EUROPEAN CENTRAL BANK

EUROSYSTEM

November 2022
Financial Stability Review

Press briefing

16 November 2022

November 2022 Financial Stability Review

Financial stability conditions have deteriorated further since the May FSR

High inflation, recession risks and tighter financial conditions challenge indebted households and firms

As monetary policy acts to address inflation, sovereigns also face higher risks, especially if fiscal support is untargeted

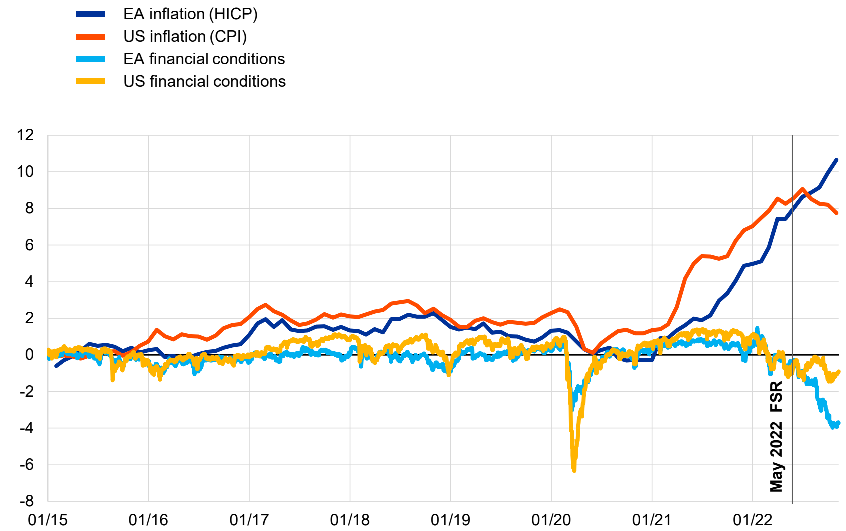
Elevated volatility, repricing risks and liquidity difficulties make disorderly stress in markets and non-banks more likely

Banks' resilience and profits benefit from higher rates, but threats to asset quality may require higher provisions

Sustained inflation, tighter financial conditions and recession risks

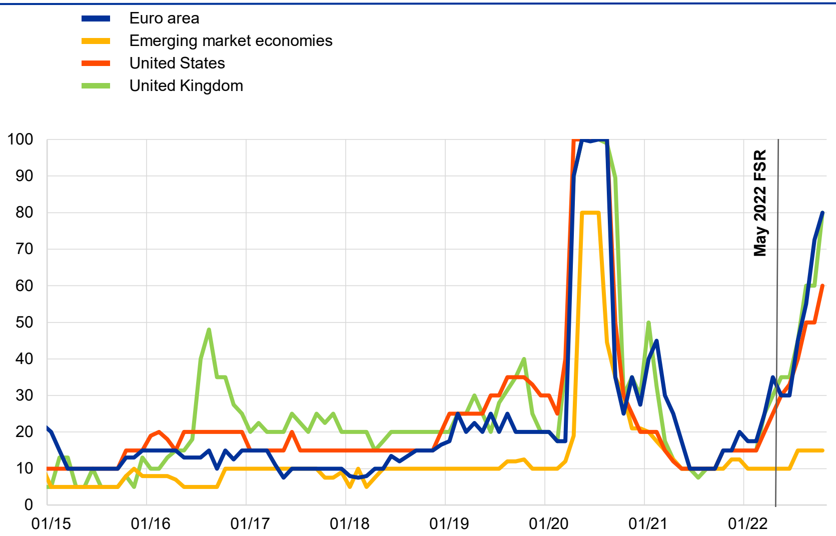
- Intensifying inflationary pressures prompted monetary authorities in advanced economies to respond
- Higher inflation, tighter financial conditions and high energy prices have raised recession fears

Consumer prices and financial conditions in the euro area and the United States
1 Jan. 2015-8 Nov. 2022, annual percentage changes, indices



Sources: Bloomberg Finance L.P. and Haver Analytics.

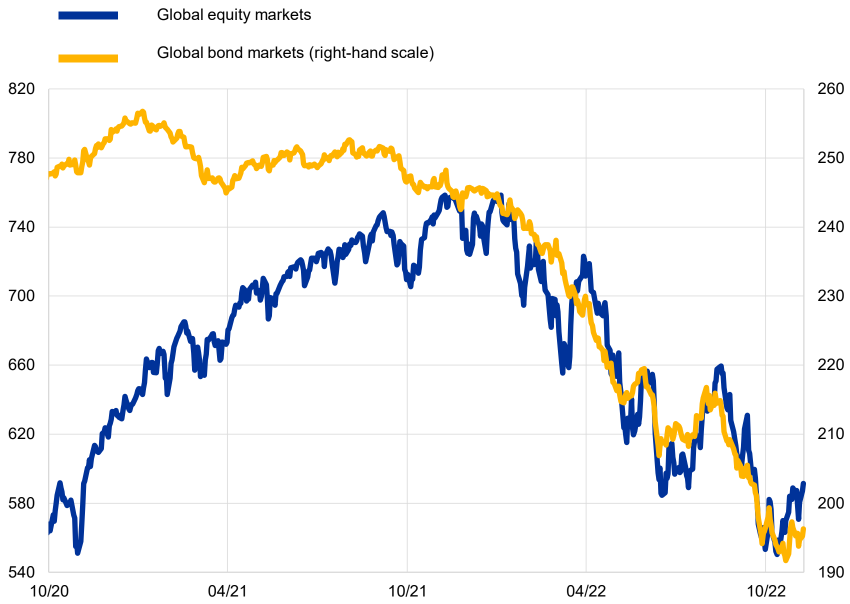
One-year ahead recession probabilities across select economies
Jan. 2015-Oct. 2022, percentages



Sources: Bloomberg Finance L.P. and ECB calculations.

Increased risk of disorderly adjustments in volatile financial markets

Global equity and bond market price indices
1 Oct. 2020-8 Nov. 2022, indices



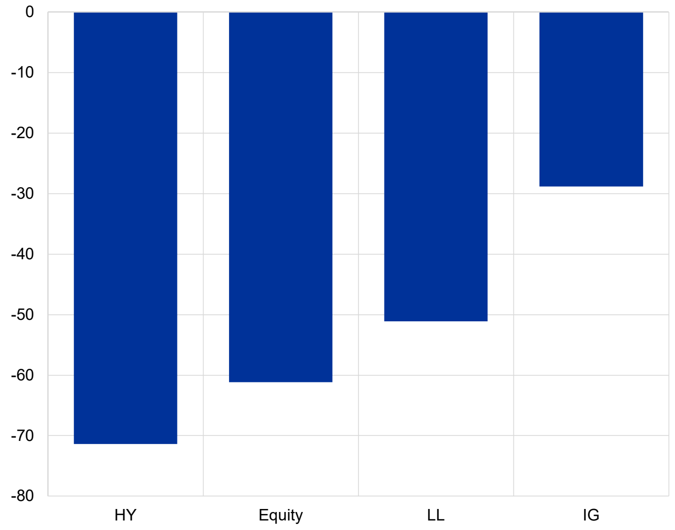
Source: Bloomberg Finance L.P.

- Equity, bond and other market volatility have increased markedly, in tandem with greater inflation uncertainty
- Notwithstanding marked and broad-based asset price corrections, valuations remain vulnerable to upside risks for inflation and interest rates

Market stress could be amplified by lower market liquidity and margin calls

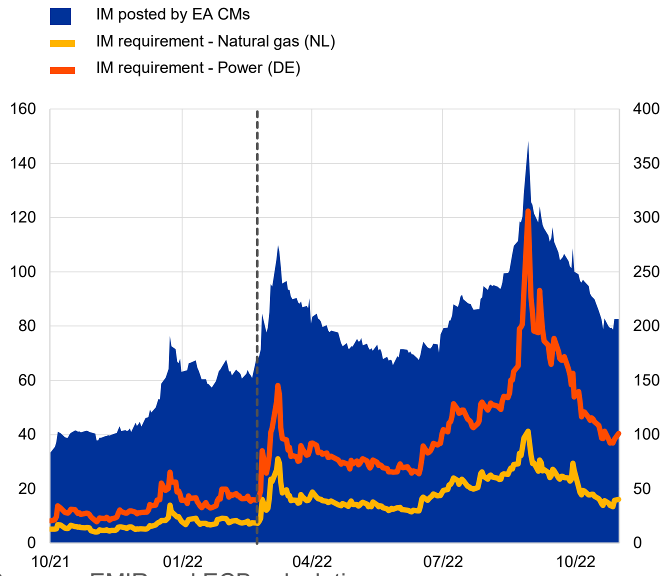
- Lower risk appetite is impairing market liquidity in corporate bond markets, especially for the high-yield segment
- Unexpected increases in margin requirements could revive dash for cash dynamics

2022 year-to-date gross issuance by euro area non-financial corporations
2017-22, percentage deviation from five-year average



Sources: Dealogic, S&P Global Market Intelligence, ECB (Statistical Data Warehouse) and ECB calculations.

Initial margins posted to all CCPs by EA clearing members on portfolios containing commodity derivatives
1 Oct. 2021-1 Nov. 2022, left-hand scale: € billions, daily stocks, right-hand scale: €/MWh

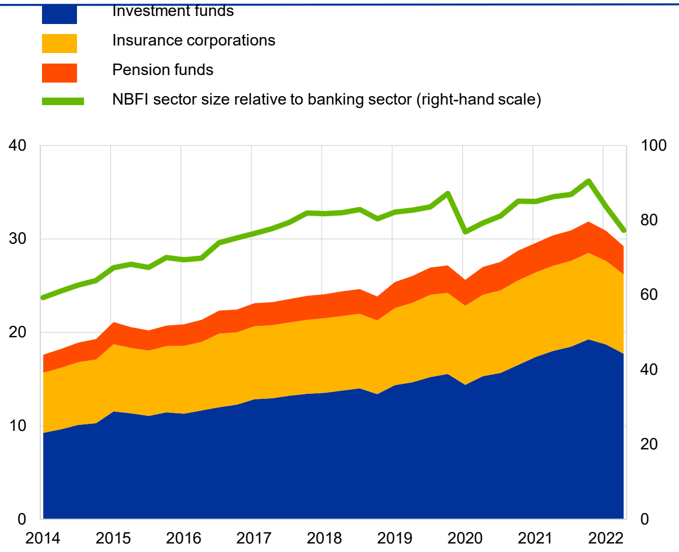


Sources: EMIR and ECB calculations.

Risk of feedback between non-banks and markets may be rising

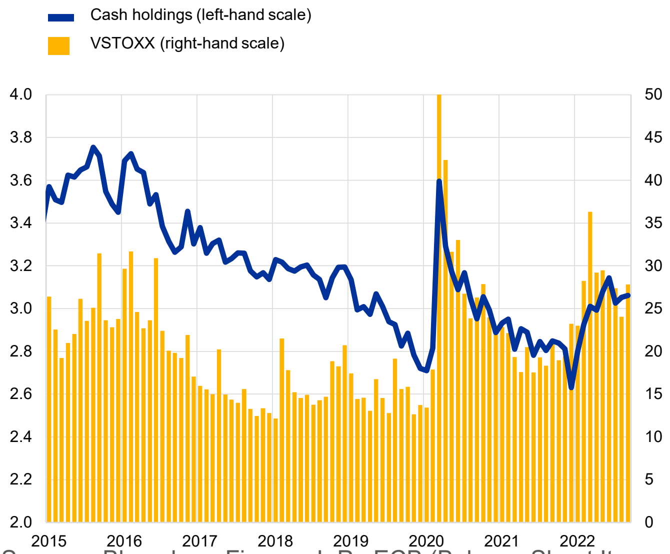
- Signs of de-risking by non-banks, but credit risks may resurface as economic conditions worsen
- Low liquid asset holdings could amplify any adverse market dynamics via procyclical selling behaviour

Total assets of the euro area non-bank financial sector
Q1 2014-Q2 2022, € trillions, percentages



Sources: ECB (Balance Sheet Items, Investment Funds Balance Sheet Statistics, Insurance Corporations Statistics, Pension Funds Regulation, Centralised Securities Database) and ECB calculations.

Cash holdings of euro area investment funds and VSTOXX
Jan. 2015-Sep. 2022, percentages of total assets, index

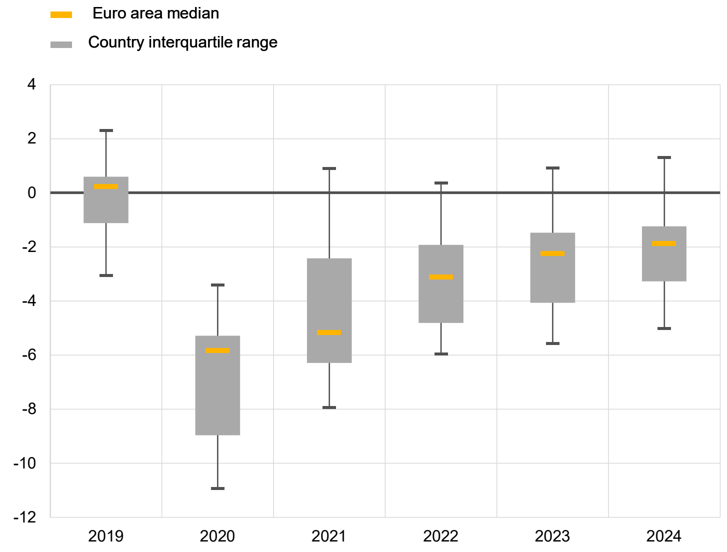


Sources: Bloomberg Finance L.P., ECB (Balance Sheet Items, Investment Funds Balance Sheet Statistics) and ECB calculations.

Sovereigns more at risk from expansionary fiscal measures

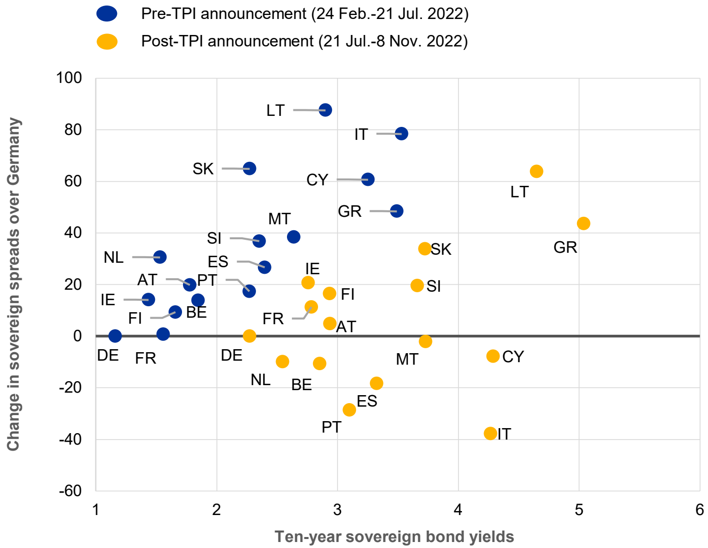
- Governments face a return of fiscal constraints at the same time as demands for economic support rise
- Fragmentation risks in sovereign bond markets partly mitigated by policy action

Distribution of budget balances across euro area countries
2019-24E, percentages of GDP



Source: IMF (Fiscal Monitor) and ECB calculations.

Ten-year government bond yields and changes in sovereign spreads over Germany
percentages, basis points



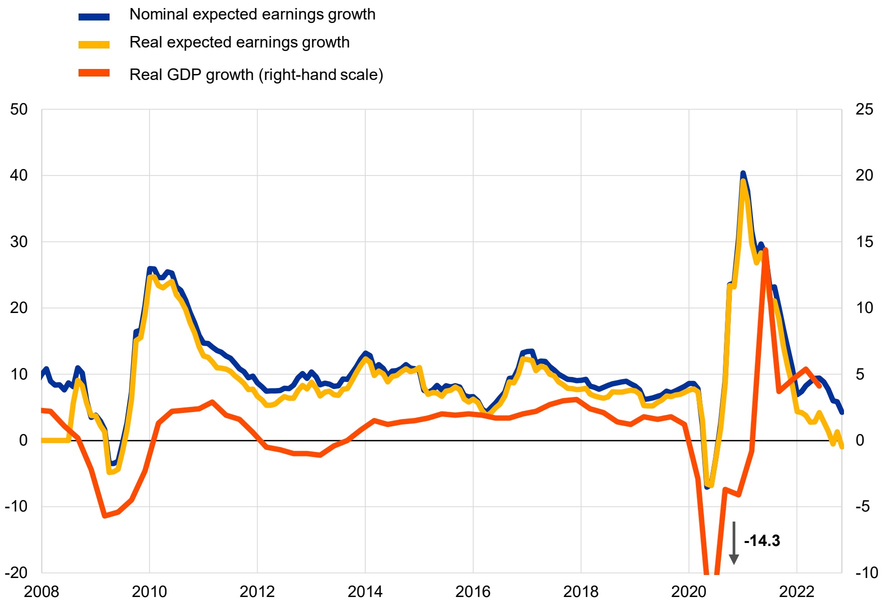
Sources: Refinitiv and ECB calculations.

Euro area non-financial corporations face renewed headwinds

- Expectations for corporate earnings growth have continued to decline

- Default risks have started to increase in some sectors of economic activity

Real and nominal 12-months forward earnings expectations for the EURO STOXX and real GDP growth
Jan. 2008-Oct. 2022, annual percentage changes

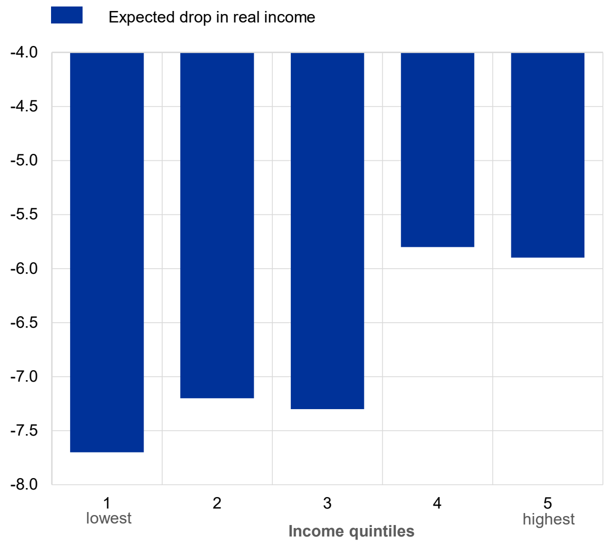


Sources: Refinitiv and Haver Analytics.

Household income squeezed as housing market turns

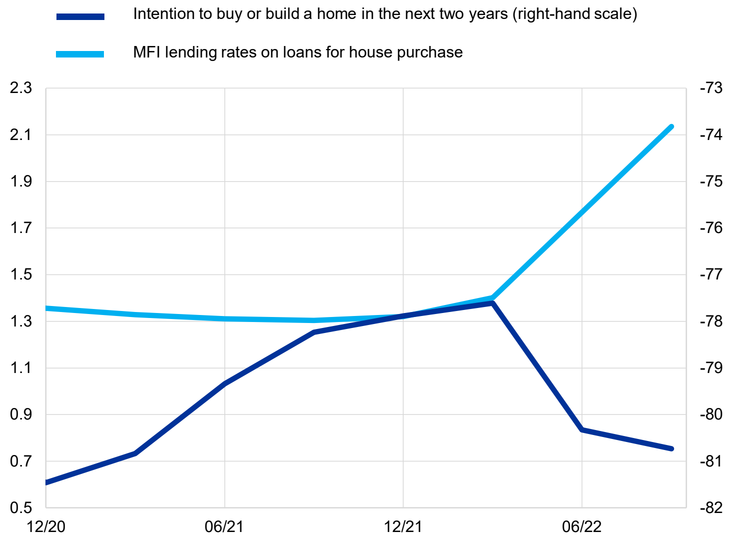
- Income squeeze/lower buffers may trigger debt-servicing problems, mainly for low-income households
- Indicators point to a turn in real estate markets that may compound vulnerabilities for households

Inferred household expectations of drop in real income by income quintile
Sep. 2022, percentages



Source: ECB (Consumer Expectations Survey).

Intention to buy or build a home and lending rates on loans for house purchase
Q4 2020-Q3 2022, percentages, net percentages

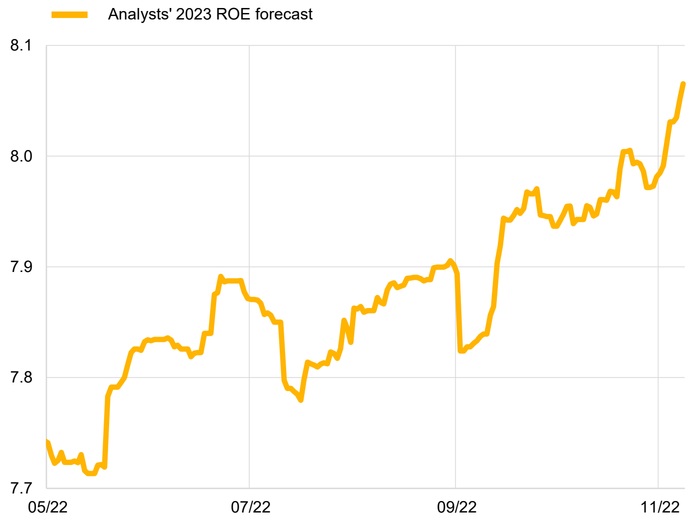


Sources: European Commission, ECB and ECB calculations.

Banks get tailwinds from higher rates but face asset quality headwinds

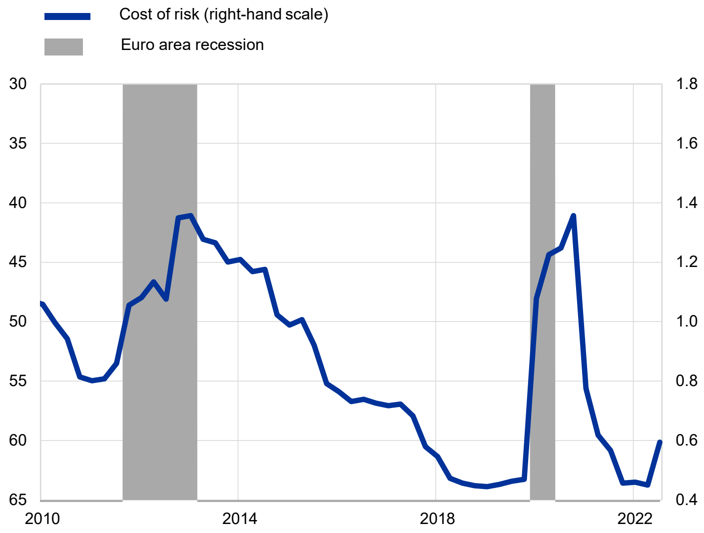
- Analysts' bank ROE expectations remain robust given benefits to income. But cost of risk remains low despite economic outlook and risks to asset quality
- Banks' solid capital (and liquidity) positions suggest lower vulnerability than non-banks and than in the past

Bank analysts' 2023 ROE expectations
1 May-8 Nov. 2022, percentages



Sources: Bloomberg Finance L.P., Refinitiv IBES and ECB calculations.

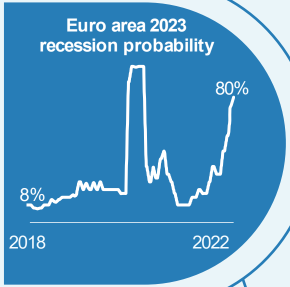
Cost of risk of listed euro area banks
Q1 2010-Q3 2022, left-hand scale: diffusion index, right-hand scale: percentages

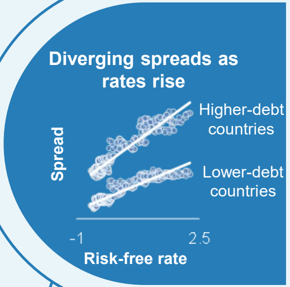


Sources: Bloomberg Finance L.P. and Refinitiv.

High inflation and low growth expose firm, household and sovereign vulnerabilities

- High inflation dampens economic activity
- Risk of house price correction
- High input costs weigh on firms' sentiment
- Energy crisis prompts fiscal pressures



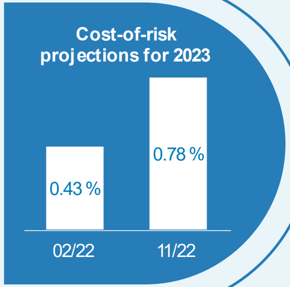


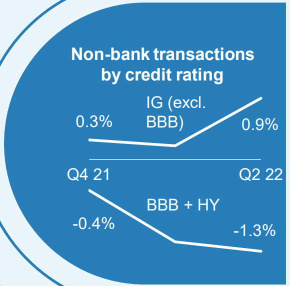
Volatile financial markets more prone to disorderly adjustments

- Higher interest rate volatility
- Corporate bonds priced for downturn
- Less liquid bond markets
- Falling issuance of risky assets

Bank asset quality concerns rise amid growing recession risks

- Higher rates support profitability
- Increase in underperforming loans
- Upward pressure on provisioning
- Further rise in bond funding costs





High credit, duration and liquidity risk in non-banks despite rebalancing

- Rising credit risk in corporate exposures
- Less capacity for corporate financing
- Funds may amplify market dynamics
- Non-life insurers face inflation challenges

On the back of active prudential policy in recent years, the euro area banking system is resilient and well-placed to face higher risks.

Targeted macroprudential policy action, regulatory reform and faithful implementation of Basel III can enhance resilience further.

Structural vulnerabilities in non-banks continue to require a comprehensive and decisive policy response.