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Financial populism in Germany

By Roberto Tamborini on March 18, 2016

In May 2015 the European Central Bank published a working paper by U. Bindseil, C. Domnick and J. Zeuner entitled "Critique of accommodating central bank policies and the 'expropriation of the saver'. A review". At first sight, this looks like a common paper of literature review. However, in the first line of the Abstract one can read:

"*In parts of the German media, with the support of a number of German economists, the ECB's low nominal interest rate policy is criticised as unnecessary, ineffective and as expropriating the German saver. This paper provides a review of the relevant arguments*"

So this is not a common paper of literature review. It is an uncommon *argumentation in defence* of the ECB monetary policy *against the attacks from the media*, hence by and large *the public opinion*, of a *particular country* (italics highlight what is uncommon in the ECB communication style). After one year of quantitative easing (QE), and its enhancement decided by the latest meeting of the ECB Board on March 9, the German hostility towards the Frankfurt Tower has grown stronger than ever, and the "expropriation of the saver" is on the front line of fire, as testified by the cover of *Handelsblatt* of March 13, where President Draghi lights a big cigar with a 100 euro bill that represents the savings of the Germans. The accusation sounds like the following

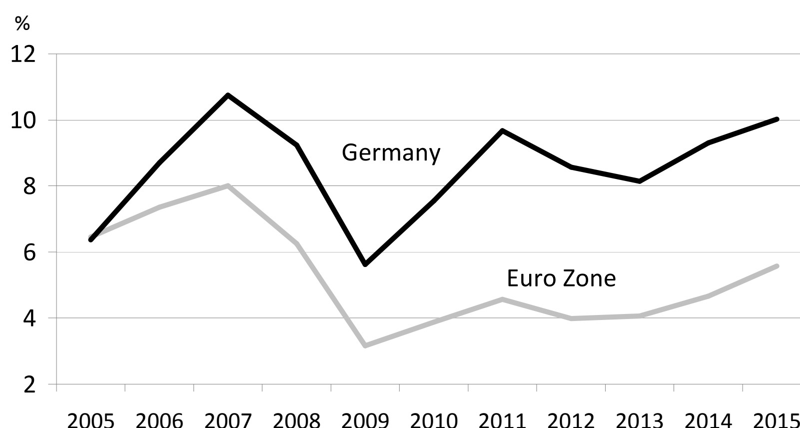
"Today, [the European Central Bank] stands for an unprecedented phase of low interest rates that expropriates the saver, damaging the savings culture and putting more and more pressure on the self-provisioning of people, banks and insurance companies… This now raises the question of how deeply an institution without democratic legitimacy can dig into the pockets of the people"[1]

"*Kirchhof attacks the policy of the ECB: Europe currently needs low interest rates, as otherwise states will no longer be able to pay their debts, says Kirchhof. Nevertheless, [German] constitutional law guarantees to each*

citizen that his or her financial capital will yield some return every year. 'This promise is no longer fulfilled. A key idea of private ownership has been abolished'"[2]

Of the three criticisms to QE reviewed by the ECB paper, the expropriation of the saver is the most treacherous one. Whether QE is unnecessary, ineffective, or with side effects are issues still open in the academic scientific debate and among the policymakers – though one may notice that the prevalent opinion is that QE is both necessary and effective, so much so that all major central banks in the world started their QE programmes well before the ECB and on a larger scale. By contrast, the expropriation of the saver due to low interest rates is an old workhorse of conservative affluent classes completely dispelled by modern economic analysis (see e.g. Blyth 2013)[3]. It happens that today, in countries with an ageing population, facing the necessity to cover health insurance and to back pension schemes with private savings, reckoning on rents generated by savings is no longer a privilege for the happy few. It is rather perceived as a necessity, and a social right, by a large share of the population. Germany is paradigmatic. Historically, it is a high saving country (with Japan and Italy). Over the last ten years, Germany's ratio of national saving to GDP has remained well above that of the Euro Zone (EZ). After its collapse during the Great Recession, the ratio has been rising again to the pre-crisis level (see Figure 1)

Figure 1. The national saving to GDP ratio in Germany and the EZ



Source: Eurostat, Database AMECO

Said this, the expropriation of the saver remains a disreputable argument neighbouring with financial illiteracy. As for learned economists and expert politicians, the appropriate word is "*populism*: type of politics that claims to represent the interests of ordinary people" (*Oxford Dictionary*). Populism is also characterised by the dramatisation of the conflict between ordinary people and élites, vested interests, established powers, and technocrats. This may also lead to the creation, or the endorsement, of popular beliefs just because they are in contrast with the "official truth", even when they are wrong and, in the long run, counterproductive.

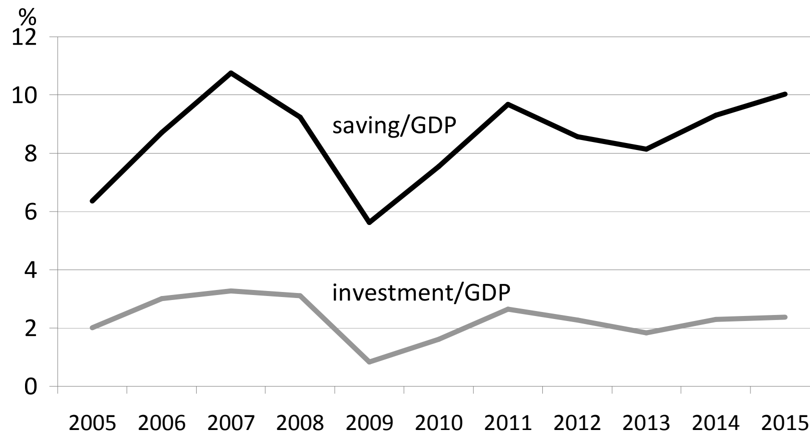
Some (ordo)liberal and neoclassical economists may endorse the story of the expropriation of the saver only because they believe that the originator of the view that saving may be a personal virtue but in some cases also a collective evil that keeps the economy in depression was Keynes, with his advocacy of the "euthanasia of the rentier" by central banks keeping interest rates low. But this a caricature of both Keynes and the neoclassical theory. The latter has no moral content, and like Keynes, focuses on the key problem of macroeconomic stability and growth: how savings are translated into investments of equal amount. The difference with Keynes lies in the answer. Ever since the foundational work by the Swedish economist Knut Wicksell[4], the neoclassical theory posits that, in a competitive economy with an efficient capital market, the saving-investment mechanism always works smoothly by means of the real interest rate (the return to one unit of additional capital financed by one unit of additional savings). The reward that the saver deserves (in real terms) depends on how much productive is investment, which in turn depends on the "real forces of productivity and thrift" – not on the law. Monetary policy has nothing to do with this mechanism: it cannot manipulate the productivity of capital at will. Central banks understand their task as it is epitomised by the so-called Fisher Equation[5]

policy interest rate – expected inflation = equilibrium real rate (= return to capital)

With the right-hand side given as explained above, the central banks seek to manage the policy rate in order to anchor expected inflation to a credible target and fulfil the equation. Note that in the EZ, owing to persistent expected *deflation*, the left-hand side of the Fisher Equation would tend to exceed the right-hand side. A high figure on the left-hand side might be welcomed by the savers' loudspeakers, but it would be misaligned with the actual productivity of capital forcing firms to downsize. Reducing the policy rate is the right and orthodox action by the ECB, and the mission is not accomplished as long as deflation persist. Thus a learned (and honest) neoclassical economist would say that the problem of savers is not Mr. Draghi, but the low productivity of capital. Indeed, this seems to be a problem common to other mature economies. Bindseil, Domnick and Zeuner quote a nice passage by the Chairwoman of the US. Federal Reserve Janet Yellen:

"*Interest rates are low not just because the Fed arbitrarily decided to set them at a low rate, but because the fundamentals of the economy are generating low interest rates … normally we think of interest rates as reflecting … a balance between savings and investment, the strength of those forces in the economy. And in the aftermath of the downturn, the desire to borrow money for private investment is weak. And reflection of that is low rates. If we were to try to keep interest rates above the levels called for by fundamentals, we would have a yet weaker economy*".[6]

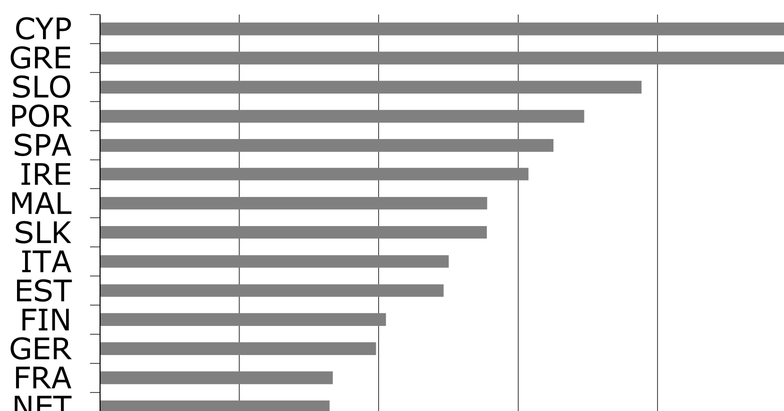
Figure 2. Investment and saving ratios to GDP in Germany



Source: Eurostat, Database AMECO

It may still be argued that the ECB looks after the Fisher Equation for the EZ as a whole, but its monetary stance is inappropriate for Germany. This would be the case because the productivity of capital is higher in Germany than elsewhere. But low interest rates and high productivity ought to spur an investment boom (and inflation). From this point of view, the German puzzle is that the saving rate remains high while investment stagnates (see Figure 2). This generates as side effect Germany's much appraised giant current account surplus of about 6% of GDP, which implies that a large part of German savings are invested abroad. Germany is structurally an excess saving economy, and the very basic notion of an efficient capital market wants the real interest rate to *fall* to reduce saving and increase investment. Hence, if anything, interest rates in Germany are too high, not too low.

Figure 3. Real interest rates on bank loans to non-financial corporations in the EZ, 2015



Source: ECB, Interest rate statistics; Eurostat: National Consumer Price Indexes, Database AMECO

Figure 3 shows the real interest rate on bank loans paid by non-financial firms in the EZ countries in 2015. Germany is towards the bottom of the

ladder, but one may wonder why German firms should pay more than their competitors in France, Netherlands, Belgium, Luxembourg and Austria.

The banks' complaints for the policy of low interest rates behind the smoke curtain of the expropriation of the saver has a lobby flavour. The squeeze of the "intermediation margin" (the difference between the borrowing and the lending rates) as a basis of profits is a long-lasting side effect of the business model imposed by the global financial conglomerates. The negative rate (i.e. a positive cost) charged by the ECB on bank reserves may make liquidity management a bit more awkward, but the basic, sound, idea is that banks' business is to lend money, not to keep it at Frankfurt. And in any case, a 2% in real terms on loans (against almost zero on funding) is a normal value on historical basis.

The fact that seven years after the crisis the Fisher Equation remains misaligned in several mature economies, vindicates Keynes's arguments that 1) the neoclassical interest-rate mechanism may fail to take care of itself, 2) the mechanism should be regulated by monetary policy, 3) this may however quickly reach the lowest limit of the interest rate (also in consideration of the opposition of the "rentiers"), 4) so that the government should intervene by either saving less or investing more.

Opposition to Keynesianism has a long and well entrenched tradition in the German public policy culture. Thus the expropriation of the saver is also espoused by those who think that the fourth of Keynes's argument is the problem, not the solution, and that the ECB policy of low interest rates is just a drug to keep bust governments alive. As a matter fact, QE is realised by buying large chunks of sovereign bonds. The point is that this argument hides from the naïve saver that the alternative would be by far worse. The naïve saver makes a typical mistake of financial illiteracy: he/she takes the nominal interest rate at face value. So the higher, the better. A high interest rate may in fact conceal a bad surprise: risk.

QE keeps interest rates low precisely because it reduces the risk premium to be paid to ordinary bond holders. If QE were suddenly stopped, risk premia would immediately jump, the savers would see the rents on their pension funds go up, but their *risk-adjusted* rents would remain roughly the same. Would the savers be better off? This is largely a subjective matter. If they are risk lovers, yes. Otherwise, which is most likely the case, definitely not. A related illiteracy bias is to take the nominal interest rate as disjoined from the underlying value of wealth. The correct calculation of the return to a bond is the *sum* of its nominal interest rate (coupon) and the change in its market value (capital gain/loss). By buying bonds, the central bank keeps their market value high, that is it *sustains the value of the savers' wealth* and creates capital gains that integrate the nominal interest rate. The anti-QE argument is that in so doing the ECB interferes with the market and loosens discipline on indebted governments. This is questionable in itself, but in any case the fact remains that the market would then punish the savers by imposing massive wealth losses onto them.

The populist idea of last resort is that the German savers would in any case be immune because German state bonds are strong. This may turn out to be a tragic illusion. The bulk of German savings (like anywhere else) is managed by financial intermediaries with large international diversification of investments. Foreign exposure is particularly high in German intermediaries (though less than prior to the crisis) precisely because national saving exceeds domestic investment. Therefore, letting profligate countries go bust would mean that quite a bit of German wealth would be burnt out. This indeed was the stake with the first wave of the financial crisis, when the German government had to bail out a number of banks on the brink of default with a huge amount of taxpayers' money. Hence Mr. Draghi is not the pyromaniac but the fireman of German, as well as European, savings.

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[1] Georg Fahrenschon, previously Finance Minister of Bavaria and President of the German Savings Bank Association, *Börsenzeitung*, 22 March 2014.

[2] *Spiegel Online*, 11 December 2103. Paul Kirchhof is a leading German lawyer, previously a member of the German Constitutional Court.

[3] Blyth M. (2013), *Austerity. History of a Dangerous Idea*, Oxford: Oxford University Press.

[4] Wicksell, K. (1898), *Interest and Prices. A Study of the Causes Regulating the Value of Money,* London, Macmillan, 1936.

[5] Fisher I. (1907), *The Rate of Interest*, New York, Macmillan.

[6] Senate Hearing , 11 February 2014, House Financial Services Committee Hearing on Federal Reserve Semi-Annual Monetary Policy Report to Congress