Monetary policy: lessons from past financial crises

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I have been asked to comment on present monetary policy from the perspective of recent financial crises.

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It is often said that monetary policies are efficient in repairing the consequences of financial crises. Indeed when the financial system was about to fall apart in 2007-2008, Central banks were quick to step in and to buy falling assets that no one wanted to keep. This avoided a complete meltdown that could have seized the whole economy.

I.-The issue of debt overhang

We have to understand that a very accommodative monetary policy can contribute to the crisis through excessive debt. This is actually what happened in 2007-2008: too much leverage had been allowed by an inordinately easy monetary policy that led to negative interest rates in real terms for a long time. Eventually, asset bubbles started bursting and central banks had no other choice than to pick up the pieces and to incur a huge and unprecedented increase in their balance sheets.

We are facing a similar problem today: the increase in global non financial debt has been spectacular since the last crisis (40% of increase). Furthermore the quality of debt has deteriorated:

- Most of the debt accumulated is of low quality: bonds rated BBB (one notch higher than junk bonds) represent more than 50% of the total outstanding investment grade bonds. The search for yield in an environment of very low rates explains this development:

- Debt is largely in the form of Collateralized Loans Obligations (CLOs) that are bought by investors searching for yield.

- A number of bubbles are susceptible to burst (shares, “riskless” bonds, real estate…) when trust fades away (the “Minsky” moment).

- The huge increase in sovereign debt bonds held by European banks and insurance companies are not treated prudentially as market risks (0 RWA in the regulatory Basel framework).

II.- The enigma of the inflation target (slightly lower inflation than 2%)

The **sacrosanct** character of that figure is literally incomprehensible. Indeed the CPI index used by the ECB is volatile because of oil price fluctuations and thus has no economic meaning in terms of fundamental inflation.

The reference to the figure of 2% is also highly questionable given the dampening influence of a number of structural factors like:

- Aging of population, which leads to less growth, productivity and inflation;
- Globalization that has allowed low wage related goods of emerging markets to be massively imported in advanced countries, which has depressed prices and wages;
- Technological changes (e-commerce….) that have reduced costs;
- New labour market behaviors leading to less pressures on wages.

In fact, the equilibrium inflation rate (the one than avoids excessive inflation as well as deflation) is closer to 1% than to 2%. And a 1 or 1,5% inflation rate should not be seen as a problem but, on the contrary, as a manifestation of stability.

Nonetheless, central banks have been anchoring their monetary policy to 2%, an unattainable objective, and thus have engineered an excessively accommodating monetary stance which is contributing to weakening the financial system and preparing further crises.

III.- The dangers of the present monetary stance

a) The buildup of a huge debt overhang:

- By governments, which have accentuated the" doom sovereign bank loop" in Europe; in spite of regulatory benevolence, it is recognized that the position of some, over-indebted, States, is fragile and could rapidly deteriorate if interest rates were to increase.

- By corporates: I have already referred to the rise in BBB ratings. It is notable that a large percentage of debt is issued by corporates that have a problematic interest coverage (ratio of debt service to profits).
  At the initial sign of a recession, those are the debtors that will be the first to run in financial difficulties.

In sum, the system has been managed by central bankers to provide credit, more than to assess (and price correctly) its riskiness.

b) The long term nature of duration

Duration of debt instruments has significantly increased over the last years which means that a huge interest risk has been accumulated by investors with no appropriate pricing (because of QE). Negative interest rates go hand in hand with massive positive valuations. But if interest rates were to normalize, would the holders of those debt instruments be able to provision the losses and to have enough liquidity to face the situation?

Or, would they, once more, count on the central bankers to buy whatever loses value and keep interest rates even lower in order to prevent imprudent investors from market losses?

Has the prudential system, overseen by central banks, prepared for such events? I am afraid that the answer may well be inadequate.

c) The worsening of pension funds and life insurance companies

These institutions have contractual long term liabilities but have been asked to keep "riskless" assets on the active side of their balance sheets. Given the very low interest rates on those assets, such institutions are incurring growing deficits and negative funding ratios of a major importance are building up.

d) The self inflicted pessimism of the present monetary stance

As the ,arbitrary, inflation target is not reachable (for the structural reasons mentioned above), central bankers have put themselves in a corner: in order to meet the target, they have come to believe that they MUST beat the "zero lower bound" by creating enough fiat money to "force" inflation up. This requires re-vamping QE or even launching helicopter money to "force" citizens to consume more….Such ideas are not only irrational but extremely dangerous for the future of money and the integrity of central banks that are becoming the only key solution to any economic drawback.

Indeed, these ideas anchor in the public mind the notion that interest rates will remain negative for a very long period (several decades!). This, in turn, has a depressing impact on public opinion: if interest rates have to remain durably ultra low, it means that central banks do not have hope for the future and this, in turn, keeps economic agents away from investing.

Betting on an unattainable goal has a real psychological cost.

As a member of the conference said: "negative interest rates mean in plain language: "your future has no more value".

e) And last, in spite of the significant costs involved in such monetary policies, there is not even the satisfaction to see low or negative interest rates foster productive investment

Research shows indeed that:

- With low interest rates policies, productive investment has reduced by more than 20% over the last 20 years at the global level.

- The" liquidity trap" feared by Keynes has become a major trend. Data show that the most liquid parts of households' portfolios have skyrocketed as well as share buy backs: not a good signal for investment!

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So, time has come to reflect, in a serene mood, on these issues. I welcome the review decided by the ECB as long as it is open-minded and does not reject systematically ideas and solutions that, today, are seen unacceptable by many for the only reason that they are non conventional.

Unfortunately, risks remain stubbornly conventional and should be carefully assessed and managed and not buried in more money.

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