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Markets have settled but tighter credit conditions remain a risk to the economy

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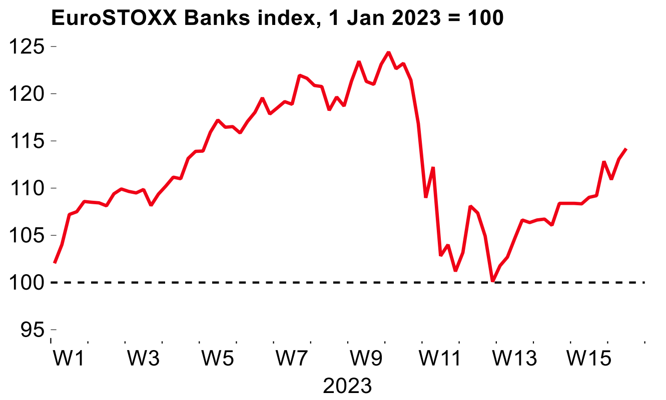
Banking sector fears have mostly subsided in Europe after a period of intense market scrutiny, but the macro repercussions could prove more persistent. Credit conditions were already looking tight even at the end of last year and there is a clear risk of a credit crunch weighing on economic activity over coming quarters. This could offset stronger economic momentum seen recently in the euro area and leave growth relatively muted through 2023.

Banking sector fears have mostly subsided

The European economy emerged from the winter on a much better footing than expected after navigating the energy crisis (see here), but any respite was short-lived as market attention shifted quickly to stress in the financial sector. The collapse of SVB in the US in early March and the sudden acquisition of Credit Suisse by UBS stoked concerns about a broader banking crisis after the sharp rise in interest rates.

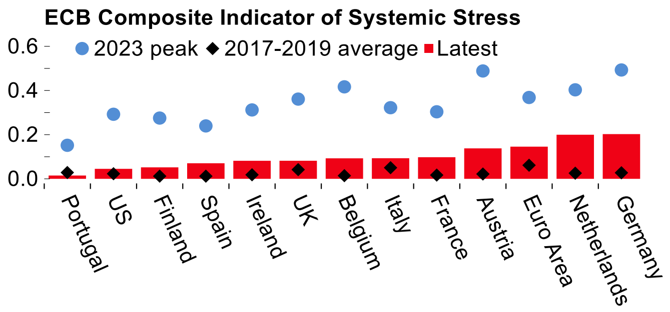
But as time has passed after the initial period of extreme market scrutiny it seems more likely that issues at Credit Suisse and SVB may have been isolated incidents rather than an indication of wider, systemic issues in the banking sector.

CHART 1: EUROPEAN BANK EQUITIES ARE NOW RECOVERING



Source: Macrobond, MUFG Bank Economic Research Office

CHART 2: SYSTEMIC STRESS INDICATORS HAVE FALLEN BACK



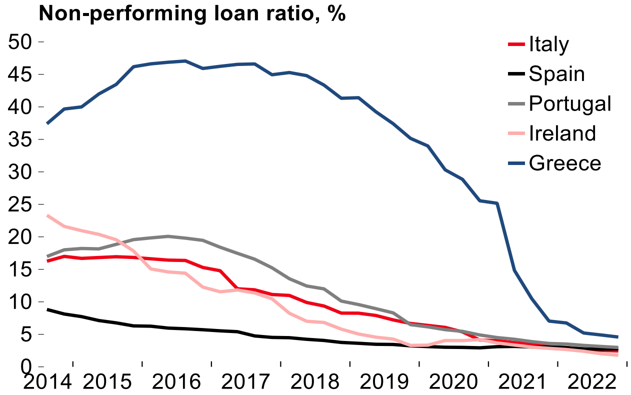
Note: The CISS index is a daily indicator published by the ECB designed to show stress in the financial system. It is created from 15 inidividual series, aggregated into 5 market-specific subindices. It is designed to place more weight on situations in which stress is occuring in several market segments at the same time.

Source: ECB, MUFG Bank Economic Research Office

Financial markets have clearly calmed over the last few weeks. The EuroStoxx Banks index, while not back to its early March levels, is still over 10% up YTD (Chart 1). The ECB's daily systemic stress indicator has also fallen back sharply (Chart 2), but does remain above post-sovereign debt crisis/pre-pandemic averages.

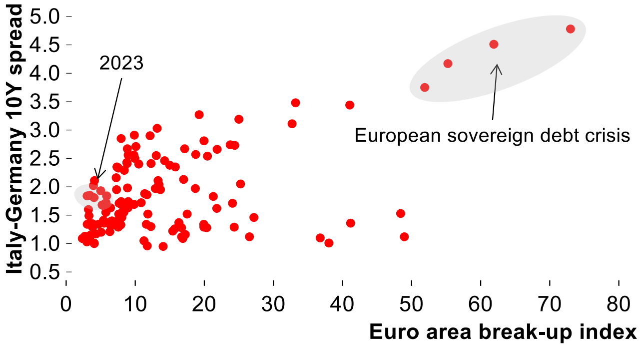
On paper, the numbers are reassuring: European banks' liquidity buffers look healthier than in the past, and balance sheets seem less toxic with a fall in non-performing loan ratios since the sovereign debt crisis years (Chart 3). European banks are also now subject to stricter regulation with the ECB granted a supervisory role since 2013. And, taking a step back, the risk of any euro area member country leaving the single currency is not a current issue (Chart 4).

CHART 3: BANKS' BALANCE SHEETS LOOK LESS TOXIC AFTER THE DECREASE IN NPL RATIOS



Source: EBA, MUFG Bank Economic Research Office

CHART 4: FEW CONCERNS CURRENTLY ABOUT A REPEAT OF THE EURO AREA SOVEREIGN DEBT CRISIS



Note: The Sentix Euro Break-up Index shows the percentage of investors surveyed who expect at least one country to leave the euro area within the next 12 months.

Source: Sentix, Macrobond, MUFG Bank Economic Research Office

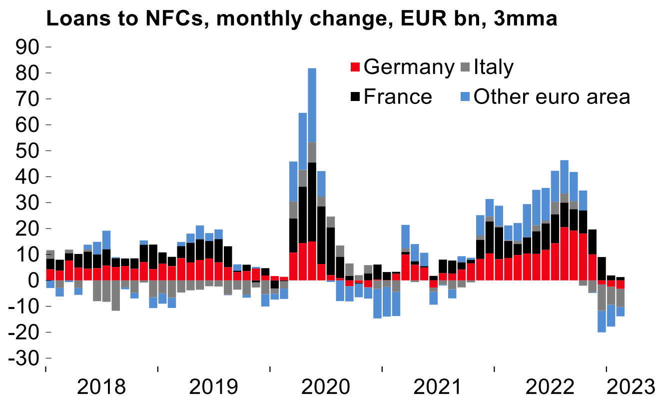
So, while we're not ready to say that a crisis has been averted, it's certainly encouraging that European banks have so far withstood intense investor examination after the takeover of Credit Suisse.

Of course, recent events have made it clear that market conditions can change quickly and concerns about the banking sector will not vanish entirely. There may well be more areas of concern yet to emerge following the shift to a higher interest rate environment after years of rates at the lower bound. For instance, we note that there are now some signs that the European housing market could be responding to higher borrowing costs, with the EU house price index showing the first quarterly decline since 2015 in Q4 2022.

Tighter credit conditions will be a headwind for growth

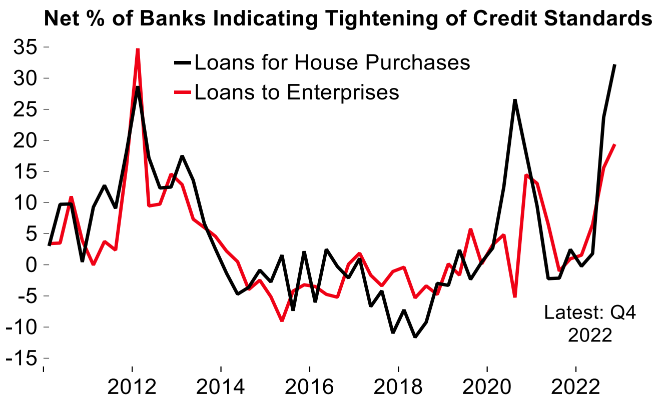
As it stands, our main concern is the risk of a credit crunch weighing on economic activity. The data suggest this is already happening to an extent: there has been a clear slowdown in credit in recent months (Chart 5), and European banks were tightening credit standards even before recent market unrest (Chart 6).

CHART 5: THERE HAS BEEN A CLEAR SLOWDOWN IN CREDIT IN RECENT MONTHS



Source: ECB, MUFG Bank Economic Research Office

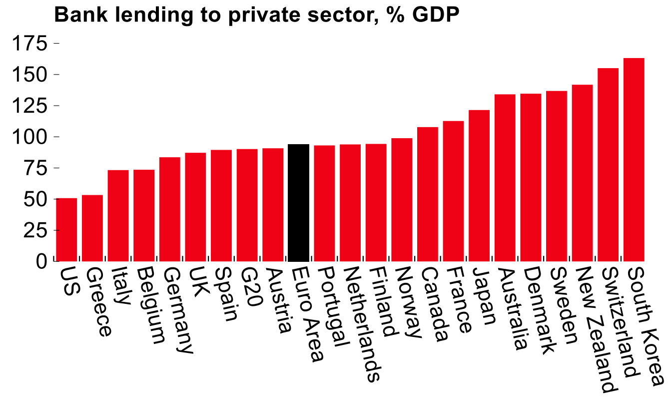
CHART 6: TIGHTER CREDIT CONDITIONS – EVEN BEFORE RECENT MARKET UNREST



Source: ECB, MUFG Bank Economic Research Office

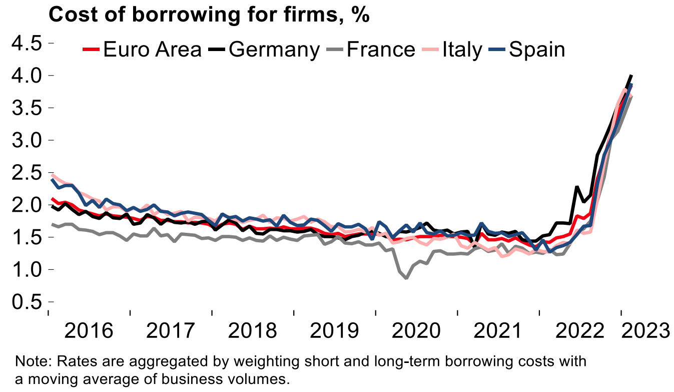
It seems likely that credit conditions will have worsened in Q1, and this could yet be amplified further by a weaker US economy (where the recession risk has probably risen recently). The European economy is more bank-orientated with bank lending to the private sector standing at about 90% of GDP in the euro area vs 50% in the US (Chart 7). After the increase in market volatility through March we expect that tighter credit conditions will remain a headwind for growth over coming quarters, which could amplify the drag from higher borrowing costs (Chart 8) after the ECB's rapid rate hikes.

CHART 7: THE EUROPEAN ECONOMY IS MORE BANK-BASED THAN THE US



Source: BIS, MUFG Bank Economic Research Office

CHART 8: BORROWING COSTS HAVE SOARED



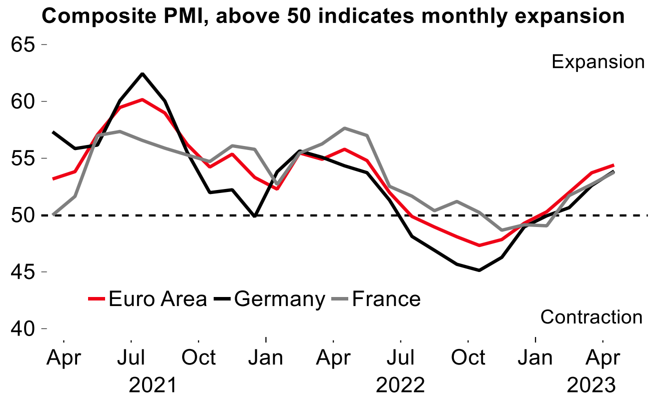
Note: Rates are aggregated by weighting short and long-term borrowing costs with a moving average of business volumes.

Source: ECB, MUFG Bank Economic Research Office

However, there's also encouragement to be found in survey data, which has been fairly resilient to the market situation in March. Euro area PMIs are now clearly in expansion territory (Chart 9). In terms of hard data, industrial production increased by 1.5% M/M in February, which, coming on the back of a 1.0% increase in January, bodes well for Q1 GDP. After slightly negative GDP growth in Q4 last year (Chart 10), it now seems that the euro area economy could avoid a technical recession in H1 2023.

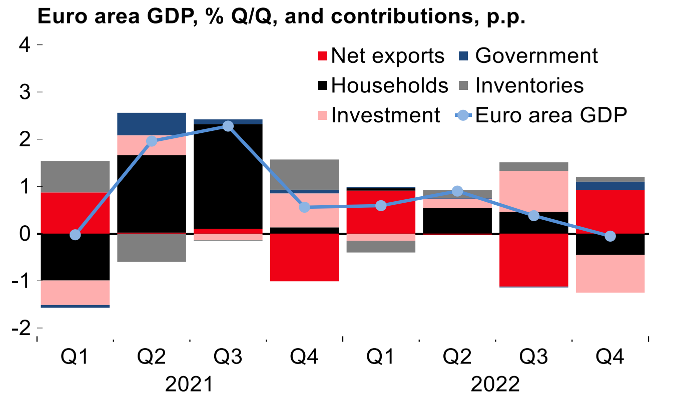
Part of reason for this is that the manufacturing sector has benefitted from both continued improvements in global supply chains and lower wholesale energy costs. These tailwinds for industry will fade through the year, however. Meanwhile, euro area retail sales again disappointed in February (-0.8% M/M). It's still a tough consumer environment (see here), even as headline inflation falls, and European governments will taper cost-of-living support packages through the year.

CHART 9: SURVEY DATA HAS CONTINUED TO IMPROVE



Source: S&P Global, MUFG Bank Economic Research Office

CHART 10: WILL THE EURO AREA AVOID A RECESSION AFTER FLAT GDP GROWTH IN Q4 2022?



Source: Eurostat, MUFG Bank Economic Research Office

Our current view is that tighter credit conditions will offset the stronger-than-expected growth momentum at the start of the year, and we continue to expect annual average euro area GDP growth of around 0.5% in 2023. But a plausible downside scenario is a more severe credit crunch which pushes the economy into recession in H2.

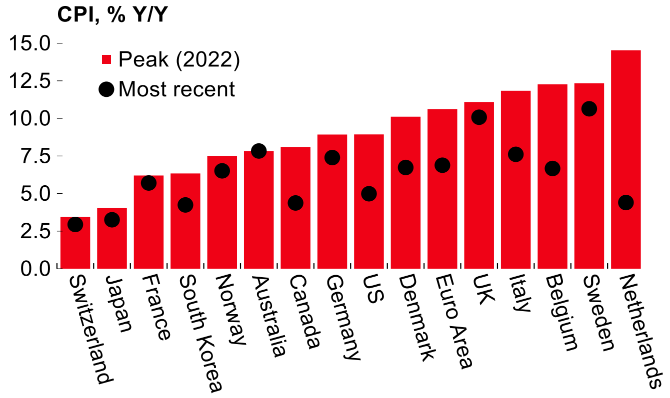
The ECB has more work to do

Major central banks all held policy meetings against the background of market unrest in March. The general from monetary policymakers was that they are willing to look past the episode of market turbulence and will attempt to hold a steady course. The ECB hiked by 50bp, as it had previously signalled it would.

The ECB was later to start tightening policy than the BoE and other central banks and the indications are that it may now continue to raise rates for longer than its peers. The latest ECB HICP projections point to above-target inflation until mid-2025 and the message from recent speeches seems crystal clear: the job is not yet done.

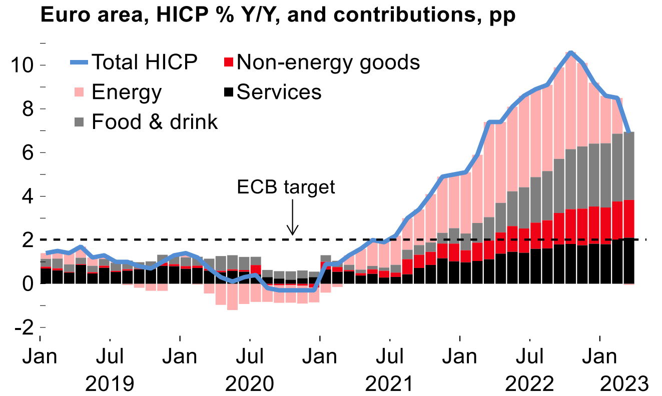
Euro area headline inflation is falling quickly now (Chart 11) but the core rate reached a new record high of 5.7% in March and there is no indication that it is set to trend downwards in coming months (Chart 12). Markets are pricing in a little over 75bp of further rate hikes by year-end.

CHART 11: HEADLINE INFLATION HAS NOW PASSED THE PEAK IN MOST DEVELOPED ECONOMIES



Source: Macrobond, MUFG Bank Economic Research Office

CHART 12: UNDERLYING INFLATION IS PROVING PERSISTENT IN THE EURO AREA



Source: Eurostat, MUFG Bank Economic Research Office

However, as noted above, there was evidence of tighter credit conditions even in Q4 2022 in the ECB's Bank Lending Survey (BLS), and a further deterioration would strengthen dovish arguments. It's worth noting that the next quarterly BLS is due on 2 May, two days before the next ECB monetary policy meeting, and could be an important factor around the decision.

And if market conditions were to deteriorate again then the aim for policymakers will be to keep decisions on financial stability separate from those of price stability. The BoE's response to the LDI market turmoil last year demonstrated that this is possible when it intervened in bond markets while also maintaining its quantitative tightening target.

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