real interest rates. The heterogeneous developments in the euro area constitute **evidence against a secular stagnation** that governments could only fight with large new spending programmes and higher public debt. On the contrary: those member states that have followed the path of consolidation and reform most decisively have succeeded more quickly in returning to higher growth and employment.

353. Reversing the consolidation steps in individual crisis countries would threaten the **credibility** of the consolidation process and its supply-side effects. Proposals to launch new debt-financed spending programmes in Germany do not withstand closer scrutiny, nor do proposals to postpone competition-improving reforms in crisis countries because of the fear of deflationary effects. Governments should not be follow these recommendations.

354. The empirical evidence on equilibrium interest rates **does not sound the all-clear** in terms of the risks resulting from the low-interest rate policy and large-scale government bond purchases. The ECB should not attempt to use additional bond purchases to prevent market corrections that would lead to higher interest rates in the medium and longer term. Instead, it should **slow down the expansion of its balance sheet** or even end the quantitative easing programme earlier than announced.

A different opinion

355. One member of the Council, Peter Bofinger, holds a different opinion than that expressed in the analysis of monetary and fiscal policy in the European Monetary Union in this chapter.

356. The majority of the GCEE members conclude in their analysis of European Central Bank (ECB) measures that its monetary policy is "too expansionary". The ECB should slow down the expansion of its balance sheet or even end it earlier than announced. Thus the majority argue in favour of **changing the course of monetary policy**. Their line of reasoning rests primarily on the risks to financial stability and the danger that governments could be tempted to postpone consolidation and structural reforms due to the low interest rates.

357. The magnetic north for the ECB's monetary policy is its mandate, the primary objective which is to ensure **price stability**. Consequently the extent to which current monetary policy is in line with this objective should be the main focus of examination. The GCEE majority argue that core inflation, the GDP deflator and long-term survey-based forecasts of inflation show no signs of a "dangerous self-reinforcing deflationary trend". One important thing to consider, however, is that this could be due to the ECB having already practiced a very expansionary monetary policy for more than a year. Another point to bear in mind is that the ECB's task is not only to prevent dangerous deflationary trends, but rather to counteract inflation, which is significantly below the target of "below, but close to, 2 %".

358. Thus the appropriateness of monetary policy should be judged primarily on the basis of **inflation forecasts**. Assuming short-term interest rates (EURIBOR) of 0.0 % in 2016 and 0.1 % in 2017, the ECB staff comes to the following conclusion in its September 2015 forecast: the rate of inflation as measured by the HICP will be 1.1 % in 2016, and 1.7 % in 2017. Other institutions forecast rates slightly lower still. Thus even with current monetary policy, forecast inflation rates for 2017 are still slightly below the ECB target. ↘ TABLE 16 No dangers of inflation are expected even for a time horizon up to 2020, which shows the credibility and appropriateness of current ECB monetary policy.

Thus, with regard to the ECB's mandate and on the basis of inflation forecast there is no cause to for a change of course in monetary policy. ↘ TABLE 16

359. The majority base their analysis primarily on the **change rule** of Orphanides and Wieland (2013). The rule still requires a rate hike before the end of this year. It would only signalise quantitative easing if the resulting interest rates fell into negative territory. Compared with this rule, the ECB would significantly deviate from its earlier policy.

However, this is no argument for the inappropriateness of current ECB policy. As it is very difficult to combat deflation with monetary policy, a central bank would be well advised to stronger dose out its interest rate policy and liquidity policy measures in a very low inflation situation than in other periods.

360. The **Taylor rule**, as is shown in ↘ CHART 46 is an important heuristic for assessing interest rate policy. The problem with this, however, is appropriately determining the neutral short-term money market rate (Bernanke, 2015). Hamilton et al. (2015) determined a range of somewhat more than 0 % to 2 % for the US, with the caveat that uncertainty is extremely high. The output gap also presents considerable problems in estimation. Clarification is also needed on which price index should be used. Bernanke is opposed to the GDP deflator, as this also includes assumed prices of public services and prices of capital goods, but not prices of imported consumer goods. Bernanke thus proposes the personal consumption expenditure deflator.

In view of these uncertainties, the Taylor rule should be used with a great deal of caution. The extent to which this rule has proven to be a problem in the context of developments since the outbreak of the financial crisis can be noted in the fact that the interest rates it suggests for the period since 2010 at times exceed the

↘ TABLE 16

Euro area inflation forecasts

	2015	2016	2017	2020
ECB Staff	0,1	1,1	1,7	.
European Commission	0,1	1,0	1,6	.
Euro Zone Barometer	0,2	1,1	1,6	1,8
Consensus Economics	0,2	1,2	1,5	1,9
Survey of Professional Forecasters	0,1	1,0	1,5	1,9
IMF	0,1	1,0	1,3	1,7

Sources: European Commission, ECB, IMF

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ECB's actual key policy rate by several basis points. In light of the euro area's weak economic development and inflation rates significantly below target, interest rate policy closely aligned with the Taylor rule would have likely exacerbated the crisis in Europe in recent years. Therefore using the rule as a benchmark in the current situation would not be advisable.

361. Interest rate rules are undoubtedly **interesting heuristics** for monetary policy analysis, but should not be overestimated as they were derived from actual behaviour of central banks in the past. They are therefore only suitable to a limited extent to describe an **optimal monetary policy**. This applies all the more in a situation which fundamentally differs from developments of recent decades due to very low inflation and key policy rates hovering at the zero lower bound.

In this respect, considerably more weight should be given to conclusions based on inflation forecasts than to a need for action indicated by interest rate rules.

362. With the primary aim of monetary stability, it is nonetheless important to take into account the **risks to financial stability** inherent in the ECB's monetary policy. These risks play a decisive role for the majority of GCEE members. Thus the first question to be asked is whether obvious risks to financial stability can indeed be derived from the very low interest rates.

363. The ECB (2015) points out that its policy provides a **positive contribution to financial system stability.** The recovery in aggregate demand stimulated by the policy resulted in higher nominal growth. This contributes to reducing the real debt burden on public, private and corporate budgets. It enabled the euro area to avoid an unfavourable downward spiral of higher debt with negative impacts on financial stability. Moreover, rising asset prices improved the financial situation of companies and private households, in turn positively affecting their creditworthiness.

364. The majority do not take sufficient account of the positive effects of the low interest policy on borrower solvency. Its focus is instead on the **lenders**, with a regard to the dangers to financial stability. Low interest rates would undermine banks' and insurance companies' business models and favour exaggerated asset prices, they say.

The year-on-year growth rate of euro area bank loans to companies was 0.1 % and for loans to private households 1.6 % in September 2015. So not even the start of a new credit cycle in the making can be determined as yet. The danger of **banks' business models being undermined** therefore results primarily from unusually low demand for their most important product, loans to private households and companies, due to the extremely low interest rates. **Depletion of banks' equity** is counteracted by the supervisors monitoring relevant capital requirements and demanding that adjustments, such as capital increases, be made if necessary. Significant asset price exaggerations have also not been noted for the euro area overall. The greatest risk at this time is **excessive maturity transformation by banks**. However, these risks can be addressed by more systematically including them in regulation, particularly by taking them into account in Pillar I. ↘ ITEM 415

365. The disadvantages to banks' interest business that doubtlessly go hand in hand with the low interest policy are offset by the advantages that arise from the simultaneous **improvement in credit quality** of governments, companies and private households. Given the persistent high debt of companies, private households and governments, the worst case scenario for euro area financial stability would definitely be a slide into deflation. Irving Fisher (1933) coined the term "**debt deflation**" to describe this.

366. The GCEE majority moreover repeat the argument that the ECB should take into account the potential **misguided incentives** to member state governments in its purchases of government bonds. Favourable financing conditions could tempt governments to postpone or abandon consolidation and structural reforms.

If the ECB were to justify its monetary policy in this manner and even accept a failure to meet its inflation target, it would clearly **overstep its mandate**. As the German Federal Court of Justice (*Bundesgerichtshof*) determined, the treaties limit the ECB's mandate to monetary policy (Articles 119 and 127ff. of the Treaty on the Functioning of the European Union (TFEU) and Articles 17ff. of the Statute of the ESCB (European System of Central Banks)). The ECB is not authorised to make its own economic policy, but limited instead limited to supporting economic policy in the European Union.

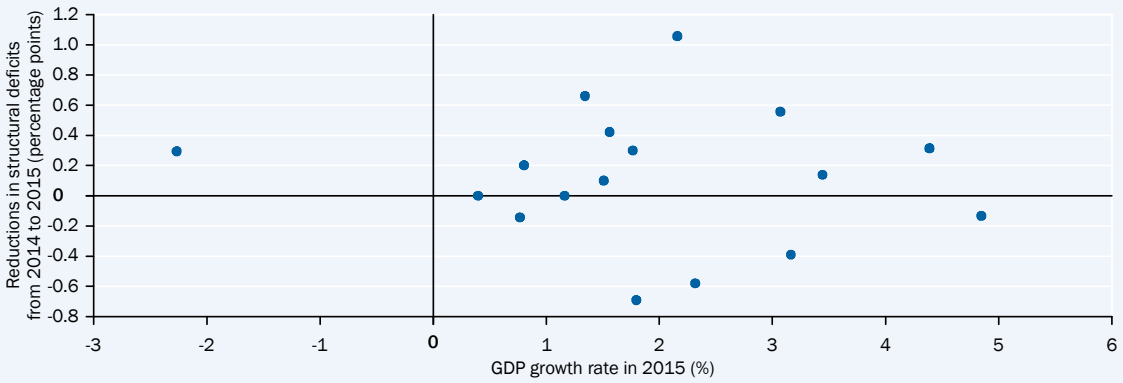
Developments in **Italy**, in addition, are a case in point showing that governments can indeed be prepared to undertake extensive structural reforms even under favourable financing conditions.

367. The GCEE majority note that those member states that have already more resolutely embarked on the path to consolidation and reform grow at a faster rate. Yet there is no systematic connection between the reduction of the structural deficit from 2014 to 2015 and the GDP growth rate in 2015 for euro area member states. ↘ CHART 54

Growth clearly did not start up again in the euro area as a whole until after **consolidation had actually been** terminated. The GCEE majority also acknowledge this positive effect. ↘ ITEM 167 The structural deficit was reduced by only 0.15 percentage points per year from 2013 to 2015. The debt ratio has actually risen slightly since 2013. If, despite its extremely low interest rates and almost neutral fiscal impetus due to the end of consolidation efforts, the euro area only achieves a growth rate that the majority considers to be "disappointing", this could be evidence of a "**secular stagnation**", which can indeed be equated with chronically low demand.

368. At a growth rate of around 3 %, **Spain** is currently one of the member states with particularly high economic growth. The majority thus present it as a model of successful reform policy. But, it should not be overlooked that Spain continues to have relatively strict regulation in key areas, particularly in the service sector and for start-ups (IMF, 2015).

↘ CHART 54
Consolidation and economic growth in the euro area



Source: IMF

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Part of Spain's growth can be relativised by the fact that in 2014, it posted the largest **negative output gap** (5.0 %) after Greece, which means that assumptions of a long-term higher growth rate should not be made on the basis of current growth rates. The International Monetary Fund (IMF, 2015) predicts that potential output in Spain will grow at a rate of 1.2 % for 2015 – 2020, the same rate as for France. Moreover, at 4.6 %, Spain continues to post the **highest budget deficit** of the entire euro area; among the world's 37 advanced economies, as classified by the IMF, only Japan has an even higher deficit at this time. Spain's structural deficit as determined by the IMF has only been reduced by an average of 0.35 percentage points per year since 2013. The country's current positive growth performance also reflects the fact that it has only opted for an extremely moderate consolidation plan in view of its very high deficit. Consequently Spain should not be cited as a counterexample of the "secular stagnation", which governments "can only combat with higher levels of government debt". ↘ ITEMS 328FF.

369. All in all, the ECB has implemented an **extremely successful policy** since 2012. It reacted promptly to an emerging downward trend in inflation and laid the foundation for recovery of euroarea economic activity with quantitative easing. This had not least a positive impact on the financial situation of indebted companies and individuals. The insufficient monetary policy options for effectively combating deflation once it has set in thus also justify a certain occasional overdose of individual tools. A period of inflation rates considerably below ECB target, or even of deflation, would pose the greatest threat to euro area financial stability, as this would have a serious negative impact on reducing high private sector and government debt levels.

References for the different opinion

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