What if the ECB raises its policy rates?

Roland Berger Institute

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Persistently high inflation rates have put pressure on central banks to act
What will happen if the ECB takes action and raises its policy rates?

WHAT'S THE MATTER?

Inflation rates in the US as well as in Europe are at their highest levels in decades after the economies rebounded from the Covid shock.

Due to the extraordinary rise in inflation, the Fed has already announced to abandon its ultra-loose monetary policy: It will halt its asset purchase program by March and has signaled policy rate hikes. Additionally, there have been discussions about reducing the central bank's balance sheet.

Conversely, the ECB is yet to communicate measures to end its ultra-loose monetary policy. ECB President Christine Lagarde has only gone so far as to communicate that the ECB plans to reduce its bonds purchases slowly and will further evaluate the underlying reasons for the current inflation rates. The ECB is cautious as it fears that the tightening of monetary policy could stifle the post pandemic upswing, thereby causing a recession.

However, financial market players have deduced a possible turnaround in the ECB's monetary policy in the near future from the ECB chief's recent statements and expect a policy rate hike in Europe in 2022.

In this edition of What If?, we ask ourselves how exactly an interest rate hike would proceed in Europe and what implications this would have.

INFLATION RATES
[yoy, %]

Source: Eurostat; BEA

Since the global financial crisis, the ECB has expanded its monetary toolkit, relying increasingly on unconventional monetary policy tools such as asset purchases

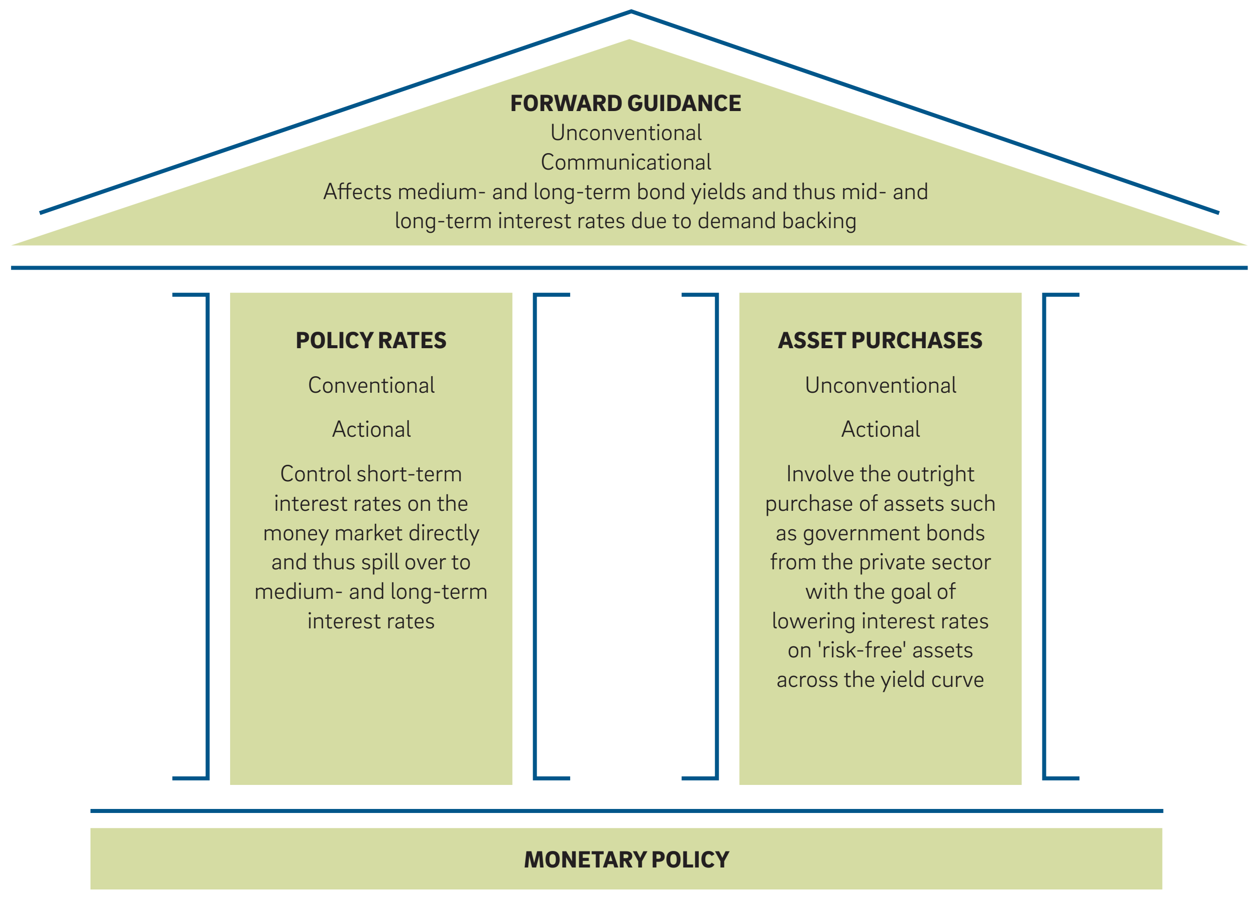
For several decades, central banks in advanced economies used policy rates as their primary tool for conducting monetary policy.

The policy rates for the ECB are the rates for main-refinancing operations, the deposit facility and the marginal lending facility. Other conventional monetary tools include the steering of minimum reserve rates or other open market operations such as longer-term refinancing operations (LTROs).

The global financial crisis (GFC) of 2007-2009 changed this, when asset purchases became a crucial tool in central banking, with interest rates setting losing its effectiveness as rates reached the effective lower bound. Although asset purchases were not a new tool for monetary policy, the extent and the consistency with which the tool was used was unprecedented.

Additionally, forward guidance, which relates to the central bank's communication of the "stance" on monetary policy, has become an increasingly important tool since the GFC.

OVERVIEW OF THE ECB'S MAIN MONETARY INSTRUMENTS

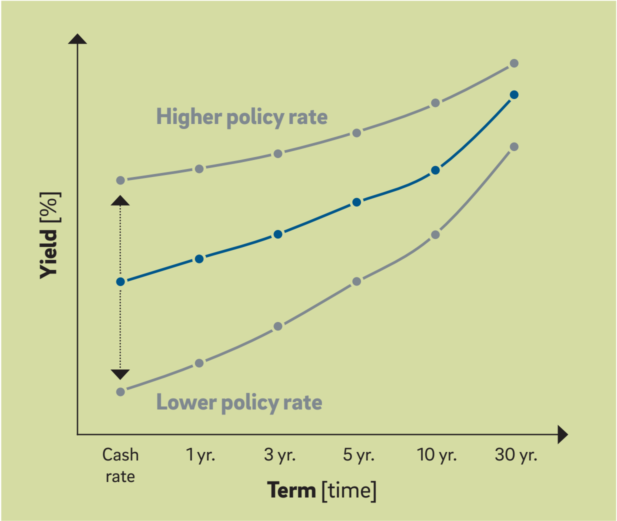


Source: European Central Bank

The yield curve is central to the transmission of monetary policy and indicates investors' expectations for future interest rates, economic growth and inflation

MONETARY POLICY AND THE YIELD CURVE[1]

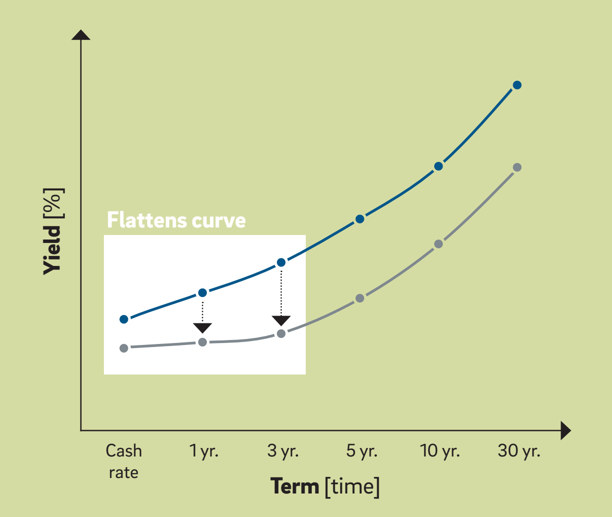
CHANGES ON POLICY RATES



Policy rate changes aim to shift the level of the yield curve up (increasing the policy rate) and down (decreasing the policy rate), particularly at the short end.

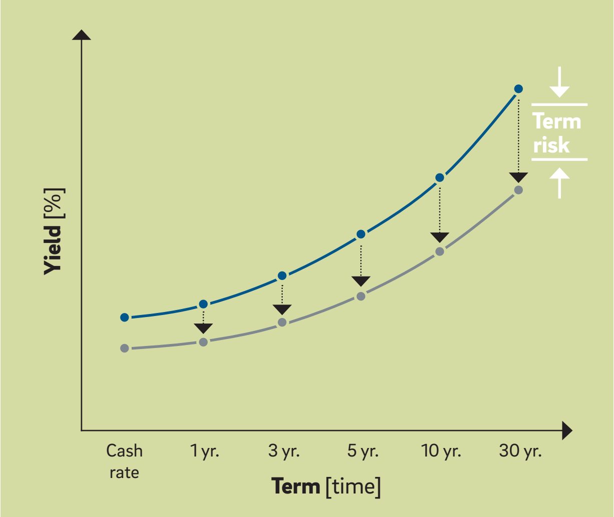
By controlling the short end of the yield curve, a central bank can affect the entire yield curve, as higher (lower) policy rates will also lead to higher (lower) expected future interest rates.

FORWARD GUIDANCE



Forward guidance aims to influence the slope of the yield curve. By communicating the central banks 'stance' on planned monetary actions, the central bank aims to influence the expectations of market participants regarding future interest rates, thereby shaping the yield curve. When a central bank announces that policy rates are expected to remain low, the yield curve can be expected to flatten between the short end and the term of the yield curve that matches the term of the guidance and further lower the yield curve out.

ASSET PURCHASES



Asset purchases aim to change the slope of the yield curve. By outright purchases, central banks add to demand for specific assets (e.g. government bonds). As a result, bond prices increase, and yields fall. A large amount of asset purchases can flatten the yield curve by lowering the additional yield investors require to compensate for the uncertainty that interest rates or inflation could rise in the future, i.e., the term risk.

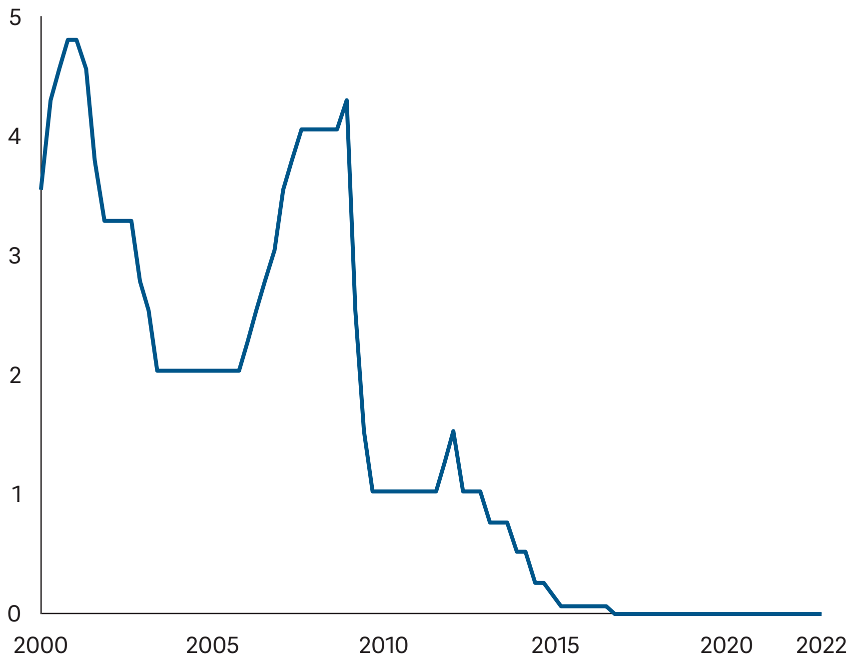
1 The yield curve plots the relationship between current market yields and the maturity of debt securities

Source: RBA

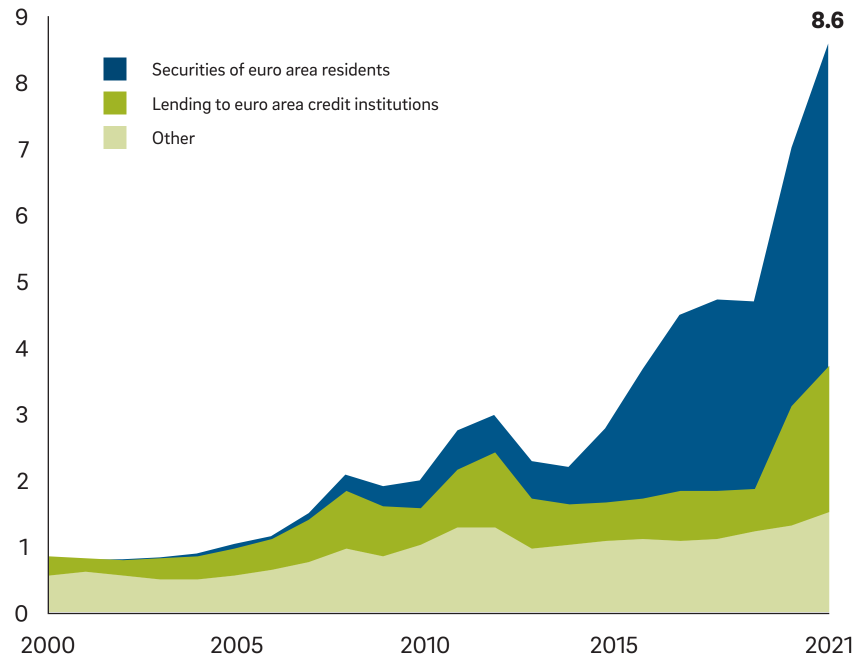
The ECB's target interest rates are at historic lows, while its balance sheet has ballooned since the global financial crisis

POLICY INTEREST RATES AND ASSET PURCHASES OF THE ECB

ECB TARGET INTEREST RATES [%]



ECB BALANCE SHEET, SELECTED ASSETS [EUR TRILLION]



Key interest rates in the euro area have sunk to historic lows after the GFC, as the ECB sought to provide indebted economies with the opportunity to boost growth with cheap financing conditions. Since then, the ECB has raised policy rates only once. Target interest rates have been at 0% for nearly six years now.

While central banks' balance sheets had already been mounting sharply after the global financial crisis, the magnitude has been taken to another level in the past decade. This is mainly due to the surge of the ECB' asset purchase program (securities of euro area residents) as well as the increase in lending to euro area credit institutions.

Source: ECB

The Fed's so-called taper tantrum in 2013 bears important lessons for the ECB's communication strategy when it comes to a turnaround in monetary policy

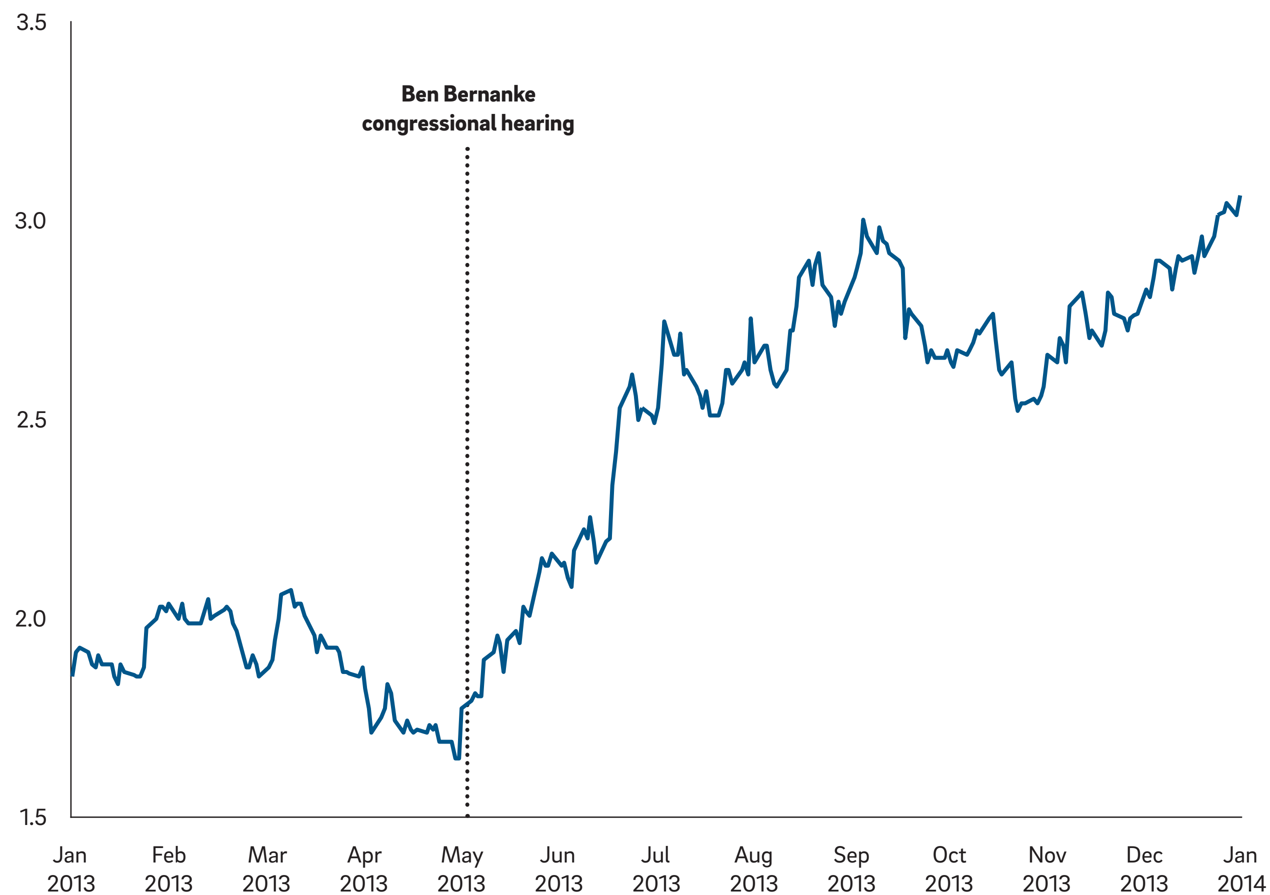
In unprepared remarks in a congressional hearing on May 22, 2013, then-Fed Chair Bernanke mentioned the idea of tapering down bond purchases for the first time, saying "If we see continued improvement, and we have confidence that it is going to be sustained, in the next few meetings we could take a step down in our pace of asset purchases."

The market was rattled by these remarks, with 10-year yields rising dramatically, as investors feared that the market would crumble if the FED discontinued or lowered its asset purchases which had increased its balance sheet from USD 1 trillion to USD 3 trillion since 2008.

The extreme bond market reaction at the time to a mere possibility of less support in the future underscored the degree to which bond markets had become dependent on Fed stimulus.

The taper tantrum holds crucial lessons for the ECB as it considers a more restrictive monetary policy: Forward guidance is essential to developments on financial markets, which spill over to the real economy, thereby impacting the overall economic development.

MARKET YIELD ON U.S. TREASURY SECURITIES AT 10-YEAR CONSTANT MATURITY
[%]



Source: Federal Reserve

Having learned from its 2013 mistakes, the Fed initiated its monetary turnaround with prudent communication before implementing concrete measures

THE FED'S PLAYBOOK FOR A MONETARY TURNAROUND

Mar 2021

Jerome Powell

"It is not time to start talking-about-talking-about tapering ..."

May 2021

Mary C. Daly (CEO SF Fed)

"We are talking-about-talking-about tapering."

Jun 2021

Jerome Powell

"You can think of this meeting as the 'talking-about-talking-about' meeting."

Sep 2021

Jerome Powell

"While no decisions were made, participants generally view a gradual tapering process [...] to be appropriate."

Nov 2021

Jerome Powell

"Our decision today to begin tapering our asset purchases does not imply any direct signal regarding our interest rate policy."

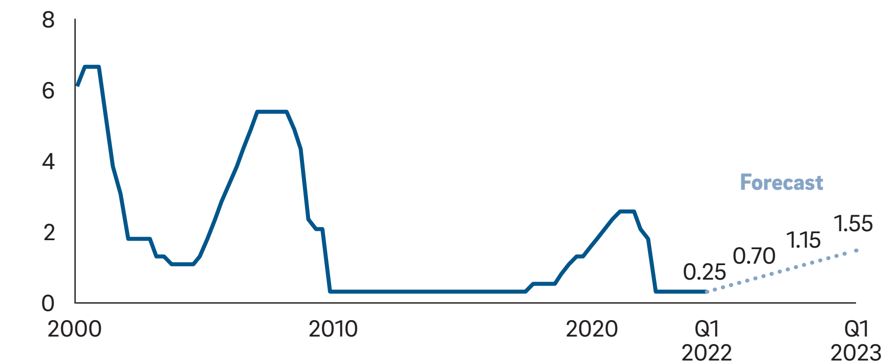
Dec 2021

Jerome Powell

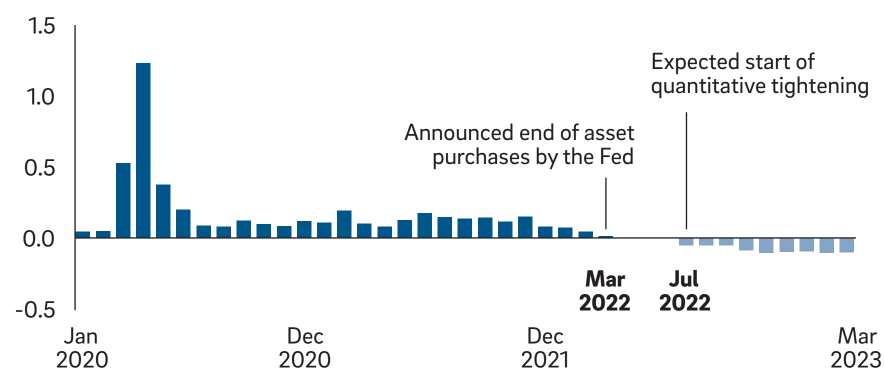
"The median projection for the appropriate level of the federal funds rate is 0.9 percent at the end of 2022, about 0.5 percentage points higher than projected in September."

Implementation

FED'S POLICY RATE [%]



FED'S ASSET PURCHASES [USD TRILLION]



Source: Federal Reserve; Bloomberg

The Fed's recent announcements on its monetary turnaround have triggered an increase in treasury bond yields around the world

As a result of the recent Federal Reserve's announcements on its monetary turnaround, yields on U.S. Treasury securities jumped – and pulled up yields on government bonds in other countries right along with them, as markets are repricing bond yields higher on expectations that central bankers will need to embark on tightening cycles to reign in surging inflation.

Most recently, ECB President Lagarde also gave the impression that the ECB might deviate from its current monetary policy course should the inflation situation not ease - which led to a further significant rise in European yields.

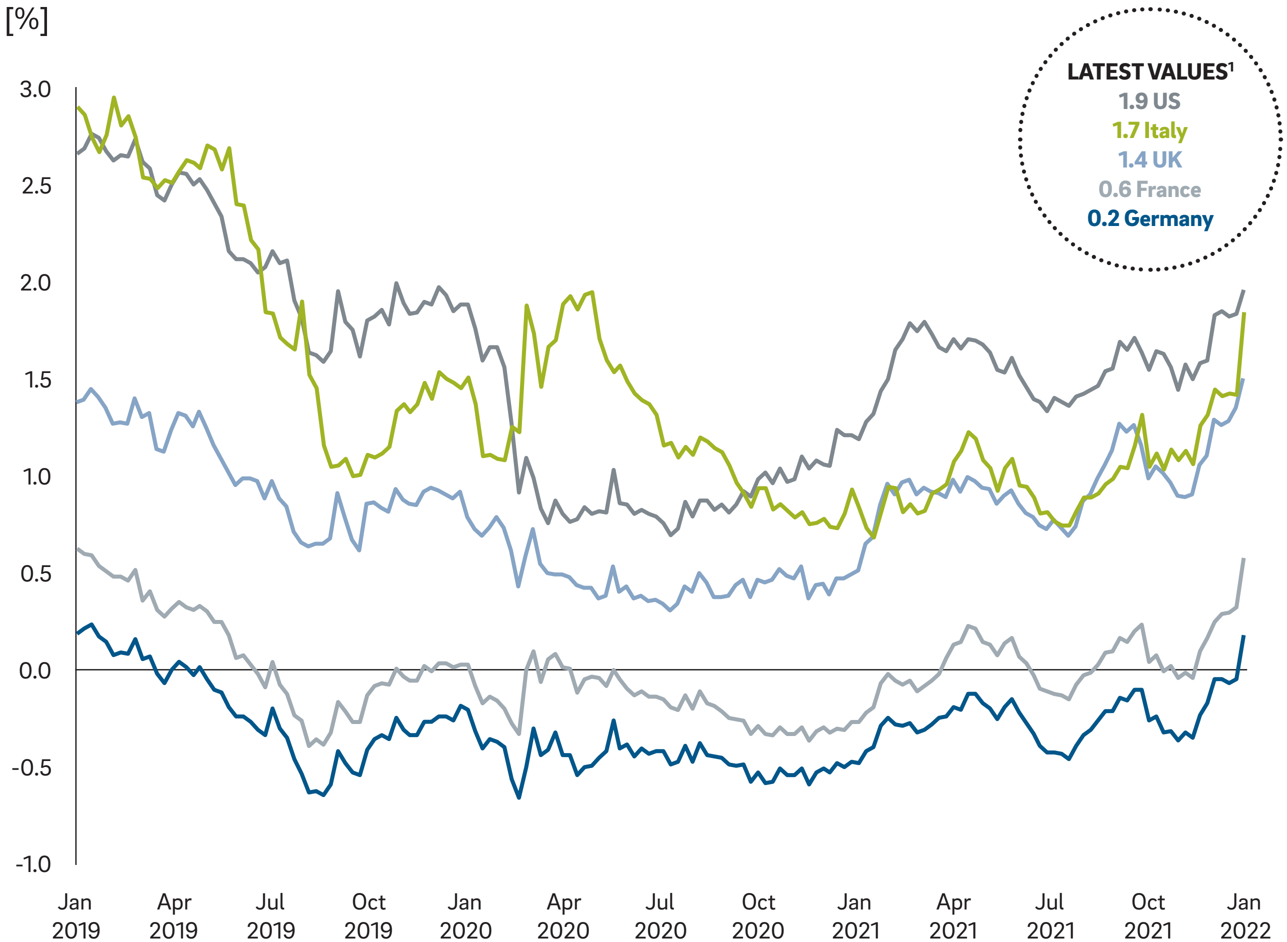
The hike in treasury yields after the announcements of the central bank presidents clearly indicate that investors react to central bank communication and already price in expected monetary actions such as rate hikes.

Rising yields on government bonds also increase financing costs of the real economy, as long-term sovereign bond yields are strongly positively correlated with long-term bank lending rates.

Government bond yields influence lending rates by inducing higher risk premia and by raising banks' funding costs.

YIELDS OF 10Y GOVERNMENT BONDS

[%]



1 Latest values as of February 2022

Source: Bloomberg

Usually financing costs for the real economy have risen fairly linearly with key interest rates in the past

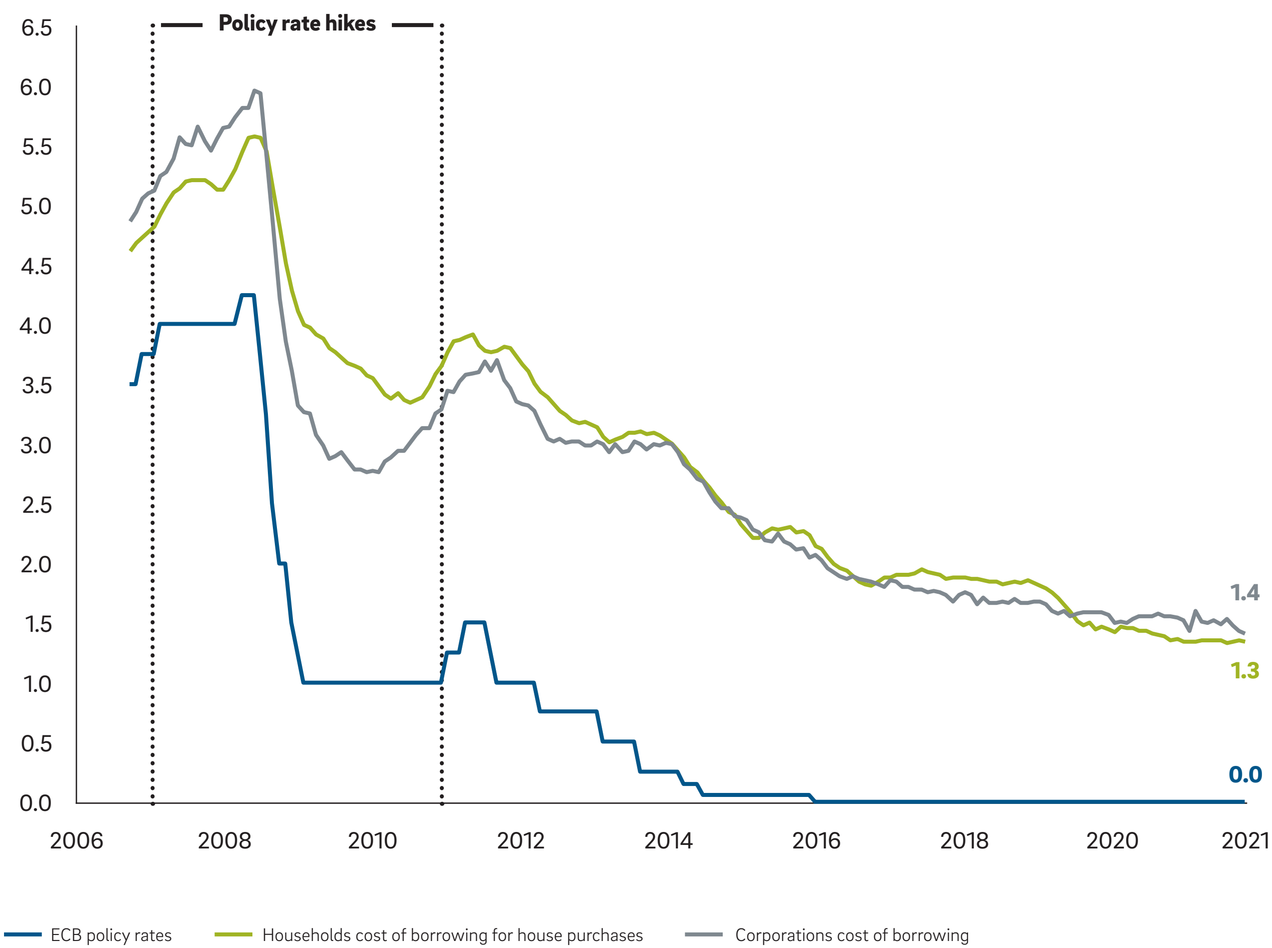
When the policy rate moves, it is often stated that bank lending rates will follow suit. However, forecasts as to when and to what extent are usually vague: The interrelationships are complex, making accurate predictions difficult.

The ECB's policy rate has only an indirect impact on long term bank lending rates: In order to grant loans, banks must obtain funding. To do this, they have various options. Among other things, banks can refinance themselves on the interbank market, with central banks or via secure bonds.

So far, average lending costs already increased before the central bank raised its policy rates. This is because banks do not obtain all their funding from the central bank but also refinance themselves via market instruments such as bonds and customer deposits.

Hence, if the ECB announces an upcoming increase in its policy rates, this communication has a direct effect on the expectations of market participants. This in turn can lead to rising yields on the bond market, which increases the refinancing costs of banks. Banks pass on this cost increase to customers in advance of the policy rate hike.

AVERAGE FINANCING COSTS FOR HOUSE PURCHASES AND CORPORATIONS AND POLICY RATES [%]



Source: ECB

Higher interest rates could contribute to the ECB's target of price stability, but also slow economic growth

POTENTIAL IMPACT OF POLICY RATE HIKES

Consumers

could benefit from

➔ price stability

➔ better returns on savings

could be burdened by

➔ higher borrowing costs, incl. mortgage

Corporates

could benefit from

➔ the prevention of a price-wage spiral

➔ a more stable planning of their sales

could be burdened by

➔ higher costs to finance their investments

Government

could benefit from

➔ stable price levels preventing further socio-economic division

could be burdened by

➔ higher borrowing costs – enforcing the government to cut expenditures and/or raise taxes

➔ not being able to decrease debt levels via inflation

Economy

The overall impact of higher interest rates is hard to assess. Higher interest rates triggered by a monetary turnaround could dampen overall demand, thereby reducing inflation to a certain degree. At the same time, lower consumer spending, investments and government expenditures could slow down economic growth. Price stability, on the other hand, could strengthen consumer and business confidence.

Source: Roland Berger

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