



Is normalising EU monetary policy feasible? If so, how and when?

Jacques de Larosière - Honorary President, Eurofi

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Andreas Dombret (Chair)

The Chair introduced himself, welcomed everyone to the discussion and wished Portugal a fruitful, productive and successful Presidency.

He noted that, as a former governor and former managing director of the International Monetary Fund (IMF), and as a founder of Eurofi, Jacques de Larosière needs no introduction, so they could jump into the first question. Despite 10 years of accommodative monetary policy, which has led to low-to-negative interest rates, growth in the eurozone is still subdued and investment is declining. He asked why this is the case.

Jacques de Larosière

Jacques de Larosière considered that today's world is made up of paradoxes. Global demand is weak, investment needs are enormous and not being realised, at least in Europe, and interest rates have been low for a number of years, although non-residential productive investment has been declining. Monetary policy has been particularly accommodative for more than 10 years, and interest rates have converged to zero or negative rates.

Looking at M0 – banknotes in circulation and bank reserves held at the central bank – shows that in advanced economies, during the last 10 years, the money base has grown almost four times more quickly than the nominal economy. This policy has been so accommodative because monetary policy has been geared to an overriding objective in terms of consumer price index (CPI) and to keep inflation at a level close to 2%. This objective poses a major problem, because structural factors have been at play for the last 10 to 15 years: ageing; opening of international trade and globalisation, which has allowed western countries to import massive amounts of goods and services that are made on low wages (approximately 1/10th of those of industrialized countries); and consequences on prices stemming from technological innovation. These factors have put inflation at a lower rate than in the old days.

This moderation of inflation has to be understood not as the result of a weakness in demand but of structural changes. Monetary policy has made a serious mistake because policymakers seemed to believe that low inflation – and lower than the arbitrary target of 2% – was the manifestation of insufficient global demand. The Keynesian recipe of monetary stimulus was therefore justified, in their eyes, and so they decided to increase monetary creation, as long as inflation was lower than 2%. More analysis should have been required on the precise nature and causes of these disinflationary forces. To the extent that these forces are structural and therefore unavoidable, attempts should not be made to redress them by more money expansion.

Money creation, in fact did not create more demand nor more inflation but translated in less velocity. If monetary policy over the last 15 years or so had been geared to a more realistic inflation target of around 1.5% or 1%, instead of 2%, the world would have avoided the unnecessary expansionary monetary stance, as well as deflation.

This systematically loose monetary policy contributed to building the enormous credit bubble that nearly broke the financial system in 2008. All financial indicators were flashing, but, as the CPI was low, central banks were not worried. However, they should have been, because a financial bubble is the present manifestation of inflation in an environment of technological disinflation.

Strange as it can seem, the extreme magnitude of the excess leverage that was appearing in the financial cycle, did not attract the attention of Central Bankers, simply because CPI was stable. The financial house was burning, but no alarm bell was ringing; complacency was the name of the game and the fire became threatening.

Andreas Dombret

The Chair noted that the COVID-19 pandemic has clearly not made the situation better but worse in the

past year or so. However, that is by no means able to explain by itself low growth and receding investment in the eurozone. He asked what have been the effects on growth of monetary policy over the last 10 years.

Jacques de Larosière

Jacques de Larosière stated that the question is at the heart of the problem. If aggregate demand remains weak, it is mainly due to structural factors such as ageing, etc, leading to an overall saving surplus. A common opinion is that, in the face of relatively sluggish global demand and excessive savings, fiscal and monetary policies are required to stimulate demand, so it is worth pausing to analyse this apparent obviousness.

In spite of the explosion of debt over the last 20 years and of very low interest rates, the stock of non-residential productive investment – not including intangibles – has fallen from 14.4% to 12% of gross domestic product (GDP) in advanced economies, which has been only partially offset by the rise in intangible investments which have risen from 4,3% to 4,9 % of GDP. This is a staggering figure. In a normal situation, the capital base should not fall but expand. It is surprising that this statistic, which is one of the most significant in terms of global demand, is not highlighted more. The collapse of productive investment has occurred despite historically low interest rates.

Jacques de Larosière stated that a strange hypothesis eventually emerged to him: is it possible that very low or negative interest rates contributed to lower investment? The answer would be that that is absurd. If the financial conditions are easy and inexpensive, it is not clear how investment could be penalised. This is where the liquidity trap comes in. Once again, Keynes was right. He was in favour of low interest rates, but he specified not too low interest rates. Indeed, when they are too low, they deter savers from investing in long-term bonds and encourage them to either keep their savings in liquid forms, which they are doing, or in assets remunerated only because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of no growth emanating from zero interest rates for a long time, are turning away from productive investment in favour of things like share buybacks and speculative opportunities.

This is not an invention; it is based on a study from the prior year that showed over the last 10 years a massive and spectacular increase in the purely liquid part of household savings – notably, in overnight bank deposits – even before the Covid crisis. This research is European and may be less verifiable in the US, where investors are less risk-averse than they are in Europe, and more interested in the opportunities offered by Wall Street. This interpretation is not universal, but, if it is correct in Europe, serious thought should be given to the problems posed by monetary policy.

This is all the more so as the role of banks in financing the European economy is much more marked than in the United States. The profitability of banks is penalized by zero interest rates. This penalty is all the more pronounced in Europe as interest rates are lower than in the United States.

Andreas Dombret

The Chair proposed going from the analysis to the recipes. He asked whether a zero-to-negative-interest-rate policy on the one hand, and fiscal domination on the other, are the right recipes for reviving eurozone economies, as it is not possible to be satisfied with the paradigm of low growth going forward.

Jacques de Larosière

Jacques de Larosière stated that not only is he not convinced that a negative-interest-rate policy and fiscal domination are the right recipes, but he is convinced that they are the wrong recipes. Zero interest rates alone do not foster economic growth. They shift savings to liquidity holdings, discourage long-term and riskier investment, as they have no remuneration. They trigger financial bubbles and pave the way to the next crisis.

Andreas Dombret

The Chair noted that it would be possible to talk about this for much longer and asked for the three most important takeaways for the audience.

Jacques de Larosière

Jacques de Larosière considered that the time has come to start getting out of the present monetary trap, gradually and with the benefit of international consultation. He proposed three simple orientations: first, to allow long-term financial markets to express their inflationary expectations through higher yields. This would provide investors with a more normal remuneration and foster long-term investment. Adequate remuneration for risk is of the essence. Second is to have a more realistic view on price developments. A price slightly less than 2% is not one of instability; it is the contrary. Third, if yields tend to get somewhat higher, central banks should not consider that they should redress their tendency and provide member states with the unconditional benefit of a zero-rate guarantee. Fiscal domination, which is presently a fact of life, should not become the rule for the future.