I MACRO-FINANCIAL AND CREDIT ENVIRONMENT

__Macro-financial risks__ remain significant in the euro area, despite some first tentative signs of economic recovery following a year and a half of economic downturn. Continued real and financial fragmentation, coupled with legacy balance sheet issues in several countries, continue to weigh on euro area growth prospects. At the global level, risks relate to fragilities associated with an ongoing rotation of growth, as an incipient pick-up in growth among advanced economies contrasts with a slowing of activity in emerging economies where accumulated financial vulnerabilities have come to the fore as financial conditions have tightened in the late phase of the credit cycle. There are risks that this shift in regional growth dynamics may yet become more pronounced, in particular if a broad-based adjustment in global capital flows takes place along the path to normalisation of macroeconomic policies in key advanced economies.

Amid some initial promising signs of economic recovery, __sovereign tensions__ in the euro area have remained contained through much of 2013, after receding considerably in the second half of last year. Not perturbed by increased volatility in global sovereign bond markets, reduced sovereign stress comes amid ongoing adjustment of fiscal fundamentals. Nevertheless, fiscal vulnerabilities persist in several countries, relating to the continued weak economic environment, high levels of public indebtedness and/or the continued potential for adverse feedback loops between banks and sovereigns. Although much progress has been made in terms of fiscal adjustment, implementation risks in the event of reform fatigue or complacency, as well as any delay in completing EMU, in particular those measures related to weakening the sovereign-bank nexus, remain a cause for concern.

Risks in the euro area __non-financial private sector__ have remained significant, though a modest economic recovery might gradually translate into improved income and earnings prospects. This still muted income and earnings outlook is compounded by high household and corporate indebtedness in several countries, as well as a combination of the limited availability and high cost of credit in more vulnerable countries, in particular for small and medium-sized firms. Residential and commercial property markets continue to show marked heterogeneity in terms of both price developments and valuations. Possible further corrections in property values in some jurisdictions represent a risk going forward.

1.1 A GRADUAL, FRAGILE AND UNEVEN ECONOMIC RECOVERY

Economic recovery is under way in the euro area, but remains fragile

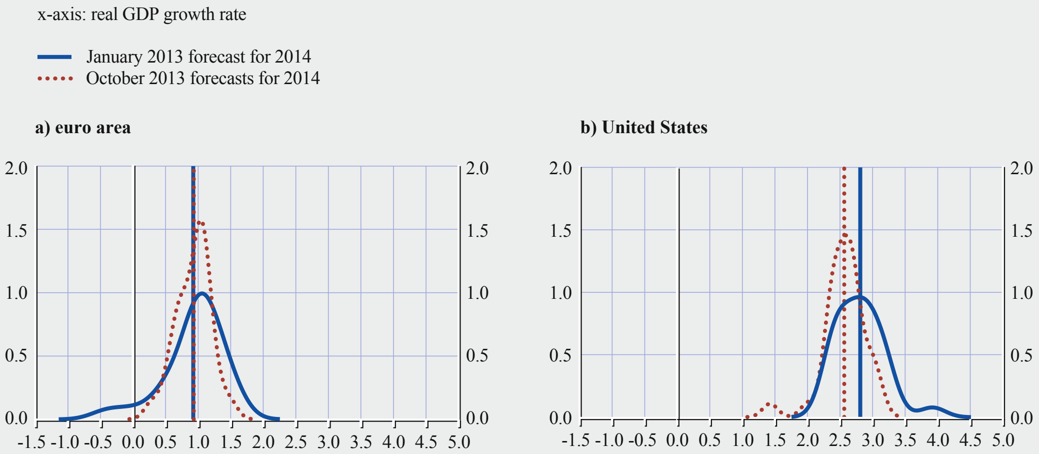
Macroeconomic conditions in the euro area remain challenging despite the first tentative signs of economic recovery. In line with private and public sector forecasts, the euro area economy bottomed out in the first half of 2013. As with any macroeconomic turning point, sustainability remains a key challenge, in particular in this case, as legacy balance sheet issues as well as the fragile earnings and income position of firms and households continue to present headwinds to economic growth.

Substantial cross-country heterogeneity…

Leading indicators suggest an improving near-term economic outlook for the euro area, with survey-based PMI composite output indicators running at two-year highs. At the same time, uncertainty regarding the strength and pace of economic recovery remains considerable (see Chart 1.1), while the growth rates seen to date remain weak. The September 2013 ECB staff macroeconomic projections for the euro area suggest an annual real GDP growth of -0.4% in 2013, which is expected to accelerate to 1.0% in 2014. Nevertheless, the economic growth prospects for the euro area remain well below those for other major advanced and emerging market economies (see Chart 1.2). Moreover, this improving euro area outlook masks continued cross-country heterogeneity, albeit with a decreasing downside skew in the distribution of growth prospects across individual euro area countries.

Chart 1.1 Distribution of the 2014 real GDP growth forecasts for the euro area and the United States

(probability density)



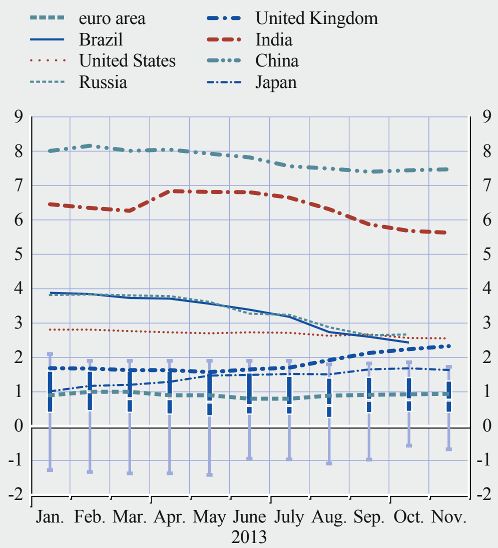
Sources: Consensus Economics and ECB calculations.

… highlights the need for further rebalancing across the euro area

Efforts are ongoing to restore competitiveness in a number of euro area countries, not least by ensuring sufficient responsiveness in wages and prices, as well as by taking other measures to boost productivity. There have been significant improvements in overall competitiveness in countries under stress, as reflected in large improvements in cyclically adjusted current account balances. However, price adjustment has been sluggish partly due to indirect tax measures, but also due to price rigidities. In addition, private sector wage adjustment has only been moderate in the context of high unemployment rates. Such adjustment is, however, essential in the euro area not only to enhance growth potential in the medium term, but also to close the relatively sizeable negative output gaps in the nearer term, particularly for countries under stress (see Chart 1.3). In particular, a sizeable disparity in labour market conditions across euro area countries has underscored the role of employment and growth-enhancing structural reforms in supporting a broad-based and inclusive economic recovery and in reducing the persistent fragmentation in both the real and financial realms (see Chart 1.4).

Chart 1.2 Evolution of the forecasts for real GDP growth in selected advanced and emerging economies for 2014

(Jan. 2013 – Nov. 2013; percentage change per annum)



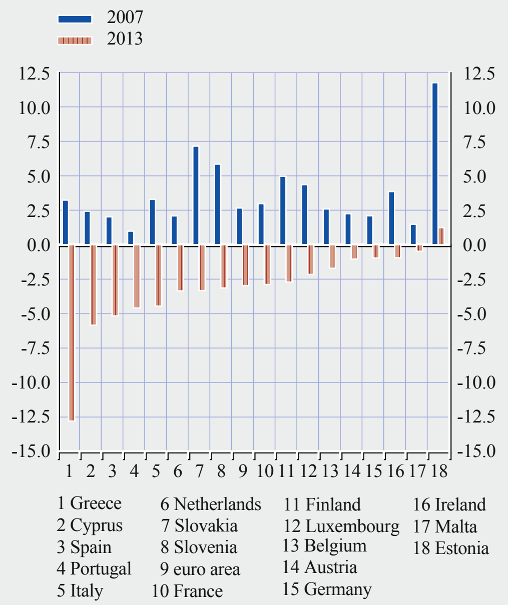
Source: Consensus Economics.
Note: The chart shows the minimum, maximum, median and interquartile distribution across the euro area countries surveyed by Consensus Economics (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain).

Muted global growth with underlying changes in regional growth dynamics

Mirroring economic developments in the euro area, the **global economy** has remained stuck in a low gear in 2013, with notable changes in the underlying regional growth dynamics. While economic activity in advanced

Chart 1.3 Output gap across the euro area

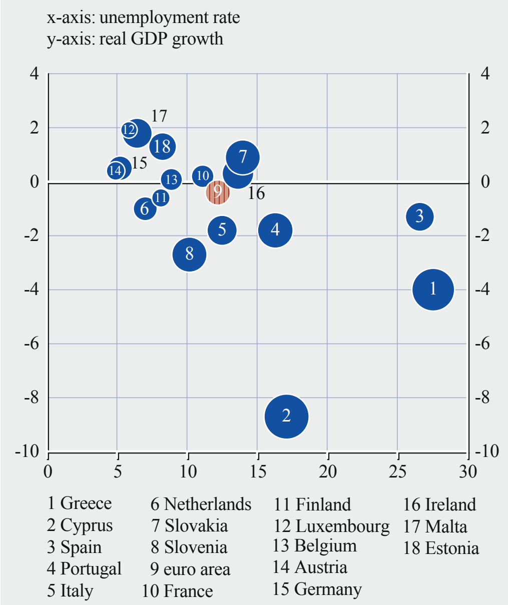
(percentage of potential GDP)



Source: European Commission.
Note: Output gap estimates for 2013 are calculated using forecasts for real GDP.

Chart 1.4 Unemployment rates, GDP growth and lending rates to the non-financial private sector in the euro area

(Sep. 2013; percentages)



Sources: Eurostat and ECB.
Notes: Real GDP growth data are forecasts for 2013. Unemployment data for Estonia and Greece are for August 2013. The size of the bubbles reflects the lending rates to the non-financial private sector.

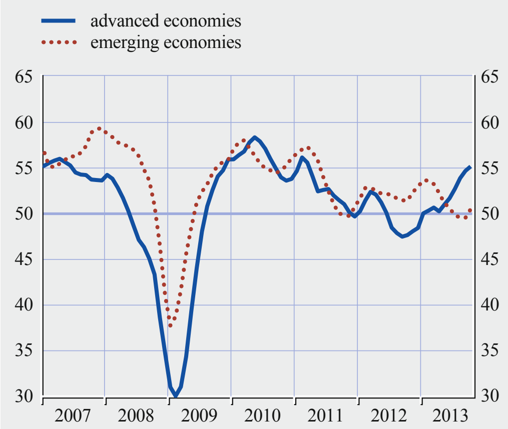
economies has gained some traction on the back of continued strong policy support, emerging economies – though remaining the main engine of global growth – have lost some of their high growth momentum observed in previous years (see Chart 1.5). This process has in many ways accelerated with the capital flow reversals from emerging market economies as part of a correction in global financial markets accompanying the US Federal Reserve's signalling that it may start to taper its bond-buying programme in late 2013.

Gradual recovery in advanced economies ahead…

Economic developments in the largest **advanced economies** outside the euro area suggest gradual recovery going forward. Nevertheless, the downside risks in the United States, Japan and the United Kingdom that have restrained growth since the onset of the crisis appear not to have fully abated. Weak labour market conditions, ongoing balance sheet

Chart 1.5 Purchasing manager indices in advanced and emerging economies

(Jan. 2007 – Oct. 2013; diffusion indices: 50+ = expansion; seasonally adjusted; three-month moving averages)



Sources: Markit and Haver Analytics.
Notes: Computed as a simple average of country-level purchasing manager indices (manufacturing). Advanced economies cover the euro area, Japan, the United Kingdom and the United States, while emerging economies cover Brazil, Russia, India and China.

adjustment in the financial and non-financial private sectors, continued tight private sector credit conditions and progressing albeit still incomplete fiscal consolidation in some countries continue to weigh on the medium-term growth outlook. However, most such growth-inhibiting factors are expected to dissipate, as the ongoing strong monetary policy support, further improving financial market conditions and a declining drag from fiscal consolidation bolster business and consumer confidence and slowly translate into more buoyant economic activity.

… but downside risks remain

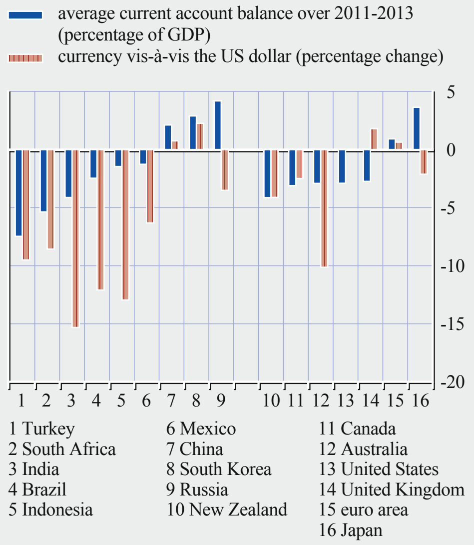
In the **United States**, economic recovery has continued on its moderate course, driven by a gradual recovery in labour and housing markets and easing headwinds from household deleveraging. Also, the monetary policy stance remains highly accommodative, despite the likely forthcoming reduction in asset purchases. Fiscal risks remain elevated as political impasses have become rather commonplace in the last years. Although the prospect of debt default was avoided in mid-October, the likelihood of this tail risk materialising cannot be fully ruled out going forward, particularly if possible ongoing political brinkmanship over the next fiscal deadlines continues, which could potentially translate into far broader financial market tensions and negative confidence effects. A financial stability risk relates to the rapid expansion of mortgage real estate investment trusts (MREITS). In particular, MREITS are vulnerable to rising interest rates due to their reliance on short-term borrowing to finance longer-term mortgage-backed security (MBS) purchases. A sharp sell-off in MBS holdings in the face of rising interest rates could expose banks to declines in the value of MBS holdings. In **Japan**, a positive near-term growth outlook is buttressed by supportive monetary and fiscal policy action, as well as the recent considerable financial market gains, which have had positive wealth effects. However, high fiscal imbalances and rising public debt levels remain a cause for concern in terms of both the sustainability of public finances and financial stability. In fact, banks hold large amounts of domestic government bonds on their books, so that any risk reassessment by financial markets could negatively affect the profitability and solvency of Japanese banks. In the **United Kingdom**, economic activity has accelerated recently, but the pace of recovery is likely to be limited by the still unfinished balance sheet repair in the private and public sectors as well as continued tight credit conditions. The recent modest pick-up in residential house prices could provide some relief for a highly indebted private sector in the short term, but it may also increase the risk of unsustainable price and debt dynamics in the longer term.

Emerging markets have lost momentum, but remain the engine of global growth

In contrast to the gradually improving activity in major developed countries, **emerging economies** have gradually lost steam over the course of 2013 as economic growth decelerated (see Chart 1.2). Financial conditions have tightened as lingering uncertainty regarding the US monetary policy stance and the economic growth outlook in major emerging economies, including concerns related to the stability of China's financial system, has taken its toll. Such uncertainty and concerns became manifest in capital flow reversals and strongly

Chart 1.6 Current account and foreign exchange rate developments in selected emerging and advanced economies

(2011 – 2013)



Source: Haver Analytics.
Note: Foreign exchange rate developments reflect the change during the period from 1 May to mid-September 2013.

depreciating exchange rates in a number of countries, particularly in those with poorer fundamentals (see Chart 1.6). For most emerging markets, the recent capital outflows have been relatively modest compared with similar episodes in the past (see Box 1) and mostly reflect a normalisation in asset prices after a prolonged period of accommodative financial conditions. Notwithstanding this adjustment, emerging economies are expected to remain the driving force behind global growth, but in some emerging economies structural factors – such as infrastructure bottlenecks and capacity constraints – may restrain potential growth. At the same time, a number of countries with large external imbalances and weaker growth prospects, or those in the late stage of the credit cycle, remain vulnerable to a deeper and more protracted deterioration in financing conditions.

Box 1

GAUGING THE MACROECONOMIC IMPACTS OF CHANGING FINANCIAL CONDITIONS IN EMERGING MARKET ECONOMIES

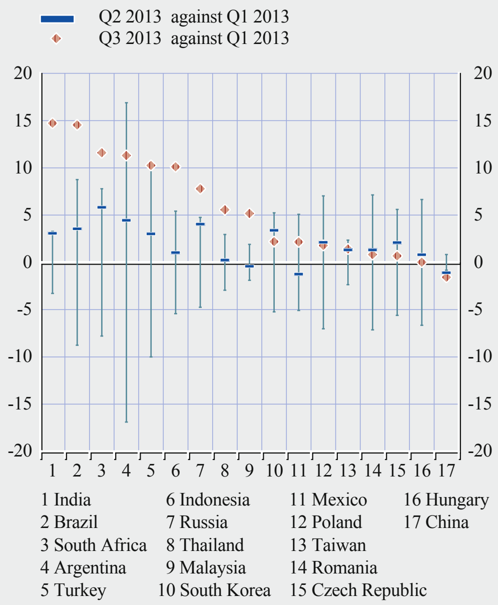
As macroeconomic conditions in advanced economies have started to improve, financial markets have priced in a normalisation of accommodative macroeconomic policies that have underpinned the recovery from the financial crisis. A corollary of this has been a capital flow reversal – sharp at times – in several emerging market economies, which intensified in early May after the US Federal Reserve signalled its intention to taper its bond-buying programme in late 2013. As the latest investment fund asset allocation data show a tendency to further rebalance portfolios away from emerging markets, this box assesses the growth implications of this activity and discusses potential repercussions for the euro area.

During the second and especially the third quarter of this year, conditions in foreign exchange, equity and sovereign bond markets deteriorated sharply in many emerging economies. Exchange rates weakened vis-à-vis the US dollar by more than 10% in India, Brazil, South Africa, Argentina, Turkey and Indonesia when compared with the first quarter of 2013 (see Chart A), while equities and government bonds experienced selling pressures across most regions (see Charts B and C).

Countries with perceived fragilities in macroeconomic fundamentals have generally been those subject to larger exchange rate and asset price drops. In more detail, concerns regarding Turkey relate to a substantial current account deficit which is largely financed by short-term portfolio flows and its unfavourable (short-term) external debt metrics. India, South

Chart A Exchange rate developments in selected emerging market economies

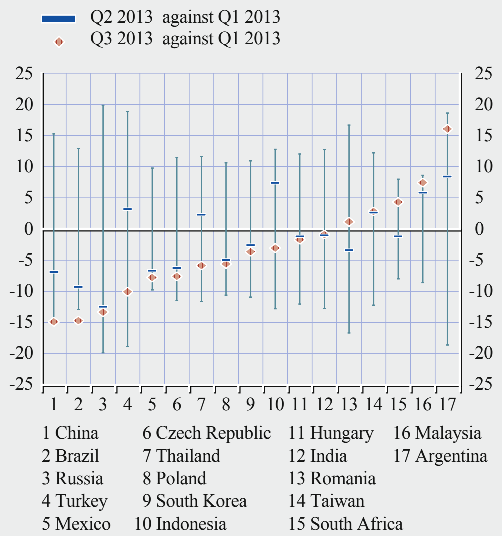
(percentage changes vis-à-vis the US dollar)



Source: Haver Analytics.
Notes: The green error bars denote one standard deviation of quarterly changes between 2000 and 2012. A rise in exchange rates indicates a depreciation of the currency.

Chart B Equity market developments in selected emerging market economies

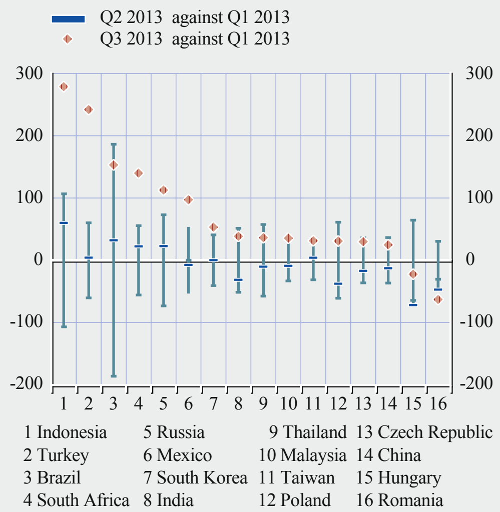
(percentage changes)



Sources: National sources and Haver Analytics.
Note: The green error bars denote one standard deviation of quarterly changes between 2000 and 2012.

Chart C Ten-year local currency sovereign bond yields in selected emerging market economies

(change in basis points)



Sources: JPMorgan and Haver Analytics.
Notes: The green error bars denote one standard deviation of quarterly changes between 2000 and 2012. Sovereign bond yields for Argentina are not available.

Africa and – to a lesser extent – Indonesia are displaying twin deficits in combination with a dependence on portfolio investment (South Africa) or buoyant credit growth (Indonesia). The latter is also a cause for concern in Brazil and China. Russia, by contrast, seems less vulnerable when compared with other emerging economies, but has nevertheless witnessed sizeable stock market losses and a significant depreciation of its currency. In spite of the prevalent macroeconomic and financial imbalances, countries in central and eastern Europe have been generally less affected by the global events, which is likely due to the ongoing adjustment of these imbalances.

The heterogeneous link between capital flow activity and domestic fundamentals suggests that elements that are not captured by the indicators most commonly used to assess domestic and external imbalances have possibly also played a role in the current emerging market asset repricing. These might include *credit* factors, such as other structural impediments to higher (potential) growth, exposure to a slowdown in Chinese output or the gradual recovery in economic activity in the euro area. However, they might also comprise *liquidity* factors, such as access to foreign currency in case of intense capital flight.

Results from two different models are used (see the notes to Table A for details) to estimate the impact of the changes in financial conditions for key emerging market economies on GDP growth. The models capture trade and financial linkages between the economies. For each country, the size of the shock to long-term bond yields and equity prices is given in Table A, based on the respective cumulative change in the second and third quarters of 2013. The model-based assessment of the substantial deterioration of financial conditions for selected emerging markets suggests that its impact on growth would be rather contained in emerging Asia, while some countries in Latin America would be more affected, owing to larger bond market spillovers from the United States.

Table A Estimated cumulative impact of changes in financial conditions on GDP growth in selected emerging market economies

(percentage point deviation from baseline levels)

	Cumulative impact		Shock	
			10-year sovereign yields	Equities
	2013	2014	*(bps)*	*(%)*
Brazil	-0.17	-0.60	155	-14.7
Russia	-0.11	-0.20	115	-13.3
India	0.06	0.00	39	-0.9
China	-0.05	-0.27	29	-14.9
South Africa	0.08	0.05	140	4.3

Source: ECB calculations.
Notes: The GDP impacts are average impacts across two models: NiGEM (maintained by the UK National Institute for Social and Economic Research) and a global VAR model, which includes 33 countries and is based on Dees, S., di Mauro, F., Pesaran, M. H. and Smith, V., "Exploring the International Linkages of the Euro Area: A Global VAR Analysis", *Journal of Applied Econometrics*, 2007. The Russia impact is modelled by NiGEM only.

Estimates range from a near-zero impact in India to a 0.6 percentage point cumulated output loss in Brazil by 2014. These results, while illustrative, could be subject to upside risks, such as a continuation or re-acceleration of the recently recorded tentative flows of capital back into emerging equity and bond markets, which may alleviate negative growth effects. At the same time, financial stability risks would arise if financing conditions in key emerging economies were to worsen beyond what has been observed to date, including the prospect of correlated declines with more widespread contagion.

For the euro area, the transmission of a deteriorating economic environment in emerging markets could stem from both trade and financial channels, which, however, suggest relatively contained direct impacts.

Table B Direct bilateral exposures of the euro area vis-à-vis selected emerging economies

	Euro area exposure		
	Cross-border bank claims (percentage of total claims) (Q2 2013)	Portfolio assets (percentage of total assets) (2011)	Merchandise exports (percentage of total euro area exports) (2012)
Czech Republic	3.0	0.4	3.8
Hungary	1.4	0.5	2.2
Poland	4.0	1.0	5.1
Romania	1.6	0.1	1.6
Russia	2.1	0.7	4.7
Turkey	2.3	0.6	3.3
China	1.7	1.1	7.0
India	0.9	0.6	1.6
Indonesia	0.2	0.5	0.4
South Korea	0.7	1.2	1.5
Malaysia	0.2	0.5	0.6
Taiwan	0.3	0.5	...
Thailand	0.1	0.3	0.6
Argentina	0.4	0.1	0.4
Brazil	3.6	1.5	1.7
Mexico	2.8	0.7	1.3
South Africa	0.2	0.6	1.0

Sources: IMF, BIS and national sources.
Notes: Net of intra-euro area exposure. Cross-border bank claims are based on data for Austria, Belgium, Finland, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal and Spain.

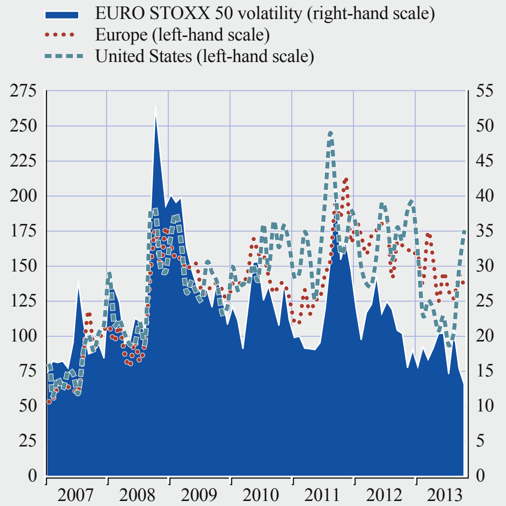
Trade linkages tend to be the strongest with emerging economies in the geographical neighbourhood of the euro area as well as with China, even though the prevailing global economic environment is clearly important, for instance, if economic conditions in the United States provide some offset. Concerning the financial channels of transmission, euro area portfolio investments in emerging bond and equity markets are relatively low and cross-border bank loans are predominantly geared towards selected countries in central and eastern Europe and Latin America (see Table B). Clearly, however, any sharper or more disruptive adjustment in emerging market economies needs to be closely monitored, given the potential for stronger and more persistent euro area impacts.

Economic growth prospects in emerging Europe hinge on the strength of euro area recovery…

Although not fully insulated from the global repricing of risk, **emerging European economies**, notably the EU countries in central and eastern Europe, have seen only limited effects compared with other emerging market regions. Clearly, reduced external and domestic imbalances as well as less abundant capital inflows over recent years serve as explanatory factors, but the prominent role of investors from the euro area in the region may have played a role too. The gradual economic recovery that seems to be under way in the region is a function of the strength and sustainability of the economic recovery in the euro area given close trade and financial linkages. On the domestic side, headwinds to economic recovery include the legacy balance sheet issues in the private and public sectors, as well as the ongoing contraction of credit to the private sector in a number of countries. In addition, declining residential house prices, existing currency mismatches on households' balance sheets as well as the high and often further increasing share of non-performing loans on banks' balance sheets continue to pose risks to economic recovery and financial stability in some countries. On the other hand, the ongoing gradual rebalancing of banks' funding structure towards a more self-sustained, domestically funded banking model should help mitigate risks to financial stability in the region.

Chart 1.7 Economic policy uncertainty in the United States and Europe

(Jan. 2007 – Oct. 2013; points)



Source: Baker, S., Bloom, N. and Davis, S. J., at www.policyuncertainty.com.
Notes: Europe comprises the five largest European economies France, Germany, Italy, Spain and the United Kingdom. The economic policy uncertainty index for the United States is constructed from three types of underlying components. The first quantifies newspaper coverage of policy-related economic uncertainty. The second uses disagreement among economic forecasters as a proxy for uncertainty. The third reflects the number of federal tax code provisions set to expire in future years. For Europe, the index is constructed on the basis of the first two components.

… while tighter financing conditions may weigh on the economic outlook in Asia and Latin America

The impacts of global rebalancing have perhaps been greatest for emerging economies in **Asia** and **Latin America**. After a prolonged period of strong capital inflows in the context of an increasing global search for yield, domestic and external vulnerabilities have come to the fore in a number of economies in the region. Although a number of countries might now be better prepared to cope with shocks compared with previous crises due to sizeable foreign reserves, the tightening of financial conditions following the global repricing of risk and the related capital outflows highlighted external funding risks, with a negative impact on asset prices. In both regions, risks remain tilted to the downside and mainly relate to stronger than expected spillovers from major advanced economies in the form of weak external demand, the potential renewed worsening of the euro area sovereign debt crisis as well as increased and more broad-based capital outflows which might stem from the US Federal Reserve's tapering. On the domestic side, recent years' rapid credit growth may pose a challenge to some countries in the context of slowing economic growth and the shift in the composition of financing away from bank lending towards non-bank lending.

Continued economic policy uncertainty weighs on global growth prospects…

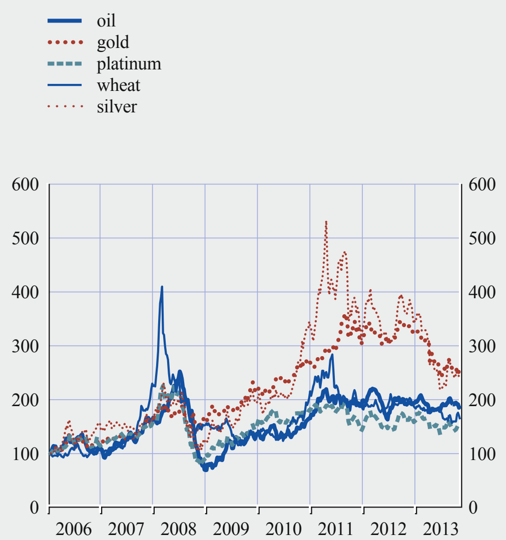
Taking all of the above regional developments into account, it is apparent that the global recovery remains muted and uneven across countries and regions. The recent volatility in financial markets underscores the fragility of the recovery and the uncertainty surrounding the global outlook. Risks are clearly tilted to the downside and continue to relate to a still high (and recently again increasing) level of economic **policy uncertainty** both in the United States and Europe (see Chart 1.7), possibly testing investor and consumer confidence going forward and posing a threat to economic recovery across the globe. While in the United States the uncertainty about the sustainability of public finances and the stance of monetary policy remains the main cause for concern, risks in the euro area predominantly relate to the possible resurfacing of the sovereign debt crisis, as mounting domestic political pressures and rising social tensions in some countries may ultimately translate into waning policy determination and reform commitment.

… as do persistent global real and financial imbalances…

A major underlying vulnerability at the global level stems from the real and financial **global imbalances** that remain high by historical standards, albeit narrowing considerably since the start of the global crisis. The largely cyclical nature of this rebalancing to date underscores the need to address long-lasting structural deficiencies. Also, despite marked corrections in some segments,

Chart 1.8 Selected commodity price developments

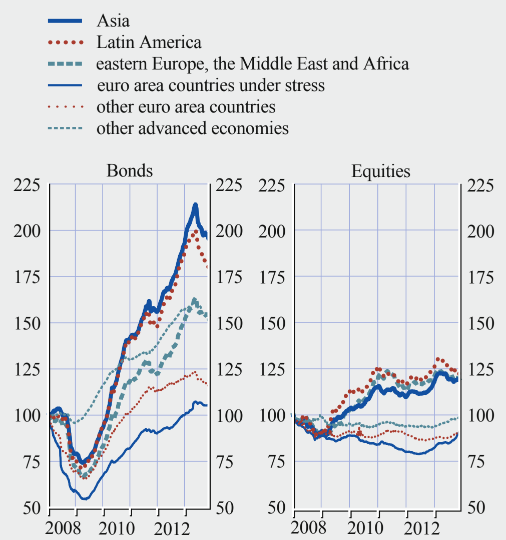
(Jan. 2006 – Nov. 2013; index: Jan. 2006 = 100)



Source: Bloomberg.

Chart 1.9 Equity and bond flows to advanced and emerging market economies

(Jan. 2008 – Nov. 2013; index: Jan. 2008 = 100)



Source: EPFR.
Note: Bonds include both sovereign and corporate bonds.

high and potentially further rising commodity prices (see Chart 1.8) that are largely driven by supply-side factors, such as the renewed flare-up of geopolitical tensions, may give rise to downside risks to global economic activity and may also contribute to preserving global imbalances. Finally, as indicated by the most recent episode of global risk reassessment and the related corrections in emerging bond and equity markets (see Chart 1.9), the risk of an abrupt, disorderly and possibly more broad-based unwinding of global safe-haven or search-for-yield flows in the context of the prospective exit from accommodative monetary policies by major central banks around the globe remains a cause for concern – particularly in bond markets with abundant inflows over the last years, where quantitative easing by the US Federal Reserve played a key role.

... with related risks to euro area financial stability

Overall, in contrast to the last years, macro-financial risks to euro area financial stability increasingly originate from outside the euro area. These external risks predominantly stem from continued uncertainties regarding the near-term economic growth path of major emerging markets and advanced economies outside the euro area, potential further corrections in financial markets across the globe and the possible further rise in commodity prices. Nonetheless, internal risks on the macro-financial side also remain and continue to comprise a potential resurfacing of the euro area sovereign debt crisis given continued policy uncertainty regarding the implementation of necessary structural and institutional reform measures, the ongoing process of balance sheet repair in the private and public sectors as well as the persistent fragmentation in the real and financial spheres. The materialisation of any of these risks may imply higher credit risk for banks, with possible negative implications for their asset quality, profitability and capitalisation. In this context, banks with high and rising non-performing loan levels, low coverage ratios and subdued profitability seem particularly vulnerable, even though broadly strengthened capital positions will serve as a risk-mitigating factor in the current uncertain and fragile macro-financial environment.

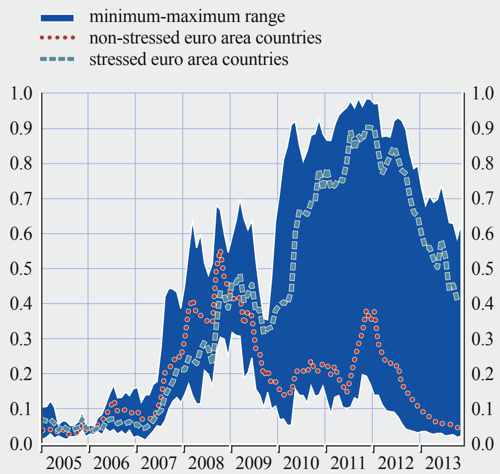
1.2 REDUCED SOVEREIGN STRESS, YET CONTINUED ADJUSTMENT REQUIRED

Sovereign stress in the euro area has remained contained…

Sovereign tensions in the euro area have remained contained due to better than expected macroeconomic data and improving confidence indicators, which have shown some first tentative signs of a gradual economic recovery and have helped to improve financial market sentiment. There has nonetheless been a temporary flare-up of sovereign tensions in more vulnerable euro area countries (see Chart 1.10) in the context of market participants' reassessment of the US monetary policy stance and, at times, heightened political risk in some countries. Overall, governments in vulnerable euro area countries have undertaken considerable reform efforts over the past two years as measured by the OECD's reform responsiveness rate indicator (see Chart 1.11) and have made notable progress in reducing fiscal imbalances. However, progress has been uneven across

Chart 1.10 Composite indicator of systemic stress in euro area sovereign bond markets (SovCISS)

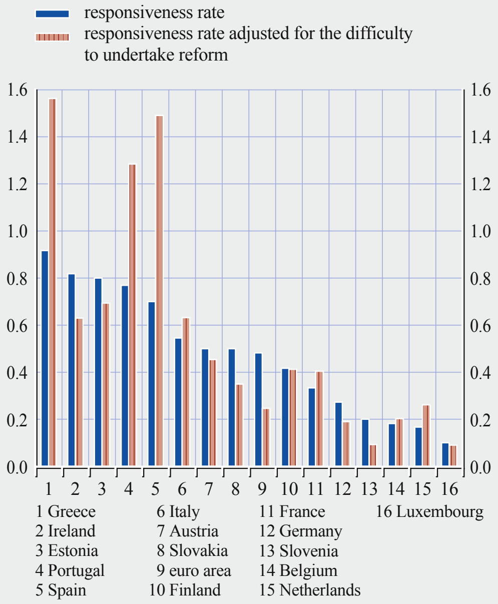
(Jan. 2005 – Nov. 2013)



Sources: ECB and ECB calculations.
Notes: Aggregation of country indicators capturing several stress features in the corresponding government bond markets (changing default risk expectations, risk aversion, liquidity risk and uncertainty) for "non-stressed" (Austria, Belgium, Germany, Finland, France and the Netherlands) and "stressed" (Greece, Ireland, Italy, Portugal and Spain) countries. The range reflects the maximum and minimum across the entire set of above-mentioned countries. For further details on the CISS methodology, see Hollo, D., Kremer, M. and Lo Duca, M., "CISS – a composite indicator of systemic stress in the financial system", *Working Paper Series*, No 1426, ECB, March 2012.

Chart 1.11 Responsiveness to the OECD's Going for Growth recommendations across the euro area

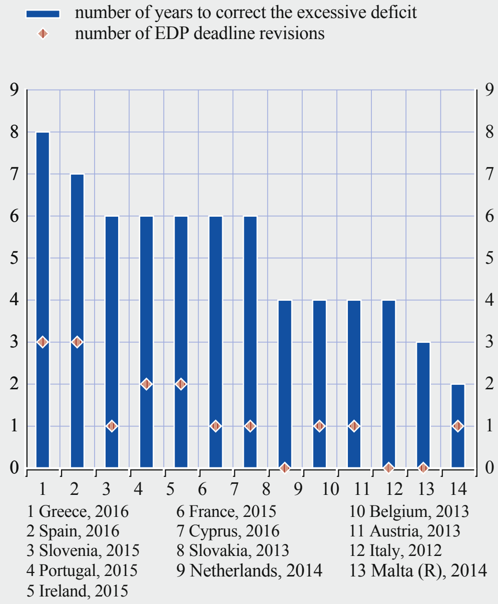
(2011 – 2012)



Source: OECD.
Notes: The reform responsiveness rate indicator is based on a scoring system in which recommendations set in the previous edition of Going for Growth take a value of one if significant action is taken and zero if not. The adjusted responsiveness rate weighs the responsiveness on each individual priority according to the difficulty of undertaking the relevant reform. The difficulty is measured by the inverse of average responsiveness to priorities in this area in non-crisis circumstances across the OECD. The indicators measure the extent to which OECD countries have followed up on Going for Growth recommendations, but they do not aim to assess overall reform intensity *per se*, as the indicators do not account for reforms carried out in non-priority areas and do not quantify the importance of each individual measure. For methodological details see Annex 2.A1 in OECD, *Going for Growth 2010*, March 2010.

Chart 1.12 Timetable for the correction of excessive deficits

(years; number of deadline extensions under EDP to bring fiscal deficits below 3% of GDP)



Sources: ECB and European Commission.
Notes: The year next to the country abbreviation denotes the latest EDP deadline for correction of excessive deficits. The blue bars denote the total number of years (including revisions) granted for the correction of excessive deficits (one year after their identification). Malta (R) denotes the reopening of the EDP for Malta.

countries, pointing to the need for further structural and fiscal reforms in countries with persistent macroeconomic imbalances.

... but vulnerabilities continue to persist in many countries...

Notwithstanding the efforts made in consolidating public finances, **fiscal deficits** remain excessive – that is, projected by the European Commission to be above the 3% of GDP threshold in 2013 – in most euro area countries.[1] Several countries under stress could not reduce their excessive deficits by the originally envisaged deadlines, primarily on account of weaker than expected macroeconomic conditions and/or explicit or implicit support to their financial sectors. In some cases, these deadlines had already been extended several times (see Chart 1.12), most recently under the 2013 European Semester in mid-June, when Portugal and the Netherlands received a one-year extension, while two extra years to correct their excessive deficits were granted to France, Slovenia and Spain. The excessive deficit procedure (EDP) was reopened for Malta and stepped up for Belgium, while it was abrogated for Italy.

1 All euro area countries with the exception of Austria, Belgium, Estonia, Finland, Germany and Luxembourg, as well as Italy and Slovakia (in the latter two countries, deficits are projected to be at the reference value).

… hence, reform fatigue and complacency should be avoided

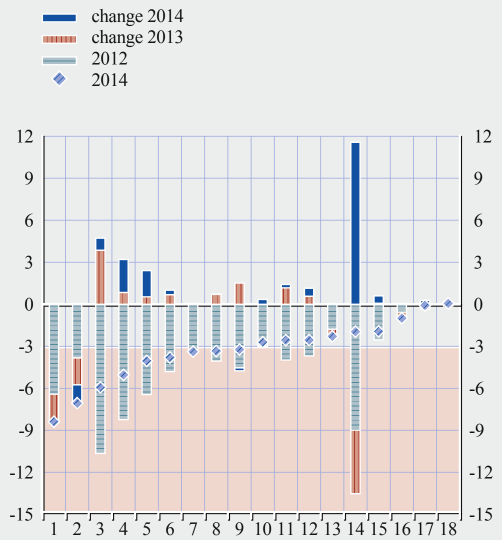
In this context, concerns mainly relate to governments' willingness and ability to continue with the implementation of fiscal and structural reforms in the context of a still weak, albeit improving, economic outlook, domestic political pressures and social tensions. Moreover, the recent relative calm in euro area financial markets, while in many ways a welcome respite from the stressed conditions only a little over a year ago, may breed complacency in terms of fiscal consolidation and structural reforms. Any associated wavering in the credibility of public finances harbours the potential to increase uncertainty and, at the limit, even to trigger further negative rating actions on sovereigns, with adverse feedback loops to the financial sector. Thus, firmly abiding by fiscal commitments under the European governance framework would help to create sufficient fiscal space to support credible national backstops for banking sector distress.

The fiscal outlook for 2013 has deteriorated slightly…

Under current government plans, the fiscal deficit for the euro area as a whole is projected to decline from 3.7% of GDP in 2012 to 3.1% in 2013 and further to 2.5% in 2014. The projected deficit in 2013, as reflected in the European Commission's autumn 2013 forecast, has deteriorated slightly compared with what was anticipated six months ago, as the better than expected GDP performance – mainly export-driven in many countries – has often not translated into higher tax revenues. At the country level, the fiscal outlook for 2013 is less optimistic compared with the previous forecast for 11 out of the 17 euro area countries. Still, compared with 2012, fiscal balances are expected to improve or remain broadly unchanged in the majority of countries, with more pronounced negative changes being projected only for Cyprus, Greece and Slovenia (see Chart 1.13), in the latter two due to temporary banking sector-related factors (particularly large and expected to be reversed in 2014 in Greece).

Chart 1.13 Fiscal positions across the euro area over the period 2012-14

(2012 – 2014; percentage of GDP)

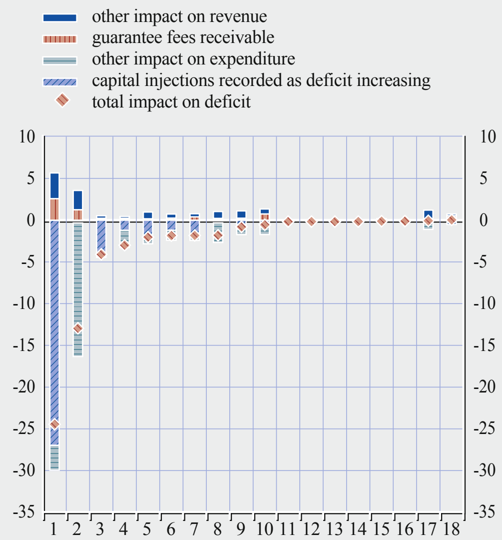


1 Cyprus
2 Slovenia
3 Spain
4 Ireland
5 Portugal
6 France
7 Malta
8 Netherlands
9 Slovakia
10 Italy
11 Belgium
12 euro area
13 Finland
14 Greece
15 Austria
16 Luxembourg
17 Estonia
18 Germany

Source: European Commission autumn 2013 economic forecast.
Note: Figures for 2013 and 2014 are projections.

Chart 1.14 Cumulative impact of financial sector support on the fiscal balance by type of operation

(2008 – Sep. 2013; percentage of GDP)



1 Ireland
2 Greece
3 Spain
4 Portugal
5 Slovakia
6 euro area
7 Austria
8 Germany
9 Netherlands
10 Belgium
11 Estonia
12 Malta
13 Slovakia
14 Finland
15 France
16 Italy
17 Luxembourg
18 Cyprus

Source: ESCB.

… but the outlook for 2014 has improved due to continued consolidation

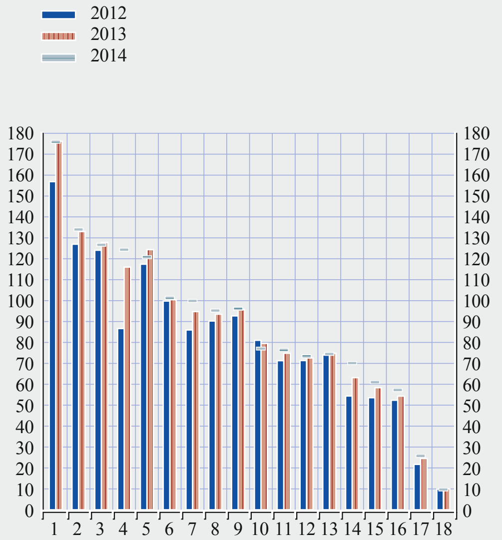
As part of the latest euro area institutional reform, with the "two-pack" having entered into force in May 2013, draft budgetary plans have to be prepared earlier than in previous years in some countries for peer scrutiny at the EU level. These plans will be assessed by the European Commission, which will issue opinions on whether they are in compliance with the budgetary policy obligations laid down in the Stability and Growth Pact. In the event that the European Commission arrives at an assessment of "particularly serious non-compliance", it is expected to request a revised draft budgetary plan. If strictly applied, the two-pack regulation will be an important tool to further strengthen the effectiveness of fiscal surveillance in the euro area. Taking into account the additional consolidation measures specified in the 2014 national budgets so far, the European Commission's autumn 2013 forecast indicates for the euro area as a whole an improvement of the structural fiscal position by around 0.3 percentage point. This is also reflected in the reduction of the headline deficit figure to 2.5% of GDP from 2.8% projected six months ago.

Financial sector support continues to weigh on public finances

In some cases, fiscal positions are expected to be affected (albeit to differing degrees) by public support granted to the financial sector. This had, up to September 2013, the most marked negative impact on the budget deficits in Ireland, Greece and, to a lesser extent, Spain. Since the onset of the financial crisis, public support to the financial sector has taken various forms, but the largest deficit-increasing impact relates in most countries, as well as at the aggregate euro area level, to capital injections. On the revenue side, fees in exchange for state guarantees extended to financial institutions, and other temporary levies, have had a deficit-reducing impact, so far with a slight positive net effect on the balance in France, Italy, Luxembourg and Cyprus (see Chart 1.14).

Chart 1.15 Public debt levels across the euro area

(2012 – 2014; percentage of GDP)

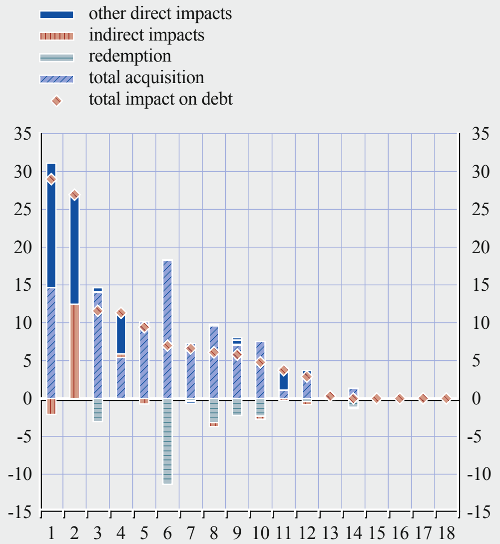


1 Greece
2 Italy
3 Portugal
4 Cyprus
5 Ireland
6 Belgium
7 Spain
8 France
9 euro area
10 Germany
11 Netherlands
12 Malta
13 Austria
14 Slovenia
15 Finland
16 Slovakia
17 Luxembourg
18 Estonia

Source: European Commission autumn 2013 economic forecast.

Chart 1.16 Cumulative impact of financial sector support on public debt by type of operation

(2008 – Sep. 2013; percentage of GDP)



1 Ireland
2 Greece
3 Germany
4 Portugal
5 Cyprus
6 Netherlands
7 Luxembourg
8 Belgium
9 euro area
10 Spain
11 Slovenia
12 Austria
13 Italy
14 France
15 Estonia
16 Malta
17 Slovakia
18 Finland

Source: ESCB.

Public debt levels remain elevated and continue to rise in most countries in 2014

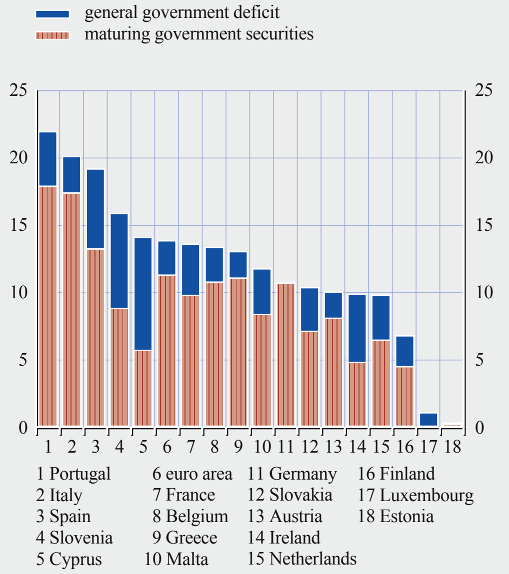
At the euro area level, the **public debt**-to-GDP ratio has exhibited a mild increase over the course of this year. The European Commission expects the debt ratio to peak in 2014 at around 96% of GDP, mainly on account of adverse interest rate-growth differentials and stock-flow adjustments. Public debt ratios are projected to rise in 2014 in all euro area countries with the exception of Austria, Estonia and Germany, as well as three programme countries (Greece, Ireland and Portugal). Overall, the largest increase in the debt ratio for 2014 is projected in Cyprus, followed by Slovenia and Spain (see Chart 1.15). This stems from liabilities related to the financial sector, adverse interest rate-growth differentials and still high primary deficits in some countries. Concerning the operations to support the financial sector since 2008, the acquisition of assets (comprising new shares, provision of new loans and other asset purchases) has added most to gross public debt in the majority of countries (see Chart 1.16). In particular in countries which extended support to the financial sector at the beginning of the crisis, such as Austria, Belgium, Germany, France and the Netherlands, the (partly early) repayment of state aid by banks is starting to have a debt-reducing impact.

Financing needs are expected to decline in 2014, but they remain sizeable in some countries

Financial stability risks may also emanate from near-term **sovereign financing needs**, in particular in euro area countries under stress. Based on available information on securities redemptions up to end-September – thus excluding part of the short-term debt refinancing requirements in

Chart 1.17 Maturing securities and projected deficit financing needs of euro area governments in 2014

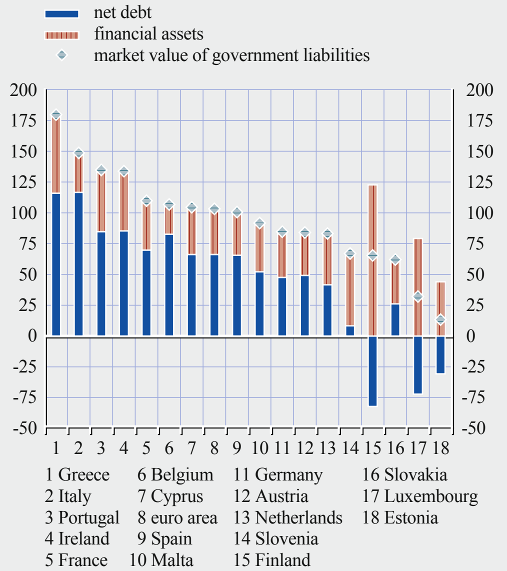
(percentage of GDP)



Sources: European Commission autumn 2013 economic forecast, ECB and ECB calculations.
Notes: Data on maturing securities as at end-September 2013. The gross financing needs for 2013 are broad estimates consisting of redemptions of government debt securities maturing in 2013 and the government deficit. The estimates are subject to caveats. First, they only account for redemptions of securities, while maturing loans are not included, given the lack of data. Second, some government securities do not fall into the definition used in the ESA 95 for general government debt. Third, estimates disregard that some maturing government securities are held within the government sector. Finally, refinancing needs corresponding to short-term debt issued after September 2013 are not reflected in the 2013 data.

Chart 1.18 Euro area governments' net debt, market value of government liabilities as well as financial assets

(Q2 2013; percentage of GDP)



Sources: Eurostat, national sources and ECB calculations.

2013 – the 2014 gross financing needs, though declining given lower deficits and broadly lower redemptions, remain significant in many euro area countries (see Chart 1.17).

Maturing sovereign debt in the near-to-medium term remains considerable in the euro area, albeit with major cross-country differences. As at end-September 2013, securities with a residual maturity of up to one year accounted for 20% of total debt securities outstanding in the euro area, while slightly below one-third of the debt securities outstanding will mature within two years, and somewhat below 60% within five years. The average residual maturity of outstanding euro area government securities was 6.3 years as at end-September 2013, ranging from 3.4 years in Cyprus to 12.1 years in Ireland.

The sale of financial assets could mitigate financing needs

To some extent, sovereign financing needs could be mitigated via recourse to existing financial assets. As at mid-2013, the average amount of consolidated financial assets held by euro area governments stood at 37% of GDP, with some variation across countries, while the market value of consolidated government liabilities was in the order of 103% of GDP (see Chart 1.18). Accordingly, the net debt of euro area governments totalled 66% of GDP. Overall, the use of financial assets for smoothing governments' financing needs depends on their liquidity and marketability, which is arguably lower in times of crisis. Nevertheless, government holdings of financial assets are relevant for assessing sovereign debt sustainability over the medium term, in that a larger proportion of these financial assets could be sold off.

1.3 A MUTED MACROECONOMIC OUTLOOK AND PERSISTENT FRAGMENTATION WEIGH ON THE NON-FINANCIAL PRIVATE SECTOR

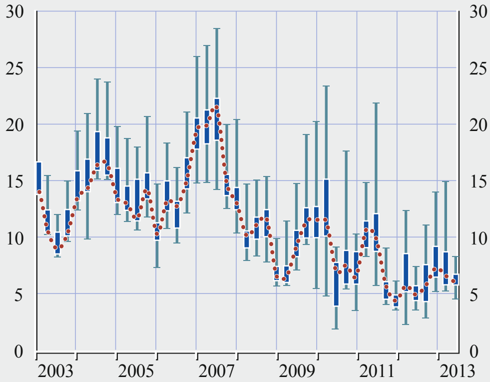
Weak economic conditions amplify income and earnings risks

As euro area macroeconomic conditions have remained weak, **income and earnings risks** in the euro area non-financial private sector have remained significant. For households, the distance-to-distress indicator has remained close to its historical low, thereby signalling continued high credit risk derived from household balance sheets, albeit amid a rather high degree of cross-country dispersion (see Chart 1.19). Although some first tentative signs of economic recovery in the euro area have emerged, euro area households still remain relatively pessimistic with regard to their unemployment expectations and their financial situation (see Chart 1.20). In fact, high – albeit recently stabilising – unemployment rates continue to weigh on households' income prospects in many euro area countries, while the continued decline in household saving rates in some countries indicates reduced buffers going forward, leaving households in a fragile position in case of further adverse income shocks (Box 2 presents an analysis of the sensitivity of household debt burden indicators to interest rate and house price shocks).

A challenging macroeconomic environment also puts the earnings-generating capacity of euro area non-financial corporations (NFCs) to the test, as indicated by rather low levels of corporate profitability as well as the high – and in more vulnerable countries further increasing – number of corporate insolvencies. That said, some first tentative signs of improvement in corporate profitability are already visible, as reflected by a slight pick-up in gross operating income and the drop in corporations' expected risk of default. While these signs are promising, with an only gradual economic recovery, corporate earnings in the euro area are expected to increase slowly and to remain at a relatively low level going forward. Hence, firms' capacity to accumulate capital through retained earnings is likely to remain limited, implying a higher degree of dependence on external financing, while at the same time slowing down the process of corporate deleveraging.

Chart 1.19 Households' distance to distress in the euro area

(Q1 2003 – Q2 2013; number of standard deviations)



Sources: ECB, Bloomberg, Thomson Reuters Datastream and ECB calculations.
Notes: A lower reading of distance to distress indicates higher credit risk. The chart shows the median, minimum, maximum and interquartile distribution across 11 euro area countries for which historical time series cover more than one business cycle. For details on the indicator, see Box 7 in ECB, *Financial Stability Review*, December 2009.

Chart 1.20 Euro area households' financial situation and unemployment expectations

(Jan. 2003 – Oct. 2013; percentage balances; three-month moving averages)

Source: European Commission Consumer Survey.
Note: Unemployment expectations are presented using an inverted scale, i.e. an increase (decrease) of this indicator corresponds to more (less) optimistic expectations.

Box 2

FINANCIAL FRAGILITY OF EURO AREA HOUSEHOLDS

The severity of the global financial crisis has entailed significant consequences for the real economy. Households, which account for the largest component of economic activity, have experienced the effects of this crisis in different ways, also translating into growing financial strains. Monitoring households' debt servicing capability is therefore vital from a financial stability perspective, not least given the associated impact on the profitability and solvency of banks.

One rich source of information on euro area households' balance sheets is the recently published Eurosystem Household Finance and Consumption Survey (HFCS), a novel dataset which collects information on the wealth, income and consumption patterns of more than 62,000 euro area households.[1] This box makes use of micro data from the survey to provide a simple gauge of households' potential sensitivity to changes in interest rates and house prices.

The first sensitivity analysis captures an interest rate shock to households' debt service-to-net income ratio, as a means to assess the capacity of households to repay debt without recourse

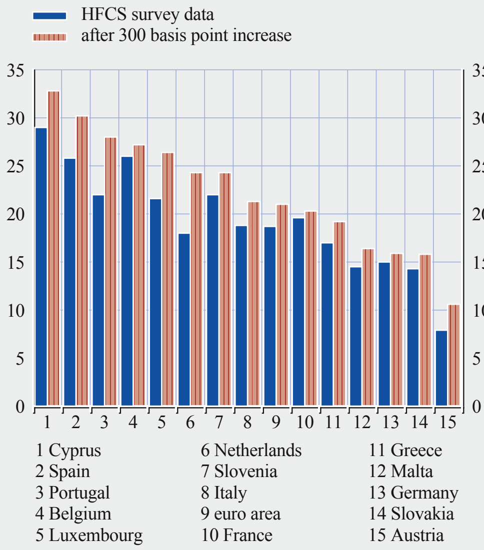
1 All euro area countries are included in the survey except for Estonia and Ireland. For a complete picture of euro area households' balance sheet composition, see "The Eurosystem household finance and consumption survey – results from the first wave", *Statistics Paper Series*, No 2, ECB, April 2013.

to their assets.[2] The effect of a 300 basis point interest rate increase on the debt service-to-net income ratio is assessed,[3] which is equivalent to the total interest rate cuts carried out by the ECB between October 2008 and mid-2010. The rise in interest rates affects the ratio via the increase of debt payments and the increase of financial income received from interest-paying accounts[4]. In both cases, a 100% pass-through of the official interest rate is assumed. It is also assumed that loans with a fixed interest rate are not affected by the shock. The ratios are updated mechanically with the new debt payment and income stream after the shock, so any behavioural reactions by households are ignored.

The results show that the impact of the interest rate shock on the median debt service-to-net income ratio for the euro area is rather small, increasing from 18.7% to 21.0%. However, there is substantial variability in the impact across countries. The median ratio increases the most in the Netherlands and Portugal, while in other countries like France and Germany the impact is minimal (see Chart A). Looking at the proportion of households which have a debt service-to-net income ratio greater than 0.4 – a threshold that is used in the literature as an indication of household distress – the increase in interest rates would have a substantial impact on the number of households in this situation. For the whole euro area, 16.0% of households find themselves

Chart A Impact of an interest rate shock on the median household debt service-to-net income ratio

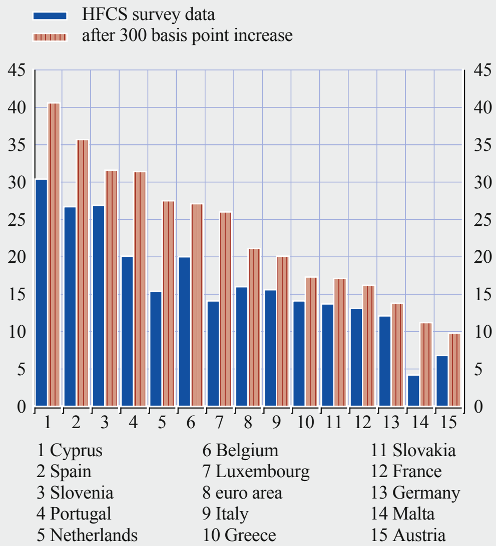
(2010; percentages; median of indebted households)



Sources: HFCS, OECD and ECB calculations.
Notes: Income is the income after tax, based on own calculations using tax brackets reported by the OECD. Finland is excluded because no data are collected on debt service. HFCS survey data refer to 2010 in all countries, except for Finland, Greece and the Netherlands (all 2009) and Spain (2008).

Chart B Impact of an interest rate shock on the proportion of households with a debt service-to-net income ratio above 0.4

(2010; percentage of indebted households)

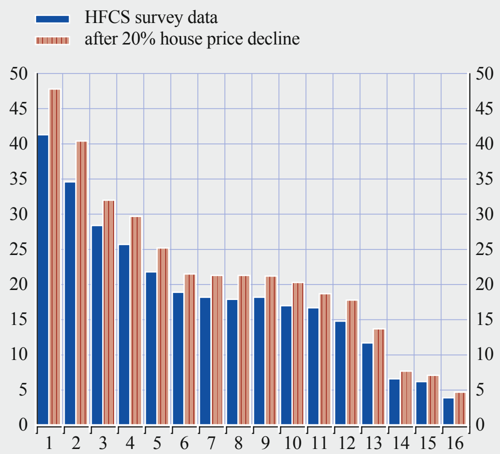


Sources: HFCS, OECD and ECB calculations.
Notes: Income is the income after tax, based on own calculations using tax brackets reported by the OECD. Finland is excluded because no data are collected on debt service. HFCS survey data refer to 2010 in all countries, except for Finland, Greece and the Netherlands (all 2009) and Spain (2008).

2 The numbers presented in this box for the debt service-to-net income ratio differ from those published in the HFCS. As it is a more relevant measure for assessing households' debt servicing capability, net (instead of gross) income is used.
3 A similar simulation has been conducted by Ehrmann, M. and Ziegelmayer, M., "Household risk management and actual mortgage choice in the euro area", January 2013 (paper presented at the EEA Annual Congress in August 2013). However, they do not take into account the effect of the interest rate change on the income derived from deposits and they consider gross instead of net income.
4 We ignore the fact that in some countries deposits might be non-interest-bearing or subject to fixed rates.

Chart C Impact of a house price shock on the median debt-to-assets ratio

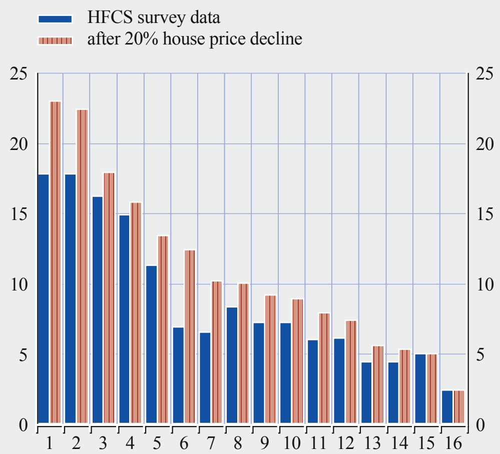
(2010; percentages; median of indebted households)



Sources: HFCS and ECB calculations.
Note: HFCS survey data refer to 2010 for all countries, except for Finland, Greece and the Netherlands (all 2009) and Spain (2008).

Chart D Impact of a house price shock on the proportion of households with a debt-to-assets ratio above 1

(2010; percentage of indebted households)



Sources: HFCS and ECB calculations.
Note: HFCS survey data refer to 2010 for all countries, except for Finland, Greece and the Netherlands (all 2009) and Spain (2008).

in this situation, a number that increases to 21.1% after the interest rate shock. Again, there is considerable variability in the impact across individual countries. In some countries, such as Cyprus and Spain, more than one-third of the indebted households have debt service-to-net income ratios greater than 0.4 after the interest rate shock. In others like France or Germany the numbers are still contained (see Chart B).

The second sensitivity analysis applied is a shock to house prices, with net worth impacts captured through the debt-to-assets ratio and associated information about the solvency of households.[5] The impact of a 20% decline in house prices on this ratio is analysed, in line with average shocks used in other studies.[6] The impact of the shock is relatively small, despite some variability across individual countries in the sample. The drop in house prices increases the debt-to-assets ratio by somewhere between 0.8 and 6.5 percentage points (see Chart C).

Households with a debt-to-assets ratio greater than 1 are said to have negative equity and pose a specific threat to financial stability. According to the HFCS data, 11.3% of indebted households in the euro area have negative equity. Again, there is a large degree of cross-country heterogeneity, ranging from 2.4% in Malta to almost 18% in Finland and the Netherlands (see Chart D). Households' sensitivity to changes in house prices is also uneven across the countries in the sample. For example, in the case of Malta or Slovenia the house price shock would have no effect on households' debt-to-assets ratios at all, while in both Finland and the Netherlands the number of households in negative equity would increase to some 23.0%.

5 Assets include both real and financial assets. Public and occupational pension plans are excluded due to the lack of coverage of these assets by the HFCS.
6 See IMF, *Financial Sector Assessment Program Update: Spain*, June 2012, and Albacete, N. and Fessler, P., "Stress Testing Austrian Households", *Financial Stability Report*, Oesterreichische Nationalbank, June 2010.

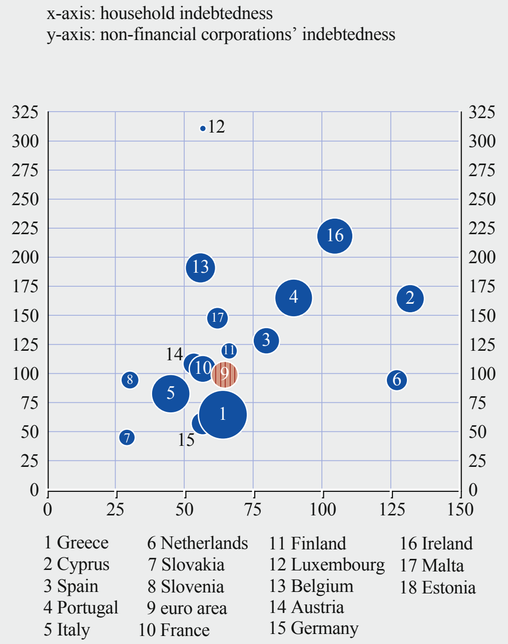
All in all, the findings presented in this box suggest that at the euro area level the impact of these shocks tends to be relatively small, although this aggregate masks substantial cross-country heterogeneity. The effect of an interest rate shock on the debt service-to-net income ratio tends to be greater for countries with a high proportion of adjustable interest rate mortgages, such as Cyprus, the Netherlands, Portugal and Spain, and rather small for euro area countries like France or Germany, in which fixed interest rate mortgages prevail. In the case of a house price shock, the debt-to-assets ratio of Dutch and Finnish households seems to be affected the most.

Indebtedness remains high amid increasing cross-country divergence

In contrast to the rather widespread weak income and earnings prospects within the euro area non-financial private sector, the level of **indebtedness** continued to differ considerably across countries. On aggregate, the indebtedness of euro area households and non-financial corporations has remained fairly stable at some 66% and 100% of GDP, respectively (see Chart 1.21), for several years now. However, the divergence of these aggregates across countries appears to have risen. This development can partly be explained by cyclical factors, including the strong contraction of economic activity, in particular (but not only) in countries under stress. At the same time, in the case of non-financial corporations, structural factors may have played a role too. In fact, firms' access to finance differs between large and mature firms which have access to market-based funding, on the one hand, and small and infant firms which are more reliant on bank-based financing and face tight credit conditions, on the other hand.

Chart 1.21 Indebtedness in the euro area non-financial sector

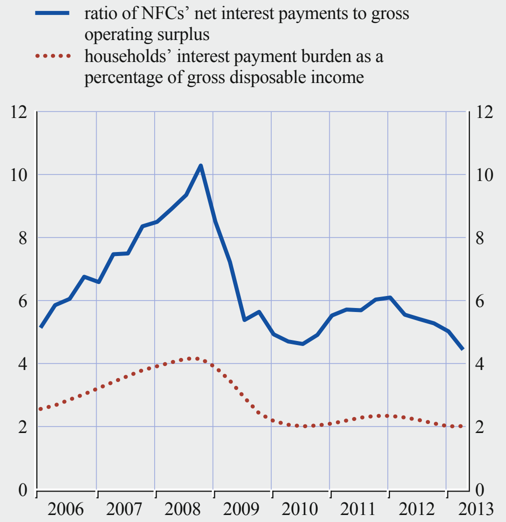
(Q2 2013; percentage of GDP)



Sources: ECB and Eurostat.
Notes: The size of the bubbles reflects the indebtedness of the general government. Data on non-financial corporations include cross-border inter-company lending, which may be particularly relevant for countries where international holding companies are traditionally located (e.g. Ireland and Luxembourg).

Chart 1.22 Interest payment burden of the euro area non-financial private sector

(Q1 2006 – Q2 2013; percentages)



Sources: ECB and Eurostat.

With a delicate economic recovery, the balance sheet repair in the non-financial private sector will be a gradual and longer-term process, in particular in the case of households given institutional obstacles to household defaults and subdued prospects for income growth as a result of persistent labour market weaknesses. In countries with high levels of non-financial private sector indebtedness, the deleveraging process may also continue to affect loan demand for a protracted period of time and to weigh on domestic demand. Thus, a solid and sustained recovery, coupled with an enhanced restructuring process in the financial and non-financial sectors, seems indispensable for households and non-financial corporations to be able to repair their balance sheets more swiftly.

Favourable interest rate conditions facilitate debt service

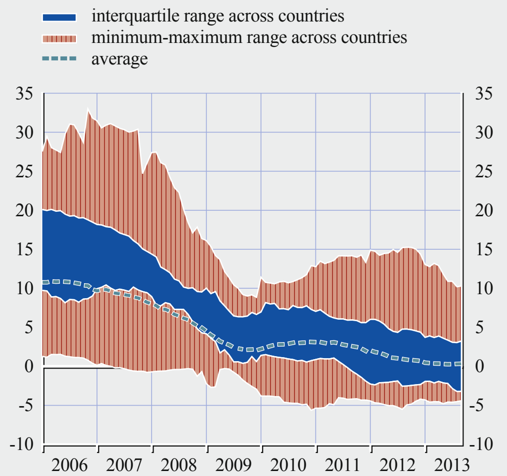
In the current low interest rate environment, households' interest payment burden as a share of disposable income fell to 2%, one of the lowest levels since the start of the third stage of Economic and Monetary Union. In addition to the favourable interest rate conditions, non-financial corporations' debt servicing capacity is also supported by the low cost of market-based funding in some countries, so that on average euro area firms' net interest payments relative to their gross operating surplus fell to the lowest level on record (see Chart 1.22). In view of the subdued outlook for prices and activity, interest rates should stay at low levels for an extended period of time, as emphasised by the ECB's forward guidance. Looking further into the future, balance sheet adjustment should help households and non-financial corporations in case of an eventual normalisation of interest rates to avoid challenges associated with a rising debt servicing burden. Such challenges might be greatest in particular for those countries where loans with floating rates or with rates with a relatively short fixation period predominate. Obviously, a higher debt service burden for borrowers in a rising interest rate environment is likely to be partly offset by the related positive impact of an economic recovery on households' and firms' income and earnings situation.

Bank lending to the non-financial private sector remains muted amid first signs of improving financing conditions

Lending flows to the non-financial private sector have remained weak, reflecting the ongoing balance sheet repair as well as weak income and earnings flows in both the financial and non-financial sectors. Bank lending to euro area households has remained subdued, but appears to

Chart 1.23 MFI lending to euro area households

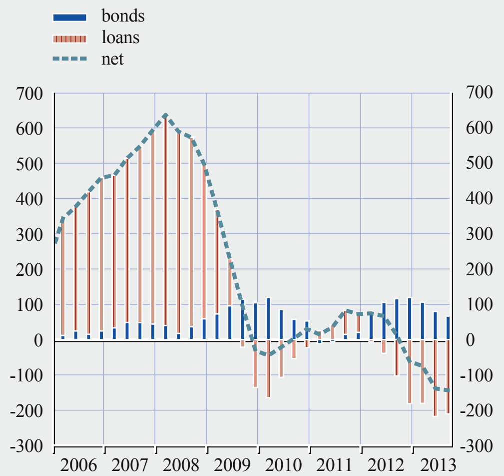
(Jan. 2006 – Sep. 2013; percentage change per annum)



Source: ECB.
Note: Data adjusted for securitisation.

Chart 1.24 External financing of euro area non-financial corporations

(Q1 2006 – Q3 2013; EUR billions; net annual flows)



Sources: ECB and ECB calculations.

have stabilised. However, rather heterogeneous developments at the country level form the basis of the relatively weak aggregate picture (see Chart 1.23). Looking at the components of bank lending by purpose, a mild but still positive annual growth in loans for house purchase is offset by net redemptions in consumer credit and other types of lending. The generally subdued bank lending to households reflects more prominently demand-side factors, even though supply-side constraints underpinned by both cyclical and structural effects also continue to play a role, in particular in countries under stress. Nevertheless, in line with the first tentative signs of economic recovery, the October 2013 euro area bank lending survey suggests an improvement of households' financing conditions, as reflected by the further decline in the degree of net tightening of credit standards on loans to households and the net increase in demand for such loans recorded for the first time since the end of 2010.

Supply-side constraints on lending appear to be easing particularly concerning euro area households. As reported by the euro area bank lending survey for the third quarter of 2013, the net tightening of credit standards applied to housing loans and consumer credit decreased to a level below historical averages (the survey was first conducted in the first quarter of 2003). Improving supply-side conditions indicate not only lower pressures coming from the cost of funds and balance sheet constraints, but also improved expectations concerning the economic outlook and the creditworthiness of consumers. In terms of credit demand, enhanced housing market prospects and consumer confidence have translated into a net increase in the demand for both housing loans and consumer credit for the first time since late 2010.

A drop in bank lending to NFCs…

The net external financing of euro area firms continued to fall in 2013 (see Chart 1.24). The lower demand for external financing was partly related to the weak economic conditions and muted investment dynamics. According to the latest euro area bank lending survey, the demand for corporate loans in the euro area continued to contract, albeit at a slower pace. This reflected lower financing needs for investments which more than compensated for the increase in financing needs due to inventories. However, the availability of internal funds may also explain the moderate dynamics of external financing in some countries, in particular for large firms. Regarding small firms, the survey on the access of small and medium-sized enterprises (SMEs) to finance in the euro area portrayed a bleaker picture. Turning to credit supply, euro area banks' credit standards for loans to enterprises have remained tight, but the net percentage changes in credit standards reveal some stabilisation in credit conditions for firms since the beginning of 2013. Since then, risk perceptions appear to have had a stronger effect on credit supply conditions, while, following the ECB's standard and non-standard policy measures, balance sheet or funding constraints of banks exerted less pressure on the tightening of credit standards.

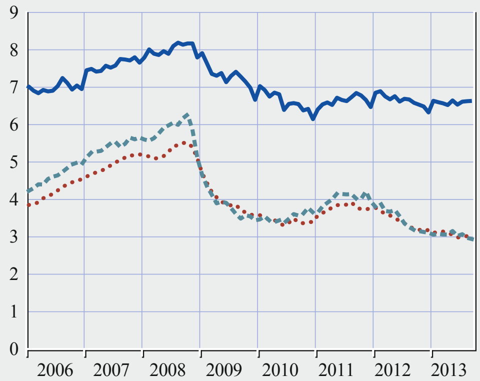
… is partly offset by the issuance of market-based debt

In terms of the components of external financing, corporate disintermediation continued, but the issuance of market-based debt fell short of compensating for the decline in new MFI loans to non-financial corporations (see Chart 1.24). These developments suggest that some firms were able to diversify their funding sources in response to tighter bank lending standards, although such substitution has mainly remained limited to larger companies and those which are mostly domiciled in countries with more developed corporate bond markets. At the same time, those corporations that are more dependent on bank funding, like SMEs and firms located in stressed countries, have remained vulnerable to persistently tight credit supply conditions. In fact, the latest survey on SMEs' access to finance confirmed that financing conditions for SMEs remained diverse across the euro area, with clear financing obstacles for SMEs in countries that have been more strongly affected by the crisis. To alleviate some of these constraints and improve the funding conditions

Chart 1.25 Euro area bank lending rates on new loans to households

(Jan. 2006 – Sep. 2013; percentages)

- consumer lending
- lending for house purchase
- other lending

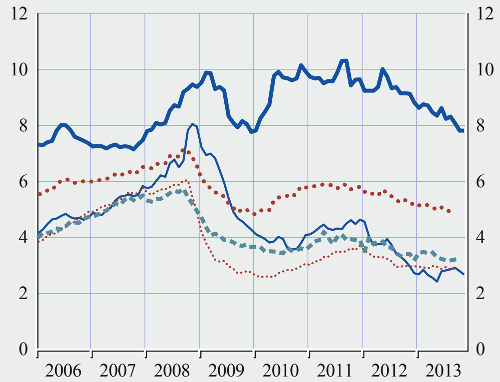


Source: ECB.

Chart 1.26 Cost of external financing of euro area non-financial corporations

(Jan. 2006 – Nov. 2013; percentages)

- cost of quoted equity
- overall cost of financing
- long-term MFI lending rates
- cost of market-based debt
- short-term MFI lending rates



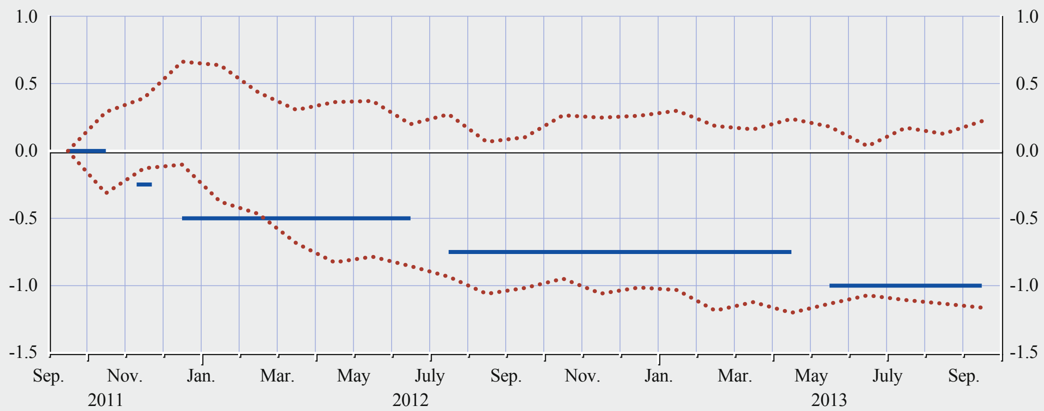
Sources: ECB and ECB calculations.

for SMEs, the ECB extended the range of collateral accepted from banks under more favourable conditions in its refinancing operations to include asset-backed securities backed by loans to SMEs. In addition, a number of public initiatives have been launched at both the national and European levels (e.g. guarantee schemes or funding availability via international financial institutions) to ease the credit constraints facing SMEs.

Chart 1.27 The ECB policy rate and the composite cost-of-borrowing indicator for non-financial corporations

(Sep. 2011 – Sep. 2013; cumulative percentage point changes)

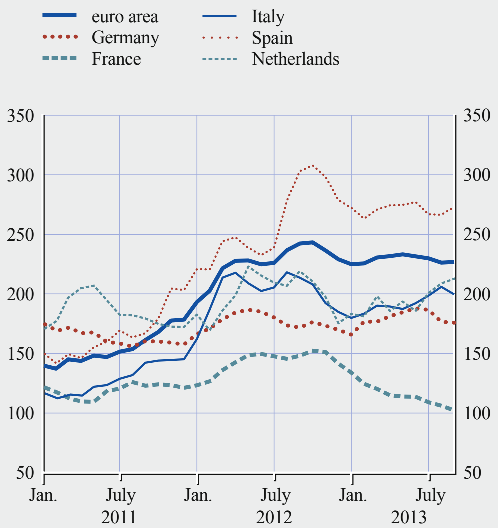
- minimum bid rate in main refinancing operations
- minimum and maximum change across countries



Sources: ECB and ECB calculations.
Notes: For methodological details on the construction of the cost-of-borrowing indicator, see ECB, "Assessing the retail bank interest rate pass-through in the euro area at times of financial fragmentation", *Monthly Bulletin*, August 2013.

Chart 1.28 Spread between lending rates on very small and large loans in selected euro area countries

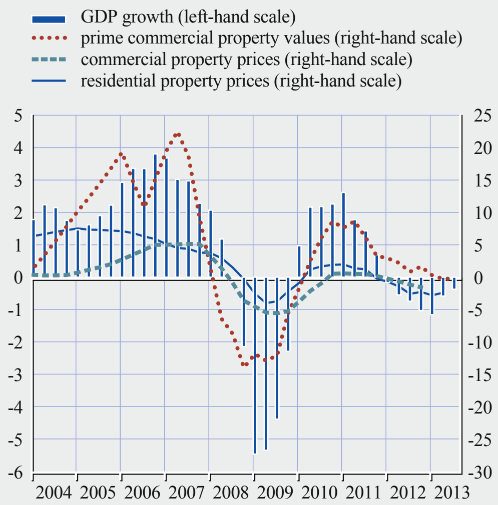
(Jan. 2011 – Sep. 2013; basis points; three-month moving averages)



Sources: ECB and ECB calculations.
Notes: Very small loans are loans of up to €0.25 million, while large loans are those in amounts of more than €1 million. Aggregation is based on new business volumes.

Chart 1.29 Euro area commercial and residential property values and the economic cycle

(Q1 2004 – Q3 2013; percentage change per annum)



Sources: Eurostat, ECB, experimental ECB estimates based on IPD and national data, and Jones Lang LaSalle.

Household financing costs have declined amid marked cross-country heterogeneity

Funding costs of the euro area non-financial private sector have continued to decline more or less significantly across most business lines, maturities and funding sources. In fact, the financing costs borne by euro area households declined marginally further between March and September 2013, mainly reflecting developments in loans for house purchase and other lending (see Chart 1.25). The financing cost for households for all categories of lending except consumer credit is now at or very close to the lowest levels since the start of the statistical recording in 2003. At the same time, cross-country heterogeneity in the euro area, as measured by the range between the lowest and highest interest rate charged on loans to households, remained at elevated levels, reflecting different country-specific risk constellations, as well as a still impaired monetary transmission in some euro area countries.

Funding costs for NFCs have dropped, but the monetary transmission mechanism remains impaired

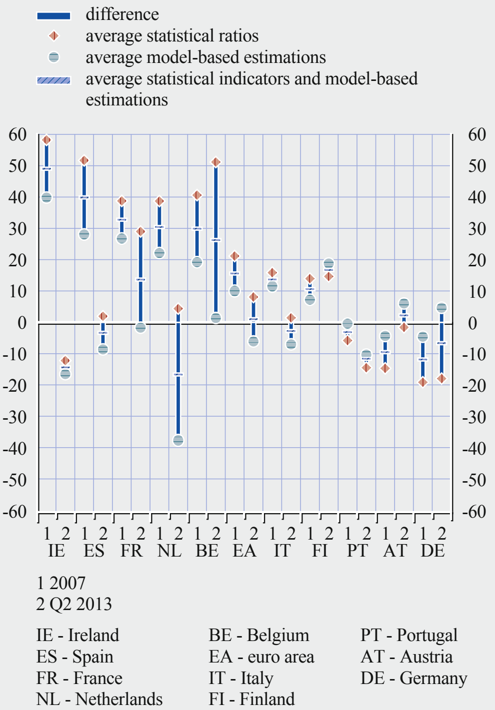
Similarly, the overall financing costs of non-financial corporations have continued to fall across most external financing sources (see Chart 1.26). While it is difficult to pin down a universally shared set of common factors given the multitude of country- and firm-specific factors at play, this outcome appears to stem mainly from favourable financial market sentiment after the announcement of the ECB's OMT programme and an ongoing search for yield. At the same time, the pass-through of the cut in the monetary policy rate implemented in May 2013 may have also played a role, especially with regard to the cost of market funding. Bank lending rates have declined marginally, but the latest cut in monetary policy rates has not yet been fully passed through (see Chart 1.27). In fact, lending rates have remained widely dispersed across the euro area. On the one hand, this may be explained by the deteriorating creditworthiness of some of the corporations in more vulnerable jurisdictions due to a prolonged period of weak economic activity and strong uncertainty regarding the growth outlook, inducing banks to charge higher risk premia and therefore higher lending rates. On the other hand, the wide divergence in lending rates may reflect the spillover effects of sovereign market tensions on bank funding conditions, as well as some possible impact from banks' deleveraging strategies in the context of adjustment towards higher regulatory capital and liquidity requirements.

The availability and cost of NFC funding is dependent on the firm size

The spread between bank lending rates for very small loans and those for large loans to non-financial corporations has widened in most of the larger euro area economies (see Chart 1.28). However, the pace of increase decelerated more recently and, for some economies, some reversal was even recorded. The difference between the loan pricing conditions for small and large firms, which primarily results from the divergence in firm-specific risks, highlights the more adverse conditions faced by small firms, particularly in countries under stress. In part, these spreads may also reflect the fact that SMEs are more dependent on their respective domestic banking sectors and are subject to tighter credit conditions, compared with larger firms that have better access to global financial markets. Developments in firms' financial conditions continue to vary markedly in terms of firm size, with balance sheet vulnerabilities being significantly more pronounced for SMEs than for large firms. According to the ECB's latest survey on the access to finance of SMEs in the euro area, profit developments remained more adverse for SMEs than for large firms in the first half of 2013. This is also mirrored by the less favourable evolution in the credit history of SMEs.

Chart 1.30 Valuation estimates of residential property prices in selected euro area countries

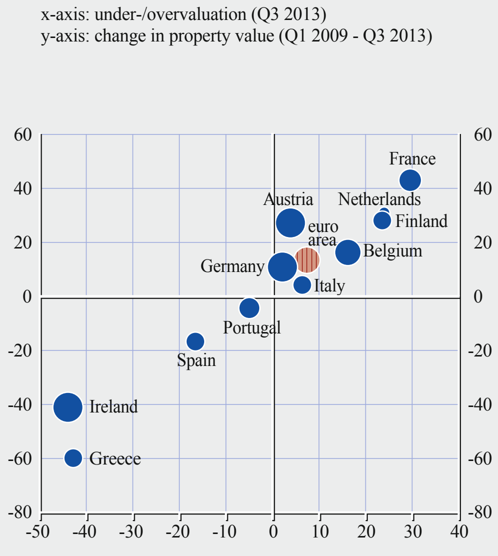
(percentages; distribution of estimates)



Sources: ECB and ECB calculations.
Notes: Estimates are based on four different valuation methods: price-to-rent ratio, price-to-income ratio and two model-based methods. For methodological details, see Box 3 in ECB, *Financial Stability Review*, June 2011. For each country, the average of the two statistical ratios, the average of the model-based methods and the overall average are shown.

Chart 1.31 Valuation estimates of prime commercial property and expected economic growth in selected euro area countries

(percentages)



Sources: European Commission, Jones Lang LaSalle, ECB and ECB calculations.
Notes: The size of the bubbles reflects the expected change in real GDP growth in 2014. For further details, see Box 6 in ECB, *Financial Stability Review*, December 2011.

Euro area property prices continued to decline, with first signs of stabilisation in some countries

Developments in euro area **property markets** have remained muted on average. Residential property prices continued their annual decline over the course of 2013 (see Chart 1.29). Commercial property prices decreased less markedly, albeit with a clear bifurcation in the market, whereby prime commercial property continues to fare better than the non-prime segment. Property prices continue to exhibit a high degree of cyclicality across both market segments (see Box 3), amid marked divergence at the country level (see Charts S.1.17 and S.1.18). Indeed, commercial and residential property prices continued to drop mainly in more vulnerable euro area countries like Cyprus, Greece, Italy and Spain, but also in the Netherlands, while they were still rising in other countries like Austria, Belgium and Finland. On a positive note, country-level data suggest that after a prolonged steep decline in residential and commercial property prices, there are some first tentative signs of stabilisation at low levels in some countries, most notably Ireland. Having said this, the outlook for euro area property markets remains weak, reflecting not only subdued developments in the demand for housing, but also potential further corrections in some countries.

Overvaluation remains a concern in some countries

Valuations in euro area property markets continued to diverge across countries, although the large range of estimates underlines the high degree of uncertainty surrounding any particular estimate. The annual decline of *residential* property prices in the euro area as a whole has continued and prices are largely in line with fundamentals (see Chart 1.30), while estimates suggest that *commercial* property valuations for the euro area are still somewhat above their long-term average (see Chart 1.31). However, these aggregate figures mask highly heterogeneous developments at the country level, which also hide strong regional disparities, as suggested for example by the estimated strong overvaluation of residential property in some large German cities. Residential and commercial property market valuations have come down strongly from previous peaks, as the continued unwinding of pre-crisis excesses has brought prices down to the level suggested by the underlying values or even lower. In Belgium, Finland and France, by contrast, estimated overvaluation remained high in both market segments. Such signals, while illustrative, should be interpreted with caution in view of the mixed quality of data, the limitations of some proxies for fundamentals (particularly to capture country-level specificities) and the possible presence of structural breaks.

Three key downside risks underpin the outlook for euro area property markets. A first relates to a re-intensification of the sovereign debt crisis resulting in higher long-term interest rates. A second more general downside risk stems from the high observed cyclicality in property markets – whereby risks to macroeconomic growth in an environment of high uncertainty could potentially trigger further property price corrections, present challenges in terms of debt servicing and contribute to rising rollover risks. Lastly, any spillover of turmoil in global bond markets to euro area property markets could yield higher de facto financing costs and borrower distress given the leverage inherent in property market lending. For all of these risks, newly available macro-prudential tools in the property market sphere may help to counteract such risks in the future.

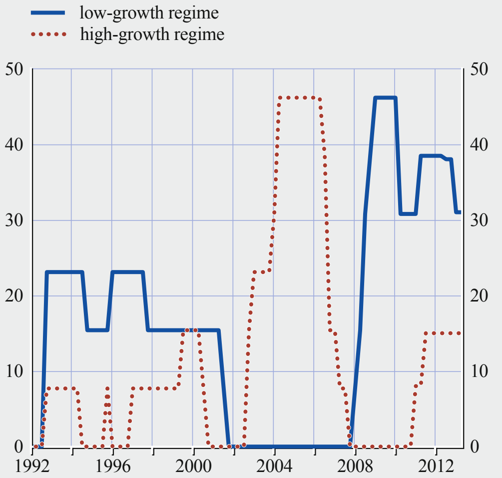
Box 3

HOUSE PRICE CYCLES ACROSS EUROPE

Housing markets are prone to boom and bust cycles. Within the euro area, striking recent cases include the Irish and Spanish housing markets, where a prolonged strong rise in house prices with origins over 15 years ago was followed by a marked downturn which is still affecting

Chart A European countries in a high- and low-growth housing market regime

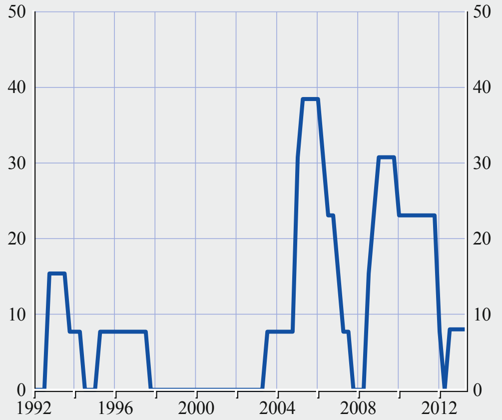
(Q1 1992 – Q2 2013; percentage of total number of countries)



Sources: ECB and ECB calculations.

Chart B European countries with house prices persistently above the long-run trend

(Q1 1992 – Q2 2013; percentage of total number of countries)



Sources: ECB and ECB calculations.

these economies. These two country cases illustrate an implicit asymmetry in housing market dynamics: booms tend to build up gradually, but busts occur swiftly. Given the tight link between housing market developments and lending activity, the early detection of costly booms is key to avoid house price bust episodes with financial stability consequences in the form of increasing mortgage default risk.

One means of capturing these dynamics in house prices is a regime-switching model which screens out those housing market phases in which house prices differ markedly from what would be implied by underlying economic fundamentals. To this end, a model is applied to 13 countries in the European Economic Area (including eight euro area countries) in which the mean rate of house price growth switches between three regimes (high, medium and low growth).[1] The model first establishes a long-run equilibrium relationship between house prices and macro-fundamentals at the country level, while the various regimes apply to the short-run dynamics of house price changes around these long-term relationships. The country-specific factors influencing house prices include affordability (disposable income), the cost of financing house purchases (long-term interest rate) and the general economic climate (unemployment rate).

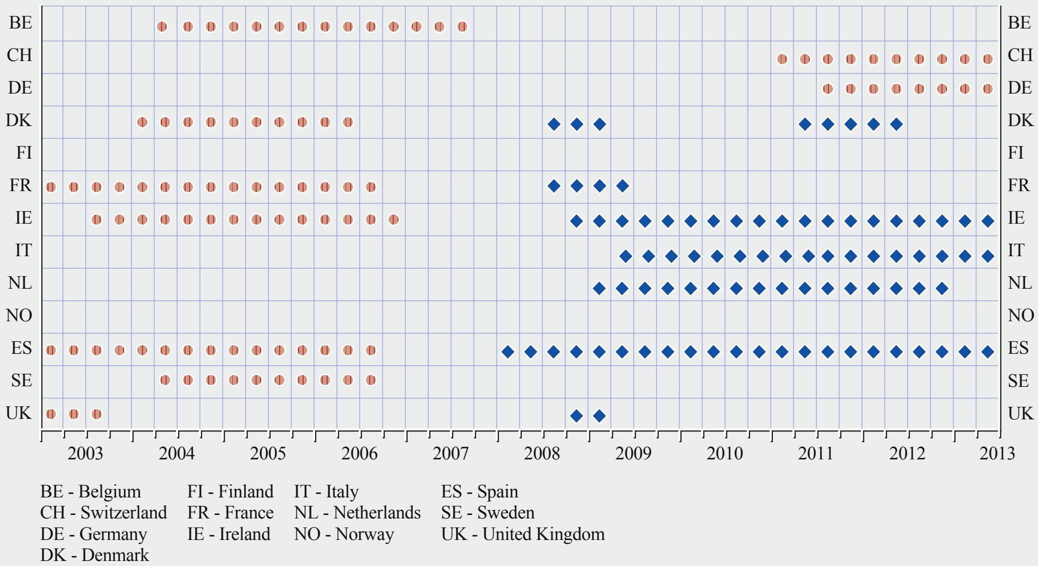
The model produces estimates of the time-varying probabilities of being in a given regime at each point in time and it allows the housing market cycle to be identified. Based on this probability for each country, the model allows for a construction of indicators aiming to measure to what extent the high- and low-growth phases of housing markets across Europe are synchronised with each other.

An application of this approach suggests considerable synchronisation of both booms and busts across countries. In particular, housing markets in Europe seem to have become more

1 The sample comprises those countries for which a complete dataset is available: Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland and the United Kingdom. For model set-up details, see Corradin, S. and Fontana, A., "House price cycles in Europe", *ECB Working Paper Series*, forthcoming.

Chart C European countries in a high- and low-growth housing market regime

(Q1 1992 – Q2 2013)



Sources: ECB and ECB calculations.
Note: Red indicates a high-growth regime, while blue indicates a low-growth regime.

synchronised with each other since the 2000s – a trend equally applying to the pre- and post-global financial crisis phases (see Chart A). First, in the run-up to the global financial crisis (between June 2004 and September 2006) European housing markets were generally on an upward trend. Approximately 46% of the countries were in a high-growth regime and the remaining countries were in a medium-growth regime.[2] In this period, Belgium, Denmark, France, Ireland, Spain and Sweden were in the same high-growth regime (see Chart C). Second, during the global financial crisis (between December 2008 and June 2012), approximately 41% of the countries were in a low-growth regime and the remaining ones in a medium-growth regime. In this period, Denmark, Ireland, Italy, the Netherlands and Spain were in the same low-growth regime (see Chart C).

The approach also allows for an estimation of housing market valuation with respect to its modelled fundamental. The results suggest that high-growth phases typically coincide with overvaluation between June 2004 and September 2006 (see Chart B). Finally, low-growth phases also tend to be characterised by overvaluation at the beginning when a downturn follows after a prolonged rise in house prices.

In sum, the analysis suggests that almost half of the 13 European countries analysed experienced a housing market boom over the period leading up to 2006, which was indeed unusual compared with the more regular house price dynamics observed in those economies. This situation eventually led to the – in some cases still ongoing – phase of house price corrections in most of the countries that experienced a prolonged period of house price appreciation. Such findings further reinforce the need for judicious use of policies to combat such country-specific build-ups of imbalances – notably country-specific policies in the macro-prudential area.

2 The percentage of European countries in the low-growth regime is zero.