Finanzgruppe
Deutscher Sparkassen-
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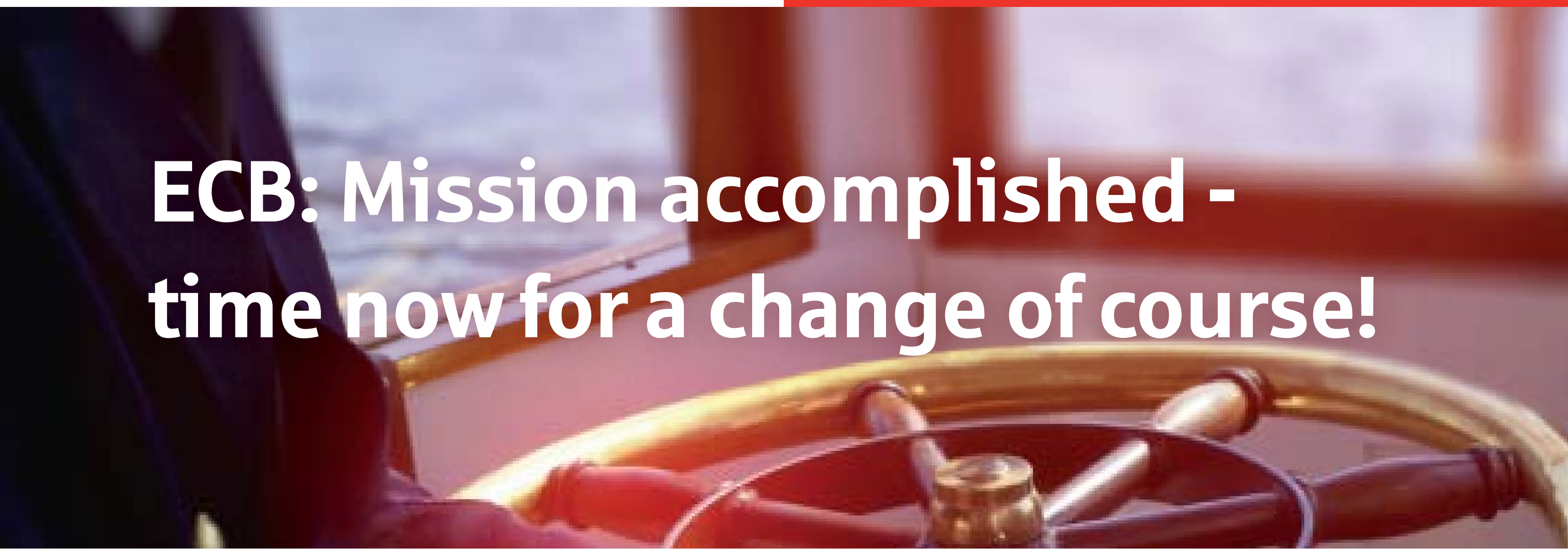
STATEMENT BY THE
CHIEF ECONOMISTS



ECB: Mission accomplished - time now for a change of course!

The Chief Economists of the Savings Banks Finance Group believe that economic and financial policy developments in the euro area are on a favourable - albeit still fragile - path. Over the past few years, the ECB has supported both cyclical activity and the stability of the financial system by means of an ultra-expansionary monetary policy stance. In the Chief Economists' view, however, it is now time to change course. Adhering to the current ultra-accommodative monetary policy stance would carry a large potential risk of spawning fresh disruptions and bubbles on financial markets. It is therefore imperative that policy-makers resolutely lay the groundwork for an exit from their ultra-loose monetary policy:

→ In view of the prevailing outlook for growth and inflation and the overall financial market environment, the ECB should signal that it is thinking about exiting its ultra-expansionary monetary policy in the first half of 2017 and should then decide on initial measures leading in this direction in the second half of the year.

→ The pro-growth reforms undertaken by European governments during the past few decades must not be rolled back. Rather, the tailored policy guidance which (especially of late) has been made available to national governments within the context of the European Semester needs to be implemented in a more determined fashion. In a „Europe of Citizens," it is necessary to find a new balance between growth and distributionen.

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A controversial but largely successful monetary policy alignment

Over the past few years, the ECB has supported both cyclical activity and the stability of the financial system by means of an ultra-expansionary monetary policy stance. The motivation behind this was the singular impairment of European economic activity constituted by the financial and sovereign debt crisis which, after flaring up in 2007, provoked the gravest economic crisis in Europe since the end of World War II.

Unlike their counterparts faced with a comparable situation at the end of the 1920s, economic policy-makers decided to fight the financial crisis of 2007/08 by adopting a Keynesian-style countercyclical policy. According to the Keynesian theory, the state alone is capable of stabilising the situation in times of major economic turmoil with fiscal policy and monetary policy instruments; thus only the state is able to prevent long and deep economic crises of the kind capable of tearing apart the fabric of society.

On a micro level, one can certainly debate whether every single monetary policy instrument that was employed - negative interest rates especially, but government-bond purchases as well - was appropriate. Nevertheless, the strategy deployed has - by and large - proved to be successful. The point of origin for the manifold modes of operation of the monetary policy in question was the extreme degree of interest-rate compression across the board, throughout all segments of the inter-bank and capital markets and throughout all regions of the euro area.

With the support of such low interest rates, policy-makers have managed to engineer a revival in lending across the euro area (even though problems do admittedly continue to persist in parts of the European financial sector). On the basis of the most recently available data from January 2017, bank lending to the private sector has recovered to an annual rate of 2.2%. Fears of deflation becoming entrenched in the euro area have largely evaporated.

Credibility contributes to successful monetary policy

It will take some time before we can assess whether the ECB‘s monetary policy has, on balance, done more good than harm. For the moment, it has to be concluded that the immediate successes have been due, in part, not only to the monetary-policy conception, but also to the stringent way in which the ECB has translated it into practice. The ECB Governing Council has implemented the selected strategy most resolutely, thereby deriving the maximum utility on the capital markets from the instruments used. However, the success achieved is also partly due to the fact that similar strategies were selected by central banks in all of the countries affected by the financial crisis. The upshot was a concerted international response to the (also international) problems posed by the financial crisis. One of the principal goals of this policy was to stave off a deflationary trend, which would have made it even more difficult to cope with onerous debt burdens in the various sectors of economies than was already the case following the onset of the financial crisis.

Institutional initial failings in the Euro Area hindered economic recovery

The situation in the euro area has been aggravated by the fact that the area has not only had to contend with a grave financial crisis (other advanced western economies have had to do that as well), but also with the institutional inadequacies of a still young currency union. Unlike in other currency areas, every member state in the euro area is supposed to maintain its financial soundness through its own efforts and to adopt the necessary real-economic adjustment measures in response to radically altered framework conditions.

The lack of country-specific monetary measures and the self-imposed fiscal rules make it harder for EMU citizens to accept adjustments in the real economy which - although painful - will ultimately render euro-area economies more efficient. It also undermines the acceptability of the currency union if the EMU has to serve as a scapegoat for failures in other policy areas. Especially at a time when national answers are widely regarded as panaceas for all possible shortcomings, the avenue of escape offered by national monetary measures - i.e. the reversion to a national currency - appears alluring.

At this juncture, we would like to point out that a national monetary policy - especially if conducted by small open economies - is less autonomous on an international scale than is often thought, the reason being that a largely independent monetary policy can only be operated by truly large currency areas. Furthermore, monetary measures can cause reforms in the real economy to be postponed ever further into the future. The ECB‘s mandate prevents it from making concessions to the differing interests of the euro area‘s various regions.

The central bank has succeeded in aligning its monetary policy to the macroeconomic average for the member states, even though that has meant it taking account of the needs of the economically weaker member countries and thus of the divergence within the euro area. However, the key feature of the ECB‘s monetary policy stance over the past few years has been to buy time for Europe‘s political class. The idea has been that structural reforms should be put in place to create efficient economies and enable sustainable public debt ratios. Whether the time which has been bought has been made use of satisfactorily is not the subject of this issue of „Statement,“ only whether the time for virtually unlimited monetary support is now over.

A continuation of the ultra-expansionary monetary policy stance can no longer be justified

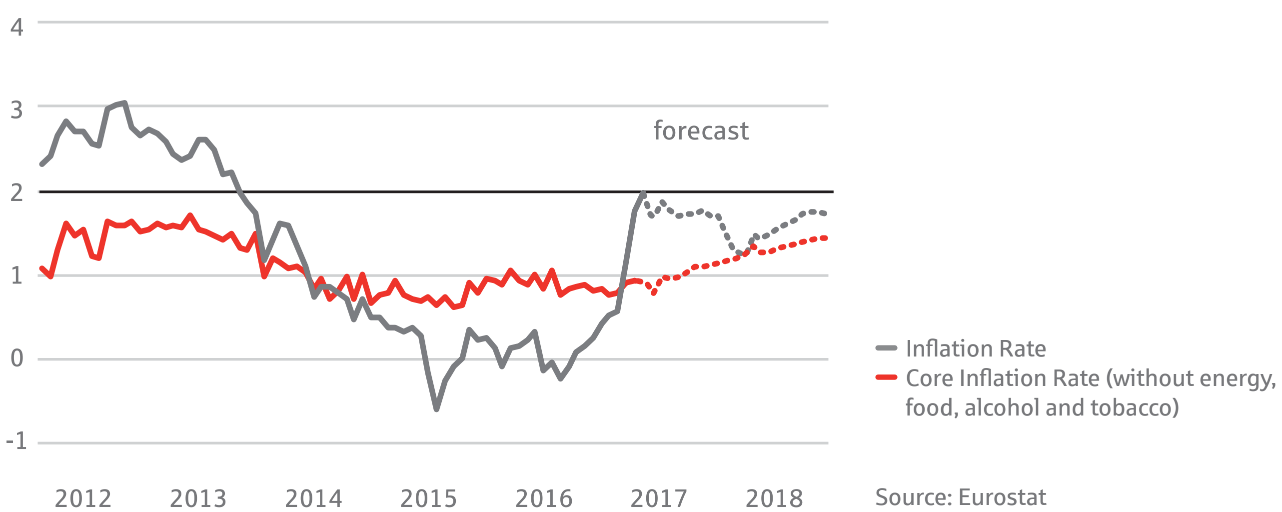
The economic recovery in the euro area, which has been on track since 2014, has laid the foundations for averting the threats of stagnation and/or deflation, most visibly embodied by the trend reversal in commodity prices in 2016. Despite the political stress factors, economic growth in the eur area gained further momentum over the second half of 2016. Thanks to the upward trend, which is mainly being driven by domestic factors, there is a good chance of the upswing continuing. This is provided that there are no political shocks in Europe‘s „super election year“ in the form of a threat to the European institutions from newly elected governments in the Netherlands, in France or in Germany.

If the Euroland economy is spared such shocks, it will, on average, move back to a normal capacity-utilisation rate from roughly 2018 onwards for the first time since the financial crisis. In the following years, tightening labour markets should also once again gradually generate stronger wage - and therefore inflationary- pressure.

Against this backdrop, a continuation of the ultra-expansionary monetary policy stance can no longer be justified, assuming that the current cyclical trend endures. Even if one disregards the collateral damage caused by this monetary policy alignment and uses the narrowest definition of the ECB‘s tasks - i.e. keeping inflation in line with the target of „below, but close to, 2 percent“ - as a yardstick, the degree of monetary accommodation needs to be scaled back in the coming year at the latest.

Otherwise, inflation could overshoot the target in the following years (even though the HICP is likely to drift down again later this year because the base effects from oil prices will be dropping out of the equation in a few months‘ time).

Euro Area Inflation Rate, change over the previous year in percent



Source: Eurostat

After many years marked by an absence of inflation and by fears of deflation, it might be possible to take a relaxed attitude here. However, inflation must not be allowed to swing too extremely in either direction.

An excessively low inflation rate is dangerous because it can be a sign of a shrinking economy, and because, in the case of the euro area, it may once again raise the question as to the sustainability of public-sector and private-sector indebtedness. But an excessively high inflation rate is dangerous too as inflation - even if the target is only overshot to a moderate extent - can induce redistribution from the private sector to the public sector or from creditors to debtors and therefore, indirectly, from poorer to more wealthy citizens, thereby exacerbating social tensions.

Continuing need for structural reforms in all Euro Area countries

Despite all the success stories, though, a serious list of deficiencies is hanging over the European economy. It is legitimate to ask why many economy watchers regard an unemployment rate of 8 percent in Europe as full labour utilisation, and why this „neutral unemployment rate" continues to differ sharply between the various euro-area member countries. Moreover, the overhang of non-performing loans which is still encumbering the balance sheets of a number of European banks (in Italy especially) is not yet really being reduced to a sufficient extent on an area-wide basis.

European public finances also continue to be in a critical state, with only a few member countries set to soon comply again with the public-debt criteria laid down in the Maastricht Treaty. Moreover, the European Commission's Winter 2017 Economic Forecast draws the conclusion that the rise in interest rates which is on the cards will lead to a hardly controllable further escalation in public-debt ratios in most of the remaining euro area member states. It is therefore justified that consolidation of public finances continues to be on Europe's agenda. And, associated with this, many questions which citizens are directing at the business sector and the state remain unanswered, for example how to preserve prosperity and social equality at a time when economic and demographic structures are shifting at an ever faster pace. Not least, it is important to ask oneself why citizens are becoming increasingly unwilling to accept the European (Monetary) Union.

All of these topics are major challenges for German, as well as for pan-European economic policy-makers. But they cannot be resolved by means of monetary policy. At a time when the population is becoming less willing to accept a political approach which focuses too strongly on globalisation and liberal positions, there is admittedly a great temptation to inflate away material problems by pumping out money. On the other hand, we cannot agree with the proposals put forward by what we view as perverse Keynesian models - which although they are also not advocated by most

ECB Governing Council members, they nevertheless surface repeatedly in the international debate, especially in order to criticise German fiscal policy. According to this brand of neo-Keynesianism, growth is to be generated by permanent large-scale deficit spending, with the necessary monetary policy backing in the form of bond purchases and a perennial zero-interest-rate paradigm. In our opinion, such an economic policy philosophy would sooner or later result in the breakdown of our monetary system.

Zero-interest policy inhibits market-based adjustments

The monetary policy operated so far has been visibly successful, but adhering to such a stance beyond this point will entail the following problems. If production capacity becomes scarcer again, a monetary policy producing „money for nothing" will cloud the judgment of an increasing number of decision-makers when it comes to assessing which investment projects could prove viable in the long term. In other words, such a policy channels today's investment spending into tomorrow's abandoned cathedrals in the desert. Such a policy reinflates speculative bubbles on financial and real-estate markets and creates a risk of bank failures. Conversely, a zero interest-rate regime keeps too many companies above water which, although doing their utmost to keep up with the pace of change in technological framework conditions, would be hopelessly outgunned by new market participants. In the medium term, such a zero interest-rate economy would lose considerable ground, especially in the wake of the current recovery.

A zero interest-rate economy would affect savers in particular. It is a reason for concern that savers are showing an increasing preference for liquid, short-term forms of investment and, for example, that no fewer than 58% of those questioned in last year's DSGV „Wealth Management Barometer" (October 2016) were most worried about the ECB's negative interest-rate policy. Furthermore, cost pressure is mounting at insurance companies, building societies specialising in home loans, banks and savings banks. Net interest margins are dwindling. If the current negative interest-rate policy continues to persist, it will be difficult for banks to prevent these conditions from being passed on to retail customers and small and medium-sized enterprises in the long run. There is a threat of damage to the regional credit bank model - which, as a factor promoting stability, is essential for the financial system in mainland Europe. Were this threat to materialise, the financing of small and medium-sized enterprises would likewise suffer.

It would be very wrong to underestimate the ratchet effect of an extreme policy which is clung to for too long. Such a policy would spawn an over-production of credit on financial markets and give rise to fresh overshoots or bubbles, to the point where a correction would scarcely be possible. In such a predicament, central banks would then be obliged to increasingly prioritise the goal of financial stability over the goal of price stability; interest rate hikes would no longer seem bearable; and the process would therefore become a self-reinforcing spiral.

Heading for the exit, but not too quickly

As the Federal Reserve has demonstrated in the USA, it is possible for a central bank to begin exiting its ultra-expansionary monetary policy without plunging the economy and financial markets into a lasting abyss of uncertainty and chaos. The precondition here is presumably that the central bank has to head for the exit in a highly cautious manner; translated into the language of monetary policy, this means winding back the ultra-accommodative policy stance over a period of several years while using communication to sufficiently prepare financial markets and enterprises for the change in monetary conditions.

However, the pace at which the ECB exits its unusually expansionary monetary policy will also depend on economic developments. At last December's Governing Council meeting, the ECB decided to scale back its monthly asset purchases to the (still high) figure of EUR 60 billion from this April onwards. At the same time, however, the ECB announced that purchases of this magnitude would continue until year-end 2017. It would therefore be wrong to construe the amendments which the ECB is planning to make to its asset purchase programme as a first step towards exiting its ultra-expansionary monetary policy. The ECB should signal in the first half of this year that it is considering heading for the exit, and should then communicate a corresponding decision in the second half of 2017 in the light of the prevailing growth and inflation outlook and the overall financial market environment. A prerequisite here, however, is that political developments do not trigger any further uncertainty shocks.

Prepare financial markets for exiting ultra-expansionary monetary policy

Two or three years could elapse between the first step towards winding down the asset purchase programme, the end of reinvestment, the decision to raise the deposit facility rate currently in negative territory, and higher money market rates. Only when the deposit rate has been raised to a sufficiently high level of around 1.0 percent could a broader interest rate corridor encourage commercial banks to once again build close relationships on the money market, thereby making themselves less dependent on ECB refinancing.

If the ECB intends to implement such an exit roadmap in the coming years, even in the midst of uncertain economic development, it needs to evolve the requisite concepts now and should start to send out initial signals in this direction before too long.

Economic policy is a matter for governments, not for central banks

Politicians across Europe need to support the ECB by increasingly shouldering additional tasks (growth generation and ensuring both financial-market stability and the cohesion of the currency union) which have been performed by the central bank in recent years.

National governments can give significant support to the revival in economic growth by refraining from rolling back the pro-growth reforms of the past few decades (recently reinforced by the European Commission's new European Semester). Demographic obstacles to growth can be counteracted by a carefully managed immigration policy. If national resources are exhausted, there should be greater European participation to tackle the necessary investment in infrastructure and education.

However, Europe's citizens no longer desire growth per se but rather growth for all, i.e. equitable growth distribution. In this context, the challenge facing politicians is to seek new forms of social equality in 21st-century service economies and to conduct a dialogue with citizens regarding this issue. It is our view that the instruments used by a social free market economy do not need to be completely redefined but rather newly honed.

High public debt can not become the driving force for monetary policy

When it comes to ensuring financial stability, especially important factors are the trend in new lending and the treatment of debt hangovers from the time of the financial crisis. The political class needs to join forces with the private sector in the various member states, with the European Central Bank and with the national supervisory authorities in order to promote the disclosure and write-down of non-performing loans.

Public finances are at the heart of the debate regarding new lending too. One argument in this connection is that the public finances of financially weaker member states, in particular, could not cope if the ECB were to raise interest rates. Quite apart from the fact that such an argument violates both the spirit and the letter of the ECB's mandate, it is also extremely unreasonable from a political point of view. There is a danger of central banks being used on a permanent basis to guarantee public debt which would otherwise be unsustainable. Such a scenario would also jeopardise the stability of the financial system in the long term. The implication is that fiscal policy alone can nurse Europe's public finances back to health.

In the very long term, the European Monetary Union will not be able to avoid a scenario in which the strong regions support the weak ones - which is what happens in every functioning currency union.

In the period between spring 2017 and spring 2018, probably as many as two-thirds of the European Monetary Union's citizens will be electing new governments. Yet the climate is dominated by deep-seated discontent in the face of rapid economic, societal and technological change, with many feeling that too few answers are being provided to the challenges in question. The point is that politicians can only generate such answers through a dialogue with the continent's citizens.

At the latest when the legislative session for the new governments gets underway, it will be time to focus fully on the major questions concerning the future of Europe and its economic system. It is not for the central banks to pave the financial way for an unending debate about how such a future should look. It is now up to the governments to take over.

Disclaimer

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

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