REFLEXION ON THE APPROPRIATE STANCE OF MONETARY POLICY

Note written by Jacques de Larosière

Today's world is made up of paradoxes.

Global demand is weak, while investment needs are enormous and are not being realized, at least in Europe.

Interest rates have been kept very low for many years, although non-residential productive investment has been declining.

Let us try to put some order in these apparent contradictions.

1. Why has monetary policy been particularly accommodative for more than 10 years and interest rates have converged to zero or less?

M0 (ie bank notes in circulation and bank reserves held at the Central Bank) has grown extremely fast since 2008: 13,5% a year in advanced countries, while their GDP grew on average 2% in real terms.

Given an annual GDP inflation around 1,5%, the average nominal growth of GDP in the advanced countries has been in the order of 3,5%. Therefore, during those 10 years, the Money base had grown almost 4 times quicker than the nominal economy.

How can we explain such a prolonged and rapid expansion of money through the massive recourse to QE?

The explanation is simple but worrisome.

In a nutshell, it is the following:

Monetary policy has been geared to an overriding objective in terms of Consumer Price Index (CPI) in order to keep inflation at a level close to 2%.

But this objective gives rise to a major problem:

Structural factors have been at play over the last 10 to 15 years (while they did not manifest themselves in the earlier years - 80's and 90's - during which the objective of 2% was conceived).

Indeed, since then, a number of structural factors have coalesced and have exerted, together, a significant and lasting dampening influence on inflation:

- The ageing of population reduces the pressure of consumption and investment on resources;
- The opening of international trade and globalization have allowed "western" countries to import massive amounts of goods and services that are made up of very low wages (approximately 1/10th of those of industrialized countries);
- In order to try and resist this over-competitiveness of emerging countries exports, the "west" has been obliged to contain its own wages, thus exerting a dampening influence on costs as well as on wage earners behavior;
- And one should add the consequences on prices stemming from technological innovations that are significantly reducing the costs related to the information technology.

The above factors explain the moderation of inflation.

This moderation was not the result of a weakness in demand, but, basically, of structural changes.

That is where, in my view, monetary policy makers have made a serious mistake.

They seemed to believe that low inflation – lower than the, arbitrary, target of 2% - was essentially the manifestation of insufficient global demand. Therefore the Keynesian recipe: ie monetary stimulus – was justified in their eyes.

So they decided to increase monetary creation as long as inflation was lower than the sacro-saint target.

I believe the nature and the causes of the desinflationary forces should have analysed more precisely. To the extent these forces are structural – and thus unavoidable – one should not try to repress them by more money expansion. It is remarkable that money expansion, in fact, did not create more demand nor more inflation but translated into less velocity. If one looks at M3 (that includes banking deposits) one observes a much slower expansion (3,8% annual average in the EU). This shows that the push in Central Bank money (M0) has not seeped into the real economy and has not created much banking credit.

Indeed, the structural environment that I describe showed that an "inflation objective of around 1%" would have been, in fact, the equilibrium rate. Such a target would have avoided inflation as well as deflation.

If monetary policy over the past 15 years had been geared to a more realistic inflation target of around 1% instead of 2%, the world would have avoided the un-necessary expansionist monetary stance as well as deflation.

This systematically loose monetary policy has contributed to the building of the enormous credit bubble that nearly broke down the financial system in 2008. All financial indicators were flashing. But as the CPI was low, Central Banks were not worrying.

However, they should have been concerned by the huge asset bubble that was building.

Such bubbles are indeed the present manifestation of inflation in an environment of technological price desinflation.

As strange as it can seem, the extreme magnitude of the excess leverage that was appearing in the financial cycle, did not attract the attention of Central Bankers, simply because CPI was stable. The financial house was burning, but no alarm bell was ringing; complacency was the name of the game and the fire became threatening.

2. Thus monetary policy has been extremely accommodative, while growth has been subdued and investment has receded. What have been the results of such a policy on growth?

Let's try – once again – to put some order into apparent contradictions.

Firstly, if aggregate demand remains weak, it is mainly, as I have just shown, due to structural factors: ageing, globalisation, technological advances, changes in labour market behaviour, leading to an overall saving surplus. This is where the debate on monetary policy and interest rates starts.

We are told that in the face of excessive savings, we need fiscal and monetary policies to stimulate demand.

Let us pause for a moment to analyse this apparent obviousness.

As we have seen, monetary policy has been particularly accommodative for more than 10 years and interest rates have converged to zero. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within 5 years (2015-2020). Private debt incurred by non-financial enterprises has also ballooned (in France, for example, the private debt service of non-financial enterprises is reaching 22% of their disposable income, while the figures are 15% and 10% respectively in the US and in Germany).

What do we see?

In spite of the explosion of debt over the past 20 years, the stock of non-residential productive investment (without intangibles) has fallen from 14,4 % to 12 % of GDP in advanced economies which has been only partially offset by the rise in intangible investments which have risen from 4,3 % to 4,9 % of GDP (see Figure 1). This is a major downward evolution.

What surprises me is that this statistic – which is one of the most significant in terms of global demand – is not highlighted more. And this collapse of productive investment has occurred despite historically low interest rates.

Let's continue this line of thinking. A strange hypothesis eventually emerges : What if it was low interest rates that contributed to lower investment ?

"Absurd and nonsense" I will be told: if the financing conditions are easy and inexpensive, how could the investment be penalized? This is where the liquidity trap comes in.

Once again, Keynes was right. He was in favour of low interest rates, but not too low interest rates. Indeed, when they are too low, they deter savers from investing in long term bonds and encourage them to either keep their savings in liquid form or in assets remunerated basically because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of no-growth emanating from zero interest rates, are turning away from productive investment in favour of share buybacks and speculative opportunities.

What I have ust said is not a confabulation. This is based on a study carried out last year on the development of the financial part of household savings in Europe: **over the past 10 years, we have seen a massive increase in the purely liquid part of household savings (notably overnight bank deposits). And this, of course, before the Covid crisis.**

For sure, this research is European and may be less verifiable in the United States, where investors are less risk-averse than in Europe and more interested in the opportunities offered by Wall Street. So, I don't pretend that my interpretation is universal. But if it is correct in Europe, we should give serious thought to the problems posed by our current monetary policy.

This is all the more so as the role of banks in financing the European economy is much more marked than in the United States (3/4 in Europe, ¼ in the United States). The profitability of banks is penalized by zero interest rates. This penalty is all the more pronounced in Europe as interest rates are lower than in the United States.

So, there is a problem in Europe: is it possible that the mantra that we have been taught for 20 years is not adequate? Could it be that slightly higher rates could boost the morale of European companies and steer savings towards productive investment?

What I have just said might not be of great interest to American economists: their country has an extremely strong stock market and economic agents are less sensitive to interest rates because of their natural tendency, when interest rates get very low, to move from bonds to equities. In addition, the United States issues the world currency, which gives it some leeway to finance its deficit.

3. So, we have to deal with the question: rather than being satisfied with a paradigm of low growth in Europe, isn't it time to ask the fundamental question: «What if zero interest rate monetary policy was not the right recipe for reviving the global economy?»

I have recently heard a Chinese economist, a professor at Peking University, say the following: «A too accommodating monetary policy raises many objections:

- Our economies need investments: to finance them we must encourage instruments with sufficiently high returns to cover the risks involved.
- Using monetary policy to stimulate the economy inevitably leads to the inflation of financial assets and thus increases the danger of a crisis».

The profound truth of the real world is that a well-functioning economy is always based on work and normal returns on savings and therefore interest rates freely defined by the markets.

I will be told that, for all the secular reasons we know, the "natural» interest rate is declining.

That's certainly true. But what is not said is that monetary policy plays a major role in lowering rates. It is so true that when the market anticipates the start of a rate hike, central banks usually buy billions of securities to discourage this trend.

Of course, I am aware of the effects of this recommended approach on sovereign securities markets. But monetary policy should not be at the service of the fiscal sustainability of States. Markets must play their role and not be entirely dictated by central banks.

Or should the wartime "Accord" between the Fed and the US Treasury be revived and sustained worldwide?

Even if the above does not convince the leading monetary thinkers, **there remains an unescapable issue: that of financial instability.**

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.

Conclusion

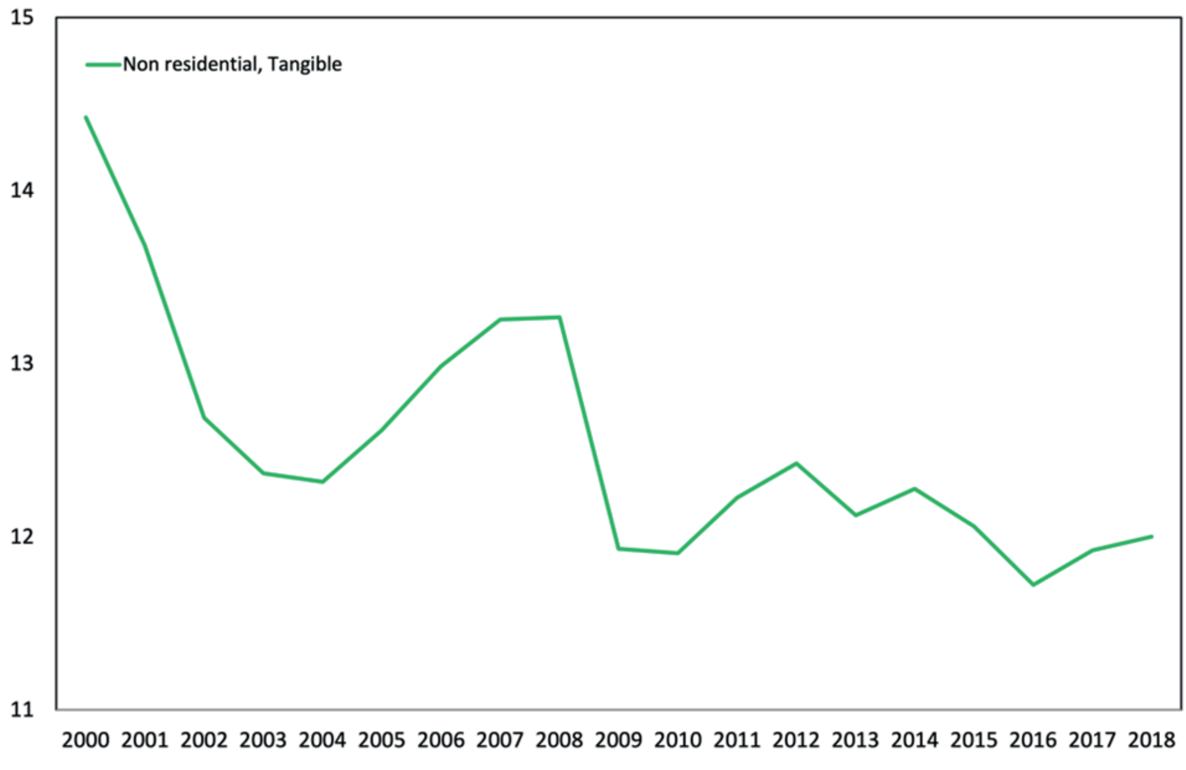
Time has come to start getting out – gradually and with the benefit of international concertation – of the present monetary trap : I would propose three orientations :

1. Allow long term financial markets express their inflationary expectations through higher yields. This would provide investors with a more normal remuneration: to foster long term investment, adequate remuneration for risk is essential;
2. Have a more realistic view on price developments. A positive CPI but slightly less than 2% is not a sign of instability, on the contrary;
3. If yields tend to get somewhat higher, Central Bankers should not consider that they should, by all means, repress that tendency and provide Member States with the unconditional benefit of a zero-rate guarantee.

Fiscal domination – which is presently a fact of life – should not become the rule.

Appendix

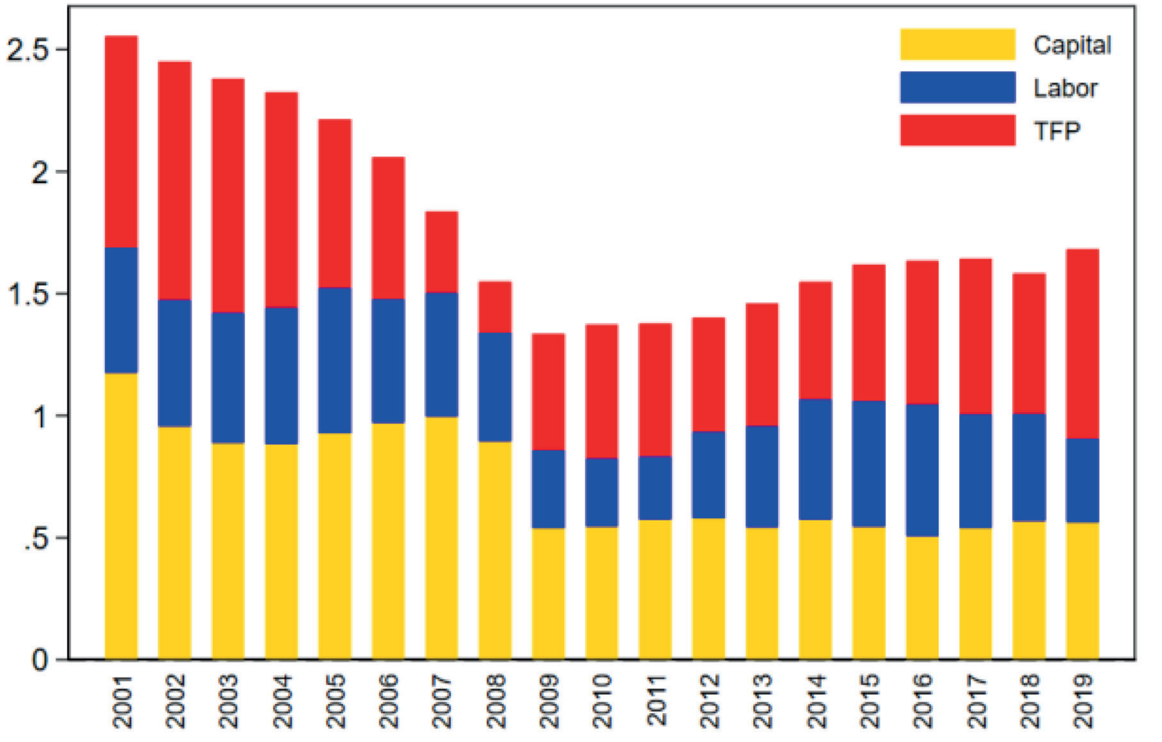
Figure 1. Advanced Economies: Non-residential Fixed Investment in GDP (Percent of GDP)



Source: OECD; IMF Staff Calculations.

Advanced Economies = Australia, Canada, France, Germany, Italy, Japan, Korea, Spain, United Kingdom, United States.

Figure 2. Advanced Economies Production Decomposition Function (Percent, year over year)



* Potential GDP = Estimate from a multivariate filter.
* Capital = OECD non residential capital stock.
* Potential labor = Trend labor participation rate x working age population x (1- NAIRU); NAIRU from multivariate filte.
* Labor share = average over the period, from Penn World Table.

Sources: OECD; Penn World Table; IMF Staff Calculations.

Advanced Economies = Australia, Canada, France, Germany, Italy, Japan, Korea, Spain, United Kingdom, United States.