Monetary policy issues: lasting low interest rates, quantitative tightening

Introduction

The Chair kicked off the discussion by observing that inflation seems to be falling as quickly as it rose. He explained, the first part of the panel would reflect on the monetary policy journey we have been on since the global financial crisis and whether it offers lessons for where we are going. The second part would then focus on central bank balance sheets, the question of how large they should be in the medium term, and their composition.

1. Central banks reacted swiftly and appropriately during the past crises

A Central Bank official stated that there were good reasons for low interest rates during a time of very low inflation after 2008. There were also periods of stress in the market, most recently during the pandemic, when there was a need for central banks to calm the markets, which was done successfully.

A Central Bank official noted that it is important to act without hesitation when it is necessary. Side effects need to be taken into account and learned from. Zero lower-bound issues are likely to come up if there are a series of shocks. There have been a series of negative supply-side shocks, but the stronger the system on a structural basis the easier it is to overcome such shocks.

There might be instances when there is a push into negative rates. The time element does matter. One should avoid staying in negative interest rates for a too long period of time. Financial stability risks via say search for yield are likely to be built up not only within the banking system, but also outside the banking system, which is less regulated, so the crisis elements may spark much quicker. To improve traction of a single monetary policy in case of negative rates, a common fiscal facility would be beneficial.

A Central Bank official observed that the response of economic policies has been extraordinary because of economic shocks such as Covid and the Russian invasion of Ukraine. That had some negative consequences, such as on how the transmission of interest rate policy is working. Monetary policy transmission is working almost completely on the credit side, but not on the deposit side. Other factors such as structural changes in the economy also cause effects. Central banks are shrinking their balance sheets while keep a watchful eye on the transmission mechanism.

A Central Bank official noted that monetary policy has been successful overall. Conditions have changed; various shocks hit European economies and monetary policy has responded in a rather satisfactory way. The monetary policy that was pursued avoided serious consequences, such as bubbles. Countervailing measures were also taken, for instance, to mitigate the profitability erosion of banks excluding some bank reserves from negative interest rates. The natural rate of interest (r^*) fell and was potentially negative. Central banks determine nominal interest rates, not real ones. The lessons learned are important for the future.

A Central Bank official observed that if r^* is low then monetary policy easier might be pushed into negative rates. The structural strength of the European economy is extremely important, and monetary policy works within the confines of that. If growth potential is higher through structural reforms and closer integration such as single market in goods and services, then the r^* is higher and there is much less risk of moving into negative rates.

2. Lasting real interest rates have negative consequences for the real economy and financial stability

2.1 Prolonged monetary accomodation has contributed to indebtedness, damaged productive investment and exacerbated financial vulnerabilities

The Chair recalled the ECB's long journey from the Securities Markets Programme to the initial three-year refinancing operations, negative rates and quantitative easing (QE), the pausing and restarting of QE in 2019, and then the pandemic.

A market expert stated that it is repeatedly said that inflation is abating, and interest rates are going to resume their downward trend. That is puzzling, because for more than 15 years the consequences of low or zero interest rates in real terms have ben experienced, as well as the well-established consequences of that situation: The financial system is dangerously weakened when interest rates are kept at zero in real terms for a prolonged period. Money has a cost, and excessive borrowing takes place when a central bank creates enough money to make people think its cost is zero. That borrowing is then invested in short-term placements, not long-term productive investments. Asset bubbles are created, which are a manifestation of inflation. Long-term very low interest rates disincentivise member states to undertake structural reforms which could boost potential growth.

People are waiting for the next fall in interest rates. But a re-establishment of lasting low interest rates, would be unfavourable. It is not favourable growth-wise, because it has been demonstrated that the more that is borrowed and the more that money is kept in short rem placements, the less is invested productively and the less growth and more unemployment there is. Periods of high investment in economic history have been accompanied by positive

real interest rates: the ecological and digital transition cannot be financed by money creation, but by long-term savings that need to be remunerated in the market. It is not up to central banks to set medium and long-term interest rates.

2.2 Persistently low interest rates may create asset bubbles and lead to a misallocation of capital

A Central Bank official highlighted the side effects of having very low interest rates for an extended period of time. Policymakers need to strike a balance at any given point in time, but it is a problem when there are very low rates for an extended period, as it creates the risk of excesses in the financial and real estate markets. If funding is extremely cheap then firms can be kept alive that should not stay in business. Care is also needed to not distort market signals too much. Central banks sometimes need to act forcefully by lowering interest rates and the cost of money, but it is preferable to do it in a way that makes it easily reversible.

2.3 Ultra-loose monetary policy created inflation, which central banks reacted to slowly

A Central Bank official noted that he had dissented on the forward guidance on the last round of QE at the end of 2021, as he could not see what the end game was of 'low for long' with uncertainty on inflation going forward and no private over-leveraging in the economy. If real rates are negative, then unproductive investment is encouraged: negative rates pushed the economy to produce investments with a negative risk-adjusted value. Europe is quite safe due to actions on the supervisory and regulatory front. The US had bank failures, inflation and a financial stability issue.

A market expert explained that 'low for long' could return, but it would be a mistake. There were two big rounds of QE. The first was ineffective in lifting inflation to 2%, there was no deflation risk but there was sub-optimally low inflation. The second round after Covid caused more damage, because governments printed 25% of GDP in terms of fiscal transfers, largely funded by an equal size expansion of central banks' balance sheets. That created a significant positive demand shock on top of negative pandemic supply shock. Excess demand caused inflation, which went up to 10%, with very little initial pushback by central banks. It took the US 12 months to recognise that inflation was becoming a problem, and it took a further six months to react.

In seven of the last 10 cycles of interest rates in the US interest rates decreased because the US hit a recession. In the other three the US did not hit a recession.US interest rates also typically declined when the US had financial stability issues. Rates have increased further than may have been needed because central banks were late and acted in a faster way, so they needed to push back harder against inflation. Going back to the old, 'not normal' situation would be inappropriate.

2.4 Extreme policies work much better in models than in real life

A Central Bank official noted that the review of the operational framework is currently being discussed and argued that probably no firm commitment should be taken. The problem with extreme strategies based on state-dependent commitment is that if things turn out differently than expected, then the outcome is even more extreme policies. Some form of proportionality is needed in the use of monetary instruments, in particular forward guidance. The cost of inflation to the population has been completely underestimated by central bankers, and the cost of low inflation has also been exaggerated.

A market expert observed that the usual adjustment of the rate hike cycle will take longer than any previous one, as this has been the steepest, fastest and most globally synchronised rate hike cycle in post-war history. Goods price inflation is down, but service prices still run at 4-5% inflation. Nobody expects inflation to be excessive, but there is a 25% purchasing power decline in the balance sheet of households. There will be broad demand that this money needs to be recovered through higher wages. The adjustment process is taking place mainly through adjustments of real wages and the biggest impact will be on the housing market. Going back to the 'old normal' would cause significant damage.

A Central Bank official agreed that there has to be an adjustment in incomes from the inflation rate and price level. Incomes and purchasing power must recover. Yet, caution is needed that income recovery is not spilling over into further price increases. There is no reason to return to the interest rates that were seen two years ago, as money is not a free good. There is also no need to rush into oversized rate cuts.

2.5 Central banks have become fiscal agents

A Central Bank official stated that fiscal policy and monetary policy should be separated. The euro area has the Outright Monetary Transactions (OMT) programme and the Transmission Protection Instrument (TPI). The actions taken during Covid were necessary and the de facto coordination with the fiscal response was welcome. But in the post-pandemic world, the rules conceived when writing the Maastricht treaty – that monetary policy should be able to operate without consideration for fiscal sustainability –, should apply again and it is not currently the case. The current situation is one of weak fiscal dominance. The fact that the euro area has OMT and TPI shows that it is not in a situation where it can completely abstract from the impact of monetary policy on fiscal sustainability.

2.5.1 Monetary policy and fiscal policy are both cyclical

In reflecting on the QE experience in terms of possible barriers for some future use of such policy, a central Bank official noted that when central banks embarked on QE the common thought was that it was uncharted territory. a great deal of money was deployed through purchase of trillions of government bonds and other type of assets with limited effect in terms of marginal utility of these type of the policies as regards targeted inflation rate. European central banks took a huge amount of the duration risk onto their balance sheets, and in the end that duration risk has materialized.

How the long period of low interest rates impacted different countries is also important. Having low interest

rates should help to reduce debt, but if a country responds by borrowing more and increasing its debt then it is being wasteful. It is the incentive of the country/government that really matters. Some countries have reduced public debt while others have increased it. Macroeconomic stabilisation and structural reforms worked well in program countries. Monetary policy and fiscal policy are important in managing the cycle, but structural policies are the ones that increase the potential rate of growth rate and can vary substantially from country to country.

2.5.2 A favourable 'snowball effect' can favour the resilience of our economies

A Central Bank official highlighted that central banks are operating in a much more difficult world environment compared to the past, due to issues such as fragmentation, geopolitical tension, trade wars, tariffs and the Middle East conflict. One crucial factor to look at is the difference between the nominal interest rate on debt refinancing and the nominal GDP growth rate, the so-called 'snowball effect'. as it contributes importantly to the stability (or instability) of public and private sector finances and determines whether there is going to be a soft or a hard landing. Central banks being independent does not mean that they should not talk to finance ministers.

2.5.3 Governments often postpone structural reforms irrespective of monetary policy

A Central Bank official noted that there is always some background situation that is detrimental to the pace of structural reforms. Many factors affect the preparedness and readiness of various countries to implement them, such as the overall political situation, the inclination of each government, the overall situation in the country, how aware the general public is of the problems, and how ready it is to respond to and bear the costs of the reforms. Monetary policy also plays an important part in the decision-making process. The long period of low interest rates and a generally very stable macroeconomic environment pushed away the desire for structural reforms. But the opposite can also be true as fostering a favourable macroeconomic and low interest rate environment increases the fiscal space for the implementation of structural reforms.

2.5.4 Monetary policy cannot help in the adjustment of the public sector

A market expert observed that the fiscal situation has deteriorated under the easy monetary policy of the last 15 years. There is currently a fiscal crisis. Some European countries have a lamentable track record on the effective deployment of public expenditures. Analysis of the effectiveness of fiscal expenditures over the last 15 years has shown a lack of effectiveness and a dearth of productivity gains.

Adjustment is needed in the public sector, because excessive inflation in that sector needs to be reined in. Monetary policy cannot significantly help in the adjustment of the public sector but can help in the sense that it should not provide free money, which is the big enemy of structural reform. A country can be deterred from entering into structural reforms if it is given free money. The key is structural policies and an adjustment or reduction in the size of the public sector.

Examining the balance sheets of economies, there is an enormous increase in passive assets. The traditional IMF view is to look at the net domestic assets, the NDA of a country, and if they are booming too much it can become the IMF's role to reduce them. Net domestic assets are too high in certain EU countries and have to be reined in. A sense of direction is needed, and not to rush back to the paradigm of zero interest rates.

2.5.5 Market dominance is also a concern

A market expert stated that the Group of Thirty recently wrote a paper that called for a certain degree of humbleness in central banking. The whole perception of central banks being the only game in town was a non-starter because central banks stepped in where they felt governments were slow or reluctant to do so. As was seen in the pandemic, when governments are forced to take responsibility with fiscal policy for shocks that hit the economy, they do so. Central banks are currently being pushed by markets more than by governments; the noise of commenting on central bank policy is currently coming from the markets, as they are now very dependent on central banks. Central banks need to prove their independence from both politics and markets.

3. Quantitative tightening: challenges and way forward

3.1 Quantitative tightening and central banks' balance sheets

A market expert stated that the balance sheets of central banks is a monetary tool that needs to be understood. Through QE, central banks have replaced the implosion of the interbank market by central bank liquidity. Central banks are reducing their balance sheets but there will be a difficult situation, because on the way up they provided massive liquidity when it was needed at no notice. On the way down, central banks are very slowly reducing liquidity, in a very predictable way, in order to not disrupt the market.

3.1.1 The Eurosystem's balance sheets could decrease to the $4 trillion to $5 trillion range by the end of the decade

A market expert noted that when he joined the ECB governing council there was a balance sheet of €780 billion, and it is now just under 10 times that. By 2030 cash will be up from around €500 billion to around €3 trillion. The central bank balance sheet cannot shrink to €3 trillion because it would be composed only of cash. Excess reserves will come down, but not to zero, because central banks have a much more core funding role in the financial system than they used to have due to the decline of the interbank funding market

Europe used to be a bank-based system. Through the various crises many other players got access to the central bank balance sheet, which can be seen with the

market funding programmes in the US Fed and the ECB. The central bank can never again completely step away from being such a central counterparty (CCP) in the markets. The assumption is that the ECB's balance sheet will be down to a range around €4 trillion to €5 trillion.

3.1.2 Central bank profit and loss should not affect monetary policy

The Chair then turned to central bank net income. He highlighted that the IMF has argued that central bank profit and loss should not affect monetary policy and asked if participants agreed.

A Central Bank official agreed that central bank profit and loss should not matter for the conduct of monetary policy, but the reality is that central banks have to bear it in mind. A period of sustained losses where equity becomes negative opens the way for risks that might undermine central bank independence. The euro system is currently in a good situation because it has over €700 billion of buffers. In designing an operational framework, the financial footprint and the risks on balance sheets should be as small as possible.

A market expert noted that central banks now pursue a bigger role then they should. They should focus on monetary policy. Central banks are pulling themselves back from being very interventionist in the market, which is the right thing to do.

3.2 Quantitative tightening should be gradual and should consider financial stability issues

A Central Bank official stated candidly that central banks do not know exactly what the optimal balance sheet size is. The relevant issues are being discussed in the governing council and a realistic approach is being taken. The crisis has taught us various lessons. The Federal Reserve, for instance, has conducted open market operations using US Treasury securities for many years. Hence, it is not clear why some people in the Eurosystem react adversely to having a structural bond portfolio for liquidity management purposes. Appropriately, decision making should be characterised by gradualism and flexibility, ensuring that banks have access to liquidity, and delivering a smooth transition.

The Chair asked panellists if it is a problem that central banks have morphed into risk-free central counterparties, replacing the interbank market.

A Central Bank official noted that it is a potential problem that market forces are not pricing to risk. An effort should be made to have unsecured money markets operating in the way that they should. There should not be an expectation that the adjustment process is somehow to be over. The impact of higher rates has not yet been fully seen and the withdrawal of liquidity provided by central banks is gradual but ongoing.

A Central Bank official added that a too large balance sheet with ample excess liquidity sustained for a too long a period of time can cause problems, so the plan is to reduce it. Due to operational and strategic issues the level has not yet been decided. Monetary policy has to be agile in order to boost the balance sheet and to be consistently quick in reducing it to reduce unwanted harmful side effects and allow for future expansion of the balance sheet when new negative shocks hit the economy.