SMOLDERING FINANCIAL UNCERTAINTY AND THE EUROZONE ECONOMY

— THE RISK OF SLIPPING INTO A VICIOUS CYCLE OF BANKS' RELUCTANCE TO LEND AND DETERIORATION OF THE REAL ECONOMY —

Ryuji Hiraishi
Global Economic & Political Studies Div.
Mitsui & Co. Global Strategic Studies Institute

SUMMARY

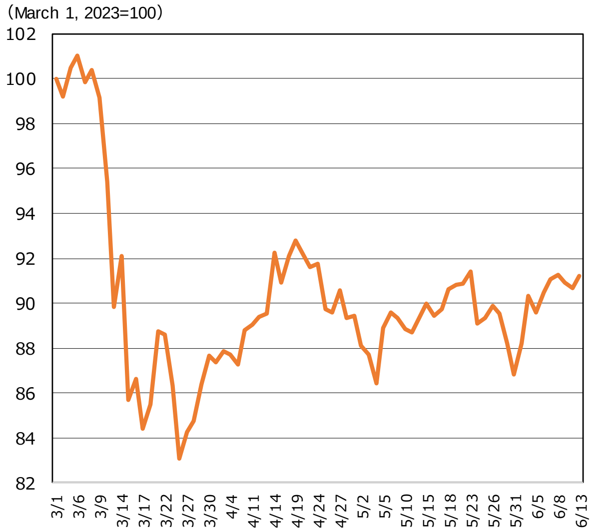
- Financial instability in the US spilled over into Europe, and although the markets were beginning to regain calm thanks to the quick response of policy authorities, the collapse of First Republic Bank in the US triggered renewed instability and other concerns. As such, financial instability has not been completely dispelled.

- The eurozone banking sector was hit hard by the global financial crisis of 2008 and the subsequent European sovereign debt crisis, but lessons learned from those events have since led to the development of a supervisory framework, tighter regulations, and healthier banks, which have greatly improved the sector's resistance to financial instability. Although financial instability will continue to fester for the time being, the likelihood of a full-blown financial crisis accompanied by a severe economic downturn is limited. The risk scenario is an intensifying vicious cycle in which banks' reluctance to lend in response to financial instability leads to deterioration of the real economy and an increase in non-performing loans, leading to further financial instability. The real estate sector warrants close monitoring as a "weak link".

1. INTRODUCTION

The financial turmoil in the US triggered by the failure of Silicon Valley Bank (SVB) in March 2023 spilled over into Europe, causing a broad-based plunge in bank stocks and a financial crisis at Credit Suisse. Financial markets were beginning to calm down as a result of the expansion of dollar supply to the market by six central banks[1] — the Bank of Japan, the US Federal Reserve, the Bank of Canada, and three central banks in Europe — and quick actions such as the rescue merger of Credit Suisse by UBS, supported by the Swiss financial authorities. However, financial instability has not been dispelled yet as bank stocks were sold down again in Europe in reaction to the collapse of First Republic Bank (FRC) in the US in early May (Figures 1 and 2).

Figure 1: European bank stocks (STOXX 600 bank stocks



[1] US Federal Reserve Board (FRB), European Central Bank (ECB), Bank of Japan (BOJ), Bank of England (BOE), Bank of Canada (BOC), and Swiss National Bank (SNB)

Figure 2: Financial instability events in the US and Europe in chronological order

Date	Event
March 17, 2022	➢ In response to accelerating inflation, the FRB reverses its zero interest-rate policy, which had been in place since March 2020 amid the COVID-19 pandemic, and raises the FF rate target range to 0.25-0.50%. The FRB continues to increase rates rapidly and sharply, raising the benchmark rate by 5 percentage points in a total of 10 rate hikes through May 2023.
July 27, 2022	➢ The ECB also reverses its negative interest rate policy, which had been in place since June 2014. It raises its deposit facility rate from -0.50% to 0.00%. The ECB continues with rapid and significant rate hikes, raising key interest rates seven times in a row by a total of 3.75 percentage points up to May 2023.
March 10, 2023	➢ SVB (Silicon Valley Bank), the 16th largest bank in the US (as of the end of 2022) with US$209 billion in assets, which mainly deals with startups, fails due to a rapid outflow of deposits against the backdrop of widening latent losses on bond holdings. ➢ On March 27, First Citizens BancShares announces the acquisition of SVB.
March 12, 2023	➢ Signature Bank, with assets of US$110.3 billion and the 29th largest bank in the US (at the end of 2022), which mainly deals with companies handling crypto assets (virtual currency), fails after suffering deposit outflows similar to SVB. ➢ On March 19, Flagstar Bank, a subsidiary of New York Community Bancorp (NYCB), announces the acquisition of Signature Bank.
March 12, 2023	➢ In addition to SVB, the US Department of Treasury, FRB, and FDIC (Federal Deposit Insurance Corporation) announce full protection of deposits for depositors of Signature Bank, which failed on March 12 (protection for deposits are normally capped at US$250,000 per account). ➢ The FRB announces the Bank Term Funding Program (BTFP), a liquidity measure that provides loans for up to one year against eligible collateral, such as US Treasury bonds and mortgage-backed securities (MBS), valued at face value.
March 19, 2023	➢ Financial instability in the US spreads to Europe. Credit Suisse suffers a run on deposits, slumping to incur a second consecutive fiscal year of losses through December 2022 against a backdrop of huge losses from transactions with US investment firms and other factors. ➢ The Swiss government deems it will be difficult for Credit Suisse to rebuild on its own, so it arranges a takeover by UBS.
March 19, 2023	➢ Six central banks (Japan, the US, Canada, and Europe) announce measures to strengthen the supply of dollars to the market. The number of open market operations in which each central bank supplies dollars to the market over a weekly period is increased from weekly to daily. The operations continue until the end of April.
May 1, 2023	➢ First Republic Bank (FRC) fails due to deposit outflows (deposits at the end of March were down over 40% from the end of 2022). FRC was the 14th largest bank in the US with assets of US$212.6 billion, and primarily had dealings with wealthy customers, for whom the bank had increased its long-term mortgage loans and bond investments. JP Morgan Chase assumes and acquires all deposits and assets of the bank.
Early June 2023	➢ Despite the quick and flexible response of policy authorities, concerns of financial instability heighten again after the collapse of FRC, and the stocks of small and medium-sized banks are sold off in the US, and bank stocks are sold off in Europe as well. ➢ Calm has returned to the market, but the smoldering embers have not been extinguished.

Source: Compiled by MGSSI based on FRB and ECB data and various news reports

The financial crisis of 2008 that started with the collapse of Lehman Brothers and the European sovereign debt crisis that followed in 2009 highlighted the vulnerability of eurozone banks, and the lack of policy measures to deal with the financial catastrophe made it difficult to control the turmoil and aggravated the impact on the real economy. As a result, the eurozone economies suffered from a prolonged slump.

Will the current financial turbulence develop into a financial crisis with the consequence of a full-blown recession in Europe? This report examines the details of the smoldering financial instability and considers the direction of the real economy.

2. PICTURE OF FINANCIAL INSTABILITY

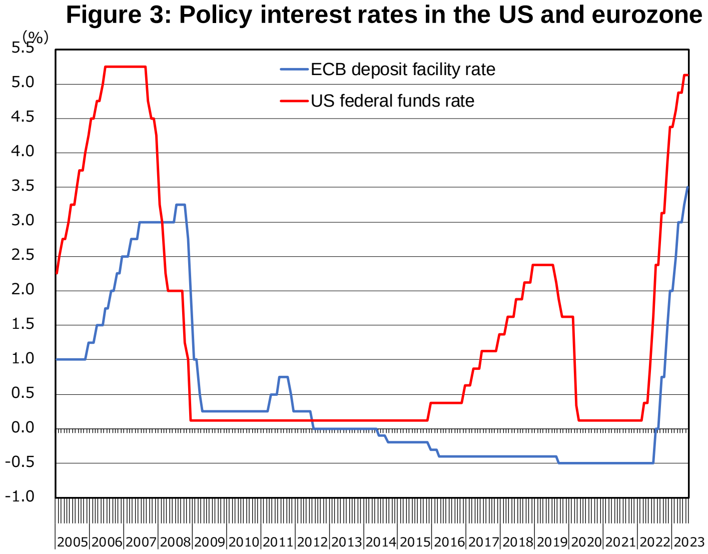
2-1. Background common to Europe and the US

The spread of financial instability in the US and Europe this time was not caused by the holding of specific products, as was the case with subprime loan[2] securitization products at the time of the 2008 global financial crisis. What Europe and the US have in common this time is a drastic change in the financial environment over a short period. To handle the impacts of the COVID-19 pandemic, both Europe and the US had been pursuing

[2] Home mortgage loans extended to US borrowers with poor credit scores. The loans were securitized and combined with other financial products and sold around the world. As US housing prices fell from the latter half of 2006 onward, these loans became bad debts and the prices of securitized products also crashed, leading to the global financial crisis that began with the collapse of Lehman Brothers.

ultra-easy monetary policies, including enhanced quantitative easing and zero- and negative-interest rate policies. But to address accelerating inflation, they abruptly shifted their policies toward quantitative tightening and sharp interest rate hikes in 2022 (Figure 3). The rapid tightening of monetary policy has worsened the profit environment for European and US banks due to (1) an increase in unrealized losses on securities holdings, especially bonds, prices of which have fallen noticeably, and (2) a shrinking interest margin (the difference between funding rates and investment yields on loans and other assets) as a result of an inverted yield curve[3].

Figure 3: Policy interest rates in the US and eurozone



Source: Compiled by MGSSI based on FRB and ECB data

2-2. Spread of financial instability from the US to Europe

The financial instability in the US triggered by the failure of SVB (Figure 4) has heightened investor caution around the world and lowered risk tolerance in financial markets, leading investors to view Europe as a "weak link" because it faces the same dramatic changes in the financial environment and deterioration in bank earnings environment as the US. European bank stocks faced a significant sell-off, and this was especially notable for Credit Suisse, one of the global systemically important banks (G-SIBs)[4]. The bank has been targeted by the market players for a number of management problems for some time, although the problems are different from those of the small and medium-sized US banks that failed.

In recent years, Credit Suisse was facing an acceleration of deposit withdrawals as huge losses on transactions with US investment firms led to the departure of customers and investors, and it incurred net losses for two consecutive fiscal years through December 2022. In the midst of this, the financial turmoil in the US resulted in the accelerated withdrawal of cash from the bank.

The Swiss government judged that it would be difficult for Credit Suisse to restructure on its own, and in order to avoid triggering a global financial crisis, the bailout by UBS was orchestrated with extraordinary conditions,

---

[3] Under normal circumstances, long-term interest rates tend to exceed short-term interest rates (forward yield), but when short-term interest rates exceed long-term interest rates, the situation is called an inverted or reverse yield curve. This is commonly caused by rapid monetary tightening, etc., and is often a sign of an economic recession. Under these circumstances, the banks procure funds from short-term markets and operate funds through long-term loans, etc. For this reason, an inverted yield curve leads to deterioration of financial institutions' earnings.

[4] The G-SIBs are selected by the Financial Stability Board (FSB). Each financial institution is evaluated on its systemically important status and is required to accumulate a certain level of additional capital relative to its risk-weighted assets. The 30 banks worldwide that have been selected as of 2022 include Mitsubishi UFJ Financial Group, Mizuho Financial Group, and Sumitomo Mitsui Financial Group from Japan.

including a CHF 9 billion (approximately JPY 1.3 trillion as of March 2023) government guarantee and a CHF 100 billion (approximately JPY 14.3 trillion as of March 2023) emergency credit line by the Swiss National Bank.

Although calm was restored to the European financial markets by mid-April, thanks in part to the aforementioned expansion of dollar supply to the market by the six central banks of Japan, the US, Canada, and Europe, the spark of a firestorm continued to smolder, and bank stocks were sold off once again in early May as the impact of the FRCB bankruptcy spilled over.

Figure 4: Overview of the financial instability in the US

1. Picture of the crisis

- Three small and medium-sized banks failed in just two months, starting with Silicon Valley Bank (SVB) on March 10, 2023, followed by Signature Bank on March 12, and First Republic Bank (FRC) on May 1.
- The three banks had the following two things in common: they saw rapid deposit outflows and were forced into bankruptcy.

(1) Depositor attribute bias and high proportion of large deposits not covered by deposit insurance

Bank deposits with low levels of "stickiness" are more likely to flow out in the event of a business downturn. The three banks dealt primarily with such customers, with SVB concentrating on the deposits of tech startups (90% of deposits were not covered by deposit insurance); Signature Bank focusing on companies handling crypto assets (virtual currencies) (86% of deposits were not covered by deposit insurance); and FRC managing the assets of mainly customers with high net worth (68% of deposits were not covered by deposit insurance).

(2) Large unrealized losses due to sharp decline in prices of bonds held

Even though deposits had previously surged due to the ultra-loose monetary policy and pandemic-related support measures, and the banks had invested those deposits in long-term government bonds and MBS (mortgage-backed securities), their balance sheets deteriorated markedly as a result of a sharp decline in bond prices and a sudden increase in unrealized losses against the backdrop of rapid monetary tightening.

2. Response by monetary and financial policy authorities

(1) Quick and bold response

To avert a financial crisis, US monetary and financial policy authorities announced immediate full deposit protection at the time of the failures of SVB and Signature Bank, as well as the introduction of the Bank Term Funding Program (BTFP), a new liquidity provision scheme. When FRC collapsed, the authorities granted JP Morgan Chase preferential treatment and a quick takeover by the bank was executed.

(2) Moves to strengthen regulation and supervision

After the collapse of Lehman Brothers, the Dodd-Frank Wall Street Reform and Consumer Protection Act (financial regulatory reform act) was passed, imposing strict capital and liquidity requirements on banks. However, under the Trump administration, in 2018, the asset criterion for banks subject to those regulatory requirements was raised from US$50 billion to US$250 billion or more, meaning the three failed banks became subject to fewer regulations than the major banks in terms of frequency of stress tests (soundness examinations), liquidity, and other factors.

Because this led to inadequate supervision and contributed to the recent bankruptcies, the US government is considering strengthening regulation and supervision of banks with assets between US$100 billion and US$250 billion, including tightening liquidity requirements, increasing the frequency of stress tests, and reflecting unrealized gains and losses on available-for-sale securities in capital requirements.

(3) Continuous monetary tightening

Meanwhile, despite the turmoil in financial markets, the FRB focused on containing inflationary pressures and raised interest rates by 0.25 percentage points at two consecutive meetings, on March 22 and May 3.

3. Current trends and points to watch going forward

(1) Market uncertainty cannot be dispelled

The embers of financial instability continue to smolder despite swift and bold action by the financial authorities. Small and medium-sized US banks with balance sheets similar to the three failed banks continue to experience deposit instability, and selling pressure on bank stocks has not abated.

(2) Commercial real estate trends pose concerns

Half of all outstanding commercial real estate loans in the US are financed by banks, mainly small and medium-sized banks. There is concern that the reduction in lending to this sector by small and medium-sized banks may lead to a further correction of the real estate market (the commercial real estate price index fell 15% year on year in March) and the collapse of real estate companies, which would create a vicious cycle with the banking crisis.

(3) The future of the FRB's monetary tightening

The rapid tightening of monetary policy in the US is entering its final phase, with the Federal Open Market Committee (FOMC) deciding in June to leave interest rates unchanged for the first time in this tightening phase in order to assess economic, price, and financial conditions. However, inflationary pressures persist against the backdrop of a labor market that continues to tighten, and there is strong uncertainty about the future of the FRB's monetary policy.

Source: Compiled by MGSSI based on US government materials and various news reports

3. HOW RESILIENT IS THE EUROZONE BANKING SYSTEM TO FINANCIAL INSTABILITY?

The eurozone banking system faced serious difficulties during the global financial crisis of 2008 and the European sovereign debt calamity that started in 2009, but is it still vulnerable today?

3-1. Progress made in developing a supervisory framework, failure resolution system, etc.

European banks failed to effectively deal with the past financial crises due to the differing banking supervision and failure resolution systems based on each country's bank supervisory principles and failure resolution systems, shortcomings in coordination among national policy authorities, and lack of unified standards for deposit insurance systems. Acting on the lessons learned from those experiences, the eurozone has promoted a reform called the "Banking Union"[5] aimed to achieve (1) centralized banking supervision, (2) centralized resolution, and (3) a centralized deposit insurance system (Figure 5).

Figure 5: Banking Union initiatives

Initiative	Details
(1) Single Supervisory Mechanism (launched in November 2014)	➢ Banking supervisory authority had rested with the financial authorities of each eurozone country based on the "home country supervisory principle", but the ECB was given the authority to (1) grant banking licenses, (2) conduct stress tests, and (3) conduct early intervention and require corrective measures from banks in noncompliance.
(2) Single Resolution Mechanism (launched in January 2015)	➢ The Single Resolution Board, consisting of the ECB, the European Commission, and the authorities of the country concerned, was established to ensure prompt resolution and prevent the spread of bank failures within the eurozone, whereas bank failures in the eurozone were previously resolved on a country-by-country basis. ➢ The Single Resolution Board is to carry out resolutions using the Single Resolution Fund. The fund is expected to accumulate €80 billion by the end of 2023.
(3) European Deposit Insurance Scheme (Unification of standards is progressing smoothly, but there are delays in establishing a single deposit insurance system)	➢ Efforts to unify standards for deposit insurance systems in the eurozone, which had differed from country to country, have progressed, and the measures include (1) protection of up to €100,000 per depositor (already in effect) and (2) a refund period of up to 7 days (to go into effect from January 2024). ➢ However, the European Commission's 2015 proposal to establish a "single deposit insurance system" in the eurozone (each country currently has its own deposit insurance system) has been delayed due to opposition from Germany and other northern European countries that are concerned they will bear greater costs.

Source: Compiled by MGSSI based on materials of the European Commission

3-2. Improved soundness and robustness of the banking system

Thanks in part to these improvements, the eurozone banking system is healthier and more robust than during past crises, as evidenced by (1) high levels of capital adequacy that far exceed Basel III standards[6], (2) ample liquidity, and (3) non-performing loan (NPL) ratios that continue to decline.

(1) Capital adequacy ratio

The CET1[7] ratio (common stock + retained earnings + other comprehensive income / risk-weighted assets[8]) of banks under the supervision of the European Central Bank (ECB) rose significantly from 12.7% in April-June 2015 to 15.3% in October-December 2022 (Figure 6).

---

[5] The Banking Union is a framework that unifies a wide range of policies related to the banking system in the eurozone, based on the lessons learned from past financial crises. It consists of three pillars: (1) a single supervisory mechanism, (2) a single resolution mechanism, and (3) a European deposit insurance scheme.

[6] Basel regulations are uniform international standards issued by the Basel Committee on Banking Supervision regarding capital adequacy and liquidity ratios of internationally active banks; standards were established for Basel I in 1988, Basel II in 2004, and Basel III in 2017.

[7] Acronym for Common Equity Tier 1. It refers to equity capital with the highest loss absorbing capacity and is also called Core Tier 1.

[8] Under Basel III, the denominator for calculating the capital adequacy ratio is not total capital but "risk-weighted assets", which is used to determine the amount of capital a bank should hold adjusted by multiplying the magnitude of risk by the risk weight of the assets.

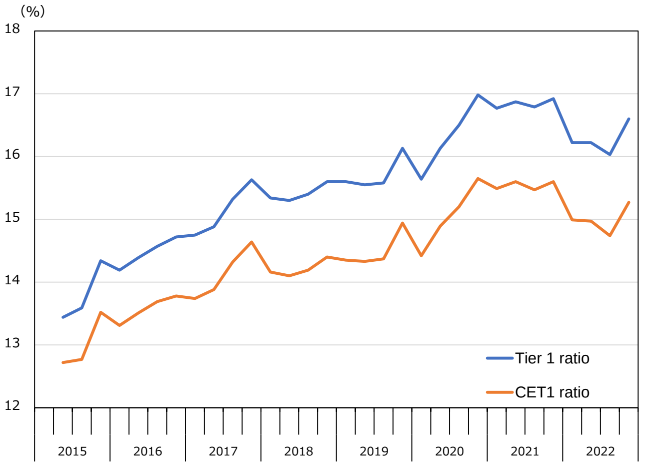
(2) Liquidity coverage ratio (LCR)

The LCR (the percentage derived from dividing a bank's high-quality liquid assets by the estimated net cash outflow under a 30-day stress scenario, such as a financial crisis) rose sharply from 137.6% in July-September 2016 to 161.5% in October-December 2022 (Figure 7).

(3) Non-performing loans ratio

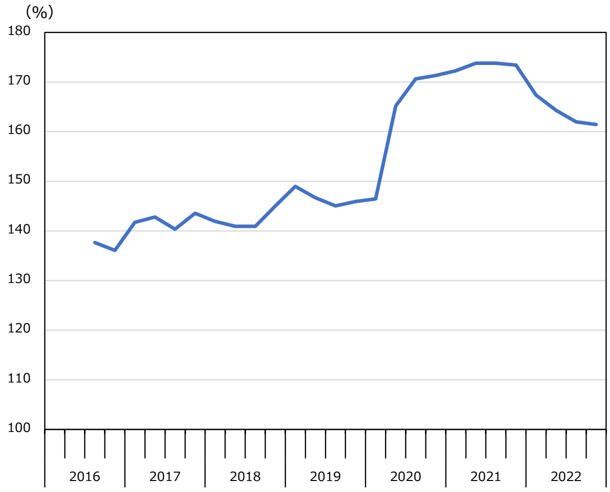
The NPL ratio (loans with principal not repaid as agreed + loans with no interest payments for 90 days or more/total credit outstanding) declined markedly from 7.5% in April-June 2015 to 1.8% in October-December 2022 (Figure 8).

Figure 6: Capital adequacy ratios of ECB-supervised banks



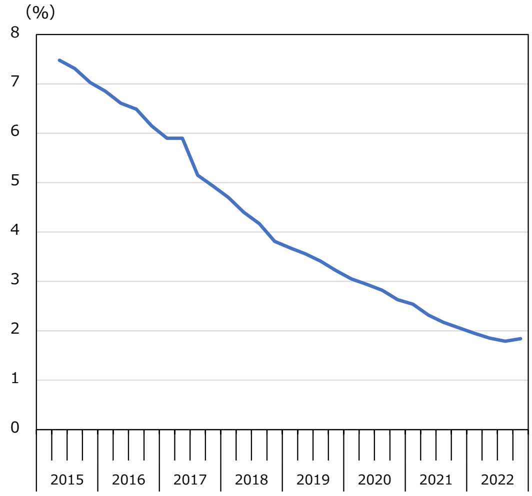
Notes: CET1 ratio = (common stock + retained earnings + other comprehensive income) / risk-weighted assets. Acronym for Common Equity Tier 1. The requirement under Basel III is 7.0%.
Tier 1 ratio = (CET1 + preferred stock + AT1 bonds + preferred investment securities, etc.) / risk-weighted assets. The requirement under Basel III is 8.5%.
Source: Compiled by MGSSI based on the ECB's supervisory banking statistics

Figure 7: Liquidity coverage ratios of ECB-supervised banks



Note: Liquidity Coverage Ratio (LCR) is the percentage of liquid assets out of total funds held that is expected to flow out in 30 days under stress conditions, such as a financial crisis. A minimum of 100% is required.
Source: Compiled by MGSSI based on the ECB's supervisory banking statistics

Figure 8: NPL ratios of ECB-supervised banks



Note: Non-performing loan (NPL) ratio = (loans with principal not repaid as agreed + loans with interest not paid for 90 days or more) / total credit balance
Source: Compiled by MGSSI based on the ECB's supervisory banking statistics

3-3. Policy authorities developing crisis response tools

Progress is also being made in the preparation of measures to prevent crises and handle them when they do occur. Since the financial crisis of 2008, the ECB has been implementing liquidity provision measures such as the LTRO[9] and TLTRO[10], and it may be possible to revive or modify these measures in the event of another crisis.

In addition, to address the widening credit spreads among eurozone countries, (1) the European Stability Mechanism (ESM) was established, and (2) the ECB's program of unlimited government bond purchases (OMT: Outright Monetary Transactions) and (3) the Transmission Protection Instrument (TPI) were introduced (Figure 9).

---

9 Longer-term refinancing operation. To help banks finance themselves during the European sovereign debt crisis, the ECB extended the maximum loan maturity, from the previous term of one year, to three years, without setting a ceiling on the amount of funds supplied. In total, more than 1 trillion euros were provided in 2011 and 2012.

10 Acronym for targeted longer-term refinancing operation. Conceived to avoid credit blockages in the real economy, the first phase was implemented in September 2014, the second in June 2016, and the third in September 2019. The operations provided low-interest funds for a period of three years to companies that have increased their lending. In the third round, 2.1 trillion euros was supplied.

As discussed above, the eurozone banking system's resistance to financial instability has strengthened significantly compared to the past.

Figure 9: Eurozone initiatives to avoid market fragmentation due to credit spreads

Initiative	Details
(1) European Stability Mechanism (launched in October 2012)	➢ A permanent rescue fund established in the eurozone during the European sovereign debt crisis to provide financial assistance (capital of €704.8 billion). The fund's capacity to disburse assistance is €500 billion. The following four types of financial assistance will be provided in response to requests from countries wishing to receive assistance: (1) Loans to countries experiencing severe financial distress (2) Purchases of government bonds from the primary or secondary markets (3) Provision of loans for the recapitalization of financial institutions to the country to which the financial institutions belong (4) Preventive financial assistance
(2) Outright Monetary Transactions (unlimited government bond purchases) (launched in September 2012)	➢ The ECB purchases government bonds with a remaining maturity of 1-3 years in the secondary market without setting a limit. The ECB makes the decision to start, continue, or end the OMT. ➢ Implementation is contingent upon the country already receiving ESM support and carrying out the program dictated at the time of support.
(3) Transmission Protection Instrument (launched in July 2022)	➢ The ECB purchases bonds issued by the public sector with a remaining maturity of 1-10 years without setting a limit. Conditions for implementation include: 1) compliance with EU financial regulations, 2) no serious macroeconomic imbalances, 3) financial sustainability, and 4) sound and sustainable macroeconomic policy management.

Source: Compiled by MGSSI based on European Commission and ECB materials

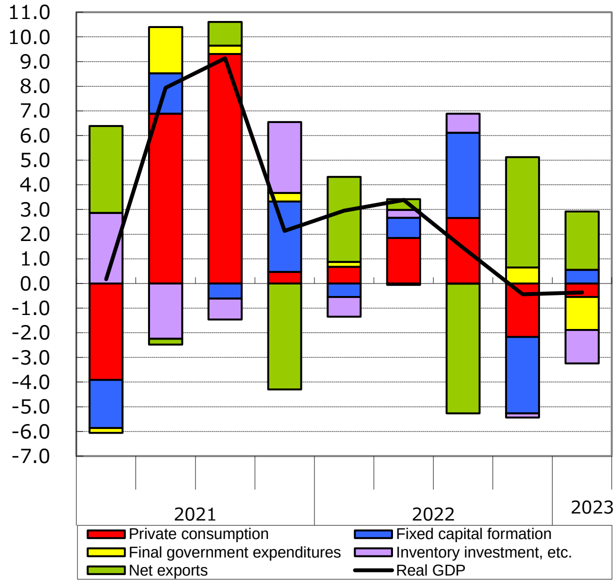
4. THE CURRENT STATE OF THE EUROZONE ECONOMY AND ECB MONETARY POLICY

4-1. Current state of the economy and prices

Real GDP for January-March 2023 fell by an annualized 0.4% year on year, marking the second consecutive quarter of negative growth following the 0.4% year-on-year decline in the previous quarter, and the economy entered a recession. Economic momentum is weak due to stagnation in domestic final demand, such as consumer spending and capital investment, against the backdrop of declining real income caused by soaring prices and the downward pressure effect of monetary tightening (Figure 10).

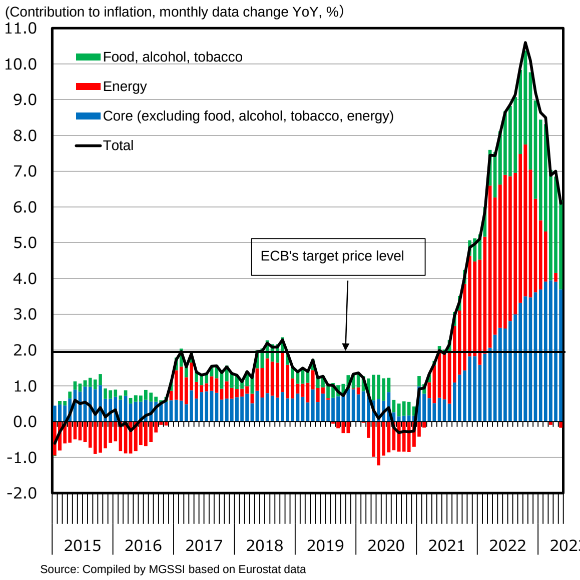
Meanwhile, the rate of increase in the consumer price index remained high in May, at 6.1% year on year (Figure 11). Although the upward push from energy prices is diminishing, inflationary pressures are persistent as the

Figure 10: Real GDP growth in the eurozone



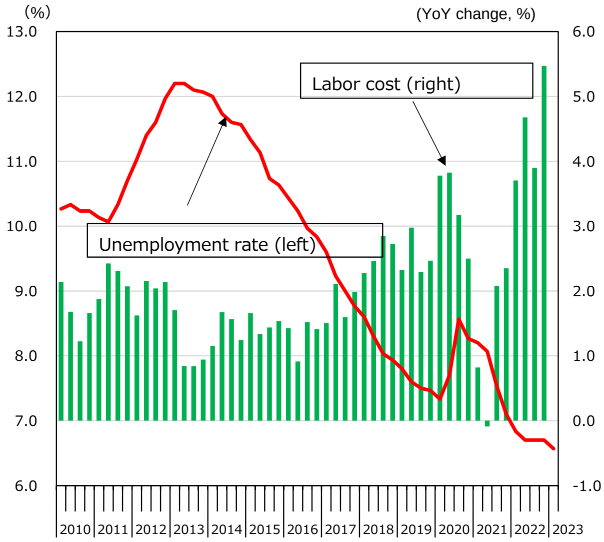
Source: Compiled by MGSSI based on Eurostat data

Figure 11: Eurozone consumer price inflation rate



Source: Compiled by MGSSI based on Eurostat data unemployment rate is at an all-time low (Figure 12), labor supply and demand remain tight, strikes are frequent, and service prices are rising on the back of nominal wage growth. As such, the core inflation rate[11] stands at a high 5.3%.

Figure 12: Eurozone unemployment rates and labor costs



Source: Comipiled by MGSSI based on Eurostat data

4-2. ECB facing a dilemma

ECB President Christine Lagarde, speaking at a press conference following the June 2023 monetary policy meeting of the Governing Council, said, “there is still work to be done”. She emphasized that the interest rate hikes are not over. The Governing Council continued raising key interest rates even after March 2023 when financial instability erupted, through June. The market has fully factored in expectations of an additional rate hike at the Governing Council’s July meeting and is beginning to increasingly factor in another increase in September. Since a rise in interest rates will cause a deterioration in bank profits through falling prices of bonds and other securities, in addition to weakening the economy, the ECB faces the dilemma of controlling inflation versus ensuring economic stability and addressing financial instability.

5. FUTURE OUTLOOK

5-1. Main scenario: Embers of financial instability continue to smolder, but a financial crisis is averted

As inflationary pressures in the eurozone are persistent, even after the policy interest rate reaches the terminal rate[12], the rate will likely remain at that level for some time thereafter. The ECB is not expected to start cutting interest rates until mid-2024 or later, when the rate of increase in the consumer price index settles down to the central bank’s inflation target of around 2%. Meanwhile, although personal consumption is expected to pick up, domestic demand such as housing investment and capital investment will remain sluggish as the effects of interest rate hikes take full effect, and annual economic growth is expected to remain around zero percent for the time being.

The embers of financial instability will likely continue smoldering for the foreseeable future with no end in sight as the ECB continues to tighten monetary policy and the environment for bank profits deteriorates further. However, given the enhanced resilience of the euro banking system to financial instability, even if individual problems emerge in the course of these developments, they are unlikely to develop into a "financial crisis" leading to a full-blown economic recession as a result of a dysfunctional financial system, as long as the financial authorities continue to respond quickly and flexibly.

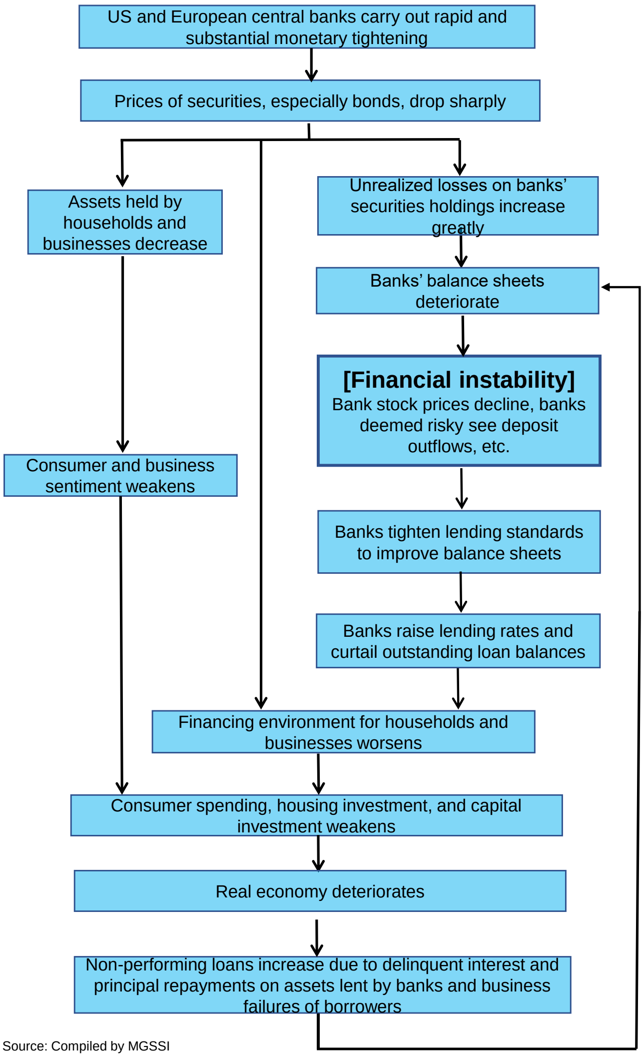
5-2. Factors influencing the scenario

Financial instability hits the real economy through the channels shown in Figure 13. Of particular note is the deterioration of the real economy caused by banks' reluctance to lend, as they endeavor to improve their balance sheets. Banks are rapidly tightening their lending standards (Figure 14), and depending on future developments, the following risk scenario could materialize.

[11] The inflation rate that excludes volatile food and energy from the overall inflation rate. It indicates the underlying trend of prices.

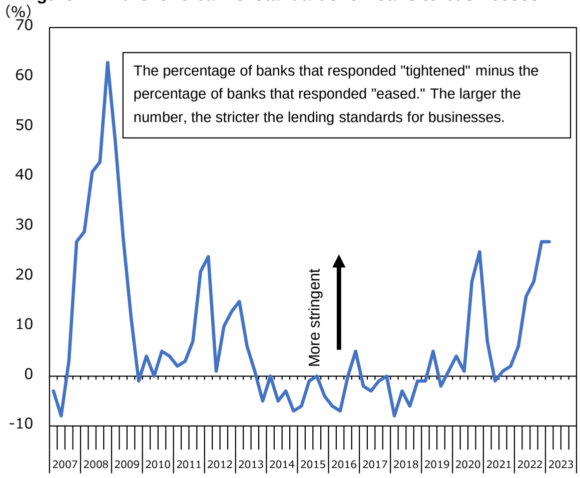
[12] The maximum level of the policy interest rate that monetary policy authorities allow during a period of tight monetary policy.

Figure 13: Impact of financial instability on the real economy



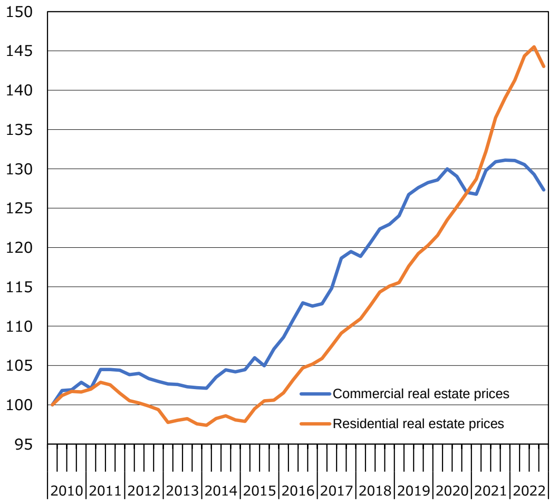
Source: Compiled by MGSSI

Figure 14: Eurozone banks' standards for loans to businesses



Source: Compiled by MGSSI based on the ECB's euro area bank lending survey

Figure 15: Eurozone real estate prices



Source: Compiled by MGSSI based on ECB data

5-3. Risk scenario: Intensifying vicious cycle of banks' reluctance to lend and deterioration of the real economy could trigger a financial crisis

There is a risk that a financial crisis could be triggered if banks' efforts to improve their balance sheets in response to financial instability reinforce a vicious cycle that leads to a further deterioration of the real economy and an increase in nonperforming loans. This, in turn, worsens financial instability and causes banks to become more hesitant in lending. If the tightening of lending standards is halted at the current level, a crisis may be averted, but if lending standards continue to be tightened to levels seen during the financial crisis of 2008, a risk scenario may develop. The real estate sector is a "weak link" vulnerable to the adverse effects of banks' reluctance to lend, and attention is warranted for trends in that segment, as it saw a large inflow of funds during the period of monetary easing (Figure 15). The commercial real estate sector, in particular, is facing structural changes as demand for office space declines due to the rise in telecommuting that began during the pandemic. Although price declines are limited at present, it will be necessary to keep a close eye on developments in this segment[13].

[13] The ECB and its financial risk watchdog, the European Systemic Risk Board (ESRB), have warned that a sudden deterioration in the commercial real estate sector could pose systemic risks to financial markets and the economy as a whole.