Examination of Witnesses (Questions 1-82)

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Mr Mervyn King, Mr Paul Tucker, Mr Paul Fisher, Dr Adam Posen and Dr Andrew Sentance

24 November 2009

Q1 Chairman: Governor, we welcome you and your colleagues to the Committee's inquiry into the November inflation report. Perhaps you would introduce yourselves for the shorthand writer.

Mr King: On my right is Mr Paul Fisher, executive director for markets; on his right is Dr Andrew Sentance, one of the external members of the MPC; on my left is Mr Paul Tucker, deputy governor for financial stability; and on his left is Dr Adam Posen, again one of the external members of the MPC.

Q2 Chairman: You have an opening statement to make.

Mr King: I do. When we appeared before you a year ago I described how a remarkable set of events had transformed the outlook for the UK and global economies. At that time in the wake of the financial crisis output was plummeting and inflation was beginning to fall from its peak of 5.2%. A year on, the sharp falls in output appear to have come to an end and we are encouraged by signs that a recovery will soon be under way, but the recession means that the level of spending is now markedly lower than it was in the first half of 2008 and, looking ahead, the economy continues to face profound challenges. That lower level of spending has opened up a significant margin of spare capacity in the economy which is evident both in surveys of companies reporting that they are working below capacity and in the labour market. Unemployment although relatively stable over the past few months is now close to 8%, markedly higher than the levels to which we had grown accustomed. That margin of spare capacity will act to pull down on inflation in the medium term. Notwithstanding this effect, inflation is likely to rise sharply in the coming months from its current level of 1.5% to above the target, reflecting an increase in petrol price inflation and the prospective reversal of last year's cut in VAT. But these are price level effects. It is not sensible for monetary policy to respond to those types of effect as they will influence measured inflation for only a year when policy does not have much traction on inflation over such a short time horizon. In the medium term when policy has its most significant impact it is the level of money spending relative to the supply capacity of the economy that determines inflation. Powerful forces continue to restrain spending in the economy. Banks are actively trying to reduce their leverage. There is a long way to go in that process and while it continues the availability of credit to households and companies will be impaired. That combined with uncertainty about future incomes and profits will make households and companies reluctant to spend. The need for a credible plan to consolidate the public finances is clear to everyone and will mean that a lower share of national income is devoted to consumption—either private or public—in the future. Although there are encouraging signs of a recovery overseas the level of world demand and hence demand for our exports is well
below its level before the crisis. These forces will act to restrain spending for a considerable period. It is to counteract those forces that the MPC has taken unprecedented monetary policy actions over the past year. Bank rate is almost at zero and the MPC has now extended its programme of asset purchases to £200bn. That programme is injecting additional money directly into the economy. Investors are using some of this money to diversify into assets that have a higher return and that in turn boosts the prices of those assets, reduces yields and the cost to companies of raising funds in financial markets. Ultimately, that will help to restore the level of spending to a path consistent with eliminating spare capacity and ensure that the Bank of England can consider it has got a little way into the medium term. The events of the past three years show that financial markets and the bank’s responses have been extraordinary. I have sent a letter to the Committee to explain more fully one aspect of the bank’s operations that was prompted by those events: lending facilities that we put in place at the height of the crisis for two individual institutions that we are now able to disclose. Having experienced the wider economic consequences of the financial crisis it is right that households and companies expect fundamental reform of the structure and regulation of the banking system. As part of that process of fundamental reform of the banking system, the Bank of England published a discussion paper setting out its initial views on how so-called macroprudential policy might be designed. We hope this will spur a debate and bring us closer to the point at which we can implement lasting and effective reform. I am grateful for the opportunity to make those opening remarks and I and other members of the Monetary Policy Committee here today stand ready to answer your questions.

Q3 Chairman: A number of commentators have commented on the bank’s optimistic growth figures for 2010 and 2011 and said that when you announced your inflation report your comments seemed to be at odds with the MPC’s written proposals, in that you seemed to be more downbeat. What is the situation?

Mr King: I think they are completely consistent. This is a point where we need to look not just at growth rates but also levels of output and spending. That is why on pages 6 and 7 of the report you see charts that show exactly the same outlook, one representing the growth rate of GDP over the forecast horizon and the other showing the level of output. In terms of growth the most likely outcome is for rates above the long run average growth rate of the economy. Taking into account the downside risks, the average growth rate for calendar year 2010 in chart 1 on page 6 of the inflation report is around 1.5 percent and for 2011 it is around three percent. Therefore, over those two years the average growth rate expected by the committee is slightly lower than the long-run average growth rate of the economy. Given that we have been in a period when there is a great deal of spare capacity from which the economy can recover and expand without putting any upward pressure on inflation that is not a particularly strong recovery. That is shown very vividly in chart 2 which indicates the level of GDP. That shows that for the foreseeable future the level of total GDP is well below—that is, about 10%—the level we would have expected it to reach had we continued to grow along the trend before the crisis hit in 2007. In terms of the experiences of businesses and households and what is happening to companies in the labour market the chart will illustrate the experience that we expect. One should expect fairly buoyant growth rates in the short run having come back from such a deep recession. I do not believe there is any inconsistency between the two. Charts 1 and 2 represent exactly the same outlook for the economy but from different angles. I think it is important for people to think in terms of levels, not just growth rates.

Q4 Chairman: You have always said that. Thank you for the information on the two banks, the RBS and HBOS. You said that the Bank of England extended emergency liquidity assistance to these two institutions. We note that you have afforded them £61.6bn. When I and my colleagues received this note we had a little intake of breath and thought about how many universities, colleagues and jobs could be supported with that money. It lends credence to the view that we need to fix this situation; otherwise, we will go back to what we had before and accept the status quo. Can you tell us whether all those moneys have been repaid to the bank? Given the view of Professor Miles that the banks are still on life support, for what are they dependent on you at the moment?

Mr King: As I sent in the letter I sent to you, the loans to RBS and HBOS extended in October 2008 were fully repaid, one in December 2008 and the other in January 2009. Those loans were short-term liquidity support of a "conventional lender of last resort" kind that the central bank is there to provide. It bridged to the recapitalisation of the banks that took place in October and again in January, but those liquidity facilities were fully repaid no later than January 2009.

Q5 Chairman: At the moment for what are they dependent upon you?

Mr King: Obviously, we will not comment on individual banks, but the total scale of dependency of the banking sector on the public sector through access to central bank facilities, the special liquidity scheme and the credit guarantee scheme is enormous and runs into many hundreds of billions of pounds. There is still dependence by the banking sector on the public sector for funding.

Q6 Chairman: You recognise that the banks need to restructure their balance sheets and tighter capital controls are required. However, you also recognise that lending will drive a private sector-led recovery. Would you prefer banks to lend more or repair their balance sheets while we have a private sector-led recovery?

Mr King: It is not for me to say what banks should do and it is quite clear that the incentives presented to banks at present are to run down the extent of their leverage and get their balance sheets back into order. That is what drives the restrictive supply of credit that we see not just in the United Kingdom but also in other countries. That is the overwhelming driving force behind the movement of credit at present; it is depressed by the actions of banks in trying to restore their balance sheets.

Q7 Chairman: Dr Posen, you made an interesting speech a couple of weeks ago in which you said that the UK lacked a spare tyre for lending to non-financial companies. I was at a CBI conference yesterday where I was told that apart from financial institutions 50% of lending went to commercial real estate and 5% to manufacturing. We really need to do something to have a channel there. What is your advice to us?

Dr Posen: I am glad to have the opportunity to respond to you on that, but clearly I do not speak for the bank but for myself. There are many ways to skin this cat. Part of it is to try to build up in a structural sense the ability of small and medium enterprises to access capital markets. Large British firms can but the bond market, as I cited in the speech which you kindly mention, is very underdeveloped as a share of GDP. Apparatus and encouragement can be provided. Government lending facilities can be put in place. There has been some discussion in the past about whether these have been effective. I admit they are not my first choice. There are efforts to use moral suasion on the banks currently in public ownership; there is restructuring of the banking system to create more competition; there is the use of moral suasion on banks such as foreign banks that used to lend in the UK but understandably, like everyone else in the world, have returned to their home markets in the past year. They can be encouraged to come back. There are also efforts to try to broker deals with the existing banking system to try not directly to mediate loans but make it easier for small businesses to make applications and get them properly processed. There are a number of things that this Committee and Parliament can consider which essentially come back to two sets of eminent consider were are those things you can do in the very short term to try to facilitate lending, because we know that small and medium enterprises are hit worse during a recession. I am worried that right now they are being particularly badly hit. Second, one can think about the structure of the banking and financial system in the UK over the longer term given that manufacturing and domestic non-financial companies are not as well served as they should have been.

Q8 Chairman: Is it right that we need three or four years to think about restructuring the financial architecture?

Mr King: Yes. I share Dr Posen’s view that the most optimistic outlook here is the longer and not shorter term. I do not think it is easy to come up with remedies in the short term, but in the long term to have a more diversified pattern of funding the corporate sector would be an attractive route to go down. That is often easier said than done, but it is worth exploring to find out because we have seen how susceptible the small and medium enterprise sector has been to problems that none of us anticipated would occur on this scale in the banking sector.

Q9 Chairman: It appears that you and John Kay are in the minority regarding separating retail banks from more risky activities. Bankers tell us that this will lead to the mortgage market being controlled by a cartel. Previously, Lord Turner said—he has expanded on his views—that it could outlaw perfectly acceptable business activity. Have you been persuaded by the arguments of the bankers on this?

Mr King: No. I think the debate has moved on. The most important point I made was that if we are to think of restructuring the banking sector in the future it does not really matter if we think that what banks do is socially useless or useful; it does not matter whether banks are doing
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Q10 Chairman: That is a core issue. You referred to a wider debate. This Committee visited Japan in October 2007 and had access to the central bank and policymakers. They had a number of issues and the one that should not be recapitalisation, which we have done; the other was public anger and resentment and there had to be a strategy to deal with it. Do you believe there is a need for a more civic engagement to understand what the future of the banking system is, what its purpose is and how it best serves the economy?

Mr King: Whether it is called “civil” or “political” I leave to you, but there must be wider involvement. What strikes me most forcefully as I travel round the country is that for a generation people adopted the view that market discipline was the best route to prosperity. They accepted that if their companies could not find customers they would fail and that if they worked for such companies they would lose their jobs and perhaps they would have to get other jobs perhaps on less attractive terms elsewhere in the economy. That applied to every part of the economy until the bail-out of the financial sector. That is wholly unacceptable not only from an economic point of view; it will simply undermine people’s confidence and the moments of the great achievements of the market economy. One of the reasons there is greater prosperity not just to the citizens of this country but also billions of people around the world who have been dragged out of poverty. We must not lose sight of the merits of a market economy but we must apply its discipline to the banking sector. That is why I place so much weight on dealing with the issue of “too important to fail”.

Q11 Chairman: The Committee is very much taken with that. The concept of “too big to fail” and macroprudential tools are the two big issues in your report. You have said that a credible path to the reduction of government debt is necessary. What is your view of the ideal of debt reduction given the current conjecture? For example, is it better to reduce debt in three years rather than six?

Mr King: It is difficult to say what that number is; it needs to be contingent on the state of the economy and no one can be precisely sure. But it needs a credible plan over the lifetime of a parliament to bring down very significantly the deficit contingent on the state of the economy. It must depend upon that, but it must be a plan of action that would explain what would be done in order to achieve that objective.

Q12 Mr Plaskitt: On page 43 of your report you talk about some permanent changes in the outlook for government revenues as a result of the recession. For example, you talk about the path of lower output and refer to lower tax revenues from particular sectors of the economy. I assume that the path of the financial sector. Would you expand on the extent of the permanent changes you see and the scale of the impact on the outlook for government revenues?

Mr King: I think it is implied by chart 2 which shows the level of GDP. You can see that for quite a long period that is expected to be well below the level we might reasonably have expected had the economy not hit the financial crisis in 2007-08. That is a pretty large figure of anywhere between 5% and 10%. On top of that is the fact that those sectors that generated significant revenues in the UK, particularly the financial sector, and other transactions taxes could not credibly continue to generate such large taxes; it was likely to be the case that the turnover in the housing market, for example, would fall back to more normal levels at a certain point and that the rate of increase of profits in the financial sector would not continue indefinitely. Obviously, that turned out to be true. Therefore, there are effects from both the impact of the crisis on particular sectors that contributed heavily to revenues and the impact on the total level of GDP. That means the amount of revenue will not be of the order it would have been reasonable to expect.

Q13 Mr Plaskitt: You are saying that even if there is a return to overall GDP growth somewhere along the track that you project in this report it will not have the same revenue buoyancy effect as growth has in the past?

Mr King: Certainly, the level of revenue for the next five to 10 years is likely to be well below that which would have expected in the middle of 2007 when we were unaware that the financial crisis was about to hit.

Q14 Mr Plaskitt: Given what you said in your opening statement about the need for a credible plan to consolidate the public finances, what are the ingredients of that credibility? What boxes must be ticked for you to believe that the plan is credible?

Mr King: There must be elimination in large part of the structural deficit over, say, the lifetime of a parliament which is the period for which a government is elected. Anything beyond that is a statement of intent or hope rather than a plan to which someone can be held accountable, but it will depend on the recovery of the economy. If the world economy fell back and we found ourselves in another period of downturn it would not be sensible to expect the deficit to be eliminated that quickly. The path must be dependent on the state of the economy. Nevertheless, it must be capable of being implemented over a period for which an administration can be held accountable.

Q15 Mr Plaskitt: Is it sensible to argue that if government tries to consolidate the public finances too aggressively it may be counterproductive in terms of support for the economy and may help to trigger a second dip?

Mr King: It is certainly true that if you eliminate the deficit too aggressively it will have an adverse consequence. It is equally true that if you implement it insufficiently aggressively it will also have an adverse consequence. As to the debate about whether we should remove the stimulus too soon or too late we should do it at the right time. That makes clear that it must be a credible plan based on actions so people can see what would be done in order to bring about the reduction in the deficit, but it needs to be contingent on the state of the economy.

Q16 Mr Plaskitt: Does that qualification make it really difficult to determine whether or not it is credible? You keep saying that it is contingent on the state of the economy, which is an obvious factor, but as it is not known you really cannot plan for it?
Mr King: To set out exactly what would be done each year for the next five or six years is an extremely difficult thing to do, but contingent upon a particular central path of the economy you can say that if that path did emerge you could expect to achieve a certain scale of fiscal consolidation and set out the actions to take to bring that about. It can be done but it is important to recognise that subtlety in saying that the precise timing of measures should depend on the state of the economy. Equally, the plan needs to be credible, not just a broad-based statement of intent.

Q17 Mr Plaskitt: Do you believe that at the moment there is any risk to the UK’s credit rating as a result of the public finances?

Mr King: I do not believe there is any immediate risk, but the longer there is not a credible plan that sets out what actions will be taken the more that is a risk. I do not believe there is any impediment to the UK putting in place a credible plan which will convince financial markets. The risks arise more from possible concerns in financial markets that might arise if other countries got into serious fiscal difficulty and it created a more generalised concern about fiscal deficits around the world. That includes the United States which also has a large deficit. I do not believe this is a UK-specific issue. It is true that our deficit is large but by putting in place a credible plan and following it through it is quite possible over a period of time to bring down that deficit and it is important that we are seen to do that.

Q18 Mr Plaskitt: Is it more important to watch the rate of reduction of the deficit than its absolute level?

Mr King: I think it is both. You have to take action to bring down the deficit of the size we have—it is a very large structural deficit—but to do so at a rate that is consistent with the restoration of growth in the economy.

Q19 Mr Fallon: The permanent secretary to the treasury told this Committee a fortnight ago that quantitative easing was a journey into the unknown and we did not understand every aspect of it. At its last meeting the MPC split three ways: some wanted to extend the programme by £40bn, others by £25bn and others to leave it unchanged. Do you really know what you are doing?

Mr King: Yes. I do not accept that this is a journey into the unknown. There are uncertainties but there always are in monetary policy. We have had three-way splits before when dealing with the level of bank rate. You can certainly say there are different views about the likely future path of the economy. We have the Monetary Policy Committee precisely because no one person has a monopoly of wisdom and it is a good idea to try to aggregate together the views and judgments of a diverse range of individuals. It is not surprising that when one is at a turning point in the economy there are different judgments about what are after all relatively small differences. No one advocated that we immediately launch and sell back the assets. The range of views about the additional asset purchases was between zero and £40bn.

Q20 Mr Fallon: The sum of £25bn represents quite a difference. At your press conference you described worrying about asset prices as “peculiar”. Can you elucidate?

Mr King: In present circumstances what I worry about is that it has become very fashionable to think of almost any upward movement in any asset price as a bubble and any downward movement as the bursting of the bubble. I do not believe that is particularly helpful. It is not surprising that there have been sharp movements in asset prices over the past six to nine months. At the beginning of the year we had experienced two quarters when the world economy, in the words people around the world have used, fell off a cliff. This was true not just of one economy but every economy. This was wholly unprecedented. World trade was falling at a rate even faster than during the great depression and there was enormous concern and uncertainty about what that might mean. Since then those falls in output have come to an end and many countries start to see positive growth rates; all countries have seen the end of those sharp falls in output. Because asset prices are forward looking I would have expected them to respond to that by sharp upwards movements, and they did. In addition the whole purpose of our asset purchases was to try to raise asset prices, so I believe it is not surprising we have seen an increase in asset prices. Of course if we maintained our policy and bought assets month in month out indefinitely we would end up injecting so much money into the economy that we would generate much higher asset price inflation but consumer price inflation and fail to meet our target. We take the target very seriously. There are differences of view and judgment on the committee, but it is there openly to express those differences about the precise scale of what we need to do, but everyone is committed to ensuring that the path we follow for asset purchases and bank rate is one that is consistent with meeting the inflation target.

Q21 Mr Fallon: Dr Posen, when quantitative easing was first authorised you were told by the treasury that you should spend up to £50bn on private sector assets. You have spent only £2bn on such assets and all the rest has gone on gilts. Should you not all along have been buying a wider range of assets?

Dr Posen: One hopes the question is moot because we are coming to the end of a large-scale quantitative easing exercise. There are clear advantages and disadvantages in buying gilts or private assets. If we have done enough and the forecast as we have it in the inflation report, as the governor described, comes out the way we hope then what we should or should not have done in the past is irrelevant; we will have moved the economy enough to have made things happen. There is genuine uncertainty about the impact of quantitative easing. As my colleague Dr Sentance said in his written report to you today, the impacts of quantitative easing are however highly uncertain particularly given that the operation of the banking system is impaired by the financial crisis. The MPC’s forecast is based on the assumption that quantitative easing is highly effective and its effects are lasting in the same way that a cut in bank rate would be. I believe that is the right guess but we do not have the evidence to try to aggregate together the views and judgments of a diverse range of individuals. It is not surprising that when one is at a turning point in the economy there are different judgments about what are after all relatively small differences. No one advocated that we immediately launch and sell back the assets. The range of views about the additional asset purchases was between zero and £40bn.

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Q23 Mr Fallon: Do you want to eliminate what you cannot wholly measure? How much of the GDP we have lost since 2007 will we not recover?

Mr King: That is very hard to judge, but the figures of the IMF and those on which our report is based suggest that for some considerable period—the indefinite future—somewhere between 5% and 10% of output will be lost relative to where we might reasonably have expected it to be had we continued along the growth path we had been on for many years.

Q24 Mr Fallon: Lost for ever?

Mr King: Lost for an indefinite period. I suspect that eventually we will claw it back and return to that level, but it will take many years, so for a considerable period there will be output well below the level that we would otherwise have attained. That is the magnitude of the cost of a financial crisis of the kind we have experienced and why it is worth putting a great deal of effort into designing an appropriate structure and regulatory framework for the financial system to avoid getting into this set of problems again.

https://publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/34/09112402.htm
Q25 Mr Love: How do you see the effects differing between reversing quantitative easing and increasing rates?

Mr King: Do you mean increasing bank rate versus selling the assets we have purchased?

Q26 Mr Brady: Yes.

Mr King: I do not think there is an enormous difference. Both of them are designed to subtract money from the economy and they have similar types of transmission mechanism, in that the effects spill over to many other asset markets. That will reduce asset prices and raise yields, making it more expensive to obtain finance. Therefore, it will tighten monetary policy. They are very similar. We would want to co-ordinate with the Debt Management Office so as not to get in the way of the auctions that it holds. When it comes to asset purchases and bank rate the committee will simply make its decision, but it will have to look at both of those and decide where it feels most confident in making the initial adjustments. That is something we will do when we get there, but certainly over a period of two to three years we would engage in both forms of action.

Q27 Mr Brady: You say that the transmission mechanisms are similar. Would you expect one to have a more immediate effect than the other?

Mr King: No. To go back to what Dr Posen said, one of the problems at present in using either asset purchases or bank rate is that the transmission mechanism has been impaired because of the way the banking sector is de-leveraging. That has made our life more difficult in terms of both dampening the potency of monetary policy but also creating a degree of uncertainty about it. I do not believe that is specific to asset purchases. That is true also of changes in bank rate. These are things we shall have to face as changes when we feel the time is right to make that judgment, but I do not think there is any technical impediment to our engaging in what many call an exit strategy. We know what we would do; it is technically straightforward. The difficult judgment which is far and away the overwhelming problem is to know precisely when and by how much to do it. The timing of that decision is very difficult and it is something we will look at carefully month by month.

Q28 Mr Brady: Given that you do not see any real difference between the two mechanisms, it would be reasonable to assume that the two would begin broadly at the same time?

Mr King: They might or might not. It may be easier to explain the movement of one instrument rather than the other. I do not think there is anything terribly significant about moving one rather than another. I am sure that over a period of two to three years we will operate both but whether we want to do both at each time we make a change is something to be seen.

Q29 Mr Brady: Dr Posen, I want to return to the question of the split between the assets that have been purchased. Would it have made a difference to the exit strategy had different assets been purchased?

Dr Posen: That is a very fair question. This is the place where one is lucky if one did not buy private sector assets. Our counterparts in the Federal Reserve, for example, have a very large portfolio of private sector assets to offload. When it has to withdraw and unwind that position it has a lot of market distortions and risk. As to selling it to the gilt markets, our colleagues Mr Fisher and Mr Tucker have the technical task of figuring out with the Debt Management Office how best to do it, but when you are selling it to the deepest and most liquid and transparent market in the United Kingdom, and in the world, you do not have all these extra headaches as well as balance sheet risk you would have if you had bought lots of private sector assets. That is not to say that that was a priori the right choice, but now we are at this point we definitely reap the advantages of having on the bank's balance sheet only or primarily gilts.

Q30 Mr Love: Is there any sign that the rebalancing of the UK economy towards net exports is taking place?

Mr King: There are some signs. Indeed, the company visits we make and the people to whom I speak suggest that those involved in either exporting or competing with import industries have found that the conditions in which they operate, although difficult because of the collapse in world demand and trade, are better than they might have feared. In part the fall in the Sterling exchange rate is helping from that point of view, but there is a long way to go.

Q31 Mr Love: But has there not been a surprisingly slow fall in imports considering the large depreciation of sterling and the recession? Similarly, as far as exports are concerned we see a global economic recovery. There has been a significant depreciation but again our export performance does not appear to have improved to match that.

Mr King: The point that really troubles me is the speed at which the imbalances in the world economy are likely to adjust.

Q32 Mr Love: It will be slower?

Mr King: We have a short-run reduction in the imbalances because of the world depression, but as the level of output in the world starts to expand again my concern is that those imbalances will simply re-emerge and as before we will be on one side of them again. This is a major problem facing the world economy. We should put at the top of the agenda two major difficulties: one is the structure of the banking sector and its regulation—the "too important to fail" issue—and the other is the world imbalances and the need for a world monetary system that prevents these imbalances emerging. If we go back to where we have doubt that as those imbalances gather large again the pressure for protectionism will build up to an almost irresistible level because there will be nowhere to go; it will be the only policy solution that seems to be left, which would be a tragedy. The G20 are now committed to a framework in which they will challenge each other and talk about the frameworks of their macroeconomic policy. We discussed this at St Andrews two or three weeks ago. This is a big step forward. People recognise the problem—perhaps it was not fully recognised before—but the proof of the pudding will be in the eating. The real test over the next year or so will be whether the G20 are willing to confront the question of what mechanisms can be put in place to prevent the build-up of imbalances on the scale we witnessed because that was one of the major contributory factors of the problems we have experienced.

Q33 Mr Love: That is a very interesting question which I am sure someone else will pursue, but I want to stick to demand in the UK economy. I want to press you about the outlook for business investment considering the uncertainties you have talked about in relation to access to finance and demand in the economy. Will we see a recovery in business investment, and what will be the long-term impact if we do not?

Mr King: I am sure we will see a recovery at some point.

Q34 Mr Love: But again it will be slow?

Mr King: Business investment is volatile and has fallen sharply. We have been surprised and concerned about the pace at which business investment has fallen; it is sharper than anything we have seen in the post-war period, and in part it reflects the adverse impact on the supply of credit of problems in the banking sector. At some point you will see that reversed and there will be a pick-up in business investment, but there is a long way to go. If you look at certain components of investment commercial property prices are 45% below their peak. That certainly puts the movement in house prices into perspective. There are small signs. We have seen a couple of small pick-ups in commercial property prices and maybe this is the turning point, but you can see why it will be difficult for people to be confident to invest in projects like that; and it will be just as difficult, if not very difficult, to persuade banks to lend on that when they will still be realising large losses over the next couple of years on past investments in commercial property.

Q35 Mr Love: I move to consumption. We have seen a shift back towards savings. There is great uncertainty out there in relation to these issues. We talk about debt consolidation. What are the prospects for a recovery in consumption over the coming period? Will that come to our rescue?

Mr King: I do not think we should keep looking at consumption to rescue us. We did so in the past. I do not think consumption got to an unsustainable level from which it must fall back, but savings ratios are likely to be higher in future as part of the rebalancing of the UK economy.
discussed two pricing options: an ex ante fee or a premium interest rate. What are the pros and cons of those?

Mr King: If private demand remains extremely weak we shall have to maintain a substantial degree of monetary stimulus, but I do not want to anticipate that. The great virtue of our inflation target is that we, you and everyone else know the framework in which we are operating which is that, if we can, we want a broad balance between demand and supply in the economy to keep inflation close to our 2% target. In our last report our judgment was that inflation would rise in the short run, not because it has been pushed up by asset purchases or quantitative easing but because of the bounce back in VAT and some non-essential turn-round in petrol price inflation, but once those effects have come through at the beginning of next year we will expect the margin of spare capacity to bear down on inflation again. That was why we felt the most likely outcome for inflation for much of the next two to three years, once we got through the short-term impact of petrol and VAT increases, was that it would be below the target. That is why we have maintained the stimulus. There will come a point when we feel private sector demand is recovering sufficiently rapidly that we need to withdraw the stimulus and at that point we shall withdraw it. We will explain that in the report to you. We may get it right; we may get it wrong, but I believe the framework is pretty clear.

Q38 John Thurso: I turn to the question put by the Chairman about narrow banking. I was much taken with your speech in Edinburgh. You discussed the differences between John Kay and Paul Volcker and said that the common element was the aim to restrict government guarantees to utility banking. I take you to the other end of the spectrum which is the merchant investing banking side. You also said that the sheer creative imagination of the financial sector to think up new ways of taking risk would in the end force us to confront the "too important to fail" question. Is it not a fact that in addition to protecting utility banking we need to liberate the investment merchant banking side and realign the risk it takes with its ownership so it is not protected by the utility banks?

Mr King: Absolutely, and that was very much what I meant by that statement. One of the big mistakes we could make in the regulatory debate is fail to lay down measures that prevent banks taking too much risk. There is no way we will be able to guarantee that. If the managers of banks make mistakes from time to time, as they will, and take on too much risk which will be the benefit of hindsight goes wrong the rules of the market economy are that the institution is allowed to fail. People need to know that in advance when they are providing capital to that bank either as equity or in the form of loans. They will then have an incentive to monitor the risks that the bank is taking. If the bank is felt to have an implicit guarantee from elsewhere there is no incentive for people who supply the money to monitor the risks and those risks will expand. It may be said that a regulator can say something is too risky and stop it. With the best will in the world, if regulators are that clever why not let them run the banks? By definition, it is a way of saying that they must be better at running risks than the present incumbents. That cannot be true in the real world. People make mistakes; risks will be taken and things will go wrong. The important thing is to allow the institutions that have taken those risks and the people who have supplied the money to those institutions to lose; that is what a market economy means. We do not want that to happen to retail depositors up to a certain level and that is why we need to protect those activities and give guarantees because that is part of the utility aspect of banking we want to protect. I believe that that needs to be ring-fenced from other kinds of banking.

Q39 John Thurso: Where does that leave the FSA's intensive supervision?

Mr King: In itself I do not think it is a direct comment on it, or certainly it is not meant to be. It is a statement that supervision should try to lay down rather simple, clear and robust rules which you want banks to follow to prevent them doing things that are not in the public interest. We care extremely about the utility side of the market about the risks that people are taking elsewhere. In other parts of it it does not make sense to believe that by having a sufficiently intensive regime of regulation we will stop banks making mistakes. That is not true of any industry. The real value of John Kay's contribution is to ask: why not try to learn from the regulation of other industries? In other industries we have said we have an absolute care about the continuity of service. It is important to have continuity of service in networks, whether it is energy or telecommunication networks, just as it is in the payment system, but that does not mean continuity in terms of the individual provider. The provider may fail and disappear but the service continues. We have to devise a form of regulation that is robust with respect to the mistakes people will make. There is no reason why people should not be allowed to make mistakes. One of the most interesting aspects is that two years ago many of our colleagues in Europe talked about the dangers posed by hedge funds. We are about to talk about whether 12 months, Why? Because over 2,000 hedge funds have failed during this crisis. Some did well; many failed. The great virtue of hedge funds is that they can fail without the government feeling it must step in to protect them. If people want to take risks let them take them but not in a way that will involve the government feeling it must step in to bail them out.

Q40 John Thurso: To pick up that point and return to the merchant investment banking end, most of these started off as partnerships where there was an obvious link between high risk and high reward. Would it not be helpful to see a return to that model? Has not incorporation smudged the risk?

Mr King: It is well worth debating. The application of the principle of limited liability to institutions that have borrowed a lot of money from elsewhere and then engaged in risky transactions has undoubtedly made this problem much worse. If you talk to people who work in the most highly regarded investment banks given their ability to control risk they will say openly that one of the reasons they feel they can do that is that over many years a culture of risk management has grown up because they are a partnership and they are managing each other's money. That is a pretty powerful incentive to ensure you do not run excessive risks. It does not prevent you making mistakes and it is still important to ensure that if people do so they understand that market discipline applies to finance just as it does to any manufacturing industry.

Q41 John Thurso: How concerned are you that the banks are going back to business as usual regarding leveraging up because of the supply of relatively low-cost money? There has been a tremendous rebound in the debt derivatives market. What you are really saying is that we should not adopt ideological positions about what to do with stimulus measures or the fiscal deficit but look at how the economy is tracking and take decisions based on the best estimates of where we are going?

Mr King: The Monetary Policy Committee has never been ideological. We hope it never withdraws stimulus too soon or too late. It tries to do it at the right time but these are difficult judgments and we are bound to make mistakes. But the great virtue of our inflation target is that we, you and everyone else know the framework in which we are operating which is that, if we can, we want a broad balance between demand and supply in the economy to keep inflation close to our 2% target. In our last report our judgment was that inflation would rise in the short run, not because it has been pushed up by asset purchases or quantitative easing but because of the bounce back in VAT and some non-essential turn-round in petrol price inflation, but once those effects have come through at the beginning of next year we will expect the margin of spare capacity to bear down on inflation again. That was why we felt the most likely outcome for inflation for much of the next two to three years, once we got through the short-term impact of petrol and VAT increases, was that it would be below the target. That is why we have maintained the stimulus. There will come a point when we feel private sector demand is recovering sufficiently rapidly that we need to withdraw the stimulus and at that point we shall withdraw it. We will explain that in the report to you. We may get it right; we may get it wrong, but I believe the framework is pretty clear.
Mr Tucker: The approach we have adopted so far is to charge a premium rate at the point at which the bank draws on the liquidity insurance facility. The advantage of that is you can make a judgment at the time about whether or not you will permit an institution to draw on the facility, on whether it has fundamental problems of solvency and viability, whereas if it pays a commitment fee upfront through an annual premium it will be harder to say no at that point. That is quite an important distinction. The ex post approach we have adopted is much easier to tailor to the amount it borrows from us, the type of collateral and the particular circumstances. I think that is the best approach for now, but I would not want to rule out switching the approach over the next 10 to 20 years. That was why I said I thought that was something for our community to debate. I do not think that it is a great priority just now.

Q43 Chairman: On the question of narrow banking, you gave a speech at Barclays whish the press interpreted as being different from the view of the governor. What is your view of this issue, in particular the “too big to fall” aspect?

Mr Tucker: I said in that speech and in a number of others that the “too big to fall” problem is massive. We must solve this problem. The great difficulty with “too big to fall” is that for any of the reasons I have given, in case it creates a systemic risk, you would guess what? It was there in the background all the time, so our generation, in Parliament as well as officials, has the opportunity to put this right. This is not just a UK issue; it is being debated actively in the House of Representatives, and it goes absolutely to the question of whether our society wants a market economy. If we do, we had better have market discipline in all parts of the economy, including banking. That is to do with allowing banks, as well as dealers, to fail in an orderly way. What we must not do in the period ahead is kid ourselves on either side of the table that we have reached a nice position where all banks can fail in an orderly way. We must not find ourselves in the position we were in five or 10 years ago when we were blinding ourselves to an awkward truth. That is where contingent capital comes in. At root this debate is about ensuring that not only equity holders can take losses, as they have, though perhaps not as much as they might have done in some cases. It is to do not only with protecting retail depositors, but ensuring that unsecured wholesale creditors take losses. That is where market discipline can come from. There are two routes to that: we can put these banks and dealers into some form of liquidation when they are in distress or, essentially, we can switch their debt holdings into equity holdings at the point of incipient distress. A lot of people believe that the latter approach is much the better and will provide for a more orderly path for our financial system and economy. Contingent capital is one way to do that. The Lloyds issue is encouraging in that respect. There is quite a lot of commentary to the effect that not too much can be drawn from it because people were swapping one type of debt for contingent capital and they really had no choice. And there is some truth in that, but it means that in a month or so from now institutions around the world, not only in this country, will be holding contingent capital so it will begin to be a debate not just in the official and academic worlds but among real world investors. That is a modest but potentially significant step forward.

Q44 Chairman: The benefit of bringing you here is we can get your unvarnished views that are not filtered through the press. I am sorry that we have not so far brought in Dr Sentance and Mr Fisher. Given this is a big issue, what are your views?

Mr Fisher: I am not sure I can add very much to what has already been said. In discussions with banks they are themselves very focused at the moment on all these issues: the regulatory agenda, the funding markets and the particular structure. There is a great deal of interest in the Lloyds issue, for example whether or not that might develop into more widespread use of contingent capital.

Q45 Chairman: Dr Posen?

Dr Posen: The two key points were the governor's reference to simple, broad, robust rules and Mr Tucker's comment about wholesale creditors coming under fire. My concern is that as good as contingent capital, deposit insurance and all these things are if we leave too much discretion to the supervisors and regulators it will go against hammering the wholesalers and regulators comes to shove. Therefore, I tend to argue for a much more robust, broader and strict rules that may preclude some activities. Thus, I am spiritually on the side of the John Kay/Paul Volcker arguments. I am also more of the simple-minded view that "too big to fall" means we should be taking another look at the size of institutions in the system. The governor and others at the table have correctly used the term "too important to fail". While obviously you can think of institutions that are systematically important even if small, nonetheless I do not believe we should lose sight of the fact that there seems to have been real good governance and information problems as well as political and economic problems from the outside when you have institutions that are too large.

Chairman: I do not think that at the moment the banking community is willing to look at the issue of size. That is a big issue. There is an element of blinding oneself to an awkward truth. There is a huge debate still to be had and we are grateful for all the views that have been put forward.

Q46 Sir Peter Viggers: I am reluctant to leave the issue of banking, but the main thrust today is the inflation report. I should like to turn to the consumer price index and inflation. There are a number of differences between the projections and fan charts in August and those in the latest edition. One significant difference is that the quantitative easing limit has been increased. Can you recalibrate for us what you regard as the main differences between the two fan charts?

Mr King: The set of differences between the August and November projections in this inflation report reflects a number of factors that have changed between the two. First, the yield curve on which the projection is conditioned is significantly lower in November than in August, so there is more monetary stimulus implied by that. Second, the volume of asset purchases is higher, so for those two reasons the projections are conditioned on more stimulatory policy than was assumed in August. Third, the exchange rate is lower than it was in August; so that is another factor which increases both the outlook for activity in the short run and also the outlook for inflation in the first year or so as higher import prices pass through. Fourth, in our view the world economy is stronger in November than in August. All those reasons mean that the outlook for inflation and activity is somewhat stronger than was the case in August.

Q47 Sir Peter Viggers: Turning specifically to the spike in inflation, which is much lower than in the August inflation report, you pick out one item as being the end of the VAT cut. Would you please calibrate for us the reasons for the change in the spike?

Mr King: In part it is the movement in petrol prices. It is also the fact that oil and commodity prices in general have moved in such a way as to change our view about some of the movements in energy prices that might otherwise have occurred in the first half of 2010. But each time we do it we sit down and form the best judgment we can about the very short run movements of energy and petrol price inflation, plus other stated government plans for taxes and duties. The view we came to in November was the judgment you see in the chart.

Q48 Sir Peter Viggers: If GDP growth were lower than expected in your analysis—some commentators said that it was a little optimistic—how would it affect the inflation projections?

Mr King: I do not think it would have much impact on the short-run projections, but looking further ahead it would mean that inflation would be more likely to be below target and less likely to return to the 2% target at the end of the forecast horizon. Obviously, that is conditional on the assumptions for monetary policy on which the charts are based. If activity turned out to be weaker you would expect us to reflect that in our own actions.

Q49 Sir Peter Viggers: Some siren voices, notably from the United States, urge that a measure of inflation and control would be helpful to the economy generally. Looking at your central inflation projections, after an inflation spike you estimate inflation to be below target. Are you
content that the expectation is that you will undershoot the target whereas a tiny measure of inflation would be quite helpful because of the effects on lower real interest rates?

Mr King: There are two senses in which your description of "a tiny measure of inflation would be quite helpful" can be interpreted. One is in terms of the impact on the real interest rate; the other is that in some generalised sense inflation will be helpful to deal with debt problems, for example. I do not think it is sensible to change our target; indeed, one of the messages from the inflation report is that the 2% target is one which, if it is weaker than we think, will be difficult for us to achieve from underneath, not on top. Therefore, we will have difficulty keeping inflation up at the 2% target in the medium term if activity is weaker than in our central projection. It would be nice if we had instruments that enabled us to hit the inflation target exactly month by month all the way through, but we do not; it takes time for monetary policy action to take effect. We start with the consequences of the extraordinarily sharp fall in output which has created a big margin of spare capacity. Even if we wanted to I do not think it would be possible to eliminate that margin of spare capacity quickly. There are reasons for not trying to do it too quickly. For those reasons we have a very stimulatory monetary policy and it is quite hard to see how it can be more so, yet we will face this prospect of inflation. But if we feel that the outlook for inflation is even more on the downside than we anticipate we will return to the question and ask ourselves whether we should carry out more asset purchases. Equally, if the outlook for inflation appears to be moving up we will return to the question of at what point we should start to withdraw the stimulus.

Q50 Jim Cousins: This morning the Committee found some very interesting information on the table in front of it. Perhaps I may ask Mr Tucker to help me understand it. The Committee has been told that the liquidity support for RBS and HBOS peaked at just over £60bn on 17 October and the bank required collateral of £100bn plus to cover it, which is a pretty substantial imposition. RBS and HBOS paid a considerable premium for that support. In turn the treasury charged the bank 1.7% over two months for an indemnity to cover the costs of the liquidity support. If I have understood that correctly, is that really countercyclical support?

Mr Tucker: If we had not done it the cycle would have been a lot worse than otherwise, so looking at the big picture the answer is most certainly yes, whether one likes the expression "lender of last resort" or "emergency liquidity assistance".

Q51 Jim Cousins: If RBS and HBOS had been able to get an American Express credit card they would have been better off, would they not?

Mr Tucker: But American Express may not have been.

Q52 Jim Cousins: This is tough stuff.

Mr Tucker: It was tough stuff; it was an absolutely classic lender of last resort operation where the only point of doing it was whether it bridged to something. This applies to every single lender of last resort operation that has ever been carried out. Either you bridge through some panic that will pass and the organisation can resume its life or you bridge to some private sector purchase of it, which was not remotely available to RBS in these circumstances, or some state equity support which was where we ended up. Can lender of last resort buy time? Yes, it can. It was very effective in buying time. It would have been a great mistake not to buy time. Can lender of last resort make all the problems of the world go away? No, it cannot. What should the price be?

Q53 Jim Cousins: Do you agree that this is a heavy price?

Mr Tucker: Perhaps I may come to the price in a moment. First, the collateral is there to protect the bank and the state from risk. The price is there—this goes back to the earlier conversation about "too big to fail" and incentives—so everybody knows that if a bank gets itself into such a mess that it cannot rely on publicly-available liquidity insurance facilities provided by Paul Fisher’s Markets area, then when it is in deep distress there is a high cost to that. It is not a new thing which has been invented by the Governor and me or by the Governor’s predecessor and the Bank team; these are principles that have applied in central banking for more than a century. It would be a great mistake not to apply them. It would also be a mistake to think that lender of last resort in those particular cases or in others was waving away all of the problems. It has to bridge to some more fundamental solution. I am afraid that in these particular cases the fundamental solution was state control.

Q54 Jim Cousins: The Bank asked for £100bn worth of assets to cover £60bn of liquidity. That implies a very large risk of impairment. Over the next few years the banking system in Britain faces an enormous risk of impairment and needs to refinance a very large scale of commercial property debt and an even bigger sum of money to refinance private equity. Does that not suggest we will need genuine countercyclical support from the bank and the government, not the kinds of impositions made last October?

Mr Tucker: You have to make a decision when considering how to handle an emergency. You ask about the scale of the collateral that we took. Within months the government had massive equity stakes. Effectively, that is saying that these institutions were bust which means that the assets on their balance sheet were significantly impaired. We had to take a big margin of surplus collateral; otherwise, we would be sitting in front of you being asked why we had lent recklessly or on terms that could endanger the state’s fiscal position. Those are not judgments for us but for the fiscal authority, and those are represented in the equity stakes that the government took during that month. We are in complete agreement with you on the broader issue of whether or not the authorities can develop and apply instruments that would be countercyclical in the way you describe and that is what the discussion paper on macroprudential instruments released on Friday and Saturday is about. But one must distinguish the use of countercyclical instruments in that sense from handling a dire emergency, which this was.

Q55 Jim Cousins: In the inflation report there is a reference to the scale of the maturing funding problem faced by the British banking system. If we cannot succeed in dealing with the impairments in the existing loan book or the requirement to refinance the enormous scale of maturing funding will not the consequence for employment in this country be very severe?

Mr Tucker: But if the banks set out now to think through a credible plan for their funding over the next two to three years, there is no reason why they cannot do it. What they cannot do is simply take no action and then throw up their hands two or three years down the road and say that the taxpayer must come in to support them. It is very important that they are made to put together a coherent funding plan that may well be countercyclical in the way you describe and that is what the discussion paper on macroprudential instruments released on Friday and Saturday is about. But one must distinguish the use of countercyclical instruments in that sense from handling a dire emergency, which this was.

Q56 Jim Cousins: Are you not in some danger of adopting a scorched earth policy when you want to keep the market economy going, so you say?

Mr Tucker: No, not at all.

Mr King: I am astonished to hear you defend the banks. It appears that you want the taxpayer to be there.

Q57 Jim Cousins: Someone has to do so.

Mr King: Do you think that the taxpayer should just hand over money at no cost to support the banks? I am astonished that you of all people would suggest that.

Q58 Jim Cousins: This exercise of moral hazard that you and Ben Bernanke have been conducting has already put a lot of parts of the British economy at risk. I indicate to you that the problem of maturing funding and the level of impairment implied by requiring £100bn of assets to cover £60bn of liquidity suggests that we will have to nurse the banking system very much through the next few years.

Mr King: I am afraid you have completely confused two separate things, as Mr Tucker pointed out. The facilities extended to the Royal Bank of Scotland and Lloyds were repaid, one in December 2008 and the other in January 2009, and the collateral was returned to them. There is no question of our hanging on to this collateral at all; it has been returned and the loans repaid. I fail to understand why you think this is remotely relevant to the funding challenge of the banking sector over the next three years.
Mr King: But that is now over and done with. Why on earth do you think that for something which was put in place for a couple of months when we had to take raw mortgages and no means of investigating their merits given the speed with which the operation had to be mounted we should put it all back in money at risk? The operation was successful: we made the loans, they were repaid and the collateral was returned to the two banks. That was over and done with already a year ago. That has no relevance to the funding challenge over the next two to three years.

Q59 Jim Cousins: It is the scale of cover for the impairments that you required and its implications for the future.

Mr King: I would distinguish between a so-called world carry trade on the one hand and the concerns that the Prime Minister and President Sarkozy expressed about the oil market on the other. Perhaps we can take them in turn. As to the oil market it would certainly be valuable if the G20 now, not G7, were to discuss the possibility of creating a deeper futures market for oil. We had a G7 discussion about this some years ago and the outcome of it was a genuine recognition that it was difficult to know what to do about it but the fact that potential producers could not sell their output of oil at that time to essentially cover their own costs was extraordinary. I do not think therefore that the dramatic fall in price was the concern that we might be about to revisit the great depression. It now looks as if we will not and that itself may explain why there has been a rebound of asset prices. I do not think it is ever easy to say that you would have expected prices to rise by 37% or some precise number; you cannot because these are very difficult judgments, but most asset prices are still well below the levels they were at when the crisis began. It is not the case that they have rebounded to levels one might have thought were unsustainable at that point. There is however one immense issue here which is very hard to judge, namely that world long-term real interest rates are still very low. That was so in the build up to the crisis and that was partly why asset prices were rising. They remain very low in large part because people believe that the large amount of savings coming out of Asia will carry on. If that is to be a permanent feature of the world economy we will have to get used to low levels of long-term real interest rates and higher levels of asset prices, but if it turns out to be the case, which obviously financial markets at present do not anticipate, that real world interest rates are falling as the Asian economies save less and we see a shake out of some of the imbalances in the world economy maybe we will see an adjustment of all asset prices across the world at some point in the future as real interest rates pick up. But that is not a factor to do with financial policy or central bank liquidity provision; it is to do with the functioning of the world real economy. It is conceivable that people may have made a misjudgement there, but it is not at all easy to be sure or to know what to do about it if they have.

Q60 Nick Ainger: Earlier this year the Prime Minister and President Sarkozy jointly authored an article in the Wall Street Journal on their concerns about prices on the oil exchanges in particular. That indicated to me that they were extremely concerned about this issue. Are you aware of any other development in the carry trade or one of its characteristics that the Prime Minister and President Sarkozy would have to invest heavily in the production of new sources of oil the price would still be high 10 years down the road when their production came onto the market. A deeper and more extensive futures market might help in that respect. There are some good reasons why it is difficult to create that kind of futures market and it may be that government has a role to play. It would be valuable for the G20 to talk that through. All countries in the G20 recognise that this is a deep and lasting problem. There are real benefits to both the producing countries and the consuming countries in having some sort of stabilisation in the oil market. In terms of a world carry trade the argument for thinking that there could be a carry trade must rely on the fact that some countries do not allow exchange rates to move in a way they would otherwise do. The idea that countries have different levels of interest rates is a very natural one and that is why we have different central national banks. You set monetary policy to suit your own conditions which naturally means that interest rates will sometimes be high in one country and low in another. That does not generate a carry trade in the normal sense of the word because in general exchange rates rise as the Asian economies save less and we see a shake out of some of the imbalances in the world economy. In the G20 means it is possible for a carry trade to develop within it, with borrowing in the currency of one country and lending in the currency of another, there is an inconsistency in those domestic policy frameworks which will eventually create difficulty at international level. The G20 has now committed itself—it was explicit at St Andrews—to invite the IMF to work with it to examine the domestic economic and macroeconomic policy frameworks of each G20 member country to see whether when the IMF puts the results on the table there are any apprehensions or steps that might be taken to remove them. One would have to be an optimist to think this process will necessarily work but the G20 has committed to it and thinks it is important to recognise that if this process leads to failure it will be a big blow to the G20 as a group. The G20 has now put its reputation on the line to make progress on this front. That is beneficial because it means there is something to lose if these talks go nowhere.

Q61 Nick Ainger: If there is no immediate solution to this apparent asset price bubble, or certainly a substantial increase in asset prices, oil being among them, is there not a serious risk that the recovery will be delayed, damped down and so on with unrealistically high energy levels?

Mr King: I appreciate that the fine-tuning will depend considerably on circumstances. However, if you downgrade your growth assumptions from 4% to 3% that brings you in lower than the treasury forecast which then has a significant impact on projections for the

Q62 Nick Ainger: I would distinguish between a so-called world carry trade on the one hand and the concerns that the Prime Minister and President Sarkozy expressed about the oil market on the other. Perhaps we can take them in turn. As to the oil market it would certainly be valuable if the G20 now, not G7, were to discuss the possibility of creating a deeper futures market for oil. We had a G7 discussion about this some years ago and the outcome of it was a genuine recognition that it was difficult to know what to do about it but the fact that potential producers could not sell to want to have their oil into future markets for asset prices where scenarios were entirely conceivable that they would have to invest heavily in the production of new sources of oil the price would still be high 10 years down the road when their production came onto the market. A deeper and more extensive futures market might help in that respect. There are some good reasons why it is difficult to create that kind of futures market and it may be that government has a role to play. It would be valuable for the G20 to talk that through. All countries in the G20 recognise that this is a deep and lasting problem. There are real benefits to both the producing countries and the consuming countries in having some sort of stabilisation in the oil market. In terms of a world carry trade the argument for thinking that there could be a carry trade must rely on the fact that some countries do not allow exchange rates to move in a way they would otherwise do. The idea that countries have different levels of interest rates is a very natural one and that is why we have different central national banks. You set monetary policy to suit your own conditions which naturally means that interest rates will sometimes be high in one country and low in another. That does not generate a carry trade in the normal sense of the word because in general exchange rates rise as the Asian economies save less and we see a shake out of some of the imbalances in the world economy. In the G20 means it is possible for a carry trade to develop within it, with borrowing in the currency of one country and lending in the currency of another, there is an inconsistency in those domestic policy frameworks which will eventually create difficulty at international level. The G20 has now committed itself—it was explicit at St Andrews—to invite the IMF to work with it to examine the domestic economic and macroeconomic policy frameworks of each G20 member country to see whether when the IMF puts the results on the table there are any apprehensions or steps that might be taken to remove them. One would have to be an optimist to think this process will necessarily work but the G20 has committed to it and thinks it is important to recognise that if this process leads to failure it will be a big blow to the G20 as a group. The G20 has now put its reputation on the line to make progress on this front. That is beneficial because it means there is something to lose if these talks go nowhere.

Q63 Ms Keeble: I want to ask about the growth forecast again. Your projection of 4% in 2011 has been described by some commentators as optimistic. Have you included factors in particular QE which have not been so strongly factored into the other models?

Mr King: We believe our asset purchases will have an impact and will stimulate the economy. To the extent that other people have not taken any of that into account that is one reason to explain the differences. You quoted 4% for 2011. That is a rough figure for the most likely outcome but it is not the expected growth rate. We have significant downside risk resulting from the state of the banking sector and a drag on the supply of credit, which means that 3% is a better guess for what we expect the growth rate in 2011 over 2010 and only 1.5% in 2010 over 2009. I would reiterate the comments on the high side, over 2009, that the whole idea of the exercise is to get the scale of the existing imbalances on course to emerge and the fundamental issues about incompatibility and policy frameworks among the major economies of the world are seen not to have been resolved at that point. Unless they are resolved the tensions and underlying causes of the financial crisis will take place all over again. The crisis will be different next time; I cannot work out in what way, but we shall return to tensions and sharp breaks in financial prices.

Q64 Ms Keeble: I appreciate that the fine-tuning will depend considerably on circumstances. However, if you downgrade your growth assumptions from 4% to 3% that brings you in lower than the treasury forecast which then has a significant impact on projections for the...
structural deficit and fiscal squeeze. Can you comment on that? The treasury assumptions for 2011 are 3% to 3.5% which have also been regarded as quite optimistic.

**Mr King:** It is a big mistake to place all one's weight on one number. The whole point about our forecast and the fan chart is that we say we believe there is a lot of uncertainty, hence taking into account the downside risk, as embodied in our fan chart in 2011 is closer to 3%. Who knows what the number will be? It is very unlikely to be any of those numbers. The key point is to have an appreciation of the balance of risks, what the general picture of recovery or failure of recovery looks like and why that is the case. We have to have a plan saying what if things turn out to be different from our central view, as it almost certainly will be, we shall adapt the policy accordingly. The point that I make about fiscal policy is that whatever precise measures are implemented will need to take into account the state of the economy at the time. We just do not know that in advance.

Q65 **Ms Keeble:** I appreciate all of that. However, the knock-on effect of all of this in terms of the public perception, public services and so on is profound and some percentage differences can have a big impact. You said that you would expect the deficit to be dealt with over the lifetime of a parliament. Therefore, it is quite helpful to know what shape it will be. You expect growth to be between 2% and 3% or so and the deficit to be dealt with on the basis of those kinds of growth figures.

**Mr King:** There must be a plan saying what will happen to the deficit over the lifetime of a parliament for which any government elected at the next election will be in power, so that is five years from next spring/summer. I think it is sensible to have a plan over that period which says what actions we will take in the eventuality that the economy performs in a certain way, that if it grows faster other actions will be taken and if it grows less rapidly there are things that at that point will not be put into effect because the economy will be unable to sustain them. My point is that to have a plan which says we will genuinely try to get rid of the deficit if the economy really does recover makes some sense, but it must be contingent on the state of the economy and a credible plan that spells out what will actually be done.

Q66 **Ms Keeble:** That sounds far too calm and measured perhaps for the debate we are having at present.

**Mr King:** I am sure you could lead a calm and measured debate now.

Q67 **Ms Keeble:** Dealing with the 5% to 10% loss of output referred to by the IMF, about which Mr Fallon asked you, there have been some sharp comments about what happens to unemployment. Increases in employment rates are likely to lag behind growth and therefore unemployment can remain higher than we have been used to. You said that 8% was higher than we had been used to. How real a threat do you think that is?

**Mr King:** It is very hard to judge. Given the scale of the fall in output it is quite striking that unemployment has not risen more than it has. Given past relationships between changes in output and unemployment one might have expected unemployment to have risen by more than it has.

Q68 **Ms Keeble:** You have referred to part-time employment, people taking pay cuts and such like.

**Mr King:** Indeed. The puzzle in all this is that you can point to pay as being extraordinarily flexible at present, much more so than perhaps we saw in recessions in the past. That is one explanation of why unemployment may not have risen as much as it might have done in the past. However, in the United States which we think of as being very flexible in terms of pay and the labour market unemployment has risen by much more than expected. I do not believe we have an explanation for that. There are real puzzles in the behaviour of the labour market in looking across Europe, the United Kingdom and the United States. That is what makes it particularly difficult at this juncture to know whether the fact that so far unemployment has not risen by as much as it might have done is either encouraging in the sense that greater flexibility means unemployment will not rise to the levels we might have feared or there are further rises in unemployment to come next year as companies catch up with the need to reduce their costs. I honestly do not know which of those two paths we will follow, in part because we do not have a story to explain differences in labour markets across the US, UK and Europe, but it is something we should watch very closely over the next few months.

Q69 **Ms Keeble:** You have probably seen the discussion on the Committee's inquiry into women in the City. What is your view of any risks to the banks generally, given comments by Professor Goodhart for example, because of lack of diversity? How do you believe it is best tackled?

**Mr King:** I do not think it is for me to comment on what the banks should be doing. I can say what we are doing. From our point of view, obviously we do not pay well relative to the private sector. We need therefore to attract the very best people we can get and in order to attract not only the best women but also the best men we need to create an environment in which there are men and women in reasonable proportions. It is a joint career; this is not a male environment. We have gone to great lengths to see how far it is possible to make our careers more attractive to women as they move through career paths. In studying it we have found that the best way to do it is to put enormous weight on programmes of flexible working not just for women but every member of staff. The bank adopts the principle that no woman should be promoted to a job because she is a woman. We take no account of that; it is purely based on merit, but we need to ensure that everyone in the bank has the opportunity to find a pattern of working that best suits them. We have put a lot of weight and effort into devising and building up patterns of flexible working. I hope it will work. We will see. Recently seven appointments were made at head of division level. Four of those appointees were women. They are still under-represented at senior level, less so at junior level. I do not think that time will solve that problem on its own. In the past the belief that time will deal with the problem did not work. There is a lot of self-selection going on in choice of career. We have to create careers that all kinds of people in the bank want to pursue and flexibility has been the mechanism chosen to do that. Whether that is for other people to follow I leave it to them.

Q70 **Ms Keeble:** The view of the Equality and Human Rights Commission is that the FSA as regulator has a role in monitoring, championing, leading or however one wants to describe it. Do you agree with that? If the bank was to be the regulator should the bank play a more active role rather than dealing with just its own internal measures?

**Mr King:** My belief is that this is a matter of good management. A good management team will want to ensure that it has a work environment that is attractive to women. It is in their commercial interest to recruit and retain better women and men. Therefore, one needs to think deeply about the way to do it. I do not believe a regulator can say it will raise a bank's capital requirement unless more women are employed. We have to create careers that all kinds of people in the bank want to pursue and flexibility has been the mechanism chosen to do that. Whether that is for other people to follow I leave it to them.

Q71 **Ms Keeble:** That was why I said “leading” rather than “regulating”.

**Mr King:** Certainly we would be supportive of the direction in which you would like to go, but I am not sure regulation is the means to achieve it.

Q72 Chairman: Mr Fisher, from your contacts how has the loss of several competitors changed the way markets are operating?

**Mr Fisher:** I am not sure they see it quite that way. At the moment each of them has its own very distinct pressures which it is trying to deal with. If anything, they see a great deal of competitive pressure at the moment. One of the big debates going on out there is about competition coming from those firms that have government support. I do not speak specifically about the UK but generally. I believe they see a reduction in competition. What these sorts of circumstances do is open up competition to a range of new entrants, so there are a lot of people out there who are busy building up their business models and trying to get into markets.

Q73 Chairman: Do you agree with Dr Posen that half a dozen big banks is not helping competition and at the end of the day we need to restructure so we increase competition with an alternative channel?

**Mr Fisher:** That relates specifically to UK retail banking. I agree that we need a wider group of banks. Some of the smaller banks may need to come together to provide competition for the larger banks. One of the big problems we have particularly with small business lending is the very high degree of concentration with Lloyds and RBS in particular. That needs to be looked at.
Q74 Chairman: Dr Sentance, given your business experience do you agree with Dr Posen that we need to reform the financial systems so that business is less reliant on the banking system? If so, what reforms would you like to see? Is there a case for government intervention to stimulate new sources of business funds?

Dr Sentance: This is a long-standing question. You can trace the issues around access to finance by small and medium size firms back to the Macmillan Commission in 1931. When I was in the CBI in the 1980s and early 1990s this kept coming back. I believe that it returns at times of recession. It has been very heavily spotlighted by the difficulties in the banking system. It appears that larger companies are able to find their way round the banking system by accessing the corporate bond markets. Dr Posen gave quite a long menu of options. If we could find mechanisms to extend that access to corporate bond markets to smaller companies—there are various ideas about how that might be done—certainly it is a direction I would favour. I agree with Dr Posen that it is not necessarily just one approach. At the moment when we talk to companies given their caution about the state of demand and the impact of the recession many of them do not want to borrow; they rein back on their investments.

Q75 Chairman: They tell us that the big issue is the cost of credit.

Dr Sentance: In some cases that is not helped by the cost of credit. In the fall in lending at the moment we see a combination of supply and demand factors. There are constraints on the supply side but also uncertainty about demand and clearly the unwillingness to make big investments at the moment contributes to that. I am not sure that in the next year or two we will find a magic bullet to solve the issue facing small and medium size companies which has been around for quite a long time, but I would encourage the Committee to continue its inquiries in this area and come up with positive suggestions.

Q76 Chairman: Governor, about a year ago you said that lending was the big issue in the British economy. We are still at it.

Mr King: We are still at it.

Q77 Chairman: You talked about a move by banks to operate as subsidiaries when they are away from their home countries. How does that fit in with the European single market?

Mr King: There are two aspects: the intra-European one and international one. The point I made earlier was that a number of significant emerging market economies had made the judgment that it would be sensible for them to require subsidiarisation overseas banks in their territories because they felt it would be safer for them to apply to those banks separate capital and liquidity requirements rather than be left exposed to the operations of a branch which they could not regulate. One has enormous sympathy for that. We saw that in part with Lehmans in this country. That is likely to be a development which will gain greater traction. The difficulty in the European context is that, as Lord Turner has said, you tend to be drawn towards either more centralised European regulation in order to be able to regulate banks as if they belonged to a single entity or recognition of the fact that national supervisors need the ability to impose capital and liquidity requirements on institutions that operate in their territory because they are responsible for what happens in that territory. That is something we will have to confront.

Mr Tucker: On the narrow question of Europe, it is not possible; there are passporting rights for authorised banks. The broader debate internationally is about developing recovery and resolution plans. There is an exercise involving about 25 of the world's largest banks and dealers which will be undertaken over the next six to nine months. That will throw up lots of issues, but we and everybody else will truly learn from it. One of the most important things is not to have too many a priori thoughts now about whether subsidiarisation would be much better than branch banking or cross-border lending. As it happens I am inclined to that view, too, but we ought to hold that in suspense until we have gone through the 25 exercises and seen what issues they throw up.

Q78 Chairman: Governor, when you appeared before us in June you expressed concern that the European Systemic Risk Board could turn out to be "a mere talking shop". We have looked at the issue in the report on macroprudential and microprudential regulation. From your point of view has the commission's publication of more detailed proposals allayed your concerns?

Mr King: I said in June that it could be a mere talking shop on the one hand or a useful talking shop on the other. We were not in a position to know, and still are not; it has not been set up yet and we are many months away from it.

Q79 Chairman: We are talking about a body of 61 members. If it is to deal with emergencies do you believe that to be a big number?

Mr King: It will not be able to deal with emergencies, and I do not think it is seen in that context. I would think of it as a good forum in which to raise the "too important to fail" question and to start a proper debate on that question right across Europe. That would be a rather good forum in which to do it. Therefore, it might be useful for dealing with the longer-term questions, but in all these things the proof of the pudding will be in the eating.

Q80 Chairman: Maybe you can give us a list of the useful talking shops that you attend round the world.

Mr King: That will be a very short one.

Q81 Chairman: Are you concerned that given ESRB's focus on market conditions across Europe it could end up making recommendations or advocating policies that are inappropriate given specific circumstances in individual Member States?

Mr King: It is possible. It will be able to issue recommendations only on a "comply or explain" basis, so it will not have any authority to impose those recommendations on individual countries. If a country felt that the recommendations were inappropriate to its circumstances not only would it be perfectly entitled to but it would find it rather straightforward to explain why they were not appropriate in the case of country x and therefore they had no intention of adopting them.

Q82 Chairman: This Committee awaits a reply from the Treasury on the potential reforms to the international monetary system. Is this a time to be bold? Do we need a Bretton Woods mark ii?

Mr King: We certainly need something because of the fear that the imbalances will re-emerge and my two big concerns about how we got into this and why we might end up with another crisis in future. We need radical reform of the international monetary system. In large part this goes to politics at least as much as to economics, so this is probably more in your domain than in mine. I shall continue to argue for reform of the international monetary system, as I have for many years in speeches. It is very important. If we ignore it and fail to tackle it I fear that some of the concerns we thought we were about to experience at the beginning of this year but fortunately did not will come back to haunt us.

Chairman: On that sober note, I thank you and your colleagues. This session has been very helpful and insightful.