EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review
November 2024

Press briefing

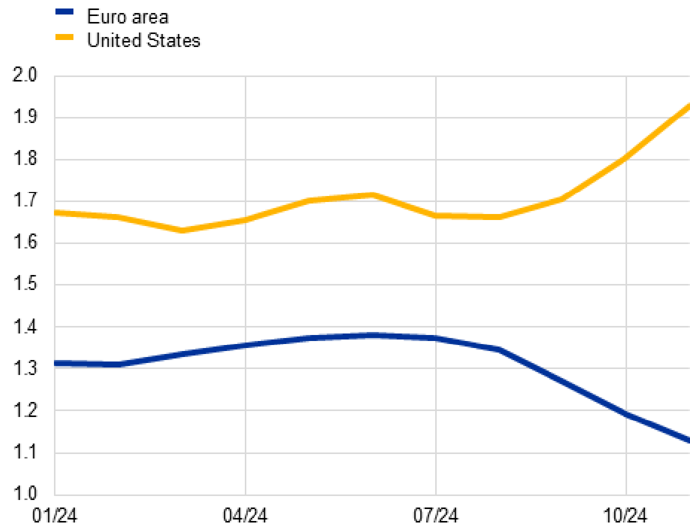
20/11/2024

What's new since the previous FSR?

- Growth fears resurface as a key source of uncertainty
- Financial markets experienced several short-lived spikes in volatility
- Uncertain environment: geopolitical risks, trade policy and economic policy uncertainty elevated

2025 real GDP growth forecasts for the euro area and the United States

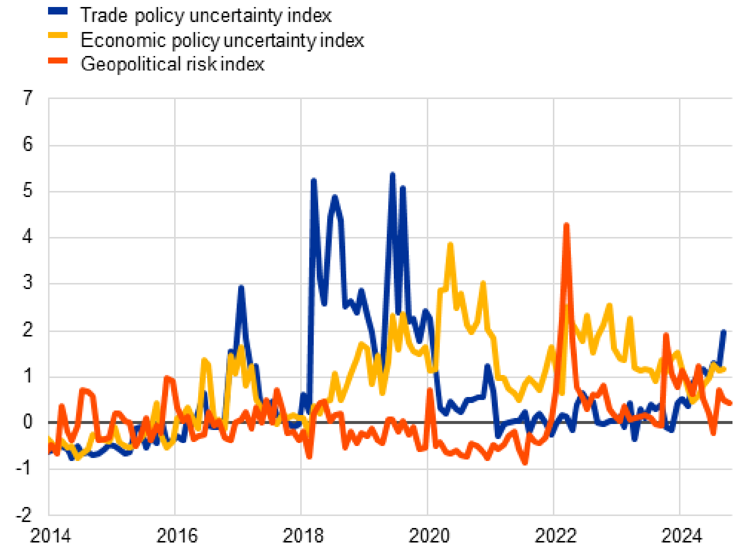
Jan.-Nov. 2024, percentage changes per annum



Source: Consensus Economics Inc.

Trade policy uncertainty, global economic policy uncertainty and geopolitical risk

Jan. 2014-Oct. 2024, z-scores



Sources: Caldara and Iacoviello (2022), policyuncertainty.com and ECB calculations.

Overview

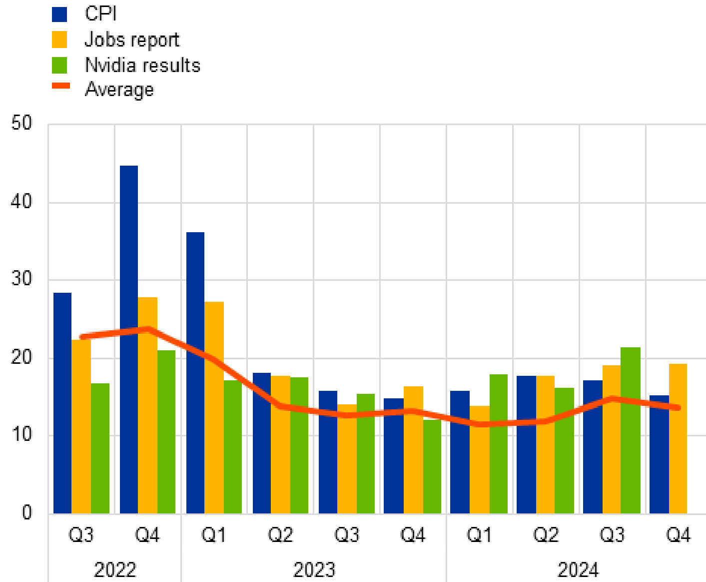
Elevated financial stability vulnerabilities in a volatile environment

1. High valuations and strong risk concentration leave financial markets vulnerable to adverse dynamics which could be amplified by non-banks, given liquidity and leverage vulnerabilities
2. Sovereign vulnerabilities are increasing in light of heightened policy and geopolitical uncertainty, weak fiscal fundamentals and sluggish trend growth
3. Credit risk concerns in some parts of the corporate and household sectors may lead to asset quality headwinds for banks and non-banks, should downside risks to growth materialise

Risk 1: Markets are vulnerable to adverse dynamics

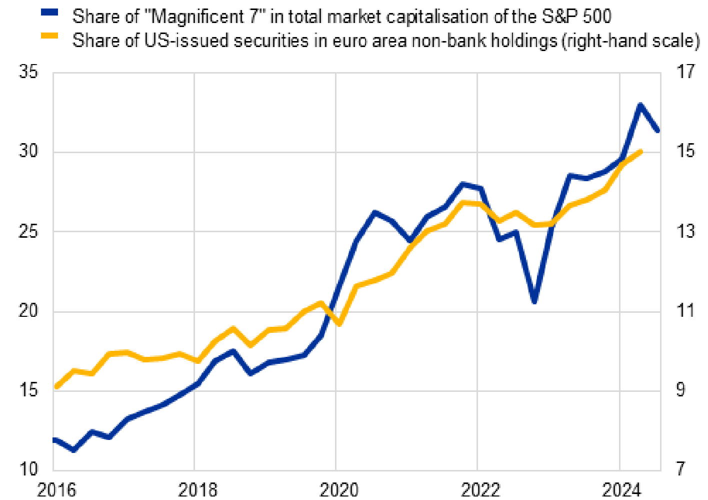
- High risky asset valuations, markets increasingly sensitive to growth data and AI earnings prospects
- US equity market concentrated in few single names, risk that firm-specific shocks drive market-wide dynamics

Implied US equity market volatility for major publication dates
Q3 2022-Q4 2024, index



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

Concentration in US stock markets and euro area non-banks' US exposures
Q1 2016-Q2 2024, percentages



Sources: Bloomberg Finance L.P. and ECB.

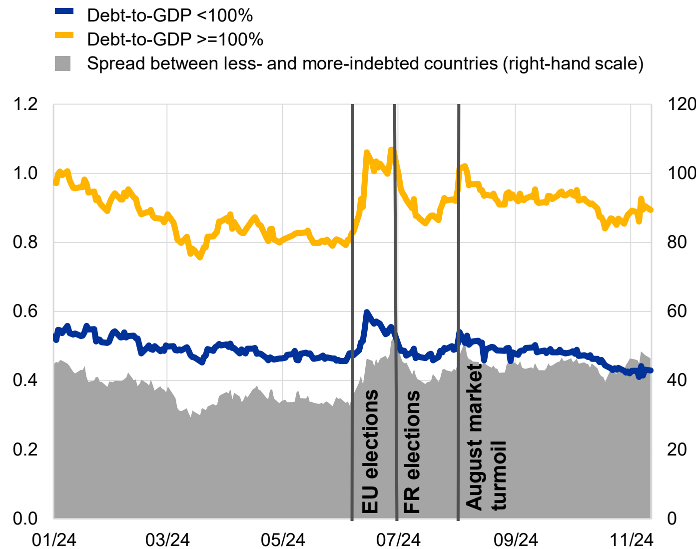
Notes: Magnificent 7 comprises the stocks of Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. Share measured in the total capitalisation of the S&P 500.

Risk 2: Sovereign vulnerabilities on the rise

- Despite recent declines in sovereign debt-to-GDP ratios, fiscal fundamentals remain weak
- Sluggish potential growth, political fragmentation and (geo)political uncertainty exacerbate sovereign vulnerabilities

Euro area sovereign bond spreads over Germany, by debt level

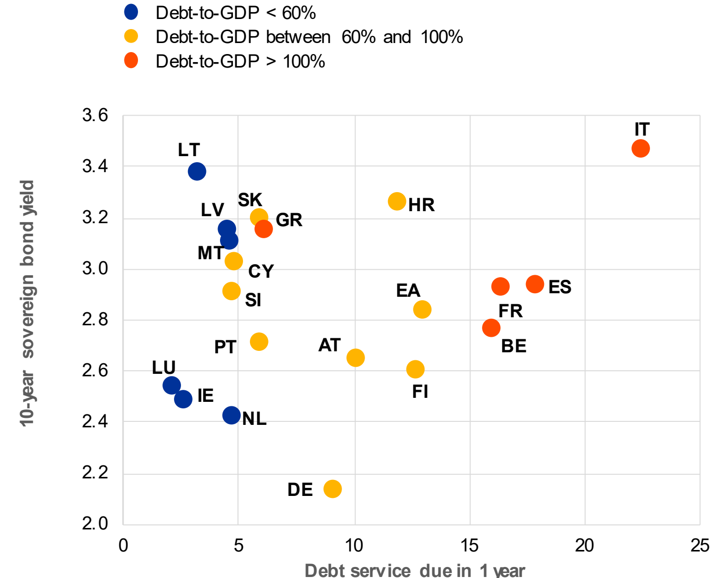
1 Jan.-12 Nov. 2024, percentage points, right-hand scale: basis points



Sources: Bloomberg Finance L.P., LSEG and ECB.

Sovereign debt, debt service costs and sovereign bond yields

Sep. 2024; percentages of GDP, percentage points



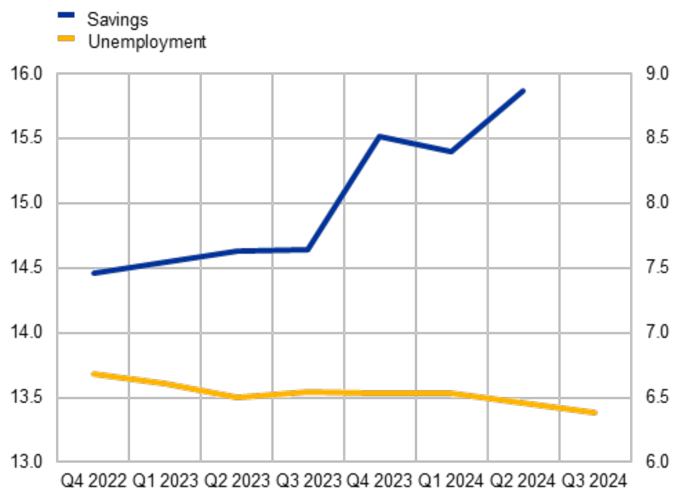
Sources: ECB (GFS), Bloomberg Finance L.P. and ECB calculations.

Risk 3: Credit risk concerns in some parts of corporate and household sectors

- Households resilient, but weaker than expected growth could erode their debt servicing capacity
- The outlook for credit risk could worsen materially if downside risks to growth materialise

Euro area household savings rate and unemployment

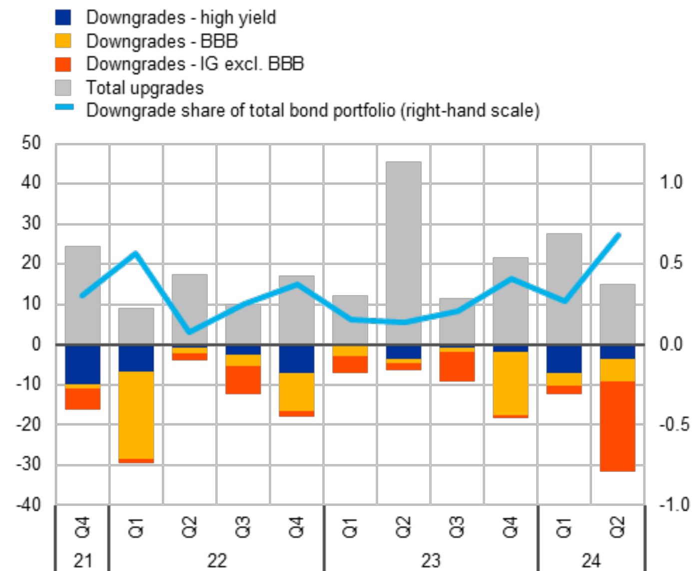
Q4 2022-Q3 2024, percentages



Sources: Eurostat and ECB.

Downgrades of non-financial corporate bonds held by euro area non-banks

Q4 2021-Q2 2024, € billions, right-hand scale: percentages



Sources: ECB (CSDB, SHS) and ECB calculations.

Macroprudential policies

Ensure bank resilience in the face of headwinds and uncertainty and enhance the macroprudential framework

Strong capital buffers and adequate borrower-based measures are needed to counter headwinds and uncertainty

Macroprudential space should be further strengthened in some countries in the medium term

Work should continue to make the **macroprudential framework for banks** more effective

Progress with the capital markets union and enhance the policy framework for non-banks

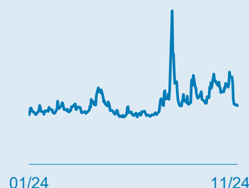
Strengthening the policy framework for non-banks **from a macroprudential perspective** is crucial for financial stability

Additional policy tools and **more integrated supervision** should be prioritised

A stable and resilient NBFI sector would support **the capital markets union**

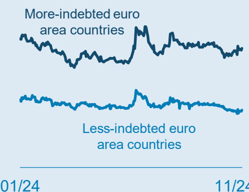
Elevated financial stability vulnerabilities in a volatile environment

1 High valuations and strong risk concentration leave financial markets vulnerable to adverse dynamics which could be amplified by non-banks, given liquidity and leverage vulnerabilities



- High equity market valuations compared to fundamentals indicate scope for greater volatility and potential for further market correction.
- Strong stock market concentration in a handful of firms raises the likelihood of idiosyncratic shocks becoming systemic.
- A growing share of US investments, notably in US-based technology firms, makes non-bank equity portfolios more susceptible to global spillovers.
- Vulnerabilities related to liquidity mismatch and leverage in parts of the NBFI sector could amplify market-wide shocks due to forced asset sales.
- Structural vulnerabilities in the NBFI sector require a comprehensive policy response to enhance its resilience from a macroprudential perspective.

2 Sovereign vulnerabilities are increasing in light of heightened policy and geopolitical uncertainty, weak fiscal fundamentals and sluggish trend growth



- Rising policy uncertainty coupled with heightened geopolitical risks rekindles concerns about sovereign debt sustainability.
- High sovereign debt and deficit levels point towards weak fiscal fundamentals in several euro area countries.
- Fiscal slippage and uncertainty around how the new EU fiscal framework will be implemented could lead to a market repricing of sovereign risk.
- Structural headwinds to potential growth from factors like weak productivity could also fuel debt sustainability concerns.
- Sovereign stress could spill over to other sectors, given the role of sovereign debt as a pricing benchmark and growing interlinkages across sectors.

3 Credit risk concerns in some parts of the corporate and household sectors may lead to asset quality headwinds for banks and non-banks, should downside risks to growth materialise

- Pockets of corporate vulnerabilities and weak cyclical conditions may translate into higher corporate insolvencies, notably among SMEs.
- Pandemic-induced and climate change-related structural factors are reinforcing downside risks for euro area commercial real estate markets.
- Losses on commercial real estate exposures are at risk of rising further and could be significant for some banks and investment funds.
- Weaker than expected growth and deteriorating labour market conditions could erode households' debt servicing capacity.
- Strong capital buffers and adequate borrower-based measures remain key priorities for macroprudential policy for banks in an uncertain environment.