BANK OF ENGLAND

News release

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Monetary policy and banking fragility - speech by David Miles

In a speech delivered at the London School of Economics, David Miles - External Member of the Monetary Policy Committee - assesses whether policies to make the banking system more robust reduce the longer term level of output and employment, threatening the recovery from the financial crisis, and making the task of setting monetary policy more difficult.

David Miles begins by considering how the economy has evolved against the backdrop of the banking crisis. He explains that the repayment of debt by households and firms, coupled with low confidence, has led to a period of weak growth and re-balancing. At the same time short-term inflation pressures have risen, making the setting of monetary policy difficult. But while inflation is likely to remain above target for all of 2011, and much of 2012, he believes there are good reasons to think that its current elevated level is unlikely to persist. Underlying domestically generated inflation - which is likely to be the dominant force for inflation over the medium term - is relatively low. Wage growth has been particularly weak, a reflection of the degree of slack in the labour market.

The seriousness of the downturn - with UK GDP around 10% below the level it would have reached on the pre-crisis path - leads David Miles to consider how a similar, future crisis might be avoided.

David Miles believes that part of the answer is to make the financial system more robust by having banks use much more equity and less debt to finance their activities so that their leverage is substantially reduced. He argues that a ratio of common equity capital to assets that is at least double current levels - and so higher than the Basel III rules - is closer to a desirable place to ultimately get to. He questions the view that having banks fund more of their assets through equity will be very costly. Because banks start with low levels of equity, even substantial increases are likely to be manageable if the transition to much lower leverage is gradual. Banks financing more of their assets with equity and less with debt is akin to an equity for debt swap, essentially a portfolio switch. The demand to buy equity and sell bank debt is likely to be forthcoming if investors want to keep the fundamental risk and return characteristics of their portfolios unchanged in the face of lower bank leverage. This is one aspect of the Modigliani Miller theorem. David Miles concedes that in practice, there are some frictions that are specific to banks which prevent the theorem from holding, but considers that these frictions will become ".less significant over time."

Furthermore, ".because the main reasons for tighter bank credit supply lie elsewhere, I do not believe that higher capital requirements that are phased in gradually must weaken a recovery or make the task of setting monetary policy more difficult...This is good news. It means the benefits of a more stable banking sector come at low cost. This is precisely why having banks hold a lot more capital plays a crucial role in making the financial system safer."

Key Resources

Monetary policy and banking fragility- Full speech