EUROPEAN CENTRAL BANK

EUROSYSTEM

Press release

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ECB Financial Stability Review shows risks increasing as economic and financial conditions worsen

- Households and firms face multiple challenges, including weakening economic outlook, higher inflation and tighter financial conditions
- Diminished market liquidity raises risk of disorderly asset price adjustments, which could test investment fund resilience
- Governments should ensure support to vulnerable sectors is targeted and does not interfere with monetary policy normalisation

Risks to financial stability in the euro area have increased amid soaring energy prices, elevated inflation and low economic growth, the November 2022 Financial Stability Review published today by the European Central Bank (ECB) shows. At the same time, financial conditions have tightened as central banks act to rein in inflation.

“People and firms are already feeling the impact of rising inflation and the slowdown in economic activity,” said ECB Vice-President Luis de Guindos. “Our assessment is that risks to financial stability have increased, while a technical recession in the euro area has become more likely.”

These recent developments are increasing the vulnerability of households, firms and governments that hold more debt. They are also adding to financial market stresses and testing the resilience of investment funds. Moreover, all of these vulnerabilities could unfold simultaneously, potentially reinforcing one another.

Corporate sector challenges have grown amid higher energy and other input costs, with profits expected to decline as funding costs increase. If the outlook deteriorates further, an increase in the frequency of corporate defaults cannot be excluded, particularly among energy-intensive firms.

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Inflation, as well as soaring gas and electricity bills, is also hitting households, decreasing their purchasing power and potentially reducing their ability to repay loans. Lower-income households that generally spend a greater share of their income on energy and food are particularly affected.

As firms and households find it increasingly challenging to service their debts, banks could face higher credit losses in the medium term. While the banking sector has recently seen a recovery in profitability as interest rates have risen, there are incipient signs of asset quality deterioration, which may require larger provisions.

Many governments have been providing fiscal support to firms and households to soften the impact of rising energy prices. However, high levels of government debt following the pandemic, paired with tighter funding conditions, limit the scope for fiscal expansion measures that do not trigger risks to debt sustainability. Support should therefore be temporary and targeted at those most affected.

Uncertainty around the outlook for inflation and interest rates has heightened the risk of disorderly asset price adjustment in financial markets, notwithstanding recent corrections. Many investment funds remain heavily exposed to further valuation and credit losses. Those with large structural liquidity mismatches and low cash buffers are particularly vulnerable to market dislocations and the outflow of funding. Diminished liquidity in some financial markets could also pose challenges for adjusting portfolios or raising funds. It also raises the risk of unexpectedly large margin calls, which could aggravate adverse market dynamics if funds are forced to sell assets to meet them.

Overall, the euro area banking system is well placed to withstand many risks, in part because of the regulatory and prudential policy reforms of the past decade. Given the deterioration of the economic and financial outlook, targeted macroprudential policies such as capital buffers can help to further strengthen the resilience of the financial system.

Persistent vulnerabilities and risks in the non-bank financial sector require close attention from relevant supervisors. Urgent progress on regulatory frameworks is needed to enhance the resilience of the sector, especially to address liquidity mismatches and leverage.

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