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oral EVIDENCE

TAKEN BEFORE THE

Treasury Committee

Bank of England May 2012 Inflation Report

Tuesday 26 June 2012

Sir Mervyn King, Spencer Dale, Professor David Miles and

Dr Ben Broadbent

Evidence heard in Public Questions 1- 158

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 26 June 2012

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon

Stewart Hosie

Andrea Leadsom

Mr Andy Love

Mr Pat McFadden

Mr George Mudie

Jesse Norman

Mr David Ruffley

John Thurso

Examination of Witnesses

Witnesses: **Sir Mervyn King**, Governor of the Bank of England, **Spencer Dale**, Chief Economist, Bank of England, **Professor David Miles**, External Member, Monetary Policy Committee, Bank of England, and **Dr Ben Broadbent**, External Member, Monetary Policy Committee, Bank of England, gave evidence.

Q1 Chair: Good morning, Governor. Thank you very much for coming. We have quite a lot to get through, as quite a lot has been going on since you last saw us. Can I begin by asking whether you think that we are close to a liquidity trap?

Sir Mervyn King: No, I do not think we are there yet. That is why I think that monetary policy still does work by injecting more money into the economy; it leads to further rounds of asset purchases. But there is no doubt that with the additional uncertainty this year, there is evidence of people behaving in a very defensive way and being unwilling to invest, and of course the most extreme example of that would be if you were to get to a liquidity trap where essentially the main assets that people wanted to hold were claims on the central bank.

Q2 Chair: You are strongly supporting the measures in the Mansion House; clearly your own as well as the funding for lending scheme. When I wrote to you on behalf of the Committee last October, you were not at all enthusiastic about looking at liquidity, so I wondered what had changed your mind.

Sir Mervyn King: I think one should differentiate between liquidity and the issues that have created the funding for lending scheme, because they are quite different. Let us take liquidity. We introduced the ECTR-Extended Collateral Term Repo-facility in December, so we did see the possible need for such a scheme down the road. We did not feel in December that there was a need to activate it, and indeed the information we got through our market intelligence and conversations with the major banks suggests that if we had activated it in December, there would not have been a great demand for it. I think what has changed is that we have seen that the impact of the ECB's own liquidity provisions wore off after the first two or three months, so it had not provided a resolution of the problems in the euro area and we could see that with the Greek elections coming up, and other events over the next three to six months, at some point there might be a need to provide emergency liquidity. I did not want to be in the position where we would have to rush in a scheme to provide liquidity at the last minute, and it was better to reassure everyone that that facility was there, so we have announced that we will carry out these monthly auctions. There was not an enormous demand for it last week when we launched the first one, but the most important thing is that it is there and that people know that it is there; that, I hope, will provide reassurance. However, I think the situation has changed in the past few months.

Q3 Chair: Do you think that any of the banks that might be applying for this, under the existing arrangements for assessing solvency, might be close to failing the solvency tests that would have been exercised prior to access to the discount window?

Sir Mervyn King: No, I do not. The discount window has been there, and I cannot imagine that any of them would have found it impossible to access the discount window. In fact, they have all been prepositioning large amounts of collateral in the discount window facility, and we welcome that, because both we and they know that that collateral has been assessed and appraised, and they will know exactly how much they can borrow against it.

Q4 Chair: The banks have argued that the problem with the discount window is that it carries stigma. Do you think that you have got around the stigma problem?

Sir Mervyn King: It is difficult to be entirely certain. Indeed, I think there is a general stigma problem-some banks would probably feel that access to any central bank facility is potentially one that carries stigma-but I think we have gone as far as we possibly can in the discount window. We do not reveal the access to the discount window except with a lag, and we do not publish the name of the bank accessing it. What we are trying to do is to make it as routine an access as possible, and that is how people should view it. What has happened in the last 12 months with the enormous access of banks to the ECB's operations and the wider acceptance that there are problems out there-which are not reflecting on the solvency of any individual bank, but reflecting on the need for banks from time to time to have access to greater liquidity-is that there is an understanding more generally in the market that if a bank for some reason does access the discount window, it does not carry stigma, but certainly we would not want to announce access to the discount window for some considerable time after it has taken place.

Q5 Chair: So, in a nutshell, it is Europe that has changed your mind from last year to this about liquidity?

Sir Mervyn King: Well, the facility we put in place, the ECTR we put in place, in December, before the deterioration of conditions in Europe-

Q6 Chair: But from last summer when I first started discussing this- when people approached me.

Sir Mervyn King: Things were in a much better position until the middle of last year.

Chair: I just want to summarise-

Sir Mervyn King: Yes, conditions deteriorated from the middle of last year.

Q7 Chair: It is not yet clear that the stigma problem has been fully resolved, but you are working on it as best you can.

Sir Mervyn King: I think we have done what we can, and my belief is that it has been effectively resolved.

One of the issues that we have been dealing with, which goes right back to many of the issues that came up in 2007, is that we are not going to disclose access to the discount window. It is actually pretty important that the banks themselves do not disclose it, and I think we have done what we can to reassure them in terms of the legal position.

What would be really crazy would be if our authorities told banks they had to disclose access to the discount window when no one else does. It would be a classic definition of shooting oneself in the foot. We do not believe they need to do that.

Q8 Chair: I would like to raise the question of an interest rate cut, which I know the IMF has given a clear hint that it thinks should at least be considered. You have rejected that on the grounds that you think a cut in interest rates might hit the cash flow of banks, because of the net interest margin problem, and also because you suggest it is possible that the money markets might be screwed up by this.

Sir Mervyn King: We haven't rejected it. We have said that, in present circumstances, we think the arguments that led us not to go below 50 basis points last time still apply, and I think we are still concerned that we would squeeze the net interest margin on, particularly, smaller building societies, which would make their position vulnerable. I don't think pushing out smaller building societies from the market will be a terribly wise course to pursue at present. It may well be that conditions-

Q9 Chair: Sorry to interrupt, but have they told you that that might happen, Governor?

Sir Mervyn King: Certainly last time when we discussed it, this was the main reason we did not go below 50 basis points.

Q10 Chair: How long ago was that?

Sir Mervyn King: That was a couple of years when we looked at it. Nothing has really changed in terms of the position on deposit rates and the rates that they are charging their customers.

Q11 Chair: Might it be a good idea to have another word with them and see if they feel the same way?

Sir Mervyn King: I think the conditions are the same. We are certainly willing to do that, but let me stress that we did not rule it out. We said that in present conditions the same arguments would apply, but we will look at this and it may well be the case that if conditions in money markets or deposit rates change, it affects the argument we used, which is a purely pragmatic one, as we have nothing in principle against cutting the Bank Rate further, if that turns out to be necessary.

What I would say though is that the big picture here is that if we are thinking of significant monetary stimulus being necessary, a very small cut in Bank Rate of the kind that is feasible here would really not make a big difference. What we have been doing on asset purchases since we started that programme is, in our judgment, very much bigger than the equivalent of a 25 or even 50 basis point cut in Bank Rate.

Q12 Chair: Do either of the externals in front of us want to add anything on the rate-cut issue, particularly in view of the fact that the Japanese and the United States have managed to cope with this net interest margin problem?

Professor Miles: I think there is a question mark about whether a cut in Bank Rate from the current low level would be net helpful, by which I mean: would it help the cost and availability of funding to households and corporates? Would it increase demand in the UK economy, which is what I think we should be looking to do with monetary policy? Because there is that issue with some building societies-and not just building societies but with some other lenders-about it squeezing their profitability, I think there is at least a question mark about whether it would do any good. Were we in a situation-

Q13 Chair: What about those mortgage holders who have come off their fixed mortgages?

Professor Miles: That is right; there is a significant stock of past lenders-

Q14 Chair: They will benefit, won't they?

Professor Miles: They will. That is true, but-

Q15 Chair: That is cash in hand.

Professor Miles: It is indeed, and that is a positive to the available income of those people. But it squeezes the available funds for the lenders, and that will have a knock-on impact on the cost and availability of funding for other people who might wish to borrow from those institutions. So, I think there is at least a question mark about whether it is effective. As long as one has other levers that I think are effective and I think we do-quantitative easing-I think that cutting the Bank Rate is not the most attractive strategy.

Q16 Michael Fallon: Governor, you explained in your Mansion House speech the background to the funding for lending scheme as being "The black cloud of uncertainty", and you say there may be a case for such a scheme. If we are living in such extraordinary times, I suppose the obvious question is: what took you so long?

Sir Mervyn King: Well, I think the situation has deteriorated, and that was why we felt it was necessary to pursue it.

Q17 Michael Fallon: When did you come to that conclusion?

Sir Mervyn King: In the past six weeks, I think the situation- I am very struck by how much has changed since we produced our May inflation report.

Q18 Michael Fallon: If the problem is generally one of confidence, how is the answer simply an increase in the availability of credit?

Sir Mervyn King: It isn't a complete answer-it is part of the answer-but it is what we can play our part in doing.

Q19 Michael Fallon: Dr Broadbent, were you involved in this decision?

Dr Broadbent: Well, we were informed at the last MPC meeting that preliminary discussions were under way between the Bank and the Treasury, but at that stage they were no more than preliminary. I think we have a meeting of the MPC later this week to discuss this scheme so, yes, we are involved in it certainly.

Q20 Michael Fallon: Governor, can you explain how a scheme like this evolves? Would there not normally be a discussion with the external members as well as the internal members, or is this something that just comes up within the Bank?

Sir Mervyn King: No, there is a discussion with a very wide range of bodies. I think one thing that you have to distinguish between are those policy instruments that are the exclusive preserve of the MPC, and those in which the MPC has a clear interest but are not the exclusive preserve of the MPC. I reckon there are about seven different bodies that we need to consult before we can go final on a scheme like this.

The first thing that has to take place is that the Government have to decide that this is an action that is within the remit of the bank. That is why the first port of call on this was indeed the Chancellor following exactly the advice and views that this Committee has always strongly held-that in an emergency, if actions are taken, the Government have to be in charge and the Government have to be confident and comfortable that this is an action that the central bank should be undertaking. But, as I said, in addition to the Treasury, the FSA and the Debt Management Office also have to be comfortable with this. Internal to the Bank, we have the Monetary Policy Committee and the Financial Policy Committee, which equally have an interest and a stake in this, and there is the Internal Executive Committee. Then, on top of all of that lot, there is the Court that has to approve the scheme before it can go ahead, because it might involve the bank's balance sheet. I reckon that if you add all those up, you have something like seven different groups of people, all of which have a legitimate claim to be involved in discussions on the scheme before it can finally go ahead. That is what we are doing.

Q21 Michael Fallon: I understand that. I just want to be clear how the MPC itself was involved. Professor Miles, when were you involved in this?

Professor Miles: Well, if we step back, the situation now is one in which the MPC at every one of its meetings, as far as I can remember, for many months has been discussing and analysing in great detail what is happening to the cost and availability of funding to the banks. I do not think that we were in a position to take a unilateral decision as a MPC on this particular facility for the reasons the Governor explained. There is a fiscal element to it, because it will involve a degree of subsidised lending to the banks. The collateral that the banks will be borrowing against will be risky assets, so it was not a situation where the MPC could unilaterally take a decision. It was discussed at the last MPC meeting. We have been pretty fully briefed on what is going on. I should say that I think there is unanimous support on the MPC for this sort of measure to try to bring down banks funding costs. The situation-which got bad at the end of last year and then got better around the turn of the year, with the ECB long-term repo operation, but has got worse again in the last few weeks-is one that we have been absolutely focused on for many months now.

Q22 Michael Fallon: Like previous schemes, has the Bank secured an indemnity from the Treasury for your own balance sheet on this?

Sir Mervyn King: That is one of the issues that is under discussion at present. When the details are complete, it will be clear.

Q23 Michael Fallon: But are you asking for an indemnity?

Sir Mervyn King: We are discussing it. No, I am not asking for it at this stage. We will discuss whether it is in fact appropriate, given that the nature of the scheme is one where it may not be necessary to have an indemnity. We are not buying assets here. There is a very big difference between purchasing assets and lending against collateral with haircuts.

Q24 Michael Fallon: So no indemnity arises then? It may not arise?

Sir Mervyn King: It may not arise, but that is something we will discuss; in due course, we will come up with an answer.

Q25 Michael Fallon: When is this scheme to be launched?

Sir Mervyn King: In a very few weeks. The final discussions to produce the design of the scheme will be completed this week. Then-and this is a very important stage-we have to have confidential discussions with the European Commission to see whether questions of state aid arise. I am pretty confident that they will not, but that is something we need to discuss with it first, before we make public the terms of the scheme, and then I would hope that shortly thereafter this could be made public and it would take immediate effect.

Q26 Michael Fallon: Finally, you stressed the background to the scheme as the weakness of the zone and the stresses it is causing. How are that weakness and those stresses now to be resolved?

Sir Mervyn King: One of the problems that UK banks have faced is a combination of weakness in the UK, and indeed world economies, has made the future prospects of their lending more risky, and they have particular exposures to the euro area-both directly to the periphery economies, and also to banks in other parts of the euro area that themselves have exposures to the periphery economies-and that means that if things were to go badly wrong in the euro area, there would, as I said in the Mansion House, be a dent to the capital position of our banks, and that inevitably makes lending to our banks riskier than would otherwise have been the case. It pushes up funding costs, which in turn gets passed on to the interest rates that mortgage borrowers and small businesses and others have to pay here, and that is what has been happening.

Q27 Michael Fallon: But my question was: how do you see it being resolved?

Sir Mervyn King: I cannot come up with a simple solution for how the euro area problems can be resolved, but I think all of us can see the enormous challenges they face. I don’t pretend to give you this morning a blueprint for the resolution of the euro area.

Q28 Michael Fallon: You sound pretty pessimistic about it.

Sir Mervyn King: I am pessimistic, and I am particularly concerned because I think for two years now we have seen the situation in the euro area getting worse with the problem being pushed down the road and not being gripped. What has particularly concerned me in the last several months, and why I voted for more easing in policy, is the worsening I see in the position in Asia and other emerging markets. My colleagues in the United States are more concerned than they were at the beginning of the year about what is happening to the American economy, so this is not a comfortable position to be in.

Q29 Chair: Just back on your Mansion House speech that Michael referred to a moment ago, in that speech you say, "Prior to the crisis risk premia and bank funding costs were unsustainably low". If the powers that are proposed in the Financial Services Bill were on the statute book and you had come to that judgment, what kind of action would you be taking? Would you be deploying macropru tools?

Sir Mervyn King: Sorry, if the-

Chair: If the tools that are proposed as a consequence of the Financial Services Bill, which is currently in the Lords, were at your disposal, what would you be doing to act on the judgment you have made-retrospectively now, but hopefully prospectively for the next time-that prior to the crisis bank funding costs were unsustainably low? What would you have done?

Sir Mervyn King: Prior to the crisis, I think we would have raised capital requirements on banks lending to the financial sector. That was where the bulk of the expansion in the balance sheet went, and I think it was the one thing that was not tackled. The Monetary Policy Committee was looking at the scale of lending to the real economy and looking at spending in the real economy. That was not running at an unsustainable rate in aggregate; what was wholly unsustainable was the expansion of balance sheets, capital requirements and limits on leverage. Those basic instruments would have been the ones-

Q30 Chair: But it is fair to say you would have taken pretty vigorous action.

Sir Mervyn King: Yes, I think we would.

Chair: To take the punch bowl away.

Sir Mervyn King: Yes.

Q31 Chair: In the next few sentences down in the speech you say, "Private sector spending is depressed with extreme uncertainty. There may be a case for a scheme to underwrite risk which the market itself is unwilling to take". There does sound quite a heavy amount of asymmetry in your approach, with a punch bowl on the one hand that you want to take away, but on the other hand many would argue that you need to get some gin in.

Sir Mervyn King: Yes, but I think that if we had been able to raise capital requirements on lending to the financial sector before the crisis hit, that would have been a capital buffer that could have been run down when circumstances became more difficult. That second part of the speech that you quoted refers not to macro-prudential measures, but to taking risks explicitly on the public sector balance sheet, which is a very different thing and not something that any Government would take lightly.

Q32 Chair: Do you think that macropru tools should be used symmetrically?

Sir Mervyn King: Yes, absolutely.

Chair: You do.

Sir Mervyn King: But they are not taking risk on to the public sector balance sheet; they are making sure the risk remains firmly with the private sector. Leverage was allowed to become far too high before the crisis. One thing that would have been much better would have been to ensure that leverage was never allowed to get to the levels that created the fragility in the system that existed in 2006 and 2007.

Chair: Are there others who want to come in on that point? No?

Q33 Jesse Norman: Governor, at a previous hearing we talked about whether the Bank might at some point do some analysis of the distribution effects of quantitative easing, and you and Paul Tucker were rather robust in your dismissal of that. Is there any update on that? Are we now going to see some of that analysis?

Sir Mervyn King: Yes. I think in one of your recent reports that appeared after our last appearance before you, you requested a distributional analysis, and you will get that before the summer recess. Perhaps I could ask Spencer Dale to update us on that.

Spencer Dale: Certainly. As the Governor said, we are working on that paper and we hope to get it to you shortly. I guess there are two points that I would make when thinking about the distributional consequences. Savers, or those living off savings incomes, have clearly borne quite a considerable burden in terms of the impact of low interest rates. But I think it is also important to say that many groups of society have been affected by this financial crisis in different ways and it is important to take that into account. Also, I am very clear in my own mind that had we not reduced interest rates so dramatically and then not conducted asset purchases, our economy would be in a far worse state than it is now, and that would have affected everybody. When we are thinking about the distribution impact of QE, I think it is important to bear that in mind.

The second thing we need to bear in mind is that many commentators, when thinking about the impact of asset purchases on the health of pension funds and individuals' pension pots, often emphasise the impact of low interest rates on the liability side-the extent to which they increase the pension fund's liabilities and the extent to which they reduce annuity rates. It is really important to remember that asset purchases have also increased asset prices-both gilt prices and also those of equity prices-and for a fully funded defined benefit scheme or for an individual, those two things broadly even out. I think that is why we have been saying that in terms of the impact of QE on pension funds for a fully funded pension scheme, those things are pretty broadly neutral. The key thing which has affected the performance of many pension funds since the financial crisis has been the fall in the price of gilts relative to equities, which to a very large extent happened prior to quantitative easing, and is not the result of quantitative easing.

Q34 Jesse Norman: Thank you very much indeed. I am so sorry, but we are rather short of time. I am very grateful for that update and look forward very much to the analysis but we have quite a lot to get through.

Governor, you are presumably looking at this situation with RBS. Are you persuaded that the current difficulties are purely technological, or do you think there may be some problem on the funding side?

Sir Mervyn King: I think once the current difficulties are over we will need the FSA to go in and carry out a very detailed investigation to find out, first, what went wrong, and then-perhaps even more importantly-why it took so long to recover. Computer systems will always go wrong from time to time; the important thing is whether you have backup systems and the time it takes to implement recovery.

As of now, we have kept in very close touch. My office was in touch with the senior RBS management right through the weekend. Our banking director was in touch with RBS and the FSA since this problem began. RBS has made its public statements; it is still going to take time for it to catch up-to get back to normal. I think the important thing now is that we provide whatever support is needed to let it put things right. Once it is back and we are back in normal times again, we must carry out a very detailed inquiry.

To my mind, one of the big lessons from this is that it shows everyone how important the basic functions of banking actually are, and what can go wrong when the system of making payments from one person to another is interrupted. Fortunately, it has been one bank-albeit a very big bank. The customers of that bank have been affected, and of course customers of other banks have been affected if payments have not gone through, but I hope that this is a reminder or demonstration to everyone of what might have happened if we had not rescued RBS in the autumn of 2008-the whole payment system would have collapsed. That is why it is so important to ensure that we have a banking system in which the people running it are completely focused on this essential service function of banking of providing not just retail customers but business customers with a well-functioning payment system. It is why, deep down, I have been driven by the belief that the nature of banking in providing these kinds of services is very different from investment banking operations. Both are important but they are very different. If you go out and see the way supermarkets operate, their senior management are utterly focused on ensuring that the IT systems-the ordering system; the delivery system-works hour by hour, and it is very important that we ensure that that is true of our banking system as well.

Q35 Jesse Norman: Yes, there is a general question about the operational risks being run by banks that deserves much more scrutiny; I agree with that entirely.

Sir Mervyn King: I can assure everyone that the problems are not problems of the way in which banks interconnect the general payment system. That worked right through this function completely normally, and there is no risk to that. No other bank has the same kind of problem. Nevertheless, when you are one very large bank where it is-

Q36 Jesse Norman: But they are not liquidity problems, Governor; that is the key point.

Sir Mervyn King: They are not liquidity problems. This is an operational problem.

Q37 Jesse Norman: Good. Thank you.

Governor, in your Mansion House speech, you said, "It is strange that those in Parliament and the press who feel the central bank should not talk about fiscal policy are often the most enthusiastic to see the bank actually do it". Who did you have in mind?

Sir Mervyn King: There is a series of people who have made public comments on whether we should comment on a fiscal position, even though I comment a lot less than my counterparts overseas, and who seem to think that the Bank should off its own bat initiate schemes for buying assets.

Q38 Jesse Norman: Is this the Treasury? Is this the CBI? Who are we talking about here, Governor?

Sir Mervyn King: I can't remember exactly who it was, but I do seem to remember coming to a hearing here and there were reservations about how much I should comment on fiscal policy, and also how enthusiastic we ought to be to buy private sector assets. The point I made was not that there are necessarily problems in buying private sector assets in an extreme position, but that it is the Government in the shape of the Treasury who should be making the decisions about that, not the central bank.

Q39 Jesse Norman: When I questioned you on the issue, I was focusing on the issue of the authority under which the Bank operated, not the advisability or otherwise of policy. The original authority was provided through a letter to you from Alistair Darling on 29 January 2009 for QE 2009, which said, "The objective of the facility is to increase the availability of corporate credit and I authorise the bank to purchase up to £50 billion of high-quality private sector assets under this." That has become the model that has been taken on in further letters. Why didn't you criticise or complain about the fact that they were asking you to engage in fiscal policy?

Sir Mervyn King: I made it very clear. I said, "Can you possibly tell me what with this £50 billion are we going to buy?" and answer cometh none. What was made very clear-

Q40 Jesse Norman: You didn't say, "This is fiscal policy we shouldn't be doing this"?

Sir Mervyn King: I did make it very clear that I thought that we could operate a scheme for corporate bond purchases where we acted as a market maker of last resort in extreme circumstances, if authorised by the Treasury to do so, and that scheme is still operating. It is still functioning; it is still open. There isn't much demand for it, because the corporate bond market is functioning perfectly normally.

May I make one last point? The Chancellor made it very clear at the time that the people who should exercise this decision were not the MPC, but the executive of the Bank, because he didn't want the MPC to be voting on which assets to buy. I understand that, but I think it would have been very problematic if we had gone out and said, for example, "Well, we rather fancy buying assets in leisure companies in the West Midlands to improve their performance." You would have been the first people to have argued, "What was the authority to do that?" I am not against this kind of scheme necessarily, provided proper governance is put in place, and that means that decisions on what parts of the economy to subsidise or help have to be taken by the Government. Indeed, there was an earlier example of this before the asset purchase scheme, when one Minister in the previous Government wanted the Bank to introduce a special scheme to help car manufacturers. We said that they are perfectly open to use the existing scheme for corporate bond purchases, and one of the car companies was eligible for it, but we could not ourselves introduce a scheme-

Q41 Jesse Norman: But in your response to Alistair Darling, you said, "The bank will focus initially on purchases of corporate bonds, commercial paper and paper issued under the CGS". That doesn't sound like a criticism of the invitation for you to engage in fiscal policy; it sounds like an enthusiastic acceptance of your engaging in fiscal policy, specifically the fiscal policy of buying corporate bonds, commercial paper, and paper issued under the CGS.

Sir Mervyn King: We took upon ourselves those three assets because he approved those three assets. He didn't approve other assets and I couldn't really imagine what they might be. Indeed, with those schemes, we did commercial paper, but the commercial paper market is small and we closed that scheme when there was no further demand for it. That was the order of £1 billion. The corporate bond scheme is still open-still functioning-and the CGS paper was guaranteed by the Government.

Q42 Jesse Norman: It feels very much as though you did the minimum possible on this area and then maximally expanded on gilts.

Sir Mervyn King: We did not do that. But I would ask you the question: can you tell me what assets we should have bought?

Q43 Jesse Norman: That is a very interesting question, and I am glad you asked that because there is a wider criticism that could be placed at the Bank, which is made in Alistair Darling's book and is made now, that you are far too slow into the game on issues of liquidity. I think that relates to an issue of providing liquidity to some of these markets where the availability of credit is so limited.

A question for you, Mr Dale, if I may: do you accept the bank was slow in 2007 and 2008 and has been slow now to address the issue of liquidity?

Spencer Dale: No, I do not, and I do think that when we are thinking about the impact of the Bank's actions in the market for commercial paper and corporate bonds, it should not be judged by the quantity of assets we purchased. In those markets, we were acting as a liquidity backstop to make sure that they functioned well. The key thing is how well those markets were functioning. If you look in 2009, at the height of the financial crisis, the net issuance by UK companies of corporate bonds was the highest in any year we have ever seen. That was consistent with the market performing well. The fact that we were there made that market function well, and I think has served our corporate sector very well in the financial crisis.

Q44 Jesse Norman: What about now? Do you not think that there is a case-if there is not a case, can you explain why there is not-for the Bank devising a scheme that allows it to return to the original mandate of quantitative easing: not to bail out the Government with cheap debt, but to encourage lower borrowing costs for small and larger businesses?

Spencer Dale: In terms of large businesses, their ability to access both debt and equity in capital markets at the moment is pretty good. For large companies that are able to access those capital markets, interest rates have come down, and their ability to those markets is pretty good. I think the far bigger issue is the extent to which small and medium-sized enterprises that are restricted to bank credit are able to access such credit, and that is exactly why the Government, with the Bank, are working on this funding for lending scheme. It is designed to improve the flow of credit to households and companies that are restricted to bank credit as their primary form of borrowing.

Q45 Andrea Leadsom: Good morning, Governor.

Just going back to what Mr Norman was saying earlier, you talk about the problem with RBS being an operational one and your personal commitment to the fact that banks need to take very seriously their role in the operational flow of payments in the real economy. Do you agree then that there is a fundamental issue with our massive banking oligopolies and the fact that some of them have only perhaps 2% to 3% of their balance sheet in the real economy, meaning that at board level there is a clear lack of incentive to focus on that very part of the operational activity that you say is core to the success of our economy?

Sir Mervyn King: Yes, and that is why my personal view has always been that there is real merit in pursuing the separation of this utility-type banking from investment banking. I have nothing against investment banking at all, but it should be institutions that are run by people who are focused on that, and I think there are very different kinds of issues that are relevant to the operation of utility banking that are better carried out on a different balance sheet. I share the sentiments you express.

Q46 Andrea Leadsom: So would you agree that there is also an issue of lack of competition, and particularly barriers to entry for new players? What about the issue of switching which, in effect, is extraordinarily difficult, and will remain so under the ICB proposals to switch from one provider to another? Do you think competition has a part to play in this?

Sir Mervyn King: Absolutely. We need more competition and more new entrants into UK banking.

Q47 Andrea Leadsom: I am kind of leading my witness here, but do you consider that the lack of a competition mandate for the new PRA and the lack of a specific statutory primary objective for the FCA will create further problems to reducing the barriers to entry for new players?

Sir Mervyn King: No. I was willing to be led by you, but I think you have led me just a little bit too far there.

Andrea Leadsom: There had to be a point; we can't agree on everything.

Sir Mervyn King: I think the PRA has its own responsibilities or regulation, and I think if regulation is to be effective, it is very important that we do not encumber the regulators with lots of other objectives that people can use to water down the impact of regulation. I think the question of competition is much more to do with structure. It is to do with things like the ICB proposals; it is to do with competition policy more generally; and it is to do with Government action to deal with the two large banks in which they have very large stakeholdings. Those are the areas of policy that will matter much more in determining competition, and I do think that where the authorities are creating barriers to entry, if they are, and I think we at the Bank have- I have issued very clear instructions that there must be no greater requirement on a new bank in terms of access to our facility than an existing bank, and it is very important that regulation is structured in that way. I would think that competition law and the approach of the authorities ought to deal with that.

I do think that underlying all of this is that a system in which for 20 or 30 years we made it possible for banking activities of different types to be amalgamated on to a single balance sheet, combined with the implicit subsidy from the too-big-to-fail guarantee, inevitably led to the disappearance of competition. If we can get rid of that, I think the underlying economics of the industry will create more competition.

Q48 Andrea Leadsom: So can you assure us then that the PRA will have its eye to allowing new entrants into the market?

Sir Mervyn King: Well, I can give my personal assurance that I regard that as of the utmost importance, and indeed we have done that insofar as we can in the Bank over those areas over which we currently have responsibility.

Q49 Chair: What the Committee feels is that we shouldn't need to rely on your personal assurance. We need something statutory.

Sir Mervyn King: Well, I think it depends on where you think regulation might go wrong in terms of allowing competition-

Q50 Andrea Leadsom: Excuse me for interrupting, Governor, but our experience, having talked to would-be new banks-and indeed small banks looking to grow-is that there are distinct regulatory barriers to entry that require enormous business models to be put together, including dealing rooms, systems and so on, at the cost of millions of pounds, only for them then to be told, "Actually no, we're not going to give you a banking licence". The hurdles to achieving bank status are massive, and there is no incentive on a regulator to approve new banks. It is a fundamental issue that this Committee is very concerned about.

Chair: It is a moral hazard for the regulator, because the regulator naturally wants to eliminate all risk.

Sir Mervyn King: I think it is a question of graduation by stages. I think it is very hard for a regulator to give a complete blanket approval to a bank to say, "You will be allowed, in two years' time, to operate as a bank," without having any evidence that it can put together a dealing room or operate functionally. We have to apply the same criteria to existing banks. If existing banks, having invested a lot of money, suddenly demonstrate their inability to operate their functions, that is also a very good reason for the regulator to be concerned. I fully share and understand the motive for your concern.

Q51 Andrea Leadsom: So would you agree that, at the very least, there is a need to come up with a way? For Tesco to exist, it does not have to build and prove its branch network before you approve it-that would be a ludicrous analogy in the grocery world-but effectively that is what we are saying in the banking world.

Sir Mervyn King: I don't want to assume that what you propose is the case now is in fact the case. I think the FSA will have to come back and argue its corner, but I certainly agree that we need to avoid a ridiculous outcome that, in order to become a bank, you have to be a bank to begin with-that would clearly be crazy. I think you are quite right as a Committee to be concerned about that.

Q52 Andrea Leadsom: Thank you. Mr Dale, what is the maximum level of quantitative easing now that the Bank of England owns a third of all outstanding UK debt? Could it own 100% of it, or where would you draw the line?

Spencer Dale: I think where you draw the line will come before you buy all the Government bonds in existence. The primary that will determine the impact of how much quantitative easing you want to do is the outlook for the economy, and whether you are confident that you need to do more, if your judgment is that you need to do more QE to make sure that inflation does not undershoot the target. I also think the quantity of QE that you wish to do will be a function of other mechanisms going on in the economy, as I suggested in my annual report.

My personal view was that in the current environment, if we did want to undertake more stimulus, I was quite keen to explore mechanisms that tried to improve the flow of bank credit directly to households and companies rather than undertaking more QE. So, in that context, I welcome on the funding for lending scheme, which I think should hopefully-once we have finalised the plans-provide some stimulus for the economy. When thinking about the judgment on QE, we will need to take that into account as well.

Q53 Andrea Leadsom: Professor Miles, I believe that you said that you supported the idea that more money should go into the real economy and into small and medium enterprises, but you also responded to Mr Norman that the decision to leave interest rates unchanged is because the MPC preferred to use more quantitative easing. Would you not agree, therefore, that in spite of the Bank's determination not to be seen to be choosing sectors or to be involved in fiscal policy in any way, your action in choosing QE over straight monetary policy is in a sense choosing sectors? In effect, you are saying, "We prefer savers over mortgage owners. We are not going to reduce interest rates further," as you have just said yourself, "because although it would benefit home owners it would hurt savers more." Is not that, in a way, preferring one sector over another? How do you justify that when your only mandate is inflation?

Professor Miles: The reason why I am somewhat sceptical about the effectiveness of cutting the Bank Rate is not so much because it affects some people who we don't want them affected, and we'd prefer other people to be affected; it was more that the net macro-economic impact of cutting Bank Rate-the question of whether it increases the amount of demand in the economy-seemed to me to be ambiguous. It was not clear that it would do what we would want it to do, and therefore not be the most effective way of loosening monetary policy.

In contrast, I think that quantitative easing continues to be a useful tool, in that the direction it would push the economy in is less ambiguous. I think it pretty clearly is expansionary. I remain of the view that buying more assets would ease conditions. It would have an impact on the corporate bond market. It has a knock-on impact in the equity market-conceivably also wider than that, on commercial property and other asset values. So, I view it as unambiguously easing monetary policy if we were to buy more assets. I think that was not so clear in terms of cutting the Bank Rate.

Q54 Andrea Leadsom: One last question, Governor-it is quite a simple one. On quantitative easing, we have had a couple of discussions about the unravelling of the asset purchases at some point in the future. Can you just reassure the Committee that the fact that you will be retiring long before the asset unwinds ever have to happen, I would imagine, has no bearing on your willingness to undertake more easing?

Sir Mervyn King: I can completely assure you of that, and I can also assure you that the Bank and the DMO have a joint working party to discuss how we would go about unwinding it. We are very confident that we would be able to put in place and implement methods for doing that.

Andrea Leadsom: It would be very helpful for this Committee to see at least an outline of how that is expected to work because, as you know, it is of concern to us that we are going down a blind alley with no precedent for how we get back out of it.

Q55 Chair: While you are at it, perhaps you could also send us a more formal explanation of the exchanges we have had previously about whether the scheme might incur profit or loss to the public purse?

Sir Mervyn King: I have written to you about that already, Chairman. That letter is with you. On that, I cannot do any more than post it again.

Q56 Chair: Cannot do any more than what we have seen. Well, by all means, post it again if you feel you cannot add to it, but we will be returning to that subject in more detail.

Sir Mervyn King: The whole operation is unprecedented. We have demonstrated that we could buy the assets in an unprecedented way, and I can assure you that we should be able to sell them equally in the same competent manner.

Q57 Stewart Hosie: Dr Broadbent, you said in your report that you thought that the higher financing premia may have affected the economy’s supply capacity. Your report also told us that you voted for an increase in asset purchases in October and February. Given that financing premia are there, that they clearly exist and that businesses in the real world tell us that, why did you not vote for an increase in asset purchases again to help further reduce that premia after February?

Dr Broadbent: I am not sure that that is what gilt purchases do, or are even designed to do. I think they help to bring down the yields on all assets. I am not sure that they necessarily compress spreads between those assets. In other words, I am not sure that it is the case that we would expect buying gilts to have a bigger impact on the price of equities than on the price of gilts, but certainly it should help to improving funding conditions, and that is why, as I said, I was happy to vote for more asset purchases in October and again in February. I did not do so at the last meeting. It certainly felt as though conditions had worsened-I am talking now about the commissions regarding demand in the real economy-and also that the near-term profile for inflation looked a little more favourable, but still a bit above target at the end of the year. I was just going to add that having become aware of the possibility of these other policies, this too, gave me pause, because to some degree at least one can regard those policies, if not as a substitute, as having similar effects.

Q58 Stewart Hosie: I appreciate the issue about those other policies being a substitute, but you also said, "There still looks to be quite a bit of spare capacity and it therefore looks like inflation will continue to drift down." Given that weak demand in the economy, and given what you yourself had said about rather modest or low inflationary pressures, why did you not think there was room for additional QE, or possibly a lower interest rate?

Dr Broadbent: Well, on the interest rate, I can only say that I agree wholly with what David has already said on that score. In normal conditions, when you cut interest rates, you would expect to reduce all the funding costs to the banks, not just those on deposits, and in the current environment that looks less possible, so we would be squeezing margins of some banks more than others.

Let me come back to the question of asset purchases and these other policies. They are, to some degree, substitutes. It clearly will have a bearing on what you believe to be an appropriate level of asset purchases by the MPC according to whether lots of other policies are conducted or not. It would have an effect on our decisions if, say, fiscal policy was changed. It would certainly have an effect on our decisions if the funding for lending scheme-

Q59 Stewart Hosie: Would it be valid to suggest that the knowledge of these other policies-ones that are not necessarily yet in place-might have skewed some of the MPC decision making?

Dr Broadbent: I do not know if "skewed" is the right word. I think it might have affected it, and we will have to see. That should be set against the fact that the conditions in business surveys have worsened a lot, so whether these things are sufficient to deal with the downward pressure that we are getting-or at least a reduction in the inflation protocol we are getting-we will have to judge month by month. In the MPC, we are in the fortunate position-fortunate at least relative to other policy-making bodies-where you can return to these things every month.

Q60 Stewart Hosie: Professor Miles, in your report to us you said that the reason for weak domestic price pressure was a substantial degree of spare capacity opened when GDP declined during the financial crisis. Do you feel that your concerns about the level of spare capacity in the economy have been adequately considered by the Committee as a whole?

Professor Miles: We spend a great deal of time trying to figure out how much spare capacity there is. Clearly the level of GDP is dramatically lower than you would have expected before the crisis, if you just assumed that the next few years would be average. We may be 13% or 14% beneath that trend. I think it is pretty difficult to try to work out how much of that gap is capacity that either was never there or has gone for ever, and how much is truly slack. There has been no shortage of time and effort expended in trying to quantify that in the Bank. My view is that a very substantial part of it is slack, but I can perfectly understand that other people can look at the same facts and think that there may be a little bit less slack. But I think there is a very large amount of slack, which is why I have consistently voted in recent months to make monetary policy easier again.

Q61 Stewart Hosie: This is your view compared with others. The Governor said in the 16 May press conference, "The idea of growth in the labour force in the long run has been affected by the crisis and the idea that the pattern of innovation has been adversely affected is not an obvious one. It may have had some effect and maybe we've lost a bit for ever but I don't think the experience of past crises have led to that conclusion". Adam Posen, appearing before us on 29 February, said, "There certainly is erosion but the scale and pace of the erosion though is slower and smaller than I would have worried about". He went on at some length about that. You do appear to be more concerned about the potential of permanent loss of capacity than others. Are you intending to push your view more on the MPC?

Professor Miles: I have a lot of sympathy with the views you have just quoted, and I do take the view that a very large part of this huge shortfall in GDP from what you might have expected is indeed slack rather than capacity that has just gone for ever. However, I am concerned that unless we get demand and growth up to a more normal level, some of what is currently unused capacity will turn into lost capacity. Forgive me using a bit of economic jargon, I think there is hysteresis; in other words, if you do not get the growth back relatively quickly, that affects permanently the amount of productive capacity in the economy. I think that is a real concern, and it is one of the reasons why I think making monetary policy even more expansionist is the right thing to do.

Q62 Stewart Hosie: Governor, are you concerned that we will get this permanent loss through atrophication?

Sir Mervyn King: It is a concern because if it were to happen, it would illustrate the enormous cost of a crisis like this. My own judgment is that in the very long run, we will be able to get back the capacity that we might have thought we had lost, but it could take a long time. I think from the perspective of monetary policy today, we are having to take a judgment over a time horizon of two, three or four years, and that is when it is very difficult to judge how quickly we can bring back the capacity. That is what is difficult in the policy decision.

Q63 Stewart Hosie: I appreciate the difficulty, but you said at the beginning of that answer, "In the very long run we may get back the capacity". Can you put a number on what is "the very long run" to get us back to somewhere where we ought to be?

Sir Mervyn King: I don’t think I can. It would be a stab in the dark-

Q64 Stewart Hosie: I am happy to have the stab in the dark. Five years; 10 years; 15 years?

Sir Mervyn King: I am not going to make a stab in the dark because it is very hard to see in the dark and I cannot see where that stab should go. What I would say is that when this crisis began-in 2007, 2008-most people, including ourselves, did not believe that we would still be right in the thick of it, in the middle of it, five years later. All the way through I said to this Committee, "I don’t think we’re yet half way through it". I have always said that and I am still saying it. That tells you an awful lot about how my estimate for how long it will take to recover from this is expanding over time. I think the reason why I talked about the very long run was deliberately not to put a number on it and to distinguish it from the time horizon that is relevant to monetary policy now. What is making our task extremely difficult is that we find it very hard to judge what will be the pressure on inflation two or three years down the road for given growth rates of the economy over that fairly short period.

There is just enormous uncertainty out there. I have no idea what is going to happen in the euro area. That is our single biggest trading partner; it accounts with other countries immediately adjacent to the euro area for half of our trade. It is impossible to imagine that in a situation where you just do not know what the situation will be in a part of the world that is close to you and is half of your trade, you can engage in any kind of economic forecasting.

Q65 Chair: David Miles, do you think that these measures of the output gap, given the scale of the crisis we have had, really amount to much more than guesswork?

Professor Miles: I think they are hopefully educated guesswork, but guesswork is not a bad way of putting it. I do not think you can avoid trying to make a guess about the issue though. It is a reflection of how difficult it is to set monetary policy even in ordinary times, but when we have been through something as extraordinary as we have just been through, it really becomes even more uncertain. My own view is that even though one cannot be sure whether the degree of capacity is merely quite significant, very significant or enormous, I think I know enough about the degree of slack to believe that an increase in demand-if you could generate it through monetary policy right now-would not increase inflation substantially.

Q66 Chair: Politicians on both sides of the debate make great use about the output gap measure, and what I am seeking from you is the extent to which we should really be doing that, rather than adding a great dose of circumspection to it.

Professor Miles: I think it is right to be aware that there is no scientific answer that will give you great precision about how much slack there is. But it seems to me that the evidence is consistent with there being a substantial amount of spare capacity.

Q67 Chair: Governor, just to be clear, when you say, "We might be able to get back in the very long run, peering into the dark future, the output that we’ve lost", you are talking there about the need for a period of above-trend growth to recoup it?

Sir Mervyn King: Clearly, yes.

Q68 Chair: All right, so while the measures that were originally put together-based on the previous experience of bounce-backs from recessions that we have had for the most part since the war-suggested that we would get that, this time you think that we are in a very different type of recession-

Sir Mervyn King: Yes, very different.

Q69 Chair: And that is likely to lead to a prolonged period of below-trend growth.

Sir Mervyn King: How prolonged I just do not know, but I think one of the lessons of the period from the mid-1990s to 2007 was that after a deep recession, the policy framework was able to ensure that unemployment did fall over that period by quite a lot, but that was not by it falling very sharply and quickly-it was a very slow and steady reduction, and the rate of growth in the economy was probably above what people would have said had been the trend. But it succeeded in bringing down unemployment while maintaining low and stable inflation, because we did not get into the business of too rapid a growth rate in any one year.

One has to regard this as a long-term project to get back to where we were. We are nowhere near starting that now. We are in the middle of a deep crisis with enormous challenges to put our own banking system right, and challenges from the rest of the world that they too are struggling with.

Q70 John Thurso: Can I come to you, Mr Dale? Your annual report, apart from a including a very good explanation of why you spent last year arguing for 0.75% and have since changed your mind, more importantly at the end had the statement, "I would like to explore the possibility that some of the support be provided by measures designed to improve the flow of bank credit". Are the recently announced measures enough to meet your aspiration?

Spencer Dale: I do not know, because we are still working on the design of the scheme, but I think they certainly go in the right direction. Part of my motivation for thinking about that was trying to think about the supply side performance of our economy. We have seen productivity growth in our economy being very weak. It is very puzzling to understand the factors underlying that, but one factor that could well underlie a weak supply performance is if we have a banking system that is not able to allocate credit efficiently across different companies and different households. Therefore, one of the advantages I see in this scheme is that it not only will help to boost demand in our economy, but may well help to support supply growth as well. I think that is quite a nice combination of factors.

Q71 John Thurso: What, in your view, is essential to the design of this scheme to ensure that it does not end up being broadly the failure that Project Merlin was?

Spencer Dale: A key design principle that we are working on is that access to this scheme is directly related to the extent to which banks increase their net lending to the real economy.

Q72 John Thurso: So we are going for net lending?

Spencer Dale: That is a fundamental design feature of the scheme that we are working on at the moment.

Q73 John Thurso: Can I turn then to-we have heard a bit of this already in answers to other members of the Committee-how this is going to work when a small or medium business is wishing to apply for credit? Last Friday, for example, I attended an IOD dinner in Scotland at which the Scottish director of a well-known large bank proudly told us that 40% of the lending applications that have been refused were overturned by the bank's internal credit assessment and the credit was granted. My immediate question is: if the front line is getting 40% wrong, is not the system broke? How do we overcome that?

Spencer Dale: I am not sure. I think there is limit to what monetary policy can do. With the few levers we have-as the Governor said earlier in another context-we cannot solve all problems. A feature of the weakness we observe in bank lending at the moment is the fact that the cost at which banks can finance their own lending-the cost of bank funding-is very high. The idea of this scheme is to try to reduce the cost of funding for banks to the extent that they are lending to the real economy, and that will certainly be a step in the right direction. I do not think it is a magic wand that will solve all problems, but it certainly would be a step in the right direction.

Q74 John Thurso: That addresses the problem of cost, but it does not address the problem of the banks' aversion to actually lending at all. How do we get past the point at which the major banks-the very small number of major banks left in this country-want to hoard money on their balance sheets rather than lending?

Spencer Dale: Again, I think there is a limit to what we can do. As I said, the way we hope this scheme will work will be by incentivising banks in terms of providing a lower cost of funding to the extent that they increase their lending to the real economy. At the margin, their incentive to lend, even if they start from a position of being somewhat sceptical, should help to push them in the right direction. I do not think that we can smash all those barriers down, but it will help, at the margin, to increase their incentive to lend to SMEs and households that are currently finding it very hard to access bank credit.

Q75 John Thurso: Let me ask you about the comment the Governor made earlier, which was that bankers in the payment system, like good grocers, need to be focusing entirely on making the system work and not have-these are not his words, these are mine-esoteric ideas about big profits in investment banking. If bankers doing traditional banking jobs-or supposedly doing those jobs-are actually fixated on increasing profitability by using the money that you are giving them in areas where there is perceived higher profitability-the capital markets and investment banking-is it not going to be the case that the more you shove in, the more they divert, and there is going to be absolutely no difference to the SMEs?

Spencer Dale: That is a danger and, as I said, if you have a design principle that the amount you shove in is directly related to the extent to which they expand their lending to the real economy-not to the extent to which they expand it to other bits of the economy and to the financial sector, but directly related to the extent to which they expand that into the real economy-hopefully you help to mitigate that problem.

Q76 John Thurso: To what extent does the potential ring fence assist with this?

Spencer Dale: I am not sure. I think the ring-fencing will have implications in terms of the longer term structure and functioning of the banking system. I do not think that the ring-fencing will have an immediate impact on the extent to which the funding for lending scheme will work over the next year or so.

Q77 John Thurso: The point I am driving at is really this: isn't there a complete structural failure in banking in that until you isolate those banks that are meant to be in the payment system and supplying normal and proper credit to the commercial and retail sectors, you will always have a position where you are trying to push bricks straight uphill in that the credit will always leak out? The only way you can deal with this is to revisit the situation and actually turn the banks into something much closer to Glass-Steagall.

Spencer Dale: Well, I think the recommendations of the Vickers Commission-the Government have laid out the extent to which they are going to take on those recommendations-will certainly help to ensure that that part of the banking system which, as the Governor was saying, is designed to provide normal banking services to the real economy, can perform efficiently and well, even in times where the investment banking arm could be affected by crises of various sorts.

Q78 John Thurso: Governor, can I ask you two very quick questions? First, following on from that, another comment that has been made is that banking is no longer undertaken by bankers but by salesmen, and there is a lack of ability to make proper banking judgments, which results in credit decisions that are poor and also risk aversion. To what extent do you think that the new model of the salesman in the regional office and all the credit reserved to central function is having a negative impact on the flow of credit to businesses?

Sir Mervyn King: I think the biggest challenge that banking is facing now is the macro-economic challenge, and whatever structure of banking we have, if the same macro-economic circumstances were to occur, there will be a difficulty. I think the fundamental thing is to try to get the macro-economic position right. That it is not something that we can do on our own. I think this is one of the reasons why the crisis occurred in the first place and why it has been so difficult to resolve. I do not think that any one country can get out of this easily on its own. It will require a great deal of international co-operation, which is why it is very striking that our friends and colleagues in the United States spend so much time worrying about developments in the euro area, because they realise that, given interconnectedness-both through trade but also through banking-no one country, and even one as important as the United States, can make itself immune from trouble if there is real difficulty in Europe. Equally, we need to be concerned about developments in Asia and the emerging markets. That, to my mind, is one of the very big lessons: we cannot expect to operate effectively in a market economy worldwide without some degree of co-operation among the different economies to make sure that we do not get into this mess again.

Q79 John Thurso: A final question to you, Governor, if I may. To what extent is the lack of confidence generating weakness in the economy and embedding a negative cycle? I ask this question because last Friday's business papers had a series of good news stories-the Rolls-Royce factory opening in Rotherham and all sorts of others-juxtaposed with an Ipsos MORI poll that basically showed that Britain is saying we are useless at business and listed three areas where we are particularly bad, which happen to be the three areas where we are particularly good. Is confidence in itself a factor?

Sir Mervyn King: It is, but I would distinguish between the two types of confidence that you mention. The confidence that is particularly lacking now is the confidence to invest today, rather than waiting to see what happens to the euro area and other developments over the next two years. It is postponing decisions that companies fully expect to take at some point, but now is not the time to commit to it. If everyone does that, you do lead in a self-fulfilling downturn in the economy. That was why I talked about the black cloud of uncertainty in the Mansion House speech. That, I think, is the real worry.

The alternative lack of confidence-in ourselves as an economy and a lack of manufacturing-is completely misplaced. As I go around the country regularly, I meet a whole of stream of very impressive medium-sized manufacturing companies. We have not abandoned manufacturing at all-we are very good at many parts of it-and we should not underplay that. There are lots of good news stories, but what we are faced with is something very, very different: a macro-economic position where a massive degree of uncertainty and a tremendous monetary disturbance in the euro area are doing things that have created an enormously negative monetary stimulus.

Again, in the Mansion House speech, I pointed out what has happened to broad money in Greece-it has fallen by over a quarter. That was exactly what happened in the United States in the great depression. Sometimes we look back to the great depression and think, "We would never do that. We would never make the same kind of mistake. They were very old-fashioned in those days. We are not like that, are we?" Well, we have done it in Greece, and this kind of monetary downturn is very, very damaging and we have to find a way to cut through it. It is a monetary situation and we have to resolve it in some way. That is why I have been keen to engage in asset purchases, despite the risks and all the problems-and I know many people think they are important-to prevent the decline of broad money in this country. I do not want to see us go down the way that other economies are following, and we have not, but we are still struggling to get back to more normal times, as are other industrialised economies.

Q80 Mr Ruffley: The first ECTR auction was fully allotted at the minimum spread, so there is obviously an appetite for what you are offering. Have you had any discussions with the FSA about relaxing its liquidity requirements to banks?

Sir Mervyn King: Yes, we have had discussions.

Q81 Mr Ruffley: Could you say something about that?

Sir Mervyn King: I would rather not, because the Financial Policy Committee, in whose area this falls-I think I am the only person here today who is on the Financial Policy Committee-is in purdah, and we publish our financial stability review on Friday. No doubt the FSA will at some point have something to say. The regulation is very much for it rather than us. I have made the general comments that I wanted to make, and I think it is now for the FSA to make their comments in turn.

Q82 Mr Ruffley: You are chairman of the MPC and the FPC, so you must be able to give us a bit more detail on the relaxing of liquidity requirements. It has an obvious impact on the decisions made-

Sir Mervyn King: It does. I will make one general comment, which is linked to what I said in the Mansion House speech, but anything else, I am afraid, will have to wait until Friday, when the FSR is published, because we are in purdah as an FPC, and it is in that capacity that I am speaking. The general comment I make is that the potential regulation, which is proposed to be introduced at international level, and which the FSA has anticipated somewhat-and produced very sensible results, as many of our banks have greater amounts of liquidity than they would have done had the FSA not taken its measures-does not adequately, in my view, take into account the way in which central banks provide liquidity in stressed times. One thing we have to do at international level-and in my capacity as chairman of the Central Bank Governors and Heads of Supervision, when we meet in Basel, I will be discussing this-is determine whether we can modify the regulations and rules that we have been discussing so that we can better take into account the way in which central banks provide liquidity. That is what we will be doing. I can assure you that a great deal of thought is going into this in terms of redesigning the framework, and there is a great deal of concern about an inadvertent application of over-tight regulation in present circumstances.

Q83 Mr Ruffley: Can I just ask, pursuant to John Thurso’s line of inquiry, the question that is asked in pubs up and down the country: is there going to be more net lending to households and small business? We know from your own lending survey stats that Project Merlin saw a decline in that lending during the course of its operation. Obviously, the funding for lending scheme is going to try to do better to expand loan books. Could you just have another go, following Mr Dale’s answer to this, on why you think there will be an expansion in loan books as a result of funding for lending?

Sir Mervyn King: I do not know whether there will be or not. I can give no guarantees. That will depend on what happens in the world economy and the impact of that on the UK. What I can say is this: the principle behind the scheme, as Spencer Dale pointed out, was to give a significant financial incentive to banks to consider expanding their lending to the real economy. I have always felt that if you want to encourage bankers to change their behaviour, what is better than having a discussion is probably to give them a financial incentive, and that is what the scheme will do. I hope you will have a little bit more patience before we publish the full details. When they are published, I think you will see that it is a real incentive, but we do need to go to the European Commission before we go public to have our discussions with it so that we can ensure that none of this falls foul of state aid rules.

Q84 Mr Ruffley: We await the detail, but can I just take you back to an answer you gave on 29 February when you came to see us on this point and the question of how we can encourage commercial banks to lend to small business over and above what they are willing to lend currently? You said, "It is either direction, in terms of the banks that the taxpayer owns, or it is an incentive to do something that the banks would not otherwise do. In other words, a subsidy, and questions of subsidy have to be matters for Government." By "subsidy", are you talking in the sense of cheap borrowing, or in some other sense of the Treasury covering or underwriting any losses that commercial banks suffer as a result of more risky lending?

Sir Mervyn King: It is in the former sense; the sense that we would be lending-

Mr Ruffley: Cheaper borrowing.

Sir Mervyn King: It is not just that the rate that we would charge would be lower; it is that we would be lending for several years. That is not something that a central bank would normally do, and we would never have produced this scheme had it not been for the circumstances in which the UK currently finds itself. We would not do it without the strong agreement and approval of the Government. The Government have to make clear that this is something that the central bank is authorised to do.

Q85 Mr Ruffley: What do you say to senior bankers who make the obvious point-I just want to check that it is obvious and that this is your understanding-that both the Bank and the Treasury want the risk of any new lending that they might wish to undertake with this cheaper borrowing that you are providing to lie fairly and squarely still with the commercial bank?

Sir Mervyn King: That is certainly part of the scheme and I think that is the right thing to do. All I would point out is that when there were discussions prior to the introduction of the national loan guarantee scheme, one of the ideas that was floated was that there would be a sharing of the returns, and hence the risk, on loans to small businesses, but it would have to apply to all loans. The banks showed no interest in that because, in their words, they wanted to keep the best loans to themselves. That is the other side of the coin to the adverse selection problem. What you cannot do, and you would be foolish to do, is to agree to share the risk of those loans that banks decide they would like to share the risk with you on, rather than-

Mr Ruffley: Yes. You start getting worried if they-

Sir Mervyn King: It seems to me that the banks made their choice when it came to the national loan guarantee scheme, when they said they were not prepared to share the risk because there were many loans that they thought were good loans-that was why they were making them-and they wanted to hang on to the returns on that. That is fine, but what we can do is to provide a guaranteed source of funding for several years-closer to the average maturity of the loans that they are making. This is not liquidity support, but it is funding support for a longer period at terms that will be attractive, and the reason why it should be attractive is that both the amount that the banks will obtain from the scheme and the price that they will pay for the money they borrow will be a direct function of the rate at which they are expanding lending to the real economy. I think that is an innovative scheme and it gives the banks a very strong incentive to consider, at least, expanding lending to the real economy.

Q86 Mr Ruffley: Before you made this announcement in the Mansion House speech, did you have a trot around the block with commercial bank senior executives about trying to share the risk with them?

Sir Mervyn King: No, because they made it clear in earlier discussions that they were not prepared to share risk, except on the terms that they would choose, which were the loans that we would share the risk on. That is not the kind of deal that I find myself attracted to.

Q87 Mr Ruffley: I understand it was on the national loan guarantee scheme when you first heard that response from them. Has there been any other attempt that you are aware of, either by the Bank or, so far as you are aware, on behalf of the Treasury? The reason I ask is that a lot of senior bankers say informally that unless there is some sharing of risk, they are going to find it difficult to make a turn, and they actually be looking at loan applications that they have up until now decided to decline because they were too risky.

Sir Mervyn King: It is a question of the cost they pay. If we are making a significant difference to the cost of funding those loans, and the proposal would indeed make a significant difference, it ought to lead them to decide that loans that they thought were previously marginal are the ones that they would now find attractive. I am in no doubt that the scheme ought to provide a real financial incentive for banks to expand their link to the real economy. What happens in the end, of course, is a result of the macro-economic outcome, not just for the UK but for the world economy, and that I cannot predict. We will be putting in place a scheme-when you see the details, I hope you will agree-that does provide a genuine financial incentive.

Q88 Chair: In the minutes, it reads, "It was possible some of the policy options available to the FPC, if exercised, would affect monetary conditions". In what ways will the FPC options affect the MPC's ability to conduct effective monetary policy?

Sir Mervyn King: That did go back to the previous debate about liquidity and liquidity regulation, and I think what the MPC was saying was that when it came to form a judgment about the need for a further stimulus, what would affect that judgment was clearly the constraints that might be affecting banks' willingness to lend, which encompass not just interest rates or prices out in capital markets, but liquidity and the interaction between liquidity and liquidity regulation. The MPC recognised that that was relevant to their judgment and, secondly, not a matter for the MPC to make decisions on, or to comment about what should happen.

Q89 Chair: You are at the apex of all the decisions because you are on both-you chair both. A little earlier, you told us that decisions that needed to be taken on the setting up of these schemes involved several groups of people. A good number of those groups of people are within the Bank. Do you think that that increases the strength of the argument that we heard in the House of Lords Second Reading debate on the Financial Services Bill that there should be a single committee, rather than a number of overlapping committees, to take responsibility for these issues?

Sir Mervyn King: I can understand why people raise the question, but I do not think it is a reason for merging the committees, at least now. I say that for the following reasons. First, the complications that result now are the result of the macro-economic position. If interest rates are very close to zero, when looking at the difference between monetary policy and debt management and fiscal policy, and sometimes supervision-certainly macro-prudential-the boundaries between the different policies become very blurred. If the boundaries between the policies become blurred, it is not surprising that the boundaries between the different responsibilities of the committees seem to be blurred. I do not think you can resolve this by creating one committee, because the biggest and most obvious example of where the responsibility has become blurred is between monetary and fiscal policy, and the only way of merging that would be to abolish the independence of the Bank of England for monetary policy. If you were to get around to doing that, you might well find that no sooner had you done it, you were back to normal times with positive interest rates and you could clearly distinguish between the instruments that belong to one and those that belong to another.

The second reason I would give is that you would lose a lot of the expertise that we have in our different committees. On the Monetary Policy Committee, we have four very professional economists who are experts on monetary policy and can bring a wealth of experience and knowledge to monetary policy decisions. On the Financial Policy Committee we have four externals who bring a lot of experience of careers in the financial sector. They know about the financial sector and about the issues relevant to the FPC. If you were to merge the two committees, you would either end up with a very big committee, where I think you would immediately lose effectiveness, or you would have to lose half the externals in order to maintain the size of it. You would lose a lot from the decision-making process.

Over 15 years, the MPC has demonstrated that having a very clear voting system based on individual voting-which can lead to my being in a minority, occasionally-is a very effective way of making decisions. It is effective because there is a very clear instrument on which we vote. On the Financial Policy Committee, it is a much more diffuse area. We are making recommendations, many of which are qualitative in nature, not quantitative, and that committee is never going to have the same kind of individual voting on the same frequency as you get on the MPC. As soon as you merge them, what you will end up with is a purely consensual basis for taking decisions.

You may gain something by doing that, but what you will lose, I think, is what has been a great strength of the MPC: the ability of individuals to say, "No, actually, I do not agree with the majority. I think we should cut rates, or raise rates, by this amount," without fear of being seen as rocking the boat or undermining the credibility of the committee. The committee's credibility has come to be defined in terms of the willingness of people to vote in different ways. I think the two kinds of committees are very different, not only in terms of the expertise that you need on it, but in terms of the way they reach decisions. I think it is too early to say, "Let's merge the MPC and FPC." Let's see what happens to the instruments of the FPC-after all, you in Parliament have not even decided which ones to delegate to us yet-and let us give it five years. After five years' experience, I think it would be perfectly reasonable to come back and ask whether we still think it is sensible to have separate committees or to put them together. That will be a good question to ask then, but not now.

Chair: We will note that you think that that should be reviewed after a time.

Q90 Mr McFadden: Professor Miles, going back to your comments a few moments ago, we have had QE and the Merlin agreement between the banks and the Government, but the outcome of all that is an economy that is 13% or 14% smaller than it might have been had the crisis not taken place. In the last year to a year and a half, we have had either flat or negative growth. Why should this latest funding for lending measure make a difference to that picture when it reflects the outcome of all the measures that have been taken so far?

Professor Miles: You are right that the economic outcome in terms of activity, GDP and employment in the past few years has been extremely disappointing. I think it is a reflection of the enormous damage that was done-not just in this country but across many countries-by the near collapse of the banking system at the end of 2008. I do not think the monetary policy measures that have been taken have been ineffective. Without them, what has been a dreadful few years could have been a truly catastrophic few years. The question-although the answer is difficult to know, for sure-must be: what would have happened had we not cut rates to effectively zero and embarked on asset purchases on a huge scale? I think the answer would have been truly catastrophic outcomes. The lesson I take from where we have been over the last few years is about the severity of the catastrophic shock that hit economies at the back end of 2008, rather than the ineffectiveness of the policy decisions that have been taken. I remain of the view that the levers we have-moving the Bank Rate, quantitative easing and these new facilities that we have been discussing-are effective. They have done a great deal of good. My own view, as you will know from the written record, is that it would be advisable to make monetary policy even more expansionary.

Q91 Mr McFadden: Do you worry that the business community and people who want to own homes do not have such a grateful view of the measures taken, given the reality of those outcomes, and that they are giving up on you? They are thinking, "The MPC are at the limits of their imagination with these bouts of QE. We do not see any benefit from it." They do not know what to do.

Professor Miles: I can understand a degree of frustration and enormous disappointment that the economic outcomes have been so weak over the last few years. I am a bit less pessimistic that the public perception that we have run out of levers to pull and nothing can be done about the situation. Although business surveys are not filled with optimism, there are some signs that companies are slightly more optimistic about where we will be in 12 or 18 months. I spend quite a lot of time talking to companies around the country and there is a degree of optimism that things will get better. For example, the majority of people who have mortgages are paying lower monthly payments now than they would have paid, and that they did pay if they had mortgages four or five years ago. I think people can see that many of the things we have done have been helpful. It is understandable, given how slow the recovery has been, that people are not filled with great optimism about our ability simply to switch levers in the Bank of England and get back to normal conditions, and they are right to be sceptical about that.

Q92 Mr McFadden: Governor, we have heard from earlier questioning that you have set pretty strict limits on what you see the Bank's proper role should and should not be. To some extent, the Mansion House speech seemed like a change of view, which you said was because of a worsening of conditions in the last few months. If things do not get better, what else have you got in your policy locker?

Sir Mervyn King: It is difficult to imagine monetary policy going much further. I think that my colleagues in the euro area and in the Federal Reserve have said similar things. Of course, we can continue to expand asset purchases and we certainly-as David Miles has said, and I share his view-could do more of that, as there is no immediate limit or constraint on that. The bigger difficulty, however-this is where there are similarities with the experience before the second world war-when there is a black cloud of uncertainty that is leading people to be extraordinarily cautious about investing, is that it is very difficult to know how you can get out of that easily, at least in terms of expanding private sector spending. This is something where countries need to work together. One of the things that is affecting us-our American colleagues seem to think it is affecting them-is concern about our banking system because of the linkages with banks across countries. If people are reluctant to invest here in any activity that is either exporting to Europe or producing substitutes for imports from Europe, that investment can be kept on hold.

Just as, in the 1930s, we failed to maintain free trade and went down a route of protectionism, which worsened the great depression, we need to make sure that if there are problems in one area, they do not lead to deterioration in other parts of the world economy which then feeds back and leads to a worsening in the first area. I have no simple way of trying to achieve this. I think we need to maintain our overall policy stance. In monetary terms, we can relax by doing more asset purchases if we have to. We have identified an area of funding costs for banks, and we are introducing a scheme specifically to tackle that. I think we will just have to see how the situation plays out and work out what to do. If we can identify further special areas of concern, we can work with the Government to deal with those, but it is a question of taking it month by month. What I would say is that we have not run out of road in terms of our basic policy weapon-asset purchases-and we are prepared to use that if necessary.

Q93 Mr McFadden: You had an exchange with Jesse Norman, I think, on what assets should be purchased and what assets you think it is not your job to decide on. If the condition worsens, is there any prospect of that position changing, or-

Sir Mervyn King: That is a question for the Government. We can always act as the agent for the Government but, as we said before, in a crisis the Government will have to take the lead. If it was actual purchases of assets, it would be a decision to put taxpayers' money at risk in the interests of trying to stimulate the macro-economy. I am not saying it would be a mistake to do it; all I am saying is that it would be a decision for the Government to take. We would act as the agent. What would be a mistake is to pretend that it is something for the central bank to do off its own bat. If we were to buy assets that, for some reason, produced big losses, I am absolutely confident that this Committee would be the first in line to say, "Under what authority did you take that decision? This is something that only the Government can take a lead on." It is exactly the same position that Mario Draghi has set out for Governments in the euro area: central banks cannot substitute for Governments when it gets to a position like this.

It seems to me that the position of your Committee has always been that when it comes to a crisis and public money is at stake, the Chancellor has to lead, and it is our job to work with the Chancellor to implement the schemes that the Chancellor wishes to use. We are about to introduce the new funding for lending scheme. Let us see how that goes. We have put in place a new facility to provide banks with backstop liquidity, which they have not shown a great need for so far. The auction went, but it went at the lowest price. If there was a big demand for liquidity and banks were in difficulty, you would expect the price they would bid at the auction to mean that the auction would clear above the minimum price, and it did not. I do not think we are in a disastrous position at all, from that point of view. What I am saying is that we ought to be concerned about what is happening in the euro area, and concerned that the world economy seems to be slowing rather than picking up. That is something that is bound to affect us and we have to try to find our way through it. The waters are choppy but, provided we can work well with our colleagues abroad, we will be able to come through it.

Q94 Mr McFadden: Thank you.

Dr Broadbent, the engineering firms in my west midlands constituency are pretty sceptical about these schemes. They have heard about Merlin and they would tell you that they have not seen any benefit from QE. Why should it be different with this new scheme? What can you say to them about this scheme that would give them the confidence that they have not drawn from the other measures that have been taken, whatever benefits they may have had?

Dr Broadbent: I would echo what David and the Governor said. When looking at economic outcomes, it is difficult to disentangle what is the impact of the initial shock to the system, which was enormous, and then try to discern what policy has done. My own view, like David's, would be that in the absence of the very dramatic easing of monetary policy-not just the cuts in interest rates, but subsequent asset purchases-this thing would have been far, far worse. The initial hit, to the extent you can measure it by the losses borne by banking systems, is probably bigger than that in the United States 1929 and 1930. If these things had not been done, and many of them were not done in the 1930s, I therefore think that we would have suffered something on the scale of the great depression-or worse. Now, I understand that that is a difficult thing to communicate to your engineering businesses. It is glass half full, at best, to say, "Well, cheer up. Things could have been far worse."

Q95 Mr McFadden: But what I am really asking you is why should they take more confidence from this new funding for lending scheme than they have from the other schemes?

Dr Broadbent: In some respects, as I say, the effects of QE are less visible than, say, cuts in standard interest rates, but I still think they matter. What I would be essentially trying to persuade your businesses of is that asset prices and the cost of their funding would have been higher without this monetary-

Q96 Mr McFadden: They would be arching their eyebrows at this point.

Dr Broadbent: They may well. As I said, it is difficult to prove one way or the other. In the case of this new scheme, as Spencer described earlier, it is much more directly linked to new lending done by the banks. To that extent, I think it is probably more easily assessed. Having said that, of course, there will be other influences on this lending, but the impact of the scheme on the incentives to increase loans is pretty clear.

Q97 Mr McFadden: How do you stop stressed, under-pressure banks from just hoarding any extra help that you give them and not passing it on?

Dr Broadbent: Remember that this is directly linked to the amount of extra lending they do. They will not get much extra help if they do not increase lending.

Q98 Mr McFadden: Can you just explain that in simple terms for the people here? What is the safeguard here against hoarding, just in terms of the design of the scheme?

Dr Broadbent: As I understand it-and the details are not finalised-the idea behind this is to say that the amount of help you get is itself directly linked to the amount by which you increase your lending. So, it is not a question of saying, "We're going to give you an amount of money,"-a collateralised loan, whatever it is-"and then you can do with it what you want." The degree of assistance is itself directly linked to the increase in their lending.

Q99 Mr McFadden: Is that the net lending or the gross lending?

Dr Broadbent: I don’t know the detail. I think the idea is the net lending. It is to link it directly to the net lending. So, it is rather different in that sense-well, it is clearly very different from, say, the ECTR, where we are providing the funding against collateral with no particular steer as to what they should do with that money. The only other thing I would say in all this is that, as the Governor said, we are trying to fight a force in terms of the degree of uncertainty and the impact that is having on investment-which is very, very large. That should be understood. It is difficult to convey that to your individual business. But I find in the conversations with individual businesses that I have had, they do understand that quite well. They understand that even for those businesses that are not constrained by credit-where they have cash or, indeed, where they can access securities markets-they, too, are reluctant to undertake investment. It is not simply a question of the banking system in my view. Even the pressures the banks are under are, in part, due to this black cloud that the Governor discussed.

Q100 Chair: Governor, when that cloud darkened in the autumn of last year, which led you to come to the view that something needed to be done on liquidity, when did you first speak to the Chancellor about it?

Sir Mervyn King: I had been speaking to him regularly, and you could see the clouds coming across in the second half of last year. I think some blue sky appeared when the ECB conducted its long-term repo operations. A lot of people took comfort from that. I didn’t take comfort about the long-run solutions that that offered, because it did not offer a long-run solution. But I think there was hope that it might have postponed the denouement for a considerable period, but in fact the impact of it wore off much more quickly.

Q101 Chair: So it was in that period, as you saw the LTRO effect wearing off?

Sir Mervyn King: We are talking here about April, May, June.

Q102 Chair: Of last year?

Sir Mervyn King: No, this year.

Q103 Chair: What I am trying to get at is when you first said to the Chancellor, "We need to do something about this."

Sir Mervyn King: Well, we have been talking about what we had to do right through the whole period, but the first time I discussed the idea of a funding for lending scheme was before Mansion House, when I put up the idea of the scheme to him.

Q104 Chair: And the liquidity scheme?

Sir Mervyn King: No, the liquidity scheme we had put in place last December. That was in place. I think we had a meeting in the Bank at the beginning of December to ask whether it would be sensible to activate it then. We decided not to. There would have been very little take-up of the scheme in December, so we decided not to activate it. However, after the May inflation report, I think that things deteriorated quite markedly, and we decided that that was time then we should consider activating the ECTR, given the context of what might happen after the Greek elections and the fact that Spain was clearly on the brink of having to apply for a loan. I could see very clearly that Cyprus would be coming in. I did not want the Bank to find itself in a position that something would go wrong over the next six month that would create a demand for liquidity to which we would then be responding at the last minute by putting in place a scheme. I wanted to get the ECTR activated so that people knew it was there.

Q105 Chair: The ECTR is now activated, but it is a six-month scheme, is it not?

Sir Mervyn King: It is an auction every month.

Q106 Chair: You have announced that you are going to do it for six months?

Sir Mervyn King: Yes.

Q107 Chair: Is that a rolling six months? Until further notice?

Sir Mervyn King: The money that anyone gets from the auction is there for six months.

Q108 **Chair:** Yes. But I am not quite asking that question. I am asking whether you are going to maintain access to this scheme.

Sir Mervyn King: This is not-

Chair: Is this being reviewed every month with a view to closure at the end of that month, or with a view to its possible closure at the end of a six-month rolling period?

Sir Mervyn King: No. We will wait until the end of six months and then review and see where we are. The terms of the scheme are not ones that you would want in normal times.

Q109 Chair: I just want to be clear. When you say, "We'll take a look at this at the end of six months and then see where we are," might you, at the end of that six-month period, bring the scheme to an end?

Sir Mervyn King: If we feel there is no need for it, because circumstances have improved, that is certainly possible. This money is not equivalent-

Q110 Chair: So it is not a rolling scheme.

Sir Mervyn King: It is rolling, in the sense that at any auction between now and six months, if you borrow money in that auction, you will keep it for six months after that date. It is rolling in that sense. The question of whether we hold new auctions is one that we will review after six months. However, with the money that is borrowed-in the fifth month, say-you are certain to have that for another six months.

Q111 Chair: Given that the primary purpose is to boost confidence, as you have pointed out, do you not think that there might be merit in giving advance notice before you fundamentally change policy?

Sir Mervyn King: We may well give significant advance notice of it.

Q112 Chair: I am not asking you whether you may well give it; I am saying to the Bank, "Have you considered making sure there is advance notice, given that your primary purpose is to benefit confidence?"

Sir Mervyn King: Chair, we have announced that the scheme is there for at least six months. In any one of the six months, if you get money from it, you have it for six months from that date. That is guaranteed. Anything after that depends on the circumstances.

Q113 Chair: I understand the scheme; I am asking you about the way you are announcing any punitive changes to it. You are telling me that you may announce that you have changed or closed the scheme with immediate effect in six months' time.

Sir Mervyn King: It depends entirely on conditions. To say that we would give a guaranteed period beyond that is equivalent of saying that the scheme is in effect for nine or 12 months. I think your question can only boil down to whether you think we should have guaranteed the scheme for more than six months. That is the substance of your question.

Chair: We have had a canter around the subject.

Q114 Mr Mudie: Just staying on that point, can you be more specific about when you took the decision with the Chancellor on running with funding for lending?

Sir Mervyn King: Certainly the final decision-

Q115 Mr Mudie: As best you can pin it, it was before the Mansion House speech?

Sir Mervyn King: Yes, of course it was. Yes.

Mr Mudie: Yes, of course, to everyone.

Sir Mervyn King: We have had several conversations at regular periods. It was sometime in the week leading up to Mansion House that we agreed that we were sufficiently clear that we wanted to do the scheme and that we would announce it.

Q116 Mr Mudie: That was after the IMF article 4 report? That was 22 May, yes?

Sir Mervyn King: That may well have been. Well, it would have been, but that was not the week leading up to Mansion House.

Q117 Mr Mudie: Dr Broadbent, you have been more forthcoming, I am pleased to say, in terms of how the MPC works. This is clearly a big initiative. Was it an agenda item on the two-day MPC meeting? Was it an agenda item? Where was it introduced?

Dr Broadbent: We were informed about the discussions, as I say, and an outline-

Q118 Mr Mudie: At what stage in the meeting?

Dr Broadbent: We were informed during the course of the meeting.

Q119 Mr Mudie: Which date?

Dr Broadbent: I am not sure that is relevant.

Q120 Mr Mudie: It is relevant. The minutes seem to suggest it was decided at the end of the meeting when you were coming to a discussion. In fact, the minutes say you were discussing that some members wished to make asset purchases rather than gilts a possibility, and in that context the Governor sprang this on the Monetary Policy Committee. Is this how the monetary policy works on major policy matters?

Dr Broadbent: Look this was a policy, as I understand it, in its infancy at best, if not yet born at all. So there was little to be done, except to inform the committee that there were discussions. There was nothing else to be discussed or said of it.

Q121 Mr Mudie: On 6 June, yes? On 6 or 7 June. On 7 June, it was in its infancy, and then about nine days later, in the Mansion House speech, it was launched by the Chancellor and the Governor-

Dr Broadbent: No, it has not been launched. The design is not been finalised.

Q122 Mr Mudie: It was announced to the world that this was going to happen.

Dr Broadbent: In principle it is going to happen; it has not yet been finalised. But I don’t think-

Q123 Mr Mudie: I would not think it had been finalised in nine days.

Dr Broadbent: Yes, exactly. That is the point. It has not been finalised.

Q124 Mr Mudie: But do you think that is the way to treat monetary policy? Whether it was in its infancy or something, it seems to me, as an outsider, that it was introduced to knock any deep discussion on extending asset purchases to the private sector in the head.

Dr Broadbent: No, I don't think that is true.

Q125 Mr Mudie: Well, that is how the minutes-

Dr Broadbent: No, no, because we have had those discussions many times.

Q126 Mr Mudie: On what?

Dr Broadbent: On principles of whether there would be other kinds of asset purchases.

Q127 Mr Mudie: No, but it is made much stronger, because the IMF had lectured you ten days or two weeks before that you should be doing this.

Dr Broadbent: No. Believe it or not, we have had those discussions, even without the benefit of the IMF's advice. We have had those discussions.

Q128 Mr Mudie: I think we get the way the monetary policy works.

Dr Broadbent: I don't think so.

Q129 Chair: Before you carry on, I think, Dr Broadbent wants to add his comment.

Dr Broadbent: I do not think that is fair. The IMF has nothing to do with it. We have had these discussions without its benefit and long before it turned up for the latest article 4 discussions. This policy is not something over which the MPC-I am talking here about funding for lending-could ever have exclusive control or veto because, as we have discussed earlier, there were many people who have an interest in it. We were informed, basically as early as we could be about these discussions. We are now involved in the discussion, we have a meeting later this week intimately involved in how it is going to be conducted and how it is going to be designed, along with other people.

Q130 Mr Mudie: So, as I trawl through the minutes of the Monetary Policy Committee, I will come across references to this scheme being discussed?

Dr Broadbent: No, no. Not this precise scheme. But on the principle of whether or not there should be other sorts of assets purchased, yes, you will.

Q131 Mr Mudie: I am okay with that.

Governor, following on from things that have been raised by others about which there are genuine worries, especially after Merlin, you suggested in your speech that the scheme will sustain or expand lending. The worry in all our minds is: is it to expand lending or is it to sustain lending? With sustain, as I think you know, there is no difference.

Sir Mervyn King: My concerns are the same as yours-that the net lending to businesses has been declining. Net lending to the household sector has been stagnant. We want both those to start to rise more steadily. All we are doing here is saying, "This is a scheme that provides a strong financial incentive to banks to expand lending." I cannot guarantee that they will do that; no one can.

Q132 Mr Mudie: No, I understand that. You suggested in an earlier answer-you not only suggested, you volunteered-that up to seven different bodies had been party to discussions about this. Had the banks been party to these previous discussions?

Sir Mervyn King: I have had a meeting with the chief executives of the banks, yes.

Mr Mudie: A chief executive of a bank?

Sir Mervyn King: No. I have had a meeting with the chief executives of the biggest banks to discuss this.

Q133 Mr Mudie: When did you discuss this with the chief executives?

Sir Mervyn King: After it was announced at Mansion House.

Q134 Mr Mudie: What did they demand, and did you indicate a wish for expansion or sustainability, because that is again our worry? When we went into Merlin, we were sold a pup. We want extended lending and expanded lending, but the options put on the table are sustainable lending or expanded lending. Now, what was your opening card to the banks and what was their opening card back?

Sir Mervyn King: I am not going to discuss the details of that meeting. But, what I will say is there is enormous difference between Merlin and this scheme. This scheme puts on the table money-

Q135 Mr Mudie: Governor, excuse me. These are discussions you have had with bankers, and you are our representative. I do not know about the rest of the Committee, but I would like to see expanded lending in the small, medium and house-building exercise. I would like to see that. Is that what you asked them, or are we back in a Merlin position where if they just sustain the level of lending we would be happy? Did you ask them at any point in the meeting for expanded? Did you ask their price for expanding the lending?

Sir Mervyn King: It is pointless to ask people just to do things. That is why Project Merlin went wrong. Just having a meeting and saying, "Will you do that? Will you make an assurance, please"-

Q136 Mr Mudie: That is how you negotiate.

Sir Mervyn King: It is not. We are putting in place a scheme that means they will not get money unless they take actions to expand their lending.

Q137 Mr Mudie: In your earlier answers you equivocated on that. Fair enough, you have moved away from the stick to the carrot, as you say, but even Spencer was speaking about the fact that if it expands, it could be marginal. Now, if you saw this scheme as a success, would it be that it had expanded lending?

Sir Mervyn King: My definition of success is that lending will be significantly greater than it would have been without the scheme, but that caveat is very important. If the world economy deteriorates and this scheme then provides a strong incentive such that lending does not contract as fast as it would have done otherwise, that would also be a success. I am afraid it cannot just be in terms of expansion. What would make me happy about the scheme would be if, in a year’s time, when I came here for the final time, we have seen some expansion of lending. That would be something we could all agree would work. But the scheme would still have been successful had it prevented a bigger contraction of lending that would have otherwise have occurred.

Q138 Chair: But it is why the definition of whether the scheme is a success-this net lending measure-is somewhat elastic, isn’t it, Dr Broadbent?

Dr Broadbent: Inevitably. That is the case with every policy decision. We cannot do experiments in economics. We only have one state of the world to observe and there are a lot of things that impinge on it, one of which, but only one of which, is policy.

Q139 Mr Mudie: One question that must be asked is this. This is referred to as a scheme for the banks, and the Chancellor specifically mentioned home ownership. This is for enterprising families who want to own their own homes. Will the scheme be extended to building societies?

Sir Mervyn King: Yes. It is available to all banks that deal with that, including the building societies that access our facilities.

Q140 Mr Mudie: Coming back to Merlin, one of the problems we had with it was the absolute lack of transparency; we see you gather the information, you don't monitor it and you have no involvement. It was not negotiated by yourself-I see you nod, so you accept that is fair. Are you talking steps to ensure that this agreement is transparent? Is the Bank of England going to monitor it so that we in this Committee and the public see what is happening month by month?

Sir Mervyn King: Yes. Now, I don't want to give a commitment today as to the precise frequency that we will publish data, because that depends on the details of the scheme, but let me give you an assurance that, first of all, we will have an enormous incentive to monitor this scheme carefully because we will be lending money to the banks. Secondly, because we have always believed, in everything we have done, in transparency, we will make sure that you have the information available to form your own judgment as to what you think of the scheme.

Q141 Mr Mudie: A last question in terms of your optimism about this being weeks. We heard that about credit easing-it was announced at the Conservative party conference in October, and it took place the following year. Now, things happen. I hear that this is in its infancy and, from your negotiations, I think there is a lot of time to spend negotiating. Do you stand by saying weeks, because I-

Sir Mervyn King: Yes.

Q142 Mr Mudie: Well, four weeks is a month. Is it not going to be months before it is here?

Sir Mervyn King: If I have anything to do with this, it is purely weeks. The biggest difficulty we have at present, and I am sure you understand this, is that I want to say as little as possible until I have been able to ensure that our people can talk to the European Commission and we can deal with the potential state aid problems. As I say, I am very confident that nothing we are proposing here would run counter to that, but it would be wrong for me to presume it because the European Commission have to make their decision. As soon as that is done, I think, we are going to be able to do it. For me, it is purely a matter of weeks.

Q143 Mr Mudie: I accept that.

This is definitely the last question-it is not so much a question as a statement. We went through equivocations earlier. As an individual, and as a politician representing an area that is desperate for investment, I would like to know if any negotiations are taking place-and if this involves any Government money or guarantees-to have an agreement that expands lending. The only question is how small a price you can pay for delivering that. Anything short of expanding is, in my eyes, going to let a lot of people, a lot of companies and a lot of small businesses down very badly.

Sir Mervyn King: I completely understand that. I am sure that you will see when the details are released that it will hit the banks in the face. The price they will pay to borrow from us is directly related to the rate at which they expand lending. The more they expand lending, the cheaper it will be to borrow from us.

Q144 Chair: Governor, I am sure you know from your experience of going around the country that it is extremely important not to underestimate the depth of discontent, not to say anger, among many of the small businesses that we represent.

Sir Mervyn King: I see that for myself-

Chair: They are extremely concerned about this.

Sir Mervyn King: I have seen that for myself.

Q145 Chair: You were talking about medium-sized companies, but it is the small business sector that is being damaged by this.

Sir Mervyn King: You do not need to tell me about that.

Q146 Mr Love: Professor Miles, could I come back to the questions about the output gap? In an earlier answer, you indicated that a great deal of time is taken on the Monetary Policy Committee discussing this subject. Would you confirm that there is a wide range of views about the output gap and-you are someone who has been a lone voice, but is now part of a significant minority-the challenges of gaining a consensus to undertake more QE and so on?

Professor Miles: There is a spectrum of views about the spare capacity. I think that reflects the fact that there is pretty contradictory evidence. If you look at some of the surveys of companies at face value, the results of surveys that ask companies, "Have you got a lot of spare capacity?" make it look like there may not be a lot of spare capacity. I think if you look in the labour market and wage settlements, it hits you in the face almost that there is a lot of slack. And it is part of the reason why wage settlements have been at remarkably low levels for several years now, given where inflation has been. I think the evidence is mixed. It is somewhat contradictory, and I think because of that it is not perhaps surprising that a group of nine people reach slightly different views on where they would put the amount of slack.

Q147 Mr Love: But would you accept that progress has been made, because the inflation rate has come back into the comfort zone? Has that changed attitudes? Is there more of a consensus developing as a result of that for the introduction of greater QE?

Professor Miles: Well, it is certainly a very relevant fact that having seen inflation, as recently as the back end of last year, close to 5%, we are now under 3%. In many ways it is reassuring that the evidence that most of us see for very weak domestically generated inflation pressures now looks like it is consistent with the measured rate of inflation. I think that has been a significant factor in people’s views about what the right policy is, alongside the rather bad news that has come from our biggest export market, which is the rest of Europe, in terms of very weak growth there, and indeed some of the rather unwelcome news from what were relatively fast growing bits of the world, Asia, and what looks like a bit of a slowdown in the US. I think it has been a combination of the economic news on growth and demand from outside the UK and the news on inflation that has moved the policy debate a bit within the Monetary Policy Committee. You can see that reflected in the minutes and the votes.

Q148 Mr Love: Governor, there is some criticism that the Bank had been taking a somewhat softly, softly approach. If the level of spare capacity is higher, as I think you now think, according to the minutes of the last meeting, will that exacerbate the problem of weak demand in the economy? The Committee has not accepted that the level of spare capacity is higher; will that lead to weaker confidence? We all understand that confidence is the critical factor here?

Sir Mervyn King: It certainly is. I don’t think anyone knows where the output gap is. There is an enormous range; it could be anywhere between close to zero and 10%. I think it is fruitless to try to pretend that we have any precise view of that. There is no doubt-

Q149 Mr Love: I understand that, but that is the answer we always get.

Sir Mervyn King: Yes, but that is the right answer.

Q150 Mr Love: People are basing their decisions-critical decisions for the economy-on their estimate of the output gap.

Sir Mervyn King: Well, if they have no real idea of where the output gap is, I do not think it follows. The policy decision reflects uncertainty about the output gap, and I think that showed up in two major considerations in our decisions over the last six months. One was a clear recognition that if there was sufficient spare capacity, you might, by not trying to do more to expand demand in the economy, then create a permanent loss of capacity through people being unemployed for a long period and dropping out of the labour force, for example. That was one of the things that motivated us to do more asset purchases. Against that, was a very understandable worry when inflation reached 5.2% six months ago and a lot of people said, "You have abandoned your inflation target. You do not care about inflation. You have lost control of inflation." We said, "No, we haven't forgotten about it. We have not abandoned the target. Our central view is that it will come down," and it has come down pretty well exactly as we said it would six months ago. Nevertheless, there was a concern, and we had to be conscious of that, that if other people did not believe that we were going to bring inflation down, or that it might not come down, the inflation expectations might pick up and that would have an adverse effect on wage settlements and pricing behaviour and, indeed, inflation would prove sticky. There was a perfectly reasonable concern that inflation might prove stickier than we had expected. As things have turned out, inflation has come down. At the last meeting, I certainly felt that there was a case for doing a bit more to expand demand, but these are very fine judgments.

My own view is that the committee is completely united on two things. One is that it must retain and confirm that its role is to meet the inflation target in the medium term. It cannot just throw it overboard, and we have not done that. We believe in that and we are looking ahead. We are looking ahead because we think that the position in the economy is giving sufficient cause for concern that we need to expand demand to prevent inflation possibly falling below the target looking ahead. However, there is a commitment to the target. I think that everyone on the committee has been voting for a very easy monetary policy. Everyone is united on the need for a very loose monetary policy. At the margin, there are slight differences of view about precisely how loose it should be. But this is not a question about some people saying, "Well you had better have a tight monetary policy as opposed to a loose monetary policy." We are pursuing an extremely loose monetary policy.

Q151 Mr Love: But if I take what you said about inflation, I think there is quite a lot of evidence that a substantial part of the inflation, when it was over 5%, was externally generated. That domestic inflation was relatively low, and therefore wouldn't we assume there was more spare capacity?

Sir Mervyn King: Well, that was what we said, and I very much hope that if it happens again, your Committee will be the first to go out and say I am right.

Q152 Mr Love: I would put it to you that a greater amount of QE would then have been justified and much faster than the committee has taken it. It is now likely now to be the next committee meeting before you take that decision. That is quite a substantial delay when, as you have admitted yourself, the clouds have gathered over the international economy.

Sir Mervyn King: I would say two things to that. One is that I personally believe that the situation has deteriorated in the last couple of months. I think the impact of the measures taken by the ECB have not had the lasting impact that many had hoped. That has created a much darker cloud than we had expected. Secondly, that there were perfectly reasonable concerns that inflation might, in the event, prove stickier. There were risks, and they were no more than risks, but let us suppose that energy prices had stayed higher-perhaps China had not slowed in the way that it has. That is not under our control. If that had happened, and inflation had proved stickier, I am quite sure that you and others would have said, "Well, what on earth were you doing loosening monetary policy when now we know that inflation didn’t fall in the way we thought it was?" You cannot set policy in retrospect, only in real time, and at each point you are balancing risks. That is what we shall go on doing.

Q153 Mr Love: Professor Miles said in an answer to Mr McFadden said that while growth in the economy had stalled, QE and other monetary policy measures have had a significant impact, but the reality is that they have not. We are in recession, so one has to ask the question, and I think you hinted at this in an earlier answer: what are the limits of monetary policy in current circumstances?

Sir Mervyn King: Well, that is no doubt a very difficult question. The BIS referred to this at the weekend-we spent the weekend in Basel for its annual general meeting-and pointed to the fact that, in the long run, very low interest rates is not a healthy position for an economy to be in. I share that view, and there is no one who would love more to be back in a situation with positive real interest rates. I wish we could get back to that point. But it is a little bit like a doctor who says to the patient, "One day you will be able to run a marathon again," but doesn’t say to the patient, "So get out of bed and run a marathon now." He says, "I will nurse you back through a period of regaining health so that one day you can do it." Our task from the MPC is not to raise interest rates today because we would like to be a world of positive interest rates. It is to nurse the economy through a period after which we can one day get back to positive long-term real interest rates, which is the only basis on which a market economy can thrive in the long run. That is the reason why I understand why so many savers-both young and old-are concerned about the level of interest rates.

Q154 Mr Love: But you accepted earlier in answer to Mr McFadden that the only mechanism, apart from the possibility of reducing the policy rate marginally-we have talked earlier about the impact that that may or may not have-is further doses of QE. There is no other mechanism, so are you suggesting that we continue with QE indefinitely?

Sir Mervyn King: Not indefinitely, but I think it is an instrument that we can use and while it is relevant to do it, we can apply it, but eventually we will get back. Remember, basically, that the economy has not been collapsing in the last two years despite the enormous headwinds; it has been broadly flat in the last two years. I hope that the euro area can come to terms with the challenges it has. I do think, as I hinted in the Mansion House speech, that a lot of the losses that have arisen, given the credit booms that have taken place around the world-not just in euro area-need to be written down on balance sheets. Many banks will need to be recapitalised as a result, and once all that has been done, it will be a lot easier to start getting back to normal. In many ways that is the lesson of the Scandinavian banking crisis of the early 1990s. If you write down credit losses early, recognise that and recapitalise the banks, you can then start again and get back to a better position. The biggest challenge we face is that this isn’t true of just one or two countries; it is true of a large part of the industrialised world. That is making the whole challenge very much greater. But we have to follow that approach, and that is why I think that trying to get the diagnosis of the problems right is absolutely fundamental. You will never get the right cure if you do not get the right diagnosis. I think, in this country, we have the right diagnosis. I think in the US they have the right diagnosis. They, too, are struggling as to where the limits to monetary policy are. But, I think in the euro area they still need to confront the challenge that a lot of loans and positions that have been taken up are ones that debtors will find impossible to repay, and hence, if debtors cannot repay, creditors should not assume they are going to be repaid. The sooner that is recognised the better.

Q155 Mr Love: Someone earlier mentioned the article 4 report of the IMF. It suggested short-range measures of further QE, but it did go on to say if those measures do not match up to the needs of the economy in recognising the gloomy economic news internationally, stronger measures would have to be taken. In other words, there is a limit to how long we can wait for monetary policy to be effective. Do you agree with that?

Sir Mervyn King: Broadly, yes, but let us take-

Q156 Mr Love: It was working on a fairly short time scale.

Sir Mervyn King: We have changed policies since then. I certainly voted for more quantitative easing. We have debated the merits of cutting the Bank Rate. We have discussed the funding for lending scheme. We have taken steps on liquidity. I am not quite sure what else at this stage you think we should do, but we will continuously review things. I make the point again, however, that these are unprecedented times. We are going through a debate, as they did in the 1930s, where people are saying, "Are there any policy instruments Governments can use?" There is no simple answer to that. We are trying very hard to find and feel our way through it. As the central bank, I do not think anyone would describe what we have done in the last four to five years as anything other than wholly unprecedented and rather imaginative. We are continuing to behave in the same way. Now we are still facing an enormous economic problem. Right through this I have tried not to underestimate the scale of the problem at the cost of being accused of being doom laden. But the problems are very, very severe, and I do not underestimate them.

Q157 Mr Love: Let me tempt you. At an earlier hearing, you said that the classic economic response to the circumstances at that time was loose monetary policy and tight fiscal policy. Is there anything that has happened, or is happening at the current time, to make you reassess that judgment?

Sir Mervyn King: No, because we don't have tight fiscal policy. We have loose monetary policy, a big depreciation of the exchange rate and a loose fiscal policy that is very slowly and gradually tightening. All that makes sense, and as far as I can see, everyone is broadly in the place of wanting that. You can debate at the margins the right thing to do. But that, I think, is the right strategy for the UK, and it is the right strategy for other countries that found themselves with a large current account deficit, a big shock to the economy and the banking system, and the need to rebalance.

Mr Love: Can I just press you-

Chair: This really is the very last one.

Q158 Mr Love: The very last one. With the international economic climate continuing to deteriorate, is it sensible for fiscal policy to be tightening going forward?

Sir Mervyn King: Mr Love, I have tried very hard not to fall prey to the temptation to comment on fiscal policy, and I am not going to do so today.

Chair: I am sure there will come time there, Governor-

Sir Mervyn King: It will not be today.

Chair: There will come a time when you will feel a sense of release about all this and no doubt it will all fall forth. In the meantime, we have had an interesting exchange, and we greatly appreciate your presence here today.

Sir Mervyn King: Thank you very much.

Chair: We will see you in July.

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