, and what impact it would have on your forecasts if a transitional arrangement were in place and/or if we just went straight back to WTO after two years?

Professor Weale: Could I say on that that one of the purposes of transitional arrangements would be to give more time to negotiate suitable financial arrangements? A part of the exchange-rate adjustment that we have seen since the Brexit vote has come about because people have worried that it will become much harder to export the output in which Britain seems to have some sort of comparative advantage. Export conditions have worsened. To the extent that that can be avoided in the short term, it would be a good thing. If, as I say, it gives us and our continental partners more time to work out long-term arrangements that are favourable to both parties, then it could be expected to have a permanent long-run gain as well.

Dr Lilico: One should distinguish between different kinds of transitional arrangements and what one means. One aspect of this is the following. Suppose that the UK were to move to being regarded as having regulatory equivalence to the European Union in a number of areas. As things stand, in order to take advantage of regulatory equivalence, you have to have a 180-day application process. If you did not have any kinds of transitional arrangements whatever, you could not apply until you were a third country and then you would have a 180-day or so window. It may not be precisely 180 days, but it would be a window of around six months where you did not have the same rights that you would have subsequently. One type of transitional question is that which deals with the very immediate period of literally the transitional process.

A second kind of transitional issue is that the EU and the UK might struggle to agree a new services trade agreement, as easily as they would agree a goods agreement. It might be that a goods agreement



could be, in some way, wrapped up with the Brexit deal, pushed through via qualified majority voting and the European Parliament and would not have to have individual chamber ratification. It seems much less likely, as I understand it, that you could avoid individual chamber ratification in respect of a services deal, so it might be that a services deal would have to be done subsequently to our actually leaving. Then you might have the question of what certain key sectors do in between. If you thought that we will have a services deal—it is just going to come three or four years down the line—what should we do in between it? It might be that you would agree at least some transitional arrangements pending some final agreement. That is a second kind of arrangement.

I would expect that the very strong incentive is for the European Union and the UK to come to some kind of arrangement, either very a rapid deal, certainly the sort of narrow transition arrangements, as I said, and possibly a transitional deal of a more general nature, pending a longer-term deal. The UK is a very important provider of financial services across the European Union, about 24% of value added. Many parts of the European Union's corporate and finance sectors are quite heavily dependent upon their access to the City and this is a time of great vulnerability for them. I would have thought there would be relatively little appetite on their side to cut themselves off from access to the City. This is the thing I have said for some time. I now understand that the Bank of England's position is much the same, if I interpret Mark Carney's remarks the other day on that. That just seems to me to be common sense.

Q229 Stephen Hammond: Of those two arrangements that you describe, which do you consider the more likely to be put in place?

Dr Lilico: I would guess that we will probably manage some kind of transitional arrangement. I think it is touch and go. It is very difficult, because of some of the language of punishing the UK and some of the strange allusions that you would make UK City activities migrate to Frankfurt or Paris, which I do not think are very plausible. If you chase them away, they would be more likely to go to New York or Shanghai than to go to Frankfurt or Paris. The relationship could break down. It is by no means certain, and that could be quite damaging to the European Union if it were to break down, but common sense will probably prevail in the end.

Q230 Stephen Hammond: In his Autumn Statement, the Chancellor used the words, "A central plank of the Government's policy is to improve productivity", and he then made the point that UK productivity lags. I think it is 30% behind the US and Germany, 20% behind France and 8% behind Italy, in terms of labour productivity. Could I ask you if that is a sensible economic ambition for UK economic policy and, secondly, how much confidence would you have in those international comparators?

Professor Weale: On the first point, if it is a sensible ambition, it is certainly a worthy ambition. If I think back 40 years, I remember a



lecturer who said that Governments had been trying to improve Britain's productivity performance for 100 years then and it had not really worked. It is an ambition, but not one that—

Chair: We do not seem to be too badly off.

Professor Weale: We are not too badly off, but you have to remember that working hours here are quite a lot longer than they are in continental countries and we make up for it with labour relative to productivity. Do I believe the numbers? In broad terms I do. Certainly, when detailed studies have been done of the performance of individual factories, they come to broadly similar answers. People particularly in western Germany, the Netherlands and France are much more productive.

Jonathan Portes: I agree with Martin. Chancellors have always said that they want to improve productivity and it has always been an entirely sensible thing for them to say. The difficulty, of course, is doing it. I would say Andrew is right: of course we are a rich country, but the urgency of doing something about this has rather increased since 2008. Until 2008, we were reasonably certain that, actually, we just trundled on at 2% productivity growth, come what may, on average over the cycle. Since then, things have been considerably worse and we do not really understand why or for how long this worsening is going to last. The urgency of doing something about it seems to have increased.

You have to work it out; simply talking about it is not enough. We know at least some of what the long-term problems are: housing, planning, the skills among that proportion of our population that are not highly educated. Those are very longstanding structural problems with the UK economy that we have failed to deal with. On the upside, we have done quite well, as Martin said, on things like competition policy, so the challenge is to continue doing well the things we do well and to improve the things that we have not done very well.

Dr Lilico: I see quite a bit of the productivity debate as just another way of saying that we have had very good labour market performance. For a given period of GDP, in the period since 2008, we have had spectacular performance in terms of keeping unemployment down and then getting unemployment down from a relatively low peak, much better than many other countries. If you have much higher unemployment, then you have much higher productivity. That is also a factor in some of the longer-term figures. It is a bit of a generalisation, but certainly relative to a number of European comparators we have tended to have a little bit lower unemployment over time. Sure, you can keep all of your relatively low-productivity people out of jobs and have them unemployed. That is a way you could get your productivity up, but I do not think that is a particularly attractive path to take myself.

Q231 **Stephen Hammond:** I take it from your answers that all of you are of the view that the international comparator numbers are broadly right and that there is no real issue in trying to measure UK services against



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German manufacturing. Going back to Dr Portes's answer, in terms of what he was outlining as some of the solutions, do you therefore think that the mix the Chancellor set out in the National Productivity Fund statement about where he was going to try to bias infrastructure spending over the next five years will actually have any impact on labour productivity?

Jonathan Portes: What we saw were some moves in the right direction. I get the impression at least that the current Administration is more serious than the previous one about increasing housing supply, rather than basically a set of gimmicks, which were designed to operate mostly on the demand side. That is quite encouraging. The infrastructure plans, so far as they go, are sensible, but the challenge there is actually implementing: spending the money and doing it sensibly and wisely. Will we notice it in the productivity figures over the next five years? That is a tough ask, frankly. These are long-term issues and getting policies right on these things is an investment for the long term, not the short term.

Q232 **Stephen Hammond:** Dr Lilico clearly thinks no, because he was shaking his head very vigorously at that, but do you, Professor Weale?

Professor Weale: Could I add that, actually, international differences in productivity performance are very poorly understood? The OECD has done a sequence of studies that apparently lead to easy prescriptions and so on, but they explain only about 20% of the variance in productivity between different countries, so there is always going to be a very large unexplained component. What the Chancellor is doing seems to me to be in the right direction, but I would not expect it to work miracles. If I could just make one other point about the international comparisons, of course the unemployment rate in Germany is very similar to ours. If all the unemployed people in France were working but producing nothing, France would still have higher productivity than Britain. The gap is of that sort of magnitude and the Chancellor is going in the right direction, but do not expect wonders.

Q233 **Chair:** The French take long holidays, longer even than ours. The Japanese seem to allow people off for about one holiday a lifetime, as far as I can tell. The Americans are somewhere in between at a fortnight. Are a very high proportion of these comparisons among the most advanced economies not really about culture, Professor Weale?

Professor Weale: No, I do not really think they are really about culture. When people try to measure productivity per hour actually worked, then you do get very large differences. People attribute that partly to the capital stock Britain has had. This features in the OBR report; Britain has had very low investment for a long time and you would expect that to lead to lower labour productivity. It certainly does. On the issue of skills that Jonathan mentioned, historically we have been a poor performer, but if we sort all those out and become more like our neighbours in those respects you may still find that there is a large difference.



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Q234 **Chair:** I will not prolong my disagreement with you, because I am really meant to be collecting your evidence, not giving mine. Jonathan Portes, you talked about gimmicks a little while ago: policies that are not achieving much but are pulled out of a hat. Could you give us a list of those or at list send us a list?

Jonathan Portes: I was referring to things like some of the help-to-buy things, which are basically operating on the demand side of the housing market.

Chair: It would be handy to have a list if you could, in due course, or of policies that you think are pulling in contradictory directions.

Q235 **Kit Malthouse:** Good morning. I just want to take you back to Rachel Reeves's question, Jonathan Portes, just in clarification. You are not advocating, when we leave, ramping tariffs to protect the steel industry.

Jonathan Portes: I do not think I was advocating anything specific about tariffs, either on steel or indeed on anything else. I was just trying to explain what I thought the economic implications of moving to unilateral free trade on steel and other things were.

Q236 **Kit Malthouse:** The general equation that the lower the tariffs, on both sides, the better is one that you would support.

Jonathan Portes: Broadly, yes. Martin quite rightly made the point about optimal tariffs. There are, particularly in steel for example, issues around dumping. There is a purely economic case when there is genuinely dumping going on, which is very difficult to prove and quite rare, for having tariffs. In general, yes, lower tariffs promote economic efficiency. To the extent that they cause distributional or other issues in the country, those are usually best dealt with by domestic policies, not by having higher tariffs.

Q237 **Kit Malthouse:** You talked interestingly about the impact of technology being much greater than any other influence, in terms of that. I guess what you are saying is that, even if we tried very hard, technology would have taken our cotton industry away from us at the end of the century before last. Even if we had ramped tariffs and tried to protect ourselves in some way from the world, that was still going to go its way largely because of technology and that technology being available overseas.

Jonathan Portes: That is broadly right. Even to the extent that you might preserve some of the industry, you still would not preserve the jobs, because of the pressures on demand. Even if we simply banned imports of certain goods, the domestic competitive pressures would mean that businesses would still have an incentive to invest in economically efficient labour-saving machinery. In terms of our GDP, a lot of it still comes from manufacturing, but our productivity is a lot higher than it used to be and hence the number of people employed in manufacturing is a lot lower than it used to be.



Q238 **Kit Malthouse:** Essentially what you are saying is that the secret to success in global manufacturing is to invest, innovate and adopt new technology or invent new technology faster than everybody else.

Jonathan Portes: Yes. That is uncontroversial.

Q239 **Kit Malthouse:** Can I also ask about the interaction between tariffs and the exchange rate? Perhaps it was you, Professor Weale, who said that the drop in sterling had effectively been the market pricing in difficulties of future trade or that might be experienced in future trade. If you have a floating exchange rate, is there an element of compensation for tariffs in the market balancing relative value? That must include compensating for the tariff cost as well. For instance, the drop in sterling thus far has, as far as I can see, more than compensated for if we were trading on WTO tariffs with the EU.

Professor Weale: A lot of the issue with tariffs, or at least in negotiating tariff arrangements, is a strategic issue that, by imposing tariffs, countries can move market terms in their favour. That is an ability that remains whatever the exchange rate is doing.

Q240 **Kit Malthouse:** What I am saying is, if the exchange rate then moves, part of the movement of the exchange rate might be to compensate for those artificial differences in relative value.

Professor Weale: It may be in one sense to compensate but, at the same time, it is probably imposing a cost on the economy. The terms of trade are worsening and, as a consequence, real national income is likely to be depressed.

Q241 **Kit Malthouse:** Say, for instance, the pound stayed broadly where it is and we reached an arrangement with the EU that was on WTO terms, possibly better on cars and agriculture. We would still be making more money and our balance of trade with Europe would still be better.

Professor Weale: One would have to think about where things moved in the long run. It is not clear to me that we would be, because there are all sorts of other things that would go with WTO trade arrangements. We know that countries make gains in competitiveness from moves in their exchange rate. Britain's experience is that they have tended not to last.

Dr Lilico: We might be making more pounds, but we would be making fewer dollars, so we would be poorer and our assets would be lower in international terms. Of course, you might have some internal asset price adjustment as well, and you have the issue of inflation, as you pointed out. I have not done any such analysis myself, but my understanding is that most of the analyses suggest that, by October, lows for sterling in the effective exchange rate index were below any plausible negative scenario for the outcome of Brexit. They were even lower than worst-case scenarios.



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Of course, it is up about 6% since the OBR's assumption. That is one of the really big changes since the OBR's assumption, and that was quite a material assumption for boosting net trade and GDP in 2017 and 2018, in the OBR's figures. That is something that you should perhaps reflect upon, as one of the ways in which things have not turned out thus far as the OBR expected. If it is a mug's game predicting migration, it is really a mug's game predicting exchange rates.

Kit Malthouse: When Robert Chote from the OBR was here, he said he was 50% likely to be right and 50% likely to be wrong, which probably means he was 100% wrong. What did he say?

Dr Lilico: He said 50% above or 50% below.

Q242 **Kit Malthouse:** He was therefore 100% wrong. You raised the point about inflation. The Governor of the Bank of England has said some stuff overnight or yesterday that was quite striking about the impact of inflation on real wages. He seems to be putting the causes of inflation as being forecast by the OBR and indeed the Bank purely down to the changes in the exchange rate. Do you think that is right or are there other underlying causes to inflation coming into the system?

Dr Lilico: The ones that they are forecasting may be connected to the exchange rate. You could expect other factors going on in the system. Clearly there is some relationship with GDP. Monetary growth has been quite strong over the past year, more than 7.5%. In fact, the M4ex figures are back to what were fairly normal figures between the late 1990s and the mid-2000s. I think there is an argument to be made that, in the monetary sense, the 2008 crisis came to an end in Q3 2016.

Professor Weale: How much inflation? Of course, what we are talking about is inflation rising materially above the 2% target and I think it is reasonable to see that in the short term as mainly a consequence of the downward adjustment in the exchange rate. The unknown question is how far that starts to be reflected in wage negotiations and so on. Of course that was something that people worried about that did not happen a few years ago, in 2010-11. This time of course the labour market is much tighter.

Q243 **Kit Malthouse:** I am a bit of a dog with a bone with this stuff, but you do not think inflation has any more connection with the money supply or changes the money supply. The Bank of England Governor sat here and denied completely that it has any connection at all.

Professor Weale: The way I see it is that the money stock is a consequence of the Bank of England's interest rate and quantitative easing policy, not something that is separately determined. I am not commenting on current Bank of England policy but, with a different policy, you would probably have had a different movement in the exchange rate and different inflation, as a consequence. In that sense, where we are is a consequence or at least in part a consequence of policy



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decisions, as you get into the medium term and away from the near term, but I have never found it helpful to focus specifically on the money stock.

Q244 Kit Malthouse: In terms of what you are saying there, what the Bank of England Governor said yesterday about this lost decade is partially a product of Bank of England policy.

Professor Weale: I am sorry; I have not read the details of the Governor's comment. The lost decade that we have experienced has been a decade of extremely weak productivity growth. That is the reason why living standards are effectively no higher than they were 10 years ago. The Bank of England may influence many things, but I do not think it influences productivity.

Kit Malthouse: Dr Lilico, you shook your head about the money supply.

Dr Lilico: There is at least a case to be made that policymakers have, in general, chosen a trade-off. Rather than seeing an adjustment in the economy, perhaps extra people becoming unemployed, extra companies going out of business, people selling their houses and adjustments in the prices of key assets, for example, they have made a choice to slow the transition of the economy to some sort of new equilibrium. You should not think that that comes entirely without consequence in terms of the medium-term performance of the economy. Substantiating exactly how that turns out is not straightforward, but the natural presumption should be that keeping interest rates at emergency levels and doing lots of QE for a very long time may have all kinds of beneficial impacts, but it does not come completely for free in terms of the medium-to-long-term performance of the economy. The economy is going to work better if it is allowed to adjust. Society may not.

Jonathan Portes: I have a minor disagreement with Professor Weale. I do not think that productivity is determined entirely exogenously to what happens on the demand side. That is to say, had we had more expansionary policies and particularly more expansionary fiscal policy at some point in the 2010-15 period, we might have seen a better productivity performance. We do not know; this is an unanswered question, but I certainly think that, in retrospect, given the balance of risk and that we now know there was no significant risk of inflation getting out of control over that period, we would have been better of at least trying more expansionary policy and seeing whether it would have led to a more positive productivity performance.

Q245 Kit Malthouse: On that note, finally from me then, on this additional spending of £23 billion that comes under the heading of fiscal stimulus, in your view is the Chancellor poking an elephant with a pin? I think you said in the previous answer to Mr Hammond that you were not sure what effect that was going to have over the next five years.



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Jonathan Portes: In macroeconomic terms, it does not amount to a huge fiscal stimulus; it is a pretty minor one. I would also say that the case for a large fiscal stimulus of macroeconomic significance is actually considerably less strong than it was at times during the 2010-15 period, when, as the Committee will recollect, I thought fiscal policy was clearly inappropriate. In current circumstances, given that we are now back to something that looks much more like the natural rate of unemployment, and given the potential uncertainties caused by Brexit, there is a case for the Chancellor keeping at least some of his powder dry. I think the case for a large fiscal stimulus now is not particularly strong.

Q246 **Kit Malthouse:** This is the last from me. The OBR is forecasting that business investment will fall by £27 billion over the same period. Would that indicate to you that the Chancellor needs to look carefully, as he moves towards the Budget, at how he can stimulate?

Jonathan Portes: Again, it is less from a macro perspective, as opposed to the investment point and the long-term impact that has on the country's capacity to grow. There I would say that the Government in general should be spending probably as much on infrastructure and public investment as they can sensibly spend. There are constraints. The constraints on that do not come from the public finances or the ability of the Government to finance that investment; the constraints come on the ability to sensibly spend money on actual productivity enhancements.

Chair: They are on the supply side.

Jonathan Portes: Yes.

Q247 **George Kerevan:** Could I ask each of the three of you to comment in turn on the change in fiscal rules that the new Chancellor has brought in?

Dr Lilico: I have always claimed that it was a mistake to believe that you could replace the will to act with a stated rule or intention. It is pretty clear that that is the way things have worked out over recent years. It was all very well saying you are going to do this, meet this target and that target, and over the horizon it is going to be this and that. If you not actually want to do it, and by and large George Osborne did not want to do it, then it does not get done. An approach of saying, "Well, we will get things back into surplus when it is feasible and we will not look too far ahead; we will not pretend that we are going to be planning exactly in detail too far into the future", seems more sensible to me, particularly given the significant uncertainties about how things are going to play out over the next few years with the Brexit discussions.

Q248 **George Kerevan:** Is that an argument for no rule at all?

Dr Lilico: It can make sense to provide some indication of your thinking, but ideas like legislating for always having a surplus or any of that kind of stuff, all of those kinds of ideas, are just a mistake. You should say, "This is what I am going to do", and then you do it. Other things almost



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get in the way of that. If you are providing some other mechanism that you are pretending is an excuse that makes it easier to do when you do not really want to do it, you are less likely to face the scrutiny and the challenge of whether you really want to do it.

Q249 George Kerevan: If pressed, are the three new rules cosmetic or otherwise?

Dr Lilico: I would say that probably all rules are cosmetic, but I think they are reasonably sensible for this point in time.

Jonathan Portes: I take that question on several levels. First of all, one of the points of a fiscal rule is to constrain what the Government do and improve the Government's credibility, both with financial markets and economic agents in the wider economy. The fact that the previous Chancellor instituted a fiscal rule that neither made economic sense nor, even ex ante, even before Brexit, was credible in some sense vitiated the point. The current Chancellor was faced with the unenviable choice of ditching the rule and essentially meaning that there was no credibility gained at all or sticking with the rule. I think he made the right choice by ditching the rule, but we have still lost something by this chopping and changing over the last couple of years. The new rules are a significant step in the right direction. They are rather vague and I guess that is excusable given the current economic uncertainty.

Q250 Chair: Is that not why they are a step in the right direction?

Jonathan Portes: Partly, but I would prefer, at least at some point in the reasonably near future, a return to rules that are somewhat more specific. Simon Wren-Lewis, who is sitting back there, and I have written a paper on this, so you know what our view is on what a sensible rule would look like.

Professor Weale: Can I make a comparison between the monetary rule and the succession of fiscal rules? The point about the monetary rule, monetary arrangements and the 2% target is that there are arrangements in place for dealing with divergences and strict procedures.

George Kerevan: We have not met the monetary rule for years.

Professor Weale: No, but inflation was high and inflation has been low. The point is that the Monetary Policy Committee always has to explain what it is doing to return inflation to its target. The fiscal rules, by contrast, are rules that have become extremely difficult to meet, as with George Osborne's most recent rule, which means that the rule has to be abandoned. As you said, a more flexible arrangement that represents the very sensible aspiration of the Government to manage the national debt and put limits on Government borrowing, but to do so in a way that is flexible and allows it, more easily than has been the case so far, to address the unexpected and the shocks that always happen would seem to me what one should be working towards.



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Q251 George Kerevan: Picking you up on that and working backwards, one of the new rules is to peak net debt at 90% and then try to massage it down. Why 90%? Given the markets did not bat an eyelid when the Chancellor, in the Autumn Statement, borrowed in excess of £100 billion just like that, why is 90% of GDP a benchmark?

Professor Weale: From a purely economic point of view, I do not think there is anything magical about 90%, despite some of the empirical evidence that some people have claimed to find. The Chancellor and the Government are in a difficult position. On the one hand, if you let debt levels rise in a crisis, in a recession, and then you never do anything about bringing them down, you can see that they will just go on creeping up and up. On the other hand, if you try to bring them down very rapidly after a recession, then you may damage the recovery, so I think this is an attempt to compromise between those two positions. As a pragmatic compromise, it has my support.

Jonathan Portes: To defend the Chancellor on this, I do not think that the key point in that rule is 90%. The key point is that it should, at some point reasonably soon, be coming down. If there was a classification change that increased or reduced the debt by 10% of GDP tomorrow, which is perfectly possible—the ONS does this sort of thing quite frequently—the rule would be 100% or any per cent. The point is that there is a time after which it should be coming down and that is not an unreasonable aspiration.

Dr Lilico: 90% is the peak.

Q252 George Kerevan: I can guarantee that, all other things being equal, in 2021 net debt will go below 90%, simply because the Bank of England will get its term funding repaid and that will come off the books, so it will automatically come down. Okay, we accept your views on that. Given that there is also expertise in monetary policy here with us, can I ask the three of you, against the background of the Autumn Statement, whether the mix of fiscal and monetary policy that we now have is the correct one?

Dr Lilico: I think that interest rates are probably a bit low and that, for example, the August cut does not look very good, in the light of subsequent data. It seems like a somewhat panicky measure, which some of us said it was at the time. I also think that the Bank of England has adopted a general monetary posture, which I would characterise as being that it is only going to put rates up when it has to, whereas I would think that the natural presumption should be that you try to move back towards some sort of approximate indication of the natural rate when you have the opportunity to. It should not be a matter of being forced to raise rates; it should be a matter of being forced to keep them far away from any plausible estimate of the natural rate, as things stand. That is the main thing that I would focus on.



On the fiscal side, it seems broadly sensible to me. There are a few things we will have to come back to later. They now have spending relative to GDP only just going below 38%. Over the medium term, we will probably need to get that closer to 36% than to 38%, partly because you are going to struggle to generate more than about 36% of GDP in taxes. If you ever want to get to a surplus, you had better be able to get your spending down to 36%, at least in better times, because it is going to go up when you have a recession.

Jonathan Portes: I tend to agree with Andrew. I take quite the opposite view on spending. I would rather see higher levels of both spending and taxes, but this is not primarily for macroeconomic reasons. I think it would be sensible, given the way the UK system works, to spend more money on the NHS and more money on reversing some of the damaging cuts to tax credits and other benefits. I would finance that by higher taxes, rather than by borrowing, certainly over the medium term. Rather unusually, as I said before, I do not see a huge amount to quarrel with in the current macro-fiscal-monetary mix and, given the levels of uncertainty, there is simply a good case for saying that now is not the time for taking precipitate policy action. If some of the more extreme scenarios materialise, we may need to take more extreme policy action down the line.

Professor Weale: Could I say first of all on the monetary fiscal mix that I have never really understood the argument that government borrowing, as a means of financing expenditure, would be a bad thing while, at the same time, monetary arrangements that encourage the private sector to borrow to finance expenditure was a good thing? What seemed to me to matter was the overall spending going on in the nation, and indeed the overall level of saving, and then, subsidiary to that, you certainly have to question what the private sector is doing and what the public sector is doing, but those are subsidiary. Within that broad framework, all I could say is that my assumption is that, even since I left it, the Monetary Policy Committee goes on setting monetary policy, taking fiscal policy as it actually is. If fiscal policy were to change materially, and I could imagine perhaps rather more than the announcement in the Autumn Statement, then presumably that would have implications for monetary policy.

Chair: Thank you very much indeed for giving evidence to us this morning. It was extremely interesting. We have asked for some follow-up material and, if there are points that you have not made today or that you want to supplement with written evidence, we would be very grateful to receive them. Thank you very much indeed.

Examination of Witnesses

Witnesses: Professor Simon Wren-Lewis and Professor Philip Booth.



Q253 **Chair:** Perhaps I could begin with you, Professor Wren-Lewis. There was a reference to the paper you have written on fiscal rules. You wrote immediately after the Autumn Statement, "The new Charter for Budget Responsibility is not worth the paper it is written on." We had a slightly more charitable view a moment ago from your co-author; in fact, it was quite a lot more charitable. "A significant step in the right direction" I think was his phrase. Where do you stand now you have had a bit more time to think about it?

Professor Wren-Lewis: I was in a sense slightly surprised, but he is also right.

Chair: You were surprised by your co-author's generosity.

Professor Wren-Lewis: Yes, but he is right in the sense that, if you have a really bad rule, then effectively having no rule is better. We have essentially moved from a really bad rule to having no rule, in effect, or no really sensible rule. That is probably better than having a really bad rule, but we do not really have a rule that makes sense as a fiscal rule, in terms that I would understand. I can certainly amplify on that, if you like.

Chair: Yes, please.

Professor Wren-Lewis: There are a number of things about the current rule that puzzle me. The first is that the target is for a fixed date and that is generally a bad idea, because it means that, if you get hit by a shock the year before the date in question, then you are frantically scrabbling to hit your target by taking quite extreme measures in terms of changing fiscal measures. Taking extreme measures in changing fiscal policy is generally a bad idea, so it is much more sensible to have a rolling target of just five years ahead all the time, moving five years out, than having a fixed target. That is the first sense in which I thought the current arrangements do not make much sense.

The second is having the target for the whole deficit, rather than just the current balance. It seems to me that there are lots of good reasons why you might want to separate out public investment and have a separate public-investment-to-GDP target, for example, and then have some kind of current balance target.

Q254 **Chair:** Is training a teacher public investment?

Professor Wren-Lewis: No, so there is an issue of definition there. In a sense, going in the right direction would be at least to recognise that there is an important difference between investment and consumption, then getting your definitions right about what is investment and what consumption.

Chair: It is very tricky, that.



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Professor Wren-Lewis: It is tricky, but you want to move in the right direction in the first place, rather than just say, "Oh, it's all very difficult. I can't do it." I could go on at length, but having a target for the change in the debt/income ratio and also having a target for the deficit, both on a fixed date, was a bit puzzling for me, because the debt/income ratio and the change in it is the deficit plus whatever is happening to GDP. You cannot control GDP, so why do you need two targets for essentially just the one thing you can control? Those are at least some of the reasons why I did not really think it was a very adequate fiscal rule.

Q255 **Chair:** Bearing in mind that we have had a good dozen, all of which have fallen by the wayside or collapsed, more or less at the first sight of gunfire frankly, do you not think that the credibility of these things has now been drained? Do you think there is anything to the view that increased volatility, for example on revenues, and the fact that we are certainly a more open economy now than we were 20-25 years ago, expose us to more risks of exogenous shocks? Both point to the need to be very cautious about tying ourselves down to these rules.

Professor Wren-Lewis: In a sense that would be reflected in the design of the rule. If you have a five-year moving target, then this short-term volatility does not really impact too much on what you end up doing, because you always have five years in which to do it. It seems to me that you recognise those things by having a sensible target. What you want is some constraint on policymakers, either from allowing debt to increase without end or from allowing them to try to reduce debt far too quickly. A sensible rule would allow them to do that.

Q256 **Chair:** There is unanimity around the table that it is helpful to have a sense of direction of where the Government are trying to go. It is a matter of intense political debate about the speed in which one moves in that direction. That was not always the case 30 years ago, when there was a quarrel going on in British politics, and indeed the wider western advanced democracies, about the direction and whether it was a good idea to try to reduce borrowing anyway. Taking all these points into account, Professor Booth, where do you stand on these fiscal rules?

Professor Booth: I am marginally in favour of fiscal rules but, for reasons I will come to in a moment, it is only marginally. I also did not like the proposed Osborne fiscal rules, for somewhat different reasons, and we had a bit of a blog splat about it, but that was because we disagreed with each other's reasons, rather than had different conclusions. What has been proposed, I noticed in one sentence, had four different ways of describing it—an objective, a charter, a mandate and a target. In the two sentences either side, it is a commitment and a framework. That is six different ways of describing it in three sentences. If this were a submission as an Institute of Economic Affairs paper, I would send it back to the author and say, "Which of these is it?" Of all those six ways of describing it, "a rule" does not appear as any of them. I would certainly rather have a weak framework than a rule that was either not credible or not adhered to. The worst thing that you can do is



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to build up a situation where you are getting the benefits of credibility by having a strong rule, then break the rule. The same is true with regard to monetary policy.

Chair: We have plenty of evidence to support that, have we not? We have had about a dozen cases so far.

Professor Booth: Absolutely, so if you are going to have a rule, it needs to be done in a similar way to the medium-term financial strategy of the early 1980s. You need to have an intellectual journey with a very clear intellectual conclusion, a well articulated framework and also a set of mechanisms for embarrassing whoever is responsible for breaking the rule. In other words, somehow the Chancellor must, quite publicly, report back, rather like the Governor of the Bank of England has to write a letter to the Chancellor of the Exchequer if the inflation target is broken.

Chair: Maybe eight hours a day before this Committee for a few days might do the trick. Would it be that sort of thing?

Professor Booth: It would be that sort of thing, yes. If I can just why I waver on the issue of fiscal rules, one is because of this issue of defining and clarifying investment. Perhaps a fiscal rule that takes investment out of it also encourages rather wasteful investment. The second is the definition of debt in general. When so much of the debt that the Government face is implicit pay-as-you-go social security liabilities, fiscal rules do give Chancellors of the Exchequer, and George Osborne was very susceptible to this I am afraid, incentives to pull forward tax receipts, which pension freedom did, or reclassify things, the Royal Mail pension fund being a good example of that, so that you take debt off the balance sheet. The Hungarian Government have done a very similar sort of thing.

Professor Wren-Lewis: This is why a fiscal rule has to be combined with effective fiscal counsel, like the OBR, but the OBR with a little bit more flexibility, so that it can pounce on instances like that where you are deviating from the spirit of the rule, even if you are holding to it technically.

Q257 **Chair:** Would you agree with the general characterisation that the fiscal rules were being used for political purposes, for salesmanship to a much wider electorate, golden rules by iron Chancellors, and although they were no more robust than any other of these rules, we now seem to be moving back towards the kind of debate we had in the 1980s: the description of rules, for example in the MTFS, designed for quite specialist markets, people who take decisions in markets and, to some degree, the business community, but much less for wider public consumption. Would that be a correct characterisation and is that how would you see the consumption of your rule?



Professor Wren-Lewis: No, I think we have just gone backwards. I think it is quite simple. In hindsight, there were problems with Gordon Brown's rules, but he broadly kept to them for 10 years until you had an extreme event, the financial crisis, which blew them up. The form of the first rule that George Osborne put in place was a moving target; it was five years ahead. That was fairly good. It was unfortunate that it had one flaw, which was that it ignored the fact that, when interest rates hit their lower bound, you should not really be following that kind of fiscal rule at all. Otherwise, it was quite a nice form of rule. All his changes since then have been going backwards, in terms of what a sensible rule looks like. It is quite simple really: we started off quite well and we have been going steadily backwards since

Chair: That was not quite the question I was asking.

Professor Wren-Lewis: I know, but I think it is the right answer.

Professor Booth: I think both Osborne and Brown meant what they said. I might have quibbles or disagree with the particular rules, but Gordon Brown in particular, both when it came to monetary policy and fiscal policy, again even though I might have disagreed with his conclusions, was well advised.

Q258 **Chair:** To whom were they addressing it?

Professor Booth: In the case of Gordon Brown, it really was to the markets and the wider public, on the monetary policy side as well, in order to give himself greater credibility, which it was felt that the Labour party has lost in the 1970s. In the case of George Osborne, it was to the markets in order to try to lower the cost of borrowing post the financial crisis.

Q259 **Mr Steve Baker:** A very good morning to you. Given the size of the economy, do you think spending an extra £23 billion will have any measurable fiscal stimulus, Professor Booth?

Professor Booth: I do not really approve in general of the use of fiscal policy to try to stimulate the economy and on that we disagree. I am not sure either that Philip Hammond is thinking about the increased spending in that context. He is thinking about the increased spending in the context of trying to raise productivity and long-term economic growth. In that respect, I also think he is mistaken. I would have rather had a reduction in current spending and an increase in investment spending, if you were going to get the increase in investment spending at all. I do not think anybody has really thought about two issues when it comes to this investment spending, spending on R&D and so on.

The first is that, at the margin, given the share of Government spending in national income, given the very damaging taxes that we have in our tax system, would it have been better to reduce some of those damaging taxes, rather than spend more money on innovation, investment, etc.? Secondly, whilst spending on innovation and investment might, in theory,



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increase productivity, in practice, very often in the hands of Government, it does not. Some of the particular decisions that have been taken by this Government illustrate that concept very well.

Q260 Mr Steve Baker: What would be your top three most damaging taxes, which you would do something about?

Professor Booth: The top one would be stamp duty, I think. The second would probably be the 60% rate, which is effective on earnings in the band of £20,000 above £100,000 or roughly that. The third would probably be the 45 pence tax rate. Given a bit longer, I am sure I could think of others.

Q261 Mr Steve Baker: I do not think I would be breaching any confidences if I said to you that, if we were to do those three things, we would be accused of favouring the rich over the poor. How would you react to those allegations?

Professor Booth: In relation to the first one, stamp duty, that is demonstrably not true. If you reformed property taxes, so that they bore less heavily on transactions and bore more heavily on the consumption value of property, land values or something like that, it would not only be much more economically efficient—I would also reform council tax at the same time, along the same lines—but it would be redistributive in the direction that those on the left of the political spectrum might prefer.

Mr Steve Baker: What about the other two taxes you mention?

Professor Booth: There is no question that, if you eliminated that 60% band, which in effect is what it is, and the 45% rate, that would be redistributive towards the top end of the income scale. I think the 60% band is sufficiently damaging in and of itself, as well as creating complexity. I would not be averse to that being removed and some other measure taken to raise taxes on that income group that was less stupid than that particular measure.

Q262 Mr Steve Baker: I am conscious that I need to bring in Professor Wren-Lewis but, just before we leave this subject of income tax, are you concerned that the balance of income tax has shifted too far up the income scale and that, actually, the tax system is less resilient, as a result of the extent to which income tax is paid by the top earners?

Professor Booth: In a word, yes, but one should not forget the proportion of income that is paid in tax by lower earners. The bottom quintile pay 11% of their income in tobacco, alcohol and fuel tax alone, which are taxes that do not cause much economic damage, because those products tend to be quite price-inelastic. Nevertheless, they are very expensive if you are at that end of the income scale.

Q263 Mr Steve Baker: Thank you very much. Professor Wren-Lewis, before we return to the original question, the extent to which we would have four or five years to spend that £23 billion, the extent of the fiscal



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stimulus, you were just agreeing with Professor Booth on one point there, I think on the stamp duty. Would you like to elaborate?

Professor Wren-Lewis: The idea of moving property taxes away from taxes on sale, transactions basically, more to consumption is basically a good idea, so I think I agree with that. What that means is putting up property taxes on consumption a lot if you are going to cut transaction taxes on property. That has defeated the political process until now, but you never know.

Mr Steve Baker: On the point, then, to what extent will £23 billion over several years have a fiscal stimulus effect?

Professor Wren-Lewis: You already heard the answer from the earlier session: it is hardly at all or not very much. It is not a big fiscal stimulus. In a sense, I felt that that was a disappointing aspect of the Autumn Statement. I thought the situation was such that a larger fiscal stimulus was appropriate. Here this is what surprised me about what Jonathan Portes said. He is obviously right that this is nothing like 2010. We are in a different situation; the magnitude is much smaller. The key point at which you know you should be having more fiscal stimulus is when the Bank of England starts doing unconventional monetary policy. It is then moving to a monetary policy instrument that is pretty ineffective; it does not really know what it does. Fiscal policy is an effective instrument at stimulating the economy and you know much more what you are doing. If the Bank of England is moving to a fourth-rate instrument to try to stimulate the economy, it is sensible to use the second-best instrument, which is fiscal policy. It did seem to me that the Bank was signalling the need for greater fiscal expansion. In a sense, we got a token of it, but we did not get as much of it as we should have done.

Q264 **Mr Steve Baker:** Just to pick up on one point before moving on to the OBR and uncertainty, I think you just said then about monetary policy being ineffective. I think you said that it does not know what its effects are.

Professor Wren-Lewis: That was unconventional monetary policy.

Q265 **Mr Steve Baker:** Do you think that the Bank of England does not fully understand what the effects of unconventional monetary policy are?

Professor Wren-Lewis: The key difference here is between interest rate movements, where there has been a lot of empirical work and which we know a lot about, and unconventional policy instruments, which are much newer and we have much less empirical data, so of course they do not. It is no fault of the Bank of England that they do not know what effect these things are going to have. We just do not have the experience and the data that tell us what kinds of effects they have, and so we are using a fourth-rate instrument to do a job.

Professor Booth: Let us not start a disagreement about the effectiveness or otherwise of fiscal policy. You have my views and you



have Simon's views. That is fine, but I wanted to comment on the issue that it is nobody's fault that we do not know the effect of unconventional monetary policy, on which you and I differ, as it happens. I think it is the Bank of England's fault that we do not know very well the effect of unconventional monetary policy. Mervyn King was the first to say it, not after the crisis, but in the run-up to the crisis. He said several times that ultimately the cause of inflation is excess money, but the Bank does not model this explicitly and we do not know enough about money and how it causes inflation, because we are modelling inflation over short-term time horizons and our models basically ignore money. Then of course you use the printing of money as the prime monetary policy tool, once interest rates have hit their lower bound. Yes, it was a responsibility of a central bank to be researching the role and the transmission mechanism of monetary policy, both conventional and unconventional, so that it would have a better understanding of how these things would work if it ultimately had to use unconventional monetary policy.

Mr Steve Baker: If it is any comfort, I have sent them some research suggestions. Professor Wren-Lewis, did you want to answer?

Professor Wren-Lewis: I read the history rather differently. It seems to me that the history is, having tried to use monetary aggregates in various different forms and ways to guide demand management, basically the story is that they were pretty lousy at doing so. Monetary policy moved to a period where we just focused on interest rate changes, because they are what really move things in the economy. We have only fallen back on monetary aggregates because we cannot move interest rates anymore.

Q266 **Mr Steve Baker:** The OBR has forecast that business investment will fall by £27 billion, so the Government's intervention would not make that up. What is your take on that? Should the Government be trying to make up for forecast falls in business investment possibly?

Professor Booth: Not as such, no. First of all, I am not a great fan of economic modelling in general, but I think that where models tend to fail is where you have a radical change in conditions. I am not really sure that anybody can forecast the extent of the fall in business investment that might happen as a result of the increased uncertainty arising from Brexit, with any confidence at all. What type of action should the Government take? It is very difficult, because we cannot just assume that all forms of investment are, in a sense, identical and therefore replacing private sector with government investment is just a sort of like-for-like replacement that will resolve the problem. That is an Austrian insight that you would be aware of.

Mr Steve Baker: We say Austrian a bit less these days.

Chair: It is borne out of an experience of countries beyond Austria, not only Austria.



Professor Booth: I am talking about a school of economics rather than the country.

Chair: I will not intervene again for some time. Carry on.

Professor Booth: The right response, if you are going to do anything on the fiscal front, is firstly to do your best to provide greater certainty. There are areas where the Government could do this, especially in relation to things like migration, where it is known that policy, by and large, will be repatriated. I can understand why in some areas the Government might want to keep their powder dry. The second is to act to counteract where the problem lies, so reductions in corporate tax and increased investment allowances. I would not approve of this type of thing, but that is the best reaction to a fall in business investment caused by increased policy uncertainty. Increased policy uncertainty is a fact of life. As it happens, businesses are postponing investment for good reasons, because the risk-adjusted return needs to be higher, and I do not you should necessarily fight against that.

Professor Wren-Lewis: I would not argue for more public investment as a kind of fill-in for business investment. That is wrong. I think that, actually in some areas, increased public investment can stimulate private investment, but that is not the reason why you should be having a very large increase in public investment now. The reason you should be having a large increase in public investment now is that it is incredibly cheap to borrow, so it is an obvious time to do it. Again, something that was said in the previous session is that the constraint on increasing public investment is on the supply side, in finding good things in which to invest. There is no constraint in terms of borrowing, so that is the main area where I found the budget particularly disappointing. We had a pretty small increase in public investment, where we should be having a very large increase in public investment.

Q267 **Mr Steve Baker:** The last area I would like to touch on is a comment from the MPC's Kristin Forbes. She said of post-referendum uncertainty that it "has seemed to create less drag than generally expected". Do you think that, given the news that we have had since the referendum vote, we should all be a bit more optimistic? Do you think that the OBR was right to take the view that they have about uncertainty?

Professor Booth: Yes, I think we should be more optimistic. First, the economy tends to respond to real shocks quite well and recover quite well, as long as you have a relatively deregulated framework, deregulated labour markets and so on. Secondly, exports to the European Union are about 12% of national income and it is not as if all of those are going to be wiped out overnight. Of course, many firms are not involved in export at all. Having said that, the quicker the Government can lay out their long-term strategy and thinking, which they may well be able to do without actually setting out their negotiating position, the better. Yes, the OBR and other forecasters have potentially



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overestimated the problems arising from Brexit and the increased uncertainty.

Professor Wren-Lewis: There are good arguments, and if you want I can go into detail, that they have underestimated the potential negative effects of Brexit. We must not lose sight of the fact that Brexit has already had two large negative effects on the economy: the Bank of England has had to cut rates and start unconventional policy, which is a big shift; and we have had this very large fall in the exchange rate which, as it gets passed through to prices, is a real income cut for this country, a substantial one. To say that we should not be so pessimistic is a bit strange in that situation.

Q268 **Mr Steve Baker:** We could debate these things for a long time, I am sure, but did you see that the currency has fallen by about the amount that the IMF said it was overvalued by?

Professor Wren-Lewis: I think that is a red herring, to be honest. Unless you think that the market was overvalued for a reason that Brexit changes, those are quite separate arguments. The market fell because of Brexit. It clearly fell because of Brexit, for Brexit reasons. If the market was overvalued for other reasons, then it still has some way to go.

Q269 **Mr Steve Baker:** Do you think that Mervyn King was wrong in his comments when he broadly welcomed the changes?

Professor Wren-Lewis: What changes did he welcome?

Mr Steve Baker: Mervyn King made comments on the exchange rate, changing house prices, growth slowing and so forth, which were much more optimistic than the picture you are painting.

Professor Wren-Lewis: "You should never reason for a price change" is a motto for economists. You do not ask what the effect of the exchange rate change is; you ask why the exchange rate has changed. It has changed because we have had this negative shock on the economy.

Q270 **Mr Steve Baker:** That is interesting, because Professor Weale, in the earlier session, was explaining that, if the Bank of England had made a different policy response, the currency would not have fallen in the same way. We would have to go back and check exactly what he said in the transcript, but that is what I understand.

Professor Wren-Lewis: That is certainly true, but not all of the fall in the exchange rate, probably quite a small amount of it, was due to what the Bank of England did. A lot of it was due simply to Brexit.

Professor Booth: In a sense, we can both be right here. It is true that the exchange rate has fallen and, as a result of that, we are poorer. I accept that entirely, but that is actually one of the adjustment mechanisms that help keep consumer spending, business investment and exports higher than they otherwise would have been without that change



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in sterling. That is one of the adjustment mechanisms that I was talking about, which might mean that the type of things that the OBR is forecasting might not be as bad as they have forecasted, despite the fact that we are of course poorer, because everything costs more that we import from abroad.

Mr Steve Baker: I am conscious that my time has come to an end. I am happy with that.

Q271 **Chair:** Just to pick up on that last point, Professor Booth, you would agree, though, would you not, that if the exchange rate remained stable at whatever level it was, those adjustments that you have just been describing that have taken place would have then needed to take place as a result of internal devaluation, in other words finding ways of improving productivity.

Professor Booth: Improved productivity or internal deflation, yes, which is one reason why I never supported the UK joining the euro, given our particular trade position and the openness of our economy in relation to the rest of the EU.

Chair: That might have been a prima facie preferable route to dealing with the problems.

Professor Booth: I think having a flexible exchange rate is actually a better and more efficient way for an open economy like the UK to get an adjustment to an economic shock than an internal deflation.

Q272 **Chair:** To the shock, but we were trying to distinguish between the longer-term adjustments that might be required to the economy—at least that is what I thought Professor Wren-Lewis was alluding to and that you were responding to by saying, “We both agree”—and the short-term exogenous shock adjustment.

Professor Booth: Yes, but I do not think that not having a floating exchange rate would make that longer-term adjustment more effective.

Chair: I am not arguing for a fixed rate. I am arguing that the point that you have made does not really square the two positions.

Professor Booth: I was talking about the OBR forecast over a relatively short period of time for business investment, consumption, national income and so on. I was saying that an exchange rate change is one of the ways that facilitates flexibility in an open economy, so you can respond to shocks and things may not be quite as bad as the OBR suggested.

Q273 **Rachel Reeves:** I just want to come back on something that Steve Baker asked you before, building on some of the questions that the Chairman asked about the fiscal rules. In your answer, Professor Booth, to Steve Baker’s question about the three taxes you would most like to reform, you spoke about the effective marginal tax rate of 60% for



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people earning just over £100,000. I wondered whether you also have a view on universal credit, which has a marginal withdrawal rate of 65 pence in the pound. I would be interested in your views on whether that is a sensible marginal tax rate, effectively.

Professor Booth: No, I do not think it is. The only way you could reduce it is either by having a longer taper, so that many more people are brought into the universal credit net, or by having a lower level of basic benefit to start with but, no, I am as worried about marginal tax rates at the bottom of the income scale as I am at the top of the income scale. It is surprising that nobody really has done any work. They might do some work and discover that there is no case to answer, but it is surprising that nobody has done any work on the potential impact of a net benefit withdrawal, which affects probably two thirds of all families with children—I am not sure exactly how many—and the impact of that, potentially, on long-run productivity, incentives to train, incentives to up-skill, incentives to take more responsibility in one's job and this type of thing. I am not aware of much work that has been done in that respect at all, but a lot of work is done at the other end of the income scale about marginal tax rates and productivity.

Q274 **Rachel Reeves:** Is that something you might be able to assist with, Professor Booth?

Professor Booth: I could probably find people who could, but I could not personally do that type of empirical work.

Q275 **Rachel Reeves:** I would be very interested to hear who you think might be able to help with that, because I think it is imperative to get people into the labour market, working more hours and taking pay rises. I worry that the marginal withdrawal rate for universal credit discourages those things that I think all of us would like to see.

Professor Booth: Certainly our shadow monetary policy committee made the point at a very early stage, when unemployment started to recover more rapidly than people thought, that there is a sense in which this acts as a job subsidy and this might have been one of the reasons for higher levels of employment after the financial crisis than most people predicted and, in turn, potentially lower levels of productivity, because you did not have the kind of shake-out of employment that you might otherwise have expected. It does act as a job subsidy, in effect.

Q276 **Rachel Reeves:** Yes, it might not necessarily be a bad thing if the costs of not having it are higher. I just wanted to pick up on that point briefly. I will just move on, and I do not want to dwell on this for very long, because I think the Chairman really got to the heart of the issue on the fiscal rules. One thing that I noted from the evidence that the IFS gave to this Committee last week was that targeting a structural deficit of 2% of GDP is not, in practice, much different from targeting a current budget balance, because investment spending amounts to around 2% of GDP. I was wondering whether either of you think it would be better to openly



target the current deficit and to exclude investments and, if not, why not.

Professor Wren-Lewis: It would be much better to do it that way, as I think I have already said. There are lots of reasons why, measurement issues apart, there are important differences between investment and consumption. One of the problems we have had when that idea has been implemented is that we have shied away from doing the obvious thing, which is to have a target for the current balance and then have a target for public investment as a share of GDP. Instead, we have had a target for the current balance and an overall target for the debt-to-GDP ratio or movements therein, and it has all got messy. It seems to me that, by having a specific target for public investment as a share of GDP, which can ensure that you do not spend money on stupid things, you can have a much more sensible overall fiscal policy, because consumption and investment are very different animals.

Q277 **Rachel Reeves:** I do not want to put words into your mouth, but are you suggesting that we have a target, for example, to get the budget back into balance, although you may not prefer balance and may prefer a different number, but also have a target for investment of 2% of GDP?

Professor Wren-Lewis: It would be more than 2% of GDP.

Rachel Reeves: You would have two separate ones: one for the current balance and one for investment.

Professor Wren-Lewis: In a sense, you know what kind of fiscal rule I would like, because it is the Labour party's fiscal rule, which is closely based on my research and does indeed have that split. It also, crucially, has this zero lower bound knockout, which means that, when interest rates hit the zero band, as they do now, you forget about the 2% deficit or whatever and you concentrate on stimulating the economy, such as to get interest rates above that.

Rachel Reeves: Then you can have a better balance between fiscal and monetary policy, with higher levels of interest rates, potentially.

Professor Wren-Lewis: Yes, exactly.

Rachel Reeves: Professor Booth, I would be interested in your views on this as well.

Professor Booth: For reasons I have already suggested, I am sceptical of separating out investment spending. It may be that my view is overly jaundiced by the fact that I come from the constituency of the Humber Bridge, which is probably the best example of wasteful investment. Actually, it is not the best example, unfortunately, of wasteful investment.

Rachel Reeves: That is a bad example of a by-election promise.



Professor Booth: Absolutely, yes, and there are all the measurement issues that we talked about before as well. Is investment in teacher training or, for that matter, education full stop something that should count as investment spending, and will investment spending actually generate more tax receipts down the line? If it does not, then borrowing to finance such investment spending is potentially creating a problem for future generations. I do not really get hung up on these things, as I say. I am fairly indifferent about a fiscal rule, full stop.

What I think is important is, as I said before, that the intellectual framework is laid out; and there is then reporting consistent with that intellectual framework, so that you can really interrogate those responsibility for taking decisions in relation to the targets that they have missed. That worked quite well in relation to the Gordon Brown fiscal rules. When he began to bend, as some people saw it, the GDP numbers to redefine whether or not we had a cyclically adjusted deficit, surplus or whatever, he got quite a lot of criticism for that, which was quite well publicised. Articulating the intellectual basis is the most important thing, but having legislation consistent with that, followed by a mechanism for reporting that holds to account those who are responsible, are the most important things. I would not get too hung up on other issues.

Q278 **George Kerevan:** Before I go on, just picking up on that area of discussion, I wonder if I could ask Professor Wren-Lewis, in terms of potential fiscal targeting arrangements, where you stand on the notion of nominal GDP growth as a target figure. I was struck by your suggestion that with the zero bound interest rate all bets were off and you spend because it is cheap to do so.

Professor Wren-Lewis: There are lots of questions involved in that. There is the separation between monetary and fiscal policy. By and large, I kind of follow the mainstream view that, most of the time, it is monetary policy that should be doing the job of stabilising. The question then becomes whether a nominal GDP target is a good target for monetary policy. I am on record for saying that I think it certainly has virtues compared to inflation targets so, yes, that is certainly an interesting area to explore.

In normal times, when monetary policy is not stuck at the zero bound, then that is an issue for monetary policy, rather than fiscal policy. When you want to use fiscal policy to stimulate the economy, it is because you have hit a big negative shock. In a sense, the target there is to get back to a sensible output gap to increase employment, decrease unemployment, etc. It does not really matter too much what the target is there; you really just want to allow monetary policy to start being used again, so it can focus on whatever target it wants to.

Q279 **George Kerevan:** Let me move on. It is obvious that the key feature of the Autumn Statement was the significant increase in borrowing overall and extra borrowing for capital spending. That is in quite significant contrast to the Osborne years, when there had been a target above all,



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although it was not reached, to reduce net debt. Last month, I noticed you wrote a wonderful blog, so I am going to tempt you to put some of it on the public record, which had the great title "Whatever happened to the Government debt doom spiral?" What happened to it?

Professor Wren-Lewis: It was a fiction. The Osborne policy was based on a fiction. I have actually called it "deficit deceit", because you can tell it as a malevolent deception to try to reduce the size of the state, by pretending that we had to reduce the deficit and therefore cut spending, which otherwise would be unpopular. There is now clear evidence that there was never any kind of idea of a debt funding crisis for the UK. We were never in that zone or anywhere near it, so all that has really happened is that this deficit deceit, this imaginary concern about the importance of the deficit, has come to an end. That imaginary bubble has been pricked, which is a good thing.

George Kerevan: I can see Professor Booth gently shaking his head.

Professor Booth: At current levels of borrowing, or the levels of borrowing we are projecting by 2019, it would not make much difference whether the Government borrowed 1% more or 1% less, but it is dangerous to describe policies we disagree with necessarily as malevolent and being based on lies. You could make a pretty strong case, ex ante, and I actually still believe it to be true, that if the Government had carried on borrowing at 10% or 11% of national income per annum, with no obvious determination in terms of direction of travel, with no huge pool of private sector savings, which exist for example in Japan and Italy—particularly in Japan they tend to stay within the country to finance government borrowing—there would be a material risk of a serious crisis evolving, particularly if people also looked forward to the demographic headwinds and all the rest of it that are going to begin to bite, over the next decade or so.

I do not think you can look at the situation in terms of the Chancellor not hitting his targets when he is still borrowing at 4%, and therefore everything is fine. If one is going to be so critical of the Chancellor, in his determination to reduce borrowing back in 2010, you have to think about the counterfactual of the Government carrying on borrowing at those sorts of levels. I would look at Japan and argue it is achieving nothing as a result of doing so.

Q280 **George Kerevan:** Leaving aside how we assess the Japanese economy, I agree with your issues about long-term growth levels, productivity and so on. Japan nevertheless raised its net debt to well over 200% of GDP, without any market meltdown. In essence, there never was the threat to public finance or the inability of Government to borrow that was suggested under the Osborne regime. It remains a moot question whether or not, given that flexibility was always there, the fiscal spending aimed at austerity rather than promoting higher growth may have been the wrong way to go.



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Professor Booth: I am not saying it does not remain an intellectual question. What I am interested in is whether or not, in George Osborne's shoes, there was a material risk of meltdown. Japan is different because of this very high level of private saving of capital that, to a large degree, tends not to be exported. If the direction of travel was not clear in terms of reducing the deficit, would there have been a material risk of meltdown? Yes, quite possibly.

Not only that: I would argue that, yes, the Chancellor should have been more honest about issues in relation to government spending, which was rather difficult after the David Cameron era of sharing the proceeds of growth and all the rest of it. Government spending as a proportion of national income at factor cost peaked at 52% of national income, and that is a level from which it is not unreasonable to have an ambition to reduce it. Sure, he should be honest about the reasons for doing it and not do it under the cover of some other pretext.

Q281 **George Kerevan:** Where I am going ultimately is whether part of the reason that there was not a threat to borrowing was in some way related to the fact that we were monetising the debt through QE.

Professor Booth: Yes.

Professor Wren-Lewis: This is the fallacy of the meltdown idea. There are so many things wrong with the meltdown idea. The thing is that a country that prints its own currency is not going to default. It is very unlikely to default. If it going to do anything, it is going to do monetise the debt. What were we doing over this period? In effect, we were monetising the debt by the central bank buying it. It is not even clear what the meltdown would have been if it was going to happen, but it was never going to happen.

Q282 **George Kerevan:** My final question is: if we accept your premise that, in some way, the increase in debt has been monetarised through QE in an unconventional form, why did the markets not react as would normally have been predicted, negatively, to that monetisation?

Professor Wren-Lewis: You worry about inflation when you are in a boom, not when you are in a huge recession, so it was just inappropriate to worry about this monetarisation leading to high inflation, which is one of the reasons why reliance on monetary aggregates is just so hopeless as a way of doing macro.

Professor Booth: The purpose of the monetisation was to prevent a decline in the broad money stock, which it broadly did, and it is only now growing at levels that are actually beginning to look alarming, for those of us who are interested in such things. For a long period of time, it looked as if the broad money would be alarming in the other direction, and that was the purpose of the monetisation.

Q283 **Chair:** Just to be clear, are you alarmed at the moment?



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Professor Booth: Am I alarmed? No, I think policy is wrong, but we are talking about wrong in terms of whether inflation will overshoot by 1% or 2%. I am not one of these Liam Halligan people who thinks there is going to be hyperinflation or whatever. I am also concerned that the Governor of the Bank of England seems to be discarding the monetary framework that has been given by Parliament. The Bank of England is quite clearly forecasting inflation to go over 2%, and is loosening into that and talking about reasons for doing that that do not relate to the mandate the Bank of England has been given at all. The Bank of England has been told it can make allowance for employment, growth, etc., when bringing inflation back to target, but it is not within its remit to decide to discard the target, even if the target is a wrong one. If it had a nominal GDP target, what it is doing might well be sensible. I think he should stick to the target he has been given. That is his job.

Q284 **Chair:** Do you agree with that, Professor Wren-Lewis?

Professor Wren-Lewis: No.

Chair: I was just wondering.

Professor Wren-Lewis: Sorry, I will elaborate on that. We have what is called a flexible inflation target. It is a target for inflation into the medium term, and one of the reasons we have that is so the Bank of England can see through a temporary increase in inflation and not react to that. That is exactly what the Bank of England is proposing to do.

Professor Booth: It is quite clear in the mandate that has been given to the Bank of England that that is true in relation to bringing inflation back to target, but the Governor is quite clearly making the kind of trade-off that it was the intention of Parliament not to give him. He is making public speeches and taking policy decisions, which are saying, "We are going to allow inflation to go above target," according to the Bank of England's forecast, "because I do not want unemployment to rise or growth to be impaired," or whatever. I do not think he has been given that flexibility.

Professor Wren-Lewis: That was what the flexible inflation target was designed to do. If you want to interpret it in a completely different way than most economists think about it, that is wrong.

Professor Booth: I am really interpreting it in the way it is written down, but anyway.

Chair: That was a very interesting exchange. As far as I can tell from the hour we have been talking, or just under, one of you wants clearer, tighter rules on fiscal policy and the other witness is saying, "I am something of a sceptic about these fiscal rules." One of you wants the Bank of England to stick pretty tightly to its monetary target or rules, whatever you want to call it. The other witness is very sceptical about that and says, "No, flexibility is what flexibility means, and should be



interpreted generously.” We have at least picked two witnesses who can bring out two quite fundamental differences of view about the conduct of fiscal and monetary policy.

Q285 Mr Steve Baker: I have two questions. Those were fascinating observations about QE. The first is: do you think that economic expectations and people’s propensity to hold cash would be the same if, instead of using electronic money in a way that almost nobody understands, which is the way it is currently done today—almost nobody understands what they are doing and, in fact, you have said earlier that they do not understand the implications themselves—the Bank of England was printing out banknotes and shipping them out on pallets on lorries, so that everybody could see what billions of pounds looked like when they were printed? Do you think that economic expectations and the propensity to hold cash would be the same and, if not the same, in what direction would they vary and what would be the effect on inflation?

Professor Booth: The transmission mechanism would clearly be different. The transmission mechanism, instead of being through securities markets, the cost of funding investments, the cost of borrowing for consumption and all the rest of it—and the exchange rate, I should add, which is a transmission mechanism not often talked about when it comes to QE—would be directly through people actually spending money. You would not necessarily get the same asset price disturbances. I would tend to the view that asset markets work pretty efficiently and using asset markets as a mechanism to get money into the real economy is better than just doling out and not doling out—and I am not quite sure how you would distribute it, but anyway—large amounts of cash.

Professor Wren-Lewis: We are going to just always disagree. We are really talking about helicopter money.

Q286 Mr Steve Baker: I am really talking about the way hyperinflation has happened in the past. What I am suggesting is that, if people could actually see pallets of bank notes, their propensity to hold cash would at least be markedly more likely to drop dramatically. That would get the velocity of money up. Notwithstanding the Governor’s recent comments to the Committee, if the velocity of money increased dramatically because people were losing faith in cash because they could see it being printed, literally, I think inflation would pick up. What I am suggesting is that, at the moment, the world is getting away with dramatically expansionary monetary policy, precisely because ordinary consumers do not understand how it works.

Professor Wren-Lewis: No, I do not think that is right at all.

Mr Steve Baker: Go on then; explain why I am wrong. I think it is the issue of our time and I am happy to be proven wrong.

Professor Wren-Lewis: You are making a presumption that all this printing of money is forever irreversible and will therefore inevitably lead



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to some future inflation, which is often the presumption that monetarists have.

Mr Steve Baker: I am not a monetarist, of course. I take a disaggregated view of these things.

Professor Wren-Lewis: People are taking a very sensible view about all this electronic money being created and I think the same would be true if it was cash. What is happening is the economy has been very depressed and inflation has been low, and this is what you have to do to get the economy out of recession. If it continued when we had a boom, whether it was electronic or real, people would worry.

Professor Booth: I am not sure that we are in fact disagreeing. You have to think about the counterfactual. This has been going on at a time when there have been increased capital requirements, liquidity requirements and so on put on the banking system. What would have happened without quantitative easing, increasing bank deposits, etc., in terms of funding to consumers and businesses? The clue there is in the fact that we have had all this QE, which has hugely increased the monetary base. Banks have been trying to shore up their capital position by flogging off assets, etc. They are not necessarily keen to lend because of capital requirements. We have had this huge QE raising the monetary base, but it has not made all that much difference to broad money, except that the counterfactual might well have been broad money collapsing without it.

Q287 **Mr Steve Baker:** The other issue is that, in the course of our travels, I have had the opportunity to ask some German economists about the effect of QE on the structure of relative prices, which is that disaggregation point. They were very comfortable talking about the effects of QE on the structure of relative prices in capital markets, the effects on capital allocation and the consequent distortions that it leads to. Do you think we talk enough about these phenomena, the detail of what happens and what that means for capital allocation, productivity and growth?

Professor Booth: No, I do not think we do talk enough about those things. You can see that issue, if I can use that word again, from an Austrian perspective, which your German friends have obviously embraced, but also from a classical monetarist's perspective, where monetarists are interested in the transmission mechanism. Where these things are a bit less obviously is in a sort of neoclassical framework, where everything happens instantly and you forget about how you get from A to B.

No, I think these issues are important and my point earlier about the Bank not understanding the role of money in the economy as well as it should have done essentially relates to that issue. It was only in 2011 that it started publishing stuff on the transmission mechanism, what the impact of QE would be on relative prices in different sectors and how it



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actually fed into the economy. I do not think we do talk enough about that.

Professor Wren-Lewis: The reason why you worry about these things is because you have an inappropriate fiscal policy. That is why the Bank did QE, because it had a remit to close the output gap, to get the economy going and to get inflation back to its target. It could not do it through interest rates, so it did it by unconventional means, which was QE. It would have just been so much more sensible to use fiscal policy, which would not have had any of these effects.

Mr Steve Baker: I hope you would not mind me saying that the Chairman and I exchanged a glance then when you said “output gap”, which is something that the Committee has considered on many occasions. I would just say thank you very much for indulging this part of the conversation.

Chair: The output gap seems to me to be—how should I describe it?—an elusive notion, at least as far as policymaking is concerned.

Professor Wren-Lewis: Can I just say this is a complete misunderstanding of the output gap? It is very difficult to measure the output gap, of course, but can we therefore completely forget about the level of demand in the economy? Of course not.

Chair: Do not go from one extreme to another.

Professor Wren-Lewis: What else are you going to look at?

Q288 **Chair:** It is just to use it as a core tool might be to give an arbitrary air of precision, which it does not deserve. I would just like to come back to one point Professor Booth made. There has been quite a bit of work done on the extent to which the strengthening of bank balance sheets, the regulatory requirements and all that has gone with that, plus the fines that have been proposed on banks, which are not inconsiderable, and the threat of fines, which have a depressing effect, could be said to have acted as an offset to all the monetary expansionist policies. It is not just QE, of course; it is very, very accommodative interest rates for a long period and a number of other policies as well, but those are the main ones. Have you done any work on that to see whether those two sets of numbers really add up?

Professor Booth: No. There are not that many people who have thought about it, if you like, as two sides of the equation. In a sense, they are not; they are two separate things that are theoretically distinct.

Chair: They both end up being intermediated through the banking system.

Professor Booth: Yes, that is true. No, I have not seen any serious work trying to trade off one against the other.



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Q289 **Chair:** I have one last question for Professor Wren-Lewis. Since we loosened policy, not only with interest rates but also with QE, is there an argument, when eventually we do decide to tighten policy, at least among the tools, to start with an unwinding of QE, rather than using interest rates, as the Bank has said it will do?

Professor Wren-Lewis: Should it be QE first or should it be interest rates first?

Chair: Should it be QE with interest rates or should it only be interest rates? Have you given any thought to that question?

Professor Wren-Lewis: That is a good question. In a sense, it goes back to something that we have talked about, which is that central banks know what they are doing with interest rates; they do not really know what they are doing with QE. If they want to know what they are doing in a situation that is rather delicate—have we got a recovery or have we not?—and you really do want in some sense to know what you are doing, then you use interest rates. The time to unwind QE is when things are a little bit easier in that respect. That is the thinking, whether it is the right thinking or not.

Chair: That is the question I was asking you. You are now saying you are not sure. I was going to give Professor Booth the opportunity for the last word, but it has to be very brief.

Professor Booth: I agree with that, but also not only do the central bank know what they are doing, but the public would understand it better as well. Also, the effects of very low interest rates on the banking system are of some concern. There are lots of reasons to start tightening, using short-term interest rates first.

Chair: It has been a very interesting set of exchanges, and the fact that we have had contradictory evidence only increases the value and the interest. Thank you both very much for coming to give evidence. I am sorry that we have finished almost three quarters of an hour later than planned.