GLOBAL ECONOMICS UPDATE

How could the situation escalate?

- **We have already outlined some different scenarios of how things might evolve from here and it is still possible that the situation calms down quickly. But in this *Update*, we think through how the more adverse of our scenarios might evolve. There are three main ways in which the situation could escalate.**

- **First, we could see more institutions follow SVB 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. Admittedly, if depositors started to take fright as they did with SVB, policymakers might be quick to insure those deposits to stem the outflow and prevent the institution having to sell assets and realise losses. Moreover, if any institution did need to raise cash, it should be able to use central bank facilities to do so to avoid realising losses. But at the very least, the sense of nervousness in financial markets would be heightened.

- **Second, even if unrealised losses do not cause any more problems, we could see more institutions get into immediate trouble for other reasons.** It is tempting to attribute recent troubles at UK pension funds, SVB, Signature Bank and Credit Suisse to idiosyncratic factors affecting only those institutions. But even if each individual case has little read-across to elsewhere, the key point is that they all reflect vulnerabilities lurking in the financial system. These vulnerabilities might manifest themselves in different ways in different institutions.

- Whereas Credit Suisse has been on the radar for some time, there are no other obvious candidates hiding in plain sight. But it is hard to be sure given that banking regulation has been rolled back since 2018 and the non-bank sector is subject to less regulation anyway. Key areas to monitor are smaller European banks and shadow banks, particularly open-ended funds that might suffer from maturity mismatches. (See here.)

- **Third, and most significant, we could see the situation evolve from one that is primarily about interest rate risk to a more slow-burning credit crisis.** This might happen if a reduction in risk appetite and fears about deposit flight cause banks to tighten their lending criteria and reduce the supply of credit, in turn harming the real economy and pushing up loan losses. We already expected higher interest rates to cause most economies to fall into recession, or near enough. But this would make that more likely.

- How bad would things get? **It is conceivable that we could see a relatively minor credit crunch and only a modest deterioration in the economic outlook.** In effect, the tightening in credit conditions would just do the job of the further interest rate rises that, until a few days ago, were looking likely in most countries. Banks would take a bit of a hit from a rise in non-performing loans but their existing capital buffers would absorb these easily.

- **But once these things get momentum, they become difficult to manage and it is hard to stop them spiralling downwards.** The main risk lies with housing markets, which are starting from a fragile position in most countries. If households find it harder and more expensive to borrow and refinance, house prices could fall further than we expect and, especially if a bigger recession pushes unemployment up further, defaults and bank losses could rise by more than we anticipate. Vulnerable countries include those with the most precarious housing markets, such as Canada, Australia and the UK. (See Chart 2 & here.)

- Admittedly, we already expected house prices to fall significantly further in many countries without prompting a banking crisis. (See here.) **Indeed, there are several reasons why, even in a "bad" scenario, a Lehman 2.0 would still not be the most likely outcome.** The rise in house prices in recent years has not been driven by a big rise in debt as it was before 2007. Subprime borrowing has not been a big feature. It is much clearer who holds the debt now. And banks are better capitalised now. (See Chart 2.) **But even if a financial crisis akin to 2007/8 were avoided, banks and the real economy would stay weak for a long time and interest rates would need to be cut significantly.**

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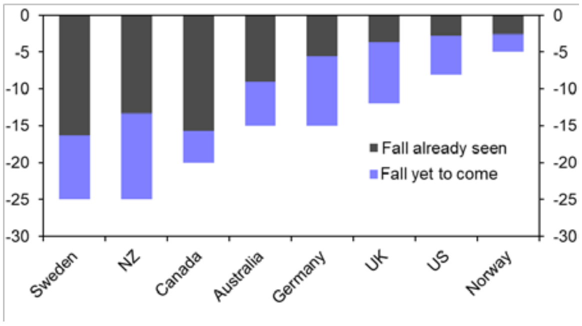
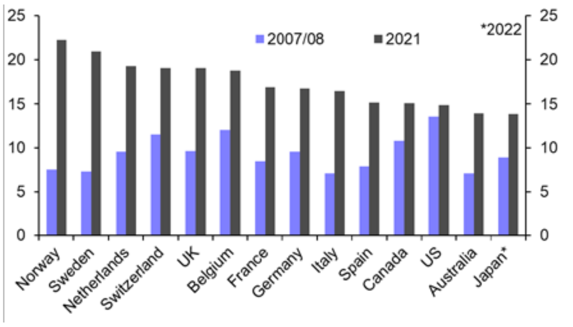
Chart 1: Nominal House Prices (%)



Source: Refinitiv

Chart 2: Tier 1 Capital Ratios (%)



Source: IMF

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