BANK OF ENGLAND

News release

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

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Monetary policy and forward guidance in the UK – a speech by David Miles

In a speech at Northumbria University today, David Miles – member of the Bank of England's Monetary Policy Committee – argues that while recent improvements in economic data are welcome, the slack in the economy generated by several years of underperformance means that people should not expect monetary policy to quickly return to normal. He explains that with forward guidance the MPC is sending a simple message to the British public: provided inflationary pressures do not head in the wrong direction, monetary policy will not be tightened until the recovery is sufficiently strong and sustainable to make a meaningful dent in unemployment.

David Miles argues that it is important to distinguish between the economy returning to more normal growth rates and the economy being back at a more normal level of economic activity. We need to recognise that this growth is coming from a depressed level of output. He states: "If that level of activity is significantly below a rate consistent with controlled inflation – as I believe is the case in the UK today – then it does not make sense to quickly return monetary policy to a more normal setting once growth moves to more normal rates."

Miles adds: "The reason I think guidance is helpful now is that it reduces the risk that a recovery that is still somewhat embryonic is not smothered by the anticipation that a tightening in monetary policy is imminent." Addressing the rise in market interest rates since forward guidance was announced, Miles notes that the market seems to believe the unemployment threshold will be reached rather more quickly than he considers likely. Miles emphasises the importance of studying how productivity responds to improving output, given the extreme sensitivity of unemployment to any change in productivity. He argues that it is plausible that productivity – which has fallen substantially since 2008 – will pick up markedly as the recovery takes hold, resulting in unemployment falling more slowly than the market anticipates.

Miles rejects the notion that improving data mean that forward guidance has backfired, given that this implies the MPC finds signs of recovery unwelcome – an idea that demonstrates a "rather Alice in Wonderland, upside down logic". He states he would be delighted if growth turned out to be strong, productivity improved and inflation moved back towards the target level over the next eighteen months. If unemployment came down steadily and significantly as a result, he says he would be pleased to begin normalising monetary policy.

Miles also points to the possibility of there being multiple equilibria for the UK economy, as different levels of confidence about economic activity become self-confirming. He argues that quite different paths for economic activity can be consistent with very similar paths for inflation: low growth in nominal wages could be offset by low growth in productivity on a path along with GDP grows only slowly, while higher wage growth can be offset by higher productivity when GDP grows more rapidly.

Miles says: “This is a powerful reason why an inflation targeting central bank should do all it can to get the economy onto the higher growth path. I view the main way in which forward guidance can help in the UK now is to raise the chances of staying on that more favourable path.”

Miles argues that – while there can be no guarantees – the recent rise in activity and confidence has the potential to be sustainable and self-confirming. He states this possibility means he is “now more confident that we are on path to recovery than at any time since I joined the MPC in the first part of 2009”.

Miles concludes: “What a potentially self-confirming and stronger path for output and confidence does not need right now is tighter monetary policy. That is what the guidance that has been given by the MPC is designed to avoid.”