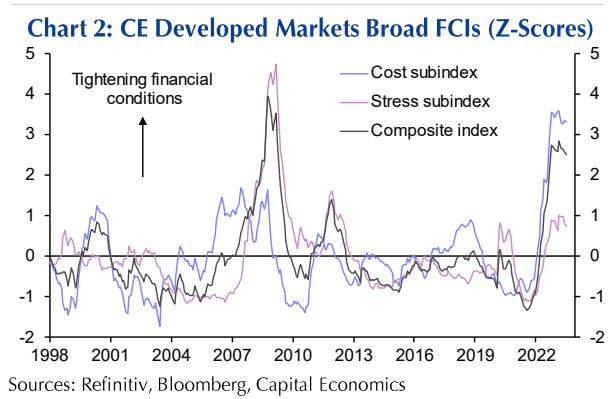
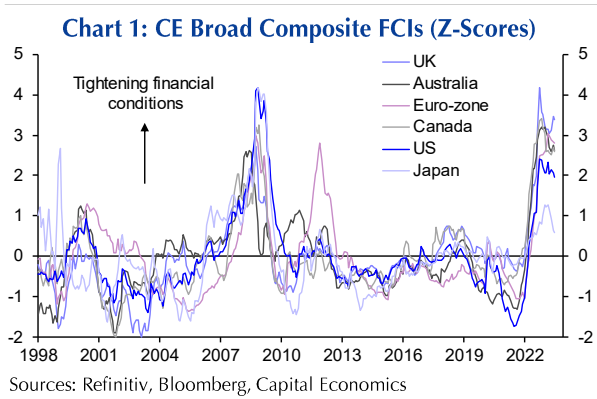




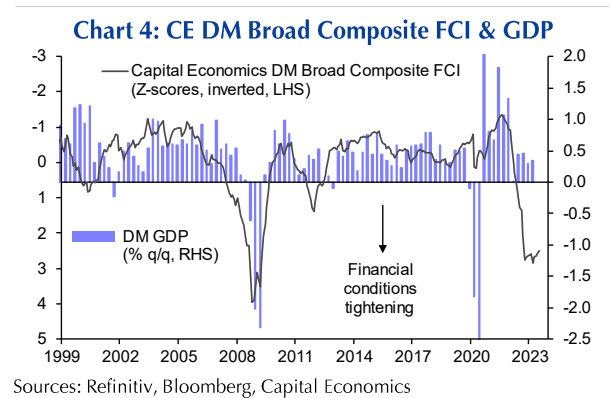
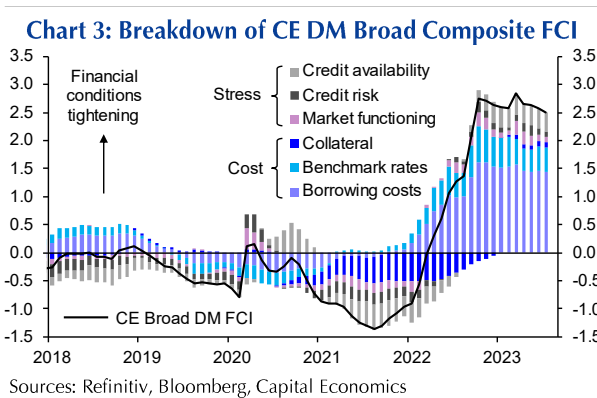
GLOBAL ECONOMICS UPDATE

Financial conditions still flagging recession risk

- Even though the financial strains that emerged after SVB’s collapse have dissipated, interest rate hikes have left overall financial conditions in major advanced economies close to their tightest since the GFC, posing downside risks to activity. As tightening cycles draw to a close, our revamped [interactive dashboard](#) gives clients an even better means of tracking financial conditions faced by households and businesses.
- To recap, our financial conditions indices (FCIs) distil a range of financial variables into indicators that try to gauge how conditions compare to the past and thus give some indication of whether they are supportive or restrictive of activity. They are expressed as standard deviations from their means, with higher FCI readings suggesting that external finance is expensive or hard to access by past standards. (For details, see [here](#).)
- While equity and credit markets have rallied in recent months, other elements of financial conditions have remained or become more restrictive. This has left our monthly ‘broad’ FCIs still close to their highest levels since the GFC in major DMs except Japan, where conditions weren’t that tight to begin with. (See Chart 1.)
- FCIs produced by other providers tend to be lower than ours because they put more weight on spreads than borrowing costs, which makes other FCIs more a barometer of financial stress than of financial conditions in general. Indeed, if we decompose our own developed markets FCI into its ‘cost’ and ‘stress’ subindices, it is clear stress levels are elevated but not especially so, while costs of finance are very high. (See Chart 2.)



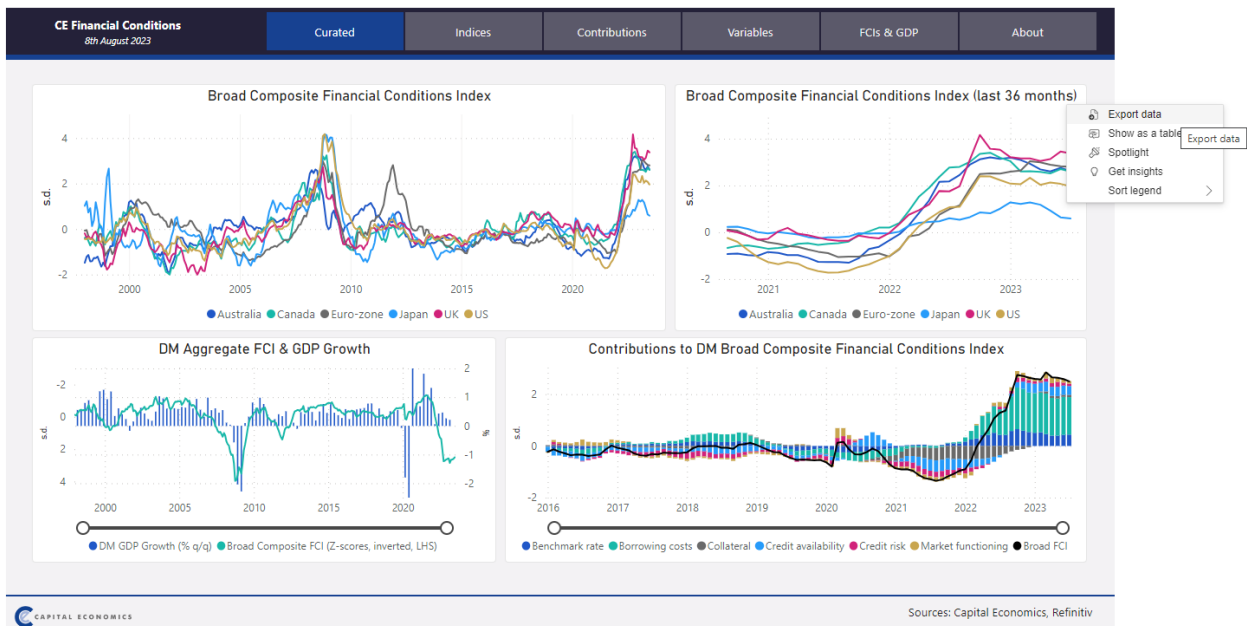
- Looking under the hood, the biggest driver of tighter financial conditions has been higher private sector borrowing costs beyond increases in sovereign benchmark interest rates. (See Chart 3.) For example, having averaged 5.5% in 2020 and 2021, interest rates on consumer credit have now risen above 8%. And interest rates on new business loans and residential mortgages have risen from about 2-3% to 5-6%, on average. Meanwhile, on the stress side, it is ‘credit availability’ as measured by indicators from surveys of banks and firms that has been the key factor, having swung from being accommodative in 2021 to restrictive in 2022.





- So, while credit spreads are narrow and equity markets have been on a tear, overall financial conditions are still super tight and consistent with significant recession risk in advanced economies. While the lags have been variable, our composite developed markets FCI has captured the major business cycle turning points from the past quarter of a century ahead of time. Today, it continues to suggest that there is a substantial chance of an outright fall in advanced-economy GDP in the year or so ahead. (See Chart 4.)
- To keep abreast of how financial conditions are evolving, our revamped dashboard is the place to go. It presents our FCIs, decompositions of the key drivers, a selection of input variables, and relationships with GDP in interactive charts, the data for which are available to download for CE Advance clients. (See Image.)

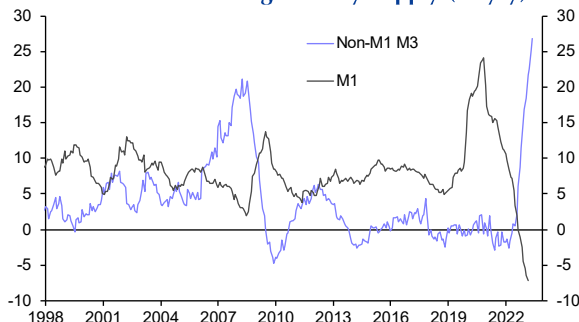
Image 1: Screenshot of the New CE Financial Conditions Dashboard



Source: Capital Economics

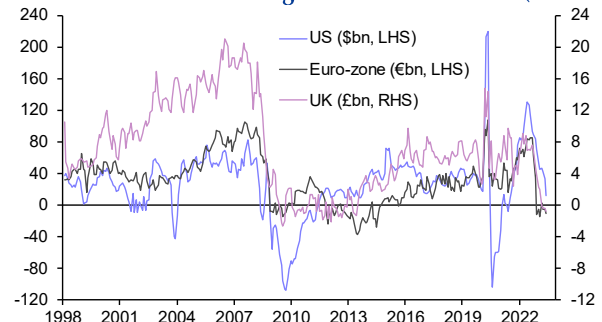
- Our FCIs add to evidence from other economic indicators that the monetary headwind is building. Money growth has slowed sharply throughout advanced economies and has now broadly ground to a halt. Within the broad money supply, there has been a shift away from instant-access M1 deposits into less liquid forms of money that are less likely to be spent, such as saving, time, and money market deposits. (See Chart 5.)
- The flipside of flat money growth has been that net bank lending has stalled. (See Chart 6.) In fact, the stock of bank credit to households and firms fell in four of the six months during the first half of this year in the euro-zone and UK, and fell for the first time since lockdowns in June in the US. In other words, in recent months, the new bank loans that were originated were smaller in value than the loans being repaid. Accordingly, the so-called 'bank credit impulse' to support spending in the economy is markedly negative.

Chart 5: DM Average Money Supply (% y/y)



Sources: Refinitiv, Capital Economics

Chart 6: Banks' Net Lending to the Private Sector (3MMA)

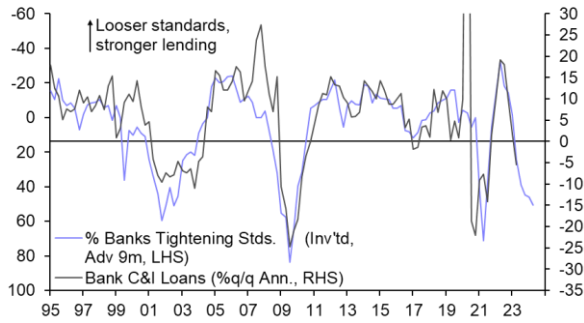


Sources: Refinitiv, Capital Economics



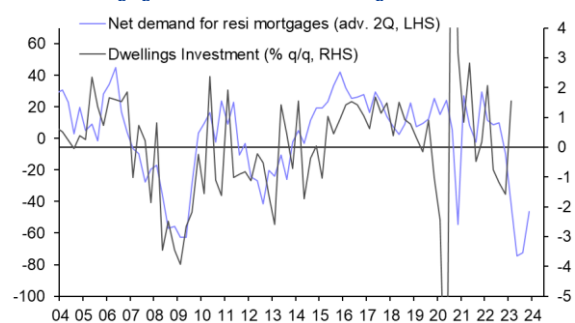
- **If bank surveys are anything to go by, the credit impulse is likely to weaken further.** The Fed’s latest Senior Loan Officer Opinion Survey **revealed** that, even though the banking crisis has faded, US banks are still firming up the criteria with which they assess the eligibility of loan applications. On past form, the net share of US banks tightening lending standards on loans to businesses points to a significant contraction in the stock of commercial and industrial loans (see Chart 7), which bodes ill for business investment. In the euro-zone, a raft of survey balances from the ECB’s latest Bank Lending Survey **signalled** falls in activity in the second half of 2023, including weak mortgage demand pointing to a drop in residential investment. (See Chart 8.)

Chart 7: Net Percentage of US Banks Tightening Commercial & Industrial Credit Standards & Loans



Sources: Refinitiv, Capital Economics

Chart 8: Net % of Euro-zone Banks Reporting Stronger Mortgage Demand & Dwellings Investment



Sources: Refinitiv, Capital Economics

- **All in all, whether it is our FCIs, the money and credit data, or the bank lending surveys, the financial conditions data all point towards economic activity in advanced economies struggling in the quarters ahead. In the absence of significant offsetting factors, recessions seem more likely than not in most cases.**



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