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News release

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Leverage and Monetary Policy - Speech by David Miles

In a speech at the 13th annual conference of The Economic and Social Research Institute and the Foundation for Fiscal Studies in Dublin, David Miles - an external member of the Bank of England's Monetary Policy Committee (MPC) - addresses two issues: first, whether the financial crisis and the recession it caused show that setting monetary policy by reference to an inflation target is flawed; second, how to address the immediate monetary policy dilemma in the UK in the aftermath of the crisis. While his comments focus on the UK, they also have relevance for Ireland and beyond.

Using monetary policy to reduce variability in asset prices is not likely to be effective. He says that "sharp asset price variability, per se, is not the most serious problem. It is the combination of (and the interaction between) high debt - or leverage - and variability in asset prices that is problematic.. I believe that an important way to help preserve financial stability is to have policy instruments directed at debt gearing (or leverage) and to be used in the light of what has happened to asset values. The aim would be to avoid a situation where gearing has gone up a lot alongside asset values so that subsequent falls in those values threaten the solvency of institutions and of individuals."

He goes on to say, "It is unlikely that monetary policy - which most of the time means variations in the short-term nominal interest rate - is the most natural tool to use to achieve this...The reason is that - even when we set aside the issues about how effective interest rates can be in controlling asset prices and what effect on consumer price inflation and activity their use for that end would be - monetary policy tools are likely to be pretty poor at affecting gearing and leverage. Changes in the level of interest rates do not obviously alter incentives to use debt relative to equity. It is likely that factors other than the level of interest rates most influence the relative attractions of debt and equity: risk premia, the tax code, regulations (most obviously rules on maximum gearing)."

For banks, he contends that the most direct way to reduce the chances of vicious cycles is to control leverage so as "to prevent an initial (limited) fall in the value of assets triggering sharply higher concerns about their solvency.This is why I think the direction of the policy emerging from the Basel III process - which will put in place higher capital requirements on banks - is right." He argues that the cost to banks of holding more equity may be small - quite possibly negligible. The idea that equity capital for banks is extremely expensive fails to properly take account of the impact of risk upon required rates of return.

On the immediate UK monetary policy problem, he finds that whatever the aftermath of the financial crisis and the unusually sharp recession that followed it, it is not likely to be a normal cyclical recovery after a downturn: "A typical downturn is not one in which the financial sector all but stopped working for a while.It was not so much that virtually no-one thought this sort of thing would happen.It was worse than that; virtually no-one thought this sort of thing could happen. These are not normal times, which is why there is a risk that monetary policy is normalised too quickly.UK inflation now sits uncomfortably above the target. But I believe that this tells us rather little about the cyclical position of the economy or where inflation will be in future. Underlying forces that were created by the financial crisis and that would have kept inflation low have been offset by other factors that have kept inflation above target for much of the past year."

It is a near certainty that four or five years from now the monetary policy that is set over the next year will, with the benefit of hindsight , look very likely to have been set too loose or too tight...If we tighten too quickly it will be the story of "myopic MPC learnt nothing from events of 2008"; if growth and inflation look stronger than I now think is the most likely outcome it will be "MPC completely failed to see what was obvious to nearly everyone - that inflation was out of control". But the only sensible thing to do is to look at all the evidence we have today, and balance the risks."

Key Resources

Leverage and Monetary Policy – Full speech
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech451.pdf