The Telegraph

German fury grows over inflation 'Horror-Kurve' as fears of destructive boom-bust cycle mount

Munich is now the fifth most expensive city in the world as property fever infects once sober Germany CREDIT: BROOKINGS

By Ambrose Evans-Pritchard

8 JANUARY 2017 • 7:39PM

Inflation rage is coming to the boil in Germany. Leaders of the country's prestigious institutes warn that the economy is hitting capacity constraints and risks spiraling into a destructive boom-bust cycle.

In a series of interviews with The Telegraph they said that the ultra-loose monetary policy of the European Central Bank is now badly out of alignment with German needs. It has begun to threaten lasting damage, and is fast undermining political consent for monetary union.

"The ECB wants to inflate away the debt of the southern European countries. This is a clear conflict of interest with net creditors like Germany," said Clemens Fuest, president of the IFO Institute in Munich.

"There is a debate building up on the expropriation of German savers by the ECB. This is going to become very difficult if inflation approaches 2pc and they still do nothing. People will conclude that their true motive is redistribution," he said.

What is new is that Germany's inflation rate has suddenly jumped to 1.7pc after a long and deceptive period of quiescence. It is now much higher than in southern Europe.

The mechanical effect is to drive real interest rates to minus 2pc, lower than at any time in German history other than the two hyper-inflations after the First and Second World Wars.

Professor Clemens said the politics are poisonous because the ECB's majority bloc is openly sweeping aside German objections. This plays into the hands of the eurosceptic Alternative fur Deutschland (Afd), while the ruling Christian Democrats are toughening their line to stop a leakage of votes.

"The perception is that we are being dominated by foreigners. This is going to become a big issue in the campaign," he said.

The ECB plans to extend its programme of bond purchases until the end of the year after it expires in March, albeit trimming the pace from €80bn to €60bn a month.

Prof Clemens warned that this is far too slow. "They should start cutting by €10bn a month as soon as April, and end QE completely in October," he said.

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The mix of rising inflation and negative rates is toxic for ordinary Germans, who keep much of their household wealth in bank accounts.

It is often claimed that Germany has a unique savings culture. The German term for debt (Schuld) is the same word as guilt. Putting money aside dutifully has a diamantine moral appeal with almost religious undertones.

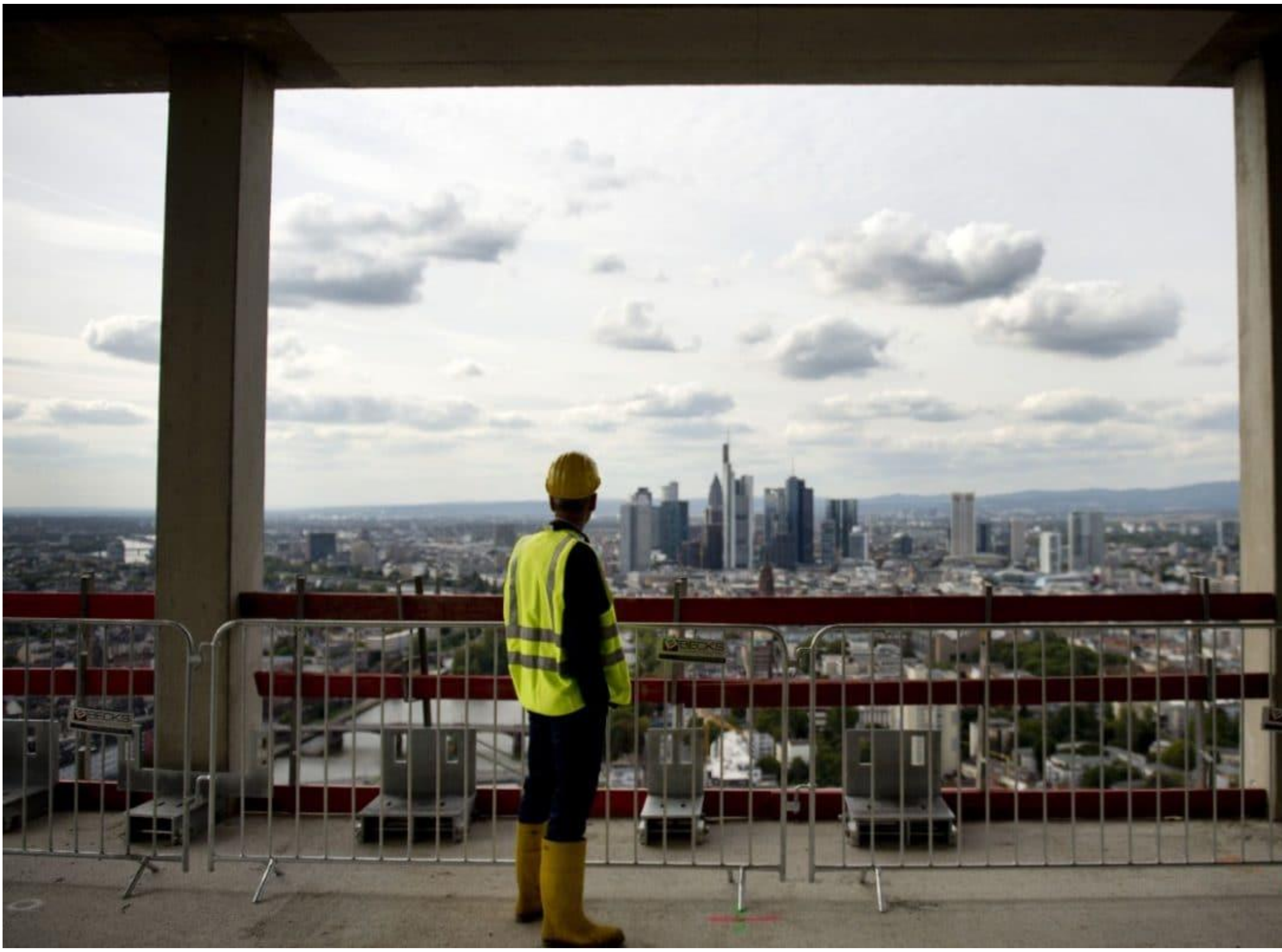
Economists dismiss this is as a fallacy. Germany's savings habits are the result of tax laws, demographics, and the structure of the banking system. But whatever the cause, the political consequences matter.

The tabloid newspaper Bild Zeitung leapt on the latest price data, splashing with a "Horror-Kurve" showing inflation soaring to seemingly frightening heights.

"If Mario Draghi's plan was to create inflation, he has certainly succeed. Millions of savers are paying for it. Their money is being cut to shreds," it said.

Relishing its daily attacks on the ECB's Italian president, Bild said €2,240bn of household wealth in German savings accounts has already been whittled down by €34bn so far this year thanks to his actions. Alongside these slapstick attacks is a deeper critique by German economists that is harder to rebuff.

"Germany threatens to overheat. It is absolutely clear that low rates are leading to a boom in the construction sector," said Stefan Kooths, from the Kiel Institute for the World Economy.



City skyline in Frankfurt: Low rates are leading to a boom in the construction sectorCREDIT: ODD ANDERSEN/AFP

"You can see signs of it everywhere. Volumes are soaring. Incoming orders are at a record high. Prices have been going at double-digit rates for almost three years," he said.

The UBS bubble index shows that Munich is now the fifth most expensive housing market in the world, with prices that have "increasingly lost touch with economic fundamentals".

Property prices in Hamburg have shot up 70pc over the last five years. A study by the German Postbank found that flats in Munich, Berlin, Frankfurt cost ten to fifteen years of earnings, the sort of extremes associated with London, Tokyo, or Shanghai.

Germans are being swept reluctantly into a real estate rush, grumbling ever more loudly that ECB policies are forcing them into warped behaviour to protect their wealth. The country has long prided itself on avoiding the Anglo-Saxon pathology of housing booms.

Prof Kooths said the ECB has crossed the line of legitimacy and should halt QE immediately. "We no longer consider the actions of the ECB to be monetary policy. Seven years ago, in the eye of the storm, the eurozone was facing a liquidity crunch but nobody can say there is a liquidity shortage now," he said.

"The ECB is engaged in financing the government debt of countries in southern Europe that cannot raise capital from the markets, and it is doing so to a huge extent," he said.

"Yes, as soon as they stop buying the bonds, the crisis will be back on the agenda. This only shows that huge intervention has done nothing to solve the problem. They are now trapped by their own policy," he said.

Prof Kooths said the EU authorities must bite the bullet and accept a "tremendous restructuring crisis" rather than trying to kick the can down the road. "All we are doing now with easy credit is keeping alive firms that should go bankrupt. It feeds into the 'zombification' of Europe," he said.

Mario Draghi has a delicate balancing act trying to lift Southern Europe out of a debt-deflation quagmire without going to so far as to provoke an elemental revolt by Germany. It is a near impossible task. The interests of the two camps have diverged too far since the launch of the euro.

The ECB says its sole task is to set policy for eurozone as a whole, and the currency bloc is still disturbingly close to deflation whatever may be going on in Germany - which is in dispute it any case.

The eurozone's headline inflation rate has jumped to 1.1pc - from 0.2pc in August - but this is largely due to the rise in oil prices. Core inflation is steady at 0.9pc, exactly where it was July.

"The ECB is trying to reinflate Germany. It is exactly what they want. It is their plan. The question is whether the German people will accept it," said Hans-Werner Sinn, emeritus professor at Munich University.

Prof Sinn estimates that it would require inflation averaging 4.5pc in Germany and zero in southern Europe for ten years to rebalance monetary union - an implausible outcome in every respect.

"The Germans have tolerated the printing press solution only because they are afraid that otherwise the whole thing will collapse. But the side-effects are becoming enormous," he said.

"We are moving more and more into debt mutualisation, and towards a planned economy where the ECB steers capital flows. Internal debt contracts within Germany are being changed, and innocent people are suffering serious wealth losses. This is stretching German nerves," he said.

View to the St. Michael's church and other churches in Hamburg, Hamburg, Germany CREDIT: ALAMY

Prof Sinn said the ECB network of central banks has built up record liabilities of €754bn to the Bundesbank through the Target2 payments system. "This is already 50pc of Germany's total net foreign wealth. It is a lot of money."

The ECB's bond purchases have covered the withdrawal in foreign financing for the deficit states. "These Target2 balances are a huge asset swap resulting from QE. But if the banking system in Italy goes bankrupt - and it is certainly a risk - then the

Bank of Italy will not be able to meet its payments. It is untrue that this is all innocuous," he said.

"I think the ECB will continue on their path until there is so much resistance in Germany that they dare not go any further."

"Once the election is over, the Germans may finally say 'no' to what is going on, and then we may start to see the break-up of the euro," he said.

Folk memories of 1923 still have a grip on the German psyche, but the situation is entirely different today. Deflation remains the greater risk

The problem is that the weak euro amounts to stimulus on steroids for Germany's export economy. Capacity usage in industry has reached 85.7pc. The Bundesbank warns of "mounting labour market bottlenecks". The Verdi labour union is pushing for a 6pc pay rise this year.

The country no longer has an output gap. The Bundesbank expects a 'positive' gap of 2pc of GDP within a year. "The German economy will consistently outpace potential output by a significant margin," it said.

There are echoes of the Exchange Rate Mechanism crisis in the early 1990s when Germany was overheating and needed higher rates than other countries. The crucial difference this time is that the Bundesbank is no longer in charge. The others are dictating terms to Germany.

Neil Mellor from BNY Mellon said one nasty surprise for financial markets in 2017 is that the ECB may be forced to retreat from QE and tighten policy earlier than it wants to keep the Germans on board.

First there may be a false calm. Finance minister Wolfgang Schauble lashed out at Mr Draghi last year, saying he should be "very proud" that his extreme policies had done so much to help AfD. His attacks have since subsided.

"Overheating can be quite pleasant when it starts, especially in an election year. The bad stuff happens later," said Hans Redeker from Morgan Stanley.

In one sense, higher German inflation is just what is needed. It is the least painful way to close the intra-EMU gulf in competitiveness without subjecting southern Europe to years of harsh deflation.

Note: Access The Telegraph's actual online article, if you can, because while I have reproduced all the copy and photographs, I cannot reproduce the three graphics showing the pick-up in German inflation, house prices and the German output gap.