In the face of an unexpected adversary: the crucial role for central banks

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Ladies and gentlemen

It is my pleasure to present to you this year's BIS Annual Economic Report, our 90th. I will give you a broad overview of its key messages and then hand the floor over to Claudio Borio, Head of our Monetary and Economic Department, who will speak in more detail on the prudential response to the pandemic. Finally, Hyun Song Shin, Economic Adviser and Head of Research, will dive deeper into explaining the centrality of central banks in the evolution of payment systems.

The shock of the Covid-19 pandemic has turned out to be a defining moment: the containment measures are inflicting an enormous economic blow, and the long-term effects will be profound.

Central banks have done their utmost. As lenders of last resort, they have reacted promptly, stabilising financial markets and working in concert with fiscal authorities to cushion the blow. By providing monetary accommodation, in some cases further expanding their toolkit, central banks have supplied dearly needed oxygen to the global economy, preserving more firms and saving more jobs that would otherwise have been lost during the lockdown.

While the global economy seems to be recovering, much remains to be done. The virus is far from defeated, and many countries, especially those with weaker defences, are still in the early phase of the struggle. The next tasks will be to address solvency, prepare for the recovery, and adjust the economy to the post-pandemic world.

As central banks grapple with these immediate dangers, they cannot ignore other priorities. For example, central banks continue to be essential in providing the foundations for safe and efficient payments, particularly in this era of rapid technological change.

An unexpected adversary

2020 will be a year for the history books. Early in January and February, near-term prospects seemed bright – until the Covid-19 pandemic struck. Around the world, output drops have been the largest since the Great Depression.

It is this global sudden stop that makes the crisis unique: the worldwide lockdowns have crippled both supply and demand, crushing the production of goods and services. Tourism, retail and travel have been particularly hard hit. Meanwhile, supply disruptions and the prevailing uncertainty have sapped investment. Moreover, central banks have faced this sudden stop in the context of some underlying vulnerabilities and limited policy space.

Pre-pandemic, during the prolonged period of easy financial conditions, vulnerabilities were growing, particularly in the non-bank financial sector. I noted last year that these vulnerabilities could easily throw the global economy off track should a shock occur. Unfortunately, an unexpectedly brutal one did just that.

Tackling a crisis of this magnitude would have been a tall order under any circumstances. Nimbleness, boldness and decisiveness were called for. And central banks delivered. However, it has been quite challenging, given the limited monetary policy space available.

Bold and prompt responses

Crisis management is part of a central bank's job description. In some respects at least, the current episode has replayed a familiar script. The initial liquidity phase of the crisis saw the usual flight to safety. The US dollar strengthened, stock markets tanked, sovereign yields fell and corporate sector spreads spiked. Although underlying vulnerabilities amplified the turmoil, central banks knew what to do: engineer a swift and forceful liquidity response.

But, this time, aggravated by the oil price collapse, the crisis unexpectedly morphed into a scramble for cash. When markets threatened to freeze up, central banks quickly went beyond their traditional liquidity support for banks and provided large-scale direct support to markets, buying government debt and other securities on an unprecedented scale. These "all hands on deck" measures stemmed the liquidity and confidence crises.

Spillovers were again large. Emerging market economies (EMEs) saw a sudden stop in capital flows that was far more severe than during the Great Financial Crisis (GFC). Yet, with inflation expectations better anchored, EME central banks had scope to cut interest rates. Moreover, and for the first time, several intervened as market-makers of last resort in their domestic sovereign debt markets. Meanwhile, the Federal Reserve expanded the size of its swap lines, made them available to more countries, and offered a new repo facility as a source of liquidity.

The lender of last resort role needed to be adjusted in real time. Central banks bought private sector securities and expanded their purchase programmes to include low-rated paper. Working with fiscal authorities, central banks also funded businesses directly, expanding their balance sheets faster than in the GFC.

Yet even this Covid-19 crisis had a silver lining. Thanks to the post-GFC reforms, banks entered it in much better shape: more strongly capitalised and less exposed to funding strains. Thus, they were better placed to channel funds to the corporate sector, especially to smaller firms. In addition, financial authorities eased some regulatory requirements, making it easier for banks to lend.

For their part, fiscal authorities acted promptly and on a massive scale, often providing the bulk of the response to support households and businesses. Acting within their mandates, central banks supported these actions by lowering interest rates, facilitating public debt financing, providing monetary stimulus, establishing funding programmes through banks, and keeping markets liquid.

The purpose of all these actions has been clear: to support economic activity, especially to help firms avoid insolvency and resume operations with limited damage, and so limit job destruction.

Central banks have been successful, but risks remain

In many of their aims, central banks have succeeded. Financial markets have stabilised, equity markets have quickly recovered, and spreads have narrowed again. The corporate sector has resorted to new issuance on a generous scale. Even so, many challenges lie ahead.

Financial markets may have become too complacent – given that we are still at an early stage of the crisis and its fallout. The outlook for the world economy is still highly uncertain. At best, we have only just overcome the liquidity phase of the crisis in the countries that are now relaxing restrictions. In many others, the health crisis is still acute. And the epidemic could flare up again anywhere.

Importantly, the shock to solvency is still to be fully felt. In this stage, the heavy lifting is expected to come from fiscal authorities. Business insolvencies and personal hardship may well increase. When this happens, possibly triggered by cliff effects as initial fiscal support runs out and payment moratoriums expire, banks will find themselves in the eye of the storm.

Risks are especially high for emerging market and developing economies, which have already experienced a triple sudden stop: in domestic economic activity, in capital flows and, for several, in commodity exports and remittances. In many cases, weaker health systems and large informal sectors make matters worse. Their policy trade-offs are starker than those of most advanced economies, given tight external constraints and much more limited fiscal and monetary space. Above all, sovereign debt could be affected. Indeed, rating agencies have already started on a round of downgrades.

Many challenges ahead

As central banks respond to the crisis, they face many questions and trade-offs. Let me mention four.

First, when allocating funding, central banks have been forced to navigate within what is, in normal times, private sector territory. Venturing into new areas brings economic and political risks to the fore. For example, there may need to be painful but necessary downsizing in significant sectors. What is the most appropriate process for differentiating between viable and non-viable firms?

More generally, when central banks justifiably overstep boundaries that have traditionally defined their central roles, transparency may need to be enhanced and other safeguards put in place to ensure that their legitimacy is not eroded.

Second, with the crisis, interactions between monetary and fiscal policies have become even more prominent. Today, monetary and fiscal policies support each other. Central banks can lower interest rates, stabilise financial markets with liquidity support, and engage in quantitative easing and other unconventional monetary policy measures. For their part, fiscal authorities can provide stimulus.

In the process, central banks have smoothed the path for government finances. However, within the central bank mandate, this should only be a temporary expedient. Moreover, it should only be attempted by central banks with a credible record of accomplishment in adhering to their inflation mandates. Let us remember that these types of policy are only possible because of the credibility that monetary policymakers have built up over the years.

These actions, while necessary, may eventually threaten central bank independence and credibility. In particular, given the massive fiscal response and the significant increase in public debt that inevitably will follow, many voices will call for financing costs to be kept artificially low and to allow the inflation tax to shave the real value of sovereign debt, possibly supported by forms of financial repression. At the point when crisis management gives way to ensuring price stability, it will be critical that central banks remain independent to fulfil their mandates, and act in consequence.

Third, as soon as circumstances allow, central banks need to regain monetary policy space. Eventually inflation will come back. As the pricing power of firms and labour increases, supply-cost pressures will emerge, pushing up prices and possibly triggering second-round effects. Staying ahead of the curve will be essential, also because easy financial conditions will lead to greater vulnerabilities.

Finally, central banks need to continue to underpin financial stability. As regulators and supervisors, central banks must balance the use of buffers and the need to support the economy, with financial stability. Central banks also have to revisit the size and design of their financial systems. For the second time in little over a decade, they have remedied the effects of vulnerabilities in non-bank parts of the financial system. They strengthened the banks post-GFC; now they need to help ensure that the non-bank financial sector optimally supports the real economy over the medium term.

Evolving payment systems require a solid foundation

Market dysfunction has been limited, despite the severity of this crisis. This shows that central banks perform essential anchoring roles for the monetary and financial system. This includes underpinning the resilience of financial market infrastructure and payment systems.

However, payment systems do present some longer-term challenges. Digital innovation is radically reshaping payment services. Technological advances have led to new payment methods and consumer interfaces. More recently, large non-bank providers have entered payment services. Some of these trends, such as contactless and online payments, have accelerated during the pandemic. These and many other innovations have reduced costs, improved convenience, and broadened access to payments.

However, technology can only do so much. As the issuers of money – which is, after all, the economy's unit of account – central banks have a key role to play in the provision of public goods. A key feature of payment systems is their two-tier structure: the private sector spearheads innovation, drawing on its ingenuity and creativity to serve customers better; and the central bank provides the solid foundation, primarily by enabling the finality of payments that settle on its balance sheet. As history indicates, and recent developments underline, the central bank's role is critical here as it underpins the public good aspects of the payment system for the economy at large.

Central banks have also embraced innovation in their roles as operators, catalysts and supervisors. In their role as operators, they provide public infrastructure, including access to central bank settlement accounts. They foster interoperability, by promoting standards and easy-to-use interfaces. This in turn helps to ensure a level playing field and so promote competition and innovation. In their role as supervisors, they boost efficiency by aligning private sector incentives and steering market structure towards the public good.

In addition, central banks have shown that they can themselves operate at the cutting edge of innovation, not least when directly providing services to the general public. This brings to mind central bank digital currencies (CBDCs). CBDCs could offer a new, safe, trusted and widely accessible means of payment. They could also spur continued innovation in payments, finance and commerce. If CBDCs are to fulfil their potential and promise as a new means of payment, their design and implications deserve close study and consideration. The BIS will continue supporting central banks in their CBDC research and design efforts, through the new BIS Innovation Hub, its committees, and broader analytical work.

Conclusion

Let me conclude.

Central banks have shown again their mettle when faced with a crisis, expanding their toolkit, reacting swiftly and forcefully to stabilise the financial system, and supporting credit flows to firms and households. In some cases, they have even adopted a wide array of prudential policy measures to buffer the impact of the shock. However, central banks are also fully aware of the challenges ahead. Some of these challenges extend beyond their mandate. Monetary policy alone cannot deliver higher sustainable economic growth in the context of price and financial stability. Growth-friendly fiscal policies and structural reforms continue to be urgently needed.

Fiscal policy could better support growth as well as financial stability. At the same time, it will be essential to keep public finances on a sustainable long-term track. Structural reforms are vital as well. As damaging as it is, this crisis could be an opportunity to implement growth-boosting economic policies. Given that their resources are limited, governments should prioritise investment in sustainable growth – for instance, by fostering energy transitions to address climate change risks.

Global cooperation will continue to be of the essence, particularly in the rapid provision of large-scale liquidity facilities. International cooperation is also required to address longer-term problems such as the cost of cross-border payments, and to address the increased risks in the global financial system. Certainly, this will keep us busy in the years to come and the BIS will stay as relevant as ever.

Let me now hand over to Claudio Borio and Hyun Song Shin, who will elaborate on some of these issues and the special chapter of our Annual Economic Report.