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"MONETARY POLICY POST COVID : UNCONVENTIONAL ACTIONS IN THE FACE OF OBSTINATE FACTS"

This is an appropriate time to pause and reflect on the future of policy mix and in particular on the stance of monetary policy.

Indeed, we seem to be getting out of the pandemic after having enormously relied on fiscal and monetary policies to inject liquidity in economies that had to be locked down by unprepared governments as a way to contain contagion, because of the insufficient medical testing capabilities. The price to pay has been an explosion of public indebtedness.

So, we are getting out of the woods but with a lot of wounds and scars.

How should we deal with the factors at play? Should we be hostage to the doctrine of present unconventional monetary policy or should we pay more attention to "obstinate" facts?

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I.-The static approach would be to stick, as long as possible, to the present unconventional stance.

This approach seems to be the Fed's preferred course, at least for the moment. It is based on the following arguments.

a) Global demand is weak and savings are high: therefore, the consensus says that there is a case for continuing stimulatory policies.

b) Any, premature, monetary tightening would risk upsetting markets- that have skyrocked- and could thus trigger a recession.

c) In an environment of still very low inflation, and low expectations, real interest rates tend to become positive and monetary policy -facing the zero interest rate bound conundrum- cannot fully play its stimulatory role. Any monetary tightening would put an unnecessary break on demand.

d) The Fed points out that the recent signs of overheating and of inflation are far from clear:

- they are overwhelmingly related to sectors that have been especially hit by the pandemic and that are lately rebounding;
- therefore, the push in inflation, linked also to the rise in energy prices, and to the disruption of supply chains ,is bound to be temporary and will abate as the economy normalizes;
- inflation remains subdued (the ”sticky” part of the CPI, as computed by the Atlanta Fed, is still flat and the 5 year, 5year forward inflation expectations hover around 2%);
- labour markets have not reached full- and inclusive- employment.

For these reasons, the Fed does not express the intention to tighten soon:

- the buying program is maintained, and bonds coming to maturity will be reinvested,
- Fed Funds rates are to be left at present levels well within 2022,
- If inflation exceeds the target of 2%, the averaging with the recent years of under achievement will allow maintaining the present stance,
- the “outcome based” monetary policy (waiting for facts and full attainment of all objectives before any policy change, instead of allowing some room for the forecasting of -and the adjustment to -evolutions) is the rule that has been presented by M. Clarida, the Fed’s Vice-President. Such a method does not seem to allow gradual changes nor a modicum of discretion when the picture starts moving.

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II.-The” adaptative” option to face the facts and the challenges of the future.

I believe that the “static option” just described is fraught with dangers and does not face up to the real challenges that lie ahead .I will try to explain why:

a) Monetary policy was already in an impasse before the Covid struck.

The system had been swamped with liquidity through the very accommodative monetary stance of the past ten years or so.
And this has pushed indebtedness to record levels: Global debt now amounts to 355 % of world GDP, a historic ratio in peace times.
In turn, this huge leverage has weakened the financial system and endangered its stability : if CPI inflation has remained subdued, the prices of financial assets and real estate have skyrocketed.

b) The pursuit of such a policy – “as if nothing had changed” – would be likely :

- to trigger eventually a financial crisis with all its negative economic and social consequences,
- to weaken further the banking and insurance systems whose profitability is affected -especially in Europe-by low or negative interest rates,
- to consolidate zombie firms (over indebted and uncompetitive) that are only surviving because of the interest rate subsidy provided to them by monetary policy.

c) The continuation of a policy of very low interest rates for a couple of more years would intensify its negative consequences on growth and employment: Indeed, as we have learned over the last years experience, abundant liquidity and low rates do not result in higher productive investment but in liquidity hoarding. Since 2008, MO in major countries (i.e. banknotes in circulation and bank reserves held at the central banks) has increased by 13,50% per year, which is 4 times faster than nominal growth in the real economy. During the same period ,M3 that includes bank deposits (and therefore reflects the transformation function of the banking sector), grew much more moderately (3,50% per year in the eurozone), showing that central money creation had not seeped into the economy.

The facts are undisputable : non residential productive investment has significantly DECLINED over the past ten years of zero interest rates. (from14, 4% to 12% of global GDP). And the “liquidity trap,” feared by Keynes, has manifested itself especially in Europe: since savings are no more remunerated, households prefer keeping their money in the most liquid forms (banknotes, sight deposits….) rather than investing in long term riskier projects with no return. The recent data on the explosion of liquid savings are staggering.
We must understand that the perspective-announced by the Fed- of extremely low interest rates for long is debilitating: it anchors in the public mind that there are no chances for growth (growth has always been accompanied by positive real interest rates), and pushes the system in share buy -backs and speculative riskier alternatives.

d) The above considerations lead to the conclusion that it is time now for central banks to start changing gears.

The moment has come to look to the future with the lens of reality and not to continue, because of doctrinaire preferences, to focus on the past 20 years.

The present return towards economic recovery offers the opportunity to start shifting from “slack dominant “considerations to overheating ones (which are already significant, given the magnitude of the fiscal US stimulus packages, the lack of qualified labor, supply chain bottlenecks and the first manifestations of inflation(4%) which can only be exacerbated by the secular demographic trend towards a shrinking of the labor force).

If the Fed does not start moving now in a very gradual way, it could face later a much tougher job when- and if- inflation takes hold in the coming years. The big risk then would be to have to resort to much more intensive tightening with its expected negative consequences on growth.
Recent growth (23,8% in March and 12,1% in April) of the US broad money signals the danger of inflation that could well continue its upward trend and stretch beyond the Fed’s comfort zone (see Center for Financial Stability June 2nd 2021).

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We must understand that the world has been accustomed to live with higher and higher public and private debt over the past decades, this huge leverage being accompanied by skyrocketing market valuations. This is a pretty dangerous situation if inflation - and higher interest rates - were to resume, which is far from unlikely given the structural - demographic -factors at play. In that case, heavily over-extended institutions would start facing debt payment difficulties, and market reversal could well feed into recession. What would then be choice left to central banks ? Fight inflation with much higher rates to the detriment of growth, or allow inflation to explode which would run the risk of stagflation ?

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If one considers that such risks cannot be dispelled out of hand, it would seem prudent to move gradually out of the present trap, to start reducing the calibration of QE, and not to systematically reinvest all bonds coming to maturity.

The “fiscal dominance” that is presently taking place carries two big dangers:

- it puts in question the independence of central banks ;
- and, more importantly, it is a major disincentive for governments to engage in the structural reforms that are indispensable to meet the fundamental challenges of the ecological transformation of our world, challenges that cannot be faced by printing more and more money.

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