November 14, 2024

Bank of Japan

Challenges to the Financial System during and after the Pandemic and a Way Forward

Speech at the IADI Annual Conference

UCHIDA Shinichi

Deputy Governor of the Bank of Japan

Introduction

It is a great honor and pleasure to be invited to the IADI (International Association of Deposit Insurers) Annual Conference. Today, I would like to talk about economic and financial developments during and after the COVID-19 pandemic, with the hope of deriving some lessons for financial stability.

Over the past several years, the global economy and financial conditions have changed dramatically. The pandemic had a significant effect on society and the economy. Governments around the world took strict and wide-ranging public health measures to prevent the spread of the virus, together with large-scale fiscal spending. Central banks aggressively pursued monetary easing and provided ample liquidity domestically as well as globally through the swap line arrangements among central banks. Some governments went further to assume part of credit risks. These measures contributed to maintaining the stability of financial markets and the financial system, facilitated the intermediation functions, and hence supported the real economy. There was no major bank failure during this period.

Thereafter, however, as the economy was returning to normal, we faced supply-side constraints due to disruptions in global supply chains and a rise in commodity prices owing to heightened geopolitical risks, which led the global economy to inflation. Central banks raised their policy interest rates. Then, in 2023, a few banks fell into trouble, including the failure of Silicon Valley Bank and the acquisition of Credit Suisse, as they suffered from liquidity and interest rate risks. Thanks to swift efforts made by the authorities, financial stability was maintained.

Governments and central banks paid careful attention to financial stability during the pandemic, but it was difficult to predict that these troubles would have arisen. At the time, we were worried about deflation rather than inflation. We were worried about credit risks rather than liquidity and interest rate risks. These episodes tell us that, even if we understand the economic and financial situations and the risks associated with them, we can hardly foresee the nature of possible future shocks. But still, as our mandate is to ensure financial stability, we have to prepare for them. What we can do is to learn from the past and use the lessons for the future.

I. Developments during the Pandemic and Responses of Authorities

Policy Mix

Let me first look back at the developments during the pandemic. When COVID-19 spread globally in the spring of 2020, governments around the world implemented strict public health measures to contain it. Although the measures were necessary to protect people's health and safety, economic activity was severely constrained, and households and businesses were deeply concerned about uncertainties over the economy. It was a shock to the real economy, unlike the global financial crisis (GFC) in 2008.

Naturally, the core of the measures to address the difficulties in the economy was macro-economic policies. Governments spent more, and central banks introduced accommodative monetary policy measures. Many jurisdictions adopted this policy mix, which was necessary to support the economy. When central banks resorted to unconventional tools, how to conduct government bond purchases in the face of increasing bond issuances became a delicate issue, as this may have raised questions of monetary finance. In Japan, under the yield curve control framework that had been introduced four years before the pandemic, the Bank of Japan set the target level of 10-year JGB yields at around zero percent, which we thought was appropriate to meeting our own mandate of price stability. As for the amount of purchases, the Bank lifted the upper limit and stood ready to purchase any amount necessary to achieve the target interest rates, while the actual amount of purchases turned out to remain largely unchanged during the course of the pandemic.

Stabilizing Financial Markets

We also needed to avoid a negative feedback loop between the financial system and the real economy. From late February 2020, global financial and capital markets became unnerved, as seen in the plunge in stock prices. The "dash for cash" led to a sharp increase in U.S. dollar funding premiums. In response, six major central banks, including the Bank of Japan, coordinated to expand U.S. dollar funds-supplying operations. Ample supply of funds to markets and central banks' strong commitment to securing financial market stability gave market participants a sense of security. U.S. dollar funding premiums soon began to decline.

As such, confidence in financial markets recovered in a relatively short time, thanks to the internationally coordinated liquidity provisioning. I appreciate the nimble actions and vigorous efforts made by the Federal Reserve and the collaborations of our central bank colleagues. This demonstrates the effectiveness of central banks' extended "lender of last resort" function -- that is, the "global lender of last resort," or GLLR, and the "market maker of last resort," or MMLR -- which has been developed since the GFC.

Supporting Corporate Financing

In many jurisdictions, governments and central banks also took extraordinary measures to support corporate financing. At the time, economic activity was severely restricted, and it was important to avoid further downward pressure on the real economy from the financial side. In Japan, the government introduced measures to assume the credit risk of bank lending to small and medium-sized enterprises. The Bank of Japan established the Special Program to provide support for corporate financing, with a total size exceeding 100 trillion yen. In this program, the Bank back-financed bank lending with favorable conditions and increased the amount of purchases of corporate bonds and CPs. This is an example of cooperation between the government and central bank to support corporate financing, with a clear demarcation of their respective roles.

I would also like to emphasize the role played by financial institutions. They showed stress resilience with sufficient capital bases, so as to maintain robust lending activities during the pandemic. In this regard, strengthened financial regulations since the GFC, Basel III in particular, were pivotal.

In all, it is fair to say that the measures by governments and central banks and the initiatives by financial institutions acted together to prevent a negative feedback loop between the financial system and the real economy.

II. Inflation and the High Interest Rate Environment after the Pandemic

Normalization of Economic Activity and Inflation

During the pandemic, governments and central banks, as well as many market participants, were concerned that the deterioration in the real economy could be prolonged, and that the problem for corporate financing could shift from liquidity to solvency. However, before such risks materialized, economic activity resumed earlier than expected, owing to progress in vaccinations and governments' fiscal support, particularly in the United States and Europe, while there remained supply-side constraints globally. These demand and supply developments, together with heightened geopolitical risks arising from Russia's invasion of Ukraine, drove high inflation. In an effort to contain this high inflation, many central banks started to raise policy interest rates at an unprecedented pace.

Bank Troubles

In March 2023, following the failure of Silicon Valley Bank (SVB), Credit Suisse was acquired by UBS after falling into financial difficulties. The reasons why these two banks fell into difficulties were idiosyncratic. In particular, SVB's balance sheet structure was quite unique. It depended on uninsured deposits mainly from the technology sector on the liability side, and held fixed-rate and held-to-maturity bonds on the asset side. Interest rate risk built up, and once deposits started to be withdrawn, concern over valuation losses on bonds has caused further deposit outflows. Turning to Credit Suisse, there had already been concerns over its business model and governance for several years, as seen in a series of loss cases, and media reports saying that Credit Suisse was having difficulties in raising capital triggered deposit outflows in a short period of time.

Although the failures of these banks were idiosyncratic shocks, these events posed the tail risk of contagion. In the United States, authorities announced that all deposits of failed banks, including SVB, would be protected and the Federal Reserve introduced the Bank Term Funding Program, which allowed financial institutions to pledge assets as collateral at par. In Switzerland, upon the takeover of Credit Suisse, the Swiss National Bank announced liquidity assistance based on the Federal Council's Emergency Ordinance. While these were rather exceptional measures at times of crisis, they contributed to eliminating uncertainty in the market and to preventing an adverse impact on the real economy.

Developments in Japan's Financial System

Let me briefly touch upon developments in Japan's financial system during these periods. As for the impact of the pandemic on the loan portfolios of Japanese banks, their credit costs have remained low. In the *Financial System Report* published this October, the Bank examined the bankruptcies and default events of borrowers. The default rate of vulnerable firms declined during the pandemic due to the various support measures I just mentioned, but it rose again after the pandemic, suggesting the possibility that past vulnerability has materialized with a time lag. We judged, however, that the quality of banks' loan portfolios has been maintained overall, as firms' financial conditions have continued to improve, while we should note heterogeneity among firms.

As for the effects of the change in interest rate environments after the pandemic, the *Report* simulated the impact of rising yen interest rates on banks' deposits and lending. Higher interest rates will likely improve banks' profits in the long run, while it may temporarily suppress margins of some banks, especially those with a large amount of fixed-rate loans and long-maturity securities. In any case, the rise in interest rates was much milder in Japan than in the United States and Europe, as was the impact on banking businesses and the financial system.

On the whole, Japan's financial system has been maintaining stability. Financial institutions have sufficient capital bases and stable funding bases to withstand various types of risks, including the global rise in interest rates and GFC-type stress. Financial intermediation has continued to function smoothly.

III. Lessons Learned and Challenges Ahead

Before I conclude, I would like to talk about the lessons learned and the challenges ahead. As I said at the outset, even if we understand the economic and financial situations and the risks associated with them, it is difficult to predict what kind of shocks will happen in the future. But this does not mean that we cannot prepare for unknowns. On the contrary, the episodes I mentioned today all highlight the importance of what we do during normal times in order to react nimbly when we face a crisis.

The Role of Central Banks

Prompt enhancement of the swap lines was possible based on the experience at the time of the GFC and day-to-day communication and collaboration among central banks. The market instability during the pandemic and the banking sector turmoil after the pandemic showed that, when the financial system is under stress, market conditions can deteriorate rapidly due to liquidity and funding concerns, and the risk of a negative feedback loop increases. In such a situation, it is important for central banks to maintain market confidence by fulfilling the GLLR and MMLR functions. Recently, we are required to respond to crises even more rapidly and on a larger scale. So, close communication among central banks during normal times is key.

A central bank also needs to keep close communication with financial institutions and monitor risks on a daily basis to fulfill its LLR function in a timely manner. Allow me to talk a bit about my own experience. Back in the early 2000s, when Japan's financial system was still unstable, I was leading a team in charge of monitoring financial institutions and coordinating LLR functions at the Bank. We tried to get as detailed information on individual banks as possible, including the expected daily inflow and outflow of deposits in the near future, eligible collaterals, and so on. As you know well, every bank is different. Whether we decide to rescue or resolve a troubled bank, we need to have detailed and technical information in making plans to implement that decision in an orderly way. Good preparation pays off.

On financial regulations, authorities have had wide-ranging discussions and have tried hard to reach a consensus since the GFC. The strengthened capital base of the banking sector proved effective during the pandemic, following the transition to Basel III. Financial institutions carried out their roles to support their borrowers, with some help from the government. Let me therefore emphasize the importance of implementing all aspects of the Basel III framework globally, in full, consistently and as soon as possible.

Underlying Trends in the Financial System

In addition to the impact of the pandemic and global inflation, there are several underlying trends in the financial system we should note, such as increasing global interlinkages among financial systems, the growing presence of non-bank financial intermediaries (NBFIs), and digitalization.

First, as the interlinkage among financial systems has been increasing globally and shocks have been spreading across borders at greater speed, central banks and supervisory authorities are under pressure to assess the situation and provide liquidity in a very limited amount of time, as I mentioned earlier. International coordination is especially critical in jurisdictions like Japan, where financial markets open ahead of other regions due to the time difference.

Secondly, the growing presence of NBFIs also warrants attention. Some reports show that NBFIs account for almost half of financial intermediations globally. Financial and capital markets are often affected by NBFIs' strategies and activities, as we observed very recently. They usually do not have direct access to central bank money, and authorities have less information on NBFIs than on deposit-taking institutions. However, as the relationship between NBFIs and the banking sector deepens, deterioration in the non-bank sector could spill over to the entire financial system via financial markets.

Finally, digitalization and advances in IT have had a significant impact on the businesses and risk management of financial institutions. Recently, the pandemic brought about an acceleration in digitalization through the rapid increase in remote work, online conferences, and so on. The proliferation of social media and the improvement in online banking platforms have drastically increased the speed and volume of deposit flows. Financial institutions and authorities must be ready for any sudden outflow of deposits, since information spreads so rapidly across these platforms. They should also be attentive to operational and cybersecurity risks.

These trends are not new. We have been aware of the problems and have discussed measures to address them. The trends will continue, and we should continue our efforts as well.

Concluding Remarks

Today, I have talked about pivotal events in recent years, especially from a central bank perspective. Of course, there are many other issues to be discussed. I am sure that you will cover a wide range of topics at this conference, including issues regarding the framework of a deposit insurance system. The deposit insurance system is a critical safety net not only for the orderly resolution of troubled banks, but also for the stability of the financial system as a whole. The very existence of deposit insurance contributes to maintaining the confidence of depositors and makes banking businesses possible, which inherently involves maturity transformation and liquidity risks. In operating a deposit insurance system, we need to strike a balance between the stability of the financial system and the risk of moral hazard, as this balance will affect the businesses of banks as well as nonbanks. Deposit insurance is also relevant to the functions of a central bank, the LLR function in particular, as both serve to complement the liquidity of banks. How central banks react at times of stress will affect how the deposit insurance system is designed and operated, and vice versa. The recent events and the underlying trends I have mentioned today pose challenges for both the deposit insurance system and central banks. Some are new and some are rather conventional.

I know it is a big question. Well, I wish I could share my ideas with you, but since time is running out, I will leave further consideration to you. I hope today's discussion will be a steppingstone toward achieving a further enhancement of a deposit insurance system.

Thank you very much for your attention.