Jan Smets: The future of central banking

Keynote address by Mr Jan Smets, Governor of the National Bank of Belgium, at the conference "Ten years after the start of the crisis: contours of a new normal", organised by the Belgian Financial Forum and SUERF, Brussels, 14 September 2018.

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Ladies and gentlemen,

it is a great pleasure for me to address this conference organised by the Belgian Financial Forum and SUERF on the impact of the crisis and how it may have shaped a new normal for the economy, for the financial system and for central banks. I thank the organisers for having invited me to share with you some of my thoughts on the future of central banking.

I will not surprise when I say that it is good to first look back before being able to fully understand where we stand now, and, eventually, give insights on where we may go from here. Indeed, the future finds its roots in the past, and the present is precisely what brings both together. So, my plan is to first walk with you through time, starting on 14 September 2008 – the day on which Lehman Brothers failed, now exactly ten years ago and which marked the start of the global financial crisis. I will then say a few words on where we stand in the euro area at the current juncture and seize the opportunity to briefly explain the monetary policy decisions the Governing Council of the ECB took yesterday. Finally, I will devote the remainder of my talk to the challenges for central banks going forward: what is the future of central banking and to what extent will it be different from central banks' past?

As I said, exactly ten years ago we saw the start of the global financial crisis and some of its repercussions are still felt today. Not that there had not been worrying signs before. On the contrary, already back in August 2007 banks started to hoard liquidity and on 9 August 2007 the ECB was the first central bank which had to inject liquidity in the money market. Be assured, I am not going to give you every single detail of the actions we undertook since then. I just want to stress that by then many observers were impressed by the sheer size of the liquidity injection – namely €94 billion - which by now is really small compared to the almost €3.5 trillion increase in the balance sheet of the Eurosystem we have seen in the meantime.

Indeed, the worst still had to come and in September 2008 it came abruptly in the form of a full-blown worldwide banking crisis. Those were the days during which in Belgium alone two major cross-border banks had to be rescued in two consecutive weekends. Very soon the real economy was hit too: euro area output dropped by around 4.5% in just two quarters and similar sharp contractions where seen elsewhere. We now refer to this as the "Great recession", contrasting sharply with the "Great moderation" – the qualification many people had given to the two preceding decades.

Just at the time that the real economy started to recover, the euro area was hit by a second recession which came with the sovereign debt crisis. That showed how much imbalances had been built up in the euro area and how ill prepared it was in weathering a severe economic shock, both at the level of the individual member states and at the level of the – indeed – incomplete monetary union. The consequences of the multiple feedback loops between weak banks, weak sovereigns and weak economies were devastating and eventually threatened the euro itself in 2012. That is when the whole EMU deepening agenda was born and since then major progress towards completing the monetary union has been made, particularly in the field of banking union. This process is still unfinished, an aspect which will be discussed in Poul Thomsen's keynote address at the end of the conference. Still, I think that it was essential in bringing about the recovery, together with the actions of the Eurosystem, namely the Outright Monetary Transactions, the credit easing policies and, finally, the additional stimulus provided in

the form of the Asset Purchase Program and the forward guidance on policy rates.

Early 2015 the Governing Council of the ECB indeed decided to significantly step up its accommodation. With a large amount of idle resources and with new headwinds stemming from emerging market economies, inflation had dropped to very low levels and inflation expectations started to show signs of downward drift. Not only was there a risk that the inflation outlook would no longer be in line with our aim of inflation below, but close to, 2% over the medium term, there were also increasing indications that the economy could slip into outright deflation.

Compared to that period, the economic situation in the euro area has improved a lot. The recovery has strengthened and broadened. All euro area countries are now growing. Contrary to the previous recovery phase, domestic demand is playing an important role, not in the least because it has been underpinned by our monetary policy measures. Employment creation has been particularly strong and drives households' consumption spending, while also investment has finally recovered. The pace of economic expansion has recently decreased somewhat, on account mainly of a less favourable external environment where the tendency towards more protectionism and the problems in some emerging market economies dent trade, and uncertainty weighs on confidence. These developments clearly imply downside risks. Still, domestic demand remains robust and the slowdown of growth up to now mainly reflects a normalisation after the particularly strong growth rates seen at the end of 2017.

With the absorption of economic slack, wage increases started to strengthen, and that process will eventually result in feeding domestically generated inflation. While headline inflation has recovered on the back of increases in the price of oil, core inflation will gradually benefit from the process of domestic reflation, further supported by receding uncertainty in inflation expectations.

In view of these developments, the Governing Council decided yesterday that – very much in line with the view already conveyed in June – progress towards a sustained adjustment in inflation has been substantial so far and that it is confident that the convergence of inflation towards our aim will continue in the period ahead, even after a gradual winding-down of our net asset purchases. Therefore, we decided to reduce the monthly pace of our purchases to €15 billion from October onwards and we anticipate ending them after December 2018, subject to incoming data confirming our medium-term inflation outlook. While this is an important step towards policy normalisation, we are also of the opinion significant monetary policy stimulus continues to be needed to support the further build-up of domestic price pressures. Hence, we reiterated the forward guidance on the reinvestment and on policy rates, implying that we do foresee a very gradual process of policy normalisation. That will allow financing conditions to remain very favourable and to support both the economy and the associated reflationary process we are aiming for.

Having outlined where we stand, I should have paved the way for my reflection on the future of central banking. How will it look like? What will be the focus of central banks in the coming years?

Well, at the risk of being a bit boring, I claim that central banks will continue doing what they did in the past and that is, building trust and confidence in the money they issue. I see three main dimensions here. As in the past, central banks will care about the value of money. In other words, monetary policy will continue to focus on price stability and in doing so stabilise the purchasing power of money. Central banks will also continue to take care of the safe nature of money, explaining their strong interest in financial stability which has even increased since the crisis. After all, the largest part of the money stock is not directly issued by central banks themselves in the form of base money. On the contrary, it is created in the financial system and is held by the money-holding sector as liabilities of financial intermediaries. A significant part of it is in fact deposits with commercial banks. Without having sound financial institutions, money cannot be truly safe, nor will it be fully trusted by the public. And indeed, during the worst days of the crisis we have seen flight-to-safety flows into banknotes, and away from the deposits held with – by

then, mistrusted - banks. Finally, central banks will continue playing a key role in contributing to the smooth functioning of the payments system and being active in overseeing this part of the financial sector which is crucial to allow economic agents using the money they hold. With this, I think, central banks will be very much in the business of making sure money performs well on each of the three functions we typically attribute to it, namely being a unit of account, a store of value and a medium of exchange.

At first sight, there is nothing new here, which confirms what I said earlier about the future finding its roots in the past. Still, it is worth having a closer look at each of these central bank activities, as I think they are subject to changes, be it as a direct consequence of the crisis or because other trends have affected the economy, the financial system or the wider society.

Let me start with monetary policy and its focus on price stability. That focus served us well during the crisis. By counterbalancing the disinflation, we avoided the Fisher type of debt deflation effects and facilitated the necessary deleveraging process. It also helped us keeping control over the real rate, at a time controlling it was complicated by the fact that we had to operate very close to – if not at – the effective lower bound for nominal interest rates. This was not only helpful from a macroeconomic perspective but was, I think, also favourable for financial stability. Of course, our 'low for long' poses challenges for financial institutions and can lead to specific risks for financial stability. Yet, I do think that some sort of leaning-against-the-wind counterfactual with less monetary accommodation would eventually have been worse for financial stability, mainly resulting from the negative macro feedback effects it would have caused. I am also of the opinion that the associated financial stability risks should be addressed by appropriate prudential policies, particularly macroprudential policies – a point to which I return later.

A continued focus on price stability, and on our specific definition of it, will also be very beneficial going forward. By stabilising inflation and hence inflation expectations at a level below, but close to, 2% in the medium term, we make sure that the steady state level of nominal interest rates will be supported by an inflation compensation component of that magnitude. That in turn will be beneficial for financial institutions as in many cases their business models have difficulties in coping with very low nominal interest rates. This inflation buffer will also contribute to safeguard monetary policy's room for manoeuvre during downturns. While all this is already underlying our definition of price stability from the beginning, the arguments supporting this choice have even gained relevance. Indeed, compared to that period the steady state real rate – often referred to as the natural rate – has dropped and that is, I think, one of the important features of the new normal.

This new normal will come with new instances of lower bound incidence. So, central banking of the future should be prepared for such situations and be capable to deploy all tools which we now have labelled unconventional monetary policy. Active use of the central bank balance sheet and forward guidance will very likely become more standard instruments in our toolkit. That of course implies that we should be operationally ready to use them. More importantly, it also implies that we must manage these tools carefully during the normalisation phase, so as to fully safeguard their effectiveness for the future. In that sense it is important that we stick to the conditionality we have introduced in our forward guidance formulation. That does not only facilitate reaching our aim today; it is also an investment in our capacity to use forward guidance in the future.

Let me now move to the second domain which will be prominently part of central banking of the future, namely financial stability. While we are still somehow in the process of dealing with the consequences of the credit bubble, it became clear from the outset that just cleaning is no longer an option going forward. Hence a bunch of policy initiatives has been undertaken to mitigate risks and enhance the resilience of the financial system. New standards for regulation and prudential supervision were introduced in the form of more demanding capital and liquidity requirements and the resilience of financial institutions is now also assessed by means of stress-testing. On

top of that, with macroprudential policy, a new policy domain has been created. It is natural to see central banks playing an important role here, given their knowledge of the financial system and their macro reflex typically adopted in the monetary policy domain. That is a clear trend we see worldwide since the crisis.

Obviously, being more active in the financial stability domain comes with new challenges and, to some extent, also with new risks for central banks. Despite considerable progress made in the macroprudential policy domain, additional research on its transmission mechanisms is still needed. Such research must also address the issue of interactions with monetary policy. I claimed earlier that monetary policy should keep its primary focus on price stability and that prudential policies should act as the first line of defence against financial instability. That setting indeed comes closest to Tinbergen's ideal world where two distinct policy instruments are available for two different objectives. Still, it would be naive to think that monetary and macroprudential policy are two fully independent instruments, as they both act through the financial system. So, I think the future of central banking also lies in learning more about possible interactions, complementarities and scope for effective coordination between monetary and macroprudential policy, without blurring, though, the distinction between the different policy domains, their respective mandates and accountability frameworks.

I would like to flag one more challenge in this domain, which will have an impact on the future of central banking. Part of the argumentation of having prudential policy as the first actor in the financial stability domain rests on its capability to be more targeted, while monetary policy is often seen as too blunt an instrument for these purposes. However, this more targeted nature tends to come with more pronounced distributional effects. Moreover, financial stability will always be a shared responsibility where fiscal authorities have their role to play. For these reasons, tensions could arise when these instruments are given to independent central banks. But at the same time, there are also forces pushing towards allocating them to independent institutions. Doing so indeed allows coping with the so-called inaction bias, which in this case may be quite pronounced precisely as a result of the targeted, and therefore fairly visible, way these policies work. I do not think we have already reached a new steady state on this, and institutional settings may still evolve depending on further experiences gained in this field. By the way, they now differ quite a bit across jurisdictions which is an indication that the search for the optimal set-up has not yet come to an end.

Contributing to the smooth functioning of our payments systems is the third pillar on which future central banking will rest. While often having been a less visible task, it is nonetheless crucial for fostering trust in money. This dimension nowadays gets a lot of more attention than in the past, in view of technological advances and progressing digitalisation. New financial players – so-called Fintechs – often focus their activities on payments services. Evidently, the Fintech agenda is a wider one which affects the entire financial system and which central banks, of course, monitor closely from a financial stability perspective. Moreover, digitalisation and new ways of producing and consuming will have a strong impact on the entire economy. They will drive many macroeconomic variables and questions on the new way of functioning of the economy are popping up, be it from the point of view of measurement or from a more conceptual perspective. Hence, these developments will also shape a new environment for monetary policy. Still, it is in the payments sphere that the technological advances have already had their strongest impact on central bank activities. And that will not change anytime soon. The future of central banking therefore will heavily depend on central banks' ability to keep up with innovation and digitalisation.

One specific phenomenon here, which has drawn a lot of attention lately, is the emergence of so-called crypto currencies. If successful, these alternatives could threaten our monopoly of issuing money and therefore also our ability to conduct monetary policy. Being moreover out of the control of prudential supervision, success of these crypto currencies could also endanger financial stability. That is why we monitor these developments closely. However, given their still limited scope, I do not see pronounced risks at the current juncture. Moreover, the intrinsic

features of crypto currencies – their inherent volatility, particularly – implies they perform poorly as far as the traditional functions of money are concerned, in turn explaining why their success is limited. Still, we should not be complacent. Only to the extent that central banks will be successful on all three fronts I have mentioned, they should not fear outside competition. And at the same time, central banks should be open-minded with respect to the new technologies underlying these developments, as they can potentially be of use for themselves.

Somewhat related to this, the idea has been floated that central banks could issue their own digital currency. Let me be clear from the outset, a central bank digital currency is conceptually fundamentally different from the so-called crypto currencies. It would just be another form to hold the same money. While being electronic in nature, it would in terms of risk characteristics, for instance, be very similar to the banknotes we issue. Here too, central banks should be open minded and carefully weigh pros and cons of possibly going this way. On the pro side, different motivations are put forward, ranging from offering an alternative for disappearing cash, to move away from the system of fractional banking or circumventing the lower bound constraint. On the con side, there are concerns regarding the structural changes it would imply for the banking sector, the possibility of having pronounced digital bank runs and the risk of a structurally longer central bank balance sheet and hence a more pronounced allocative role for central banks. Any steps towards a CBDC should therefore be subject fo careful consideration, and further research is warranted.

I have done the tour of the most important domains in which central banks will be active in the future and I have highlighted to what extent they may differ from what was done in the past. Before concluding, I would like to make three final observations of a general nature on the way central banks will function.

First, with the degree of globalisation we have seen so far and the strong interlinkages between economies in both the real and the financial spheres, I do think that the international dimension will become still more prominent for the central banking of the future. While mandates continue to be geared towards domestic objectives, one's actions can spill over to other economies, which in turn can generate spillbacks for the own economy or financial system. As a minimum, this calls for an enhanced exchange of information about what is going on in the respective jurisdictions, if not for more active policy cooperation. The Bank of International Settlements in Basel plays already an important role in this respect and this is likely to become more pronounced in the future.

Second, we see worldwide that central banks have come under increased scrutiny since the crisis. While initially their prompt reaction to the crisis was widely applauded, support for later actions has weakened and some of them are openly challenged. Calls to restrain the discretion of central banks are openly made. I see several reasons for this. First, a lot of the crisis resolution de facto fell on the shoulders of central banks. That forced them to stretch the interpretation of their mandates, the backlash of which is felt now. It also implied overburdening the central bank and a suboptimal reaction to the crisis, giving rise to the impression that central bank action was not effective. On top of that, many of the policy actions were new and not always well understood. They generated a lot of concern, for instance regarding the risk implications of the balance sheet policies and the distributional effects of the asset purchases, claimed to be regressive in terms of income and wealth distribution – a claim wich however abstracts from the strong macroeconomic effects the asset purchases had as these benefit, via the job creation they entail, to the most vulnerable group in society, namely the unemployed. Finally, the broadening of central banks' remit into the financial stability domain has also contributed to it, while at the same time complicating somehow the accountability framework.

To counter these forces, central banks have to be excellent policy makers. For that a profound knowledge of the economy and the financial system is needed. The future of central banks will therefore very much rest on their ability to be adequate knowledge centres. At the same time,

transparency must be enhanced and appropriate accountability frameworks are needed. Increased communication efforts will have to be made to explain policy actions, not only to the more informed audience of financial markets participants but also to the wider public. The skill to translate central bankers' knowledge into non-technical terms has to be developed.

Finally, just like every other enterprise, central banks must adapt their ways of working to the standards imposed by the changing environment they operate in. Non-hierarchical, multidisciplinary work processes should unlock the knowledge now sometimes contained in local silos. Enhanced diversity of staff should both improve the quality of work and increase society's association with the central bank and its policies.

I conclude. Price stability, financial stability and promoting the smooth functioning of the payments system will also in the future govern most of central banks' actions.It is the task of central banks, also in the future, to foster trust in money in each of these domains. This trust is not something which falls from heaven; it has to be built, and maintained, on a daily basis. While technical know-how of experts is of course essential, on its own it is not enough. The stability of money is a common good and deserves a quasi-constitutional status. In other words, it is a deep and precious fundamental which must be safeguarded under all circumstances, as a prerequisite for welfare, but also for freedom and fairness. Therefore, it has to rest on strong societal underpinnings and be shielded from the volatility or even arbitrariness resulting from short-termism. Thus, it is fully justified to allocate this goal to institutions which have this stability as their primary task and which are accountable for achieving it. That is precisely the mission of central banks, also in the future.

I thank you for your attention and I wish you a pleasant stay at this conference.