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Issues raised by present monetary policies

My purpose, in this speech, is not to make an assessment of Quantitative Easing. It is just to share a few questions and thoughts.

I will focus on three main issues:

1. Can zero or negative interest rates become a source of problems for financial stability ?

2. Are there fundamental risks linked to the massive creation of liquidity by Central Banks?

3. Is present monetary policy consistent with the idea of strengthening the International Monetary System ?

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I - Zero interest rates.

When Central Banks reach the zero interest rate bound while there is still slack in the economy and while inflationary expectations have disappeared or have turned negative, the commonly accepted answer now is to engage in Quantitative Easing Policies (QE).

QE is, indeed, a way of reducing interest rates and, more importantly, interest rates on the whole yield curve through massive purchases of securities distributed on all maturities.

This policy has shown its immediate effectiveness : on both sides of the Atlantic, in the US as well as in the UK, 10 year interest rates have been brought to a level at least 100 b.p. (more in the US) lower than would have been the case in the absence of any FED and Bank of England purchase programme.

In a mainly market financed economy – as is the case particularly in the US – such a significant – and prolonged – effect on interest rates is bound to have significant consequences : issuing bonds is cheaper, and investment should in principle be encouraged.

Besides, stock values tend to go up, which creates a positive wealth effect that normally fosters demand.

On the whole, higher stock and bond prices improve the balance sheet of borrowers: the higher value of their assets reduces, in relative terms, the size of their debt. The fact that interest rates in advanced countries have been lower than nominal growth rates over more than a decade, has favored deleveraging.

All this seems pretty good. But I cannot refrain from asking a few questions.

In macro-economic terms, the fact that Central Banks purchase such large quantities[1] of high quality securities, can lead to financial distorsions.

I will just mention a few of them:

- The reduction in «risk free» Treasury bonds held in private portfolios could push investors into more risky assets (carry trade, foreign exchange, or more remunerative but riskier financial instruments …).

- The fact that Treasuries are able to borrow at close to zero or even negative[2] rates could deter some governments from adjusting their fiscal, overextended, positions. Monetizing fiscal deficits (which are mainly the result of excessive current expenditures) bears some long term monetary risks.

- Insurance companies and pension funds hold long-term liabilities with contractual obligations that cannot be met by assets carrying no return. The pension system – which is a major element of financial markets – cannot operate for long under such tensions. The danger is to create a fundamental asset-liability mismatch in institutions that are a centerpiece of financial markets.

- What could be the long-term consequences of 0 interest rates on savings ?

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[1] *(The purchases by the Bank of England in 2009-2010 amounted almost to the total net guild issuance by the Treasury)*

[2] *The average interest rate on sovereign debt in the Eurozone is negative up to 4 years (June 16, 2015).*

- What is the impact of quasi-zero interest rates on the functioning of the banking system ? This issue is fundamental for Europe because of the overwhelming role played by banks in the financing of the economy. In theory, banks should take advantage of the low cost of funding provided by the Central Bank. By on-lending at higher rates, banks are able to rebuild their margins (and thus to beef up their regulatory capital). But in continental Europe we observe two countervailing factors :

  - Many investor-grade corporates – that used to borrow from banks – are shifting towards cheaper bond financing ;

  - This trend results in a concentration of banking assets on riskier credits (especially to SMEs that cannot access markets directly). This evolution has two sorts of consequences : on the one hand, it results, for banks, in higher capital charges and provisioning, and on the other hand, it leads to higher spreads for borrowers (which SMEs are not presently in a position to pay).

This analysis shows that very low interest rates can lead, in the longer run, to a shortage – and a higher cost – of lending to SMEs, as Ronald McKinnon has established.
This is far from being a technicality. SMEs represent 2/3 of employment and close to 60% of value added creation in the EU. This is, in fact, a major problem.

- Furthermore, the wave of fixed term mortgage loans renegociations (because of the extraordinary low level of interest rates) could result in systemic problems, if rates were to increase.

II - Are there fundamental faultlines and risks stemming from the creation of massive liquidity ?

The fact is that the global financial pattern has changed since the crisis.

Before 2007, we lived in a world where bank intermediation was a leading element in finance.
At that time, the changes in outstanding debt of non-financial corporations in advanced countries were overwhelmingly (2/3) originated by bank lending.

Today bank lending to corporate borrowers in advanced countries has been replaced almost entirely by « non-bank» sources of credit,

If one looks at the world globally, one sees an even more striking change : total corporate bonds have increased by 4,2 trillion $ since 2007, compared to a 1,3 trillion change between 2000 and 2007 (China and other emerging and developing countries have seen, over the last 7 years, their outstanding corporate bonds jump by 61%).

On the basis of these figures, we could be tempted to say that the global financial situation is much safer than it was in 2007.

Indeed, before the crisis :

- Banks were insufficiently regulated (too little capital) as well as poorly supervised ;

- Banks performed excessive maturity transformation ;

- And were too dependent on refinancing opaque complex products by wholesale markets (that eventually dried up).

Now, banks are deleveraging under strong regulatory pressure. Basel capital requirements have been more than doubled and the TLAC negociation is about to end up in a new massive wave of bailing-in constraints which will accelerate and compound bank deleveraging.

Furthermore, supervision on the quality of banking assets and on the way risk weighted assets are dealt with is getting tighter.

Therefore, if one takes into account the reduction of some of the riskiest forms of banking activities (SIVs, ABCP …) as well as the new liquidity requirements, one could think that the system is much more robust than before 2007. It is less dependent on bank intermediation and more geared to bond markets.

But one has also to gauge some of the consequences of these changes on the working of the system and its stability.

In fact, the financial system is far from being immune from further crises :

- The same causes produce the same effects : low interest rates eventually lead to more – and riskier – lending ;

- Financial markets are prone to volatility and "exuberance". The fact that QE has contributed to the boom of financial markets since 2009 is incontestable (from March 2009 to March 2015 the SNP 500 index has gone up from 676 points to 2000. QE has, no doubt, contributed to this jump. And during the same period, US Treasury 10 year yields have gone down 50% from 4,3% to 2,12% under the strong influence of QE).

Do these moves reflect fundamentals ?

- The answer is that when Central Banks buy such large quantities of securities, they are by definition engaged in massive actions to **change** the "normal" conditions of market equilibrium by stimulating the official demand for securities. This has an impact in terms of financial volatility : **any perception of a risk of tightening of the monetary policy stance can trigger huge market reactions.** . We have seen such volatility these last weeks in the Eurozone [3]. But high volatility of interest rates should not be taken lightly. It has a cost : it breeds uncertainty and may well put off investors from financing projects.

[3] *In December 2014, before the beginning of QE by the ECB, German 10 year bonds carried a yield of 0,5%. After the announcement of QE, those yields tumbled down to 0,1% mid April 2015. Since then, they have bounced up towards 1% in June 2015 (see Graph 1) …*

- **The mere size of Euro QE raises a problem.**

With deficits falling, the act of simply transferring the increasing government bond issuance to the Central Bank – which was so common, particularly in 2009/2010 - , is not an option for the Eurozone (in terms of net issuance). **In contrast to the Fed and the BoE, the ECB is launching QE at a time when net issuance is already declining**. So the forecasts are that net issuance less ECB purchases will be – 260 billion € in 2015 [4]. This means that if the ECB is to achieve its goal of restricting purchases of all individual securities to 25% of the outstanding amounts, it will have to buy across all bonds, including for the refinancing of "old" securities coming to redemption. This raises questions :

Which types of investors will sell (i.e. selling their bonds to the ECB on the secondary markets or not using the redemption proceeds to buy new Treasury bonds and thus letting them available for ECB purchases) and what alternative assets would they buy ?

What would happen if bond holders did not wish to divert from Treasuries (or, for regulatory reasons) were not in a position to do so ? Would the ECB engage in crowding out the market and in forcing investors to move away from Treasury bonds because of too high pricing and extremely low interest rates ?

[4] *- 100 for Germany, - 20 for France, - 80 in Italy … (Morgan Stanley, February 13, 2015) – see Graph 2*

With a public buyer determined to go beyond the total amount of net new borrowing by Governments, markets tend to be more volatile in such an unchartered environment.

- Relying more and more on financial markets as well as on low interest rates to finance the economy appears today as the name of the game. But such a situation can only be sustainable if markets are liquid. **A systemically dangerous situation would arise from the conjunction of a return to higher spreads and illiquid markets**. In fact, markets, while they are playing a growing role in financing the economy, have become much less liquid due in large part to bank regulation (higher capital ratios, incentives for banks to keep on their books "0/risk" Treasury bonds, restrictions to market making …). It is a fact that, "over the past years, it has become more difficult to sell bonds in the secondary markets in sizeable amounts without moving the price. In other words, market liquidity has declined" (see Tom Huertas : " Six structures in search of stability" LSE June 2015).

- **Keeping interest rates close to the zero bound when the economy has already picked up is dangerous** because it reduces the margin of manoever of Central Banks to lower interest rates when the downward cycle starts ;

- **Massive creation of liquidity does not necessarily sink into the real economy through bank credit as has been shown**, but through the issuance and purchasing of new bonds. This has, by itself, produced an element of volatility.

What could happen if interest rates were to increase ?

This reminds me the question that was seldom asked in 2005-2006 : « What could happen if the prices of houses were to fall ? »

I do not have an answer (as I did not get one in 2006 !), but I always feel weary when the mere prospect of a change in markets (or in the monetary policies that underpin them) is seen as carrying almost unthinkable consequences. We seem to be accustomed to the idea that the stickiness of a policy is proportional to the magnitude of the consequences that could happen if it were changed.

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III   Have we moved towards a more stable international monetary system ?

QE does not seem to be a way of improving our unstable monetary system.

Indeed, creating more (dollar) liquidity does not, in itself, cure the causes and problems of large current account imbalances.

Actually, it tends to facilitate the financing of deficits, and forces creditors to accept 0 returns on their – dollar – balances.

Has this contributed to a more « inward » consumption-led orientation of the Chinese macro-economic policies since a few years and, therefore, to a reduction in US and global imbalances? The matter is debatable [5].

But, what seems clear is that the juxtaposition and succession of different – national and regional – QEs eventually leads to significant swings in exchange rates. Without going as far as evoking currency wars or competitive depreciations, one can ask the question: is this, more volatile, pattern of exchange rates the right system to aim for ? Is it the best instrument to fight against deflationary expectations ?

When I hear that, in Europe, - where banks still account for the bulk of the financing of the economy but, in part, because of more stringent regulations, are not in a position to channel Central money to enterprises - , the most tangible advantage of QE is the depreciation of the Euro, I have some misgivings.

Is such a depreciation - as we are told - the way to fight against deflationary expectations ? Or, as some of us believe, are such expectations rooted in the dim prospects operators have on the future of the output gap in Europe ?

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[5] The external current imbalances have not much changed since 2011 :

Current account as a % of GDP

	2011	**2012**	**2013**	**2014**	**(2015)**
US	-3,1%	-3,5%	-2,3%	-2,3%	(-2,5%)
Eurozone	0	+0,9%	+2,3%	+2,5%	(+2,8%)
China	+2,8%	+2,4%	+2,1%	+2%	(+1,8%)

If that were the case, it is not QE, but, structural measures that would really matter and influence expectations.

I would add that, at the heart of a proper International Monetary System, we need better macro-economic and structural coordination, not necessarily additions of bigger and bigger QEs.

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In 2008 the Fed played its role as a lender of last resort and acted swiftly to offer massive liquidity to the market while bringing official rates close to zero. But, seven years later, rates are still unchanged as if the US economy had remained in recession. In fact, US growth has been around 2% since 2010, while inflation hovered between 1% and 2% - far from the deflationary threshold - and unemployment has come down to 6%.
In the meanwhile, markets have exploded, and credit is expanding fast, financing the more risky assets.

Is it right to turn a blind eye to the risks stemming from over booming financial markets ?

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CONCLUSION

To conclude, I would recall old beliefs such as :

- We need enough savings to finance long-term investments,
- We need more equity and less debt,
- We need fiscal discipline,
- We need to strictly monitor excessive borrowing and avoid asset bubbles.

Are these beliefs outdated ?
Or are they just postponed ?

If that is the case, monetary ease would only be a way of buying time, not solving issues.

But buying time makes sense only if time is **used** to adopt necessary reforms that can help to unlock employment and competitiveness.

If easy monetary policy were used as a long-lasting substitute to structural reforms, we would be in a very dangerous situation.

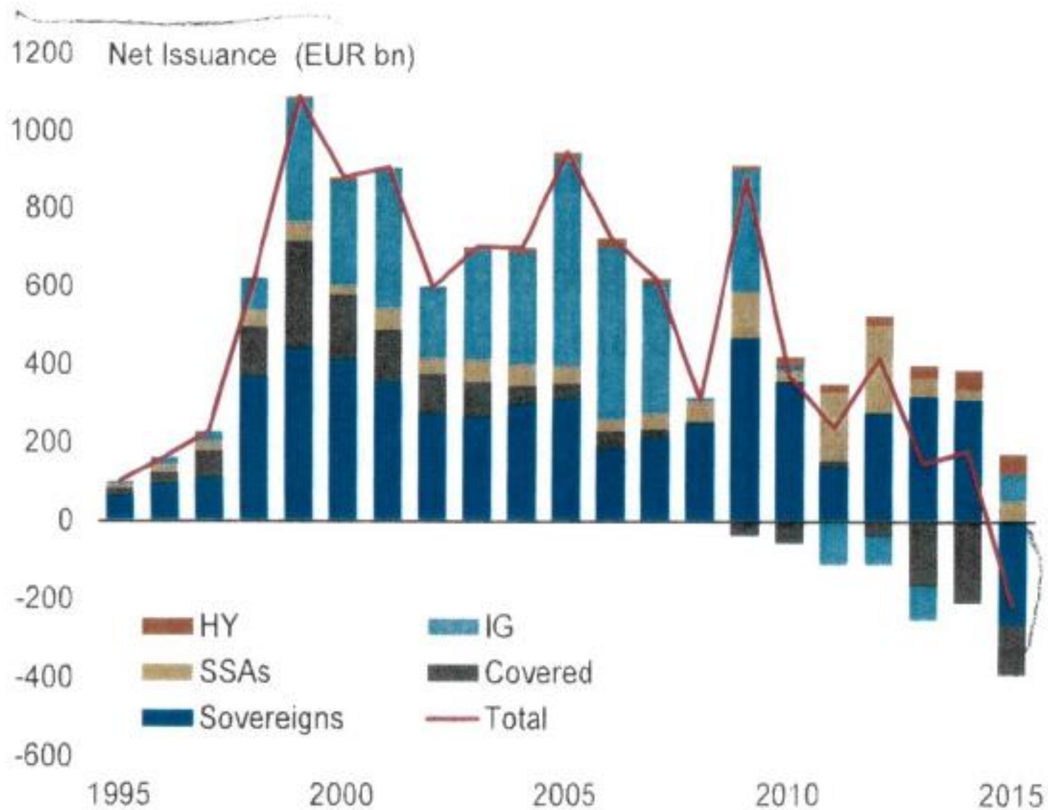
Jacques de Larosière

GRAPH 1

GERMAN 10 YEARS BOND YIELDS

GRAPH 2

Eurozone Bond Net Issuance After ECB Purchases



2015 Eurozone Issuance Outlook – QE Taking Net Issuance Considerably Negative in Italy & Germany