EUROPEAN CENTRAL BANK
EUROSYSTEM

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Financial stability vulnerabilities have eased but the outlook remains fragile, ECB finds

- Euro area financial stability conditions have improved as recession risks decline, but markets remain exposed to possible adverse macro-financial and geopolitical surprises
- Tight financial conditions are testing the resilience of vulnerable euro area households, firms and governments, while downturn in property market presses real estate firms
- Euro area banks have been a source of resilience, but low market valuations suggest challenges remain, notably related to asset quality, funding and revenues

Financial stability in the euro area has benefited from an improving economic outlook, with inflation steadily declining and investor confidence recovering, according to the May 2024 Financial Stability Review, which was published today by the European Central Bank. The outlook remains fragile, however, as the scope for economic and financial shocks is high in an environment of elevated geopolitical and global policy uncertainty.

"Geopolitical risks continue to cloud the outlook for financial stability," said ECB Vice-President Luis de Guindos. "While financial stability conditions have improved in line with reduced recession risks and lower inflation, it remains crucial that we build further on the resilience of the financial system in the light of global economic and geopolitical uncertainty."

Financial markets remain vulnerable to further adverse shocks. While expectations of monetary policy easing have boosted optimism in investors' risk assessments, sentiment could change rapidly. For example, acute geopolitical stress could spark volatility, creating the potential for outsized market reactions that could be amplified by non-banks with structural liquidity fragilities.

Tight financial conditions continue to test the resilience of a cohort of vulnerable euro area households, firms and governments. In aggregate, debt-to-GDP ratios of euro area households and firms have declined to below pre-pandemic levels, which helps alleviate debt sustainability concerns. At the same time, sovereign debt is expected to stabilise at levels that are higher than before the

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pandemic, rendering government finances more vulnerable to adverse shocks. More generally, debt service costs may still rise across all economic sectors going forward, as maturing liabilities continue to reprice at prevailing, significantly higher interest rates. A downturn is meanwhile under way in property markets. The commercial segment in particular is continuing to experience a substantial price correction, and further declines cannot be excluded. By contrast, residential property markets are showing some signs of stabilisation after what has so far been an orderly price correction.

Euro area banks have remained resilient, but low bank valuations suggest that investors are concerned about the durability of bank profitability. Challenges for euro area banks may arise from three sources. First, worries about bank asset quality are growing, given signs of mounting losses in some loan portfolios that are more sensitive to cyclical downturns, notably commercial real estate. Second, bank funding costs seem set to remain high, even if policy rates start declining. And third, banks' revenues may be dampened as operating income weakens due to still-muted loan growth and lower income on variable-rate loans ahead.

Overall, the euro area banking system is well-equipped to weather these risks, given strong capital and liquidity positions. To preserve and strengthen banks' resilience in an uncertain macro-financial environment, it is advisable for macroprudential authorities to maintain existing capital buffers to ensure that they are available to banks in the event of headwinds, together with borrower-based measures that ensure sound lending standards. The implementation of a comprehensive macroprudential framework for non-banks and more integrated EU-wide supervision of these entities would play a big role in mitigating financial stability risks. A resilient non-bank financial sector would support progress towards a capital markets union in Europe, helping to ensure that non-banks provide a stable source of finance to the real economy through the cycle.

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