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DR MARK CARNEY, GOVERNOR OF THE BANK OF ENGLAND

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Witness: Dr Mark Carney

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Members present

Lord MacGregor of Pulham Market (Chairman)
Baroness Blackstone
Lord Griffiths of Fforestfach
Lord Lawson of Blaby
Lord Lipsey
Lord May of Oxford
Lord McFall of Alcluith
Baroness Noakes
Lord Rowe-Beddoe
Lord Shipley
Lord Skidelsky

Examination of Witness

Dr Mark Carney, Governor, Bank of England

Q1 The Chairman: I think, in view of the time, we ought to start. I start by welcoming the recently appointed Governor, Dr Mark Carney. This is the first opportunity that this Committee has had to have a session with you, and we are very grateful to you for coming. We did have regular, though not too frequent, sessions with your predecessor, which we greatly valued. I ought to explain that this session is being televised; that is just a forewarning. I understand, Governor, that you wish to make a statement?

Dr Mark Carney: If I may, Chairman.

The Chairman: Absolutely. Please do.

Dr Mark Carney: Thank you very much. I thank you for the invitation and for taking the time at this busy period. I am very grateful for this opportunity to give evidence today. These sessions in front of the Committees of both Houses are the cornerstones of the Bank of England's accountability to Parliament and, through Parliament, to the British people.

At this time of year, it is natural to take stock, and I would like to make a few brief remarks on the progress that the Bank has made in discharging its responsibilities over the course of the past year. First, inflation has fallen back to within a hair's breadth of the 2% target, and

the economic recovery has finally taken hold. Relative to market expectations, the news about the strength of the recovery in the United Kingdom has consistently surprised on the upside, and by much more than in either the United States or the euro area. It is, of course, welcome that the economy is growing again, but a return to growth is not yet a return to normality. Nearly 1 million more people are still out of work than in the years before the crisis, and the economy remains 2.5 percentage points smaller than it was in 2008.

The recovery has some way to run before it would be appropriate to consider adjusting the exceptional level of monetary stimulus that we continue to provide to the economy. In recognition of that, the Monetary Policy Committee introduced forward guidance this past August, making it clear that we will not even consider raising the Bank Rate at least until the unemployment rate reaches 7%. That gave households and businesses confidence that interest rates would not go up until jobs, incomes and spending are recovering at a sustainable pace.

The effect of forward guidance is evident in financial markets. Short-term interest rates and expectations have not reacted as strongly as they have in the past to the sharp bounce-back in expected activity, and measures of market interest rate volatility have fallen noticeably. More importantly, forward guidance is having an effect in the real economy. My experience, having met more than 300 businesses around the country, is that businesspeople understand forward guidance well. This is confirmed by the reports and surveys from our network of agents across the nation. Of course, what matters most for households and businesses is not market expectations of interest rates but what actually happens to the Bank Rate now and in the future. That is because interest rates on 70% of mortgage loans to households and more than 50% of loans to businesses are linked to the Bank Rate.

Our forward guidance framework builds in safeguards against the risks to inflation and financial stability that arise from an extended period of stimulus. In the event, inflation

pressures are well contained at present, although we are monitoring inflation expectations closely. We are equally alive to the risk that an extended period of stimulus could promote financial instability. With the adoption of forward guidance, we have made it clear that monetary policy is the last line of defence against such risks, with the Financial Policy Committee taking the leading role. In its most recent financial stability report, the FPC paid particular attention to the risks posed by the recovery in the UK housing market. These risks are manageable, and they are being managed. By acting in a graduated and proportionate way, we are reducing the likelihood that larger interventions will be needed later, and we are allowing the broader economy to continue to receive the stimulus it needs for as long as it needs to sustain the recovery.

Securing financial stability requires much more than a resilient housing market. The FPC and the PRA have acted to ensure that our major banks and building societies are adequately capitalised for expected future losses; that there is a more conservative assessment of their asset risk weights; and that future costs of redress for past misconduct are taken into account. In total, UK banks' equity has increased by more than 140 billion sterling in the past six years, and risk-weighted capital ratios have doubled. The Bank remains at the forefront of international efforts to solve the problems of financial institutions that are too big to fail. Next year, the Financial Stability Board will establish standards on the amount, type and location of gone-concern loss-absorbing capacity—alternatively, that is termed "bail-inable debt"—that banks should hold to ensure that they are resolvable in a crisis without taxpayer support. Alongside our international partners, the Bank is working to establish practical resolution plans for major UK banks.

The Bank is also working towards more robust financial markets. An important part of that is catalysing more efficient and effective collateral management by back-stopping private markets. Accordingly, we have revised our sterling monetary framework to offer money

and collateral for longer terms against a wider range of assets to a wider range of participants at more competitive costs. As this Committee is well aware, the year has also seen the conclusion of the impressive work of the Parliamentary Commission on Banking Standards and the Banking Reform Bill, which has benefited from the wisdom of many here. The Bank will now take forward implementation of many of the Bill's measures, including ring-fencing of retail banking activities and the new Senior Persons regime. As these reforms are given life, they should accelerate the rehabilitation of the financial sector, so that it once again merits trust and is focused on serving the needs of the real economy.

Chairman, those are some of the headlines from a very busy year for the Bank, and I appreciate that you will want to discuss these and other issues in more detail. I welcome your questions. Thank you.

Q2 The Chairman: Thank you very much. We have a very wide range of questions—quite a number—ahead, and, as you indicated, you have anticipated some of them. We will want to probe further in detail. Could I start with a very general question? It is six months since you took up your appointment. Have things turned out as you expected, or have there been unanticipated experiences, if I can put it that way, and what do you feel you can bring from your time as Governor of the Bank of Canada? What lessons from that experience are you applying here?

Dr Mark Carney: Let me start with "relative to expectations". I am pleased that my quite high expectations of the quality of the staff at the Bank of England have been met; the quality of the individuals, the intellectual rigour, the diligence and the spirit of public service in the institution that I have found have met very high expectations and the international reputation of the Bank of England, which is almost without parallel. That is pleasing. The second thing that has been pleasing and has exceeded my expectations—along with those of others—has been the strength of the recovery thus far. When I arrived at the start of July, it had only

recently become clear that the UK had not entered into a technical triple-dip recession, and the strength and breadth of the recovery was just picking up. I would say that, while the recovery has been stronger than the Bank of England's forecast, in my view, the Bank did get the direction of the recovery right, being at the top end of market forecasters. It called the turning point appropriately. Those are the positive surprises.

Of the challenges that have been brought up, which partly relate to the experience in Canada and the lessons from Canada, I will highlight two, and then hand back. The first is that the experience here reinforces one of the core lessons from the crisis in Canada: the importance of having a leverage ratio as a complement to the capital framework. When I arrived, I was towards the end—but towards the difficult end—of a process that my predecessor, Lord King, and his colleagues had implemented through the Financial Policy Committee. That was, in effect, a review of the asset quality of the major banks and building societies, and checking both against risk-weighted asset standards and, as necessary, a leverage ratio standard: the adequacy of their capital positions relative to a series of headwinds, which included the asset quality side but also—as you will be familiar—to conduct costs and potential issues around the quality of their modelling of risk as well. That review occasioned, with some controversy, capital actions by a number of those institutions. In the first few weeks of my time here, it was necessary to come to agreements with a few of the remaining major institutions on additional measures that they needed to take. The discipline of the leverage ratio helped focus those discussions. That experience reinforced a lesson that we learnt in Canada. I am often asked whether I have one lesson as to why Canada fared as well as it did during the crisis, and of course I would like to think that there was more than one reason, but if I had to boil it down to one it would be the effectiveness of having a true leverage ratio in the run-up to the crisis. That is the first point.

The second element, which is a challenge but also a tremendous opportunity, is the strength of the new institutional structure of the Bank of England. The recovery that we are seeing—and I highlighted a few issues in my opening remarks—requires co-ordination across monetary policy, macroprudential policy, and microprudential policy. The Bank of England has, in independent committees—but in committees that can be co-ordinated through dialogue and cross-membership—all of those responsibilities. Even in the short period of time that I have been Governor of the Bank of England, I think we have seen several occasions where that co-ordination has been necessary, and I think it will prove one of the strengths of the new structure of the institution.

The Chairman: We will come on to a number of those points in detail later. Can I just ask another, more general question? Coming here, do you feel that you have got the powers and resources you need to carry out your very wide-ranging responsibilities? I include in that, of course, the changes that have been made in the Banking Reform Bill, which passed in this place late last night.

Dr Mark Carney: I think the institution has immense responsibilities, and it has considerable additional powers—powers that are appropriately governed through the various committees. They are not concentrated in a single individual but are discharged through those committees. There are appropriate and multiple accountability mechanisms that have been put in place. We have been set a number of tasks through the Banking Reform Bill and other associated legislation, and it is our responsibility now to start to implement those. I mentioned the leverage ratio; we need to get an agreement internationally next month among the major central banks and supervisors. We then need to ensure that that is mapped appropriately into European regulation. We need to then calibrate and apply that here in the subsequent months—this is all in the course of 2014—in terms of base levels of leverage and leverage ratios for the ring-fenced banks, and also in clarifying and justifying our

policy of varying the leverage ratio according to the variance of the underlying capital ratio. That is one example.

The clarity that can be brought through the Senior Persons regime in terms of accountability and responsibility of the very top management of banking institutions is incredibly important. We need to supplement that—I think we have been doing so, in my brief experience on the PRA board—with a more rigorous review of the governance of institutions and the qualifications of the individuals who hold these positions. However, without question, the Senior Persons regime, which we very strongly support, reinforces those responsibilities. Those are two examples I would give of additional powers that will greatly assist the Bank of England in discharging its responsibilities.

Q3 Lord Lipsey: Governor, you have rightly drawn attention to the reasonably respectable recovery we have got under way, but the two indicators that would most suggest that we had a good opportunity of turning this into a medium- and long-term recovery—that is to say, the indicators for productivity and investment—are nothing like as good. Are you confident that we will return to the sort of historic rates of growth that we have seen in the British economy over the medium to long term?

Dr Mark Carney: Let me, if I may, break that into two parts. My Lord, you are absolutely right that the initial phase of the recovery has been concentrated effectively in household spending, consumer expenditure and housing investment. The measured figures for investment and productivity have both been lacklustre, and have not yet picked up. I would say, on the investment side, that we—meaning the MPC—take the official statistics with a note of caution, because there are some inconsistencies between those statistics and broader survey measures and other indicators of investment intentions. However, the broad point remains absolutely correct; there has not been a sharp upturn yet in business

investment. Certainly, measured productivity, as I say, remains lacklustre, and productivity remains at the level it was before the crisis happened.

We think there is a prospect for two things to happen. First, we do think that there will be some so-called endogenous recovery in productivity. The mere pick-up in activity will create growth through learning by doing, through individuals who are working part-time and who can more effectively work full-time, and through re-siting of staff on more productive activities. All of those aspects will bring some pick-up in productivity, but that will not fully sustain itself without a pick-up in investment. What we have tried to do is twofold. One is to ensure that the core of the financial system is operating properly. Significant progress has been made there—the job is not finished, but significant progress has been made—and we have also provided as much certainty as we can about the stance of monetary policy. That is the first bit of my answer to the question, and the dynamic of the recovery that we have in our inflation report does have a pick-up in investment in the latter part of 2014 through to 2015, which is absolutely necessary to sustain the types of growth rates—2.9%, 2.5%—forecast for 2014/2015.

Looking a little further ahead, which is contained in your question, one of the challenges that we are all facing in advanced economies is how long the hangover, if you will, will last from the financial crisis, in terms of the length of time it takes to fully repair the financial system, get public balance sheets in order, and get household balance sheets back in order. The headwinds that we face from all three of those aspects will persist for some time—to which is added for the UK the headwind from very weak demand and likely very weak demand for some time from our major trading partner, Europe. The combination of all of that could reduce the potential growth of this economy for some time. There is less likely to be a robust, sustained recovery in this area.

Perhaps I could add a third part—I should have said this at the start. It is that the question becomes, "Once those headwinds are worked through, what are the longer-term prospects for this economy?" I would say, as a relative outsider still, that those longer-term prospects—abstracting from demographics, which are important and cannot be controlled—remain quite robust with respect to other advanced economies. This is a very flexible economy—a very open economy with flexible labour markets and high-quality education. Provided we implement properly a financial system that is resilient and should be more competitive in all senses of the word, those aspects are the building blocks of longer-term prosperity, as this Committee well knows. Shorter term, it does turn on investment—to oversimplify it—and in the latter half of our forecast, 2014 into 2015, medium term, there are these headwinds that will mean that this is unlikely to be as strong as previous recoveries for some period of time, even given how far we have fallen. In the long term, provided the institutional strengths of the economy are maintained, if not reinforced, there is no reason to think that there has been a permanent diminution in the potential of this economy.

Lord Lipsey: Just to draw an analogy, the Japanese economy has had a long period in the relative doldrums. How do you distinguish the prospect you have just painted in a measured way from what has happened in Japan, so we can be confident that we are not going down the same route?

Dr Mark Carney: I will give you the positives, and then the caution. The positives are that some of the institutional frameworks have helped with speed of action. Having an inflation target, and the discipline that my colleagues at the Bank of England had in focusing on the 2% target and being able to act quickly as a consequence, in terms of the scale and the innovation around monetary policy, without question helped. Secondly, while it might not have been perfect in retrospect, the speed with which problems in financial institutions were

addressed also helped with that. The work done over the course of, let us say, the year preceding my arrival in terms of bringing a number of institutions over the hump on the adequacy of capital has been significant, and perhaps a little more significant than was recognised at the time. Those are two things that are, without question, distinguished.

The caution I would give is that Japan entered its stagnation—not stagnation in per capita terms, but overall stagnation—through a period of relative strength of the global economy. We are in a period, obviously, of potentially sustained—and I am sorry to use the same adjective—effectively lacklustre performance among advanced economies. It is not bad performance of the global economy, but it is only relevant to this economy if there is a reorientation of trading markets, basically.

Q4 Lord Skidelsky: Governor, I gather from your reply to Lord Lipsey that you do not attach so much importance to two theses recently associated with Larry Summers. The first was hysteresis: the longer unemployment lasts, the lower the medium-term growth potential of the economy. The second was secular stagnation, which he introduced quite recently.

Dr Mark Carney: Having studied under Larry, and knowing him well, I know it is extremely dangerous to disagree with Larry Summers; I normally come off poorer on that. There are elements of deep insight in both of the issues, but let me apply them to the UK. With respect to hysteresis, this is one of the reasons why monetary policy has been as aggressive as it has within the context of an inflation-targeting regime. The risks of labour force detachment—I know you know this well—are real and proven. The positive experience in the United Kingdom contrasts quite strongly; this is a bigger issue in the United States, actually, than it is in the United Kingdom. As I am sure members are aware, the employment ratio is the same in the United Kingdom today, proportionate to the working-age population in employment and looking for work, as it was prior to the crisis, whereas it has fallen almost four percentage points in the United States. There have been huge

numbers of people who have exited the labour market in the United States. The long-term proportion of unemployed—those still looking for work, as you know—in the United States is north of 40%, whereas it is about 20% in the United Kingdom. Now, it is higher here than it used to be, so there is a hysteretic risk, if you will, with those individuals, because they have been unemployed for a period of time, but the orders of magnitude are different. This consideration is, though, relevant to the stance of monetary policy, so I am not dismissing it; I am just trying to put it into context.

In terms of secular stagnation, it is an interesting concept, and my sense has been that we need to drill down on exactly what is meant. It can mean two things, in my view. The first is that we are in a liquidity trap. The launching-off point of secular stagnation, as you may know, is that the Wicksellian rate of interest—the so-called natural rate of interest—is negative. That is a liquidity trap. Are we in a liquidity trap? Have we been in a liquidity trap for the past several years? Yes, we have been. That is why monetary policy has been as aggressive as it has been; that is why my predecessors rightly embarked on a large quantitative easing programme to get the effective rate of interest down below the zero lower bound. Are we condemned to stay in a liquidity trap? No. There are signs that the natural rate of interest is becoming less negative—to put it in the safest possible terms, for those who may be watching—over time, and that is consistent with a financial system that is beginning to work more effectively, and with monetary policy having more traction. Now, we are still—as I said in my opening comments—in an environment where we need to provide exceptional monetary stimulus for some time, but that is not inconsistent with the liquidity trap ultimately becoming less binding.

The second leg of the secular stagnation thesis, as I understand it, is that there has been a permanent deterioration in the potential growth of the economy. It is not clear why that would be the case for the United Kingdom. There have not been structural changes to this

economy that should have reduced either the rate of growth of productivity or the attachment of individuals to the labour market. The labour market, for example, has not become less flexible over time, and there have not been a series of distortions introduced into a variety of product or financial markets. So, for all those reasons, I would suggest a degree of scepticism about this thesis as a longer-term driver of prospects. The only caveat—again, just to paint the full picture—is to go back to my previous answer to Lord Lipsey, which is that in the medium term, there are these headwinds from deleveraging that would necessitate a stance of policy, and monetary policy in particular, that continues to be quite stimulative for some time to lean against those headwinds.

Q5 Lord May of Oxford: Could you summarise for us your view of monetary policy in the UK as you found it on appointment, and how, if at all, you would like to reshape it during your term?

Dr Mark Carney: Thank you. The monetary policy, as I found it, was exceptionally stimulant, for the reasons we just discussed. The issues were that policy had come—which can be seen now in hindsight, barring any additional shocks to the economy, and at least in my opinion—to the end of the period of additional quantitative easing. There were at the time some differences of opinion in the Committee about whether additional quantitative easing would be required. There was potentially less clarity, as well, about how the Committee viewed the optimal trade-off between inflation and unemployment; in other words, as I think everyone is well aware, inflation had been consistently above target for a number of years, for a variety of reasons: a series of one-off shocks, largely, including depreciation of sterling. The challenge had been, and is, to bring inflation back to target over a reasonable timeframe without risking the recovery, to the extent possible. That was one of the reasons why we felt that it was appropriate to implement forward guidance, because it provided much more clarity about how we saw these trade-offs. By using a threshold on

unemployment, it gave a sense for at least the minimum period that this exceptional stimulus would be in place. That is what we did, and it has helped the recovery for those reasons.

In terms of your broader question, which is the conduct of monetary policy over my term, and how we might further improve it and change it, I would say that we should start from a recognition that the Bank of England has long been at or near the forefront of the conduct of monetary policy, but we can get better. There has been a steady series of initiatives to improve the transparency of monetary policy; forward guidance was one example, but a more long-lasting example will probably be the way we conduct our forecasts, and what information we reveal about our forecasts. We have made a big effort as a committee to be clearer about what the key judgments behind the forecast are, and provide indicators, so people can follow whether or not those judgments are being met. We will provide scenario analysis in future inflation reports to indicate what would happen if, for example, productivity does not pick up—that would be one of the key judgments—and what the path of unemployment and inflation could be in that instance; or, on the converse side, if it picked up to historic levels more rapidly. We need to do a series of things like that that aid people's understanding of why we are doing what we are doing, and then make it easier for them to take a different view and see how we would be most likely to react if the alternative view of the world were to come to pass. By animating our communications with those objectives in mind, there will be a series of changes that further improve the conduct of policy.

Lord May of Oxford: Could I ask a follow-up in a more general sense, about forecasting? You have focussed a little bit on things like leverage and ring-fencing and so on, for which the primary aim, as I understand it, is more in a sense trying to limit the damage done when something has gone wrong somewhere so that it does not cascade through the system. The statistic that hugely impresses me, and seems to have had no impact until ex post facto, was

that if you plot the ratio of UK bank assets to UK GDP, for a century it was steady—give or take 10% or 20%—around 0.5. It ticked over from 1870 to 1970, and then with the advent of computer power that enabled you to do increasingly complex things and create increasingly untransparent instruments, it started climbing until, just before the crash, it had risen to eight. I would have hoped that somebody would have looked at that critically, asking in what meaningful sense bank assets had actually increased by a factor of 16, and what you can draw from this or other things as a way of an early warning of what has gone wrong. Of course, after the crash it fell, but as you know better than I, it is climbing again. I wonder what thoughts you might have about that, or whether you think it is a misconceived question.

Dr Mark Carney: No, the question is not misconceived at all. As a general principle, any time we see any financial asset—particularly any credit liability—grow faster than nominal GDP, questions should be asked about the sustainability of those trends. That is at the heart of our new approach. We would never boil things down to one indicator; you would not advocate that, but that is the first thing we look at across a range of markets, a so-called credit gap—whether something is growing faster than nominal GDP, but also the extent to which it is growing faster than its previous trend as well. Those two legs are warning signs to dig deeper. In terms of the growth of UK bank assets relative to the size of this economy, some of that was unstable, certainly in the latter years.

Lord May of Oxford: It was basically slicing and dicing—having assets, and counting them over and over again.

Dr Mark Carney: It was slicing and dicing, and it is intrafinancial exposures, as opposed to the financial sector to the real sector. To the extent to which that is built on sand, that needs to be taken out with leverage ratio, higher capital requirements, tripling of capital requirements for trading book assets, margining requirements, collateral rules—a series of

things. A separation of, in effect, investment banking from retail banking that informs all of those will have an impact. The one thing, which is partly our responsibility, but that we should all be cognisant of is that prospectively—it is not a guarantee—there is an element of growth of UK banking assets relative to the size of this economy that, for secular reasons, will continue to happen to the extent to which London is a global financial centre. The very simple dynamics behind that are that the UK's share of global GDP is likely to continue to fall. That is not inconsistent with what I just said about longer term potential growth, but it is a factor of the rate of growth in major emerging markets as they catch up to the advanced economies, so it is likely to fall.

As those economies catch up, their financial sectors will deepen relative to their GDP, so their financial sectors will get bigger. London and the UK's traditional role has been as an intermediary on global flows to regions, whether it is the US, Europe, or offshore emerging markets. That dynamic—to the extent London maintains its market share, so to speak—will drive an increase in those assets relative to the size of GDP. I will finish with this: if that is the secular push, we have a responsibility to see whether these trends are safe or whether it is built again on sand, and what can be done to make it more resilient. Regardless of whether that activity can be made resilient, as members of this Committee have stressed in the Banking Reform Bill, we need to make sure that the ring-fence between that activity and the domestic retail banking is effective. The question is spot-on.

Q6 Baroness Blackstone: You partly anticipated what I want to ask you about in your initial statement. It is about forward guidance. I wonder if you could just say a bit more about your claim about the effects on economic behaviour and, in particular, both financial markets and the real economy. Perhaps you could also respond to the criticism that has been made that in fact, with the discretion of the three knockouts, it does not really add

very much to the clarity of what the MPC is doing, because it leaves them with very much the same amount of freedom of choice over policy as they had before.

Dr Mark Carney: All fair questions. In terms of supporting my claims, I provided in the background to my statement—which, I presume, will be circulated after the meeting—some statistical analysis of that, which shows that interest rate volatility over the horizon out to about a year and a half is much lower now than it was prior to the introduction of forward guidance. That is one example. Secondly, despite the outsized improvements—and it is really quite a remarkable improvement—in, for example, purchasing manager expectations of economic activity, there has been a very limited move in shorter-term interest rates, and certainly nothing compared with what happened historically when we saw similar movements of that sort. I tried to put all that into the context of overall levels of surprises. I am sorry, I cannot remember the second bit of your question.

Baroness Blackstone: It was about whether, with the discretion of the three knockouts, it really makes a lot of difference in terms of the MPC's choice about policy.

Dr Mark Carney: Thank you. The knockouts are there to provide appropriate discipline. We should not be taking risks with financial or price stability. I would remind you that when we implemented forward guidance here, unlike in the United States, where they have implemented it with inflation persistently below target—below 2%—we had had five years of inflation above target, so our challenge has been to set a path to get inflation back towards that 2% target in a responsible way. We should not take risks with price stability or, in this case, financial stability as well, which is why we provided a knockout that, as much as anything, provided clarity for the first time in terms of the hierarchy of, "Which committee is responsible for what?" with respect to financial stability.

There is a concern, both here and in the United States and elsewhere, that an extended period of monetary stimulus could result in excessive risk-taking behaviour, whether it is in a

housing market or in financial markets. These are valid concerns; these are the types of things we have to worry about. What we have done with the financial stability knockout and subsequent policy actions of the FPC has been to make it clear that monetary policy is the last line of defence. We are not going to swing monetary policy around to address issues in the housing market if those can be addressed by the considerable range of policy tools that are available to the Financial Policy Committee. We have laid out those tools in more detail in our most recent Financial Stability Report.

The knockouts are there for a reason, but in terms of how forward guidance has been interpreted—again, I will go back to markets and market analysts as an example—there is a distinction, and it oscillates a bit—one or two quarters—in terms of the expectations of the economists who follow the Bank of England of when that 7% threshold will be reached and when they expect the Bank of England to raise interest rates. They expect that to be at least a quarter later, and in some cases two quarters later, on an average basis. That shows a recognition that there is a discretion that extends beyond the 7% threshold. The lower volatility in the short end shows a much sharper and improved expectation, relative to the period before forward guidance, that we would not be raising interest rates in the short term. The last point, just to re-emphasise, is that those expectations have been really tested because the economy has recovered so strongly in the period over which we have had forward guidance in place. You would probably expect me to say this, but I think that all of those facts—and those are facts—bear out the effectiveness of the policy.

Baroness Blackstone: But since both the MPC and the FPC have a role in deciding when knockouts apply, do I take it from what you say that you see no danger of any conflict between these two committees?

Dr Mark Carney: The danger of conflict would have been in a situation where there was underlap or confusion about who is responsible for what, and so there was an agreement

between the MPC and the FPC that there was this hierarchy, in that the FPC—as it should—had first and primary responsibility for issues related to financial stability; it would exhaust its tools to address any issues that arose, but it would also advise the Monetary Policy Committee if it felt that those tools were going to prove insufficient and there should be monetary policy action. That relieves the Monetary Policy Committee of having to make that judgment, which is more properly made by those whose job it is all the time to worry about these types of issues.

Q7 Lord Skidelsky: Do you see a danger under forward guidance that using the unemployment threshold as a signal to raise interest rates might be too late for effective control of inflation, given that unemployment is a lagging indicator?

Dr Mark Carney: No, for a few reasons. One is the knockouts that are in place, and we just had a discussion around those knockouts. Those knockouts, importantly—just to restate them—include medium-term inflation expectations remaining sufficiently well anchored and, secondly and importantly, the relative probability that our forecast of inflation, 18 to 24 months out, would be above 2.5 percentage points. That takes into account the lagging. If we were in a situation where unemployment were falling, let us say, too slowly, and inflationary pressures were picking up, we do have the knockout that allows us to act based on those forecasts.

The second reason, which is adjacent to your question, if I may, is, "Why did we set the unemployment threshold at 7%?" Let me paint a scenario of reaching that 7% unemployment threshold just at the time when, under any scenario, monetary policy should be tightened. We purposely used a threshold that, in our view, was higher than the equilibrium unemployment rate; in the longer term, the natural rate is something more akin to 5%. Under a series of prudent assumptions, given hysteresis, the proportion of longer-term unemployed may in the short term be as high as 6.5%. We wanted to have a fair bit of

room between the threshold and that level at which there may need to be an adjustment. I should say that that 6.5% figure is dynamic, so the very factor of the recovery proceeding and people moving back into the labour force and back into work from longer-term unemployment, all things being equal, should imply that that number falls with the recovery proceeding and with jobs being created. It is our responsibility to provide more perspective on that in our inflation reports and public communications.

Lord Shipley: Dr Carney, that was a very helpful explanation of where the figure of 7% for the unemployment threshold came from, but obviously it is an average figure. Some parts of the UK have a lower unemployment rate; other parts have a higher rate, and in some cases, over 10%. Do I understand your response to mean that you expect unemployment to continue going down, or is there a rate below which you do not think it is going to go?

Dr Mark Carney: There are a few aspects there. The first is, obviously, I think you already know that we have to set monetary policy for the entirety of the United Kingdom, and just as we have to look at inflation across the country, we will look at unemployment across the UK. Our expectation is that unemployment will continue to fall. The rate at which it will fall is subject to some uncertainty. The reason it is subject to some uncertainty goes back to where we started on productivity. There has not been this productivity growth; we have still seen only relatively modest productivity growth with the recovery picking up. We do expect the rate of productivity growth to pick up with the recovery. As it does, there should be for a given percentage point, if you will, of additional GDP growth, more of it supplied through productivity and less through additional hiring. Exactly when that happens is unclear. It is one of the big uncertainties that we have about the economy, and that is part of the reason, again, why we had the discipline of the 7%. If I may go beyond the two- or three-year horizon of monetary policy and speak from a longer-term perspective, we do not see a reason why there should have been material diminution in the natural rate of

unemployment in the economy; in other words, we do not see that the natural rate of unemployment in the economy should have moved up materially. At this stage, we do not see that, so the potential for unemployment to continue to fall over the medium term is certainly there, but the pace at which it does will be a product of both growth in demand and the reaction of productivity growth.

Q8 Lord McFall of Alcluith: Dr Carney, when the Prime Minister and the Chancellor went to China and agreed to Chinese banks doing business in the UK, were you consulted beforehand?

Dr Mark Carney: The broad policy of foreign branches—the new policy rules around foreign branches—adopted by the PRA was adopted in advance, I believe, of the Chancellor's trip to China. We had made an independent policy determination on that front, yes.

Lord McFall of Alcluith: Given the experience we had with Iceland in the financial crisis, where there was an international incident and the United Kingdom lost money, do you have no fears of Chinese banks coming here, despite the concerns of some people that there are some dodgy elements on those bank balance sheets?

Dr Mark Carney: Let me speak more generally about banks outside of the UK, and banks, particularly, outside the European Economic Area. That is the policy that would apply in the case of China. The first thing is to differentiate between retail and wholesale banking, obviously. We are talking about wholesale banking, so not retail depositors, as you can appreciate. The second thing is that one of the absolute prerequisites is satisfactory resolution regimes being in place. Certainly, Lord McFall, there are issues with any specific institution in terms of their integrity, their reputation, and the solidity of their balance sheets that would come into the determination of whether they are qualified to have branches in the United Kingdom—or subsidiaries, for that matter. We need to be satisfied that there is

a plan in place for resolution that is credible, that would be acted on, and that would respect the appropriate hierarchies of wholesale depositors here.

Lord McFall of Alcluith: On 27 September, the *Financial Times* quoted you as telling the *Yorkshire Post* that you saw no case for more quantitative easing. In fact, they have you in direct quotes here: "My personal view is, given the recovery has strengthened and broadened, I don't see a case for quantitative easing, and have not supported it". Is that your view?

Dr Mark Carney: Yes. Certainly, it has been reinforced.

Lord McFall of Alcluith: Can we expect QE to be unwinding soon with the Bank?

Dr Mark Carney: I would not want to mislead anyone watching. I said "additional quantitative easing", and that is my personal view. Obviously, I am one member of the MPC, so others can have different views. Secondly, I would distinguish between additional quantitative easing and unwinding of the £375 billion of gilts in the Asset Purchase Facility.

Lord McFall of Alcluith: I am interested in the latter, because when Lord King used to come to parliamentary committees, he said that this would be the most delicate process, with obvious implications for interest rates. What effects do you see unwinding having on the Bank Rate, the term structure of interest rates, funding the government deficit through new issues, and more generally on the economy?

Dr Mark Carney: Let me start with the last, which is that obviously any future decision would be some time in the future, I would say, sitting here today—some with a capital S.

Lord McFall of Alcluith: What does "some time" mean?

Dr Mark Carney: I did not get into my position by being overly precise when I did not need to be.

Lord McFall of Alcluith: Are you not answering?

Dr Mark Carney: The view of the MPC, Lord King, and of my colleagues on the MPC who have spoken on this matter—and I agree with this—has been that the first move in tightening monetary policy would be to tighten conventional monetary policy. We would likely—and I think this is sensible—tighten conventional monetary policy for some time or to some degree before we would begin to consider adjustments to the size of our balance sheets, and one of the variety of reasons for that is that we can be more flexible in terms of adjustments of conventional monetary policy. We would want to have some room of travel, if you will, to adjust the interest rate if we needed to, subsequent to any tightening. I said in my opening comments that, in my view, we need to provide exceptional monetary stimulus for some time, and that would include some time after the 7% unemployment threshold were reached. It is entirely appropriate, obviously, to talk about this issue of unwinding quantitative easing—it is important—but one cannot be drawn, and it would be foolish to be drawn, on any precise timetable for it.

The one other point I would make, if I may, on QE is that—to get to your issues—in general, asset purchases are more likely to have operated on the term structure of interest rates, so that has implications for the steepness of the yield curve, obviously—the adjustments. We would co-ordinate—and we have been on record for this, and it is right—any adjustment with the Debt Management Office and their issuance. I would put one other point of context into this, if I may, which is that, in terms of liquidity requirements in banks, collateral requirements for banks and the prudent management of financial institutions, how much things have changed since 2007/2008 is not fully recognised. There is a much greater demand of banks for central bank assets than there was prior to the crisis, so it is unlikely that the size of our balance sheet in steady state would return to the same size of our balance sheet previously, relative to the size of GDP.

The Chairman: Lord Lawson.

Lord McFall of Alcluith: Can I just ask a quick last one? Adam Posen, a former MPC member, said that banking in the UK lacks a spare tyre, and there has been a cry since 2008 that banks have not been lending to small businesses. As we see from the Autumn Statement, business investment in the UK has been very disappointing. Would you agree with the statement that quantitative easing in the UK has failed in its principal objective of stimulating the economy?

Dr Mark Carney: I would merely observe that, after a period of exceptional monetary stimulus and repair of the financial system, the UK economy is growing at its strongest rate in years. For the moment, it is the strongest economy in the advanced world, subject to all the caveats we discussed earlier. The stimulus has gotten through to the economy, but monetary policy is not going to solve everything.

Lord McFall of Alcluith: Do you think it has got through to small businesses?

Dr Mark Carney: In terms of the improvement of credit conditions for small businesses, there has been some, but there has been much, much less than there has been for medium and large-sized businesses. There is considerably more progress that needs to be made there; you are absolutely correct.

Q9 Lord Lawson of Blaby: I was slightly surprised to hear what you said in answer to Lord McFall, Governor Carney, when you said that, when the time comes to tighten monetary conditions, you would move interest rates up before you started to unwind quantitative easing. Most people see quantitative easing as a rather exceptional measure, which you undertake when official interest rates have effectively reached the lower bound, and they cannot go any lower—although that is not at all true of market rates, and certainly not market rates for small businesses, but leave that aside. The expectation is that once there is no need for that anymore, you would first of all start to unwind the exceptional measures before you started to put up interest rates. When Lord McFall asked why you got

it back to front, you said it was because interest rates are very flexible. My question to you is: why is it not possible to be flexible in your gradual unwinding of QE?

Dr Mark Carney: I think there are a couple of answers to that. The first is that I would underscore that what I said in terms of our expectation of how we would handle the exit from quantitative easing is, to my recollection—I am quite confident in this—entirely consistent with the responses of any of my colleagues in any other setting in public. To the extent to which those were followed, I would be surprised if the expectation would be different, but I can understand the logic of your question, which is: "Why not take the exceptional off first?" Part of the answer, in my view, would be that, in that it is exceptional, it is a crude instrument. It is most effective in times of most distress, and it potentially has the most amplification on the other side in times of more normal market conditions.

I would draw attention—I think it is somewhat instructive—to the reaction that the world saw to discussions of the possibility of the beginning of reduction in the pace of additional asset purchases by the Federal Reserve that began in the spring of this year. That is something near the third derivative in terms of the change in the stance of monetary policy, so the reduction in additional purchases, as opposed to actual cessation of purchases or asset sales. There was quite a sharp market reaction—accelerated volatility, steepening of yield curves, term structures, and other aspects associated with that—because markets have a tendency to overshoot. They have a tendency to pull forward a series of adjustments that they perceive could happen, and there is that issue. If we were to, it will be news. It will be material news. Even if everyone anticipates it, it will still feel like news at the point at which an advanced economy central bank actually tightens monetary policy—not just stops stimulating, but actually tightens monetary policy. To the extent to which that tightening is applied with an unconventional instrument that is harder for the market to understand, and of which there is less experience on both sides of the equation, there is a greater risk in

terms of the execution of that, and for all of those reasons—and there are associated debt management issues and debt management co-ordination issues that are required—it would be most prudent, in my opinion and the opinion of my colleagues past and present who have opined on this issue, to begin with a conventional instrument when the time comes and to create that necessary flexibility.

Lord Lawson of Blaby: I can understand—I will not pursue this; I just want to say one thing—as since this has never been done before, it is a bit more difficult for you and a bit more complicated. I can understand that. That does not make the easy way out, which is what you are advocating, necessarily the right choice. But, anyhow, I will leave it there.

Dr Mark Carney: It is the prudent course, in my opinion. Given the demand of financial institutions for safe assets, which will persist for some time, I do not see a material risk to the other side—that there is some material acceleration, for example, in the money multiplier, which would create challenges for us to meet our inflation target. Remember, of course, as you well do, that we are disciplined by having a clear inflation target, and that is what will ultimately govern the choice of instruments.

The Chairman: Governor, this is a very interesting and fascinating conversation for us. We have a lot more questions. Are you all right on time?

Dr Mark Carney: Yes. I have to do a reading at a carol service later on, but that is my only constraint.

The Chairman: You are all right for the moment? Lord Griffiths.

Q10 Lord Griffiths of Fforestfach: Mr Chairman, first I have to declare an interest as a member of the Board of Directors of Goldman Sachs International and Goldman Sachs International Bank. I really have two questions; the main one is in the field of housing, but just to carry on from that last discussion, can you really unwind quantitative easing without changing the size, quantitatively, of the balance sheet of the central bank? If you raise

interest rates, by definition, you have to make them real in the market, and that means there have to be asset sales.

Dr Mark Carney: The interest rates that are affected by the assets we hold are further out the gilt curve.

Lord Griffiths of Fforestfach: I see. It affects the term structure.

Dr Mark Carney: Yes, which is why the term structure is more likely to be affected. The short answer is "yes"; there is not an execution issue in terms of using conventional policy.

Lord Griffiths of Fforestfach: Having given these potential reserves to the Bank, is there not a question of, in a way, bringing in or reducing the reserves banks are holding in the central bank through the asset sales?

Dr Mark Carney: Ultimately, that would happen with the liquidation of the positions, yes, if we were to do that. I think you understand, Lord Griffiths, the sequencing that I view we would pursue and that is shared by my colleagues.

Lord Griffiths of Fforestfach: Thank you. We have seen activity in the housing market pick up, and we have seen house price inflation gaining some momentum. As an economist, and having lived through a number of cycles in the UK—dramatically in the early 1970s—when house prices start rising, you feel it is an early warning sign of inflation. It certainly was then in a major way. I just wonder: do you see the risk of another housing price bubble at present? Do you see a rise in house prices as a precursor to general inflation, and would you raise interest rates in order to control house prices? More generally, would you actually target asset sales and asset prices, rather than simply the prices of goods and services, in the definition of inflation?

Dr Mark Carney: There are a number of important questions there. Let me start with the last, which is that we are very clear in terms of our responsibilities on monetary policy. The inflation target is consumer price inflation. We are targeting that over the medium term,

and we will continue to do so. Secondly, in terms of house prices, it is interesting that you gave the example of the 1970s; of course, we also have the example of the 2000s, where there was material house price inflation but not CPI inflation, and one had similar experiences in the United States. That underscored the issue and the limits of monetary policy, and there were limited efforts of the MPC at the time to tighten monetary policy because of the potential risks of asset price boom/bust and deflation risk—to try to justify it in the context of future strong disinflationary pressures, at a minimum. There are limits to which the mandate can be stretched in that way, which is why the new institutional structure is, in my view and the view of Lord King and others, superior, because there is a clear macroprudential financial stability responsibility to the FPC, and so it is the FPC's responsibility to address, first and foremost, the risks that could arise around housing.

Just so we are clear, the FPC is not trying to control house prices. We are not targeting some rate of growth of house prices. What we are trying to ensure is that vulnerabilities do not develop in the financial system that ultimately threaten broader financial stability and strong, sustainable, balanced growth in the UK economy. We have a range of tools that we can use. What we have started with—and this may well be enough—is to ensure that the underwriting standards that have dramatically improved since pre-crisis, although it is not hard to have them improve relative to that, are maintained. There have been mortgage market review standards that the FCA is surveilling. We are working with the FCA to create a new tool that will strengthen those by the ability to vary interest rates. The FPC underwent the effort to increase the capital that is held against potential headwinds. One of those headwinds was from the housing market. In calculations, they use standardised floors on models that the banks use for the housing sector, so that made them hold more capital against housing. We are going to conduct stress tests, as you know, next year: joint FPC/PRA stress tests. We will co-ordinate that with the European stress test, and in doing

so, we will focus particularly on the housing market and the domestic economy to make sure that banks are adequately capitalised for the potential risk that they have.

All of that is to reinforce the initial protections we have against the classic dynamic, which is that the economy improves; people's expectations of incomes go up; house prices start to recover—all of that makes sense to that point—and then it becomes an extrapolative set of expectations. House prices will keep going up, because they went up in the past. Financial institutions, particularly banks, start to adapt to that and underwrite on the basis of house prices going up. Their standards slip, and that perpetuates the process for a period of time before the inevitable correction. What we are focusing on is the underwriting standards and the appropriate capitalisation to ensure that that does not happen.

Lord Griffiths of Fforestfach: However, in terms of changing Bank Rate, the key objective is ultimately inflation, and keeping inflation contained, rather than house prices.

Dr Mark Carney: It is inflation. That is correct.

Lord Skidelsky: Among the additional tools, would you consider the ability to vary loan-to-value ratios or loan-to-borrower-income ratios? Those would be the most direct tools for influencing the amount that supports housing lending.

Dr Mark Carney: Yes. They are some of the more powerful tools that would be available, and we, as the FPC, are in a position, if we had to, to make recommendations in those regards. Yes.

Q11 Baroness Noakes: Could I, before asking this question, declare my interests as recorded in the register, in particular that I am a non-executive director of the Royal Bank of Scotland? I am going to talk not about particular banks but about financial stability and the impact on banks in general. Focusing on the "too big to fail" problem, my question is, in relation to the UK, do you now believe that we have sufficient arrangements and tools in place to ensure that systemically important financial institutions can be safely dealt with in

the event of a crisis? There is a number of bits of legislation that we have been through, including in particular—as has already been referred to—the banking reform legislation that passed its last but one stage last night, and is expected to receive Royal Assent this week, I believe, but there is a lot still to do. That legislation is, for example, still only framework legislation, so I would be interested in your views as to whether the tools are all there now, and how long it is going to take before they can actually be regarded as operable.

Dr Mark Carney: You are absolutely right, in that a number of very important steps have been taken, particularly in the banking reform Bill. You all know this far better than I do, but the move to secondary legislation, particularly around ring-fencing, will be very important in this regard. We need to ensure that the spirit of the Independent Commission on Banking recommendations is fully lived up to—that inside the ring-fence, there are viable entities that are appropriately focused both on the liability side and on the asset side, and that they are sustainable and viable if the event were to transpire of a broader failure of the group. That needs to animate what follows.

In terms of what is required for a large, cross-border systemic UK banking institution, there are more things that need to be done. There is a plan to execute those, but this needs to dovetail, if you will, with the domestic efforts. Without a global agreement on gone-concern loss-absorbing capacity, it will be difficult to effectively and speedily wind up these firms. That means not just the amount of this bail-inable debt, but its location and how it is connected down within the actual institution, from the parent holding company to the various subsidiaries. We need to address a series of issues around the triggers within the inter-company debt and the parent company debt, and who pulls those triggers. There is a variety of issues around that, but there is a commitment that has been made by G20 leaders at the St Petersburg summit; there is instruction, effectively, for the Financial Stability Board to come to an agreement on this and make that proposal for the Australian summit in the

fall of 2014. That will be crucial to providing the global complement to what has been done domestically.

We also need to internationally—and I do not yet anticipate that this would require domestic legislation, but I would not entirely rule it out—have in place mechanisms to have stays in derivative contracts. This is, again, outside of the ring-fence. We would like to come to a market-based solution, working with ISDA and others, and we are working with them, to do that, but it is possible that that may need to be buttressed, and obviously as soon as we felt that were the case, we would raise it. The gone-concern loss-absorbing capacity, ideally, would be reinforced by cross-border agreements or memoranda of understanding between the major regulators in the US, the UK, continental Europe and Japan. That is also something that needs to be done to complement. Many of the most important tools are in place. Certainly, what can be done domestically at this stage appears to have been done; it now has to be fully implemented, but for the largest institutions, it does need to be complemented by these other aspects.

Baroness Noakes: Could I ask you whether or not you think there is sufficient national resolve, globally—not necessarily when people are sitting as G20 institutions, but when they go back home—to actually do the things that will enable this to happen? I have in mind, for example, that the US is now looking to protect the US banking industry by interface and holding companies, which can end up trapping capital in a way that is not available to help resolve global institutions. Is there not, actually, a very strong nationalist element starting to build up again in the banking system, which will make international efforts hard to pull off?

Dr Mark Carney: I think you have put your finger on one of the risks. I could turn it around slightly. In the absence of international agreements on these types of issues, what will happen is that more capital and liquidity will be trapped, ring-fenced domestically, at a greater cost globally with greater fragmentation but also just a much larger requirement of

capital liquidity that is less effective and efficient, because you cannot get it to where you need it. That is one of the reasons why it is not optimal just to solve the domestic problem. There needs to be this interrelationship between the global amount of bail-inable debt or gone-concern loss-absorbing capacity, to use our favourite term for it. There is an issue with respect to the foreign bank holding company measures in the United States, which, according to some depictions, do exactly what you said in terms of ring-fencing capital liquidity. There is an extent to which, if we could be successful on these broader efforts, that can result in a more efficient way of delivering the same protection in the US and the UK—in other words, access that is controlled domestically to broader group capital, if and when it is needed.

Q12 Lord May of Oxford: This probably is a silly question, or more a semantic question, but the way this is phrased, it seems to me—as I understand it—that a systemically important institution cannot be made to fail safely. As I understand it, the general feeling—and there is some very interesting data pulled together in support of the idea by Shin at Princeton—was that much of what happened was not so much the writing down of overpriced assets but the general loss in confidence that shortened and drew in loans and caused the system to go into lockdown, in a sense. In so far as that is right, it is still important to have things that do their best to stop the systemically important thing going belly up, but at the same time, one has to recognise that it comes back to the question I asked earlier of wanting to orient on looking at the system as a whole, and asking how you handle the things. Have I been intelligible? I feel I have not.

Dr Mark Carney: You have. I think there are two issues there. First, to the semantic point, if you will: you are right. If an institution is still systemically important, then it is too big to fail. The strategy has been, as you know, to have higher loss-absorbing capacity—higher capital, basically—to begin with, and then this series of measures so that it could be

wound up effectively, so it would no longer be too big to fail. I hope I am not misquoting him, but I saw Sir John Vickers today in the paper saying that you can never be 100% certain about these things. These are the right measures, obviously, but you are never 100%, and I think we collectively have to get ourselves in a position where we have credible resolution plans that are buttressed by real economic incentives, where the capital and the relationship between holding company capital, capital of the operating subsidiaries and the control over the triggering of that is appropriately designed, and that is reinforced with agreements and other aspects. We have to get all of that in place. I do not think we should stop calling these institutions systemically important financial institutions until we have actually resolved that, and obviously, we should not do that until the time comes that it is actually necessary. The consequence of all these structures should be to, clearly, increase the resilience of the system. They may also have consequences for firm strategy and how institutions choose to organise themselves, which also goes some way to improving resilience. That is the first point.

The second point, on the Shin work—and he is very prolific and very insightful—an important element of his work relates to collateral markets, asset markets, and liquidity and illiquidity cycles and the risks around those. That has two implications; the first is the funding structure of banks, and to what extent it is a short-term versus a long-term wholesale funding structure. There was too much of the former, obviously, in the run-up to the crisis. Secondly, there is a seemingly very arcane but incredibly important set of reforms around how collateral markets operate, and they include something that we have been out consulting on and that I expect to be put in place next year, which are minimum haircut requirements—or margin requirements, to use a different term—for any repo or security financing transactions. What happens, in a gross analogy with the housing market during those periods of euphoria, is that the underwriting standard slips; these haircuts disappear

into nothing, and then all of a sudden when things go wrong, not only does the asset price come down but the haircut goes up, and that is a self-perpetuating cycle. Shin and a few others have been very effective in showing how much that amplified the crisis, so authorities are stepping in and saying, "You have to have a minimum. You cannot have that euphoric phase; you have to maintain underwriting standards there." Related to that, though—and I will not belabour this—is the role of the central bank in ensuring that collateral markets themselves continue to function in times of stress, which is one of the reasons why we made adjustments to our sterling market framework that I just briefly referred to at the start.

The Chairman: You read my mind, actually. We have got a number of other subjects we would very much like to ask you. What time is your carol service? When do you have to leave?

Dr Mark Carney: I am reading at 6.10, so I can miss the first bit.

The Chairman: How far do you have to go?

Dr Mark Carney: 20 minutes, apparently.

The Chairman: We will have to speed up, if you do not mind, to get through all of our subjects.

Dr Mark Carney: Sorry about that.

Q13 Lord Rowe-Beddoe: Governor, in the conclusion of your opening statement, you talk of the banking reform Bill and its measures, and you said "including ring-fencing of retail banking activities", which leads me to the question of whether you consider that the financial stability objective would be easier to meet if there were a full structural separation of retail and investment banking. Your predecessor, as I think you know, was a strong supporter of that.

Dr Mark Carney: Well, it is an interesting question. I have seen that the House just passed the banking reform Bill; I am not sure whether this is going to be reopened. I think our

responsibility is to make what was passed work, and there are—as you are well aware—very important safeguards that have been put in place in terms of, to use the vernacular, the electrification of the ring-fence to ensure that it does, and associated reviews will be in place. We need to make what is there work. I am not sure I want to speculate on what the Bill should have been, or what any future one might be.

Lord Rowe-Beddoe: Is there a bit of déjà vu, though, going back to Glass-Steagall and so on, 30, 40 or 50 years ago?

Dr Mark Carney: Yes. Well, it was put in place in the 1930s.

Lord Rowe-Beddoe: Sorry, more.

Dr Mark Carney: And it came off in the last 15 or 20 years. The way I would term it is that these issues have been pretty thoroughly debated. Parliament has spoken, and our job is to implement what has been decided.

Lord Rowe-Beddoe: Do you think that banks are, or can be, or could be, too big to manage?

Dr Mark Carney: We have seen examples of that, yes. The complexity of some of these institutions—the breadth of their business lines, both in geography and product, and overlaid with poor governance structures and lack of accountability, or sense of accountability—have made a handful of them too big to manage. Some of them are not even that big or that complex, but the combination of the two has made that the case.

Lord Rowe-Beddoe: I am afraid it is human beings again, is it not?

Dr Mark Carney: Well, certainly. Ultimately, whether it is monetary conduct or monetary policy or running a financial institution, there is appropriately reliance on data and analysis but, in the end, judgment and again—to take a lesson from monetary policy—a clear objective, clear lines of accountability, were to some extent the missing links in monetary policy frameworks until recently.

Q14 Lord Lawson of Blaby: I am going to ask a supplementary to Lord Rowe-Beddoe's question before going on to slightly different territory. My supplementary is this: you say the banking reform Bill is now passed, and the banking reform Bill says the ring-fence is going to be there. There will be a review of the ring-fence, and if the ring-fence seems to be a flawed system, we may have to go to full separation, but that is a matter for the review. Of course, there is another route possible to separation. It may be that, if the ring-fence is working so effectively, banks feel there is no longer any advantage in their being a universal bank. Indeed deconsolidation, or whatever you like to call it, might release shareholder value. The HSBC has, according to the *Financial Times*, tentatively dipped a toe into these waters so far as UK operations are concerned. If universal banks in this country voluntarily chose to separate their retail, deposit-taking banking and SME banking and all that on the one hand, and the investment banking, would you mind?

Dr Mark Carney: I would not. Commercial decisions of private financial institutions and entities are for them and their boards of directors. We would not mind, number one. Number two, to the extent to which a bank is effectively a portfolio between a ring-fenced bank and an international banking activity—that international banking activity having to be organised in a way that is consistent with effective resolution—it moves towards the question of whether that portfolio of activities is better housed under one holding company roof, or whether it is better for the market to make a decision in terms of constructing their own portfolio. There have to be synergies. Part of the synergies I leave to management and their expertise. The effectiveness and the efficiency of this gone-concern loss-absorbing capacity will be one determinant of the advisability of that structure.

Q15 Lord Lawson of Blaby: The question I move on to is this: I was very glad indeed to hear the importance that you attached to the leverage ratio. As you know, the Commission on Banking Standards—of which two of us here were members—strongly recommended

that the responsibility for setting this ratio should be moved from the Treasury to the Bank of England—the FPC. The Government very reluctantly accepted this at the end of the day. I wondered, first of all, when you think you are going to exercise that responsibility. To some extent, it is up to you now. The second question is this: we did not take a collective view on what the leverage ratio should be, but many of us considered—and incidentally, so did the Vickers Commission—the 3% set up by Basel III as insufficiently rigorous. I was interested that you pointed proudly—or, certainly, happily—to the Canadian ratio. You said this was an important part of why Canada was not affected by the banking crisis so much. Correct me if I am wrong, but I think the Canadian ratio is more rigorous than 3%. Certainly, in the United States, where the Fed sets it, for large, systemically important banks, it is also more rigorous than 3%. What are your feelings on what the appropriate leverage ratio is?

Dr Mark Carney: That is a very important set of questions. First, in terms of when to put it in place, the FPC will conduct its review. It will be informed by the ultimate decision in Basel.

Lord Lawson of Blaby: Sorry to interrupt you; forgive me. You are not telling me that you will do whatever Basel says, are you? If in your judgment the Basel ratio is insufficiently rigorous, I take it you would set a more rigorous ratio.

Dr Mark Carney: Yes. The definition matters, and to the extent possible, we would hope to get to an agreement that is applied in all of the major jurisdictions. We will try to get that, but in the context of what that agreement is, we would calibrate it appropriately, and so the answer as to when really works to that by the end of 2014 we would be in a position to have finished the review, made a recommendation, taken all this and applied it to the UK institutions.

In terms of level, it does depend on definition. One caveat on the Canadian leverage ratio: it looks tighter, but is less tight than it looks because the numerator in Canada is total capital; it includes both common equity and other Tier 2 instruments, so it looks like a 5% leverage ratio. On a common definition, it is more like a 3.5 or so leverage ratio. I do not have the Canadian figures.

Lord Lawson of Blaby: It is higher than 3.

Dr Mark Carney: It is a bit higher than 3. All this does is say the reason why we have not put our foot down and said, "Okay, this is what it should be in the UK," is we need to try to get a common definition and then calibrate it appropriately. Just to be clear, I am, certainly personally, in the same position as the Vickers Commission in terms of the proportionate scaling for the ring-fenced institution.

Lord Lawson of Blaby: They recommended 4%—or 4.06% curiously enough, but we will say 4%.

Dr Mark Carney: Yes, it was absolutely precise but entirely consistent logically.

Baroness Noakes: The PRA are already using a leverage ratio to set capital requirements, so what is different?

Dr Mark Carney: We used a judgment. What would be different is that it will be a formal requirement. It was used as guidance to set the headwinds in terms of the amount of capital that needed to be raised.

Baroness Noakes: In practical terms, will there be a difference between what the PRA can do by way of setting capital guidance and what—

Dr Mark Carney: In practical terms, one would expect there to be a formal leverage ratio that is part of the capital framework. Just for governance reasons, I am not prejudging the final decision of the FPC, but one would expect that to be the case.

Q16 The Chairman: Can I turn to another question, then, and that is in relation to the recent Scottish Government White Paper? I note that you said in a comment, in relation to things that affect the Bank of England, "They will need to make these decisions as fully informed as possible," before the vote takes place, which concurs exactly with the view that this Committee took when we looked at the economic implications of Scottish independence for the United Kingdom as a whole. We talked about red lines that need to be clear before the vote takes place. Could I just ask you about a couple of points? The White Paper talks about retaining sterling—as part of the formal monetary union with the rest of the UK—being the best option from Scotland's point of view. They go on to say that "under such an arrangement, monetary policy will be set according to economic conditions across the Sterling Area with ownership and governance of the Bank of England undertaken on a shareholder basis". They equally say that "the Bank of England, accountable to both countries, will continue to provide lender of last resort facilities and retain its role in dealing with financial institutions which posed a systemic risk". At some point, do you not feel that you, as Governor, need to make the Bank of England's position on this clear?

Dr Mark Carney: Anyone in my position should distinguish between issues that are properly the responsibility of Parliament and issues of economics, and the associated risks.

The Chairman: This is what I focused on.

Dr Mark Carney: As I indicated the other week, we will provide some technical, objective, dry analysis of some of these issues in due course. The issues—many of which were covered in the work of this Committee—relate to the appropriate role of lender of last resort, participation or not in the sterling monetary framework, associated deposit guarantee schemes, and the extent to which FSCS were available. There are issues in any monetary arrangement around the fiscal arrangements, whether there are fiscal rules or where there is fiscal federalism that supports a monetary area. There are obviously issues

that would impact on the appropriate monetary arrangements that would relate to the underlying economic arrangements that were ultimately in place in terms of mobility of labour, capital, goods, and any issues around that, and then, as you highlighted, associated issues of monetary policy governance. There are a host of issues. I am going to plead, given my time constraints, that I cannot do them all justice here. I have a very convenient obligation—it is the Bank of England carol service, just in case anyone was wondering, so I am still fulfilling my gubernatorial duties, just in a different way.

The Chairman: If I can put it this way, these are not dry technical issues; they are very fundamental to the work that takes place.

Dr Mark Carney: They are, but our analysis would be around the economics of these issues.

The Chairman: Exactly, and of course, the question of whether you can have monetary union without a full political union. We are seeing difficulties in the EU at the moment on that score. Will the Bank, in relation to the issues that affect all the Bank of England's responsibilities, be making a position clearer as we get nearer to the vote?

Dr Mark Carney: Yes.

Q17 Lord McFall of Alcluith: Along with a number of colleagues, I was with the BBC Scotland this morning, and saying to them that the real serious issues have not been discussed, and we are really pushing them to engage in them—such as currency and implications. However, in our report on economic implications for the UK, we stated that continued use of sterling by an independent Scotland in a monetary union with the rest of the United Kingdom would raise complex problems of cross-border monetary policy, multiple financial regulators and taxpayer exposure, and could only come about—if at all—on terms agreed by the UK Government. Do you agree with the integrity of that statement?

Dr Mark Carney: I may not have the entire context of the statement, but the current sterling monetary union works well because it is buttressed by all aspects in terms of governance, fiscal arrangements, the underlying economic arrangements, and clarity of responsibility and governance, et cetera. To the extent to which any of those aspects were changed, it would change the effectiveness of the monetary union. The responsible parties would have to consider whether other arrangements could be put in place to make up for those derogations.

Lord McFall of Alcluith: So in terms of complex problems, you would agree that in terms of cross-border monetary policy, possible multiple financial regulators and taxpayer exposure, with lender of last resort, these issues—

Dr Mark Carney: These are all issues that would need to be addressed, yes.

Lord McFall of Alcluith: Yes, but in being addressed, they would bring their own complexity, possibly.

Dr Mark Carney: Yes.

The Chairman: Have you got time for one last question?

Dr Mark Carney: Yes.

Q18 The Chairman: Do you think that the audited accounts of British banks give a true and fair account of their financial condition? We have had quite a number of discussions about IFRS in this Committee.

Dr Mark Carney: The short answer is yes, but that does not necessarily mean that it gives a prudent representation of their positions, their reasons for adjustments, and supplemental disclosure. Both I, personally, and the Bank support very strongly the work of the Enhanced Disclosure Task Force, which is actually a private-sector initiative to improve disclosure and give disclosure more in a way so that management actually looks at their own accounts—first point. Secondly, there are improvements that need to be made to IFRS, including on

expected-loss loan impairment. They are trying to make those efforts. We will see how effective those are. Ideally, they would be harmonised with those of the Americans. There is a range of issues. It may be true and fair in the current state of the art, but it is not necessarily prudent and it does not necessarily map to prudence, and so we need to look at other aspects. Secondly, as in everything, it can be substantially improved.

Lord Lawson of Blaby: What you are saying is very much along the lines of what, again, the Banking Standards Commission recommended: that IFRS left a lot to be desired—expected losses, prudence and a number of other things. It probably leaves a lot to be desired in the context of many companies' accounts, but it is particularly serious in the case of banks. However, when you say you would like to see some changes in IFRS, that may not be possible, because that requires agreement over a large number of countries and might not happen. What we recommended—as you will recall—was that there should be a second set of accounts. You have to have the IFRS accounts by law—okay—but there should be a second set of accounts drawn up in a way that is most useful for prudential supervision and regulation. The answer we had was that it was a good point, but the PRA has the power to require there to be a set of accounts drawn up by banks in this way. There is no need to put anything on the statute book; it already has the power to do that. My question is simply: can you reassure me that you will exercise that power?

Dr Mark Carney: If we have the power, and we see fit to exercise it, we will exercise it. I am slightly unsighted on our powers on this.

Lord Lawson of Blaby: Could you let us have a note on this?

Dr Mark Carney: I shall.

The Chairman: It is the first time you have been unsighted. Governor, you have been extremely generous with your time and sharing your thoughts with us. I think the transcript

will deserve a lot of very careful reading by us all. Thank you very much indeed, and I hope you have a good carol service.

Dr Mark Carney: Thank you very much. Thanks for your questions.