Key risks to the global outlook

What happens if central banks hike interest rates too much, and how a renewed crisis in the banking system could weigh on the global economy

First Republic Bank would be the third bank to fail in the past two months after the collapses of Silicon Valley Bank and Signature Bank in March.

Source: Shutterstock

1 Aggressive interest rate hikes trigger a 'hard landing'

Our base case: The most aggressive rate hike cycle in decades will no doubt take its toll. We're more concerned about the US, where a tightening in lending standards post-banking crisis is likely to trigger more noticeable weakness in hiring and investment. Europe is currently enjoying the benefit of lower energy prices, which partly offsets the impact of higher rates in the short term. But the longer-term outlook for Europe remains one of subdued growth at best. In the US, we're not expecting a deep downturn, and developed economies are insulated by the greater prevalence of fixed-rate mortgages relative to past crises. That makes for a longer/more drawn-out transmission to the economy. Stagnation is likely, and the impact of higher rates is less concentrated in any single quarter.

Risk scenario and how it plays out: There are three ways things could be worse than we expect. Firstly, central banks hike more aggressively than currently expected – and with rates already well into restrictive territory, that would make deeper recessions in 2024 more inevitable. Rates at 6% or above in the UK and US, or 5% in the eurozone, would be challenging. Secondly, businesses begin to feel the pinch more acutely. Corporates have enjoyed pricing power over the past couple of years as economies emerge from Covid. But that's fading as consumer demand – especially for goods – abates, and the impact of interest rates on unemployment could accelerate as debt servicing becomes a greater challenge.

Finally, a high interest rate environment raises the risk of something breaking in the financial system. March's banking crisis was a taster of that, and despite central banker assurances to the contrary, persistently higher interest rates clearly risk having knock-on effects for financial stability. The feedback loop could tighten lending standards yet further, adding to the pressure on smaller businesses as well as real estate and the construction sector.

Wider economic impact: We'd expect to see many major economies enter recession through the early part of 2024, or perhaps earlier. Where economic weakness has so far been concentrated in manufacturing, we'd expect the service sector to enter a downturn too. That would see a corresponding easing in service-sector price pressure, via lower wage growth. Central banks would turn to rate cuts much earlier than we're currently forecasting.

2 US banking troubles flare up again

Our base case: The European banking system has coped well with the bank worries at the beginning of the year. The positive impact from higher interest rates continues to support European banks, with the negative side effects still contained. The solid liquidity positions of banks have been confirmed by the very limited additional drawings from the ECB's regular funding operations, despite the substantial TLTRO-III maturities that took place at the end of June. The European bank debt markets have also shown some promising signs with some action on the AT1 debt markets in mid-June, despite the full write-down of Credit Suisse's AT1 capital earlier this year.

Concerns over the US banking system have eased in the course of the second quarter. The issues have not spread to larger US banks, we have not seen further severe liquidity stresses and deposit flows have broadly stabilised.

The Fed published its bank stress test results in late June, which confirmed that the larger US banks could weather substantial weakness with their existing capital buffers. The Fed modelled a severe recession including US$541bn in forecast losses to result in a 230bp decline in the average CET1 ratio of the 23 banks. Large banks retained relatively solid modelled CET1 ratios. Banks with the lowest (and highest) stressed CET1 capital ratios were smaller or mid-sized banks. This group could be somewhat less well-positioned to weather weakness with their existing CET1 buffers.

Risk scenario and how it plays out: The US bank problems were driven by a quick loss of confidence on the part of uninsured depositors towards regional banks. If the loss of confidence were to spread quickly to impact more institutions, it could result in several banks struggling to absorb deposit outflows simultaneously. This could create worries over contagion in the system and exaggerate further deposit instability. Finding buyers for assets to safeguard depositors and operational continuity for several, although smaller, banks at the same time could pose challenges.

In the very worst-case scenario, several smaller lenders end up being absorbed by larger ones. The failing banks may, however, come with unforeseen additional risks, which may eventually result in the credit profiles of the larger acquirers weakening more than expected. If the issues are severe enough, they may pose risks to the stability of the larger acquiring banks. If investors start second-guessing the stability of the financial system, this may have severe consequences on financial markets.

Wider economic impact: Fresh banking stresses would fuel a further tightening in lending standards than we've already seen in the US. History shows this is almost always followed by a sharp rise in the unemployment rate and would deepen the recession we already expect. While it's uncertain whether contagion would spread directly to Europe, the prospect of a US downturn would inevitably have wider economic repercussions overseas. Central banks have so far been able to separate out financial stability and monetary policy tools, but such stresses, should they happen, are ultimately borne out of higher interest rates. This scenario would likely herald earlier and more aggressive rate cuts in both the US and Europe.

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