



EUROPEAN CENTRAL BANK

# Financial Stability Review

December 2004

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*Calling attention to the main sources of risk and vulnerability to financial stability does not aim at identifying the main – or most likely – future scenario for the euro area economy. It entails the highlighting of potential and plausible sources of negative events, even if these are remote and very unlikely.*

# Financial stability monitoring by central banks

- 16 of the 25 EU central banks publish a review, particularly those without supervisory responsibility
  - Seven within the Eurosystem
  - Three of the remaining EU15
- Outside the EU, there are many others
- Mission and purpose is varied but common themes are:
  - Informing the public and market participants
  - Encouraging discussion among authorities and market participants

# 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
- Governing Council has regular discussion of financial stability issues on the basis of a financial stability review

# Conceptual framework

- Definitions:
  - Financial stability
  - Financial system
- Method
  - Identify main sources of risk
  - Assess robustness of financial system



# December 2004 Financial Stability Review

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

# Procedure and policy issues

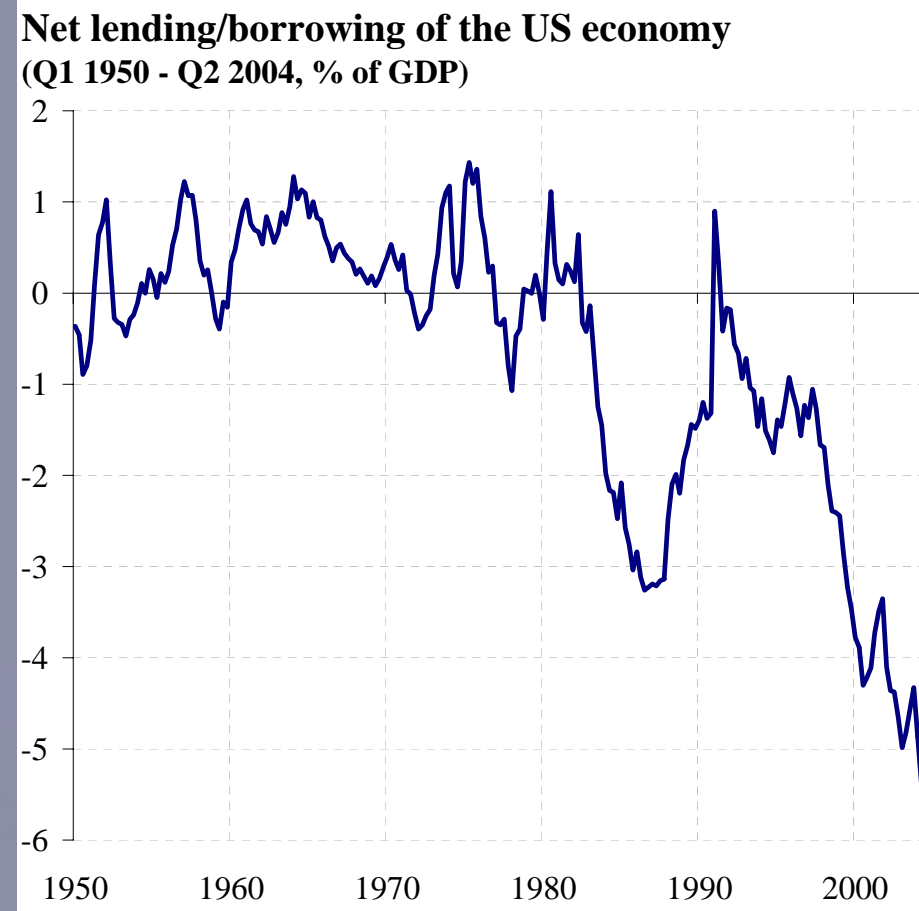
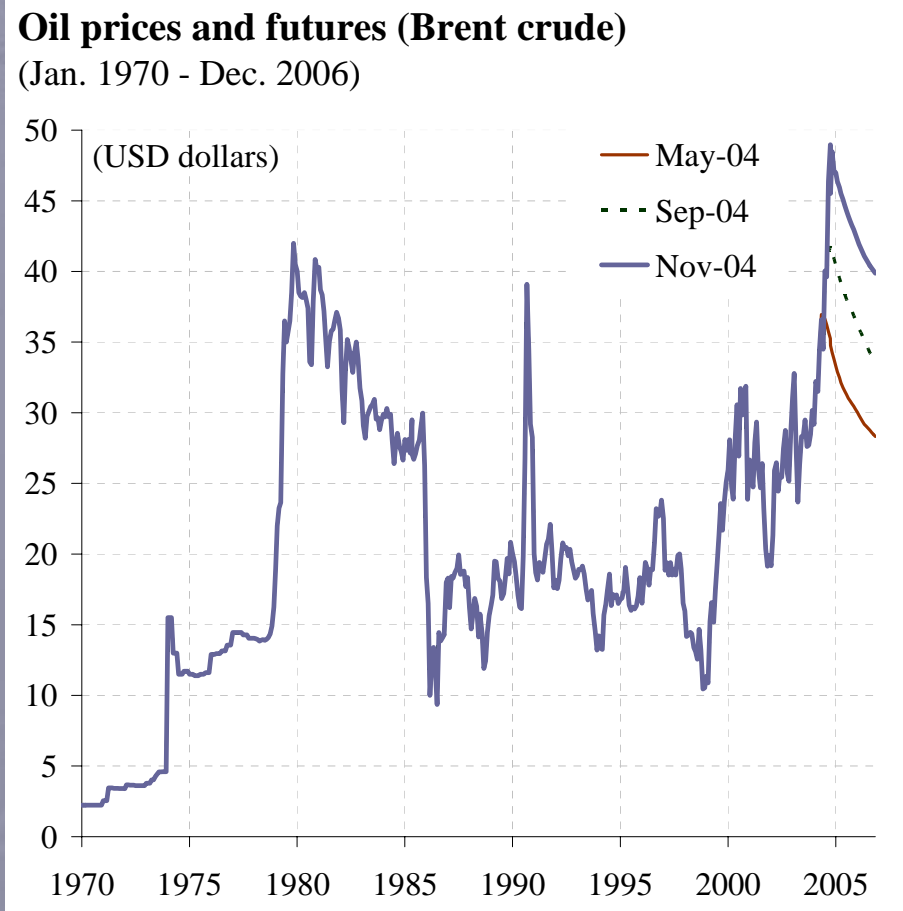
- Identifying main sources of risk:
  - Intelligence gathering and cross-checking
  - Analysis
  - Judgment
  - Overall Assessment
- Open policy issues:
  - Objective
  - Instruments
  - Role of central banks

# Areas of vulnerability

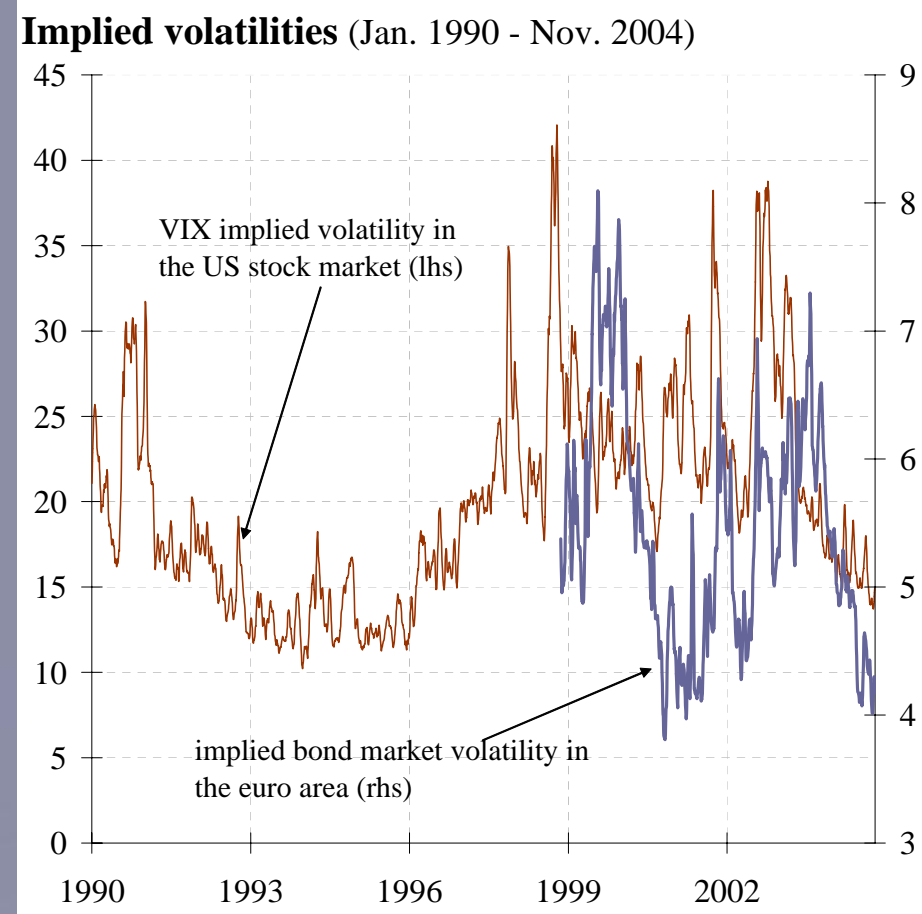
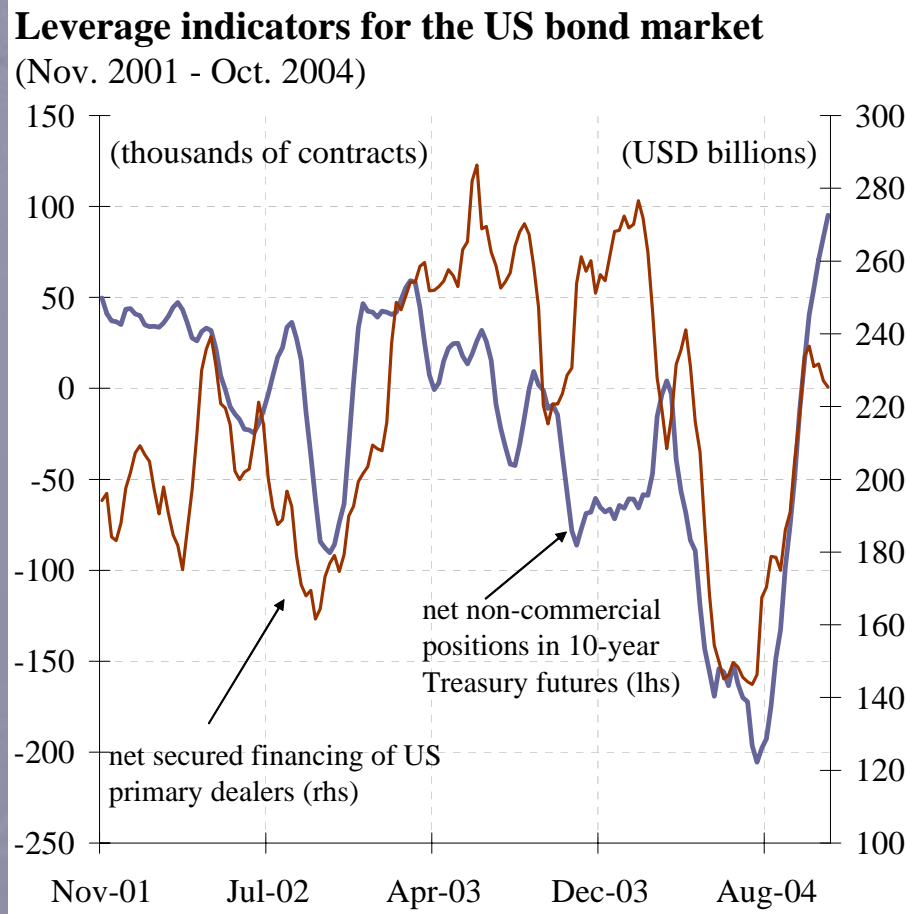
- Global macro-finance
- Financial markets
- Euro area sectoral balances
- Financial institutions



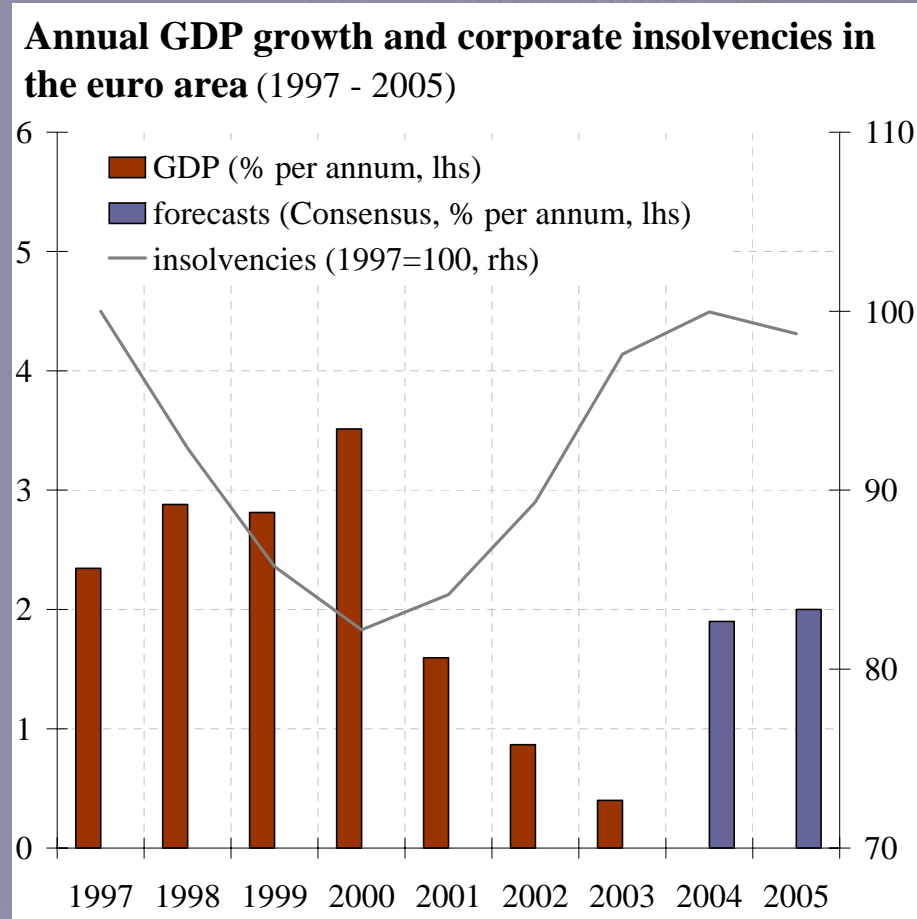
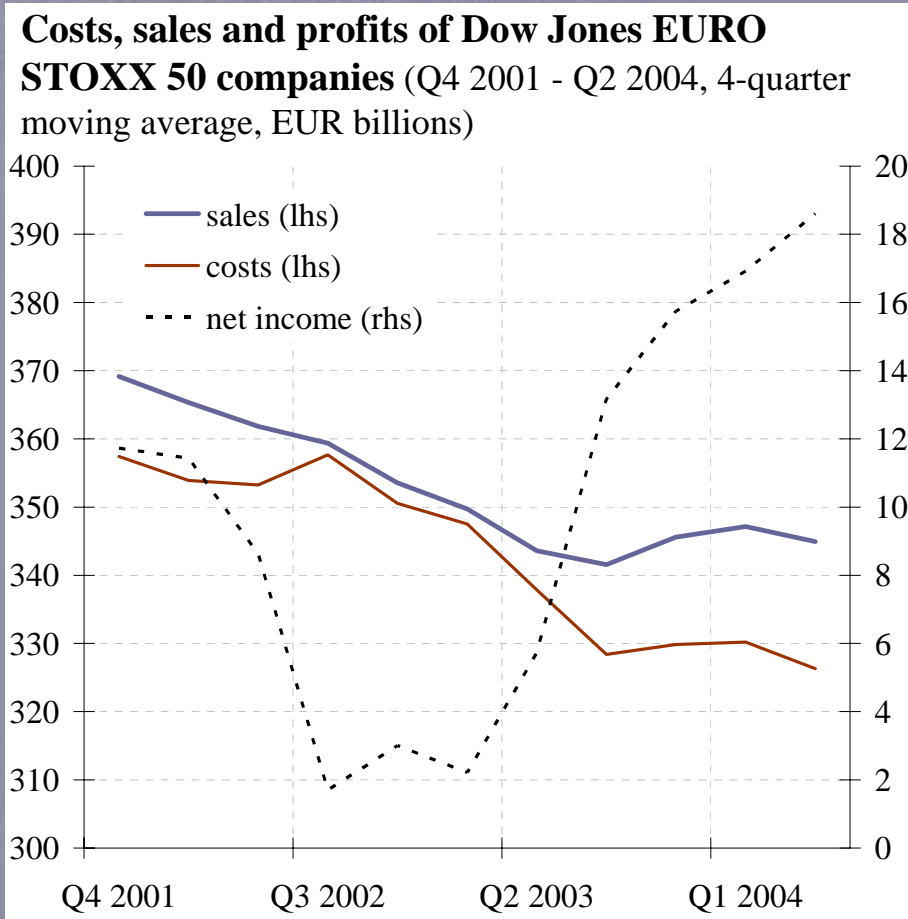
### Two main issues: Oil prices and US imbalances



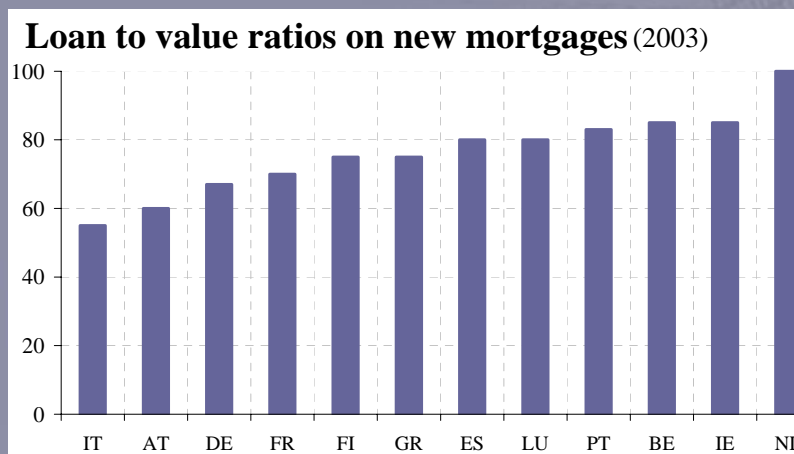
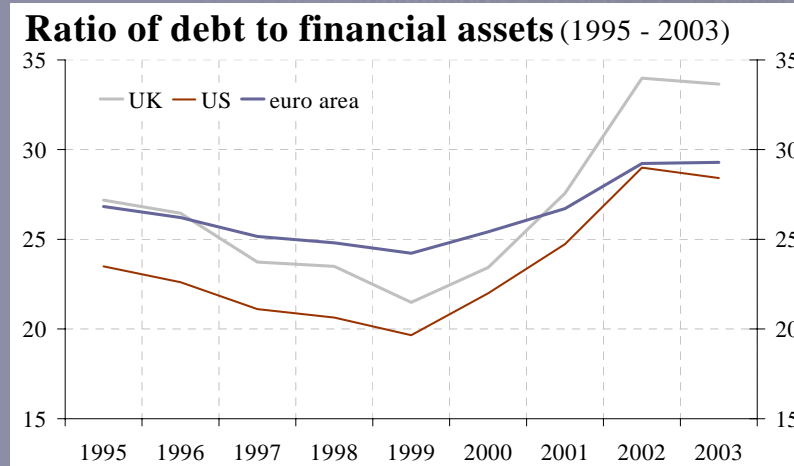
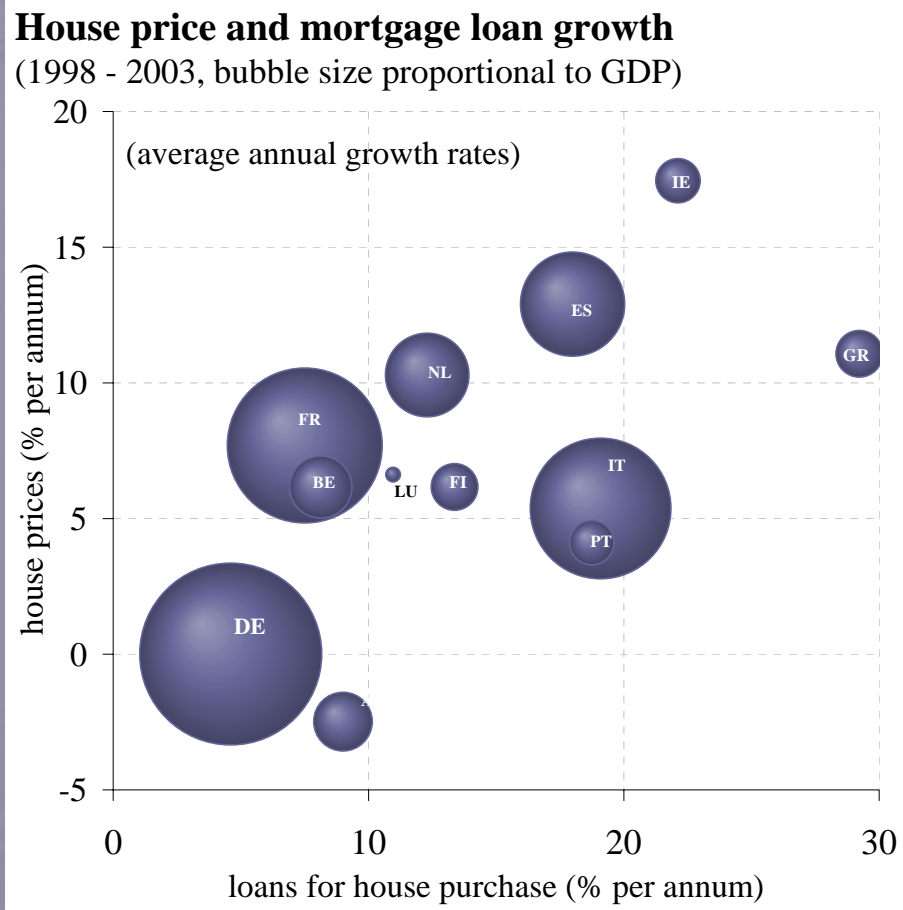
# Renewed leverage in bond markets and volatility declines



## Large firms improving, but small firms still weak

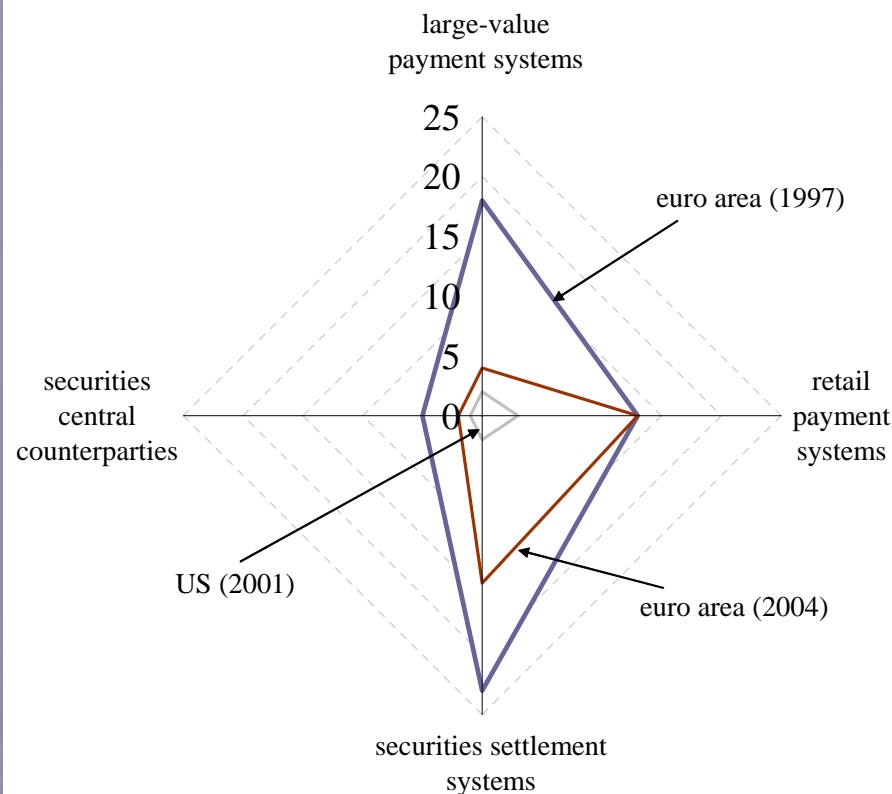


### Risks on both sides of balance sheets



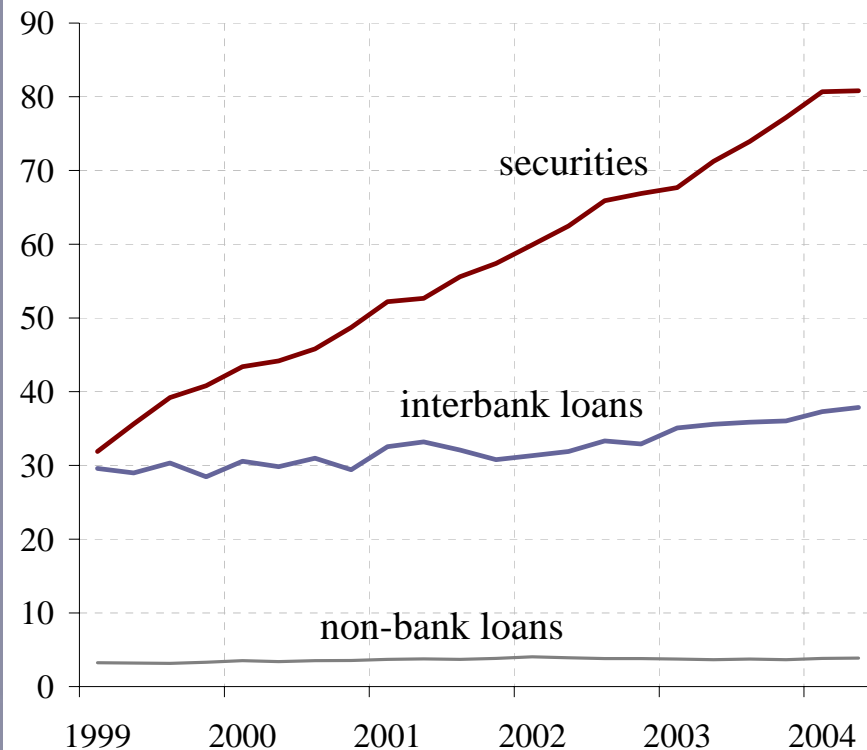
### Integration continues, but room for further progress

**Number of settlement systems**



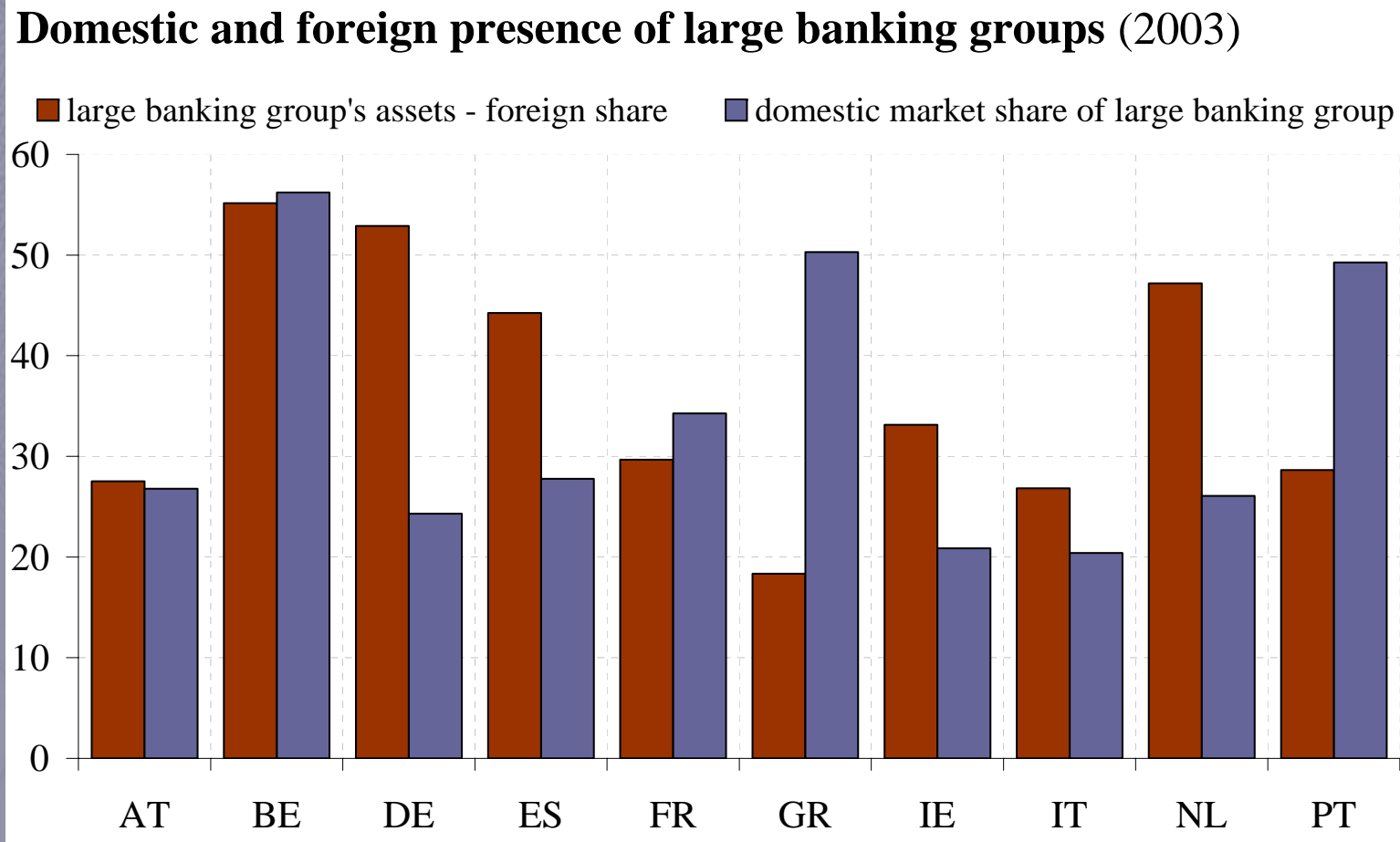
**Euro area holdings of cross-border interbank loans, securities and non-bank loans**

(Q1 1999 - Q2 2004, % of domestic activity)

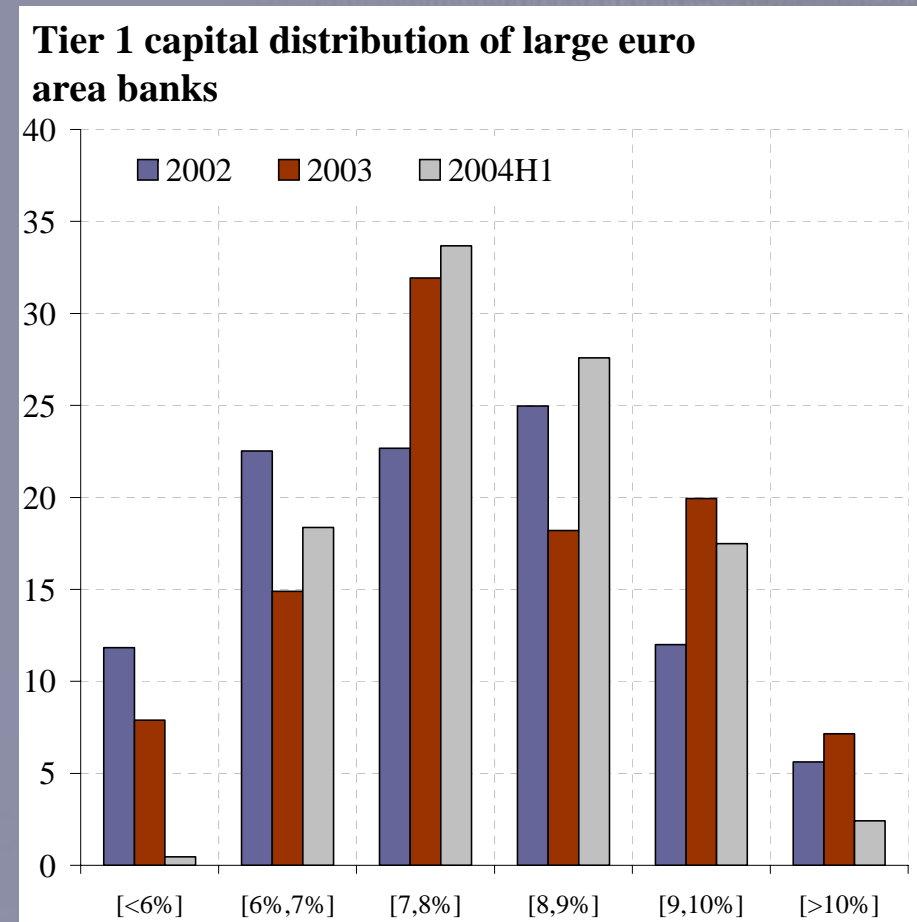
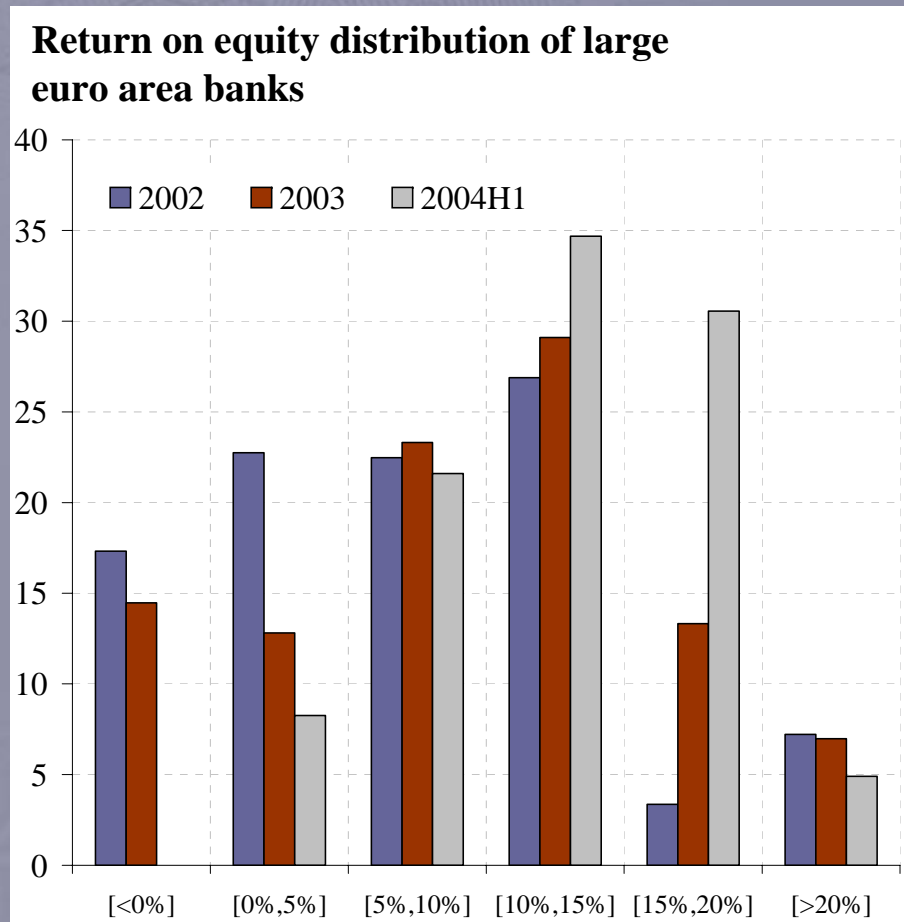




### Cross-border presence of large banks



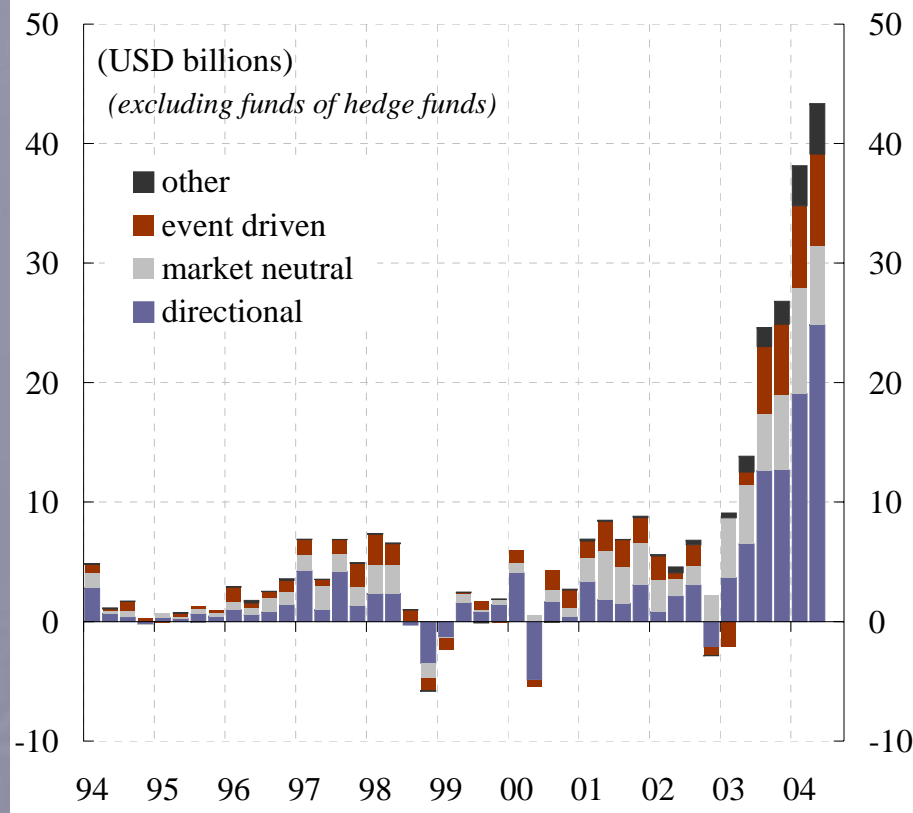
### Bank profitability and solvency improve



### Hedge funds grow fast and change nature

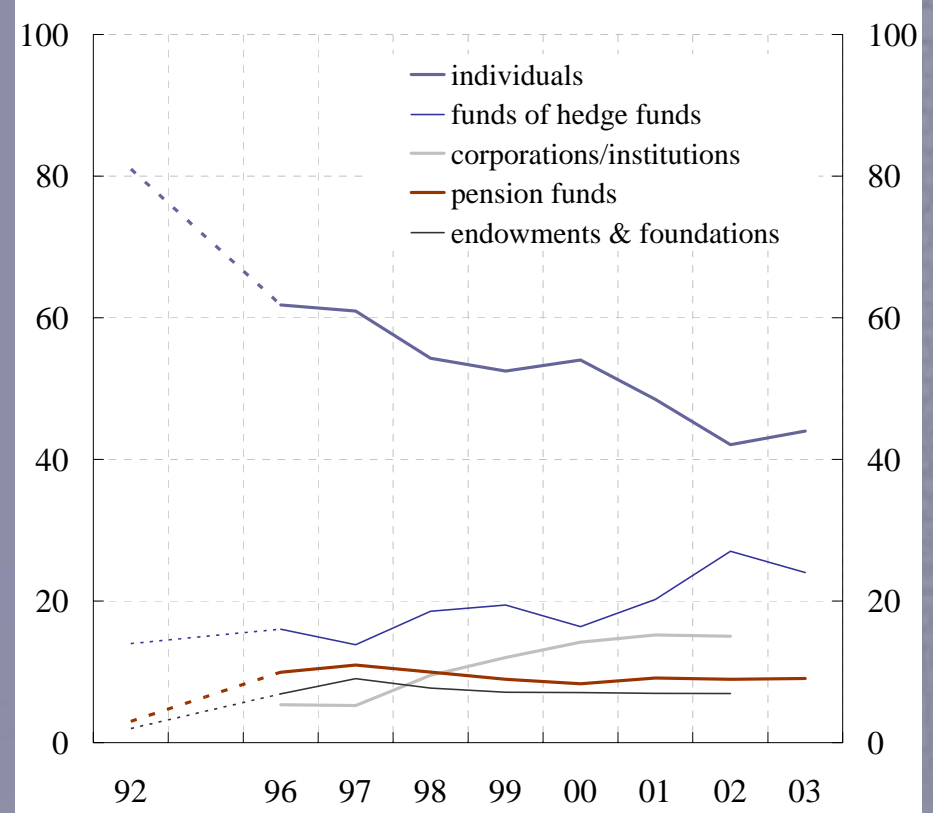
**Hedge fund inflows**

(Q1 1994 - Q2 2004)



**Hedge funds investors**

(1992 - 2003)

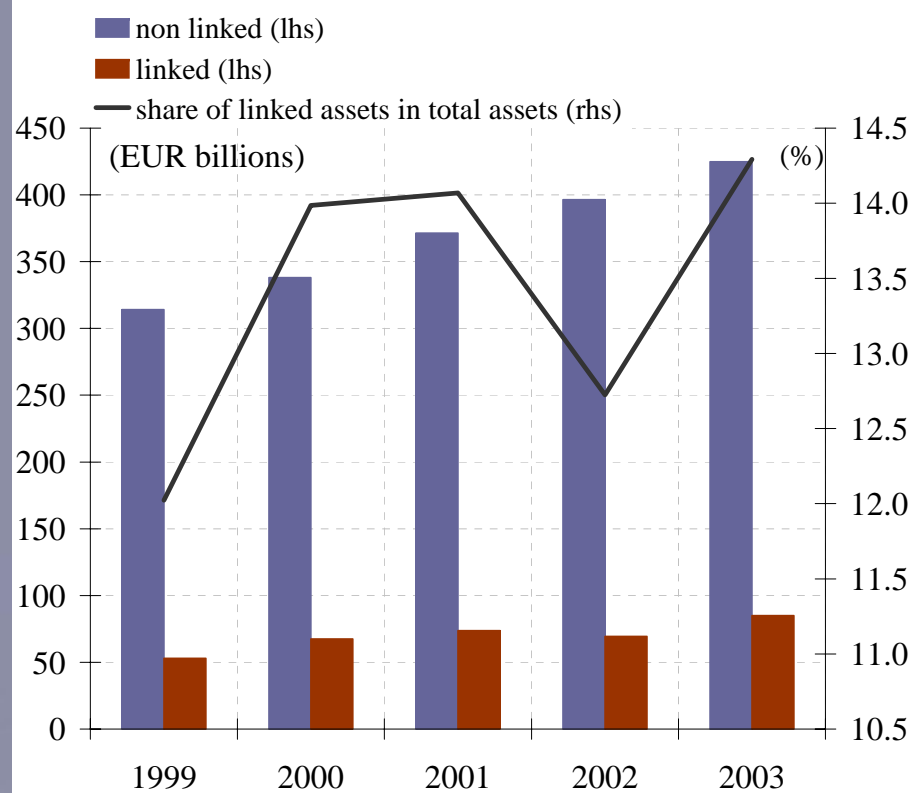


### Life insurance: profitability and balance sheets improve

**Frequency distribution of return on equity of euro area life insurance companies**



**Equity linked and non-linked products (1999 - 2003)**



# Five main sources of risk

Financial fragility may increase if:

1. Hunt for yield in fixed-income markets unwinds
2. US re-balancing becomes disorderly
3. Oil prices amplify corporate sector credit risks
4. Financial sector fragilities intensify
5. House prices correct

Other risks, such as geopolitical risks – including terrorist attacks or middle east tensions – always remain in the background



# Overall assessment

- Risks to financial stability have become less pronounced since late 2003 because:
  - The pace of global economic activity has remained strong
  - Balance sheets of large corporations have improved
  - Balance sheets of financial institutions have been strengthened
- Important risks to financial stability remain including:
  - Possible disorderly correction of serial bubbles
  - Unruly unwinding of global imbalances
  - Credit risks posed by sluggish domestic demand