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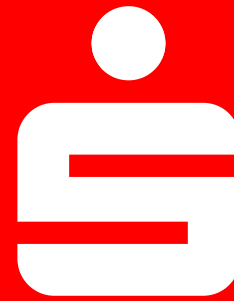

STANDPUNKTE
DER CHEFSVOLKSWIRTE

Monetary Policy: Crisis Measures are not Permanent Instruments

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Monetary policy has effectively supported fiscal policy in the Corona pandemic. The spread of real economic difficulties to the financial sector has been prevented so far. Now it is important to ensure that the economies do not become permanently dependent on these special measures to overcome the acute crisis situation. A perspective normalization must be conceived and signaled.

- Key interest rates must not be lowered any further in the Euro area.
- The additional liquidity and credit needs of the corporate sector have been satisfied, and the M3 money supply is now about 10 percent higher than last year. The double-digit percentage increase in government debt this year did not lead to a rise in interest rates on the capital markets.
- The prices of assets have stabilized again more or less at their pre-Corona crisis levels. They are thus sending signals of confidence to the real economy.
- As the decisive perspective it remains clear: The resulting high surplus liquidity will continue to increase and cannot be directly repaid. An increase in the exemption from the negative deposit interest rate in the tiering system should follow soon. This would strengthen the earning power of banks, improve liquidity management and therefore have a positive impact on their ability to lend to the real economy.

Determined commitment in the crisis

The decisive measures taken by the ECB during the crisis initially meant that the slump in the real economies of European countries did not translate into a self-reinforcing downward spiral through negative spillovers via the financial system. The measures are also helping the economies to recover from the exogenously-triggered slump. The interim status of the economic recovery as of late summer 2020 is, in principle, encouraging: in terms of production across the industrial sector in Germany, around 60 percent of the shutdown-related declines from the first and second quarters have been achieved so far. Private consumption is also still affected, with only retail sales and private-vehicle registrations now exceeding pre-crisis levels. Catch-up effects have been coming into play here. Yet the phase of rapid recovery should nevertheless be over by now. What is more, there are also broad swathes of the economy, as in the case of consumer-related services, where capacity utilisation is still significantly curtailed.

Recovery is on the way, but will remain incomplete for a longer time

Without a second comprehensive shutdown, economic output in Germany will rise again towards the end of the year to around 95 percent of the pre-Corona level - but that would still correspond, in effect, to a recession scenario. So the economic crisis is anything but over. There can only be a real normalisation when the virus no longer causes any impairment of daily life and when activity in the "contact industries" (such as tourism, catering, transport, live events) can normalise. This can only be achieved by the hoped-for successful completion of vaccination campaigns in the coming year. The implication for monetary policy is definitely that the emergency measures should be continued unchanged into the coming year until more clarity is available for the economic framework conditions for the years ahead, particularly in the light of the progress made on the vaccination issue.

Crisis instruments are not permanent measures

On the other hand, crisis instruments are not permanent measures: Both the fiscal programs for structural maintenance and demand stabilisation and the monetary-policy programmes designed to spur lending can only be kept in operation for a limited period of one or two years. The worst mistake that economic policymakers can now make is to assume that the substantial increase in credit volumes and public and private debt, which in recent months seemed capable of being conjured up as easily as if by magic, was a permanent instrument for fulfilling all kinds of social and economic wish lists.

In our view, the increase in government-debt ratios and money-supply growth is sustainable for some time at the current level, for a while even at higher levels. We consider it almost impossible that the industrialised countries will go bankrupt in the coming years because of the

coronavirus-related measures or that a huge wave of inflation will sweep over us during this time. But these means of stabilisation policy cannot be deployed in an unlimited manner. After the end of the corona state of emergency, which is difficult to assess from today's perspective, work must also be done to establish normality on the monetary-policy and fiscal-policy fronts. This process will take many years.

Situation of credit supply

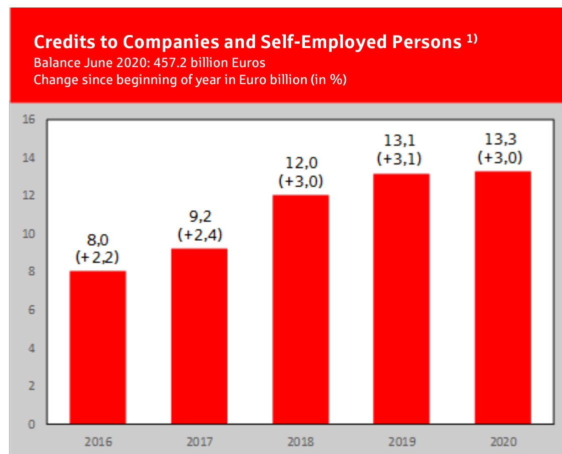
Survey results, according to which individual companies are complaining about sluggish lending by the German banking sector, do not contradict the success of the ECB's crisis package.

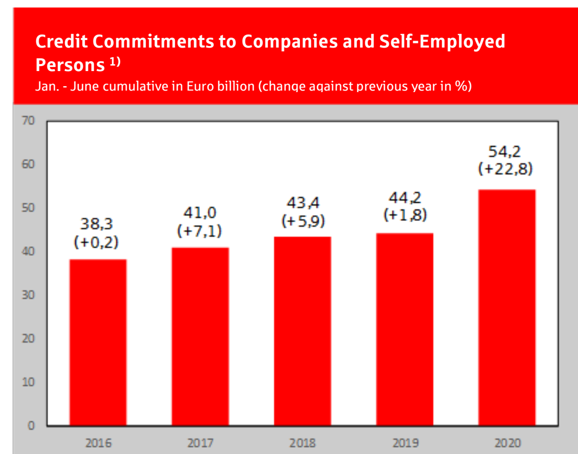
Lending is in expansion mode

- The annual rate of unsecured loans to the private sector in the Euro area rose from 3.2 percent at the beginning of the year to 5.2 percent in May. There can be no talk of a "credit crunch". On the contrary: bridging the shutdown, by means of the loan instrument s well, is part of the solution to the crisis.

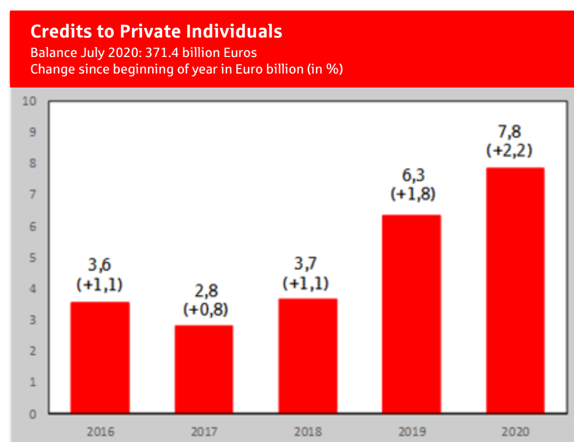
Savings banks are making their contribution

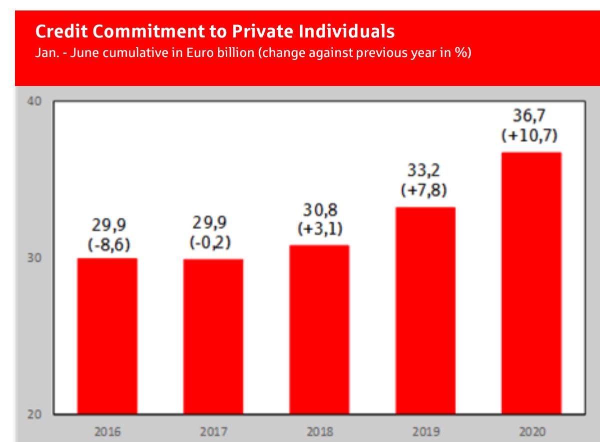
- In Germany, the Savings Banks alone committed new corporate loans in the first half of 2020 to an amount of EUR 54.2 billion (+22.8 per cent year-on-year), **more than ever before** in the first half of the year. The same applies to loans to private households. Here, new lending business - driven by continued strong demand for housing loans - amounted to EUR 36.7 billion (+10.7 percent year-on-year). Accordingly**, loan portfolios** have also grown strongly. The aggregate corporate loan portfolio surged by EUR 13.3 billion (+3.0 per cent) to EUR 457.2 billion. This is a similar growth rate to that witnessed in the first half of 2019 (EUR +13.1 billion, +3.1 per cent) and the highest absolute increase within a first half of the year. Loans to private individuals also rose by a record amount for a first half of the year, with the overall portfolio increasing by EUR 7.8 billion (+2.2 per cent) to EUR 371.4 billion.





1) Including credits for commercial housing construction





- Euro area-wide lending conditions likewise remain decidedly relaxed: the ECB's Bank Lending Survey indicates that credit conditions for companies have remained largely stable since the outbreak of the Covid-19 crisis. One explanation for this is that, in addition to the accommodative monetary-policy stance (above all lower-cost TLTRO-III refinancing options), government guarantees in particular have encouraged banks to grant extensive loans to their corporate customers. However, since the states' assumption of liability is limited in time, the majority of the banks surveyed already expect far less generous loan conditions for the current quarter.

Bank lending is also dependent on public-sector framework conditions

- In our opinion, it makes sense for states to continue functioning as back-stop guarantors for new loans for some time into next year. Otherwise, there would be a risk that, along with a lack of revenue and increased uncertainty, poorer access to credit could prompt companies to cut back on investment and other expenditure. In our opinion, a similar line of argument applies to short-time work benefits and other measures that preserve jobs and thereby bring financial relief to private households and companies. On the other hand, extending the exceptions to

insolvency law is more problematic, as this can lead to an excessive backlog of insolvencies. These exceptions should definitely be phased out at the end of the year. As long as an end to the exogenous crisis determinants is foreseeable with the development and application of a vaccine in the coming year, bridging measures continue to make sense. Central banks and national governments should only scale back this aid to the extent that the economic recovery allows without risking a deterioration in the labour market. If, however, a complete containment of the Covid-19 pandemic proves unrealistic - for example due to failed vaccination campaigns -permanently new framework conditions for individual sectors or the economy as a whole can be expected in the long term. In that case, a transitional assistance programme would no longer be appropriate. The state should then support the economy in coming to terms with permanent transformation processes in many sectors. For some sectors this task is already foreseeable today.

More critical capital allocation will again be necessary in the long run

- At the end of the day, however, even in the current situation it is self-evident that companies should not be provided with unlimited and indiscriminate credit. Despite extensive state guarantees, credit checks by banks and savings banks remain an important instrument for, as far as possible, limiting the dangers of excessive credit supply. Where banks, savings banks and Volksbanks assume that companies do not have a viable business model even without the coronavirus-related obstacles, the granting of credit cannot be justified even under the current extreme conditions. The savings banks know their customers very well indeed - this is the great advantage of Germany's decentralised banking system - and have been acting according to this principle in the past months.

The ECB's primary objective should remain to ensure sufficient lending to the real economy on a broad macroeconomic basis. In addition to purchases of securities, long-term refinancing facilities for banks, of the kind expanded again at the end of April, are the most suitable instruments to this end. The temporary easing of the collateral framework should also be seen in this context. Technically speaking, there is still scope room for all instruments to be expanded, for example by extending the duration of purchase programmes or by the ECB buying up corporate bonds that have recently lost their investment-grade status. We consider it appropriate to scale back these programmes when the European economies have, on average, reverted to their pre-crisis levels and inflation is on the rise again.

Monetary policy after the crisis

After a stormy start, purchasing activity under the ECB's Pandemic Emergency Purchase Programme (PEPP), stabilised in mid-August. The total PEPP envelope at that time was around EUR 470 billion. The ECB's monthly bond purchases have stabilised at EUR 100 billion.

The PEPP has had a strong impact

The ECB now points to the dual character that the PEPP programme has allegedly had from the outset: on the one hand, it is intended to improve the transmission of monetary policy and, on the other, to increase the general degree of expansion of monetary policy. This does not quite correspond to our perception when the programme was first announced in mid-March: at that time, ECB President Lagarde declared that it was the central bank's goal to offset the dampening effect of the corona pandemic on the medium-term inflation outlook by means of a comprehensive but temporary securities purchase program. Apart from the question of the time horizon, there now seems to be no difference between the PEPP and other instruments. The PEPP is having a very similar effect to low interest rates and to the overall Asset Purchase Programme (APP).

Distinguishing between the two securities purchase programs would certainly have an objective rationale. The PEPP was explicitly designed to be temporary in order to be able to respond to the special requirements resulting from the Corona pandemic. This time constraint, in turn, is an important legitimation for its flexibility (e.g. with regard to the national composition of the purchases), i.e. only the present exceptional circumstances justify a temporary deviation from the stricter rules of the APP.

Yet the PEPP must not displace the somewhat stricter

In our opinion, however, there has been a creeping change in the character of the PEPP. If the crisis-combating character of the programme is in the foreground, the ECB would have to start slowly communicating the exit from the programme, provided that the conditions for adequate crisis containment are in place. If, on the other hand, the PEPP is regarded from the point of view of the inflation target, the ECB would have to continue buying bonds for as long as the inflation outlook was worse than before the onset of the coronavirus pandemic.

It is not unlikely that the ECB staff projections for inflation will still be lower in the middle of next year than before the coronavirus crisis. In this respect, the flexible PEPP is increasingly replacing the limited APP in its function and objectives. In our view, this does not make sense.

We do not consider it necessary to upscale or extend the programme beyond June 2021 if the preconditions for an end to the Covid-19 health

crisis materialise in the coming year. Otherwise, this would amount to permanently throwing restrictions such as the capital key and the issuer and ISIN limits overboard. If, for monetary-policy reasons, bond purchases were to remain necessary, the APP would continue to be the appropriate instrument for this.

Other instruments and the target discussion

Even lower interest rates would not bring any benefit

We do not believe that a further reduction in the deposit facility rate would prove an effective instrument for combating the crisis. In the event of a disruption in the monetary-policy transmission process, a further reduction in the deposit rate would not reduce lending costs for the real economy to the usual extent given the extremely low level already reached. At the same time, such a key-rate move would not be devoid of risk. If negative interest rates were to be passed on by banks to depositors to a greater extent, that could further increase their uncertainty. If negative rates were not passed on, however, the profit margins of the banks and thus their ability to create loans would continue to suffer.

The original problems facing monetary policymakers that existed before the coronavirus struck- too low inflation, too low economic dynamism, uncertainty about the level of the “natural interest rate” - are thus being further aggravated by the current crisis. This makes it all the more important for the ECB's monetary-policy strategy to be reformulated so that there is greater clarity again about the conditions governing the deployment of monetary-policy instruments in this "brave new world" of monetary policy.

Concerning the supply of liquidity to the banking system, the ECB continues to regard TLTROs as a core element of its monetary policy. For the time being, this should remain so.

The strategy debate must bring clarifications

What we believe to be essential, however, is the overall strategy for the long-term alignment of monetary policy and, in particular, the communication channel to the financial markets, which accounts for a significant part of the effect of monetary policy. The merely modest success of central banks in stimulating inflation in recent years is at least partly due to structural changes in national economies. In particular, the neutral rate of interest, at which monetary policy has neither a stimulating nor a restrictive effect on growth, is likely to have declined in recent years as a result of demographic, technological, and regulatory influences, which weakens the effectiveness of a central bank's interest-rate instrument.

Conversely, the importance of expectations as a channel for monetary-policy transmission has increased. This is because it is only with the help of inflation expectations that key interest rates, yields on securities, deposit and lending rates are translated into real interest rates, which are the variable ultimately relevant for economic decisions.

A longer inflation horizon would be meaningful

We advocate a monetary-policy strategy under which the central bank seeks an average inflation rate over a longer period of time ("average inflation targeting"). This would give the ECB greater legitimacy to tolerate deviations from the inflation norm of close to but just below 2 percent, both downward and upward, even for longer periods. This specification of the inflation target should enable the monetary custodians to exert a stronger stabilising influence on inflation expectations than with their previous strategies.

Tiering should be strengthened

All additional corona-related crisis instruments amount to a further increase in excess liquidity sloshing about in the banking system. This metric has more than doubled in the German banking system in recent years, from EUR 307 billion at the beginning of 2017 to EUR 668 billion. For the Eurosystem as a whole, the corresponding figures are EUR 840 billion at the beginning of 2017 and EUR 2.2 trillion in mid-2020. In September 2019, the Governing Council decided on a two-tier system for the remuneration of excess reserves, whereby reserves as much as six times the minimum amount a bank is required to hold will be exempt from the negative deposit rate. Despite a simultaneous reduction of the deposit rate by 10bp, the tiered deposit rate ("tiering") has reduced costs facing banks by a net amount of about EUR 2 billion.

When introducing the concept, the ECB signalled that the parameters of the tiered interest rate, in particular the exempt tier (currently six times the minimum reserve requirement for the commercial bank in question), should be adjusted to take account of changes in the burden imposed by excess reserves subject to negative interest rates.

Surplus liquidity continues to grow due to monetary-policy instruments

Since the introduction of tiering, excess liquidity in Germany and the wider Euro area has risen further by almost 50 percent. The relief effect of tiering is being gradually eroded by the additional burdens deriving from rising volumes. Thus, the negative impact of the negative deposit interest rate on the earnings of the financial system has increased in recent months even without further interest rate cuts.
Admittedly, part of the increase in excess liquidity is also due to the tender operations. The ECB has recently been granting very favorable conditions for these (TLTRO-III). Here the relief is, as it were, already built in.

However, a part of the increase in excess liquidity is also due to the tender operations. The ECB recently granted very favorable conditions for these. The relief is virtually already built in. However, a net analyses must also take into account the significantly increased other additional burdens for which the ECB's supervisory authority is partly responsible. The additional burden of the bank levy increases considerably, especially in times of this pandemic. Deposits, for example, grew by 30% in the first half of the year 2020, which means that the bank levy, which had already risen by 287% in the last five years for the German banking industry, will increase significantly once again. A decision on the increase of the tiering factor should therefore be made dependent on all the burdens on the banking system, and in particular on whether they negatively impact the willingness to lend, which is in the next month very important for the recovery phase. With further growing deposits the problems will also increase.

At least, however, the part of the growing central bank money liquidity, which is generated by the ongoing purchasing programs, should be relieved. For these amounts, the burdens would have to be balanced by a consideration in the tiering.

The tiering multiplier should therefore urgently be increased and adjusted to the changed volumes. This would strengthen the resilience of the European banking system and enable it to continue to work with the capital markets to ensure the supply of credit to a recovering European economy.

The European dimensions need to be taken into account

When justifying its use of monetary-policy instruments, the ECB regularly argues that it can thereby ensure that monetary policy is homogeneously effective throughout the Euro area. This basically amounts to the elimination of interest-rate differentials, that persist due to different national credit ratings between the still far too separate financial systems of the member states. Without an - asymmetrical - intervention by the ECB, such diifferentials would be much more pronounced still. The associated quasi-fiscal function of monetary policy has already become the subject of many political and legal altercations concerning European monetary policy.

Monetary policy threatens to lose its independent ability to act

We share the reservations towards such an approach. If monetary policy has to restore the creditworthiness of states by purchasing bonds, it robs itself of its freedom to act, for example, in the case of resurgent inflation requiring higher interest rates. It takes on fiscal functions that

national constitutions stipulate are reserved for parliaments, partly because only parliamentarians can make such decisions transparent to the public. Moreover, hiding fiscal problems behind the central bank balance sheet reduces the incentives for fiscal policymakers in member states to adhere to their budget restrictions.

The division of labor between monetary and fiscal policy must be tidy up

In general, a cooperation between monetary policy and fiscal policy is necessary, on the one hand to deal with the damage wrought by the Covid-19 crisis and on the other hand to promote growth in an era marked by serious demographic challenges. However, the extent of the intergenerational burden shifts must not be decided on the drawing-board at the Central Bank Council, but rather is a topic for the lecterns and voting boxes of the parliaments. Moreover, in the case of monetary union, the development of national debt must not simply be decentralised and placed in the hands of the member states, while such debt is at the same time being centrally funded by monetary policy and market discipline is being prevented. Uncontrolledly ballooning indebtedness would be the consequence. Control of public debt at the member-state level is still necessary, and the Stability and Growth Pact must be reactivated and actively enforced by 2022 at the latest. If the fiscal stimuli under this constellation are not sufficient, fiscal policy must be supplemented at the pan-European level, as has already been done with the decisions on the European Reconstruction Fund. However, this presupposes a much deeper political integration between the member states of the Europeann Monetary Union.

Disclaimer

The present position paper by the Chief Economists does not necessarily correspond to the stance of the **DekaBank** or to the stance of the respective **Landesbanken** and Savings Banks or of the DSGV.

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