The ECB gambles away its credibility

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In contrast to the nine previous hikes, the European Central Bank's (ECB) decision to raise key interest rates by 0.25 percentage points on 14 September 2023 was no longer unanimous in the ECB's Governing Council but, according to ECB President Christine Lagarde, only approved by a *„solid"* majority. The public response is also no longer as unanimous as before. Some experts, such as the President of the German Institute for Economic Research (DIW) Marcel Fratzscher, emphasise the risk that the ECB is taking with this step regarding the economic development in the Eurozone. Markus Demary, an expert at the Institute of the German Economy (IW), which is close to employers, criticises the decision more or less directly: *„The ECB has chosen to take inflationary pressure out of the economy and is accepting a recession for the sake of price level stability"*.

In the ECB press conference Lagarde was asked: *„[W]hat do you say to people who might accuse you of making a likely recession worse and adding to the woes of the eurozone economy?"* The President replied: *„[W]e are doing that, not because we want to force a recession but because we want price stability to be there for people who are taking the brunt of inflation and high prices, and predominantly for those who are not the most privileged people."*

This sounds like a sense of social responsibility, which makes the ECB appear in the eyes of many to be the protector of the poorer people and thus seemingly invulnerable. The ECB leadership stresses in its press statement that "*[u]nderlying price pressures remain high, even though most indicators have started to ease."* In its opinion, the inflation rate is not going down quickly enough. Therefore, it wants to accelerate this process by raising key interest rates again. That this course is not without risk is admitted by the ECB itself: *„The risks to economic growth are tilted to the downside. Growth could be slower if the effects of monetary policy are more forceful than expected …"*.

The ECB’s optimistic growth forecast is hardly credible

In its new macroeconomic forecast from September, the details of which are available as a download on the ECB server, the ECB assumes that its interest rate policy will not stifle economic development in the Eurozone. Looking at the GDP percentage change rates from quarter to quarter, it is first noticeable that an outdated, too high value is used for the second quarter of 2023 (+0.3 percent instead of +0.1 percent, the latest calculation by Eurostat). For the current (third) quarter 0.0 percent is now forecasted instead of +0.3 percent as in the June projection of the ECB – a necessary adjustment, because the indicators show stagnation. But in the coming (fourth) quarter a minimal growth is already expected to materialise again (+0.1 percent compared to the third quarter), which then increases rapidly to +0.4 percent within the next two quarters and maintains this pace until the end of the forecast period in 2025.

If Eurostat’s current calculation for the second quarter 2023 had been used, the correction to the forecast value for 2023 as a whole would have been larger than now announced: The +0.9 per cent of GDP in the Eurozone predicted in June would then shrink to around +0.5 percent rather than just +0.7 percent. This might have led to more critical questions in the press conference.

But even beyond this detail, the forecast growth rates are bold, not to say unrealistic assumptions. It is understandable that the ECB does not want to predict a recession in the Eurozone while at the same time raising key interest rates once again. This could hardly be justified to the public even with the aforementioned sense of social responsibility.

But what makes monetary authorities assume that the skid marks of their interest rate policy will be so mild? After all they emphasize elsewhere that the transmission mechanism between key interest rates, lending and real aggregate demand is working well: *„Our past interest rate increases continue to be transmitted forcefully. Financing conditions have tightened further and are increasingly dampening demand“*. Only in the last step, the actual goal of current monetary policy, there is a hitch: the rate of increase in consumer prices is reacting only very slowly to weakening demand – hence the renewed tightening of monetary policy seems to employ the motto ‘if the medicine doesn’t work, we increase the dose’.

This suggests the question whether interest rate policy is a rather ineffective means of combating price surges, which are mainly due to price increases in energy and commodity imports (including food), but not to a boom in demand. And, again in medical terms, what is to be made of a remedy that has harmful side effects but hardly serves to achieve the actual goal? In such a situation, these side effects should be given much more attention.

Anyone who clearly distinguishes between different causes of price level increases knows that the respective macroeconomic environment in which monetary policy takes place is different. If interest rates are raised in response to an exuberant demand boom that causes the price level to rise undesirably sharply, firms and consumers are in a very different starting position when monetary policy is tightened compared to a situation when an interest rate hike occurs in response to a large exogenous price shock. Temporal lag patterns between interest rate policy and the response of the rate of price increases are likely to differ significantly depending on the underlying scenario.

How could the ECB have been satisfied? A thought experiment

To better assess the effect of interest rate policy in the current situation, the following thought experiment helps: How would the economic agents of a country that imports fossil energy on a substantial scale have to behave in order for the country's central bank *not* to raise key interest rates in the event of an extreme price increase of these imported goods? If the central bank adheres to the same principles as the ECB currently does, a prerequisite for keeping monetary policy on hold would be that the rate of price increase remains at the desired level of 2 per cent, or deviates only briefly and slightly from it, despite the surge in the price of imports of a commodity that is central to the economy.

How could this be achieved? The excessive increase in the cost of energy imports would have to be offset by a reduction in costs elsewhere so that companies would not be forced to make correspondingly higher increases in their sales prices. Since in the short term the substitution of expensive imports by other domestic or foreign goods either does not work sufficiently or leads to higher prices there because of shortages even in these „substitute" markets, only two paths remain: increasing productivity and/or decreasing (or increasing by less than 2 per cent) prices for intermediate goods and labour.

Productivity, as we know, cannot be increased overnight but only over a longer period of time with investments, say of at least two years for planning, ordering and implementing. This means of dampening prices is therefore not an option in the short term. After all, it is this short period that is at stake if one takes the ECB as a yardstick for the patience of a central bank to wait for the rate of price increases to calm down in response to an exogenous shock.

This leaves the second possible solution. Because the prices of all domestic intermediate goods that can be domestically influenced are themselves essentially based on labour costs, it is sufficient at this point to focus on the price of labour, the wage. (Those who consider competition in some domestic markets insufficient can also use profit margins as a potential price buffer. I refrain from doing so at this point in order to keep the thought experiment simple. The macroeconomic result that matters here is the same).

Since this is a thought experiment, let us abstract from implementation problems and instead assume that there is a clause in the collective agreements that provides for a correspondingly opposite wage development in the case of unforeseeable import price surges, so that the companies' cost increases would be absorbed. Then the companies do not have to raise their prices correspondingly strongly and the central bank sees no need to raise the key interest rates.

However, nominal wages would then fall and with them nominal mass incomes. Despite adherence to the target inflation rate and the central bank keeping still, there would be a loss of real income – the redistribution of purchasing power from the domestic market to the countries with fossil exports simply cannot be avoided. This decline in real income, in turn, triggers a recession via falling private consumer demand, the resulting decline in capacity utilisation and thus in private investment demand.

In other words, a recession in response to an imported energy price surge is inevitable.

To avoid this fiscal policy would have to cushion the loss of real income (as many governments have done in Europe) and/or monetary policy would have to respond by lowering interest rates (if it is not already at zero rates as the ECB was then) to stimulate demand.

Imported price surges are to be accepted

Back to reality: we have no wage agreements to compensate for import price surges. Therefore, price increases triggered by such price surges are pre-programmed for practically all goods to the extent of the energy intensity of their production process. A loss of real income is therefore unavoidable, just as in the thought experiment, except that it is not caused by falling nominal incomes but by rising prices.

In such a case, the central bank of the oil-importing countries cannot choose between inflation and recession, but only between recession and a worsening of the recession (by raising interest rates) or a cushioning of the recession (by lowering interest rates) – it cannot prevent the price surge itself. (This has escaped the critics of the ECB's interest rate decision quoted at the beginning. That is why their criticism is a „matter of opinion" and does not put the monetary guardians under pressure).

The ECB should therefore have accepted the price adjustments taking place on a broad front instead of losing its nerve after the pandemic-related price spikes and raising key interest rates at the next big shock, the energy price crisis. It could not prevent or even mitigate the loss of real income to foreign commodity suppliers because interest rates were already at zero.

However, it made it worse by raising interest rates, because this hampers investment activity. And this damage goes far beyond the loss of demand that has been caused in the meantime.

The fatal side effects of a useless remedy

For Europe actually wants to free itself from dependence on fossil fuels, at least in part. This structural change requires corresponding investments. And the more expensive they are to finance and the poorer the prospects for overall economic utilisation, the less likely they are to be realized. It is true that in the long term there are substitution effects from fossil to renewable energy when oil becomes more expensive, which promotes structural change. But in the short term, the negative income effect of a strong oil price increase predominates like any other massive commodity price increase.

If the central bank raises interest rates in such a constellation, it further weakens

the economy and thus prolongs the dependence on fossil fuels. As ironic as it may sound, in this way the central bank makes it more difficult to remove the bottlenecks in the real economy that could put a permanent stop to the imported price increases, thus impeding the goal of its policy itself.

And wage policy?

But didn't the ECB have to send a clear signal to wage policy by raising interest rates that it would not accept a wage-price spiral as a consequence of imported price surges? No, it did not have to. Because even in the pre-pandemic years, when the economy was doing better and labour was available in a similar way to today, wages in the euro area did not go off track. The power of workers in Europe is not nearly as great as many claim. The alleged labour shortage has so far not been able to push unemployment rates in Spain and Greece below the ten per cent mark, nor has it put an end to France's labour market woes: At over seven percent, the unemployment rate in our neighbouring country is more than twice as high as here. Talks between the central bank and the wage bargaining parties in the EMU countries as well as intensive public information about the correlations would therefore have been sufficient to secure a standstill in monetary policy against excessive wage settlements.

Wage policy in Germany did what it could to help cushion the energy price shock. The collective agreements concluded have given above-average wage increases to the lower wage groups and below-average wage increases to the upper wage groups. What was and is important is that the collective agreements as a whole do not attempt to make up for the loss of real income to foreign countries. For that would lead to a wage-price spiral, which monetary policy would actually have to combat.

The collective bargaining parties in many EMU countries have understood this and have reacted accordingly and sensibly to the difficult situation: According to Eurostat, the growth rate of nominal hourly labour costs in the euro area is 4.5 per cent year-on-year in the second quarter of 2023 – down from 5.2 per cent (Q1 2023) and 5.9 per cent (Q4 2022), so it is declining. The four big countries Germany, France, Italy and Spain even come to only about 3.7 percent in the second quarter.

What the ECB had warned of in earlier press conferences on its interest rate

decisions, namely a wage-price spiral, has therefore not occurred. And the ECB does not expect that such a spiral is ahead: compared to its estimates from June, it has even slightly reduced its forecast for the growth of wages per employee in the euro area for the next two years (4.3 percent in 2024 and 3.8 percent in 2025). This means that wage policy also did not provide a valid reason for the recent increase in key interest rates.

And fiscal policy?

The ECB devotes a section to fiscal policy in the press statement on its latest interest rate decision. In the section on „Economic activity" it says: *„As the energy crisis fades, governments should continue to roll back the related support measures. This is essential to avoid driving up medium-term inflationary pressures, which would otherwise call for an even stronger monetary policy response."*

So the central bank is threatening the governments that have just pulled the chestnuts out of the fire, i.e.: narrowly avoided a Europe-wide recession (in Germany this did not succeed) as a result of the energy price shock – and this under tougher interest rate conditions. The ECB announces to tighten its monetary policy stance if public budgets are not tightened. This appears odd because the ECB itself assumes in its projection for 2024 that gas and electricity prices *will rise again* and justifies its current interest rate hike, among other things, explicitly with this factor. Doesn't this put the claimed "fading" of the energy crisis into perspective?

But it gets even stranger: *„Fiscal policies should be designed to make our economy more productive and to gradually bring down high public debt."*

How is this to be done? A functioning modern infrastructure is central to the productivity of the private sector. However, a partly dilapidated infrastructure like the one in Germany cannot be renovated for free. Does the ECB only have the notorious reduction of bureaucracy in mind? Or does it still believe in the neoclassical fairy tale that public debt sweeps the capital market dry and thus crowds out private investment? And that therefore a reduction in debt would promote private investment and thus productivity? In any case, the ECB does not believe in this nexus in its forecast assumptions, otherwise it could not assume an inverse interest rate structure (long-term interest rates below short-term interest

rates). So what exactly do the monetary politicians who agreed with this statement imagine by a financial policy that increases the productivity of the economy?

In the next sentence, the officials write: *„Policies to enhance the euro area's supply capacity … can help reduce price pressures in the medium term, while supporting the green transition."*

Exactly, and among the simplest policy measures to improve supply capacities are favourable interest rates. The ECB's leadership would do well to exhaust its own policy options before suggesting that other policy areas should square the circle.

The ECB's self-made predicament

Unfortunately, it is to be feared that the ECB underestimates the impact of its interest rate policy on the overall economic development of the Eurozone. At the latest, if the predicted pick-up in economic activity in the euro area fails to materialise from the fourth quarter of 2023 onwards, or if the current stagnation even turns into a recession, the central bank will have to change course – even if the growth rate of consumer prices still has a way to go towards the central bank's target.

And the ECB will have to ask fiscal policy for renewed support in the event of a recession, because an interest rate cut needs some time before it has a positive effect on the real economy. In the meantime, the economy is likely to take off in the wrong direction because the impact of the previous monetary policy restrictions must first be absorbed – just think of the construction industry. But asking for fiscal support then is not in line with the cited monetary authorities' admonition of the governments.

The situation will be even more difficult if the international cartel of oil suppliers decides to tighten supply, as Russia and Saudi Arabia have surprisingly agreed to do in recent days. In its September projection, the ECB assumes declining annual average oil prices per barrel: US$ 82.7 (2023), US$ 81.8 (2024) and US$ 77.9 (2025). Currently, the price is climbing and has surpassed US$ 90.

If the prices of fossil raw materials were to rise again significantly, Europe would once again be faced with a price surge in the economy as a whole. A loss of purchasing power, which would dampen private consumption, falling capacity

utilisation and a redistribution of profits to the oil-exporting countries as a result of the worsening terms of trade (i.e. the relationship between export and import prices) would lead to a Europe-wide recession, which could hardly be averted through fiscal policy alone.

How would the ECB react to another imported price surge? With further interest rate hikes, because – according to its own current definition – there would then be even more „inflation"? That would be consistent with the logic of its argumentation so far. But a tightening of monetary policy despite a macroeconomic slump is hard to imagine.

Thus the ECB finds itself in the predicament it has created, especially with the justification for the latest interest rate decision. For the press release says: *„The rate increase today reflects the Governing Council's assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission."*

The ECB assesses monetary policy transmission as strong. Most of the available empirical indicators are downward sloping. The ECB forecasts the development of the core rate (i.e. the growth rate of the price index excluding energy and food) to be weaker than in its June projection. Only energy prices are rising again somewhat in the ECB forecast. Should energy prices increase even more than expected so far, this could not be a reason to lower interest rates in the ECB's logic, but rather a reason to raise them.

If the monetary authorities had at least mentioned the development of the real economy more explicitly in their bundle of reasons than just with the meagre word *„economic data"*, they could initiate a change of course in the event of unexpectedly rising energy prices in a somewhat face-saving way. As things stand now, however, they would lose credibility with the citizens no matter what they decided: In the case of interest rate cuts, some would wonder why that should be the right remedy in the case of an energy price increase, after the opposite had been practised before. In the case of an interest rate hike in a recession not triggered by wage increases, some would deny the monetary guardians any competence.

Analytical competence from outside?

Unfortunately, large parts of the German expert community are not doing their

part through own clear argumentation that the ECB leadership is forced to be more consistent in their considerations regarding their interest rate decisions and their external communication. The two critical voices already quoted above manoeuvre themselves into the analytical dead end when assuming there is a choice between fighting inflation and avoiding recession. Clemens Fuest, president of the ifo Institute, travels the same dead end and comes to the conclusion that the ECB's decision is right. He comments: *„The ECB's interest rate hike is well justified. Inflation remains high despite the economic slowdown. For 2024 the ECB has raised its inflation forecast. Against this background the rate hike is logical."*

Fuest also seems to be convinced that an interest rate policy based on energy prices, and even *forecast* energy prices, is the right thing to do. After all, the increase in the ECB's inflation forecast is based solely on its assumption about the development of energy prices. By the way, this is an open flank of European monetary policy: If it makes itself dependent on the price development of imported energy, the key interest rates may be steered more from Riyadh and Moscow than from Frankfurt.

Fuest continues: *„For Germany, the interest rate hike is painful in view of the contraction of the economy. But the ECB makes monetary policy not only for Germany, but for the euro area as a whole."*

Does that mean that monetary policy would have to be different if the ECB were only responsible for Germany? That the ECB should be given credit for not being able to take into account the German business cycle (which at least required an interest rate freeze), but was virtually forced to raise interest rates further because of the situation in the other Eurozone member states? So, along this line, Germany would have to endure a tightening of monetary policy although it did not fit its own situation, because it did fit that of the rest of the Union?

If this is to be a logical argument, the growth rates of prices in the other EMU countries would have to be higher than in Germany. For the German rate – as one must understand Fuest's comment – apparently offers no reason for further restriction, at least not in combination with the shrinking economy in this country.

Now, however, the rates of price increase are exactly the opposite. The August consumer price index only rose more in Austria (7.6 percent), Slovakia (9.6

percent) and Croatia (8.5 percent) than in Germany (6.4 percent). All other EMU member states, which account for two-thirds of the economic power of the Eurozone, are below the German value (e.g. France with 5.7 percent, Italy with 5.5 percent or Spain with 2.4 percent).

Therefore, contrary to Fuest's statement, it is rather the 16 other EMU states, above all Spain, that could be moaning about the ECB's interest rate policy, which they would unfortunately have to endure because of Germany, Austria, Slovakia and Croatia.

Or is it about countries that are still experiencing growth having to contribute more to achieving the ECB's inflation target, which is based on the eurozone average, than those that have already slipped into recession? How would that work? If the economies of none of the other 16 EMU countries are currently contracting, but they have lower rates of inflation than Germany, tightening monetary policy in these countries cannot bring much relief to the average rate of inflation, but it can push the countries into recession as well.

Whichever way you look at it, Fuest's rationale for approving the current interest rate decision is analytically incomprehensible. A closer look at the empirical evidence reveals something quite different: The currently measured national rates of price increase have little to do with the current development of the national economy, but much to do with international commodity markets and national economic structures.

A largely cyclically independent but undesirably high growth rate of consumer prices cannot be meaningfully combated by any monetary policy. It would be the task of economists in Germany who sit on the Council of Economic Experts, run an economic research institute or hold a chair in macroeconomics to recognise and communicate this.

Conclusion

By imposing this interest rate hammer on the EMU countries, the ECB is only preventing the market economy from doing what we urgently need and what it can do best compared to all known systems if it is managed with sense and reason: an adjustment to bottlenecks, be they of a climatic, commodity-related, demographic or other nature. Investment is the key instrument for adjustment. If monetary policy damages this instrument, it itself – as paradoxical as it sounds –

hinders the elimination of the most important current cause of the undesirably high rate of price increases. The social cloak it tries to wrap around its policy turns out to be more of a disguise for monetarist hawks.