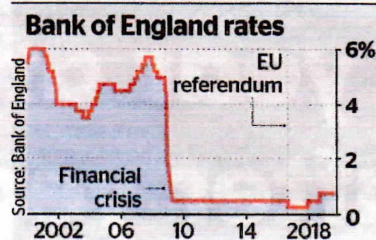
DeAnne Julius

Needed: bankers with nerves of steel to end era of low interest rates

The death last week of the illustrious central banker Paul Volcker reminds us that courage and tenacity are sometimes more important for effective monetary policy than economic modelling and communication skills. In the late 1970s the US economy was stuck in stagflation: low growth and high inflation triggered by oil price shocks. Today western economies are stuck in low growth, unnaturally low interest rates and high debt, triggered by the global financial crisis of 2008-09. The parallels for monetary policy are striking.

In 1979, as new chairman of the US Federal Reserve Board, Mr Volcker argued against the orthodoxy that low interest rates were necessary to spur growth amid rising prices. He recognised that

Bank of England rates



rising prices were the problem and that inflationary expectations were entrenched among the public. Wage and price controls had failed. Only a complete policy reversal and a sustained period of restricting monetary growth with high interest rates could return the economy to stable prices and strong growth. The initial shock was painful — a double-dip recession and an election defeat for President Carter — but the ensuing decade was one of the country's most successful.

Today western economies, particularly in Europe, are struggling with low growth, below-target inflation and rising asset prices, especially for housing. While there are many contributing factors, such as trade tensions, global restructuring of the car industry, and the uncertainties overhanging Brexit; an underlying cause is the sustained period of low and even negative interest rates brought about by monetary easing.

These policies were appropriate and effective after the financial crisis. Ten years later their efficacy has worn off while their distortionary effects have multiplied. Sustained low rates and expansion of the money supply through quantitative easing has led to unproductive financial engineering, ballooning pension deficits, which soak up corporate resources, extreme valuations for dividend-paying investments, risky assets in the search for yield and precarious money markets — all contributing to low productivity growth. This has spilled over into politics. Populist anger has been stirred as the benefits of rising asset prices go to those who own shares and property, while the younger and less wealthy are priced out of housing.

It is time for central banks to rethink their policy settings. Christine Lagarde, now head of the European Central Bank, aims to do that by launching a policy review "with an open mind". The US Fed is reviewing its policies and tools. The central function of interest rates is to signal equilibrium resource allocation between companies, investments, borrowers and savers. In the short term, low interest rates can provide a cyclical stimulus. But when those rates are held down over long periods misallocations become entrenched and financial risks grow. Then a downward dynamic sets in. Those very risks deter central banks from raising rates, despite their unnaturally low level.

To escape this trap, the mandate of central banks should be strengthened to include financial stability as well as price stability, and lengthened to aim at a neutral rate of interest over five years. The former would probably preclude negative rates while the latter would imply raising rates in most western countries to between 2 per cent and 4 per cent over time. Indebted companies, households and governments would feel the pain in the short term.

Longer term, resources would flow to the most productive sectors, housing would become more affordable and those approaching retirement would have sustainable pensions. But it will take courageous central bankers with political nerves of steel to get there.

Dame DeAnne Julius is a former member of the Bank of England monetary policy committee