Treasury Select Committee
Re-appointment questionnaire completed by Ms Kate Barker

Monetary policy framework and individual role

1. **What contributions have you made individually to the conduct of monetary policy on the MPC? What lessons have you learned from your period as a member?**

   In the answers to the questionnaire completed when I joined the MPC, I commented that the main criterion for judging the record of any MPC member is whether or not the Committee as a whole has been successful in meeting its policy objective. I would certainly argue that that has been the case; despite a number of shocks to the UK economy over the past six years (such as the fall in equity prices post the internet boom and the rise in oil prices since 2004).

   Further criteria I suggested included ensuring that the MPC took account of the full range of data. In this context, I have supported the increasing use of business survey data alongside official data to ensure that we are benefiting from as rich a data set as possible.

   I have also given a number of on the record speeches – covering a range of topics relevant to current monetary policy. In particular these have included:
   - how policy could or should take into account financial imbalances in the economy
   - the economic consequences of the rapid emergence of China into the world economy
   - the contrast between greater macroeconomic stability over the past decade and some increase in volatility of sales and profits for individual firms
   - reflections on the circumstances in which it would be appropriate to make monetary policy changes gradually, and comments on the actual behaviour of the MPC in this respect.

   In terms of lessons learned, the MPC as a whole has of course developed its thinking on a number of issues over the past six years. Particular areas where my own thinking has been altered include:
   - Bank staff analysis has improved my understanding of the uncertainties of early ONS data estimates, and I am now more cautious about placing weight on the latest data.
   - While this is not a novel reflection, I have become more conscious of the importance of looking for early signs of changing economic relationships. Examples where this has occurred would include the reduced response of household spending to house price changes, and the modest response of nominal wage settlements over the recent past to fluctuations in inflation.
   - The apparent changes in the behaviour of wage and price setters, as monetary policy has become more credible, has led me to focus more attention on inflation expectations.
   - In my early months on the MPC I was inclined to argue in favour of giving firmer indications about the future path of interest rates. The necessity of being flexible in responding to a domestic economy, and an external environment, which rarely develop exactly as projected has led me to reconsider this view. However, I strongly support the Governor's recent proposal that the MPC should seek to give more information about likely future responses should particular risks crystallise.

2. **What contributions have you made to explaining the work of the MPC and enhancing public confidence in its actions over the last three years?**

   Over the past three years I have given five on the record speeches and eighteen off the record talks (including three to sixth form students). This excludes eleven inflation report briefings given on regional visits, and the numerous informal talks to groups of business people and others on regional visits, of which I have made 22. In general I have tried to respond positively to every invitation to talk about the work of the MPC, and have actively sought out some opportunities.

In addition I have given two national newspaper interviews, and a number of regional press and radio interviews.

I would hope that the above has been part of enhancing public confidence; however the most important aspect of this is clearly the MPC's collective actions and communications. All members play a full role in considering how our communications, especially the minutes and the *Inflation Report* could be improved.

3. In what ways have the two reviews you have conducted into UK housing supply and on land use planning contributed to your work on the MPC?

The first independent review on housing supply involved analysis of both the housing and land markets which has been very helpful background information to the regular discussions on the housing market within the MPC. I also gained a useful understanding of the housebuilding industry, its structure, pressures and skills requirements.

The review of land use planning was of less relevance to the MPC work – apart from establishing a number of useful contacts in the construction industry.

4. What other work commitments do you maintain in addition to membership of the MPC, and how do those benefit your work on the MPC?

The only other remunerated work commitment which I have at present is on the board of the Housing Corporation, to which I was appointed in October 2005. This supports a continued understanding of trends in the housing market.

I have a number of unremunerated activities. However, only one is a significant time commitment, which is that I am just taking over as Chairman of Governors at Anglia Ruskin University. It is of no particular benefit to my work on the MPC.

All my additional commitments, remunerated or otherwise, are approved by the Governor and the Chancellor.

Interest rate decisions and monetary policy

5. Of the votes that you have cast in the MPC over the last three years, are there any which with the benefit of hindsight you wish you had cast differently?

The most important point to make in reply to this question, looking back over the past three years, is that it seems clear that monetary policy has overall continued to do a good job of keeping inflation low and stable, and there are no indications in inflation expectations, of a loss of credibility. Given this record, and my part in it, there is no vote which I strongly feel ought to have been different.

Of course, events have not always developed in line with my expectations. For example, if I had foreseen the continued upward pressure on inflation from energy and food prices over the past year or so, and therefore the likelihood of several months with inflation markedly above target, it is possible that I would have voted to raise interest rates a little earlier in 2006. However, this would only have been a marginal difference – it has always been clear that the MPC does not seek to keep inflation exactly at the target month by month.

6. Over the next three years, what are the major risks you foresee to the MPC meeting the inflation target?

Answering this question literally runs the risk of giving a hostage to fortune, as over such a long period it is very likely that some unforeseen event will occur which has a significant impact on UK inflation. The key risks which are at present of concern to me are:

- A marked loss of credibility in UK monetary policy, indicated by a significant move upward in inflation expectations. There is no evidence that this has occurred as yet, either from financial market inflation expectations (although these have drifted up a little over the past eighteen months or so) or from surveys of the general public's inflation expectations. However, while there are no good measures of general inflation expectations for price-setters, surveys of companies' pricing intentions have shifted up recently, particularly in the manufacturing sector.
- An abrupt shift in the perception of risk in financial markets (see answer below) which could result in a marked increase in real long-term interest rates, linked to falls in bond, equity and house prices.
- Continued import inflation at a higher, and also more volatile rate, than over the early years of the decade, especially from raw materials.

The first and third of these underpinned my view that there was an upside risk to the central projection for CPI inflation in the May 2007 *Inflation Report*.

7. How far do you think there has been an under-pricing of risk within UK financial markets?

The first point to make here is that it is not at all easy to get clear indications from financial market data of precisely how risk is priced. However, the big picture of the recent past is that the fall in macroeconomic volatility in major developed economies has been associated with falling volatility in financial markets. This has led to financial market participants seeking to improve yield by adding potentially riskier elements to their portfolios, and this has driven down spreads on some riskier assets.

How far this represents an under-pricing of risk is hard to assess. Firstly, it is arguable that the changes in the operation of fiscal and monetary policies in several countries have genuinely contributed to greater economic stability. Secondly, some financial institutions are now distributing their risks more widely among end investors, so that there is less concentration of risk.

However, a counter-argument would be that there has been no major shock to the world economy, or a major country-specific shock in the UK, which would fully test the robustness of policy and the resilience of the financial system. (Although of course a number of shocks have been weathered over recent years, for example the large falls in equity markets around 2000-02 and the rise in oil prices since 2004). Nevertheless, there must be a possibility that risk has been under-priced, and therefore, as discussed in the Bank's latest *Financial Stability Report*, this is a vulnerability in the UK financial system.

8. When considering the UK economy, how much emphasis do you place on the international economic environment? For example, how sustainable is the current (UK) trade deficit in your opinion?

The international economy clearly plays a major role in my consideration of the economic outlook both in the monthly round and the quarterly forecast. In particular it impacts on export demand, where prospects for the euro area are of most importance. In addition, import prices generally can affect short-term inflation prospects, unless the exchange rate adjusts to compensate for the difference between UK and foreign goods and services prices. Movements in the effective exchange rate, which are in part driven by factors external to the UK, will also impact on relative prices, and on the balance of demand and supply and therefore inflation prospects.

Turning to the sustainability of the UK's trade deficit, it is probably more appropriate to focus on broader measures of the UK's external balances. The table below sets out some key facts:

Table One
UK Current Account Balance Components

	Goods Trade	Services Trade	Net Income Flow	Current Transfers	Current Account
1990-1994	-2.2	0.9	-0.1	-0.7	-2.1
1995-1999	-2.1	1.5	0.5	-0.8	-1.0
2000-2004	-4.3	1.7	1.7	-0.9	-1.9
2002	-4.5	1.6	2.2	-0.9	-1.6
2003	-4.4	1.7	2.2	-0.9	-1.3
2004	-5.2	2.2	2.3	-0.9	-1.6
2005	-5.6	2.0	2.2	-1.0	-2.4
2006	-6.5	2.3	1.8	-0.9	-3.4

All variables are expressed as % of GDP
Source: ONS

Broadly, the situation is that the UK is now running a large deficit on goods trade compared with historical experience, although trade in services remains in surplus. Over the past few years, the resulting trade deficit has been partly offset by a surplus in net income flows (the difference between the return on assets held abroad by UK residents, and the return on UK assets held by foreigners). The source of this surplus is to some extent uncertain. Official data suggest that the UK has an overall net debt position, but some of the UK assets and liabilities, especially for foreign direct investment (FDI) are included in this data at book value. Some estimates suggest that, if the stocks of FDI are correctly revalued, the UK is in fact still an overall net creditor[1]. In addition, it may be that the UK earns higher yields on its assets held abroad than the yield paid on the assets held by foreigners in the UK, partly because the latter tend to be lower-risk assets.

[1]This is discussed in Whitaker, S. 'The UK's international investment position' *Bank of England Quarterly Bulletin* 2006 Volume 46, no.3.

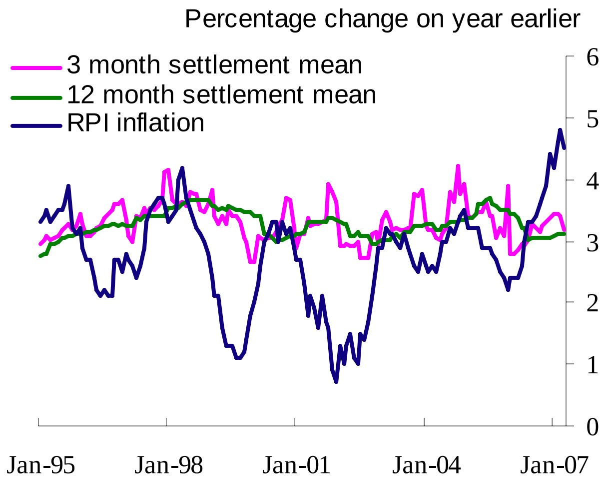
These net income flows in any case fell back a little in 2006, possibly reflecting the strengthening of sterling during the year.

The implication of these net income flows is that the current account deficit may be sustainable at around the level of the last few years for some time, although over time the probable gap between UK foreign assets and liabilities would close. And there is a risk that the higher returns on UK assets abroad will not prove durable. So at some point an adjustment to bring the current account back towards balance is to be expected, and will probably entail a depreciation of sterling. The size and timing of this are highly uncertain, and so it does not affect my judgement on the appropriate level of Bank Rate at present.

9. How important do you think the official measures of inflation are in the wage-setting process in the United Kingdom?

There is strong anecdotal evidence from discussions with firms and with union representatives that the Retail Price Index (RPI) will be cited in wage negotiations. This is not surprising, as it is the longest-established and most familiar measure of inflation. However, this does not of course mean that movements in the RPI translate one-to-one into changes in the growth rate of pay settlements. The chart below shows RPI inflation and two measures of settlements: the three-month settlement mean, and the twelve-month settlement mean. Visually it suggests a weak positive relationship between movements in the RPI and settlements.

Chart One
Settlements and RPI inflation



Recent work at the Bank has looked at how far different measures of inflation are correlated with different earnings measures. The broad conclusion is that, post-1995, there has been a weak positive correlation between settlements and RPI, no correlation between the overall average earnings index and RPI, and modest negative correlation between the CPI and the different earnings measures. So the role of RPI should not be overstated, as other factors, such as the competitive environment and the overall labour market situation will also play a role in determining settlements.

Does it matter that the RPI has a rather stronger relationship with earnings than our target measure? Firstly, over longer periods the gap between RPI and CPI is likely to prove reasonably steady, so there will not be any long-term consistency issue.   However, it does mean that the MPC needs to be aware, as we are, of the RPI/settlements link, and factor this into our forecasting and policy-setting.

Secondly, it is perhaps worth reiterating that, over the long-term, nominal wages would reflect a combination of some measure of ‘true’ inflation and productivity. The change in the target measure is estimated to have had only a small impact on the true long-term inflation rate (of around 0.25 percentage points). So it should not be expected to have a significant impact on nominal wage growth.

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