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Small is beautiful but big is necessary – speech by Minouche Shafik

Although for central banks small may be beautiful, today's economic circumstances mean big is necessary. Central banks have greater responsibilities, larger balance sheets and a wider range of tools than ever before. In a speech at Bloomberg's *Markets Most Influential* Summit Minouche Shafik, Deputy Governor for Markets and Banking, considers the co-ordination and impact of recent wide-ranging decisions by the Bank of England's policy committees, and the outlook for further stimulus by the MPC. She concludes that while monetary policy can help the process of adjustment following the referendum, it is not the complete answer.

Minouche begins by discussing the benefits of joined-up policymaking, as embodied by the Bank of England's contingency planning ahead of the referendum on European Union membership. In part because of this and similar planning in firms across the UK and internationally, the day after the referendum was remarkably orderly. One particular success was the improvement in the resilience of banks' liquidity positions, supported by the overhaul of the Bank's liquidity facilities in recent years. The referendum was "one of the first times these new facilities had truly been put to the test, and I am pleased to say they performed admirably".

Once it became clear that the immediate financial stability risks had either not materialised or been effectively mitigated, policymakers' attention turned to the macroeconomy. Minouche says that "there is no doubt in my mind that the UK is experiencing a sizeable economic shock in the wake of the referendum. Any reduction in openness or need to reallocate resources will necessarily imply a slower rate of potential growth for the economy. Moreover, the reality of the protracted process of withdrawing from the EU means we still know very little about the nature of our future trading arrangements, and this uncertainty is weighing on prospects for business investment".

Monetary policy can help the process of adjustment. The most reliable leading indicators are generally flashing amber rather than red. Minouche says "it seems likely to me that further monetary stimulus will be required at some point in order to help ensure that a slowdown in economic activity doesn't turn into something more pernicious".

However, “the likely timing of that stimulus will depend on the continued evolution of the data over the coming weeks and months”. Minouche says that “thus far, the welcome improvement in the forward looking indicators suggests that the slowdown may not be as sharp or as sudden as we might have feared”.

Minouche goes on to explore how the MPC anticipated criticisms frequently levelled at unconventional monetary policy. These include that ultra-low interest rates are self-defeating because banks are unable to pass them through to customers, that quantitative easing has adverse consequences for pension funds and insurance companies, and that the central bank should not be involved in the allocation of credit. Minouche says that “we are aware that some of our policies have spillovers and side effects, but we take steps to address them where feasible to do so within our mandate” of monetary and financial stability.

Ultimately, unconventional monetary policies are required because the rate of interest which would bring the economy into equilibrium is low. If Minouche were to be granted one wish as a central banker, “it would be to increase the neutral rate of interest toward a more historically normal level”. This would “hasten our return to a simpler world in which Bank Rate would be our only monetary policy tool” allowing the Bank to reduce its footprint in financial markets and the wider economy. Over the long run, the neutral rate “is determined by deep structural forces, including demography, the flexibility of our labour and product markets, the quality of our institutions and infrastructure, and the balance of savings and investment in the world economy”.

Minouche concludes that “monetary policy is just one part of the story alongside government’s fiscal and structural policies and the degree of international policy co-ordination. A good balance between them can put us on a more prosperous and stable path. But for now, even if we might wish for the time when small was beautiful, big is necessary”.

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