ECONOMIC AFFAIRS COMMITTEE HEARING

Tuesday 10th March 2015

Opening Remarks by the Governor

Thank you for this opportunity to testify. I would like to begin with a few comments on some of the Bank's efforts to promote monetary and financial stability.

UK inflation has fallen to its lowest level since the introduction of Inflation Targeting two decades ago. It will likely fall further to around zero in the coming months and remain near there for much of the year.

As a consequence, I have written the first open letter from a Governor to the Chancellor explaining why inflation is so low and what the MPC is going to do about it. And I will likely write a few more before the year is out.

The majority of the weakness in inflation reflects falls in energy and food prices, particularly lower global oil prices.

Commodity prices do not, however, wholly explain weak inflation. Core inflation is running at around 1½ per cent. This reflects a long period of muted wage growth and the remaining degree of slack in the economy, currently judged to be in the region of ½ per cent.

The MPC's job is to clarify the horizon over which it aims to bring inflation back to target and then take the actions necessary to achieve it.

The MPC is seeking to return inflation to the target as quickly as possible after the effects of energy and food price movements have abated. In the MPC's judgement, it is appropriate to do that within the next two years.

The dynamics of the UK economy are consistent with this objective.

Output growth remains solid, at a little above 2 ½ per cent, and domestic demand growth robust.

The labour market continues to strengthen. Unemployment has reached its lowest level for more than six years, and 600,000 new jobs have been created in the past year. Average hours worked continue to recover on a strong upward trend. The number of people working is at a record high, and as the margin of slack in the economy narrows, there are increasing signs of wage and unit labour costs picking up.

The combination of rising wages and weak headline inflation will strengthen household finances and boost real take-home pay growth this year to its fastest rate in a decade. In turn, this will support continued solid growth in consumer spending.

As demonstrated by the recent Bank of England stress tests, the core of our financial system is increasingly resilient. Access to credit continues to improve and many borrowing rates are at or near historical lows.

Against that backdrop, surveys point to robust investment intentions outside of the extraction sector.

According to the Bank's latest forecast, a gently rising path of Bank Rate is likely to be consistent with eliminating the remaining slack in the economy, and thereby ensure that inflation returns to target within two years.

The MPC recognises that a prolonged environment of low interest rates could create financial stability risks which threaten its secondary objective of supporting strong, sustainable and balanced growth. It is working closely with the FPC, sharing analysis and conducting a series of joint meetings to compare perspectives on risks to medium-term stability.

The FPC is the first line of defence against such risks. The FPC's remit – bestowed by Parliament – is to identify, monitor, and take action to remove or reduce systemic risks in order to protect and enhance the resilience of the UK financial system.

While there are considerable global risks, including geopolitical flash points, ongoing strains in the euro area and the possibility of dislocations from the widespread mispricing of liquidity risks, these are generally beyond the scope of UK monetary and macroprudential tools. These risks do, however, put a premium on ensuring that the core of our system is resilient to shocks. I will address this in a moment.

Closer to home, the legacy of high indebtedness and structural imbalances in the UK economy means that there are risks that, if left unchecked, could undermine the durability of the expansion. The biggest medium-term risks relate to the housing market.

Last year, the FPC took graduated and proportionate actions to mitigate the risks of the build-up of unsustainable levels of debt and credit growth.

To be clear, the FPC does not believe that household indebtedness poses an imminent threat to stability. Underwriting standards are more responsible than they were in the past. But time and again, this country has seen how quickly responsible can turn to reckless, creating imbalances that ultimately destabilise the economy.

The FPC has taken out insurance against such risks by introducing a new affordability test to ensure households can continue to meet their mortgage repayments even if interest rates rise, and by setting a cap on the proportion of highly-geared new residential mortgages.

These measures were deliberately calibrated so they would not constrain existing housing market activity, but rather to prevent an erosion of standards which could have broader macroeconomic consequences.

Given the legacy of the crisis, risks from housing, and risks from abroad, the Bank has continued to strengthen the resilience of the UK's banking system.

Since last summer there have been two major structural milestones. First, the Government is taking steps to give the FPC powers of direction over a leverage ratio. Second, the Bank helped the G20 achieve a watershed in ending the scourge of Too-Big-To-Fail banks as the G20 Leaders endorsed the proposal for Total Loss Absorbing Capacity (TLAC) at the Brisbane Summit. Once implemented, TLAC could effectively double the private capital available to resolve a globally systemic bank.

Last year, the FPC and PRA Board also conducted the first concurrent stress test of major UK banks by stressing their ability to withstand a severe housing market shock.

The results and related capital actions demonstrate that the core of our banking system is much more resilient than prior to the crisis. Collectively, the banking system was found to be strong enough to continue to lend to households and businesses even during a severe stress. We will conduct another stress test this year, with greater focus on international risks.

Having taken action to deal with the immediate aftermath of the crisis, the Bank is broadening its work to address new and evolving risks. We are particularly focused on those involving misconduct in financial markets – where the Fair and Effective Markets Review will make recommendations in the summer – and on risks that could be being built up through the provision of market-based finance.

Throughout all of our efforts, the Bank has sought to increase the transparency of our decision-making processes and our actions. Since I last appeared before this Committee we have:

- Announced the most significant set of changes to how we present and explain our interest rate decisions since the Monetary Policy Committee was formed in 1997. Following the recommendations of the Warsh review, we will commence publication of both the minutes of MPC policy meetings and (in the relevant months) the *Inflation Report*, at the same time as MPC policy decisions, starting from August 2015. We will also publish complete transcripts of our decision meetings with an eight year lag.

- Enhanced the transparency of our governance by publishing the minutes of Court meetings from the crisis period, 2007-2009 and by bringing the publication of historical Court minutes within our new archive policy. That aligns us with best practice in Whitehall.
- Opened up our historical data sets and are actively encouraging their use by outside researchers and commentators.
- Completely overhauled our Market Intelligence function to make it open and transparent, including by publishing an MI Charter.

The Bank recognises that it should be held to the highest standards. When we fall short, we will review the circumstances, draw the lessons learned and publish the results in as timely a fashion as possible. Recent examples include the Grabiner Report and the forthcoming RTGS review. We welcome opportunities such as these to account for its activities to Parliament and, through Parliament, to the people of the United Kingdom.