CEMLA
CENTER FOR LATIN AMERICAN MONETARY STUDIES

XII MEETING OF HEADS OF FINANCIAL STABILITY

A New World of Challenges for Central Banks

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Welcome and acknowledgements

Good morning. It is a great pleasure to give these introductory remarks at the XII Meeting of Heads of Financial Stability. This meeting is taking place for the first time since the COVID-19 pandemic in hybrid format, hosted by CEMLA and co-organized by Banco de México.

I first wanted to thank the co-organizers for setting up this outstanding agenda. Particularly, Fabrizio López-Gallo Dey, Director General of Financial Stability at Banco de México and his staff for the excellent joint work in defining this year's agenda.

The meeting features a distinguished group of international policymakers from Latin America, the U.S. and Europe, who will share and discuss thought-provoking challenges for central banks. We are also honored to host Prof. Allen N. Berger, Carolina Distinguished Professor of Banking and Finance at the University of South Carolina´s Darla Moore School of Business. Prof. Berger is among the world's most renown scholars in financial stability and banking research. His more than 120 published articles in leading journals have shaped academic and policy discussions in the last decades in areas ranging from the efficiency of financial intermediation, to the role of banks in recent financial crises.

I am convinced that we will benefit extensively from Prof. Berger's knowledge and experience to enrich the exchange of ideas between the more than 80 representatives from 40 institutions who are joining us today.

Last, but not least, let me also thank Matías Ossandon Busch and Carola Müller for organizing this event. They did a splendid job.

A new world of challenges for central banks

This meeting takes place in challenging times. Some of the cornerstones that largely defined economic conditions over the last decades appear to be crumbling away. The era of "Great Moderation", only briefly disrupted by the Great Financial Crisis, where volatility was low and markets were ever rising, is seems to be coming to an end. A whole generation of young investors has known nothing but bull markets. They are also unfamiliar with inflation. In the past 20 years, inflation in Advanced Economies was often below target, and even most Emerging Economies successfully kept inflation in check by putting their public finances in order and increasingly making use of inflation targeting and forward guidance.

Since the outbreak of the Covid-19 Crisis

and the ensuing hike in uncertainty due to geopolitical tensions and uneven recovery paths, a new world is presenting itself to us. We see a regime-switch towards more volatile global financial markets. Instead of prospering Emerging Markets eager to catch-up with industrialized countries, we see inequality on the rise and a divergent trend across countries in their post-COVID recovery.

More generally, the new world is facing three important structural challenges. First, the trend in deglobalization and possible bifurcation, not only economically, but politically and socially as well; second, the dangers emanating from a deterioration in the environment, such as global warming and biodiversity loss and the public policy and price response to them and, third, changing demographics. Most of these lead to a decrease in potential growth across the globe, as well as to higher inflation.

Under this dimmer outlook, the question is how policymakers can navigate in this new world with higher inflation, higher interest rates, and lower growth prospects. In the following, I will focus on three financial stability concerns that arise in this new regime: 1) the risks due to high indebtedness; 2) the changing patterns in financial markets' way to operate; and, 3) climate and biodiversity loss related financial stability risks, Finally, I will also give a brief comment on the challenges and risks to central banks of administering the digital transformation in finance.

Concerns about debt sustainability

First, I join in the many voices that have serious concerns about debt sustainability in a scenario of rising interest rates and lower expected growth. One of the perils comes from the widening gap between the growing need to invest to avoid a slump in economic output, and the increasing costs of doing so.

At the time the crisis hit, fiscal space was very limited to begin with in Latin America and the Caribbean, with many governments running fiscal deficits that implied a high debt burden (ECLAC, 2020). As the crisis evolved, market conditions worsened, so that the refinancing of the existing debt, as well as the issuance of new one, has gotten costlier.

Countries in Latin America and the Caribbean spent on average 4.7 percent of GDP on public support, adding up to more than 400 billion USD. Still, the need for fiscal spending continues, as the long-term consequences of the crisis unwind. Several structural shortcomings, such as weak health care and social systems require large public investments. Furthermore, those in the lower income deciles have been particularly affected by the rise in the prices of food and energy. The World Bank estimates that in Latin America and the Caribbean about 4.7 million people have fallen into poverty or lost formal employment since March 2020.

In matters of financial stability, a main concern derives from the bank-sovereign nexus, as both commercial and central banks hold large amounts of sovereign debt. This scenario raises financial stability concerns of a potential "doom loop", where fiscal problems spill over into the banking system (Farhi and Tirole, 2018). Furthermore, indirect systemic risk emanating from banks´ overlapping portfolios of sovereign debt is potentially even more important than the direct systemic risk

from maintaining sovereign debt, as the work of Serafín Martínez Jaramillo has shown.

Other concerns for financial stability arise from private debt markets. Many companies delayed investments during the crisis. This is proving to be economically costly, since investments would have been needed to sustain productivity, competitiveness, and growth (IDB, 2022). Yet, given the high dependence of firms in Latin America and the Caribbean on dollar-denominated debt, the depreciation of domestic currencies, along with rising interest rates make it increasingly costlier to raise, repay, or refinance funds.

Evidently, akin to physical investment, something similar has happened to the accumulation of human capital, as a recent analysis in the US has shown, whereby students have suffered severely from a deterioration in the quality of their education, i.e., future productivity has been adversely hit.

Against this backdrop, central banks and supervisory authorities will require monitoring any signs of credit quality reduction, identifying possible debt overhang dynamics when refinancing mechanisms become impaired. In the same vein, the loan repayments moratoria and reliefs implemented during the pandemic in several jurisdictions will require a close analysis, as these intervention policies are unwound in order to prevent a widespread deterioration in lenders' balance sheets.

In sum, the wonderful era of painless debt sustainability, where the interest rate is below the economy´s growth rate seems to be at an end. In other words, the world of extraordinarily low risk-free rates is no more. Of course, the repercussions of this will probably be very challenging to many countries.

Overall, the higher indebtedness scares international capital away, thus aggravating the tight conditions in domestic funding markets. Simultaneously, the depreciation of local currencies erodes collateral values. Thus, subdued public and private investments, as well as lower human capital investment, could contribute to lower growth prospects and hamper a transition towards sustained growth.

Financial markets in a new world

A new world of high inflation and tighter monetary conditions has material implications for the operation of financial markets, the more so given the uncertain macroeconomic and geopolitical environment that we observe worldwide.

Inflation surprises have been historically linked to increased market volatility and a disorderly repricing of assets (Mosk and Welz, 2022). Simultaneously, high inflation may lead equities to become more attractive than fixed income assets, particularly considering that bonds' nominal cash flows do not offer protection against inflation. These factors, among others, are likely to put upward pressure on bonds' yields, as some recent numbers are already showing in different countries.

A clear example of this trend is the benchmark figure for the US 10-year Treasury Bond, whose yield has increased from 1.3% in January 2021, to 3.2% in August 2022.[1] Similarly, the

[1] Data from Yahoo Finance.

Bloomberg U.S. Aggregate Bond Index is down 12.5% from its highs in 2020.[2] Notably, this number is more than double than any other peak-to-through decline observed in this index historically. Given that central banks are sending clear signals of further tightening, as suggested in the recent discussions at the Jackson Hole Meeting, we can expect bond markets to further deteriorate as investors become increasingly risk averse.

In a context of subdued growth, these figures are likely to persist and affect the stability of bond markets, both domestically and in a cross-border dimension. From a macro angle, the possibility of income increases partially offsetting the negative impact of inflation also becomes limited, especially when considering the supply-side factors, from disrupted supply chains to rising energy prices, explaining an important part of current inflationary pressures.

It is important to note, as we have experienced since the Global Financial Crisis, that in times of stress, or under certain circumstances, even the market for US Treasuries can be highly affected. Indeed, the U.S. Treasury market suffered from severe stress and liquidity shortages a few months before and at the onset of the COVID-19 crisis, with a drastic impairment of market functioning and sharp increases in bid/ask spreads (see, e.g., He et al., 2022). The Fed's prompt reaction with its expansion of repo operations helped to alleviate stress, highlighting the importance of supporting short-term funding markets in periods of widespread financial contagion. Despite this effective reaction, markets may have taken note that in future crisis scenarios the Treasury market could experience large liquidity dry ups again.

Undoubtedly, the effects of this new world will also affect the banking industry and overall financial conditions in Emerging Markets. On this regard, it is important to bear in mind that monetary policy adjustments and the phasing-out of liquidity support measures in Advanced Economies may induce a pro-cyclical reduction in banking and overall capital flows, with banks in EMEs experiencing tighter conditions to access global funding markets. This effect can be further exacerbated by what is known as the risk-taking channel of dollar appreciation (Bruno and Shin, 2015), particularly considering the exchange rate movements observed in our region in recent months.

In general, it would be fair to say that the world of negative real yields in Advanced Economies is coming to end, which can potentially complicate market conditions in EMs.

In the prudential policy domain, central banks may consider supporting banks in the process of policy adjustment by providing flexibility when tightening macroprudential policy conditions. The convergence towards a sustained path of economic growth will require addressing the need for widespread debt restructuring mechanisms, as well as the differential financing need across economic sectors (Haselmann, R. and T. Tröger, 2021). A flexible and targeted use of macroprudential policy tools can certainly contribute to this objective by providing banks the necessary support to underpin those firms and industries most affected by the pandemic (see FSB, 2022a).

[2] See https://www.bloomberg.com/quote/LBUSTRUU:IND

The urgent challenge of environmental risks

As the world experiences heightened macroeconomic uncertainty, the challenge of environmental degradation continues posing what is probably the highest threat for the sustainable future of humanity.

In Latin America and the Caribbean, climate change vulnerabilities are mounting and have been estimated to represent a sizable share of our economies. The region is prone to climate-related natural disasters, such as tropical storms, floods, droughts, and fires, among other consequences of environmental degradation. These forms of materialization of physical risks have become more frequent, with their associated economic losses and social impact accelerating and accumulating over time.

From central banks' perspectives, it is key to recall that these physical risks add to significant transition risks, both in real and financial sectors. Transition risks reflect the risk of changes in policy, preferences, or technologies due to adaptations to sustainable practices to prevent environmental degradation. The ever-increasing public scrutiny towards firms' investments is a good example of this type of risk.

The transition towards a greener economy means that certain economic sectors can face higher costs and sudden shifts in asset values, affecting financial firms through channels such as collateral values, credit risk, or the concentration of sectoral exposures in their credit portfolios. Transition risks have received relatively less attention, but their importance is likely to increase as action against environmental degradation takes place.

I want to call your attention to the fact that biodiversity losses are also a key component of environmental degradation, with significant implications for financial and economic systems. The main channel connecting biodiversity with the economy are the so-called ecosystem services provided by natural environments that help to sustain economic production. Examples of these services include agricultural productivity gains via soils' fertility or the cleaning of water streams and rivers. The increasing use of biomass for energy production highlights how these ecosystem services can have far-reaching implications for economic sustainability. Central banks' efforts could be effectively complemented by building-up capacities to measure and track financial risks derived from widespread biodiversity losses in our countries.

Although central banks are becoming aware of these risks, attempts to incorporate climate-related risks in financial stability frameworks are at a very early stage.

At CEMLA, we are contributing to this effort through the Climate Financial Risk Center for Latin America and the Caribbean, a joint initiative with the UN Environmental Program that will be launched during our III Central Banks Conference on Environmental Risks in December this year. This initiative aims to bridge knowledge and action gaps among central banks in the region to create a community of practices that facilitates incorporating climate risk in central banks' policy frameworks. I invite you to actively

participate in this initiative from your institutions.

Central banks facing a digital financial system

Before I conclude, I want to briefly discuss another major disruption of the financial system: the digitalization of the financial system and the ensuing emergence of new digital assets in private markets such as crypto assets and stablecoins, as well as in public markets through the issuance of central bank digital currencies (CBDCs).

It is impressive that most live CBDCs in the world are issued in Latin America and the Caribbean. The central banks of the region are operating on the forefront of new technologies by using distributed ledger technology (DLT) to implement the new currencies. However, this technology can expose them also to operational risks, a problem for which little experience has been obtained yet. Therefore, the region is becoming the world laboratory for CBDC implementation. Several questions remain about how consumers adopt CBDCs into their portfolio and which repercussions this adoption has on deposit-taking institutions.

CBDC initiatives evolved in a rapidly developing competitive environment where private crypto currencies including stablecoins, and Bigtech companies threaten to build a parallel economy by offering payment and other financial services to customers outside of the control of central banks and regulatory authorities (BIS, 2022). In fact, the decentralization or "democratization" of finance has been perhaps the most important explicit goal stated in the creation of these crypto assets or coins. I will not delve into many of the huge problems associated to either most crypto assets and stable-coins, or to the presence of platform-based businesses that want to get "in the game". Suffice it to say that there are many significant problems in both cases, although the nature of these risks can vary from being of a microeconomic nature, to the highly intensive inefficient use of fossil fuel-based energy, to the creation of silos by Big Tech with proprietary data that can consolidate their market power. What all of these do have in common is that they can lead to serious systemic risks and financial instability. Several central banks have been extending their regulatory frameworks to cover the expansion of Bigtechs in financial services and the rising interconnection between fintechs and traditional financial institutions.

Going forward, these developments must be monitored constantly. Despite the small portion of overall global financial system assets that are attributable to crypto assets now, disruptions in crypto markets might spillover to the financial system as more banks and financial services providers offer their customers access to these markets (see, e.g., FSB 2022b).

Final remarks

Before concluding, I would like to welcome you again and emphasize that this meeting is key to foster the dialogue between central banks on common challenges for financial stability. At CEMLA, we are grateful to co-organize this year's meeting and we are looking forward to promote further collaboration and research initiatives among central banks that

can improve our common understanding of relevant challenges, especially in these uncertain times.

I wish you a fruitful discussion during the meeting. Thank you for your attention.

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