Depletion of the Tool Kit and German Intransigence

Mario Draghi's surprise power may even be larger then his star power. At least this is the impression one can get since his speech at the central bankers' meeting in Jackson Whole. First interpretations of his talk and in particular of his statements in the Q&A hinted to a reassurance of his previous 'we will do whatever it needs' -statement but now combined with a rather strong request for active fiscal policy. This was highly welcomed in the Keynesian camp of observers. A careful second read of his speech, however, shows a desperate central banker who is painfully aware that his arsenal is too limited to avoid a truly 'Japanization' of the Eurozone. Even though he was not explicit about the limits of monetary policy in a zero bound situation it became pretty clear that he plead for an addition to the bank's previous sole mantra of 'structural reforms' by calling for fiscal flexibility. The op-ed by former ECB-member Asmussen - now the right hand of the German Minister for Labor - and Benoît Cœuré, Member of the Executive Board of the ECB, in a German Newspaper only indicates the lever of despair. Even though both seem only to repeat the three pillar strategy emphasized by Draghi the piece dares to be explicit when it comes to naming the countries with fiscal space:'Meanwhile, Germany can use some of its budgetary room of manoeuvre to support investment and reduce tax wedges, while preserving its sound fiscal position'. One can only imagine how those words may have sounded in the ears of Jens Weidman who, in some circles at least, must feel more and more like a leper.

If it needed a proof that the ECB is in a situation of despair then the first auction under the auspices of the LTRO - the longer-term refinancing operation - provides a clue. This ECB program is supposed to provide banks with cheap credits in the amount of overall Euro 400 bn, delivered by two auctions. Even though observers were anticipating that the September tranche may be the smaller one, it came as a surprise
that banks were only willing to take up Euro 82.6 bn. Given that the interest rate was only 0.15 per cent the problem can't have been the price for those credits. One explanation is that banks assessed the overall macroeconomic situation and concluded that even cheap money is currently not in strong demand by private sectors. Another explanation could be

that banks are waiting until the results of the stress test will be published, and thus we will see a strong usage of the liquidity facility at the December auction. Banks indeed are eagerly awaiting the outcome of the stress test which decides, besides other things, whether they need to improve their capital base. And yet, arguments have a lot to commend that the combination of low or in some cases even negative inflation rates and subdued economic growth is the main cause for the disappointing take-up. In a deflationary economic constellation demand for credit from the private sectors gets dis-coupled from the interest rate, and this again is bad news for the ECB. One can argue that the design of the program came with a serious flaw. Quantitative easing programs where a central bank buys assets according to a predetermined plan seem to be the better option in a low inflation-environment then the ECB program that is relying on an auction of securities that are backed by banks. Banks may have good reasons to be hesitant, in particular if they doubt that the private sector's credit demand will be strong enough to absorb the new facilities.

The relatively low up-take may not be the last word. The December auction could work out differently, has been argued, as banks may be forced to make use of the residual Euro 320 bn of this program. However, the program is by design meant to repair the credit channel to the 'real economy' and not so much to rescue banks. In any case, chances are that teen a full up-take of the program volume is not enough to (i) breath growth dynamics into the Eurozone economies and (ii) to re-anchor the inflation rate close to 2 % as it is defined in the ECB policy rules. September 2014 is a different game then July 2012 when Draghi delivered his 'whatever it takes'-promise. At the time it was all about reassuring financial markets that the ECB would not accept a bankruptcy of a member state of the Eurozone. The promise was strong enough to calm down financial markets, and all this without any material action of the ECB. This time is different. Yields on government bonds across the Eurozone are at a record low and markets seem not to expect an exit of one or more of the member states. The problem today is the combination of low or negative inflation rates and low economic growth tied in with high unemployment. Of course, not all cases are equal. Germany on which depends a lot when it comes to policy action has a macroeconomic constellation of low inflation-low growth-

low unemployment. Given that the economy is close to full employment and that the federal government could deliver zero-deficit budgets in the last two years- not least due to the record low yields of governments bonds that reduced the debt service enormously- there is no political interest on the German side to turn to active fiscal policy and thus to disturb the image of a sound fiscal manager.

From a liquidity trap perspective, the low up-take rate of the ECB program was to be expected, at least to some degree. The balance sheet situation across the Eurozone hints to seriously impaired credit channels. Moreover, in a a situation where the interest rate already is in the zero bound region and prices keep falling the private sectors of member economies are now in a wait-and-see-trap that is difficult to overcome by only means of monetary policies, how heterodox they may seem. Let us trust Paul Krugman who praised Mario Draghi as an excellent economist, and we can firmly assume that his Jackson Whole speech was not less then an anticipation of the disappointing first auction outcome, and thus also understand his turn to fiscal policy deciders asking them to flank monetary policy. Time ago, the idea that a combination of aggressive monetary policies and active fiscal policy can lift economies out of low growth-traps used to be part of economics 101. And yet, it is not a bit surprising that Draghi's speech and also the op-ed by Cœuré and Asmussen stirred an uproar in Berlin (and probably also in Bundesbank-Frankfurt) :
'The article does not reflect current government policy and we don't agree," a spokesperson for Germany's finance ministry said. "Complaints that the German government supposedly does not invest enough are unfounded. We do invest significantly."(FT September 19, 2014).

German Finance Minister Wolfgang Schaeuble was even more outspoken when he told the German Lower House that calls for making use of existing fiscal space are kind of intellectual errants: 'Growth and jobs don't come about via higher deficits as if that were true case we (in Europe) really wouldn't have any problems at the moment' (Financial Times, 10-09-2014). Unlike Schaeuble whose intervention is more based on political principles then on macroeconomic insights, the German spokesperson at least can claim

some facts. According to the recent revisions of social accounting that now allows that all R&D expenditures are counted as investment, the overall investment share no longer sticks around 18% but is now around 22%. If one follows the logic of those new rules then the public budgets for education and research could be treated in a similar manner, and this would result in an even further increase of the investment share (Erber 2014). And yet, according to number crunching efforts on the side of the economic research institute DIW in Berlin it is also a fact that German public investment has eroded over time and today is significantly lower then in other OECD economies. It goes without further saying that it is still higher then in many other Eurozone economies but this his due to the harsh austerity regime that has been established in the sovereign debt crises economies. In any case, if Germany wants to keep its global competitiveness position and thus to lift its growth path it seems only sober to argue that public investment efforts over the last years under-perform. Consequently, calling for increased public investments makes sense in domestic policy terms.

'We do invest significantly' not only misses the actual German situation. More critical, it shows the narrow understanding of fiscal policy in the German Finance Ministry where everything seems to be seen through domestic lenses. In the tradition of functional finance Germany's stabilization function has to address the wider Eurozone, and in this respect it is almost tragic that Germany - independent from the concrete party coalition in government - sticks to a policy orthodoxy that misses theoretical as well as empirical underpinning. Is there a chance that this will change? Any change will definitely not come from domestic politics because the external austerity approach is so deeply entrenched in German politics that only the left party is not part of the austerity camp - without offering any substantive policy alternative such a oppositional voice can be easily neglected, though. Change only could come from outside, either by a new wave of economic crises or by the emergence of national governments of the Eurozone who would be able to successfully establish a growth coalition. At this point the formation of such a coalition is highly unlikely, despite the strong political grumbling in some member states. Moreover, experience shows that any new severe economic crisis does not automatically result in the strengthening of the anti-austerity camp. What seems, unfortunately, more likely is a

further strengthening of all variants of populism that has the quality not only to break apart the Eurozone but to risk the overall project of European integration. It would be silly to put the responsibility for such a situation solely on German shoulders. The most recent proposal for the 'Juncker College' of the European Commission indicates that it does not need a visible German leadership in order to present a market-liberal policy program.

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