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STANDPUNKTE
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Fresh Challenges for Monetary Policy

Following decades of low inflationary pressure, the historically violent outbreak of inflation in 2022 is now seriously threatening price stability again. In this situation, the urgent task incumbent on the European Central Bank, as well as on other central banks, is to maintain their inflation targets and thus to defend the stability-policy achievements they have notched up over the past decades.

- In Europe, the ECB recognised the signs of the times after initial hesitation, and has now embarked on a restrictive tack. This is good news for price stability in the euro area.

- It is true that inflation is set to fall significantly in the European Monetary Union over the coming months; however, it is certainly still too early to sound the all-clear for monetary policy. Second-round effects stemming from wage developments will probably keep the core inflation rate excessively high in the coming year as well. In response to this, further monetary-tightening measures are necessary until the summer, and the tightening cycle needs to be continued into 2024.

- If it then turns out that the inflation process is still not subsiding, monetary policymakers will need to tighten further, even at the price of a possible adjustment recession. Preserving financial-market stability is an important secondary condition, but must not interfere with the top priority of fighting inflation.

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Authors

Uwe Dürkop – Berliner Sparkasse
Jochen Intelmann – Haspa
Dr. Ulrich Kater – DekaBank
Dr. Moritz Kraemer – LBBW
Christian Lips – NORD/LB
Dr. Jürgen Michels – BayernLB
Dr. Reinhold Rickes – DSGV
Dr. Gertrud Traud – Helaba
Prof. Dr. Carsten Wesselmann – Kreissparkasse Köln

Coordinator:

Dr. Holger Schulz
Holger.Schulz@dsgv.de

A historic interest-rate turnaround – from negative territory to a 20-year high

Until the coronavirus crisis hit, monetary policymakers worldwide essentially had an easy job: in an environment of structurally low inflation rates, the main objective of monetary policy, achieving price stability, was considered to be fulfilled, or was even at times threatened on the downside by concerns about deflation. Central banks therefore had a free hand when it came to stabilising the economy in times of crisis. Such a phase of relaxation for monetary policymakers was abruptly over, though, when we witnessed the most violent outbreak of inflation in decades during 2022. Central banks now face the fresh challenge of restoring price stability in accordance with their mandate. For the absence of inflation remains an essential prerequisite for stability and prosperity - inflation devastates the basis for economic planning and thus impairs both investment and growth. Inflation is, moreover, an antisocial phenomenon because households with lower incomes and fewer assets are burdened particularly heavily.

Why it is important to keep inflation expectations low

For decades, monetary authorities around the world were able to, as it were, sit back and enjoy a trend of falling inflation. This trend was, at bottom, brought about by external factors: global competition, increasing labour supply through the integration of new countries into the world-trade network, and rapid technological progress. Yet monetary policy itself also wrote a substantial chapter of this success story: since the 1990s, monetary policymakers had come to realise through their work on the ground that the inflation expectations of economic agents are a decisive determinant of the inflation trajectory - stable low inflation expectations promote a low inflation trend.

In accordance with this, more and more central banks set strict targets for inflation of around two percent in order to firmly anchor the inflation expectations of all economic agents and financial-market participants. What is more, monetary policymakers had the opportunity to do this because the institutional principle of independent central banks no longer subject to operational instructions from governments had become established in almost all industrialised countries. The creation of such a low-inflation world is a great achievement on the part of monetary custodians during recent decades. The European Central Bank is a prominent mainstay of this monetary-policy consensus which prevails in the advanced industrial countries, in particular. Anchoring inflation expectations at low levels continues, in principle, to this day - but it is something which must now be defended anew.

This is because the problematic aspects of a low-inflation world have likewise become apparent in recent years. If negative economic shocks occur, even the minor downward fluctuations in inflation associated with these are liable to take inflation down below the zero line and thus into deflationary territory. At the same time, monetary-policy-instruments effectively freeze over at such minus temperatures, the reason being that key interest rates are also then trapped in such low regions that interest-rate cuts quickly end up at the zero lower bound.

Why unconventional monetary-policy instruments needed to be invented

The last fifteen years have administered two such massive negative shocks to the global economy, namely the financial crisis lasting from 2008 to 2010 and the coronavirus crisis of 2020-2021. By 2009, the key policy rates of the major central banks had already crept down close to zero, yet monetary policymakers nevertheless felt the need for further expansionary measures. This need was catered for by creating so-called "unconventional" instruments. Forward guidance now also influenced longer maturities. Widespread bond purchases were the next unconventional move. Some central banks even took their benchmark rates down into negative territory.

Negative interest rates should only be resorted to in exceptional circumstances

It has not yet been clarified to what extent such innovative monetary-policy instruments are really successful in such situations and whether their side effects (for instance in the form of sharply rising asset prices) are a truly proportionate tradeoff. What is already clear is that zero and negative interest rates are extreme monetary-policy instruments that should only be resorted to in equally extreme, and thus comparatively rare, situations.

The coronavirus phase turns out to have been the starting point of a new inflation process

In the meantime, the inflation environment has been completely upended: over the past two years, both the euro area economy and its US counterpart have experienced surges of inflation whose extent and rapidity have been unprecedented. In 2022, the highest inflation rates for fifty years were registered on both sides of the Atlantic. There were two causes which conspired to provoke what has been the fastest inflationary burst in modern economic history. The first cause is to be found in the coronavirus crisis: although this initially resulted in an economic slump that could have had a clearly deflationary effect, national economies got back onto their feet unexpectedly quickly because the respective governments had put together very sizeable stabilisation packages for their economies, with central banks pumping in additional stimulus. On the one hand, these pump-priming measures served an important purpose, namely to stabilise economic expectations, thus preventing the global economy from sliding into a prolonged crisis.

On the other hand, however, some of the transfer programmes for private households and companies - especially in the world's largest economy, the USA - were of such gargantuan proportions that they triggered a demand-side stimulus that overtaxed the production capacities of the global economy, which were still significantly crimped by Covid-19. This problematic cocktail of demand stimulation and restricted scope for production prompted an initial surge in inflation, which already made itself manifest in the autumn of 2021 in the shape of rising goods prices.

The war in Ukraine and the sanctions against Russia then acted as a turbo for inflation

The second cause involved the extreme energy-price increases triggered by Russia's war of aggression in Ukraine and by the subsequent sanctions imposed on Russia, but also by the Russian government's decision to interrupt deliveries. This caused the prices of some types of energy to spike exponentially, especially in Europe, and these price rises were then gradually passed on to consumers from 2022 onwards. We estimate that inflation in Europe would have worked out at less than half as high without the energy crisis.

Mired in such a predicament, states again felt compelled to stabilise: a broad and confusing mesh of government measures has eased the burden on consumers, in Europe especially. These included, on the one hand, measures that dampened the prices for energy and transportation and, on the other hand, financial transfers to private households and companies, designed to enable them to more easily bear rampantly high energy prices. This complex raft of measures again resulted in significant fiscal stimuli for the economy. Measuring these stimuli is difficult due to their diversity and breadth, yet their magnitude corresponds to no less than around 2 to 5 percent of GDP in individual European countries.

Fiscal policy and monetary policy are communicating channels

In principle, we support the kind of stabilisation policy which was applied in the coronavirus crisis and has been implemented again in the most recent phase. This past winter, the measures adopted have helped to ensure that an energy recession in Germany will, in all likelihood, prove to be only a shallow one. The fact remains, though, that monetary policy and fiscal policy constitute a system of communicating channels with respect to aggregate demand and thus inflationary pressure. What happens when both policy areas overreach in their efforts at stabilisation can be gauged from the anti-Covid policy mobilised in the USA: stateside, overly large government programmes, launched in 2021 to bolster private households, clearly contributed to the emergence of the current inflation process.

Further fiscal stimuli are now no longer necessary for European economies, and would indeed even do more harm than good. The more fiscal policy in Germany now withdraws from expansion mode, the more this will facilitate the European Central Bank's fight against inflation.

A new monetary-policy paradigm?

Inflation readings need to return to around the 2 percent mark

Now that a new inflation process has flared up, we believe that the most urgent objective of monetary policy is to defend its inflation targets. Concretely, this means that the inflation rate in the euro area needs to revert to the two-percent range over the next two years. A prolonged target overshoot, even if it were "only" by one or two percentage points, would result in a de-anchoring of inflation expectations. In that event, economic agents and capital-market actors alike would call into question the existing monetary-policy regime predicated on "low inflation at two per cent." That would spawn deep uncertainty among market participants. And such uncertainty would not only result in pronounced market fluctuations and higher long-term nominal-interest-rate expectations, but would also push up real interest rates via rising risk premiums and thus worsen investment conditions.

Raising the inflation target would not be a solution

An alternative regime produced by the academic debate would entail raising central-bank inflation targets, for instance from two to four percent. We do not think this is a good idea. It is true that such a shift would increase the scope for expansionary monetary policy, which will be required again at some point. However, this advantage would be more than outweighed by the growth-damaging consequences of higher inflation rates. In addition, a step of this kind would, at the present point in time, arouse suspicions that the inflation target was not being moved higher because of such overarching considerations, but because the former target was no longer politically enforceable. That would not be a good starting-point for ensuring the credibility of a new monetary-policy-target formulation - for why should the new target not be raised yet again in the immediate aftermath of the next surge in inflation?

The inflation rate is poised to remain well above the target variable in 2023

The low-inflation regime that monetary policymakers installed in recent years is still intact, but is nonetheless under threat. At the beginning of this March, long-term market-based inflation expectations for the euro zone were hovering at 2.5 percent. As the latest survey on the *S-financial climate* shows, about 80 percent of Germany's savings banks (Sparkassen) still expect inflation rates of above 4 percent at the end of 2023. A strict anti-inflationary course is often criticised for allegedly crowding out necessary government and private spending, for example on the sustainability transformation of the economy or on social issues.

Special problems involved in inflation measurement

In February, a mere statistical revision meant that inflation in Germany in 2022 was no longer projected at 7.9 percent on an annual average, but only at 6.9 percent. What looks like a case of doctoring the figures or cooking the books is actually due to an exercise that takes place at regular intervals every five years. This exercise is part of the German inflation-measurement methodology via a so-called Laspeyres index, a generally recognised method for computing inflation. Under this approach, the basket of goods and services of private households on which inflation measurement is based is kept constant for a longer period of time. The rationale behind this is that only price changes, and not changes in consumption behaviour (i.e. shifts in the weightings of items in the basket), are to be measured as inflation. After a longer period of time, however, the basket of goods and services becomes outdated, no longer reflecting real-time consumption patterns. When the basket is updated every five years on the basis of the current consumption surveys conducted by the Federal Statistical Office (Destatis), inflation rates are also adjusted back to match the new weights: The time series of inflation data is thus revised as well. In this context, it regularly proves to be the case that the previous inflation-rate projections were too high. This is attributable to the fact that, over time, consumers switch from goods whose prices have risen sharply to other products and that the weighting of such consumer products decreases as a consequence.

The fact that it was the turn of the extremely distorted coronavirus year of 2020, of all years, to function as the new base year for consumption weights in the revision process implemented this year has been compensated for by the Federal Statistical Office by using the - pragmatic - measure of using an average of consumption habits from 2019 to 2021 to derive the new weights in the inflation basket. There is nothing to be said against this approach, nor against the practice of utilising a Laspeyres index, which has been the method employed for decades. In no way do they represent politically intended manipulations.

A detailed explanation of how the methodological basis for calculating the German consumer-price index has been revised can be found on the Federal Statistical Office's website at: www.destatis.de/DE/Presse/Pressekonferenzen/2023/vpi/hintergrundpapier-vpi.html

What is worthy of criticism, however, is the increasing muddle in German inflation reporting. The characteristics sketched above refer only to Germany's national Consumer Price Index (CPI). With the inception of the European Monetary Union, a further official inflation metric came into being following the standardisation ("harmonisation") of inflation statistics, namely the Harmonised Index of Consumer Prices (HICP), and it is to this index that the ECB mainly gears its policy.

The HICP is a representative of another type of index, in which adjustment of the inflation weights takes place every year. Such a revision happened in February, as in the case of the Federal Statistical Office's recent revision of the German CPI methodology. In future, the divergent changes in the weights for goods and services in the two indices will lead to significantly larger deviations in inflation measurement on the basis of the CPI and the HICP. In principle, both concepts are suitable for measuring inflation - neither can be said to be objectively superior to the other. In the interests of transparency, however, the public debate should be focused on one core inflation measure. Anything else will damage the credibility of inflation measurement in general, as we are once again witnessing at the moment.

On this score, it needs to be countered that all these goals will be more difficult to achieve in the long run if monetary stability fails to be maintained. This does not mean that these issues are unimportant, but only that there is a division of labour in the policy field too: the central bank is responsible for price stability. Assigning other objectives to monetary policymakers would overburden them and plunge them into conflicts. Other entities are responsible, and other instruments available, for climate policy or social affairs.

Inflation: The situation will ease this year – but the last few metres to the finishing-line are going to be difficult

When discussing inflation, a distinction needs to be drawn between one-off price spikes that unwind again after a year or two, and permanent price increases that take place year after year and may even accelerate. The fiscal-policy reactions to Covid-19 and the war in Ukraine set the inflation stone rolling and were the two initial stages in the current inflation process. But the second stage is now being followed by reactions from economic agents. The general rule is that workers make higher wage demands when inflation rates are very high, and are also able to enforce them to a greater extent - the enforcement rate (ratio of final wage agreements to trade-union demands) in the most recent wage round in Germany is standing at a historical high of 80 percent. Furthermore, companies change their supply-side behaviour when costs are rising sharply, for example by marking up their prices at shorter intervals.

Inflation: a temporary shock which it is possible for policymakers to "look through," or else a permanent effect?

In the interim, the exogenous price shocks are subsiding to a large extent. Since peaking last summer, the prices of energy commodities have retraced to a considerable extent and are now back at levels similar to those in autumn 2021. Companies are referring less and less frequently to supply bottlenecks in surveys, and some hard indicators tracking their material and transportation costs have also fallen significantly. However, all this does not necessarily mean that the inflationary push is over, as some of the reactions alluded to above are only just beginning to kick in. Later in the year, many unions can be expected to demand wage increases even in excess of the rate of inflation, and trade unionists are threatening strikes more vehemently than they have done for a long time. At the same time, major consumer-goods manufacturers are announcing a need for further price increases despite the easing cost situation.

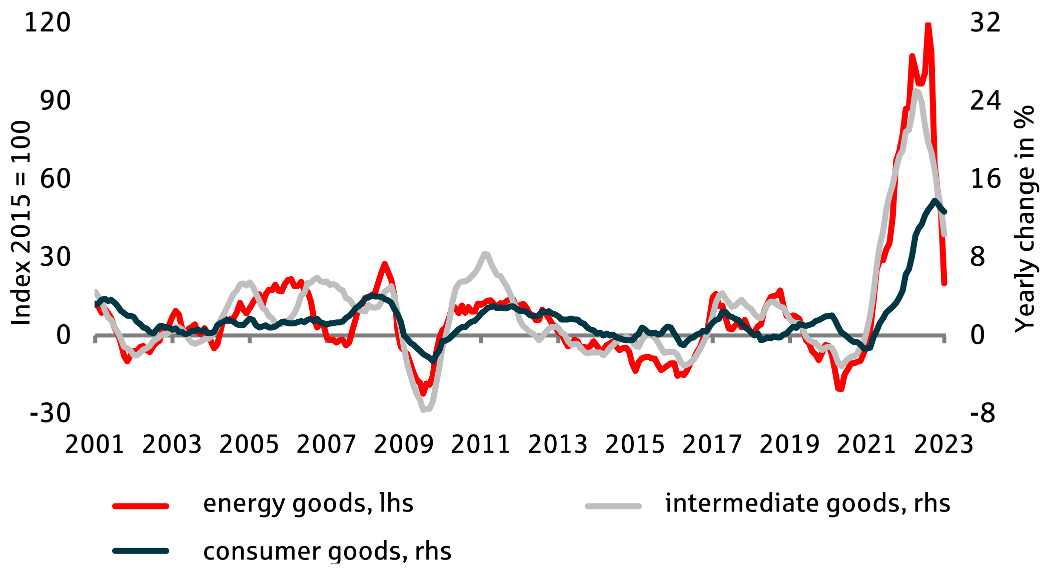
Trade unions are currently pushing through no less than 80% of their wage demands

Clearer signs of a downward trend reversal on the inflation front can be gauged, in particular, from producer prices at the upstream stages of the production process (Fig. 1). Massive base effects as well as price declines in individual months have caused the annual rates of producer-price inflation (PPI) for both energy goods and intermediate inputs to backtrack significantly. If these developments continue, the annual rate of inflation for intermediate goods is likely to fall back to almost zero in the coming months, and that of energy prices is even likely to turn temporarily negative later in the year. It should be noted, though, that the price spikes in producer prices witnessed in 2022 were not passed on in full to consumers.

Core inflation is seen at about 3 percent at year-end 2023

That said, a pronounced flattening of the producer-price curve can be expected to provide relief for consumer goods after a short time lag. This assessment is the essential basis of the widespread expectation that core inflation will soon recede significantly - from over 5 percent in January to about 3.0 per cent by the end of the year.

Fig. 1: Producer prices in the euro area

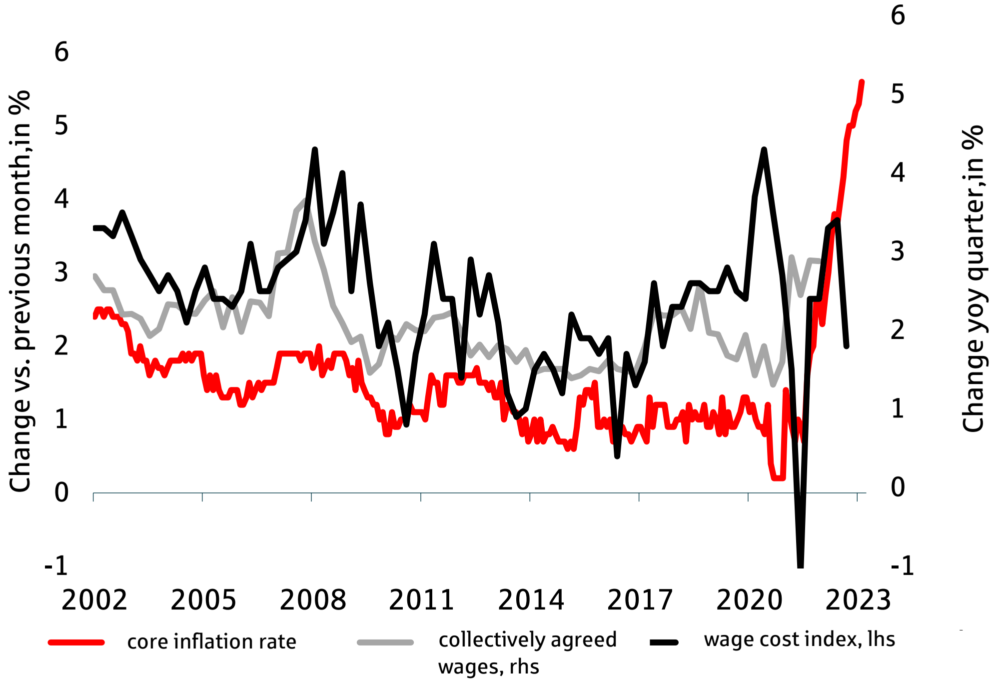


Source: ECB, DekaBank, DSGV

The problem is, though, that industrial goods excluding energy, a category where pronounced disinflation is to be anticipated in the near future, only account for just under 38 percent of the basket used to calculate the core inflation rate. The remaining part of the basket is accounted for by services, with wages being easily the dominant cost factor in that sphere. So far, wage developments have only been fuelling the increase in inflationary pressure to a manageable extent. But the reverse causality should rather be kept in mind at present, namely that high inflation has a habit of leading to correspondingly hefty wage increases.

Collectively agreed wages in the euro area did not increase with an elevated speed in the fourth quarter of last year and, at just under 2.9 percent year-on-year, are running at a level that is not worrying from an inflation-boosting point of view (Fig 2). What is also clear, however, is that these wage settlements have involved serious real wage losses from the perspective of the employee side. Wage momentum is currently accelerating. The wage agreements concluded over the last few months strongly suggest that the annual rate of wage growth is poised to soar into the region of 4 to 5 percent. In the longer run, such an annual wage-cost trajectory would not be consistent with inflation rates close to 2 percent, the central bank's target.

Fig 2: Wage developments in the euro area



Source: ECB, Eurostat, DekaBank, DSGV

In the months ahead, the demise of supply shocks (dampening inflationary pressure) and the increase in second-round effects (stoking inflationary pressure) will overlap. Headline inflation rates and core inflation rates should therefore move in opposite directions. In such a constellation, a disinflation process will only continue until consumer prices have adjusted to the lower level which energy and material costs have again reached. In the subsequent phase, wages will then, once again, become the decisive determinant of inflation. So if expectations prove correct that wages are set to rise at well-above-average rates for some time in order to compensate workers for the loss of purchasing power suffered in recent years, it would not be likely, even in the longer term, for inflation to fall back to 2 percent on a sustained basis.

Vigilance and caution are the watchwords of the moment – the ECB is on the right track

The European Central Bank, like the Federal Reserve over in the USA, has been drawing a good deal of criticism for being “behind the curve” by reacting too late to last year’s major outbreak of inflation. An ideal monetary-policy course would certainly have looked different in such a situation, but it is, of course, always easy to determine the right course in retrospect.

What seems essential to us is that this delayed reaction on the part of the monetary authorities was caused not so much by political gridlock as by a technical misapprehension about the nature of the rising inflation rates observed from autumn 2021 onwards. Over the course of 2022, it became increasingly clear that any hopes of "transitory" - i.e. quickly evanescent - price increases were unrealistic in the wake of Russia’s attack on Ukraine and of the resulting energy crisis. In reaction to this, the ECB embarked on a strictly restrictive tack in the summer, and is steering its monetary policy accordingly to this day. The ECB’s deposit facility rate - currently the benchmark key policy rate for the money market - has been ratcheted up from minus 0.5 percent to 3.0 percent in March of this year.

On average, we are expecting the ECB’s tightening cycle to wind down, with the deposit rate subsequently settling in a range of 3.25 to 4.0 percent. The primary reason why the ECB will tend to proceed cautiously from this point onwards is the current turmoil shaking financial markets.

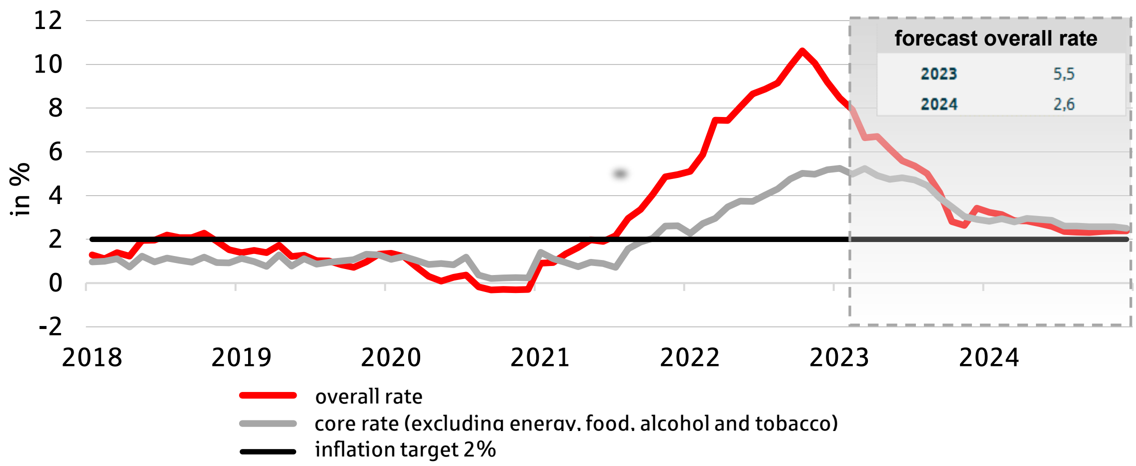
We see the ECB deposit rate being pushed up to a range of 3.25 to 4.0 percent

At the same time, the consolidated balance sheet of the Eurosystem is set to shrink significantly over the coming months. Currently, banks' deposits at the ECB account for more than half of the liability side of the Eurosystem balance sheet, at around EUR 4,140bn. In line with repayments of TLTRO-III liquidity, utilisation of the deposit facility has already waned by about EUR 500bn since November; the major TLTRO-III expiry date in June of this year should see excess liquidity, and thus utilisation of the deposit facility, declining again by about EUR 450bn; and deposit-facility liabilities are then expected to have fallen towards EUR 3,200bn by the end of the year. In addition, the bond holdings in the Eurosystem’s asset-purchase-programme portfolio are now being reduced by EUR 15 billion per month since all of the principal payments from maturing securities are no longer being reinvested.

Where the restrictive range for eurozone key interest rates begins is a question that can hardly be clearly clarified by academic research. At the end of the day, the answer has to be an empirical one. Nevertheless, banks, savings banks and small and medium-sized enterprises are preoccupied with the question of when the present rate-hiking cycle is going to come to an end. From our vantage-point, the clearly restrictive effects of the rate-tightening cycle so far are already clearly observable. Financing conditions have deteriorated significantly in terms of both costs and prices, and lending in the euro area has slowed down considerably as a knock-on effect. The European money-supply aggregate M3 is shrinking. This has already led to noticeable restrictions in activity in highly interest-rate-sensitive sectors such as construction. By and large, the ECB - after a certain degree of initial hesitation - is now reacting appropriately to this inflationary threat situation. We are observing that there has been a broad pivot in the ECB Governing Council towards energetic enforcement of the central bank's statutory mandate to maintain price stability. The ECB turns out to also be adept at turning policy restrictive, if necessary - this is a welcome development.

In particular, the ECB has been very clear about telegraphing its determination to adhere rigorously to the targets it has defined. And yet Team Lagarde has also resisted the temptation to exploit the flexibility of its recent strategy revision. The tolerance towards target overshoots built into the stategy revision is, at most, intended for evidently temporary inflationary influences. The point is, though, that the current inflation trend has long since got beyond this stage. The danger of second-round effects, and thus of inflation becoming permanently entrenched at a higher level, is simply too great.

Fig 3: Outlook for headline and core inflation in the euro area



Source: Eurostat, DekaBank, DSGV

It is unrealistic to expect interest-rate cuts in the foreseeable future

What is more, we consider the level to which inflation is likely to converge in the medium term to still be too high for monetary policymakers to contemplate key-rate cuts in the foreseeable future.

In views of this, the key-interest-rate levels reached in the summer should be kept on hold until it becomes clear next year whether the current forecasts regarding the downward trend in inflation are realistic (Fig. 3).

Balance-sheet reduction should be speeded up in order to more quickly reduce the excess reserves sloshing around within the banking system. If it turns out in the coming year that the inflation process cannot be sufficiently contained with the help of the measures taken so far, the monetary-policy stance will have to be made more restrictive still. If push came to shove like this, only an adjustment recession could then re-anchor inflation at a lower level.

Monetary policy: A steady hand in an unsteady environment

The monetary-policy environment is anything but clear-cut at the moment. The problems start with the difficulties over measuring inflation. Price statistics are having serious problems capturing the immense dynamics that were triggered first by the coronavirus scenario and then by the energy crisis. Furthermore, central macroeconomic relationships that have an important bearing on monetary policy may well be shifting. For example, as a result of demographic changes, the labour market is now reacting quite differently to cyclical fluctuations than it used to do in the past. There are likewise indications that the transmission of monetary-policy stimuli may take somewhat longer than was previously the case. Last but not least, new trends in globalisation or in sustainability transformation may well be influencing inflation, currently tending to push it up.

Further burdens on the banking industry need to be kept in sight

It is true that such changes in the framework conditions are nothing unusual for central banks; however, they underline the current uncertainties when it comes to assessing the inflation process. In keeping with this, monetary-policy decisions should therefore be made on the basis of a broad inflation picture in which the core inflation rate, possible second-round effects from wage developments as well as the transmission of monetary policy stimuli to individual sectors such as the real-estate industry or the financial sector are closely monitored. Such a broad monetary-policy picture should also factor in the effects of regulatory measures, such as increasing countercyclical capital buffers for the banking sector. For savings banks as for other credit institutions, the restrictive effects of higher equity-capital requirements on the credit supply are similarly serious to the dampening effects deriving from the now higher interest-rate level.

Financial stability is a key secondary condition

Especially in such turbulent times, it is important, albeit difficult, to keep a close eye on the banking sector's ability to digest the changes taking place. Financial-market stability is namely an indispensable secondary condition for the smooth functioning of monetary-policy transmission.

In this respect, the environment has not become more settled recently: the mid-March collapse of Silicon Valley Bank and of several other regional banks in the USA illustrates the challenges being faced. In Europe, Credit Suisse has also run into difficulties, having to be first propped up and put under enhanced supervision, before being forcibly merged with its rival UBS.

Rapid interest-rate increases subject banking systems to stress

The developments which have played out in the banking system since the beginning of March have demonstrated that the swift pace at which interest rates have risen has subjected the banking sector to stress. The reason is that all assets have lower valuations as a result. Banking institutions now need time to acclimatise to the new high-altitude interest-rate environment. The equity-capital and liquidity buffers which have been built into the banking system for this purpose are certainly very solid and substantial, in Europe in particular. Yet, as in every industry, there are stronger and weaker links in the banking segment too. Especially when irrational modes of behaviour rear their heads - when market participants succumb to herding behaviour, for example - this may result in an existential problem for weaker banking entities.

Interlinkages between the USA and Switzerland via the market-reaction channel

A case in point: there were no direct connections at all between Silicon Valley Bank and major Swiss High Street banks, and yet Switzerland's second-largest banking institution, Credit Suisse (CS), was quickly hit by a contagion effect after troubled Silicon Valley Bank had been temporarily closed by regulators, and the problem had to be resolved, with support from the national supervisory authorities and from the Swiss National Bank, by selling off CS to the country's largest bank UBS.

This way of proceeding will be the blueprint for dealing with any adjustment problems in the current - historically unique - rate-hike phase. Monetary policymakers must not allow themselves to be deflected from their target of containing inflation, but need, at the same time, to be highly vigilant with respect to isolated malfunctions within the financial sector. In this context, blanket guarantees - for instance, providing insurance for all bank deposits without limits - can only be ultima ratio instruments since it would be neither sensible nor expedient to keep every single bank afloat without taking account of whether or not its business model was functional.

The historically sharp interest-rate increases experienced in recent months have been taking a toll on the real economy as on the financial sector in many of the world's economies for some time now. Financing is becoming more expensive, and loan conditions are tightening. Lending, in the euro area for example, has already slowed down considerably, and the money supply in Europe is contracting. These braking effects of monetary policy on the overall economy are intended, so as to reduce inflation rates and stabilise them in the vicinity of the inflation target. So far, economies have proved highly resilient to these braking effects and to other pressures such as high energy prices. Both the US economy and the euro area are traversing a period of weakness, but not a severe recession. It is normal that the braking effects of interest-rate increases do not become apparent immediately, but persist over a period of one to two years.

In this respect, central banks have to tread a fine line during this "braking phase" between resolutely fighting inflation, on the one hand, and avoiding an abrupt stalling of the real economy and of the financial sector, on the other.

The priority accorded to inflation-fighting must remain indisputable

Avoiding tears in the economic fabric also involves preserving financial stability. In the current case too, in which some US banking entities with special models have not survived the sharp run-ups in interest rates and yields, the task of central banks and supervisory authorities is to prevent the difficulties from escalating by providing liquidity quickly, but at the same time not to deviate from their anti-inflation tack. The supervisory authorities in the USA and the central bankers at the Federal Reserve have definitely acted promptly along these lines. The effects of a specific company's difficulties on other market players have been absorbed wherever they did not appear to be sustainable, and the entire banking system is being offered relief in terms of liquidity provision. We do not see European, and especially German, banks being affected by the problems which are being encountered by various US regional banks due to the more robust balance-sheet structures required by regulation in our part of the world.

Conclusion

All in all, monetary policymakers are facing major challenges, both in the USA and in Europe. On the one hand, central banks will probably have to impose comparatively restrictive financing conditions for a long time to come in order to defend their inflation targets. In the process, they could come under considerable political pressure in the coming years if interest groups brand them as growth-killers and recession-causers, or if government budgets are squeezed by new restrictions on account of higher interest rates. At the present juncture, the ECB is still being helped by the fact that the economic trend, and especially the labour-market constellation in the euro area, are coping surprisingly resiliently with the various burdens. This will probably prevent a recession in the euro area as a whole this year. But even if the economic costs of running a tighter monetary policy turn out to be higher, a stable monetary environment must not be sacrificed on the altar of short-term economic stimulation.

Disclaimer

This position paper by the DSGV Chief Economists does not necessarily reflect the stance of all institutions belonging to the Savings Banks Finance Group.

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Charlottenstraße 47, D-10117 Berlin
Tel: +49 30 20225-5303
DSGV-Volkswirtschaft@dsgv.de

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Image credits
unsplash/John Towner

Responsible
Dr. Thomas Keidel – DSGV
Director
Head of Department,
Financial Markets & Economics
thomas.keidel@dsgv.de

Dr. Reinhold Rickes – DSGV
Chief Economist
Deputy Head of Department,
Financial Markets & Economics
reinhold.rickes@dsgv.de

Note
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