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GERMANY VERSUS ECB: HOW DANGEROUS IS THE DISPUTE?

Berenberg Macro Flash

Careful what you wish for. For decades, Germans strongly believed in price stability and an independent central bank. Fate and the European Central Bank (ECB) have granted them both wishes. Prices are more stable than ever before. And the ECB is so stubbornly independent and focussed on its price stability mandate that it rejects all suggestions to gear its monetary policy towards other objectives such as creating more jobs in France or guaranteeing a risk-free interest income for savers in Germany. None the less, Germans seem to be complaining more about the central bank than ever before. Three incidents illustrate the widespread German discontent after the ECB's March policy package:

1) In a somewhat off-the cuff remark, finance minister Schäuble suggested to ECB president Draghi that his monetary policy may explain half of the rise of the radical right AfD party in Germany.
2) A Bavarian conservative, ex-interior minister Friedrich, demanded in 'Bild' tabloid that the next ECB president after Draghi must be a German in the Bundesbank mould to turn the ECB away from its misguided course.
3) The small liberal FDP, which is enjoying a rebound in opinion polls from 3.5% to 7%, has joined the choir of complaints. On most other economic issues, the FDP tends to be a voice of economic reason and a staunch supporter of European integration.

How dangerous is the dispute between the ECB and major parts of Germany's conservative-liberal elite? And do the German critics actually have a point? We deal with these issues in turn.

IS THE DISPUTE DANGEROUS?
Any conflict between a major stakeholder (Germany) and top management (the ECB) carries risks. It may destabilise the institution and blunt its message. The current dispute goes a bit beyond an awkward nuisance. At the margin, it may constrain the ECB's room for manoeuvre slightly and make ECB monetary policy a little less effective.

However, these effects are small. We do not view the dispute as real danger. It is no make-or-break issue for Europe or the euro. Germany will not become euro-sceptic to such an extent that it could pose a longer-run risk to the cohesion of the region. Germany's conservative-liberal mainstream seems to be torn between two views that both are hard-wired into German public opinion, a strong pro-European orientation and a very conservative view of monetary and fiscal rectitude shaped by memories of the early 1920s. Short of a highly unlikely dramatic spike in German inflation, the solid pro-European orientation of the German mainstream will clearly prevail over the unease about unconventional monetary policy.

DOES THE DISPUTE CONSTRAIN THE ECB?
The particular German monetary concerns do not resonate well in most other parts of Europe. They are likely to remain very much a minority view on the ECB council. Still, the dispute may come at a small cost for the ECB, Germany and the Eurozone in three separate ways:

1) Bolstering confidence and sending clear signals are integral parts of monetary policy. The noise and perceptions of a potential conflict can cause a small safe haven effect: Some extra capital flows into German Bunds may show up in bigger Target2 imbalances and slightly wider spreads. At the margin, this can impair the transmission of monetary policy to the real economy and curtail the boost to confidence which should usually be a key aspect of an expansionary monetary policy. In a weird twist, those Germans who

criticise the ECB for doing too much may thus help to create conditions which could suggest that the ECB ought to do even more in order to comply with its mandate.

2) Independent as it is, the ECB does not operate in a political vacuum. Strong political resistance and the risk that the resulting noise could reduce the effectiveness of any monetary stimulus raise the bar for the ECB council. After the March package, it would take a major shock such as Brexit for the ECB to scale up its stimulus again. A modestly weaker outlook for growth and inflation would probably not suffice for the ECB to act again even if the economic logic would suggest that it should. In this sense, the German backlash probably constrains the ECB a little. Fortunately, we expect no need for a further loosening of ECB policies anyway. Note that "helicopter money" is not on the ECB menu of options. When Draghi responded to a question by saying that it is “an interesting concept”, we took that as a polite way of saying “no thank you” rather than an attempt to trigger any serious discussion about it.

3) Germany's constitutional court is at least as independent as the ECB council. But by their personal background, the judges are of course mostly part of Germany's conservative-liberal mainstream. The court’s hearing on the ECB's OMT programme earlier this year suggested that the judges will not opt for open conflict with the European Court of Justice by outlawing German participation in a potential OMT programme. But the judges may use the opportunity of their OMT verdict (probably this summer) to offer a rather narrow legal interpretation of the circumstances under which a central bank should buy bonds. The German backlash against the ECB adds to the risk that the court may, with such comments, sow the seeds of future disputes between Germany and the EU.

DO THE GERMAN CRITICS HAVE A POINT?
Not really. The vulgar complaint that the ECB is expropriating German savers is simply wrong. The major reason for ultra-low real bond yields and interest on bank deposits in the Western world is the weak demand for credit at a time when cautious savers want to save more. With less demand for and more supply of savings, the equilibrium real interest rate is very low. The ECB tweaks this equilibrium only a little. Also, the ECB has no mandate to guarantee savers a risk-free income. Instead, its mandate is to prevent an erosion of the purchasing power of such savings through inflation. The ECB is doing that better than any German central bank had managed before.

A slightly more sophisticated critic of the ECB was offered, for instance, by two German academics, Sinn and Schnabl, in an FAS article last Sunday: they argue that higher ECB rates would promote growth in two major ways. First, countries at the euro periphery would be forced to implement pro-growth reforms. Second, higher interest rates would kill zombie banks and companies and force companies to invest only in projects with a higher marginal return. The result would be more innovation, more Investment, more productivity growth, more well-paid employment and hence more consumption as well. To minimise disruption, the ECB should gradually raise rates in rigid pre-announced 25bp steps every six months.

If that sounds too good to be true, that is exactly what it is. First, the euro periphery had a lot of pro-growth reforms in the last five years. Getting more of those and extending them to France would be great. But the technocrats appointed to run an independent central bank have no mandate to punish elected parliaments for a lack of reforms. Sinn-Schnabel are de facto asking the ECB to grossly violate its price stability mandate and gear its policy towards a very different objective. Whether or not pushing the entire Eurozone back into stagnation and the periphery plus France into a potentially deflationary recession would elicit major supply-side reforms or perhaps a very different kind of revolution is also an open question, to put it mildly.

And what about the argument that ECB rate hikes would strengthen supply and demand? The logic looks much more unconventional than current ECB policies. Tightening monetary policy while demand growth is somewhat tepid and fragile and while core inflation remains stable at around 0.9% would hurt. Yes, it would probably put some zombie banks and companies out of their misery. But it would likely cause a further decline in credit growth, weaker aggregate demand and additional tensions in the Eurozone. In turn, such tensions would likely hit confidence and investment across the Eurozone. Remember that, before the ECB had announced its OMT programme in mid-2012, tensions within the Eurozone had pushed even Germany to the brink of a recession into which the overall Eurozone had already fallen.

Once again, Germany would likely be at the receiving end of safe haven flows. Rate hikes combined with a weaker economy and capital flight would likely show up in a strongly inverted yield curve for German Bunds. Better not to ask what that would do to bank balance sheets and the business model of German life insurers. Even worse, a weaker economy everywhere coupled with artificially stoked tensions at the periphery and deeply negative bond yields Swiss style at the longer end of the German yield curve could inflame populists sentiment across the Eurozone. At times in which political risks already loom large, that could be the recipe for disaster rather than salvation.

The best way to get back to more conventional monetary policies is to follow the US example and act decisively as early as possible. Because the US Fed started its serious asset purchases six years before the ECB, the US economy has had a less fragile economic recovery than the Eurozone. As a result, the Fed stopped asset purchases in 2014 and started to raise rates cautiously last December. With the more aggressive stance that the ECB has adopted in stages from June 2014 onwards, credit growth has strengthened slightly. The more the ECB supports demand and confidence now, the better the chances that interest rates can edge up again in coming years. That would help even German savers in a lasting way.

See the links included here for a more deeper discussion of what central banks can and can't do and the substance behind the German arguments against the ECB: Geldpolitik der EZB: Fluch oder Segen (in German).

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