BANK OF ENGLAND

News release

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11 September 2012

Winding and unwinding extraordinary monetary policy – speech by David Miles

In a speech delivered at the RBS Scottish Economics Society Annual Lecture, David Miles – External Member of the Monetary Policy Committee (MPC) – describes the exceptional ways that monetary policy has been set to help the economy to recover from the financial crisis. He considers what the lessons from this extraordinary period are for the design of policy. He assesses whether asset purchases have stopped having an impact and whether other more radical policies need to be pursued. He also considers how, in due course, the transition back to a more normal monetary policy might be made.

David Miles begins by describing monetary policy during the financial crisis: the rapid decrease of Bank Rate from 5.75% in December 2007 to 0.5% in March 2009; the asset purchase programme (QE); and the expansion of the Bank's lending facilities. He reviews how people have judged the effectiveness of QE, looking in particular at what has happened to the Bank of England's balance sheet: "...one thing one *cannot* do is to take as proof of its [QE's] ineffectiveness the fact that reserves held by banks at the Bank of England have gone up enormously. It is a mistake to see that as proof that somehow the money created by QE has got "trapped" in the banking sector and is doing no good." Nor is the fact, he says, that GDP has been more or less stagnant over the past eighteen months clear evidence that QE has become ineffective. He is not convinced by this argument because it fails to ignore the range of factors that have restrained demand and which might have caused output to fall significantly had an increasingly expansionary monetary policy not been pushing back in the opposite direction.

David Miles continues by considering the call for the MPC to undertake money financed spending, or 'helicopter drops' of money. He is unconvinced of such a scheme: "Either money financing (or helicopter drops) is done in a way which pays no attention to the inflation consequences – in which case it is not a very attractive policy – or it is done in a way which is sensitive to the longer-term inflation consequences, in which case the differences with conventional QE largely evaporate." He addresses the arguments that the Bank is effectively monetising the government's debt and has lost focus on its inflation target. He says: "The decision of the MPC to embark on asset purchases...was not done because it had abandoned the inflation target; it was done ***because of*** the inflation target. It was done because the outlook for demand has been so weak that unless monetary policy was set to offset this it was likely that inflation would ultimately be driven below the target level as output languished far below the productive potential of the economy."

In concluding his review of monetary policy during the financial crisis, David Miles comments on the blurring lines between fiscal and monetary policy. He sees this as inevitable once the policy rate becomes close to zero so that policy can only be made more expansionary by the central bank expanding its balance sheet. He emphasises that this blurring does not mean that the aims of monetary policy have become unclear – it is still being conducted with an inflation target as the guiding light. And inflation is the natural means by which one judges how expansionary monetary policy should be. Indeed, he comments that when the MPC's inflation projections suggest that monetary conditions should be tightened, it will reverse some of the extraordinary stimulus that monetary policy has provided over the past few years.

This leads David Miles to consider what the post-crisis monetary policy framework should look like. He concludes three things. First, that banks should continue to earn Bank Rate on their reserves and choose their reserve targets; secondly, that there is no compelling argument for changing the inflation target. And thirdly, that he does not believe that targeting inflation is too narrow an objective: "inflation is affected by a wide range of macroeconomic variables, including asset prices, credit growth, the saving plans of households and the change in the supply capacity of the economy...In the light of this the idea that focusing on inflation means focusing on some narrow aspect of economic activity has always struck me as bizarre." He says that what the UK has, in fact, is an inflation targeting regime which allows the MPC to respond in a flexible way to temporary deviations of inflation from target so as to avoid excessive volatility of output.

Finally, David Miles states that he believes that when the time comes to reverse the current accommodative monetary policy stance, that there are likely to be advantages to raising Bank Rate ahead of reducing the Bank's portfolio of gilts.

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