

Treasury Committee

Oral evidence: The work of the Bank of England, HC 474

Tuesday 17 October 2017

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Members present: Nicky Morgan (Chair); Rushanara Ali; Charlie Elphicke; Stewart Hosie; Mr Alister Jack; Alison McGovern; Catherine McKinnell; Kit Malthouse; John Mann; Wes Streeting.

Questions 1 – 65

Witness

I: Dr Mark Carney, Governor of the Bank of England.

Examination of witness

Witness: Dr Mark Carney.

Q1 Chair: Governor, thank you very much indeed for coming before the Committee this morning. I am sure this is the start of a long and productive relationship with just the odd questioning session. You will notice a few changed faces from your last Committee appearance.

I want to start on the question of 20 years of independence, which is something that the Bank marked in September. I wondered if you might just share with us what you think are the most important threats to Bank of England independence today. What are you considering guarding against, if you like?

Dr Carney: Thank you, Chair. I will say hello to new members and to previous, returning members. It was quite helpful to take a step back and look at the track record over the course of the last 20 years of operational independence for monetary policy. The first thing is to re-emphasise that we forget at our peril that it is Parliament that decides what the objective is—it is in the Bank of England Act—which is a price stability objective. It is refined by the annual remit letter from the Chancellor, and then the Bank has operational independence, as you know, in order to achieve that inflation target.

The first threat is one that developed over the course of the last two decades, in particular in the run-up to the crisis, which is thinking that monetary policy can do more than it can. Monetary policy is effective for achieving its sole or its primary objective, which is the inflation target. It can be helpful in contributing to its secondary objective, which is to support the Government's economic policy of strong, sustainable and balanced growth, as currently defined. It is not the principal instrument for financial stability, and this is one of the lessons. It is not unique to the United Kingdom, but one of the lessons in the run-up to the crisis was a healthy focus on price stability became a somewhat dangerous distraction away from issues of financial stability. The reforms that brought in the other responsibilities for the Bank of England around the financial sector macro-prudential safety and soundness have been complementary to the inflation target and that aspect of independence.

Those two points bring me to a broader point, which is that what is crucial is that we focus on what the Bank can and cannot do. We can contribute to price stability and contribute to financial stability. Our actions have implications for other variables and other outcomes in the economy, but those are not the objectives of the Bank. While we can contribute to an understanding of those, we are neither empowered to nor should we swing those policy levers around to try to achieve, for example, distributional outcomes. We have very little impact on productivity over the long run, save that, if we get it wrong, either in



price or financial stability terms, we can be detrimental to productivity, but we cannot contribute. I would summarise by saying we are not the determinants of long-run prosperity in the United Kingdom. We provide some of the important foundations for that, but the key determinants, certainly from a policy perspective, are determined by you and your colleagues in Parliament.

Q2 Chair: I wanted to turn to look at inflation now, which obviously is in the news this morning. In your remarks in September, you said, "High inflation hurts the least well off in society the most. It distorts price signals, inhibits investment, and ultimately damages the economy's productive capacity". You went on to say, "Equally, deflation imperils growth and employment, and, in the extreme, leads to financial ruin and economic collapse". This morning, since the Committee started, we have had the latest September CPI inflation figure, which has reached 3%. That means you are now 0.1% away from having to write to the Chancellor to explain the deviation from the target and that would be your ninth letter for target breaches, if you have to write it in the future. Do you think the Bank is doing enough to keep inflation to target? Do you think you will be writing another letter soon and, if so, what will you be saying in that letter?

Dr Carney: I will take the second part of your question first, which is that I think it more likely than not that I will be writing, on behalf of the MPC, a letter to the Chancellor. We expect that inflation will peak around the October/November figure, peaking potentially above the 3% level. We would take a step back and look at why previous letters have been written since my time on the committee, recognising that in the initial phase of my time on the committee I will have inherited the very good decisions made by the MPC prior to my arrival. In other words, there are lags in monetary policy, so the outcomes, at least in the first year or so, were largely determined by previous actions.

The principal reasons behind inflation being very low, initially in 2014-15, was a very strong run-up in sterling and the level effects on a variety of energy prices, which flowed through. These are shocks that the Bank can choose to look through and it has to justify why we look through. The justifications—we can go into them if you want—are detailed not just in the inflation report, but in the letters that were written to the Chancellor.

Inflation rising potentially above the 3% level in the coming months is something that we have anticipated. We had signalled prior to the referendum that, in the event of a vote to leave, one of the adjustment mechanisms would be through sterling. This is a quote: we expected sterling to "fall sharply". It did. That passes through to prices. In fact, the UK has one of the highest degree of exchange rate pass-through to consumer prices among the advanced economies, in part because it is a very open economy, but there are other reasons behind it. As a consequence, we faced a trade-off. We still face a trade-off between



HOUSE OF COMMONS

having inflation above target and the desirability—this goes to a secondary objective—of supporting jobs and activity.

Could I make one other point? I will hand back; I do not want to go on too long. What matters is inflation.

Chair: I am under pressure to make sure that not only questions are short, but answers are short too.

Dr Carney: I understand. You have other business. The point I want to make is, when we look at that trade-off—and I am sure we will get into this—of course it is over the policy horizon. There is not much monetary policy can do about the initial rise, the spike in inflation with sterling's depreciation. Oil prices have not gone up recently. There is not much monetary policy can do about that. What we have to look at is inflation and output 18, 24, 36 months out. That is where we focus our attention, because monetary policy can definitely affect nominal variables and real variables, in other words jobs and growth, at that horizon. That is the trade-off we are looking at as a committee, in judging the right stance for policy going forward.

Q3 **Chair:** We are going to move on. I know colleagues will have detailed questions on monetary policy, so I will not go on too long on this, but you talked about inflation peaking in October and others have said the same thing. What is it at the moment that leads you to think that October may be a peak and then we might see a reduction towards the end of the year, or is it possible to say that yet?

Dr Carney: We will have an updated forecast in the first week of November. We have just started that process now. The principal reason, in fact the sole reason, why inflation has gone up as much is the depreciation of sterling. From history and past experience, we have a sense of the time path of that pass-through into inflation. Once you roll forward from the initial big depreciation, you have a so-called level effect.

The point that I want to make, and I will finish on this, is that in general if you think about pass-through in the United Kingdom of an exchange rate move, broad brush, you get 40% of the move in the first year, 40% in the second and 20% in the third. That last bit is relevant because, if you have a very big move in the currency, which is what we have had, you still have an effect out in year 3, in other words something that is pushing up. In previous forecasts including the August forecast, it has been keeping inflation above target, even out at year 3.

Q4 **Chair:** Thank you. Just moving on, I wanted to ask you about a story that appeared on the front page of the *Telegraph* business section yesterday, about the ONS. I think they were reading their numbers on the UK's international investment position. I wondered whether the ONS's revision to the net international investment position had affected the Bank's analysis of the economy. You previously said the UK is relying on "the kindness of strangers" in reference to our current account



HOUSE OF COMMONS

international investment deficits, but this rather dramatic change in the ONS's numbers perhaps affects how kind strangers have been and continue to be.

Dr Carney: We had expected that the current account, which previously was 3.4% in deficit, would be revised up. Directionally, we expected something. We obviously were not right on the top of the numbers. That is the ONS's job. Directionally, we expected the current account moving up to 4.5%, consistent with the FPC's previously expressed concerns about some of the risks around the current account deficit.

I would make one point though, and this is in the realm of financial policy— it is about financial stability, as opposed to monetary policy. If you look at the UK's net international investment position, so the stock as opposed to the flow, it is actually quite healthy. Helped by the ONS, we do a mark-to-market calculation of that net international investment position. Even on the revised figures, it is in the order of 70% of GDP. That is in part helped by the structure of the liabilities. The UK owes a lot in sterling and owns a lot in foreign currency assets. A lot of what it owes, although not all of it, is low-yielding gilts and a lot of what it owns is higher-yielding real property and real investments. With the depreciation you get a positive move, and that is one of the mitigants to the risks around the current account, but it is still a sizable deficit.

I said that was going to be the last point, but I want to make one other point, because it is important. The sustainable level of that deficit will in part be determined by the nature of the ultimate trade and investment agreement with the European Union.

Chair: We will come back to that, I have no doubt.

Q5 **Mr Jack:** Governor, you said a few moments ago that, with the referendum result, you expected sterling to drop. Would you agree with me that that was the time to raise interest rates by 0.25% to support the pound, rather than to drop them by 0.25%? Effectively that drop of 0.25% on the Brexit vote was unnecessary.

Dr Carney: No, I would not agree at all. The pound has largely been determined by the prospects for that trade and investment deal with the European Union, and has fluctuated largely around both the expectations of the scale of the deal and the timing of that deal. We saw a movement in the run-up to the referendum; we saw a sharp movement post the referendum. Those movements are based on the markets. That does not mean the market is right but, if you take the market as a whole, the market's judgment about what Brexit will mean for a period of time—I am not making a personal judgment about the fullness of time, but for a period of time—is relative to real incomes in this country, UK versus the rest of the world. In relative terms, the market's judgment is that real incomes would be lower than they otherwise would be. That is a real factor that has driven the exchange rate.



HOUSE OF COMMONS

The Bank, from a monetary policy perspective, is faced with what is termed under the remit as an exceptional circumstance. You have a fundamental change in the trade relationship with our largest trading partner. Prospective other changes will come because of that: in other words, other reforms domestically and other trade deals with other partners around the world. That fundamental real shock is leading to inflation being above target for a protracted period of time. The question faced by us is if we support adjustment in the economy during that period of time. The unanimous judgment of the committee was yes. We had the August package, which has supported the economy in the last 14 months.

Q6 Mr Jack: You talk about the fundamental shock. In good times we should prepare for bad. I would put it to you that a 0.25% bank rate does not leave much in the armoury. By moving interest rates up to broadly match inflation, for the next recession when it should come, or the next financial shock when it should come, we would have more flexibility in being able to manage the situation. At the moment, we have very little left.

Dr Carney: I am afraid we are zero for two on agreement. The path of policy is designed to achieve a sustainable return of inflation to target. In those circumstances, for the last 14 months up to and including our last decision in September, the view of the committee was that the stance has been appropriate. Monetary policy is stimulative, as you know, at this time. It is the only macro policy that is stimulative. Fiscal policy is still restrictive and there are a variety of headwinds going against this economy. The judgment has to be about balancing that trade-off: when do we want to get inflation back to target versus the relative amount of support?

Having made progress over the course of the last 14 months, the economy having created almost 400,000 jobs—you know the figures in terms of overall employment—having used up our spare capacity, having seen some early evidence of building domestic pressures, the judgment of the majority of the committee is that some raise in interest rates in coming months may be appropriate in order to have that sustainability, my point being that the trade-off has moved away. That is different—and this is where I am slightly disagreeing with you—than an idea of raising rates now so we can cut them later if the economy needs support. That is not consistent with achieving the target. Building a war chest in interest rate terms for a potential future shock is not staying on point in terms of the inflation target; nor in my judgment is it appropriate or necessary, given that the policy can move quite quickly if required.

Mr Jack: We will agree to differ.

Q7 Kit Malthouse: I wanted to ask you about the current status on clearing. It seems that much of the City has reconciled itself to Brexit. Indeed, there is a growing opinion that it might actually be beneficial, recognising that it is not a zero-sum game, but there is still quite a lot of anxiety



HOUSE OF COMMONS

about clearing. Now, you have been on record, most recently in your Mansion House speech, ringing alarm bells about the threat to stability, fragmentation of liquidity, the efficiency and the extra cost there will be for business. What physical progress are you making with our European partners?

Dr Carney: Thank you for referencing the Mansion House speech, because it summarises the headlines in terms of the Bank's views. I would just underscore—I think you know this, Mr Malthouse—that those costs of fragmenting clearing, particularly the clearing of interest rate swaps, would principally be borne by the European real economy and they are considerable. The implementation of a so-called location policy, in its purest form, would in our judgment raise clearing costs in euros, for euro interest rate swaps, by at least a basis point and potentially up to 3 basis points. It does not sound like much but, given the underlying volumes, it is €20 billion per basis point. Again, that is ultimately borne by the real economy in Europe. We do not see that as a desirable outcome.

The impact in the UK on sterling interest rate clearing, on US dollar interest rate clearing, on yen interest rate clearing and Canadian dollars for that matter would be quite marginal. There would be some impact, but it would not be significant, just so that we are clear on that. In terms of progress, as you can appreciate, the negotiations are a matter for the Government, so the Bank of England is not engaged in negotiations about any aspect of the future partnership. This would fall under the arrangements for the future partnership. We can comment on the proposals of the Commission, because we are still a member of the European Union. We have.

Kit Malthouse: These are the June proposals.

Dr Carney: These are the June proposals.

Q8 **Kit Malthouse:** Do those look like an act of aggression to you?

Dr Carney: There are two broad elements to the June proposals. There is one that is a location policy-type approach with various tiers and another that emphasises a co-operative supervisory relationship, which looks very much like something we would advocate and something that the Bank of England actively participates in, whether it is with the Canadian authorities or the US authorities. I and colleagues sat down with the CFTC and the SEC when we were in Washington last week on exactly that existing relationship with the Americans. We have said that we welcome that aspect of the Commission's proposals.

Q9 **Kit Malthouse:** Does that aspect of the Commission's proposals allow them to discriminate against London? Obviously there is euro clearing in New York, because there is this mutual recognition agreement. Could they deny that to us and therefore discriminate against London?



HOUSE OF COMMONS

Dr Carney: In terms of the Commission proposal, there are two aspects. We do not see the merits of location policy. As to the other, which I would broadly term supervisory co-operation and enhanced information-sharing, I very much prefer to see the glass half-full. That is the way forward for handling very important clearing entities, such as those resident in London. That is what we would look to work on, the collective “we”, through the Government and the Bank of England supporting, and the relevant EU authorities. I would note as well—you know this—that the relevant EU authorities have been expanded with the proposal to the ESMA and, importantly, the ECB. There is a logic to that, so there is much to like about the broad Commission proposals, with one big caveat, with which you are familiar.

Q10 **Kit Malthouse:** Governor, I think you are on the council of the ECB, are you not?

Dr Carney: I am on the general council of the ECB.

Q11 **Kit Malthouse:** That is a collection of all the central bankers from the EU. What is the general consensus? You have talked very compellingly about the threat to financial stability from this issue. That is not just internal to the EU; that is a general shock to financial stability in this hemisphere. Are they apprised of that? Do they get it? Is there a consensus on the council that you are right?

Dr Carney: There is a learning process under way. I am testifying, so I am giving you my straight answer. I think there is a learning process on the scale of some of the financial stability issues. I will give you an example that is related to this, which is not about clearing per se, but relates to derivative contracts that could be bilaterally cleared, as opposed to centrally cleared. There are tens of thousands. Our last count was 40,000 derivative trade pairs between different counterparties that are UK-resident or EU27-resident.

On the continuity of those contracts post-Brexit for a number of life events, which go everywhere from compression and rollover to exercise of options and substitution of collateral—big things in the mechanics of the derivative world—it is pretty clear that those contracts do not continue to be valid, if I can put it that way. They are valid if nothing changes and they just run off but, if anything changes, and something always changes, then they would not be. That can only be solved by both sides. It is not something that the UK can do unilaterally to solve it, nor something that the EU27 can do unilaterally to solve. That is an issue and we have surfaced that. We have done that publicly in the last few months, in part because we have been working to find other solutions, which do not work. The market cannot “novate” all these contracts in time. I am using that as an important example; that is an area that we have to work on, and I think that had been underappreciated on the continent.

Q12 **Kit Malthouse:** You would presumably like the go-ahead from whoever.



HOUSE OF COMMONS

You have done this before. When you were Governor of the Central Bank of Canada, you agreed a supervisory arrangement with the UK to allow clearing of Canadian dollars here. You would like to get the go-ahead from the UK Government and whoever has to push the green button in Europe to start those conversations to come up with that regulatory framework.

Dr Carney: We would like to get the go-ahead or to have the right interlocutors from the UK Government to have the go-ahead to have those discussions, supported by us in a technical sense. It is clear that the UK Government would like to have the go-ahead to have those discussions as well.

Kit Malthouse: Presumably you are lobbying, when you go over to your meetings at the ECB council, for them to put pressure on.

Dr Carney: I am not sure central bankers lobby, but we have full and frank, objective, evidence-based discussions. I am bringing more evidence to the table.

Q13 **Kit Malthouse:** We will take that as code. Say the EU decides to go for what I guess you would characterise as this kind of self-harming option, adding this additional cost to their own industries. They go for this location policy. They find some way in their own legal terms to discriminate against London, but let New York carry on and all the rest of it. What is to stop two international counterparties deciding to clear whatever currencies they want in London?

Dr Carney: It is difficult to design. Certainly if I am a UK-based bank, whether it is a UK-headquartered bank or a foreign bank that has its operations and subsidiary in London, or branch in London for that matter, if it is trading with a Japanese, Canadian or American bank, and it wants to clear euros in London, it can clear euros in London. Currency nationalism goes to that point.

The proportion is a low-teen proportion, in terms of European counterparty to European counterparty, of the overall bucket of swaps cleared in London. Forgive me; I can write back. It is 12% or 14%. It is referenced in the speech. For the sake of argument, let us say it is 14%, just so I am giving the high estimate. That means that 86% of everything else is there, which is why the economics of what is left are not quite as good, but are still pretty compelling. As you know but just for the record, the more collateral you have and the more diversification you have, by way of currency and others, the better the economics are in terms of central clearing.

Q14 **Kit Malthouse:** Sorry, so what you are saying is that, if a European-based institution attempts to clear euros in London, the EU would have to find some way to punish that institution.

Dr Carney: You need to clear through an authorised clearing house. That is done in part to protect the institution from making its own



judgment about the credit-worthiness of the clearing house, but it is done in part to protect. If it is an unauthorised clearing, you can go anywhere from capital penalties or other penalties. There are ways to do it. The question is the logic of it. We would suggest that it just does not make sense for European car manufacturers, European pension funds, European banks and ultimately European individuals to pay tens and tens of billions of euros in extra cost for a service that is done properly in London, for which there can be a close supervisory co-operative arrangement, information-sharing and it works. Ultimately, and I will finish with this, it is consistent with the objectives of the G20 and the FSB, including all the European members of the G20 and the FSB, to clear derivatives in this way, because that is one of the ways to learn the lessons and address the issues of the last financial crisis.

Kit Malthouse: You are champing at the bit to get going.

Dr Carney: Yes, and I would say this as well: we are absolutely ready. We have worked this out in deep detail.

Q15 **Stewart Hosie:** Morning, Governor, and my apologies for not being here for the end of this session. Sam Woods from the PRA has criticised the state of contingency planning among some EEA firms with branches in the UK. He said that “We are having to push the inbounds”—i.e. EEA, including EU, firms exercising passport rights—“to move on with their thinking”. Do you believe they are responding to the calls to develop their planning? Can you shed any light on why, of the firms supervised by the PRA, this group of inbound EEA and EU banks are the least well prepared for no deal?

Dr Carney: First, I obviously subscribe to the comments that Mr Woods made. We worked together on the PRC and closely on all these Brexit issues. It is absolutely correct that there has been a difference in terms of the depths, level of sophistication and advancement of contingency planning of outbound firms versus inbound firms. That is one of the main reasons why Mr Woods wrote to all of the firms to get their contingency plans and we are working more closely with the inbound ones.

To some extent it is a matter of speculation, but I would say, based on some conversations, there have been two assumptions of interest. Let us put it that way. First, there has been some assumption by inbound firms that there would be some form of transition arrangement put in place and, therefore, the urgency of this type of planning was less important. Perhaps there was an implicit assumption that they would effectively be grandfathered if they were operating as branches here previously, under European passporting. I think they now understand that the latter is not necessarily going to be the case and we will have more to say about that in due course.

In terms of the presumption on transition, it could go back a bit to Mr Malthouse’s questions around derivatives. It is interesting; I would observe that, while we are preparing, as we should, for the possibility of



HOUSE OF COMMONS

a hard exit, if I am allowed to use that term, without any transition period, we are doing all those preparations for that. There has been much less of that done in the European Union, including by the member firms.

- Q16 **Stewart Hosie:** That is interesting. I would have assumed, just to digress, that transition for complex financial institutions would be required to be over a considerable timeframe. Is it your judgment that they are assuming this will not be a one-year or two-year, but a prolonged transition, at least in their minds, given how long for example it has taken for Solvency II to be brought about? Do you think that is the judgment in their minds?

Dr Carney: I would probably limit the degree to which I try to interpret other people's thoughts. I will state this. In my opinion, it is absolutely in the interests of the EU27 to have a transition agreement. Also in my judgment, given the scale and the complexity of these issues, as they affect the EU27, there will ultimately be a transition agreement. There is a very limited amount of time, as pertains to your question, between now and the end of March 2019 to transition large, complex financial institutions and activities. You reference Solvency II. If one thinks about the implementation of Basel III, it was agreed back in 2011 and will be implemented fully in 2019.

We have extensive experience, and we are alone as current members of the EU in having this experience. We have extensive experience and expensive experience, I might say as well, of managing the transition for individual firms of various derivative and risk activities from one jurisdiction back into the UK. That tends to take two to four years. Depending on the agreement, we are talking about a substantial proportion of the activity in London. Common sense and familiarity with the issues dictate that a transition agreement is in everyone's interest, and that is why we have been saying this from day one.

Stewart Hosie: I would not want to bring you into political debate at all, Governor, but that sounds like a rallying call against a hard exit, a clean exit or any other sharp exit.

Dr Carney: You have rightly alerted me to be careful. There is a question of what the ultimate arrangement is, but in having an orderly move, I will quote the President of the European Council: a disorderly Brexit is in no one's interests.

- Q17 **Stewart Hosie:** Let me move on from that bit of fun. The PRA expects around 130 applications for authorisation from those firms to do business. Some will be allowed to retain a simple branch operation. Others, however, would be required to move to a subsidiary basis. What is the balance between the two and what is the difference in complexity between continuing to run a branch operation and being required to set up a subsidiary, given the circumstances of Brexit?



HOUSE OF COMMONS

Dr Carney: The PRA has an existing branch policy, and there are a couple of criteria that are relevant. First, if you are engaged in significant retail activity, we will tend to want you to be a subsidiary to be appropriately capitalised. Secondly, the degree of comfort we have in terms of the resolvability of the institutions, to go to the other end of the spectrum, so that there will be an orderly resolution if something goes wrong, will increase the prospects of that institution being a branch, as will the degree of information-sharing and supervisory co-operation. If I could put it broadly, there are questions around how systemically important the activity is. That is one consideration.

The other consideration is the degree of supervisory co-operation and information-sharing. If I map that to the subject at hand, the future relationship with the EU27, that second bucket, the future degree of supervisory co-operation and information-sharing—the analogy of what Mr Malthouse was asking around central clearing—what is that going to look like? In my view that will be determined as part of the ultimate trade and investment agreement with the EU27, so we need to know that.

I will finish here. If I am an inbound firm, I should not necessarily presume that that is going to be the best outcome there. I should have a contingency plan. In fact, I have to have a contingency plan, because we have asked them for it, for a world where we do not have that agreement and they are a third-country branch coming into the UK. Now, we do not want that outcome. We have very good relationships with the European authorities. We have full information-sharing and good supervisory co-operation. We think that is in the best interests of the EU and the UK, but the question is how that would be structured in an agreement. Those discussions, as you know, have not yet begun.

Q18 Stewart Hosie: I will come back to a little more of that. You said in the middle of that answer about potential risks or difficulties with resolution and the worst-case scenario. Do you think, given any number of the potential outcomes, that we are going to have to revisit the primary legislation on resolution, if we end up with a number of substantial institutions operating simply as branches in the UK?

Dr Carney: No, I do not think you will need to revisit legislation. As the PRA, you would look to us to determine if that is indeed the case. Those institutions should not be allowed to operate as branches. We have those powers.

Q19 Stewart Hosie: In which case, it leads me on to the risk of disruption to wholesale banking as well, because EEA firms branching into the UK lose their authorisation to do business, but these banks provide a 10th or thereabout of all lending to UK companies. Notwithstanding that we do not want the branch scenario and would prefer the subsidiary model for the reasons you have given, is there any immediate prudential reason why the PRA should not allow these firms to continue doing business or potentially risk the loss of tens of billions?



HOUSE OF COMMONS

Dr Carney: That is the judgment. It would be an error to presume that we would authorise all those EU branches that are currently active here, because they are active here on a framework where we have close supervisory co-operation, we have information-sharing and we have ultimate appeals to joint decision-making through the EBA and other processes. Those are to be used in extremis, but that deep arrangement exists and underpins so-called passporting. If we do not have any of that, the systemic-ness of the branch determines whether it can continue to be a branch or whether it would need to be a subsidiary. Again for completeness, we may not have exactly what we have under the current arrangements, but we could develop something that is very close to that, which would provide a great deal of comfort and would have a much more seamless transition and keep that activity here.

Q20 **Stewart Hosie:** As one final adjunct to that, should an EU or EEA bank have a branch here that services its customers, but it is a small part of its business and it chooses not to go down the difficult and time-consuming route of subsidiarisation, one could easily envisage, with no malice, a loss of capacity. I presume the Bank is preparing to see how it can support the bank subsidiaries that are left to pick up the slack, in that kind of circumstance.

Dr Carney: That circumstance goes both ways. One thing that is happening for a series of financial institutions that are resident here outbound into the EU27 is their ultimate boards are looking at the economics of splitting the business or shifting the business, incurring the cost to move to the continent. There are cases where they will shut down the business as opposed to shift it. The economics do not work, and that is unfortunate. That is a net loss for everybody concerned.

This is less about us supporting the banks that remain, but as a general thing, in an unco-operative outcome, which everybody wants to avoid, the UK will, at least initially, be long financial services, if I can put it that way. We will have more capacity, capital, individuals and collateral in the UK, and the EU will be short financial services, because not all of that capacity will be able to go across. That is one of the reasons why the entire economic impacts are greater for the UK in the short term, but from a financial stability perspective they are greater for the EU than the UK.

Mr Jack: I must apologise; I have another appointment, thank you.

Q21 **Rushanara Ali:** Just picking up on that point, Governor, do you think that the EU sees the legal vacuum facing cross-border contracts as a shared problem? There are lots of issues on our side but, in your judgment, is this something that they see as equally important to them?

Dr Carney: I think there are those in European institutions who now recognise that it is a shared problem, yes.

Q22 **Rushanara Ali:** In terms of the points relating to the Financial Policy



Committee considering the risks of a no deal and the conclusion that a deal is the best way to mitigate those risks, is it your view that the risks to financial stability cannot be addressed unilaterally by firms, regulators or the Government?

Dr Carney: With respect to these specific issues around derivative contracts, they cannot be addressed. In our judgment, certainly absent of a transition deal, there is not enough time to be address these. To be a little more precise, what is required is to “novate” these contracts, so shift them from the counterparty that happens to be here to a counterparty in Europe. That requires a three-way agreement, which inevitably will be held up, even if by a relatively small number. When we are in the tens of thousands, it is not feasible.

Q23 Rushanara Ali: You mentioned earlier the length of time it takes. Is the suggestion of two years for a transition deal adequate to deal with some of these complexities? For instance, the estimate is that the value of these notional contracts and derivatives is around £20 trillion. Is two years adequate to do this?

Dr Carney: £26 trillion is the notional value of these derivatives, so it is the same ballpark. Is two years enough? Our view is that the first, best way to address this issue would be through legislation that would give continuing permission for these contracts and effectively grandfather these contracts. That requires legislation both in the European Parliament and in this Parliament.

Q24 Rushanara Ali: How realistic is that?

Dr Carney: It requires an understanding of the issues. If it is understood, it is realistic. This is your world not mine, but what makes me nervous is that legislative timetables are packed, certainly here but also in Europe. You do need it to come through and you need it on both sides. If we just authorised the UK and the EU is not authorised, then the continuation cannot happen.

I will make a more general point, away from just derivative contracts. The timetable for transition is two years. Is that sufficient time? One has to work with what one gets, but it is sufficient time particularly if we get, if I am allowed to use an adjective, a reasonable agreement on the end state—in other words something that has a degree of supervisory co-operation and information-sharing, which means that not all risk, capital, collateral and individuals have to move. If you do the latter, if it is a very limited agreement in terms of cross-border flows and authorisations, the EU authorities have to be in a position to approve all the individuals. They have to approve all the models. The collateral has to move. These counterparty issues are not just for historic reasons; there are big economics that are determined by the history of where trades have been made, on top of all these other technical issues. All of those would require a longer period of time to be done properly. If there



HOUSE OF COMMONS

is an agreement that certain activities can continue to flow cross-border, then it is a reasonable period of time for the types of activity.

Q25 Rushanara Ali: If the agreement is not reasonable, what is going to be required to mitigate the consequences?

Dr Carney: If there is not an agreement, we have highlighted three big areas of cross-border issues. We have been discussing the derivative issue. On cross-border provision of insurance, there are tens of millions of people in Europe who have insurance from the UK. The UK-domiciled entities cannot pay out without authorisation, so the EU has to address that. There are data protection issues and authorisation for data to go, which is again an issue, if I can put it this way, where there is more data that are relevant to the EU in the UK than vice versa, in this case. It is a consistent thing that is not surprising, given the historic position of London and the UK as an important financial service provider to the EU. These issues are bigger for Europe than they are for us, although they are material for us.

Q26 Rushanara Ali: In this case we have much more leverage in order to be able to get a deal.

Dr Carney: I would not want to use financial stability issues as leverage.

Rushanara Ali: I am not suggesting we should.

Dr Carney: I want them to be addressed in a sort of bloodless technocratic way, in the interests of all the citizens on both sides of the Channel.

Q27 Rushanara Ali: You were talking about insurance and what it will mean in terms of real lives, both in terms of insurance and banks.

Dr Carney: Yes, these are real issues. These are real issues.

Rushanara Ali: What would be the consequence of an unreasonable deal or no deal on real lives, in these markets?

Dr Carney: If there is not a deal, and we are into conjecture, but if there is not a deal, for these issues there need to be legislative solutions to address. Some of it is secondary legislation, as opposed to primary, but there needs to be secondary legislation as a minimum that would, for example, authorise European holders of UK data, so that the standards continue to meet our standards. Now, it is reasonable to make that judgment, because we implicitly make that judgment today. At least it is reasonable for a period of time. Parliament would decide what that period of time would be.

Rushanara Ali: Parliament could choose to set a longer timeframe as part of that legislative process.

Dr Carney: Parliament could address, with respect to UK residents, UK citizens, insurance and data. Parliament cannot solve Europe's issues



with those two issues. Parliament, as we have been saying, cannot unilaterally solve the derivative issue.

Q28 Rushanara Ali: Just to pick up on Kit's point earlier, can you clarify whether there have been opportunities to speak with financial regulators in your counterparts, outside of the Article 50 process, on some of these really important issues?

Dr Carney: The risk, yes; the solutions, no, because it is the responsibility of the Governments and the negotiators of those solutions.

Q29 Rushanara Ali: I have one final question. Has the FPC considered the macroeconomic impact of a no-deal scenario and how that would affect financial stability?

Dr Carney: You just slipped that in at the end.

Rushanara Ali: Just answer yes or no. That would be fine.

Dr Carney: Yes.

Q30 Catherine McKinnell: Since the referendum, the MPC's economic forecast, which now extends to quarter 3 of 2020, has been conditioned on the average of a range of possible outcomes for the UK's eventual trading relationship with the European Union, which you have already referred to this morning. What is the current standing of that range of possibilities?

Dr Carney: Thank you for drawing attention to that. It has been conditioned on two things. One is that range of possible outcomes. We have not been mark to marketing those probabilities. We have just taken an average of a range of outcomes, from a WTO outcome to something approximating a full, comprehensive, ambitious trade agreement, which is the objective of the Government. We have also assumed a smooth transition from where we are today to that outcome.

Q31 Catherine McKinnell: Are you therefore working on a best-case scenario or are you working on an average scenario between the worst and best?

Dr Carney: The best-case scenario would be to assume a smooth transition to a full, comprehensive trade agreement. We are not assuming that. We assume that it is somewhere in the middle. You are not going to be able to draw me on more than that, because I do not want to have us predicting a certain outcome of the negotiations. We have an average of various scenarios. The consequence of that is that there are some impacts of the future agreement in the forecast. They are relatively modest, but they do weight a bit on productivity and the path of supply or potential growth—they are different words for the same thing—over the forecast horizon. So it does matter. If we were to have an agreement reached, that would have positive implications for our forecast. If we were to have a full, comprehensive, ambitious trade agreement reached, all things being equal, that would have positive implications.



Catherine McKinnell: In my understanding, you are not working on multi-case scenarios. You are working on somewhere in the middle, in terms of what a possible outcome might be. That perhaps is based on an assumption that that is the most likely place we would arrive at.

Dr Carney: If I may, it is a simplified assumption.

Q32 **Catherine McKinnell:** Is there not a risk that we might end up with a scenario at either end of the extremes and, therefore, we would be ill prepared?

Dr Carney: We would adjust policy accordingly.

Catherine McKinnell: At what stage?

Dr Carney: It will be a big event when an agreement is ultimately struck with the European Union, including any transition to that agreement. At that point, not just the MPC but, more importantly, businesses, households and financial markets, across the country, will adjust to that and reorient accordingly. We have the simplified assumption. As I say, we are not going to mark to market it with every headline in the newspaper or utterance from Brussels, but when there is a material change to the circumstance. If a transition agreement were reached and the horizon of the new relationship were pushed off into the future as a consequence, that would potentially be material for the forecast; or if, as you say, we end up closer to one or the other end of that spectrum, that will also be material to the forecast. What really matters in the end is what businesses and households are expecting and how they are reacting. Maybe we will come on to that.

Q33 **Catherine McKinnell:** I was going to ask about that. I have to say, I was expecting a range of possibilities being looked at, only because there is concern that, therefore, we will be ill prepared for whenever that financial outcome comes.

Dr Carney: We have looked at a range of possibilities. To Ms Ali's question, first and foremost in the Financial Policy Committee, we have looked, as you would expect us to, at the worst-case scenarios and the channels of risk that would come from those, which go above and beyond what we have been discussing. What can we do now to mitigate those risks? In a slightly different tack than on monetary policy, in response to Mr Jack's question, where I said it did not make sense to build up a war chest in advance in interest rates, just so you could cut them in the future, from a capital perspective, from a liquidity perspective and for the preparedness of the financial system, it makes sense on the margin to make sure that they are robustly capitalised. In fact, you would expect it to be the case that these institutions are robustly capitalised, including for a very bad outcome, at least a very bad outcome in the short term.

Q34 **Catherine McKinnell:** The Chancellor told the Committee last week that there is cross-departmental modelling being used by the Government to assess the impact of different Brexit outcomes on different sectors of the



economy and different regions. Does the MPC have access to this data?

Dr Carney: I apologise; I do not know exactly to what he was referring. We have regular discussions with certainly the Treasury, but also DExEU regarding sectoral impacts. Ultimately, our concern is the aggregate impact and we have our own modelling of scenarios and aggregate impacts, but they are for internal analytics, as opposed to public.

Q35 **Catherine McKinnell:** By your own assessments, do you have concerns about particular sectors or particular regions of the UK?

Dr Carney: If I go to our remit and back to where the Chair started this discussion today, we do not target regions and we do not target specific sectors. If we are looking at a sector, whether it is the auto sector or the agricultural sector, or a sector concentrated in the north, steel for example, we look at it to see the multiplier impacts through the economy, as opposed to any targeted intervention to those sectors.

Q36 **Catherine McKinnell:** Another Brexit-related judgment in the MPC's post-referendum forecast is that "households and companies base their decisions on the expectation of a smooth adjustment to a new trading relationship", which you have already referred to. Have those expectations of that smooth arrangement changed? What is the current status, in terms of your consumer engagement?

Dr Carney: I would say in terms of businesses there has been an evolution of those expectations, in that businesses have become less confident about a smooth transition and less confident about the ultimate end state and the degree of access, but less confident, not lacking confidence. I will put it that way. In terms of households, households have been more affected by the path of real income growth. Consumer confidence has held up relatively well, despite the spike in uncertainty, and you can measure that uncertainty, related to Brexit. At present, household expectations as a general statement would be broadly consistent with a smooth outcome to some future state.

Q37 **Catherine McKinnell:** On what basis is that assessment made? Has the MPC engaged with consumer groups, for example, about whether they are confident consumers on an ongoing forecasted basis?

Dr Carney: Yes, we engage in several ways. First, as you are aware, there are aggregate surveys of consumer confidence. GfK is the most prominent of those, and various subcomponents of that are particularly relevant. As I say, consumer confidence has held up. It is not robust, but it has held up. It has certainly come off its peak. We have an agency network, which is very active in meeting with businesses, consumer groups and groups such as Citizens Advice Bureau or other social support groups to gauge sentiment. We have regional visits. There is a fairly extensive programme of regional visits of all the members of the MPC and the FPC as well, so that is how we are staying in touch.



Now, the expectations of households could change. You tend to get sharper changes in expectations around focal points around big events, as opposed to around changes in—I am searching for the right euphemism—a lead opinion, if I could put it that way, or commentariat opinion about relative probabilities. Notable events would, in my view, most likely be part of the intergovernmental process. To summarise, confidence has come off. It is not exclusively related to lower real incomes, in my judgment. There is probably some Brexit uncertainty element in there for households and that is probably part of the story as well, on the wage side. We get that from intelligence from businesses and labour groups. Households are less affected thus far than business, and financial markets are the most affected by far. Financial markets have brought forward a fairly substantial adjustment and they may have to mark up the UK's prospects, as things move forward.

- Q38 Catherine McKinnell:** Can I have one final question, just to bring all that together? I am aware that there are some firms already making contingency plans, which may or may not be required, because they have no additional information as to what the final outcome of the negotiations will be. For many businesses, they have already passed that point of making changes regardless of the outcome. At what point do the Bank of England's projections that there will be a smooth transition, even though there is actually no clarity on that and we have March 2019 looming, become untenable.

Dr Carney: We are a way from that point, absent a political event, meaning a clear event in the negotiations.

- Q39 Catherine McKinnell:** Do you have a date in mind?

Dr Carney: No, I do not. I would say that the financial sector is the most advanced. Maybe one clarification: the financial sector, not surprisingly, is the most advanced in contingency planning. As others have commented and we broadly agree—Sam Woods has commented as well—the first quarter starts to be quite crucial on transition. For other businesses, there is a bit of a lag.

Chair: We are going to turn to the broader economy now.

- Q40 John Mann:** First, an observation for the record, Governor: there is a higher percentage of women participating in this accountability hearing at the Bank of England than ever in history. Changes are coming, albeit slowly. I have a question. Household debt is increasing five times faster than wages. When, in which year, is this going to implode?

Dr Carney: The overall context is that UK households have worked hard. They have paid down a lot of debt. At its trough, they paid down 20 percentage points of debt relative to income, vis-à-vis the peak that came in 2008. There has been some pick-up from there, but it is still down 14 percentage points from the peak. The second point is that people have got themselves into work. They have improved their balance sheets. The quality of the borrowers has gone up quite substantially.



HOUSE OF COMMONS

Now, we think the banks have put too much credit on that but, directionally, it is absolutely the case. We would agree that there has been a substantial improvement in the quality of the borrowers as well.

The third point is that from a debt service perspective, so the burden on the people who are borrowing, it is very low. The debt service ratio is about 7.7%. The historic average is about 9%. If you get a 100 basis point increase in bank rate and it all flows through on the debt, which it would not because a lot of the consumer credit is fixed rate, but just assume it all flowed through, it would take 100 basis points of bank rate to bring those debt service ratios up to historic averages. We think all those points of context are important.

With that context, from a Financial Policy Committee perspective, we see this as a pocket of risk. As you note, it has been growing at 10% rates and, as we note in terms of our reviews of the underwriting standards, as I said a moment ago, in our judgment, banks have given too much credit for the improvement in the underlying creditworthiness of those households. We are looking for an adjustment to be made. We are using the stress test, which formally comes out at the end of November. We are using that as the mechanism in order to make those judgments.

Q41 John Mann: That increasing household debt, as opposed to wages, is bigger than in 2007-08, is it not?

Dr Carney: In 2007-08, it was starting from a very high level. It started from a much lower level. Then it started from a much higher level in terms of debt service, and the underwriting standards were very poor. That is easy to see in hindsight.

Q42 John Mann: Let us take the example of car financing. With the system of car financing that has sneaked in, in this country, people can only exit their debt at an incredibly expensive rate and that was not the case before. They have a depreciating asset, but they cannot exit. They are tied in, in reality, to an extended series of debts ad infinitum, as it is. That bubble has not existed before. How are you going to solve that, particularly when the same people who are the most indebted with the new systems of car finance also tend to have a mortgage as well?

Dr Carney: There are a couple of things. First, as you term it, on the new system of car finance or so-called PCP contracts, the debt burden of that is actually overstated. You are right that you have a payment over the three or four-year life of the PCP but, at the end of that, you can just give the car back. In fact, the risk of the residual value of the auto is on the bank or, in most cases, is on the books of the company that manufactures the car, because they supply half of this car finance. I would not overplay this but, actually, in the debt numbers, the amount that debt has increased has been somewhat inflated by this statistical anomaly as you transition from the old way of having car finance to the new one. Yes, you have a fixed payment for your car, which is not dissimilar from the fixed payment one has as rent. As you know, many



HOUSE OF COMMONS

of your constituents need a car to live, to get to work and to ferry their children around. They need it, so it is a fixed payment.

I would go back though to two points of context, as you used the word “implode”, in thinking about how this affects the financial system as a whole. We had this stress calculation in the June *Financial Stability Report*. In auto finance, if a quarter of these were defaulting and if the residual values of the cars went down more than 20%, the net high-case impact on bank capital ratios is seven basis points. That is seven one-hundredths of a per cent for institutions that have 14.3% average CET1 ratios. This is not a big risk to the banks. What is crucial is that the standards for household debt as a whole hold up. They have been improving, but they need to hold up. That is what we are focused on. In terms of individual suitability for some of this debt, back to where the Chair started this discussion, that is not the responsibility of the Bank of England. That is the responsibility of the FCA. You would have noted the comments not specifically related to car finance, but the comments of the CEO of the FCA yesterday.

Q43 John Mann: I am sure it is an issue we will come back to. Others are being very honest that they do not have a clue about the productivity puzzle. Do you have a clue?

Dr Carney: I have a clue, yes.

John Mann: What is the answer to it?

Dr Carney: I thought it would be a short answer. I want to get my average answer time down. Look, there is a 16% shortfall relative to pre-crisis trends in productivity in this country. About five to six percentage points of that can be explained by what I would term almost ephemeral productivity that was in the financial sector in the run-up to the crisis. Colleagues, Andy Haldane and others, have testified and the Bank has catalogued this. Productivity, as measured in the financial sector, was actually flow of lending, which certainly in the run-up to the crisis was not the most productive activity ever. Part of it is that and part of it is the shift in North Sea oil. If you adjust for that, you have a 10% gap.

In the initial stages, access to credit post financial crisis has obviously gone away. We had some uncertainty effects. We have seen very soft investment growth, despite access to capital. Ben Broadbent has detailed this. If you look at hurdle rates for companies they are actually quite high, despite the low interest rate environment and the low cost of capital. They are mid teen-type hurdle rates. Why is that the case? Actually, a good chunk of that is uncertainty. That is backed up by any business survey from the Bank’s Decision Maker Panel to the CBI to the SIPP surveys and other surveys. We can guess what the main uncertainty is at the moment for businesses, so that is part of what has been dragging on both investment and so-called TFP or process



HOUSE OF COMMONS

improvements, if I can put it that way. It has been dragging more recently on productivity.

There is one other factor, if I may, which is that there have been quite positive developments in the labour market. As you know, more people are working than ever before and more people are working for longer. I recognise that a number of those people do not necessarily want to be working for longer but, because of past debts or changes in benefits, they need to stay in the labour force. That has changed the relative cost of capital and labour. All of that has led to some lower investment as well. Those are components of the productivity story but, if I added all those up, I would still be left with a residual. I would still be left with a circumstance, at least on measured figures, in which productivity has not picked up as much as we would have expected. Even with all the uncertainty, it has not picked up as much as we would have expected over the last year. I have some explanations, but I will still leave you with a smaller puzzle.

Q44 John Mann: This is my last question then. Of course, for people out there we have a fall in real wages. We have a fall in living standards. That seems to be worsening and is projected to be worsening, so people are going to be worse off. Do you not think that the Bank needs to be investing more of its expertise in looking at what has happened with the labour market, the nature of work, employment contracts, zero-hour contracts, the way in which the labour market has become so flexible and the relationship between that and productivity?

Dr Carney: We do invest and we will continue to invest, so you are absolutely on point, in understanding these potentially pretty sizeable changes in the labour market and the way the nature of work, platform work and the gig economy affect both wage determination in the economy and how, if I can use this term, there is the contestability from it. It is not just the flow of people into these jobs, but the possibility of shifts into these jobs, both here and abroad, and how that affects inflation dynamics in this economy. Related to that, we would look at productivity, because it matters for the path of supply in the economy. The next word we will have on that to bring it together from a monetary policy perspective will be in February. What we do, as I think you know, is an annual so-called supply stock take, which is to look at the nature of the labour market. We will do our best estimate of where the equilibrium levels are on that and where productivity is going, on a go-forward basis. Yes is the shorter answer.

Q45 Wes Streeting: I want to pick up some further questions on household debt. Briefly just returning to Brexit and the issue of transitional arrangements, it seems to me that the strong message comes through from financial services, which we have heard played out again this morning. Quarter 1 of next year is pretty critical, in terms of having some certainty then around transition, let alone what comes further down the track before potentially irreversible decisions are made.



HOUSE OF COMMONS

One of the challenges from our point of view is we can speak to individual firms about their contingency planning, but there are very few organisations and individuals who will have sight of contingency planning across financial services. You are one of those people, so what is your assessment, both in terms of the urgency of having a transitional deal, but also the cumulative impact on financial stability and the health of our economy, both in the short term but also over a five-to-seven-year period? One of the messages that we hear is that it is over a five-to-seven-year period that we will see a greater impact in terms of jobs and economic activity.

Dr Carney: I will try to bring those together. These are all the right questions. Consistent with the previous discussion, there is a limited amount that firms can do in a short period of time. The first thing is that it is incredibly important, in our judgment, that not too much is asked of them. In our view, it is not desirable to shift a host of complex sales trading derivative activities to the continent or to divide them up. We can go into detail on why we think that, but part of Mr Malthouse's questioning gets to some of the economics of that. It is not desirable, but there is also the feasibility of that shift in a short period of time, to Ms Ali's question. It is not really feasible and, if you try to do it too rapidly, mistakes will happen and things will be caught halfway. There will be financial stability consequences from that.

That is in part why, when people talk about the full impact in five to seven years, they are speculating on one thing and then being realistic about another. The speculation is the nature of the ultimate agreement, which I would not want to prejudge. If one assumes a relatively narrow agreement that forces a host of activities to be located on the continent—complex sales trading and wholesale-type activities located on the continent—to do it properly takes that sort of time horizon.

There are interim ways to address it, which require some degree of forbearance, for lack of a better word, by the recipient countries, where you would have a certain number of people, activities and legal changes in the continent, and then risk transferred back to London and managed in London through the London operations, so-called back-to-back transactions. That is not a sustainable end state, and so you get into that five-to-seven-year horizon, when more activity would be pulled forward. Again, I would like to think that the agreement that could be struck in mutual interest would not lead to that ultimate end state needing to happen.

When people talk about transition in the near term, if I can put it in those terms, and Q1, it is the initial transition of activities, the initial set-up of subsidiaries, the initial move of people and potentially the initial move of counterparty arrangements, as much as possible, to the continent. Even in its most limited sense, you need about 18 to 24 months to do that. Understanding the scale of that is needed by that horizon, which is where



HOUSE OF COMMONS

you get to Q1. If you do not need to do that all in a rush it would be in everybody's interest.

I would make the further point that anything more ambitious than a relatively limited shift of the front line—not the risk management, not the collateral, not the capital, not the models, but anything more ambitious than that—is very, very risky to do in that horizon. That is a risk that for the UK is an indirect risk. Risks in Europe matter for the UK, but it is a primary risk for Europe.

Wes Streeting: Presumably you would endorse the view that what we really need is some degree of continuity in the immediate period and then a period for adjustment to whatever the long-term future is.

Dr Carney: Yes, absolutely.

Q46 **Chair:** Can I just interrupt there to clarify something that you said earlier on? You talked about the MPC changing their forecasting assumptions on the type of deal, based on, I think you said, a material change of circumstances. The question to be asked is, if the market decided that one type of deal or one outcome was most likely for a sustained period of time, and people coalesced around one likely outcome, could that be classified as a material change of circumstances?

Dr Carney: I do not think the market alone makes that determination, no. We will have a view on whether there is a material change in circumstances, but markets can overshoot on euphoria and despair sometimes, including on issues like this. What matters is what agents think. Now, I will say this though. If there is a material difference in terms of the markets' optimism or pessimism around the end state, relative to the view of households and businesses in the UK, it makes the forecast more challenging. I do not think we take the lead from the market about judging what is an extremely complex negotiation, unprecedented in many respects, and the type of negotiation that is not over until it is over. Nothing is agreed until it is agreed. There are signposts along the way, moving from sufficient progress on phase 1, a transition deal and various things that would be material. For final agreement, I would not take the view of the market, nor would I take the view of the Bank of England. That is part of the reason why we do not express a view of what the final agreement is going to be, because we just do not know.

Q47 **Wes Streeting:** Back to household debt—the lure of Brexit is all-consuming. You have already picked up John Mann's picture of the overall situation on household debt and unsecured lending in particular. They are concerns that are reflected very broadly, and Andrew Bailey's remarks yesterday underpinned the degree of anxiety about this. When I asked the Economic Secretary to the Treasury, back in July, what the Government plan to do to tackle household debt, he replied, "It is an independent responsibility of the Bank of England", and when pressed further said, "There will always be frequent discussions with the Treasury,



but it is a Bank of England matter". The buck having been firmly passed to you, what is the Bank doing about it?

Dr Carney: What we have been doing about it is we have looked through the underwriting standards. We have looked through the scale of the risk and we have thought through the channels from a financial stability perspective, and obviously safety and soundness of individual institutions. The view of the FPC is expressed in its most recent record and, in co-ordination with the PRA, we have done the following.

Our judgment is this is a risk principally to the banks, the underwriters of this household debt, as opposed to a macroeconomic risk. Let me quantify that macroeconomic point. The first is that the change in household debt/consumer credit is contributing about 1.5% to consumption growth. It is very small relative to the growth in consumption. What UK households are doing is they are consuming out of income. More of them are working and they are consuming out of income. They are under a squeeze. Some of them are borrowing but, in aggregate, this is quite small from a macro perspective, which is why, from an MPC perspective, it is not the principal focus.

From an FPC perspective and a PRA perspective, it does matter. It matters because losses on consumer credit, if I can call it that, are much higher than losses on mortgages, historically. People here pay their mortgage come hell or high water, but defaults on household debt are much larger. If you look, for example, at our previous stress test, the losses on household debt in stress, even though household debt is about one eighth the size of mortgages, are about 60% higher than the losses on mortgages. That gives you a sense of magnitude.

We look at that and we say, "There have been improvements in the economic situation. There have been improvements in household balance sheets. There have been improvements in underwriting standards, but have they all been added up in the right way?" In our judgment, there has been too much credit given for those factors, risk weights have come down too much and the pricing has become too fine for the credit element of that. Through the PRA, we are going to make adjustments on an individual institution level to the amount of capital they need to hold against their consumer credit.

Some of that will come out more formally in the stress test results that come out at the end of November, but we have given an overall figure for this. We would expect, in stress, losses on consumer credit to be in the order of £30 billion, so it is significant. That translates into about 150 basis points of capital, 1.5% of capital on the concerned banks. To put that in context as well, we have taken this deeper dive. If you had asked me this question last year, I would have said £20 billion of losses. Two things have happened. One is there has been a bit of an increase in debt but, secondly, we have taken a much harder look at it and we think the standards have been a bit too optimistic.



HOUSE OF COMMONS

Q48 Wes Streeting: Do you think the FPC has acted as quickly as they should have done on this or do you think an earlier intervention would have been more beneficial?

Dr Carney: There are issues that the FCA is looking at about the suitability, whether it is overdrafts or other types of household debt. Mr Bailey has talked about those and it is actively looking into them, as you know. From a macro-financial perspective and from a prudential perspective, we are acting in a timely way. I would say this as well. It is quite targeted, because it is institution-by-institution adjustment. What we looked at but decided not to do was a general increase in capital levels for all institutions, because that would penalise those who either are not active in this area or have been. Some of the underwriting standards are quite tight, so we do not want to penalise people. We want to be more targeted and that is one of the advantages, in my view, of the structure we have. You can look at a macro issue, you can bring it down to the right level and then, ideally, you work in co-ordination.

Q49 Wes Streeting: In my opening question, I alluded to the fact that the Treasury clearly sees this as very much your responsibility to look at, but Andrew Bailey has said that the whole issue of consumer credit needs Government involvement. Do you agree with Mr Bailey and, if so, what kind of Government involvement would you like to see?

Dr Carney: I do not know. I will let Mr Bailey speak to that, if I may. From a prudential perspective, the Bank of England has the tools we need to address the issues around here. It is entirely right that you and your colleagues are questioning us on this, and we have to give an accountability. We have taken action and we could take more action if we needed to but, in my judgment, the action has been proportionate.

Q50 Wes Streeting: Can I just press you a bit further? It may be more of a cautionary note or is perhaps for further reassurance. In terms of the macroeconomic point that you mentioned earlier, we are now at a point where the total stock of consumer credit amounts to over £200 billion or 34% of household disposable income. Yesterday, we had a pretty bleak picture painted, particularly of younger people and the extent to which they are taking out unsustainable levels of unsecured debt, not for luxuries, which perhaps is why we have seen this boom in debt. You say it is a pretty limited contribution to overall growth. They are not spending on luxuries or items that might generate further growth, but on everyday expenditure. Are you comfortable with this level of unsecured debt? It may be an unfair characterisation of your earlier remarks, but it sounded to me that, from a wider macroeconomic point of view, you are fairly relaxed about levels of consumer debt.

Dr Carney: We are never relaxed about anything. You can presume varying levels of concern. It is our job to look for issues but, equally, we are rightly charged with taking a proportionate response. It certainly does not warrant a monetary policy response. It is not a determinant in terms of monetary policy. In our judgment, it merits a macro-financial,



HOUSE OF COMMONS

macro-prudential response, but that should be targeted to the firms and we can target it to those firms. We are taking action. What we are talking about is not immaterial and, for some firms and some banks, it will be material.

What the authorities, ourselves and the FCA need to be alert to is the possibility that growth of debt in non-bank actors picks up, particularly if you tighten standards over here. You really want to be concerned about that. Most of those are overseen by the FCA. Andrew Bailey, as CEO of the FCA, sits on the FPC. He sits on the PRA. He is very alive to these issues and very experienced. It is a pocket of risk. It needs a response. We have responded in a timely manner and to an appropriate degree.

We need to be alive to how this evolves, but I would finish with this. Consumer credit plays a role in this economy. It is appropriate for people to borrow. British households have, by and large, put themselves in a better position. They are going through a difficult time with negative real income growth. There is some smoothing that is appropriate to happen. People still buy houses and, alongside the house, they refurbish, or they refurbish their existing house, and they buy cars. It is appropriate, but we have to manage the risks around that, so they can have confidence that it is there.

Q51 Alison McGovern: Before I come to Help to Buy, you mentioned before, Governor, that monetary policy was taking most of the strain on stimulus. A yes or no answer will do here; should fiscal policy be taking more of the strain?

Dr Carney: We take fiscal policy as given. It is a decision of the Government, so it is not for us.

Alison McGovern: We assume fiscal policy.

Dr Carney: We take the policy as given. It is not for us to tell the Government how to run fiscal policy, any more than it is for the Government to tell us when to change interest rates or not.

Alison McGovern: That is an excellent economist's answer.

Dr Carney: If I may, Ms McGovern, it is the statutory remit of the Bank.

Alison McGovern: I was tempting you to have an opinion. That is all.

Dr Carney: I have an opinion; I am just not going to voice it.

Q52 Alison McGovern: We are not going to hear it today. Next, and again I hope it is a simple, straightforward answer, in your view, do we have a housing bubble?

Dr Carney: No, there are structural challenges in the housing market that are well known in this country, which are best summarised, at least the way I think about it, by saying that there are roughly twice as many people in this economy than there are in Canada. It is actually a slightly



HOUSE OF COMMONS

younger population in the UK than in Canada, and they build twice as many houses every year in Canada than they do in the UK. Now, it is obviously easier to get planning permission in the world's second-largest country by landmass, but there is a supply-demand element. Yes, the level of interest rates matters to prices but, ultimately, the challenges here are structural.

Q53 Alison McGovern: Given that the problem is supply, do you think Help to Buy has increased house prices?

Dr Carney: Help to Buy, in orders of magnitude, is a single percentage, about 5% of transactions in equity Help to Buy over the course of its life. There is some evidence that its structure, given that it is for new build, has encouraged the supply of those new builds but, on the margin, it has not been a big determinant of where house prices have gone.

Alison McGovern: You are saying that Help to Buy has not substantially increased supply, and supply is the central problem in the housing market.

Dr Carney: It has not had a multiplier effect on supply, no.

Q54 Alison McGovern: Have you mentioned that to the Chancellor of the Exchequer?

Dr Carney: What we have mentioned to his predecessor, publicly, is judgment about the other component of Help to Buy, which was the high-LTV mortgages. It happened that he had asked whether it had financial stability consequences. The FPC would have volunteered an opinion if it had financial stability consequences. Our judgment, in terms of orders of magnitude and the nature of people borrowing, was that it did not have financial stability consequences.

Q55 Alison McGovern: We obviously have a lot of potential risks in the economy, particularly associated with Brexit. Love it or loathe it, it certainly inputs uncertainty into the future picture and that could have an impact on house prices. Do you feel under any pressure to defend property prices in the UK?

Dr Carney: No.

Q56 Alison McGovern: Do you think that, because of the role of Help to Buy, particularly in relation to first-time buyers and the structure of the broader housing market, Help to Buy will become a permanent feature?

Dr Carney: I am not trying to avoid it; I do not have an opinion on the future path of housing policy. If I may, I do not see it as material to developments in the housing market. It is obviously material for the first-time buyers who have access to the scheme. It is important for some homebuilders, in terms of guaranteed demand for their product. It matters for them but, from an economy-wide perspective for the housing market, candidly, we have looked at it in the past, but it is not something that is of active interest to either the MPC or the FPC.



HOUSE OF COMMONS

Q57 Alison McGovern: It matters to individuals. The specific question that I have is: what does the world look like where those individuals who currently require Help to Buy to purchase a house do not need Help to Buy? Does this become permanent because we have no other policy tools to enable those individuals to purchase a property?

Dr Carney: I guess the way I would answer that is it depends on the structural evolution of the housing market. If there is a substantial change in the supply of housing, the need for assistance for first-time buyers will go down. That is the fundamental thing that would change. I would say as well that, in the end, this is well targeted because it is first-time buyers and new builds, so it brings its own supply. In general, buyer support policies ultimately just result in higher prices. You benefit early stage but, ultimately, prices will adjust, all other things being equal. Things like the other component of Help to Buy, encouraging high-LTV mortgages, in the end come off.

Q58 Alison McGovern: That is great, thank you. Just to switch now to QE, do you think we will see the withdrawal of QE while you are Governor? Will we see the unwinding of QE while you are Governor? Will it happen?

Dr Carney: I do not want to speculate. The MPC provided guidance in 2015, which is that we view bank rate as the marginal rate of policy. The first tightening would come through bank rate. All things being equal, it would be better to be in a position where we got bank rate up to a level where you could run through an average interest rate cycle. With the exception of the drop in interest rates post the financial crisis, in this country, it has been about 150 basis points on average since the advent of inflation targeting in 1993. That is partly because there is a lot of floating-rate debt in this economy, so it is quite interest-rate-sensitive, even with more fixed-rate mortgages. As you know, they roll off in a couple of years.

My first guess would be to have interest rates in that area where we could be in a position to drop them, 150 basis points. We have shown with the August 2016 rate cut that the effective lower bound on interest rates is a little lower than we thought it was at the time we said that. We maybe did not have to get quite as close to 2% at the time. There have been some developments. That is one development. Another prospective development is that the Fed is obviously going to engage in some quantitative tightening. In other words, they are not going to reinvest all the proceeds. Undoubtedly we will learn from that.

The last point I would add, and we have made this point publicly in recent weeks, is that UK financial markets, as we all know, are quite open. UK financial conditions are very influenced by foreign developments, particularly in the US. Over time, with the Fed's policy on QE, one would expect adjustments in the term premia in the US, so the steepening of the yield curve. We can expect that, ballpark, about 75% of that will spill over to the gilt curve and steepen the gilt curve. That is one of the learnings that we will have through this.



Q59 Alison McGovern: Briefly further on QE, it would be interesting to know what you think of negative side effects. Nick Macpherson's view is apparently that it is "like heroin". I am sure none of us is familiar with that personally, but it has increasing negative side effects over time. We always will need a bigger hit. Do you agree? Were you surprised by Nick Macpherson's view?

Dr Carney: I am aware of Nick Macpherson's view, the accounting officer of the Treasury who signed off on the APF. With respect to QE, our experience and our view have been, in general, that it is most effective in times of other dislocations in financial markets. The first round of QE was quite effective, both here, in the US and elsewhere. It probably had less of an effect, but still a material effect, in subsequent rounds. I am going to caveat that, because the QE with corporate bond package of 2016 had quite a sizeable effect on financial conditions in this country. It is always difficult to control for other factors in making those determinations, but it does have an impact on financial conditions. It does provide stimulus to the economy. In a perfect world, we would not be engaged in quantitative easing. In a perfect world, we would be using the bank rate as the instrument of monetary policy. The way for that to happen is for the economy to continue to grow, relative to its supply capacity, and for other factors to happen globally.

To go to the analogy, we are clean. We are not addicted to QE. We are not going to go through some withdrawal symptoms if the time comes and it is appropriate to gradually reduce asset sales, but we are not going to prove a point either. We are not going to do it just for fun. We provided clear guidance, in terms of the marginal instrument policy. We will learn and be transparent about those learnings from what the Fed does. Certainly in my view, bank rate will be the relevant instrument for some time to come.

Q60 Charlie Elphicke: Let us again stay away from Brexit and talk about the incredibly interesting and wide-ranging speech you gave a month ago, as the Camdessus central banking lecture. Just talk about labour markets and labour market trends. You said that "domestic vacancies filled by sourcing workers from abroad may have reduced the relative bargaining power and wage expectations of workers". "Overall, the greater global supply of labour has lowered the relative wages of lower-skilled workers in advanced economies". Is it fair to say that the high rates of migration we have had in the UK have had a dampening effect on pay growth?

Dr Carney: Yes, it is fair to say. The question though is orders of magnitude. I would distinguish our own modelling of this and our own understanding of it, and there is an extensive evidence base, not just the MPC's judgment. I would refer to Professor Steve Nickell's work and Jumana Saleheen of the Bank. If I can use this term, there is a general equilibrium effect here as well, because migrants into the UK work. They spend the bulk of their earnings here in the UK. That creates demand. That creates upward pressure on wages so, in aggregate, we see quite a modest direct downward impact of migration into the UK on wages.



If I make one point, what we cannot measure is what I would call the contestability element of this, so the possibility of bringing in more workers for a job and the extent to which that influences wage bargaining and overall wage levels. One of the questions, once we leave the European Union, is the government policy to control migratory flows and, therefore, all things being equal, reduce that contestability element. One could see more upward pressure as a consequence of that, but I cannot put a figure on it.

- Q61 **Charlie Elphicke:** That brings me to my next point, which is that you then say, "Abrupt decreases in migration", say leaving the European Union and restricting migration, "could result in shortages" and "contribute more materially to inflationary pressures", presumably because wages rise.

Dr Carney: That is right.

- Q62 **Charlie Elphicke:** Moving on to Brexit, in your speech you are very wide-ranging and thoughtful on Brexit. I am still talking about your speech, I hasten to add. We have heard a lot today about the risks of Brexit, but in your speech you are much more wide-ranging. What do you see as the opportunities of Brexit?

Dr Carney: I mentioned some opportunities of Brexit in the speech. In fact, I used the term stepping back in order to jump forward better. If I may explain that just for a moment, because it goes to monetary policy, one can be very optimistic or clear-eyed, depending on your adjective, about the future trade opportunities that come from Brexit. What is likely to happen, at least for a period, is losing access to elements of the European Union before gaining access to other markets. Even if those were simultaneous, so even if there was less access than we currently have to Europe and trade deals with the rest of the G20, for the sake of argument, were instantly struck, the economy is not oriented in that direction and it would take a period of time to reorient. Therefore, it would have a hit on the supply of the economy. That is one of the inflationary aspects, all things being equal.

I have partly answered the opportunity set, which is that Brexit obviously brings an opportunity to negotiate trade deals that would be exclusively focused on UK interests, with a range of other partners, with the United Kingdom choosing at least the time of engagement. Subject to the arrangements with the European Union, it brings an opportunity to look at a host of other aspects of the design of the economy that are consistent with the acquis, which might be adjusted to be more tailored to the nature of the UK economy. The last opportunity, which is a very large grab bag, is this is a seminal event. It is an opportunity to step back and think about the organisation of a host of aspects that go well beyond the relationship. If you are thinking about new trading relationships, you are thinking about new regulatory structures or adjustments to regulatory structures. It then follows naturally into other



HOUSE OF COMMONS

aspects of fiscal policy, labour market policy, education policy and beyond.

- Q63 **Charlie Elphicke:** In that case, can I ask you about the risk of what you might call opportunity lost? Do you see that there is a risk that we could agree a trade deal with the European Union that makes it harder for Britain to take those regulatory independence opportunities to do wider deals around the world? Is there a risk that we could actually end up with the worst of both worlds?

Dr Carney: The judgment that the Government and ultimately Parliament will have to take is the balance of those opportunities. Exports in goods and services to the EU are approaching 50% of UK exports. For certain tax-rich sectors, most notably the financial services sector, there is a substantial fee pool and tax take that comes from the European relationship. To look at that balance, there is a known market, for which this economy is oriented, and a known revenue stream that comes from that. One balances that against the probability of gaining access to other markets and the timeframe over which we would. You could term it that way, but part of the question is in terms of balancing those aspects. The bird in the hand is quite large though, if I could put it that way.

- Q64 **Charlie Elphicke:** Finally, as a matter of your own personal opinion, how do you think that Britain will be better off after Brexit?

Chair: That was not a leading question at all.

Dr Carney: I restrict my view on this issue to the impact on monetary and financial stability, so apply all my personal opinions and analysis to the issues touched on in the speech, in terms of the potential temporary inflationary consequences of the nature of leaving. That needs to be front of mind, depending on the nature. It is very much the financial stability risk that we touched on.

If I can make a broader point, there are specific financial stability issues. We have gone into them in some length, as we should. Then there is just the general question of what could be the short-term economic impact of leaving and what that would do to bank balance sheets and broader balance sheets in the financial sector. We have a responsibility, as the Bank of England, to make sure that those institutions are as resilient as possible and they can withstand even scenarios that we might think are relatively unlikely and certainly ill advised. The system has to be resilient in order to withstand those.

After the release of the stress test and the *Financial Stability Report* at the end of November, while we are not specifically stressing against Brexit, given the circumstances, it is entirely reasonable to ask how that looks relative to Brexit risk and what needs to be done in order to put the financial system in that resilient position, so that the United Kingdom can realise all the opportunities associated with leaving the European Union.



Charlie Elphicke: Can I ask a quick follow-up on household debt?

Chair: No, because I am afraid we have not got time now. We are nearly there. Alison has one very final quick question.

Q65 **Alison McGovern:** The answer is just a figure. What is your hourly gender pay gap at the Bank?

Dr Carney: I can tell you our gender pay gap. Just give me a second. As you know, this needs to be reported by the end of March. You may know this, but we intend to report next month. Fellow governors and I have been briefed on the analysis in preparation for that, a few weeks ago. The gender pay gap at the Bank on a median basis is 24%. On a mean basis, it is 21%. There is no pay gap on the basis of equal work for equal pay. What explains the gender pay gap at the Bank of England, which is an issue we have been addressing, is that there are a lot more men than there are women in senior positions.

Alison McGovern: Are there really?

Dr Carney: It is true. It took me about five minutes to figure that out when I came to the Bank. Three and a half years ago was our first strategic plan, as one Bank. The first pillar of that is diversity and we have steadily increased the number of women in senior positions, as detailed in our annual report, from 20 to 35. You still get to a position where there are more men. We are doing extensive things, including external recruiting, unconscious bias training, blind panels, promotion, moving away from recruiting just economists, recruiting from 40 universities as opposed to 10, as we used to do, and only taking 50% of intake as economists, as opposed to broader disciplines where women are much more prevalent.

If you start from a position of an almost exclusively white male institution and you want to move, you need a deliberate strategy of movement. We are in the middle of that, which leaves us in a position where, I would venture—because we are part of the Gadhia initiative, Women in Finance, which in fact was launched at the Bank—we will end up being middle of the pack for the financial services industry. We will be high relative to the broader public sector, certainly higher than the health service and the education sector. The Treasury can speak for itself; I do not know where it is. That is where we are.

Chair: Thank you. As you know, we are going to be doing an inquiry into women in finance. Governor, can I thank you very much indeed? As you say, I think you are back before us on the *Financial Stability Report* before the end of the year. Before that, we are looking forward to seeing some of the external members of the MPC on the inflation report. Thank you for your time today.