DIRECTORATE GENERAL MACROPRUDENTIAL POLICY AND FINANCIAL STABILITY

FINANCIAL STABILITY CONTACT GROUP

FRANKFURT AM MAIN, THURSDAY, 19 SEPTEMBER 2024

MEETING SUMMARY

1) The external threat: (geo)political risks

There was a broad consensus among Financial Stability Contact Group (FSCG) members that geopolitical and political risks currently represent the greatest threat to euro area financial stability. The geopolitical landscape was described as a Hydra with financial markets viewing and pricing these risks in terms of fiscal drift, given that their solutions almost always require more government spending. According to several members, geopolitical risks are difficult to price and challenging for financial institutions to measure in stress-tests and scenario analyses. They observed that financial markets have a poor track record in pricing binary events (e.g. election outcomes). In the experience of several FSCG members, these events tend to be discussed ex-ante from a risk management perspective and ex-post from an asset allocation perspective. Members observed that while "safe havens" perform well initially during periods of heightened geopolitical stress, risky assets still outperform in the long-run (over 5 years), as government bonds ultimately suffer from higher inflation and larger budget deficits. Taking a longer-term perspective, some members expressed concern that persistent fiscal deficits and low productivity in Western economies could challenge their dominance in the global financial system, with geopolitical and financial stability consequences.

2) Addressing sovereign vulnerabilities

FSCG members expressed concern regarding fiscal dynamics in the euro area, seeing the high level of public debt as the euro area's greatest vulnerability. Many members believe that euro area governments face an impossible trinity: (i) ensuring debt sustainability; (ii) facilitating green, military, digital and demographic transitions, while also; (iii) maintaining social and political stability. They acknowledged that the sovereign-bank nexus has weakened since the sovereign debt crisis but believe it remains a key contagion channel, should debt sustainability concerns re-emerge. Members observed that the balance of fiscal risks in the euro area had shifted from the so-called "periphery" to the so-called "semi-core". Concerning the former, they noted that reform efforts by several euro area countries had paid off, and that these countries were now outperforming their peers both from a credit perspective and in terms of their compliance with EU fiscal rules. Members saw the new EU fiscal framework as an improvement but were not optimistic about an improvement in compliance. Concerning the latter, they anticipated a worsening of public sector balance sheets in several euro area countries, with risks of rating downgrade considered elevated for some of them.