Sunday Wrap

Happy Sunday,

It's been a rough week in markets, with the mid-week selloffs triggered by further evidence in both the US and Germany of the pronounced weakness in the manufacturing sector now beginning to spill over into services. Friday's lukewarm US payroll numbers did nothing to convince markets of better times ahead.

As I have discussed before, in my assessment, it was the contours of this potentially significant global slowdown that earlier this year led Draghi to step up calls for fiscal action, and – when nothing seemed to be coming - virtually pre-announce a big monetary easing back in June in Sintra. Not first-best, but if you are the "only game in town", you'll have to try – particularly when you continue to undershoot your inflation target. With two-thirds of the Governing Council agreeing, at their last meeting the ECB decided on the package of further easing.

Afterwards, some of those in the minority went public with their disagreement (via interviews in the tabloid press and brief Twitter-like statements), while Philip Lane defended the policy package in a detailed speech at a public Bloomberg event in London.

This past week saw the debate of the policy stance among (the overwhelmingly critical) financial sector executives gain some nuance. On the one hand, Allianz CEO, Oliver Bäte, stepped up his long-running unhappiness with the ECB with a claim that necessary fiscal consolidation in the eurozone is being avoided because the ECB is holding interest rates too low. In other words, as I understand him, Bäte believes that higher interest rates are desirable because they'll lead to fiscal tightening, and – apparently – that this policy combination would be good for the European economy. On the other hand, my boss, UniCredit CEO, Jean Pierre Mustier, speaking in his capacity also as EBF president, said that "you have to be careful complaining about one leg [of the policy] without taking into account the second leg", because while negative rates are bad for net interest income, they have – in combination with other parts of ECB policies – supported the real economy which, in turn, is "net positive" for the financial sector.

Then on Friday, the criticism of ECB policies escalated to a more problematic level. Former ECB chief economists Otmar Issing and Jürgen Stark, along with two former governors of the Dutch and Austrian central banks, as well as (pre-Euro) Bundesbank, and a former deputy governor of the Banque de France published a pretty explosive memorandum claiming that the ECB is misinterpreting its mandate of price stability, raising their "suspicion that behind this … lies an intent to protect heavily indebted governments from a rise in interest rates [and that] … from an economic point of view, the ECB has already entered the territory of monetary financing of government spending, which is strictly prohibited by the Treaty." Their memorandum is here: Memorandum on ECB Monetary Policy by Issing, Stark, Schlesinger

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In today's note, I'll argue that:

- **Monetary policy – in combination with additional regulation, too slow adjustments in parts of the banking system and fiscal tightening – has indeed caused severe stress in the financial system.**
- **But given its mandate, the ECB had no choice but to pursue its inflation target – and I'll argue that the criticism is misplaced, including how precisely price stability is defined.**
- **Beyond disputes about details in policy-making, the culprit in this sorry state of affairs is the fiscal authorities. It's high time to address the short-comings. I'll summarize my suggestions.**

I'll take them in turn:

1. Monetary policy: The backdrop.

I'll be brief here because I have argued this case before, but in a nutshell:

As the financial crisis hit some ten years ago, the fiscal toolbox was employed to a staggering extent throughout Europe to bail out banks and their shareholders to the tune of 10%-15% of GDP, including in Germany and the Netherlands, but not in e.g. France and Italy. Thereafter, the fiscal wisdom quickly changed to worshipping austerity instead, which was implemented to the tune of a whopping 3.5pp of GDP during 2010-13 (for the eurozone as a whole). Only about a year ago did the overall fiscal stance shift to being marginally stimulative, particularly in Germany.

As a result, monetary policy became "the only game in town" to help nurture the European economy back towards full employment. When the required monetary easing to meet this huge task (broadly speaking illustrated by the ECB meeting its inflation target) far exceeded what could be achieved by the normal monetary policy arsenal, we got negative rates, QE, forward guidance, etc., to flatten the curve.

This cocktail of monetary policy measures, along with an unprecedented amount of (uncoordinated) regulations, cut profits at banks to levels well below that of almost all other sectors, even though the banking sector set out to tame their cost base, including by cutting about 25% of jobs. This drove capital allocation away from banks, thereby raising the cost of term financing.

So, another form of "life-support" was provided instead of the bail-outs, now in the form of term financing at low rates from the ECB because – for political reasons, and because of the continued lack of a proper banking union – bank closures, and cross-border mergers (which would help increase productivity, and reduce risk, in the sector), still seem to be politically unacceptable. Not by the ECB, but by the national governments.

This policy mix of super-easy monetary policy and tight-to-neutral fiscal policies had three key consequences:

First, it imposed a huge cost on the financial system. Banks were kept alive via the TLTROs and now tiering (the ECB had no choice because they needed to protect the transmission mechanism). Pension funds and insurance companies, restricted via regulation to move toward riskier assets to seek better returns, also suffered; with defined benefits pension funds in serious trouble.

Second, QE provided a boost to asset prices, benefitting asset owners and companies which saw their funding costs decline. Some of this drizzled through to the real economy, but the distributional effects became excessive, as the non-asset owners were not compensated.

Third, the single biggest beneficiary of monetary policies – the governments via lower cheaper financing – chose to use the lower funding costs to lower their fiscal deficits, rather than channel the benefits back to the real economy. One interpretation would be that this will benefit the young and future generations via lower public debt, another interpretation (which is more in line with normal economic thinking) is that it's a lost opportunity to invest to improve the prospects for the young and future generations.

2. Why the ECB's critics are wrong on the economics and policy implications.

On this Sunday - following the release of the highly critical memorandum by a number of prominent European economists, who have previously served as senior central bankers, in which they accuse the ECB of fiddling the definition of their mandate, possibly for political reasons, while staying clear of any economics arguments - I cannot help longing for a European debate more like in the US.

As you may have noted, also this past week, Brookings hosted a public event at which economists and former central bankers, including Janet Yellen and Ben Bernanke, debated "What's (not) up with inflation" and the policy implications. Setting the scene, Yellen observed that "If the Phillips curve is very flat, and if inflation expectations are insensitive to fluctuations in actual inflation, the Federal Reserve may be able to run the economy hot, yielding significant benefits to workers, while imposing only minimal costs on society in terms of the higher inflation, [and] … a high-pressure economy improves upward mobility. We're seeing that in the current expansion. Those who are least advantaged in the labor market—those with less education and minorities—are experiencing the largest gains in wages and declines in unemployment." Former Fed Chair Janet Yellen on why the answer to the inflation puzzle matters

Many things are wrong in the US these days, but not the type of debate US economists and former central bankers are having. Indeed, isn't this precisely the type of debate European economists and former central bankers should be having now, rather than whether the monetary policy stance has led to inappropriately large fiscal deficits? Reminder: On latest Eurostat numbers, eurozone fiscal balances will range this year between +2.4% of GDP in Luxembourg and -3.0% of GDP in Portugal, and among the big members between +1.7% of GDP in Germany and -2.5% of GDP in France and Spain - and, since you asked, -2.1% of GDP in Italy.

Forgive me, but I can't help wondering if we haven't gotten our focus all wrong here! So, let me provide my two cents' worth on this debate, in the hope that we can get on to the right type of topics.

I'll make three arguments on inflation and the ECB in this section, followed by my broader conclusion:

First, a central bank with an inflation target must take that target seriously, both because of its credibility and hence ability to shape inflation expectations, but also because very low inflation, say around 1%, is a lot more dangerous to long term growth than moderately higher inflation of, e.g., 2%-5%.

Second, while it's easy to believe that "real" (or properly measured) inflation is different (higher) than the index targeted by the ECB, it's a non-starter for a policy debate.

Third, to suggest that the ECB is holding interest rates low to protect heavily indebted countries (from what exactly?), and/or should implement policies to encourage a certain fiscal policy, would not only breach the ECB's mandate, but would violate democracy more broadly.

First, the issue of inflation. We all agree that deflation is dangerous and should be avoided at (virtually) all costs. In this context, I was surprised to read Issing et al postulate in their memorandum that while the "2014 … ultra-loose policy [was claimed to be justified] by the threat of deflation … there has never been any danger of a deflationary spiral". That seems easy to say in retrospect, but this certainly isn't my memory of 2014. Rather, my sense from looking at the numbers at the time, and speaking daily with financial markets participants and key members of the corporate sector across Europe, was that the risk of deflation was real and that it declined – and has remained low - precisely because of ECB action.

More broadly, there is no economic evidence that moderate inflation below 5% is harmful to real economic growth, but there is plenty of evidence that very low inflation of barely over 1% is detrimental to long-term growth – and the reason for the empirical evidence is pretty straight-forward:

Think of it this way: In a dynamic (growing) economy, you'll need a constant rotation of resources – both of labor and capital – to seek out the latest opportunities. Such rotation of resources needs to be driven by changes in relative prices and wages. And since price changes (particularly for wages) tend to be sticky when they approach zero, an average inflation rate of, say, 1% leaves virtually no room for the optimal change in relative prices and wages. It would be so much easier if the index were to be, e.g., 3%. Anyone advocating 1% inflation need to consider the risk of a slippery slope towards Japanification.

Furthermore, headline inflation (i.e. including energy prices) is pretty volatile, so if it runs at an average of 1% over several years, chances are that it'll be negative in some periods, e.g. due to an energy price shock. And any time you go through a negative inflation period, you'll have to worry (at least a bit) that it takes hold via second round effects.

Second, the issue of the index and what inflation really is. I often hear the claim that the inflation index targeted by the ECB (the HICP) does not accurately measure "true inflation". There is the peculiar claim by some that they "know better" what average inflation really is, but this is, of course, nothing more than a confusion of their personal consumer basket with the average basket represented by the index.

Then there is the more complicated claim that the ECB should take asset price inflation into account beyond the issue of financial stability. However, for many of those making this argument, the key concern is real estate prices – always expressed by people sitting in one of Europe's great cities. But surely, real estate prices in selected German (or other) cities cannot be an objective for the ECB! Simple tax measures, along with selected local regulation, would easily dampen such house prices, if desired.

Finally, there is the very important issue raised by Issing et al on asset prices more broadly and the risk of a disruptive correction: "The negative impact of the ultra-low interest environment extends [to] … the re-distribution effects in favour of owners of real assets, [and that] create serious social tensions. The young generations consider themselves deprived of the opportunity to provide for their old age through safe interest-bearing investments. The search for yield boosts artificially the price of assets to a level that ultimately threatens to result in an abrupt market correction or even in a deep crisis."

I'll make three quick points on this: (i) the social tensions are clear, but it should be addressed via fiscal policy, and there is plenty of room to do so, re the next section; (ii) in their (surely well meant) concern for the young generation, are these prominent former central bankers really calling for the mirage of a "safe interest-bearing" asset – guaranteed positive return on investments without risk? I'm very surprised by this; (iii) has the search for yield "artificially" boosted the price of assets to a level that ultimately threatens to result in an abrupt market correction or even in a deep crisis"? Possibly, but I truly struggle to see the bubble extended beyond specific assets (e.g. certain EM countries, specific stocks, or specific areas of real estate) to systemically important asset classes. But of course, this is an issue for debate – and it emphasizes the need for a better-balanced policy mix.

Third, in my opinion, to suggest that the ECB is politicizing monetary policy by not raising rates because of a hidden agenda to protect some fiscal authorities is to confuse the elected political class with the power of appointed technical experts. I certainly do not agree with the fiscal policy stance in most countries, and even less so with the composition of revenues and expenditures in almost any country, but to suggest that a central bank should run policies to encourage a certain fiscal stance would not only breach its mandate but challenge the very foundation of our democracy.

It would be no different than a supreme court refusing to hand out sentences until Parliament changes the legal code to its liking. In other words, a dangerous power grab by an independent institution of experts with a specific mandate relative to the elected officials who appointed them.

So that leads me to a rather easy conclusion:

3. The policy mix is wrong – it's time to use the fiscal room.

ECB policies are clearly stressed beyond reason and this has severe implications for the effectiveness of policies. It also implies a risk to long term sustainability, including via the distributional effects in society of such a skewed policy mix. This desperately needs to be addressed via fiscal expansion in tandem with a gradual adjustment in the monetary stance back towards normal.

I suggest the following four key policy changes in the eurozone:

First and most importantly, the Eurogroup should announce that they take co-ownership of the inflation target until headline inflation expectations are solidly anchored close to 2%. And to put their money where their mouth is, the eurozone national governments should announce a massive coordinated fiscal expansion of 2%-3% of GDP over a three-year period, starting immediately with at least 1% of GDP, focused first on tax cuts for (primarily) youth employment, as well as spending on educational programs.

This should be calibrated across Europe with a view to the available fiscal room. However, with the opportunity for governments to lock in present funding costs for the next ten years, there really is a good deal of fiscal room in most countries. For example, for decades up until the financial crisis, Germany and France spent typically 5%-6% of their fiscal revenues on interest payments, but now less than 2% in Germany and a bit more than 3% in France. Italy spent more than 20% of its revenues on interest payments back in 1980-90, a number that fell to about 12% just before the crisis, but is now down to less than 10%.

In addition, as argued by, e.g., Olivier Blanchard in a recent lecture, history shows that when nominal interest rates are lower than nominal GDP growth, the fiscal cost of higher debt is very small, if not zero. The OECD made the same argument, calling for the fiscal levers to be used, in their Economic Outlook publication all the way back in 2016. Blanchard's very readable paper is here: Public Debt and Low Interest Rates.

Second, at the EU level, the new European Commission should design and implement a large investment program in digital infrastructure and university education across Europe, at least on the order of 1% of GDP. The EIB could be helpful here.

Third, as fiscal measures are rolled out, the ECB should gradually raise the depo rate to zero, wrapped in detailed communication to explain that this is a coordinated policy move along with the fiscal and institutional story, and that it is not to be interpreted as the beginning of a tightening cycle. In addition, the ECB should announce a fast-track review of monetary policies ala the ongoing Fed review. I would suggest that such a review could be conducted and concluded within 6-9 months.

Fourth, rapid progress should be made towards completion of the banking union and a refocused capital markets union aimed at encouraging equity (in all its forms) over debt, including on the balance sheets of pension funds and insurance companies.

And on that note, I'll move on to other work – and begin to look forward to a few days off this coming week on the beautiful Danish coast from where, as you know, the citizens of Lake Wobegon came. And, as you know, according to Garrison Keillor, at Lake Wobegon, "all the women are strong, all the men are good-looking, and all the children are above average". (Just a shame all those fine people left Denmark for Lake Wobegon…)

Best

Erik

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