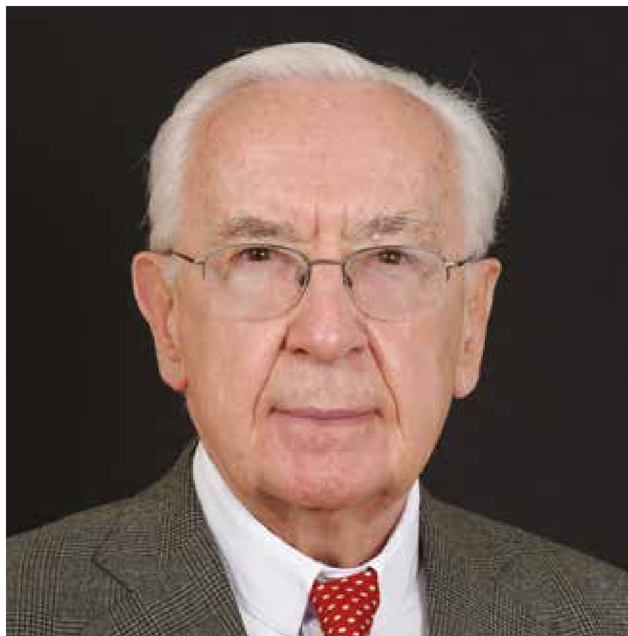

Q&A

JACQUES DE LAROSIÈRE

Honorary President -
EUROFI

Central banks must get out of the control of the yield curve

How did the ultra-accommodating monetary policies of the last 10 years create the conditions for a financial crisis?

The policy stance has been continuously accommodative and interest rates have been kept too low for two long. Even if secular factors (ageing, globalization, ...) explain that interest rates have been declining, it remains that the Fed funds rate have been kept negative, in real terms for 20 years. After the worst was over after the Global Financial Crisis and the EU sovereign debt crisis, policy rates should have been gradually raised above zero. But monetary policies have been asymmetric especially in the euro area: as soon as the economy showed slight signs of weakening, monetary policy was immediately loosened while it was reluctantly tightened in case of overheating. The fear of deflation was overdone and was not based on objective facts (fall in prices never happened).

Lasting very low interest rates favored the growth of debt, which reached unprecedented levels and increased financial leverage which undermined financial stability. A normal monetary policy includes the monitoring of credit growth in its indicators, but the credit growth rates for 20 years have exploded without control by the central banks. Between 2000 and 2019, M3 grew between three and four times faster than GDP, in the US (2.9 times) and in the Eurozone (3.8 times). But it is always the explosion of credit that is the source of financial crises! The fact that central banks turned a blind eye to the explosion of credit is incomprehensible.

This created the conditions for financial and real estate asset prices inflation and discouraged productive investment. The entire financial system and the real economy have been weakened over the last 20 years by this addiction to permanently zero interest rates. A Mc Kinsey report shows that 75 per cent of the trebling of net wealth observed in the global balance sheet over the last 20 years came from higher market valuations of "speculative" assets and only 25 per cent resulted in real investments and wages!

Central banks were convinced that interest rates would remain at zero for a very long time, to the point that the markets were convinced of this. The risk of rising interest rates has even not been included in the US stress test in February 2022.

They have therefore prepared the financial crisis to come.

Faced with inflation, which they wrongly considered to be transitory, central banks are raising nominal rates since several months, which reduced the value of fixed-rate bond portfolios. Risk management, and in particular interest rate risk, is becoming essential. This is where we are today.

Last but not least, instead of stimulating money creation and public debt, it would have been better to undertake structural reforms capable of increasing productivity and thus potential growth. The mistake that has been made for a very long time is to believe that the deficiency in potential growth lies mainly in the insufficiency of demand, whereas this deficiency was and remains above all a problem of supply. When monetary policy is too lose, it damages aggregate supply.

In the current macroeconomic context, what does normalizing monetary policy mean?

Central banks must get out of the control of the yield curve. QE has been used and abused to reduce artificially long-term yields while such yields should be the result of demand and supply on the financial markets. If central banks were to reduce their balance sheet only in a limited or symbolic way, the excess liquidity which is the source of financial instability would persist.

We need to stop telling fairy tales. We need to recognize that the policies that have been pursued over the past 20 years or so have caused serious damage to the soundness of the financial system.

We must not cling to positions that have proven dangerous in an attempt to pretend that we were right all along.

Denial is not a strategy. It is the recognition of the facts and the willingness to get out of the problem that justifies public action.

A gradual, but determined, return to a more traditional and sensible monetary policy is of the essence. It should:

- Restore the oversight of credit expansion.
- Reintroduce symmetry in monetary policy and not stimulate continuously.
- Not give the market a form of free insurance against possible losses; moral hazard has pleagued the system, upset the risk-reward relation and encouraged short term speculation.
- Be more careful on the risk of fiscal dominance; having created money to buy some 70 % of GDP in the euro area, the central bank is getting so deeply involved in fiscal affairs that its independence is questionable.
- Should refrain central banks from the temptation of being "popular" and having too many goals (green, social inclusion....) that are not at the heart of their primary mission which should be monetary and financial stability.

But haven't monetary conditions tightened much in the Eurozone since July 2022?

This is not the case in real terms. It is true that central banks have raised their policy rates by 350 basis points in the euro area between July 2022 and March 2023, and by 475 basis points in the US between March 2022 and March 2023. Nevertheless, real interest rates in the euro area are more negative than they were before the war in Ukraine. It seems difficult to fight inflation with such a debt premium.

The ECB, for its part, bases its policy not on realised and observable inflation but on the expectations of economic agents. Market expectations seem reassuring. However, there is a risk in relying on these expectations. Just because inflation expectations are limited does not mean that they are accurate. These expectations are always subjective and rarely based on a rational forecast of future price increases.

The investors interviewed are often tempted to play down their expectations in order to reduce or hide the disadvantages that could arise from too much inflation. Having suffered only a part of the losses caused by the rise in rates (central banks having borne a third of them), investors even if they feel relatively "serene", want to stop the rise in rates. Investors are also influenced by the emblematic centrality of the 2% target, as created by central banks.

It can also be shown that positive real interest rates would force over-indebted states to reduce their deficits and debts; savings would no longer be taxed but remunerated and medium and long-term investments would be encouraged because they would be remunerated.

Zero or very low interest rates foster the "liquidity trap" as Keynes taught: they push households to choose increasingly liquid forms of savings and to move away from long-term investments whose risk is not remunerated. Actually, the huge monetary and accommodative fiscal stances of the last decades have not led to productive investment or growth.

How important is it to achieve a swift agreement on the reform of the EU economic governance framework in the coming months?

When the house is burning (when deficits and public debt are increasing in certain countries), we must not postpone the arrival of the fire department (absence of European rules and endless discussion on the economic governance of Europe). This is the reason why an EU agreement on the reform of the economic governance framework needs to be achieved in the coming months.

It is important to understand that if fiscal policies were to remain expansionary, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus. Moreover, as public debt ratios worsen, the problem of debt sustainability becomes more acute.

Since the pandemic hit in 2020, the general escape clause of the Stability and Growth Pact has been applied and the Commission motivated the Member States to pursue an expansionary fiscal policy. Reacting to the economic consequences of the Russian invasion of Ukraine, the European Commission postponed again the renewed enforcement of its fiscal rules by a year, to 2024. However, the problem of excessive public deficits and indebtedness of some EU Member States constitutes the central explanation for the financial fragmentation within the eurozone.

Without an effectively implemented European fiscal framework, it is not possible to resolve this issue and thus to reduce the growing heterogeneity in terms of budget and debt between the virtuous states and the others.

As we have observed, these fundamental problems have been with us for nearly 20 years and were not created by the war in Ukraine or the Covid crisis. These two shocks have exacerbated these problems but are not the cause.

By renewing the suspension of European fiscal rules once again in May 2022, policy makers believed that they would have an easier time later. In reality, postponing has solved nothing, and only complicated the resolution of problems that are likely to become even more acute.