Permafrost (for interest rates)

While Vladimir Putin worries about the permafrost thawing in Siberia, we should not expect to see the same phenomenon in the landscape of eurozone interest rates. Recent decisions by the ECB to lower its deposit rate to minus 0.5 per cent and resume its bond purchase programme instead indicate that the frosty season will continue for interest rates.

Recent ECB decisions led to sharp criticism by former central bankers.

In addition to likely motivating the resignation of ECB Governing Council member Sabine Lautenschläger, the promotion of ultra-loose monetary policy also led to strong criticism by a number of former central bankers from Germany, France, Austria and the Netherlands. They expressed their concerns about the ongoing crisis mode and loss of control over inflation in a memorandum of 4 October. They stated that bond purchases would hardly have any effect and were increasingly becoming an indicator of an underlying intent to protect highly-indebted countries from an increase in interest rates. The symmetric inflation target, which also allows target overshooting, could undermine the public's trust in the central bank and the stability of the euro. The artificially low level of interest rates would contribute to a zombification of the economy and create asset-price bubbles that could threaten the stability of the financial system. The low interest-rate policy also prevents the younger generation from using safe, interest-bearing investments to provide for their old age and will therefore create social tensions. Another criticism was based on the reversal interest rate theory, according to which decreasing interest rates past a certain point weakens banks to such an extent that new lending suffers, thereby weakening the economy and increasing the risk of recession. Finally, the authors noted that continuing the use of an ultra-loose monetary policy makes a turnaround increasingly difficult.

We have raised these points repeatedly in previous years. In all cases, we concluded that no one will be able to stop the ECB from continuing its ultra-loose monetary policy aimed at saving the euro. The severity of the criticism raised by the former central bankers and their final warning that

central banks are in danger of losing control over the money creation process is, however, noteworthy. The appeal to the ECB's monetary policy hygiene is therefore like an ultimate wake-up call:

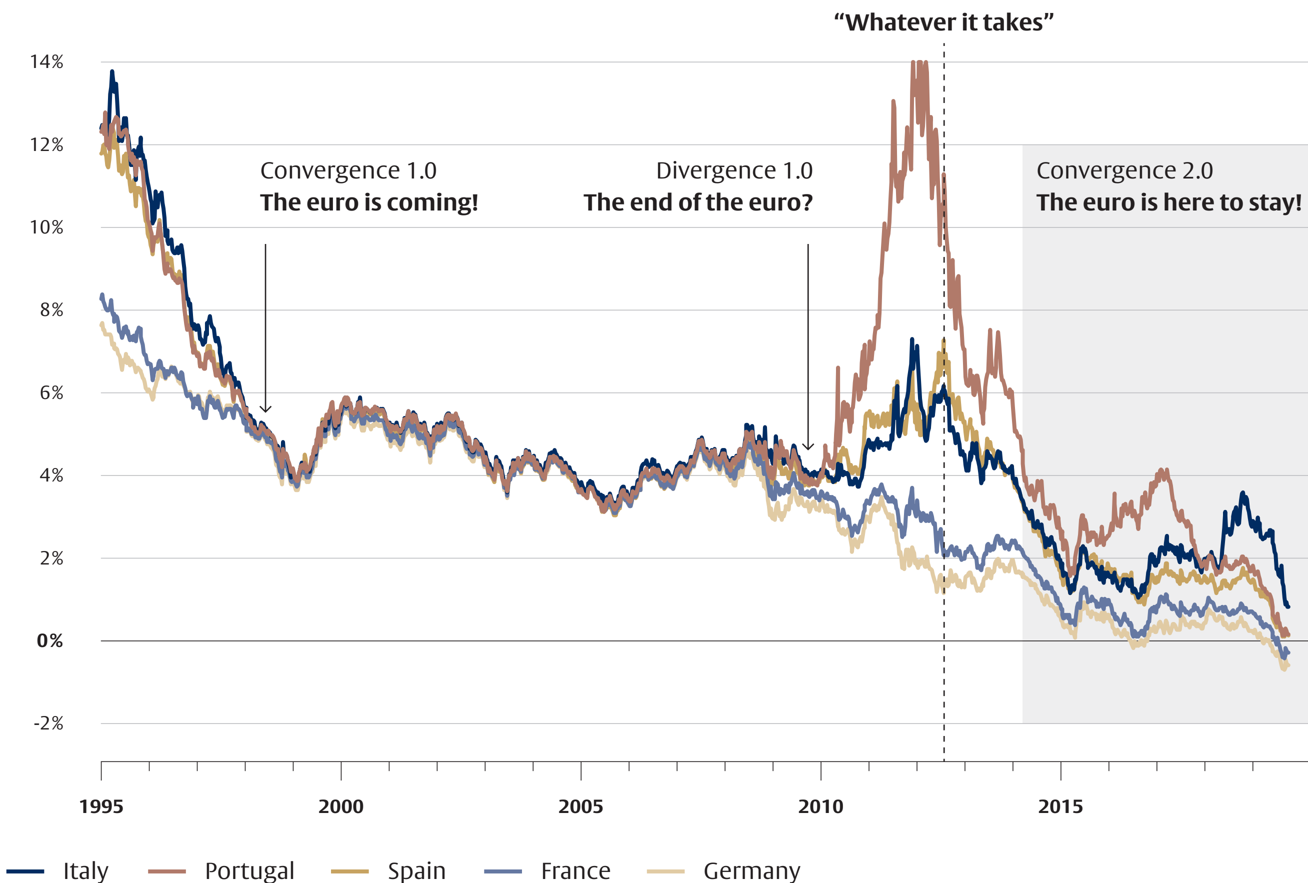
"How dare you?"

The monetary policy "point of no return" has been passed.

Unlike Greta Thunberg, however, the authors appear to have given up all hope of a turnaround, in full knowledge that the "point of no return" has already passed for monetary policy.

And, in this almost hopeless situation, a woman is stepping onto the stage to perhaps achieve the nearly impossible. The designated president of the ECB, Christine Lagarde, is a smart, experienced politician with the best connections

Figure 4 **Convergence 2.0** – Yields on 10-year eurozone government bonds



Source: Refinitiv, Flossbach von Storch, data as at 11 October 2019

Past performance is not a reliable indicator of future performance.

who will soon lead the most complex central bank in the world and therefore also have the future of the euro in her hands. A courageous announcement by her predecessor to do "whatever it takes" to preserve the euro successfully countered a dangerous divergence of eurozone yields and brought about a new convergence (see Figure 4).

Lagarde wants to avoid a new euro crisis at all costs during her eight years in office.

Lagarde now has to live up to this strategic standard and avoid a new euro crisis at all costs during her eight years in office. Her predecessor has also already set a course for medium-term interest-rate policy.

Given that interest-rate changes hardly generate stimulus any longer, Lagarde has to convince EU countries to provide more fiscal policy support. Some need to introduce structural reforms and budget consolidation, while others have to increase expenditures to stimulate the flagging economy. Perhaps she can even convince Germany to abandon its adamant defence of balanced budgets, which would not be all that bad given negative yields, provided the funds were invested for the future and not depleted.

Everything boils down to a scenario of muddling through, with a repeated cycle of tentative normalisation followed by new loosening.

As long as the eurozone economy continues to record moderate growth, the ECB can maintain the pretence that monetary policy normalisation is still possible. In the event of a recession, further interest-rate reductions would act like an overdose, further weakening banks and procyclically restricting lending. If an unexpectedly strong economic recovery occurred, on the other hand, the ECB could perform cosmetic interest-rate increases. Capital markets would otherwise experience high volatility, causing trouble for many debtors and triggering an implosion of real-estate prices. This is also an undesirable result. So everything boils down to a scenario of muddling through. A repeated cycle of tentative normalisation followed by new loosening – as long as it takes.

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