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Italy can stem the increase of interest rates

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April 8, 2022

Don’t exaggerate concerns about financial stability. ECB must act.

In March, inflation in the Euro area rose to 7.5% (in words: seven point five!). The pressure for monetary policy action is becoming increasingly inevitable. After the March 10 meeting, President Lagarde explained how the overdue normalization of monetary policy is envisioned in Frankfurt: In the third quarter, bond purchases are to be reduced to net zero and only maturing securities are to be replaced. Only after that will interest rates be raised "gradually" (synonym for "creeping"?).

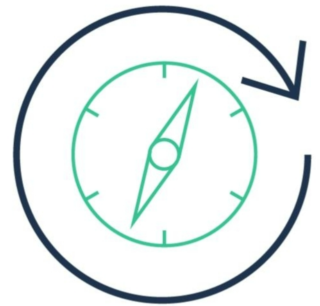
The fear of whether Italy can withstand higher interest rates

The ECB is likely to be concerned that a more rapid normalization of the monetary policy mix could entail risks to financial market stability. For this reason, the ECB should move only cautiously, almost as if on eggshells.

What is this about? The concern is about Italy. In the press conference in March 2020 Lagarde pointed out that the ECB is not there to decrease sovereign bond spreads. There is nothing wrong with that, of course. But the sentence had not yet faded when a massive sell-off of Italian government bonds began, worse than on any single day of the Euro crisis. This shock runs deep and is probably still a reason for the hesitant pace today.

Italy can cope with the interest rate turnaround!

However, the starting situation today is much more favorable than it was just a few years ago. Last month, for example, Lagarde's surprise announcement that the ECB intended to end its bond sales more quickly than had previously been widely expected provoked a comparatively restrained reaction in Italian government bonds.



Italy is considered a doubtful case in the Euro area. But Rome can live with higher interest rates.

It will in fact not be without consequences if the ECB no longer buys over 100% of all new issues of Euro government bonds, as has been the case to date (see chart). Interest rates have already risen. Spreads are likely to widen further.

But Italy is in a better position than many skeptics believe:

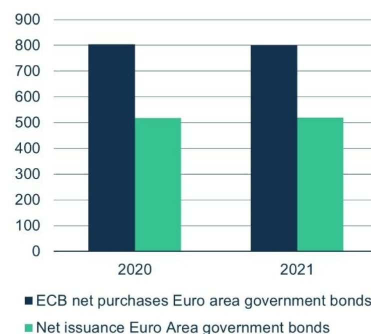
1. High inflation reduces government debt. With inflation-driven nominal growth of 10%, the debt ratio falls by 15% of GDP in 2022. This helps.
2. However, it helps even more that effective interest rates are very low (below 2% for outstanding debt). And since higher-yielding bonds are still maturing and can be refinanced more cheaply today, the effective interest burden will also remain low for a few more years.
3. And it particularly helps that Italy currently has a stable and competent government that enjoys broad parliamentary support. Not a matter of course.
4. Last but not least, Italy will receive substantial budgetary relief from the EU reconstruction fund over the coming years. Between 2023 and 2025, Italy can expect annual grants of more than 1% of its GDP and somewhat more through favorable EU loans.

Seizing the opportunity

Inflation is in danger of slipping away. More and more every month. The ECB has to shift up a gear. Concerns that Italy cannot get through this financially are unfounded. It can and it will. The longer Mrs. Lagarde hesitates, the more likely it is that an Italian government crisis will get in the way. And then things would get really difficult.

ECB bond purchases exceeded net issuance

Billions



Sources: ECB, Bloomberg, Finance Ministries, LBBW Research

Special factors make Italy less vulnerable to rising interest rates

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