Addressing the dangers of the monetary policy deadlock

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Central Banks played a crucial role in stabilizing the financial system and restore confidence during the Lehmann Brothers, EU sovereign debt and Covid crises. They expanded their toolkit, reacted swiftly and forcefully to prevent a potential economic collapse. This policy has allowed the financial markets to continue functioning and being liquid. In addition, in Europe, the measures taken by the ECB have avoided fragmentation in the dynamics of bond prices, particularly for sovereign bonds. The volatility observed in April- May has receded and financial conditions are again rather loose.

That being said, one has to recognise that Central Banks have paved the way to financial crises which they tried to contain thereafter. Monetary policy is further moving into unchartered territory and faces many questions and trade-offs. The 2% target, which has become the absolute guide to monetary policy has led Central Banks to implement an overly accommodating monetary policy. Striving to reach, whatever happens, an inflation target that has proven to be too high in relation to fundamentals leads to serious distortions. It is an illusion to believe that monetary policy of zero interest rates for long favours aggregate demand and the whole economy.

The fact is that such policy has steadily been supporting credit and indebtedness, and persistently low interest rates have encouraged liquidity hoarding at the expense of productive investment. The price paid in terms of crises, decline in corporate dynamism and productivity growth, bubbles and instability has been high. Monetary policy cannot replace the reforms needed for long-term growth. Other budgetary and structural instruments must be implemented.

But it is a fact that central banks have been overly involved in these areas in recent years. It is high time to return to a more reasonable conception of monetary policy: that of the stability of the currency and the financial system: there is a path to get out of the monetary policy deadlock in Europe.

1. The fundamental problem of monetary policy over the past years is that it seeks to achieve an unattainable 2% inflation target. Discretionary changes in interest rates cannot affect the structural factors which explain the downward trend in inflation

Over the past decade, the 2% inflation target has been the main guide to the ECB monetary policy although inflation of consumer goods has become much less responsive to changes in interest rates. This inflation target has trapped monetary policy in a systematic and asymmetric accommodation.

The questionable 2% inflation target

Over the past decade, the excessive accommodative stance of monetary policy taken by the Fed and the ECB stem from the objective for central bankers to bring inflation *"close to, but below"* their target of 2%[1].

However, does this figure of 2% really reflect the balance that should underlie the notion of stability? According to the proponents of this concept, below 2% there would be risks of deflation. In other words, economic agents would expect future prices to fall, which would encourage firms and households to postpone investment and consumption. Indeed, the former would be concerned with future low returns on investment and the latter would hope to take advantage of lower prices later. Hence, deflationary anticipations would become self-fulfilling and add risks to the growth path.

But it is very difficult to establish that 2% is the norm below which deflation would occur. In fact, the equilibrium inflation rate is the one that gives a sufficient margin to avoid the risk of deflation and is low enough

[1] As early as 1998, the ECB provided a quantitative definition of price stability, which was refined in 2003: maintaining inflation rates below but close to, 2% over the medium term. Other central banks such as the US Federal Reserve and the Bank of Japan, in 2012 and 2013 respectively, have also adopted this.

not to generate hyperinflation dynamics. This rate is determined by a multitude of time-varying factors. Some of these factors are cyclical (changes in oil and raw material prices, the influence of changes in inventories and demand for consumer goods, etc.) but others are structural and have been at work for some twenty year.

Several structural factors are at work in the direction of reducing trend inflation

These include:

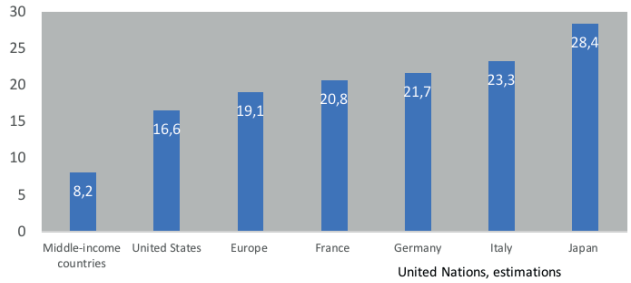
- The ageing of our societies who consume and invest less but save more.
- The opening of international trade to imports from countries with very low wage rates (China in particular), that has led to the introduction of cheaper products on the market.
- The changes observed in labour markets behaviours; as well as productivity gains resulting from new technologies.

Concerning the deflationary pressures of demographics, populations in advanced economies are steadily growing older (*see Chart 1*).

Such a demographic trend, which is more salient in Europe than in the US, undermines any growth prospects as older people do not have the same spending habits as the working age population. Consumption in capital goods declines.

A higher saving rate is a feature of ageing societies. Working people expect to live for longer due to a better standard of living - life expectancy has reached 83 in Italy, 82 in Germany and 78 in the US according to UN 2020 estimations. Consequently they tend to squeeze their consumption to save ever more due to the high cost when acquiring their home (linked to the steep increase of asset prices under the accommodative monetary conditions) and to prepare for longer retirement, all the more as prospects are uncertain, not to say adverse, concerning their retirement schemes. A lower fertility rate or birth rate for women is also a deflationary factor: its declining trend reveals that future ageing and smaller populations will reduce the global demand.

Chart 1 Share of the population aged 65+ in 2020, %

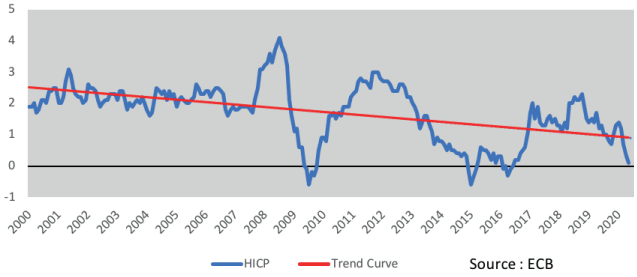


All these factors together explain why a 2% equilibrium inflation (the one that avoids deflation as well as hyperinflation) may no longer be a realistic baseline for monetary policy.

Even ultra-loose monetary policy cannot bring inflation at 2%

In the US, the four-year-quantitative-easing programme set up by the Fed in 2010 has had questionable effects on the consumer price index (CPI) which remained close but constantly below the target of 2%.

Chart 2 The Trend of HICP in the Euro Area



As for the euro area (*see Chart 2*), the ECB has struggled to boost its harmonized Index consumption price (HICP) anchored at 1,3% in average over the same period despite its quantitative-easing programme launched in 2015 that has purchased EUR2,6tn as of January 2020.

The 2% inflation target is today becoming an enigma rather than a realistic guideline for monetary policies.

The 2% inflation target, although it has proven to be unattainable, has urged the ECB and Fed monetary policies to be asymmetric over the past 20 years

Economic theory and empirical studies explain that:

- When there is a threat of overheating, higher interest rates and reduced liquidity help dampen demand. In such a context, economic agents wishing to keep a minimum amount of cash in hand increase their savings to counteract the fall in liquidity.
- This reasoning is reversed in the event of an economic slowdown: when short (key policy) rates fall, the yield curve tends to flatten for all maturities, whatever market forces.

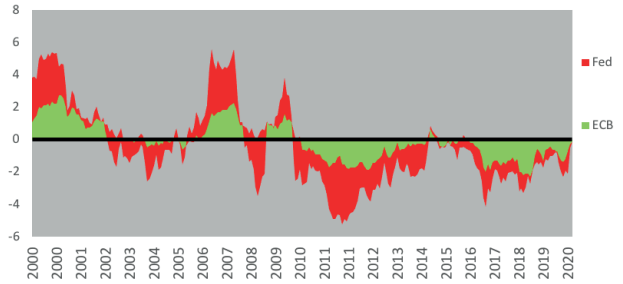
Instead of trying to be countercyclical, over the past two decades, monetary policy has broadly remained accommodative in order to achieve the 2% inflation target: it has therefore been conducted asymmetrically. Indeed, after negative shocks in OECD countries (in 2000-2002, 2008-2009, and 2020), the public debt ratio has increased and monetary policy has become more expansionary (rate cuts, increased money supply) leading to a fall in interest rates (even getting into negative territory) and to an increase in the monetary base.

But in the euro area especially, once the economic situation improved after the sovereign crisis, the ECB monetary policy has not been tightened or started to be normalized. In 2017-2018 for instance, the ECB kept its main rates at zero despite significant economic improvements. Moreover, the "sacralisation" of the 2% inflation target led to questionable decisions with

significant unintended consequences for financial markets and the real economy (see section 2). Indeed, in September 2019, the Governing Council decided to resume the asset purchase programme (APP) at a monthly pace of €20 billion in response to the decrease of the HICP inflation by 0,3 percentage points between June and August 2019 to reach 1%! It would have seemed appropriate to start raising slightly interest rates in 2017 -2018 in Europe because growth was recovering. The Fed's interest rates hiked in 2017 and 2018 and this did not cause deflation nor market instability.

This asymmetry of Fed and ECB monetary policies over the past 20 years can be illustrated by the trajectory of their real short-term interest rate (*see Chart 3*).

Chart 3 Real main rates in the eurozone and US - Short term interest rate - Inflation



Sources: ECB, BIS, OECD

Notes: for the euro area, refinancing rate - HICP; for the US, federal rate - CPI

Since 2010, the real short-term rate has mainly evolved in the negative territory both in the Euro Area and the US. In the Euro Area, HICP has risen even at or above 2% between May and October 2018, whereas the key rate was left unchanged at zero. The explanation was that the price developments were assumed to result mainly from energy prices while core inflation remained subdued; hence inflation anticipations may not be altered in the short term. It seems that this line of reasoning has proved to be consistent with what happened next.

The reality is that overall monetary policy has become disconnected from the cycle: it has been accommodative over the two past decades. As interest rates were close to zero or even negative, Central Banks have also used quantitative easing programmes during as well as after the crises. They did not tighten monetary conditions when the economic situation improved thus limiting the ability to act decisively at the next turning point.

In short, by allowing nominal interest rates to stay at 0% for a decade or so, monetary policy has prevented the use of interest rate margins in an environment that would have called for cyclical responses in monetary policy. The lower bound has been the result of such accommodative monetary policy for too long.

The cause of this focusing on zero interest rate for long has probably to do with in the weak economic expansion over the years. As activity and inflation were low, monetary authorities believed that interest rates were bound to be low as long as inflation did not pick up.

That is the heart of the monetary impasse that we are facing. It may well be that neutral interest rates are very low for secular reasons (ageing, globalization…); But what is questionable is to gear monetary policy to the single objective of 2% inflation and to press down interest rates, all along the yield curve, to set them as low as possible. For sure monetary policy is not the sole factor behind the "secular" lowering of interest rates. But it has been a significant and potent additional factor in that direction. In fact, inflation in its widest definition was higher than the CPI indexes show. Asset bubbles are a manifestation of inflation.

The fact that monetary policy has been exclusively geared to consumer prices and has turned a blind eye to asset price bubbles has led our system into over financialization and repeated crises.

There is not a magical neutral interest rate that will ensure a 2% inflation target and full employment by itself

The ECB justifies the use of very low interest rates and unconventional policy instruments because the neutral real rate is close to zero or even negative and there is a need to maintain price stability "close to, but below 2%".

The natural or neutral rate of interest is the real interest rate that would balance savings and investment in a context of full employment and stable prices[2]. The level of the real equilibrium rate is determined by a number of structural factors, such as a country's demographic situation or capacity to innovate.

This neutral real interest rate cannot be directly observed and needs to be estimated. As it is computed, this rate has fallen markedly globally and in Europe in particular over the past 20 years not only because of the monetary policy, but in reaction to structural changes.

Central banks tend to adjust their main policy rates to be in line with the neutral interest rate, as a way to best reflect and foster economic health. In order to maintain price stability and be in line with the trajectory of r*, central banks around the world resorted to a number of unconventional instruments in order to reach a level that is consistent with their medium-term inflation aim.

According to this low real neutral interest rate view, monetary policy can regain its ability to stabilize the economy only if it can get real interest rates low enough. And the solution is therefore to enable Central Banks to achieve more deeply negative real interest rates: QE programmes, forward guidance, enabling nominal interest rates to fall deeply negative, control of the yield curve.

[2] This "r*" rate, described by the Norwegian economist Wicksell, is estimated to have fallen by between 150 and 200 basis points over the past 15 years

But these solutions are not able to achieve a 2% inflation target or increase growth. Research shows that there are a number of reasons why aggregate demand may be less interest-sensitive at low nominal interest rates and/or at low real interest rates.

Monetary stimulus may be ineffective at stimulating aggregate demand:

- The banking system is not always able to pass on to depositors the cost of negative interest rates;
- Observation shows that saving behaviour can be encouraged by lower interest rates: the lower the interest rates the higher the savings (as if households wanted to offset the negative yield they get by saving more);
- A strong accommodative monetary policy tends to bring forward consumption that has not yet taken place. Such an acceleration of potential consumption has of course its own limitations;
- With negative rates, it is difficult to promote private long-term bond insurance (savers prefer to hold liquid instruments that carry no yield but also no negative tax);
- Lasting zero or negative interest rates reduce economic dynamism (see 2.2);
- It is also often argued that effects of monetary policy may be asymmetric: while interest rate increases can contract the economy, interest rate cuts may be less effective at stimulating the economy.

The neutral real interest rate appears to be a poor guide for monetary policy and for stabilizing the economy. Changes in interest rates cannot affect the structural factors which explain the downward trend in inflation and cannot be the engine of growth. In other words, it seems clear that there is not a magical neutral interest rate that will ensure an inflation below but close to 2% and full employment by itself.

A 1% inflation in itself is not worrying

On average, having a "normal" core inflation of 1% per year (instead of 2%) is by no means a sign of deflation as (i) prices continue to rise and (ii) people's anticipations will expect them to do so. And it rather helps consumers to gain purchasing power, thus supporting demand.

Moreover, getting closer to the 2%-inflation target does not mean that growth problems would be solved. To reach the target, monetary creation would have to be so large that it would only increase the instability of the financial system without solving the structural problems facing the euro area countries: too high labour costs, labour market inflexibility, unskilled workforce, etc.

Only structural policies can solve structural problems. Keeping interest rates at a low level cannot increase potential growth. Rather, it creates financial stability issues and damage productive investment (see 2.2).

Wanting, at any cost, to raise inflation to 2% through monetary policy has, in fact, had very damaging consequences.

2. Pushing too hard and too long on the monetary pedal has severe negative consequences

Lasting loose monetary conditions contributed to the over-indebtedness of our economies which has steadily been the cause of all crises, discouraged productive investment, raised structural issues (e.g. disincentivized Member States for undertaking structural reforms which should lift potential growth, captured economic resources in inefficient uses), generated financial vulnerabilities and widened income and wealth inequalities.

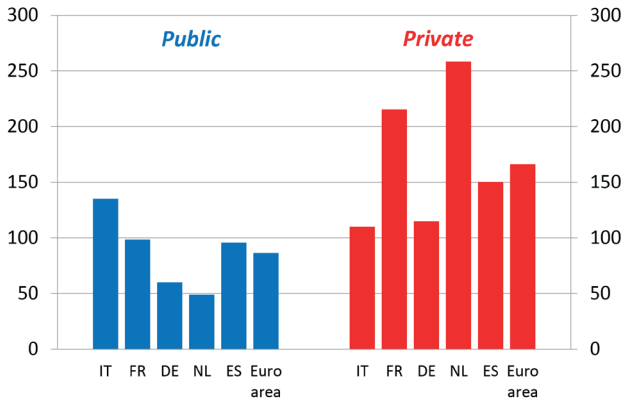
The policy of lasting persistent low rates contributed to the over-indebtedness of our economies

For several decades, the loose credit conditions have systemically encouraged the growth of public and private indebtedness and have entailed a huge debt overhang. Indeed, since the financial crisis of 2008, global debt has continued to rise: Global debt reached a record high of 331% of GDP at the end of March 2020, up from 320% in 2019 and 200% in 2011 according to the IIF. Regarding the global debt in advanced economies, it has grown by 54 percentage points over the past two decades, to reach 266 per cent in 2018, according to the World Bank.

Such a level of indebtedness had never been reached before in peacetime.

The 2020 health crisis occurred in such an already very unstable financial context due to this increase and high level in debt[3]. In fact, as William White explained, "we had an unsustainable economy even before the pandemic hit. In effect, the patient had dangerous preconditions".

Chart 4 Public and private debt (per cent of GDP)



Sources: Based on data from Banca d'Italia, ECB, European Commission, Eurostat and Istat.
Note: End-2019 data. Private debt: households' and firms' financial debt

[3] The economic consequences of the current health crisis are worsening this situation. Indeed, with a view to supporting their economies, highly indebted governments set up massive countermeasures, totalling $8tn since March 2020, according to the IMF.

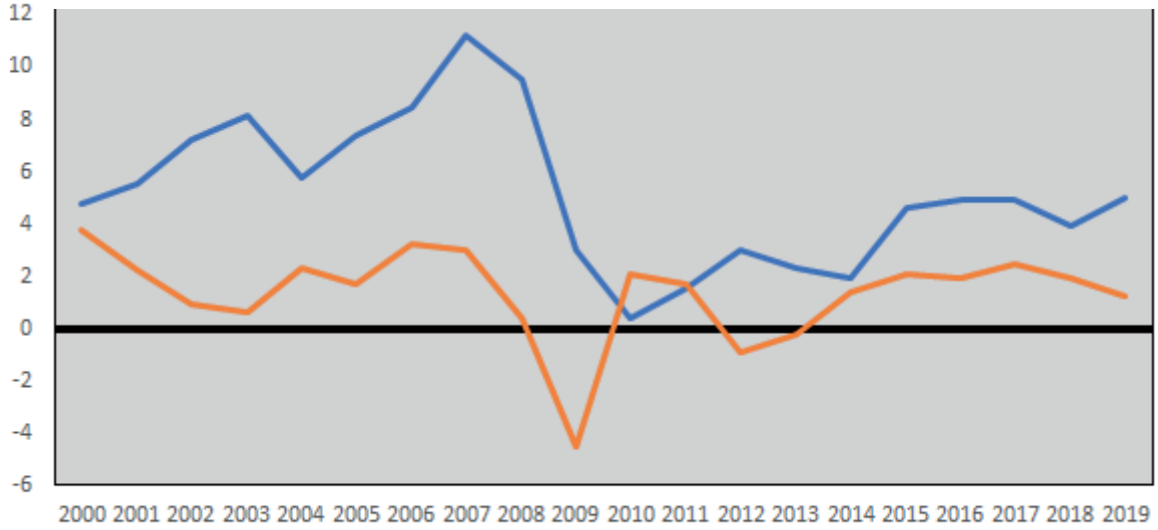
In the Euro Area, public and private debt have reached a new record-high in 2019, according to Banca d'Italia[4] (*see Chart 4*).The private sector in some Member states (e. g. nearly 215% of GDP in France, 260% in the Netherlands) entered the crisis with high levels of debt and necessarily borrowed more to navigate the crisis, raising solvency concerns for a significant number of borrowers[5].

Central Banks have not acted to control the credit growth during the past decades

Accommodative monetary policies over the past two decades have been widening the gap between the steady rise in debt and the more moderate economic growth, which has eventually been one of the main causes of the Grand Financial Crisis.

This gap can be illustrated by the divergent trajectory of real economic growth and the broad money (M3) growth in the euro area over the past two decades (*see Chart 5*). This significant difference reflects the over-financialization of the economy: additional debt has fueled asset bubbles and so erodes financial stability, in greater depth and faster than it contributes to economic growth[6].

Chart 5 Real GDP growt against M3 growth in the euro area, %



The significant increase of Central Banks 'balance sheets reflects this indebtedness issue

Lasting accommodative non-conventional monetary policies contributed to the significant increase of Central Banks 'balance sheets. The steady and bold non-conventional monetary policy operations on financial markets have led total assets held by Central Banks to steeply rise and reach unprecedented levels. Using QE as a permanent feature of monetary policy would eventually threaten the credibility of central banks.

Between 2008 and 2015, the Federal Reserve's balance sheets expanded from $ 0.9 to $ 4,5 tn (nearly 25% of GDP) after slashing its main rates to zero[7]. Non-standard measures have been experienced later in the euro area[8]. In 2015, three years after the EU sovereign crisis, the ECB launched its "assets purchase programme – Between January 2015 and December 2018, total assets held by the Eurosystem – ECB and national central banks – totalled EUR 2,6 tn (above 20% of GDP). In September 2019, Mario Draghi decided to resume with the quantitative easing programme by a monthly purchasing pace of € 20bn.

[4] Annual report, May 29, 2020.

[5] As for corporates, low interest rates in the past decade have enabled firms with weaker credit profiles to access capital markets. As a result, according to S&P Global ratings, 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.

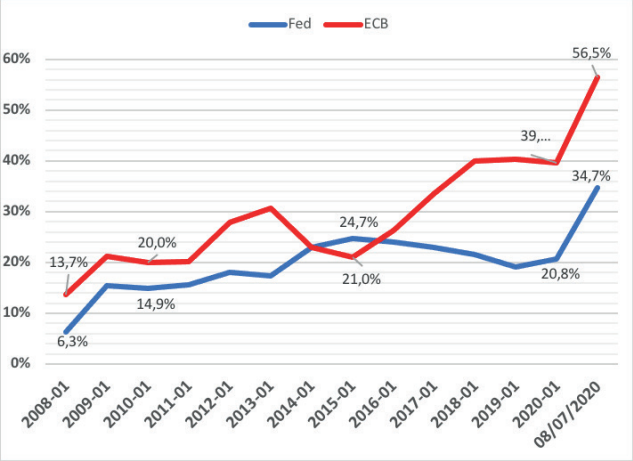
[6] In previous periods, economic growth and credit growth were moving more or less at the same pace).

[7] US Treasuries bonds and especially mortgages-backed securities have been purchased to first remove toxic assets held by commercial banks, helping the housing market to recover, restoring trust and stabilizing the US economy. This bond-buying programme ended in 2014, after economic figures such as the unemployment rate falling below 6,5%- indicated significant signs of recovery and inflationary risks.

[8] In 2009, following the sovereign debt crisis, the ECB launched its first Covered Bond Purchase Programme (CBPP1). Under this initiative the Eurosystem purchased €60 billion worth of covered bonds between July 2009 and July 2010.

Following the Covid19 crisis, the Fed and the ECB have launched massive bond-buying programmes debt in purchasing public and private debt to stabilise financial markets. The Federal Reserve balance sheet increased from $4,2 to $7,1 trillion from early to mid-July 2020, to account for 34,7% of the US GDP. The Bank of Japan balance sheet has grown by JP¥ 68bn to JP¥ 649bn, approaching 120% of Japanese GDP. Over the same period, the consolidated Eurosystem assets (ECB + euro area national central banks) rose to € 6,3 trillion mid-July from € 4,7 trillion at the end of 2019.

Chart 6 Total Assets held by the ECB and Fed compared with GDP, %



Sources: ECB, Fed, AMECO

With this staggering rise in balance sheet size, both Central Banks have also taken a more significant place in their domestic economy: as of July 8, 2020, the Fed owned nearly 35% of the US GDP, while total ECB assets amounted to 56,5% of the eurozone GDP (*see Chart 6*). The share of public debt holdings also reveals how entrenched is becoming the Central Banks' path in real economy (*see Chart 7 in Annex*).

These persistent unconventional monetary measures do blur in particular the traditional boundaries between monetary and fiscal policies. Monetary policy function become subordinated to short-term fiscal needs (fiscal dominance). If using QE becomes a permanent feature of monetary policy, this may eventually threaten central bank independence and credibility and would affect stability and confidence in the currency (see 3.1).

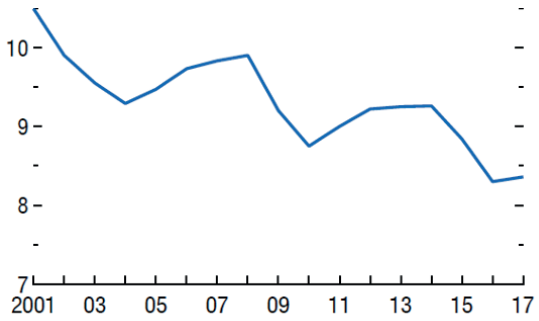
Lasting zero or even negative interest rates damage productive investment and growth in Europe

If at least, lasting accommodative monetary policy had boosted productive investment, one could be convinced by such a policy. But the reality is different. 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 Chart 8*);
- 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 9*).

Chart 8 Decline in the level of non-residential investment as % of GDP

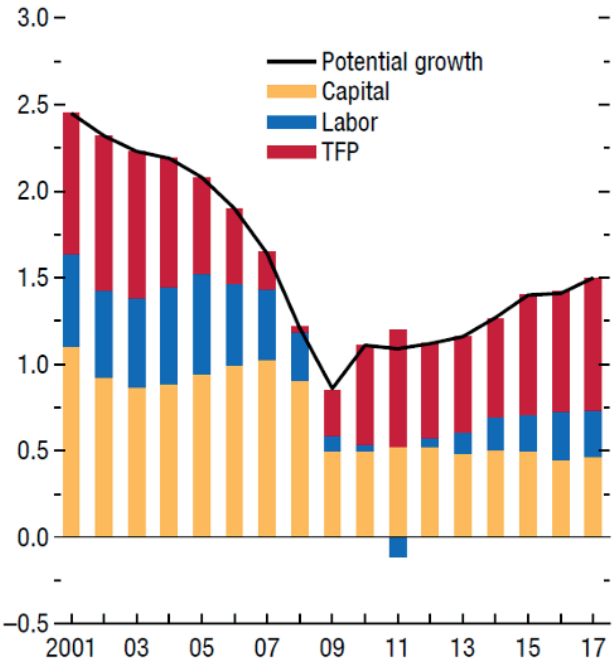


Source: IMF staff calculations.

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

Chart 9 Contribution to potential growth; capital share remains low

(Percent)



Source: IMF staff calculations.

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

It is a mistake to believe that lasting low interest rates favour long term investment. On the contrary, they urge preference for liquidity behavior, particularly in Europe. Moreover, they encourage the survival of "zombie" firms and favours a misallocation of capital.

Preference for liquidity prevails over productive investment

The buying of sovereign securities squeezes the normal functioning of markets between savings and investment and brings interest rates to levels close to zero which encourages the holding of liquidity detrimental to productive investment.

Indeed, loose monetary policies coupled with expected low return on earnings drive a preference for liquidity. The liquid share of financial assets held by all economic agents increased from 7 to 16% in Germany (1999 to 2017), from 7. 5 to 12% in Spain, from 5 to 12% in Japan, and from 5.8 to 7% in France (*see Chart 10 in annex*)[9]. Since investment by purchasing securities is taxed, investors tend to forgo illusory remuneration and retain liquid instruments which, at least, are not affected by the application of negative rates. But such a preference for liquidity (Keynes' "haunting") diverts savers away from long-term investment. They would face higher taxes if they invested long-term which is counterintuitive and bears heavy consequences. In the traditional investor trade-off between return, risk and liquidity, the notion of return loses its importance with low interest rates. The arbitrage is only between liquidity and risk.

Lasting easy monetary conditions favours a misallocation of capital

Lasting accommodative monetary policies encourage the survival of "zombie" firms - firms whose profitability is so low that they would not be viable if interest rates were higher-, widen productivity-gap between industry leaders and other firms and impedes the reallocation of resources necessary for innovation and growth.

There is now ample evidence that easy monetary conditions have encouraged banks (notably less- well capitalized ones) to make loans to zombie companies. Lasting low interest rates may reduce bank incentives to recognize write off non-performing loans to these firms, to avoid negative market perceptions or solvency issues. As well, "the search for yield" provides buyers for the bonds issued by these less productive firms.

W. White noted[10] that this maintains excess capacity in the low productivity growth sectors (e.g. retail and construction), hampering the reallocation of resources necessary for growth and innovation.

Low rates may also give industry leaders a strategic advantage over other companies. Indeed, E. Liu, A. Mian and A. Sufi recently explained[11] that the fall in long term interest rates has contributed to raise market concentration, reduce business dynamism, market competition and productivity growth.

The accumulation of very high public debt, negative interest rates and massive repurchases of public and private securities against the backdrop of an accelerating ageing population has been experienced for many years by Japan (47% of outstanding public debt is held by the BoJ as of June 2020), which shows that it is inseparable from a sharp fall in potential growth. G. Davies[12] recently stated that instead of restoring confidence and economic activity there appears to be a "reversal rate" of interest. "Below a certain point, really negative rates not only do not stimulate the economy, they weight it down".

Lasting low interest rates incentivize companies to take on cheap debt to buy back their shares rather than invest in future projects

Loose monetary conditions have encouraged corporate management in the US and UK especially to cut investment and to borrow in order to raise cash to finance share buybacks (*see Chart 11 in annex*). In doing so, companies managers succeeded in raising the share prices and the value of the share options they owned of their companies to their advantage, as W. White stressed in a recent paper[13].

Lasting zero or even negative interest rates disincentivize Member States for undertaking structural reforms which should lift potential growth

The interest rate is the price of leverage in the economy. With interest rates at ultra-low levels, governments are under no pressure to reduce their debt. Negative rates actually encourage them to borrow more. And if government borrowing becomes a free lunch, there is a clear disincentive for fiscal discipline.

Indeed, the monetary financing of fiscal deficits gives rise to moral hazard: as fiscal deficits are very easy to finance thanks to public debt monetisation, the euro-zone countries no longer have enough incentives to improve their public finances and implement structural reforms to lift their longer-term growth prospects.

In addition, monetary policy has seemingly aimed to control the yield curve which is another way to keep loose financial conditions and allows governments to finance large fiscal deficits at low interest rates. As governments know that they are insulated by central banks against the risk of insolvency, they run up excessive fiscal

[10] W. White, "Why Central Bankers should be humble", The International Economy, Winter 2020 Edition.

[11] E. Liu, A. Mian and A. Sufi, "Low Interest Rates, Market Power, and Productivity Growth", NBER Working Paper No. 25505, August 2019.

[12] Gavyn Davies, "Why the Fed dislikes negatives rates", Financial Times, 14 March 2020.

[13] W. White, "Why Central Bankers should be humble", The International Economy, Winter 2020 Edition.

deficits. In other words, the monetisation of public debt weakens market discipline and the incentive to reduce fiscal deficits and public debt. Public debt, for example in Italy and France, has risen while not contributing to increase investment in future infrastructures or supporting private investment.

Monetary policy, whatever its instruments (helicopter money, yield curve control or other) cannot replace structural policies (vocational training, apprenticeships, emigration, labour market flexibility, lower labour costs, etc.) which alone can increase potential growth.

Pushing too hard and too long on the monetary pedal would generate financial vulnerabilities

The impact of systematically accommodative monetary policy -with interest rates at zero or even negative for a long time- on the stability of the financial system is unfortunately too well documented: incentives to borrow more, weakening of the banking system, deterioration of the accounts of pension institutions whose liabilities remain subject to contractual obligations but whose fixed-income assets no longer yield anything, financial environment where interest rates no longer play the discriminating role of a "quality signal" that should be theirs.

The profitability of the banking and financial industry is particularly affected in Europe

One of the main side-effects of the ultra-low interest rates policy is that it is threatening the financial stability by eroding banks' profitability and insurance's and pension funds' ability to keep up with the claims and benefits expected by the policy holders – especially regarding pensions and life insurance.

It first weakens the banking system by squeezing their net interest margin. Moreover, commercial banks are also raising their risk exposure : in a world where the financial markets provide resources at a rate of around 2% to companies with a good rating, it is difficult to distribute credit with a fixed cost of credit that is around 3% on average. Accordingly, large, well-rated clients tend to move towards direct, low-interest financing on the bond markets at the expense of bank credit. This results in a concentration of the banking asset portfolio on the potentially riskiest loans, particularly for SMEs that cannot access markets directly. This development is forcing banks to bear higher capital charges due to the increased risks taken.

Lasting zero-interest rates also pose a solvency problem for insurance companies, pension funds and other pension institutions. Faced with long-term commitments - in part contractualized in guaranteed returns - safe bond assets no longer yield much. 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). For customers, low rates mean higher non-life insurance prices, lower guarantees and fewer long-term savings.

In addition, low-for-long rates increase risk to the system. Indeed, it encourages risk-taking by financial institutions in order to counteract the effect of low rates.

Interest rates no longer play their discriminating "quality signal role" leading to mispricing of risks

Increasingly central banks 'intervention is turning financial assets from market prices into administrated prices. Indeed over time, central banks in OECD countries are controlling the prices of a growing number of assets: not only short-term interest rates but those with QE which actually leads to monitor, not to say master the yield curve, hence long term interest rates; and with government bonds purchases, sovereign risks premia do not reflect market forces.

Financial asset prices no longer provide savers with appropriate information about individual issuers and, more broadly, about the economic and financial developments. In other words, they are obliterating the distinction between what is a genuinely profitable activity and what is not, in turn making little or no distinction between good and bad signatures.

Therefore, financial markets, which are dominated by the role of central banks, should discriminate against signatures according to their quality and not be dominated by the setting up of interest rates by Central Banks.How can free markets assess value in these conditions? Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premia. This reduction of risk premia was already the phenomenon observed prior to the 2007-8 crisis.

Central banks have fundamentally altered the investing landscape. Indeed, C. Smith stressed that "bond market prices in the euro zone may no longer adequately reflect the risk inherent in record high debt levels: as of June 30, roughly 86% of the global bond market was traded with yield not higher than 2%"[14]. More than 60% of the market were yielding less than 1% (*see Chart 11 in annex*). Such a proportions of ultra-low remunerative assets has brought financial markets to shift away from the economic fundamentals. This has pushed investors into riskier segments in search of income, compelling them to lend to lower-quality companies and countries.

The policy of massively buying securities, supported by the Central Banks to force low rates, is likely to exacerbate moral hazard: whatever the actual risks inherent to a company or to the relevance of its projects, any investment in it may be protected and treated as good quality.

[14] C. Smith, Desperate hunt for yield forces investors to rake "extreme risk", Financial Times, 27 July 2020.

As Charles Goodhart put it 45 years ago in his famous theorem: "When a measure becomes a goal, it ceases to be a good measure". Thus, as the special measure of momentarily buying securities to avoid excessive spread widening becomes an objective in itself, moral hazard is likely to return in force.

The markets are led to believe that the price of shares is protected for ever by an implicit put[15].

If it becomes inherent in monetary policy to macroeconomically erase asset losses or write-downs, this implies that the Central Bank is doomed to buy everything forever and, in so doing, to guarantee the growth of the gains received by the small fraction of the population that holds the shares while keeping unproductive zombie enterprises alive. If or when economic conditions deteriorate, Central Banks are likely to act even more aggressively to counter the downward movements and may even start buying shares.

The development of asset bubbles

Lasting low interest rates interest rates open the floodgates of credit to both governments and the private sector, encourage search for yield behaviour and represents a source of financial instability with the resulting asset bubbles.

Chart 13a OECD*: Central banks' key interest rates and stock market index

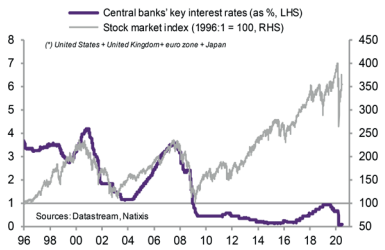


Chart 13b OECD*: Central banks' key interest rates and house prices

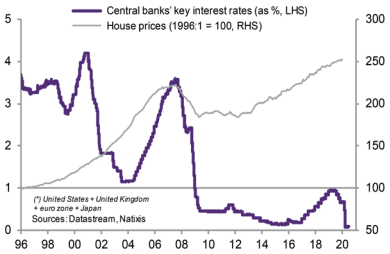
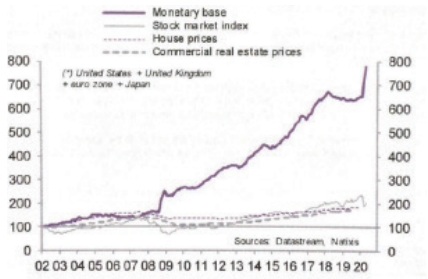


Chart 13c OECD*: Monetary base, stock market index and real estate prices (2002:1 = 100)



In contemporary economies, excess money creation leads to asset price bubbles, particularly in equities and real estate. Such assets bubbles are reflecting the form of inflation of certain financial assets or real estates that we do not see, or do not want to see (*see Charts 13a, 13b & 13c below*).

Monetary policy is widening income and wealth inequalities

Low interest rates, asset purchases and other accommodative unconventional monetary policy instruments tend to increase asset prices (particularly housing, equity, as well as government and corporate bonds) and thereby especially benefit the wealthiest segment of society[16]; the 10%, or even the 2% of populations who own them – they hold them in far higher proportions –, earn high returns on their investments; obviously these asset price changes do little for those who do not hold such assets[17].

Moreover, unlike in the US, European retail savers (individuals or households) tend to be risk-averse and few are financially literate. Most of them may have real estate property and some may hold liquid assets on their saving accounts.

Accordingly, they receive low returns and their savings accumulate extra money more slowly. In contrast, richer people are less risk averse, also as a possible temporary loss in asset value will not affect their standard of living the same way, and more financially educated.

Hence, they invest into riskier, more remunerative assets, such as equity, to escape these low returns. Rising equity prices therefore benefit stockowners, who tend to be people with higher wealth and income.

Ultra-accommodative monetary policy also has distributional consequences across generations. Since elderly people tend to have higher savings (accumulated from their families and during their active time), they are able to sell them whenever appropriate for them so as to maintain their consumption. So they really benefit from upward price changes. Conversely, younger households are usually the ones that will buy these assets at a rather high price for their accommodation or to save for retirement. This absorbs a higher share of their revenues at the time when they start their activity and bring up their children.

More generally, these income inequalities have a lasting effect because they tend to be transmitted across generations: wealthiest elder or retired people can far more easily help their offspring to buy accommodation in residential places, also giving more chances to their

[15] J. Authers, "The Fed's Stocks Policy Is Exuberantly Asymmetric", Bloomberg, August 4, 2020.

[16] This has particularly been the case in the US, UK ... and China. This happened to a far lesser extent in continental Europe as taxes and social benefits tend to level out the most salient inequalities there. When looking at developments in the Gini coefficient (a recognised indicator of inequalities in societies), the gap has widened in the three former ones, not in continental Europe.

[17] To some extent the opposite can be observed: the asset prices bubbles push the rents upwards. Those households who do not own their homes may face a growing share of their revenues absorbed by the rents, even though, in some countries, the less wealthy ones may get allowances for their housing.

grandchildren to go in the best schools and universities with less efforts.

If the Central Bank were doomed to buy everything forever, it could institutionalize moral hazard and, in doing so, will continue to ensure that the small fraction of the population that holds shares and other assets will continue to grow in wealth and earnings.

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Wanting, at any cost, to raise inflation to 2% through monetary policy has, in fact, had very damaging consequences. A zero-rate strategy cannot work for long without creating instability in the financial system and yet we are being told that we are committed to this policy for an almost indefinite period. The current impasse is eminently dangerous: continue indefinitely a policy of monetary easing that leads to declining growth, , a reduction of government and corporate dynamism, rising debt, market instability, speculative bubbles and the survival of zombie companies boosted by low rates… is a grim outlook.

It would be honest to recognize that monetary policy is at a dead end.

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

It is a fact that Central Banks have been overly involved in these areas in recent years. Indeed, nobody thought QE would become a permanent feature in the new economic landscape a decade ago. Ultra-low interest rates were designed initially to be an emergency measures to help economies' recovery from the 2008 financial crisis. But now it has become the only game in town.

Monetary policy cannot do everything. It cannot replace the fiscal reforms needed for long-term growth. 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 can only be addressed by structural reforms. Monetary creation will not for instancebe a substitute for ecological measures.. This will be only possible with the development of long-term investments financed, in particular by equity.

Monetary accommodation can buy time to implement this repair and reform, but it cannot substitute for them. Public debt will fall much faster in relative terms if growth is boosted by such reforms. It is high time to return to a more reasonable conception of monetary policy: that which fosters confidence in the economic prospects and stability of the currency and the financial system.

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3. How to get out of the monetary policy deadlock in Europe

Even though central banks have in practice and indirectly become state budget agents, the role of monetary policy should not be overemphasized and should not be overly demanding.

Some economists call for pushing interest rates into deep negative territory to "retrieve some margins". But this could lead to disastrous consequences. It is urgent to restore a monetary and fiscal space so they can become countercyclical during a future crisis.

Three issues should be addressed to get out of this deadlock: revisiting the 2% inflation target, normalizing cautiously and gradually short term nominal interest rates and putting this monetary discussion in the international perspective. At the same time, encouraging structural reforms and sustainable fiscal policies are essential to promote a return to healthy growth in over indebted countries.

Should the ECB go further by eliminating or even lowering main interest rates below zero?

Given the unprecedented scale of the recession, some economists propose that new monetary policy space should be regained. In ordinary times, in the face of such a crisis, central banks would reduce rates to reach - as it has often been the case in the past - negative real rates. But, in the current economic context of depression and low inflation, they cannot do so since nominal rates are already at zero (zero low bound). They should therefore be able to "retrieve some margin" by deliberately setting negative rates. Monetary policy would then regain its traditional driving and shaping role, since it would be able to recreate, on its own, negative real rates in the absence of inflation. Kenneth Rogoff[18] has especially suggested that short-term policy rates to be cut "-3%, or lower".

Proponents of this thesis have considered some of the objections:

- The liquidity trap: when rates are negative, investors tend to turn away from bonds to avoid the "tax" caused by negative rates. Thus, an accumulation of savings is formed, held in the form of liquid assets (bank notes, bank accounts etc) that barely contribute to the development of productive investment. The answer to this danger is to eliminate large denominations and ensure that the banks, themselves affected by negative rates, pass them on in full to their depositors.
- The risk of inflation is inherent, in the long run, in any monetary policy designed to make up for "negative output growth" by eliminating, through money creation, the difference between potential growth and current growth depressed by the crisis. This risk

[18] "The case for deeply negative interest rates", Project Syndicate, May 4, 2020

is hardly considered likely in the coming years given the scale of the crisis, the slow recovery, envisaged monetary policy, and the structural forces at work (ageing, much higher unemployment, technological progress, etc.). And, one might add, if inflation were to return, there would still be time to turn the tide and return to more traditional monetary policy.

Permanent expansionary monetary policy and low rates would thus be necessary to absorb fiscal deficit, as we are running toward the Modern Monetary Theory's era. MMT claims that fiscal deficit would systematically be financed by money creation until full employment is reached. This would lead to important consequences.

According to this view, Central banks would not reduce their balance sheets and interest rates would no longer return to normal in the future, which means that governments bonds held are effectively cancelled. Accordingly, there is no limit to fiscal deficits. Surprisingly, however, these proposals, designed to eliminate a major economic driver, namely the cost or price -of savings, fail to consider the essential question of the value of money. Money is based solely on trust.

The risk of a loss of trust will threaten if those responsible for that trust are resigned to see their role as suppliers of an unlimited commodity rather than as vigilant guardians of its stability. Moreover, the moral hazard involved in a system where indebtedness can be permanent and infinite, regardless of the quality of the paper or signatures, poses a serious moral hazard and political problem. These proposals also neglect another essential element: as we have seen above, negative rates damage productive investment, lead to financial vulnerabilities and structural imbalances.

Who believes that the private sector will finance the vast productive investments needed for sustainable energy transition if the "juste retour" will be much higher taxes or negative rates?

An economy whose rates are forced by public authorities to remain negative for decades will not inspire confidence in those who want to be entrepreneurial.

Debt sustainability should not be an objective of monetary policy: Thinking that monetary creation can solve the problems arising from excessive debt is an illusion

Public debt sustainability has become an implicit objective of Central Banks. The idea that states can compensate for everything by exposing their balance sheets is unfortunately, in part, an illusion. Indeed, most States have fragile balance sheets with monumental debts and the extension - which some would like to see unlimited - of these financial capacities obviously raises the essential issue of the sustainability of deficits – except if one agreed that all incremental expenses were to end up for ever on central banks' balance sheets.

Despite the QE and its possible magnitude, the budget constraint remains. This is an important point. Despite the quasi "guarantee" of sovereign securities purchases by the Central Bank there remains assessments and analyses by the markets. Analysts and rating agencies continue to examine ratios and make judgments about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of an issuer's "signature" and a key factor in the decision to buy securities by private investors, especially non-residents. As they are very sensitive to the rating, they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgments voiced by the markets actually do not matter, because the Central Bank will always be there to buy, is doubly inaccurate: the Central Bank will not always be able to buy everything, as we shall see below, and the quality of a State's signature is an essential element of confidence that must be preserved at all costs for the country's future.

Even if the Central Bank were to acquire without any limit the securities issued by States, this would not solve the problems of the future and generate may vulnerabilities as we have just explained.

However, such an approach would ultimately lead to the systematic monetisation of all deficits, which would affect stability and confidence in the currency. Eventually, the monetization of the bulk of the assets – which will end up on the balance sheets of central banks – will presage a creeping nationalization of our economies and the crowding out of profitable economic activity.

Given the heterogeneity of fiscal performance across euro-area Member States, this approach would most probably be incompatible with the functioning of monetary union. In the longer turn, such a result would mean that the market economy would eventually become an economy largely directed and owned by the central bank, which poses an existential problem.

We cannot pretend that money creation can exempt our societies indefinitely from having to face the question: "who will pay?" Do we seriously believe that unlimited issuance of sovereign securities will never come up against a fundamental questioning of the markets as to the solvency of States? Moreover, only productivity enhancing, and productive investment can create sustainable increases in productivity, neither negative rates nor QE.

Revisiting the 2%-inflation target

It is now imperative to start 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 into an endless financing hole that can only maim business and consumer confidence. We need a minimum of international discipline. Setting an unattainable goal has a real psychological cost.

Desacralizing the 2% and no longer to consider it as an absolute guideline that does not take into account the deflationary and structural forces. One way to

achieve this would be to set the inflation target within a range (e.g. 1%-2% or 1,5%- 2,5%) which would make it possible to abolish the magical figure of 2%.

Given this way of thinking, any attempt to "compensate" for the years when inflation did not reach 2% and therefore to ignore the overruns beyond 2% makes no sense.

In addition to price stability, monetary policy should include financial stability in its mandate, regarding financial and real estate assets prices especially. Macroprudential policies should notably pay more attention to several indicators: credit to economy and to the public sector (net domestic assets). It is better to think of macroprudential policy and monetary policy as complements, not substitutes.

Normalizing gradually and cautiously the monetary policy

The first priority is to re-establish a financial market that functions on the basis of market forces and not according to the prescription of zero interest rates and ditch out the asymmetry principle of monetary policy.

Such an asymmetry is becoming unsustainable: central banks only react aggressively in time of crisis by imposing ultra-expansionary measures while adopting a wait-and-see attitude in time of economic prosperity. The central banks have come to follow the market and to fear all its reactions.

Gradually phasing out QE programs as soon as the crisis is over and taking into account the impact on the market to avoid too strong jolts is therefore of the essence. Indeed, we must not allow ourselves to be imprisoned indefinitely in a policy that has disadvantages recognized by all on the sole pretext that the re-entry into the atmosphere is difficult.

Then, we will need to take advantage of the first upturn in economic growth to start to gradually and cautiously normalize interest-rates. Of course, any monetary policy based on the avoidance of any debt restructuring is obviously absurd.

A Central bank should also look for the appropriate level of the interest rates of their related economy. As Tobin said, "in a world of fluid markets, monetary policies tend to play a beggar-thy-neighbour game. When all the Central Banks focus on interest-rates differences between countries, the overall average of rates is no longer anyone's business. This average will always end up being too high or too low". In other words, do not just look at your neighbour's rates but look for the right rates.

Putting this monetary discussion in the international perspective

The absence of any form of an international monetary system today can only encourage trade and currency wars. Any monetary policy of a country or a major area inevitably has external effects. Using national monetary policies for competitive purposes must be avoided. The exchange rate must regain its stability role in an organized international monetary system.

To avoid the possible consequences for exchange rates, it would be advisable to reach an agreement with the Americans on the evolution of interest rates at the earliest opportunity.

Encouraging structural reforms and sustainable fiscal policies means promoting a return to healthy growth in over indebted countries

At this point of time, it is not interest rates that hamper productive investments but economic prospects (mass unemployment, trade war, uncertainty about the future, high labor cost, excessive corporate debt…).

In the current context, it is essential to scrutinize the public budget and give priority to future expenditures (education, health equipment, research, innovation…) and undertake structural reforms which are the only ones that can promise a sound sustainable and better future. It is also of the essence to give priority to financing companies with equity rather than debt. Fiscal stimulus through current expenditure does not stimulate investment.

Governments must take corrective actions to ensure a path of primary fiscal balances. We must stop this psychodrama of so-called austerity, which is said to have weakened certain States of the Union. In fact, it is the fiscally virtuous countries that have best prepared their economies for the challenges of the crisis.

In countries with too much debt, decisions must now be made to stop "walking on their heads»; and to reduce unproductive and inefficient public spending. This is the only way to release the necessary resources to the productive sector. Just a few years of efforts mobilizing all the energies are all we need. Such a fiscal policy requires a spirit of cooperation among the different political parties and on a bi-partisan basis, examples abound in the Northern European Member States.

Many countries have undertaken such domestic structural reforms during the past decades. The successful efforts of many democratic States to adjust have enabled them, within a few years, to regain their fundamental balance and reverse their debt curves. Examples include a number of developing countries (in Asia and Latin America), Germany, Scandinavian countries, Canada, and to some extent the United Kingdom.

Under the prevailing lax financial conditions, the only countries liable to regain their strength and dignity will be those prepared to remedy their own structural imbalances, abandoning that these will be wiped out by the global monetary and financial mess.

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ANNEX

Chart 7 Share of public debt held by Central Banks on Mid-2020, %

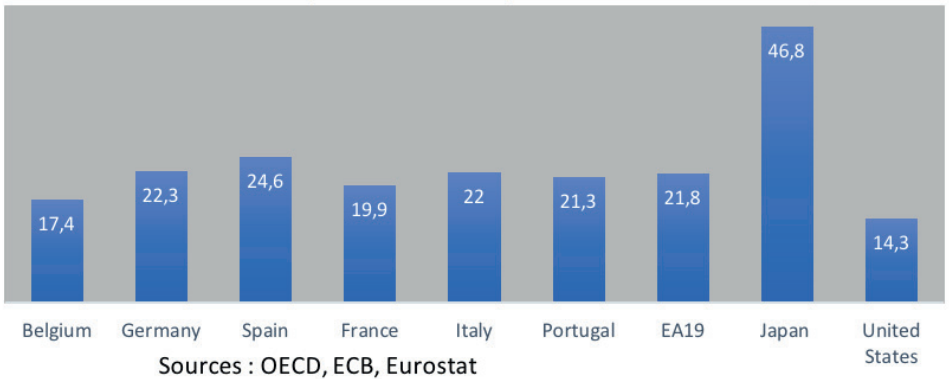
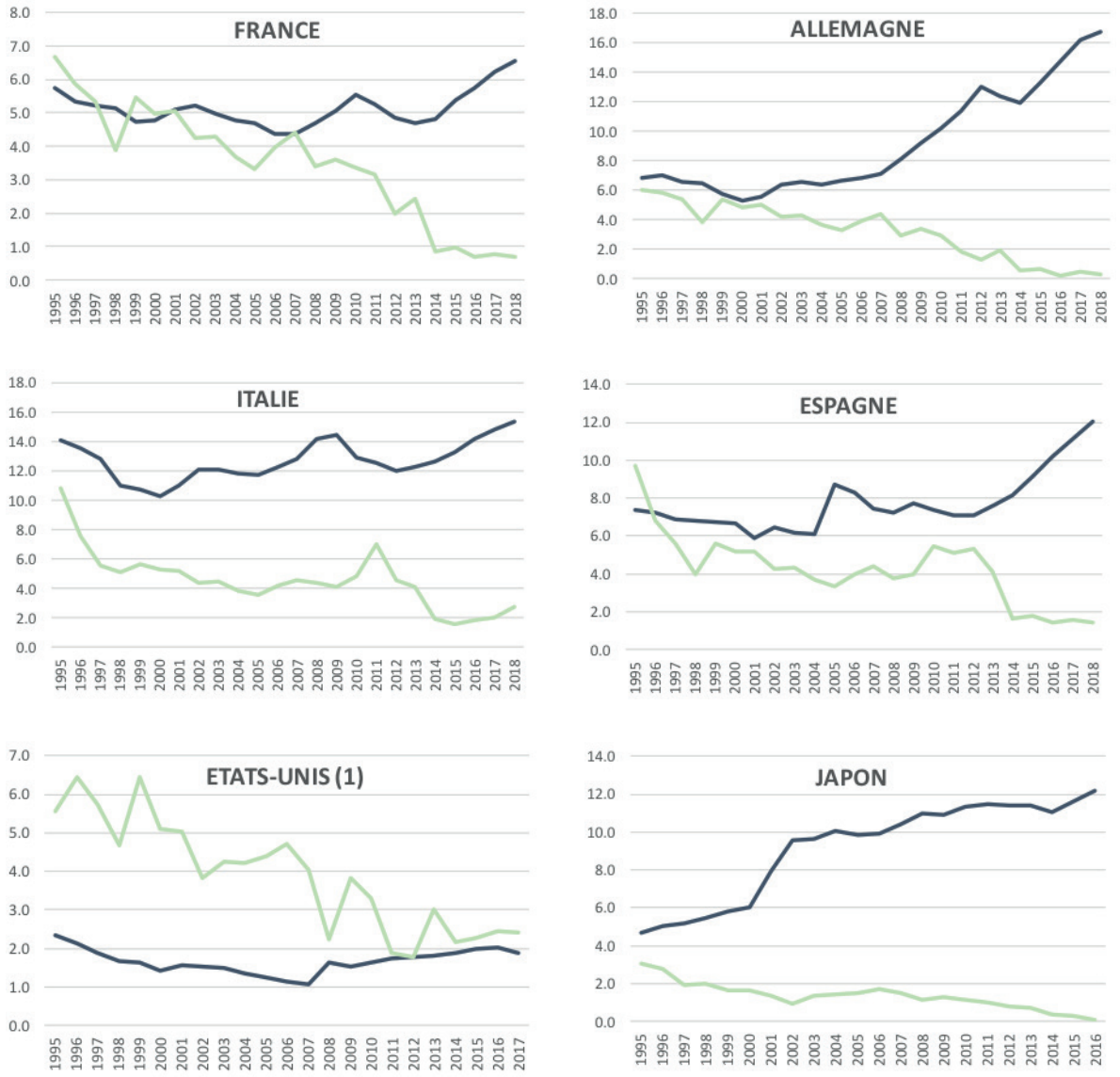
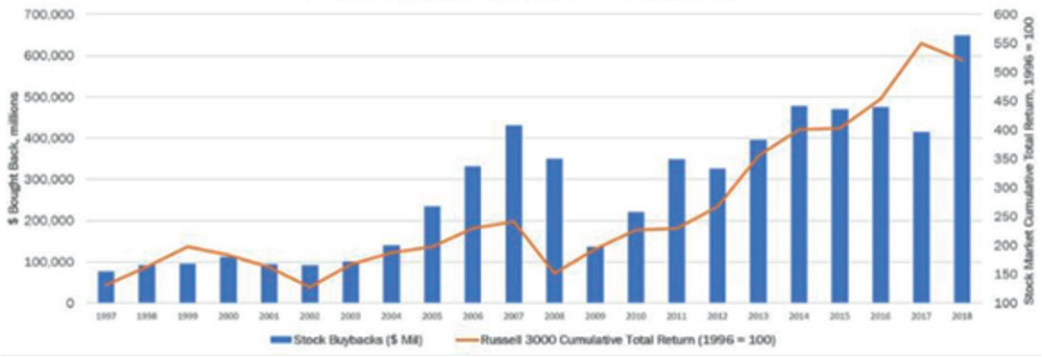


Chart 10 As interest rates fall, portfolios become more liquid
Evolution of the liquid assets of economic agents and interest rates on government bonds



(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).

Chart 11 Low interest rates encourage share buybacks



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

Chart 12 Share of bond market given the level of yield