Flossbach von Storch
RESEARCH INSTITUTE

MACRO 03/07/2024

The ECB's political room for manoeuvre is limited. This hints to more inflation.

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Abstract

While the US Federal Reserve remains reluctant to cut interest rates, the European Central Bank has already lowered its key interest rates despite persistent inflationary pressure. This could indicate that the political pressures emanating from governments, corporations and the Eurosystem itself are considerable. Inflation in the eurozone could remain for longer above the two per cent target.

Zusammenfassung

Während die US-amerikanische Zentralbank Fed mit Zinssenkungen weiterhin zögert, hat die Europäische Zentralbank trotz fortbestehenden Inflationsdrucks die Leitzinsen bereits gesenkt. Das könnte darauf hindeuten, dass die politischen Zwänge, die von Regierungen, Unternehmen und dem Eurosystem selbst ausgehen, groß sind. Die Inflation im Euroraum könnte sich über dem 2-Prozent-Ziel verstetigen.

The US Federal Reserve System and the European Central Bank (ECB) have parted ways. While the Fed has continued to reduce its balance sheet and postponed interest rate cuts, the ECB has lowered its key interest rates again in June 2024, although inflation in the eurozone and the ECB's inflation forecasts had risen again. The reduction of bond holdings on the ECB's balance sheet is progressing only hesitantly. The reason could be that the ECB's interest rate hikes between July 2022 and September 2023 have restricted the room for manoeuvre of governments and corporations in the euro area as well as for the ECB itself. This is particularly evident in Germany.

The governments under Chancellor Angela Merkel had received a powerful tailwind from the ECB's interest rate cuts and extensive government bond purchases in the wake of the European financial and debt crisis. The ECB not only reduced the interest costs of the German Government. It also revitalised the economy, driving general government revenues up from 1,055 billion euros in 2008 to 1,700 billion euros in 2021. Thanks to this rapidly growing financial strength, the Chancellor was able to present herself as a skilful crisis solver with ease. Perhaps this is why she called ECB President Christine Lagarde a "dear friend" and an "inspiration".

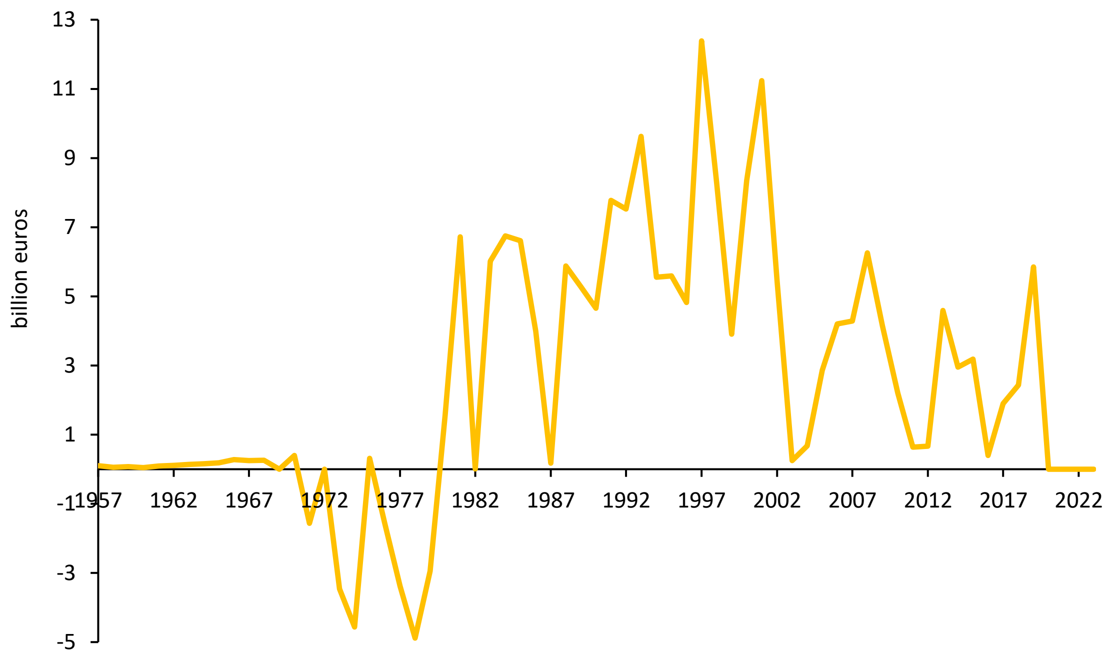
In contrast the new traffic light coalition, which set itself the goal of further expanding the welfare state and climate protection from December 2021, quickly reached its limits, as the ECB raised interest rates sharply from July 2022. This slowed down the economy and thus tax revenues. The interest burden on public debt has swelled, from around €4 billion in 2021 to €40 billion in 2023 for the federal government alone. A ruling of the Federal Constitutional Court in November 2023 on the debt brake has set limits on attempts to finance more government spending through hidden debt. Since then, Federal Finance Minister Christian Lindner has been urging his spending-prone coalition partners to make unpopular cuts to social and climate policy.

Corporations also lived in a land of milk and honey for many years, as the ECB pushed their lending rates down from an average of around 5.5 per cent in mid-2008 to 1.2 per cent at the end of 2021. The ECB also generously bought the bonds of large corporations and channelled profits into the exporters' coffers by devaluing the euro. During the coronavirus crisis, the ECB's pandemic emergency purchase programme financed a huge economic stabilisation fund and plenty of short-time working benefits. The number of insolvencies and unemployed people continued to fall, while employment rose sharply.

However, lending rates for corporations have now hiked and the consumption has been dampened by the sharp rise in prices. Large companies in particular are now calling loudly for more subsidies. The Kiel Institute for the World Economy has estimated that these subsidies will amount to an impressive 362 billion euros in

2023. However, the Federal Constitutional Court has put a stop to the debt required for the public support. So all that remains is to cut costs. Chemical giant BASF wants to save 1.1 billion euros a year until 2026. Bosch is planning to cut a further 3,500 jobs worldwide by the end of 2027 in household appliances alone. Volkswagen wants to cut administrative staff costs by 20 per cent by 2026. The list of announced job cuts is growing. The number of insolvencies is rising again.

Figure: Profit of the Deutsche Bundesbank



Source: Deutsche Bundesbank.

And even the Eurosystem itself - i.e. the ECB and the national central banks belonging to the euro - has not been spared from the changes. During the financial, coronavirus and climate crises, Mario Draghi and Christine Lagarde were praised, because they saved the euro, the European financial system, several crisis states, numerous jobs and the climate. However, the inflation that has been clearly visible since 2021 has undermined the ECB's authority as the guardian of price stability. High losses are now being incurred because the ECB and the national euro central banks have bought large amounts of low-interest government bonds from commercial banks since 2012. The central banks have credited the equivalent value of these purchases to the commercial banks' accounts at the central banks, and the banks receive interest on these deposits. Therefore, the interest burdens of the central banks in the eurozone have swelled considerably due to the key interest rate hikes.

The ECB has already made a loss of 1.3 billion euros in 2023. The Deutsche Bundesbank's loss was 21.6 billion euros. To end up with a "red zero" result, it had to liquidate a large part of its reserves. The Deutsche Bundesbank has not reported any profits since 2020 (see figure). There could soon be losses, meaning that the equity of the Bundesbank, of other euro central banks and of the ECB itself could become negative. Although this will not lead to bankruptcy, it will undermine confidence in the currency.

It would therefore come as no surprise that governments, corporations and even the central banks of the Eurosystem themselves are hoping for further monetary easing. However, any resulting breather is likely to be short-lived. Although the short-term interest rate level is significantly higher than in 2021, the Eurosystem has hardly reduced the extensive securities holdings that it has accumulated on its balance sheet in the course of its euro rescue measures. There is therefore still a lot of excess liquidity in the European banking system. In addition, wage demands remain high. Renewed monetary easing could therefore quickly cause inflation expectations in the eurozone to flare up again.

This points to a dilemma. On the one hand, the ECB, as currently still the Fed and the Bank of England, would have to keep interest rates tight and further reduce its balance sheet to counteract the ongoing inflationary pressure. On the other hand, a persistently high interest rate level could bring to light new risks for highly indebted euro states, banks or real estate corporations. The ECB's political room for manoeuvre appears to be very limited. This could hit to permanently higher inflation.

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