BANCO DE **ESPAÑA**
Eurosistema

17.01.2018

Panel: “New challenges for central banks”*

Russia and the world: values and virtues /Gaidar Forum

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* On 17 January 2018, Governor Luis M. Linde participated in the 2018 Gaidar Forum panel entitled “New challenges for central banks”. The panel was structured around a debate format moderated by Ksenia Yudaeva, First Deputy Governor of the Central Bank of the Russian Federation, with the participation of Jacob Aharon Frenkel, Chairman of JPMorgan Chase International and former Governor of the Bank of Israel, and Petr Aven, Chairman of the Board of Directors, ABH Holdings S.A. This note includes the thoughts on central banking that were the focus of Governor Linde’s speech.

I. Taking a step back: three main developments have defined the global economy in the 21st Century.

- **Globalisation.** The period between 1990 and the early 2000´s was characterised by an intense process of globalisation, with rapid growth of trade and financial relations among countries. For instance, between 2000 and 2007 the growth of world imports averaged 7.4% per year, about twice as much as global GDP growth. Global banking also expanded markedly, in terms both of cross-border activities and local entry into banking sectors overseas. The crisis entailed a dramatic and severe reversal of this trend. Trade plunged by more than 10% in 2009, an extraordinary collapse by historical standards. Since 2012, trade has gradually recovered at a slower pace than pre-crisis levels, with imports growing around 3% annually. Financial markets experienced a sudden stop in the fall of 2008. The decline in global banking activity has been particularly pronounced in cross-border positions vis-à-vis advanced economies, which declined by 20% between 2008 and 2017, whereas cross-border lending to emerging market economies increased by 44% during the same period (primarily driven by very strong lending to China).

- **Global Financial Crisis.** During the years of expansion of the so-called Great Moderation, from the mid-80s until the crisis, the global economy was progressively accumulating high levels of debt and leverage, assisted by easy financing conditions and the underpricing of risk. This led to increased vulnerability of the global economy and to the accumulation of bubbles, mainly in the financial and real estate sectors in advanced economies. What took us all by surprise was the intense depth and global nature of the crisis that exploded in 2008. In a context of high integration and complex interconnections between financial institutions, instability spread rapidly across markets and economies, leading to the most serious global financial crisis of the last 80 years. In the European Union, the crisis was exacerbated by a double-dip recession, which hindered our recovery period and revealed as well the weakness of the institutional framework of the euro area.

- **Technological change.** In the 21st century we have seen an explosion of technological changes that are reshaping the global economy: internet, e-commerce, mobile phones, artificial intelligence and big data. In the financial sector the new fintech companies are challenging the traditional banking business models and providing services in all functions of finance, from payment systems, to saving, borrowing, managing risks and financial advice. This has important implications for productivity and competitiveness and for further deepening the interconnectedness of the global economy.

II. Central banks have reacted to the global financial crisis in three main ways:

- **Highly expansionary and unconventional monetary policy.** Central banks were already applying near-zero interest rates in 2008. But interest rate policy was not effective under the “zero-lower bound”, which is basically the Keynesian liquidity trap at near-zero interest rates. Accordingly, it was necessary to develop new policy instruments, the so-called “unconventional monetary policy”, mainly quantitative easing and forward guidance. The result has been a huge increase in central bank balance sheets. In terms of GDP, the approximate size of the balance sheet of the central banks before the crisis was 12% in the Eurosystem, 5% in the US and 20% in Japan. These numbers have increased between four and five times, and are now at around 40% in the Eurosystem, around 4.4 trillion euro, 24% in the US (4.4 trillion US dollars), and almost 100% of GDP in Japan (5.2 trillion Yen).

- **Tighter financial regulation and supervision.** Pre-crisis regulation was based on microprudential regulation and supervision. The crisis revealed this framework to be no longer effective to ensure financial stability in the new context of globalised and highly interconnected financial markets. The response has been centred on three main layers:

  - Strengthening of the microprudential framework with higher capital requirements (Basel III) and new resolution frameworks in most jurisdictions;
  - The introduction of a separate and tighter framework for systemically important financial institutions
  - The development of a new macroprudential policy framework addressing systemic risk

- **Enhanced international coordination.** The global nature of the crisis required a global response and new international institutions to coordinate the regulation of the financial sector. At the global level we saw the creation of the Financial Stability Board and the intensification of the work at the Basel Committee (BCBS). In the case of the European Union, we have taken an important step towards financial integration, most notably with the activation of the Banking Union, currently comprising two elements: the Single Supervisory Mechanism and the Single Resolution Mechanism. There is a third necessary pillar, the **European Deposit Insurance Scheme, which is still under political negotiations.**

III. Four broad challenges for central banks ahead:

1. Are we under a "new normal" macroeconomic environment for the macroeconomy and what does it mean for monetary policy?

New normal? Debate about whether or not we are facing a new structural reality of secular stagnation that defines a "new normal" for the macroeconomy, characterised by low growth, low inflation and low real and nominal interest rates. Most estimates suggest that the *natural interest rate* (i.e. the real interest rate consistent with inflation stability and output at its natural level) is now at historically low, possibly *negative*, levels. Some possible explanatory factors are of a transitory nature (such as the still-ongoing deleveraging processes), while others are more structural (i.e. low productivity growth and demographic factors). We have to deepen our analysis further in order to have a full grasp of this "new normal" reality.

Implications for monetary policy:

- **New conventional?** The question that arises is whether the "new normal" should lead to a "new conventional" for monetary policy. Indeed, inflation and real interest rates are likely to persist at a low level in the future, and therefore nominal interest rates will also be lower and hence closer to their *effective lower bound*, limiting their effectiveness as a monetary policy instrument, which will possibly lead to balance sheet management as a permanent policy. There are still no conclusive debates about balance sheet management, including on its marginal effectiveness, the optimal size of the balance sheet and the repercussions it could involve in terms of financial stability. Again, in this area, we need further analysis.

- **Once the conditions for it are met, the exit strategy from the accommodative policies will require gradualism and predictability.** As the recovery gathers speed, and as long as this translates into a sustained adjustment in inflation towards its objective, the need for monetary policy support will tend to diminish. Yet the persistence of low inflation and the financial implications of normalisation call for a gradual approach. The experience of the "taper tantrum" episode in the US, in 2013, showed us that markets can rapidly shift their sentiment and prompt an abrupt adjustment of financial variables. Predictability and a clear communication strategy will be important in order to avoid adverse market reactions. It will also help mitigate spillover effects in third countries. In any case, emerging economies are now better prepared to manage this new context, given their enhanced resilience and stronger growth outlook. At the same time, we have to be vigilant regarding the signs of overvaluation of asset prices, the underpricing of risk and the exceptionally low levels of expected volatility.

- **Risk of overburdening monetary policy:** It is important to stress that we should avoid overburdening monetary policy. Secular stagnation requires an overall policy strategy: in particular, both fiscal policy and structural reforms have an important role to play in supporting demand, and in raising productivity and potential growth.

2. Implementing new financial regulation

- **Safer scenario / implementation challenge.** The new micro and macroprudential regulations and the strengthened supervisory framework provide a safer scenario for the financial sector. There are higher capital requirements for financial institutions and enhanced supervision, including new instruments for early identification of financial risks. For sure, if there is a lesson to be had from the crisis, it is that there is always a risk of another crisis; we cannot easily repeat the famous "this time is different" approach. But we are now better prepared. As a general approach, the main challenge is to fully implement the reforms and to closely monitor their impact on the financial sector, and if necessary, fine-tune them.

- **The interrelation between monetary and macroprudential policies.** Under general circumstances, monetary policy and macroprudential policy complement each other. But, as shown by the run-up to the global financial crisis, there might be periods in which achieving monetary policy goals does not necessarily guarantee achieving macroprudential goals and vice versa; low interest rates had an influence on financial imbalances and excessive risk-taking while inflation was contained and the real economy did not show overheating pressures. This is a trade-off which central banks will have to deal with. It would help to design an institutional set-up that ensures synergies and consistency among monetary, micro and macroprudential policies, but also separates ex-ante analysis, probably through Chinese wall-type structures.

3. The fintech challenge

- **"Fintech" is gradually entering into the financial sector.** Information technologies can have important implications in terms of increasing competition and redefining the relationship between consumers and suppliers of financial services, fostering efficiency gains, better financial inclusion and improvements in quality through tailored services. Compared to other sectors of the economy, fintech is progressing at a slower pace, especially in Europe, as new companies need to gain the confidence and trust of consumers and investors, which traditional financial institutions have gained over long periods of time having been anchored by strong financial regulation and supervision.

- **For regulators the challenge of fintech affects both prudential and consumer protection.**

  - Prudential perspective: supervisors have to strike the right balance between catalysing the innovation and efficiency that fintech can bring, while preserving at the same time the regulatory level playing field and a safe and sound framework. We should seek to apply the same regulation to the same services. As fintech steps up its presence, it might be useful to place increasing emphasis on regulating services rather than institutions.

  - Consumer and investor protection: it is key that financial investors and consumers fully understand the implications of the fintech services, including credit risk, cybersecurity and protection of privacy risks. We have to strengthen our policies of information and financial education regarding fintech services.

4. International cooperation

- **Need for coordination.** Given the context of highly interconnected and cross-border financial markets, it is of paramount importance that we sustain the efforts to strengthen international financial coordination. We need to avoid the risks of regulatory arbitrage or a regulatory race to the bottom among jurisdictions. International fora such as the G20, the Financial Stability Board, the Basel Committee and or the IMF are key in this task.

The important role of emerging economies. The world economy is now more balanced between advanced and emerging economies. Measured in PPP terms, China is the world´s first economy, representing 18% of global GDP, and Russia the 6th (3% of world GDP). We share the same world economy but our respective economic structures and cycles differ. We need a shared analysis, to learn from our respective experiences, and it is crucial that international coordination and regulation take into account our realities.