QUESTIONNAIRE FOR TREASURY COMMITTEE HEARING ON 9 JULY 2014

DR NEMAT SHAFIK

PERSONAL/GENERAL

1 How has your experience to date prepared you for the role of Deputy Governor of the Bank of England, including your roles on the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC)?

I have been in senior economic policymaking roles in financial institutions with a public purpose for about 20 years. This has ranged from international financial institutions (the IMF and the World Bank), to a UK government department with an economic mandate (DFID) to an organisation encouraging private sector investment in emerging markets (the International Finance Corporation). I have also been a producer of research and policy ideas in academia (Oxford University, the Wharton Business School of the University of Pennsylvania and Georgetown University) and have extensive managerial experience based on 15 years of managing 1000+ staff and multi-billion dollar administrative budgets, programmes and investments.

For the last three years at the IMF, I have been responsible for macroeconomic policy advice and programmes for 48 countries in Europe and the Middle East, with a particular emphasis on the Eurozone crisis. In that capacity, I have been responsible for the IMF's advice on monetary and fiscal policies as well as financial stability, exchange and trade and real sector issues in the context of both surveillance and programmes. In the case of the euro area, I spent much time on discussions around managing the risks of contagion for financial stability and on completing the architecture of the monetary union, particularly the need for a firewall and a banking and fiscal union. I also participated actively in the IMF's surveillance of markets and the world economy, the growing body of work on spillovers and interconnections after the crisis, and learning lessons from the application of unconventional monetary policies and macro-prudential policies. I also oversaw the IMF's $1 billion administrative budget and its $10 billion pension scheme including its asset allocation and investment strategy which delivered consistent performance above benchmarks. On the managerial side, a key area of focus for me was on breaking down the IMF’s internal silos which undermined its ability to anticipate the crisis in 2008. This involved introducing a variety of products, processes and policies which helped ‘connect the dots’ through more cross-cutting work, more joint teams, greater staff mobility and better accountability for deliverables.

My seven years as a civil servant gave me a good understanding of policy challenges facing the UK. As a Permanent Secretary, I was part of a wider team that worked on delivering the Government's fiscal consolidation plans and agenda for improving value for money. I have experience with Parliamentary accountability having appeared frequently before the Public Accounts Committee, the Development Select Committee and the Defence Select Committee. I also had to represent the Department in a variety of public fora and with the media, both internationally and in the UK.

At the World Bank I worked on a variety of topics, many of which are relevant to my future role at the Bank of England. For example, I oversaw the World Bank programme which provided partial credit guarantees (for sovereign bond issues) and partial risk guarantees (for project finance) to promote greater private investment. This required an understanding of financial markets and the allocation and management of risks. In both Eastern Europe and the Middle East, I ran programmes on bank restructuring, privatisation, capital market development, regulation and competition policy. Early in my career, I was very involved in macroeconomic modelling and econometric analysis to support country work as well as global economic forecasts.

My role as Deputy Governor will also include joint oversight of the Bank's international work. Here I will be able to draw on my extensive experience of international negotiations at the IMF, with the EU and the ECB, the UN, the G20 and G7. I have knowledge of the issues and process, as well as a strong network of international contacts that can help deliver policy outcomes relevant to the UK as an open economy and a global financial centre.

My experience on governance issues and with boards is also relevant to my future role as a member of the MPC and FPC and in leading the Fair and Effective Markets Review. I have chaired over 150 meetings of the IMF Board, where forging a consensus between 188 countries is a constant challenge. I have also chaired half a dozen international consultative groups and served on many Boards, so have a strong appreciation for the need for candid debate, consensus building and clear accountabilities. I am also someone who likes working on teams and bringing out the best in the people I manage. I think both these qualities will be especially important for the Bank going forward given its wider powers and larger staff and the need to integrate across monetary, macro-prudential and micro-prudential policies.

2 Do you intend to serve your full term?

Yes.

3 What do you regard as the main challenges you will face as Deputy Governor with responsibility for Markets and Banking in the next five years? What criteria do you suggest should be used to assess your record as Deputy Governor?

Obviously I would want to consult with colleagues at the Bank once I start, but the following is my initial view on the key challenges in my role as Deputy Governor (those relating to my responsibilities for markets and banking are elaborated on in the response to Question 7):

- First, managing the eventual exit from unconventional monetary policy in a manner that delivers the inflation target, has an orderly impact on markets and maintains financial stability.

- Second, ensuring that the Bank's balance sheet operations and associated risk management practices continue to be subject to regular review and refinement to ensure they remain fit for purpose in light of changing economic conditions and structural developments in financial markets.

- Third, completing the Fair and Effective Markets Review in a way that restores confidence in, and the credibility of, wholesale markets.

- Fourth, working closely with Jon Cunliffe, Deputy Governor for Financial Stability, to make a success of the Bank's new International Directorate, serving as G7 Deputy and strengthening the Bank's role and influence on the world stage through producing high-quality international surveillance, analysis and engagement.

- Fifth, by playing a full part in the Bank's external communications programme, to help deepen and strengthen public understanding of, and confidence in, the full range of the Bank's policy responsibilities, including monetary policy, macro- and micro-prudential regulation. As part of this, I will place particular priority on explaining the role that the Bank's balance sheet operations can play in supporting its policy objectives.

- Sixth, helping to deliver the new 'One Bank' strategy, building a strong and cohesive management team, and using my role on the MPC, the FPC and the PRA Board to ensure the Bank's markets and banking operations are integrated effectively into everything we do, and more broadly to make connections across the Bank's monetary policy, macro and micro prudential instruments to deliver its mandates for price and financial stability.

In terms of evaluation criteria I believe that, broadly speaking, I should be assessed on the part I play in helping to deliver the two key legs of the Bank's mission – monetary stability and financial stability. As a member of the management team of the Bank, I should also be held to account on the performance of the Bank as an institution, including delivery of the 'One Bank' strategy, and on the Bank being seen as a well-run organisation. The Bank has been asked to deliver a much more complex set of objectives which means it must be an even more capable institution. I would hope to contribute to achieving that.

In my specific areas of responsibility for markets and banking, I would expect to be judged on: the delivery of consistently professional, high-quality operations, including in particular a clearly articulated and well implemented strategy for exit from unconventional monetary policy; a balance sheet framework for the Bank that is seen as fit for purpose in terms of size, facilities and operations; an improved market intelligence function that supports all the Bank's work; and a set of reforms that helps to deliver fair and effective wholesale markets, restoring confidence and garnering international support and endorsement.

4 Which of your publications or papers are of most relevance to your role as Deputy Governor?

A full list of my publications is available in my CV, but those most relevant to the role of Deputy Governor are:

'Political Economy, Financial Stability and Equitable Growth,' presented at Conference on 'Capital Account Management and Macro prudential Regulation for Financial Stability and Growth,' Delhi, January 2014.

'Smart Governance: Solutions for Today's Global Economy,' Annual Global Economic Governance lecture, Oxford University, UK, December 2013.

'Europe's Choice: Risk Stagnation or Pursue Integration,' IMF blog, October 2013.

'Communication, Engagement and Effective Economic Reform,' 2013 Maggy Nally Memorial Lecture, London March 2013.

'Europe: Toward a More Perfect Union,' IMF blog, February 2013.

'Debt in a Time of Protests,' IMF blog, October 2012.

'Convergence, Crisis and Capacity Building,' Vienna, July 2012.

'Reviving Growth in Europe,' Brussels Economic Forum, May 2012.

'Avoiding a Lost Generation,' IMF blog, March 2012.

'Straight Talk: Stolen Dreams,' Finance and Development, volume 49, number 1, March 2012.

‘Global Economic Challenges and Fostering Future Prosperity,’ Address at the University of Iceland, Reykjavik, October 2011.

‘Selling Privatisation Politically,’ Columbia Journal of World Business, winter 1996.

‘Making a Market: Mass Privatisation in the Czech and Slovak Republics,’ World Development, volume 23, number 7, July 1995.

‘Exchange Reform, Parallel Markets and Inflation in Africa,’ (with Ajay Chhibber) in Economic Reform in Africa edited by Ajay Chhibber and Stanley Fischer, the World Bank, 1992.

‘Are High Real Interest Rates Bad for World Economic Growth?’ Working Paper, World Bank, May 1991.

5 What will be your priorities with regard to the Bank’s international surveillance, analysis and engagement?

As home to the world's largest international financial centre, it is essential that the UK both monitors and shapes the global economic and regulatory environment. I would highlight three key priorities for the Bank's international work:

- First, to identify the major risks to global economic and financial developments and understand their impact for the UK so as to inform decision making by the MPC, FPC and PRA Board, and for the Bank’s markets and banking operations;

- Second, to coordinate and develop the Bank's international strategy and policy to maximise impact on global developments that have consequences for UK monetary and financial stability; and

- Third, to serve as a centre of excellence for analysis and research on international issues of relevance for the Bank's mission.

Jon Cunliffe and I are in the process of working with the Bank’s newly-appointed International Director to agree the key areas of focus going forward. The creation of a new Directorate gives us the opportunity to ensure that the work serves the Bank as a whole. Many aspects of the current work will continue – such as monitoring global economic developments or participating in various international negotiations and fora – but I would like to highlight a few topics that I think should get particular attention.

A key priority for international engagement will be to forge a consensus around the findings of the Fair and Effective Markets Review. While the UK has the largest share in some areas (like foreign exchange), these wholesale markets are essentially global and forging international agreement on better standards will be critical to restoring confidence among market participants and the public. I would plan to work with the authorities in the EU, US, Asia and elsewhere, the FSB, industry groups and others to make that happen.

For surveillance purposes, a significant risk to the world economy arises from possible disruptions from exit from unconventional monetary policies. Last summer's episode of ‘taper talk’ gave us a flavour of some of the risks, with considerable volatility for many emerging markets and some evidence of spillbacks for advanced economies. The normalisation process has only just begun, and the world's major central banks are not synchronised in their exit timing. In one sense the lack of synchronisation may be a positive thing because simultaneous, across-the-board rises in interest rates in the advanced economies could trigger large outflows from emerging markets. But it is inevitable that there will be some bumps along the road. Monitoring this process, particularly the impact on capital flows, asset prices and the real economy, will be critical for the period ahead. Other key topics for surveillance include the nature of the recovery in Europe and the risks around low inflation, as well as the slowdown in China and the risks around shadow banking.

In terms of analytical work, I think the new frontier is around building a better understanding of international spillovers and spillbacks from exogenous shocks and policy decisions in other countries. The 2008 crisis revealed that, while of course trade and capital flows are important, increasingly financial interconnections can be a source of significant vulnerabilities. There is a great deal of new work being done in this area to better assess the impact on the UK of global shocks using event studies and modelling techniques, with which the Bank has and should continue to engage. I would be keen to see such work expanded and shared across relevant central banks, international organisations and research centres. I also think that, given the unprecedented nature of many of the challenges facing the Bank, learning lessons from others is at a premium. The Bank's international team should also be a place where other countries' experience with issues such as exiting from QE or calibrating macro-prudential policies is synthesised and potential lessons for the UK are drawn out.

The UK has traditionally played a major role engaging in international economic and financial negotiations, given its history, economic position and global perspective. The challenge of setting new international standards under the auspices of the G20 and FSB is in train with significant progress made in some areas (such as the capital adequacy and national resolution regimes) and well under way in other areas in the lead up to the Brisbane Summit (such as too big to fail, OTC derivatives reform and shadow banking). These standards are, or will be, implemented in EU law, which the UK authorities, including the Bank, are fully engaged in shaping. There is also an important process of regulatory reform going on in Europe under the umbrella of the 'banking union' with the ECB taking on a key role as a common supervisor and the creation of a single resolution mechanism. The UK has a huge stake in these processes. I would hope to bring my experience and contacts to support the Bank's engagement in building a better international monetary system and standards for an increasingly globalised financial sector that benefits the UK.

6 What is your assessment of the governance structure of the Bank?

The Treasury Committee's 2011 report on the Accountability of the Bank of England lays out clearly the governance challenges that arise from the expanded powers given to the Bank, especially in the area of financial stability. Oversight of the Bank is ultimately vested in Parliament, which sets the legislative framework, holds the government to account for that framework, and holds the Bank to account for its performance in discharging its functions. The Bank's Court of Directors is responsible for managing the affairs of the Bank, determining the Bank's strategy, and overseeing its financial and risk controls. Given the Bank's expanded mandate, it is natural that the oversight roles of both Parliament and Court also have to expand considerably.

I will need to form my own view of how the new structures are operating over time as I gain experience of the Bank. Judged from the outside, there certainly appear to have been a number of welcome improvements in transparency many of which originate in recommendations in the Treasury Committee's own report. Three in particular stand out. First, the newly-published minutes of Court meetings provide a clear and timely account of discussions amongst the executives and non-executives which seem to me at least the equal of other public bodies. Second, the three reviews commissioned by Court from Ian Plenderleith, David Stockton and Bill Winters were very high quality, and the Bank's response to the recommendations thorough.

Third, I strongly support the newly-created independent evaluation unit that formed part of the Bank's new strategy announced earlier this year. I have experience working with the Independent Evaluation

Office of the IMF, which was created in 2001 to produce a variety of assessments of the Fund's policies and activities. I was also involved in the creation of the Independent Commission for Aid Impact, an evaluation function for the Department for International Development. Important lessons from these experiences for me are: (1) the relationship needs to be open, candid and interactive in selecting topics, sharing information and commenting on reports; (2) external evaluation must be complemented by internal evaluation, knowledge sharing and lesson learning; and (3) evaluations should avoid trying to assess 'live' operations to avoid jeopardising their success.

These and other changes have clearly strengthened the arrangements for oversight of the Bank's new expanded responsibilities. At the same time, some aspects of the Bank's governance arrangements have evolved in response to specific developments over time and could perhaps be clarified. I broadly agree with the views expressed by Anthony Habgood in his testimony to the Treasury Committee on these matters on 25 June, particularly around the advantages of a unitary board and greater clarity in the respective roles of the Court, the Oversight Committee and the policy making committees.

I also support the other aspects of the governance arrangements around the MPC and FPC, which I believe represent global best practice. The independence of monetary policy needs to be protected to ensure that the inflation target is met and members of the MPC are held clearly to account for delivering this objective. There is no single governance model for financial stability. Some countries assign responsibility for macro-prudential policies to a separate institution or committee (such as in Australia, Chile or Mexico), others house it in the central bank under distinct governance arrangements (like the Bank of England).

Whatever the precise structure, however, the key is that there should be clear responsibility and accountability for macro-prudential policies because otherwise they risk being neglected. I believe housing monetary and macro-prudential and micro-prudential policy under one roof in the Bank provides important opportunities for synergies and policy coordination.

MARKETS & BANKING

7 What will be your priorities with regard to your responsibilities for markets and banking?

My main ongoing priority will be to ensure that the Bank's markets and banking operations are carried out professionally and effectively, in a way that delivers the Bank's policy objectives. Amongst other things, that means: implementing monetary policy, through setting Bank Rate, operating Quantitative Easing and the Funding for Lending Scheme; managing the risks on the Bank's £400bn balance sheet; managing the Government's and Bank's foreign exchange reserves; ensuring the Bank is ready to provide liquidity insurance to any bank and critical non-banks facing an unanticipated liquidity shock; providing the infrastructure for the UK's high-value payment systems; and providing banking and foreign exchange services to the government and to other central banks. These operations lie at the heart of what it is to be a central bank, and it is imperative for the Bank and for the country that they continue to be carried out with the utmost professionalism.

In addition, I would identify a number of key change priorities:

- First, ensuring that the Bank is operationally ready to exit unconventional monetary policy when the MPC chooses to do so, allowing it to begin raising short-term market interest rates to more normal levels. This is a key priority in the near term. Further out, there are important and difficult questions to consider around managing down the size of the Bank's balance sheet, including managing the exit from quantitative easing and from the Funding for Lending Scheme. Cutting across both sets of issues is the need to ensure that we understand the implications of the post-crisis regulatory framework for bank and financial market behaviour, and adjust our operations appropriately.

- Second, completing the implementation of the Winters and Plenderleith Report recommendations. The bulk of this has already been done – but a number of important pieces of work remain work in progress, including the extension of access to the Bank's liquidity insurance facilities for broker-dealers and central counterparties and an assessment of whether the Bank needs to develop its capacity to lend in currencies other than sterling (as the Governor announced in his Mansion House speech), and the appropriate capital base for the Bank.

- Third, leading the Bank/HMT/FCA review into Fair and Effective Markets, with the objective of identifying principles and other tools to promote greater trust and confidence in our wholesale markets and institutions. We have already begun detailed planning for this review, including appointment of a practitioner panel under Elizabeth Corley, and preparatory work to ensure we can issue a consultation document in the autumn and recommendations to HM Government on which benchmarks should be brought within the scope of legislation.

- Fourth, leading a review of the Bank's Market Intelligence function – covered in more detail in my response to Question 9.

- Fifth, ensuring that the Bank's banking operations, keep pace with technological developments in private markets and that we coordinate effectively with the new Payment System Regulator which has the objectives of promoting competition, innovation and the interests of end-users.

In addition, I will want to ensure that we embed the new One Bank strategy in everything that the Markets and Banking Directorates do, exploiting the many synergies between the use of the Bank's balance sheet and our major policy responsibilities to the full, and reviewing the structure and shape of the Bank's financial risk management operations.

8 What do you believe the future shape of the Sterling Monetary Framework should be? Do you believe that the equilibrium size of the Bank of England's balance sheet should be larger in the future than it was pre-crisis?

The Sterling Monetary Framework (SMF) sets out the published operational framework under which the Bank uses its balance sheet to: (i) implement the MPC's decisions in order to meet the inflation target; and (ii) provides liquidity to the banking system, during periods of both normal and abnormal market conditions. In judging the appropriate future shape of the SMF, I would identify three initial questions: (a) has the SMF responded to the lessons of the financial crisis?; (b) does it reflect the realities of the current and prospective structure of financial markets?; and (c) does it provide the Bank with the tools needed to ensure that the eventual normalisation of monetary policy can be achieved in an orderly way?

It seems to me that the Bank has done a great deal of work to respond to the lessons of the crisis. I have read the excellent independent report on the Bank's toolkit for providing liquidity to banks by Bill Winters, commissioned by the Bank's Court, and note that the large majority of the recommendations of that Report have already been implemented, as the Governor set out in his speech in October last year. Compared with the pre-crisis period, the Bank now has a much more flexible set of facilities, can lend against a very wide range of collateral, at longer maturities, and at more reasonable prices. These changes, and the others announced by the Governor, should go a good way towards reducing the stigma that, rightly or wrongly, built up around some of the Bank's facilities during the crisis. I read with interest the first SMF Annual Report, recently published by the Bank,[1] which noted that the changes have been widely welcomed, but look forward to learning more first-hand from market participants and other commentators when I take up my new role.

Turning to the second question, what more can be done to adjust the SMF to the changing structure of financial markets? The shift of intermediation away from banks and towards non-bank financial institutions and capital markets means that liquidity insurance aimed at banks alone may not be sufficient to tackle financial instability risks of the future. This concern is behind the Governor's recent announcement at the Mansion House that the Bank would be extending facilities to some broker-dealers and Central Counterparties. I will be overseeing the delivery of these new arrangements over the next year and keep them under review.

The third question – ensuring the SMF has sufficient flexibility to implement the normalisation of monetary policy – is clearly a very important issue. The current 'floor' system has kept market rates within a narrow range of Bank Rate. But, as the Winters report highlighted, a key question is whether over the longer run the Bank seeks to return to its pre-crisis 'reserves averaging' framework (in which the Bank injects the aggregate level of reserves chosen by the banks each month, and the banks then trade between themselves to hit their targets) or adopts some other permanent framework. This will be an important policy issue for the Bank over the coming period.

I think it is highly likely that the equilibrium size of the Bank's balance sheet will be larger in the future than it was pre-crisis. Total liabilities are currently some £400bn (a quarter of GDP), compared with only £50bn in 2006. For some time to come, the size of the balance sheet will be mainly determined by the Asset Purchase Facility that holds the stock of gilts purchased by the MPC under its quantitative easing programme. The timing and pace with which this stock will run down will be a judgment for the MPC in pursuit of the inflation target. But the MPC has made it clear – rightly, in my view – that reinvestment of maturing gilts will continue at least until the first rise in Bank Rate and that active gilt sales will be deferred at least until Bank Rate has reached a level from which it could be cut materially if required. Even past that point any sales would be conducted in an orderly programme over a period of time, with liaison with the Debt Management Office, so as not to disrupt the gilt market or cause a sharp tightening in monetary conditions. Taken together this suggests that, in the central case at least, it will take some time for the asset side of the Bank's balance sheet to decline significantly.

Although the size of the balance sheet is likely to decline as the stock of QE falls, it is unlikely to return to pre-crisis levels even in the long run. That is because banks' demand for central bank reserves is likely to remain substantially higher than pre-crisis, reflecting both tougher liquidity regulation and (at least for a period of time) heightened risk aversion. Though it is hard to quantify where this level will be with any precision, the balance sheet could be several times larger in steady state than it was pre-crisis. That is something which is likely to be true in other countries too.

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1 http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q2prereleasesmfar201314.pdf

9 What do you believe are the strengths and weaknesses of the Bank's market intelligence function?

As the Governor told the Treasury Committee earlier in the year, one of my early priorities as Deputy Governor for Markets and Banking will be to oversee a comprehensive review of the Bank's market intelligence ('MI') function. The review will look at: the objectives of gathering MI, the ways in which MI-gathering is carried out, how the Bank processes and synthesises MI, the range and type of MI outputs produced, and the appropriate criteria for success. This review is timely, since the context in which the Bank carries out MI has clearly evolved materially in recent years, reflecting the addition of major new responsibilities for micro-prudential and macro-prudential supervision, the actual and alleged instances of misconduct in financial markets, and the launch of the Bank's new strategic plan, which places new emphasis on ensuring the Bank's MI functions support all of the Bank's policy responsibilities. I am conscious too of the investigation by Lord Grabiner QC currently underway on behalf of the Bank's Oversight Committee into the role of Bank officials in relation to conduct issues in the foreign exchange market. It is important that we learn the lessons of recent years, and ensure that our MI operations are fit for purpose in this new environment.

It would be wrong to pre-empt the outcome of the MI review by setting out too rigid a view of the strengths and weaknesses of the Bank's current approach ahead of time, particularly when I have not yet had first-hand experience of the MI function from the inside. At this stage, I can give the Committee a few preliminary thoughts about how I see this work evolving.

It is in my view critically important that central banks have a deep understanding of how markets operate. That is true both from an operational perspective, in order to guide and inform the implementation of policy, and from an analytical perspective, in terms of ensuring that monetary, macro-prudential and micro-prudential policymakers and supervisors take account of the risks and trends in markets. Given the structural changes that are likely to take place over the coming years, with financial intermediation increasingly moving away from traditional banking structures towards a greater reliance on capital markets and so-called 'shadow banking', it has never been more important that central banks strengthen this understanding. The Bank is in an unrivalled position to do this, given both its position at the heart of the biggest international financial centre, and its new structure, bringing together all of the possible functions of a central bank under a single roof.

The Bank's knowledge of markets is widely respected internationally. My colleagues at the IMF consider the Bank's work in this area to be world class. It is clear from even a cursory review of the Bank's main policy publications, including the Quarterly Bulletin, the MPC's Inflation Report and Minutes and the FPC's Financial Stability Report and Records, that Bank policymakers pay close attention to MI in their policy deliberations.

From my early thinking on this issue, I would identify three particular forward-looking challenges, each of which will be part of the review:

- The first, and by some distance I suspect the most important, is how to ensure consistency between the Bank's MI operations and its new micro- and macro- regulatory responsibilities. Do our new responsibilities change the ways we can gather MI, including how we engage with market participants? Are we producing the right MI outputs for the PRA and FPC?

- Second, I am keen to ensure that we are applying the best possible analytical techniques and approaches in our MI work.

- Third, does the Bank have the right structures and resources in place to deliver MI effectively?

Once we have completed the MI review, we intend to publish the findings. I hope it will provide clarity within the Bank, with market participants and to key stakeholders such as Parliament about the objectives, approach and impact of this important work.

MONETARY POLICY

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

The recent pace of economic recovery in the UK has been striking – a welcome development after the extended crisis and post-crisis period in which the level of output has fallen far behind that implied by historic trends. But there are substantial risks around the outlook in both directions:

- First, as a highly open economy the UK remains very dependent on developments in the global economy. I see the most likely outcome as being continued sustained growth in activity in the advanced economies. But a key uncertainty is the outlook for the euro area, the UK's main trading partner. Underlying growth has been sluggish, and some have voiced concerns about the possibility of deflation. The recent package of policy actions from the ECB was a welcome development in that context, and it will be important to monitor its impact over time.

- Second, there are risks in both directions around the progressive exit from unconventional monetary policy and the normalisation of interest rates in the US and in the UK. As elaborated in my answer to Question 14 which considers wider risks, there is a concern that a sharp upward movement in global interest rates and resulting volatilities could cause a reassessment of risk globally, with adverse implications for activity in the UK and elsewhere. I have discussed the operational aspects of this in more detail in other answers in this questionnaire.

- Third, the persistent weakness in UK productivity growth remains a major puzzle. Recent output growth and employment have been surprisingly strong. But if the recovery is to be sustained, it must ultimately be underpinned by a recovery in productivity and real incomes. Although the UK can borrow (or dis-save) for a period in order to fund expenditure, it cannot hope to do so indefinitely. The size of the current account deficit – the key counterpart to that dissaving – is a particular concern. The UK economy will need to see a sustained rebalancing away from domestic consumption and towards investment (which has picked up recently) and exports (which have been more subdued).

- Fourth, the uncertainties over the rate of future productivity growth make it much harder to know how rapidly the economy can grow without generating higher inflation. So far there have been few signs of inflationary pressure – indeed CPI inflation has been undershooting the 2% target quite materially, in part because of the pickup in the sterling exchange rate, and wage growth has been subdued. But the outlook remains heavily dependent on the remaining degree of slack, which is highly uncertain and I know from the Minutes and successive Inflation Reports has been the subject of extensive discussion among MPC members. I look forward to joining that debate in August.

- Fifth, there are clearly concerns about the housing market – but I agree with the view reiterated in the latest MPC minutes, and echoed by the IMF in its recent UK Article IV report, that macro-prudential policy should be the first line of defence against financial stability risks from housing. My views on that issue are discussed in more depth below.

11 How successful was the first phase of forward guidance? What are the risks to the success of the second phase of forward guidance?

We have long known that monetary policy works at least as much through its impact on the expectations of households, firms and financial markets as it does through changes in policy instruments. It is therefore important for central banks to do all they can to ensure their policy 'reaction functions' are well understood. The Bank's MPC has for some time been at the forefront of monetary policy transparency, through its Inflation Report, its 'fan charts' for inflation and growth and its Minutes of Committee discussions, including individual voting records. It therefore seems to me quite natural that, at a time when it was crucial to ensure that the fragile early stages of recovery were not choked off by inappropriately pessimistic expectations about interest rates, the MPC took the extra step of providing forward guidance about the future path of policy. It is in my view right that guidance did not take the form of a simple date before which interest rates would not rise, but instead has been linked, in both its first and second phases, to economic developments. That link has been helped by the publication of considerably more detail on the MPC's risk assessment and key forecast variables, one of the recommendations of the Stockton report to Court.

The first phase of forward guidance seems to me to have been broadly successful in ensuring that the early period of recovery was able to take hold without triggering a sharp increase in interest rate expectations. As always with such things it is hard to evaluate how big this effect was because we do not know what would have been the counterfactual without forward guidance. Nonetheless, surveys do suggest that forward guidance caused households and firms to push back their expectation of the date of the first interest rate rise. Short-term market interest rates stayed low throughout the first phase with informal market intelligence suggesting that contacts felt rates would probably have moved a little higher in the absence of guidance.

Clearly, in the event, unemployment fell to the 7% threshold more rapidly than either the MPC or other forecasters had anticipated. While this may highlight the difficulties of macro-economic forecasting, it need not be seen as a failure of the policy since it served its purpose of affecting expectations and behaviour. The sharp fall in unemployment, associated with a pickup in activity, was of course a welcome development from an economic perspective. In the February 2014 Inflation Report, the MPC stated that, once unemployment passed through the 7% threshold, the future path of Bank Rate would continue to depend on economic circumstances, in particular: the sustainability of the recovery, the extent to which supply responds to demand and the evolution of cost and price pressures. I know that the MPC has consistently emphasised that the eventual upward path for Bank rate will be gradual, and is expected to level out somewhat below the average rate set by the Committee in the pre-crisis period.

Monetary policy must continue to respond to the economic outlook, which is inherently uncertain and involves considerable judgment. Describing the future path of rates is clearly more complicated than simply describing the conditions that needed to be met before rates could rise. These can be difficult and complicated messages to get across when people are looking for simpler answers. But I do think that we have to keep trying to make sure that households, firms and markets have a good understanding of our "reaction function" so that we are able to deliver our mandate. This will be one of the biggest challenges facing the MPC in the coming period as we move to normalise rates.

12 What is your assessment of the effectiveness of the policy of quantitative easing in the UK? What do you believe are the challenges to overcome when quantitative easing is eventually unwound?

There seems to me to be reasonably sound evidence that the MPC's policy of asset purchases, or quantitative easing (QE), played a significant role in supporting the UK economy during the worst period of the crisis. It is difficult, if not impossible, to put precise numbers on this effect, because the counterfactual – of what would have happened if QE had not been carried out – cannot be known. But it seems to me very likely that, in purchasing £375bn of gilts in return for central bank reserves, gilt yields were lower than they otherwise would have been, boosting other asset prices, wealth and therefore spending. I note that the Bank's own research suggests that the impact of QE, at its peak, may have boosted GDP by some 2 ½ percentage points. Clearly there is significant uncertainty around this figure in both directions, though I take some comfort from the fact that these figures are broadly consistent with work carried out in the US on the impact of the Federal Reserve's Large Scale Asset Purchase programme.

In terms of unwinding QE, I would identify two key challenges – the first is for the MPC to be as clear as it can be about the relative roles that Bank Rate and gilt sales will play in the eventual normalisation of policy; and the second lies in the operational arrangements for gilt sales so as to achieve as orderly a process as possible.

On the first issue, it seems to me that it was sensible for the MPC to clarify in its May Inflation Report that it would use Bank Rate as its marginal policy tool, that it would want to raise Bank Rate to a level where it could be materially reversed before embarking on any active gilt sales, and that any sales would take place in an orderly programme over time. Of course, these broad parameters announced by the MPC still allow for a wide variety of alternative specific exit paths, and given the uncertainties over the economic impact of gilt sales on exit, the Committee is likely to have to adjust as it learns. But I would note that even if the MPC were simply to cease reinvesting the proceeds of maturing gilts after the first Bank Rate rise, the stock of QE would fall by around £20bn a year – so even a passive strategy would involve some effective exit over time.

The impact of a programme of sales on gilt market conditions clearly depends on the size and timing of the programme, on the extent to which it is anticipated by the market, and on prevailing market conditions, including the Government's own issuance programme. Although the decision on the timing and amount of QE sales must be for the MPC, it is important that the Bank should liaise closely with the Debt Management Office to minimise the degree of disruption to gilt market conditions. I know that the Bank and DMO maintain a jointly-owned operational plan to govern this process – and that is an important safeguard for the MPC as well as the DMO, because we would not want to see an unintentionally sharp tightening in monetary conditions. The intent for sales to take place in an orderly programme over time will also assist considerably in that process.

13 What consideration should be given to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles, and does the current MPC remit provide sufficient scope for such action?

The MPC does not, and should not target any particular level of asset prices. But it does need to monitor developments in asset prices closely, as it does all variables that potentially bear on the outlook for activity and inflation. How it reacts to movements depends on what is driving them, and what their likely impact is.

Where asset prices pose risks, or potential risks, to financial stability, the MPC's remit is clear that the Financial Policy Committee's macro-prudential tools should be the first line of defence. That seems to me precisely the situation the UK is currently facing in the housing market, as I have discussed in other answers in this questionnaire, and I therefore support the FPC's policy actions announced on 26 June. Of course, the precise impact of those actions will need to be kept under close review. But it would be a mistake in my view to divert monetary policy from its primary objective, solely to deal with a potential financial stability risk from the housing market, when the FPC has more targeted tools available. Clearly it is important that the MPC and FPC stay close on these issues, and that is something that will be helped by my membership of both committees, alongside the Governor and the Deputy Governors for Monetary Policy and Financial Stability, and by periodic joint meetings of the kind I understand have occurred on a number of occasions over the past year.

FINANCIAL STABILITY

14 What do you view as the main threats to UK financial stability at present? What other risks would you wish to monitor closely in future?

Compared with a year or two ago, some of the most concerning risks to financial stability have moderated. Aggregate growth in the advanced economies has picked up, under the influence of exceptionally stimulative monetary policy. Volatility in financial markets has remained at historically low levels. The perceived risk of a breakup in the euro area has fallen back sharply. And the capital and liquidity position of the UK banking system has substantially improved, reflecting a combination of regulatory action and deleveraging.

At the same time, serious threats to UK financial stability remain – some of which are the flipside of the factors listed above. I would highlight three in particular:

- First, the interaction between household indebtedness and the housing market. Household debt in the UK and elsewhere did not adjust downwards as sharply during the recent crisis as in previous recessions, and hence remains relatively high by historical standards. Rising house prices tend to exacerbate that trend. Households with high levels of borrowing may at some point find themselves facing repayment difficulties, leading to sharp adjustments in spending, which if large enough could have implications for financial stability and for the economy. My understanding is that it was these concerns that caused the FPC to take actions on housing at its last meeting in June. It will be important to assess the impact of these actions over time before reviewing if we have done enough to address this issue.

- Second, we have seen a substantial search for yield by investors, driving spreads on bonds and other trade instruments down close to historic lows, inducing investors to purchase increasingly exotic or risky assets, and lowering underwriting standards, for instance on commercial property in the UK. To a considerable degree this search for yield has been a desired consequence of central banks' chosen monetary policy settings. But we must be extremely vigilant to the possibility that this process has gone too far, leading to an underpricing of risks which will at some stage reverse.

- Third, but closely linked, is the risk of complacency in financial markets. Markets have proved surprisingly resilient to any number of recent global shocks, from the unrest in Ukraine and Iraq, the coup in Thailand, the recent European elections to major fines for financial firms. At one level that may be reassuring. But at another it feeds a concern that there may be excessive confidence that monetary policy will offset any adverse effects of market developments and an underweighting of the risks of transition back to more normal policy settings. The various stress tests currently underway in the UK and continental Europe should also throw light on the vulnerability of financial institutions to shocks of this kind.

In addition to these conjunctural risks, there are a number of more structural threats to financial stability. Ending the 'too big to fail' problem remains a key priority for the international community. The Bank has led the way globally in parts of this programme, most prominently perhaps in the field of strengthened processes for resolving or 'bailing in' financial institutions, including the case of cross-border resolution. We need to 'finish the job' in implementing the new post-crisis international capital, leverage and liquidity regime for banks. We need a better understanding of the risks emerging from the shadow banking sector. And, conversely, we also need to find ways to promote safer non-bank forms of financing, as I know the Bank and ECB have advocated recently with their new securitisations proposals. I look forward to working with my FPC colleagues on these issues when I arrive in the Bank.

15 What do you regard as the strengths and weaknesses of the work undertaken by the Financial Policy Committee?

The FPC is still a relatively new institution and its mandate – financial stability – is more difficult to communicate than the MPC's clear inflation target and well-established policy instruments. Having looked at how macro-prudential policies are being implemented in other countries, I think the FPC stands out in having a clear governance structure and a well-articulated framework for macro-prudential policy making. The steps taken by the (initially interim) Committee to improve the capitalisation of UK banks were arguably the most important early decisions. UK banks are around £150bn better capitalised today than they were before the crisis. The Committee has also developed a clear framework for the macro-prudential tools it could use, a regular set of communications about its work (including the Financial Stability Report and quarterly meeting Records) and has begun an outreach effort with the public and the markets. The co-ordination mechanisms put in place with the MPC and PRA are also very welcome achievements.

The areas where further work is needed are: (i) helping the markets and others to develop a better understanding of the FPC's reaction function and (ii) deepening our understanding of the transmissions channels and impact of different macro-prudential instruments on the economy. I am not sure the FPC could have done much more on these issues up to now: this is in many respects virgin territory, and the Committee has simply not yet had a long enough track record with which to judge its reaction function and effectiveness. The recent decisions by the FPC on housing are an important step in this process. Given the experience with macro-prudential policies in other countries and the novelty of these instruments in the UK, it will be crucial for the FPC to monitor their impact closely and be open to adjusting if necessary. Such adjustments, if they are required, should not be seen as a failure of policy, but as examples of learning and adapting prudent policymaking in an uncertain environment and using new tools.

I would also highlight the difficult political economy aspects of macro-prudential policy. It is hard to get the public excited about financial crises averted, most of which they will probably never hear about. Macro-prudential policies may also sometimes impose costs on certain groups that are likely to be very vocal, while the benefits of financial stability are amorphous and more widely dispersed. This creates very real communications challenges, but also reinforces the need to have independent views and rigorous analysis underpinning decision making, as the FPC has worked hard to do over its early history.

16 What is your assessment of the macroprudential tools that are available to the FPC? Would you prefer the FPC also to have the ability to limit loan to value and/or loan to income ratios?

The use of macro-prudential tools is still at an early stage of development. There have been some important successes, mainly in emerging markets such as Korea (where banks’ short term external debt was halved between 2008-2013) and Hong Kong (where property prices levelled off and loan-to-value ratios declined). But there are also countries, such as Israel, Switzerland and Turkey, that have been unable to slow credit growth and house price inflation despite macro-prudential measures. Inevitably, use of these instruments in advanced economies will require some flexibility as we better understand the transmission mechanisms to calibrate the use of these tools. In that context, the countercyclical capital buffer and sectoral capital requirements are potentially powerful instruments, as are the FPC's powers of recommendation, which have already been used on a number of occasions.

I do see value in the FPC also having the ability to act more directly on the availability of credit, since it seems to me quite plausible that financial instability may sometimes originate not from the banking sector but from the existence of unsustainable levels of leverage, debt or credit amongst households, or elsewhere in the non-banking sector. The FPC was already free to make recommendations on loan to income or loan to value ratios, but I was pleased to hear the Chancellor announce at the Mansion House his intention to formalise that into a directive power by the end of the Parliament. The FPC was right, in my view, in announcing in June its intention to limit lending at high loan to income ratios and to emphasise the importance of banks stress testing borrowers' ability to pay under higher interest rate scenarios. I do not minimise the challenges we will now face as a Committee, communicating the purpose of the policy and how its design is intended to minimise unintended side effects, monitoring its impact on the housing market, and standing ready to review and adjust the policy if that is what is required to maintain financial stability. But the alternative, of a potential return to the type of housing cycle the UK has seen all too often, is clearly worse.

17 Do you think there is any reason why the FPC should intervene in the housing market other than for financial stability reasons?

The statutory objectives of the FPC are to contribute to the protection and enhancement of financial stability in the UK through the identification, monitoring and reduction in systemic risks – and, subject to that, to support the Government's economic policy. In exercising its recommendation or direction tools in relation to housing (or any other matter), therefore, the Committee's primary concern has to be the implications for financial stability. I would however make three points:

- First, there are many potential channels through which housing may influence financial stability. As the legislation makes clear, systemic risk may arise from an unsustainable distribution of risk within the system, from structural frailties in the system (such as excessive interconnectedness), or from unsustainable levels of leverage, debt or credit growth. Unsustainable developments in house prices are dangerous for financial stability because of their implications for the health of banks' balance sheets, but they may also operate through the other channels. For example, household debt burdens have consequences for reducing aggregate demand excessively in response to shocks and thus impairing financial stability. We saw this in operation during the recent crisis in the US, a point made convincingly in the recent book House of Debt by Atif Mian and Amir Sufi. It is important that the FPC is alert to all of these possible channels.

- Second, in addition to formal interventions in the housing market such as that in June, the FPC may also be asked to provide its advice to Government or others on the implications of policies for financial stability. Having seen the various exchanges of letters on this issue towards the end of 2013, my understanding is that it is under this heading that the FPC will provide an assessment of the implications of the Help to Buy scheme for financial stability.

- Third, although I can see that it is at least a theoretical possibility that the FPC might act in response to its secondary objective – that of supporting the Government's goals of strong, sustainable and balanced growth – it could only do so if it was confident that acting in this way would also improve, or at least not harm, the resilience of the UK financial system, which must always remain the Committee's primary objective.