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News release

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Monetary policy and the damaged economy – speech by David Miles

In a speech delivered at the Society of Business Economists Annual Conference, David Miles – External Member of the Monetary Policy Committee (MPC) – explains why he believes there is a case for making monetary policy more expansionary, even when inflation has surprised repeatedly on the upside. Miles explores the interdependence between inflation, output and potential output. He discusses how potential output may have evolved since the crisis started, and how it might evolve in the future under different assumptions for GDP growth.

Miles begins by discussing the wide gap between the current level of GDP (at 4% lower than in 2008), and where it might have been in the absence of the crisis (about 10% higher than in 2008). He questions how much of that gap reflects a fall in the amount the UK could produce rather than the current output gap (the between actual production and the economy's potential output). He argues that this is a central question for monetary policy, and inflation. Miles highlights the importance and difficulty of estimating potential output, noting that different measures are now giving very different signals.

Miles reviews the evidence on the degree of spare capacity (or slack) and on the impact of a given degree of spare capacity on inflationary pressures, bearing in mind the difficulties in measuring each of these directly. He notes that the level of GDP and of labour productivity suggest there is currently lots of spare capacity in the UK. But surveys suggest the degree of slack may not be so large. And while the path of inflation is at present a reflection of cost pressures not really affected by UK spare capacity, inflation inertia does suggest that the degree of slack may be having less of an impact than usual, a phenomenon that he suggests could be linked to the disruption of credit.

If this is right it means that the so-called Phillips curve – which shows the link between slack and inflation pressures – is flatter than had seemed likely. "My own view is that rather than interpret the recent slightly greater inertia in inflation as simply reflecting much less slack in the economy I would ascribe a significant part to a smaller downward impact of a given amount of slack on inflation pressures...If spare capacity does have a weaker impact on domestically generated inflation pressures it changes the costs and benefits of bringing inflation back to target faster or slower...In a situation where weak demand is likely to be having a negative impact upon productive capacity the cost of having a tighter monetary policy to bring inflation back to target fast will be some long lasting damage to incomes."

This leads Miles to look at the policy implications. He concludes that the existence of significant slack, a flatter Phillips curve and a high degree of dependence of productive potential upon demand are all likely. He concludes: "I believe they are consistent with the evidence and that they make an exceptionally expansionary monetary policy appropriate. No one on the MPC feels comfortable with the prolonged and substantial overshoot of inflation above its target level. But that does not mean bringing inflation back to target very rapidly is the best thing to do."

Key Resources

Monetary policy and the damaged economy – speech by David Miles (262KB)
Full speech by David Miles