EUROPEAN CENTRAL BANK

EUROSYSTEM

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Euro area financial stability vulnerabilities remain elevated in a volatile environment

- Economic growth remains fragile, while concerns about global trade outlook add to geopolitical and policy uncertainty
- High valuations and risk concentration make markets more susceptible to sudden corrections
- Policy uncertainty, weak fiscal fundamentals in some countries and sluggish potential growth raise concerns about sovereign debt sustainability
- Credit risk vulnerabilities in some euro area households and firms could lead to weaker asset quality for banks and non-bank financial intermediaries if downside risks to growth materialise

The European Central Bank (ECB) sees elevated financial stability vulnerabilities in a volatile environment, according to its November 2024 Financial Stability Review, which was published today. Risks to euro area economic growth have shifted to the downside as inflation has moved closer to 2%, while financial markets have experienced several pronounced but short-lived spikes in volatility in recent months. “The outlook for financial stability is clouded by heightened macro-financial and geopolitical uncertainty together with rising trade policy uncertainty” said ECB Vice-President Luis de Guindos.

While financial markets have proved resilient so far, there is no room for complacency. Underlying vulnerabilities make equity and corporate credit markets prone to further volatility. High valuations and risk concentration, especially in equity markets, increase the odds of sharp adjustments. Should adverse dynamics materialise, non-banks could amplify market stress given their liquidity fragilities, in some cases coupled with high leverage and concentrated exposures.

Despite the decline in sovereign debt-to-GDP ratios after the surge during the pandemic, fiscal fundamentals remain weak in some euro area countries. Sovereign debt service costs are expected to continue rising as maturing debt is rolled over at interest rates that are higher than those on outstanding debt. Elevated debt levels and high budget deficits, coupled with weak long-term growth-

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potential and policy uncertainty, increase the risk that fiscal slippage will reignite market concerns over sovereign debt sustainability.

High borrowing costs and weak growth prospects continue to weigh on corporate balance sheets, with euro area firms reporting a decline in profits due to high interest payments. The outlook for real estate markets is mixed, with residential real estate prices stabilising, while commercial real estate markets are still stressed because of challenges posed by remote working and e-commerce. Households, by contrast, are benefiting from a strong labour market and have bolstered their resilience by increasing savings and reducing debt.

While the overall increase in credit risks has so far been gradual, small and medium-sized companies and lower-income households could face strains if growth slows by more than is currently expected, which could, in turn, adversely affect the asset quality of euro area financial intermediaries. Losses on commercial real estate exposures are at risk of rising further and could be significant for individual banks and investment funds. In aggregate, however, banks' ability to absorb further asset quality deterioration continues to be supported by high levels of profitability and by strong capital and liquidity buffers.

To preserve and strengthen financial system resilience in the current uncertain macro-financial environment, it is advisable for macroprudential authorities to maintain existing capital buffer requirements together with borrower-based measures that ensure sound lending standards. In addition, the growing market footprint and interconnectedness of non-bank financial intermediaries calls for a comprehensive set of policy measures to increase the sector's resilience. Such resilience across the NBFI sector would also help to foster more integrated capital markets. This should enhance financial stability and complement the objectives of the capital markets union, which is aimed at supporting Europe's productivity and economic growth.

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