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Independent Thinking

Recession Watch: the three C's in crises

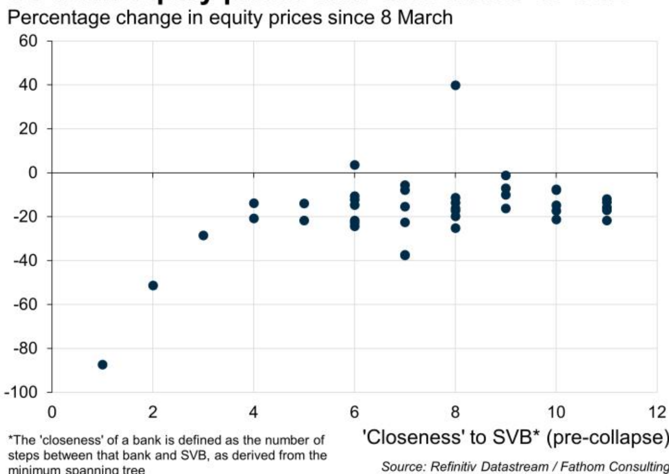
5 April 2023 Andrew Harris

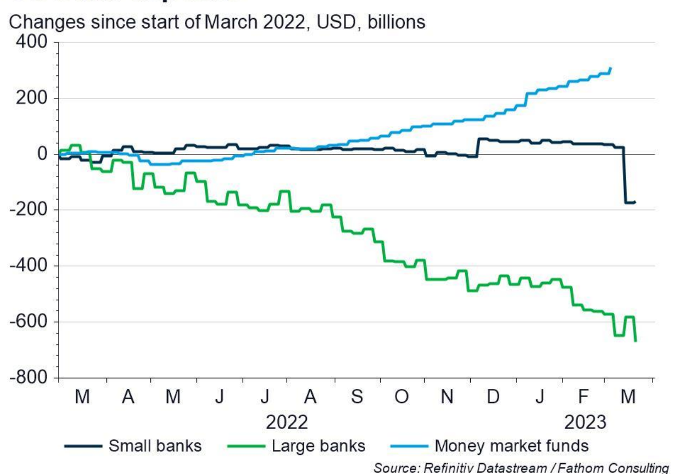
- We flag three signs of a systemic banking crisis: contagion, credit losses, and official complacency
  - Contagion: to date, spillovers following Silicon Valley Bank's collapse have been relatively limited, but instability can spread more quickly than ever in the digital era
  - Credit losses: we have not yet seen the full macro effects of Fed tightening — these could cause credit defaults and possibly spark a second round of concern about the banking system
  - Complacency: policymakers have taken swift, decisive action to address risks but there is always scope for a policy misstep
- We see limited evidence of any of these signs flashing red

It remains a possibility that the US will endure a systemic banking crisis this year after recent turbulence, although Fathom's central view is that this is unlikely. In this week's Recession Watch, we lay out the three C's (contagion, credit and complacency) to watch out for as potential warning flags for a systemic crisis.

Contagion

There are two forms of contagion — one is driven by sentiment and the other by fundamentals. Sentiment itself can perhaps be broken down into two separate elements, one related to the perceptions of investors and the other to the perceptions of depositors. In our note of 15 March, 'Contagion risks from SVB failure', we included a chart which mapped the correlations in bank equity prices prior to the collapse of Silicon Valley Bank. These relationships could be interpreted as investors' perceptions of the path through which shocks propagate through the US banking system (i.e., the likeliest route for contagion to take). The first chart below relates that measure of 'closeness' to SVB to subsequent changes in bank equity prices. It validates the findings of the previous map, and demonstrates how far contagion from SVB spread. As can be seen, there is clear evidence of contagion to those banks 'closest' to SVB, but limited evidence that it has spread beyond that.





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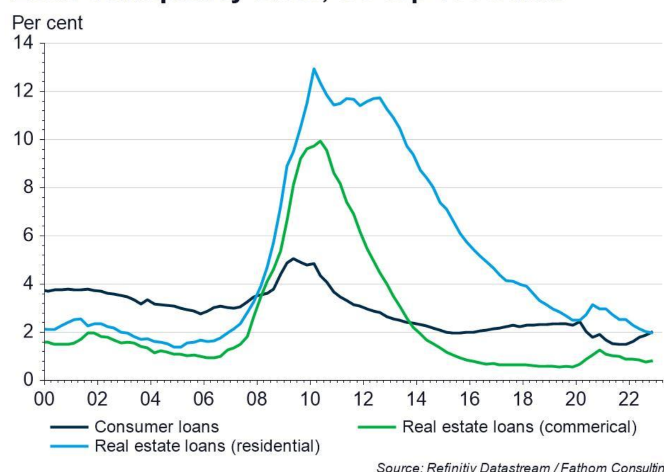
A second way of viewing sentiment-driven contagion is through the lens of deposit outflows. If individuals lose confidence in the banking system, they will withdraw their deposits rapidly — in other words, there will be a run on the banks. This is what happened during the GFC, and is also what happened at SVB. You can see some evidence of this extending to smaller banks following SVB's collapse (the second chart above shows that deposits dropped by around $200bn), but there is limited evidence of contagion to the larger US banks where roughly two thirds of all deposits reside; the trend of falling deposits at those institutions appears to be more closely related to the increase in money market funds and a search for higher yields on savings.

These two charts are perhaps two of the most important to watch for signs of sentiment-based contagion and, for now, the story appears to be 'so far, so good'.

Credit losses

The final form of contagion is driven more by fundamentals — if one company defaults on a loan then the company that lent that money might not be able to repay its own creditors. This form of contagion can amplify the effect of credit losses from monetary policy tightening. Fear of loan delinquency led to the drying up of interbank lending and ultimately to a credit crunch during the GFC. To date, we have not seen a rapid rise in either corporate failures or loan defaults (although the delinquency rate on consumer loans has started to rise gradually). However, given the long and variable lags with which monetary policy acts, we cannot rule out this possibility further down the line. Indeed, as the second chart below shows, there is a clear relationship between the rate of corporate failures and changes in the policy rate. This is to be expected — the reason that monetary tightening is expected to rein in inflation is that it slows aggregate demand.



For this reason, we maintain our view that the US economy is likely to enter a recession later this year and that there is likely to be a rise in loan defaults and business failures (the continued, alarming, slide in the ISM manufacturing survey supports this view). If this proves correct, banks could suffer significant losses and it is entirely possible that the US banking system will find itself under a second round of pressure, with talk of a systemic banking crisis rearing its head once more. Again, this is not our central case, but we will continue to monitor the signals provided by the charts above and revise our views as appropriate.

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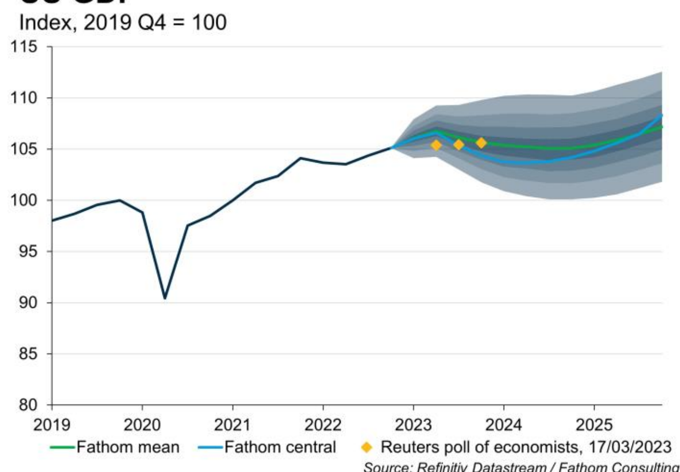

Complacency

Even if the credit cycle does turn negative and banking losses rise alarmingly, we still think that regulators have enough tools at their disposal to avoid a systemic crisis. The biggest risk in our view comes from complacency. Although there have been some criticisms about the risks of moral hazard, policymakers have been generally praised for their rapid handling of the collapses of SVB and Signature Bank, and the forced sale of Credit Suisse.

A recent paper and dataset produced by the US's National Bureau of Economic Research help to contextualise the magnitude of policymakers' interventions. Looking at responses to almost 900 historical banking crises, the authors conclude that only 6.5% of crises have elicited the same type of response (i.e., account guarantees and emergency lending interventions), as we have seen this year. More than 70% of those interventions took place in and around a systemic crisis. In other words, policymakers are reacting as you might expect them to in a world of systemic vulnerability.[1]

However, one word of caution — credibility can be easier to lose than it is to win. When US Treasury Secretary Janet Yellen denied that a blanket guarantee for all US banking deposits was under consideration, it spooked investors and prompted a sell-off. This is not unprecedented — Mervyn King's concern about moral hazard during the Global Financial Crisis and Christine Lagarde's March 2020 comments on European sovereign spreads provoked similar sell offs. There is a time to deal with moral hazard, and it is generally not in the midst of a crisis.

1. These interventions did not prevent systemic banking crises from occurring in the examples identified in the paper. It should also be noted that the dataset only logs examples of banking crises and not the number of occasions that such measures were imposed without banking crises occurring.

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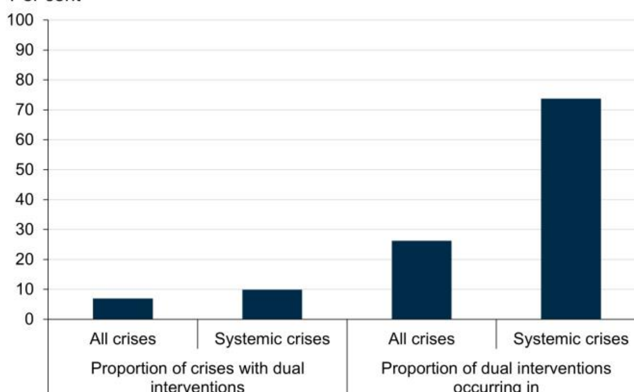

Further reading

[Recession Watch: the size of prospective rate cuts]

[Recession Watch: the banking system's known knowns]

[Gauging the risk of a banking crisis]

[Recession Watch: SVB triggers risk-off mood]

[Contagion risks from SVB failure]

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