



Fixed Income Special

NORD/LB Markets Strategy & Floor Research

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Marketing communication (see disclaimer on the last pages)

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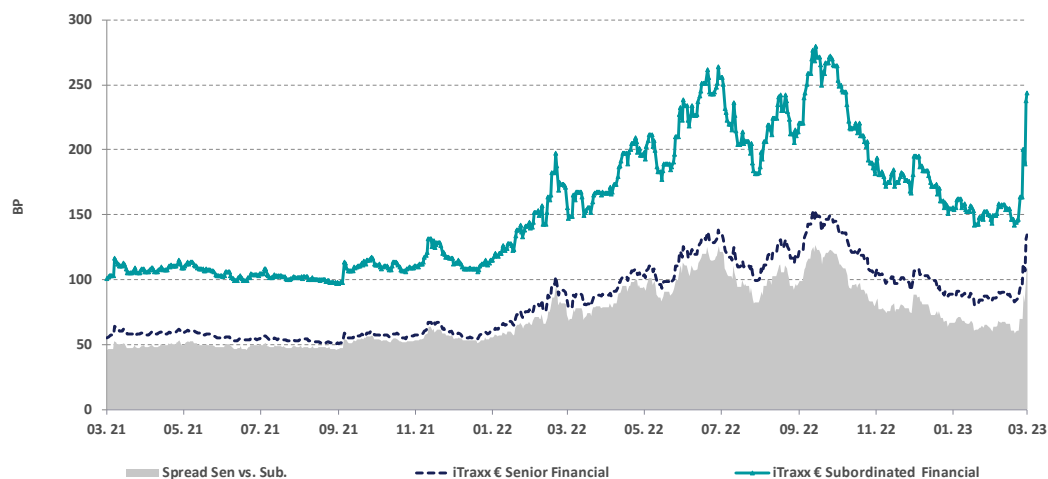
ECB interest rate decision: Backbone in times of turmoil?!

Authors: Dr Frederik Kunze // Dr Norman Rudschuck, CIIA // Jan-Phillipp Hensing

Another interest rate decision in times of turmoil

Groundhog Day is on 02 February! On 02 February this year was also the last ECB interest rate decision. Here, the Council members had agreed on an extremely hawkish course. In fact, today's interest rate decision is reminiscent of the classic 1993 film "Groundhog Day". Once again, the central bankers on the Main have to make an immediate decision in a market phase of extremely heightened uncertainty, weighing up possible reactions of financial market participants in advance. The current times of turmoil can be traced back first to the developments in the US banking market. The failures of the two regional banks there, Silicon Valley Bank and Signature Bank, are now making waves in Europe as well. In the eye of the storm is Crédit Suisse. However, the major Swiss bank was already in a long phase of restructuring and in our opinion should not be seen as a "model" for the European banking market. Nevertheless, the uncertainty is also driving up risk premiums overall and at the same time raises the question of how far the ECB can succeed in continuing on its chosen course. The possible range of reactions of the ECB's Governing Council to the recent events has been discussed both by experts and by the uninitiated. There is no doubt that the ECB's goal of financial market stability has once again come to the fore. If there was any need at all for a statement by the central bank from the Eurozone on the difficulties of a Swiss credit institution, the Swiss National Bank (SNB) as well as the Swiss Financial Market Supervisory Authority (FINMA) took the wind out of the sails of the cash callers by [confirming](#) the fulfilment of the capital and liquidity requirements by Crédit Suisse and at the same time assuring the provision of additional liquidity to the institution as needed. Finally, the situation actually eased, which can be attributed to the announcement that Crédit Suisse would stock up on liquidity (up to CHF 50bn) at the SNB and buy back its own senior bonds (up to CHF 3bn).

iTraxx Spread development: EUR Senior Financial and EUR Subordinated Financial

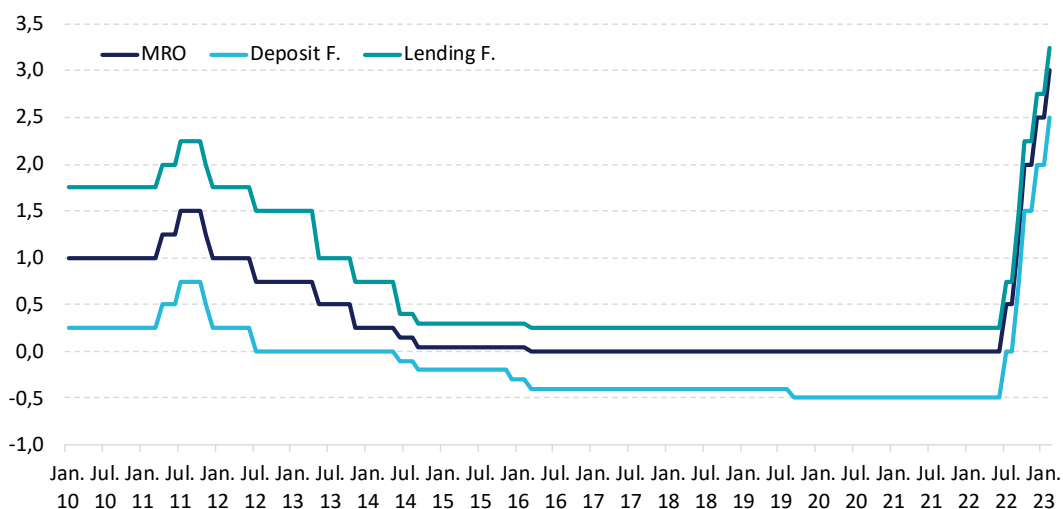


Source: Bloomberg, NORD/LB Markets Strategy & Floor Research

ECB Governing Council sticks to +50bp: Imprudence, ignorance or backbone?

The market turbulence has by no means left the ECB Governing Council cold. Nevertheless, the central bankers stuck to their "forward guidance", which should actually no longer exist. But regardless of this, a pure focus on data dependence would not have justified turning away from the 50 basis point step. After all, the upward pressure on prices in the common currency area remains considerable. All three key interest rates will be raised accordingly. The Governing Council certainly did not ignore recent developments in the banking sector or concerns about the stability of credit institutions. There were also divergent opinions in the Council. Even if, in our opinion, the ECB in its role as bank supervisor can certainly rely on a banking sector that is solidly capitalised and equipped with liquidity, the monetary guardians will have to increasingly deal with the possibly asymmetrically distributed effects of the steep interest rate path on the earnings and liquidity situation of the banks. In doing so, it may also be necessary to focus on individual institutions and avoid contagion effects. Following this logic, the "stress" in the banking sector – indicated, among other things, by the increased levels in the synthetic iTraxx indices (see above) – will remain for the time being. But this is more a task for the supervisory arm of the central bank. Did the Council show backbone today? We say yes! Nevertheless, new (or old) front lines now seem to be drawn within the Eurozone's monetary policy-making body, showing a stronger delineation of hawks and doves. Certainly, Robert Holzmann's ideas on aggressive monetary tightening have put his more "dovish" colleagues on notice. Another +200 basis points (including today) in 2023 seemed too excessive for some Council members, especially since the head of the Austrian central bank takes the meeting-by-meeting approach ad absurdum when he gives such "guidance" to the capital markets. However, it should not be forgotten at this point that Holzmann had linked his "+200" to a corresponding inflation scenario. This directs the focus accordingly to the new ECB projections for inflation and economic output growth in the common currency area.

ECB key interest rates (in %; incl. current interest rate decision)



Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

ECB projections: Inflation remains high for now and "soft landing" ahead?

The adjusted *ECB Staff Projections* speak a clear language here. For 2023, the central bank's experts still expect an average inflation rate of 5.3% (previously: 6.3%). For 2024, according to the projections, 2.9% (previously: 3.4%) would still be on the books, while for 2025 a further decline to 2.1% (previously: 2.3%) is painted on the wall. Inflation excluding energy and food, on the other hand, is seen by the ECB at 4.6% in 2023, before "coming down" in 2024 (2.5%) and 2025 (2.2%). We can see clearly a disinflationary trend here. With regard to economic activity, the "soft landing" scenario remains in our view. After all, the central bank experts adjusted their projection for 2023 to 1.0% (previously: 0.5%). For the following years 2024 and 2025 the central bank communicated a growth rate in the common currency area of 1.6% (2024 previously: 1.9%; 2025 previously: 1.8%). There is almost no better way to describe a soft landing in figures.

Latest ECB projections for euro area growth and inflation (in %)*

| | March 2023 projections | | | | Adverse scenario | | | | Severe scenario | | | |
|----------------|------------------------|------|------|------|------------------|------|------|------|-----------------|------|------|------|
| | 2022 | 2023 | 2024 | 2025 | 2022 | 2023 | 2024 | 2025 | 2022 | 2023 | 2024 | 2025 |
| Real GDP | 3,6 | 1,0 | 1,6 | 1,6 | - | - | - | - | - | - | - | - |
| HICP inflation | 8,4 | 5,3 | 2,9 | 2,1 | - | - | - | - | - | - | - | - |

* Change versus previous year in %

Source: ECB, NORD/LB Markets Strategy & Floor Research

Liquidity support for the financial system: ECB has all monetary policy instruments

The other decision variables regularly in the focus of central bankers have remained somewhat quieter today. The moderate reduction of holdings from the Asset Purchase Programme (APP) will continue. The pace will remain unchanged at an average of EUR 15bn per month until June 2023, after which it will be "determined over time". For the Pandemic Emergency Purchase Programme (PEPP), the ECB is sticking to its decision to fully reinvest maturities at least until the end of 2024. Mention is also made of the now heavily repaid TLTRO III tenders. The Governing Council "will regularly assess how targeted lending operations are contributing to its monetary policy stance". So here, too, it's business as usual. At least a verbal flanking of the interest rate decision with a reference to the concrete possibilities of, for example, a specifically designed TLTRO IV programme would have been conceivable here. However, the Council confines itself to the more general final clause. Thus, the Council declared at the end, as usual, its readiness to "adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term". Here, however, the central bankers added in the latest statement that this was also about preserving the smooth functioning of monetary policy transmission. In view of the current situation on the financial markets, the statement that the ECB's policy toolkit is fully equipped "to provide liquidity support to the euro area financial system if needed" is likely to be taken with a certain amount of goodwill. Therefore, we view today's interest rate decision as more of a prudent backbone than hara-kiri!

Conclusion and comment

The current financial market turmoil is in part unexpected and timing was almost bad for the ECB, but they cannot be described as another “Black Swan”. The Council continues to steer its monetary policy tightening course. The high price pressure and robust economic activity seem to be pointing the central bankers in the right direction. But to what extent this course will be maintained in the future should, in our opinion, finally be made truly data dependent. One can almost cheer Lagarde's statement that a "robust decision" for 50 basis points should be followed by a look at the data. And data dependence must then also include a look at the banking landscape. For as we know from the crises of the past, not every strain is a crisis, but neither is every recovery an end to the crisis. The mere reference to "liquidity support to the financial system" can serve as a calming pill in analogy to the TPI and have a lasting effect. It would be too easy to rely on this. Apart from this debate, however, the other monetary policy instruments must also be kept in mind. After all, the reduction of the ECB's balance sheet will proceed inexorably. The central bankers still have to set the pace with a view to the APP for the second half of the year. Against the background of recent developments and uncertainties, it will now be more challenging for the ECB to keep this tightening course as market-neutral as possible. The steps may now become smaller, after all, each interest rate change needs 12-18 months to arrive in the real economy. As a reminder: the first interest rate step took place in July 2022 – just nine months ago – and has not yet had its full opportunity to develop. Fighting inflation does not work like an "on/off" light switch, the transmission is rather lengthy. However, to ensure that the banking landscape does not experience its next “black swan”, they should proceed with caution. We feel comfortable with another +25bp in May. Until then, there is enough time to carefully examine some bank balance sheets instead of losing focus on fighting inflation. In addition, we wish the ECB a steady hand in future decisions so that it does not allow itself to be driven by the market or even by individual media representatives who thought they knew before the interest rate decision that the ECB was deviating from its own precommitted course – what a misconception chasing the next headline!

Appendix

Publication overview

Covered Bonds:

[Issuer Guide Covered Bonds 2022](#)

[Covered Bond Directive: Impact on risk weights and LCR levels](#)

[Risk weights and LCR levels of covered bonds](#) (updated semi-annually)

[Transparency requirements §28 PfandBG Q4/2022](#) (quarterly update)

[Covered bonds as eligible collateral for central banks](#)

SSA/Public Issuers:

[Issuer Guide – German Laender 2022](#)

[Issuer Guide – German Agencies 2022](#)

[Issuer Guide – Dutch Agencies 2022](#)

[Beyond Bundeslaender: Belgium](#)

[Beyond Bundeslaender: Greater Paris \(IDF/VDP\)](#)

[Spotlight on Spanish regions](#) (Update planned in 2023)

Fixed Income Specials:

[ESG-Update 2022](#)

[ECB interest rate decision: Roadmap to QT](#)

[ECB: The Wishing-Table, the Gold-Ass, and the Cudgel in the Sack](#)

[ECB interest rate decision: delivered as expected?](#)

[ECB acts as the 'House of Hikes' – or: Winter is coming!](#)

Appendix

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| Sales Sparkassen & Regionalbanken | +49 511 9818-9400 |
| Sales MM/FX | +49 511 9818-9460 |
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