



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

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Monetary Policy and Financial Stability Speech by David Miles

In a speech to the Bristol Business Forum, David Miles - an external member of the Bank of England's Monetary Policy Committee (MPC) - explains his view of the appropriate policy response to the financial crisis.

In describing the unprecedented level to which interest rates have fallen, David Miles argues that "...it has been right to loosen aggressively the stance of monetary policy because of the scale of the deflationary and recessionary forces unleashed by ... the crisis in the banking sector". He adds that "...fragilities in the banking system remain and pose risks that the recovery in demand and activity we have seen across Europe - including the UK - falters". The MPC's challenge is to balance "...risks that inflation of 1.0-1.5pp above target lasts long enough to become ingrained in expectations and affect behaviour so that it is hard to bring down, versus risks that the recovery in output becomes weaker and then disappears, leaving inflation pressures lower than is consistent with the target further ahead". David Miles notes: "I look forward to the day when it will be appropriate to tighten monetary policy since a return to more normal levels of interest rates would be a welcome sign that economic conditions were also more normal. But I do not think that is where we are today."

David Miles counters those who argue that monetary policy should be set in a different way, so as to reduce the chances of banking crises in future, rather than aimed at ensuring price stability: "capital requirements are a better means to that end". At the heart of the current economic situation, he says, is "...a banking system which proved catastrophically fragile". "On the eve of the crisis", he notes, "...the capital of UK banks, relative to their assets, was around half the level that was typical fifty years earlier". And banks' liquid assets were "...a fraction of what would have been normal twenty years earlier and a tiny fraction of what would have been normal before the 1970's".

The speech goes on to argue that the fragility of the banking system can be reduced without incurring a high cost in terms of lower economic activity. David Miles says: "I am rather sceptical about the claims that substantially higher capital requirements must mean significantly higher costs of funds for those who borrow to invest and that total investment and output in the economy will be significantly lower", noting that "...there is little evidence that investment or the average (or potential) growth rate of the UK economy picked up as

spreads on bank lending narrowed over the past decade, and the volume of credit expanded sharply". The analysis he presents suggests that, under a plausible range of assumptions, the economic costs of higher bank capital requirements may be small, but the impact on the robustness of the financial system large.

In conclusion, David Miles says that "using the interest rate as a tool to maintain the stability of the banking system strikes me as a strange assignment of policy tools to targets. Changes in interest rates have an uncertain impact on financial stability; often it would be unclear in which direction to move interest rates to help make the banking sector more robust. But in the UK changes in interest rates have a powerful - and relatively predictable - impact on the wider economy. In contrast capital requirements may have a powerful and relatively clear impact on bank robustness and an uncertain - but quite likely relatively small - impact on the wider economy. So it seems to me natural to use interest rates as the active tool to affect the balance between demand and supply in the economy - and so control inflation pressures - and use capital requirements to maintain stability in the banking sector.... If banks do come to hold much more capital this would make the job of setting monetary policy easier."

Key Resources

Monetary Policy and Financial Stability – Full speech

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech443.pdf>