LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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FINANCIAL POPULISM IN GERMANY

Roberto Tamborini

IN MAY 2015, the European Central Bank published a working paper by U. Bindseil, C. Domnick, and J. Zeuner titled "Critique of accommodating central bank policies and the 'expropriation of the saver'. A review". At first glance, this looks like any other commonplace literature review. However, the first line of the Abstract reads:

> *"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 more than literature review. It is an uncommon *argument in defence* of the ECB's monetary policy *against attacks from the media*, and by extension *the public opinion*, of a *particular country* (italics highlight what is uncommon in the ECB's communication style). After one year of quantitative easing (QE) and the enhancement decided in the meeting of the ECB Board on March 9, German hostility towards the Frankfurt Tower has grown stronger than ever. The "expropriation of the saver" is first in the line of fire, as evident in the cover of *Handelsblatt* on March 13, where President Draghi lights a big cigar with a 100 euro bill representing the savings of Germans. The gist of the accusation is encapsulated by the following statements:

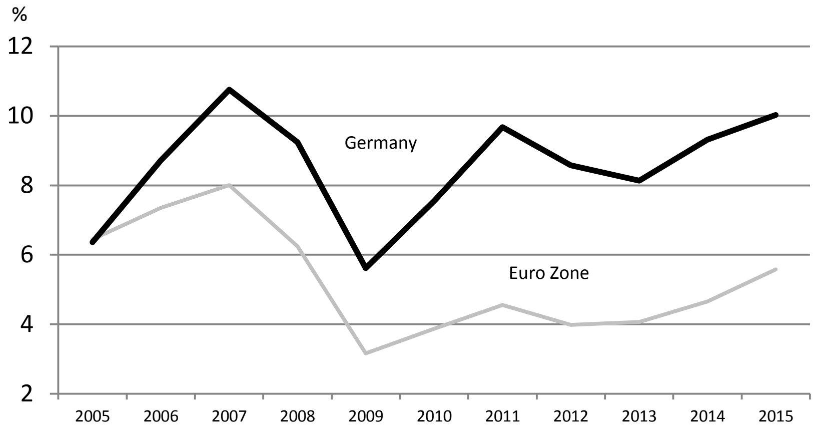
> *"Today, [the European Central Bank] stands for an unprecedented phase of low interest rates that expropriates the saver, damaging the savings culture and putting more and more pressure on the self-provisioning of people, banks and insurance companies… This now raises the question of how deeply an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

> *"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'"*[ii]

Of the three criticisms to QE reviewed by the ECB paper, the expropriation of the saver is the most treacherous. Whether QE is unnecessary, ineffective, or with side effects are open issues in the debate among academics and 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 own 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 rhetoric, popular among the affluent classes and completely dispelled by modern economic analysis (see e.g. Blyth 2013)[iii]. It so happens that today, in countries with ageing population facing the need to cover health insurance and pension schemes with private savings, relying on rents generated by savings is no longer a privilege for the happy few. Rather, it is perceived as a necessity and social right by a large share of the population.

Germany is paradigmatic. Historically, it is a high savings country (along with Japan and Italy). Over the past ten years, Germany's ratio of national savings to GDP has remained well above that of the Euro Zone (EZ). After its collapse during the Great Recession, the ratio has been rising once again to pre-crisis levels (see Figure 1)

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



Source: Eurostat, Database AMECO

That said, the expropriation of the saver remains a disreputable argument bordering on 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 dramatization 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 contrast with the "official truth", even when such beliefs 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 view that saving may be a personal virtue, but in some cases also a collective evil that keeps the economy in depression, is due to Keynes, with his advocacy of the "euthanasia of the rentier". But this is a caricature of both Keynes's 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. They differ in the answer. Ever since the foundational work by Swedish economist Knut Wicksell[iv], the neoclassical theory posits that, in a competitive economy with an efficient capital market, the saving-investment mechanism 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 the productivity of investment, which in turn depends on the "real forces of productivity and thrift," not 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 epitomised by the so-called Fisher Equation[v]:

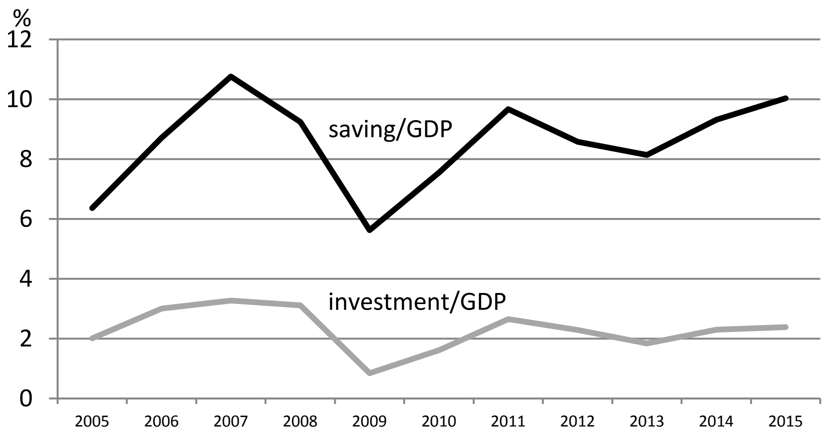
policy interest rate – expected inflation = equilibrium real rate (= return to capital)

Central banks seek to manage the policy rate in order to anchor expected inflation to a credible target and fulfil the equation. In the EZ, owing to persistent expected *deflation*, the left side of the Fisher Equation would tend to exceed the right. A high figure on the left might be welcomed by savers and their advocates, but it would be misaligned with the actual productivity of capital, forcing firms to downsize. Reducing the policy rate is the correct and orthodox action by the ECB, whose mission is to keep inflation at around 2% and by extension, in the current economic environment, combat deflation. 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 in 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".*[vi]

It may still be argued that the ECB looks after the Fisher Equation for the EZ as a whole, but its monetary policy stance is inappropriate for Germany. This would be the case were the productivity of capital in Germany higher 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 a side effect, Germany's 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 is that the real interest rate should *fall* to reduce savings and increase investments. Hence, if anything, interest rates in Germany are too high, not too low.

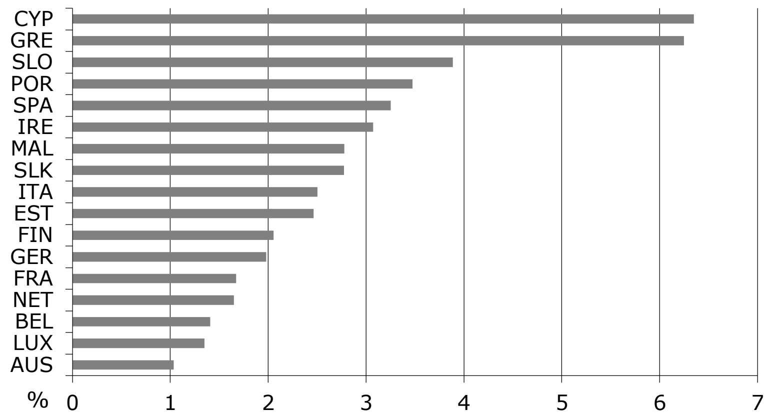
Figure 2. Investment and saving –to-GDP ratios in Germany



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

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

Behind the smoke curtain of the expropriation of the saver, the banks' complaints against the policy of low interest rates have a lobbyist taint. The squeeze of the "intermediation margin" (the difference between the borrowing and 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 the role of banks is to lend money, not to keep it in Frankfurt. In any event, 2% in real terms on loans (against almost zero on funding) is historically a normal value.

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 taking into consideration the opposition of the "rentiers"), and 4) 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 Keynesian argument is the problem, not the solution, and that the ECB policy of low interest rates is just a drug to keep failing governments alive. As a matter fact, QE is realised by buying large chunks of sovereign bonds. However, this argument hides from the naïve saver the fact that the alternative would be far worse. The naïve saver makes the 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 nasty 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, 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, *sustaining the value of the savers' wealth* and creating capital gains that integrate with 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 event, the market would then punish the savers by imposing massive wealth losses.

The populist idea of last resort is that the German savers would 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 at stake during 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 taxpayer money. Hence, Mr. Draghi is not the pyromaniac, but rather the fireman of German, as well as European, savings.

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

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

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

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

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

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