EUROPEAN CENTRAL BANK

EUROSYSTEM

May 2022
Financial Stability Review

Press briefing

25 May 2022

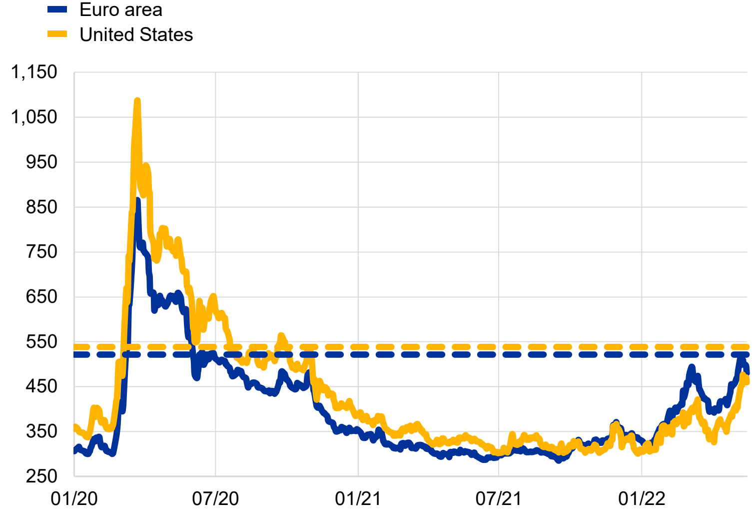
Financial stability conditions have deteriorated

- Impact of war in Ukraine expected to weaken growth and push up inflation, amplifying pre-existing vulnerabilities
- Volatile financial markets at risk of further corrections
- More heavily indebted sovereigns, firms and households could be tested by higher interest rates and cost pressures
- Bank profitability improved markedly in 2021 but faces new headwinds

Large but orderly reactions in markets, with some issues for derivatives markets

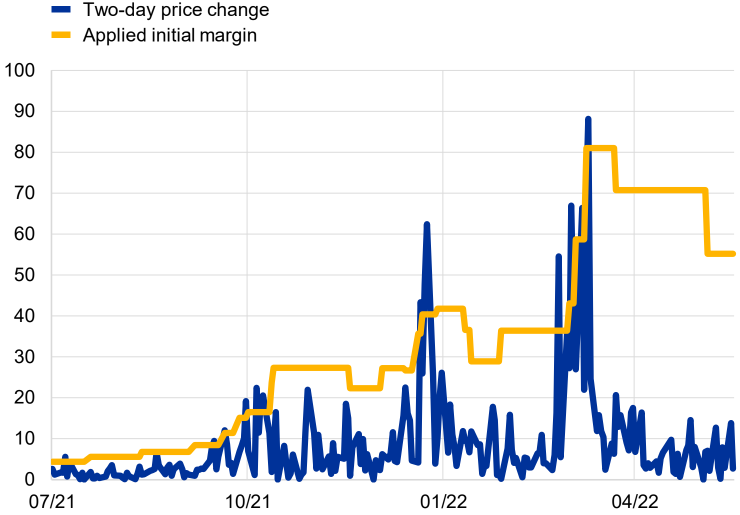
- The Russian invasion of Ukraine triggered a large but short-lived, market reaction
- Escalation of the conflict or faster monetary policy normalisation could trigger further market corrections
- Large shifts in some commodity prices prompted liquidity issues in derivatives markets

Euro area and US high-yield corporate bond spreads
1 Jan. 2020-17 May 2022, basis points



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

Natural gas futures two-day absolute price changes and applied initial margin
6 Jul. 2021-17 May 2022, €/MWh



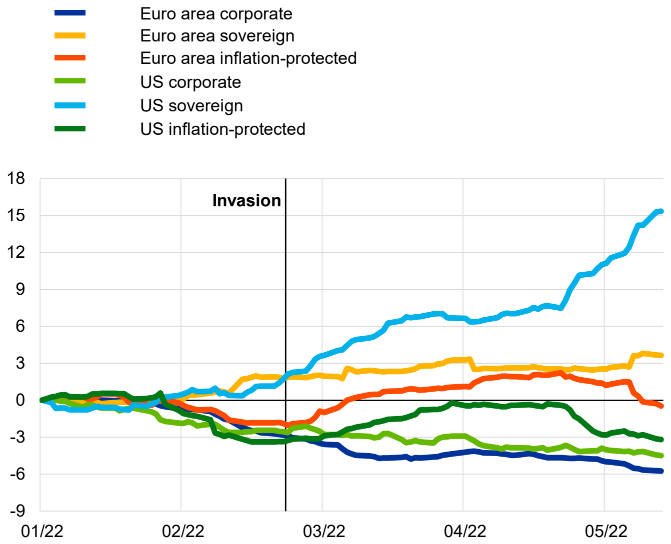
Sources: Bloomberg Finance L.P., ICE Clear Europe and ECB calculations.
Note: Applied initial margins are based on the scanning ranges published by ICE Clear Europe.

Non-banks resilient to the shock of war, but underlying risks remain a concern

- Investment funds in several sectors experienced contained outflows during the recent turmoil
- But euro area funds are vulnerable to further market corrections given high duration, credit and liquidity risk

Euro area bond fund flows

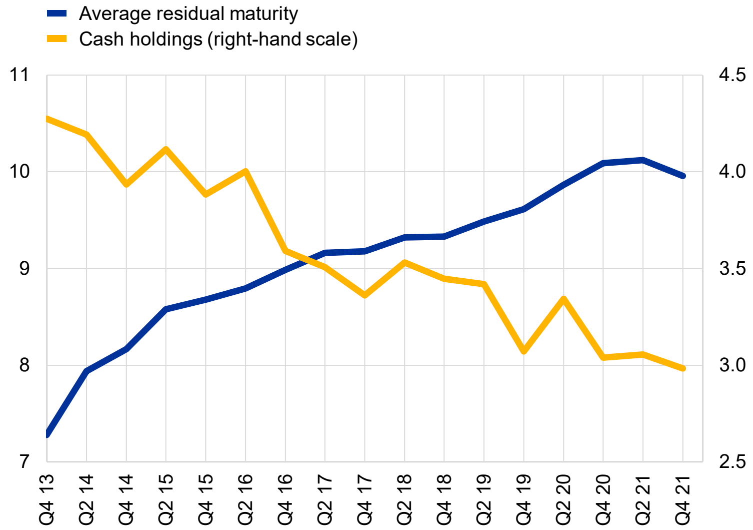
1 Jan. 2022-17 May 2022, cumulative daily flows as a percentage of total net assets



Source: EPFR Global.

Investment fund duration and liquidity risk

Q4 2013-Q4 2021, left-hand scale: years, right-hand scale: percentages of total assets

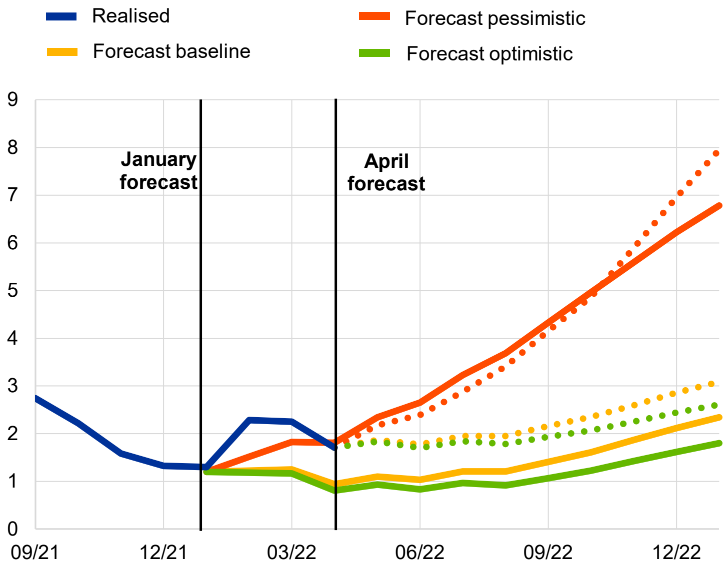


Sources: ECB (Investment Funds Balance Sheet Statistics and Securities Holding Statistics) and ECB calculations.

Signs of renewed risks for the corporate sector

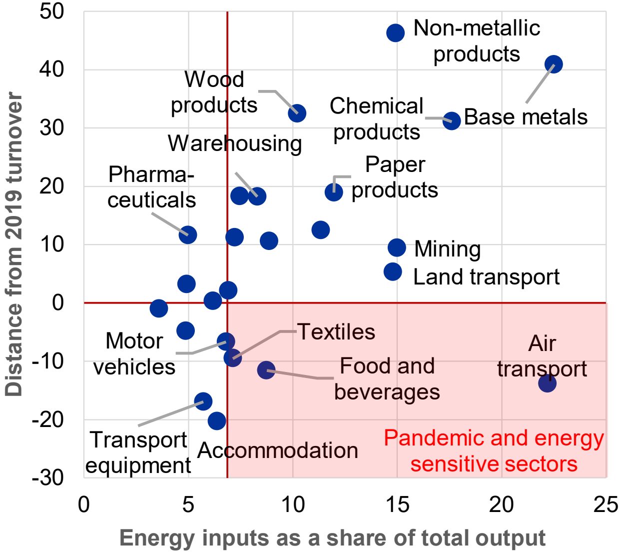
- Euro area firms under pressure as input prices soar and the economic outlook clouds
- Impact likely to vary across sectors, with some pandemic-strained sectors also heavily energy-reliant

European speculative-grade 12-month trailing default rates
Sep. 2021-Feb. 2023E, percentages



Sources: Moody's Analytics, ECB and ECB calculations.
Note: Solid lines represent European speculative-grade default rates forecast by Moody's Analytics as at January 2022 and dotted lines as at April 2022.

Corporate turnover relative to pre-pandemic and energy use by industrial sector
x-axis: 2019, percentages, y-axis: difference 2019/21, index: 2019 = 100

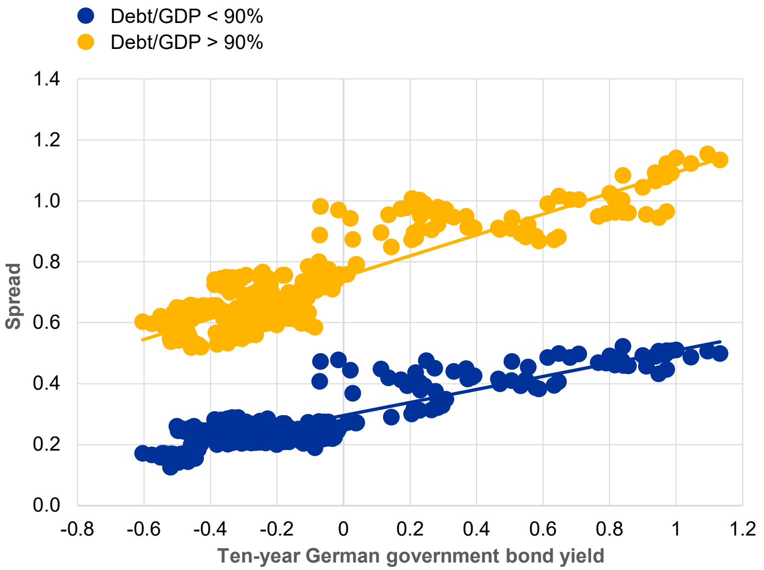


Sources: OECD Trade in Value Added (TiVA) database, Eurostat and ECB calculations.

Sovereigns challenged by a weaker recovery and tighter financial conditions

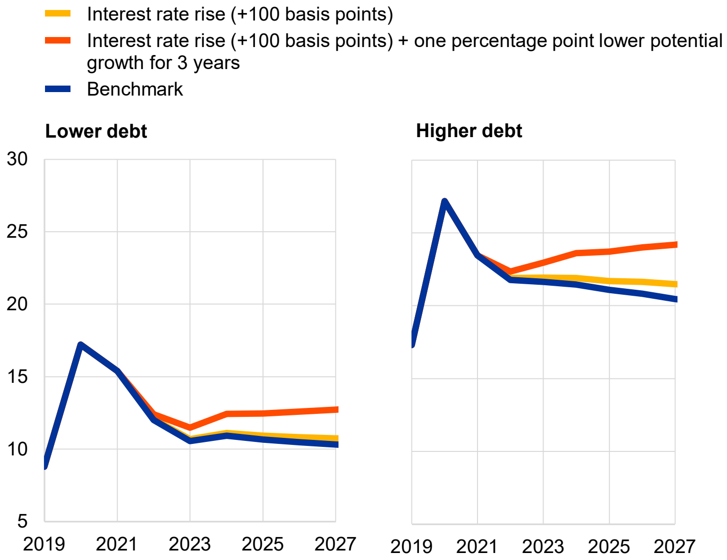
- Euro area sovereigns transition from pandemic support to tackling the fallout from the war
- At the same time, higher rates may cause refinancing risk for highly indebted sovereigns

Euro area sovereign spreads versus risk-free rate
1 Jan. 2021-17 May 2022, y-axis: government bond spread over Germany; GDP weighted by indebtedness buckets of debt/GDP



Sources: European Commission, Eurostat, Bloomberg Finance L.P. and ECB.

Impact of an interest rate and GDP shock on sovereign gross financing needs
2019-27, percentages of GDP

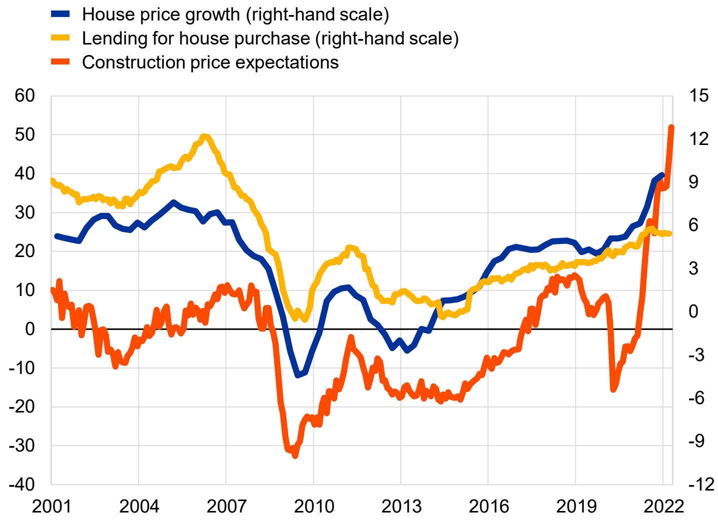


Sources: ECB and ECB calculations.

Pressures on household finances could increase risks via residential real estate

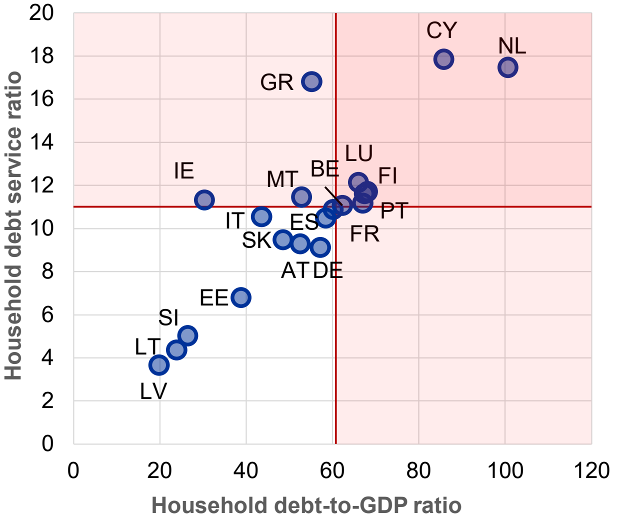
- Expansion in euro area residential real estate markets continued amid elevated mortgage lending growth
- Risks from mortgage indebtedness amplified by the impact of higher costs on debt servicing capacity

House price and mortgage lending growth, and construction price expectations
Jan. 2001-Apr. 2022, left-hand scale: index, right-hand scale: percentages



Sources: Eurostat and ECB calculations.

Household debt-to-GDP and household debt service ratios
Q4 2021, percentages

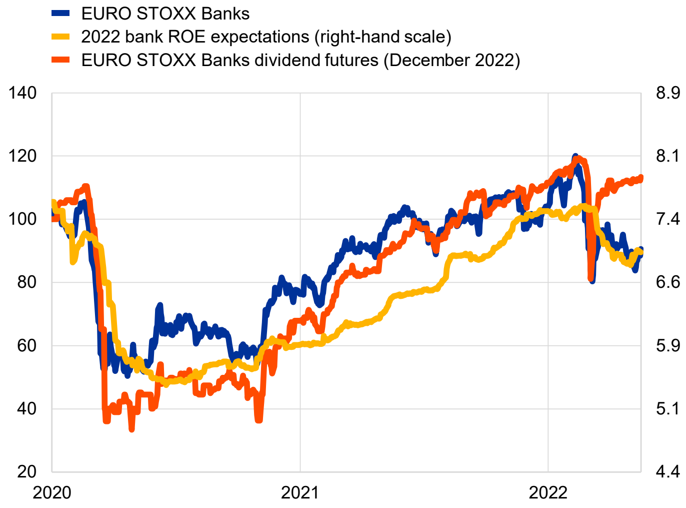


Sources: ECB and ECB calculations.

Banks' profitability prospects weaken again as asset quality concerns resurface

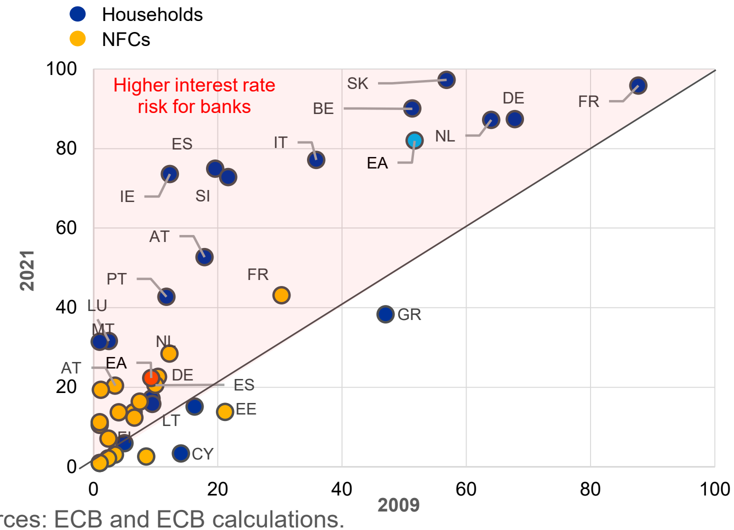
- Bank stock prices and profitability projections for 2022 revised down as credit risks rise after invasion
- Rising interest rates should support banks in near term. In medium term, benefits are less clear-cut given banks' increased interest rate risk

Euro area banks' stock prices, dividend futures and 2022 profit expectations
1 Jan. 2020-17 May 2022, indices: Jan. 2020 = 100, percentages



Source: Bloomberg Finance L.P.

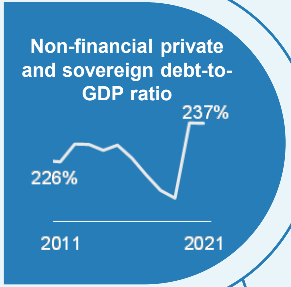
Fixed-rate lending to euro area households and firms
2009, 2021, percentages of total new lending

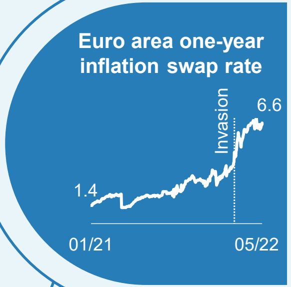


Sources: ECB and ECB calculations.

Rising inflation and lower growth put pressure on vulnerable borrowers

- Inflation spikes as outlook deteriorates
- House prices face correction risk
- Rising input costs weigh on corporate margins
- Ukraine war may challenge fiscal positions



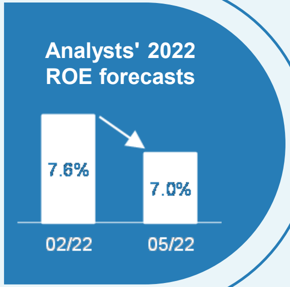


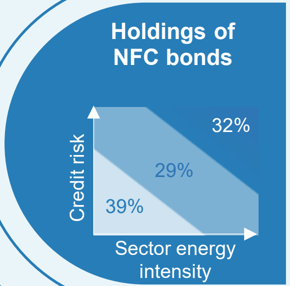
Markets vulnerable as rates adjust to inflation and growth weakens

- Higher-for-longer energy prices
- Corporate spreads widen as risks grow
- Financial fragmentation could emerge
- Interest rate volatility increases

Renewed bank asset quality and profitability concerns

- Re-emerging credit risks
- Possible tightening of credit standards
- Higher bond funding costs
- Rising cyber risks





Non-banks face duration risk amid low liquidity and uncertain credit risk outlook

- Valuation losses from rising rates
- Fund outflows may trigger forced sales
- Increase in illiquid holdings of insurers
- Exposures from synthetic leverage

Macroprudential authorities should continue to address building vulnerabilities, adjusting the type of measure, pace and timing for economic conditions in order to avoid procyclicality.

Having macroprudential space and effective buffers using the whole range of macroprudential instruments would help support medium-term resilience.

Risks arising from liquidity mismatches, leverage and margining practices in the non-bank financial sector need to be tackled comprehensively.