

January 2007
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NEW CHALLENGES FOR MONETARY POLICY IN A GLOBALIZING WORLD

I am grateful to the governor of the National Bank of Hungary for having asked me to give a few remarks on the subject of monetary policy as a backdrop to the symposium he has organized on inflation targeting.

I have witnessed over the years three main periods in monetary policy :

- before the 1980's, governments were convinced that there was a trade off between "a little more inflation" and less unemployment. They were thus biased towards low interest rates and used to engage Central Banks in "fine tuning". This policy eventually led to double digit inflation in advanced economies and galloping inflation in a number of developing countries. High inflation was finally recognized as inimical to growth and socially disruptive. In 1979-80, the game of systematically seeking employment at the expense of price stability came to an end. The whole process had entailed high economic and social costs ;
- in the 1980's and 1990's, monetary policy managed to reduce inflation. Not only actual inflation, but also expected inflation. Most Central Banks were gradually made independent from governments and acquired renewed credibility. This was the period of the "triumph of Central Bankers". US inflation (CPI) came down from 13 % in 1979-80 to 2,2 % in 1999 ;
- the third period, which we are now experiencing, is characterized by significant changes in financial markets, by globalization and the explosion of different and sophisticated forms of credit. This new environment poses serious new challenges to Central Banks.

I shall briefly touch on these new challenges.

I. As world markets are getting more and more globalized, traditional indicators are loosing some of their significance :

- inflation seems less sensitive to traditional measures of domestic resource utilisation. Indeed, in a growingly integrated world, “global slack” might well be a more meaningful yardstick of inflationary pressures, than domestic rates of capacity utilisation. When some forty millions low wage earners enter each year into the world competition, one can understand that wages in advanced countries tend to show restraint. This is one of the reasons that explain that the “non-accelerating inflation rate of unemployment” (NAIRU) is on a lower trend¹. This beneficial global dampening of inflation² has played a significant role in the monetary policy stance of a number of Central Banks over the past few years ; it has allowed them to keep price stability while not restricting growth ;
- the traditional relation between money and inflation -which, no doubt, remains valid in the long run- is more difficult to establish in the short run as financial institutions have been developing money substitutes which, in turn, make the demand for money more unstable. This is one of the reasons why a number of Central Banks have been abandoning “monetary targeting”, let alone exchange rate targeting, for “inflation targeting” ;
- the previous factors -flattening of the Philips curve, greater wage restraint in a growingly competitive world, and blurred interpretation of money aggregates- have made the conduct of monetary policy more complex and may have inclined some Central Banks to a more benign stance than might have been warranted otherwise. A national monetary policy has to be determined in the framework of its domestic setting (including fiscal and structural policies, as well as medium term potential growth), but it is also heavily influenced by global inflation and by interest rate convergence due to a financially integrated world. This duality is not easy to deal with.

II. Some worries down the road :

As C.P.I. inflation -especially core inflation- appears tamed (in part for globalization reasons but also because of productivity gains) and as energy and commodity price hikes –also a reflection of globalization- have not yet “contaminated” headline inflation, monetary policy has been relatively accommodating over the past years, in spite of the gradual tightening (up to 5,25 %) initiated by the Fed in June 2004 when the rate was at 1 %. The ECB has also more recently (end 2005) engaged in a process of increasing rates.

¹ See : 2006 BIS Annual Report, page 77.

² But if -because of higher commodity prices caused in part by emerging economies rapid growth- the global terms of trade of advanced countries were to deteriorate so as to more than offset the gains presently derived from lower priced imports, headline CPI could eventually rise and workers in those advanced countries could exert pressure to obtain wage increases. This would alter monetary conditions.

But are monetary conditions, -given the delayed effects of past expansion and the present position in the economic cycle,- really “neutral” ?

It is difficult to give a clear cut answer to this question. Let me suggest a few remarks :

1. Global liquidity remains high : money and credit are so abundant that the price of almost all types of assets (equity, real estate, bonds, commodities...) has been rising, signalling possible bubbles in the system. Let us not forget that, when they are not justified by “real” and structural reasons to believe in higher long term returns, asset price hikes are a sign of inflationary expectations.

- modern financial instruments have contributed to this expansion in liquidity and credit. I shall just mention two of them : securitization and credit derivatives. The former is a way for financial institutions to reduce their credit risk in selling it to (usually non or less regulated) market investors. Thus, collateralized loan obligations (CLO's) repackage bank credit and sell it to the market as “asset-backed loans”. Loans have become therefore as “tradeable” as bonds. In contrast to the traditional practice, a growing number of banks tend to securitize their credits. This leads to a more rapid “rotation” of their balance sheets and thus contributes to an increase in credit creation. As for credit derivatives, they have literally exploded: to the extent banks are net buyers of protection (from less or differently controlled entities like investment funds or pension funds or even insurance companies...), this frees regulatory capital for new lending and therefore contributes to the increase of net domestic assets³. Hedge funds and private equity funds are highly leveraged entities. Their multiples (exposure/equity) are way higher than was the case when banks were the main source of financing. This shift of power -in terms of credit creation- from the banks to the market tends to loosen the classical transmission channels of Central Banks who, for regulatory reasons, can only interact with banks.

- the pricing of risk is low : too much money chasing too scarce assets leads to thin spreads and under-priced risk⁴. This low level of spreads is due in part to the large liquidity enhanced by derivative instruments. But, if things were to reverse, how would financial institutions cope with the situation ? What would be the impact of hedge funds or private equity failures on banks (through increased provisions) ? How would the other lenders (non banks) and the buyers of packaged loans behave and withstand the shocks ? Would they “rush out” ?

³ In notional terms, the stock of credit derivatives has gone from 4 trillion \$ end 2003 to 27 trillion in June 2006. Of course, one should net these amounts and deduct pure trading positions in order to determine the “credit impact” of these instruments. But this exercise is not yet statistically robust enough.

⁴ Yield spreads are at historically low and still shrinking.

How would that compare to the more “institutional” reaction of banks when they were the major lenders ? How would banks react to “reputational” risk ?

2. In spite of some tightening in monetary policies, long term rates remain stubbornly low and yield curves flat. This “conundrum“ is the result of a number of factors :

- excess liquidity,
- structural reasons : insurance companies and pension funds need to match their long term liabilities with long term, and safe, bonds ;
- the credibility gained by Central Banks may also explain that inflationary expectations remain strikingly low⁵ ;
- the massive acquisition of US Treasury bonds by Central Banks of emerging countries is also a major reason for the low level of long term interest rates over the past years. A recent NBER study shows that such foreign flows have an “economically large and statistically significant impact on long term US interest rates”⁶. One may add that the difficulty for emerging Central Banks to fully sterilize their interventions leads to a “ loose” bias in their monetary policy.

3. But the question remains : can we lastingly live in a world where the level of long term interest rates is low (around 2 % in real terms) and remains to a large extent disconnected from tightening moves by Central Banks, thus undermining the effectiveness of monetary policy ? Is this, as some suggest, the manifestation of too weak global productivity, too low marginal returns on capital, in addition to “excess savings” and insufficient investment opportunities (which would signal that global equilibrium interest rates have gone down and, as a consequence, that monetary policy might be seen as too restrictive) ? But this thesis does not seem consistent with the vigorous world growth rates (4-5 %), with rising asset prices and with the strong performance of productivity and of corporate profits. This is why I tend to believe that the present situation is more the result of excess liquidity and of a revival of monetary illusion.

According to this interpretation, monetary policy has been allowing too much credit expansion and too high asset valuations. Therefore, down the road, in case of a sharp economic slowdown, looms the old scenario of a fall in equity values,

⁵ As of December 4, 2006, on a French Treasury 25 year inflation indexed bond, the implied annual European inflation expectation until 2034 is 2,32 % (2,13 % for a 5 years bond).

⁶ “International Capital Flows and US Interest Rates” by Francis and Veronica Warnock (NBER Working Paper n° 12560), 2006. “In the hypothetical case of zero foreign accumulation of US government bonds over the course of an entire year, long rates would be almost 100 basis points higher ». See NBER Digest, November 2006

liquidity issues for some over-leveraged institutions, “bad debts”, “risk repricing”, higher spreads, contagion... This outturn could be all the more damaging if monetary conditions and over-leveraging were to get out of hand. Thus the importance of adopting a reasonably vigilant and prudent approach to monetary policy and to financial stability.

Keeping price stability under control is, in any case, of the essence : a pick up of inflation would lead to higher interest rates and could trigger the unfolding of the scenario mentioned above.

We all know that it is difficult to conduct a cautious monetary policy when inflation remains apparently low. Politicians are particularly sensitive to this issue. Perhaps the dramatic insistence put by US policy makers, a few years ago, on the dangers of price deflation has something to do with present attitudes towards monetary policy. After all, in a world growing at 4 to 5 %, where labour costs are restrained because of low wages in emerging economies and where technological changes and productivity gains are strong, a 2 % rate of inflation should not be seen as an absolute minimum (let us remember that strong growth and declining prices were often combined in Europe in the XIXth century).

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I shall conclude.

Securitization and leveraging mechanisms are flourishing (the explosion of private equity LBO's - in particular those concerning non-investment grade corporates- is a case in point⁷ : the acquisitions at high prices made by these funds are involving more and more layers of debt⁸ at the expense of equity). Because of securitization, risk has been spread out, which, no doubt, strengthens the banking system but raises uncertainties on the behaviour of market players in case of crises. High asset valuations and low risk pricing are, as they have always been, a source of vulnerability since they can well be reversed. The boom in property valuations has been used and abused to “extract cash” : this has favoured consumption and additional borrowing by households. In the meanwhile, as consumption was expanding, particularly in the US, corporate profits have tended to be returned to shareholders through share buybacks⁹ and the distribution of additional dividends (thus sustaining consumption and asset valuations) to the detriment of investment. Indeed, advanced economies have been investing (in terms of fixed capital formation) relatively poorly over the

⁷ The value of leveraged buy-out deals reached almost 80 billion euros during the three first quarters of 2006.

⁸ The debt-to-earnings ratios for leveraged loans has reached record highs.

⁹ Share buybacks have peaked in 2006 (close to 120 billion US dollars against less than 40 billion per year in the period 2000-2004).

last years. Emerging markets are the net savers of the world but also the most dynamic investors (thanks, in part, to capital flows from advanced countries).

Massive US current account deficits (6,6 % of GDP) are mirrored by huge surpluses and accumulated foreign reserves¹⁰ in emerging countries who often choose to peg their currencies in order to preserve a strong competitive advantage. This is an unsustainable and dangerous situation that makes the dollar and the system at large more vulnerable. The necessary resumption of savings by US households and the declining value of the dollar- two facets of the US adjustment process- could, if they were to be excessive or precipitous, lead to significant financial disturbances, in particular, via the housing market.

In such an unbalanced, but globalized, world, where emerging growth -oriented economies are not endowed with developed financial markets, the challenges are huge. Credit defaults and insolvency issues may, indeed, be more difficult to cope with than in a more traditional and less cross-border intensive setting.

Is global financial integration really achieved ? Are systemic crises prevention and treatment mechanisms between large and more and more consolidated lenders, investors and borrowers, in place and solid enough ? Is IMF surveillance on countries that are at the centre of large imbalances, up to the challenge ? Let us not forget that the Fund's articles call for "multilateral surveillance" and give the IMF the mission to assess the appropriateness of the underlying policies and of the exchange rate behaviour of the "unbalanced" countries. But that mission is far from being completed fulfilled.

Therefore, my conclusion is that monetary policy makers who have less influence on credit creation (for the reasons explained above) need to take into consideration -on top of inflation (with all the uncertainties and variations attached to the chosen definition)- money aggregates and credit expansion, asset prices, global imbalances, exchange rate trends, potential growth evolution, financial innovation, the possible "crisis behaviour" of non banks and its impact on banks, the increased vulnerability of overleveraged corporates to adverse cyclical developments... I know that Central Banks are developing their analysis of these risks and are conducting stress-tests. This is to be welcomed as would be the setting of a new check-list of various indicators in order to better cover the broad concept of financial stability in a changing and globalized world. It might also be timely to consider asking high leveraged funds to disclose their liabilities -as well as their value at risk- on a regular basis so as to provide the full picture of their exposure.

¹⁰ Emerging countries foreign reserves have grown fast. They amount to 3 trillion \$ (from 800 billion in 2000) and represent 70 % of world international reserves.

As Henry Kaufman stated in one of his recent illuminating speeches : “We have moved well beyond the point where we can navigate the financial markets with the single compass of the Fed funds rates. The compass served early navigators well, but today we need guidance mechanisms every bit as precise and sophisticated as the markets in which we journey¹¹ “.

¹¹ « Creeping Inflation, Monetary Tactics and Longer Term Implications », Greenwich RoundTable, September 21, 2006.