EUROPEAN CENTRAL BANK
EUROSYSTEM

Financial Stability Review
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SUERF

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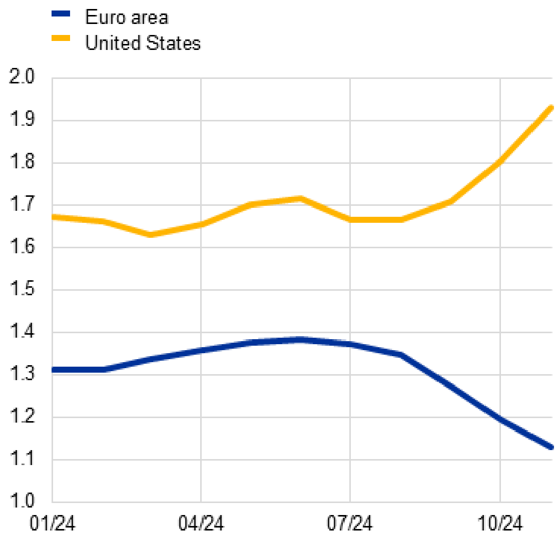
What's new since the previous FSR?

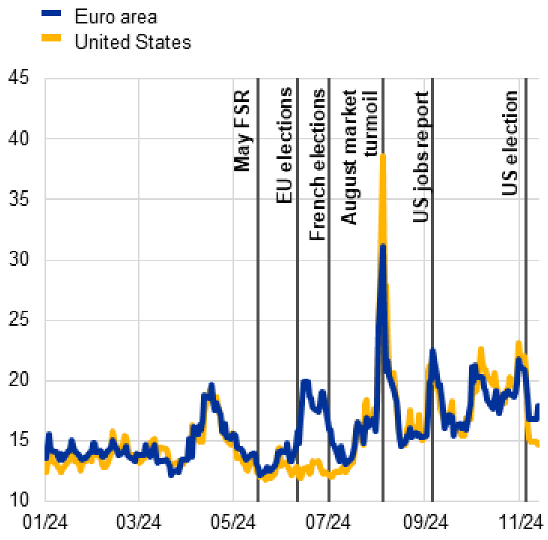
- Growth fears resurfaced while markets endured several short-lived volatility spikes …
- … with geopolitical risks, trade, and economic policy uncertainties all creating potential for repetition …

2025 real GDP growth forecasts for the euro area and the United States
Jan. 2024-Nov. 2024, percentage changes per annum



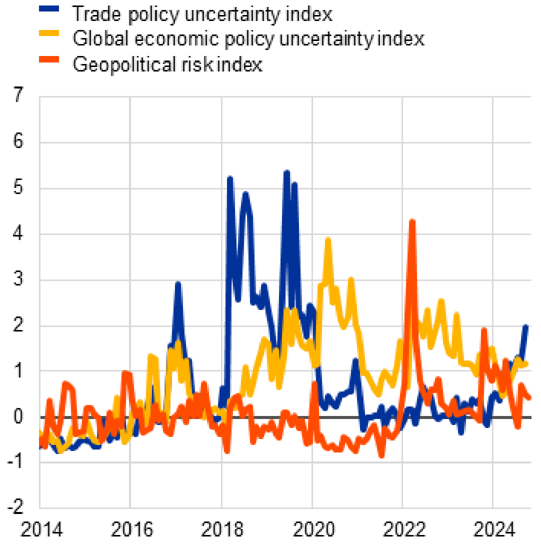
Source: Consensus Economics Inc.

Implied stock market volatility in the euro area and the United States
1 Jan. 2024-12 Nov. 2024, index



Sources: Bloomberg Finance L.P. and ECB.

Policy uncertainty indices and geopolitical risk index
Jan. 2014-Oct. 2024, z-scores



Sources: policyuncertainty.com and ECB calculations.
Note: Indices are transformed as level deviations, measured in standard deviations, from long-term averages.

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

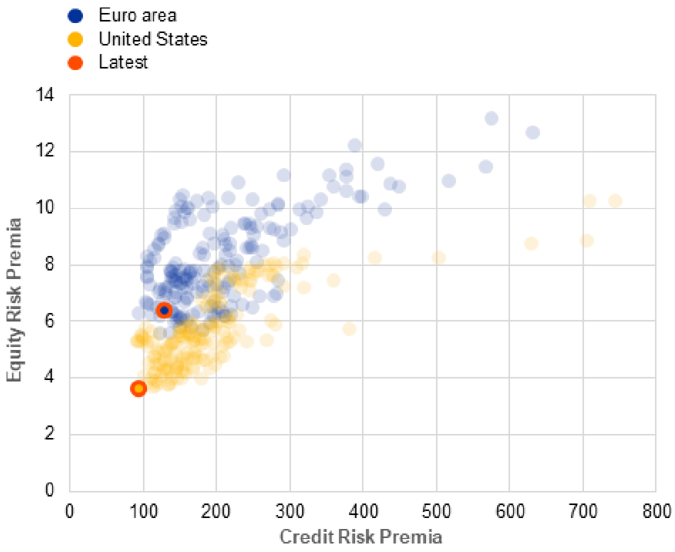
2 Sovereign vulnerabilities are increasing in light of heightened policy and geopolitical uncertainty, weak fiscal fundamentals and sluggish trend growth

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

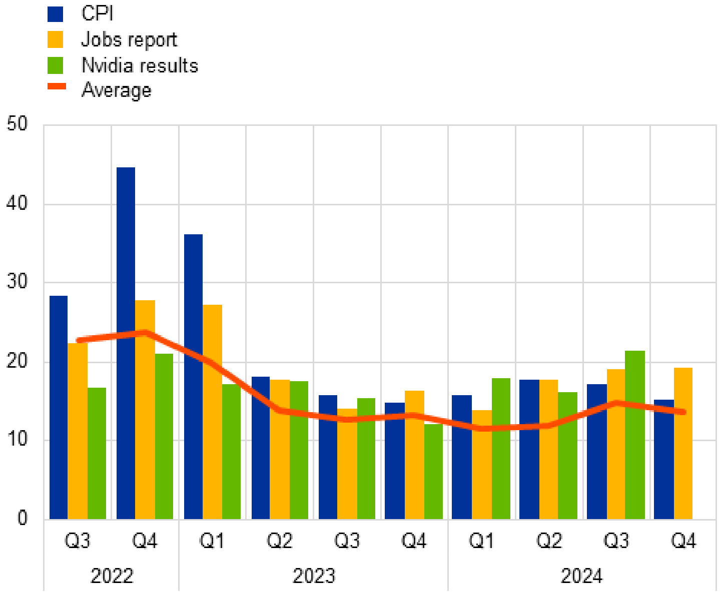
- August market turmoil proved short-lived but underlying vulnerabilities linger …
- … including compressed risk premia, and heightened sensitivity to economic growth and AI earnings prospects

Equity and credit risk premia for the euro area and the United States
Jan. 2009-Nov. 2024, percentages, basis points



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

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



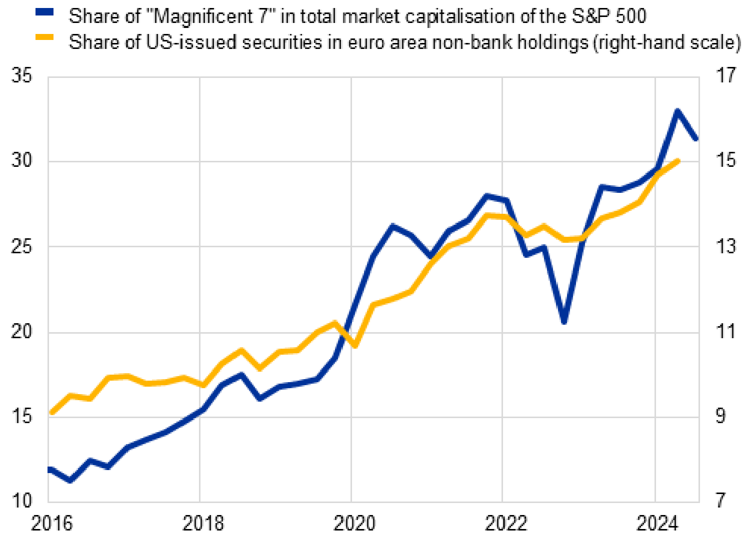
Sources: Bloomberg Finance L.P., LSEG and ECB calculations.

Risk 1: Markets are vulnerable to adverse dynamics

- Rising concentration of US equity market renders market-wide dynamics vulnerable to firm-specific shocks
- Increasing US exposures of euro area non-banks create potential for material spillover effects, which could be amplified by liquidity and leverage vulnerabilities

Concentration in US stock markets and euro area non-banks' US exposures

Q1 2016-Q2 2024, percentages

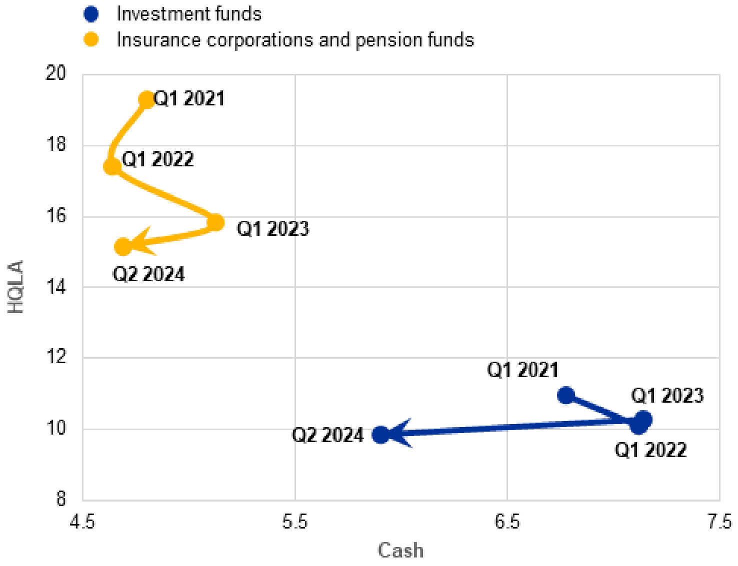


Sources: Bloomberg Finance L.P. and ECB.

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.

Euro area non-banks' holdings of cash and HQLA

Q1 2021-Q2 2024, percentages of total assets



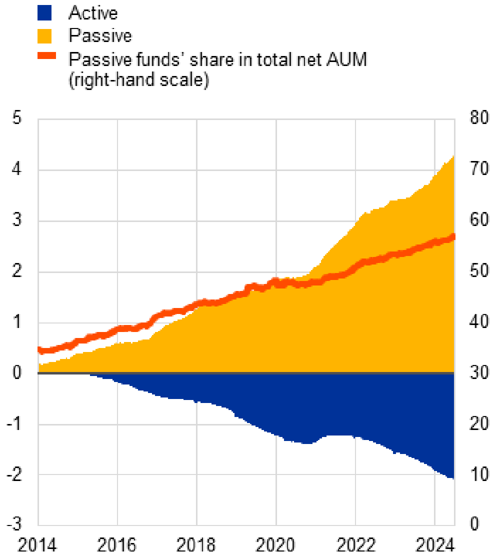
Source: ECB.

Risk 1: Markets are vulnerable to adverse dynamics

- Passive investing may increase equity market concentration and the co-movement of stock returns, making markets more volatile

Cumulative flows into global equity funds, by management style

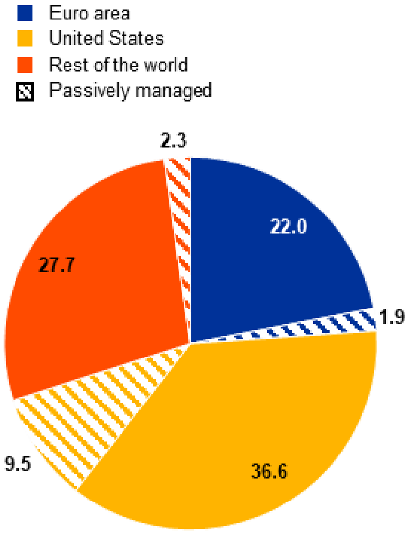
1 Jan. 2014-30 June 2024, left-hand scale: USD trillions, right-hand scale: percentages



Sources: Bloomberg Finance L.P., EPFR Global and ECB calculations.

Equity portfolio of euro area investors, by issuer region

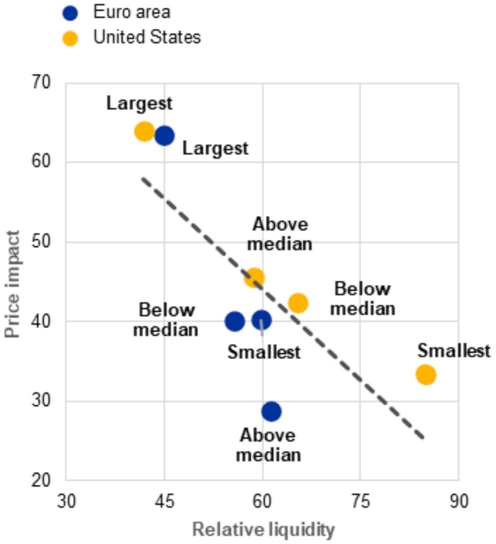
Q1 2024, percentages



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

Market liquidity and stylised stock price impact of passive investing, by company size

30 June 2024, x-axis: percentages, y-axis: basis points

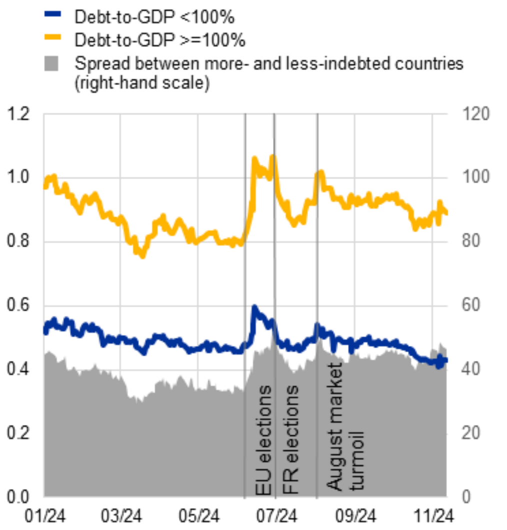


Sources: Bloomberg Finance L.P. and ECB calculations.

Risk 2: Sovereign vulnerabilities on the rise

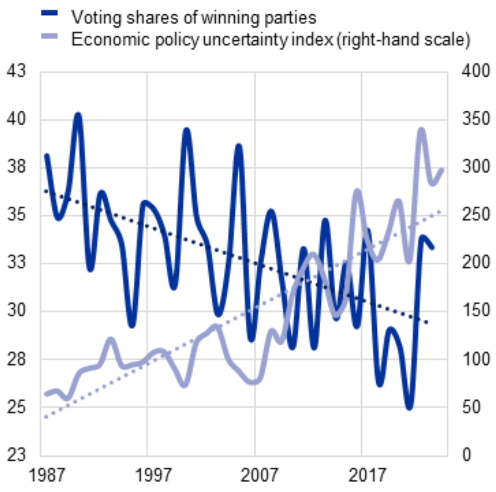
- Despite post-pandemic declines of sovereign debt-to-GDP ratios, fiscal fundamentals remain weak
- Political fragmentation, (geo)political uncertainty and lowered growth-potential exacerbate sovereign vulnerabilities

Euro area sovereign bond spreads over Germany, by debt level
1 Jan. 2024-12 Nov. 2024, percentage points, basis points



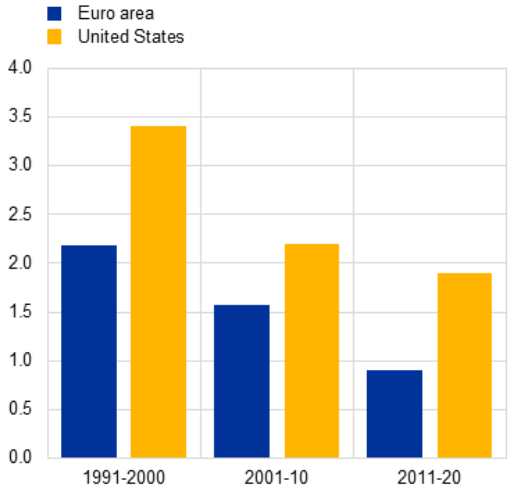
Sources: Bloomberg Finance L.P., LSEG and ECB.

Vote shares of winning parties and economic policy uncertainty in Europe
1987-2024, percentages, indices



Sources: parlgov.org, policyuncertainty.com and ECB calculations.

Average potential output growth rates in the euro area and the United States from 1991
1991-2020, percentages

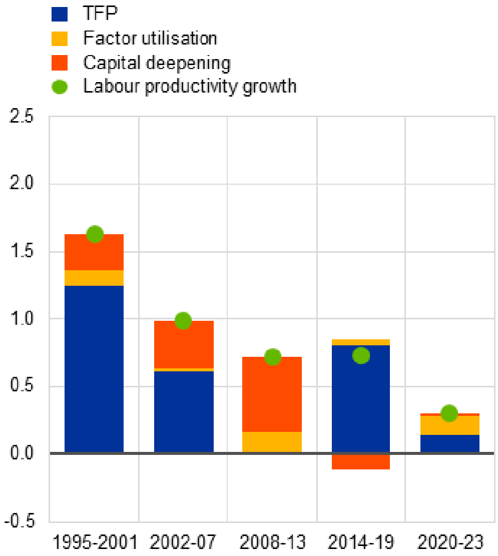


Sources: European Commission (AMECO) and ECB calculations.

SF B Low corporate productivity: the role of finance and financial stability implications

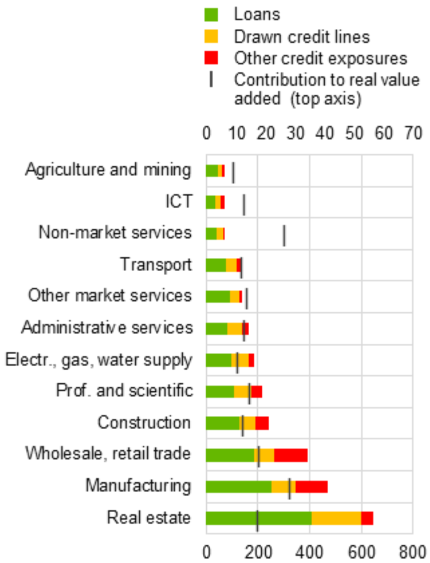
- Decelerating TFP growth and a stagnating capital-to-labor ratio result in lower EA labour productivity growth
- Bank lending has been channeled to the real estate sector and, within sectors, towards less productive firms

Drivers of euro area labour productivity growth
1995-2023; annual percentage change, percentage point contributions



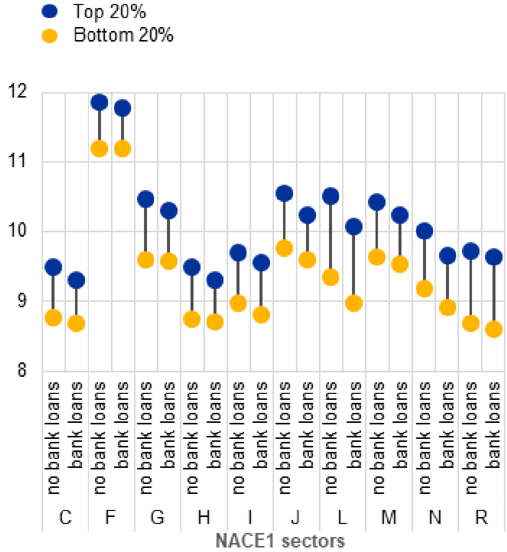
Sources: European Commission (AMECO) and ECB calculations.

Sectoral contributions to real value added and to banks' corporate exposures in the euro area
2022; bottom axis: € billions; top axis: percentages



Sources: ECB (AnaCredit), EU KLEMS database and ECB calculations.

Distribution of TFP levels among firms with and without bank loans, by NACE1 sector
2019-22, log TFP levels

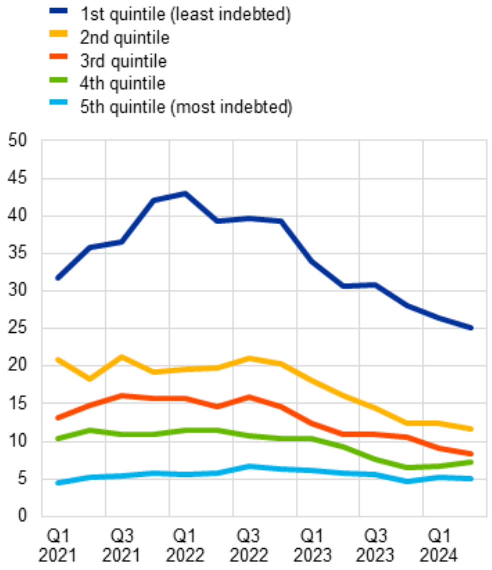


Sources: ECB (AnaCredit, RIAD), Orbis and ECB calculations. Notes: C: Manufacturing, F: Construction, G: Wholesale & retail trade, H: Transportation & storage, I: Accommodation and food, J: Information & communication, L: Real estate, M: Professional, scientific & technical activities, N: Administrative & support services, R: Arts & entertainment.

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

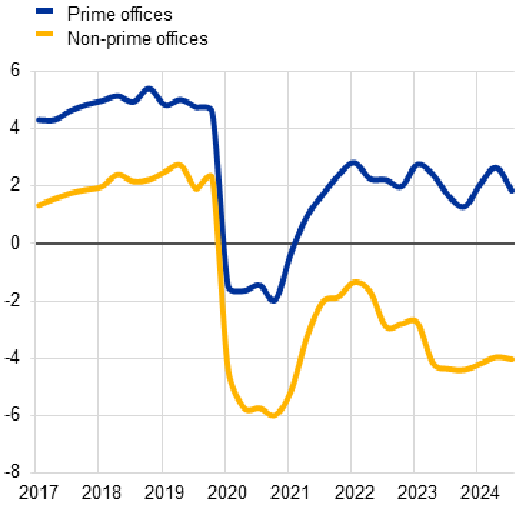
- Weak business environment together with high borrowing costs are straining firm balance sheets
- Further stresses expected in commercial real estate markets before conditions stabilise
- Households remain resilient but weaker-than-expected growth could undermine debt servicing capacity

Median interest coverage ratios of large firms, by debt-to-assets quintile
Q1 2021-Q2 2024, ratios



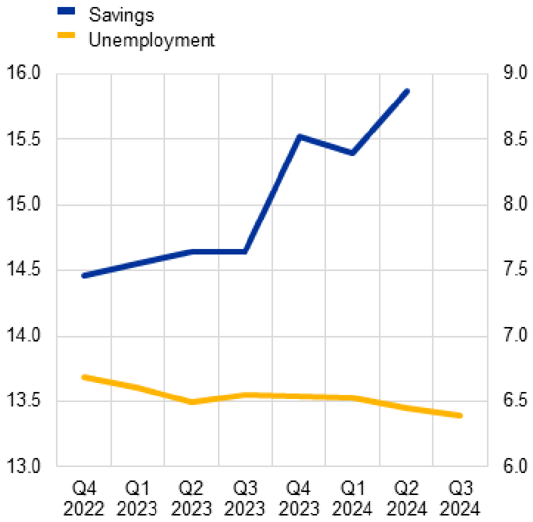
Sources: S&P Global Market Intelligence and ECB calculations.

12-months-ahead rent change expectations
Q1 2017-Q3 2024, percentages



Sources: RICS and ECB calculations.

Euro area household savings rate and unemployment
Q4 2022-Q3 2024, percentages

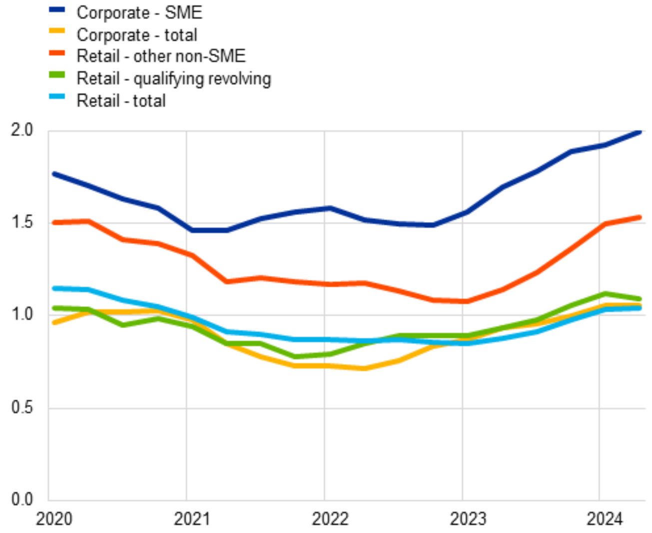


Sources: Eurostat and ECB.

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

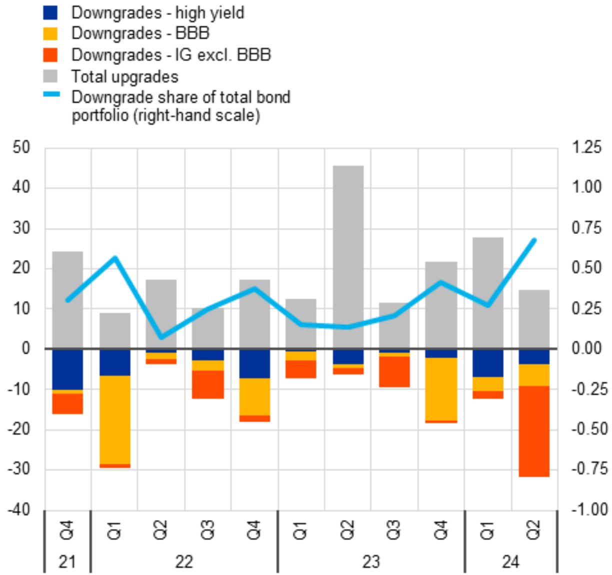
- Slight deterioration of bank asset quality, while credit risks faced by NBFIs are also rising
- Credit risk outlook could worsen materially if downside risks to growth were to materialise

Default rates of euro area bank loans
Q1 2020-Q2 2024, percentages



Sources: ECB (supervisory data) and ECB calculations.

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), EC and ECB calculations.

Macro-prudential 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

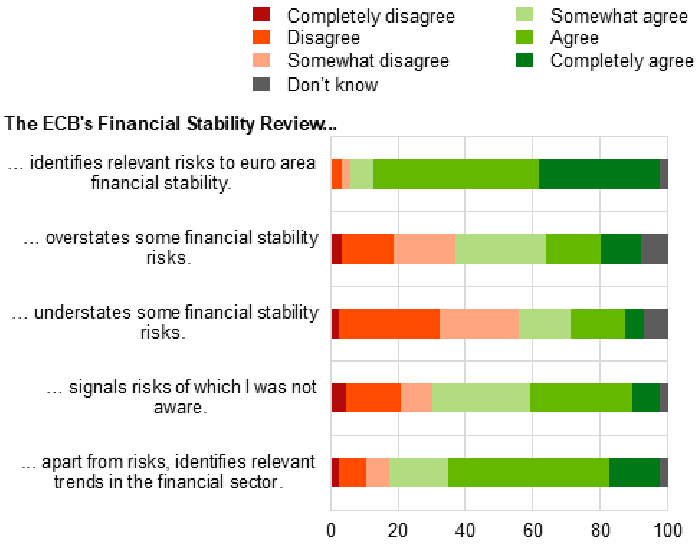
Additional policy tools and **more integrated supervision** should be prioritised

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

SF A Communication for financial crisis prevention: a tale of two decades

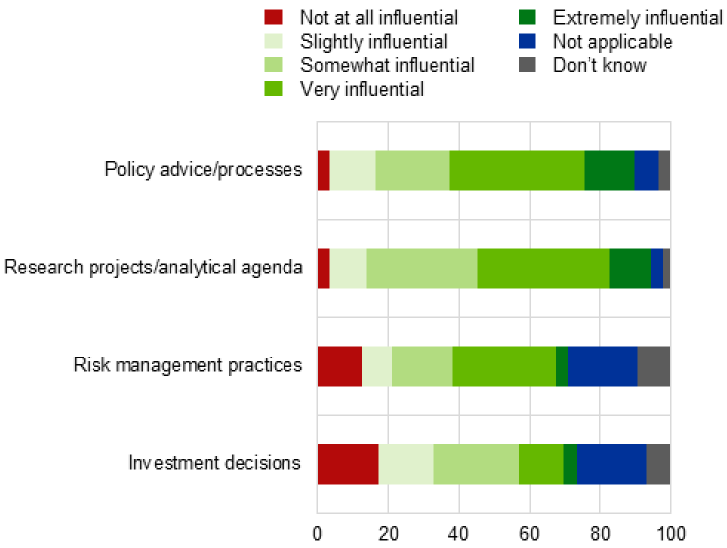
- Some readership survey findings:
  1. FSR identifies relevant sources of risk, but may overstate them
  2. Influence on a range of decision-making, including risk management

FSR readers' agreement with the following statements
May 2024, percentage of respondents



Source: ECB.

Influence of the ECB's FSR on readers' considerations in taking certain decisions
May 2024, percentage of respondents

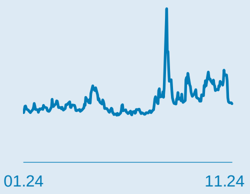


Source: ECB.

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

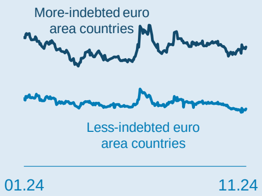
Equity market volatility



- 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

Sovereign bond spreads over Germany



- 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

Corporate insolvencies in the euro area

- 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.