Financial Stability Review

December 2004

Presentation by
Tommaso Padoa-Schioppa
15 December 2004
Calling attention to the main sources of risk and vulnerability to financial stability does not aim at identifying the main — or most likely — future scenario for the euro area economy. It entails the highlighting of potential and plausible sources of negative events, even if these are remote and very unlikely.
Financial stability monitoring by central banks

• 16 of the 25 EU central banks publish a review, particularly those without supervisory responsibility
  – Seven within the Eurosyste
  – Three of the remaining EU15
• Outside the EU, there are many others
• Mission and purpose is varied but common themes are:
  – Informing the public and market participants
  – Encouraging discussion among authorities and market participants
Financial stability mandate of the ESCB

• Treaty base - Article 105(5)

• Since 1999: Banking Supervision Committee prepares internal banking stability reports

• February 2003:
  – First BSC report on banking stability published

• Governing Council has regular discussion of financial stability issues on the basis of a financial stability review
Conceptual framework

I. Financial stability – concepts and process

- Definitions:
  - Financial stability
  - Financial system

- Method
  - Identify main sources of risk
  - Assess robustness of financial system
December 2004 Financial Stability Review

I. Financial stability – concepts and process

- Scope
- Structure
- Analytical highlights
- Co-operative production process
Procedure and policy issues

• Identifying main sources of risk:
  – Intelligence gathering and cross-checking
  – Analysis
  – Judgment
  – Overall Assessment

• Open policy issues:
  – Objective
  – Instruments
  – Role of central banks
Areas of vulnerability

- Global macro-finance
- Financial markets
- Euro area sectoral balances
- Financial institutions
Global macro-finance

Two main issues: Oil prices and US imbalances

II. Areas of vulnerability

Oil prices and futures (Brent crude)

Net lending/borrowing of the US economy
(Q1 1950 - Q2 2004, % of GDP)
Financial markets

Renewed leverage in bond markets and volatility declines

II. Areas of vulnerability

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004
Euro area sectoral balances – corporate sector

II. Areas of vulnerability

Large firms improving, but small firms still weak

Costs, sales and profits of Dow Jones EURO STOXX 50 companies (Q4 2001 - Q2 2004, 4-quarter moving average, EUR billions)

Annual GDP growth and corporate insolvencies in the euro area (1997 - 2005)

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004
Euro area sectoral balances - households

Risks on both sides of balance sheets

II. Areas of vulnerability

House price and mortgage loan growth (1998 - 2003, bubble size proportional to GDP)

Ratio of debt to financial assets (1995 - 2003)

Loan to value ratios on new mortgages (2003)
Financial system
Integration continues, but room for further progress

II. Areas of vulnerability

Euro area holdings of cross-border interbank loans, securities and non-bank loans
(Q1 1999 - Q2 2004, % of domestic activity)

Number of settlement systems

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004
Financial system

Cross-border presence of large banks

Domestic and foreign presence of large banking groups (2003)

- large banking group's assets - foreign share
- domestic market share of large banking group

AT  BE  DE  ES  FR  GR  IE  IT  NL  PT

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004
Financial institutions - banks

Bank profitability and solvency improve

II. Areas of vulnerability

Return on equity distribution of large euro area banks

Tier 1 capital distribution of large euro area banks

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004
Financial institutions – hedge funds

Hedge funds grow fast and change nature

II. Areas of vulnerability

Hedge fund inflows
(Q1 1994 - Q2 2004)

Hedge funds investors

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004
II. Areas of vulnerability

T. Padoa-Schioppa - Presentation of the Financial Stability Review, December 2004

EUROPEAN CENTRAL BANK 17
Five main sources of risk

Financial fragility may increase if:

1. Hunt for yield in fixed-income markets unwinds
2. US re-balancing becomes disorderly
3. Oil prices amplify corporate sector credit risks
4. Financial sector fragilities intensify
5. House prices correct

Other risks, such as geopolitical risks – including terrorist attacks or middle east tensions – always remain in the background
Overall assessment

• Risks to financial stability have become less pronounced since late 2003 because:
  – The pace of global economic activity has remained strong
  – Balance sheets of large corporations have improved
  – Balance sheets of financial institutions have been strengthened

• Important risks to financial stability remain including:
  – Possible disorderly correction of serial bubbles
  – Unruly unwinding of global imbalances
  – Credit risks posed by sluggish domestic demand