



Q&A

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Central banks must change course to avoid possible financial crisis

High leverage poses great dangers

Central banks around the world appeared to wish to stick to the 'static approach' of monetary policy, maintaining their present unconventional stance. This policy was clearly inadequate to solve the world's real challenges and was fraught with danger.

Since then, the Fed plans to start withdrawing in the coming months its massive pandemic stimulus programme. The minutes from the July meeting of the Federal Open Market Committee stated that "most participants noted that, provided the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year". Maintaining the present unconventional monetary stance could have eventually triggered a financial crisis, bringing with it all the associated negative economic and social consequences. It would have weakened banking and insurance systems whose profitability has been hit – especially in Europe – by low or negative interest rates. Moreover, it would have unjustifiably kept alive over-indebted and uncompetitive 'zombie' firms that are surviving only because monetary policy grants them an interest rate subsidy.

Monetary policy was already at an impasse before Covid-19 struck. The system had been swamped with liquidity through the highly accommodative monetary stance of the past decade. This has pushed global debt to 355% of world gross domestic product, a record for peace time.

Huge leverage has weakened the financial system and endangered stability. Consumer price inflation has remained subdued but prices of financial assets and real estate have skyrocketed.

The continuation of very low interest rates for a couple of more years would have intensified already negative consequences for growth and employment. Abundant liquidity and low interest rates result not in higher productive investment but in liquidity hoarding. Since 2008, the M0 money supply (banknotes in circulation and bank reserves held at the central banks) has increased by 13,5% per year in major countries,

four times faster than nominal economic growth. During the same period, M3, which includes bank deposits (and therefore reflects the transformation function of the banking sector), grew much more moderately – 3,5% per year in the euro area – showing that central bank money creation had not seeped into the economy.

It is indeed time for central banks to start changing gears and tighten policy. Various factors – the US fiscal stimulus, shortages of qualified labour, supply chain bottlenecks and the first signs of inflation of 4% and more – all point in one direction. It would seem prudent for the Fed to move gradually out of the present trap, by reducing monthly bond purchases and not systematically reinvesting all bonds coming to maturity. If the Fed does not start shifting course now, it could face a much tougher task if inflation takes hold in coming years. By delaying, the Fed might have to resort to much more intensive tightening with still worse consequences for growth. The world has grown accustomed to ever higher public and private debt. High leverage has massively increased market valuations. This poses great dangers if inflation and higher interest rates re-establish themselves. This is far from improbable, given the structural and demographic factors at play. In that case, heavily over-extended institutions would start facing debt payment difficulties and market reversal could well lead to a recession. Central banks would then face an unenviable choice: to fight inflation with much higher interest rates, to the detriment of growth, or allow inflation to explode, running the risk of stagflation.

Beyond this, the fiscal dominance now taking place brings two further hazards. It puts into question the independence of central banks. More importantly, it is a major disincentive preventing governments from engaging in the structural reforms that are vital to meet the fundamental challenges of the world's climate crisis. These challenges cannot be solved by printing ever more money.