Questionnaire in advance of Treasury Committee hearing

Reappointment hearing for Ian McCafferty

October 2015

A. PERSONAL/GENERAL

1. Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in continuing to carry 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. Why have you decided to stay on for a second term? What have you learned from your experience of being on the MPC so far? Do you plan on doing anything differently during your second term?

I believe I have a further contribution to make to the MPC, and was therefore happy to accept to stay on for a second term. I believe that the MPC and its external membership benefit from having a balance of experience and new blood amongst its members. Over my first term, I have learned a good deal about how the Bank and the Committee work and have developed good working relationships with the Governor, other Committee members and Bank staff, which improve the effectiveness of my contribution. It is generally recognised that it takes new members a little time to achieve full effectiveness on the Committee – to experience and understand the evolution of MPC thinking such as to be fully able to both contribute to and challenge key issues in the debate. Staying on for a second term allows me to bring this experience to bear, and to support my newer colleagues on the Committee.

I also believe I have more to contribute to the working of the MPC and the Bank more widely. In my first term, I was able to work closely with staff economists in the Bank to use my experience of key issues – including the way in which business operates within the economy (issues such as corporate funding and investment behaviour), and the functioning of oil and commodity markets – to develop Bank analysis and thinking. I intend to continue to do this in my second term, on these subjects and others in which I have external experience and expertise.

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

During my first term, I made a number of speeches on a series of topical specialist economic issues relevant to the MPC. I undertook research and delivered speeches on the sectoral dimensions of the productivity puzzle, on commodity cycles and their implications for monetary policy, on the role of internal finance in business investment and on SME financing issues (forthcoming). These are all areas which remain relevant to the MPC over my second term, and which I intend to continue to analyse, in support of our forecasting and policy-making. Further, my work while at the CBI on the labour market and wage determination is becoming increasingly relevant to the MPC's deliberations as the economy evolves, and I intend to do more in this area.

In addition, when I joined the MPC, I stated that I felt there was a valuable role to be played in communicating the Bank's thinking on the economy and monetary policy issues to non-specialist audiences, including schools and business representative groups, in addition to our communications to markets and analysts. Communicating to these broader audiences helps improve both economic understanding and the credibility of the Bank, and thus improves the effectiveness of monetary policy. Over my first term, a number of my speeches, presentations and media interventions were designed with this aim in mind (as an example, I have broadened the Bank's repertoire by instigating a regular LBC radio phone-in on economic issues). I intend to continue this role over my second term.

5. **Have you received the support from the Bank that you need to fulfil your role? Are there changes that the Bank could make to support external members of the MPC better?**

The MPC has now been operating for almost twenty years, and the evolution of the systems of support for external members over this period has meant that the level of support is very good.

- External members each have a small dedicated research and support team within the External MPC Unit, and the level of expertise of these teams (who are drawn from specialist roles within the Bank) is extremely high.

- I have developed close working relationships with the Governor and members of the senior Executive of the Bank, allowing me to perform an effective role as an external member.

- The Deputy Governor for Monetary Policy, Ben Broadbent, runs an excellent system of liaison and regular meetings with the external membership, such that any issues we have can be addressed.

- The Court, and in particular its Chairman, communicate regularly with external members of the MPC, and the annual review with individual external members conducted by the Chairman provides a good procedure for resolving any concerns about my ability to fulfil my role, were I unable to resolve them informally with senior management.

- The specialist economics staff at the Bank are very supportive, if I require any research or analysis, both in addition to and in support of that undertaken by my own team. Bank staff are keen to develop a close working relationships with all external MPC members, and the service they provide is of a high calibre.

There are always small areas in which changes and improvements in the nature and level of support can be made, as the work of the Committee evolves. For those of us who are officially part-time, timely circulation of the extensive library of research and analysis is always a challenge, as is ensuring that, as hardware and systems change, Bank IT provides the high level of communication required for full effectiveness. These are constant issues for all organisations, and Bank staff are keen to ensure that we are provided with the best support.

B. OTHER PROFESSIONAL ACTIVITIES

1. What other work commitments do you maintain in addition to membership of the MPC, and how do those benefit your work on the MPC? Do you expect to take on any other commitments in the future?

I recently stood down from my roles on the Advisory Boards of the UK Innovation Research Centre (jointly run by the Universities of London and Cambridge), and of the Centre for Business Research at the Judge Institute in Cambridge. I stood down from the first as their ESRC funding had expired, ending the term of the Centre as an independent body, and from the second as my six year Board term had expired. These had been of benefit to my work on the MPC by maintaining my understanding of academic research in their specialist areas.

As a result, I have no formal external work commitments at present, although I am maintaining links with these bodies, and with the Universities of Durham and Nottingham Trent, where I have given lectures in the past. I remain willing to accept such roles, subject to their suitability and lack of conflict with my work on the MPC.

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

Throughout my first term on the MPC, I gave regular on-the-record interviews and background briefings to journalists, wrote articles and made a series of formal speeches and regular presentations to a variety of business, academic, schools and civic groups on the outlook for the UK economy, MPC thinking and economic issues of topical importance to monetary policy.

In conjunction with the Bank press office, I also initiated ways of communicating the work of the Bank to wider audiences, through radio interviews, and in particular regular participation in a phone-in programme for LBC, taking questions and explaining work of the Bank and the MPC. In this way, I was able to present the Bank and explain the workings of the economy to more non-technical audiences, to enhance understanding and hence monetary policy credibility.

I have also maintained close links with business community, including participation in meetings of Chambers of Commerce, the CBI, and the Institute of Directors, as well as a full programme of regional visits using the Bank's Regional Agents' network.

I have given a series of lectures and presentations in schools, explaining the work of the Bank of England, and have been a regular judge for the Bank's Target 2.0 schools competition, including the national final in each of my three years.

C. MONETARY AND ECONOMIC POLICY

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

There are a number of risks to the sustainability of the short/medium term recovery in the UK economy, as well as some more structural risks over the longer term. Such risks generate uncertainty on both sides of the MPC's central forecast.

Short/medium term risks

The current recovery in the UK economy is likely to continue to be influenced by some of the headwind legacies from the financial crisis and subsequent recession, the effects of which have long tails. More subdued growth rates across the world, the need for further financial restructuring and debt adjustment, and continued fiscal consolidation will all continue to shape the outlook for growth in the UK for some time, and the responses of the economy to such processes generate significant uncertainties in themselves. Around this scenario, there are a number of key specific risks:

Many, representing risks to the UK growth outlook, originate in the global economy.

- The world economic cycle is desynchronised, with advanced economy growth picking up as emerging economy growth is slowing. This is being exacerbated by the sharp falls in oil and commodity prices, which have hit exporters hard, but provided an income boost to importers. This situation generates several financial stability risks, including sharp moves in exchange rates, significant capital outflows or foreign debt issues for individual EMEs, and the possibility of a negative reaction when the Fed tightens monetary policy.

- In China, the policy complexity of a transition to a more consumption-driven economy, with less emphasis on both fixed investment and net exports, raises the possibility of a sharp, disruptive slowdown in growth rates, particularly given levels of domestic credit and the fragility of the domestic banking system.

- In the Eurozone, our largest trading partner, the need for further adjustment to both the banking sector and the fiscal position in a number of countries suggests that growth will be sluggish, and financial market confidence volatile. While the likelihood of immediate instability stemming from Greece has been reduced by recent developments, further uncertainty about the future of the euro cannot be ruled out over the medium term.

The main domestic short/medium term risks stem from the uncertainty about the structural characteristics of the post-recession labour market, such that there is great uncertainty about the remaining level of economic slack in the economy, its likely impact on wage costs, and how far the expansion will be supported by a recovery in productivity growth. All of these generate risks around the expected inflation outlook and the pace and timing of policy normalisation.

The possible persistence of a low global nominal environment, in which global inflation pressures remain low for some time, also potentially generates uncertainties for the outlook and for monetary policy. Low nominal growth generates additional pressures from existing debt levels, as the real value of the debt remains high, as well as complicating monetary policy if nominal interest rates become constrained by the zero lower bound.

Over the longer term, a number of more structural risks and uncertainties raise questions about the long term performance of the UK economy. These include the underlying rate of productivity growth, and hence how fast the economy can grow at full employment, the extent to which a persistent current account deficit might limit the rate of growth through exchange rate instability, and whether the UK economy has sufficient skills to improve competitiveness.

2. What do you think explains the UK's 'productivity puzzle'?

Since the onset of the financial crisis in 2008, productivity growth in the UK has seriously underperformed its pre-crisis trend, such that by the end of 2014, the level of productivity was some 15% lower than it would have been had the pre-crisis trend continued. This calculation has only changed a little as a result of the publication by the ONS of the latest Blue Book, such that it is becoming ever more difficult to assign any meaningful element of the underperformance to measurement issues.

In spite of extensive analysis, both within the Bank and outside, there is as yet no definitive and detailed answer to the cause of the 'productivity puzzle'; a complete answer is unlikely to emerge until after the end of this economic cycle, if ever. Nevertheless, our understanding of the causes has improved significantly over the past few years, such that the phenomenon is much less of a 'puzzle' that it was.

It must be recognised that there is no single cause for the productivity performance over the period since 2008. The drivers of low productivity performance differ, both at different points in the cycle since 2008, and in terms of the impact on different sectors of the economy. This is one reason why estimating the precise magnitude of the different causes is difficult. The UK is not alone in suffering from this productivity problem. As Martin Weale's work has shown, productivity puzzles following the crisis are widespread internationally, albeit that the individual magnitudes vary.

Within the UK, the impact has not been uniform across sectors. As I showed in my speech (June 2014), much of the poor productivity performance was highly concentrated in a few specific industrial sectors, including Mining and Quarrying (including North Sea oil) and Finance and Insurance. In these, the causes of the productivity underperformance seem idiosyncratic (due to long term decline in North Sea production in a capital intensive sector, and the changes in financial regulation as a result of the financial crisis requiring larger compliance functions). For the rest of the economy, sectoral differences exist, but are somewhat less marked, and are more probably the result of at least one of the more economy-wide factors linked to the crisis.

There appear to be a number of causes linked either directly to the financial crisis, or to the nature and depth of the recession that followed. While this means that they are likely to prove cyclical, it does not mean that they will not be long-lived, or persistent.

The crisis itself is likely to have affected productivity directly in a number of ways.

- The dislocation of the banking system, and the need for banks to downsize their loan books, will have disrupted flows of capital to the corporate sector, likely leading to a misallocation of capital as newer, more productive firms found it difficult to source external capital. The very low interest rate environment required to support the economy, combined with some forbearance on the part of HMRC and banks themselves, kept firms in business that would otherwise have failed (corporate failure rates through this cycle have been historically low). While this will have had benefits to employment and the broader economy, it has probably led to some low-productivity firms to survive, reducing average productivity levels.

The depth and duration of the recession that followed the crisis are also believed to have driven some changes in productivity.

- In the early part of the cycle, as output fell sharply, there was a steep reduction in capacity utilisation. This is likely to have been compounded, in productivity terms, by some labour hoarding, as firms sought to retain key skills. Inability to cut employment below minimum thresholds (overhead labour) will also have contributed to measured productivity falls, as will greater intensity of effort in winning and retaining business in a tough trading environment.

More recently, as output has started to recover, other factors have come into play.

- The sharp fall in capital investment earlier in the cycle, combined with a reduced take-up of new technologies as intangible capital, will have gradually eroded the level and quality of the capital stock, reducing productivity growth in more recent years. Shifting patterns in the labour market as the economy has recovered, and in particular the shifts in the composition of newly re-employed labour towards lower skilled employees, are also likely to have depressed productivity, at least temporarily.

Some of these factors, though ultimately largely cyclical, may nevertheless prove persistent, especially those linked to the investment cycle. This suggests that, as the recovery continues, some recovery in productivity growth is likely, albeit that growth rates may be somewhat depressed for some time yet. The most recent National Accounts data for Q2 2015, suggesting that productivity growth may now be improving, are encouraging in this regard, but re-attaining the pre-crisis level of productivity will take some time, and as such represents a more 'permanent' loss to the economy.

3. What is your assessment of the effectiveness of the policy of quantitative easing in the UK? What, in your view, are the principal challenges of unwinding quantitative easing?

The effectiveness of QE

The purpose of the Asset Purchase Facility, and its policy of quantitative easing (QE) through the purchases of gilts and other financial assets financed by the issuance of extra reserves, was to inject further monetary stimulus into the economy, in order to increase the level of broad money and stimulate nominal spending, once further reductions in Bank Rate were judged to be constrained by the Zero Lower Bound. The effectiveness of QE therefore needs to be judged by its impact on the economy, an exercise made more difficult as a result of a lack of a closely-defined counterfactual.

Nevertheless, I agree with the large body of literature assessing the effectiveness of QE that generally concludes that it provided an effective monetary stimulus to the economy, such that the level of activity and the rate of inflation were less depressed than otherwise would have been the case. Estimates suggest that the two programmes of QE, in which

£375bn of assets were purchased, lowered gilt yields by some 300bp, raising the level of GDP by 2-2½% and inflation by some 1½-2 percentage points On standard multipliers, this was the equivalent of reducing Bank Rate by a further 250-400bp, though there is significant uncertainty around these calculations.

QE works through a number of channels. First, asset purchases raised the level of broad money, lowered gilt yields directly, and through portfolio rebalancing, raised the prices of a range of other assets, including corporate bonds and equities. At a time of considerable financial disruption, they may well have reduced the liquidity premium in some markets, also lowering yields. In addition, QE may have provided some additional signals about the degree and duration of easy monetary policy, affecting expectations, as well as some support for confidence more widely. As well as the short to medium term impact, there may well have been some more durable benefits to the economy, as higher economic activity may well have prevented some deterioration in supply capacity (through labour market hysteresis and scrapping of productive assets).

It is likely that the impact of QE is state-contingent. This is supported by the estimates of the impacts of the two different programmes of QE (2009-10 and 2011-12), as it appears that the impact of the second round of QE was lower than the first. This is likely to be because the degree of signalling about monetary policy intentions was less powerful, and financial markets were already better functioning, such that there was little reduction in the liquidity premium. The portfolio rebalancing and confidence channels appear to have been effective in both programmes. The effectiveness of QE also depends on the demand for money and credit, and propensities to consume and invest, which may have shifted over the period of the recession and initial recovery. Although its precise impact on economic activity and inflation is likely to vary depending on the underlying conditions within the economy, I believe that it remains an effective tool should further stimulus be required.

QE is often criticised on the grounds that it has hurt savers, and generated other distributional effects. Much of this criticism is unjustified. Without the stimulus provided to the economy, most people would have been worse off, as economic growth would have been lower, with unemployment and company failures higher. This would have been detrimental to all groups, including savers. QE raised the prices of a range of investment assets, including gilts, corporate bonds and equities, also benefiting savers. This will have acted to offset lower coupon rates and annuity rates. The fall in income for those holding savings accounts came from the sharp decline in Bank Rate, rather than from QE. Moreover, as far as pensions are concerned, the burden of the increased deficit on defined benefit schemes (the only class of scheme in which QE specifically causes a deterioration in the valuation) has fallen on employers and future employees, rather than on those approaching retirement.

Challenges of unwinding

The unwinding of QE will be part of the objective of the MPC to maintain price stability and achieve the inflation target set by Parliament. The nature and timing is therefore an operational monetary policy decision, although, as the MPC has already made clear, when the time comes, one of the key objectives of the unwinding of QE is to minimise the disruption to the gilt market, such that the programme of asset sales will be announced in advance and will be conducted in consultation with the Debt Management Office.

As a monetary policy instrument, one of the challenges of unwinding will be assessing the precise impact on the economy of such asset sales. There is greater uncertainty about the impact on the yield curve from asset sales than from a change in Bank Rate, and as the impact of QE appears to be state contingent, it is not clear that the economic multipliers will be the same as those that applied to purchases, such that the precise degree of policy tightening involved in sales of, say, £25bn of assets, can only be discovered once the programme is underway.

As a policy instrument, asset sales represent a substitute for an increase in Bank Rate. One of the operational challenges is therefore the operation of the two policy levers in concert. As there is a greater understanding of the impacts of a change in Bank Rate, as well as a need to return Bank Rate as early as possible to a level at which it can be an effective instrument in both directions (that is, far enough above the effective zero bound to allow effective easing as well as tightening), it is important that Bank Rate is used initially as the method of policy normalisation, with asset sales deployed later, if additional tightening is required once Bank Rate is returned to a level that ensures its effectiveness as the marginal tool. It is also likely to be the case that the costs of reversal of an unwinding of QE are likely to be higher than those for a reversal of Bank Rate, such that unwinding should not begin until the MPC is confident that it can be sustained. As a result, in my view, the unwinding of QE is unlikely to begin for some time.

The fiscal impact of the timing and pace of unwinding cannot be known until the process is finished. The later the process starts, the greater the likelihood that some of the gilts, at least, will be sold at a loss unless they are held to maturity, as the yield curve is likely to rise in response to the improvement in the performance of the economy. However, the timing of sales will also determine the flow of coupon income to the Treasury, such that the net effect will depend on market conditions over the whole of the purchase and sale periods. Overall, the net fiscal implications of the APF are unclear, and should not influence the timing or pace of unwinding when it happens.