BANK OF ENGLAND

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

News release

23 February 2011

Monetary policy in extraordinary times - Speech by David Miles

In a speech to the Centre for Economic Policy Research and the London Business School, David Miles - External Member of the Monetary Policy Committee - discusses the extraordinary economic circumstances that have followed the financial crisis, and the appropriate policy response to the current period of above-target inflation.

David Miles begins by explaining how exceptional the current period is in two respects. First, the scale of the reduction in output during the recession is comparable to that experienced during the Great Depression. And second, growth during the recovery is expected to be only at around its trend rate, rather than above it. He says: "This is a very sobering picture; some might call it bleak. Anyway what it is clearly not is a standard textbook cycle when the lost output in the downswing is offset by what happens in the upswing.. This is one aspect of how serious the crisis and its aftermath have been".

The position we are now in is a difficult one, David Miles says, "We have a large banking sector - which is one reason why the downturn was very sharp and the hit to confidence severe.... We are also highly reliant on imported commodities - whose recent dramatic rise in price has reflected recovery in parts of the world where the financial crisis does not seem to have done any lasting harm. The UK also now has a very large fiscal deficit, and has had a substantial and long lasting current account deficit which reflected low public and household sector saving rates rather than unusually strong investment. We also have a current rate of inflation of around 4%." This, David Miles states, is ".not a nice place to start from". But the question is what to do about it.

David Miles goes on to discuss the current rate of inflation. Given what has occurred, he asks why inflation is not even higher than 4%. He notes that: ".if shocks from changes in VAT, energy prices, and import prices had hit us in normal circumstances, inflation might well have climbed to 6% or 7% over the past year". So, he concludes, other factors stemming from the depressed level of demand must have been working in the opposite direction.

Countering those who argue that the factors boosting inflation above the MPC's 2% target reflect expansionary monetary policy, David Miles argues that the path of commodity prices and increases in VAT

have little to do with the monetary policy set by the MPC. The case of the sterling depreciation is less clear cut, he says. But given the timing of the depreciation, and the expectations of UK monetary policy that prevailed at that time, ".it is a strange interpretation of history that says that the exchange rate depreciation of 2007-08 was a reflection of a loose monetary policy". Furthermore, he notes, ".the observation that Bank Rate is close to zero - in isolation - very significantly overstates the degree to which policy has been loosened.", since the cost of debt to households and companies has fallen by much less.

What then is the appropriate policy response, David Miles asks. While monetary policy could be set so as to bring inflation back to the target rapidly by creating more slack in the economy and lowering domestically generated inflationary pressures, he is sceptical about whether that is desirable. First, much tighter monetary policy might cause a substantial appreciation of the exchange rate adding to the volatility of output and harming the rebalancing process. Second, inducing more domestic economic slack could undermine the UK's productive potential lowering the level of output and employment consistent with meeting the inflation target further ahead. And third, the sharp rise in Bank Rate that would be required would probably necessitate an aggressive easing of monetary policy next year, creating volatility. David Miles argues that the MPC should avoid ".showing how tough on inflation one is with a tightening in policy on a scale which the assessed profile for inflation and growth do not warrant". But the MPC must learn from higher-than expected inflation outturns and ".try to understand why they happened and use that to make the best assessment today of where we might be going next."

Finally, David Miles stresses the importance of making the financial system more robust to reduce the chances of another banking crisis. He suggests that substantially higher equity buffers for banks are required and emphasises that the potential economic costs of lower bank leverage are considerably smaller than the benefits. Crucially, he disagrees with those who suggest that higher bank capital requirements would hamper the flow of bank lending to businesses and households. Equity is a form of financing, he points out; ".other things equal, a bank that raises more equity has more money to lend - not less." Moreover, there is no necessity for banks to bolster their capital bases too rapidly, he notes. And he concludes that: "The big question here is what the banking system should come to look like to reduce the chances of the sort of mess we are now dealing with happening again - happening to our grandchildren and their grandchildren and their grandchildren. This is a time for long-term thinking."

Key Resources

Monetary policy in extraordinary times – Full speech
Accompanying slides