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Joint interview with the General Manager of the Bank for International Settlements (BIS) and the Governor of the Banco de España*

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* English translation from the original in Spanish.

Question: Since the 1980s inflation has been rare in western economies. Has this been an exceptional period or is the inflationary spike a one-off shock?

Agustín Carstens: This inflationary episode is indeed different from others. One feature we can point to is higher inflation worldwide, in the sense that inflation has surpassed 5% in many countries (both emerging and advanced economies) – a picture that perhaps wasn't quite so stark in other inflationary periods. We have a situation in which supply shocks have gone hand-in-hand with demand shocks. Activity fell sharply during the lockdowns, causing major disruptions to value chains.

At the same time, we saw measures to contend with the pandemic that left the economy in suspended animation and created the impression of a major economic downturn, eliciting a very aggressive fiscal and monetary policy response. The recovery was extremely fast. This made it impossible to adapt the support measures, which were designed in anticipation of a lengthy period of very weak activity. We were then faced with a supply shock (Ukraine) that, in and of itself, would have likely led to a surge in inflation and a slowdown in economic activity. While many of the supply shocks have been resolved, demand remains a challenge. It is important to persevere with the monetary policy measures to bring down inflation. Does this mean that we are dealing with a new inflation paradigm? I think we are unlikely to return to a situation like the one we had last decade, when inflation stood consistently below target. Economies have changed, and this will leave inflation at more traditional levels (around 2%), where central banks will have to be very vigilant.

Pablo Hernández de Cos: Accepting that we are set to have high inflation for an extended period of time would be tantamount to admitting that central banks will not fulfil our mandate. This is not the case. The main central banks, including the ECB, have shown and will continue to show our commitment to doing whatever it takes to prevent inflation from becoming entrenched at above-target levels, a state of affairs that would be particularly damaging for medium-term economic growth and the most vulnerable cohorts. The fact that medium-term inflation expectations remain anchored around the inflation targets (2% in the case of the ECB) is proof that economic agents have confidence in central banks' determination and ability to comply with their mandate. As to whether we can ultimately return to an environment in which inflation rates remain consistently below the 2% target, as was the case before the outbreak of the pandemic, I agree with Agustín that this is unlikely.

Certain new factors have emerged which, while cause for much uncertainty, could drive up inflation. For many decades, globalisation has exerted downward pressure on inflation. In recent years, however, although the globalisation process has perhaps not been entirely reversed, it is undergoing a transformation, with trade flows becoming increasingly regional, value chains being shortened and stockpiling to secure supplies. All of these developments could cause costs to rise. Among other measures, the fight against climate change will call for an increase in environmental taxes, which could generate additional inflation during the green transition.

Q.: Monetary policy is contending with asymmetric risks. Banks cannot afford to allow expectations to become deanchored or the idea of persistent inflation to take hold.

P. H. de C.: Once it was clear that the scale and persistence of the inflationary episode were greater than initially expected, it became essential to ward off a potential deanchoring of inflation expectations. Hence the change in our monetary policy stance in late 2021 and the forcefulness of our overall response. Indeed, the medium-term inflation expectations have remained anchored around our target, and we have not observed any widespread second-round effects for the time being.

A.C.: There are whole generations that have never lived with inflation. It has been absent from the public debate. In episodes such as this, it is very important that the authorities be seen to respond decisively. Independent central banks are there to respond to precisely this type of episode and to accomplish what is expected of them: keeping inflation low and stable. The authorities have responded with the strength and determination that the circumstances require, thus cementing their credibility.

Q.: How will this episode affect the outlook for growth?

A.C.: Activity has slowed, albeit less than one might have expected. The pandemic-related fiscal and monetary impulse has helped: many of the support packages set in place enabled households to save, making consumption fairly resilient. Moreover, many firms and households took advantage of a decade of very low interest rates to extend the terms of their loans and, where possible, to lock in low rates. We have also seen less slack in the labour market than might have been expected, and fewer wage-driven inflationary pressures.

P. H. de C.: Economies have proven more resilient than we had anticipated. This is because, in recent months, the correction of the adverse supply shock which shaped economic activity during much of last year has been larger than anticipated. We have seen a very significant drop in energy prices, against the backdrop of a mild winter and easing energy supply shortages. Supply chain bottlenecks have also cleared appreciably. Household savings built up during the pandemic, the measures rolled out to cushion – at least in part –

the fall in real income, and the buoyancy of the labour market have also contributed to sustaining activity.

The resilience shown by this market has been particularly important and is partly due to the economic policy response during the pandemic – when the use of furlough schemes became widespread, helping to preserve employment –, and, as Agustín said, to wage moderation. But we must continue to be very prudent. The savings built up during the pandemic are being depleted, the effects of monetary tightening have not yet been fully felt, the geopolitical uncertainty has not subsided, and persistent inflation increases the probability of second-round effects, which, should they materialise, may require further tightening of monetary policy.

Q.: To what extent might these household savings cushion the impact of the mortgage market and the consumption basket?

P. H. de C.: They are acting as a buffer, although their ability to prop up activity is clearly waning. Even more pertinently, the savings built up during the pandemic are distributed very asymmetrically across households. It is precisely the lowest income households, which are those most vulnerable to inflation and rising interest rates, that have saved the least and that, right now, have the smallest buffers with which to maintain their levels of consumption. The latest data show that private consumption made a negative contribution to growth in 2022 Q4, in Spain, France and Germany alike. Moreover, in the case of Spain, floating rate mortgages account for more than 70% of the total, and the effect of monetary policy tightening on households' interest burden, even though it has not yet fully passed through, is therefore more pronounced and faster than in most European economies.

Q.: The support measures rolled out played a very key role during the pandemic and the energy crisis. Are you in favour of gradually withdrawing these measures to ensure that fiscal expansion does not further aggravate inflation?

P. H. de C.: We have been very clear on this point. This energy crisis calls for a completely different fiscal policy response from the one to the pandemic. The measures must be temporary in nature so as not to increase the structural public deficit, and must be targeted on the most vulnerable cohorts. As far as possible, they should also avoid distorting the role prices have to play in encouraging lower energy consumption. A broad-based fiscal impulse would aggravate inflationary pressures, requiring a more forceful monetary policy response. And, needless to say, as and when energy prices begin to fall and activity gathers momentum, it is important to start unwinding these measures without delay.

A. C.: In a setting in which aggregate supply is less flexible, fiscal impulses may very well lead to inflationary pressures. Given the current circumstances, this would mean that monetary policy would have to neutralise the impulse. Moreover, the debt-to-GDP ratio is at historically high levels in the great majority of countries. Low rates mean low financing costs, meaning that debt service will increase somewhat gradually. But sooner rather than later this increase will be felt and it will be an important phenomenon.

P. H. de C.: In the case of Spain, we are starting from high levels of debt and a considerable structural public deficit. This situation and the setting described by Agustín explain why

Spain should embark on a process of fiscal consolidation this year. It is very important to start bringing the structural public deficit down in 2023, gradually reducing this vulnerability and creating headroom to respond to future shocks. It should also be noted that tax revenue has increased very significantly in recent years. Nonetheless, doubts remain as to whether some of this increase is simply transitory in nature, and it should not therefore be earmarked for structural spending. Also, this time round, the adverse short-term impact of the fiscal consolidation process could be minimised, since we can now draw on the European funds. If a careful selection of the projects financed is combined with the appropriate structural reforms, this could have a notably positive impact on activity, partially (or even wholly) offsetting the negative effects. We must not let this opportunity go to waste.

Q.: Are there many areas where risks to financial stability are perceived?

A. C.: The interest rate adjustment process has not prompted any significant episodes of financial instability. This may be partly attributable to the fact that commercial banks are well capitalised and well regulated. Some borrowers are also proving resilient, due to the locking in of low interest rates that I mentioned before. One potential area of concern that I see is the non-bank financial system, where financial intermediaries, such as hedge funds and private equity, are subject to less stringent regulation and may be prone to opaque and excessive leverage, along with liquidity imbalances or mismatches. In some countries we have seen central banks having to act as market maker of last resort. To mitigate such events, we must redouble our efforts to regulate the non-bank financial system more effectively.

P. H. de C.: All of the regulatory changes over the last decade have served to shape a more resilient, better capitalised global banking sector, with larger liquidity buffers and healthier balance sheets. This has allowed the banking industry to continue to finance the economy over the last three years, and now against a backdrop of rising interest rates. However, as Agustín has said, there are vulnerable segments of the economy. Among households, those with floating rate mortgages and whose real income has been hit hardest by inflation. Among firms, those that are highly indebted and have very energy-intensive production processes. In the real estate sector, there is vulnerability in countries that have seen particular exuberance in recent years, which has not been the case in Spain. And there is vulnerability in some segments of the non-bank financial sector.

Q.: Governor, not long ago you or the Banco de España warned against the risk of the banking industry paying excessive dividends...

P. H. de C.: Higher interest rates have prompted stronger net interest income at banks whose business model allows for a swift pass-through to customers, as evidenced by the 2022 profit figures. However, the economic slowdown and higher interest rates drive up credit risk, reduce the flow of credit and lower the value of the debt securities held by banks. All this in a setting of high uncertainty, not least regarding the medium-term impact on the industry's profitability and solvency. That uncertainty, coupled with very strong profits in the near term, leads us to call on banks to not only maintain but to reinforce their resilience and build up additional buffers. One of the risks that we pointed to in recent years was low bank profitability. We were concerned that this might hinder banks' capacity to generate capital organically, as needed to improve their solvency levels. The situation has since changed.

Profitability has increased and in many jurisdictions stands above the cost of capital. Now is therefore the time to build up buffers in readiness for any unexpected shocks.

Q.: Deglobalisation is a word that comes up a lot these days. You have mentioned regionalisation. Are there signs that countries are pulling back from trade and financial interconnection, or do they simply need to take back a little more control in light of recent events?

P. H. de. C.: It is important to bear in mind that even before the global financial crisis the process of rethinking globalisation I referred to earlier had already begun. Security considerations are now taking priority over efficiency, with firms shortening value chains, diversifying suppliers and stockpiling. All of which could further harm trade in goods. Conversely, international trade in services remains on the rise. It is hard to say just how enduring the geopolitical issues behind these reactions will be. What I am sure of, however, is that a framework that is global – one that covers trade as well as the financial sphere –, standardised and has international consensus is clearly the way forward, and something we must continue to pursue. This is precisely what institutions such as the BIS aim to achieve.

Q.: General Manager, you mentioned some days ago that traditional money had won the battle over cryptocurrencies. But there has been some pain along the way...

A.C.: Money does not owe its value to the form that it takes. History shows that private money issuances tend to be repeated. When issuances are made for financial gain – the key question here –, the capacity to do so is overexploited and the market ultimately turns its back on that money. We have seen this happen with cryptocurrencies, which has been compounded by a lack of regulation and of fundamental respect for the rights of the currency holders. These expressions of currency lack the traditional attributes of money; namely, being a unit of account, a store of value and a means of payment. Because they are a poor store of value, no one would want to price their goods and services or to have their wages paid in such currencies. The same goes for their price volatility, which means nobody wants to accept them as a medium of exchange. Clearly, cryptocurrencies lack these attributes. Given their rapid growth, it is imperative that steps be taken towards their regulation. So far, efforts to keep interconnections with the traditional banking system at a minimum have succeeded, thanks to the fine work done by the committee that Pablo chairs. There are further aspects that cannot be ignored, such as the potential for such markets to be used for illicit purposes, including money laundering, ransom payments and cyber attacks. In short, there are plenty of considerations that need to be addressed from the regulatory standpoint. But it is important to stress that these assets, as past experience has made abundantly clear, bear very little resemblance to money as we have traditionally understood it.

P. H. de C.: Recent events have clearly demonstrated the risks associated with such assets and why we regulators must act as a matter of urgency. The Basel Committee on Banking Supervision, which I chair, has indeed taken action in recent years. In December we approved a new international standard that establishes highly prudent regulatory treatment for banks' exposure to crytpo-assets. The goal is to prevent the characteristic instability of the crypto world from spilling over into traditional finance via the interconnections between the two. The challenge now is to establish a common regulatory framework for the rest of the financial sector, one that is sufficiently prudent to fend off the risks to financial stability.

Q.: There are many different views on what that regulation should look like...

P. H. de C.: We tend to talk about crytpo-assets as if they were uniform, but in fact they have differing characteristics and risks. Some require a highly conservative regulatory treatment because they are so risky. Others, such as the so-called "stablecoins", may be lower risk and may offer benefits from the innovation standpoint, provided we can be sure that they are indeed stable and genuinely backed by other assets. However, the most stable stablecoins, those backed by traditional financial assets, deepen the interconnections with the traditional financial system. Accordingly, they require stringent regulation and supervision. The regulatory challenges are considerable given that some of these activities are decentralised, making it difficult to determine which party should be the subject of regulation. A case in point is decentralised finance (DeFi), which can also entail significant leverage. Not to mention the risks posed by the growth in crypto conglomerates. FTX is a prime example of what can happen here if no action is taken.

A. C.: Several aspects can be singled out, both in relation to the cryptocurrencies or crypto-assets themselves and the different practices involved. In my view, some practices should be banned outright, such as failure to segregate customer assets, to keep at least basic accounting records or to uphold good governance. Any form of misleading advertising that might persuade investors acting in good faith to make ill-advised investments should be removed. Then there are other practices that should either be regulated or restricted. It is very important to emphasise that the approach must be a global one, because crypto-assets are themselves global by nature.

Q.: Both of you have expressed support for central bank digital currencies.

P. H. de C.: As digitalisation has an increasing impact on our lives, central bank currencies will inevitably evolve to respond more effectively to the demands and preferences of the general public. What do we want from the digital euro? It needs to mirror, and if possible improve on, the qualities of cash in terms of privacy, security and usability, and of course it must not upset financial stability or interfere in the smooth functioning of monetary policy. It should also serve to foster European digital payment solutions, which we currently lack and which could be of vital importance at times of geopolitical tension.

A. C.: Sections of society are calling for better, digital representations of money, which the central bank, as the primary issuer, cannot ignore. It is not yet an urgent matter, but it will be important going forward so we must be prepared. We must look ahead to the monetary system of the future and consider how to move towards tokenised deposits, meaning how bank-issued money can be represented in different ways. Central banks have a responsibility to provide money to society with their full institutional authority and backing, but in a digital format that meets society's demands

Digitalisation and climate change at central banks

Decarbonisation. "The most effective policies against climate change are not in the hands of central banks or supervisory authorities, but in the hands of governments. But we have plenty of evidence that climate change poses physical and transition risks that may ultimately affect financial stability", explains Hernández de Cos. "It is our responsibility to build, in partnership with banks and financial institutions, a regulatory framework that ensures that such institutions internalise those risks. This will also foster a shift in relative prices, penalising the most polluting activities and encouraging their transformation, which is key to driving the green transition".

Digitalisation. "Artificial intelligence, technology... these are all developments that will have a significant impact on potential growth and the labour market, and, therefore, on the ability of central banks to maintain price stability", says Hernández de Cos. "It is very important that central banks document how productivity can be improved, since this entails stronger potential growth and lower inflation", adds Carstens.