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The ECB stayed the course: that's good

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Moritz Kraemer -- Chief Economist

LBBWResearch@LBBW.de

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Banking woes in the U.S. do not threaten Europe's financial stability

Yesterday, the Governing Council of the European Central Bank raised interest rates again by 0.5%. This met our expectations and is a good thing. Just over a week ago, this interest rate move had been expected unanimously by all analysts. But the turmoil surrounding the demise of Silicon Valley Bank (SVB) in California had fueled speculation that Frankfurt might not dare to act out of concern for financial market stability.

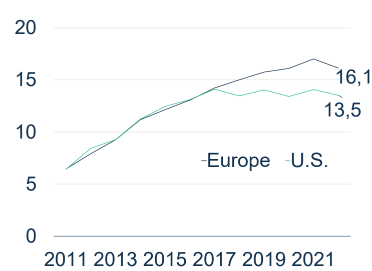
Silicon Valley Bank is not Lehman Brothers

The fact that Lagarde & Co. have not allowed themselves to be swayed by overblown banking concerns is right and important. There was actually no reason to renege on the preannounced “big” rate hike. The bankruptcy of the medium-sized SVB is a specific phenomenon: Management has made just about every rookie mistake in risk management while aggressively expanding the balance sheet. And that also went relatively undisturbed because deregulation during the Trump presidency reduced oversight by financial regulators. Otherwise, the SVB's dangerous behavior would probably have been exposed much earlier. It is to be expected that regulation will also become stricter again in the U.S. – as is already the case in Europe.

But SVB has also pursued a uniquely risky business model by U.S. standards. The bank is also not strongly interconnected with the rest of the U.S. banking system, for example through the interbank market. A systemic banking crisis is therefore unlikely. All this was completely different in the Lehman crisis. Back then, the risks spread like wildfire through the entire financial system because of Lehman's central role. And it did so on both sides of the

The ECB held its nerve

Capital ratios of large banks (CET1, %)



Source: BIS, last observation: H1/2022

Atlantic, as European banks held the same dodgy assets that brought Lehman down.

Europe's banking system not affected

It is likely that European banks will also have to write down the value of the bonds they hold due to the rapid turnaround in interest rates. But the massive, unhedged maturity transformation à la SVB (lumpy short-dated liabilities of a few tech and crypto companies versus long-term bonds) is unlikely to exist in this form in Europe. Regulatory Supervision is stricter and the capitalization of the banking system is higher than in the U.S. (see Figure 1).

Despite the turbulence on the capital markets this week, there is currently no sign of a crisis escalating. European bank shares were taken to the cleaners and sold off. But they are still up on the start of the year. A key Euro area stability gauge, the risk premium of Italian government bonds (guaranteed to be on Lagarde's personal ticker!) has hardly moved.

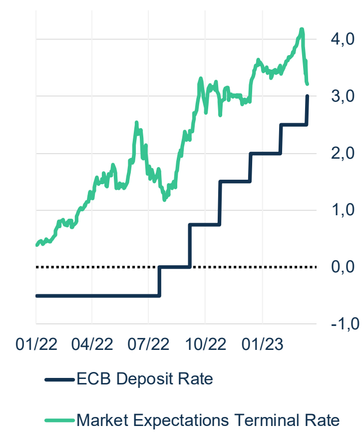
Where do interest rates go from here?

It was therefore right and important that the ECB did not allow itself to be dissuaded from delivering the previously announced rate hike of 50 basis points. Anything else would only have stirred up panic: do they know something we don't yet suspect?

The outlook is somewhat more nebulous than of late. Lagarde stressed that in the future, they would be data-driven and reshuffle the deck at each meeting. LBBW Research still expects three "small" interest rate steps of 0.25% each into the summer. Then the ECB deposit rate would be 3.75%. The probability that this so-called "terminal rate" will be lower has certainly grown. The market expectation reflects that SVB has provided the monetary policy doves with new arguments. The terminal rate is seen by the capital market at just 3.2% (see chart).

Risks to financial market stability are manageable, despite US bank failure

ECB Deposit Rate and Target Rate (%)



Source: Refinitiv, LBBW Research