Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

OVERCOMING CHALLENGES IN BANKING REGULATION AND SUPERVISION AND MONETARY POLICY

To: The General Manager of the Bank for International Settlements
From: Olivier Jeanne
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Background: Established in 1930 and based in Basel, Switzerland, the Bank for International Settlements (BIS) is "owned" by 63 central banks. Its role is to serve as a counterparty in financial transactions and to facilitate collaboration, research, and analysis promoting stability in the global financial system. The current recession created by the COVID-19 pandemic makes it imperative for the BIS to help its members to overcome the main challenges in banking regulation and supervision and monetary policy.

On the **banking side,** the regulatory reforms that followed the global financial crisis allowed most banking sectors to enter the COVID-19 crisis in good shape. The liquidity stress resulting from the COVID-19 shock was largely contained and governments used banks to provide economic stimulus in emerging-market and developing economies and also in advanced economies in unprecedented ways. Bank credit was supported by various forms of government guarantees, regulatory forbearance, and looser macroprudential policy. Macroprudential policy thus seems to have become a tool in managing demand in the COVID-19 crisis. But a bank solvency shock of unknown size is coming. A macroprudential loosening is not what is called for in expectation of a solvency shock, which raises questions about the appropriate path for macroprudential policy looking forward.

On the **monetary policy side,** the COVID-19 crisis has rung the death knell for monetary policy's long awaited return to normality. Unconventional monetary policy is no longer the prerogative of advanced economies. For the first time, central banks in emerging-market and developing economies have also resorted to large-scale market interventions. While the pre-COVID-19 debates about unconventional monetary policy will continue and intensify, new questions will arise as to their effects in the emerging-market and developing economies. In a world of low natural rates of interest, more fiscal-monetary cooperation is needed, and the management of high debt-to-GDP ratios will pose further challenges. Political pressures are likely to rise in favor of rolling back central bank independence in all countries.

KEY PRIORITIES

Against this background, the BIS should focus on the following priorities and initiatives:

- **The BIS must provide advice on how macroprudential authorities can support bank credit now and at the same time generate buffers for the coming solvency shock.** The countries that fail to reconcile these two objectives run the risk of "zombifying" their banks, effectively rendering them insolvent and unable to allocate credit efficiently in the long run. One approach would be to mandate early bank recapitalization based on COVID-19 stress tests that would be frequent enough to phase in recapitalization as the magnitude of the shock becomes clearer. It will be important that higher capital adequacy ratios be achieved through an increase in bank capital rather than a decrease in bank loans.
- The international banking linkages and spillovers are likely to be important given the size and the correlations of the solvency shocks. **The BIS could propose that an international stress test incorporating these spillovers be run under its auspices.** This exercise would also have the advantage of ensuring a minimum standard of information sharing (to which national supervisors may become more reluctant precisely when it is more important).
- The experience of China after the global financial crisis of 2008-10 shows that bank credit stimulus can be associated with the development of undesirable forms of shadow banking, in which nonbank financial intermediaries step in to supply credit throughout the system but without regulatory oversight. **The BIS will need to expand its efforts to track and measure the development of shadow banking among its members.**
- The containment of the liquidity stress in March 2020 should not breed complacency about liquidity risks in the future. The liquidity stress observed so far came primarily from financial market disruptions rather than solvency concerns. Concerns about solvency could lead to liquidity pressures of a different nature and they could become more difficult to contain. **The international stress test proposed above should include a strong liquidity component, in particular for the dollar wholesale funding market.** One question is whether reliance on the wholesale funding market should be prudentially curtailed.

NEGLECTED ISSUE

- **One neglected issue that may require an increasing share of BIS attention is the threat to central bank independence.** There has been an increase in populist pressures to curtail central bank independence, in advanced and emerging-market and developing economies. The case for central bank independence as it was made in the 1970s and 1980s (as a bulwark against inflation) has lost its appeal. However, central bank independence may still be very important for different reasons (think, for example, of the risks of having US Federal Reserve international liquidity provision succumb to nationalist influences). Another relevant issue is the independence of financial regulators, whether inside the central bank or free standing. Central banks should not just lay low and wait for threats to their independence to pass. The case for central bank independence needs to be intellectually reinvigorated, and the BIS is a natural thought leader on this.

ACTIONABLE TO-DO LIST:

- Provide advice on how macroprudential authorities can support bank credit now and at the same time generate buffers for the coming solvency shock.
- Propose an international bank stress test under BIS auspices, which should include a strong liquidity component, in particular for the dollar wholesale funding market.
- Expand efforts to track and measure the development of shadow banking among its members.
- Intellectually reinvigorate the case for central bank independence, which is under threat as populism rises across the globe.