Monetary policy: truth or prejudice?

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

However, 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: risk is mispriced, capital is then misallocated and growth impaired.

As the Eurofi Monetary Scoreboard demonstrates, pushing too hard and too long on the monetary pedal has severe negative consequences: the lasting excessively accommodative monetary policy over the last decade has enhanced incentives to borrow more, increased financial leverage and undermined financial stability. It also discouraged governments from undertaking structural reforms since borrowing "cost nothing" and undermined growth potential. Thinking that monetary creation can solve the problems arising from excessive debt is an illusion. In other words, supply-side obstacles cannot be overcome by throwing money at problems or by using cyclical policy instruments. Yet this is what has been done too often by pursuing lax fiscal, monetary and economic policies that will inevitably pose systemic risks to financial stability and therefore to future growth. Actually, the huge monetary and accommodative fiscal stances of the last decades have not led to sufficient productive investment or growth. 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 over 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. Do they help reduce social inequalities? In fact, the opposite is true; they tend to increase wealth inequalities because the beneficiaries have been those who have the income and capital to profit from inflated financial and real estate asset markets. Not poor people.

Formerly attempting to "look through" what they considered to be "transitory" higher inflation, many Central Banks across Advanced Economies responded late and slowly. Inflation must remain the priority of central banks despite the vulnerabilities they have created over the years.

Since the resurgence of inflation, a number of approximations and untruths have emerged.

- **"The war in Ukraine with its consequences on energy prices was the main factor in the return of inflation".** However, this is not the case: in January 2022, inflation in the Eurozone was 5.1% and has been above 2% since July 2021 – well before the outbreak of the war in Ukraine – since when it has been rising.
- **"The high levels of inflation since February 2022 are mainly the result of the supply shock (bottlenecks in production chains, rising commodity prices)"**. The situation was in fact more complex because demand, driven by expansionary monetary and fiscal policies, ran up against the long-standing structural problem of inelasticity of the productive capacities, which is largely due to insufficient productive investment over the last decade.

  Instead of stimulating money creation and public debt, it would have been better to undertake structural reforms capable of increasing productivity, labour participation 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.
- **"Since we had a partial view of the causes of inflation last year (oil price rises, the exit from Covid and the war in Ukraine), we thought that it would be transitory"**: in fact, the rise in the price of commodities was only supposed to be a shock limited in time. This was to forget that a significant rise in energy and food prices inevitably spreads throughout the economy. Moreover, given that the inelasticity of the productive capacities largely explains the inflationary problem, the shock could not be transitory because it is the supply side that is in question and the insufficiency of investments cannot be corrected overnight.

This explains why core inflation – excluding changes in energy, food and other volatile components – remains very high in the US and Europe. In March 2023, core inflation reached 5.7% in the euro area and 5,5% in the US in February 2023.

Moreover, the costs of decarbonisation are expected to increase with the rise of renewable energies, the increase in the price of carbon, the upward pressure on the prices of precious metals (lithium, cobalt, nickel, etc.) needed for the equipment required for the energy transition (electric batteries, etc.), which should contribute to making inflation structurally higher.

It is therefore necessary not only for monetary policy to normalise but also for governments to undertake reforms to encourage productivity instead of pursuing expansionary fiscal policies which often seek to preserve household purchasing power, but which thereby accelerate inflation and thus complicate the action of central banks.

- **"The evolution of monetary aggregates does not impact on inflation"**. One thesis, particularly in the US, tends to show that the Fed's easy money policy has not led to an increase in bank lending insofar as the banks have maintained their reserves with the central bank instead of granting credit to the economy. Nevertheless, the truth of the Quantity Theory of Money is not denied. What is difficult is to establish precise links between the evolution of the money supply and inflation (the velocity of money is volatile, investment and savings decisions are motivated by multiple factors...).

But just because these relationships are difficult to formulate does not mean that reality does not exist. The simple fact that we continue to be interested (albeit insufficiently) in the evolution of credit shows that quantitative theory cannot be ignored. Indeed, the increase in the money supply (M3 or M2) is strongly determined by the evolution of credit (a large part of M3 is the counterpart of bank credit), so indirectly it is indeed a money supply problem that is at stake.

In any case, central banks have not been very interested in the explosion of credit over the last 20 years and their permanently accommodating monetary policies have contributed to the real estate and stock market bubbles which have accentuated social inequalities.

The willingness to use the monetary weapon continuously to stimulate the economy has led to the vulnerability of the financial market which now dominates the economic cycle.

- **"Inflation reduces debt and should be tolerated at levels above the 2% target"**: in the short term, inflation does reduce debt. But we need to look at the longer-term consequences of sustained high inflation: lenders are being mislead, which is detrimental to the future of savings and investment. A prolonged period of inflation has never been shown to result in a revival of investment and strong economic growth. To base a system on the plundering of some would, in fact, represent a major social danger. Inflation is a surreptitious tax, not voted by Parliament, which hits the poorest first. Its persistence increases social risks and the development of populism.

- **"Monetary conditions have tightened in the eurozone since July 2022"**. But 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 bases its policy not on realised and observable inflation but on the expectations of economic agents. Market expectations seem reassuring. They are of the order of 3% over 3 years, which, with nominal rates of 3%, suggests that the ECB has reached the neutral zone.

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.

- **"The transmission of price inflation to wages has been moderate so far"**, we were told.

We see that in the fourth quarter of 2022, labour costs rose by 5.7% in the euro area compared to a year earlier. This is more than twice the historical average of 2% recorded between 2014 and 2019. The higher inflation becomes, the greater the risk of significant wage increases or even a return to indexation.

- **"The reduction of the balance sheet of central banks should be normalised at a very slow pace".**

However, the rise in medium and long-term interest rates, the fall in inflation and the return to an economy where interest rates are the result of the supply and demand of capital, would move away.

A recent ECB publication[1] has shown the drawbacks of the excess liquidity that has built up (commercial bank reserves placed with central banks). This trend in high

1. I. Schnabel, "Quantitative tightening: rationale and market impact", 2 March 2023.

reserves can only increase as nominal rates rise. Hence the need to reduce the Eurosystem's balance sheet.

The mistake of the Quantitative Easing policies carried out was to buy long maturity securities financed by short term money which maximises the risk of market reversal and leads central banks to keep on their balance sheet a legacy that dissolves only in the long term. This strategy explains the magnitude of the losses recorded and to come by central banks.

In monetary theory, it is better to use the purchase of short securities (punch effect) as already demonstrated by the economist Bagehot[2].

- **"When a country has little private debt, the consequences of monetary easing policies are less penalising thanks to the low debt and the solidity of the balance sheet of private actors".** This is true but according to the BIS, if the debt of non-financial companies alone was only 80% of GDP in June 2022 in the US, in the euro zone it was 108.5% (in France 164.7%, an absolute record). This excess of private corporate debt in Europe is a factor of increased fragility in the event of a rise in interest rates.
- **"Positive real interest rates would be nightmarish".** It can also be shown that they 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 properly remunerated.
- **We have been told again and again that the banking system was well regulated and supervised. But it is a fact that some US regional banks, especially those with less than $ 250 billion in assets, have been exempt from international prudential constraints since 2018 and are vulnerable.**

Central banks have pursued an unprecedented policy of monetary accommodation for some twenty years. With the QE and the monumental securities purchases that have been made, the value of the assets purchased by the issuing institutions has surged while interest rates have been lowered, and then maintained, at zero when they were not nominally negative.

In such a situation, the risk is to believe that rates will remain low indefinitely. If you believe this, the danger is that rates will go up again one day or another, which mechanically leads to a loss of value of the assets accumulated. If one has accumulated such fixed-rate assets while turning a blind eye to the possibility of a rise in rates, one risks very heavy losses on the depreciated assets.

Central banks have deliberately accepted this interest rate risk without bothering to hedge it. After all, these banks are not subject to regulation and the huge losses they are potentially about to incur do not seem to worry them much.

But the same cannot be said for private sector financial institutions: they are responsible for their own financial health and risk bankruptcy. And for those that might be tempted to ignore this risk, regulation would put them on the right path.

Generally accepted regulations state that:

- In a portfolio intended to be traded, the bank has to to record these securities at their market value ("mark to market"); in the event of a rise in interest rates, additional capital will automatically compensate for the potential loss thus created.
- If the bank decides, on the contrary, to keep its portfolio without trading it, by classifying it as "held to maturity", then the transactions will be resolved at the maturity of the securities in the portfolio without loss; in this case, it is logical not to impose additional capital requirements.

But it should be remembered that if the bank decides to sell even a small part of these securities, the entire portfolio would have to be reclassified as marketable and thus accounted for as mark-to-market. **This reclassification, although mandatory, was not required of the Californian banks, which gave a false impression of solidity to banks that had begun to dispose of their impaired assets without having to incur a capital charge for the losses already recognized.**

European banks, on the other hand, strictly applied the rules in question.

The Basel regulation goes even further in the treatment of interest rate risk.

According to the IRRBB ("Interest Rate Risk on the Banking Book") on how to deal with interest rate risk in the banking sector as adopted in Basel in 2015 and duly transcribed into European law (with entry into force in 2019), ALL portfolios – on the assets as well as on the liabilities side – held by banks (regardless of their classification) should be permanently subject to an interest rate sensitivity calculation.

The result of these calculations must be treated either by an adjustment of the equity capital (*Pillar 2*), which encourages to cover the risks by hedging (interest rate swaps).

2. The Bagehot rule ("Lombard Street" 1873) is that the Central Bank must, in a crisis, "lend freely against good collateral and at high rates".

It should be noted that this very protective regulation has not been formally mandated by the US regulator, either in the large systemic banks or in the smaller or regional institutions. As a result, the management of interest rate risk is not subject to systematic reporting that would allow supervisors and market analysts to monitor the risks incurred in a harmonised and efficient manner. The risk of quickly rising interest rates has not been included in the US stress tests either.

It is clear that **there are considerable differences in the regulatory and supervisory systems on both sides of the Atlantic. As the financial world is open, such disparities pose a real systemic risk that should be urgently identified and addressed.**

- **"Some believe that central banks are schizophrenic".** Indeed, with one hand they are taking back liquidity (reducing their balance sheet) but with the other hand the Fed is giving liquidity back to the banking system to avoid the withdrawal of deposits by banks affected by the rise in interest rates and the inadequacy of the management of this risk

Are these two approaches contradictory? It all depends on how the banks use the additional liquidity. If, as we have reason to believe, the banks keep this additional liquidity in the form of deposits at the Central Bank without transferring it to new loans, the operation is neutral from the point of view of the credit to the economy.

Therefore, it is possible to conceive of a restrictive monetary policy with increasingly high nominal interest rates and, at the same time, the granting of financial aid to banks in difficulty.

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It is imperative to revive productive investment. Therefore, long term interest rates should no longer be determined by central banks. QE has been used and abused to reduce artificially long-term yields while this should be the result of demand and supply on the financial markets.

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.

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The fear of the reappearance of spreads in Europe should not dominate the decision-making process of the monetary policy. Indeed, sooner or later, structural spreads – based on the past accumulation of fiscal and structural deficiencies – in Europe will appear on the markets. The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But central banks do not have an obligation to forever erase all traces of interest rate differences in the appreciation of the markets. The elimination of all spreads would be difficult to reconcile with the Maastricht Treaty, as some member states – known for their fiscal discipline – place greater emphasis on the objective of monetary stability (believing that the ECB should not monetise public debt).

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 GDP 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.

If fiscal policies were to remain expansionary to address ingrained structural problems unrelated to the crisis, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus. In this respect, the issue of revising the Stability and Growth Pact appears central and urgent.

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 real interest rates, nor QE.

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Ultimately, the paradox of the euro is that a single currency and 27 national economic policies coexist without a strong cement of coordination. Ultra-accommodating and asymmetric monetary policy has been used to overcome this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth should help to resolve these contradictions and thus make the euro sustainable.