

Questionnaire in advance of Treasury Committee hearing

Professor David Miles

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. I resigned from Morgan Stanley to take up the appointment. I retain academic links to Imperial College, London which I do not believe create any conflicts.

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 economist for over 25 years. In that time I have worked as an academic, in the Bank of England, in the City, as a consultant to companies, and also spent a period in the Treasury. I have also worked with researchers at the Institute for Fiscal Studies on the funding of government spending and the operation of the gilt market. My research as an academic has focussed on the interaction between financial markets and the wider economy.

A good deal of my time in recent years has been spent thinking about monetary and fiscal policy. A key issue for the Bank of England now is how its unconventional policy measures – quantitative easing – might work. A second issue is what extra policy tools might be needed to help prevent a repeat of the sort of financial train wreck we have seen. The issues here for the Bank and the wider regulatory community are what are the best macro prudential policy tools and how they should be used. For the MPC, the crucial question is how these tools might interact with monetary policy. To assess these things you need to understand the interaction between banks' balance sheets, their pricing of loans and the link from those things to the spending of households and companies. That is an area where most macroeconomic models need supplementing. It is an area where I aim to undertake research in the Bank.

Some of my recent research focuses on portfolio allocation, the optimal design of public and private pension arrangements and financial regulation. Analysis of the risk characteristics of household assets and liabilities is an integral part of this work and has close connections with the review I undertook for the Treasury in 2003-4 on the UK mortgage market. The economics of mortgages and housing, and its links to saving and public policy, is an ongoing research interest. More recently I have looked at the pricing of assets when there are many sources of risk and

small probabilities of catastrophic events. There is a connection between all these issues and portfolio choice and asset pricing. In my role at Morgan Stanley I directed the research of a group focusing on UK monetary and fiscal policy.

In the periods when I have worked in the City I have spent a good deal of time talking to investors (in equities and in bonds) about how they saw market developments.

I have been an advisor on macroeconomic issues to the Treasury Committee.

4. To what extent will membership of the MPC require a different approach from that required in academic research, and your work as a business economist, with regard to the discharge of the duties and responsibilities involved?

My academic research has nearly always been policy orientated. And as an economist in business I tended to focus on the operation of financial markets. I don't think there are a set of tools that are relevant to academic research, or to the work of an economist in a business, that are different from those that should be used in a central bank. So while the questions I will look at in the Bank will be different, the approach I would take is not.

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

Here is a short list of some of my publications that I believe are relevant. I think the titles are fairly self-explanatory, but I have added a couple of sentences on each:

“Incentives, Information and Efficiency in the UK Mortgage Market”, **The Economic Journal**, March 2005. [This paper analyses the way mortgages have been supplied in the UK.]

“Quantitative Easing: What is it? How might it work?” **Morgan Stanley research report**, March 3 2009. [A report that considers how QE might work and how its effectiveness could be judged].

“After The Mess”, in **After the Apocalypse: Lessons from the Global Financial Crisis**, edited by Philip Collins and Peter Harrington, Demos, 2008. [An essay on the lessons for regulatory and macroeconomic policy from the financial crisis].

“What Should Equities and Bonds be Worth in a Risky World”, **Morgan Stanley research report** September, 2005. [A paper which considers the effect of there being very bad economic outcomes which have small probabilities for bond and equity prices].

“Financial Innovation and European Housing and Mortgage Markets “ **Oxford Review of Economic Policy**”, vol 24, no 1 2008. [An article which looks at what drove house prices up across developed economies and assesses the sustainability of property values across countries].

B. ACCOUNTABILITY

6. 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?

I believe that ex-post parliamentary accountability is a crucial part of the monetary policy framework in the UK. Explaining the MPC's views on monetary policy at the regular Treasury Select Committee (TSC) hearings is an important part of building and maintaining confidence in the monetary policy framework.

Until now MPC members have been accountable for decisions on Bank Rate. With quantitative easing (QE) we have moved into new territory. QE involves a different set of decisions; it generates a big expansion in the balance sheet of the Bank. There is a real challenge for the MPC in understanding and explaining how QE affects the wider economy and how the MPC makes decisions on it.

It is a strength of the current system that each member is responsible for their decisions (and cannot hide behind group decision). It is another strength that members are not chosen to represent specific interests; they are there on the basis of the knowledge and experience they can bring to decisions on monetary policy directed at meeting specific goals.

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?

The questions I would ask are these:

Given the information available when decisions were made, did I use that information in a thoughtful and efficient way? (That is not the same thing as asking whether decisions I made were the same as those that would be made with the benefit of hindsight.) Did I contribute to the decision by questioning assumptions and offering (in a constructive way) alternative views? Did I bring some extra information and insight to the decision making process? Did I fall into the trap of accepting conventional ways of thinking and stop questioning the evidence and assumptions underlying such thinking? Did I effectively explain the thinking behind those decisions to a wider audience? Did I use the opportunity an MPC member has to speak to a wide range of people around the country to gather information useful to making the policy decisions?

8. 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?

I am open minded on this issue. I see some value. But I think it is fairly easy to see what was behind most votes since when there are different votes there is a description of the main reasons for taking one view as opposed to the other. And of course the individual votes are published.

There are many opportunities for MPC members to explain their thinking already – for example through speeches and in TSC hearings.

If there were specific paragraphs by each MPC member there is a danger of the minutes becoming a back-covering document. That is, one focused much more on justification than one which described the issues and the debate about them. It would probably become a longer document, but not one that would necessarily improve the quality of the information about the reasons for policy decisions.

There is one practical problem with having each member include a paragraph in the minutes justifying their vote. If the minutes are to be a record of the discussion at the meeting where the decisions are actually made, then MPC members would probably prepare their statement (and decide on their vote) before hand. This would greatly reduce the value of the meeting. Members could prepare their paragraph later – in which case the minutes are no longer a record of the meeting itself.

C. OTHER PROFESSIONAL ACTIVITIES

9. 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?

I am in no hurry to take on other things – I want to concentrate on the job at Bank of England. I will keep on my non-executive role on board at FSA (which runs until Spring next year) and also continue as a Visiting Professor at Imperial College, London. I am also part of a Commission to look at funding of the Welsh Assembly Government (The Holtham Commission).

10. Outside of 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?

I plan to:

Make speeches

Undertake regional visits (the first of which will likely be to Belfast)

Produce and present research reports

From time to time give interviews in the press.

I also expect to give evidence to the Treasury Committee.

D. MONETARY AND ECONOMIC POLICY

11. How might the system of control over monetary policy in the UK be improved? Is the framework of an explicit symmetrical inflation target the best within which to conduct policy? Has the MPC been given an appropriate inflation target?

I believe that having an explicit, symmetric target for inflation is valuable. I think that having an inflation target is a necessary part of the framework for overall economic policy. A credible inflation target provides an anchor for inflation expectations. That the target be symmetric is important because too little inflation can be as damaging to the real economy as too much inflation.

Abandoning an inflation target because it has not prevented the UK avoiding a steep global recession would be a mistake. Having such a target has not stopped the MPC responding to the dramatic slowdown in activity with an aggressive, indeed unprecedented, easing of monetary policy. This is because the MPC's remit allows it to look through short-term movements in CPI inflation (which stayed above target during the period when policy became highly expansionary).

But events have shown that an inflation target alone is not sufficient to manage both monetary and financial stability. While we have been fairly successful in targeting inflation (and experienced a decade of low and stable inflation) we are now seeing acute financial instability. There has been a train crash in the financial sector – not just in the UK but globally. But I do not believe that abandoning the inflation target is a sensible response to the global financial crisis.

Indeed, abandoning the inflation target would be very risky – if inflation expectations drift upwards it is unlikely that UK companies and the UK government could raise funds at yields close to current levels. It is an immense benefit that inflation expectations have remained close to target throughout this financial crisis.

The inflation target needs to be supplemented with tools that help maintain financial stability. What we have seen is that, in the absence of other tools, you cannot expect the interest rate that is most likely to achieve the inflation target be the same as the one best suited to preserve financial stability. This is why there is a need for a new policy instrument (or set of instruments).

There are various candidates for a macro-prudential instrument. I see a lot of merit in counter-cyclical capital requirements. But I would not rule out other options – which might include specific limits to the gearing ratios of institutions. (There are also micro policy instruments, such as loan-to-income limits on mortgage products.)

There are important questions about how policy instruments would interact. Capital requirements have some of the features of interest rates (and some of the features of a tax) in how they work. The co-ordination between the inflation-targeting monetary policy instrument and the instrument(s) focused more on aggregate financial stability is a hugely important policy issue. To get this right we need to better understand the links between bank balance sheets, their lending capacity and the spending of households and non-financial companies. Macroeconomic models have neglected this.

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?

One part of this question is, I think, fairly straightforward: housing costs need to be in a measure of consumer prices. It is not obvious what the right way to do that is. But I believe it is clear that a measure of inflation which does not allow the costs of housing to have any influence is flawed. I believe Eurostat have been considering the best way to do this for some years. But they have not come up with an answer yet, so CPI measures in Europe do not include it. Yet housing is a significant part of the cost of living. So we do need to re-introduce housing costs. This would mean house price changes have some effect on the inflation measure and inflation targeting central banks will naturally respond to house price movements. But given the weight of housing costs in a plausible measure of the cost of living this will not mean that monetary policy will respond very powerfully to asset prices. This is one reason why the short term interest rate is not the ideal policy lever to reduce asset price instability.

Of course one could introduce other asset prices – those of equities, bonds and commercial property – into the overall price index and let that index bear less and less resemblance to a measure of the cost of living. If there were to be no other macro instrument beyond interest rates available to help preserve financial stability I could see a case for including those asset prices in some hybrid price index (a hybrid between a cost of living measure and an asset price measure). This would be far from ideal because it divorces the target from the cost of living. Linking the target to the cost of living is important. It ties monetary policy to what matters to people. (Consider the problems if consumer prices were rising fast when equity prices were falling – it would be difficult to convince people that inflation was not then a problem).

But in fact there are a range of other instruments to help target, or more accurately maintain, financial stability. (Targets is not quite the right concept with macro stability; it is more that there are a range of indicators of potential problems: growth in asset prices; growth in lending; leverage; indicators of irrational optimism. Movements in these indicators would trigger changes in the instruments.).

13. How would you describe the state of the UK labour market at present?

Considerable slack in the labour market exists already. It has risen very fast. Employment has fallen, vacancies are down all measures of unemployment are up very sharply over the past year. Unemployment amongst the young has risen very rapidly. This is very worrying. Unemployment is very likely to rise further and for some months. So slack will get even larger. Signs of the impact this is having are very clear – wage settlements have been falling, with a great many zero settlements. There are more and more examples of deals where pay cuts have been accepted; people are giving themselves a bit more job security by pricing themselves into their jobs. That is not easy – and nobody wants to see wages stagnant or falling. But it is likely better than even more rapidly rising unemployment.

All this is, of course, one of the reasons that cutting the policy rate (Bank Rate) very sharply and embarking on quantitative easing has been right.

14. What are your views on the prospects for the UK housing market?

Before house prices started falling I - like many others - believed that prices were over-valued. I said that in 2005 and 2006 (and was ridiculed by many in the mortgage industry for so saying).

The economic modelling I did then suggested prices might be 20-25% too high – relative to sustainable levels.

Since then there have been many offsetting developments: Incomes are weaker; unemployment is up sharply, and is expected to rise further. But interest rates are down a lot (and there has been a reasonable amount of pass-through to the cost of mortgages since the significant cuts in Bank Rate).

High loan-to-value mortgage products have dried up. Ultimately that is not a disaster; people will wait a bit longer to buy and rent a bit longer. The owner occupation rate would be lower, but the rented sector bigger. It does not clearly reduce substantially the long run demand for housing. The short run issues are more difficult. Now 20-25% deposits are typically required. The flow of first time buyers will be reduced as they accumulate higher deposits. This means that the volume of house purchases on a transition to a new equilibrium, where people buy later and with higher deposits, will be reduced. That is part of what we have been going through over the past 18 months. But it is a transition.

Expectations are crucial in the housing market and they look a bit better now than a few months ago.

My hunch – and I put it no stronger than that – is that we have seen most of the overall aggregate house price falls. But no-one knows.

15. As a former Chief UK Economist at Morgan Stanley, and Board Member of the FSA you have built up a detailed knowledge of the world of finance. What insights will you be able to bring to MPC discussions about the interaction of the financial sector and the wider macroeconomy?

I was working for Morgan Stanley, and was also a non-executive Board member at the FSA, as the financial crisis unfolded. Being in those institutions made me think hard about how things went so badly wrong. I draw several lessons that are relevant to the conduct of monetary and regulatory policy from the crisis. I summarised some of them in an article in the Financial Times written several months ago. I asked in that article “How can financial regulation and monetary policy help stop this happening again?”

Here is part of my answer:

“First, more needs to be done to prevent huge run-ups in asset prices – particularly in house prices. To that end, some element of housing costs should be reintroduced into the measure of inflation targeted by the Bank of England’s

monetary policy committee. If house prices affect the measure of inflation – as they should if that inflation measure is to reflect movements in the cost of living of households – then an inflation-targeting central bank would tend to offset very sharp rises in house prices by tightening monetary policy. But if the weight of house prices on the inflation measure reflects its significance to the cost of living, it will not have a huge impact on monetary policy. So reintroducing a house price impact on inflation – while useful – would have only limited value in enhancing financial stability.

A more powerful tool is capital requirements on banks. There has been a consensus in financial institutions – and also among their regulators – that equity capital is expensive, that debt is cheap and that the more capital that is held the less profitable will be the institution. This belief has always been puzzling. A basic bit of finance theory – the Modigliani Miller theorem – says it is false. There should be a link between the cost of debt for any institution and the amount of equity it has. Once you take into account the fact that more equity makes the debt safer – and therefore should make it cheaper – then the apparent extra cost of raising equity is offset by the benefits it brings in terms of a lower cost of debt. My experience has been that when this argument is put to people in the financial sector – including regulators – it has been greeted with bemusement and pity (at its hopeless naivety).

But when we see financial companies that are perceived (rightly or wrongly) to be under-capitalised having difficulty raising debt and needing to pay a lot for it, this is a very powerful reminder of why the Modigliani Miller theorem is fundamentally right.

Anyone who still firmly believes that equity capital is expensive and debt is cheap – so that minimising the amount of equity capital is the optimal strategy – does not really get this. But once you get it, it is liberating. No longer do capital requirements set by regulators become an irksome burden where the goal is to minimise the extent to which they bite. For regulators, too, it is liberating. Worrying endlessly that the complex system of weights, devised and refined over many years in various iterations of Basel capital rules, has set capital requirements slightly too high is not sensible. If the true cost of having more capital is not that great, then the cost of setting higher capital weights on assets is also not so high.

But in setting higher capital requirements we also need to ensure they do not operate in an unhelpful pro-cyclical way – letting capital fall in booms when asset prices and lending are growing and rise in downturns when asset prices are falling. Unfortunately the current rules on capital adequacy operate in this way and to that extent have undermined financial stability. Making capital requirements countercyclical should be a high priority.

Finally, there needs to be a much more serious focus on whether those who take on credit can afford to do so. We need to get (back?) to a situation where there is a strong coincidence of mutual interest between lenders, intermediaries and borrowers in not having credit extended where there are high risks that it cannot be repaid. When intermediaries have incentives to generate new lending they also need incentives to ensure the lending is sound.”

(Financial Times, January 2009)

There is now a widespread realisation that the direction of regulation needs to change: there was too much acceptance that lighter capital controls were desirable; not enough questioning of business models and risk assessments of firms; too much reliance on individual firms apparently being able to withstand shocks and not enough seeing that aggregate risks that hit most firms simultaneously were the real problem. I believe we have dramatically overestimated the cost of having financial firms hold more capital and underestimated the damage of their not having enough. We assumed liquidity would not be a problem for solvent banks. That was a mistake.

The internal report by the FSA on how Northern Rock was supervised, and the appropriate reaction to it, was discussed at great length by the Board at the FSA. (There was never any question at the Board that it should not be published – in full). The Supervisory Enhancement

Programme, and the new direction subsequently laid out in the Turner report, are the results. There is no doubt at all that the way the FSA will supervise firms and regulate markets has been profoundly changed. I believe that the lessons of the mistakes that were made have been taken.

Where I believe there needs to be some careful thinking now is how new tools to help preserve financial stability – which I think are much needed – interact with monetary policy. It is in that area that I think my recent experience at Morgan Stanley and at the FSA is of use at the Bank of England.

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