



EUROPEAN CENTRAL BANK

# *Financial Stability Review*

## *June 2005*

*Presentation by*

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# Outline

## *I Financial Stability – concepts and processes*

### *II Areas of vulnerability*

- *Global macro-finance*
- *Financial markets*
- *Euro area economic balances*
- *Financial institutions*

### *III Outlook for risks*

### *IV Overall assessment*

# 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
- December 2004: First ECB Financial Stability Review published
- Governing Council has regular semi-annual discussions of financial stability issues on the basis of a financial stability review
- Financial Stability Review to be published twice a year in June and December from now on

# June 2005 Financial Stability Review

- Scope
- Structure
- Analytical highlights
- Co-operative production process

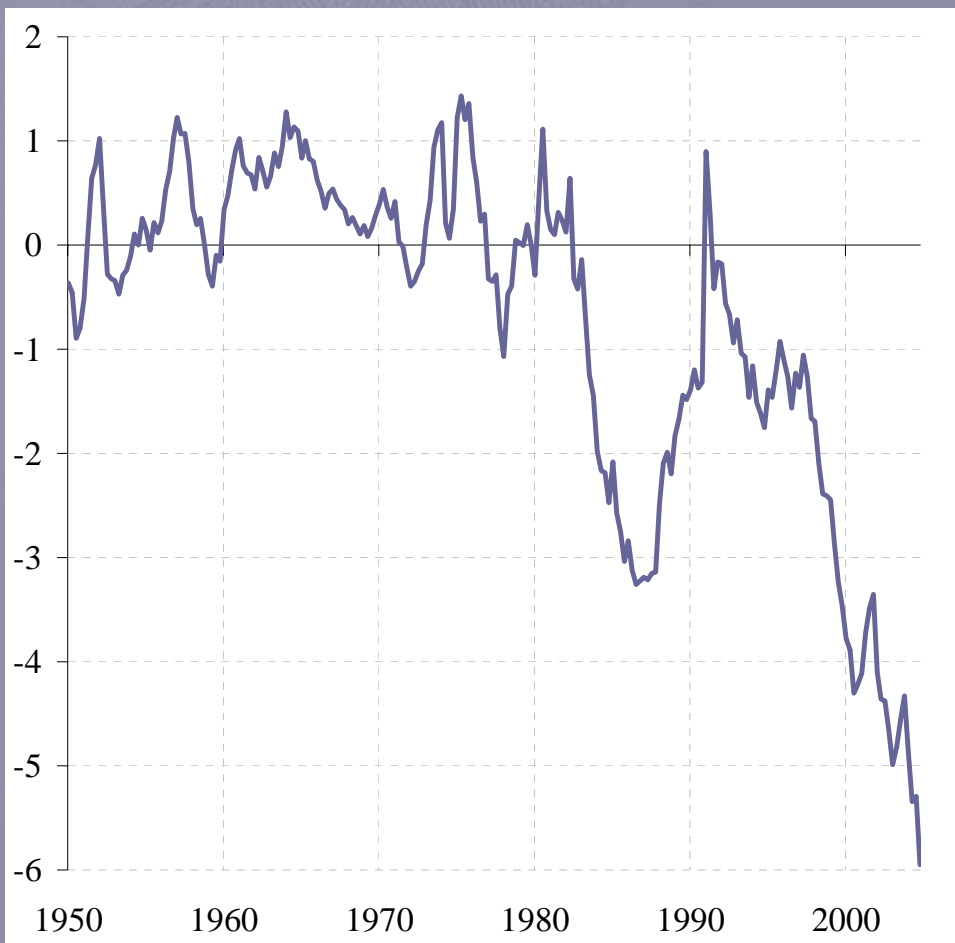
# Main areas of vulnerability

- *Global macro-finance*
- *Financial markets*
- *Euro area economic balances*
- *Financial institutions*

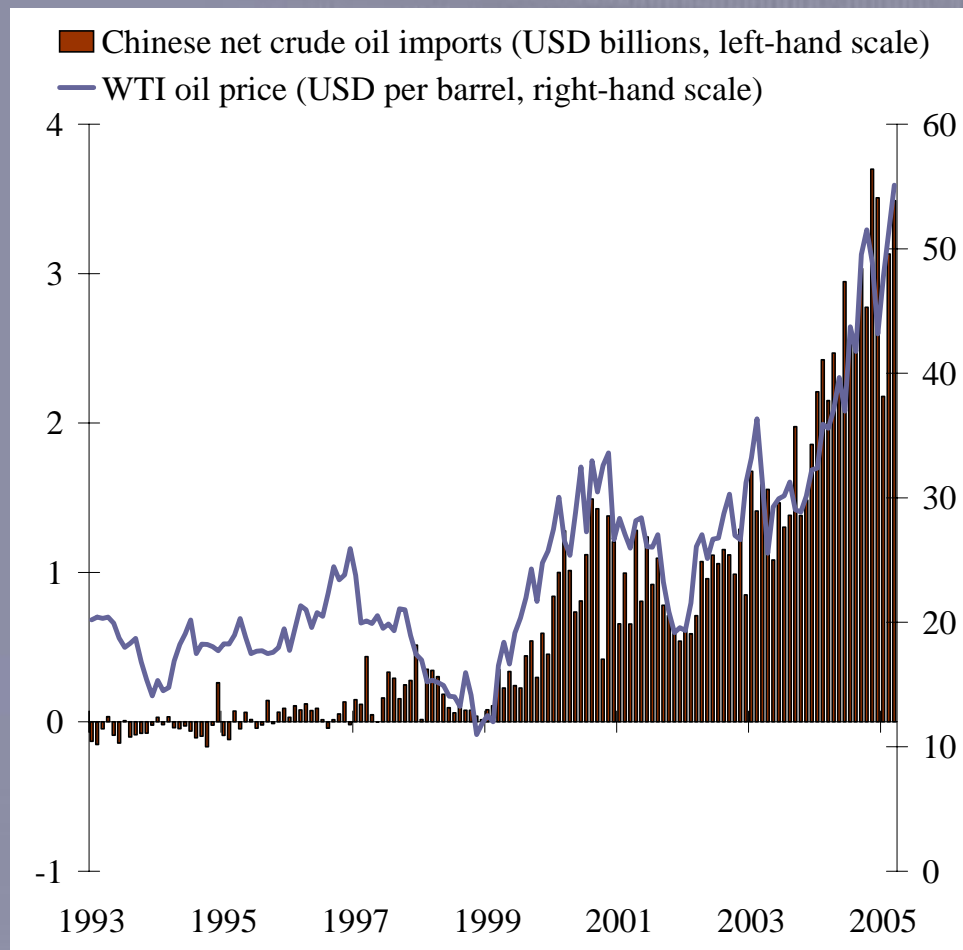
# Global macro-finance

## *US imbalances widen and oil prices reach new highs*

Net lending/borrowing of the US economy  
(% of GDP)



Evolution of Chinese crude oil imports and  
oil prices



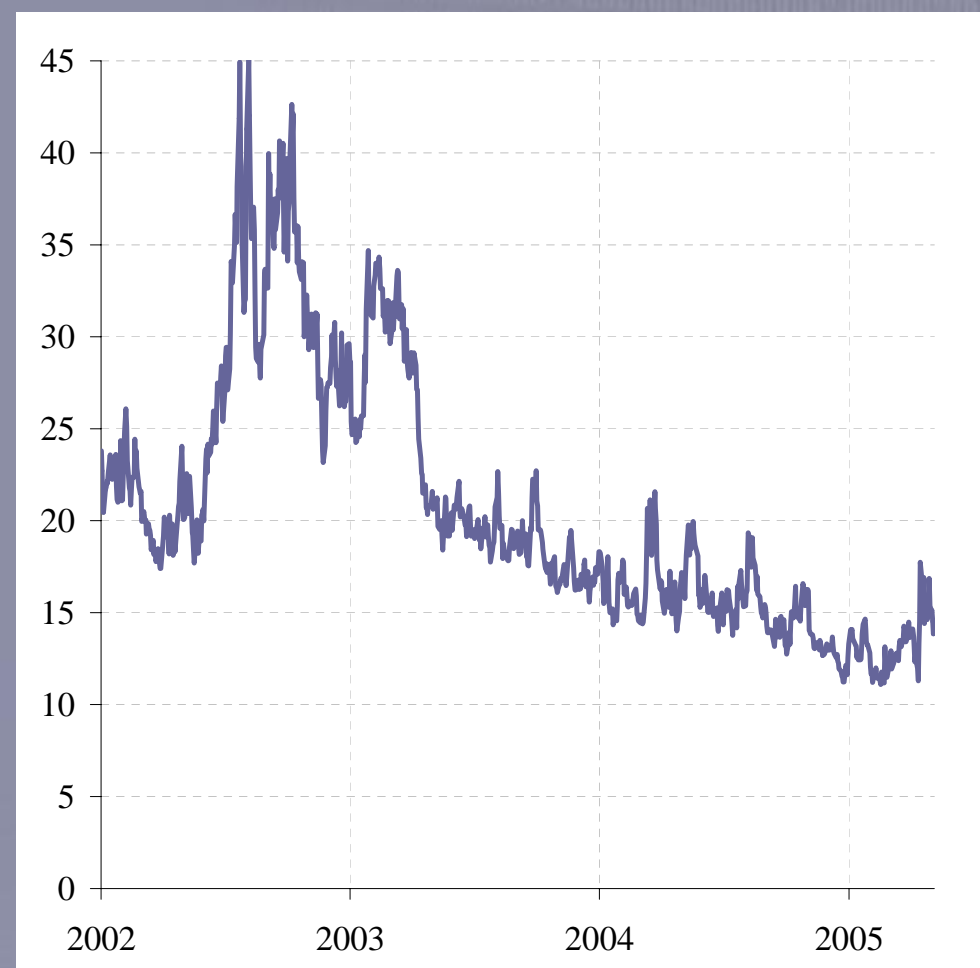
# Financial markets

*Corporate bond spreads widening, equity market volatility rising*

Spread of corporate bonds issued by US industrial companies



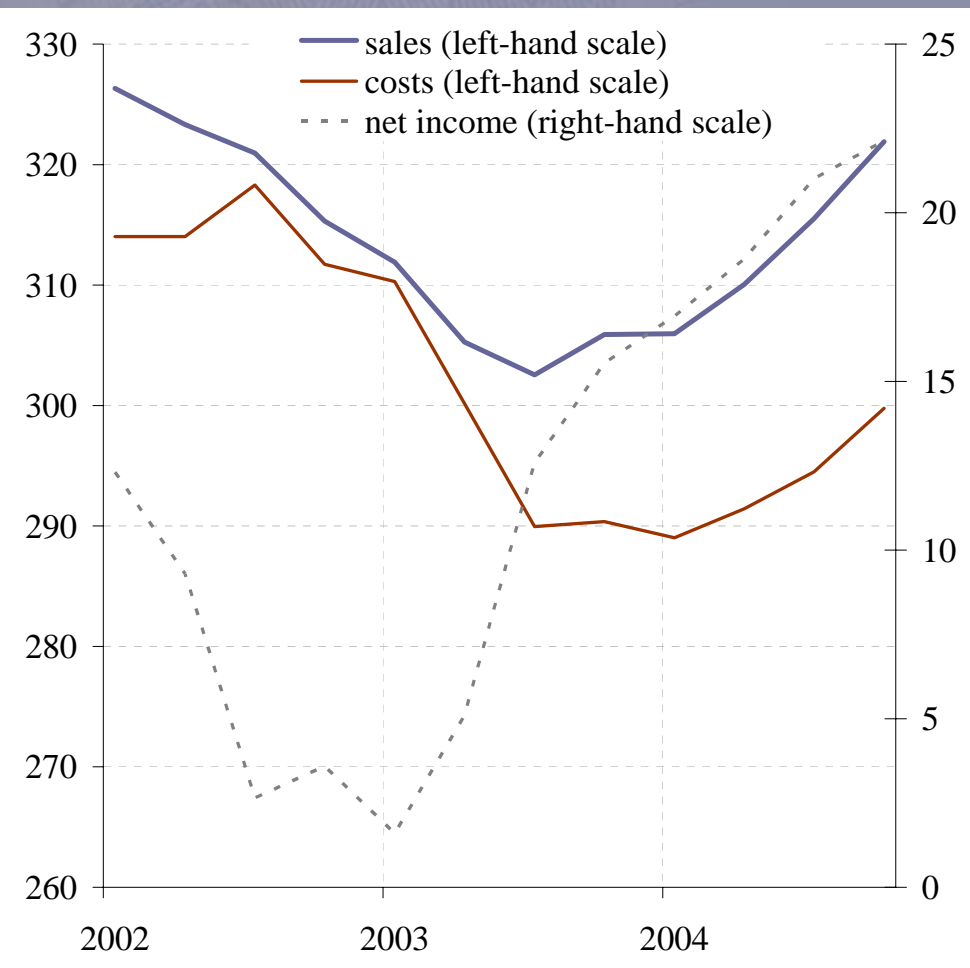
VIX implied volatility in the US stock market



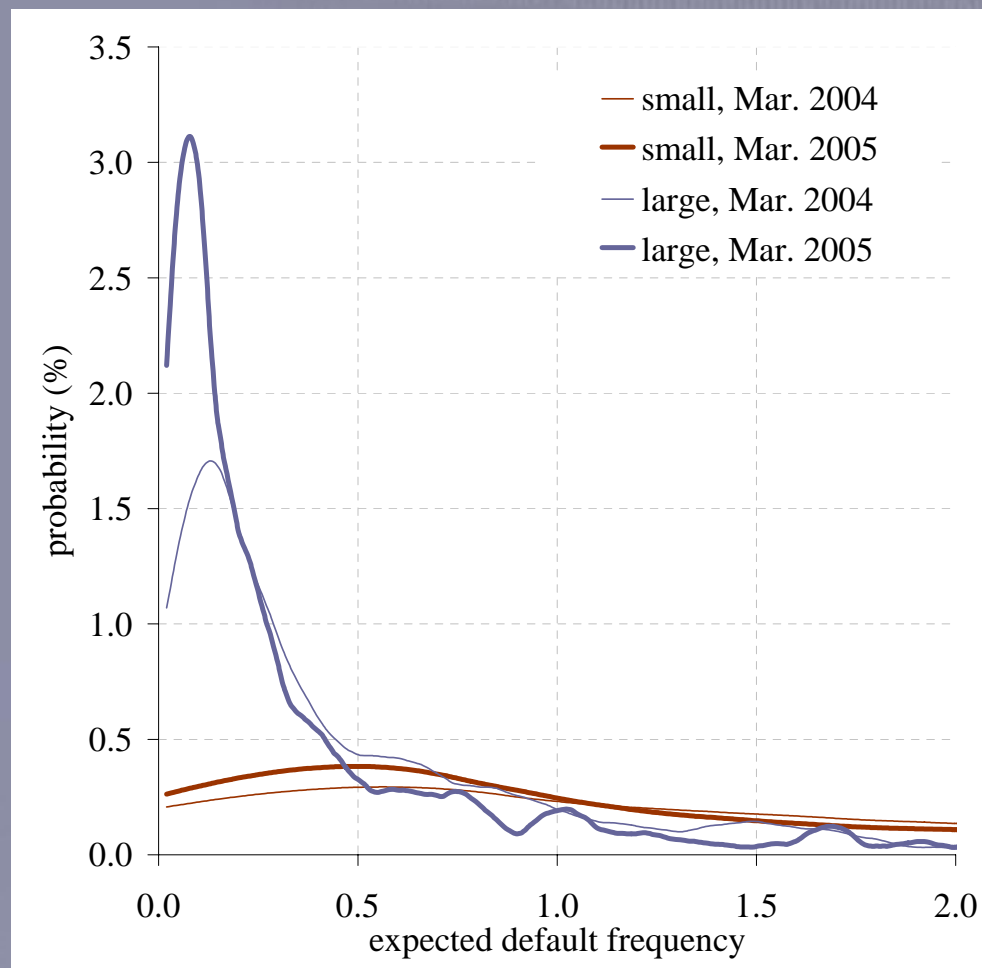
# Euro area sectoral balances – corporate sector

*Large firms improving but small firms remain weak*

Costs, sales and profits of Dow Jones EURO STOXX 50 companies (EUR billions)



Expected default frequency distributions for large and small euro area firms

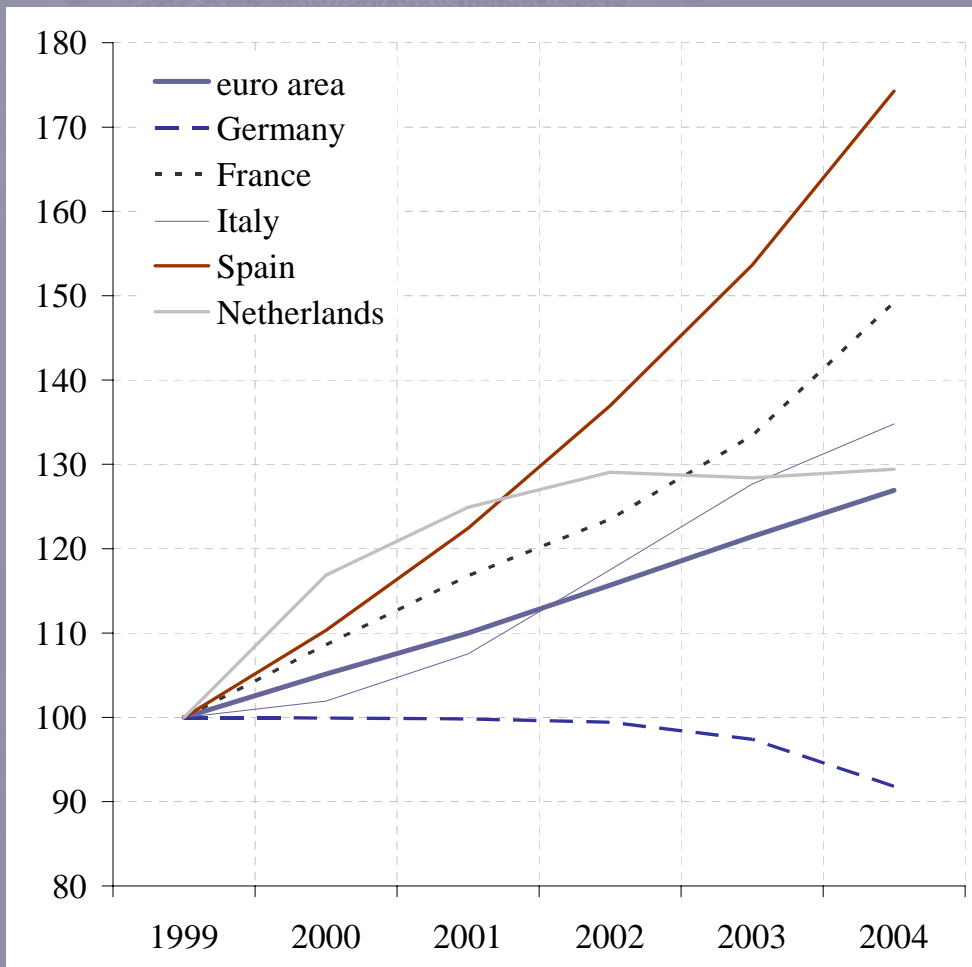




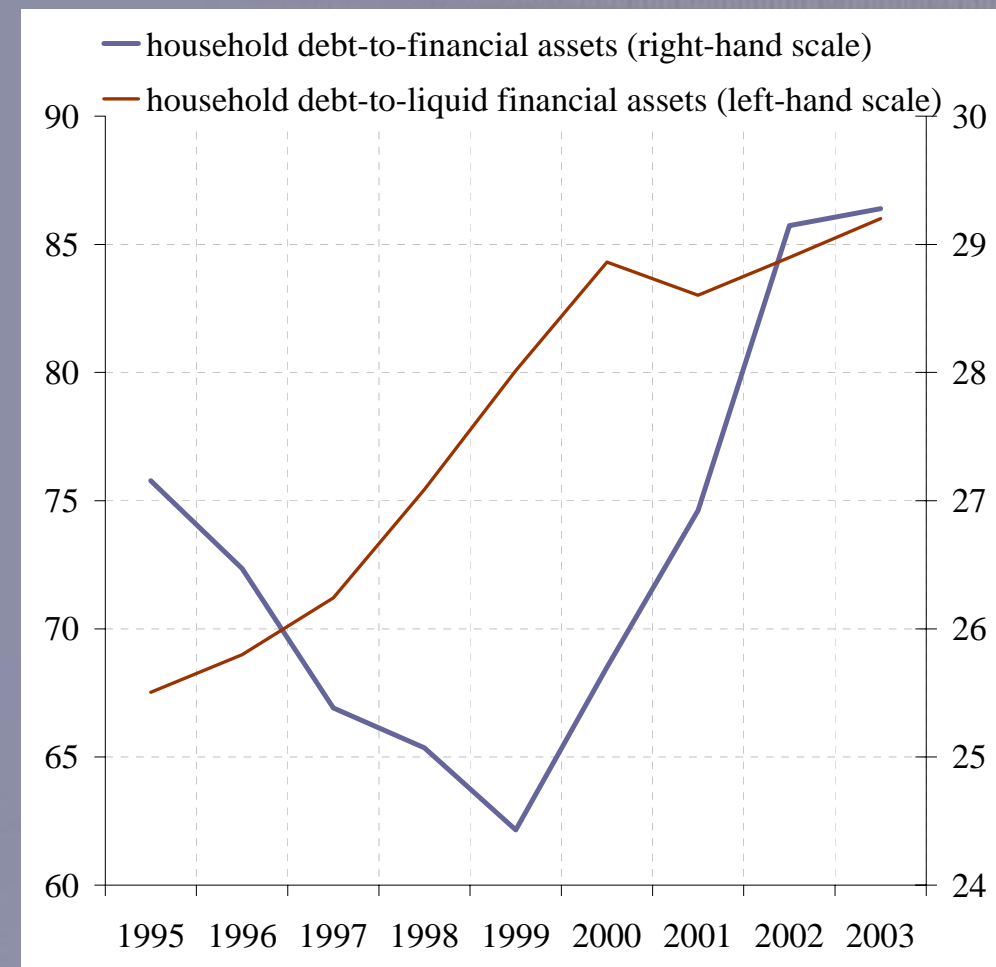
# Euro area sectoral balances – households

## *Balance sheets and risks expand further*

House price-to-rent ratios in the euro area  
(index: 1999 = 100)



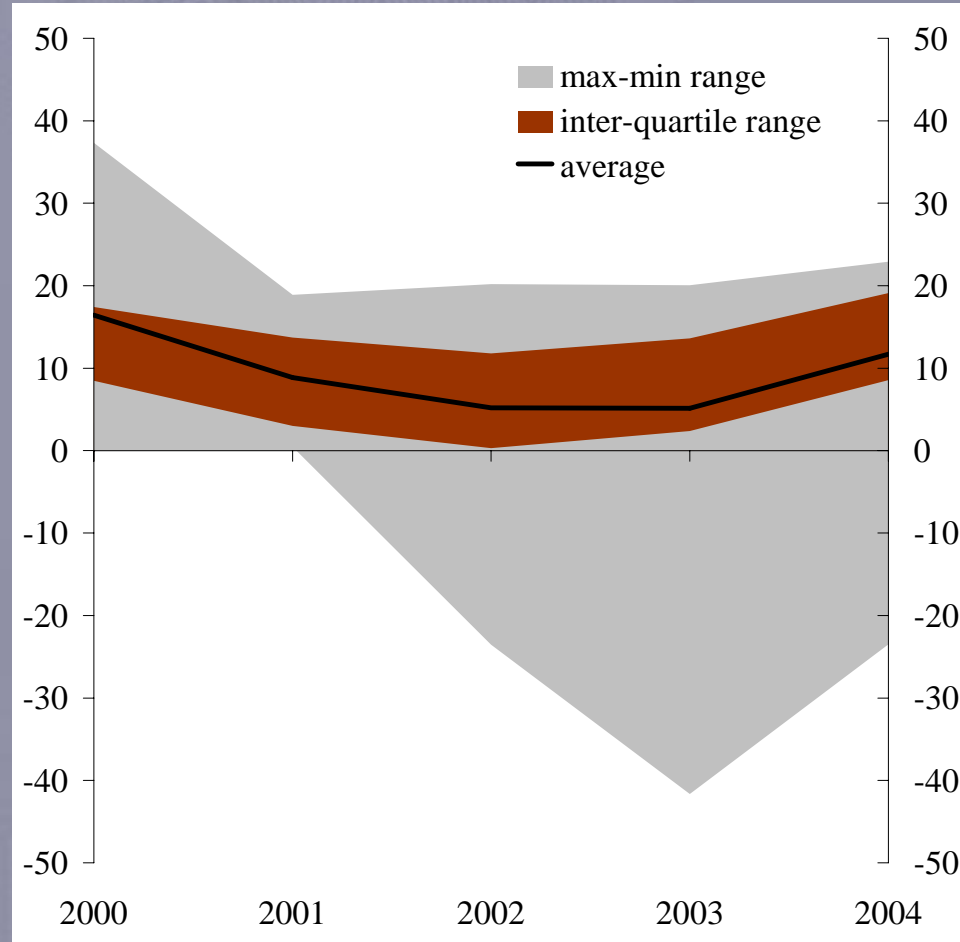
Household debt-to-financial and liquid  
financial assets (%)



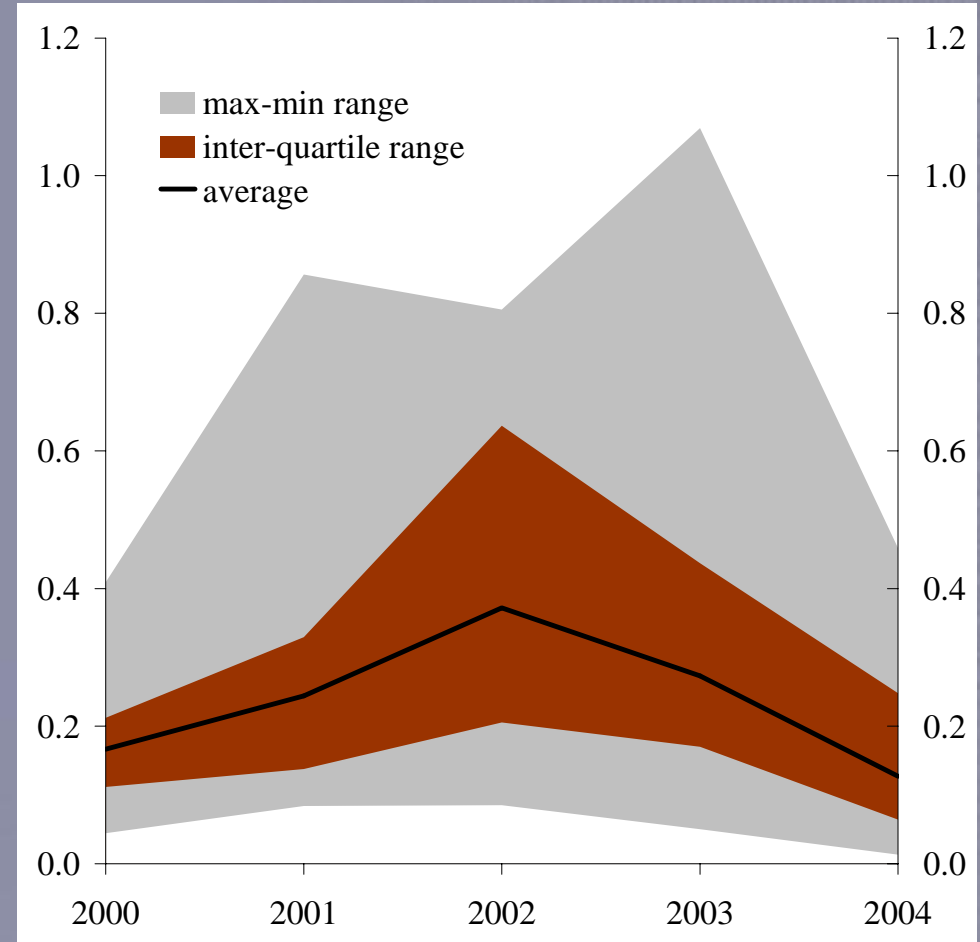
# Financial institutions – banks

*Broad recovery of profitability and lower provisioning*

Return on equity (ROE) of large euro area Institutions (%)



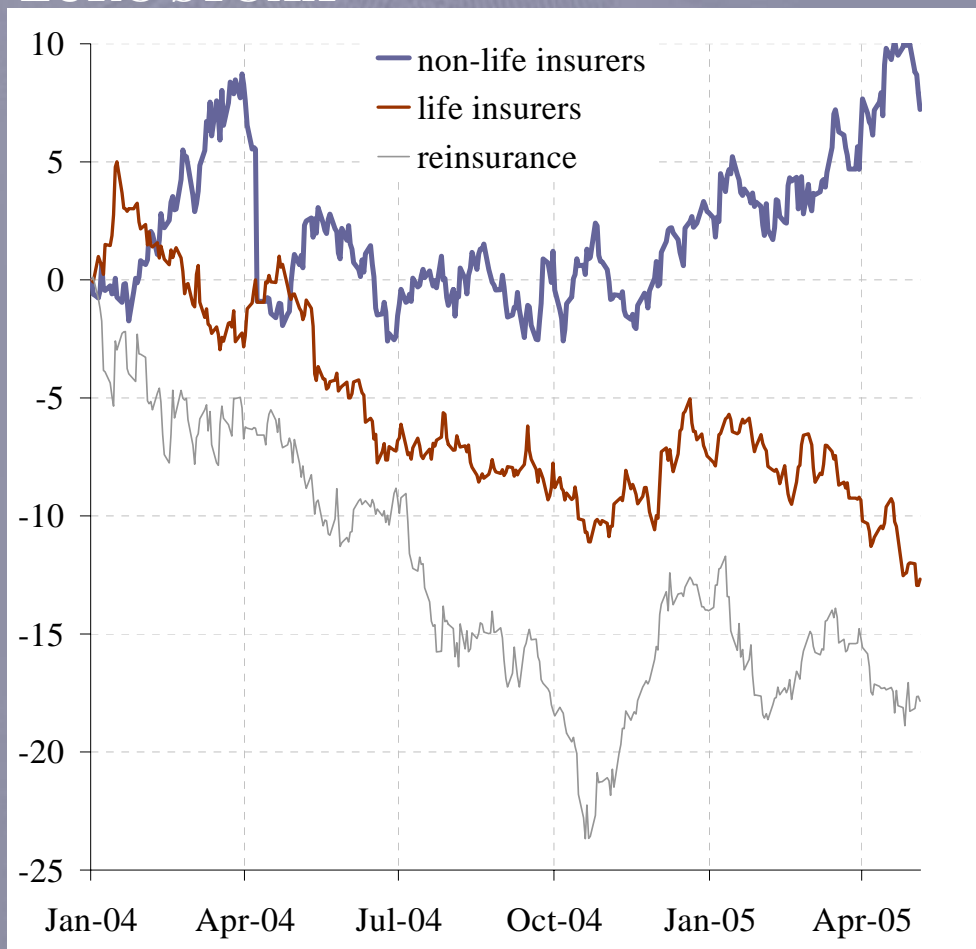
Loan loss provisions of large euro area institutions (% of total assets)



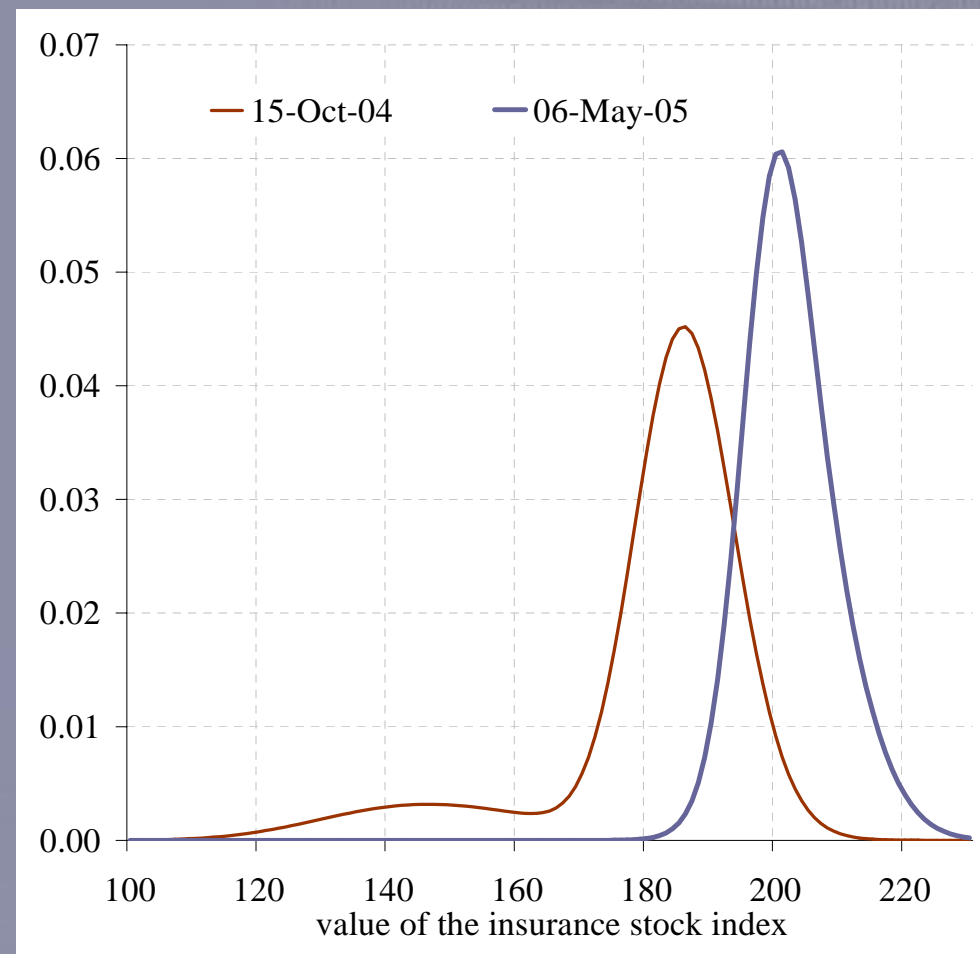
# Financial institutions – insurance

## *Indications of improving financial health*

Cumulative change in euro area insurance stock price indices relative to the Dow Jones EURO STOXX



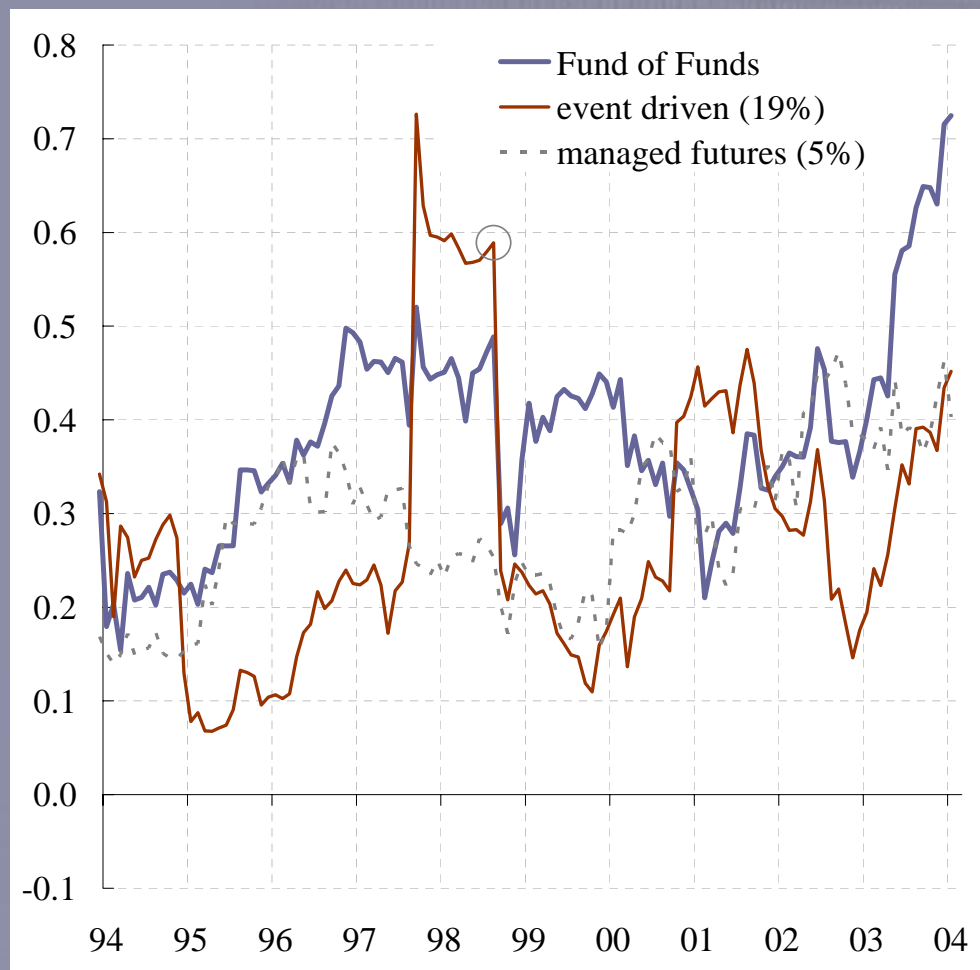
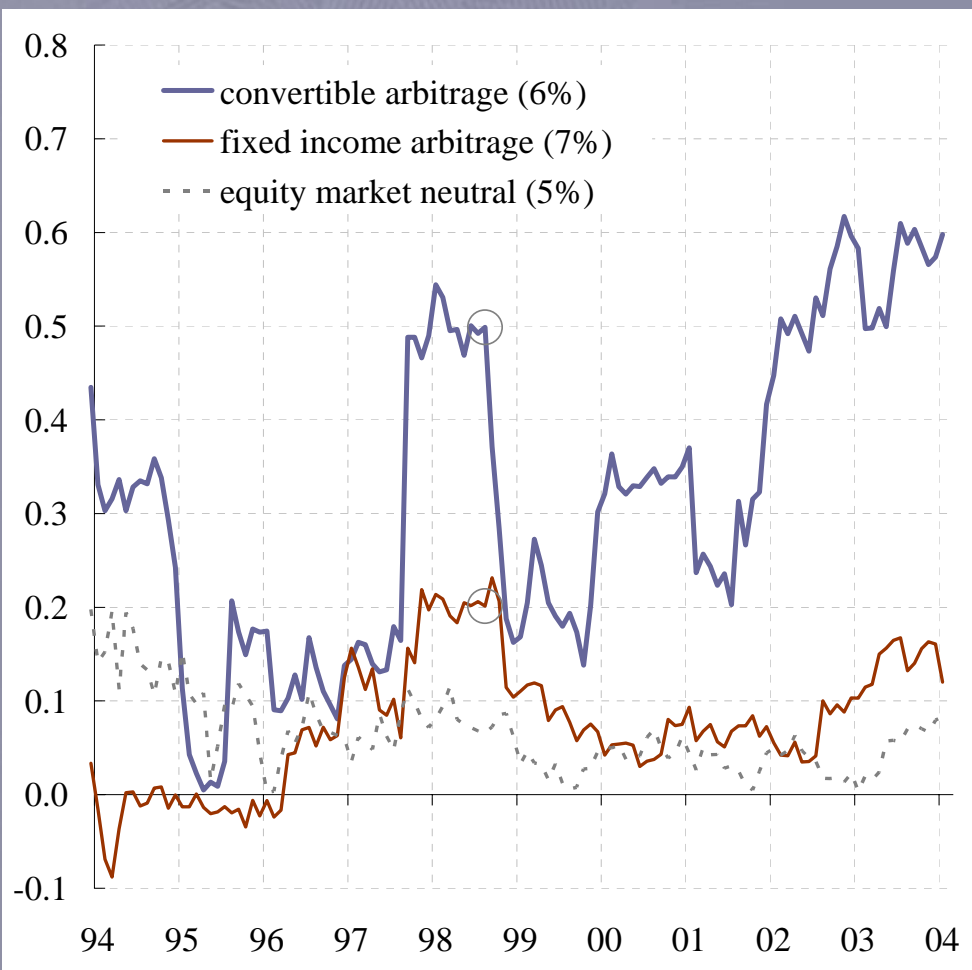
Risk neutral probability density function on the DJ EURO STOXX insurance index



# Financial institutions – hedge funds

## *Risks for markets of “crowded trades”*

Medians of pairwise correlation coefficient of monthly hedge fund returns within strategies



# Outlook for risks: *main sources of uncertainty*

*Financial fragility may increase if:*

- Markets abruptly re-assess risks, especially credit risks
- Global re-balancing becomes disorderly
- Oil prices remain persistently high
- Low levels of provisioning prove to be inadequate

# Overall assessment: *likely outcomes are bi-modal*

*The outlook for financial stability is more mixed than six months ago:*

- The pace of global economic activity has remained quite strong
- Balance sheets of large corporations have improved further
- Balance sheets of financial institutions have been strengthened

*But risks have not declined:*

- Possibility of disorderly correction of serial bubbles
- Possible unruly unwinding of global imbalances
- High oil prices and sluggish domestic demand raise corporate sector credit risks
- Further increases raise risks of house price correction