J.P. Morgan Asset Management

March 15, 2023
09:30 AM EDT

Karen Ward: Good afternoon, everybody. It is March the 15th. Thank you so much for joining us. I'm absolutely delighted to have Rolf Strauch with me today. He is formerly of the ECB. He's now Chief Economist and Management Board Member of the European Stability Mechanism.

It was back in November I asked Rolf if he would come and join me. And at that time, I said I think what we want to talk about is how Europe has changed. A lot has been thrown at Europe in the last few years, but a lot has changed, and really to bring to light some of those changes. And also, I always still get the question about sovereign risk in Europe, and therefore we were going to talk about that. I didn't think that on the day we met we would be encountering quite this market turmoil and whether right today we would be questioning financial stability and sovereign risk. So in some ways, I think the timing is perfect, but unfortunate circumstances.

If we can go on to the next slide for your learning objectives for today. We're going to talk about all of these things. We're going to talk about the European economy. We're going to talk about growth. We're going to talk about inflation. We're going to talk about some of the reforms that have happened and particularly with regards to the crisis management architecture. But I think we have to start by addressing what's happened in the last few days. And particularly, I'm just going to start with just a couple of moments of my thoughts of Silicon Valley Bank, of course SVB, this new acronym that suddenly has entered our daily parlance. And I just wanted to start by giving my thoughts on the U.S. side of things, and I know, Rolf, you've kindly offered in your comments later, discuss whether or not there is any read across for the situation in Europe.

I just wanted to start with focusing on Silicon Valley Bank in particular. And I think the first question you always have to ask yourself is, what was it that went wrong with that financial institution? I think there are aspects of it that really are unique to that institution or maybe a couple of small regional banks. The first is that 93% of the deposits were corporates, which is unusual. Usually they're a mix of household savers and corporates. And within those corporates, they were very concentrated in highly niche, early-stage technology companies. As the funding, the venture capital funding for some of those depositors dried up, they were then calling on their cash, and therefore, what would have already been quite flighty capital, we saw quite significant outflows. That really was unique. Though the scale of that 93% of those depositors being corporates, that really does stand out relative to any other institution that you look across in the U.S.

On the other side of their balance sheet where they were investing those deposits, it wasn't that they were investing in highly risky assets. In fact, what they were investing in was largely high-quality bonds and U.S. treasuries, which you might have thought to have been safe. Now unfortunately, this is a real timing problem. They invested a lot of that cash because they saw a rapid increase in growth in deposits in that institution. They invested at the time where interest rates were at a record low. Then, of course, we experienced the turmoil of 2022, and therefore significant unrealized losses, which were then having to be realized as the depositors were withdrawing their cash.

And I really think there were aspects of this story, not entirely unique, because of course it was followed then by Signature Bank in New York with very similar characteristics. But they do really stand out relative to any other U.S. financial institution.

Now of course, even if that's the case, after any bank failure, there's always the risk of a loss of confidence in the banks and a broader bank run. So we had on Sunday night an announcement from the Fed, the FDIC and the Treasury, a joint announcement. A pretty comprehensive, extraordinary backstop package of measures to make sure those depositors would get their money back in full, regardless of the fact that 95% of them were over the $250,000 threshold for receiving depositor insurance. And they also announced a new term facility so that any financial institution would be able to park high-quality bonds and receive cash at par, which overcomes this issue of having to realize unrealized losses. So that was really extraordinary measure that came through very late on Sunday night to shore up confidence in the financial system.

So what happens next? Well, the key question is, has it worked? Has it shored up confidence? Has it stopped deposit flight, deposit movement within the U.S. banking system? We just don't know at this stage. We will not know for days, weeks when the data is revealed exactly what is going on. So I think it's very much just a wait-and-see game at this time.

What are the implications for the economy is the second question I'm asking myself. As we say, we don't know at this stage. But I think the risks are that if other regional banks find themselves having to compete for those deposits to keep those deposits within their institutions, the risk is that increases their savings rates and their lending rates, and that really tightens financial conditions for the businesses that they lend to. So I do think this has economic impacts, and we will see those play out over the coming days and weeks. But we have no idea at this stage the scale or the gravity of that.

What does that then mean for the Fed? Because they're going to meet tonight. They don't have time on their side at this stage. My thought here is -- and as I say, there are likely to be financial conditions and economic implications that will slow the economy, and that will influence inflation. So I personally don't think that the Fed should put this down to a financial stability issue. They should focus single mindedly on inflation. I do think it has implications for growth and inflation. However, I think if they were to say tonight, we're going to just wait and see, we won't do anything, then if anything, the risk is the market would say, well, what do they know that we don't know?

So my expectation is that tonight we do see a 25 basis point increase from the Fed. And then I can only presume what they would want to say is we now need to wait and see. We don't know. We need to see how the next weeks and months evolve. Our commitment is absolutely to inflation, which as Jerome Powell said last Wednesday, was looking concerningly persistent. So they need to see how the situation unfolds and whether that in itself will start to drag down on inflation.

So that's my thoughts on SVB. But I've got a much more important source of authority in the room to talk about what's going on in the world. So I want to turn to you now, Rolf. And let's start by thinking about growth, thinking about the economy in Europe. As we came into last Friday, what shape was the European economy in? What's your assessment at the moment of how strong Europe looks?

Rolf Strauch: So first of all, thank you for having me here, Karen. It's a great pleasure to talk to you, talk in this form, in this format. And compared to the time when you invited me last November and we set this up, obviously the Euro area seems to be in a better shape in a sense that Euro area has turned out to be more resilient than we expected at the time. And actually, growth forecasts have been revised upward. Maybe we can show the first slide, actually, and the first chart that clarifies that a bit.

Here you see the performance of Euro area growth compared to the Great Financial Crisis and the Sovereign Debt Crisis where you see that we are overall coming out of this crisis and out of this double shock much stronger than was the case in the past decade. The other point is also what you see on the back of the changes in the energy prices. Actually, the current account is kind of reversing and flipping back.

So overall, the Euro area has shown quite some resilience, and there are different elements that come to this. First is that some of the supply side constraints that we were facing have eased, obviously, over the time. The second point is there have been quite supportive policy measures, but also inherently the resilience that is in the economy due to the labor market, due to the accumulated savings has been stronger than we may have expected. And the third point, obviously, is also kind of the good weather. And there one must say we were lucky. But sometimes it also takes a little bit of luck of making that point. And the implication of this is that obviously less energy use, which is on the back also then of the readjustment of energy prices, which gives us, in a way, also a better position going forward.

And here maybe we can turn to the next slide because that is an important point, also in a way forward-looking. So what we see here is the cost of energy imports, but also the EU gas storage and gas prices. I think what you see at this stage that in terms of, if you wish, resilient factors and what can shape us forward-looking is the fact that storage is still very high, and high also compared to historical standards, so which gives quite some comfort in going through this year, into this year.

The other point, what you see is that actually the energy price hike in the last year was partly self-inflicted because everyone felt this strong urge to fill storage, and that is what drove prices up. Now, with the Euro area countries being able, A, to have higher storage now and also to diversify the energy sources, obviously in 2023, there would be much less of a race towards specific energy sources at a specific point in time. That should help very much to contain, actually, price pressures. So this is, I think, a very good point to see.

And finally, also with a view to energy, we have seen real savings of energy which are not only related to the mild winter, but also related to the fact that industry has been reshuffling processes. We know that the German industry was particularly dependent on Russian gas, and they have made substantive savings with a relative small loss of actual output. So the adjustment capacity here played a role, and that has added overall to this resilience that we have seen.

Now that is not to say that there are no risks out there. That is very clear. And here we obviously have to think about geopolitics that remains high on the agenda. So we don't know what Russia will do. We will have to see how China also positions itself forward-looking. That is certainly one point.

The other point is inflation itself. And here the question is how persistent will it be? We now see that actually headline inflation is going down, and we can show this also on the next slide. So headline inflation is going down, but core inflation is still staying up and relatively high, was actually trending upward. So we can expect core inflation to go down, but that may take a bit. And then there is the question of second [draw] effect.

Other risks may emerge simply from the economy readjusting to the higher interest rate environment that we are having, and SVB is one element in this adjustment process. If I look overall at the economy, at balance sheets, we can say that companies by and large came out relatively strong. Households also have -- are relatively well positioned, but there are risks, and we cannot deny them.

The financial sector, we have done a lot, and we will talk about that more in detail later on. Financial sector has significantly improved its position, and also here we see quite some inherent strengths. And then one has to think further how to address the risks that are actually emerging.

So I think the starting position for digesting, if you wish, for working out this kind of interest rate increase is actually a fairly good one, which if you ask me for the outlook against -- and growth forward-looking, in my view, it's still set for rather a soft landing. So a soft landing meaning that we can avoid a recession, get over the medium run hold on inflation, and bring inflation back without having a major financial instability event. So we can get there. Obviously along the way, some policies need to fall into place. So monetary fiscal policy need to actually play their part. But with this being done -- and there are a lot of policy initiatives going on, there is a lot of policy dialogue going on -- I think we can actually get this done.

Karen Ward: I want to come back to a couple of the points you've made. So you said about how -- and it was on the slide previous, maybe if we can go back, that it's really quite remarkable how we've come through with still 60% gas storage. So as you say, the risks for this winter, which just four or five months ago, whether Europe would literally be rationing energy. At that point, there were forecasts of a 5% contraction in GDP in Germany. So this winter has gone remarkably well. Are we at the point yet, do you think, where we have got confidence for getting through next winter? Or do you still think we need to see how the rest of the winter plays out, how we achieve importing from other sources through the course of the summer? What's your conviction on next winter at this stage?

Rolf Strauch: Yes, indeed. This concern about -- or this narrative of this winter we kind of managed, but next winter will be much more complicated has been out there. What I actually get from the discourse with energy experts is a relative more comfort also next winter. So the fact that we have this high storage is an important one. The fact that we have diversified energy sources is an important one, and we have gone relatively efficiently and relatively fast on that. And the fact that we actually made some energy savings. So for Europe, the commitment was 50%. We got to 20% savings. So we don't need additional savings, basically, to make it through next winter under normal conditions.

So if it were excessively strong, I don't know what will happen. But so that what I get from energy experts is now much more focused really on what are the needs for the medium term, about energy transition in the long run, then about big worries about next winter. So I'm relatively comfortable with a reasonable degree of policy coordination through the course of this year, as I said, that we can avoid the same kind of price development and price hikes that we had last year and still end up with full storage and well prepared for next winter.

Karen Ward: And going on to the inflation story a little bit, so going back on to the next slide. It's fair to say if we compare that left-hand side panel to the same chart for the United States, for example, there's many more what we might hope to be temporary factors. So food and energy that are contributing to inflation. And hopefully as those base effects drop out, that could lead to inflation falling back quite quickly. But as you say, there are questions about core inflation and how sticky that is.

One of the questions that I often get and I'm thinking about is the role of the labor market and inflation in Europe, and particularly how that contrasts to the U.S. Because I think the Fed or markets have been very concerned about the fact the labor market is just too hot. And therefore record low unemployment, rapid wage growth, that's going to keep inflation persistently high. Is it a very different situation in Europe where the underlying inflationary pressures are more muted in your assessment?

Rolf Strauch: So, I think in drawing this comparison to the U.S., we must be very mindful that the starting point for Europe and the U.S. obviously was very different for this inflationary pressure. While in the U.S. it was much more driven by domestic demand and a massive, massive fiscal stimulus, it was much less the case. For Europe, this is, to a very large extent, imported inflation, in terms of trade short, big loss of income, that nonetheless, has kind of a more stagflationary risk that comes with it.

Now if you look at those charts, obviously, so we see the decline in headline, as one would expect also on the back of declining energy prices. And actually, we see that this decline is, to a large extent, driven by energy. In terms of food, food is still working through the inflationary pressures, so there is less of a -- or generally, food inflation is more persistent than energy inflation. And the same holds for services, service inflation.

So this is all what we call pipeline pressures. So the original impetus on inflation working through the economy, generally this is expected to recede after a while with a certain delay, nine months, one year, after headline inflation so that core inflation also starts to declining. And if you look at the right-hand side chart, you already see that the short and selling price expectations are actually declining. So with a certain delay, that could be expected to follow, but there are risks. We don't know exactly how long that will take.

And then there's importantly the second round effects that you said, and here we mainly relate to wages. If you maybe on that one could show another chart on European labor market. So if you go to this here, we said that U.S. labor markets are very tight. What we see is and what is on the backdrop of this resilience is that I mentioned, is this very strong performance also of European labor markets. This year, it shows actually the labor force development in the U.S. and in the Euro area over the last decades. In a way, I like to show this chart because it also greatly illustrates what many people tend to forget is the huge transformation of the European labor markets over the past decades due to the reforms that were taken.

So we see here a massive increase in the labor force and labor market participation, which is by and large female labor market participation also, which is great to notice that a lot of labor force has been actually been added to the point that, indeed, now labor market participation in Europe surpasses the U.S. Having said that, it also allows for some adjustment, and that is helpful with a view to wages. If you look at the reaction after the second oil price crisis in the '80s, you had a slump in labor market participation, which was a lot of early retirement.

What we see here in recent years is actually that labor market participation in Europe and the U.S. dropped rather the same amount by 3 percentage points in the pandemic, but then it came back faster in Europe than in the U.S., which was also the fact of keeping people on the job. But obviously, high labor market participation also allows to be more constrained in wages, and so it alleviates the labor market. So it's I think one of the crucial reasons to understand why actually wage developments have not been as belligerent as they were in the past and also past crises.

So from that perspective, I think wage developments in Europe have been -- or unions and the wage demand have been incredibly responsible. So there are only very few countries, and it's Belgium, it's Luxembourg, and parts of Spain, we still have wage indexation, but otherwise not.

Wage demands and wage settlements have always have mostly, to my -- as far as I know, generally been below inflation, which means that workers and unions have been willing to take a real income hit in the short run for not kind of having accelerated wage requests. This means that wages may stay somewhat higher for a time because you cannot expect full -- that workers in the long run will be willing to take this real income hit. But at the same time, you can have productivity playing in and lowering unit labor costs. So from my perspective, actually economically, it's a very good move not to have seen this kind of wage -- rampant wage increases that would fully compensate for real income which could lead to a wage price spiral.

So forward-looking, I don't see any risk of wage price spiral. I see the point that wages may stay up higher than 2% for a bit. But this is also will be attenuated by productivity gains. And so that overall I think, yes, there is a point of being cautious about medium-term inflation, but still all in a relatively reasonable environment.

Karen Ward: And so I won't ask for your opinion on this, but perhaps that will give the overtime at some point in the next few months, the ECB a little bit of confidence that their inflation situation is back under control.

The next thing I wanted to ask you about, Rolf, was about some of the support packages that have been put in place over the last couple of years. So the next generation EU package I think is, to me, really important in many aspects, partly with regards to stimulating growth. But also, of course, this was the step towards the fiscal union, which for the critique -- those that were critiquing the Eurozone back in 2012, the argument was that it could not be sustainable to have a monetary union without a fiscal union.

And I think really in the past few years, this movement towards the recovery fund and the Next Generation EU takes us towards solving that issue of complementing a monetary union with a fiscal union. But there's honestly obviously significant growth impact. And I know maybe you could speak to this slide about quite the extent of the growth impact and the main beneficiaries, because I think people underestimate the scale of this and the support to growth.

Rolf Strauch: When you -- in your introduction, you talked about the additional confidence also that people may have in Europe. We see it a lot when -- I mean, we are on the sell side. We are on the buy side. We talk a lot to investors. And we see a lot also the additional confidence that was expressed towards Europe by investors. And a lot is on the back of the fact that Europe was in a position to actually pronounce a coherent strategy to get out of the pandemic.

This was just -- and since then, I think also if you look on the back of it, also the response towards the Ukraine challenge, yes, with (inaudible) on there, but overall has been very decided, very clear and also very united. I think this is actually indeed a reason to -- for more confidence in Europe, as I said, and actually real progress.

When we look at those elements, and what comes with Next Generation EU is basically it's two points. The one point to note is that when we went into the pandemic, we had a common shock but a different impact on countries. And there was a deliberate attempt to help countries that were particularly hit by the pandemic. And that is why, actually, the assignment of funds under Next Generation EU has also registered with the kind of notion and impact. And so much was redirected to those funds that are here -- to those countries that are here, shaded a bit darker, which is kind of to southern and more central eastern countries in order to also allow for a catch-up and allow for compensation for the impact of the pandemic.

The other point, obviously, is it's greatly transformative in aiming at the digital transition and aiming at climate change. So really wanting to transform the economy and do that both with investment and do it with structural reforms. In order to allow for investment, and that is what you said, making those resources available, it is loans and grants. So real transfers, really broadening the envelope available to countries. And that is overall on the investment side very helpful. If you look at the overall package, it's about 6% of Euro area -- European GDP, which is by and large the size of the Netherlands.

Karen Ward: It's not a small number.

Rolf Strauch: That's actually GDP, so this is really quite a number. The impact that is expected from it at the end of the program, which will be 2026, is an increase of growth by 1.5%. And this is basically only counting in the impact in terms of investment. If on top of this, the hope and the expectation is that you, through the structural reforms, get on the longer term, higher growth path. And with the help of transforming the economy and making it more digital, making it more sustainable, that you actually will be shielding off much of the impact that you will see with climate change.

Obviously, this is a longer term project and more needs to follow up, but I think as a starting point, it is indeed massive. And I think it's also -- I know that there are calls for more money, bigger money, but one must also acknowledge there is a certain absorptive capacity of member states. And I think at this stage, it's really -- there is a great follow-up with those different programs that the countries put forward, but at the same time, one can also not overburden member states. And I think we found here really a good balance in the overall design of this very transformative overall package.

Karen Ward: Yeah, absolutely. I think to me, it transforms not only the nominal growth outlook but -- and I know this is what we're going to come on to now -- but as you say, the signal to the rest of the world about solidity in the region, but also how it plays into regional politics and disruption to populism. It's a significant benefit for so many of these countries. So I think it's a hugely significant package that was put together.

Let's come on to the question, which I'm sure many of the people that have dialed in today really want to hear from you on, which is the risk of sovereign crisis in the future. Have we -- we've talked a lot, therefore, about the growth advancements, about moving towards some common fiscal policy. Have we sufficiently moved forward in the whole architecture of the region to feel that we have a better prevention and measures in place to prevent another sovereign crisis such that we won't be encountering something like we encountered in 2012?

Rolf Strauch: Let me say, I think we are far away from a sovereign crisis at this stage, and let me explain why. So first, in terms of overall crisis architecture, I think we have made great developments, and from the start of the Great Financial Crisis, the Euro crisis until now. And what I see is now in terms of overall Euro area crisis management, we have basically created these pillars or European crisis management over the course of the different crises. A, we need to notice that monetary policy has way more tools and has a more -- really a bigger, more developed toolbox at the ECB in order to address speculation, address spread widening, unjustified spread widening, and so address fragmentation and monetary union than they had in the past.

Second point, obviously, and then it comes mainly also to our institution, we have rescue mechanisms. We have crisis resolution mechanisms, which is -- and that is us. But also in the pandemic, we have created ad hoc mechanisms like the European Commission's short program that could support member states. So that is the rescue mechanism arm. And third, with Next Generation EU, we have also added to the existing tools like the EU budget, or the EIB, in order to address common growth problems and this transformation of the economy that we talked of before.

So that I think from that, we have created a relative resilient also infrastructure to manage crisis, and we should also notice that by itself gives confidence. What many people told us, when we in the pandemic, we created a pandemic support tool. We didn't deploy money, but we often heard from investors that, indeed, it helps to give confidence, that in case of need, you can step in.

When it comes next to this, we also must notice that Europe has obviously made great progress in establishing banking union and in being firmer and better in the supervision of the banking sector. And that is key obviously also at this juncture. And then with a view to what you said to SVB, I fully agree with what you said on the special business model and character of the bank. From what I understand, the immediate spillover to Europe is very, very limited. So the UK has dealt with SVB in the UK. The German Supervisor has put a moratorium. There is no deposits involved to the extent that I understand, at least in Germany. So from that perspective, the immediate -- there are no immediate repercussions.

Then we have to see that European banks are regulated differently. And for European banks, generally the Basel principles apply also to liquidity management. And actually, liquidity in European banks at this stage is relatively high. So that from that perspective, I see much less of a risk within the banking system. And it now came to the fore at SVB, which I understand specifically also falls under a certain regulation in the U.S. that has liquidity requirements. So overall, which gives me relatively still comfort to say that I think the European banking system is much safer.

I do understand that there are developments in the equity market also with a view to European banks so that they have taken at least a relative hit or a temporary hit or adjustment of equity prices. But that I think has also been seen against a background of profit expectations that are linked maybe to monetary policy and not with a view to the specific risk of the bank or the banking sector, the risks that are directly borne by the banking sector.

We will have to see how that plays out. But I think, indeed, we have done -- Europe has done quite a remarkable job, and I think it's still a very thorough job, which is now also kind of reconfirmed by repeated stress tests that are done by the banking authorities in order to see how much banks are safe in weathering housing price adjustments, interest rate price adjustments. And so far, the verdict has been relatively positive. It has been not relatively, but has been overall very positive, and also because European banks have holding a lot more capital than is required under regulatory -- the strict regulatory rules.

So from that perspective, SVB reminds us that we need to be careful and reminds us that we should have a robust crisis management structure. In that regard, again, also ESM comes in the picture in being -- that we will be the backstop. The Single Resolution Fund will be a fiscal financial backstop to this banking union structure and making us -- making therefore banking union resilient. But overall, I think the banking system to me looks pretty sound.

Karen Ward: I just want to reiterate a couple of points because I think they're so important. I just want to make sure that the audience really got that. The point that you made about how -- I'm getting a lot of phone calls today, why are European bank stocks down more than U.S. Bank stocks since last Thursday? Does that mean there is a greater risk within the European banking system? And the point you made, which I fully agree with, is to me, it's not clear at all that this reflects institutional credit risk. This is more that the whole global interest rate environment has changed. Yield curves have completely repriced across the world. And of course for banks, it's very good for profitability to have higher, steeper yield curves. What's happened is the yield curves have fallen and flattened or inverted.

So it's about the profitability, which isn't to say it's just that maybe profits aren't quite as high as thought maybe a week ago. And I think the influence of that on what's happening to share prices in the financial sector is really important to digest to distinguish between the two.

The other point in your house here I think is really important for when I -- when people talk to me about how will governments cope with higher interest rates? How will Italy cope with higher interest rates? Is what matters for their sustainability is, of course, the differential between the interest rate and nominal growth. And in 2012, the problem was the interest rate was going up as the prospect for nominal growth was going down, and it was this vicious cycle of that getting continually worse. So that third pillar in your house I think is really important and is very different, as you say, because so many of that growth support -- I mean it's 7% or 8% of Italian GDP, I think, the NGEU. So yes, interest rates are higher, but nominal growth is higher. And I think that's really important for us thinking about debt sustainability.

But maybe on this specific question -- and I know your next slide does speak a little bit more to higher interest rates and what it does mean for governments and debt sustainability. Maybe you could just elaborate a little bit more on this question of essentially governments coping with higher interest rates.

Rolf Strauch: No, that is indeed a crucial point, because if you look at this chart, that obviously it's clear that for the Euro area, the real interest rate, long-term interest rate increase -- the increase that we are seeing now is exceptionally high. So it's the highest in the history of the Euro area. So that it's clear that governments need to adjust to that.

And I think -- you asked me before, people see the risk of a sovereign debt crisis. If you really look at it, the point is, as a matter of fact, is that we know the average maturity of sovereign debt is about 8 years. So it also takes some while for higher interest rates to feed through the system, or so to speak, to feed through the stock of debt before it then becomes -- really ends up in higher real -- in higher expenditures and significantly higher expenditures. So that there is some adjustment time.

Having said that, at the same time, also we are very clear with, in our message, in saying but yes, in the medium term, it plays a role. You were talking about the interest rate growth differential in nominal terms or in real terms. What it means if real rates are above real growth is that you cannot run down your debt without making a savings effort. And that is what I think will be relevant in the medium term for governments, that they have to be very conscious about this. That maybe the past times where you could expect to get down your debt without a savings effort, over time this, in my view, is over, and governments need to be prepared to have those savings. That is -- but, again, and that also on the back of aging and pension. This is for me more in the medium term and not something that kind of becomes completely constraining or binding at this moment.

Here I want to also reiterate, there is quite some recognition of that. So actually come back from -- or earlier this week, I was at the Eurogroup in Brussels, and there the European Commission gave its fiscal guidance. There was a statement by the Eurogroup, which is the Euro area Ministers of Finance related to this. And there is clear recognition that the current support measures that are given to the economy that may have been well warranted, backward-looking, but they need to end. It's time to end them. It's now also time to think more about building the fiscal buffers. And that is a message to which we certainly fully subscribe.

Karen Ward: Excellent. Okay. Well, we've got lots of questions, Rolf, that have come in, so I know we're going to turn our attention to those. Perhaps if I can do just a little housekeeping before we do, just to remind you of guests coming up in the next few months.

So I've got Anton Pil who's my colleague over in New York. He's the Global Head of Alternatives. Anton was recently in Ukraine with Zelensky talking about how J.P. Morgan are going to be funding some of the rebuild efforts. So I'm going to ask him about that experience, but also, I'm going to talk to him a lot about real estate in the U.S. Obviously by that point in a month's time, we'll have a lot more information about whether we can still remember what SVB stands for. Let's hope we don't still remember because we hope that's all gone away. But if not and it is escalating, I think he'll be very at the forefront of what's going on there, particularly across the U.S. property market. And as we know, Anton is not short of opinions, so he will bring those, I'm sure. And then an external author that was going to focus on his new book, we need to talk about inflation on the 17th of May. So do put those dates in your diary.

And also before I forget, in event resources, there is not only this presentation that Rolf has kindly supplied, if you want to have a look at those charts in more detail, but also the note that I put out on Monday about my thoughts with regards to SVB and how it will influence the global economy and global policy, so you can read that again. And also the deck that I used a couple of months ago when I spoke about European stocks, if you want to think more deeply about what some of this maybe means for the European equity market.

Okay. Some of you pre-submitted some questions already, and I'm very grateful for that. So we're going to start off with one from Dennis here, which is -- hold on. This question -- let me just get my right question here. We're going to start off with Sonda, actually. So things have improved, she agrees, thus, the risk of recession have receded. Perhaps a little bit more -- I think we've ticked off the question about an energy crisis next winter. I think we've done that part. But maybe a little bit more about some of the risks from the lagged effect of ECB rate hikes coming through, the housing market weakening, and one dropping fast, bank lending standards. Could you perhaps elaborate on the economy-wide impact of the ECB tightening that we've already seen so far?

Rolf Strauch: Maybe I kick it off with the housing market and my view on that. And maybe also what we see with an interest rate increase is obviously an adjustment of asset prices, other asset prices other than fixed income, that is something that one should expect to happen. And for me, obviously, also with the ESM experience and background, we look into housing markets. And we see that there is current price adjustment, but what we see is so far not beyond also what one could expect on the back of interest rate increases. So in a way, this is to some extent also a welcome adjustment of prices to this environment, which we should not be disruptive, of course, but which is also not something that we should be, per se, very worried about.

What gives me, on top of that, some comfort is that when you think about the past European crisis, and where actually there was a housing price bubble as a driver of that development, that was a different environment where the housing sector, say, in Spain was much, much bigger and had much more excess supply than it had in this case. So while we see this adjustment in housing prices now, I see less of a macroeconomic impact of it. And that, I think, to me is somewhat is reassuring in terms of our ability to also deal with it and adjust it. So the macroeconomically and the impact macroeconomically should be less.

Which is not to say that there is no risk coming with it. And then we come to household balance sheets and how it works for household balance sheets. Again, we still I think in the household sector, we are benefiting from the low interest rate environment. Also, if you look at indebted households, the interest payment to income ratio is still relatively low on the back of the formerly very low interest rates. And in Europe overall, we benefit a lot from fixed interest mortgages. So that gives a buffer. But obviously, we are also concerned about cases and countries where this rate of variable interest rate mortgages is much higher, and then there are some risks for households. So we do expect some increase in non-performing loans. And it is indeed that banks should be prepared for this -- or should prepare for that.

The same on the corporate side. Corporate sector balance sheets are relatively sound. The corporates came very relatively strong across the model, so to speak, out of the pandemic. We see that corporates actually have increased profit margins overall. Now during the time period of the Ukrainian war and the interest rate -- and the price increases, so that again, balance sheets are relatively sound. That does not mean that corporates -- all corporates can go healthy through this -- through the current setting. And also on that side, one must be cautious. But risks overall in that regard seem to be more contained than they were in the past.

So from that perspective overall, yes, there will be asset price adjustment. It will have some fallout, but at this stage not of a magnitude that I would expect not to be manageable.

Karen Ward: And there's some further reading that might help you for this question, Sonda, which is one of my team put out a piece on risks of the housing market. And I was very pleased when I was hearing you discuss, Rolf, that we came to very similar conclusions. That on the whole, on aggregate, we felt the macroeconomic fallout of the housing downturn would be lower, but there are some specific countries where that sensitivity is higher. And if you read that piece, you can certainly see that.

There was a great paper from the BIS as well, which I do think is worth reading recently, which was about the elongation of the transmission of monetary policy this time. Because how so many households and companies -- and this isn't just a European phenomenon, but in the U.S. as well -- took advantage of those low interest rates and have termed out their debt. Now obviously, that does mean it's just slower. Eventually those higher interest rates will feed through to everybody. But I do think that explains some of the resilience that we've seen in economies to date in the U.S. and in Europe to these higher interest rates because that transmission is a little bit more smoothed. If you follow me on LinkedIn, and actually, can you see my little QR code, I'll post that paper on the BIS -- the BIS paper, because I do think that's a good one worth reading.

Okay. Another question from Dennis, which is about the contributors of inflation, as we saw in that chart in Europe being, as you say, primarily more cost factors, imported inflation. The question here is can interest rates actually control that inflation, given its energy costs and supply shortages?

Rolf Strauch: A very pertinent question, of course. As a former central banker, actually, I worked -- at the ECB they have a report on energy prices and the impact on inflation. And it was one of the things that I did before moving to the ESM, and so it's a topic very dear to my heart also. And obviously, any energy price shock puts the central bank in a difficult situation because of this stagflationary impact. You have a cost price shock up. It increases inflation at the same time. Puts -- makes growth lower. And because it's imported in the first stage, as a central bank, you cannot influence world prices on energy. That is indeed beyond your element, beyond what you can do, which however, doesn't say that, A, you should not react if you have the impression that it's more persistent and you cannot do anything.

In my view, I'm just now can say I repeat what ECB and many central bankers have said. Obviously, it's not the first impact that you can go for, but then everything that follows from that. Because energy prices, as we see now and we discussed with the pipeline pressures, they affect price setting, price setting behavior. They have done so massively now. That is what we see going into core inflation. Then the next stage it goes into wage negotiations, inflation expectations. And all the discourse of the ECB is indeed about more -- or the main discourse about the forward-looking factors.

I was on a panel with [Klaus Node] and he literally said, I don't care about past inflation in a way, because it's past. I cannot do anything. I care about the forward-looking part. And I think this comes across in all the central bank communication, and that is I think also from an economic perspective, general economic perspective, the right angle to look at it. We need to think about this price setting forward-looking, wage setting forward-looking and anchoring inflation expectation. And on that, the central bank can have an impact.

Karen Ward: Yeah, absolutely. Doing this webcast since three years now, there's been so many times that people have said to me, well, why are they raising interest rates and making life harder? The cost of living is harder. And as you say, they just have no good options just to not lean into a cost shock. You have those risks of the second round effects. But, yeah, I don't envy them, that role at the moment.

Okay. So on to perhaps -- okay, this is an interesting one that I've been thinking about from Saga here, which is saying European households are net savers. We're saying Europe saves money more sensible than our U.S. counterparts who like to spend. Is it possible that actually higher interest rates are a stimulant to growth because of the net savers having that income rather than leading to a drag? It turns the idea of monetary policy on its head, of course. But is there anything to that theory, do you think?

Rolf Strauch: What my hope would be for Europe is that Europe is less of an exporter of net savings than it has been in the past. And the Euro area has run a persistent current account surplus for many years. And I think it would be great if the Europeans would invest more of the savings actually at home. If I want something for the Euro area, it's actually creating the conditions for doing that.

I think to some extent, with Next Generation EU, we are on that way. Taking the lead on a climate agenda also means it creates great investment opportunities. And we know that the public sector can only give a small portion of that. The main part of this must actually come from private savings and private investments. So that is where I would see the hope and where we should be going in trying to turn more of those savings that are -- that the Europeans generate actually towards investment in Europe and bringing it really towards more growth for the economy, for the people.

Karen Ward: Okay. There's a lot of questions here, but I'm going to answer this one because I don't think it would be appropriate to ask you your thoughts on this, which is about whether the ECB should raise interest rates when it meets tomorrow following the Fed. It comes down to the comment that I made earlier on about the Federal Reserve. I think what the central banks will be thinking right now is how does this change my inflation problem? And is there evidence at this stage that the change -- that what's happening in banking turmoil will lead to a change in credit conditions, but that alone will slow the economy in a way that I potentially don't need to therefore lean as heavily on the brake. So that's the discussion that every central bank -- the U.S. tonight, the ECB, when it releases tomorrow, and then the Bank of England next week -- that's what they're all going to be trying to fathom.

Then I think they do have this slight tricky thing to think about is how they, through their actions, instill confidence rather than create further uncertainty and volatility. That's another sleeve, I think, that they'll be thinking about.

Just to give you some idea of how market pricing has changed. The peak rates, so the high in interest rates last Thursday before this banking turmoil kicked off was expected to be 5.5% for the Fed, 4% for the ECB and 5% for the Bank of England. They've all come down. So peak rates are 5% now for the Fed, 3.5% for the ECB and 4.5% for the Bank of England.

So what the market is saying is they're probably still not necessarily done. The Fed will continue with its current plan. The ECB, what's priced is 42 basis points for tomorrow. And then it will be much more -- there's a lot less price after that. So there will be a wait-and-see data dependency mode. That all looks perfectly sensible to me with the information that we have today. But I really stress that there's a lot we don't know. The measures that the Fed put in place, which are designed to reinstill confidence that your money is safe, whatever bank you've got it in, they really couldn't have been more comprehensive, in my view. I think it's really quite extraordinary. In fact, some of the criticism I noticed in The Financial Times today is it's too generous. They never can get it quite right, can they? They never can win over everybody.

But we just don't know. We don't know if households can understand that, whether they're influenced by the news that they're seeing, by what their neighbors are telling them. Really, we have to watch and see what happens to the deposit flows and whether it then influences what some of these other banks will do.

So I suspect what we will hear from the Fed tonight, from the ECB tomorrow, is inflation is still their job. They will do what it takes to bring down inflation. There are now more uncertainties about financial conditions, the transmission of policy, and therefore they will need a little bit more time to assess. So I think that we see 25 basis points from the Fed tonight, 50 basis points from the ECB tomorrow, but with a much more ambiguous tone about whether there will be anything further from there.

I think at that point, we're going to wrap up, Rolf. Thank you so much is the final thing I have to say. As I said at the beginning, I think the timing for hearing from someone in your position who's the Head of the European Stability Mechanism, in a day where everybody is once again worrying about financial crises and sovereign crises, to get to hear firsthand from yourself and feel reassured by the structures that have been put in place over the last 10 years, how we learn from 2008 and from 2012. And I think as you said, how we really learn here in Europe fills me with much more confidence, much more ability to sleep at night.

But do keep an eye on what everything we're doing here. If the turmoil does increase, I will go back to doing very regular webcasts to keep you updated. My job, I always think in times like this, is not necessarily to tell you what's going to happen next. It's to give you a framework for thinking about and telling you what we need to focus on to think about what comes next.

So, thank you so much for your time this afternoon, and do join me again next month. Thanks again, Rolf.

Rolf Strauch: Thank you, Karen. Thank you.