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MACRO COMMENT

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Bank lending standards and recessions

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BANK LENDING STANDARDS AND RECESSIONS

The exceptional monetary policy tightening of the past year has restricted access to, and the demand for, bank financing. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the outlook for bank lending in the US and the eurozone considering the recent banking sector turmoil and concludes that the risk of recession has increased.

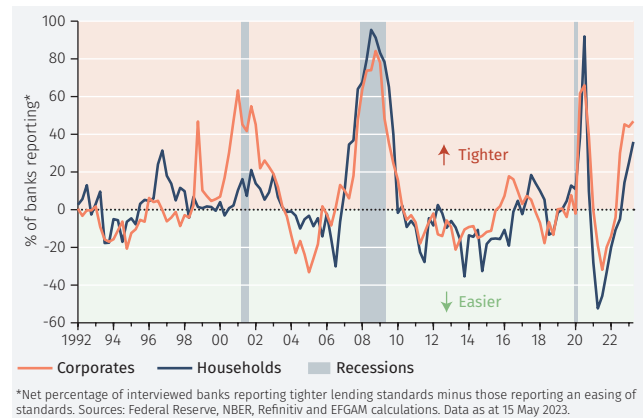
The growth in bank loans is a reliable barometer of the economic cycle. The results of the latest bank lending surveys in the US and the eurozone are therefore worrisome. Between late March and early April, banks surveyed in the Federal Reserve’s Senior Loan Officer Opinion Survey (SLOOS) and the ECB’s Bank Lending Survey (BLS) reported a further, significant tightening in lending standards to businesses and households compared to three months earlier.

The survey results show that the banking sector turmoil that broke out in early March has made banks more cautious. Despite a downward shift in the expected path of interest rates in the coming quarters, financing conditions have become more restrictive. This increases the likelihood of a slowdown in credit flows and the risk of recession in the second half of 2023 (see Figures 1 & 2).

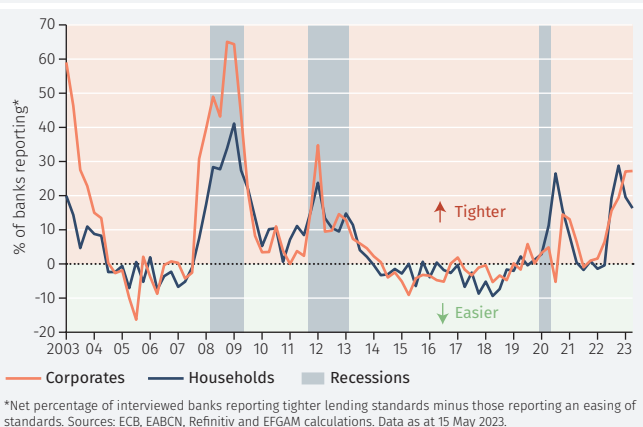
The recent tightening of bank lending standards is similar to that seen prior to recessions in the US and eurozone over the past 30 years.

The surveys show that a growing share of commercial banks in the US and eurozone have raised interest rate spreads on loans relative to their cost of funding (see Figure 3). Furthermore, the latter has increased both because of central bank rate hikes and also as a consequence of the recent increase in banking sector uncertainty. The result is that for non-financial firms and households the cost of credit has increased more than indicated purely by central banks’ policy tightening. This matters when assessing the need for further monetary policy tightening.

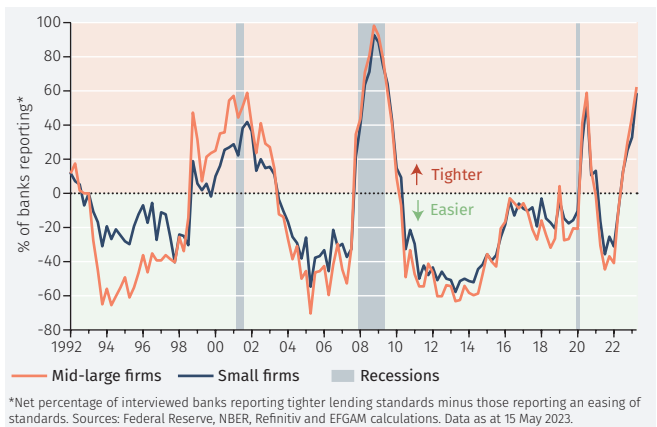
1. US banks’ lending standards and recessions



2. Eurozone banks’ lending standards and recessions



3. US banks raising spreads on loans

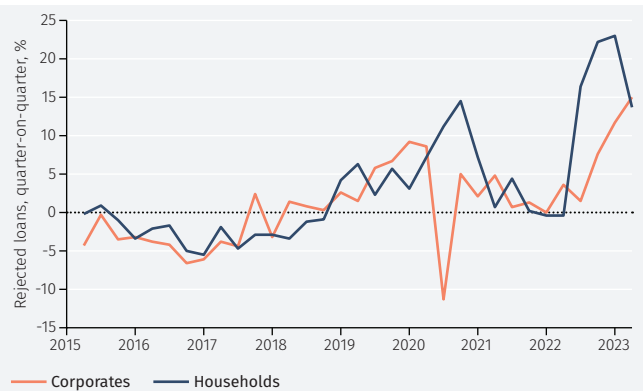


The granularity of bank lending surveys shows that US banks have reduced the size and duration of loans granted relative to requests from firms and households. In contrast, in the eurozone, commercial banks increased the share of rejected credit applications. In the case of corporate loans, this occurred at the fastest pace since this question was added to the survey in 2015 (see Figure 4).

Finally, the surveys show a sharp decline in credit demand in the US and the eurozone (see Figures 5 & 6). It is evident that declines in demand for bank loans are correlated with recessions and that the collapse in demand reported by commercial banks is equal to or greater than that recorded during the recessions of the last 30 years.

BANK LENDING STANDARDS AND RECESSIONS

4. Eurozone banks, change in loans rejection rate



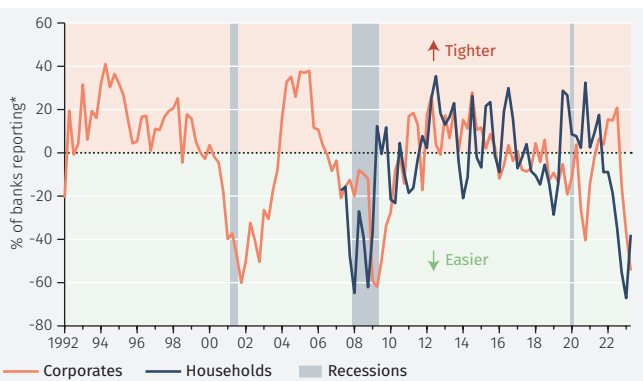
Sources: ECB, Refinitiv and EFGAM calculations. Data as at 15 May 2023.

According to the ECB survey, in early 2023 loan demand from firms and households fell mainly due to increased interest rates.¹ President Lagarde said this showed that the measures taken by the ECB since July 2022 made eurozone monetary policy restrictive even before interest rates were increased again on 4 May.

In conclusion, the evidence from the last 30 years shows that tight lending standards have preceded recessions in the US and eurozone. The tightening reported in the latest bank lending surveys therefore increases the risk of recession in the second half of 2023.

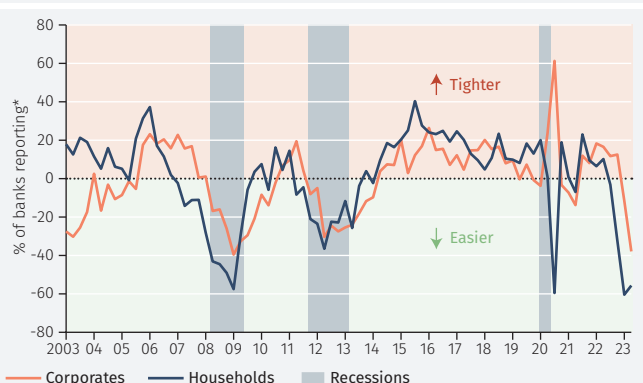
Even if a recession is avoided, moderate growth will tame inflation. The implications for monetary policy are that there is less need for further interest rate increases on both sides of the Atlantic.

5. US loan demand and recessions



*Net percentage of interviewed banks reporting tighter lending standards minus those reporting an easing of standards. Sources: Federal Reserve, NBER, Refinitiv and EFGAM calculations. Data as at 15 May 2023.

6. Eurozone loan demand and recessions



*Net percentage of interviewed banks reporting tighter lending standards minus those reporting an easing of standards. Sources: ECB, EABCN, Refinitiv and EFGAM calculations. Data as at 15 May 2023.

¹ There is no specific question in the US SLOOS about the impact of interest rates on credit demand.

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