››› ECB policy remains unchanged – despite temporarily higher inflation

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After years of mostly excessively low price increases, inflation in Germany appears to be picking up noticeably. Current price increases, however, are due chiefly to temporary factors. Inflation has not yet stabilised on a lasting basis, and even less in the euro area as a whole. The ECB's monetary policy thus remains unchanged as well.

The debate over monetary policy in the euro area should not be conducted from a national perspective. Given the size and heterogeneity of the euro area, a single monetary policy cannot be optimally aligned with all economies at the same time. Just as interest rates are probably too low for Germany today, from 2002 to 2005 the country benefited from the fact that the ECB did not tighten rates.

Exaggerated inflationary fears in Germany

The loose monetary policy of the European Central Bank (ECB) has still not fuelled inflationary pressure. Germany's inflation rates of the past months take nothing away from this either. In February the general rate of price increases was 2.2 % on the previous year, rising above the two-percent mark for the first time since 2012. This prompted calls for ending the ECB's expansionary monetary policy.

The inflationary fears are exaggerated, however, because the reason for today's perceptibly higher inflation rate lies in the heavily fluctuating energy prices of the last twelve months. The oil price had fallen sharply in early 2016 but has since recovered. Its contribution to headline inflation is therefore high at the moment. But if the oil price does not rise any further (which is definitely plausible), energy price inflation will soon drop towards zero again. Since energy prices influence overall inflation not just directly but also indirectly, for example through rising costs of food production, the oil price also drives other components of the consumer price index. But here, too, the effect is short-lived. In other words, the currently higher rates of price increases are largely due to temporary factors and will recede again in the course of the year.[1] Part of the additional purchasing power gained from lower oil prices thus lasted for only a short time. The core inflation rate, which does not include particularly volatile elements of the price trend, namely energy and food prices, therefore remains on a weaker level in Germany, too, of a little bit below 1.5%, on which it has been since 2012.

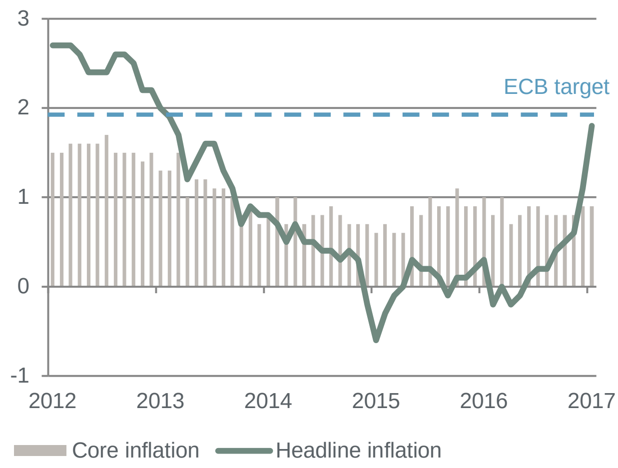
Euro area inflation is much lower

The ECB bases its policy decisions on economic trends in the euro area as a whole, anyway. There inflation is affected by similar factors as in Germany: driven by the energy component, annual inflation rates will accelerate only temporarily.

However, there are two further differences that have to be taken into account in assessing euro area inflation. First, core inflation in the euro area is around one half of a percentage point lower than in Germany, meaning it deviates even more from price stability. Second, euro area inflation rates vary widely. In economically successful Germany, prices are currently rising more strongly than in other euro countries. By contrast, inflation in the euro heavyweight France is lower and was a mere 1.4 % in February, including the oil price effect. This lack of convergence is not good but must be taken into account in monetary policy decisions.

Figure 1: Inflation has been too low for too long

Euro area inflation (in per cent on previous year)



Source: ECB

ECB is staying the course

The ECB should therefore stay the course for three reasons:

- First, the ECB's 2 % inflation target has not yet been achieved on a sustainable basis. This is best shown by core inflation, which for years has been standing at only around 1 % in the euro area (Figure 1). An inflation rate too close to the zero line is problematic because it is impossible to rule out a slide into negative territory. If that happens, the costs of deflation are extremely high.

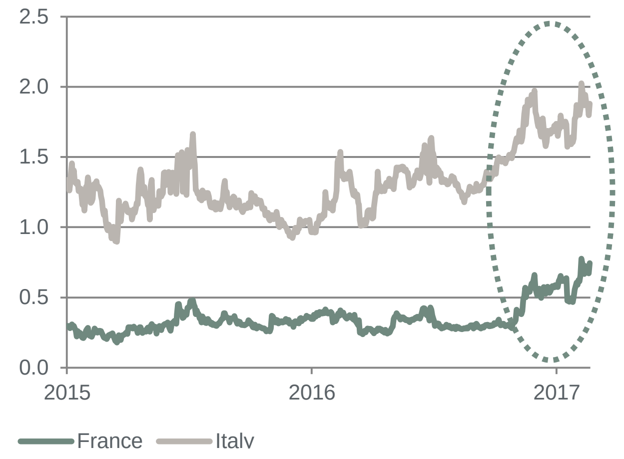
- Second, the ECB's measures keep the credit channel open in economies whose banks are grappling with the legacy of the financial crisis and the new regulatory requirements.

Moreover, low interest rates provide an incentive for businesses to invest. In addition, the ECB is bolstering people's trust in banks and counteracting liquidity risks. In this way it is also addressing the risk of sudden capital outflows, which had recently grown in the euro area, as shown by the yield spreads of government bonds (Figure 2). Such a development can quickly put pressure on the business cycle.

- Third, the ECB's monetary policy is facilitating the convergence of competitiveness. A sufficiently high level of inflation in the euro area overall is necessary so that individual economies can become competitive again by keeping wage and price increases below average.

Figure 2: Spread between yields widening again

Yields of ten-year government bonds, differences to Germany (in per cent)



Source: Datastream

Positive impacts in Germany, too

The ECB's policy has a number of positive consequences that are also being felt in Germany:

- According to Bundesbank statistics, interest rates on mortgage loans have fallen continuously after the outbreak of the financial crisis, by almost half to around 2 % for maturities between one and five years. Financing real estate is thus more affordable than ever.

- Asset prices, especially of real estate and shares, have risen. The ECB's decisive action was one of the factors that initially stabilised the stock markets of the euro area during the critical phases of 2009, 2011 and 2012. Share prices there even increased as a result. The German DAX 30 benchmark index, for example, has doubled since the end of 2011 (Figure 3). Better business prospects arising from a very favourable interest environment and reduced discount factors have contributed significantly to this.

- Amid the ECB's expansionary monetary policy, Germany has been experiencing a sustained recovery of almost four consecutive years; it is at the top of the European growth statistics and, most of all, the labour market statistics. Employment, wages and tax revenues are increasing as a result while unemployment is falling (Figure 3).

Figure 3: Stock and labour market both bullish

DAX 30 (in index points) and unemployment in Germany (in per cent)

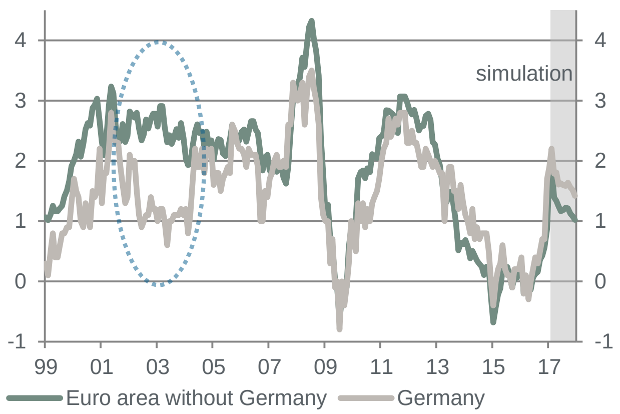
Source: Bloomberg

Germany has also benefited at the expense of others

Finally, it is worth looking back at the period from 2001 to 2005, when the inflation rate in Germany was much lower than in the rest of the euro area because of a weak business cycle and a number of unresolved structural problems (Figure 4). At the time, the ECB also followed the inflation rate of the euro area as a whole. It did not raise interest rates even though a more restrictive policy would have been more appropriate for individual countries such as Spain, France or Italy. Germany thus benefited from a relatively expansionary monetary policy that prevented further increases in unemployment and/or decreases in nominal wages – at the expense of European savers.

Figure 4: Low inflation in Germany has had its negative side-effects on European savers in the past, too

Inflation in Germany and the euro area (in per cent)



Sources: Eurostat, Bloomberg, own calculation

Conclusion: The ECB 'thinks European'

The ECB's monetary policy is very expansionary. But those who have been sending out powerful inflation warnings against its policy stance have so far been proven wrong. Euro area inflation remains too low. This will soon be reflected more clearly in the overall rates once the special effects of the oil price trend have vanished.

The current monetary policy has a number of advantages for Germany, although it is not without its side-effects. Because of the divergence between the euro area economies, monetary policy cannot be exactly aligned with individual national needs. The ECB has to accommodate the economic area as a whole. Having a European currency requires compromise. Over time, however, many advantages and disadvantages for individual economies even each other out. The greater the convergence is between the economies in future, the smaller the differences will be in the national needs relating to monetary policy. Achieving this remains a major challenge for the member states of the euro area. ■

[1] Cf. Wanke, S. (2017), Inflation in Germany rises only briefly above two per cent, KfW Research, Focus on Economics No. 160.