Conference on the occasion of the 175th anniversary of the Banco de Portugal

Rebuilding Social Capital: the role of Central Banks

Session: A new social contract for central banks in times of shifting societal concerns

The forces driving the world economy (technology, demographic trends, and globalisation, amongst others) have generated economic progress but are putting the social contract – the way in which the provision of collective goods is organised in the society – under strong pressure. Within societies, a dominant view is emerging that economic outcomes are not achieving fairness and equality of opportunities.

The prevailing conviction that the social contract is breaking down reflects many facts: increasing income and wealth inequality, unequal labour market prospects, unfairness of opportunities across generations, low productivity gains, the rise of market concentration in some industries, environment exploitation, and the inequality of opportunities in advanced versus low-income economies.

These shifting societal concerns are pressing governments, authorities, individuals, businesses, and civil society in general to redesign the way in which societies and economies function, in order to achieve a greater fairness of outcomes and sharing of risks. A new social contract is needed. Rebuilding social capital – the strength of communities, relationships and trust – is essential for economic and social development.

Technological and digital acceleration, structural transformations of how people work, demographic decline, slowbalisation, shifting economic power towards emerging economies, and climate transition are creating a transformed world with structurally higher uncertainty. The tensions caused by the pandemic have intensified technological, societal and economic change. These underlying trends, the asymmetric recovery from the pandemic shock across economic sectors, and the necessary transition to a more sustainable economy are likely to have a very heterogeneous impact on businesses and individuals, with potentially large effects on the allocation of resources.

The senseless war in Europe has brought about – beyond the suffering and humanitarian tragedy – strengthened risks for price developments and growth prospects, further amplifying all the existing uncertainties. Policy makers were already facing the unpleasant combination of a recovery together with rising inflation, in a context of normalisation of fiscal and monetary policies. They now have to handle the very unfortunate coincidence of an energy supply shock, higher commodity prices, trade disruptions, renewed disturbances in supply chains, and the debt legacy of the pandemic, which further increased financial leverage.

The aftermath of the Great Financial Crisis brought new challenges for central banks. The growing multiplicity and complexity of roles has fundamentally changed the nature of central banking, bringing more responsibilities and much higher expectations among citizens. Central banks are required to play a more influential role, creating confidence and greater understanding of their missions. Strengthening trust and promoting proximity with society becomes preponderant, in parallel with greater accountability and transparency.

The conference *Rebuilding Social Capital: the role of Central Banks* addresses the role of central banks in these challenging times.

- How should central banks contribute to rebuilding social capital?
- How should be improved the social contract for central banks?
- How should central banks reinforce accountability frameworks and enhance effectiveness, transparency, and trust?

Panel 1: Social Capital and financial stability

The role of central banks in preserving financial stability is significantly more demanding today than it was before the Great Financial Crisis. Knowledge of the interactions between monetary and fiscal policies is very important, in particular under the current low-for-long interest rate environment. Financial reforms were decisive to rebuild social capital, restoring trust in market mechanisms and institutions. The reform process is however not completed and many challenges still lie in the years ahead.

- It is too vivid in our memories how high the social costs of financial instability can be. As new risks to financial stability have appeared on the horizon – like the existence of pockets of overvaluation (credit, stock, and housing markets), increasing risk-taking and record high levels of debt (public and private) – how should this be incorporated in monetary policy? Should central bankers deviate from their objectives of price stability to promote financial stability? Which improvements in policy frameworks – monetary and macro-prudential policies – could reduce the incidence of financial crisis episodes?

- The Basel regulatory reform still lacks consistent implementation across the globe, whereas macro-prudential policy for the non-banking sector (including insurance and pension funds) is in its infancy. What is it still missing in the regulatory reform? What are the lessons learned from the pandemic crisis on the functioning of the macro-prudential framework for the banking system? What is the right balance between new regulation and reinforced supervision?

- Covid-19 has further underlined the importance of addressing emerging structural trends that impact global banking systems, like the digitalisation of finance, the sustainability of banks' business models, and climate-related financial risks. How to address and mitigate the resulting risks with a forward-looking perspective?

- Crypto-assets and associated products and services are growing fast, increasingly interlinking with the regulated sector and potentially changing the international monetary and financial system. How should global standards for regulation of crypto assets be defined and implemented? As the supply of financial products and services is changing so fast, are financial authorities doing enough on the demand side through financial literacy and financial inclusion initiatives, in an increasing digitalised environment?

Panel 2: Welfare considerations beyond price stability (employment; output growth; income distribution; climate change)

Monetary and financial stability are key pillars of strong and sustainable growth. The distributional impacts of central bank actions have again become a key topic of debate. The inclusion of heterogeneity in New Keynesian models captures the influence on aggregate outcomes of individual differences within broad groups of economic agents.

- Monetary policy affects employment and wages in complex ways. The same monetary policy decision may have very differentiated impacts according to labour market status, educational level, skills, gender, age, household composition, income, and wealth. How does this heterogeneity affect the transmission of monetary policy? How do different indicators of labour 'slack' perform in capturing the interconnections between monetary policy and the labour market?

- Monetary policy choices – conventional or unconventional – affect income and wealth distributions, through channels like earnings in the labour market, net interest income, or asset prices. This may have unintended distributional effects across different labour market status and skills, between borrowers and creditors, between owners and non-owners, across different generations, and across different economic sectors. How do these distributional aspects affect the transmission of monetary policy?

- Monetary policy affects the probability of a crisis not only in the short term, through its usual effects on output and inflation, but also in the medium term, through its effects on savings and capital accumulation. From a welfare point of view, what is the right balance between inflation targeting, response to output fluctuations and systemic risk assessment?

- Climate change and biodiversity loss bring new challenges to monetary policy and the preservation of financial stability, with an impact on inflation, economic activity, financial institutions, and the functioning of the markets. How should central banks address the impact of climate change risks when designing monetary policy, in preserving financial stability, and in managing balance sheets?