European Central Bank maintains a balancing act

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The European Central Bank has sought to keep balancing between demands from Germany for a pull-back from its low-interest rate regime, and retaining its present “accommodative” monetary policies. The pressure has increased over recent months, with signs of increased euro zone inflation and marginal improvements in growth.

The ECB’s governing council, which met in Frankfurt yesterday, left its interest policy and bond buying program on hold but decided to remove a key sentence from its statement.

ECB president Mario Draghi told a press conference that a sentence stating that “if warranted, to achieve its objective the governing council will act by using all the instruments available within its mandate,” which appeared in previous statements, was no longer included.

This was a “signal that there is no longer that sense of urgency in taking further actions”—a concession to German demands.

Headline inflation in Europe has moved closer to the 2 percent level that the ECB says is its target. The rise, however, has been due mainly to increased oil and unprocessed food prices. Draghi said “the risks of deflation have largely disappeared” but he was not prepared to pronounce “victory on the inflation front.” For that to happen, he stated, wages would have to rise at the faster rate. The governing council’s members wanted to be “convinced that they actually see a self-sustained adjustment in inflation” and “we don’t see it yet.”

In addition to demands from Germany for a winding back of the low-interest rate regime, which is regularly denounced as impacting adversely on German savings, the ECB is facing pressures from the policies of Donald Trump’s administration in the United States, in particular over currency values and trade.

Those pressures have increased following the latest data, which showed that the US trade deficit in January jumped to its highest level in five years. It rose by 9.6 percent to $48.5 billion, up from $44.3 billion in December, the largest monthly trade gap since the deficit of $50.2 billion in March 2012.

The Trump administration has focused on China, insisting that it has benefited from the international trading arrangements since its entry into the World Trade Organisation in 2001, to the detriment of the US economy. White House officials have also taken aim at Germany, declaring that, with the euro’s establishment as the European Union’s common currency, Germany has benefited in international markets because the deutschmark’s value would have been significantly higher.

During the ECB press conference, the attacks on Germany were raised in a question that referred to the country’s trade surpluses and the large surplus for the euro zone as a whole.

Draghi delivered a reply in polite language but the underlying tensions were discernible. He repeated the defence of euro zone policy that he made to the European parliament last month after US criticism.

“I don’t think there is any merit in attacking Germany,” Draghi said. “The currency of Germany is the euro and the euro area’s monetary policy is conducted by the ECB.” The euro’s exchange rate was “determined by market forces.”

Obviously prepared for such questions, Draghi quoted from a US Treasury determination of October 2016 that Germany was not a “currency manipulator.” The euro’s real effective exchange rate was close to its historical average, he said. “But the [real] effective exchange rate of the dollar is off the historical average.

So it means that it’s not the euro, which is the culprit for this situation.”

The ECB’s caution in reading too much into the uptick in inflation and growth figures was also reflected in a global economic assessment issued by the Organisation for Economic Cooperation and Development (OECD) on Tuesday.

It said global gross domestic product was expected to “pick up modestly” to around 3.5 percent in 2018, from just under 3 percent in 2016. But a “disconnect between financial markets and fundamentals, potential market volatility and policy uncertainties” could “derail the recovery.”

Referring to the boost in share prices—the US market is up by about 15 percent since Trump’s election—the OECD noted an apparent “disconnect” between the positive assessment of economic prospects as reflected in market valuations and forecasts for the real economy.

The improvement in market sentiments, the OECD said, “contrasts with continued low growth of consumption and investment, which still lag well-behind previous recoveries, and the slowdown in productivity growth, with persistent inequality.”

The OECD noted a risk of exchange rate volatility due to the rising variance in interest rates between major economies. The world’s two major central banks, the US Federal Reserve and the ECB, are on divergent paths. While the ECB decided to maintain its rate of minus 0.4 percent, the Fed is expected to again raise its base interest rate by 0.25 percent at its meeting next week.

The report noted that uncertainties in many countries about future policy actions and political directions were “high” and there was “significant uncertainty about the future direction in trade policy globally.” No-one was named, but this was a reference to Trump’s “America First” trade agenda and the rise of right-wing economic nationalist parties in Europe.

The same issue surfaced in the final question at Draghi’s press conference. The ECB president had emphasised the importance of statements from G20 summit meetings about avoiding competitive currency devaluations and other protectionist measures.

Draghi was asked how important it was that these commitments be maintained at the G20 meeting in Hamburg, Germany on July 7-8, given there were reports that such commitments may be dropped.

There is uncertainty over the make-up of the G20 meeting because of elections in the Netherlands and the presidential election in France prior to the summit. Right-wing economic nationalist parties could make significant gains. While the polls are currently running against her, Marine Le Pen of the right-wing National Front could even take the French presidency.

Draghi replied that the commitments not to engage in competitive devaluations and to maintain open trade had been “the pillars of world prosperity” for many decades and it was important that the G20 reaffirmed them.

It would be a major step for the G20 to drop its previous commitments. The fact that the possibility is even being raised and has reached the ear of the ECB president points to the sharp rise of tensions in global economic relations.