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Inflation is Dead, but Not German Angst: How the Monetary Policy of the ECB Undermines the Culture of Stability

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The recent expansionary course of the European Central Bank confuses Germany. Getting the southern members of the eurozone out of recession is important, but the price could be damage to domestic savings, fading enthusiasm for reforms in the eurozone and more lax approaches to inflation in the future. In addition, the anti-deflationary bias in the eurozone can mark a point from which the traditional German macroeconomic preferences stop pushing themselves forward. Berlin needs allies to defend those preferences and Poland seems to be among them.

In early June, the European Central Bank made monetary policy history by cutting the interest rate from 0.25% to 0.15% and pushing the deposit rate into the negative, -0.1%. Not only borrowing became cheaper than ever but also savings have become rather unprofitable as well. The idea behind these measures was simple: money should leave quiet bank accounts and start to fuel investment in companies and consumption in the eurozone.

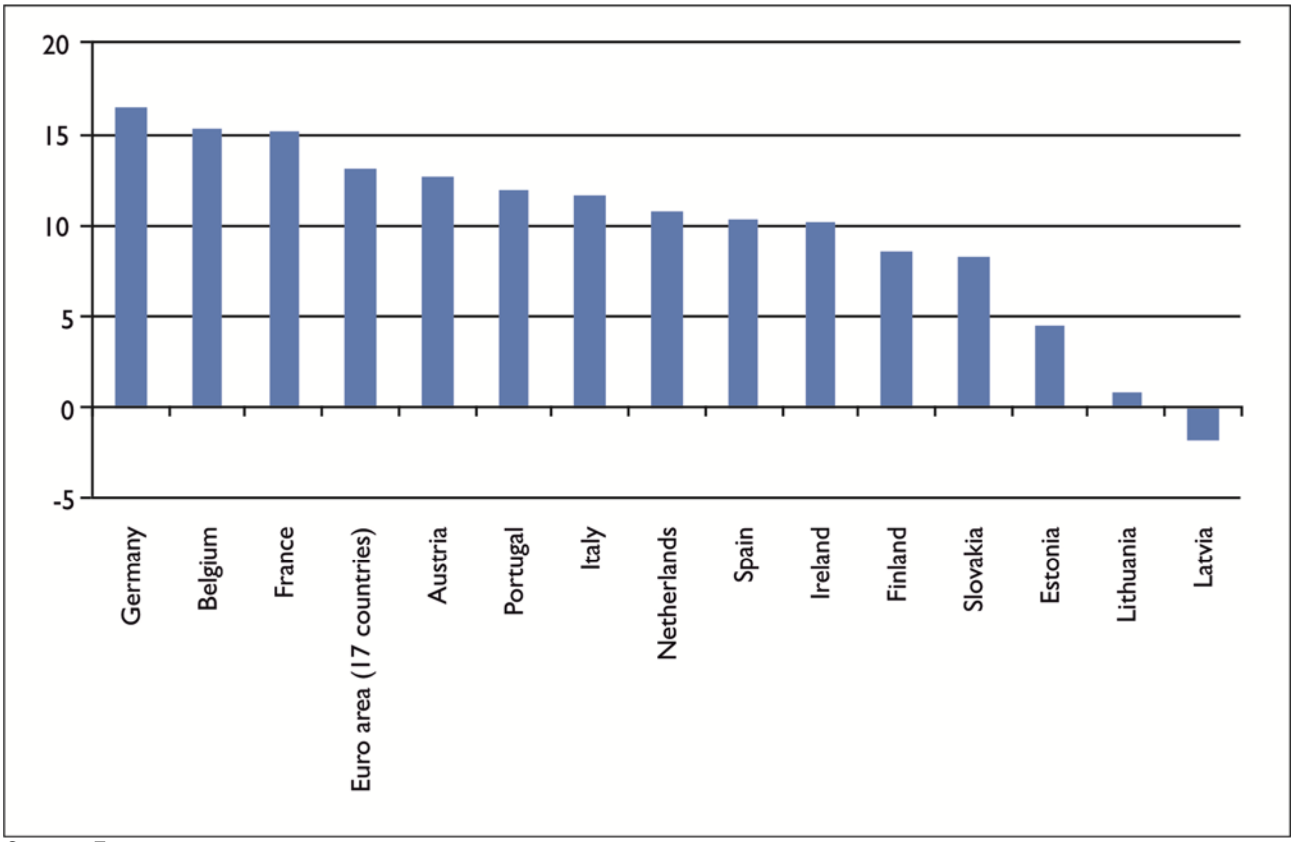
It does need it, indeed. Many countries of the monetary union have still not recovered from the last financial and economic crisis and are plagued by stagnation and high unemployment. The monetary union has been on the brink of deflation, which can destroy for years dreams about a comeback to the pre-crisis levels (similar to Japan in the 1990s). The falling prices discourage investment, which is the most desirable engine of growth.

This tough experiment by ECB chief Mario Draghi does not make all of the Member States happy. The biggest nit-pickers have been the Germans. They expect the rate cuts to increase economic risks for which their country will pay a particularly high price.

From a Culture of Saving to a Bubble Economy

The most outspoken fear of the new direction concerns one of the distinct features of German capitalism: a high level of savings, or more broadly, a culture of saving. The temper of households to reduce current consumption in order to invest and have more income in the future has been traditionally almost unbeatable in Europe. While the average of the EU28 in the last quarter of 2013 was 10.06%, Germany reached 16.4%[1] (Figure 1).

Figure 1. Household Savings Rate in 2012 in selected eurozone countries, in percent



Source: Eurostat.

This performance has many roots. It is not only about the high GDP level, which naturally encourages savings and the country's protestant culture, which sees salvation in self-restraint. It is also about the institutional environment, which includes a variety of banks, mutual funds and insurance companies along with financial incentives from the state. The latter have become particularly high after the government started generous support of private pension schemes (Riester Rente).

According to the German Institute of Economy (DIW), in 2012 some 47% of Germans of age 17 or older had average savings of €29,000. More than half of them (51%) had life insurance or a building society account with an average of €18,000.[2] There are fears that Draghi's experiment will make many of these German small savers much poorer. One of the popular low-risk savings schemes offered last year just €19 on a €10,000 investment annually. Soon, even this won't be guaranteed[3] and if the government wants to ease the problem, some generous relief on taxes imposed on capital income will be necessary. Another challenge is the condition of insurance companies, which have begun to have massive problems keeping their previous premises on profit rates on life insurance schemes. The government has tried to help them but there is no golden path here. The guaranteed rate will be lowered from 1.75% to 1.25% in 2015, but this will lead to a further weakening of savings.[4]

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[1] Eurostat, "Household saving rate stable at 13.0% in the euro area and down to 10.6% in the EU28," 30 April 2014, www.epp.eurostat.ec.europa.eu.

[2] DIW Berlin, "Vermögen in Deutschland: Durchschnittlich 83.000 Euro für jeden - aber höchst ungleich verteilt," 26 February 2014, www.diw.de.

[3] M. Fabricius, "Sparen ist jetzt nur noch eine ökonomische Dummheit," *Die Welt*, 12 June, 2014, www.welt.de.

[4] *Spiegel Online*, "Reform: Garantiezins auf Lebensversicherungen sinkt—SPIEGEL ONLINE," 27 May 2014, www.spiegel.de.

A systemic consequence could be the growth of a bubble economy. With low interest rates in the money market, the owners of capital will look for profit opportunities on the asset and stock markets and in real estate. It is not by accident that DAX, the main index of the German stock market, climbed to 10,000 right after the decision by the ECB. Booming prices on the real estate market have been observed for a long time,[5] and now Minister of Finance Wolfgang Schaeuble warns explicitly of the danger of a bubble.[6] This new environment can lead not only to sudden price moves and instability, it also may have some consequences for social coherence because it gives the rich an upper hand during a deflationary period. They can simply use their savings as collateral to borrow more money and invest it in such things as U.S. government bonds, which still offer 40 basis points more than the German ones. The middle class, without such financial firepower and facing transaction costs in international operations, can only accept losses or start a bit of desperate consumption.

Inflation Instead of Reforms

German ideas for the eurozone to help it recover from the economic and financial crisis were rough, straightforward and very conservative. Crisis-ridden countries should apply austerity measures in spending policy and start supply-side reforms, such as cuts in social spending, increasing the flexibility of their labour markets, while making bureaucracy smaller and more efficient. This, after a period of painful adjustment, should lead to lower costs, lower prices, increased competitiveness, higher demand and finally economic growth combined with higher employment. The eurozone's south has never accepted this "suffer feast" and successfully pushed to soften the strict German course.

The recent ECB decisions may mark a cornerstone in these attempts, since they create a friendly macroeconomic environment to take a break from harsh reforms. It is not only about the close-to-zero interest rate policy but also the weaker euro. Manuel Valls, the French prime minister, complained in May that the euro is too strong.[7] He should be happy now since the common currency after the ECB decision in early June dropped to the dollar from $1.40 to around $1.35 a month later, with $1.20 not an abstract scenario. In the eyes of the German "currency guardians" this is not good at all. Jens Weidmann, the president of the Bundesbank, said that other players of the global economy will simply do the same and the spiral of devaluation can lead all to worse economic performance, because, after all, "competitiveness cannot be achieved by devaluation, it is created in companies by making good products that can contend successfully on markets."[8]

But this "tedious" view on macroeconomics has been forced on the defensive. If the situation in the eurozone does not improve soon, even more aggressive measures are plausible and could be implemented. The ECB can offer such solutions as more money to banks on the condition they transfer it into loans for companies (a so-called TLTRO, or "targeted longer-term refinancing operation"). But Germany fears much more the potential purchase of government bonds by the central bank. This would mean not only a massive monetary expansion, but also a breach of one of the fundaments of the eurozone: a ban on financing government deficits by the EBC.

In 2010 and 2011, the bank made the first step towards this by starting a bond-buying programme worth more than €200 billion. Germany agreed but also convinced Draghi to neutralise potential inflation by relatively high deposit rates, which should take the issued money out of the market. In summer 2012, the ECB announced the unlimited purchase of bonds if things go wrong. This readiness went too far for Berlin. Luckily for all, the relatively calm situation on the financial markets in the last two years has silenced the proponents of radical measures. But if deflation still looms, the ECB may go back to this idea and start massive quantitative easing, just like the U.S. Fed did. Since the market for corporate bonds in Europe is weak, the only feasible alternative may remain government bonds.

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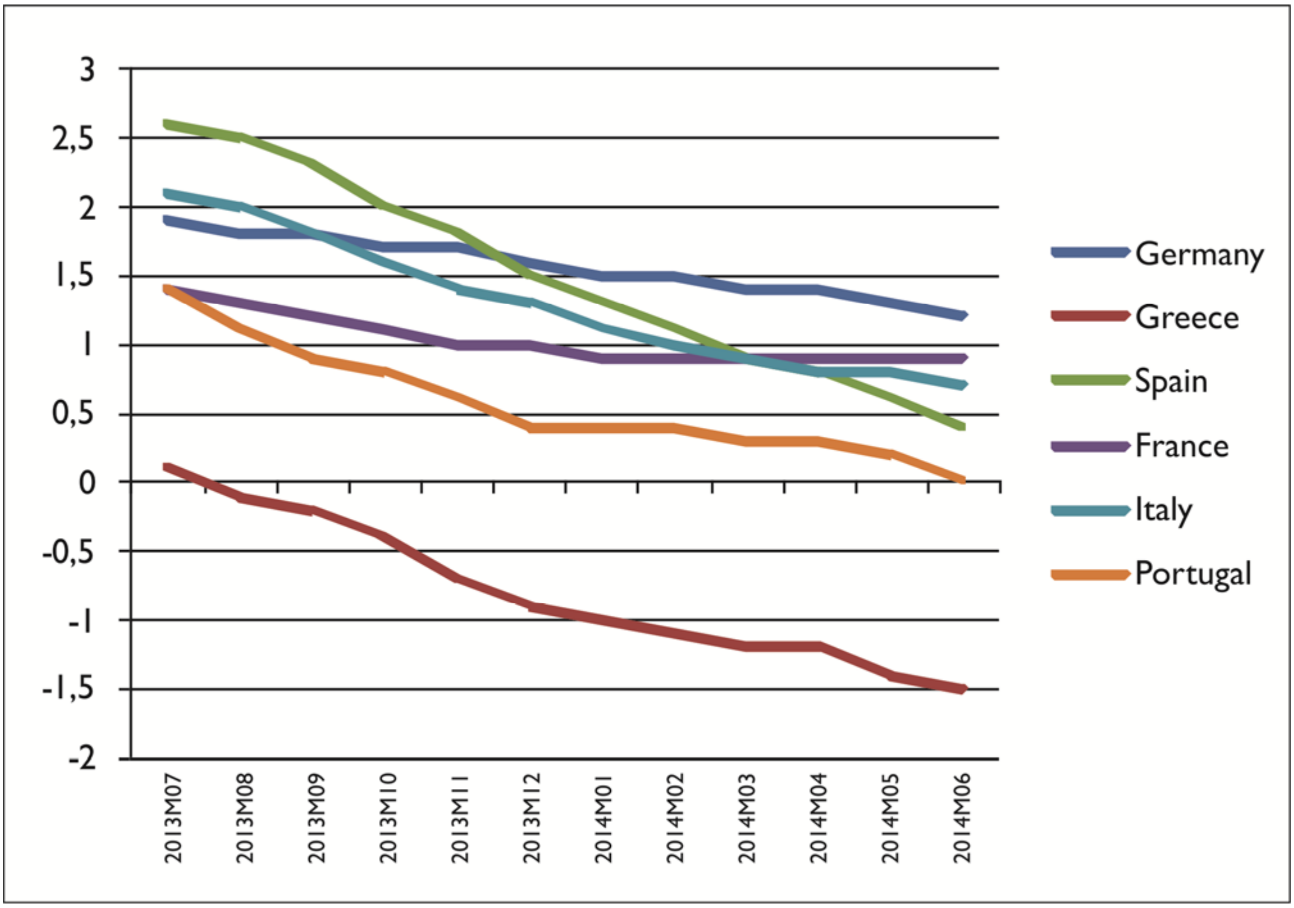
[5] Deutsche Bundesbank, "Die Preissteigerungen bei Wohnimmobilien seit dem Jahr 2010: Einflussfaktoren und regionale Abhängigkeiten," *Monatsbericht* 13–29, October 2013, www.bundesbank.de.
[6] *Frankfurter Allgemeine Zeitung*, "Schäuble warnt vor Immobilienblase," 19 June 2014, www.faz.net.
[7] Reuters, "French PM Valls says euro too strong," 3 May 2014, www.reuters.com.
[8] *Handelsblatt*, "Bundesbank-Präsident gegen weichen Euro," 15 June 2014, www.handelsblatt.com.

At the end of the process, many Germans foresee rising inflation, their traditional nightmare usually associated with dramatic pictures from the 1920s. This concern may seem absurd with all the talk about the threat of deflation, but there is a reason casting more light on the German position. Inflation indexes showing averages for the last 12 months are higher than in Southern Europe and some expect a longer trend behind it (Figure 2). Germany has a very low level of unemployment, so any kind of monetary push can translate into a quick rise in wages and prices. In such a scenario, companies can face higher costs and lose their cost-export competitiveness. This would have been a reversal of what Germany achieved in the past and what enabled its current economic prowess: impressive wage restraint. In addition to that, low and anticipated inflation rates have helped companies to bargain better about long-term wage arrangements with trade unions and work committees. Traditional industry branches in particular are not keen to lose this advantage.

Figure 2. Harmonised Indices of Consumer Prices (HCIP), percentage change, 12-months average in selected eurozone countries



Source: Eurostat.

Fading Shine of the German Model

Hans-Werner Sinn, director of the Institute for Economic Research IfO in Munich, called the ECB decision a "desperate attempt" that could start a massive diversion of capital flows in the eurozone in order to stimulate the southern economies."[9] For many Germans, it is simply another "transfer union"—a project that they have fiercely fought—introduced now through the backdoor. This may be perceived as a political defeat and evidence that their vision on how the European economy should work is losing the ability to push itself forward When the financial and economic crisis reached its climax in 2009, it was quite obvious

[9] CESifo Group Munich, "Ifo President Hans-Werner Sinn criticizes ECB's decisions," 5 June 2014, www.cesifo-group.de.

to think about the German model as a template for economic reforms in the crisis-ridden countries and for European economic governance. The combination of strong stabilisation bias and flexibility of the labour market seemed to be a golden path to recovery. It might sound like a paradox, but it is not the eurozone and its members who have become German but rather Germany which has drifted, though not always voluntarily, from its traditional path.

Monetary policy bias could be a good example of this. Since the 1970s, Germany had dominated this area of economic integration with its obsession on inflation. The "currency snake," the European Monetary System, the independence of the ECB and finally the definition of monetary stability at 2% of inflation all expressed German considerations. This domination is near its end now. Not only has Draghi's experiments with interest rates marked the end of it but also attacks on the German position that the current 0.5% inflation rate is a sign of monetary stability. No, say the opponents, it is the same condition as when 3.5% of inflation deserves intervention by monetary authorities. The eurozone partners expect the European Central Bank to be more active, ready to experiment and take up responsibility for not only monetary stability but also unemployment and growth, quite far from the Bundesbank pattern. This debate coincides with a symbolic issue: after Lithuania joins the eurozone in 2015 Germany won't be represented at every meeting of the ECB board. This is a result of the voting rotation system introduced more than a decade ago when nobody thought about a eurozone with close to 20 members. Many in Germany would like to see that change and a regular place for the biggest economy in Europe at the table be restored. They also fear that other countries may use this opportunity to rebuild the ECB and degrade the importance of monetary stability.

German capitalism seems to have adjusted gradually to the new, central role of the ECB and new orientation of monetary policy. The financial sector has gradually become more open and dynamic. In the past, Germans were happy to have a *Sparbuch* with a small but guaranteed profit. Now they are forced to make friends with a stock market scorned a decade ago as "casino capitalism" and investment funds labelled as locusts. They should look for opportunities in speculation on highly volatile asset markets or in real estate. This shift has been speeded by the "unpredictable" approach of the ECB. Another example is the introduction of the minimum wage—an almost obvious institution in other EU countries—which weakens the old corporatist German model and shifts more power of the labour market processes to the central bank and the government. Taking all that into consideration, one should not be surprised about confusion in Germany. Thomas Straubhar, director of the Hamburg World Economy Institute (HWWI), pronounced the recent decisions by Draghi as "the end of capitalism."[10] But what is approaching is in fact a more rough and unpredictable version of it.

Conclusion: Poland's Approach Interesting for Germany

For Poland, this process is of great importance, even if the country is still not a eurozone member. The monetary expansion guided by the ECB can boost demand in Europe, thus increase the sales of Polish exports. This effect could ease if the euro depreciates against the zloty and the exchange rate becomes less advantageous. However, a cheaper euro will help maintain the debt of Polish companies and individuals denominated in the euro as well as that of the government. Bond issues this year can attract investors disappointed with the low profit margins offered in the eurozone.

Some consequences can emerge for Poland's position on European integration. Germany, confronted with eroding support for its macroeconomic preferences in the eurozone, may try to find new allies. Poland has had a relatively strong stabilisation culture with a clear anti-inflationary bias, thus it could become an interesting partner for Berlin—but only as a eurozone member. For this reason, Germany could start pushing Poland to set up a date to join the monetary union. Warsaw can use this situation and coin a tactical alliance with monetary hawks from the eurozone. But in the longer perspective, an economy based on cost competitiveness, a flexible labour market and the floating zloty, may be better suited to the proactive and non-dogmatic approach of the ECB. As a member of the eurozone, Poland would probably support Draghi, not Weidmann.

[10] T. Straubhaar, "Das ist das Ende des Kapitalismus," www.welt.de.