REGULATORY UPDATE - TALLINN SEPTEMBER 2017
Policy note drafted by the Eurofi Secretariat

Challenges and conditions for a normalisation of EU monetary policy

1. Quantitative easing has contributed to a revival of bank credit in the euro area

Since June 2014, the ECB has introduced a range of unconventional measures, alongside conventional ones, in pursuit of its price stability objective. Together, these measures have proved effective in preventing a period of disinflation from spiralling into one of severe deflation.

The easing of financing conditions has contributed to a revival of bank credit in the Eurozone and has supported domestic demand. The non-standard measures of the ECB have been particularly effective in counteracting bank funding and financial fragmentation in some jurisdictions. Indeed, the ECB decisively contributed to the rapid setting of a lower and more homogeneous interest rate pattern in the Eurozone. In such a context, while the outstanding bank credit to non-financial enterprises was reduced from 2012 to 2015, there has been an upward movement since 2015.

In addition, low interest rates have significantly supported public debt refinancing which has contributed to short-run political and economic stability in some countries. Furthermore, the lasting low interest rate environment has provided additional space for accommodative fiscal policy.

The more positive outlook of the global economy as well as heavy acquisitions of bonds by Central Banks have resulted in sizeable gains on the equity markets. This is healthy as long as it is in line with the fundamentals of the real economy, but can become problematic if the economies overheat.

2. However, large scale monetary stimulus also comes with significant risks

Since loose monetary policy has stimulated risk-taking in financial markets, asset prices can quickly grow out of sync with real economic developments. This can create imbalances, which might become unsustainable once monetary conditions are normalized. Furthermore, market discipline could be weakened by the abundant availability of liquidity. This can distort the risk compass of investors, contribute to a misallocation of resources and dangers of a higher propensity of bubbles and episodes of financial instability.

Global indebtedness remains a major problem. The world economy has massively increased its leverage since the 2007-2008 crisis. Global debt – facilitated by easy monetary policy – has increased by 58 trillion $ from 2007 to 2015 (against an increase of 36 trillion from 2000 to 2007). This big debt overhang represents a risk to the stability of the system and a drag on long term growth.

The overall situation of financial markets therefore remains fragile:

- Long term interest rates are increasing;
- Equity valuations are high;
- Bonds are still very highly priced.

Over the past years, we have learnt that a monetary policy approach that takes a neutral view on the possible formation of asset price bubbles, instead focusing more on picking up the pieces after bubbles burst can be very costly. Therefore, in such an environment, monetary policy should not only focus on inflation but also target financial stability.

Moreover, inflation is also influenced by long term structural factors (e.g. oil prices, potential growth, supply constraints...). But it is not the primary job of monetary policymakers to repair the economy and bring about long-term growth. That is the job of parliaments and governments. Only governments can put the economy on a higher permanent growth path by implementing appropriate labour market, economic as well as social and tax policy reforms. The key is to find effective and synchronized policy synergies between the two.

3. How to move forward?

Normalization seems inevitable and is proceeding in the US. For a large part, normalization of interest rates is coming from the markets themselves. After the tapering off of an active quantitative monetary policy by the Fed in 2015, markets are normalizing. The prospect of more growth in the US, less unemployment and higher inflation can only encourage markets in this belief.

The normalization process should be different from a traditional cycle of interest rate hikes. Central banks currently have a very powerful presence in markets, owing to the implementation of unconventional policy tools. As a result, policymakers face the formidable challenge of designing a strategy for the withdrawal of the stimulus that does not unleash disruptive market movements.

Normalization raises a big issue in the Eurozone: the one of public debt and finance. Public debt remains very high at around 90% of GDP in the euro area. Some core countries of the euro area are still running substantial primary fiscal deficits. Therefore if and when monetary policy becomes less accommodative and interest rates rise, the cost of public financing of the Eurozone will feel strong pressure as well as a significant impact on budgetary outlays.

The time provided to European Governments by the massive fall in interest rates (that has reduced to a minimum the debt service burden of these States), has not been sufficiently used to start meaningful structural reforms that are needed to achieve the reduction of excessively high public expenditures and to revitalize the supply side. In essence, the ECB's understandable interventions in the government bond markets have parri passu weakened market pressure and discipline on governments.

Here is a paradox of European Monetary Policy:

- By easing financial costs it allows deficit countries to postpone structural reforms, buy time and borrow more...
- But this makes a change to "normal" monetary policy all the more problematic since the budgetary cost of tightening of monetary policy is significant.

This also raises the issue of the independence of Central Banks. Whilst they are, de facto, massively monetizing public debt (through public bond acquisitions programmes) they become, de facto, fiscal agents of Governments.

It is clear that the Eurozone CPI recent trend is an important factor. From close to 0 at the end of 2014, the European CPI reached 2% in the early part of 2017 (1,4% in May) ie closer to target.

Of course oil had played a major role in this upswing of CPI before it fell more recently therefore core inflation stands only at 0,9% by the end of April this year. In this regard, it is interesting to note that

the ECB is focusing now on the relative stability and moderation of core inflation. But when inflation was falling from 2011 to 2014, the ECB was then focusing on headline inflation, not core ….

4. Too much responsibility may have been put on the shoulders of Central Bankers over the years.

In the old days, Central Banks used to fight against inflation by raising short term interest rates and monitoring credit expansion. Today they have become quasi responsible for the whole outcome of economic cycles.

Their core mission is to ensure maximum growth over the cycle by forcing long term rates to fall, and remain low. This has enticed the ECB into hyperactive monetary policies. Such policies – whatever their short term advantages – can bear long term costs that could be very significant, notably concerning the stability of financial markets as well as on the profitability of the banking sector. The longer the period of exceptionally low rates, the stronger the impact on interest rate margins.

The time has come to overhaul such policies and to correct the mistaken view that money creation can, by itself, resolve structural economic problems which mcan only be addressed by structural reforms. Public debt will fall much faster if growth – boosted by such reforms – is higher than the present forecasts.

5. Setting aside ammunition for any future slowdown

If the world economy were to start decelerating (which is not likely given the relatively high rate of actual growth compared with potential growth), there would not be significant margins left to policy makers.

Budgetary solvency, weakened by very high debt ratios, could be threatened by the deceleration of growth or/and/ by higher interest rates.

As for monetary conditions, they are still pretty loose. Interest rates are presently lower than growth rates. Therefore the margins for further loosening of monetary policy are extremely limited.

Given the possibility of a slowdown of the advanced economies in the not too distant future, have policy makers sufficiently prepared for such a turnaround? Budgetary and monetary policies should normalize in good times in order to be able to provide countercyclical cushions when economic growth weakens.