Q&A

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Interview of Jacques de Larosière conducted by Didier Cahen on 30 March 2021

Views on the responses to the Covid-19 crisis

A little over a year ago, China sealed off the city of Wuhan. This was the starting point of an exceptional global health and economic crisis. One year later, what is your perspective on this crisis?

It is a crisis that has been exacerbated by our unpreparedness. Many expert reports had been highlighting the high probability of a pandemic for decades. But short-term concerns prevailed over long-term ones. We had not taken any preventive measures. As a result, we have approached this crisis like all the other major health crises in history, including the Middle Ages. With the same tools. The focus was on trying to contain the risk of contagion, confining the population as much as possible, managing the availability of hospital beds even if it means arresting the economy.

This extraordinary crisis has been treated not in an extraordinary way but mostly in an ad-hoc way like a crisis of the past. That said the scientific community has reacted impressively fast to develop vaccines, but their distribution is now provoking some ugly nationalism and greed.

Can we measure the damage caused to the world economy at this point of time?

Again, we reacted because we had not sufficiently acted preventively. Many companies stopped trading, with very high economic cost. The State has stepped in to pay workers. We have an unprecedented budgetary shock, commensurate with our unpreparedness. Overall, global GDP has fallen by almost 3.5% in 2020, according to the latest OECD estimates (March 2021), with three groups of countries:

- Some advanced countries that have seen their GDP fall sharply, by around 10%, include France (-8.2%), Italy (-8.9%), Spain (-11%) and the UK (-9.9%).

- Other advanced countries that have experienced a decline half as strong, such as Germany (-5. 3%) and the United States (-3. 5%).

- And emerging countries, with GDP down 2.4% apart from China, the only major country to have maintained some growth last year (+2.3%).

For the year 2021, there are still too many uncertainties to make solid forecasts: mutations of the virus, effectiveness and distribution of vaccines, social reactions, etc. But economic activity will generally remain below the pre-crisis level in 2022, or even 2023 for the most vulnerable countries. However, taking official forecasts projected growth in the U.S this year will be nearly twice that of the EU.

Why has the economy suffered so much more in some countries than in others, notably emerging ones?

For one simple reason. Although emerging countries have taken advantage of globalization to expand their exports, they are less integrated into globalization, and the virus has often been less prominent or percolating in their countries. They have also been protected from a very different “virus” attacking advanced countries: financialization.

Over the past 30 years, credit has grown faster than business, a development that will eventually be understood to be dangerous. Emerging and developing countries have not had the luxury of catching this “virus”, as markets do not lend money easily to them.

Why is the economic performance different between advanced countries, such as Germany and France, as well?

Germany is an industrialised country, France a country in the process of de-industrialization. In 20 years, the share of manufacturing industry in France's GDP has fallen from 15% to 10%, while it has remained at almost 25% in Germany. In a pandemic crisis, however, an industrialized economy is more resilient, relying on cutting-edge technologies. This is not the case with a service economy, which has been affected by a shutdown of normal neighbourly activities, such as tourism in all its forms: airlines, hotels, hospitality industries etc with major knock-on and negative economic multipliers. Because of de-industrialization, de-specialization, distribution rather than production, the Covid crisis has accelerated the weakening of the French economy – the consequence of "forty years of bewilderment."

What role does the pandemic play here?

It is a triptych revelator, accelerator and eye-opener.

Let's take the case of France: on the soft pillow where we too often rest, we were under the impression that we had an economic system capable of withstanding any exogenous shock having a very efficient health system. The coronavirus has been a rude awakening. Secondly, it is an accelerator, because the epidemic affects have impacted less on a healthy economy than on an obese one. With a public debt of around 100% of GDP and a ratio of public spending to GDP of 54% at the end of 2019, France is in the obese category compared to Germany at 60% and 44% respectively. It is the condition of the patient before the pandemic struck that is important.

How can we explain that EU countries have suffered more from the crisis than the US and China and are slower to get back on track?

Indeed, the economic crisis is more severe in Europe than in the US, and China which are now bouncing back more strongly than in the EU. China quickly contained its health crisis with fairly radical methods. As for the United States, the economy remains very flexible and the State has been very active in its federal interventions (including vaccination).

How can we encourage a return to healthy growth in a zero-interest rate environment, in European economies that are often over-indebted? What role for monetary and fiscal policies?

A priority is to re-establish financial markets that function on the basis of market forces and not according to the prescription of zero-interest rates. We must therefore stop advocating an indefinite period of zero interest rates if we want to revive economic growth. History (notably during the 19th century) shows that growth always implies work and the remuneration of risks: Adequate remuneration for risk is of the essence for fostering long term investment. Fiscal policies can also be used to promote investments for the future (research, infrastructure programmes, ...) but to do so, it is necessary to have the means to do so, i. e. to reduce non-productive current public expenditure.

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.

We can see how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours did not have the same margin for maneuver. Furthermore, the German economy is projected to return to its pre-pandemic size much sooner this year than for example Italy and Spain.

In countries with too much debt, decisions must now be made to stop « heads in the sand » syndrome and to reduce, sustainably, unproductive and inefficient public spending. This is the only way to release the necessary resources to the productive sector. Such fiscal policy requires a spirit of cooperation among the different political parties and on a bi-partisan basis, and examples abound in the Northern European Member States.

As in 2008, central banks have been at the forefront of this crisis. Have they performed well?

I have said for a long time that the excessive issuance of money is leading us to an unsustainable situation. If interest rates are to remain at zero for an indefinite period of time, a depressed view of society is created. Let me explain: few people have noticed it, but for several years now, productive investment has been collapsing. Why, when you can borrow money for nothing? The reason is investment project managers are discouraged from investing in a zero-rate environment synonymous with low growth; they tend to focus on remunerative, buy-backs and speculative assets.

Moreover, as a result of zero interest rates, household savings in Europe have shifted to liquid, non-risky assets, mainly bank accounts. This makes perfect sense when making investments no longer earn any interest because of zero interest rates and taking into account that retail savers in Europe are risk adverse. This is what Keynes already called the "liquidity trap". The decisions made have resulted in no longer remunerating investor risk and so turning away from risky long-term projects. Today's monetary policy makes tomorrow's economic decline. A society that no longer invests is a society with no future.

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), which shows that it is inseparable from a sharp fall in potential growth.

You have previously emphasized the dangers of monetary policies that remain accommodative for too long. Can you remind us of those dangers?

The impact of excessively 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:

- enhanced incentives to borrow more and increase financial leverage;
- 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 sufficient returns;
- proliferation of zombie companies in an environment where interest rates no longer play their necessary, selective "quality signaling" role;
- a strong disincentive for governments to undertake structural reforms since borrowing "no longer costs anything".

Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premiums (one of the characteristics of the 2008 crisis). In such a monetary environment, the market does not play its allocative function among different types of assets due to the massive asset purchase of the central bank. Indeed, the universal buying of sovereign securities eliminates the normal functioning of market forces between savings and investment and brings interest rates to levels close to zero which, as we have already seen, encourages the holding of liquidity to the detriment of productive investment.

How can free markets assess value in these conditions? How do productive economic projects distinguish themselves from sheer, speculative financial profit opportunities in the search for investment capital?

And regarding financial stability?

The present situation does not augur well for financial stability.

The Financial Times has recently reported that "the riskiest borrowers in corporate America are making up their largest share of junk bonds sales since 2007. From the start of 2021, more than 15 cents of every dollar raised in the US high-yield bond market have been issued by groups with ratings of triple C or below". And I would add that, according to a gauge of "cross-asset complacency" from JP Morgan, investors are feeling the least fearful and most complacent since the dotcom bubble. This sounds familiar and should be taken seriously by those who are responsible for monetary stability and still feel comfortable with the present monetary expansion.

A monetary policy that massively increases indebtedness as a response to insufficient inflation accumulates all the disadvantages: it is paradoxical to hope that inflation ("business") will take off again not so much on the basis of favourable economic expectations but as the result of even more public and private debt. However, given the extremely high levels of this debt, it is illusory that an additional dose of over-indebtedness will result in an increase in investment projects. This could lead to an increase of delinquencies and through a contagious "Minsky process" to broader contagion.

Another disadvantage is that the natural result of money creation in an environment of over indebtedness and depression due to the prospect of zero interest rates for a very long time, is the spiking of financial assets, not real assets.

Could the monetisation of public spending by central banks, if not accompanied by a control of public spending by Member States, lead to a break-up of the euro zone?

What threatens the break-up of the zone is the disparity of the economic policies and performance of the Member States and their lack of coordination. The Covid crisis is amplifying these disparities between northern and southern members of the Eurozone.

This is something which is very obvious and is connected with the structure of economies, the weight of the services sector, of tourism, or the average size of companies. Another additional element is the fact that the fiscal space available was different in every country at the start of the crisis.

This heterogeneity, these structural fault lines are bound to increase with the further increases in public spending during this crisis. If Member States whose public debts are already excessive do not make a more serious effort to reduce public expenditure not justified by imperative and urgent needs, the problem of the Eurozone' centrifugal forces can only worsen.

For the time being the ECB equalizes interest rates through very heavy interventions. But if structural reforms are not implemented in the "southern" countries, it will be difficult for the Central Bank to intervene forever, which should not be allowed by the Maastricht Treaty.

What mechanisms can Europe use to correct the growing heterogeneity of economic performance between euro area countries?

The Next generation EU recovery package is a significant fiscal deal and a welcome EU step forward. But the EU mechanisms to correct this growing heterogeneity remain limited and the name of the game for mitigating the risk of further economic divergences will remain national. It needs to be implemented quickly.

This means implementing structural reforms to strengthen productivity and lift potential growth rates, mitigating failures of healthy firms, ensuring a smooth re-allocation of resources, improving the functioning of markets and public administration, reorienting fiscal policies towards sustainable and digital investment….

When should the ECB prepare the markets for a normalisation of its monetary policy and what are the expected benefits?

Once the health crisis is truly under control, the ECB must prepare the markets for a gradual normalisation of its monetary policy.

Central banks would become more flexible and would regain room for manoeuvre: public opinion would begin to realise that zero interest rates for an indefinite period (perhaps a decade or two) would become unrealistic; in so doing, the illusory dynamic: “zero interest rates for an indefinite period, supposedly a factor in the recovery of investment” would be replaced by a more effective and more traditional paradigm: “the markets remunerate savings invested over the medium and long term in accordance with the supply of, and demand for, capital”.

Finally, financial stability can only benefit from such a normalisation of monetary policy because asset bubbles should tend to stabilise or shrink.

Does such monetary normalization require a revision of the inflation target of the central banks?

Indeed, central banks should relax their inflexible inflation targeting of 2% inflation, assuming that it has been below its target in recent years, as break-even inflation is more likely to be around 1%.

Failure to meet the 2% target should no longer be an excuse for mechanistic monetary easing. It should also be clear that the systematic purchase of bonds should not become a means of enabling governments to finance large stimulus packages without ex-ante conditions, including spending efficiency.

Wouldn’t such a normalisation of risk lead to a bond crash?

Such a normalisation can only be gradual and explained to the markets. Moreover, they seem to have understood this before any explanation. The increase in long-term interest rates remains very modest to date.

Shouldn’t such standardization be agreed at an international level?

Of course. This is an essential part of the success of the operation. All monetary policies are interconnected, exchange rates react immediately to changes in interest rates: in order to avoid the “beggar thy neighbour policy”, international cooperation is needed, as was the case until the 1990s.

At what point should Member States withdraw the exceptional fiscal support that has been granted to companies and households? What precautions should be taken in this regard?

Given the scale of the recession caused by the pandemic crisis and given the direct and extensive role played by governments in supporting companies and activities, this budgetary support will have to be maintained for some time. But the quality of expansionary fiscal policies must be improved without delay. The continuation of excessive current expenditure appears very dangerous.

A public debt rate of 120% does not have the same effects if it covers current expenses or if it finances productive investments that will generate future revenues. In the first case, the budget sinks into cumulative deficit. In the second case, the deficit eventually stabilizes or even narrows in line with investment income.

The sustainability of public finances requires that fiscal policy really should take into account this improvement in the quality of public expenditure in the coming years. This criterion should be a guiding element of the reform of the Stability and Growth Pact (see below).

How can Member States and the financial sector increase equity support for highly indebted but viable companies?

A broader concern in all EU economies – and in particular in France and the Netherlands- is the high level of debt, especially corporate debt, with private sector debt service burdens at or above their level during the global financial crisis despite historically low nominal interest rates.

Although some firms have used borrowing to build up sizeable cash buffers since the onset of the pandemic, high leverage could moderate new investment. According to the OECD, the debt service ratio of the private non-financial sector of adjusted sector gross disposable income is 22% in France, 15% in the US and 10% in Germany.

Two cases will arise: companies whose business model are very seriously threatened and who are unable to assume their debt and, secondly, companies whose fundamentals offer hope.

For the latter, it will be necessary to provide for the transformation of debt into equity (equity loans and investment funds with a guarantee for investors). For the former, it will be necessary to carry out structural transformation (mergers and acquisitions) or liquidations. A pan-European system for dealing with these companies in difficulty under current conditions should be established, including for NPLs.

Another essential policy ingredient is a fully functioning Eu-wide banking and capital market. In the EU, these projects like banking and capital markets Union are moving too slowly hampering the emergence of a more dynamic economy able to finance more flexibly and quickly companies and individuals.

What is the future for the Stability and Growth Pact (SGP)? Should it be reformed before it can be implemented again? When should we consider a return to these rules?

We can always envisage improvements, but the reality is unfortunately very simple: when the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average of the eurozone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

It is all the more important to strengthen the common discipline the system has put on the backburner during the crisis. Those rules are the cement to keep together the eurozone [and let us be honest they have never been properly applied].

As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that will inevitably pose systemic risks to financial stability and therefore to future growth.

Do the rules of the SGP need to be amended (3% deficit, 60% public debt compared to GDP) or completed (e.g. with a rule regarding the evolution of public expenditure in relation to GDP)?

When the facts are proven, some ratios, notably the 60% public debt/GDP ratio, appear to be problematic. Firstly, they have not been respected in the past and secondly the heterogeneity of Eurozone economies do not fit well with single ratios. The following are some guidelines that could inspire reform:

(a) For countries with debt levels of 100% or more, it is essential to maintain their ratings, which requires that public debt be stabilised. The way to do this is to achieve a primary surplus (without taking into account the interest on the public debt) as a number of European countries such as Italy understood before the crisis.

This is important because the markets are probably guided more by dynamics than by absolute numbers in determining country spreads. The economic literature has shown that non-resident investors are extremely sensitive to the slope of government debt. However, if we accept that monetary policy will not always be there to buy all the new sovereign issues, it will be imperative to reassure the markets by gradual fiscal normalisation policy. From this point of view, the updated rules should include special monitoring of the primary balance by prohibiting primary deficits.

(b) Insist in these future rules on the importance of the quality of public spending, as Mr. Draghi emphasised in his Rimini speech. We have become accustomed to considering a deficit of 3% of GDP to be normal, regardless of the quality of the expenditure. This has led Europe to tolerate deficits that have essentially financed current expenditures that have no capacity to generate future revenues. It is time to focus on public investment spending that creates future revenues and that balances the equation in the medium term. This requires a strong shift from the present situation where public investment is only a tiny part of public expenditures.

The quality of public spending should be an important criterion for assessing fiscal policies. Countries that tend to perpetuate very high ratios of public spending to GDP should be discouraged from doing so, and these Member States should be encouraged to maintain investment spending for the future.

We have to recognize that this shift towards more productive public investment will require very substantial political effort because presently public investment only accounts for some 4% of GDP while current - non productive expenditure - represent almost all public expenditure. So, in order to make room for a significant improvement of public investment, we will have to reduce in parallel the overwhelming share of current expenditures.

In order to achieve the two objectives above, ie primary surplus and shift towards public investment, a set of EU mechanisms will be required. We need to establish, country by country, the appropriate levels of primary surplus and rigorously monitor the progress towards a better quality of public expenditure.

c) Put in place early warning mechanisms to prevent unsustainable public finance trajectories: a country whose share of public expenditure reaches record levels in relation to the European average should be subject to special discipline: it is more serious to have 54% of public expenditure/GDP (before Covid) when the European average is 8 to 10 percentage points lower than to have public debt above 60%.

Of course, all of the above could be completely unimplemented, as was the case with the old rules of the Stability and Growth Pact. The sanctions originally provided for were never implemented. If this drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them.

If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.