EUROPEAN CENTRAL BANK

EUROSYSTEM

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Financial stability outlook remains fragile as macro-financial conditions weaken, ECB finds

- Financial markets remain exposed to adverse macro-financial and geopolitical developments, potentially amplified by vulnerabilities in some non-bank financial institutions
- Full impact of tighter financial conditions on real economy yet to be felt
- Higher borrowing and debt service costs will increasingly test resilience of euro area households, firms and governments
- Euro area banks see profitability benefit from rising interest rates but face headwinds from higher funding costs, worsening asset quality and lower lending volumes

According to the November 2023 Financial Stability Review, which was published today by the European Central Bank (ECB), the outlook for euro area financial stability remains fragile, as tighter financial conditions are increasingly propagating to the real economy in an environment of weak growth, high inflation and heightened geopolitical tensions.

“The weak economic outlook along with the consequences of high inflation are straining the ability of people, firms and governments to service their debt,” said ECB Vice-President Luis de Guindos. “It is critical that we remain vigilant as the economy transitions to an environment of higher interest rates coupled with growing uncertainties and geopolitical tensions.”

Financial markets and non-bank financial institutions remain highly sensitive to further negative developments and their vulnerabilities could be exposed to downside surprises in economic conditions. At the same time, investment funds and other non-bank financial institutions remain vulnerable to liquidity, credit and leverage risks. This highlights the need to strengthen their resilience from a macroprudential perspective.

While tighter financial and credit conditions are increasingly translating into higher debt service costs, the full impact on economic activity is yet to materialise, given a general extension of loan maturities across economic sectors when interest rates were very low. Financial and non-financial sectors alike

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could face challenges ahead as these costs rise. This effect is already visible in euro area real estate markets, which are experiencing a downturn. In residential property markets, declining prices have been driven by deteriorating affordability as mortgage financing costs rise. In commercial real estate markets, the effects of rising financing costs have been reinforced by structurally lower demand for office and retail property following the pandemic.

Euro area banks have proven resilient to shocks since the pandemic and their profitability has been rising. At the same time, they are facing headwinds from three main sources. First, their funding costs are expected to increase as they gradually pass on higher interest rates to depositors and the composition of their funding shifts away from overnight deposits towards more expensive term deposits or bonds. Second, bank asset quality can be expected to suffer under a combination of higher debt service costs and a weak macroeconomic environment. And third, bank profitability will have to face a substantial drop in lending volumes stemming from higher lending rates coupled with lower loan demand and tighter credit standards.

Overall, the euro area banking system is well placed to withstand these risks. Macroprudential authorities have increased buffer requirements in recent months to make banks more robust. To help safeguard the resilience of the financial system, macroprudential authorities should maintain capital buffers together with existing borrower-based measures that ensure sound lending standards to make it easier for banks to navigate the turn of the financial cycle. However, it is essential that remaining Basel III reforms are implemented faithfully and that the banking union is completed. A comprehensive and decisive policy response to address structural vulnerabilities in the non-bank financial sector, stemming for example from liquidity risk or leverage, is still required to enhance the resilience of the financial system.

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