

The monetary policy challenge

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This challenge could be defined as follows.

If we accept, as central bankers do, that inflation - which now stands at around 1.5%, i. e. slightly below the 2% target - is a major problem, the only possible way forward, in their view, would be to ease monetary policy until the target is met.

But is this justified and reasonable?

First, why should the 2% target be the absolute guide to monetary policy?

Does this figure reflect the balance that should underlie the notion of stability? According to the proponents of this concept, below 2% there would be a risk of deflation, i. e. price expectations would be very likely to become negative. In other words, economic agents would expect future prices to fall, which would be dangerous for growth since it would then be rational to postpone consumption in order to take advantage of the lower prices later on.

But it is very difficult to establish that 2% is the criterion below which deflation would occur.

In reality, equilibrium inflation (the one that gives a sufficient margin to avoid the risk of deflation and is low enough not to generate hyperinflation dynamics) is determined by a multitude of time-varying factors. Some of these factors are cyclical (changes in oil and raw material prices, influence of changes in stocks and demand for consumer goods, etc.) but others are structural and have been at work for some twenty years.

Those are the ones to examine in order to choose an inflation target. In fact, these factors are profoundly changing the conditions that govern consumer price formation.

Let us look at these structural factors.

- First, there is the ageing of our populations: increasingly older societies are also societies whose potential growth and productivity gains are declining. As a result, their economic growth is weakening, as is the pressure on available resources. Savings tend to increase, consumption and prices are moderating.
- To this, must be added technological advances that gradually lead to lower production costs and lower consumer price indices.
- There is also globalization, which has played a decisive role in the trend reduction in prices in advanced countries. The fact that they have opened their trade to imports from countries like China, which incorporate much lower wage rates than their own, has had a double influence. First, this has led to the introduction of cheaper products on the market and has also led to a moderation in the evolution of labour costs in the importing countries themselves; this largely explains the low consumer price inflation over the past two decades.
- Finally, the functioning of labour markets has changed in recent years and explains that employees - both less unionized and less secure about their future - use less competition between companies to raise their wages than in the past.

These considerations are essential if the issue of monetary policy is to be addressed rationally. It appears, in the light of previous observations, that the equilibrium inflation rate is no longer 2% (which was perhaps still the case some fifteen years ago) but rather 1%.

There is, moreover, nothing to worry about in such a development. Having, on average, a “normal» core inflation of 1% per year (instead of 2%) is by no means a sign of deflation as prices continue to rise. And it is rather a positive phenomenon since it prevents consumers from losing more purchasing power and supports demand.

But there are serious drawbacks to not recognizing this trend decline in the level (and rates) of inflation.

Wanting to “anchor» for a long-time inflation expectations at a higher level than the equilibrium level of consumer prices has worrisome consequences. This has led Central Banks to implement an overly accommodating monetary policy. If the inflation target had been set at around 1%, there would have been a better match between the target and reality, and monetary creation would have been more in line with the stability target.

Striving to reach, whatever happens, an inflation target that is too high in relation to fundamentals leads to very serious distortions:

- The impact of excessively accommodative monetary policy - with interest rates at zero or even negative for a long time - on the stability of the financial system is unfortunately too well documented: incentives to borrow more, weakening of the banking system, deterioration of the accounts of pension institutions whose liabilities remain subject to contractual obligations but whose fixed-income assets no longer yield anything, proliferation of zombie companies in an environment where interest rates no longer play the discriminating role of a “quality signal” that should be theirs, disincentive for governments to undertake structural reforms since borrowing “no longer costs anything»;

Let us not underestimate this importance of loss of benchmarks; zero interest rates eventually blur risk premiums (one of the characteristics of the 2008 crisis).

- The desire to “anchor» in the public the idea that inflation MUST reach 2%, while failing to achieve this objective (for the structural reasons mentioned above) also leads to “anchor» in the public mind that interest rates will remain very low for a very long time, which in turn leads to the flattening, or even reversal, of the long-term yield curve and thus to pessimism. By relying on “guidance», it is suggested - which is debilitating - that the success of monetary policy depends almost exclusively on whether an unrealistic inflation target can be achieved.

Let us not forget Keynes' lesson, which is particularly relevant today, that interest rates that are too low (below the marginal efficiency of capital) can favour liquid placements and discourage investment and confidence. Marginal capital efficiency represents the return on an investment over its lifetime. Today, economists estimate it at an average of 6% for long-term equity investments. As a result, monetary policy of zero interest rates has not succeeded in lowering the cost of capital, which is essential for the development of private investment.

For companies that still face high risk premiums, being able to raise debt at nearly 0% can also encourage them to buy back their shares, which reduces the capital base in favour of debt. In other words, the coexistence of a high cost of capital and the ease of borrowing at 0% makes it easier for companies to buy back their shares than to make real investments. It is an illusion to believe that monetary policy of zero interest rates favours the whole economy while it only supports consumption.

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It would be honest to recognize that monetary policy is at a dead end. It has not succeeded in bringing inflation back to its target level and therefore seems to be mechanically preparing to revive money creation even further. The start of normalization in the United

States two years ago was abandoned in January 2019 and the Fed gave a new message: further rate cuts are planned. And this is at a time when the economy is at its highest, unemployment is at its lowest and production capacity is saturated.

When the recession comes, what margins will remain to lower rates?

This is even more true for the ECB whose key rates are at zero and which is apparently considering further tightening the negative rates applied to bank deposits at the Central Bank. . . One is already talking about a revival of the QE. . .

A zero-rate strategy cannot work for long without creating instability in the financial system and yet we are being told that we are committed to this policy for an almost indefinite period. . .

We are told that monetary policy is constrained by the “zero bound». If inflation remains low, there is a concern that even low nominal rates may turn positive in real terms.

Hence, we are told, the need to raise inflation (including by activating the QE) and bring nominal rates to zero for as long as it takes.

But this means that we forget that until recently all periods of economic expansion have been accompanied by positive real rates.

Who could reasonably believe that lowering already low rates would strengthen growth? None of the surveys conducted among companies on investment barriers even mention interest rates (and for good reason!)

It can be noted that real 10-year sovereign bond yields in the US averaged +2.1% from 1990 to 2005 (a period rather favourable to investment) and -0.3% from 2000 to 2019, a period marked by the fall in investment.

To argue that, when the cycle is still favourable, rates should be brought down to zero for fear of seeing them become positive in real terms is to say, in a way, that growth will always be dependent on zero rates. Productivity growth has been declining in advanced countries for a long time: the factors underlying this productivity growth are multiple and have little to do with interest rates.

Obviously, herd behavior, competition and fear of contagion are at the heart of the problem: the United States does not want to be late to release monetary policy, because, given its trade deficit and the uncertainties of the tariff war and its negative consequences on its growth, it fears an appreciation of the dollar. As for the ECB, it also wants a low euro and rates that protect the budgets of over-indebted countries in the area in which it holds a large proportion of the public debt (almost 20%).

It can be seen that these cross-policy strategies, in which monetary policy is used - without being admitted - as a way of influencing exchange rates and fiscal data, pose great dangers to the global economy. Nationalism and beggar thy neighbour policy are in action and international cooperation is at its lowest. We have never been so close to the 1930s (competitive devaluations, trade wars. . .) as we are today.

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If we resign ourselves to the system’s bogging down in an uncontrolled situation of indebtedness and indefinite monetary creation “like in Japan»; (we have seen the results for twenty years!), if we accept fiscal laxity “on a freewheel» basis (to avoid the crisis, we are told in some circles, we would have to systematically increase public spending by financing it with money) and possibly direct monetary distribution to citizens (“helicopter money”), we will have to face the return of inflation and crises that are increasingly difficult to deal with and increasingly depressing growth prospects.

Ultimately, by taking things to the extreme, Central Banks would eventually hold most of the debt (and, perhaps, even shares). But, by dint of being taxed, household savings are likely to decline, and the Issuing Institutes could be led to become the main actors in the equation: savings/investment.

It is not too late to act.

If, as the observation shows, Central Banks cannot - for structural reasons - raise inflation to 2%, a strategic choice is required. Either go back to the old method whereby monetary policy must be cyclical and output gap-dependent (or capacity utilisation rate) and accept that, in good economic times, rates are positive. Or persist in keeping low rates indefinitely, which would have the double disadvantage:

- not to allow monetary policy flexibility in the event of a downturn;
- and to continue to undermine the stability of the financial system.

If the first branch of the alternative is chosen, which seems desirable, a “discreet»; international agreement should be sought on the following basis:

- adapt the course intelligently with a very gradual rise in rates and not insist on focusing everything on a mechanical inflation target of 2%, a dangerous objective because it traps monetary policy in an exaggerated accommodation; (by dint of “guiding»; the market by announcing the future policy, the Central Banks have come to follow the market, to fear all its reactions and, in particular, the “warnings»; - highly mediatized - of the large private equity funds faced with the risk of a less systematically generous monetary policy);
- to this end, show some flexibility in defining the desired inflation (possibly by varying the indicators according to regional situations, which would “desacralize»; the single inflation target);
- return, for Central Banks, to a more varied dashboard and not limited to the inflation target alone, as this is the case today. The inflation target has become a minimum level constraint more than an instrument to limit excess inflation (in this respect, we should restore the objective of stability of the financial system, credit monitoring - including that of “non-banks»; - macroeconomic surveillance, asset bubble analysis. . .);
- restore, at the global level, a form of cooperative discipline in balance of payments, exchange rates and monitoring of competitiveness conditions (multilateral formula much more efficient and fair than current tweets and intimidation).

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In conclusion, a few remarks

1. Monetary policy cannot do everything. It cannot replace the reforms needed for long-term growth. Other budgetary and structural instruments must be implemented. But it is a fact that central banks have been overly involved in these areas in recent years. It is high time to return to a more reasonable conception of monetary policy: that of the stability of the currency and the financial system.

2. It is easier to create abundant liquidity than to absorb it. Let us not believe that overliquidity is a benefit: it poses stability problems and its neutralization requires favourable conditions that are rarely achieved.

3. Finally, it is high time to put these problems in an international perspective: any monetary policy of a country or a major area inevitably has external effects. We must avoid using national monetary policies for competitive purposes. The exchange rate must regain its role of stability in an organised international monetary system.