Berlin April 2022

REFLECTIONS ON EUROPEAN MONETARY POLICY

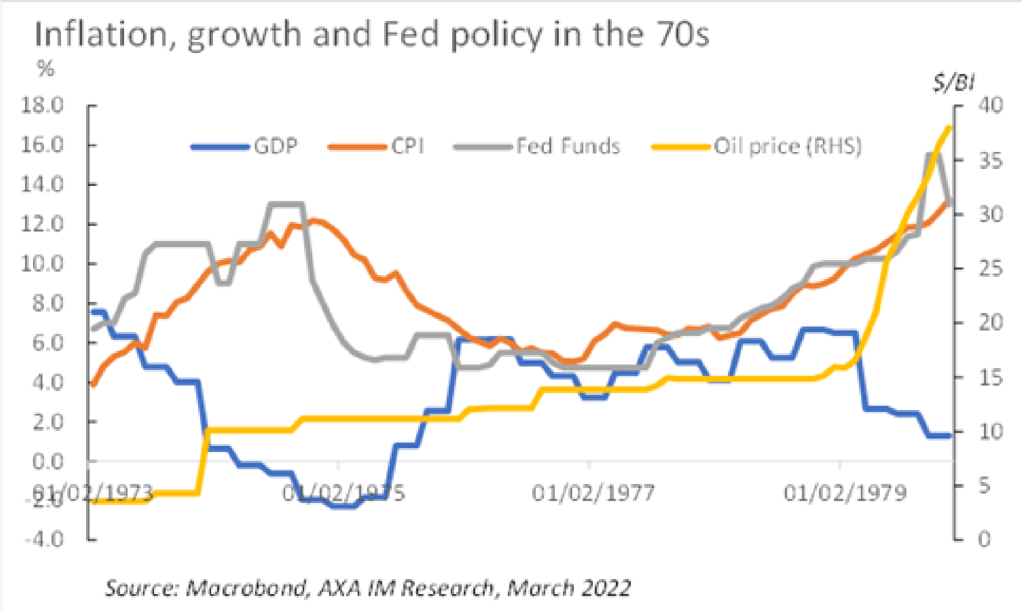
MONETARY Policy has almost always been influenced by politics. Let us try to assess what should be the monetary policy of the ECB in the current high inflationary context.

I. The "anguish" of Central Bankers: Memories of the 70's

I remember the 70's when inflation was raging, pushed by major increases in the price of oil.

The US Fed hiked aggressively in 1973 in response to the 1st oil shock.

But it did not have the political courage to maintain the adequate pace of tightening for long enough because of the cost to GDP growth (see Exhibit I).



In 1975, the Fed gave up the battle against inflation and cut rates aggressively despite inflation soaring.

Thus, real rates entered in negative territory. Oil had stabilised but inflation remained above 5% and, eventually, CPI exceeded 10% before the 2nd oil shock (1979).

Paul Volcker, the new Chairman of the Federal Reserve System, took the brave decision, in 1979-1980 to break inflation by hicking interest rates up to 20%.

He had had the courage to act vigorously.

Double digit Inflation was broken, but the world started a recession. And over-indebted economies (notably in Latin America) were caught in the debt trap (interest rates went up while the recession drove export prices down).

II. The monetary dilemma in case of an oil shock

Bernanke, in 2004 (just before he took over from Greenpan) said: - **"Monetary policy cannot offset the recessionary and inflationary effects of increased oil prices at the same time. It must choose"[1].**

The question is therefore: how to choose?

One has to weigh the relative drawbacks and advantages of each option.

1) Letting inflation rise in order to protect GDP growth?
That option should only be envisaged if growth were severely heading downwards, unemployment were soaring and the economy were getting farther and farther away from full capacity in an environment of low inflation.
This is not the present environment.
The unemployment rate in the US presently has reached the record low of 3,8% and wages are on the rise.
In Europe, the unemployment rate is on a declining slope and inflation is surging. The EU unemployment rate fell again in February 2022 to a historic low: It reached 6.8% of the labor force. This indicator is the lowest since Eurostat began compiling this series in April 1998. In contrast, the annual inflation rate for the euro zone is estimated at 7.5% in March 2022, up from 5.9% in February

Graphique inflation US euro area plus détail mars euro area (Eurofi scorboard)

[1] See Gilles Moec, Macrocast (AXA): "Augmenting the Bernanke Doctrine"

2) Tightening Monetary policy: is advisable if inflation has become a serious risk in itself.

This is the case today. Eurozone Inflation runs at a yearly rate of 7,5% in March while real interest rates are becoming more negative in real terms because of the ECB policy and high inflation. Correctly, the Fed has decided to start hiking interest rates and reducing its balance sheet during the present energy shock albeit gradually.

Never monetary policy has been as loose as it is now in terms of real interest rates. When inflation appears, one has to tighter monetary policy but this time, Central Bankers are letting it get looser.

The question that many people are ultimately asking is this one: "isn't inflation the miracle cure for debt? The more inflation occurs, the more the debt burden in real terms will decrease. This is what happened after the great conflicts of the 20th century to the detriment of creditors".

Why not consider a similar solution today, when the capacity of central banks to finance public debt has become massive?

Two observations must be made in response to this observation:

1) The reasoning is based on unlimited inflation: one must be prepared to undergo very high double-digit inflation to neutralize a debt that is out of all proportion to that of the past. Such exuberant inflation is not without risk:

- Social risks and the development of populism, even if salaries can be protected by indexation, the same cannot be said of service or financial income. Therefore, an important class of the population (the middle classes and the most “disadvantaged") will see the ineluctable decrease of their incomes)

- The investment horizon is blurred and altered for entrepreneurs in an uncertain inflationary context
- The exchange rate falls with the development of inflation, which increases the cost of imports ("imported inflation”)

2) The recessionary effect of inflation should not be underestimated: consumption tends to decrease with the sustained rise in prices; the margins of companies in strong competition are reduced, investment is sluggish because of no real remuneration and of the absence of clarity on future developments and stagflation sets in...

III. <u>The ECB response: The ECB is hesitant and gives an ambiguous message</u>:

What is the ECB announcing?

“First, we have to rein in quantitative easing and only then start increasing rates.”

- The Covid PEPP ended in March 2022 but could be resumed, if necessary, to counter negative shocks related to the pandemic. Monthly net purchases under the Asset Purchase Program (APP) will amount to 40 billion in April, €30 billion in May and €20 billion in June. Net asset purchases under the APP should be concluded in the third quarter.

- Interest rates would only be lifted "some time" after the end of APP purchases, but with no automaticity and depending on macroeconomic conditions.
- The Governing Council intends to reinvest the principal payments from maturing securities purchased under the PEPP until at least the end of 2024.

We have to note that, given the present inflation (7.5% in March 2022), real interest rates have never been so negative as they are today. So, instead of tightening monetary policy, we observe a great loosening of monetary conditions in real terms.

IV. <u>The ECB inflation projection seems pretty moderate</u> – *see Exhibit 2*

ECB's Growth and inflation projections for the euro area

(annual percentage changes)

	March 2022 projections				Adverse scenario				Severe scenario			
	2021	2022	2023	2024	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	3.7	2.8	1.6	5.4	2.5	2.7	2.1	5.4	2.3	2.3	1.9
HICP inflation	2.6	5.1	2.1	1.9	2.6	5.9	2.0	1.6	2.6	7.1	2.7	1.9

Notes: Real GDP figures refer to seasonally and working day-adjusted data. Historical data may differ from the latest Eurostat publications due to data releases after the cut-off date for the projections.

Source : ECB - AXA

The chart shows inflation abating in 2023-24:

- ECB March 2022 scenario: from 5,1% in 2022 to 2,1% in 2023 and 1,9% in 2024
- "severe scenario" from 7,1% in 2022, followed by 2,7% in 2023 and 1,9% in 2024.

In other words, the ECB discards the "stagflation" scenario where GDP growth would be lower than expected and inflation higher.

But one can have doubts on this rather sanguine forecast of the ECB on growth and inflation.

Indeed, commodity prices are soaring (with the Ukrainian war, but also independently) and the market expectations are factoring in worse assumptions than the ECB's with oil at 125/bl, plus the impact of a collapse of Russian demand for EU goods. Growth could then fall in Europe lower than the 2,3% anticipated in the "severe scenario".

If one adds the inevitable "energy transition" for ecological reasons and the cost of decarbonisation, it is difficult to foresee much relaxation, if any, of energy prices in the coming years.

A paper from the BlackRock Institute[2] highlights the seriousness of the risk of stagflation given Europe's dependence on Russian gas. The elimination of Russian gas imports could add 1 to 1.5% to Europe's inflation and reduce its growth substantially.

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You may ask me: "if inflation and its recessionary effects on growth rise, is it a good time to tighten monetary policy? The risk is that we will get more recessionary impact".

My answer is this one:

- <u>Interest rates in real terms are dangerously low at: -7%</u> - this loosening of monetary policy (because of high inflation) is creating massive distortions:

[2] BlackRock Investment Institute, "Taking stock of the energy shock", March 2022

- Investment (badly needed for growth) cannot be restored with such a severe “taxation” on savings. But investment is the key to reduce the output gap.
- Zombie firms (left alive because of the interest rate subsidy) reduce global productivity.
- Real estate bubbles will continue to inflate with very low interest rates that make mortgage loans so cheap.
- Share buy backs will continue to expand (267 billion dollars of buy backs at the end of March 2021 and now 319 billion dollars at the end of March 2022)

So, the good question seems to be: “if we let inflation go further up and allow too loose monetary policy, what are we gaining?”

- Not more long-term growth: because of the “liquidity trap” (savings are kept liquid since long term projects earn no return) and because high inflation reduces the purchasing power and therefore, demand. The consequences of this liquidity trap are devastating: the preference showed by investors – especially in Europe - for real estate and speculative assets – encourages bubbles and deters from long term productive investment.
- What we would get is more inflation, the one coming from supply side bottlenecks, war and commodity price shocks clashing with a strong rise in demand. That inflation, if left unleashed, could be dangerous and feed (through wage indexation) the daunting “spiral”. Indeed, it is difficult to imagine that in such an inflationary environment the wages will remain stable in nominal terms.

So, in my view, the only answer now is to do all we can to reduce inflation and increase interest rates, which are conditions for kickstarting growth.

I heard a European Central banker say a few weeks ago: “how could higher interest rates reduce the price of oil?”

I believe the more pertinent question would be:

“How could lax monetary policy (with even lower-real-interest rates) boost demand?”

The answer is that it could not.

- Demand depends on confidence and on purchasing power (that are both hurt by inflation and higher commodity prices)
- If anything, oil prices would tend to go up even higher if we let our currencies depreciate (traditional reaction of OPEC to buyers exchange rate depreciations).

Therefore the moment has come to increase interest rates.
It would be abnormal not to do it while real rates are becoming negative and while capacity constraints (labor market) are getting worse.

To this argument some object two points:

  - ➢ Increasing interest rates would recreate higher spreads to the detriment of most indebted countries. This would be a daunting challenge for the euro zone and the sustainability of member states' public debt.

- As a result of this potential financial fragmentation, some public debt would be difficult to service.

  As previously argued it seems inevitable to raise interest rates in the current inflationary context. If a recession appeared, we would have recreated the margin to reduce rates, whereas if we do nothing now, monetary policy will be powerless when facing a recession.

Raising rates today would have a much weaker restrictive effect than doing nothing and letting inflation flourish. Indeed, as long as interest rates in real terms remain negative or zero, the increases implemented can only have extremely weak recessionary effects.

We might add that the fear of the reappearance of spreads in Europe should not override the decision-making process. Indeed, one day or another, structural differences in Europe will appear in the markets. Is it an obligation for the ECB to delete forever any trace of interest rates differences in market appreciation? If so, the central bank would be led to buy vulnerable securities without any limit. If this is what is proposed, it would be difficult to reconcile it with the Maastricht Treaty since some Member States put more stress on monetary stability (believing that the ECB cannot monetize public debt).

Furthermore, such open-ended decision would deter Member states from structural reforms.

The result of monetary inaction would be accelerating inflation. Consequently, productive investment would fall as we have observed over the last 20 years in a period of very low interest rates. In the essence, the implicit policy behind the objection leads to a combination of high inflation and low growth (stagflation). This is the major weakness of those who pretend that high and ever-increasing debt coupled with no interest rate is the “magic wand” for the future. It is not a magic wand. It is a fatal trap: structural reforms are disincentivized and productive investment is discouraged by the insufficient remuneration.

So, what to do?

If the idea is to throw vouchers at the entire economy in order to abolish all the effects of inflation, we would be condemned to endless spiral of high inflation, due to the monetary creation thus produced and low growth. Indeed, at a certain stage of public indebtedness, the recipe for stimulating demand through higher public spending and deficits, works with increasing difficulty, as the country's credit rating deteriorates, and the fiscal multiplier weakens.

History has taught us the social and political price of such a policy. The reason calls us to handle these issues in a more constructive way: reduce excessive public deficits, restore remuneration of productive investment, incentivize work more than redistribution and not accept the fatal chain of decline.

Europe benefits from a substantial surplus of savings. Instead of letting those savings flow outside of the EU, it would be important to put this money at work within Europe, which requires a remuneration that is at least as attractive as that which exists in the United States. In this respect, if the divergence in interest rates between the two sides of the Atlantic were to increase in favor of the United States, the problem of a transfer of savings to high-interest areas could have extremely negative consequences for Europe.

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Let me touch now on an intriguing issue: Why did monetary policy go so far and so deeply in over-accommodation?

I see three main reasons:

1. An intellectual conundrum

Our monetary "leaders" have been underestimating the negative consequences of systematically loose monetary policies.

Recently, Federal Reserve Chairman Jerome Powell stated that he still believes that there is no connection between inflation and money supply.

In his Monetary Policy Report to Congress in February 2021, one can read: "the growth of M2 doesn't really have important implications for the economic outlook": But since then, annual inflation rate has climbed to 8,5% from 1,7%...

However, Mr Powell has still not changed his mind. In a December 2021 congressional testimony, he argued that the connection between money and inflation ended about 40 years ago. (!)

With such a mindset one can understand that US M2 has been growing at a record rate (39,9% cumulative growth since February 2020).

And, nonetheless, the predicted inflation (on the basis of M2 evolution) has always been rigorously correct. [3]

So, there is an intellectual bias against the recognition of any connection between money creation and inflation, which is strange given the strength of the correlation observed over centuries and the policy of trying to reach 2% inflation through money creation.

2. The second reason has to with the mechanistic reliance on the 2% inflation target

An inflation target is supposed to protect the system from excessive price increases or from deflation, but not to seek an artificial price level higher than the one resulting from business and market forces.

The problem with the 2% target is that the equilibrium at the time was in fact attained, for structural reasons, with an inflation rate of around 1%. That was the order of magnitude that avoided deflation as well as excessive inflation.

But instead of letting the 1% inflation operate, which would have been appropriate, Central Banks wanted, at all cost, to push inflation up from 1% to, 2%. This misconceived view led Central Banks to inflate massively and unnecessarily money creation. The pretext was: “we have not yet attained the Sacro-saint 2% objective” (in

[3] See : « Powell is wrong. Printing Money Causes Inflation Wall Street Journal – February 20- 2022 by Steve Hanke and Nicholas Hanlon

spite of the fact that the 2% figure was artificial and even if it had been reached it would not have guaranteed optimal prosperity).

The danger of deflation was overstressed while the perils of too low interest rates were completely underestimated.

3. The third reason is that nowadays, Central Bankers want to be "popular"

A central Bank should be concerned by the need to maintain the stability of currency and to fight against the biggest evil of all: inflation.

But nowadays Central Bankers like to be seen as popular:

- a policy of continuous monetary stimulus is, in itself, absurd. But people like it, and it makes borrowing governments happy;

- Central Bankers tend to multiply their objectives: green initiatives social inclusion…

Fiscal dominance is a real problem. The idea that there might be some divergence between EU spreads seems excluded. This is a serious drag on monetary policy.

The existence of such diverse - and possibly incompatible - objectives tends to weaken and waterdown the main purpose of a Central Bank which is monetary stability.

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I would like to share with you an observation.

Too low interest rates - as those we have been experiencing in Europe for the last 10 years are extremely harmful.

- They push savings into liquid assets and deter them from financing long term productive investment ("the liquidity trap"),
- They favor the survival of zombie companies,
- They weaken the banking and financial system.

However, neither the Fed nor the Bank of England allowed nominal interest rates to get in negative territory. The ECB did it.

This is the manifestation of a lack of understanding. Indeed, Central Bankers should know that productive investment – that is dependent on remuneration – has been <u>falling</u> over the last 20 years thus threatening our future growth. So, negative rates are not conducive to investment. It is the opposite.

The ECB must learn from its mistakes. In 2017, it missed the opportunity to withdraw from ultra-lose monetary policy when the conjuncture would have made it easy.

5 years later there is no justification for hesitation. If the ECB continues to waiver, it will have to take much stricter measures later If and when inflation gets completely out of control.

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In conclusion, the fact that the ECB has decided to buy - and to monetize – more than the equivalent of 70% of the EU GDP, gives an idea of the magnitude of the explosion of money creation over the last 8 years.

The results of such an unmatched policy can only be problematic:

- It is a way of “de facto” nationalization the economy;
- It is moving the Central Bank deep into the fiscal area and in the financing of the Treasury;
- The substitution of a public body for market forces in the determination of interest rates is a major change in our supposed “market economy”.

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Fighting inflation is a demanding exercise. It requires vision and courage.

The Fed seems to be acting to tighten monetary policy. But this has to be qualified.

If the Fed was <u>really</u> determined to fight inflation as it did in the 80s and 90s, the Fed Funds rate would have to reach the level of inflation (8,5%) in order to become positive in real terms.

Since this is not yet the case, the risks are:

- Negative real interest rates will continue (this will perpetuate the debt explosion);
- Inflation will not fall;
- The economy will suffer growth-wise because of inflation much more than from higher but limited raises in interest rates;
- For investors, real assets will remain a good hedge against inflation.

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