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News release

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The Future Financial Landscape - Speech by David Miles

In a speech today in London, Professor David Miles - an external member of the Monetary Policy Committee - discusses the current problems in the banking sector, how it might operate differently in the future, and the near-term and long-term monetary policy implications.

He proposes two reasons why the banking sector might become smaller. One is the requirement for banks to hold more capital, which is highly desirable though likely to mean that their average cost of funds rises and so less saving will be channelled through the banks. A second reason is that banks will need to hold more reliably liquid assets. He argues that the lower capital and less liquid assets that banks held in recent decades reflected the belief that there was an implicit and explicit state insurance of banks. He says that a combination of implicit subsidies from state support, tax factors and optimism that steady growth and rising asset prices would continue, were reasons that accounted for the increasing importance of banks. Some of these forces are now working in the other direction.

David Miles considers the macroeconomic effects of a smaller banking sector where there is likely to be a larger spread between lending and borrowing rates. It is likely that in future less saving will pass through the banking sector to finance investment and it is possible - though not inevitable - that the overall level of investment and owner occupation could be lower. But this does not mean the average growth rate of the economy must be lower. One reason is that financial crises - which are likely to permanently wipe out capital - would be less frequent and less serious.

Turning to the monetary policy implications of changes in the banking sector, David Miles thinks it plausible that the average effective cost of funds in the economy would become "...a larger mark-up over the policy rate set by the central bank", reflecting a reduction in subsidies, that may have artificially held down the cost of bank debt. As a result it is possible that the average central bank rate consistent with a particular average rate of inflation could be lower.

In the short-term, substitutes for bank debt are less readily available than they might be eventually. David Miles argues that quantitative easing (QE) has helped offset some of that impact by making it easier for companies to raise funds in the capital markets. This has eased the transition to a situation where the banking sector becomes smaller and thereby reduces the risks of undershooting the inflation target.

Key Resources

The Future Financial Landscape - Full speech

http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech418.pdf