Vitas Vasiliauskas: Central banking in the age of financial innovation – what does it take?

Speech by Mr Vitas Vasiliauskas, Governor of the Bank of Lithuania, at the Conference "Living without globalization?", Session 8 "Digital transformation and innovation", organized by the Hamburgisches WeltWirtschaftsInstitut (HWWI) and the Reinventing Bretton Woods Committee, Hamburg, 4 July 2017.

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Good afternoon, ladies and gentlemen,

Firstly let me thank the other panelists for their insights. I would like to add some thoughts on financial services and central banking – their new mission in the age of innovation.

I guess, some of these thoughts may sound unusual or even controversial. Especially for a representative of a central bank that also holds the role of financial system supervision. However, this is our goal for today – to have a productive discussion, frankly sharing our thoughts and offering outside-the-box views.

Needless to prove the obvious: financial markets are changing. And they are doing so swiftly and fundamentally. In this light, central banks – being the guardians of financial stability – must alter the way they operate.

To respond to new challenges, they need to become more flexible. Otherwise – you see the poor guy in the picture – central banks and supervisors will stand with their hands tied, while the financial sector is moving forward, fueled by technological advance.

Yet while saying “A” we must say “B”.

Despite a surge in innovations, there still exists a vast unused potential. In practice, private actors may be held back by unfavorable market structure and regulatory environment. What these actors often need is a gentle push – a supportive stance from the authorities.

On the other hand, authorities – and consumers as well – also face challenges.

Firstly, fintech developments formulate the need to balance innovation on one side and – stability on the other.

Adding to this, certain sectors – such as payments – may be ready for innovation. But they are hampered by high entry barriers, preserving relatively inefficient and costly systems. What is more, technological advances – like automated trading and investment – alter market structures. This calls for upgrades in regulatory frameworks.

Conventional wisdom and tools are often insufficient. Central bankers and supervisors are thus facing a choice. They must either opt for an unconventional path, which requires broader outlooks, or risk lagging behind the markets.

Now let us look past the financial sector.

It is widely agreed that international trade has been instrumental in boosting global growth throughout the last decades. What are the reasons for this?

Apart from other factors, bringing previously unbanked segments of societies into the financial system has been crucial in making global trade and, therefore, the global economy more vibrant.

It is widely believed that the saturation point for boosting international trade via financial deepening has already been reached. But I am not so sure about that. I believe that by employing technological advances wisely, we may take the process further.

Financial innovations may become the crucial trigger in unlocking at least some of the unused potential of global trade, bringing new life into this sector. However, as I have already mentioned, markets need additional impulse. This is where authorities may come into the picture. Their role is quite clear – establishing forward-thinking regulation, which would allow innovative financial products and services maximize their potential.

Such developments would add to efficiency gains for societies across the globe.

Let us now focus on fintech. As you can see, global investment in fintech companies has surged from 9 to 25 billion USD in just few years.

What makes this sector so lucrative for investors?

To put it straight, it is the potential benefits. Creating more competition in the financial market, fintech developments cut prices for consumers, offering them better and faster services. They also empower users, democratizing financial services and making them more inclusive.

Due to greater decentralization and depth of the market, the financial system becomes more resilient. New credit channels for households and SMEs reduce the risks of disruptions in bank credit due to economic distress. On top of this, there are obvious gains in terms of financial efficiency and productivity of capital allocation.

What do we – as a central bank – do to maximize these benefits? The Bank of Lithuania has set a strategic goal of establishing itself not just as a watchdog, but also as a partner for the financial sector. In practice this means putting the right infrastructure in place – facilitating innovation, while ensuring system stability.

We have launched a "Newcomer program", which works as a one-stop shop for new market entrants. We are among the pioneering central banks in establishing regulatory "sandbox" regime, which operates as a safe space for market participants to test their innovative ideas. From the supervisory perspective, this is a crucial instrument, as it allows building the necessary know-how and designing adequate instruments in advance.

The payments sector.

We believe that efficient and easy-to-use payment methods at a competitive price are key to improved overall competitiveness of the economy and decreasing social or regional exclusion.

We have thus designed and implemented measures to facilitate widespread adoption of innovative payment methods – concentrating particularly on instant mobile payments.

Among the most important steps so far is the provision of open access to our payments infrastructure for non-bank service providers. New players are constantly joining the system – just in the last several days, for instance, three internationally-renowned companies have come on board.

Such open-access infrastructure allows reducing the new players' dependence on banks, providing them with a level playing field and creating an additional source of competition for the established banking sector.

This comes hand in hand with payment schemes standardization – creating a one-stop shop for both firms and consumers. This allows eliminating intermediaries and increasing the efficiency and speed of payment chains. Standardization helps ensure that individual service providers do not develop incompatible systems, which would fragment the market and reduce their competitiveness vis-à-vis commercial banks.

Trading and investment strategies. These activities have decisively shifted toward systemic quantitative decision-making and minimization of the human factor. The aim is clear – improving the risk-to-reward ratio and increasing efficiency in asset management.

Questions of artificial intelligence or even quantum computing may seem far from central banking. But again: authorities cannot fall behind in face of critical changes taking place. This is the one and only way of implementing effective regulation.

And it is crucial for central banks to master these new paradigms so as to maximize efficiency of public funds management. We have already taken steps in this direction – for instance, we have launched an automated trading project. The central aim of this project is to enhance and diversify the bank’s investment decisions by employing cutting-edge automated quantitative strategies.

I believe these examples illustrate that the Bank of Lithuania is aiming to constantly stay not just side by side but one step ahead of the market. Our goal is to function as an accelerator of innovative solutions. Solutions, which, under the right regulatory regime and supervision, would lead to more efficient and resilient financial markets.

Wrapping up, these are the principal takeaways from this presentation.

Firstly, financial innovations can bring benefits for the real economy – for instance, by boosting global trade. Secondly, new players in the financial markets create additional competitive pressures for commercial banks. Thirdly, this is good news both for consumers (due to price gains) and for the financial system as a whole, as it becomes more resilient and efficient.

And lastly, operating in this new environment, central banks, as well as supervisors, must become more flexible and facilitate innovation – while taking into account new challenges and constantly building new regulatory and supervisory know-how.

This might sound like a bold statement, but otherwise authorities risk failing to meet expectations in a rapidly changing and dynamic financial system.

Thank you for your attention! It has been my pleasure to address you.