

Chief Economist's Note

Market squall or global crisis? The three big questions from a tumultuous week



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When things move as rapidly as they have done over the past week, it's often difficult to see the wood for the trees. Although the situation is still in flux, whether the relative calm of the end of last week marks the

beginning of the end of the recent turmoil, or a lull amid a deepening crisis, will depend on the answers to these questions:

1. Have policymakers done enough to avert a system-wide crisis?

The most immediate question is how markets digest news of the UBS deal to buy Credit Suisse. In principle a complete takeover of Credit Suisse may be the best way to end doubts about its viability. However the devil will be in the details of the UBS agreement, not all of which are clear at the time of writing. One issue is that the reported price of \$3.25bn (CHF0.76 per share) equates to ~7% of book value, and about 13% of Credit Suisse's market value at the start of the year. This suggests that a substantial part of Credit Suisse's \$570bn assets may be either impaired or perceived as being at risk of becoming impaired. This could set in train renewed jitters about the health of banks. Another is that the reported decision to write off the subordinated "Additional Tier 1 (AT1)" bonds entirely could adversely affect that asset class, particularly if other institutions get into trouble. And third, there may yet be deal risk for legal or financial reasons, or if confidence in UBS is dented and it gets cold feet about the deal. Only time will tell how this shotgun wedding is received.

All that said, a key point to stress is that the global banking system as a whole remains well capitalised. Likewise, central banks can also take comfort from the fact that new tools that have been put in place over the past few years to provide liquidity to financial institutions are working and can be expanded if needed. This includes extensive currency swap lines between central banks – which the Fed and its peers announced in a joint statement Sunday evening would be strengthened further – as well as the Fed's own standing repo facility and the ECB's LTROs and TLTROs. A full-blown repeat of the Global Financial Crisis of 2007-08 therefore looks unlikely.

Set against that, containing crises is a bit like a game of whack-a-mole – with new fires starting as existing ones are extinguished. A key issue over the next week will be whether problems arise in other institutions or parts of the financial system. On which note...

2. How could the situation escalate?

There are three areas to watch.

First, we could see more institutions follow Silicon Valley Bank in struggling with unrealised losses. According to the US Federal Deposit Insurance Corporation, unrealised losses at US banks and financial institutions stood at \$620bn at the end of 2022. The key issue is whether these institutions have hedged this risk and, if not, whether they are forced to divest assets and thus crystallise losses. The most likely trigger for this would be a loss of confidence and an outflow of deposits.

There are some sources of comfort. For a start, the US banking system as a whole does not have a worryingly high uninsured deposit ratio or unrealised losses on "held-to-maturity" securities in excess of capital. What's more, if an institution did need to raise cash, it should be able to use central bank facilities to do so, thereby avoiding the need to realise losses. So on balance we don't believe that unrealised losses on bond portfolios will be the source of a system-wide crisis. Even so, it's possible that some smaller banks might run into similar problems as SVB, which would add to the sense of nervousness around the financial system and trigger a renewed market sell-off.

Second, even if unrealised losses do not cause further problems, we could see more institutions get into trouble for other reasons. While it's tempting to dismiss the problems at SVB, Signature Bank and Credit Suisse as

idiosyncratic, they have revealed that problems are lurking in the financial system as interest rates rise. Key areas to monitor include smaller European banks and shadow banks, particularly open-ended funds that might suffer from maturity mismatches.

Finally, Credit Suisse aside, the problems so far have been caused by a failure to adequately manage interest rate risk. An altogether more serious crisis would develop if credit risks start to emerge – or, to put it differently, if loan default rates rise as banks’ asset quality deteriorates. The good news on this front is that the global banking system is much better capitalised than in the past. But with banks likely to tighten lending conditions in response to the events of the past week, it’s possible that a vicious circle develops, in which credit tightens, the real economy deteriorates, and default rates start to rise. The biggest risks lie in economies with overvalued housing markets. As we noted in a piece last week, despite the recent focus on banks’ holdings of debt securities, mortgage loans form a much larger part of their assets.

3. What does all of this mean for monetary policy?

At the risk of stating the obvious, it all depends on whether the crisis escalates and worst case scenarios materialise.

A reasonable base case is that we avoid a system-wide crisis on the scale of 2007-08 but further problems emerge at individual institutions. If so, the Bank of England’s response to the LDI crisis in October last year provides a template for others to follow. Back then the BoE provided substantial liquidity to markets in order to ease financial strains, while at the same time raising interest rates in order to get on top of rising inflation.

This appears to be the blueprint that the ECB is following. Last week it [raised interest rates by 50bps to 3%](#) while at the same time stressing its role as a lender of last resort and committing to providing liquidity to institutions that needed it. Similarly, assuming problems don’t escalate further from here, we still anticipate that policymakers at [the Fed](#) and the [Bank of England](#) will raise interest rates when they meet this week too. But this is a perilously difficult path for central banks to tread.

Crucially, while markets have spent the past several months focussing on macro data on inflation and jobs, last week’s developments are a reminder that money, credit and the financial sector matter too. In fact, they are a critical channels through which monetary policy operates and perhaps the first areas to exhibit signs that higher interest rates are starting to take effect.

A key issue over the coming months will be the extent to which the crisis of the past week causes banks to reduce credit availability. This in turn would weigh on consumer demand and business investment and therefore accelerate the deterioration in the real economy. At its worst, it could lead to a rise in loan defaults, which then feeds back into a further tightening of credit conditions, creating a deeper recession in the real economy and ultimately requiring a substantial *loosening* of monetary policy.

As things stand, we think that bank lending will contract in most advanced economies but that the negative feedback loop through rising credit risk (and a system-wide crisis) will be avoided. So while the exact implications of recent events for monetary policy are still unclear, it is likely to mean that interest rates will be lower than the markets had anticipated a couple of weeks ago, though not necessarily lower than our forecasts.

[In case you missed it:](#)

- You can track all our key insight into the turmoil sweeping the banking sector on [this dedicated page](#).

- Benjamin Guttman, a Senior Economist on our consultancy team, explored [the impact of global economic fracturing on Australia](#).
- Argentina’s hopes that a “Malbec dollar” will help it avoid a [steep peso devaluation](#) look set to be disappointed, said Latin America Economist Kimberley Sperrfechter.

Details

Chief Economist's Note | 20th March 2023



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