CAPITAL ECONOMICS

GLOBAL ECONOMICS UPDATE

Three scenarios for how the SVB fallout will evolve

- **Given the large amount of uncertainty about how the fallout from** SVB's collapse **will evolve, we have grouped possible outcomes into three broadbrush scenarios. Only in the worst scenario of financial problems spreading overseas will the global effects become significant enough to materially alter the course of monetary policy elsewhere.**

- **Scenario 1. In a "good scenario", the problems are confined to the collapse of a few lightly-regulated regional outfits in the US, caused by idiosyncratic factors.** Unlike SVB, other institutions prove to be well-hedged against rising interest rates. Confidence quickly returns, risk premia drop and credit conditions ease. **Implications for the rest of the world are minimal.** The US Fed reverts to raising interest rates to contain inflation, beginning with a 25bps or even 50bps hike in March, and interest rates are not cut until next year.

- **Scenario 2. In a middle scenario, problems possibly continue to emerge in the financial sector, but they are confined to the US.** US banks rein in their supply of credit to the private sector and financial conditions remain tight. The resulting impact on aggregate demand means that the US Fed does one more 25bps hike at most; and a rate cut before the end of year becomes likely. (See here.)

- The knock-on impact on financial conditions in other countries is modest. **Accordingly, other central banks remain focused on getting inflation down and crack on with the further interest rate rises that were in the pipeline.** The ECB goes ahead with its pre-announced intention to raise the deposit rate by 50bps on Thursday and the Bank of England raises Bank Rate by 25bps next week. The 1999/2000 dotcom crash is a reminder that other central banks do not have to follow the Fed in lockstep when the severity of a crisis differs across borders; although all major central banks cut interest rates, the 475bps cut in the US was far bigger than the 150bps cut in the euro-zone or 200bps cut in the UK.

- However, even if there is no significant financial contagion from the US, the slowdown in US economic growth still affects other economies via conventional economic channels (such as weaker trade). Accordingly, aggregate demand in economies closely connected with the US (including Canada and Mexico) is slower than otherwise**. At the margin, this could mean that interest rates outside the US peak at a slightly lower rate/are cut a bit more quickly than otherwise, especially if the SVB episode has increased central banks' nervousness about potential dangers lurking in the financial system.**

- **Scenario 3. The worst case would be if SVB's collapse does turn out to mark the start of a global financial crisis.** Other financial institutions run into trouble, either because of similar problems to SVB or, more likely, because SVB is an early indication of other unknown vulnerabilities lurking in the financial sector. Although all central banks step up their emergency liquidity assistance, this does not prevent a loss of confidence in the system and a significant tightening of credit conditions**. We already expected recessions in many major DMs this year; now, those recessions look much deeper and more widespread.**

- **With inflation concerns rapidly fading, interest rates are cut quickly in all countries.** Given the high level of interest rates relative to the standards of the past decade, there is scope for them to be cut significantly before the zero lower bound on nominal rates is reached, meaning that central banks do not need to restart quantitative easing. But central banks might halt their quantitative tightening programmes.

- Investor risk aversion increases globally and puts pressure on sovereign spreads in the euro-zone in particular. Meanwhile, global capital flows dry up, making it much harder for those EMs with large current account deficits (such as Turkey, Colombia, Romania and the Philippines) to fund their shortfalls, causing currencies to fall sharply and deepening their recessions. (See our forthcoming EM Update.)

- **Clearly everything is in a state of flux but, as things stand, something between the first and second scenarios seems to be shaping up to be the most likely outcome, with the third scenario more of a distant tail-risk. In other words, the US economy is likely to feel at least some lasting effects, which will affect the path of US monetary policy, but the knock-on impact elsewhere should be relatively contained.**

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