Central bankers still must face their past behavior

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The case for the September interest rate cut of the Fed was much more clear-cut than the case made by the ECB. Yet both central banks risk re-igniting a debt-fueled financial boom that will further feed financial and economic instability.

"Get down, deeper and down", so goes the chorus of the 1975 hit song of the rock band Status Quo. High voltage guitar solos and associated vocals are not the things one associates spontaneously with the world of central bankers, a world steeped, if not drenched, in extremely courteous manners and delicate language. One never knows, of course, but it would have been highly surprising should this song have been blasting out in the meeting rooms during the recent discussions by the decision-making committees of the European Central Bank (ECB) and the American Federal Reserve System (Fed). Yet despite the manifold contradictions between the world of Status Quo and that of the present day central bankers, "get down, deeper and down" are lyrics that seem to form a perfect match with the decisions taken by the ECB on September 12 and by the Fed on September 18.

After ten consecutive policy rate increases since July 2022 (increasing its deposit facility rate from – 0.50% to 4%), the ECB first lowered its three policy rates by 25 basis points in June this year. A second rate cut of the same magnitude was decided upon on September 12. The ECB deposit facility rate now stands at 3.50%, its rate on the main refinancing operations at 3.65% and its marginal lending facility rate at 3.90%. For the Fed, the rate cut a week after the ECB's one was the first one after eleven rate increases since March 2022 (pushing up its main policy rate from 0.25-0.50 to 5.25-5.50%). Contrary though to the ECB, the American central bank immediately went for what some defined as a "blockbuster" cut. The Fed decided to lower the target for its principal policy rate, the federal funds rate, by 50 basis points to the range of 4.75 to 5%.

Price stability remains the overriding objective for the ECB. It is one of the two elements of the Fed's dual mandate, the other one being striving for full employment. So the recent policy rate decisions have to be judged against the evolution of inflation. Both Christine Lagarde, the ECB president, and Jay Powell, the Fed chairman, showed substantial confidence with respect to the path along which inflation is evolving. Nevertheless, the judgement on the appropriateness of both policy decisions has to be different, as also outlined by Ignazio Angeloni, a former supervisory board member of the ECB, in the Financial Times of September 11.

In the US headline annual inflation declined from 2.9% in July to 2.5%. Core inflation remained unchanged at 3.2%. With these data the Fed is still not yet at its 2% inflation target, but the Fed expects further movement towards that goal. With the pre-18 September policy rate of 5.25-5.50%, real interest rates, being the nominal interest rate corrected for inflation, were of the order of 2.50 to 3%.

That is really restrictive territory, so the Fed's cut was justified, given also the weakening of the American economy. Such positivity can be caveated perhaps by the observation that with growth forecasts for this year between 2 and 3% that weakening is not really outspoken. A further caveat is that annualized service inflation remains stubbornly high in the 4 to 5% range.

Matters are different for the ECB. Headline annual inflation declined between July and August from 2.6% to 2.2% but that was entirely due to declines in the notoriously volatile energy prices. Although slowly declining, core inflation is still at 2.8%. With the second cut this year in the ECB policy rates, real interest rates are now in the 0.7 to 1.5% range. It is still a matter of heated debate among economists where the so-called neutral interest rate (neither expansionary nor restrictive) is to be found, but the actual real interest rate in the eurozone cannot really be defined as restrictive anymore. So despite the unanimous decision within the ECB's Governing Council, it can be questioned whether the September rate cut was appropriate. Doubly so because also in the eurozone annualized service inflation remains stubbornly above 4%. The rate cut decision certainly stands at odds with the declaration of Philip Lane, the ECB chief economist and traditionally a dove on monetary policy, two weeks earlier that "the return to target is not yet secure". Just like the Fed, the ECB has an inflation target of 2%.

There is however a more general critical remark to be made with respect to the recent rate cuts by the ECB, and even also the Fed. As a consequence of the extremely accommodative monetary policies of, say, the first two decades of the 21st century, there is still a huge amount of excess liquidity sloshing around in the financial markets. A first way to measure excess liquidity is to look at the money that is left in the banking system after the banks have met their minimum reserve requirements as imposed by the ECB.

This difference stood at 1 700 billion euros in December 2019. By July of this year it had risen to 3 200 billion euros.

A second measure of "excess money" can be found in the data on the money supply, more specifically M3, a broad measure of that money supply. The share of this M3 quantity not absorbed by the real growth of the economy can be considered an indication of excess money percolating through the economic and financial system. I admit that this measure of excess liquidity needs further refinement in order to be really reliable but it nevertheless gives a first approximation. Measured in this way, the monetary overhang stands at the moment at 2 600 billion euros, up from 1 900 billion euros at the end of 2019. So, given those two measures of the monetary overhang, it seems reasonable to define the present monetary overhang or excess liquidity within the eurozone at more or less 3 000 billion euros. There is still a (very) long way to go in order to come to more reassuring levels of excess liquidity floating around.

For more than two decades until the tightening of policy in 2022, monetary policy has been extremely accommodative, contributing importantly to the build-up of highly unstable debt and leverage positions in the private and the public sector. These positions are a constant source of potential financial and economic instability. With the recent relaxation of monetary policies central bankers not only bet that their expectations as to the path of inflation are correct, but more fundamentally risk sending the signal that they bend to the financial sector's and governments' desires to be able to re-engage in the build-up of debt and leverage. Such an evolution would unfortunately be the very last thing that is needed in the present world of mounting risks and uncertainties.