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

21 February 2013

What should monetary policy do? – speech by David Miles

In a speech delivered at the Institute for Policy Research at the University of Bath, David Miles – External Member of the Monetary Policy Committee (MPC) – discusses what the optimal monetary policy in the UK is today. He explores some of the most significant sources of uncertainty now and how they affect his thinking about the best monetary policy to adopt. He develops a simple model to explore what different views about the possible structure of the economy imply about how monetary policy should be set. The model is broadly consistent with the assessment made by the MPC in its latest Inflation Report but it also allows an explicit calculation to be made about what optimal monetary policy is.

David Miles begins by emphasising that monetary policy has to be about taking calculated risks. In addressing the key issues for policy probability judgements have to be made. How likely is it that a loosening in policy today will create more jobs and output and be consistent with inflation moving towards a target level? Will inflation move towards a desired level far more quickly if policy is made tighter? And at what cost in terms of higher unemployment and lower output? "Focusing on the most likely outcomes at unchanged policy does not tell us what the right monetary policy is. The big question remains whether the future, intrinsically uncertain, outcomes are better at unchanged policy or with a more expansionary policy."

He concentrates on four sources of uncertainty: about how demand and output will evolve if monetary policy is left unchanged; about the level of spare capacity today; about how productive capacity would respond to faster (or slower) growth; and about how a change in monetary policy will affect demand and output. In each case, he discusses the extent of the uncertainty, and its effect on optimal policy.

In thinking about what policy is optimal, David Miles examines how one might translate the MPC's remit into a quantitative objective for the MPC. "The remit defines a flexible inflation target. The MPC can set a policy that does not bring inflation back to target in the shortest possible time if that prevents undue fluctuations in output...What the Bank of England's remit does not specify is how quickly inflation should be returned to its target." David Miles therefore explores optimal policy under a range of plausible quantitative interpretations of the remit.

David Miles concludes that in the majority of cases, optimal policy is more expansionary than unchanged policy. Based on plausible ranges for the degree of spare capacity, the sensitivity of productivity to demand, the effectiveness of monetary policy and the strength of a recovery at unchanged policy he finds that a strong case can be made for more expansionary monetary policy.

He quantifies how small the degree of spare capacity would need to be for more expansionary policy to be inappropriate: "An unchanged, or slightly contractionary, policy would be about optimal if the initial output gap is, on average, just 0.75% ....or when supply capacity only grows at 0.5% a year instead of by 1% per year. Both cases strike me as on the pessimistic side". He also assess how fast growth might need to be (on average) for a less expansionary policy to be appropriate: "Withdrawing monetary stimulus would also be optimal if output at unchanged monetary policy, on average, grew by 3% a year over the next 3 years instead of by 1.5%. This strikes me as being on the optimistic side of a balanced judgement; it is certainly more optimistic than the latest prediction taken from the February Inflation Report, where the central forecast is that output grows at an annual average rate of about 1.5% over the forecast horizon."

David Miles concludes: "Optimal policy depends on making judgements on the relative likelihood of different outcomes; it makes no more sense to just focus on the single most likely outcomes than it would in making decisions on buying insurance or crossing a road...Based on my views about plausible ranges of outcomes a good case can be made for more expansion."