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Why short term financial stresses could actually de-stress the ECB in the long run

Peaks in systemic stress generally result in recession and lower inflation down the line, making the work of the European Central Bank easier. So far, we have not seen stress reach worrying levels, meaning that we expect the ECB to continue to hike at the next two meetings

Don't worry too much, Christine Lagarde. Peaks in systemic stress generally result in recession and lower inflation down the line

Following the bankruptcy of Silicon Valley Bank, financial stress spiked globally as concerns about the banking sector emerged. Even though events have not specifically impacted eurozone banks (other than share price volatility), we have seen financial stress indicators increase in the region. There is no way of telling how this turmoil will end, even though things have calmed since the UBS takeover of Credit Suisse last month, and even though we agree with ECB President Christine Lagarde that eurozone banks are more resilient than during the financial crisis. Back then, the eurozone didn't have a Single Supervision Mechanism or a Single Resolution Mechanism, and liquidity and tier 1 capital positions were much lower than they are today.

To get a sense of how financial stress events usually impact the economy – even though we're not there yet –let's learn a little bit from history. When you look at previous 'stress events', we find that even though outcomes differ significantly, overall, there's a dampening effect on inflation.

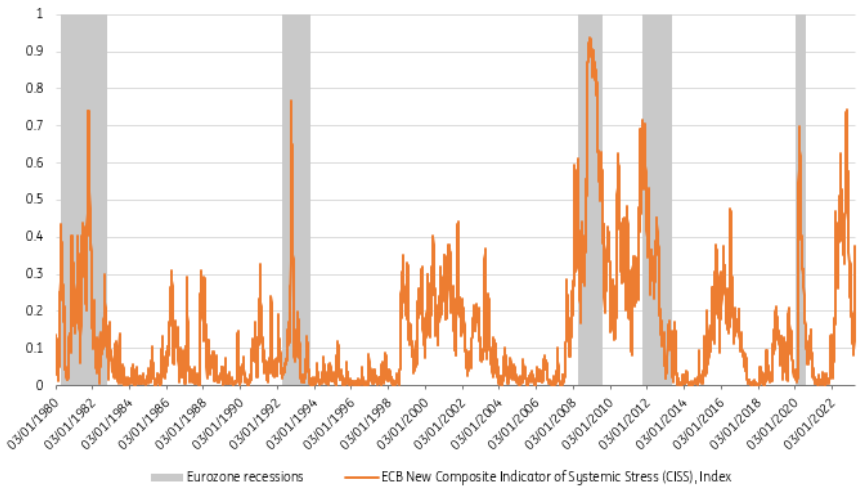
This means that if we were to see more elevated stress in the eurozone financial system from now on, the ECB might have to hike less than we previously anticipated.

The ECB's own indicator of financial stress has not reached troublesome levels

The ECB's own Composite Indicator of Systemic Stress (CISS) seems as good as any to examine when the eurozone economy underwent periods of elevated financial stress. The indicator goes back to 1980, so this includes the period of high inflation in the early 80s and the early 90s recession (and with it, the Savings and Loan banking crisis in the US and the Exchange Rate Mechanism crisis in Europe), but also the Global Financial Crisis and the Covid-19 pandemic. This is enough for us to go on.

We take the, somewhat arbitrary, level of 0.5 as the cut-off for a stress event, which has been breached only six times (while worth saying we count the prolonged stress after 2008 as one event). Currently, we see levels between 0.3 and 0.4, a level reached more often and not usually associated with recession.

Systemic stress events usually associate with recession, but current levels fall short (CISS)



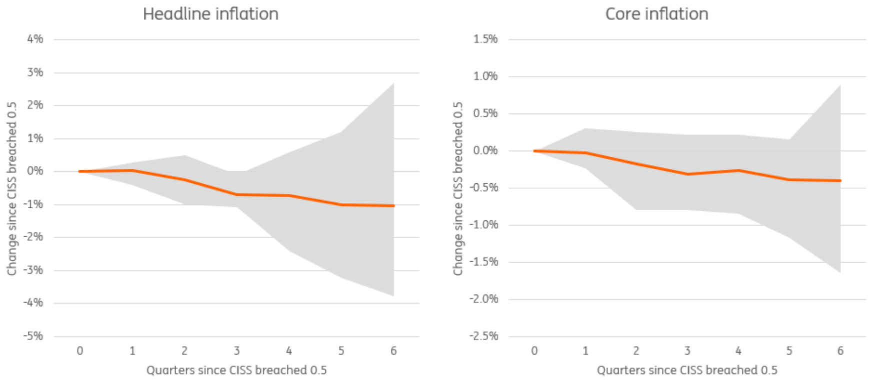
Source: ECB, Macrobond, ING Research

High peaks in systemic stress usually lower inflation

We examined the effect on economic activity, prices, labour markets and interest rates and found that the average response after a few quarters is one of weaker economic activity, slower inflation, higher unemployment and lower interest rates. Indeed, it is quite rare that a stress event is not associated with a recession of some sort.

For inflation, we differentiated between headline and core and found that headline inflation falls much faster after a stress spike than the core rate. This relates to oil prices being quite sensitive to expected economic activity and, therefore, it is mainly the energy component of headline inflation that drops quickly after a stress event. But core inflation also typically falls and was, on average, about 0.5% lower one-and-a-half years after a stress event. The impact is clearly lagged though, and the first half year sees barely any impact on both headline and core inflation.

Inflation on average trends down after a financial stress event



Note 1: fans show maximum and minimum value from previous stress episodes
Note 2: previous stress episodes used are 3Q 1981, 3Q 1992, 1Q 2008, 3Q 2011 and 1Q 2020. Not enough data is yet available for the 2022 episode

Source: Eurostat, Area-wide Model, ING Research

Don't expect the ECB to stop hiking if things don't worsen

For GDP, stress events are generally bad news. On average, spiking financial stress results in a few quarters of negative growth. Interestingly, the one time that a recession was avoided was the recent spike seen in 2022. The jury could still be out on that one, of course. But the impact of last year's tightening of financial conditions has generally been offset by a strong rebound effect from the pandemic and significant fiscal stimulus.

Overall, the weaker economic environment that results from the financial stress episodes is generally responded to with rate cuts. Looking at the three-month money market rate, we see that it was lower after a year every time, with substantial cuts of about 2ppt on average. In short: rate cuts are generally the response to a stress event. Also, a longer hiking cycle often preludes a financial crisis. As for 10-year yields, we see a decline on average, although more subdued than for short-term interest rates.

So overall, we found that episodes of significant financial stress result in lower headline and core inflation. In short, the ECB's work will be done if financial conditions continue to tighten and economic activity contracts. But then again, last year's spike in stress so far has not brought any of that. There are no guarantees when it comes to economics. As recent turmoil has not caused the CISS to reach the levels associated with recession so far, the ECB is therefore set to stay on track with more rate hikes.

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