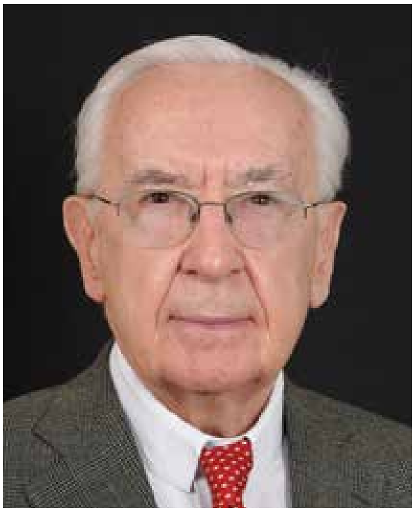
Is current monetary policy doing more harm than good and are there alternatives?



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Negative interest rates cannot save indebted economies

Can interest rates be eliminated to avoid servicing monumental debts? The Covid-19 crisis, exacerbated by the consequences of having hyper-accommodative monetary policy for too long, has led to entire economies becoming over-indebted.

To deal with this situation where public leverage has broken all peacetime records, some advocate monetising the debt through central bank purchases of new bond issues and negative interest rates. This is despite the historical record which shows that debt restructurings have proven to be the most effective way to address unsustainable debts.

In the context of economic depression, low inflation and interest rates already at zero, central banks of course cannot achieve negative real interest rates. So, instead, they may want to retrieve some margin by deliberately setting negative rates. Monetary policy would then regain its traditional driving role, as it would be able to recreate negative real rates, despite a lack of inflation.

Proponents of this approach have anticipated some of the objections.

First, the liquidity trap. When rates are negative, investors tend to shun bonds to avoid the "tax" caused by negative rates. One result of this is an accumulation of savings, held in liquid assets such as banknotes or cash accounts. But these barely help foster productive investment.

Proponents of negative interest rates argue that the response to this problem is to eliminate large denomination banknotes and ensure that banks pass on the full cost of negative rates to their depositors. But should depositors be taxed and made to pay most of the cost of emerging from this crisis? That would create major economic and political problems in a country like France, where household savings historically finance about 85 per cent of national investment.

Then there is the risk of inflation. In the long run, any anti-recessionary monetary policy must eliminate the difference between potential growth and currently depressed growth rates through money creation. The risk of inflation is nonetheless considered unlikely given the scale of the Covid-19 crisis, the slow recovery, and structural forces such as ageing, unemployment and technological progress. Even if inflation does return, there will still be time to turn the tide and return to more traditional monetary policy.

Surprisingly, such proposals — which are designed to eliminate an economic fundamental, namely the price or cost of saving — fail to consider an essential question: the value of money. Money is based solely on trust. But the risk of losing that trust will loom if those responsible for it resign themselves to a role that leaves them as suppliers of an unlimited commodity rather than as vigilant guardians of its stability.

Moreover, the moral hazard of a system where indebtedness can be permanent and infinite, regardless of debtors' credit quality, poses serious moral and political problems as it nationalises risk and responsibility.

Negative rates also damage productive investment. They encourage companies to take on cheap debt to pay for share buybacks instead of investment; allow zombie companies to survive, lowering overall productivity; encourage asset bubbles; obliterate the distinction between profitable and unprofitable activities; and make little or no distinction between good or poor-quality debtors.

An economy where interest rates remain negative for decades will not inspire confidence in entrepreneurs. Paradoxically, it will create more precautionary savings. The monetisation of government debt — most of which will end up on central bank balance sheets — will also lead to creeping economic nationalisation and crowd out profitable economic activity.

Everyone knows how excessive debt can lead to crisis. We have paid the price of this causality for decades. And yet negative interest rates open the credit floodgates to both governments and the private sector. They are a source of financial instability and help to create asset bubbles.

A more reasoned policy response to over-indebtedness is clear. Undertake, where necessary, debt restructurings with a co-operative spirit and a sense of market priorities. Scrutinise public budgets and prioritise certain future expenditures, such as education, health and research.

Last, undertake the structural reforms that have been postponed for too long but are the only measures that can deliver a sound, sustainable and better future.

Boris Vujčić

Governor, Croatian National Bank

Hand that rocks the cradle: limits of unconventional monetary policy

A debate on side effects of unconventional monetary policies has gained a lot of traction over the past decade. Issues like governance of central banks or interaction of monetary policy with income and wealth inequality made their way into the mainstream. And then central banks reacted to the Covid-19 crisis with unprecedented speed, scale and scope. As recovery gradually advances, there will be ample time to contemplate potential effects and possible adjustments to the monetary policy. With no ambition to exhaust the topic, I will raise only a few points on overreliance on unconventional monetary policy.

First of all, we should not forget that monetary policy alone is far from sufficient to lift growth and inflation. Low interest rates are a real phenomenon rather than simply a reflection of monetary conditions. The "natural interest rate" has been on a declining trend for at least a few decades due to the combination of secular and cyclical factors. This trend has coincided with a slowdown in productivity and with falling investment levels. Adjusting dials on monetary policy instruments to reflect this underlying economic reality will not resolve the dearth of investment opportunities. Fostering perception that unconventional monetary policies will simply take away the savings glut is risking inaction on more relevant policy-front.

The real issues for economic policy are how to improve business environment, remove structural impediments for investments, foster competition, boost investments in R&D and encourage new businesses to start and grow. Long period of exceptionally loose monetary policy may provide a headwind as it softens the debt sustainability constraints and can reduce both government and corporate dynamism, capturing economic resources in inefficient uses. In communism something like that was called soft budget constraint, and the central bank was in charge of enabling it.

Excessive reliance on unconventional monetary policies may divert attention from needed policies.

The impact of unconventional policies on financial system is another popular topic. We rely on a healthy financial system in order to pass-on our monetary policy actions to the wider economy, and the financial system relies on maturity transformation with upward sloping yield curve to function properly. Sure, loose monetary policy is supporting banks' loan books and banks can improve on their cost effectiveness in order to dampen the effects of low interest rates. However, as we push our unconventional policies further, we may be nearing the "reversal rate" where damaging effect of persistently low interest rates and flattened yield curve overwhelms their positive effects.

Finally, one way in which unconventional monetary policy operates is the risk-taking channel. Encouraging "search for yield" type of behaviour should support investments. But it is also fuelling asset price rally and a boom in real estate markets. In theory, macroprudential policy should deal with growing imbalances and excesses in the financial markets. In practice, our macroprudential toolkit still lacks instruments to cover non-bank intermediaries in a comprehensive manner and cross-border activities may circumvent even the best policies. Also, significantly stepping-up macroprudential policies may exacerbate legitimacy issues. Monetary policy should not shun the financial stability concerns.

Monetary policy is like most medicines – it can speed-up recovery, but it is up to the immune system to restore health to its normal state. Undesired side effects expand if the medicine is administered for longer periods and if the dosage is increased. The primary goal for our economic policies should be to foster creation of profitable business opportunities, inject more dynamism and increase long-term growth potential. Excessive reliance on unconventional monetary policies may divert attention from needed policies and even work in the opposite direction – reduce government and corporate dynamism by creating the soft budget constraint and permeate our financial systems with risks.

Klaas Knot

President, De Nederlandsche Bank

New sails for new waters: towards a Covid-19 recovery policy mix

The Covid-19 crisis that has hit the economy poses unprecedented policy challenges for both economic policy authorities. The euro area economy is experiencing the worst recession since its inception. In response monetary, prudential and fiscal policy authorities have stepped in rapidly to help the economy establish a foothold as it went into lockdown. The ECB responded forcefully by employing a multitude of instruments including the new Pandemic Emergency Purchasing Program, while prudential authorities released capital buffers. Fiscal authorities responded swiftly with major stimulus packages by supporting workers and companies facing a sudden stop of economic activity.

Now that we have moved past the impact phase of the shock, we can shift our attention toward the recovery phase. Recently, forward-looking confidence indicators look robust, while high frequency data suggest that mobility is recovering. These developments solidify the confidence in our baseline projection with a more favorable balance-of-risks. However, even if no further setbacks materialize economic activity will only approach pre-corona levels at the end of 2022. It is therefore clear that ample policy support to the economy will remain important also during the recovery phase.

At the same time, we will only learn more about the underlying state of our economy as the recovery unfolds. What we do know is that the observed increase in private sector savings as a consequence of crisis-induced uncertainty provides a strong rationale and leeway for the public sector to increase spending to lean-against the increased propensity to save. Over the medium to longer-term horizon, dissipating uncertainty will invoke a resumption of private sector activity which will allow fiscal support to be gradually withdrawn. At the same time, we have learnt that there are significant benefits to ensuring that fiscal policy moves consistently with monetary policy. Looking ahead, the extent to which the impact on the economy will materialize as a demand versus a supply shock is still unknown. While we are fairly confident that in the near-term increased uncertainty implies a strong withdrawal of aggregate demand, in the medium to longer-run negative supply effects may very well gain relevance as businesses adjust their production processes to the new environment. Since the latter would be associated with upward price pressures, this impacts on the intensity with which monetary policy can continue to support the economy.

Relying too heavily on monetary policy to get the job done might have contributed to perceptions of a “central bank put” in the recovery from the euro area debt crisis, where the ECB bore all of the downside risk to the economy. More generally, an important element was missing in the policy mix. Monetary policy can be successful in eliminating slack in an economy, and, indeed, euro area labor markets saw a strong recovery. But without sufficient sustainable (public and private) productive investment to put the economy onto a permanently higher growth path, it is difficult for sustainable growth to take hold.

These observations imply that the policy mix will continuously have to be adjusted in terms of composition, based on our evolving assessment of the economic outlook. A broad and encompassing policy response is important to ensure that we don't rely overly on individual measures or policy areas that could be subject to unintended side effects if they are kept in place for too long.

It is in this light that I particularly welcome the establishment of the European Recovery Fund that has been agreed upon by the European Council. It is vital that, contrary to previous crisis episodes, in the wake of this crisis productive investment does not get crowded out by the immediate need for countercyclical stabilization policies. Furthermore, the recovery fund provides an important political signal that we do not stop short at only stabilizing our economies, but also take the opportunity to address common longer-term structural challenges that enable us to sail through future storms smoother.

Madis Müller

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Evergreen temporary policy measures may pose hidden risks

History has shown that the next crisis may hit us before policy makers have exited from the stimulus measures applied during the previous emergency. The limits of monetary policy have been significantly extended in recent years both by introducing new policy tools, as well as by going beyond what has previously been the norm with traditional instruments, such as lowering the interest rates.

Most of the non-standard measures applied during the last decade have been initially proposed as temporary measures to address a very rapid fall in activity. As the economic outlook and the conditions in the financial markets have not improved significantly, the extensive policy support has become long lasting. By introducing temporary policy measures, we understandably focus on their expected short-term positive impact. Given their intended short-lived use, there is less of a need to worry about their long-term effects, which in any case are also more difficult to foresee. Decisive action by central banks has worked well by easing the financing conditions at times where markets where freezing up or by supporting the gradual recovery. Nevertheless, we should refrain from viewing the very accommodative policy stance as the new standard just because it has been around for long.

An important innovation during the last crisis was the ability to utilize the extra policy space provided by negative rates. Following the conventional logic of banking, negative rates might trigger dramatic changes in business models. The fact that negative rates would be introduced only for a limited time was expected to mitigate this risk. Now that ultra-low rates have been around for longer than initially expected, we need to study the impact this might have on the term structure of interest rates, business models in the financial sector, or changes in the real economy.

When temporary measures last longer, they may bring about structural changes that are not the expected outcome of the policy. Structural shifts in the financial sector caused by the prolonged accommodative policy stance can be viewed as unintended side effects of monetary policy. While change is natural and there might be nothing wrong with the financial sector adjusting to new policies, there may also be changes that weaken policy transmission.

> *A timely exit from temporary emergency measures is just as important as decisive policy action during the acute phase of a crisis.*

Asset purchases by central banks have led to flatter yield curves and lessened the turbulence in financial markets. But there is also the risk that central bank interventions may weaken the role of markets in adequately pricing the credit risk. This in turn may hold back favourable structural changes in the private sector and necessary reforms in the public sector, both leading to lower productivity. "You cannot fix the roof when the house is on fire" and similar considerations are valid during the days of an acute crisis.

However, one should be careful not to plant the seeds for the next crisis by allowing short-term relief provided by policy measures to continue for too long. We know that debt levels and asset prices tend to become elevated, as interest rates remain low for a long period. High levels of debt in turn can limit the upper bound of policy rates, since financial and political stability concerns may emerge.

A timely exit from temporary emergency measures as the economic outlook gradually improves is just as important as decisive policy action during the acute phase of a crisis. This will minimize the risk of undesirable side effects of accommodative monetary policy kept in place for longer than strictly necessary. Other factors can facilitate a timely exit from non-standard policy measures. For example, a fully functional Capital Markets Union can contribute to a more efficient transmission of the monetary policy. In addition, a regulatory environment that encourages the creation and use of financial buffers in the real, financial and the public sector may improve the resilience of the economy and reduce the need for policy support.

Jordi Gual

Chairman, CaixaBank

The specter of fiscal dominance

The struggle to contain the epidemic has immersed the global economy in a recession of unprecedented scale. The response needs to be bold, everywhere and by everyone. Everywhere because there is a need for a synchronized recovery –otherwise, weak external demand will lead to a slower and incomplete rebound. And by everyone because all policymakers, both monetary and fiscal, need to act forcefully.

There is little doubt that they have risen to the challenge. Monetary policy has done what was necessary thus far. In the eurozone, the ECB has not only supported the economy but also –and crucially– preserved an effective policy transmission and swiftly placated any signs of financial fragmentation. On the fiscal front, the response has also been commensurate to the crisis. In the European Union, not only at a national level but also at the Union level with the agreement on the Next Generation European Union (NGEU) package. A consequence of this necessary fiscal boldness, however, will be a staggering increase in public debt levels. This is not without risks.

An easy monetary policy and a fiscal expansion will reinforce each other and make the overall response more effective and efficient. Policy coordination, however, must be the result of independent institutions acting within their respective mandates. This is a fundamental cornerstone of every prosperous economy and cannot be taken for granted. It could easily be compromised by the simple fact that every monetary policy action has fiscal consequences, more so in the age of quantitative easing.

High budget deficits and public debt levels raise the specter of fiscal dominance, especially if the central bank holds a significant portion of domestic public debt on its balance sheet. Under these conditions, there is a serious risk that the decisions of a central bank end up geared toward guaranteeing the sustainability of public debt rather than achieving a certain level of inflation. Fiscal authorities may also take advantage of this bias and delay the necessary fiscal adjustments when economic conditions improve.

The coordination problem is even more complex in the case of several sovereigns sharing a central bank, such as in the euro area. A robust institutional architecture is absolutely key to surmount these challenges anywhere but even more in a monetary union that remains incomplete and where fiscal rules do not have a successful implementation track record.

This is why NGEU –funded by common debt issuance and including grants– is a very welcome step. With its €750bn firepower, it will meaningfully add to macroeconomic stabilization efforts, easing an excessive reliance on monetary policy, and can spur reforms and investments that increase potential economic growth. The issuance of EU debt in large quantities will also enable the creation of a European safe asset that increases the effectiveness of monetary policy, improves financial integration and mitigates the bank-sovereign doom loop.

But more will need to be done. For instance, European fiscal rules need to be reviewed with a view to simplifying them, moving away from the use of imprecise estimates of unobservables like the output gap. Instead, simple spending rules may be easier to monitor and implement. The Banking and Capital Market Unions also need to be finalized.

Robust institutions are key to allow fiscal and monetary policies to work hand in hand when their joint action is needed. But also, to allow them to part ways when the time comes to do so.

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Low interest rates: What should policymakers do?

Interest rates have been at historically low levels for many years and are widely expected to stay low for some time. Low interest rates drive down returns on new and re-investments and this can have some major negative impacts on insurers and also on their customers.

For customers, low rates mean higher non-life insurance prices, lower guarantees, fewer long-term savings and — potentially most damagingly — lower pensions when they retire. For insurers, in addition to lower returns on investments, low interest rates can significantly increase the valuation of liabilities and capital requirements and make it more difficult to offer long-term products and guarantees, particularly in respect of long-term business and investments, which tend to exaggerate liabilities and capital requirements. Very low and especially negative interest rates amplify these measurement problems.

Insurers have been taking actions and adapting for many years in response to low rates and this has helped them to remain strong and profitable. Actions taken include looking hard for investments (such as infrastructure) that can provide a reasonable trade-off between risks and returns, even under current market conditions. On the liability side, companies have adjusted prices and lowered guarantees on new business in line with the lower returns available. In some cases, products have been redesigned, costs cut and there has been a shift towards unit-linked business. And, of course, asset/liability matching and hedging remain key tools that are used to manage interest rate risk.

So, what should policymakers do? Firstly, in setting monetary policy, they need to consider, along with the potential benefits, the wider and negative impacts of low interest rates on long-term consumer savings and pensions. While, the need for low interest rates following the global financial crisis and now the COVID-19 pandemic is well understood, the monetary policy behind the low rates should be continually reviewed and planned with an exit strategy in mind.

Secondly, policymakers should make use of the current review of the Solvency II insurance regulatory framework to address measurement flaws that can create important barriers to long-term business and investment. Some of these flaws are amplified by the low interest rate environment. Addressing these is especially important, given the need to encourage insurers to contribute to supporting the recovery from COVID-19, to supporting sustainable long-term growth and financing transformation to net zero carbon and to tackling the pension savings gap — rather than preventing them from doing so.

There are two main improvements needed related to the valuation of liabilities. One is the Volatility Adjustment which is intended to reflect the additional return above the risk-free rate insurers can earn on the assets backing liabilities in order to avoid artificial volatility in the balance sheet. This is currently designed and calibrated unnecessarily low and also results in too much artificial volatility in insurers' balance sheets. The other is the Risk Margin which is a notional amount above the amount actually needed to pay all costs and claims and is added to make liabilities transferable in a market context. However, in 2019 it reduced European insurers' total capital by over €180bn and is another source of artificial volatility. These two issues unnecessarily reduce the industry's capacity for and interest in long-term products and investments.

> *Policymakers should make use of the current review of the Solvency II insurance regulatory framework to address measurement flaws.*

Changes in interest rates, including if they go negative, are already immediately reflected in the valuation of insurers' assets and liabilities. The interest rate methodology used in Solvency II as part of liability valuations is already conservative enough and should not be changed. For example, the euro risk-free rates in Q1 2020 were -0.12%, 0.12% and 1.49% for years 10, 20 and 40 respectively. The current solvency capital requirement (SCR) to cover the risk that interest rates go even lower needs some change because it does not currently allow for negative rates. However, care must be taken in setting an appropriate and plausible "floor" on how negative interest rates can go.

Low interest rates are already a challenge for insurers and customers. Policymakers should use the Solvency II review to fix measurement flaws and so help insurers play their role in protecting and investing.

Alexandra Dimitrijevic

Global Head of Research, S&P Global Ratings

Post-Covid-19 productivity growth is paramount to cope with higher debt

The extraordinary monetary policy response to the Covid-19 crisis has bought time. It averted a liquidity crunch by sustaining the supply of credit and keeping debt markets open. Combined with a massive fiscal response, monetary policy helped preserve economic capital and social cohesion. Illustrating this, investment-grade bond issuance in Europe increased about 180% since the ECB created PEPP, the region's unemployment rate barely increased, and the 12-month speculative-grade corporate default rate rose only slightly to 3.2% in July. Even so, this is nothing like a normal recession. No central bank nor government can fully control the virus's evolution nor when a vaccine will become available. The necessary opening of monetary and fiscal spigots has elevated global leverage to new highs.

This follows a decade of steady increases, weighing further on corporate and government creditworthiness. Global debt reached a record high of 331% of GDP at end-March, up from 320% in 2019 and 200% in 2011 according to the IIF, driven largely by governments and corporates. The GDP-weighted median rating of EU countries weakened from 'AA+' to 'AA-' as the financial crisis snowballed into the Great Recession and sovereign debt crisis.

As for corporates, low interest rates in the past decade have enabled those with weaker credit profiles to access capital markets. As a result, we entered today's crisis with 11% of European non-financial corporate ratings at 'B-' and below, indicating high vulnerability to economic and financial cycles. Most additional COVID-19-related public debt globally has been incurred by countries with wealthy economies, monetary and fiscal flexibility and reserve currency status (G7 countries account for about two-thirds of global direct and indirect fiscal support). At the EU level, S&P Global Ratings estimates the median sovereign debt will peak close to 64% of GDP by year-end, up from 58% at end-2019, but low interest rates will ease the burden. Taking Italy as an example, while general government debt is set to rise by 20 percentage points to 147% of GDP at the end of 2020, the interest burden should remain below its 2018 level (close to 7% of revenues).

The situation is more difficult for lower-rated countries, particularly in emerging markets, more vulnerable to fluctuating capital flows and with less flexibility to cope with the economic consequences of the pandemic. Ultimately, containing the build-up in credit risk across the EU will hinge on the strength of the recovery and the resilience of non-financial corporate, which were hit first and hardest by the recession. Though the effects have been uneven across sectors, it may take well into 2022 or later for certain industries to return to pre-COVID-19 credit metrics, and some like retail face an accelerating secular shift toward digital.

As a result, we forecast the speculative-grade corporate default rate in Europe to rise to 8% in the next 12 months. Although banks entered the crisis with solid balance sheets, they are not immune. We estimate credit losses for banks in Western Europe will more than double this year and next. While preprovision earnings should cover most of those, some banks will unavoidably report net losses. Durably low rates and flat yield curves will exert further pressure for many to undertake a further round of structural reforms.

> *The monetary response averted a liquidity crisis, but solvency challenges will hinge on higher growth.*

The pace of withdrawal of extraordinary fiscal support will be critical to the unfolding of the crisis. Policymakers will have to manage the delicate balance between the risk of rising bankruptcies with the long-term costs of greater government intervention. While preserving employment is beneficial in the short term, the survival of companies with unsustainable capital structures or obsolete business models might hinder long-term productivity.

The accommodative monetary policy will buy time, but prolonged, very low interest rates tend to fuel asset bubbles and push investors in search for yield take on greater credit risks. More positively, there is momentum to implement structural reforms and build greater potential growth by funding infrastructure and human capital development to support the digital and green transitions. While government has its role to play, we believe the shape of recovery will depend on how the corporate sector emerges from this crisis.