Finanzgruppe
Deutscher Sparkassen- und Giroverband

Monetary policy in the face of the virus

So far, monetary policy has effectively supported fiscal policy in overcoming the Corona crisis. However, the Chief Economists of the Savings Banks Finance Group wish to emphasise that, in the long term, the division of labour between monetary and fiscal policy must once again come into play to a stronger effect in order to stabilise the national economies.

- ➔ **At present, monetary policy is acting above all to secure liquidity. In all major currency areas, the degree of monetary expansion has again increased. The ECB is offering new tenders with very attractive conditions.**
- ➔ **Monetary growth is currently accelerating exorbitantly. Strong lending, partly due to government support measures for companies, is driving the momentum here. Interest rates remain permanently low.**
- ➔ **In the short term, in 2020 and 2021, inflation is set to remain low due to the crisis. However, other developments are conceivable in the medium term, including higher inflation rates.**
- ➔ **In the long term, the systemic question is: Will the allocation of capital in industrialised western countries return to sustainable viability or will the high level of indebtedness which has been accumulated lead to a permanent dependence on zero interest rates?**
- ➔ **Greater unbundling of monetary and fiscal policies is necessary if a permanent system change is to be prevented.**

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The current dosage of liquidity protection is correct and important

- ➔ During the Corona crisis, the central banks of the major currency areas significantly expanded their already highly expansionary monetary-policy measures at an early stage. The Federal Reserve made use of the room for manoeuvre that still existed in the dollar area on the interest-rate side, lowering its key interest rates to virtually zero. The ECB relaunched and further increased the firepower of its purchase programme, adding a new flexible programme worth up to EUR 750 billion (Pandemic Emergency Purchase Programme, or PEPP). Collateral requirements were relaxed and grandfathering was introduced through the acceptance of collateral even in the event of rating downgrades

- ➔ At the end of April, the ECB added further liquidity, announcing further pandemic emergency longer-term refinancing operations (PELTRO) and significantly improving the terms and conditions of the third series of targeted longer-term refinancing operations (TLTRO III). These tenders are aimed at providing credit to the real economy. Therefore, the conditions are linked to the development of credit portfolios at credit institutions. With growing loan books, the interest rates set by the ECB for the tenders can be as low as -1.0 percent. We also see this as recognition of the important role of the credit industry regarding the services which credit institutions are currently performing in maintaining payment transactions, the supply of credit and the transfer of bridging funds to the economy.

- ➔ We very much welcome the fact that the ECB has chosen the route involving tenders and has not made interest rate cuts via its benchmark rates. Further interest rate cuts, taking them deep into negative territory, would only have increased the burden on the transfer of loans to the real economy. In addition, this would have given the wrong impression to fiscal policymakers, implying that the central banks were fighting the crisis on their own. Fiscal policymakers in particular are - and will continue to be - called upon to take action; and it has to be acknowledged that they are doing so decisively and to a considerable extent in this crisis. It is true that discussions on a reconstruction fund at a pan-European level have been postponed for the time being. However, thanks to the proposal of stabilisation bonds (Newsletter of 15 April 2020), a way could be found that

simultaneously satisfies the principle of solidarity and balances responsibility and control.

➔ Further interest rate cuts deep into negative territory pose enormous risks to financial stability. It is not without reason - perhaps also against the background of mixed European experiences with a negative interest rate - that the Federal Reserve has stopped at the zero line and has so far shown no tendency to want to move into the negative area itself.

➔ With the introduction of tiering system, the side effects of the negative interest rate in the euro area have been somewhat mitigated since November 2019. If excess liquidity in the euro area now continues to grow as a result of the expanded purchasing programmes and the new tenders, it will be necessary to consider over the further course of the year if the tiering system system should be increased. This so-called tiering multiplier reduces burdens and thus also facilitates the liquidity management of banks and savings banks faced with increased credit requirements of the real economy. The multiplier with the factor "six" was well and appropriately chosen for the initial phase of tiering. However, deposit-strong institutions, to which further surplus liquidity flows, should continue to receive appropriate relief. This is especially true in the wake of the shutdown situation, in which many current accounts remained full because consumers simply did not get to spend at that particular time. The credit institutions holding the accounts of these households should not be charged the negative interest rate.

Money creation is getting off the ground

➔ But it is above all credit business that drives monetary growth. Germany is experiencing a real boom in the flow of bridging and support funds. In other countries in the euro area, other similar instruments are being developed. The cumulative effect will be to considerably stimulate the growth of the broader monetary aggregates. In March, the M3 broad money measure already grew at an annual rate of 7.5 percent across the currency area as a whole. In recent years, the development of M3 was not really weak either, with growth proving to be rather on the strong side, mostly a good five

percent per year, although not as dynamic as has been the case recently. The narrower aggregate M1 had already been growing disproportionately for some time, but in March growth was even stronger still at a rate of 10.3%

➔ The figures for April are not yet available. However, in the month in which the shutdown first became fully effective and in which credit dynamics for subsidized loans only really took effect, money supply growth is likely to have accelerated further.

➔ One could say that the Corona crisis has led to a situation in which monetary expansion is now doing what the ECB has been trying to do for ten years: not only are central bank balance sheets being expanded and central bank money increasing, but the money supply is also expanding more widely than money in the hands of non-banks. The change in the spirit of the times on the regulatory front is contributing to this: Over the past decade, ever tighter regulations, more and more key parameters adhered to and higher capital adequacy requirements have imposed such a tight corset on banks that the old mathematical money creation potentials known from pre-financial crisis times could not be exploited. This trend has now turned around. Multiple money creation is back again thanks to the appropriate adjustments in regulations. Many regulations, accounting rules and risk assessment metrics that increase the cyclicality of the economic cycle are now being suspended, and this is having an effect. The Corona crisis should therefore also be followed by an examination of how the transmission of monetary policy can be improved in the long term.

In the long term the systemic question arises

➔ Currently, the measures of all actors - those responsible for monetary policy, fiscal policy, supervision and regulation - but also the actions of the financial sector itself are being assessed very pragmatically in crisis mode. This is thoroughly warranted in such an acute situation. The priority is to contain the epidemic and to forestall a collapse in the real economy. And yet it remains clear that bridging the gap with money and largely unprincipled flexibility can weaken the long-term viability of the structures. As a result of the crisis, the big task remains: central bank balance sheets and debt levels must be brought back to

normal levels!

- ➔ One conceivable medium-term consequence is that inflationary processes will arise. After several decades of low rates of price increase, such a notion now seems foreign and distant. True, this is not an issue for the years immediately ahead. In the sharp recession, in view of the numerous demand-side shocks and the sharp drop in oil prices, and with rising unemployment and lower wage pressure, the upward trend in prices will initially continue to be strongly dampened. This scenario is dominating current forecasts. In the appendix to this newsletter, we have compiled some price and interest rate forecasts from the group of Chief Economists of the Sparkassen-Finanzgruppe who are co-sponsors of this publication - and have clarified our position in the latest ECB Forecaster round.

- ➔ In the long term, by contrast, higher price pressure is possible, perhaps more structural inflation could be possible. Monetary expansion (which is now also beginning to feed through to the broad non-bank aggregates) and possible permanent, productivity-depressing scars from the current crisis (such as a degree of globalisation that is likely to remain somewhat depressed) could reduce the supply of goods on the market or make such goods structurally more expensive.

- ➔ The theses put forward by those subscribing to "Modern Monetary Theory (MMT)", which advocates practically unlimited debt sustainability of states with the support of the central bank, are met with extreme caution by the Chief Economists of the Savings Banks Finance Group. Based on the experience of the last few years - with zero interest rates and in the current crisis - there may seem to be a great deal of leeway. But, in the end, such constructs are threatened with collapse in a similar way to "snowball systems". If money is created in excess, fundamental downward spirals and dangers for our monetary orders threaten. Therefore, the new monetary policy strategy and the developments on the financial markets must always be accompanied by confidence-building expectations.

- ➔ One result of the Corona outbreak is that the debt levels that are now exploding in the crisis will sooner or later have to be added to and paid

off as hard burdens, even for the states concerned. This can be done either by means of a classic consolidation policy or with the relief provided by higher inflation. However, if nominal relief is overdone, currency crises threaten, which could affect several currencies simultaneously.

➔ The financial system is at a crossroads between the perhaps old-fashioned and restrictive road - which is the only serious approach that allocates capital according to sustainable viability - and the alternative of a supposed perpetuum mobile.

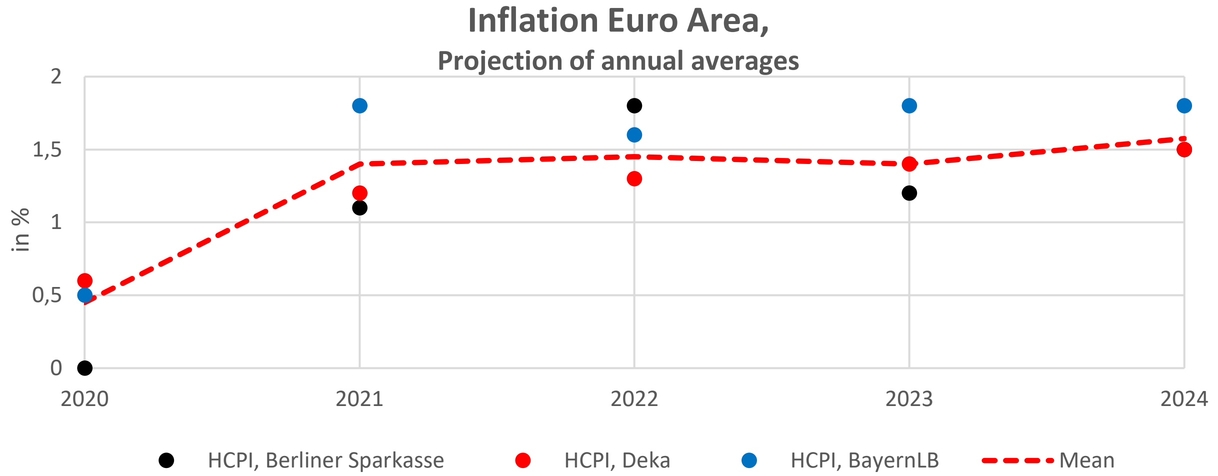
➔ During the tightrope walk of recent years, and now once again inevitably in the throes of the current acute crisis, the ability of many countries in particular - but increasingly also of the corporate sectors of some countries - to service their debts has depended to a large extent on two preconditions: sustained extremely low interest rates and direct intervention by central banks. The institutional independence of central banks practiced in previous decades is increasingly threatening to become history. Monetary and fiscal policy would be forced to marry.

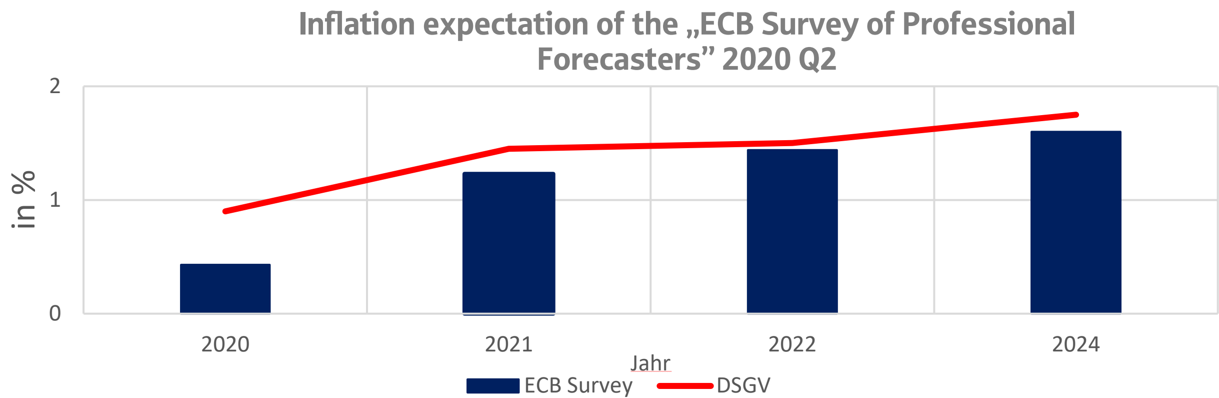
➔ The most recent ruling of the Federal Constitutional Court also falls within this area of conflict. The court demands a stronger justification from the ECB of its compliance with the limits of its mandate and of its de facto action on the fringes of state financing. Purchases of government bonds are not prohibited in principle; however, they must be better explained in future. Demanding more attentiveness and transparency in this regard is certainly to be welcomed. Admittedly, a review of the central bank's actions by the Bundestag and the Federal Government is not entirely unproblematic with respect to the principle of autonomy the Eurosystem. From the perspective of the Eurosystem, such opportunities can likewise be used to clarify the actions and procedures of democratically legitimised constitutional bodies.

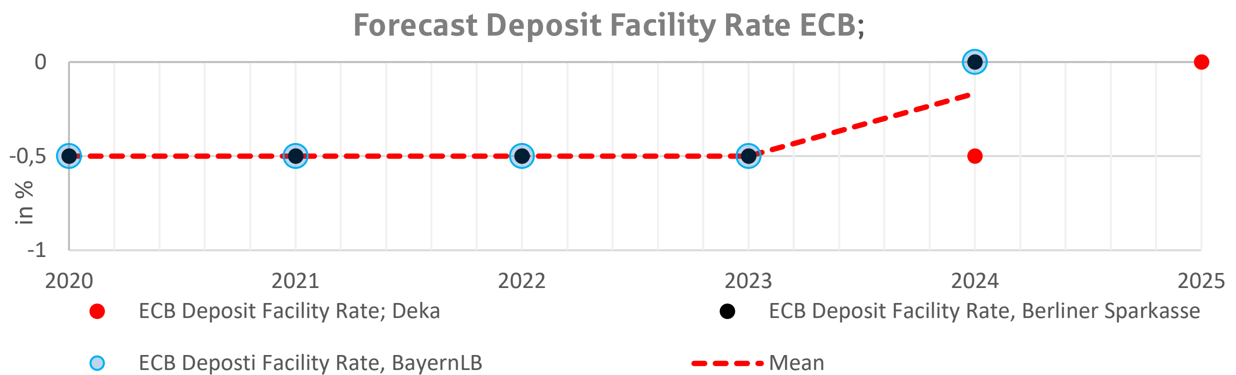
➔ But quite independently of the legal framework, the question arises as to how to unravel the mix of monetary and financial policy to a greater extent again?Furthermore an important question will be, which course should be set in the next few years for a coordinated European financial policy. These are big questions that go beyond the scope of

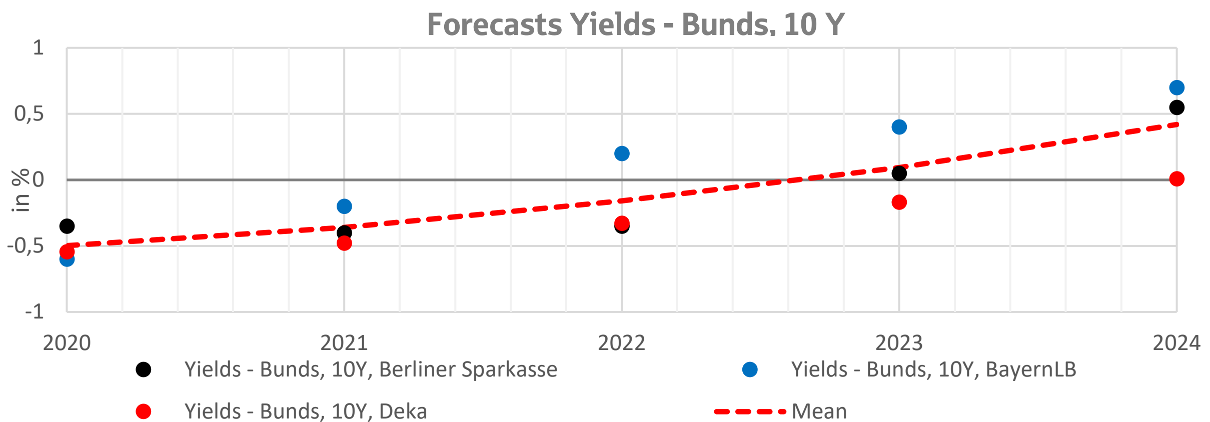
this current "Newsletter" format. The Chief Economists of the Savings Banks Finance Group plan to publish a separate position on economic governance and the significant increase in public debt due to the Corona crisis, as well as on the conditions for government bond purchases, especially in view of the recent ruling by the German Federal Constitutional Court.

Appendix: Forecasts by selected institutions of the S-Finanzgruppe









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