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Finance outlook 2023

A new test for financial stability

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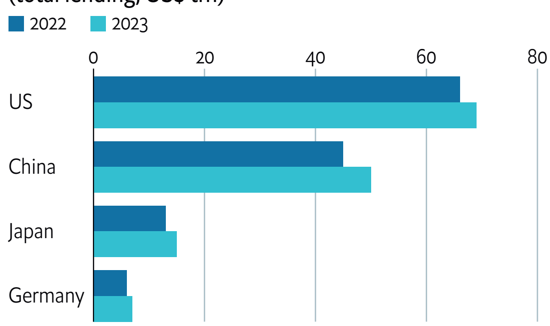
- Weakening economic output and rising interest rates will lead to more difficult conditions for banks, insurers and fund managers in 2023 than in the past two years.
- The impact will be particularly acute in North America and Europe, where governments will offer support. The environment will be tough in Asia as well, although policy rates will rise by less.
- Heavily indebted developing countries will find it harder to refinance foreign debt, driving some to default or require rescues to avoid it. However, the IMF will continue its lenient treatment of economies requiring its financing programmes.
- The current capital-market crunch will hobble a wide variety of loss-making fintech challengers that sought to outflank incumbents in banking, payments and other activities.

Global financial firms will face tougher conditions in 2023 in an environment marked by slowing economic growth, spiking prices, unevenly rising interest rates and sharpening international political tensions. Fortunately, firms in the industry have greatly improved their resilience over the past decade by bolstering their capital and liquidity positions, and leaving behind non-core activities and markets. As a result, most should prove capable of riding out the stresses arising from this latest economic downturn. In the longer term, the industry will benefit from enduring trends towards greater use of digital services, improved financial inclusion and expanding needs for savings to cover ageing populations and investment to confront challenges like the green transition.

Arrears and debt defaults will rise, but governments will offer support

Rising rates generally have positive impacts for financial firms, as they lead to wider interest-rate spreads for banks and better investment returns on the portfolios of insurance companies and fund managers. However, they also slow the overall economy and reduce the cash available to households and firms, while trimming demand for now-more-expensive credit. According to our forecasts, financial firms in the west have enjoyed some widening in interest margins recently, but these will soon narrow again as demand wanes for credit for consumption and investment. Meanwhile, margins will remain stable in China, Japan and most of the rest of Asia.

Lending will continue to rise in 2023
(total lending; US$ trn)



Source: EIU.

The toxic combination of weakening economies and rising interest rates may lead to a rise in arrears and defaults on debts. There are few signals so far indicating such distress, setting aside the special case of China's property developers who took advance payment for future apartments and borrowed heavily in US-dollar debt on overseas markets.

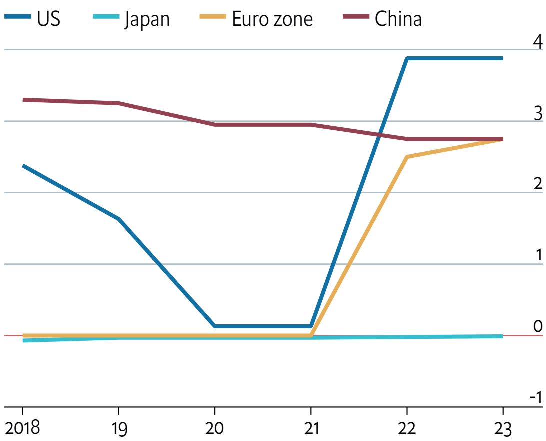
In any case, policymakers may step in, as they did during the pandemic, to support household and company borrowers who would otherwise struggle to repay debts. For example, lawmakers in Europe have outlined plans to cap or subsidise energy costs. This will leave borrowers in a better position to repay loans, while shifting rising costs to the public exchequer.

Sovereign debtors and asset markets will remain under pressure

One class of borrowers—heavily indebted developing countries—will have to proceed with only a limited safety net. Tightening financial conditions and rising costs on US-dollar and euro debt will make it more difficult and costly for them to roll over their debts. Small economies like Sri Lanka and Zambia have already defaulted (as did Russia in special circumstances), and larger economies could soon come into distress.

Moreover, China has emerged as an important creditor in the past decade but remains reluctant to participate in the types of debt-relief efforts used by OECD creditors. This could make it more difficult to reach compromises on debt reduction. On a positive note, the IMF under its current management has taken an accommodative approach to debt-burdened countries, provided they outline some path towards fiscal sustainability.

No more easy money
(policy interest rates*; end-period; %)



Source: EIU. *2022-23 are forecasts.

Markets for stock and bonds tend to anticipate economic recoveries, generating financial conditions and rising asset prices well in advance of official output figures. However, market participants first want to see a future turning point, such as a pause in interest-rate hikes by the US Federal Reserve (Fed, the central bank). This will not take place so long as price pressures remain very high in the US.

Financial challengers will stumble badly

The incumbents of the financial industry will suffer in 2023, but their upstart rivals - including fintech companies - are likely to fail in large numbers. Funders such as venture-capital and private-equity firms are insisting in the current market environment that financial challengers stop making losses and chart a path to profitability. This will prove impossible for some upstarts in consumer credit, payments and robo-advised fund management. Others will have to sharply curtail their expenses, including for marketing and customer acquisition. The culling of competition will ease pressures on established banks, insurers and fund managers.

Meanwhile, the recent sour turn in the markets has deflated a wide range of frothy financial activities that thrived in the bull run. The air has gone out of the cryptocurrencies and decentralised finance that aimed to displace banks and payments firms. Blank-cheque companies intended to outflank investment banks in bringing firms to the public markets, but instead they are being forced to return funds to investors. Non-bank consumer lenders are succumbing to rising levels of borrower defaults.

Taking a longer view, a number of enduring trends will sustain most financial firms. Most will enjoy a tailwind from citizens' rapidly rising use of formal financial services, increasing needs for savings for ageing populations and the huge financing needs for policy objectives such as decarbonisation and infrastructure improvements. A shift to digital strategies focused on mobile and online services will allow firms to close physical locations and trim staff expenses.

To watch

Exiting Mexico: Citigroup is likely to sell its Mexico retail banking franchise, which was once a crown jewel in its globe-spanning network. The US banking group has spun off many of its far-flung operations in recent years as international lenders trim their footprints.

Fresh Basel: The final implementation dates for Basel III (also known as Basel IV) arrive on January 1st 2023, after having been delayed by one year due to the pandemic. Customers will not notice the changes, which require new government regulations and will change the way that banks account for base capital, credit risk using standardised or internal models, as well as mandatory disclosures.

China's e-yuan: China is likely to expand its pilot use of its central bank digital currency (CBDC), dubbed the e-yuan, and may implement it countrywide. The country is the most advanced among major economies in pursuing CBDCs, but has yet to devise a way to use it in international trade.

Key risk scenario: Rising geopolitical tensions

Following the outbreak of Russia's war in Ukraine in early 2022, a coalition of democratic nations imposed sanctions on Russia, which in turn imposed exchange controls and other measures that locked capital inside its economy. As a result, many western banks and insurers moved to sell their local operations, often at fire-sale prices, or simply wind them down. Other firms continue to operate under local management and without access to any funds. Authorities in western Europe seized and closed Russian firms' operations across the continent.

This led to substantial losses, but the costs would be much larger if China seized Taiwan in 2023 (not our core scenario). US bank executives told a congressional committee in September 2022 that they would comply with any official demand to exit their China operations. Financial firms from Japan and elsewhere would also inevitably shutter their China units. Developed-country financiers have only a small footprint in China, but have coveted the country's large and growing financial markets. At the same time, China's banks, which have expanded overseas in recent years, would be frozen out of the economies of countries backing Taiwan in any conflict.

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