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One year of interest rate hikes

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The ECB is on the right track, but has still some ground to cover

Exactly one year ago today, the ECB raised key interest rates for the first time in a decade. Gone were the days of ultralow, yes, negative interest rates. Since then, the central bank has been turning the interest rate screw at an unprecedented pace. 400 basis points in less than a year, plus the (initially hesitant) reduction of balance sheets that had been inflated by the gigantic bond purchases: That deserves respect. By and large, since awaking from its slumber exactly one year ago, the ECB has done well.

The ECB has gone full throttle

Interest rate hikes and financial stability can go together

At the time, many observers suggested that interest rate hikes would almost inevitably lead to a renewed flare-up of the euro crisis. After all, public debt in the eurozone had already swelled to over 90% of GDP by 2022, up from "only" 66% on the eve of the financial crisis (2007). But those gloomy predictions faded. The crisis did not materialize. Of course, long-term interest rates have risen substantially last year. After all, this rise in interest rates is precisely what restrictive monetary policies are trying to achieve. But inflation expectations embedded in long-term interest rates should put a smile on the face of the ECB. They appear to signal that investors trust the central bank to successfully fight inflation after all.

But it seems almost more important to me that the risk premiums have remained stable for sovereign debt of governments with lower credit ratings. After an initial rise in the risk premium for ten-year Italian government bonds last summer, the situation has calmed down considerably (see chart). And this despite the uncertainty brought by a new right-wing populist government in Rome. And despite the threat by a leading rating agency

Yield differential government bond Italy versus Germany (10 years, %)

Source: LBBW Research, Refinitiv

(Moody's) to downgrade Italy to junk. In my opinion, the latter is mere bluster. I am willing to bet you that they will not do it!

The "Transmission Protection Instrument" intervenes

Two factors have been crucial to this success in maintaining financial market stability, notwithstanding a substantial turnaround in interest rates. On the one hand, governments, including Italy, will continue to benefit from the long period of low interest rates for many years to come. Only a small portion of government debt is due for refinancing each year. The interest rate shock is therefore cushioned in the near term.

Worries about a new euro crisis were exaggerated

In addition, the so-called "Transmission Protection Instrument" (TPI), which the ECB also officially adopted a year ago today, plays a role. This raises the prospect that the ECB will buy government bonds shaken by speculative attacks. In investors' minds, TPI may have had a soothing effect by putting a lid on sell-off risks. However, this instrument has never been tested. And the question remains unanswered as to how the ECB would react if a sell-off of government bonds were due to home-made policy errors (think of Liz Truss); or how this judgement would be made in practice. But for now, the confidence trick works.

The interest rate plateau almost reached

In the meantime, the ECB has almost reached its interest rate peak. But it is actually a plateau, because interest rates are likely to remain at the high level for a long time. We expect two more small rate hikes of 0.25% each: one next week and a final one in September. The level that will be reached by then (deposit rate of 4%) will then be persistent in winter. A first interest rate cut will not come until the second half of 2024 at the earliest.

Two more small interest rate steps. Then it's over.