**Lessons on Monetary and Financial Policy from the Financial Wreck**

***By Professor David Miles***

Review by Rebecca Zhang

The collapse of Lehman Brothers and the effects thereafter nearly caused a complete breakdown of the financial system. In response to the extraordinary effects of the financial train wreck, The Bank of England adopted a series of conventional and unconventional monetary policies to alleviate the recessionary effects. This included cutting Bank Rate to historical low of 0.5% and a variety of measure to enhance liquidity support, such as marking making large-scale asset purchases financed by central bank money, that is Quantitative Easing. The pressing questions remain: How effective have these unconventional monetary policies been? What lessons can we draw from the financial crisis?

On the 21st January 2014, The Economist’s Society was honoured to have Professor David Miles, who gave an insightful talk on the monetary and financial policies from the financial crisis. Professor Miles provided an extensive overview of the current extraordinary macroeconomic climate, and expounded on the rationale and effects of the monetary policies adopted by the Bank of England. Professor Miles is a distinguished member of the Monetary Policy Committee at Bank of England. He is also a Professor of Financial Economics at Imperial College Business School. His current research focuses on the setting of monetary policy in the wake of the financial crash and explores the nature of unconventional policy and the links to financial stability. Professor Miles began his talk by highlighting the current historical- low bank rate of 0.5%. From 1694 up to the 1950s, the average level of Bank Rate has been close to 5%, which is a stark contrast to the sharp decrease in Bank Rate in 2009 when the Bank of England reduced the rate to its effective lower bound to deal with the recessionary effects. Professor Miles then moved on to show the level of output relative to pre-crisis trend during the past recessions. The comparison is made among recessions in 1929 (Stock Market Crash, Great Depression), 1973, 1979, 1990 and the recent 2007 crisis. Data reveal that six years after the 2007 financial crisis, projected output is only around 90% of the pre-crisis output trend. In comparison to the effects of the Great Depression, the weakness of economic activity due to the 2007 financial crisis is as weak as the Great Depression, but the recovery of economic activity from the Great Depression is much stronger than after the recent crisis. Furthermore, there has been relatively high rate of inflation in the UK (which until recently has been above the 2% inflation target set by Bank of England). With the weak economic activity, wage inflation and increase in prices are low, or even close to zero, which should translate into low CPI figures. While this is largely true in the US and Eurozone, the UK has until recently had a relatively high inflation rate, which adds to the policy challenges that the Bank of England face. Using all the above data, Professor Miles poignantly illustrated the challenging current macroeconomic climate, which justifies the monetary policies adopted by Bank of England.

Moving on to the effectiveness of lowering bank rates, Professor Miles explained that while Bank Rate has been significantly reduced, the interest rates that “really matter in the economy” had not decreased as much. For instance, household unsecured borrowing rate remains at pre-crisis levels of 14%-15%, and corporate borrowing rate only decreased marginally. A significant takeaway drawn from the data is that before the financial crisis, interest rates faced by households and firms like corporate borrowing rate changed in close tandem with Bank Rate. However after the crisis, the sharp decrease in Bank Rate had much smaller effects on the various interest rates, suggesting a more detached relationship. Professor Miles clearly highlighted that the lesson here is that zero lower bound problem is not just a theoretical possibility, but rather a realistic constraint that the Bank of England faces.

Professor Miles then talked about Quantitative Easing (QE). He first provided a definition of QE as the government buying assets from the private sector so as to lower borrowing costs for households and firms and stimulate demand in the economy. In March 2009, the Monetary Policy Committee (MPC) announced that it would reduce Bank Rate to 0.5%. The Committee also judged that Bank Rate could not easily be reduced below that level, and thus a series of asset purchases became needed to provide further monetary stimulus to the economy. Between March and November 2009, the MPC authorised the purchase of £200 billion worth of assets, mostly UK Government debt, and eventually by 2012 increased asset purchases to a total of £375 bn. The purpose of QE is to inject money directly into the economy in order to boost nominal demand. However, this policy does not involve printing more banknotes. Rather, Bank of England electronically creates new money and uses it to purchase gilts from private investors. These investors generally do not want to hold on to this money given its low return so they use it to purchase other assets. This in turn may lower borrowing costs and boost demand for companies’ equities and bonds, thereby stimulating spending.

Professor Miles went on to further explain the sterling corporate bond spreads for financial, non-financial and high yield products. For financial and high yield products, bond spreads were as high as over 3000 basis points just after the crisis.

Assessing the causes of the crisis, Professor Miles noted that banking debt increased drastically from around 200% of GDP in 1987 to 1000% of GDP in 2011. Professor Miles then analysed UK banks leverage ratio, which increased significantly in the period leading up to 2008. (In 2008, debt was around 35x assets.) On top of the high leverage ratio, the liquidity ratio of UK banks has also decreased drastically over the years, reaching to levels close to zero percentage of total assets in 2008 across broad, narrow and reserve ratios. As the banking sector was highly leveraged, a slight loss of confidence in the markets would have severe effects since it quickly caused funding pronlems and financial institutions were mainly holding illiquid assets. Illiquid assets are assets that cannot be easily sold or exchanged for cash without a substantial loss in value such as mortgages.

To conclude his talk, Professor Miles highlighted the key lesson that we can learn from the financial train wreck is that we need to prevent the banking sector from being too leveraged and ensure that financial institutions hold sufficient liquid assets. This is reflected in a number of regulatory responses to the financial crisis, particularly the Basel III framework. All in all, Professor Miles provided a fascinating overview to the lessons we can draw on monetary and financial policies from the financial train wreck. On behalf of The Economist’s Society, I would like to thank Professor Miles for his invaluable time and insights.