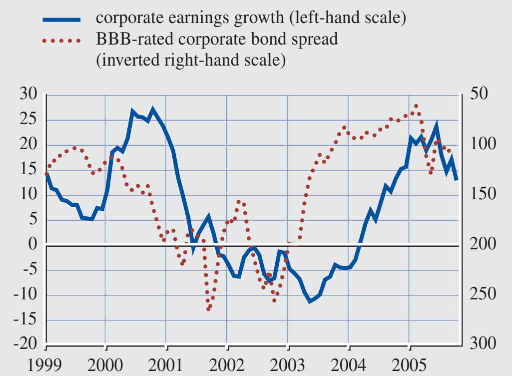
Box 6

CORPORATE EARNINGS AND SECTORAL EXPOSURE AT RISK IN THE EURO AREA

An important determinant of corporate sector creditworthiness is the (expected) profitability of firms. When firms' profitability begins to improve, the availability of internal sources of finance also rises, and often this is associated with, and even anticipated by, narrowing corporate bond spreads (see Chart B6.1). In early 2005 there were some signs of a deceleration in the rate of profit growth of stock exchange-listed firms. Since aggregate figures may hide differences at the sectoral level, and because banks may have different exposures to different corporate sectors, this Box examines corporate earnings at a sector level, making links to the sectoral exposure at risk of euro area banks.

Although operating earnings growth in the euro area in the first three quarters of 2005 was very strong, there were substantial differences in performance across sectors (see Table B6.1). The early product chain sectors, such as resources (RES), basic (BI) and general industries (GI), demonstrated comparatively strong earnings growth, despite high and rising oil prices. The earnings growth of the financial sector (FIN) was also strong, albeit consistently lower than that of the non-technology, media and telecommunications (TMT) sector in 2004 and 2005. Most striking is that the annual growth rate of reported earnings in the

Chart B6.1 Corporate earnings growth and bond spreads in the euro area



Sources: Thomson Financial Datastream and Merrill Lynch.

Table B6.1 Reported earnings growth of stock market-listed companies broken down by sector

(% per annum, average of monthly data)

	RES	BI	GI	CC	NCC	CS	NCS	UTI	IT	FIN	TMT	Non-TMT
Q1 2004	13.3	-15.8	-14.0	-5.9	0.9	-11.8	49.4	5.3	-9.8	-6.9	26.7	-5.2
Q2 2004	11.5	-3.6	24.1	-6.0	0.4	-9.0	22.9	13.0	0.3	0.8	14.1	2.8
Q3 2004	16.1	2.1	19.9	8.9	14.4	1.0	23.4	11.5	13.9	4.2	18.2	7.7
Q4 2004	25.5	16.9	49.6	8.1	23.6	27.3	10.9	16.9	3.9	2.8	16.6	13.0
Q1 2005	29.5	35.3	48.6	8.7	21.4	32.4	7.0	27.8	6.5	11.7	12.0	20.8
Q2 2005	40.0	48.9	30.5	15.9	30.1	44.3	14.6	33.2	8.5	15.2	18.8	25.3
Q3 2005	31.4	39.4	33.1	5.5	13.9	41.2	-2.4	23.2	5.0	14.4	8.7	19.9

Source: Thomson Financial Datastream.
Note: 2005 Q3 up to August. RES = Resources, i.e. mining, oil & gas; BI = Basic industries, i.e. chemicals, construction & building materials, forestry & paper, steel & other metals; GI = General industrials, i.e. aerospace & defence, diversified industrials, electronic & electric equipment engineering & machinery; CC = Cyclical consumer goods, i.e. automobiles, household goods & textiles; NCC = Non-cyclical consumer goods, i.e. beverages, food producers & processors, health, packaging & printing, personal care & household products, pharmaceuticals, tobacco; CS = Cyclical services, i.e. distributors, general retailers, leisure, entertainment & hotels, media & photography, restaurants, pubs & breweries, support services, transport; NCS = Non-cyclical services, i.e. food & drug retailers, telecommunication services; UTI = Utilities, i.e. electricity and gas distribution; IT = Information technology, i.e. information and technology hardware, software & computer services; FIN = Financials, i.e. banks, insurance, life assurance, investment companies, real estate, speciality & other finance; TMT = Technology, media and telecommunications; Non-TMT = Other than TMT.

cyclical consumer goods (CC), non-cyclical services (NCS) and IT sectors slowed down significantly in the course of 2005.

Given that earnings growth matters for the creditworthiness of firms, it is of interest to consider the patterns of exposure at risk of euro area banks to the different sectors (see Table B6.2) The largest exposure at risk of euro area banks at a sectoral level in early 2005 was the consumer cyclical sector, a sector which at the same time was showing rather low earnings growth figures. Even the next two sectors to which euro area banks had large exposures in early 2005 – i.e. the financial and TMT sectors – endured a slowdown in earnings growth through 2005. Between early 2004 and early 2005, euro area banks increased their exposure at risk to the financial sector, whereas they reduced their exposure to the early-product chain sectors, which subsequently recorded very strong earnings growth figures in the course of 2005.

Table B6.2 Euro area bank exposure at risk broken down by sector

(March 2005)

		BIC	EUTI	CAP	CC	NCC	FIN	TMT
Total exposure	EUR billions	609	224	224	1,682	805	6,360	218
Sectoral EDF	% probability	0.25	0.08	0.50	0.46	0.23	0.07	1.13
Exposure at risk	EUR billions	1.52	0.18	1.12	7.74	1.85	4.45	2.47
	in % all sectors	7.9	0.9	5.8	40.0	9.6	23.0	12.8
% change March 2005 – June 2004		-66.9	-87.6	-50.3	-14.5	32.1	46.3	-14.5

Sources: Banking Supervision Committee and ECB calculations.
Note: The euro area refers to the sum of nine euro area countries with only large exposure data for Finland and no data for Greece, the Netherlands and Luxembourg. BIC = Basic industry and construction; EUTI = Energy and utilities; CAP = Capital goods; CC = Consumer cyclical goods; NCC = Non-cyclical consumer goods; FIN = Financials; TMT = Technology, media, and telecommunications.

All in all, data on sectoral earnings growth, together with bank exposure at risk data for the euro area, show that the greatest exposures of euro area banks have been to sectors that have been enduring decelerating rates of growth in earnings (cyclical consumer goods, financial and TMT sectors). By contrast, exposures have been lower to sectors which have shown very strong earnings growth (energy and utilities, basic industry and capital goods sectors). Looking ahead, it appears that euro area banks will most notably be exposed to sectors that show less capacity of generating internal funds and thus a lower level of creditworthiness. Consequently, it cannot be excluded that the general decline in euro area loan loss provisions may only prove to be temporary.