

**Questionnaire in advance of Treasury Committee hearing
Ian McCafferty**

A. PERSONAL AND PROFESSIONAL BACKGROUND

1. Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC?

No.

2. Do you intend to serve out the full term for which you have been appointed?

Yes.

3. Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC? In particular, what areas of the MPC's work do you believe you will make a particular contribution to, and which will you have to undertake additional research into upon your arrival?

I have been an applied economist for over 30 years, in a variety of roles in business (as Head of Macroeconomics at BP), in the City (as Chief International Economist for NatWest Markets and Director of Economics at Baring Securities) and since 2001, as Chief Economic Adviser to the Confederation of British Industry. In this last role I was responsible for leading and directing all of the CBI's work on economic issues – analysing and monitoring the economy, producing forecasts and developing economic policy positions.

I believe my experience equips me for my role at the MPC in a number of specific ways:

- I have significant expertise in the analysis of the economic conjuncture, the preparation of formal forecasts of the UK economy using forecasting models and making explicit judgements about the economy.
- I have expertise in the generation and interpretation of business survey data, and its strengths and weaknesses. Such data can provide invaluable information to supplement and test preliminary official data. Through the CBI I have also developed close direct contact with businesses and other economic agents, allowing me to develop good understanding of how business both shapes and reacts to economic developments.
- I have detailed experience in analysing other economies, including the US, Germany, France and China. The UK economy is now so integrated with the rest of the world that a good understanding of the developments in these economies is required to make sound judgements about the UK.
- Having worked in the City for ten years, I have gained an understanding of the interaction between monetary policy and financial markets. From my time at BP, I also gained an understanding of energy and commodity markets, as well as how business operates and interacts with the broader economy.
- My roles have required me to develop an ability to present economic issues to both specialist and non-specialist audiences, and I am keen to use this further during my time on the MPC, to ensure that the work of the MPC is widely understood and supported.

I intend to use my experience as a business economist to make contributions to the work of the MPC in a number of areas. I hope that my knowledge of business surveys and business conditions will support the MPC's analysis of the economic outlook, in particular on pricing behaviour, profit margins and business investment. I also hope to support the Bank in the development of its economic forecasting activities. There are a number of topics on which I would like to undertake additional research on my arrival - these include company finances and investment; the current "productivity conundrum"; and the changing nature of international commodity cycles and their impact on UK inflation.

4. Which of your publications or papers are of most relevance to your future work on the MPC?

While at the CBI, and in the City, I regularly published commentary and analysis on the UK and international economies, as well as formal detailed forecasts. I have also published work on the Euro (e.g. NatWest Markets Guide to the Euro (1997); the CBI analysis on UK membership of the Euro (2002) and on energy markets (e.g. the BP Statistical Reviews of World Energy 1997-2001).

As an economist working in business, much of my work was not published, but was used as internal analysis by senior management, or as communication with government or information to businesses. While at the CBI, I provided regular briefing to the Bank of England, the Treasury, BIS and the OBR on the economic outlook and business conditions, as well as on topical economic issues. Recently, these have included such topics as: the impact of pension regulation on corporate finances and investment; the availability of credit to the corporate sector and its impact on investment, and changes in labour market functioning and their implications for productivity.

B. ACCOUNTABILITY

5. How important do you think it is for MPC members to be subject to ex post parliamentary accountability? What are the strongest and weakest parts of the current procedures in the UK?

The operational independence of the Bank of England in setting monetary policy has been critical in delivering credibility that price stability will be achieved over the long term. Bank independence is only operational; the mandate is, rightly, set by Parliament and HMT. But for such operational independence to be democratically viable, it is also necessary that the conduct, thinking and decisions of the MPC are, as far as is consistent with candid discussion and financial market stability, transparent and subject to exacting external scrutiny. While a good deal of such scrutiny is conducted through the media, democratic accountability also requires formal accountability to Parliament.

Such accountability requires the MPC to explain and justify its decisions, and be subject to formal examination and challenge. This is achieved through the combination of the detailed examination of the Committee's thinking at the regular hearings of the TSC and the public letter of explanation to the Chancellor when inflation deviates from the target. I believe that, overall, the current system works well, and is in a number of respects superior to that practiced in other jurisdictions.

Its strengths are the openness with which the hearings are conducted and reported, and the degree of detailed challenge on matters of substance. I see no obvious weaknesses, but there is a risk that, if the letter to the Chancellor were to become a more frequent feature (if, for example, the UK were to be subject to a period of more volatile inflation than has been the case in the past), it might lose some of its effectiveness and symbolic status.

6. Do you believe there is merit in having an individual paragraph in the minutes of MPC decisions in which to explain your most recent vote?

One of the strengths of the MPC is the collective nature of its decision-making, and the active debate within the Committee that supports the decision-making process. I believe that that debate, and the opportunity for members to be influenced by the views of others in making their final decisions, is best served by the current system, in which differences of opinion and emphasis are recorded in the Minutes, but without individual opinions being attributed. Such attribution would likely hamper debate and encourage inflexibility in approach. Individual members of the MPC also have good scope to discuss their individual views in the external speeches that they make.

7. If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?

I would want to be judged on the basis of my positive contribution to the debate about the performance of the economy and to the analysis that supports the decisions of the MPC, as well as my contribution to communicating the activities of the MPC to wider audiences.

C. OTHER PROFESSIONAL ACTIVITIES

8. What other professional activities do you expect to continue/ undertake in addition to your position on the MPC and how do you intend reconciling these activities with your position as a MPC member?

At present, I have no plans for professional activities other than those related to my position on the MPC. While the contract is nominally for 3 days a week, more might be required in the early stages as I work myself into the position. Thereafter, if the opportunity arose, I would consider some part-time university teaching.

9. Outside MPC meetings, what activities do you intend undertaking in order to add to the public's understanding of the role and decisions of the MPC?

As an MPC member, I intend to be active in supporting the work of the Bank agents throughout the UK, assessing the current economic conjuncture and communicating the views of the MPC through dialogue with business and other audiences. Alongside other members, I intend to act as a representative of the MPC to the wider public, through speeches and other representational activities. I am experienced in communicating economic issues to non-specialist audiences, so am keen to visit schools and other bodies to help explain the work of the Bank and views of the MPC, including becoming involved in the annual Bank 2.0 Challenge.

10. What role do you plan to take at the end of your term?

I have no specific plans about my role once I leave the MPC.

D. MONETARY AND ECONOMIC POLICY

11. What do you regard as the major risks to the outlook for the UK economy?

The continued uncertainty about the outlook for the sovereign debt and banking crisis in the Eurozone continues to weigh on business confidence and, with growth rates across the Eurozone slowing, the risk of a deeper Eurozone recession hitting export demand from the UK (to what is still our largest single export market) has increased. Serious financial market disorder or a banking crisis in the Eurozone would have significant negative effects on the UK economy.

Recently, there have also been signs of a loss of economic momentum more widely, with both the US and Chinese economies slowing since the early part of the year. If this were to persist into 2013, the outlook for the UK would be consequently weaker.

Domestically, the main downside risk lies with the consumer. One of the key reasons that the economy grew more slowly than had been expected in 2011 and 2012 was the significant decline in consumer real disposable income, squeezed by the rise in imported inflation following the sharp rise in sterling-denominated energy prices. UK inflation has fallen sharply, allowing real disposable income growth to start to pick up, and suggesting that consumer spending should slowly recover towards the end of this year and into 2013. However, recent increases in the prices of several raw materials, including crude oil and some agricultural products, if sustained, may lead to inflation falling rather more slowly than set out in the Bank's August forecast, posing a downside risk to the rate of UK consumer demand growth.

These downside risks are to a certain extent already built into existing forecasts of the outlook for the UK. If they do not materialise, or are quickly resolved, growth in the UK economy may be higher than current projections.

12. What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?

Both the level of the exchange rate and movements in asset and house prices are included in the framework with which the MPC thinks about the transmission mechanism of monetary policy. Asset and house prices give important information on the likely path of demand, and the exchange rate on import price pressures, so both are critical in considering the appropriate policy stance.

This does not imply that separate or explicit targets for either asset prices or the exchange rate would be appropriate for the MPC with its current mandate. The current inflation target has the advantage of simplicity, and with only a single set of policy tools (the level of short term interest rates and by extension QE), the MPC would risk being unable to achieve targets for different policy variables simultaneously, thus damaging its credibility.

It is, however, now widely accepted that asset prices – and the avoidance of excessive credit growth - are important to the broader stability of the economy, above and beyond their impact on the outlook for inflation, and that policy intervention to influence them directly may be required. Instruments other than Bank Rate, such as those being considered by the Financial Policy Committee, will be required if they are to be specifically targeted.

13. What is your current estimate of the extent of the output gap?

Estimates of the output gap are always uncertain, as we cannot measure potential output directly, and at times of major adjustment in the economy, such estimates are more imprecise than normal.

At present different sets of indicators give very different signals about the level of spare capacity:

- Estimates of the current level of GDP, relative to its pre-crisis trend, suggest that the economy is close to 15% below where it would have been had the financial crisis not occurred. However, both the sustainability of the pre-crisis trend in GDP and the current level of GDP are subject to significant uncertainty, and it is likely to be some time before this data is sufficiently robust to be used with full confidence.
- Other data suggest that the degree of slack in the economy is somewhat less than suggested by the GDP analysis. CBI measures of capacity utilisation, for both the manufacturing sector and the non-financial, non-distribution service sector, are closer to their long run means, although these often measure the potential to increase output only in the very short term, without changes to working practices or shifts. Recent trends in the labour market, and in particular, the increase in private-sector employment of the past year, also suggest that the degree of slack in the economy is somewhat lower.
- Direct estimates of the output gap, such as those employed by the OBR, suggest a figure in a range closer to 2½-3%, although these, too, are subject to significant margins of uncertainty.

On balance, I would estimate that the output gap is probably slightly greater than the direct estimates would suggest, but well below that given by the GDP trend analysis. However, at times in which the economy is undergoing major adjustment, with shifts in the contribution to total demand from different sectors and shifts in relative prices underway, a single estimate of the aggregate output gap is not, in itself, the best predictor of inflation, as the spare capacity is unlikely to be evenly distributed across the economy. A more sectorally-disaggregated approach, looking separately at trends in the labour market and capacity utilisation provides more information in assessing future inflation pressures.

14. What has been the overall effect of quantitative easing on the UK economy?

It is difficult to be precise about the effects of quantitative easing, both because we do not have a counterfactual of how the economy would have performed without it, and because there is little evidence about likely time lags between the implementation of the policy and the full impact on the economy – as far as the more recent programme of QE is concerned, we are still in the early stages.

However, it would be difficult to argue that it has had no impact. Following the announcement of the first round of QE, asset prices reversed their previous downward trend, and estimates of the impact on gilt yields suggest that they were up to 100bp lower as a result of QE than would have been the case. The impact on both market sentiment and liquidity of the first round of QE, undertaken at a time when credit markets were effectively frozen, seems also to have been positive.

The Bank has produced some estimates of the impact of the first programme of QE on the broader economy, estimating that it raised the rate of inflation by ¾-1½ percentage points, and the level of GDP by 1½-2%, relative to what would have otherwise been the case. These estimates do not look implausible, but are necessarily surrounded by a significant margin of uncertainty, given that the econometric estimates of the effect on the broader economy of an easing in policy through QE are as yet less well understood than those from changes in short-term interest rates.

15. How important are current measures of inflation expectations when considering the outlook for future inflation?

Inflation expectations are an important part of the monetary policy framework, in that the credibility of the MPC and of the inflation target are important elements in achieving the inflation mandate. The more stable are inflation expectations, and the more credible the policy framework, the lower the effect on underlying inflation of one-off price shocks to the system, and the greater the consistency of wage- and price-setting behaviour with the inflation target.

It is therefore important that the MPC monitors both the direct surveys of inflation expectations and other indirect indicators. However, such indicators are better interpreted in terms of what they indicate about short term attitudes and behaviour than as predictors of inflation in the medium-term, with which the correlation is poor.

16. What impact do you think the Funding for Lending scheme and the activation of the Extended Collateral Term Repo Facility will have on the economy?

Although the quantitative easing programme raised both equity and bond prices and has thus reduced the cost of finance to companies with recourse to the capital markets, the indirect impact of QE on bank lending appears to have been much less, with flows of lending to the broader economy remaining depressed. While some of this will have been due to low levels of demand for bank lending, reflecting the uncertain outlook for the economy, targeted incentives to both boost the volume and reduce the cost of lending, that are built into the Funding for Lending Scheme, are likely to be of benefit. The impact is likely to be supplemented by the changes in the amount of liquid assets that banks are required to hold recently announced by the FSA in response to the recommendation of the FPC. Together these should help expand lending flows to the broader economy, though the impact is likely to be more visible over the medium term, as it is likely to take time for the increase in lending to take effect.

Recent heightened uncertainty about the health of individual Eurozone banks poses risks of illiquidity stress in the inter-bank markets. If inter-bank liquidity were to dry up as it did in the months following the collapse of Lehmans, this would pose risks both to the stability of the UK banking system and further depress levels of lending. The activation of the ECTR, which would permit repo operations against a wider range of collateral, is a useful precautionary measure to help support lending conditions in the event of liquidity stresses within the banking system re-emerging.