Financial Stability Review 2024:II

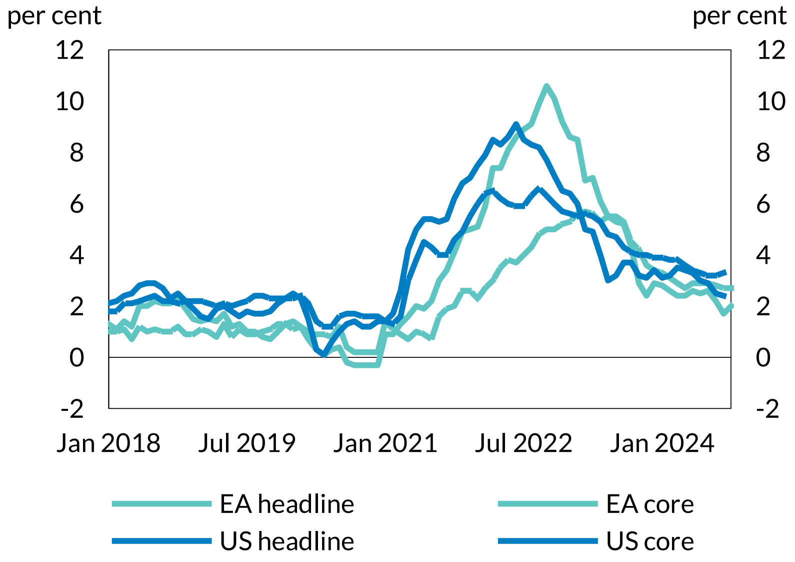
Main messages of the Financial Stability Review

- **The global economy and financial system continue to show resilience, but uncertainty is high and downside risks remain.**
- **Global inflation has fallen** and is close to target in many countries, **allowing policy makers to begin cutting rates.**
- Some forward-looking indicators of activity have weakened, geopolitical tensions have increased and **the balance of risks has shifted from inflation to growth**.
- The widening disconnect between high economic uncertainty and low market volatility / compressed risk spreads increases the chances of sharp repricing of assets, while **vulnerabilities in the non-bank financial sector** may amplify adverse market dynamics.
- The **Irish economy is growing strongly**, but reliance on trade and international investment leaves the economy **susceptible to global shocks**.
- **Capacity constraints, overheating risks and housing shortages** could affect growth and FDI in the medium-term.
- **Irish households and businesses remain resilient**, and loan performance is strong, but some sectors are also exposed to global shocks due to Ireland's substantial trade exposure.
- The **aggregate capital ratio for domestic banks remains above regulatory minimum requirements**, providing loss-absorbing capacity in the event of adverse shocks, but profitability is likely to decline as interest rates fall.
- There is **no change to the Central Bank's macroprudential policy stance**.

With increased confidence that inflation will sustainably return to target, interest rates are expected to fall further

Inflation has fallen sharply since 2022, and is close to target levels

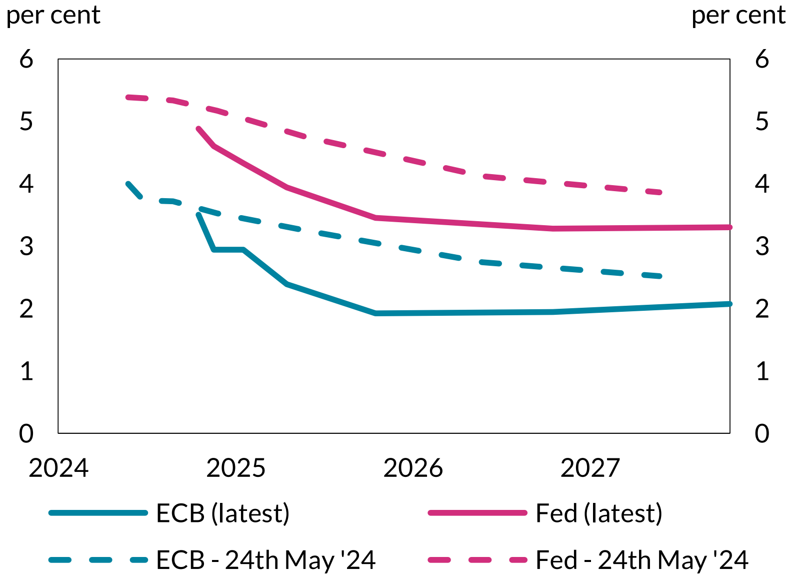
Euro areaand US inflation



Source: Eurostat and Bureau of Labor Statistics via Haver Analytics,
Notes: Last observation for monthly inflation data is October 2024

Market rate expectations have fallen since the last *Review*

Market implied policy rates for the ECB and Fed



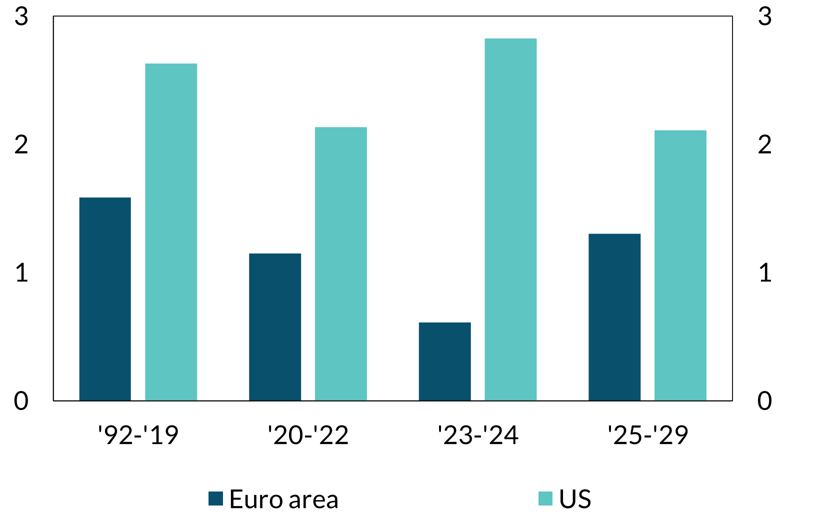
Source: Bloomberg and Central Bank of Ireland calculations
Notes: Latest data show market expectations of policy rates as at 20th November 2024. The ECB rate refers to the deposit facility rate.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Risks to global growth are to the downside, and any intensification of geopolitical tensions could affect inflation, trade & geo-fragmentation.

Potential growth in Europe is expected to lag behind the US and other economies

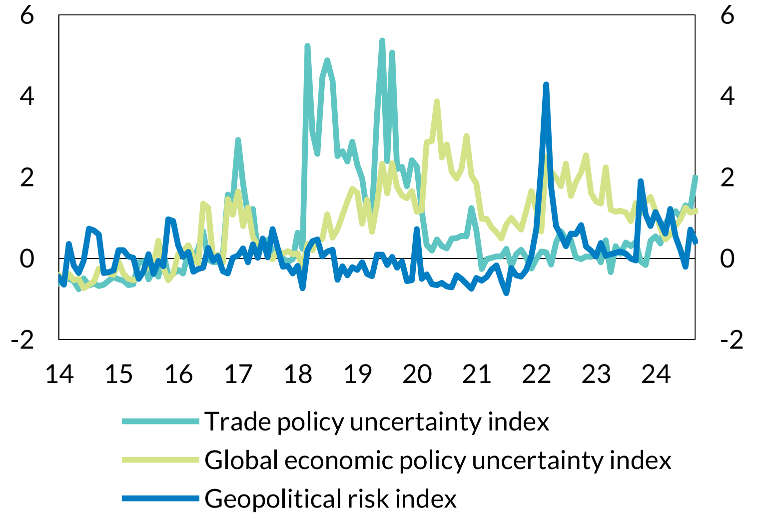
Historic and forecasted GDP growth, averages



Source: IMF World Economic Outlook October 2024
Notes: WEO refers to IMF's World Economic Outlook.

Recent geopolitical tensions raise the prospect of trade fragmentation and commodity price shocks

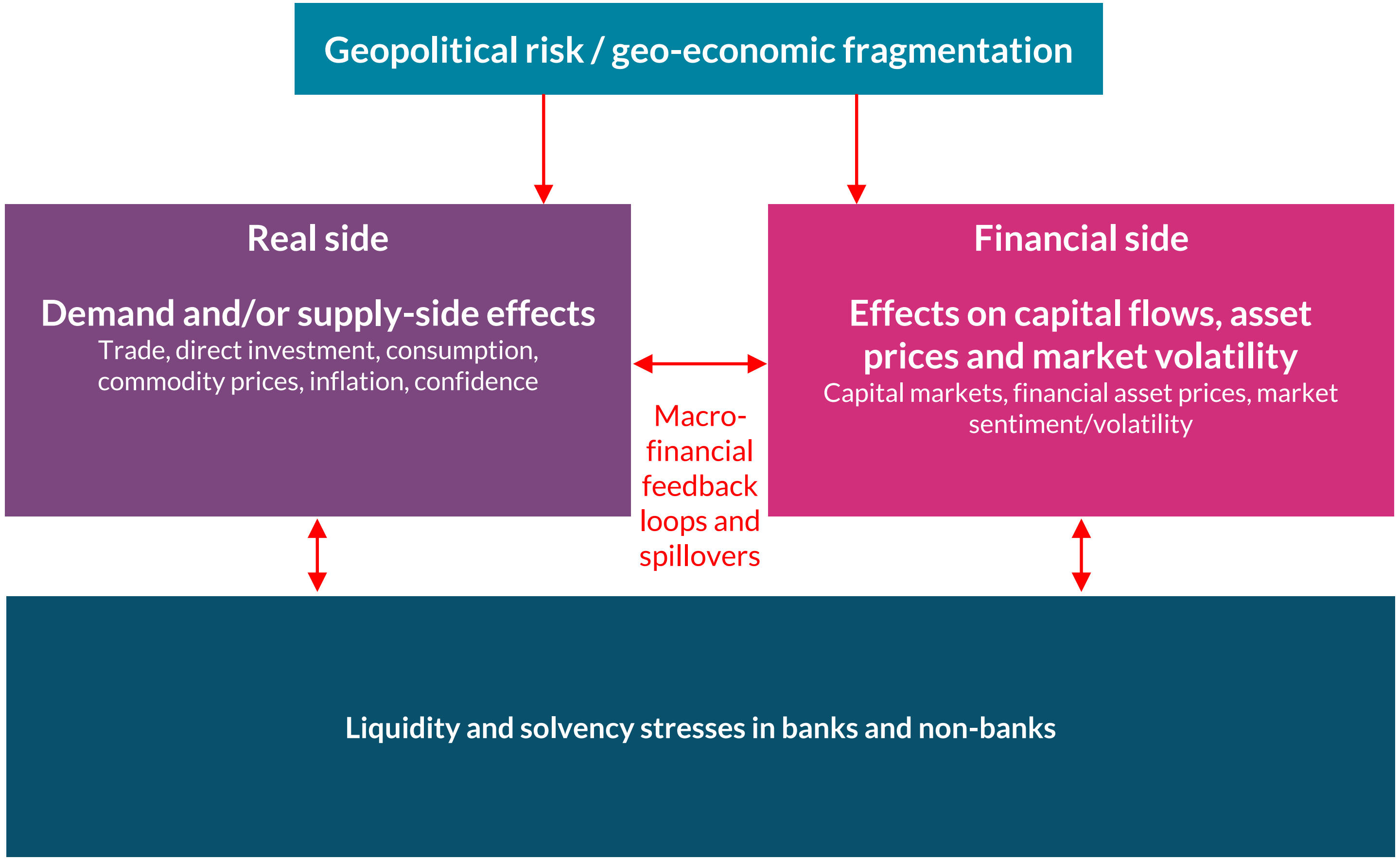
Trade policy uncertainty index, global economic policy uncertainty index and geopolitical risk index



Source: Caldara, D. and Iacoviell, M., Baker, Bloom and Davis
Notes: Last observation 30th September 2024.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Geopolitical risks can affect the financial and real economy through a number of channels

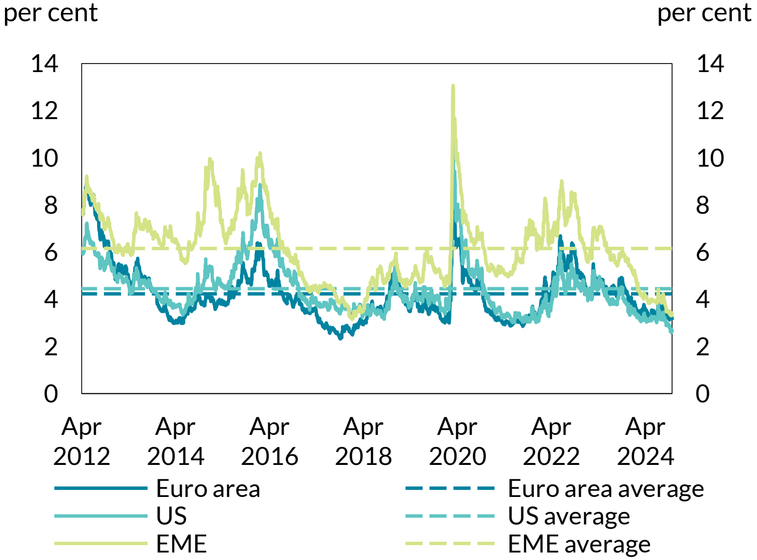


Central Bank of Ireland staff – adjusted from ECB (2024): *"Turbulent times: geopolitical risk and its impact on euro area financial stability"* & IMF GFSR (2023)

There is evidence of compressed risk pricing in corporate debt markets, while investor sentiment has shown signs of fragility

Credit spreads are falling and concerns persist over investor mispricing of risk

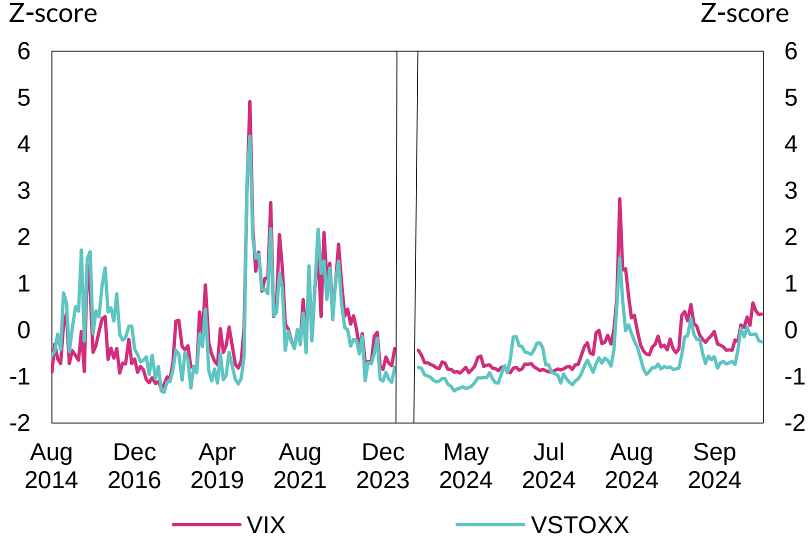
High-yield corporate bond spreads



Source: Ice Data Indices via Federal Reserve Bank of St Louis
Notes: ICE BofA Option-Adjusted Spreads on below investment grade corporate bonds. Dashed lines indicate historic averages since April 2012. EME refers to emerging market economies. Last observation 20th November 2024.

Equity volatility is low, and there is potential for market disruption if expectations change quickly

VIX and VSTOXX z-scores



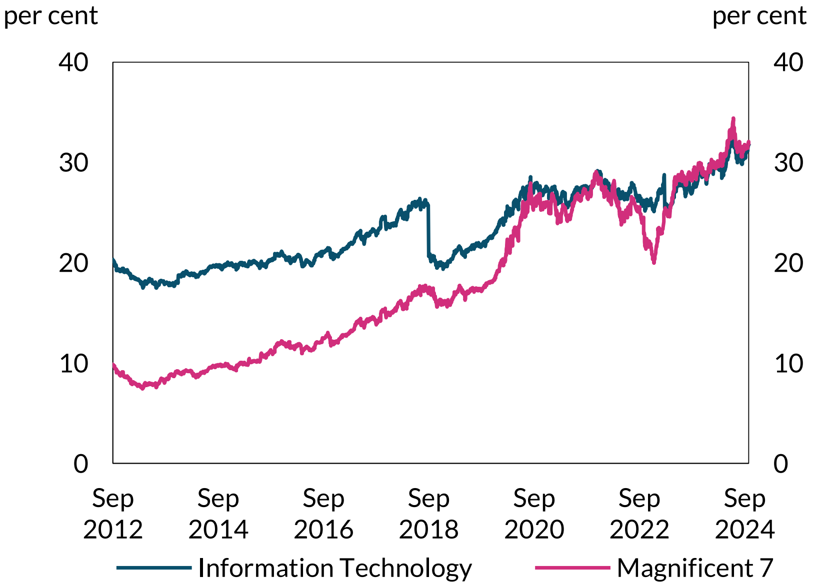
Source: Chicago Board Options Exchange, Merrill Lynch via Bloomberg.
Notes: Z-score based on mean and standard deviation of end-of-month observations between August 2014 and April 2024. The VIX index measures 30-day expected equity market volatility of the US stock market while the VSTOXX index measures 30-day equity market volatility based on the EuroStoxx 50 index.. Left panel shows long term data up to April 2024. Right panel shows the last 6 months. Last observation is 20th November.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

There are concerns over exposures to US technology stocks, while leverage in the non-bank sector could amplify market adjustments

Market concentration in the tech sector has been increasing

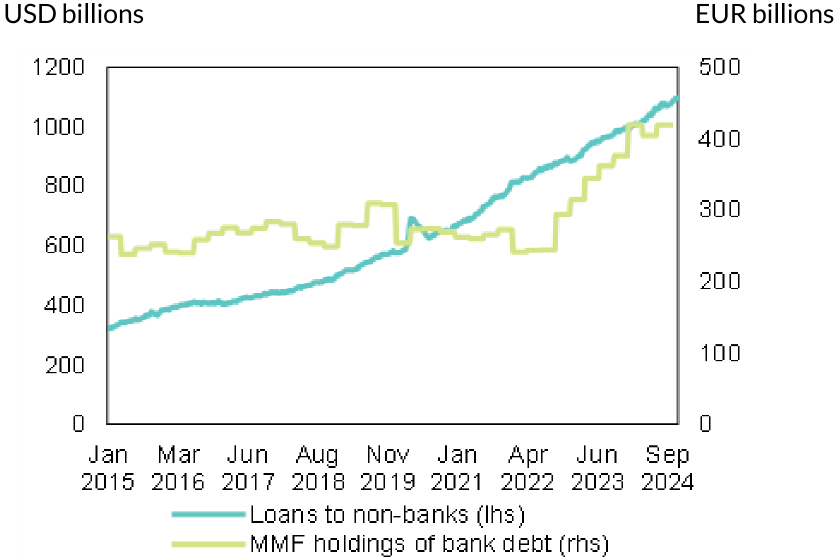
Market cap percentage of S&P500



Source: Bloomberg
Notes: Last observation 23rd October. “Magnificent 7”: Amazon, Apple, Alphabet, Nvidia, Meta Platforms, Microsoft and Tesla

Interconnectedness between banks and non-banks could be a source of contagion

US commercial bank loans to non-banks and euro area MMF holdings of MFI debt securities

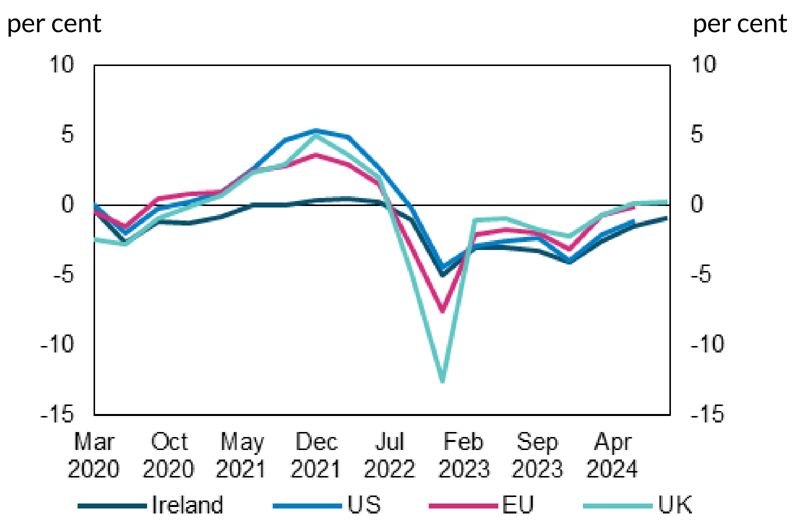


Source: Federal Reserve, ECB.
Notes: Loans to non-depository financial institutions from commercial banks in the US. Holdings of debt securities issued by euro area MFIs reported by MMFs in the euro area (stocks). Last observation for Federal Reserve data is 6th November 2024. Last observation for ECB data is provisional data for 2024Q3.

Global CRE markets have been adjusting, as higher borrowing costs and weak demand are factored into price declines

CRE price declines show signs of bottoming out in some jurisdictions

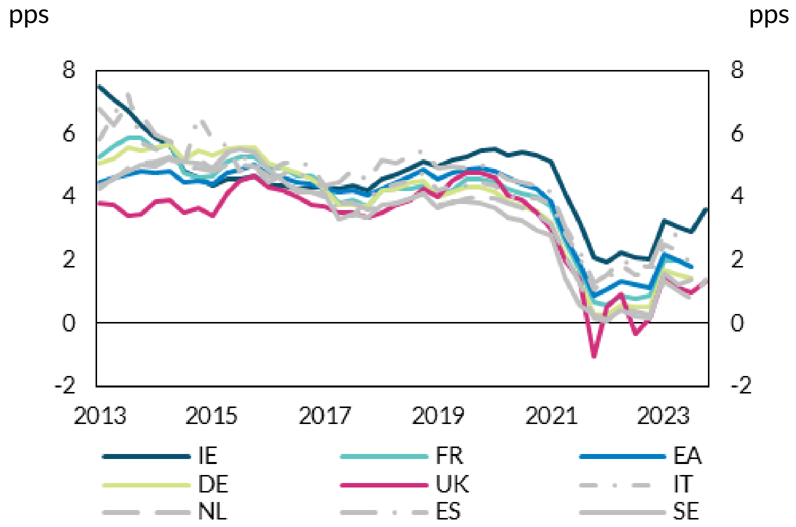
Global commercial real estate price growth



Source: MSCI.
Notes: Quarterly percentage change. Last observation for EU and US is June 2024. Last observation for UK and Ireland is September 2024.

The compensation that investors receive over risk-free rates for investing in Irish CRE remains above cross-country peers

Spread between CRE yields and 5 year swap rates



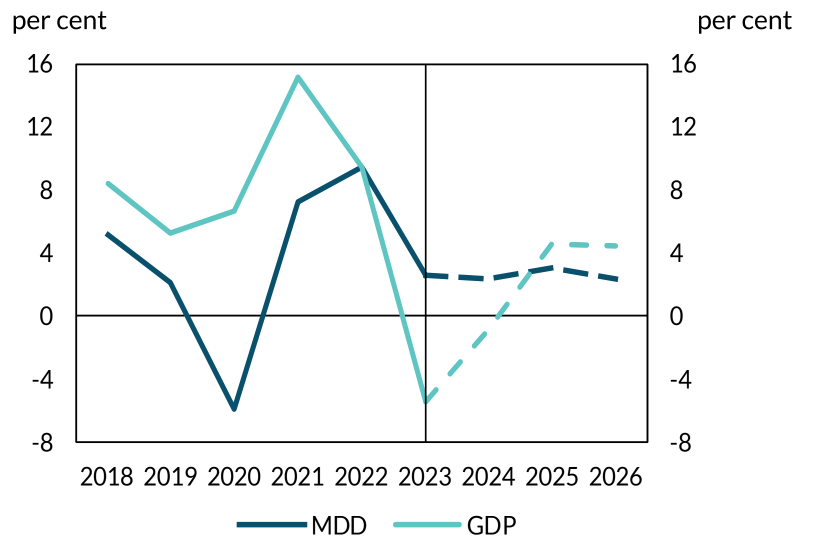
Source: MSCI and Bloomberg
Notes: Swaps are 5-year Euribor for EA, UK and SE swaps, respectively. Latest observation 2024Q3 for Ireland, Netherlands and the UK, 2024Q2 for all others.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

The Irish economy has continued to perform robustly although remains vulnerable to external shocks

The central expectation for the Irish economy is one of continued robust growth

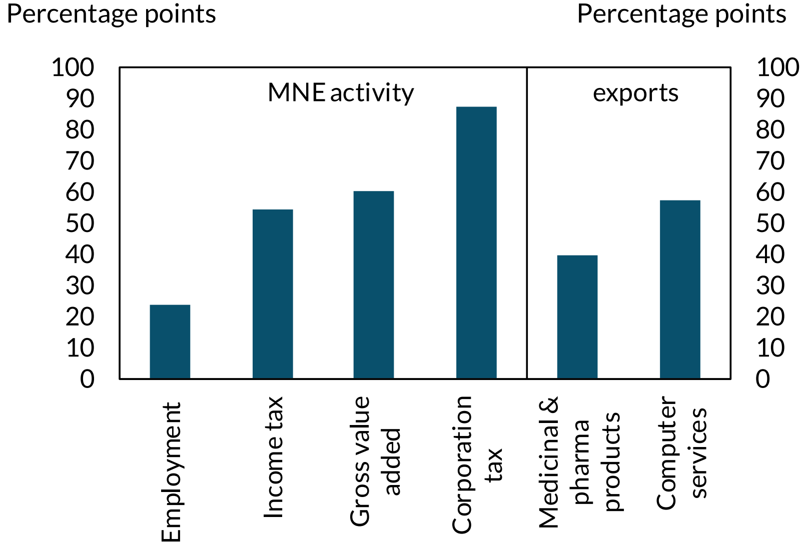
Actual and forecast economic activity



Source: CSO & Central Bank of Ireland calculations
Notes: dotted line denotes forecast as published in Quarterly Bulletin No.3, 2024

Structural factors such as a large MNE sector and concentration in export sectors are evident

Share of MNE contribution to various measures of activity and the importance of certain sectors for Irish exports

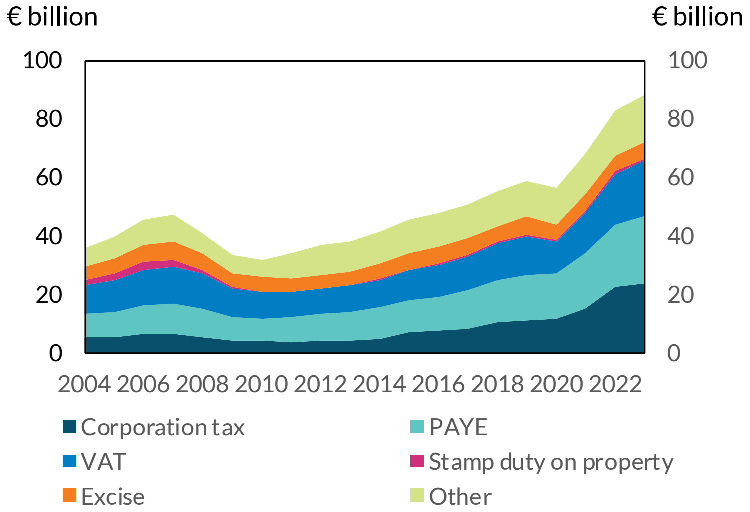


Source: CSO, Eurostat, The Revenue Commissioners and Central Bank of Ireland calculations
Note: Data for MNE activity are for 2022. Computer services exports are expressed as a percentage of total service exports. Medicinal and pharma products are expressed as a percentage of total goods exports. Services exported and goods exported are for 2022 and 2023, respectively.

The public finances are relying heavily on excess corporation tax receipts, with clear downside risks associated with this revenue

Tax receipts has been strong in recent times – largely due to corporation tax

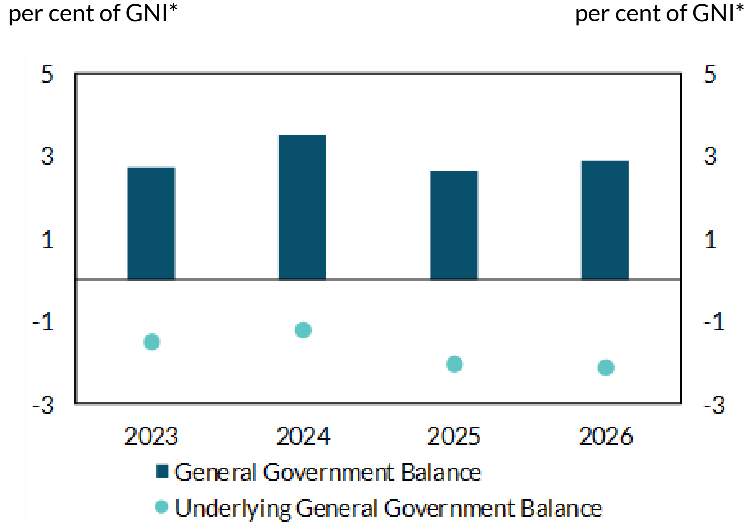
Breakdown of tax



Source: Revenue Commissioners

Excluding 'excess' CT receipts the budget outlook would be much less favourable

General government balances



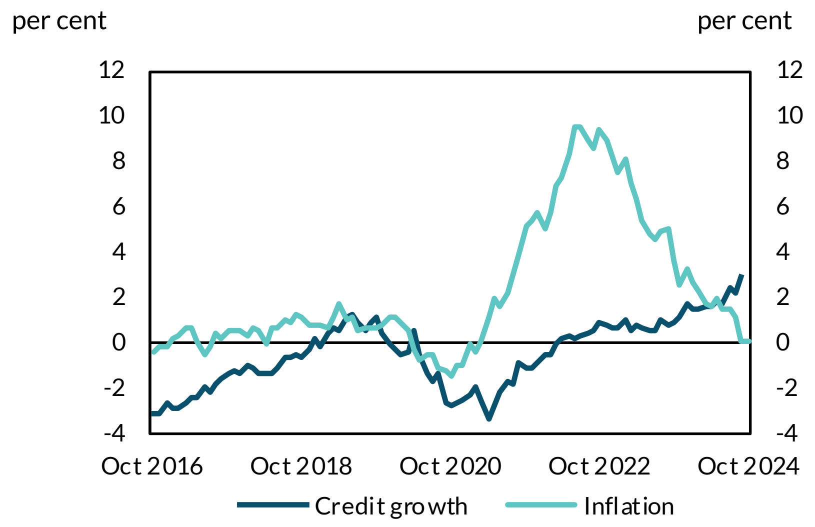
Source: Department of Finance, CSO and Central Bank of Ireland forecasts
Note: The observed and projected GGB, with and without 'excess' corporation tax revenue. 'Underlying' General Government Balance excludes estimates of excess corporation tax receipts. All figures are expressed as a percentage of GNI*

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Rate cuts and expansionary fiscal policy could exacerbate domestic economic overheating risks, while credit growth has picked up

Inflation has eased while credit growth has accelerated, although still at moderate levels

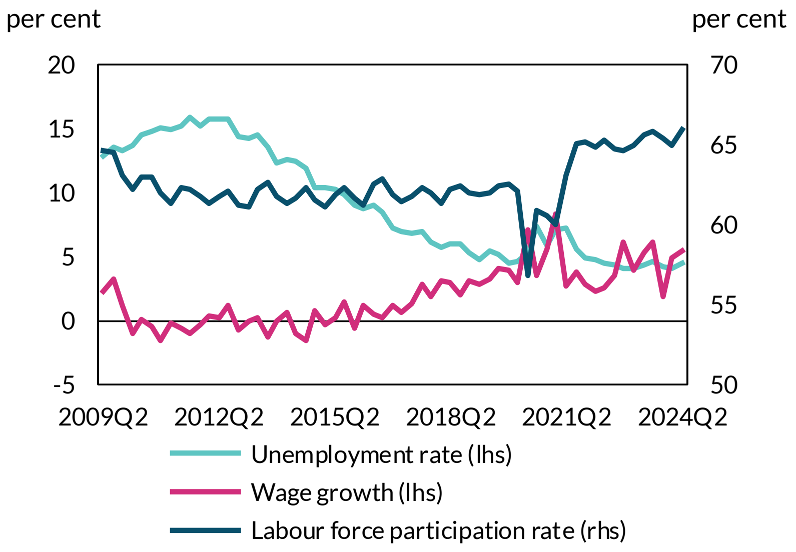
Credit growth and inflation



Source: Central Bank of Ireland and CSO.
Note: Credit growth relates to lending to Irish households and NFCs. Inflation is measured as he annual percentage change in the HICP index.

Ongoing tightness in labour market could exacerbate inflation expectations and fuel overheating concerns

Labour force participation, unemployment and wage growth

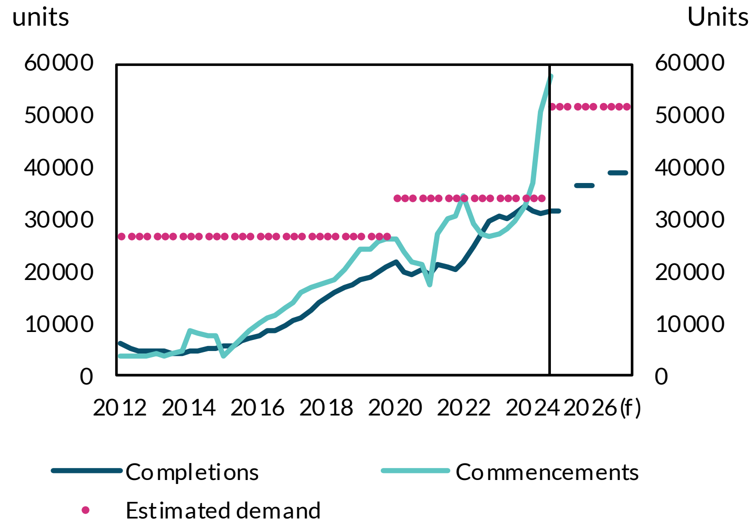


Source: CSO,
Notes: Wage growth refers to annual change in average hourly earnings.

House price growth has accelerated with persistent excess demand relative to supply

Demand for residential property continues to outstrip supply

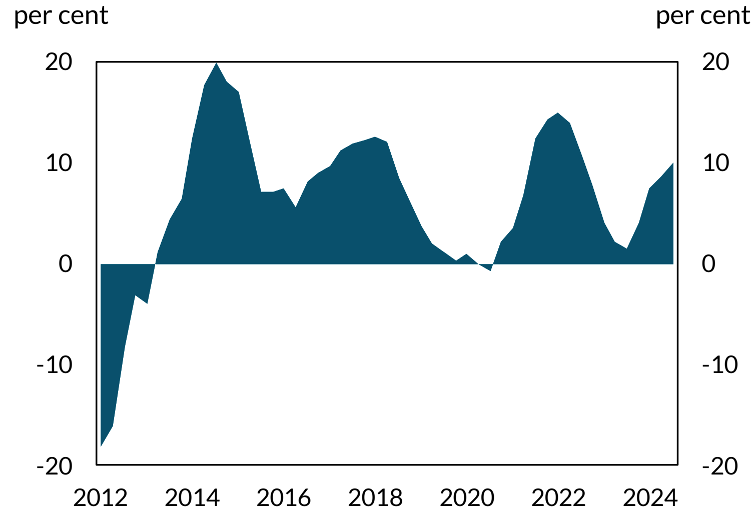
Supply and estimated demand (rolling annual total)



Source: CSO, Department of Housing, Local Government and Heritage and Central Bank calculations.
Note: Last observations for commencements and completions 2024Q3. Chart also includes latest Central Bank of Ireland housing completion forecasts for 2024, 2025 and 2026, as well as updated estimates of annual housing demand.

This has contributed to robust increases in residential property prices

Year-on-year residential real estate price growth

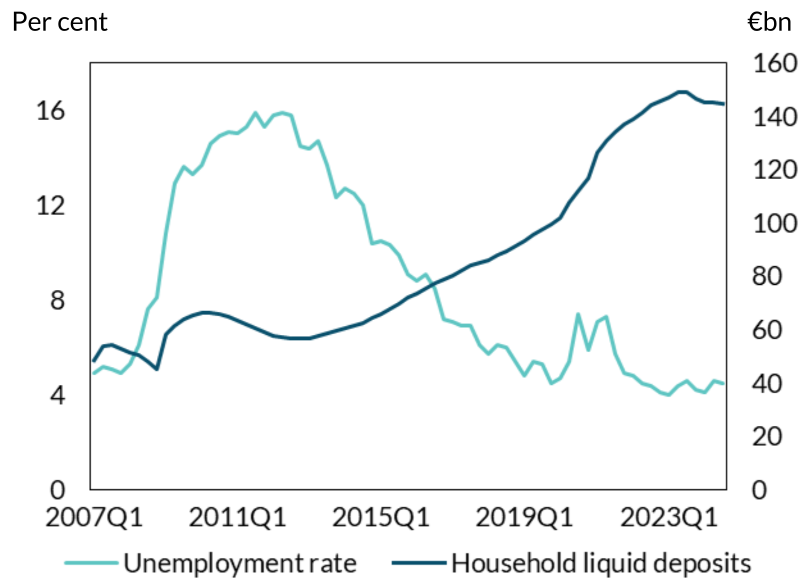


Source: CSO
Note: Last observation August 2024.

Household finances supported by a strong labour market, though a downturn in MNE activity would have a sizeable effect on the economy overall and affect resilience

Households have a sizeable stock of liquid assets, while unemployment is near historic lows

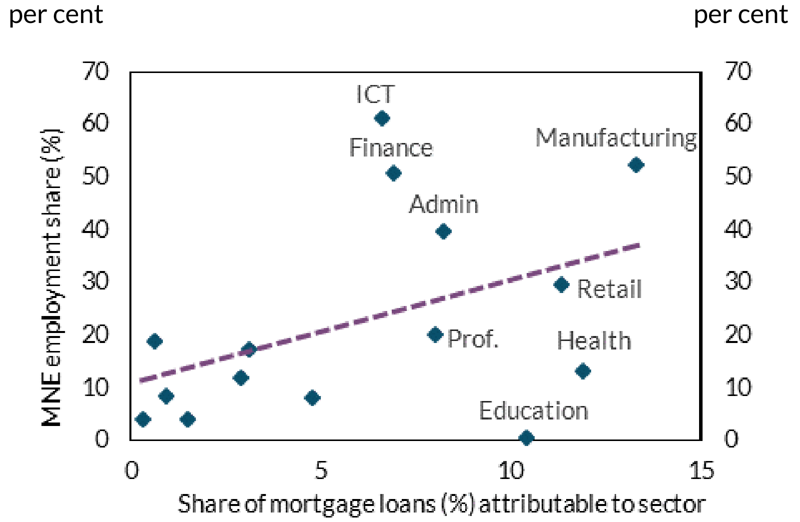
Household liquid savings stock and unemployment rate



Notes: : Household liquid deposits are the sum of overnight deposits and redeemable at notice

As well as broader economic effects, MNE employment plays a further role in transmitting global shocks to households

Share of mortgage loans owed by sector of employment, MNE share of employment



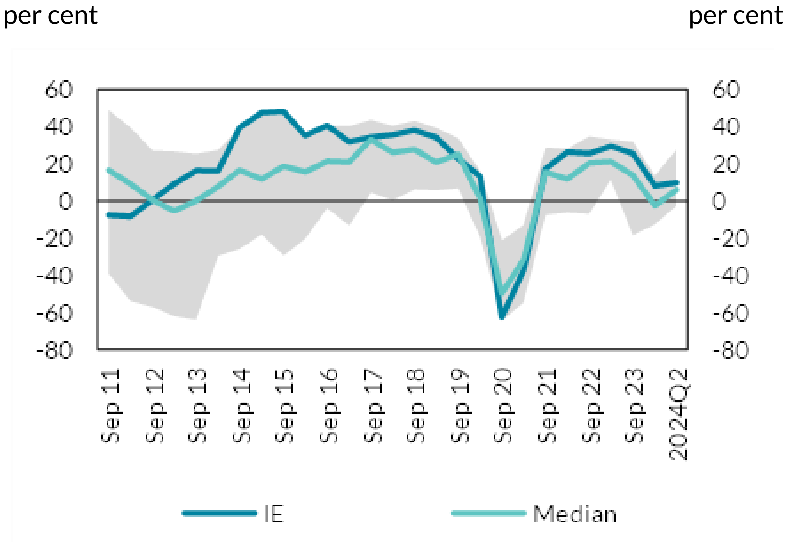
Source: Central Bank of Ireland; CSO; HFCS
Notes: The share of mortgage loans owed by employees in different sectors, as observed in the 2020 HFCS wave.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

SME turnover growth appears to have moderated, with wage growth expected to further weigh on profit margins, but there are limited signs of borrower distress

SME turnover growth appears to have moderated in 2024

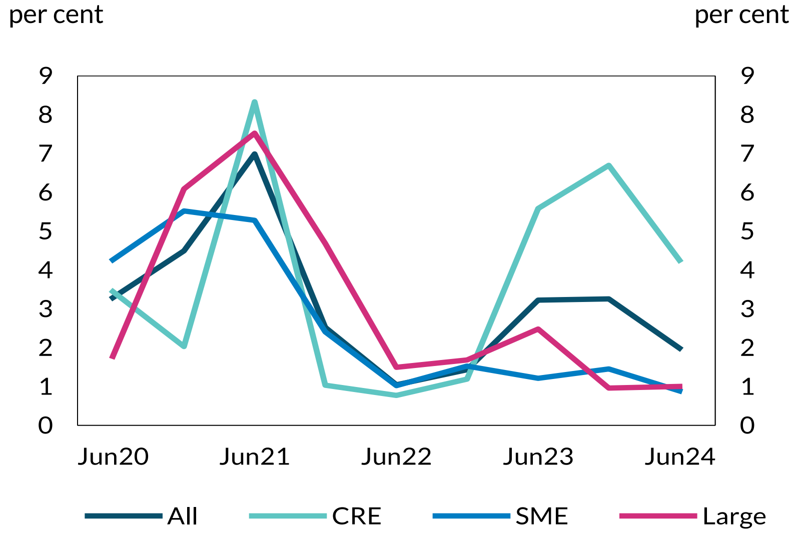
Net share of firms reporting increased turnover



Source: ECB SAFE.
Notes: Net share of firms reporting increased turnover. Grey swathe shows the range of euro area countries

CRE borrowers continue to display weaker loan performance than other NFCs

Transition rate of performing NFC loan balances to weaker loan performance states by borrower cohort



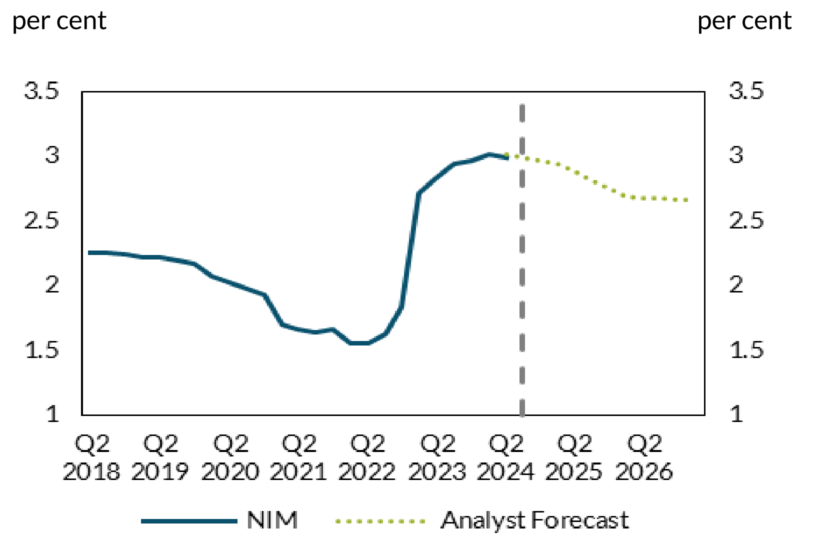
Source: Central Bank of Ireland.
Notes: The share of performing domestic bank Irish NFC loan balances transitioning to arrears, forbearance, or non-performing status in each six months by cohort. Last observation June 2024.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Domestic bank profitability is likely to moderate in the near-term as interest rates decline, but domestic banks remain resilient

Domestic bank profitability has likely peaked, with net interest margins expected to fall

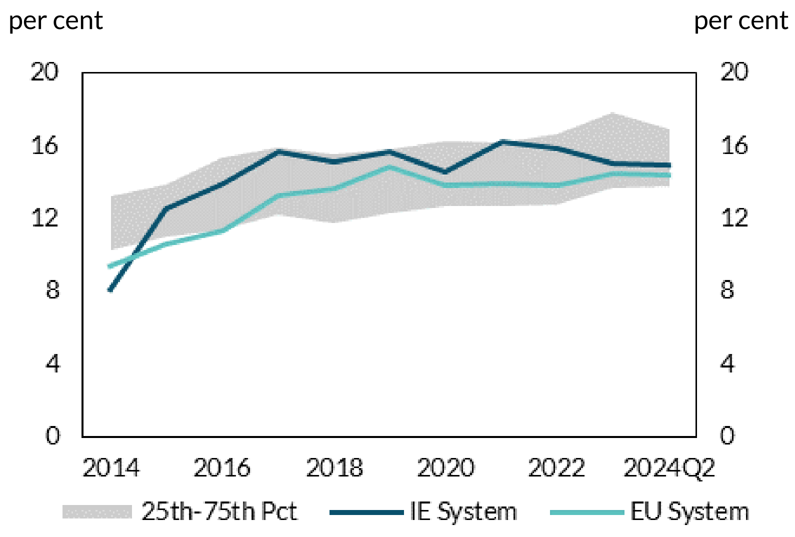
Net interest margin and analyst projections



Source: Bloomberg, Central Bank of Ireland
Notes: Net interest margin of the three domestic banks. 'Analyst Forecast' refers to Bloomberg Professional Forecasters series.

CET1 capital ratios remain above regulatory minimum requirements

Fully-loaded CET1 ratios



Source: BankFocus and FINREP.
Notes: Domestic bank fully-loaded CET1 capital ratio. EU Average: fully-loaded CET1 capital ratio for all EU supervised institutions. 25th to 75th percentile range of fully-loaded CET1 capital ratios for EU institutions

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

The Central Bank's macroprudential policies aim to promote resilience, and are proportionate to the risks faced by the financial system.

- The **CCyB rate** of 1.5 per cent supports the resilience of the banking sector, remains appropriate in the current cyclical risk environment and provides scope for the Central Bank to release the buffer should systemic risks crystallise.
- The **2024 O-SII review** will see no change to the list of identified institutions and buffer rates.
- The **mortgage measures** continue to ensure sustainable lending standards in the mortgage market, following a refresh of the framework.

  In the first half of 2024, the shift towards the recalibrated LTI and LTV limits continued, with limited lending above these levels (4 times LTI and 90 per cent LTV) ensuring that riskier new mortgage lending remains contained.

- The Central Bank continues to develop **the macroprudential framework for non-banks**, and has published a Feedback Statement to our Discussion Paper on an **approach to macroprudential policy for investment funds**.
- The Central Bank continues to work with international partners in this area. For example, in addition to contributing to a Eurosystem response, we recently **published our response to the European Commission's targeted consultation on macroprudential policies for NBFI** which closed at the end of November.
- Domestically the Central Bank's focus is on evaluating the implementation of two macroprudential measures in place which relate to specific cohorts of investment funds:
  - **Irish-authorised GBP LDI Fund measures** announced April 2024 aim to ensure funds are more resilient to shocks to UK interest rates.
  - **Irish property fund measures** announced in November 2022, with a phased implementation. While Irish property funds are taking action to reduce leverage, the current deteriorating CRE market has partially offset these movements.