

# Five years later, part II

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*The fear of monetary tightening significantly slowing the economy is overblown. Relying on monetary and fiscal policy to do the heavy lifting for sustaining and enforcing economic growth is increasingly illusory and even counterproductive. More than ever, monetary policy should focus on price stability. Full stop.*

In [my latest blog](#), I argued that to contain rising **inflation** and keep inflationary expectations well-anchored, the **European Central Bank (ECB)** should not wait too long to tighten monetary policy through a rise in its **policy interest rates**. In the reactions to this blog, there was a lot of emphasis placed on the negative impact an upward move in interest rates would have on **economic growth**. Certainly, in the present environment of **energy supply disruptions** and heightened **geopolitical uncertainty**, further downward pressure on economic growth is the last thing the **European economy**—and the **world economy** in general—needs.

This fear of monetary tightening significantly impacting economic growth on the downside appears overblown. In my opinion, this impact is limited, and there are other concerns, closely related to the structural growth potential of the economy, that support the plea for **higher interest rates** at this moment in time.

First of all, there is the evidence related to the forceful tightening of monetary policy that the ECB orchestrated between **September 2022** and **September 2023**, when the **deposit rate**, the most significant policy rate of the ECB, was pushed up from **0% to 4%**. At first glance, this severe tightening had a significant impact on growth, but a closer examination of the context of that period nuances this conclusion significantly.

The **Covid pandemic** produced a huge decline in the economy in **2020**: -6% for euro area GDP. The economy rebounded forcefully when the worst of the pandemic was over: +6% in **2021** and +3.6% in **2022**. After such a substantial pickup in economic activity, it was inevitable that the euro economy would slow again toward its structural growth rate of somewhere between **1% and 1.5%**. This indeed happened, with growth coming in at **0.4% in 2023**, then picking up again to **0.9% in 2024** and **1.4% the following year**.

Based on the aforementioned growth figures, it seems obvious that the **monetary tightening** and the slowing of the economy are closely linked. Not so, for the simple reason that monetary policy always impacts the real economy with a **time lag**. Different estimates of the length of this time lag exist, but one year seems to be a more or less realistic ballpark estimate. This time lag indicates that the full impact of the quite severe monetary tightening would arrive by the end of **2023** (the ECB started to really raise interest rates in **September 2022**). This timeline means that if the more restrictive monetary policy were truly pushing down the economy, this effect would mostly be visible in the growth data of **2024** and **2025**. Exactly the opposite happened: the euro economy fell back strongly before the impact of tighter money filtered through and recovered when, given the time lag discussed above, that impact was supposed to be in full swing.

## Regime Change

The episode of fierce tightening by the ECB between **September 2022** and **September 2023** and its impact on the business cycle in the real economy represents substantial evidence supporting the thesis of a **regime change** in terms of the main determinants of that business cycle. This thesis has, in recent years, emerged from an intense research program at the **Bank for International Settlements (BIS)** under the leadership of **Claudio Borio**, who headed the BIS' **Monetary and Economic Department** until **December 31, 2024**.

This BIS thesis essentially concludes that the business cycle in **industrialized countries** is no longer primarily determined by changes in monetary policy but much more by the unwinding of **financial imbalances**. The **2008 meltdown** in the financial markets and its destructive impact on the real economy are a clear illustration of this sequence. The pattern of the euro area business cycle in the first part of the third decade of the **21st century** generally confirms the BIS model. The large fall in economic activity as a consequence of the **Covid-19 pandemic** was followed by an equally large uptick in economic activity that was, admittedly, certainly aided by extremely accommodative monetary policy but primarily fueled by huge **pent-up demand** from citizens. After such a burst in activity, a substantial fallback was inevitable. Once this sequence was complete, the euro area economy returned to growth close to its potential growth rate of **1% to 1.5%**.

The regime change concerning the **Western business cycle**, as detected by BIS researchers, has profound implications for monetary policy. More specifically, what is often referred to as the **unintended consequences** of monetary policy should occupy a much more central role in decision-making regarding monetary policy than is currently the case.

*“The regime change concerning the Western business cycle has profound implications for monetary policy.”*

First and foremost, **low interest rates** encourage taking on more debt and increase the degree of **leverage** throughout the financial and economic system. The **IIF Global Debt Monitor** shows that **global debt** (private + public) peaked during the Covid-19 pandemic and now stands at a historically high **308% of worldwide GDP**. Government debt in the world has not been as high since the **Napoleonic wars** of the early 19th century. The more debt that permeates through the system and the higher the degrees of leverage, the more pronounced **financial imbalances** become, increasing the risk that even a partial unwinding of these imbalances will negatively impact the growth path of the economy.

*“The more debt that permeates through the system and the higher the degrees of leverage, the more pronounced financial imbalances become.”*

Secondly, there is the phenomenon of **zombie companies**. First described during the long stagnation period of the **Japanese economy** despite relentless budgetary and monetary stimulus, zombie companies are entities that can only survive in an environment of extremely low interest rates. Otherwise, their debt burden would drive them out of business. Some estimates indicate that up to **15%** of corporate entities in the West exhibit zombie-like characteristics, which means that huge amounts of **capital** and **labor** remain trapped in these zombies at the expense of new, more profitable endeavors. The forces of **creative destruction** that underpin real economic development are seriously hindered by the zombie phenomenon, which is fundamentally a consequence of very low interest rates.

Last but not least, there is the impact of **expansionary monetary policies** on **wealth inequality**. Very low interest rates consistently give rise to a search for yield by investors, both large and small. Money is channeled into **stocks** and **bonds**, benefiting those who already own these assets as compared to savers who cautiously keep their money in savings accounts. Wealth inequality increases, leading to heightened tensions within society, a force that does not directly stimulate smooth economic and social

progress. Moreover, in the search for yield, a whole range of more exotic but practically always riskier investments (art, cryptocurrencies, etc.) become more attractive, simultaneously increasing the fragility of the financial system. Again, the unwinding of such imbalances negatively impacts economic growth.

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To conclude, monetary policy remains a powerful tool of economic policymaking. More than ever, and primarily due to the regime change that has occurred in the features of the business cycle, monetary policy should focus on **price stability**. Full stop.