The present monetary deadlock

JACQUES DE LAROSIÈRE - Honorary President, EUROFI
November 2019

I would like to present some thoughts on our monetary environment.

I will present my ideas around two themes:

1. Why is the very accommodative monetary policy of recent years now being debated?
2. What are the consequences for productive investment of the very low (or even negative) interest rates that prevail today, particularly in Europe?

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1. Why is monetary policy in recent years now being discussed?

It should be recalled that it was to fight the recession following the 2007-2008 financial crisis that Central Banks were called upon to loosen their policies.

The excessive indebtedness observed during the ten years preceding the crisis had weakened the financial system. When the subprime credit bubble burst in 2007, the whole system seized up:

- The asset bubbles burst;
- Companies with too much debt entered into difficulty and many of them had to ask their creditors to restructure their debt;
- Investors, worried about the fate of their assets, or in search of liquidity, began to sell in a failing market and prices plunged.
- Large banks with too much market risk exposure needed government support.

It was in this dramatic context that the Central Banks intervened as «financiers of last resort». They bought back the securities that could no longer be sold and provided massively the liquidity that was evanishing.

From this point of view, it can be said that the Emission Institutes have played a crucial role. They avoided the economic and social disaster that could have resulted from a seizure of the entire financial system.

But let us not forget that the origin of the crisis - namely the excessive indebtedness of economic agents - came from the lack of credit control by the monetary authorities and the asset bubbles that triggered the crisis. This lack of supervision has been a serious failure in the conduct of Central Banks policies. These have focused more on meeting the consumer price inflation target than on the stability of the financial system and the need to moderate the unbridled financialization of our world.

Central Banks therefore supported the economy by buying financial assets that could not be sold.

In fact, the balance sheets of the Emission Institutes have literally exploded (they have, on average, multiplied by 4).

But what is also important to note is that the Central Banks have also decided to embark on an «unconventional» policy of «quantitative easing» (QE) after the crisis.

Thus, the Fed launched three waves of QE in 2009, 2010 and 2013, i.e. a systematic policy of buying securities aimed at lowering interest rates throughout the yield curve. This led to a sharp rise in government securities and a deep decline in interest rates.

This Fed monetary policy influenced the whole world insofar as the fact that a Central Bank, which would not align itself with the Fed's policy would quickly have been sanctioned by the appreciation of its exchange rate, which would have immediately raised competitiveness problems.

These purchase programmes have had the dual characteristic of being massive (in the euro area, ECB purchases accounted for up to 60% of total public securities issues) and extended over a long period.

It is perhaps the duration of these programs that can be the most problematic.

While in the US, the Fed decided to stop the QE in 2017 until January 2019 (when the rate hike was interrupted), the ECB maintained its purchasing programme even though growth resumed in 2017-2018, and that, in my opinion, the rate policy should have been normalised when this extraordinary monetary ease was no longer justified.

It is necessary here to open a methodological parenthesis that I consider essential.

The Fed and other Central Banks decided about 30 years ago to set an inflation target. This target has been set at « just under 2% ».

But this figure of 2% (probably valid 20 years ago) no longer corresponds to today's reality.

Indeed, several structural factors are at work in the direction of reducing trend inflation. These include:

- The ageing of our societies (which consume and invest less);
- The opening of international trade to imports from countries with very low wage rates (China in particular);
- We can add the changes observed in our labour markets; as well as the productivity gains resulting from new technologies.

All these factors together explain why structural equilibrium inflation (the one that avoids deflation as well as hyperinflation) is now around 1% rather than 2%.

This is not a disadvantage, as prices continue to rise, and the spectre of deflation is not to be feared. This provides even greater support for purchasing power.

But setting the inflation target at 2% (compared to a more realistic figure of 1 to 1.5%) has led to an expansionary drift in monetary policy. Wanting, at any cost, to raise inflation to 2% through monetary policy has, in fact, had very damaging consequences.

Indeed, such a policy, if it is too long in time, leads to a weakening of the financial system.

Let us analyse the weaknesses promoted by this so-called «unconventional»; policy:

1. It encourages indebtedness (which had been the cause of the previous crisis). It should be noted that overall debt (of non-financial agents) since the 2008 crisis has increased by 50% up to $ 200 000 billion (i.e. 230% of world GDP);
2. It can generate asset bubbles: this is notably the case for equities whose high valuations have followed the QE episodes;
3. Interest rates lose part of their role as a signal of quality and discrimination between signatories. Risks are not reflected in spreads;

4. It weakens the banking system by eroding their interest margin. However, it is the banking system that constitutes the essential transmission belt of monetary policy; the negative rates charged by the ECB on banks' reserves at the Central Bank encourage them, at the limit, to pass on this tax to depositors;

5. It poses a solvency problem for insurance companies, pension funds and pension institutions.

   Faced with long-term commitments - sometimes contractualized in guaranteed returns - safe bond assets no longer yield anything. This is a source of weakness that insurance companies must manage by increasing their equity, diversifying their investments into less liquid and more risky assets or adapting their business models to sectors other than finance (health or personal insurance).

   However, the combination of Solvency 2 - which is indifferent to the desirable adequacy between Assets and Liabilities in terms of duration - and the decline in yields on bond assets is a problem for insurers.

6. It promotes the sustainability of zombie companies which, because of zero rates, can continue to survive and therefore slow the growth of market share of innovative companies;

7. It accustoms States not to consider the reform of their public finances as a priority;

8. It encourages investors to seek more remunerative returns («search for yield»;) and therefore to make riskier investments.

   In this respect, the warning given recently by the IMF should be taken seriously: the world economy is vulnerable to a downturn. Central Banks have facilitated short-term debt, but at the cost of a weakening of the financial system. Non-bank organizations, such as pension funds or investment funds which are increasingly investing in unlisted shares, BBB debt, or Collateralized Loan Obligations (CLOs) -are likely to suffer major setbacks the day when some over-exposed companies will have difficulty refinancing their debt. We're starting to wonder:

   «Are the current dividends (which have, in a way, replaced interest in terms of return on savings) sustainable?»

   From this point of view, it can be observed that dividend coverage has decreased significantly (from 3 in 2010 to 2. 3 in 2018), which means that profits are only 2. 3 times higher than the dividends distributed. This ratio collapses in the event of a recession.

9. The importance of negative-rate bond issues is a warning signal.

   About $17 trillion (17,000 billion) of bonds (government and corporate) now have negative rates (20% of world GDP) according to BIS figures.

   This increase in negative rates has accelerated since the beginning of 2019. It results in a significant increase in the value of the assets in question. This bubble coexists with the markets'; belief - maintained by the Central Banks - that low rates are there for the long term.

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II. But, at least, has this very accommodating monetary policy encouraged productive investment and growth?

It is sometimes believed that a non-conventional monetary policy with zero interest rates is conducive to a recovery in investment, since, by definition, financial conditions are easing.

Let's take a closer look.

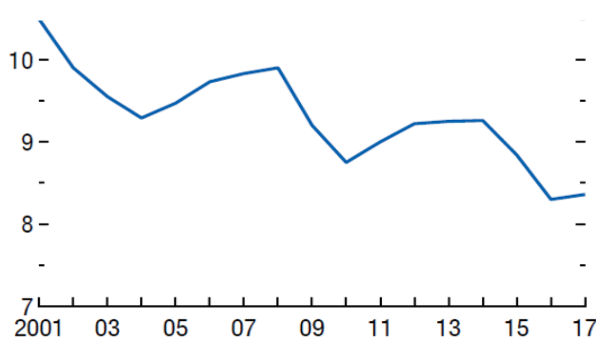
1) First, how has the overall investment performance been in recent years?

The investment trend has been disappointing. It can be characterized as follows:

- The level of gross non-residential investment in advanced countries as a percentage of GDP has declined significantly (from 10. 5% of GDP in 2001 to 8. 5% recently) (see graph 1);
- Fixed capital growth remains low;
- Growth in intangible investments (which contribute to productivity gains) hovers around 3-4% annually, which is significantly lower than in the early 2000s (around 6%).

Overall, the contribution of the capital stock to potential growth remains historically low despite very low interest rates over the past ten years (see Chart 2 below).

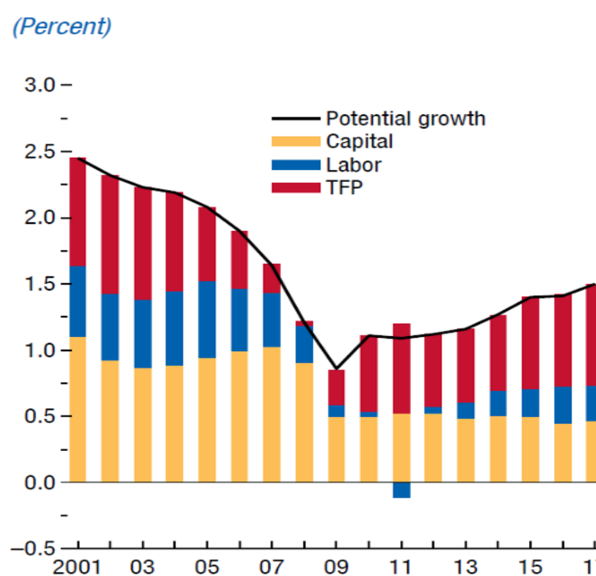
GRAPH 1 Decline in the level of non-residential investment as a % of GDP



Source: IMF staff calculations.

Note: Advanced economies = Australia, Canada, France, Germany; Italy, Japan, Korea, Spain, United Kingdom, United States.
[1] Gross fixed capital formation data are used for Japan and Korea.

GRAPH 2 Contributions to potential growth: capital share remains low



Source: IMF staff calculations.

Note: Advanced economies = Australia, Canada, France, Germany; Italy, Japan, Spain, United Kingdom, United States; TFP = total factor productivity

2) Some empirical observations.

Statistics show that periods of investment growth have always been accompanied by positive real interest rates.

Thus, we observe that the real interest rate generated by a 10-year US Treasury Bond averaged +3. 6% per year from 1990 to 2000 (a rather favourable period in terms of investment), while from 2000 to 2019 (a period when investment performed very poorly) the real interest rate was on average +1. 2%.

If we look at them over a long period of time, these correlations are very strong: thus the 19th century was a period when investment, which was very dynamic, was remunerated, on average, at nearly 5% in real terms. Even if these correlations are not evidence, they have a consistency and robustness that cannot be dismissed out of hand.

What has happened to explain this decline in interest rates over the past several decades?

The phenomenon of the secular slowdown is often mentioned: ageing societies have less productivity gains, they consume and invest less: the result is less pressure on available resources and lower inflation.

It is also argued that the «savings glut» (i.e. structural current account surpluses in some creditor countries), amplify global liquidity and result in accumulations of reserves in those countries that fight against an appreciation of their exchange rate, through dollar purchases, in order to maintain their competitiveness.

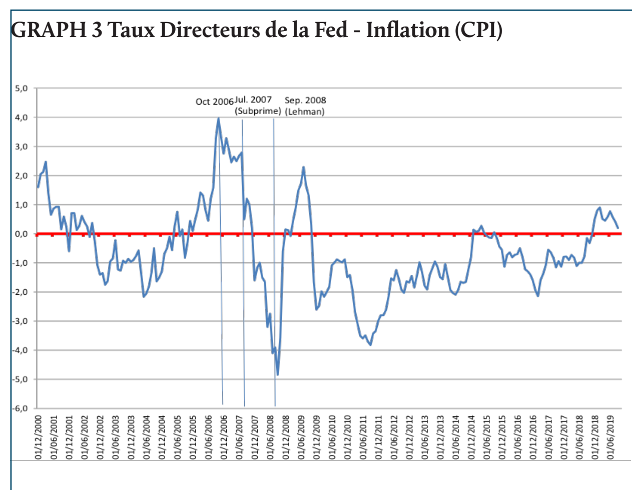
These phenomena have undoubtedly contributed to the downward trend in world interest rates.

But let us not forget that another determining factor is the monetary policy that has been in place for the past 20 years.

The Fed has systematically implemented a policy of negative real interest rates (Fed funds) since the early 2000s.

Over the 18-year period (2002 to 2019), with the exception of 2006-2008 and 2018, **the Fed's key rates in real terms (less consumer price inflation) were negative for 15 years.** This has contributed to the rise in global debt and the crisis. (See graph 3 below).

GRAPH 3 Taux Directeurs de la Fed - Inflation (CPI)



Source : Bloomberg

However, as we know, the Fed's policy has an impact on the rest of the world (if only because of the fear of countries that would like a more conventional policy to see their currencies appreciate against the dollar).

3) Let us now turn to economic reflection, which can shed light on the relationship: zero rate/ investment.

Several factors must be analyzed.

It is undeniable that the fall in rates favours debtors: governments, companies, individuals. The debt of these agents becomes less heavy in terms of interest charges. Thus, we are witnessing a transfer of income from savers to debtors and from safe bonds to risker equities securities. In Europe this has significant distributional wealth and income effects increasing inequality.

But does this improvement in the situation of debtor agents translate into an incentive to take on more debt? To a large extent, yes: public and private debt has increased steadily since the 2008 crisis. The rise in the indebtedness of governments and non-financial corporations has been considerable; similarly, household indebtedness and the housing bubble it causes are significant. Overall, global debt has increased by 50% since the crisis.

But what about productive investment?

This is where the «liquidity trap»; comes in.

« The liquidity trap »

When rates approach zero, it is difficult for a Central Bank to go lower. This is called the «zero lower bound». In fact, the ECB does apply a negative rate of 0.50% on reserves held with it by commercial banks. But it is difficult to go much further. Indeed, the profitability of the banking sector is directly affected by the existence of this «tax» on their reserves (reserves imposed, moreover, largely by regulation).

If the ECB were to lower significantly the negative rates, banks would eventually be forced to pass this tax on to customers'; deposits. Such a tax (already partially applied to large deposits in countries such as Germany, Switzerland and Denmark) would have the disadvantage, in addition to its unpopularity, of reducing household consumption capacities, which would run counter to the authorities'; desire to stimulate domestic demand[1].

The «unconventional»; policy response to this difficulty is as follows: to further lower real rates and escape the zero-floor constraint, the only solution would force inflation to rise through a systematic monetary expansion (QE) policy.

But there is still a difficulty: if the recovery in inflation and demand proves to be unwilling (which is the case for reasons of concern for the future: fear of a recession due to the trade war, structural factors slowing growth - already mentioned -, preference for liquidity[2]. . . which weigh down on the inflation rate), then we do not see where this desired recovery in demand could come from.

The reasoning becomes circular: not enough inflation, so more QE, but if that is not enough to trigger inflation, what should we do? This is where once starts talking about «helicopter money»; that would allow individuals to be credited directly in Central Bank currency with the hope - which is uncertain - that these allowances would be consumed.

The core problem of current monetary policy is the preference for liquidity. Since investment by purchase of securities is taxed, investors tend to forgo illusory remuneration and retain liquid instruments that, at least, are not affected by the application of negative rates.

In the traditional investor trade-off between return, risk and liquidity, the notion of return loses its importance with low rates. The arbitrage is now only between liquidity and risk.

As can be seen in Chart 4, the decline in government bond interest rates was accompanied by a very sharp increase in the share of liquid assets in the financial assets of economic agents[3]. But such a preference for liquidity (Keynes' «haunting») diverts savers away from long-term investment. The risk here is the proliferation of

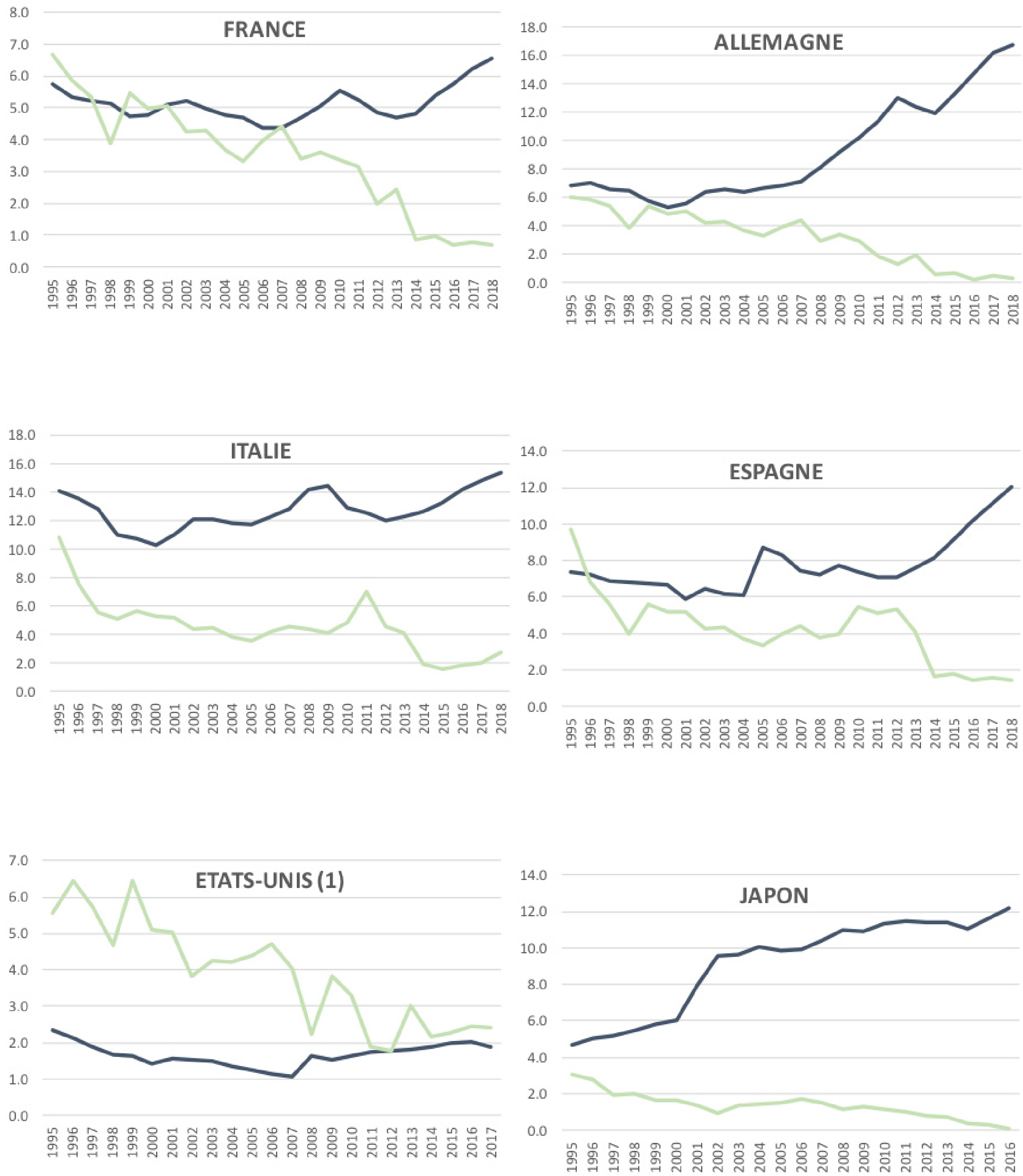
[1] See Steven Pressman: « How low can we go? The limits of monetary policy » - Elgar Online April 2019.

[2] The preference for liquidity: note the rise in Livret A passbooks, which are approaching the record level of 300 billion euros (15 billion euros more since the beginning of 2019. The outstanding amount has increased by 50% in eight years!).

[3] The liquid share of financial assets held by all economic agents increased from 7 to 16% in Germany (1999 to 2017), Spain from 7.5 to 12%, Japan from 5 to 12%, and France from 5.8 to 7%. Source: Eurostat, Thomson Reuters, OEE.

GRAPH 4 As interest rates fall, portfolios become more liquid

Evolution of the liquid assets of economic agents and interest rates on government bonds



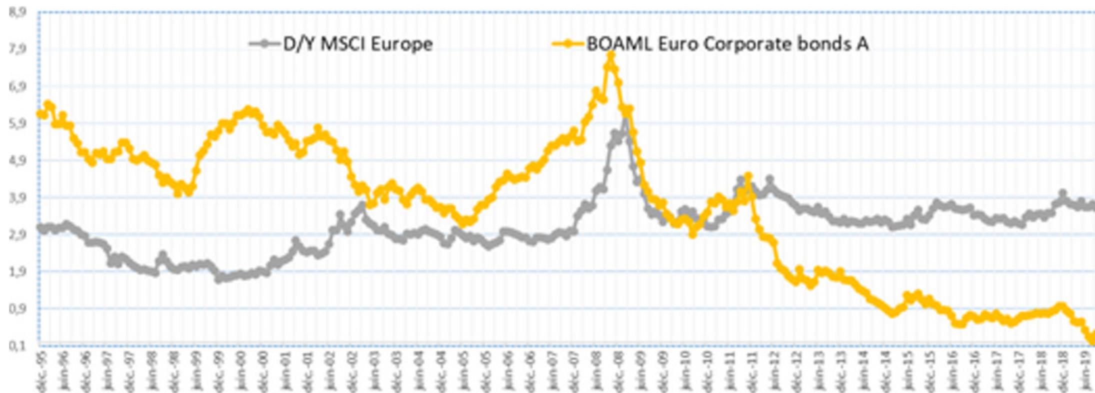
(1) For the United States, this refers only to assets held in the form of currency, as the distinction between transferable and non-transferable deposits is not available.
Sources : Eurostat, Thomson Reuters, OEE calculations (European Savings Observatory).

4) The market response is risky

When there is a craze for so-called «risk-free»; assets, the price of these assets rises while their interest rates fall. At the same time, returns on equities remain high (see graph 5 below). For the first time since 1993, dividends significantly exceed interest received on debt.

GRAPH 5 Returns on equities and government bonds

Evolution historique depuis 1995 du rendement des actions de l'indice MSCI EUROPE et des obligations Euro corporate Rating A de l'indice Bank of America Merrill Lynch Euro corporate A



The low interest rate policy has favoured dividends over returns on government bonds:

- *Dividend yield MSCI Europe = 3.62% on 30.09.2019 (Source MSCI)*
- *Average yield on ICE BofA Merrill Lynch Euro Corporate Rating bonds A = 0.22% on 30.09.2019 (Source ICE BAML)*

The risk here is the proliferation of asset bubbles: in equities, bonds, consumer credit, the purchase of real estate financed by very low-interest debt, not to mention «zombie» companies that continue to survive thanks to zero interest rates, but penalize the most innovative firms by maintaining their market share.

This search for returns at all costs results in a deterioration in the quality of financial assets.

Thus, bonds rated BBB (one notch above junk bonds) now represent more than 50% of the total outstanding amount of investment grade bonds, which is a perilous record.

The debt issued by non-financial corporations has massively increased since the 2008 crisis.

This explosion in non-financial corporate debt is the result of the monetary policy pursued in recent years, which has kept interest rates at historically low levels.

This debt is largely in the form of collateralized loan obligations (CLOs), which are popular with investors around the world seeking returns (particularly Japanese banks).

The coming recession and the fate of many companies with excessive credit risk exposure will be at stake.

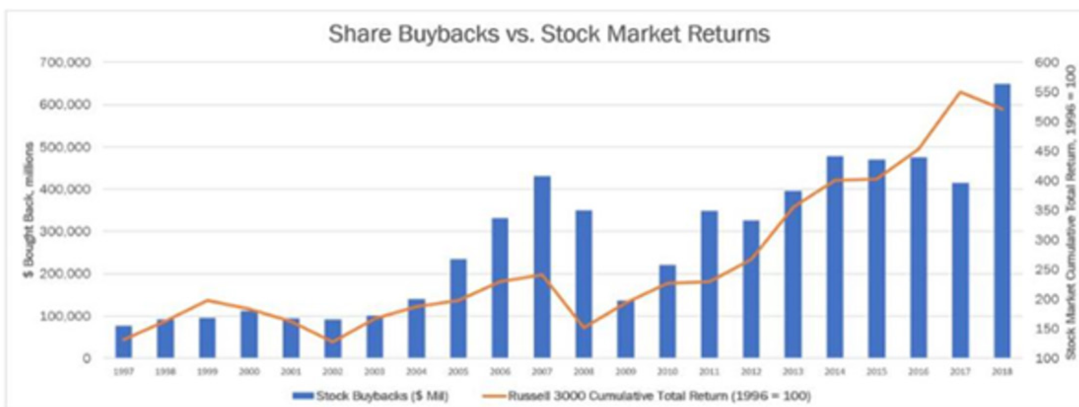
The risk is well known: it is the 2007-2008 risk of an increase in the number of bubbles that eventually burst, and the financial crisis that comes after the «Minsky moment».

In fact, continuing the practice of zero interest rates for too long encourages, as we have seen, speculation on risky assets («search for yield»;), crushing risk premiums, and causing financial bubbles to form. This diverts investors away from the «real» long-term projects - which are essential, however - while making the financial system more vulnerable.

Between engaging in a risky project with a risk premium of around 7% or buying back shares with a 0% credit, the temptation for a company is great to choose the second solution. This is, moreover, what we are seeing on a large scale today (see Figure 6 below).

And it is at the very moment when governments are telling us that financing the energy transition is essential. . .

GRAPH 6 Low interest rates encourage share buybacks



Source: Bloomberg, share buybacks, equity data contained in the Russell 3000 Index (excluding financial institutions)

In conclusion, we must understand the current monetary dilemma. By pursuing an inflation target of 2%, which is proving unattainable for the structural reasons already mentioned (ageing, globalisation, changes in the functioning of the labour market, technological progress, etc.), central banks are anchoring in the minds of the markets the idea that interest rates will remain low for an indefinite period.

This expectation of low rates for very long has a «depressing» effect: economic agents conclude that the growth horizon will be closed for a long time and therefore refrain from undertaking. We are in a situation where the inverted yield curve (long-term rates lower than short-term rates) is less the result of a feared cyclical slowdown than the realization by the public that central banks no longer believe in growth since they are entering an indefinite phase of low rates, as a result of their inability to reach 2% inflation.

Setting an unattainable goal has a real psychological cost. Positioning the target closer to equilibrium inflation (around 1 to 1. 5%) would lead to a monetary policy that is less systematically expansive and less likely to generate pessimistic, self-realising expectations.

Whatever the arguments presented by the proponents of non-conventional policy, there is no objective evidence that zero rates generate growth and investment.

All things considered, it is clear that the rapid deterioration of the financial environment which we are witnessing by the day cannot last for a long time. And when the crisis comes, there will be no monetary margins for maneuvering. The irony is that the taxpayer will then be call upon for financing fiscal laxity!

Central banks cannot do everything. They have been overstretched and their monetary independence has been blurred by fiscal compromise. Time has come to recognize the deadlock in which we are, especially in Europe. It has become clear, at last!, that structural reforms cannot be implemented by money creation.

It is now imperative to start moving: desacralizing the 2% inflation target and preparing new rules of the game that would be implemented gradually and cautiously. This would stabilize monetary anxieties and avoid falling in an endless financing hole that can only maim business and consumer confidence. In parallel, one has to open a true discussion on international exchange rates consistency. The absence of any form of an international monetary system today can only encouraging trade and currency wars. We need a minimum of international discipline. ■