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The ECB's creeping strategy shift: An analysis

The Maastricht Accords stipulate that the ECB shall be the EU's guardian of monetary stability. Taking this literally would suggest an inflation target of zero percent. However, a literal interpretation is not practical as it would be impossible to maintain exactly zero percent inflation over time. Indeed, practicality levels the strong argument of futility against pursuing such goal with literal mindedness. Averaging zero percent inflation is a different matter, though, with both inflation and deflation balancing out over time. That invokes the dreaded specter of deflation where consumers curb consumption and companies curb capital investment based on the expectation that things will become cheaper. Such thinking then starts a vicious cycle from frugal spending habits to deflationary economic indicators that reinforce the save-for-later attitudes that then bring down the economic data further.

This is why many central banks (including the ECB) have reinterpreted the monetary stability objective to mean up to two percent inflation to avoid deflation whilst ensuring reasonable monetary stability. The Fed led the way in rebalancing this asymmetrical strategy and now the European Central Bank is following suit. That means the new standard is no longer one of tolerating up to two percent inflation but actually trying to average two percent inflation. While this may sound like a minor game of semantics without real practical implications, it is actually a major turning point in monetary policy upon closer inspection. When the strategy was still asymmetrical it was abundantly clear that inflation around two percent would necessitate swift central bank intervention. That is not the case anymore. Euro zone inflation has remained almost consistently below two percent since 2013. Current Euroland inflation is at a mere 2.2 percent despite high energy prices, extreme shortages in many input products, and pent-up demand from pandemic restrictions. That means inflation in Europe could top two percent for a longish time without arithmetically exceeding the strategy objective of two percent inflation on a long-term average.

That means the central banks have fundamentally given themselves carte blanche for virtually unfettered monetary policy for the foreseeable future. Recent statements by various ECB directors are quite clear about this. Fabio Panetta, for instance, actually said in an interview a few days ago that the EU should let the economy run hot and just accept the wage-price-spiral effect. This does not sound like a central banker concerned about an overly expansive monetary policy. ECB Director Mārtiņš Kazāks showed a similar sentiment when he said that discussions to scale back the PEPP bond purchase program would be premature.

This is where it gets interesting. Excessively expansive monetary policies as have been extant for some time now and probably will continue for quite some more time going forward will have different effects in different economies. Whether this liquidity overhang will at all and to what extent spill into the real economy depends on the respective economic frameworks. The German economist and former Minister of Economic Affairs (1966-72) Karl Schiller famously summarized this as: "You can lead a horse to water, but you cannot make it drink." The situation is akin to a hospital where two patients with the same disease get the same treatment but the patient who was in better condition to start with will recover faster.

It thus comes as no surprise that countries like Germany currently have higher inflation than Italy although they are subject to the same ECB monetary policy. We therefore assume that northern Euroland inflation will remain higher on average in the next few years than in the southern euro zone. One may shrug this statement off but that is not the end of the story. After all, the ECB had a reason to soften its inflation target and pursue a highly expansive monetary policy. We believe that the true reason is to facilitate long-term, secure government debt refinancing for countries like Italy and gradually stabilize or even reduce their real debt through higher inflation.

Unfortunately, the asymmetric effect of the more expansive ECB monetary policy is to disproportionately raise inflation in countries who do not necessarily need it while having a much weaker inflationary effect where it is needed most. Therefore, the expansive monetary policy exacerbates the existing economic north/south slope. One may solve this dilemma by introducing a transfer and debt union. In terms of the hospital analogy this would mean that the fast-recovering patient donates blood to the more severely ill patient. While this would be rather like emergency antibody transfusion in a real hospital setting, it is the solution the EU is currently preparing. There have been motions made to abolish or modify the stability pact (see *La Rebublicca* interview with Fabio Penetta) and the EUR 750 bn Covid Fund is technically just a glitter-sprinkled gateway into a transfer and debt union.

Where is this development going? There could be great potential for frustration among the general public as there appears to be no more immediate correlation between democratically legitimate action and liability for such. This might become particularly critical if the transfer recipients are all chanting to the tune of their populist leaders and therefore pursue policies that the transfer payers do not wish to support. Moreover, citizens of countries with higher inflation will find it harder to provide for their retirement on the capital markets as particularly safety-oriented, fixed-income securities are becoming unattractive investments in artificially low-interest environments during times of high inflation.

In general, such scenario solely revolves around stocks as stock prices largely follow corporate earnings which are nominal quantities. This makes stocks a decent safeguard against inflation especially if that higher inflation does not come at the risk of higher interest rates. Those who predominantly park their savings in checking accounts for any reason will gradually erode their wealth particularly in countries with higher inflation. A global perspective, too, shows a cloudier outlook for Euroland’s economies in the medium to long term. As actions and liability for selfsame decouple, tax funds will be used less efficiently and the hobbled interest rates will negatively impact capital use: When interest rates lose their controlling and signaling function, capital will not always be employed as efficiently as possible. Moreover, in this New World, companies survive that would otherwise have perished in the structural shift. This is where the process of ‘creative destruction’ starts breaking down. The result is a growing number of zombie enterprises that are ever less capable to contribute to the function of economies. That is not exactly a rosy future. It will come to pass nonetheless as politicians only stand to lose from warning about this. Being a stingy spoilsport does not win voter affection and thus the path into a dystopian future seems like a one-way road to perdition. Considering the increasing politicization of the ECB, one cannot assume that the ECB will eventually rein itself in. There seems to be no doubt that we are moving into another monetary union.

Market data

Stock marktes	As of 06.08.2021 10:23	Change versus 29.07.2021 -1 week	02.07.2021 -1 month	04.05.2021 -3 months	04.08.2020 -1 year	31.12.2020 YTD
Dow Jones	35064	-0,1%	0,8%	2,7%	30,7%	14,6%
S&P 500	4429	0,2%	1,8%	6,3%	34,0%	17,9%
Nasdaq	14895	0,8%	1,7%	9,3%	36,1%	15,6%
DAX	15749	0,7%	0,6%	6,0%	25,0%	14,8%
MDAX	35618	1,0%	3,4%	11,2%	34,1%	15,7%
TecDAX	3821	3,8%	7,1%	12,6%	26,5%	18,9%
EuroStoxx 50	4156	1,0%	1,8%	5,9%	27,7%	17,0%
Stoxx 50	3608	1,1%	2,0%	7,4%	21,4%	16,1%
SMI (Swiss Market Index)	12199	0,9%	2,0%	11,2%	20,0%	14,0%
Nikkei 225	27820	0,1%	-3,3%	-3,4%	23,2%	1,4%
Brasilien BOVESPA	121633	-3,2%	-4,7%	3,3%	20,2%	2,2%
Russland RTS	1646	0,4%	-0,8%	9,6%	30,7%	18,7%
Indien BSE 30	54355	3,2%	3,6%	12,6%	44,2%	13,8%
China CSI 300	4922	1,5%	-3,1%	-3,9%	3,1%	-5,6%
MSCI Welt (in €)	3102	0,9%	1,9%	8,0%	32,2%	19,8%
MSCI Emerging Markets (in €)	1300	0,9%	-4,0%	-0,9%	18,8%	4,6%
Bond markets						
Bund-Future	177,29	85	420	663	-52	-35
Bobl-Future	135,45	13	118	50	20	27
Schatz-Future	112,38	3	21	28	22	10
3 Monats Euribor	-0,54	2	2	2	-7	4
3M Euribor Future, Dec 2017	-0,54	0	-1	0	-4	0
3 Monats $ Libor	0,12	0	-2	-5	-13	-12
Fed Funds Future, Dec 2017	0,08	0	-1	-1	11	0
10 year US Treasuries	1,23	-4	-20	-36	72	32
10 year Bunds	-0,50	0	-22	-26	8	8
10 year JGB	0,01	1	-2	-8	0	-1
10 year Swiss Government	-0,41	-5	-17	-19	9	8
US Treas 10Y Performance	710,77	0,8%	2,4%	4,3%	-3,9%	-0,7%
Bund 10Y Performance	683,96	0,4%	2,5%	2,9%	0,0%	-0,1%
REX Performance Index	499,71	0,2%	1,1%	1,5%	0,1%	0,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,09	-1	-17	-15	-8	7
IBOXX BBB, €	0,45	-2	-19	-21	-58	-11
ML US High Yield	4,70	13	12	-9	-129	-28
Convertible Bonds, Exane 25	8336	0,0%	-0,7%	1,0%	9,2%	0,1%
Commodities						
MG Base Metal Index	437,95	-1,2%	2,9%	0,9%	45,0%	23,5%
Crude oil Brent	71,59	-6,0%	-6,2%	3,7%	60,9%	38,0%
Gold	1800,43	-1,6%	0,9%	1,3%	-9,7%	-5,1%
Silver	25,43	-1,3%	-3,7%	-3,1%	0,1%	-3,6%
Aluminium	2562,40	-1,8%	0,6%	5,4%	48,0%	29,8%
Copper	9443,75	-3,6%	1,0%	-5,2%	46,3%	21,9%
Iron ore	171,91	-19,5%	-19,1%	-9,4%	48,8%	10,3%
Freight rates Baltic Dry Index	3376	5,0%	2,8%	6,9%	130,8%	147,1%
Currencies						
EUR/ USD	1,1815	-0,5%	-0,1%	-1,7%	0,4%	-3,7%
EUR/ GBP	0,8491	-0,1%	-1,2%	-2,0%	-5,8%	-5,1%
EUR/ JPY	129,65	-0,6%	-1,6%	-1,2%	3,9%	2,5%
EUR/ CHF	1,0720	-0,6%	-2,1%	-2,4%	-0,4%	-0,8%
USD/ CNY	6,4661	0,1%	-0,1%	-0,2%	-7,3%	-1,0%
USD/ JPY	109,49	0,0%	-1,4%	0,1%	3,6%	6,0%
USD/ GBP	0,72	0,4%	-0,9%	-0,2%	-6,3%	-1,8%

Source: Refinitiv Datastream

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com