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“Don’t just do something, stand there”… (and think)

In his final speech as an external MPC member David Miles reflects on the past six years of low interest rates, the lessons we can take from the financial crisis and where monetary policy might go from here.

Speaking at the Resolution Foundation, David explains that when he joined the MPC in June 2009, interest rates had already been cut to the record low of 0.5% and the Bank bought £75 billion of government assets via its quantitative easing programme. At the time no one on the Committee would have predicted that more than six years later Bank Rate would still be 0.5%; that the Bank would have made a further £300 billion of assets purchases and none would have been sold; that inflation would be 0% and that the market implied Bank Rate three years ahead (mid 2018) would be only around 1.6%.

“All this is a sign of the enormous and lasting disruption that came after the financial crisis of late 2008.”

Conditions, however, have started to change and now “the case for beginning a gradual normalisation in the stance of monetary policy is stronger than at any time since I joined the committee over 6 years ago.”

Having been called an “arch-dove” in the past some might think it “bizarre” for David to say this. But, he says, “they should not; the ‘hawk – dove’ labels are pretty silly because they suggest some unchanging genetic tendency towards favouring one type of policy; anyone who was like that would be very ill suited to be on the MPC.”

Dealing with the aftermath of the financial crisis has proved exceptionally hard, but there are lessons we can take from it for both financial stability and monetary policy. First, “the best way to handle the risks of incurring huge costs from another financial crisis is to control leverage in the financial sector”. Since the crisis, policy makers have debated the value of using macro-prudential tools versus interest rates in tackling financial instability. David argues that the UK is going down the right route by increasing capital requirements and reducing leverage in the banking sector rather than “skewing monetary policy towards trying to stop financial instability problems”.

Second, we have learnt more about the dynamics of the effective lower bound (ELB) and the efficacy of QE. When central banks the world over cut interest rates to their ELB many believed that the risks of self- reinforcing deflation and protracted slumps had increased sharply and that asset purchases were not likely to help much. In the end, only a few OECD countries experienced outright deflation and falls in short term inflation expectations were temporary.

Turning to the likely future path of monetary policy, given the current outlook David finds that though “it is not all good news” we are in “a much better place than we have been: unemployment is down to just under 5.5%; annualised GDP growth has been near 3% for several quarters; consumer and business confidence has risen sharply over the past year or so; the household saving rate is low and suggests that spending is not being held back by expectations of low near term inflation; wages are rising; the availability of finance has risen and its cost fallen; corporate profitability looks solid.”

So where might Bank Rate be heading? “That question could be couched in terms of so called r* (the appropriate interest rate to keep inflation on track and demand in line with productive capacity)”. A number of factors might mean that this rate will be “significantly lower than in the past”, four important ones are: increased credit spreads, fiscal headwinds, secular stagnation and demographics. David concludes that the combination of these factors, and their various weights, could lead to a rough estimate of r* three years or so down the road of around 2.5 - 3%, relative to the 4.5 - 5% prior to the crisis. This lower range is “some way north of the conditioning assumption used at the time of the May Inflation report of just under 1.5%.”

“Given that, and given that many of the after effects of the mess of 2008 do seem to have faded (e.g. the drying up of bank credit) then I think a first move up in Bank Rate soon is likely to be right. I do not attach great weight to the idea that starting this process will create great risks of dropping back into very weak growth, falling into negative inflation and engendering a splurge in risk avoiding behaviour. I attach more weight to the risks of waiting too long and then not being able to take a gradual path to a more normal stance for monetary policy.” David adds, “one thing the MPC will not do (and never has) is just follow another big central bank; it is a daft idea that we cannot raise rates in the UK before the US and also cannot be long behind them.

“As conditions change you change your view on what is right; and things have changed a lot in the UK in the past year or so and very largely for the better. Now is closer to the right time to start a gentle amble back towards a more normal setting for monetary policy…”

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