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The new challenges facing central banks

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Let me begin by thanking the School of Civil Engineering for inviting me to inaugurate this cycle of meetings with regulatory agencies. Many thanks to the President of the School, its Management Board and all of you for being here today.

The international financial crisis that began in 2007 has given rise to various changes and to the emergence of new challenges. Central banks are, today, in a rather different and novel situation compared with where we were before the crisis some 10 years back, and we are affected by a debate about our functions in the economy and the thrust of our policies.

In the past decade central banks have increased monetary stimuli manifold and there have been deep-seated changes in the monetary and regulatory policy objectives and instruments implemented. We are now emerging from the crisis and this is raising even more the profile of the debate on the role central banks should play and whether the policies pursued in recent years should be maintained, or progressively abandoned, and at what speed and to what extent either alternative should be taken.

The challenges facing central banks can be grouped in three areas:

- first, what is being labelled as the “new normal” in the macroeconomy and its implications for monetary policy;
- second, the challenge for financial regulation policies;
- and third, the new challenges posed by financial innovation and the new technologies.

The impact of the crisis on monetary policy

But before addressing these challenges, I think it might be useful to take a short step back to remember where we have come from. We can only understand today’s challenges if we bear in mind the changes, often far-reaching, that have come about in central banks in response to the crisis.

The global financial crisis came about following a build-up of bubbles in the advanced economies, mainly in the financial and real estate sectors, a process to which easy financing conditions proved conducive in a setting in which risks were not appropriately priced.

In any event, what was surprising was the intensity and global nature of the crisis that broke in 2008. Given highly integrated financial markets and complex interconnections, instability spread rapidly, leading to the most serious financial crisis since the Second World War. In the European Union the crisis was, moreover, exacerbated by a double-dip recession, which has prolonged the recovery period and has also revealed the weakness of the euro area’s institutional framework.

The crisis also left the monetary and regulatory policy “manual” that central banks had been applying in tatters.

Pre-crisis, monetary policy in the advanced economies was essentially defined by inflation targets and a key instrument, the interest rate. In parallel, the goal of financial stability was chiefly addressed with microprudential regulation and supervision. This framework was broadly consistent with the goal of economic growth, given that the control of inflation was estimated to be the best means for ensuring the economy drew closer to its potential growth.

The crisis showed that this framework was no longer valid. The control of inflation, though it remains a necessary condition, is not sufficient to ensure growth; and microprudential regulation was no longer effective, in or of itself, for guaranteeing financial stability.

As a result, central banks have adapted their policies, which are now more complex in terms of objectives and instruments.

Monetary policy has had to face up to the problem of what is known as the "zero bound" on interest rates. Basically, this is the situation that Keynes coined the "liquidity trap": interest rates close to zero cease to be an effective monetary policy instrument. This has led to the development of new instruments, so-called "unconventional monetary policy", which mainly includes quantitative easing, private and public-sector financial asset purchases, and the explanation and signalling of the monetary policy to be applied in the future, namely "forward guidance".

The outcome has been a large increase – four- or fivefold – in the balance sheet of the main economies' central banks. In the case of the Eurosystem, the ECB balance sheet accounted for 12% of euro area GDP before the crisis and now stands at approximately 40%, around €4.4 trillion.

Supervisory policy, for its part, has had to face the challenge of macrofinancial instability in a context of highly interconnected markets at the global level. In this area, the response has been three-pronged.

First, the strengthening of microprudential regulation, with the new Basel III Accord, which includes greater capital requirements and a stricter framework for systemically important financial institutions. Second, the development of a new instrument, macroprudential policy, which addresses systemic risk and the procyclical behaviour of the financial system as a whole. And, third, the greater international coordination of regulation, which is necessary given the reality of globalised financial markets. Notable in terms of coordination has been the creation of the Financial Stability Board and, in the case of the European Union, the activation of the Banking Union, beginning with the SSM and the Single Resolution Mechanism.

The new monetary policy

I shall now turn to the challenges central banks face. The first is, evidently, identifying what is understood by the "new normal".

One question on which economic policy discussions are focusing is whether the advanced economies are in a new situation of secular stagnation, a "new normal" characterised by low growth, low inflation and low interest rates.

We are seeing how, despite lower unemployment rates and the closing of the gap between potential and real output, inflation rates remain persistently low. A series of factors can account for this behaviour. Some are transitory, such as the insufficient increase in employment, or the impact of deleveraging processes in some economies. But there are also factors of a more structural nature, including the effect of globalisation and technological progress, or demographic factors.

In any event, it should be stressed that there are other policies apart from monetary policy. In particular, both fiscal policy and structural reforms have a key role to play in supporting demand, boosting real interest rates and raising productivity and potential growth.

Regarding monetary policy, the central question is this: to what extent should the macroeconomy of the "new normal" lead to a new "conventional model" for monetary policy? In particular, it is considered whether the management of the central bank's balance sheet will become entrenched as a permanent part of the normal instruments of monetary policy. Estimates, while subject to major uncertainty, suggest that real interest rates and inflation will remain at low levels, meaning that nominal rates will also be low, thereby limiting their effectiveness as a monetary policy instrument.

Against this background, central banks are likely to retain the use of unconventional monetary policies. Analysis of these policies is leading to debate, as yet inconclusive, on their effectiveness, the optimal size of central bank balance sheets and on the impact that they might have in terms of financial stability and the medium- and long-term fiscal situation.

True, as the recovery gains momentum, and provided this translates into a sustained adjustment by inflation towards its target, the need for monetary policy to support the economy will tend to diminish. The US Federal Reserve has already begun to reduce its balance sheet at a gradual and predictable pace, and the ECB has slowed the pace of increase of its own balance sheet. This reduction in stimuli will extend the monetary policy headroom for acting effectively in the face of possible future crises.

The monetary policy normalisation strategy can but be slow and will tend to be applied predictably, with close scrutiny of its impact both on economic growth and inflation and on financial stability.

It is worth recalling that, in 2013, the markets rather hastily interpreted some statements by the Federal Reserve, the clarification or correction of which gave rise to a bout of turbulence, owing to the different forecasts as to the speed at which expansionary monetary policy would be abandoned or softened. That episode provided a lesson for all central banks that have applied unconventional policies, in two respects: monetary policy should be corrected very slowly, and the correction should be predictable to the markets. In sum, predictability and a clear communication strategy will be important in preventing adverse market reactions.

Financial regulation and supervision

The second area I would like to mention concerns the challenges in financial regulation and supervision. As I said, the crisis has led to an overhaul of financial regulation, centred on three main areas: the strengthening of microprudential regulation; the development of macroprudential regulation; and the stepping-up of international coordination.

These new regulations provide a scenario of greater security for the financial sector. If we have learned anything in recent years it is that there is always a risk of another crisis. But I believe we are now better prepared. The new regulations impose greater capital requirements on financial institutions and stricter supervision, including new instruments for the early identification of financial risks.

The main challenge for regulatory policy is now to fully implement the reforms approved and to closely monitor their impact on the financial sector, and, where appropriate, to calibrate the new regulatory framework. Along with this general challenge, I would highlight two elements that will have a bearing on regulatory policy management.

Firstly, the interrelatedness of monetary and macroprudential policy. Generally, both policies can be complementary. But, as the years of expansion prior to the financial crisis demonstrated, the economy's cyclical position and the accumulation of financial risks may become decoupled. Financial imbalances thus built up, and yet inflation was contained and the real economy appeared to show no signs of overheating.

Central banks will have to have both policies strike a balance in order to achieve the dual objective of economic and financial stability. Here it is important to have an institutional structure that ensures synergies and consistency between monetary and prudential policies.

The second conditioning factor is the fact that globalised financial markets are a reality, which requires a permanent international coordination effort in the management of financial policies. Coordination is needed to tackle contagion across different markets in jurisdictions and, also, to prevent regulation being distorted by means of regulatory arbitrage, or the competitive lowering of regulatory standards across jurisdictions.

Fora such as the Financial Stability Board, the Basel Committee and the European Single Supervisory and Resolution Mechanisms have gained in importance. A third pillar, the European Deposit Insurance Scheme, has still to be defined and remains the subject of political negotiations.

The challenges of financial and technological innovation

Finally, I shall refer to the challenges posed by financial and technological innovation.

Since the year 2000 we have witnessed a proliferation of technological changes that are re-shaping the global economy. This started with the Internet, which was only incipient at the turn of the century, followed by electronic trade, mobile phones, artificial intelligence and big data. Technology is introducing new types of services and products, and is challenging the traditional commercial models in all economic sectors.

In the case of the financial system, there is considerable scope for improving the efficiency and quality of services through the application of new technological processes. We are seeing how new technologies are being incorporated into traditional functions, for instance in how payments are made, in the automated management of risk pricing and in financial consultancy.

The financial sector is adapting to this new reality. Traditional banks are taking the new technologies on board, occasionally through strategic alliances with new technology firms. New companies are also being incorporated into the sector, ranging from small start-ups to large firms. The new firms must, however, win the confidence of consumers and investors, something that traditional financial institutions have secured over a long period of time, anchored by strong regulation and financial supervision.

From the standpoint of the regulators, the fintech challenge affects both prudential and consumer protection policies.

From the prudential perspective, regulators must strike a balance between catalysing innovation and the efficiency that new technologies can provide, and maintaining a sound regulatory framework. The guiding principle should be to apply the same regulation for the same type of financial services. In this respect, as the presence of fintech increases, it might be useful to put greater emphasis on the regulation of services, instead of placing it on the institutions that provide these services.

Turning to consumer protection policies, it is vital that investors and consumers should understand how the new services function and the attendant risks, including, for example, credit, cyber-security and privacy-protection risks. Here we should strengthen our information and financial education policies.

We are mindful at the Banco de España of the need to step up our efforts in this area. Indeed, last week we approved a reform whereby, under our Directorate General Operations, Markets and Payment Systems, a new Associate Directorate General Financial Innovation and Market Infrastructures was created to assume the competencies in these areas, centralising in this new structure the functions previously assigned to different units in the Bank.

This Associate Directorate General will have to face two families of problems.

First, the questions that arise with the emergence of new agents and new operators in the financial markets, providing services that already existed (but in a different way), or services that did not exist, namely new types of financial services. As regards these new market players, two groups of problems are posed: on one hand, those referring to matters of competencies, i.e. all agents and operators should be subject to the same demands or regulations; on the other, investors and consumers should be protected and alerted as to the new risks, just as they are in respect of the former operators and their products.

The second family of matters which the new Associate Directorate General of the Banco de España must face concerns new technology and its application in financial markets, something which, in these times of continuous innovation, is obviously of great importance.

Thank you for your attention.