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Long-term investment has been hurt by the crisis and by the way it was managed

We live in a new world. The economic cycle of the past has become a financial one. While the global economy was – according to the classical model – mainly influenced by the variations in demand, nowadays it is the monetary stimulation provided by major Central Banks that trigger and amplify the increasingly powerful financial cycle.

Monetary policy has been increasingly accommodative over more than twenty years. For sure, some secular trends (ageing population, globalization, …) have contributed to the moderation of global demand and prices, to low interest rates and to the high level of savings. But the Fed's policy (followed by the other important central banks) has considerably accelerated and amplified these phenomena. US Fed funds rates – in real terms – have been maintained negative during two decades (a peace-time record), and the average increase in Central Bank money has exceeded eight times the nominal rate of economic growth in the advanced economies from 2007 to 2021.

This prolonged stance of easy monetary policy has had two important consequences on the issues discussed today :

- It has weakened the financial position of the pension systems ;
- And it has hindered long term productive investment.

I shall touch on these two aspects in my remarks.

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The measures that should be taken to fight against these trends are clear and obvious :

- Increase, when needed, the length of retirement ages (while taking into account the painfulness of work and the age of recruitment) ;
- Increase the forms, opportunities and incentives of additional capitalized pension funds (additional to the central, compulsory system, generally called "pay as you go").

Just an insight from France.

In France, such additional, voluntary capitalization - based pension funds are scarce. They amount to some 230 billion euros. The figure represents only 5.4% of the total financial assets of French households.

This is consistent with an OECD statistic that shows that pension funds in France represent only 10% of GDP (against 126% for the average of OECD countries).

<u>Given the uncertainties of the future pay as you go system in an ageing world, it seems rational and careful to encourage savers to build additional sources of retirement schemes.</u>

According to a study by the French financial regulatory arm (AMF), 71% of interviewed households say that they would like to have an additional, private, source of retirement benefits to enhance their pension at retirement (53% are already saving for that purpose. But half of those who save consider that their level of saving is insufficient).

The real problem in France is not build a new scheme to centralize and unify our many retirement regimes, but to increase retirement age (presently at 62 years) and to incentivize future pensioners to save additional amounts for their retirement.

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<u>I – Prolonged very low interest rates have hurt the profitability of the pension systems.</u>

The accelerating ageing of most of the populations of our planet deteriorates, by definition, the ratio between working and retired people.

In Europe there were :

- In 1950 : 20 retired for 100 active workers (5 working agents for 1 retired)
- In 2000 : 32 retired for 100 working (3 working for 1 retired)
- In 2015 : 56 retired for 100 working (1.8 working for 1 retired)

This is a fundamental change for the financial balance of “pay as you go” systems.

If one wants to avoid a fall in pensions, one can only resort to two measures :

- Increase the contributions,
- Or extend the age of retirement.

To that fundamental – demographic – issue, lax monetary policy has added another difficulty.

Given the fact that retirement entities have long term liabilities – which are often contractually guaranteed – they must count on adequately long term funding to match these liabilities.

But when interest rates, which are the main element of the remuneration of their funding, falls to - and is kept at - zero, it becomes problematic to match the cost of liabilities with enough revenues emanating from assets.

On a worldwide plane, the “global gap”, result of ageing and of zero or negative interest rates – amounts to around a trillion dollars. In 2050 the deficit could reach 15 trillion on the basis of present demographic and interest rate trends.

II – Low interest rates for long do not favour productive investment, but foster liquidity.

In march 2021, 20% of lending carried negative interest rates and this has been going on for the last 5 years (see **chart 21**).

This was never seen before.

It was instinctively thought that zero or negative interest rates would favour productive investment.

But, in fact, non residential fixed investment has declined significantly (in terms of GDP) over the past 20 years, in spite of low interest rates (**chart 22** shows that the level of gross non-residential investments in advanced countries as a percentage of GDP has declined from 14 to 12% of GDP during that period, which is a huge change).

Indeed when savings are no more remunerated, it makes sense for households to keep their funds in liquid forms (banking accounts) or to engage in real estate acquisitions (boosted by low borrowing rates).

Chart 25 shows how fast the share of liquid assets held by households has exploded over the last decade.

Weak (or zero) returns on investments have discouraged agents to undertake risky productive projects.

Since remuneration is non existent, households prefer to keep their savings in "riskless" instruments and not in productive, but riskier, projects.

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The conclusion is simple.

Our policies tend to be short sighted.

A strategy of zero interest rates has profound consequences :

- It achieves demagogic purposes (cheap credit to buy an apartment) ;
- It facilitates the financing by Treasuries of big fiscal deficits ;
- It keeps alive zombie firms who can only survive with subsidized interest rates , but deteriorate global productivity ;
- It pushes up the valuation of assets (financial, real estates ...) generating financial bubbles and weakening the stability of the financial system.

Pension funds and retirement systems are caught in a pattern of policies that systematically gives preeminence to short term preferences.

The result is :

- A weaker global economy because of the decline of long term investment ;
- A systemic fragility in the pension systems.

It is time to change gears and think of a proper framework for the future.

Jacques de Larosière

See Annex (sourced from EUROFI monetary scoreboard)

Chart 21

Chart 22

Chart 25

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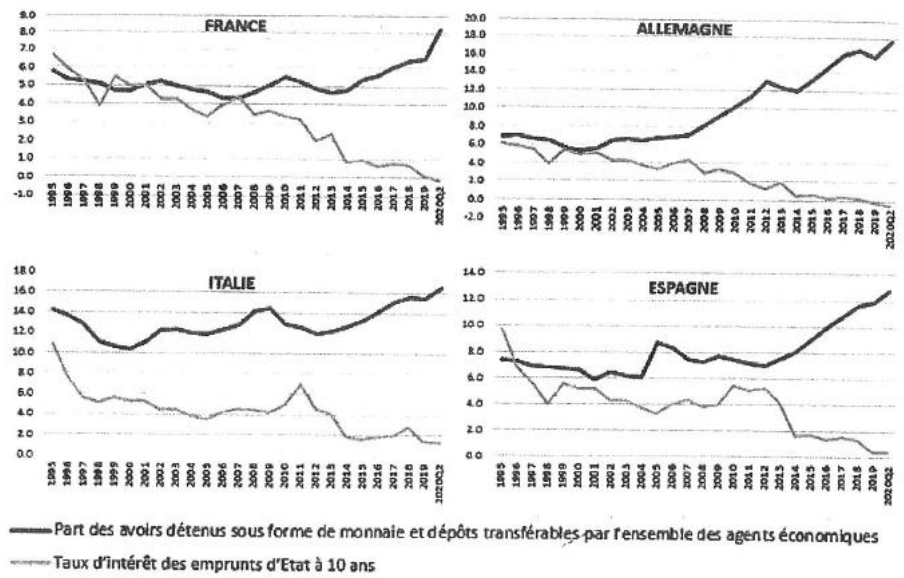
CHART 21.

Evolution of the liquid assets of economic agents and interest rates in govenrment bonds

Sources: Eurostat, Thomson Reuters, calculs OEE (observatoire de l'Epargne Européenne)



Weaker returns on investments in the event of rock-bottom interest rates has discouraged agents to undertake risky and productive projects. As can be displayed by Chart 22, the level of gross non-residential investment in advanced countries as a percentage of GDP has declined significantly, from above 14% in 2000 to less than 12% in 2018.

CHART 22.

Advanced Economies: Non-residential Fixed Investment in GDP (Percent of GDP)

Source: OECD; IMF Staff Calculations

Advanced Economies = Australia, Canada, France, Germany, Italy, Japan Korea, Spain, United Kingdom, United States

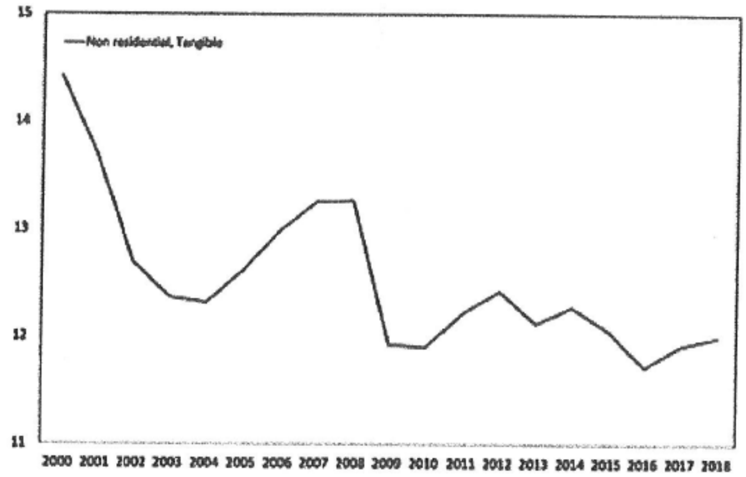


CHART 25.

Share of negatively remunerated debt in the euro area

Source: Banque de France

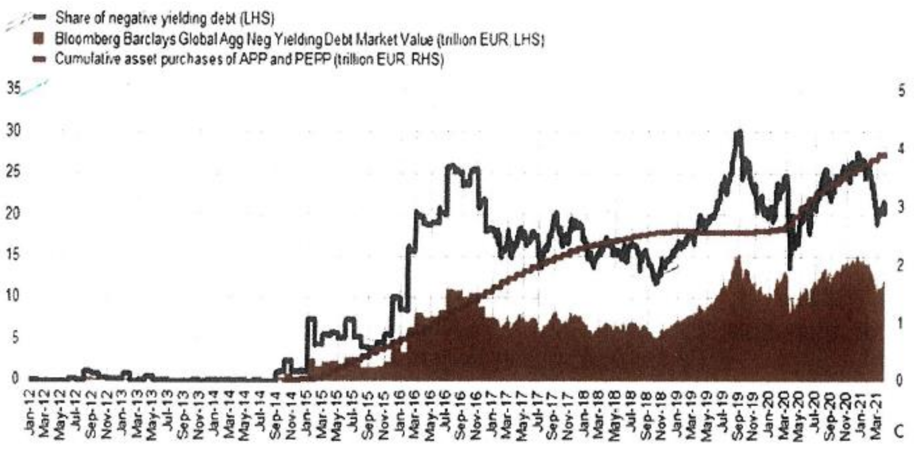


Chart 25 exhibits that as of April 2021, roughly 20% of bond yield returns in Europe were negative, and around 60% were below 1%. As an example, the Greek 5-year bond yield turned negative for the first time in May 2021. Such a proportion of ultra-low remunerative assets has brought financial markets to shift away from the economic fundamentals. This has pushed investors into riskier segments in search of income, compelling them to lend to lower-quality companies and countries.