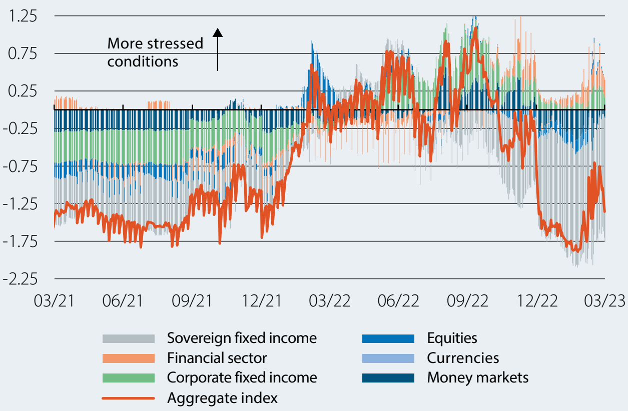
Financial stability considerations amid monetary tightening

Until not long ago, the financial markets had seemed to digest with relative ease the heavy dose of monetary tightening that the central banks have introduced to curb inflation. However, with interest rates increasingly entering restrictive territory – that is, at levels that should cool the economy – the risk of stress events and financial turbulence increases.

In this regard, the sudden deterioration in the financial situation of some regional banks in the US, with the collapse of Silicon Valley Bank (SVB) on 10 March, and the difficulties endured by Credit Suisse, which was acquired by UBS on 18-20 March, have highlighted the potential side effects that the monetary tightening process, which seeks to achieve price stability, can have on financial stability. In theory, the monetary authorities pursue the first objective using conventional measures, while the latter is tackled through regulation, supervision and the provision of liquidity. However, when a loss of confidence occurs, the tools and objectives can enter into conflict with one another. Historical experience also suggests that rapid, intense and unexpected monetary tightening cycles can uncover financial pockets of fragility, as has already happened with SVB.

Financial conditions in the euro area: the CaixaBank Research index and its components

Index (0 = historical average)



Source: *CaixaBank Research.*

A concentrated and limited, but revealing, episode of stress

The recent episode of turbulence has led to a tightening of financial conditions which is clearly reflected in our indices (FCI), both in the euro area and in the US.[1] However, the metrics suggest that the deterioration was short-lived and much less intense than in previous episodes.

According to the breakdown by component, the sharp repricing of interest rate expectations and the consequent fall in short-term sovereign bond yields provided a significant buffer for financial conditions, at a time when they were also under pressure from widening spreads in both corporate bonds (especially poorer quality assets) and interbank rates (in our FCI this is measured according to the spread between the 3-month Euribor and the German 3-month treasury bill), as well as from banking stock valuations. Thus, this spread in monetary rates, corporate fixed-income securities and the shares of the banking sector in the stock markets were the main drivers of the deterioration in the FCI in March.

It should be borne in mind that our FCIs do not include liquidity metrics in the system, so they may underestimate the tension in the current macro-financial context. That said, the fact is that the indices reveal that the impact of this episode on the capital markets has been contained and even largely reversed, especially in Europe. In fact, the last few weeks have seen a moderation in the levels of stress: in the US, the outflow of deposits from banks has stopped and, with it, the use of the Fed's liquidity windows has fallen. Furthermore, the valuation of banking stocks in the euro area has recovered, and even the AT1 bond market has stabilised.

Where could the Achilles' heels be?

The market reading seems to point to an episode with specific and idiosyncratic causes. However, the fact that the banking sector was the epicentre of the recent turbulence has dented investor confidence, with consequences that are still evident in some institutions and markets. In this context, what does this episode of possible fragilities in the financial system tell us?

Firstly, it illustrates some vulnerabilities which the monetary tightening process could uncover in the financial sector, particularly in banks with many uninsured depositors and which are subject to high interest rate risk (i.e. those which see their profitability deteriorating due to the recent rise in interest rates). Indeed, this is what appears to be happening in some US regional banks, as the IMF has pointed out.[2]

On the other hand, in the non-banking financial sector there is some concern about certain investment funds that have accumulated risk exposures in recent years and that have very tight liquidity positions. Moreover, unlike the banking sector, most of these funds do not have

1. For more information on the FCI, see «The ECB's holistic approach» in the MR06/2021.

2. See Global Financial Stability Report (2023). «Safeguarding Financial Stability amid High Inflation and Geopolitical Risks».

access to all of the liquidity windows provided by the central banks.

Within the non-financial sector, a great deal of attention has been focused on the real estate sector, including both residential and commercial property, as cooling demand and possible structural changes following the pandemic threaten major price corrections in a sector which the IMF considers «significantly overvalued».[3]

Thus, according to the IMF, because the commercial real estate sector is closely connected with the financial sector, the combination of tighter financing conditions and declining prices could trigger a downward spiral in valuations and further tightening, which could reverberate throughout the real economy. In the US, this connection is closest through the banking sector, as the commercial real estate sector depends largely on regional banking. In the euro area, banks' average exposure to commercial real estate is lower. Nevertheless, the European Systemic Risk Board recently warned of the systemic dangers of adverse developments in the commercial real estate sector.[4] In addition, the commercial real estate sector's non-bank financing channel is a potential source of instability around the world. Both the IMF and the ECB have warned of the growing role of real estate investment funds, where the markets for real estate investment trusts and commercial mortgage-backed securities stand out, as they have amassed significant losses in recent months.[5]

On a separate note, the corporate non-financial sector has shown a healthy performance in recent quarters thanks to increased margins, but it will still have to demonstrate its ability to withstand an environment of moderating consumption and higher financing costs for a few more quarters to come. The financial turbulence in March illustrates that, in adverse macro scenarios, stress in corporate risk premiums (especially in the case of riskier assets) can put further pressure on financing costs. This seems to be corroborated by the IMF, which estimates that the percentage of debt of large corporations in advanced economies that could be downgraded from investment grade to speculative grade would increase by 30 pps in a severe recessionary scenario.

Meanwhile, the process of central banks reducing the size of their balance sheets could also pose challenges for sovereign debt markets, at a time when excess liquidity is

Financial conditions in the US: the CaixaBank Research index and its components

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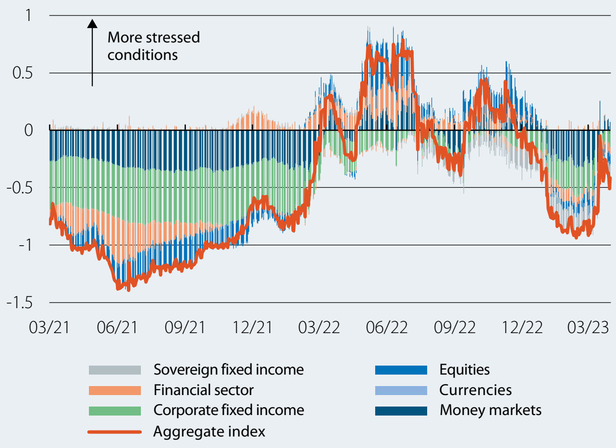

Source: *CaixaBank Research.*

shrinking, debt levels are high and the additional supply of bonds will have to be absorbed by private investors. That said, central banks have shown a willingness to support these markets in times of financial stress, such as in the United Kingdom in October.

Finally, so far, emerging markets have managed to navigate the monetary normalisation process in advanced countries and the recent period of financial upheaval, although they remain under pressure and will have to demonstrate their resilience in adverse scenarios. After all, the economic environment is still demanding, with risks ranging from geopolitics, to the persistence of inflation (with the consequent greater monetary tightening), to the risks of price corrections in some stressed real estate markets or other unexpected events.

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3. According to the IMF, the commercial real estate market appears to be significantly overvalued in all countries, considering the current deviation observable in the ratio between net income and property prices relative to the historical trend.
4. See https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/InformacionInteres/JuntaEuropeaRiesgo/jers2023_01.pdf (content available in Spanish)
5. See ECB. «The growing role of investment funds in euro area real estate markets: risks and policy considerations».