Sizing the Impact of the Banking Crisis on the Broader Economy

The ripple of the banking crisis is one way the tightening will bite into activity and slow growth, cutting some borrowers off from lending and driving a shift in the way consumers and small businesses think about saving.

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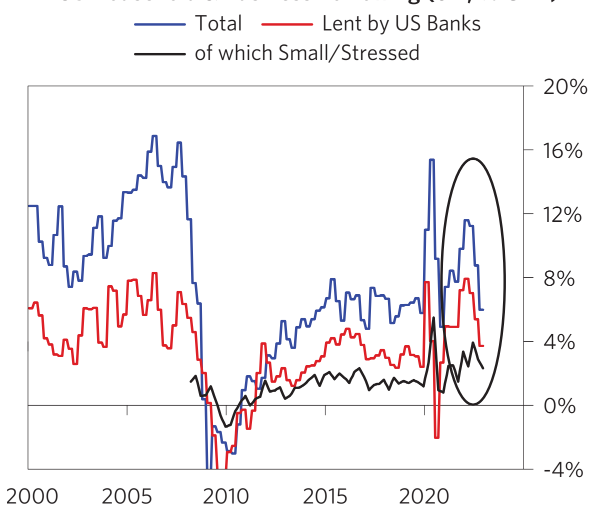
The problems in the US banking system will ripple through the economy via both direct and indirect channels. Our systematic process works by mapping cause-and-effect linkages through to the outcomes that drive economies and markets. In today's case, we are in the middle of a rapid tightening cycle, prompted by high inflation. Tightening increases costs for borrowers and incentivizes saving, often continuing until growth slows or something important breaks. Looking forward, we expect the tightening to cause a material slowing in growth as it works through the system (our leading estimate is -2.4% year over year). Typically, the most vulnerable players—those that had grown reliant on cheap capital and abundant liquidity—are exposed first. The cracks in the banking system today are one example, alongside the pockets of weakness that have already emerged, like those in real estate and tech. In this research, we walk through the main ways that the banking stress will have knock-on effects for spending in the economy overall.

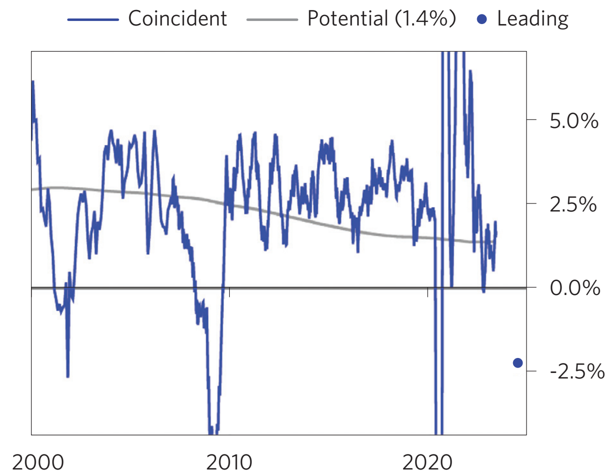
- As mentioned in part 2 of this series, **the most direct impact will be through disruptions to the supply of credit and a continued tightening of lending standards**. Small and other stressed banks provided around 2.7% of GDP (annualized) in lending to the economy over the last three years. This amounted to more than half of the total banking sector lending during that time. These banks are the most likely to tighten credit from here, and that will disproportionately impact some sectors of the economy, where small banks had been the dominant lenders (e.g., VC-backed tech and commercial real estate lending). Large banks and other sources of lending remain in good shape, and there is a viable path to consolidation for weaker banks that are unprofitable or that have mark-to-market capital problems. But as that process is worked through, the flow of credit is likely to be impacted for some time.
- More broadly, this crisis is likely to **drive a shift in the way consumers and small businesses view and respond to higher interest rates, which could have larger implications for household and corporate savings rates**. The failure of Silicon Valley Bank has highlighted the risks associated with keeping cash in zero-yielding deposit accounts and the relative attractiveness of saving at market rates (via money market funds or T-bills). Higher interest rates incentivize saving (alongside dissuading would-be borrowers), and the dynamic of deposits seeking yield has accelerated meaningfully over the past few months and particularly in the past few weeks. More saving is another way spending could cool from here.
- Finally, the crisis has impacted **market discounting of monetary policy and will likely continue to influence bank purchases of bonds for years to come**. In the near term, bond yields have fallen rapidly as investors have flocked out of risky assets, and this will provide some offsetting stimulation (e.g., by lowering mortgage rates). But looking further out, banks have been one of the primary buyers of bonds over the last several years, which has helped keep yields and mortgage rates lower. But in the aftermath of this crisis, banks will likely be looking to reduce their duration exposure, possibly amplified by regulation that may come down the pike, reversing their support.

We start by showing the total borrowing by households and businesses in the US, alongside our current and leading reads on activity. We identify stressed banks—a measure of both large banks facing significant strain and small banks. Growth has been resilient to date, even as credit has slowed. The emerging bank strains and their likely pass-through to borrowing and saving should contribute to a broad pullback in activity.

US Household & Business Borrowing (6m, % GDP)

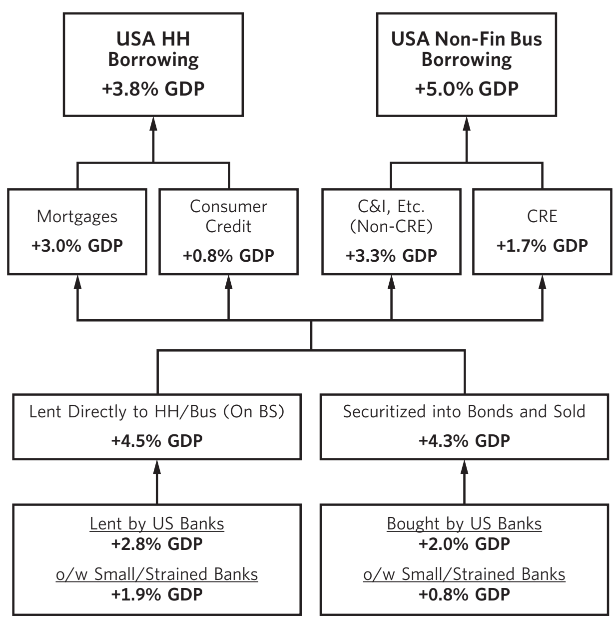


Real Growth



Below, we show the credit pipes through which banks have extended credit to US households and businesses since the pandemic. More than half of the lending had been coming from banks, and much of that from the areas of the banking system that are currently under strain.

How US Banks Lent to Households and Businesses—Average Since 2020 (Ann)

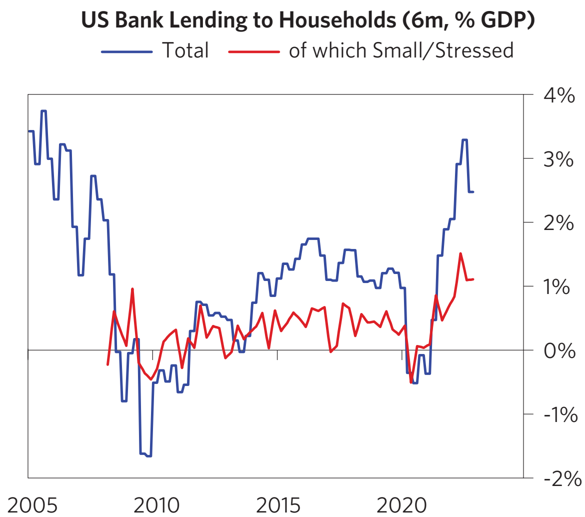


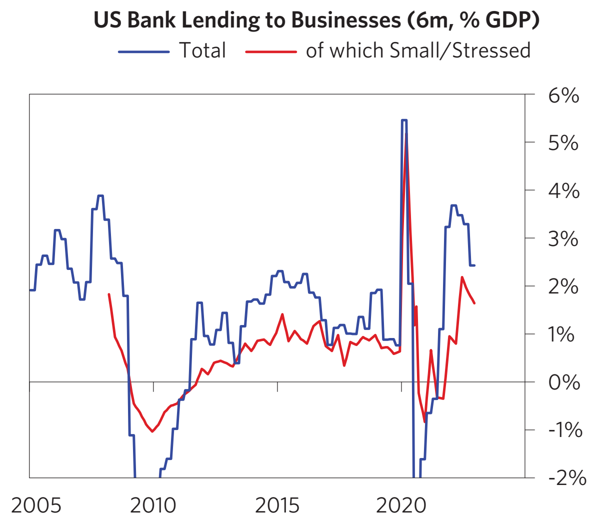
Note: BS stands for balance sheet, C&I is commercial and industrial, and CRE is commercial real estate.

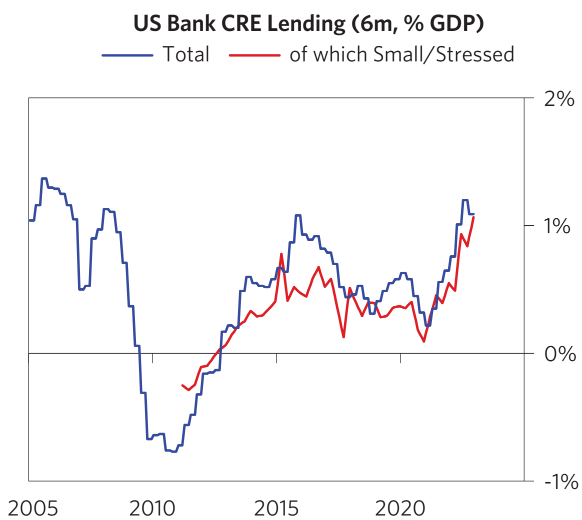
As of 3/22/2023

The charts below put the direct lending by banks into perspective relative to history and help show how it has evolved. As you can see, in the last year, as credit overall began pulling back, small and stressed institutions continued lending at a strong pace—particularly to businesses and commercial real estate borrowers. Small and stressed banks were particularly significant commercial real estate lenders and had been ramping up lending coming into this period of stress. The largest banks, in contrast, were pulling back from the sector, and the pace of securitization in the commercial mortgage-backed securities market was also slowing. Regional banks snapped up the business. Part of the reason they were able to outcompete the large banks in this segment was that, in 2018, a regulatory rollback exempted banks with $100–250 billion in assets from the Fed's annual stress tests. In its latest round of these stress tests, the Fed included an extremely harsh scenario for commercial real estate prices (a 40% decline over two years), which likely limited the largest banks' risk appetite in the space.

For weaker and stressed banks, the likely and least painful path forward is consolidation, which should avert the most disastrous outcome. But even with larger, well-capitalized banks willing to continue lending (albeit at higher standards), some borrowers are likely to struggle to access credit. Many of the businesses served by Silicon Valley Bank and other small banks operate in specialized or concentrated industries and may have a more difficult time demonstrating creditworthiness to bigger lenders who are less familiar with these businesses' markets or assets.

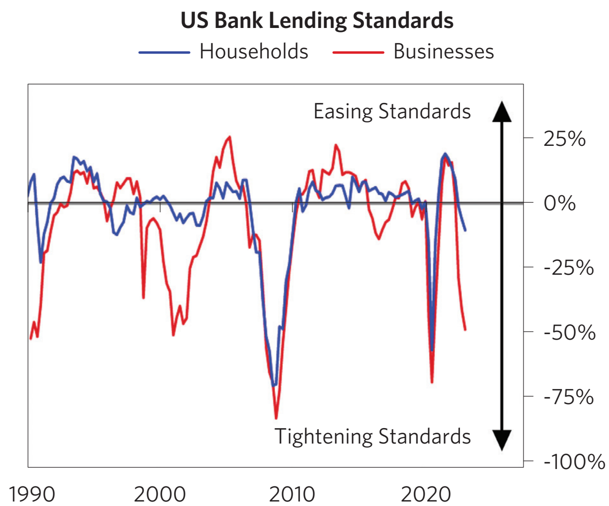


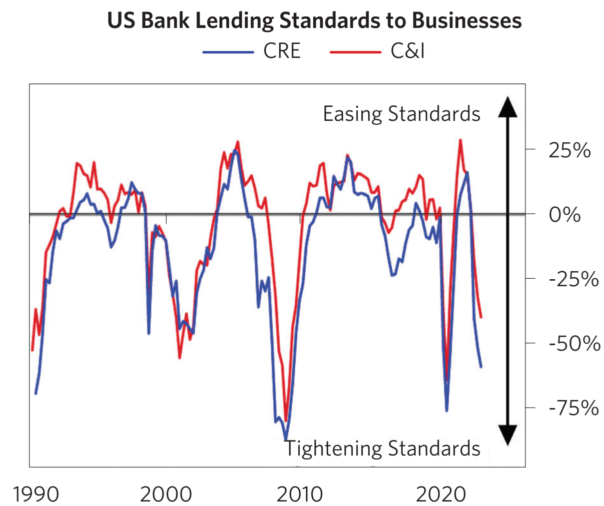


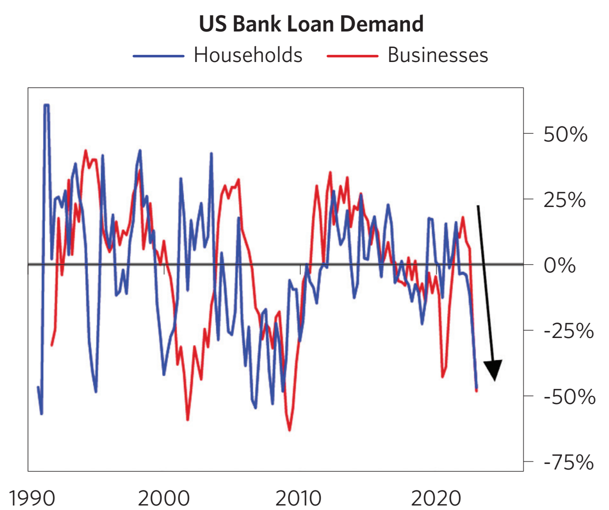


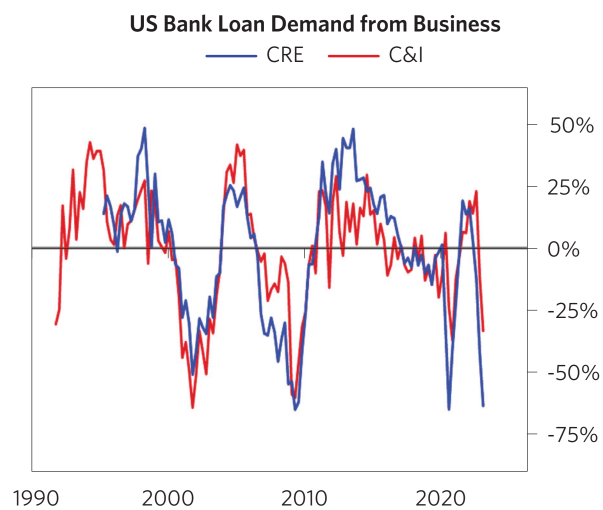
Higher Interest Rates Have Already Driven a Tightening of Standards and a Decline in the Demand for Credit That Will Likely Worsen from Here

At the end of last year, banks had already begun to tighten credit standards for all borrowers in response to the rapid increase in interest rates. As the charts below illustrate, the greatest degree of tightening of standards occurred in commercial real estate, a sector hit hard first by the pandemic and then by higher interest rates. Now that the cheap deposit funding enjoyed by small banks is at risk of moving elsewhere and bank exposure to risky assets is being heavily watched, it is likely that a further tightening of standards is ahead of us. At the same time, higher interest rates have also driven a pullback in borrowing as businesses and consumers are dissuaded by high borrowing costs.





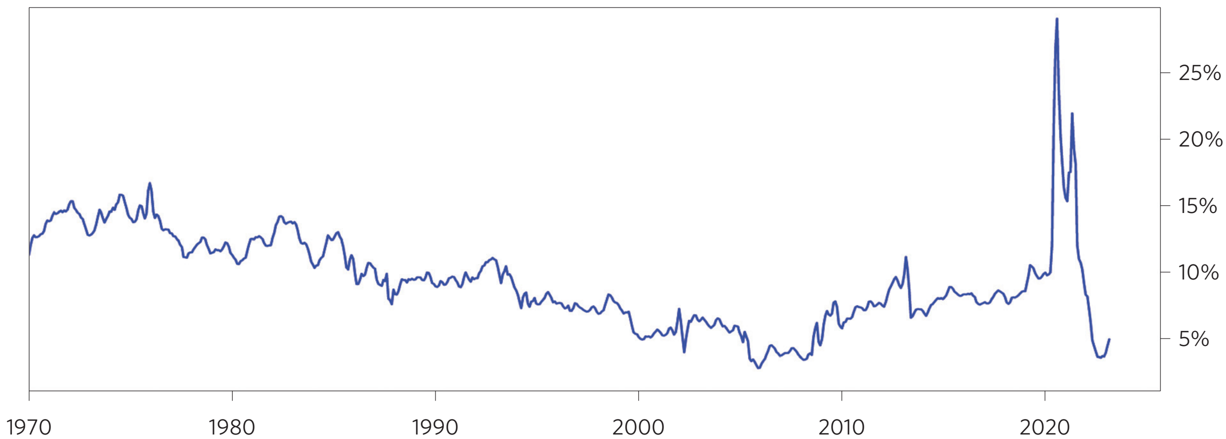




Changes to How Households and Businesses Perceive Bank Risk and the Attractiveness of Saving Have the Potential to Drive a Broader Pivot Toward Saving

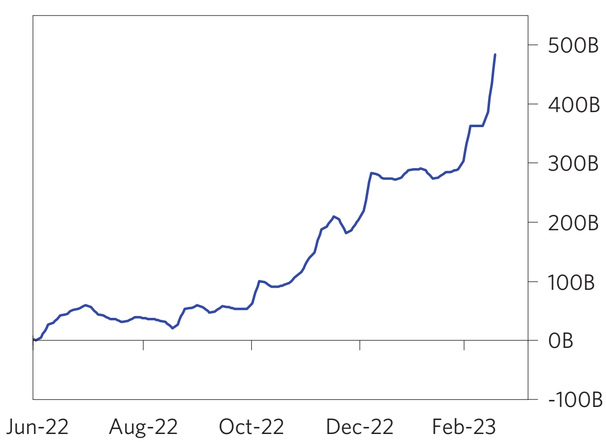
Higher interest rates also make saving more attractive relative to spending, as cash can earn a higher return. Until recently, banks were largely paying well below the cash rate on deposits and were seen as the main, or only, option for where to keep cash. As consumers reassess their willingness to keep their deposits in low-earning accounts and concerns about financial stability mount, this may ripple through to decisions about how much to pull back from spending to save. The chart below shows the household savings rate, which remains near historical lows.

US Household Savings Rate (% Disposable Income)

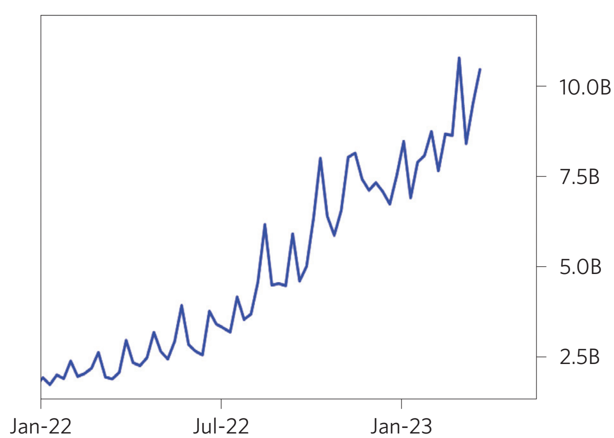


As the charts below show, demand for money market funds and T-bills has been picking up rapidly over the last several months, and households and other players have been moving cash to capitalize on the increase in the cash rate. The timeliest inflows into money market funds show that the move out of deposits is still ongoing. These point to some households and businesses responding to higher interest rates but, as reflected in the perspective above, haven't yet been enough to materially impact spending decisions so far.

MMF Inflows Since Mid-2022 (USD, Bln)

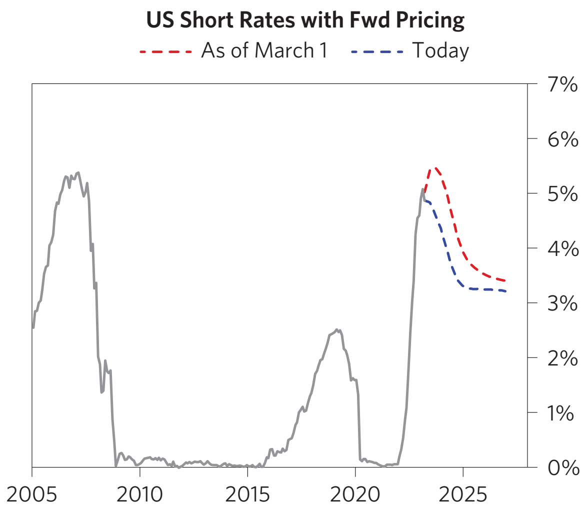


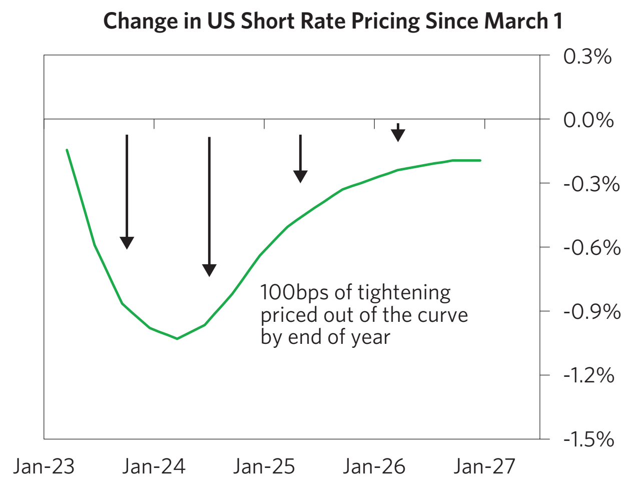
Direct Household Purchases of T-Bills (Weekly)



Markets Are Now Pricing That the Banking Crisis Will Be Enough to Cause an Easing by June

The crisis has also brought about an immediate material shift in the forward discounting of monetary policy. Today, almost 100bps of tightening have come out of the short rate curve since the beginning of March. In the near term, this price action is stimulative as lower interest rates bring down the costs following borrowers. But this price action likely under-reflects the degree to which the Fed remains constrained by inflation. Without more evidence of a larger hit to activity, above-target inflation remains a constraint, just as causing further financial instability presents a challenge to setting policy too tight.





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