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ECB needs to change gear

During the Lehmann Brothers, EU sovereign debt and Covid crises, central banks and fiscal policies played a crucial role and intervened on an unprecedented scale to keep financial markets liquid and stabilize the financial system.

Meanwhile central banks have been overly involved during the past years. No well-functioning economy should operate with real interest rates that remain negative for too long: capital is then misallocated and growth impaired.

Can money creation indefinitely outpace the pace of economic growth? Can we ignore the financial vulnerabilities created by zero interest rates, the inexorable rise in global debt and the "search for yield" when productive investment has performed poorly over the past 15 years? Does the resumption of activity in Europe require the extremely accommodative stance of monetary policy? Can we stop inflation in Europe with increasingly negative real interest rates and continued QE programmes? Is the priority mission of central banks to protect States from fiscal difficulties by financing their deficits rather than to protect the purchasing power of citizens by fighting inflation, even if it means risking a social crisis to avoid a financial crisis?

The continuation of very low interest rates in the euro area would intensify already negative consequences for financial stability, growth and employment. As the Eurofi monetary scoreboard (February 2022) demonstrates, pushing too hard and too long on the monetary pedal has severe negative consequences: the lasting excessively accommodative monetary policy enhances incentives to borrow more and increase financial leverage, disincentives governments to undertake structural reforms since borrowing "no longer costs anything". Persistent low or negative interest rates induce a fatalistic mindset that lowers, not raises, propensity to invest. Under what J.M. Keynes called the "liquidity trap", investors play safe by placing savings in very short-term instruments rather than deploying them longer term when low interest rates bring them inadequate returns for higher risks.

The social significance of persistent very accommodative monetary policies should not be underplayed. Did they help reduce societal inequalities? In fact, the opposite is true; they tend to make societal disequilibria worse because the beneficiaries have been those who have the income and capital to profit from inflated financial and asset markets. Not poor people.

Thinking that monetary creation can notably solve the problems arising from excessive debt is an illusion. 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. Actually, the huge monetary and fiscal stances of the last decades have not led to investment or higher growth. In other words, supply-side obstacles cannot be resolved by throwing conjunctural money at problems.

Monetary policy can erase spread differentials in the euro area but cannot relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect the persistent doubts of investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

Policy makers need to rebuild safety margins. As stated by the BIS in its Annual Economic Report (June 2021), "an economy that operates with thin safety margins is vulnerable to both unexpected events and future recessions which inevitably come. These margins have been narrowing over time. Rebuilding them means re-normalising policy".

Inflation has risen sharply in recent months and could be more persistent than thought which would endanger the economic rebound: indeed, inflation is lowering notably real revenues and the earnings of companies with negative consequences not only for consumption, but also for investment.

Easy money policies have become even more accommodative because of rising inflation, which has caused negative real rates to fall still further. It is rational to believe that wage-earners will react substantially to higher prices. Trade unions will insist on some form of compensation or indexation to adjust wages. In theory if inflation abates, price adjustments should disappear. But experience shows that it takes a long time to get rid of indexation, because it comes a habit and even a social right.

Central banks are behind the curve and need to move more quickly. In such a context, Federal Reserve Chairman Jerome Powell has announced an accelerated ending to the Fed's quantitative easing through massive government bond purchases. This delivers an urgent message worldwide. If central banks fail to act now, the economic rebound could be running into severe problems. Inflation will lower real revenues, prompting destabilizing wage demands, from income-pressed workers.

The world should move gradually and cautiously towards monetary normalisation, in order to avoid a cliff effect. Central banks should pursue without compromise their primary objective of monetary stability, especially without taking governments' funding costs into consideration as well as the kind of addiction and dominance of markets that is hard to give up, markets regularly challenging central banks with instability and the threat of correction as an — even modest — tightening in monetary conditions approaches in the end acting as inhibitors.

As W. White stated, "until now, central banks have been lured into a "debt trap" where they refrain from tightening, to avoid triggering the crisis that they wish to avoid, but that restraint only makes the underlying problems worse".

Normally, central banks policies should tighten when inflation threatens, and overheating is apparent. Instead, we see the opposite: a significant de facto loosening. The climbing of inflation from 1% to 5% in Europe with still no significant upward adjustment in interest rates results in a huge further monetary stimulus. Responding this with assurances that price pressures are 'transient' is not sufficient.

Waiting too long will not make life easier: neither for central banks nor for the economy. Indeed, the risk is that hesitation could force central banks to tighten credit far more abruptly later on, causing more pain than if they acted in timely fashion. Preparing for European interest rates to return to more normal levels would not only be a signal of central bank independence on both states and markets, but also be the first step to a more productive post-pandemic period of higher growth and productive investment.

Fostering a sustainable path to stronger growth is essential, notably in the current indebtedness environment. Raising long term potential growth requires structural reforms, an appropriate remuneration of risky investments and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries, has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything; and more productive investment does not require more redistribution by budgets: only domestic structural - supply side oriented - reforms can resolve structural issues and foster productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

In over-indebted countries, governments must take corrective actions to ensure a path of primary fiscal balances and reduce unproductive and inefficient public spending. Reforming the Stability and Growth Pact is an urgent necessity.

Only productivity enhancing, and productive investment can create sustainable increases in productivity, neither negative rates, nor QE.