



REPORT ON THE ECONOMIC SITUATION

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Monetary policy, fiscal and financial dominance

Exclusive report for ACATIS Investment: Prof. Dr. Dr. h.c. Lars P. Feld, University Freiburg and Walter Eucken Institute

Just a few days ago, on 6 June, the European Central Bank (ECB) lowered its prime rate by 25 basis points - the main refinancing rate to 4.25%, and the deposit rate to 3.75%. In view of the steep decline in the inflation rate compared to the corresponding month in the previous year, the ECB is concerned that its monetary policy may have an overly restrictive effect, resulting in significant disinflation (with the usual time delay). Even though inflation rates in the Eurozone have ticked up again slightly, and even though the ECB is quite aware that there may be turbulence on the way back to the inflation target (the "last mile"), prompting it to raise its inflation forecast for the year 2025, this policy step is nevertheless reasonable. The ECB wants to avoid plunging the Eurozone into recession. Rather, it is trying to achieve a soft landing, therefore it must make its decisions prudently and on the basis of data for an economic situation that will probably not occur for another two to four quarters.

The extent to which -i.e. whether, how many times and how gradually - interest rates will be lowered this year is something that the ECB is not committing to - again a reasonable approach. In January of this year, capital markets were expecting a total of six interest rate movements in 2024, which were priced into the long-term interest rates. Currently, a good argument can be made that the markets were too optimistic. The ECB will wait and see, and only in September will it consider whether the next interest rate action can be justified by the current price developments and forecasts. Perhaps this analysis will result in one or more actions on interest rates, or perhaps in none.

So far, so good. Even so, against the background of the monetary policies of recent years, the ECB must consider a series of questions. It has long since recognised that it waited too long to respond to the inflation pressures. While it was not the only central bank to do so, lessons must be learnt. In particular, it seems to have underestimated the significant effect of a greatly expansionary fiscal policy on the inflation process.

Not only because (but particularly in view) of the doubts expressed by the Federal Constitutional Court, namely whether its bond purchase programmes veered into fiscal policy, the ECB must now confront questions regarding the fiscal dominance of its monetary policy: Is the ECB helping highly-indebted member states in the Eurozone to obtain more favourable refinancing conditions, thereby undermining the disciplinary effect of risk premiums for national financial policies?

On 7 June, at a conference organised by the foundation

Geld und Wahrung (Money and Currency) ECB board member Isabel Schnabel refuted the fiscal dominance of ECB monetary policy. She said that by raising interest rates so quickly, the ECB actually demonstrated that it does not take heed of the fiscal conditions in the member states. Also, the ECB is reducing its bond holdings, which sends another restrictive signal. The flexible use of bond purchases in the context of the Pandemic Emergency Purchase Program (PEPP) would at most lead to a situation in which some member states are over-represented in the ECB portfolio (compared to their capital formula), but this situation resolves over the course of the year. Moritz Schularick also noted that in view of the increased importance of financial markets, central banks must hold a certain proportion of government bonds in a now larger portfolio.

But it is not that simple. Because Ms. Schnabel actually illustrated the importance of the Transmission Protection Instrument (TPI), which the ECB approved at the beginning of the rate hike cycle to support the bonds of some member states if their government bonds came under pressure in the market. This is similar to the Outright Monetary Transactions (OMT), except without the requirement of a macro-economic adjustment program, but the message to capital markets is the same: Do not speculate against the ECB; it will cost you dearly.

The fact that the ECB recognised the need for such a program from the beginning could be viewed as an alarm signal, said Peter Huber, a former judge on the Federal Constitutional Court. In any case, this action does show the close connection between monetary policy and the objective of financial stability. The stability of bond markets then becomes the gateway for fiscal policy interests. Therefore it is questionable whether the financial dominance that might be expressed as a result does not constitute just as much of a problem.

The ECB appears to face a dilemma if it wants to achieve financial stability while also trying to avoid financial dominance. Avoidance of fiscal policy dominance is measured not least by whether sovereign debt rates in the Eurozone decline..

Sincerely yours

Prof. Dr. Dr. h.c. Lars P. Feld