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The transition to a new normal for monetary policy - speech by David Miles

In a speech to the Mile End Group, David Miles – member of the Bank of England's Monetary Policy Committee – argues that there are good reasons to think that the neutral, or 'equilibrium', Bank Rate will be significantly lower than its long-run average of 5% for some years ahead.

Miles defines the neutral rate as the level of Bank Rate which, once inflation is at target and output in line with potential, keeps the economy there on average.

Miles suggests that one useful way of thinking about what comprises the equilibrium rate is to see it as the sum of the rate of real return on safe assets - the risk-free rate - and the inflation target. Combining the long-run historical average real return on safe assets (3%) with the inflation target (2%) indicates an equilibrium rate of 5% - which, Miles adds, has also been the average level of Bank Rate over the 320 years since the founding of the Bank of England.

However, Miles notes that in recent years this safe return – one part of the equilibrium rate – has been falling.

Miles argues that the single most important factor driving this sharp fall in the risk-free rate has been the changed perception of risk in the world since the financial crisis of 2008 – and it is a change he believes will be persistent. Miles says: "People who might have thought of [these extreme events] as one in a 100 year events (or even 1 in a 1000 year events) might now think of them as one in 50 year events – or even 1 in 25 year events."

He finds that this increased perception of risk could potentially reduce the return on safe assets by 1.5-2% for an extended period, which in itself would make for an equilibrium Bank Rate some way below its long-run historical average.

Miles also discusses the impact of the increased spread between the risk-free rate and returns on riskier assets such as loans to households and businesses. These spreads have increased sharply since the start of the crisis partly because banks underestimated the risks that debt would not be repaid.

He states: "Spreads between lending rates and Bank Rate may come down somewhat in the coming years once banks have built their capital to more adequate levels and if competition in the banking sector picks up. But spreads on risky lending, whether by banks or by capital markets, are unlikely to fall to where they were before the crisis."

Miles notes that all the developments he has outlined are closely linked to the financial crisis – and some will last longer than others. However, each is potentially significant. The risk-free rate may have fallen by 1.5-2% since the crisis. Spreads over that rate have increased by around the same degree.

He states: "To add them together and conclude that the neutral rate may have fallen by of the order of 3% is almost certainly to double count. But for an extended period we might expect the equilibrium policy rate to be as much as 2%, and conceivably a little more, below what we used to think of as normal."

Miles does not believe that the composition of the Bank of England's balance sheet would materially affect this estimate. The Bank of England currently holds £375 billion worth of government bonds on its balance sheet. Miles argues that if the Bank were to sell gilts at a time when financial markets were operating smoothly the impact on monetary conditions might be small – much smaller than the impact when the Bank bought those assets in more stressed conditions.

David concludes: "Households, firms, and investors now attach a higher probability to financial crises and sharp, prolonged downturns in economic activity: events that that many may have thought close to inconceivable. This makes assets which generate a real return with little risk more attractive, driving down the real risk-free interest rate. It also makes the wedge between safe rates and the rates of return required on riskier assets greater. Those forces will tend to reduce the neutral level of the policy rate set by the central bank."