1 MACRO-FINANCIAL AND CREDIT ENVIRONMENT

Macro-financial conditions *in the euro area continue to show signs of gradual improvement amid an ongoing cross-regional shift in global growth dynamics. While advanced economies have gained further momentum, bolstered by continued policy support, underlying financial vulnerabilities and resurfacing geopolitical uncertainties still weigh on growth prospects in emerging economies with often limited room for policy manoeuvre. The recent emerging market tensions have remained largely confined, with only a limited global impact to date. There are, however, risks that this shift in regional growth dynamics may yet become more pronounced, in particular if a broad-based adjustment in global capital flows materialises along the path to monetary policy normalisation in key advanced economies.*

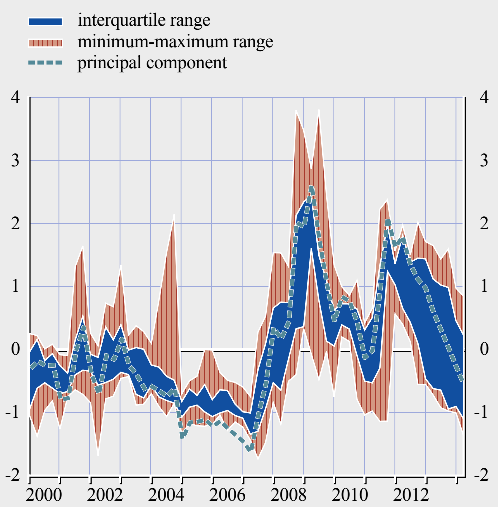
In this environment, market-based ***sovereign stress*** *indicators for the euro area as a whole have fallen close to pre-crisis levels amid a continued marked turnaround in market sentiment towards more vulnerable euro area economies. At the same time, an adjustment of fiscal fundamentals across the euro area continues, with improving budgetary outcomes in a context of a gradually strengthening economic recovery. Debt sustainability challenges nonetheless remain, given elevated, and in some countries still increasing, levels of public debt, alongside continued (albeit reduced) potential for renewed adverse feedback between bank and sovereign distress.*

Balance sheet adjustment also continues in the ***non-financial private sector****. While the availability and cost of funding for euro area households and firms show tentative signs of improvement, fragmentation persists in terms of both countries and firm size. The ongoing macroeconomic recovery appears to be slowly translating into improved income and earnings prospects, which, together with the favourable interest rate environment, should help support the process of balance sheet repair in the household and non-financial corporate sectors.*

Developments in euro area ***property markets*** *continue to diverge strongly at country and regional levels in terms of prices and valuations in both the residential and commercial segments. In particular, signs of a turning point in prices in those jurisdictions, where macroeconomic rebalancing continues, contrast with strong price growth in other countries. More generally, increased investor appetite is fostering strong growth in the prime segment of commercial real estate, warranting close monitoring.*

Chart 1.1 Macroeconomic uncertainty in the euro area

(Q1 2000 – Q2 2014; standard deviations from the mean)



Sources: Consensus Economics, European Commission, ECB, Baker, Bloom and Davis (2013) and ECB staff calculations.
Notes: Mean for the period from the first quarter of 1996 to the second quarter of 2014. Macroeconomic uncertainty is captured by examining a number of measures of uncertainty compiled from a set of diverse sources, namely: (i) measures of economic agents' perceived uncertainty about the future economic situation based on surveys; (ii) measures of uncertainty or of risk aversion based on financial market indicators; and (iii) measures of economic policy uncertainty. For further details on the methodology, see "How has macroeconomic uncertainty in the euro area evolved recently?", *Monthly Bulletin,* ECB, October 2013.

1.1 ONGOING ECONOMIC RECOVERY, BUT DOWNSIDE RISKS REMAIN

Ongoing economic recovery amid diminishing uncertainty…

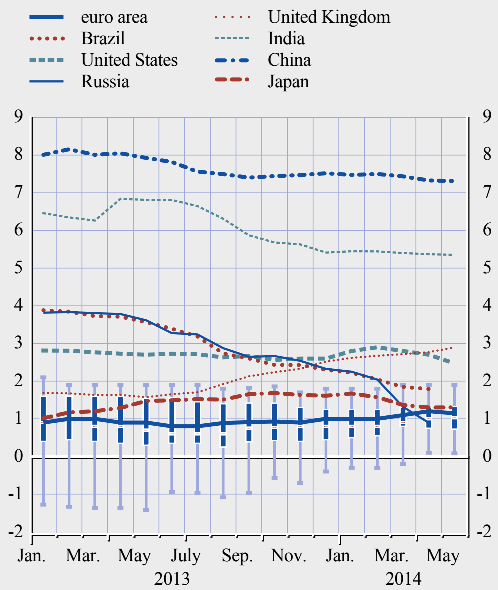
The economic recovery in the **euro area** continued to take hold at the turn of 2013/14, supported by further improving business and consumer confidence, and the ensuing turnaround in the domestic demand cycle. The recovery has also been buttressed by considerably reduced macroeconomic uncertainty, which now again appears to be below the long-run average (see Chart 1.1). While the decline common across various indicators has been impressive, various uncertainty measures continue to suggest a high degree of heterogeneity.

... and reduced cross-country heterogeneity

Economic conditions in the euro area are expected to improve further in 2014, bolstered by an accommodative monetary policy stance and improving financing conditions, as well as by the progress made in fiscal consolidation and structural reforms. The March 2014 ECB staff macroeconomic projections for the euro area indicate annual real GDP growth of 1.2% in 2014, which is slightly higher than at the time of the last Financial Stability Review, and is forecast to accelerate to 1.5% in 2015, and further to 1.8% in 2016. Nonetheless, over the near-term forecasting horizon, the economic growth outlook for the euro area is still somewhat less favourable than that for other major advanced and emerging market economies (see Chart 1.2). Indeed, uncertainty

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

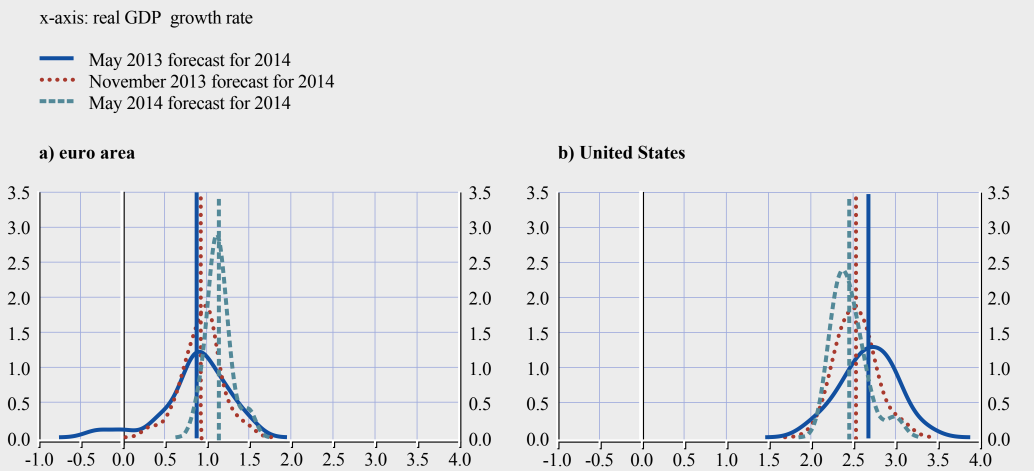
(Jan. 2013 – May 2014; percentage change per annum)



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).

Chart 1.3 Distribution of 2014 real GDP growth forecasts for the euro area and the United States

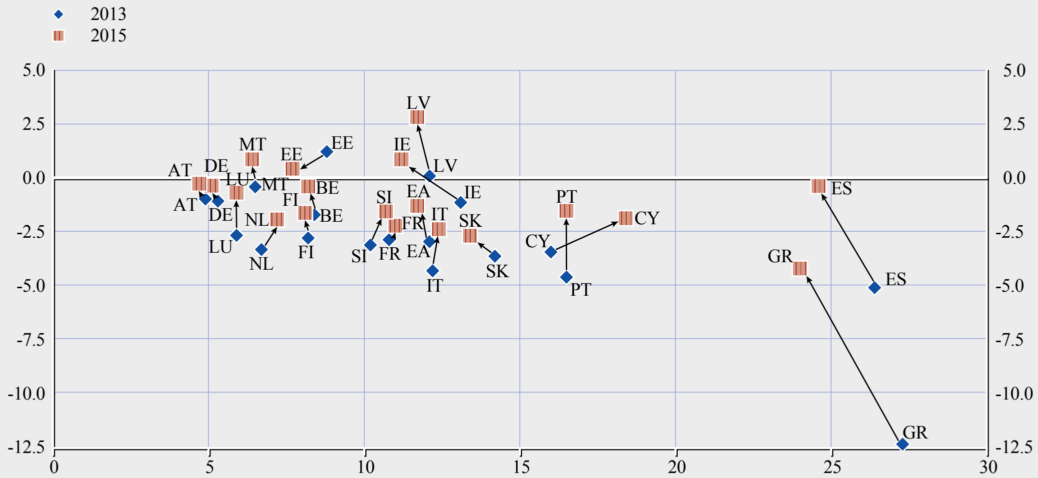
(probability density)



Sources: Consensus Economics and ECB calculations.

Chart 1.4 Changes in the output gap and the unemployment rate across the euro area

(percentages; x-axis: unemployment rate; y-axis: output gap)



AT – Austria
BE – Belgium
CY – Cyprus
DE – Germany
EE – Estonia
ES – Spain
EA – euro area
FI – Finland
FR – France
GR – Greece
IE – Ireland
IT – Italy
LU – Luxembourg
LV – Latvia
MT – Malta
NL – Netherlands
PT – Portugal
SI – Slovenia
SK – Slovakia

Sources: European Commission and Eurostat.
Note: 2015 data are projections.

regarding the strength and pace of economic recovery remains, not only in the euro area, but also in other important global growth engines such as the United States (see Chart 1.3). In addition, the improving euro area outlook continues to mask a high degree of cross-country heterogeneity, albeit with a decreasing downside skew in the distribution of growth prospects across individual euro area countries and – for the first time since early 2011 – a positive real GDP growth forecast for all euro area economies.

Despite the progress made to date, there is a continued need for further rebalancing across the euro area

As reflected by the considerably improving current account balances (even after adjusting for economic cycles), marked progress has been made in restoring competitiveness in recent years, especially in vulnerable euro area countries. The further reduction of real fragmentation across the euro area will require continued nominal adjustment to restore price competitiveness. This includes relative price adjustments across economies in the euro area – with the challenge in some cases of downward nominal rigidity in prices and wages (see Box 1). It will also require real adjustment in non-price competitiveness and, in particular, continued efforts are needed to enhance the euro area's medium-term growth potential. Indeed, negative output gaps are diminishing in most cases, but remain fairly sizeable, particularly in more vulnerable euro area economies such as Greece, Spain, Portugal and Italy (see Chart 1.4). In this context, labour market conditions are continuing to diverge considerably within the euro area, where high unemployment in countries experiencing a prolonged and more pronounced cyclical downturn contrast with still relatively benign labour market conditions in others, such as Austria and Germany. This dispersion also highlights the need for employment and growth-enhancing structural reforms to support an inclusive, broad-based and self-sustaining economic recovery.

Box 1

FINANCIAL STABILITY CHALLENGES POSED BY VERY LOW RATES OF CONSUMER PRICE INFLATION

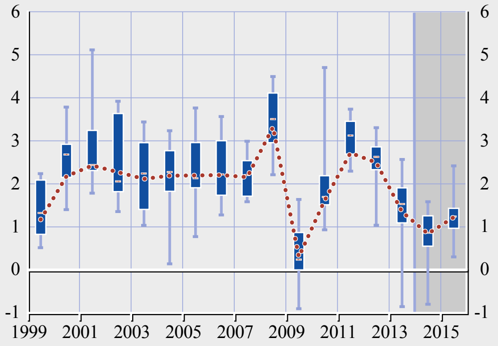
Over recent months, HICP inflation in the euro area has fallen to low levels. The ECB's Governing Council expects inflation to remain low for a prolonged period, followed by a gradual upward movement in HICP inflation rates. However, some analysts have voiced concerns about the potential for deflation. Associated financial stability concerns relate primarily to debt sustainability challenges posed by low (or even negative) inflation outturns at the national level (see Chart A).

Low rates of inflation in the euro area are the result of a confluence of many factors. *Cost-push* factors, both global and local in nature, have contributed to the decline. Global factors have in many ways been dominant, stemming from broader developments outside the euro area. They have affected the euro area and other advanced economies alike, including a deceleration in energy and food prices (see Chart B). For the euro area, this has been amplified by an appreciating euro effective exchange rate. Local factors have also contributed, including the impact of labour and product market reforms. More country-specific *demand-pull* factors have led to differentiated inflation outturns, as countries have been recovering at a different pace from recessions of varying magnitudes. Euro area medium to long-term *inflation expectations* have remained firmly anchored in the midst of these probably transitory cost-push and demand-pull forces.

The impact these low inflation outturns will have on financial stability depends on how they affect debt dynamics – notably how the amplitude and persistence of disinflationary pressures interact with prevailing levels of debt (see Chart C). On the one hand, differentials in inflation

Chart A HICP inflation in the euro area and differentials across countries

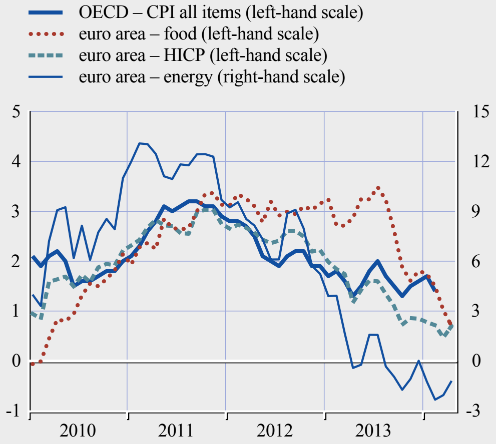
(1999 – 2015; percentage per annum)



Sources: ECB, Eurostat and European Commission.
Notes: The chart shows the minimum, maximum, median and interquartile range across the 18 euro area countries. The shaded area shows projections from the European Commission's spring 2014 economic forecast.

Chart B Price developments in OECD countries and in the euro area

(Jan. 2010 – Apr. 2014; percentage per annum)



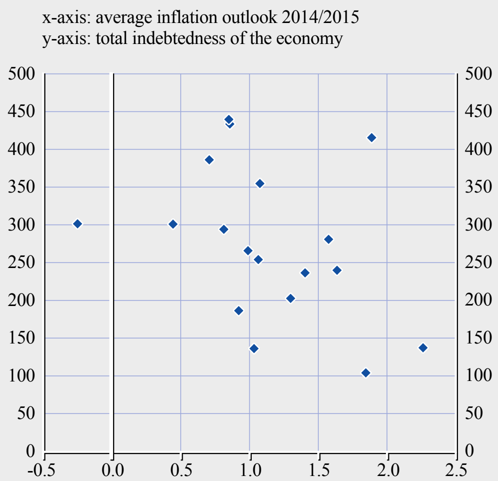
Sources: OECD and Eurostat.

rates across euro area countries can be seen as welcome relative price adjustments which are part of a structural process of rebalancing, contributing to the restoration of price competitiveness in economies where it had been eroded in the pre-crisis period. On the other hand, low inflation rates complicate balance sheet repair and may thereby also jeopardise financial stability through adverse effects on debt dynamics. As the vast majority of debt contracts are written in nominal terms, lower inflation contributes to a slower than expected decline in the real debt burden for households, firms and the government. At the limit, generalised falls in the price level would de facto increase the real value of debt contracts and the real debt service burden through the potential for higher real interest rates.

In general, a debt deflation spiral can be amplified by three potentially mutually reinforcing channels:[1]

Chart C Total indebtedness of the economy and inflation outlook across the euro area

(Q3 2013; percentage of GDP; percentage per annum)



Sources: European Commission spring 2014 economic forecast, ECB and ECB calculations.
Note: Total indebtedness of the economy comprises the debt level of households, non-financial corporations and the general government.

1. *Price level deflation* increases the real debt level and induces households and firms to redeem their debt to at least counter the real debt increase. These effects are greater, the longer the average maturity of the debt stock and the interest rate fixation period. The associated decline in consumption leads to a further fall in the general price level.

2. Downward pressure on *asset prices* may ensue if debtors need to sell some of their assets to service their debt. Broad-based distress selling of assets in turn leads to further asset price declines, causing a reduction in net worth with a detrimental impact on aggregate demand and a falling general price level.

3. The banking system may be affected directly to the extent that higher real debt burdens cause widespread default, which in turn leads to impaired *credit intermediation*. The resulting credit contraction would exert additional downward pressure on asset prices.

An initial level of debt that is sustainable as well as inflation expectations that are well anchored close to the central bank's inflation objective are crucial for financial and, ultimately, economic stability. Where debt levels are sustainable, negative or very low inflation rates would complicate the deleveraging process because less of the real debt burden would be diminished by inflation, leaving less capacity to expand aggregate demand and thus resulting in a slower economic recovery. Only in an extreme situation, where initial debt levels are unsustainably high and inflation expectations are not anchored, would a destabilising debt deflation spiral involving the above channels evolve, placing increasing pressure on consumer and asset prices.

1 For a taxonomy of these three channels, summarising the literature on debt deflation, see von Peter, G., "Debt deflation: concepts and a stylised model", *Working Papers*, No 176, Bank for International Settlements (BIS), April 2005.

The potential for debt deflation to materialise in the euro area is very remote as it would require an economy-wide and protracted decline in prices and inflation expectations. Despite low readings of headline inflation across the euro area and modest wage declines in the presence of continued high debt levels in some euro area countries, medium-term inflation expectations remain firmly anchored and HICP inflation rates are expected to move gradually upwards. Moreover, ECB monetary policy remains firmly geared towards price stability in the euro area. Ultimately, debt sustainability depends not only on inflation, but on a broader set of factors such as the level of indebtedness and economic growth. This clearly underscores the role that structural reforms and continued balance sheet repair have to play in supporting the resilience of the financial sector.

Gradual global recovery amid a continued shift in regional growth dynamics

Similarly to economic developments in the euro area, the **global economy** has been gradually gaining traction, albeit against the backdrop of an ongoing underlying shift in regional growth dynamics. Economic recovery in advanced economies continues to strengthen amid continued strong monetary policy support. By contrast, economic dynamics in emerging economies have lost further steam, owing to credit overhangs, structural problems and tighter financial conditions, in particular in countries exhibiting more pronounced external and domestic imbalances. This development appears to have been reinforced by changes in financial market sentiment towards emerging economies as a corollary of the US Federal Reserve System's ongoing tapering of its quantitative easing programme (see Box 2).

Box 2

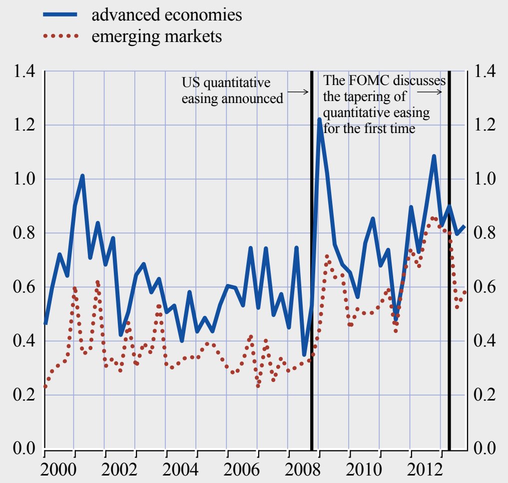
GLOBAL CORPORATE BOND ISSUANCE AND QUANTITATIVE EASING

Global non-financial corporate bond issuance has surged over the last four years. This increase has been particularly pronounced in emerging market economies (EMEs), where gross issuance has reached unprecedented levels, while issuance in advanced economies has also reached elevated levels by historical standards.

This rise in global corporate bond issuance has coincided largely with the inception of quantitative easing policies, notably the large-scale asset purchases of the US Federal Reserve System. In terms of *timing*, the rise in EME issuance appears to have corresponded largely with the introduction of quantitative easing in the United States in late 2008, while a noteworthy retrenchment accompanied signals of a potential withdrawal in mid-2013 (see Chart A). It terms of *extent*, issuance was also highly synchronised across countries, suggesting that common factors played an important role in driving global issuance activity. Since 2009, issuance has been above average, or in the highest quartile, in an

Chart A Global bond issuance by non-financial corporations

(Q1 2000 – Q4 2013; percentage of GDP)



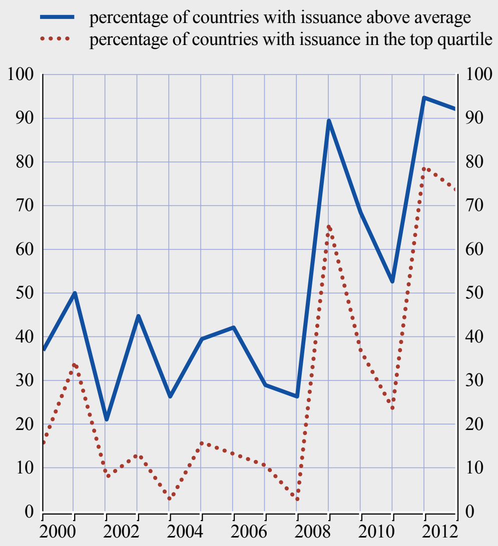
Source: Dealogic.

increasingly large number of countries, and was in the highest quartile almost everywhere in 2012 and 2013 (see Chart B).

US quantitative easing may have increased global bond market activity through at least two demand channels. First, its effectiveness in improving US and global financial conditions (by providing lower yields and reducing volatility) may have more than attenuated any cyclical downturn in bond issuance. Second, investor portfolio rebalancing across asset classes and countries may have resulted from the lowering of expected yields in the United States and/or reduced supply of certain US assets to the public. Clearly, supply factors may have also been at play. Bank deleveraging as part of the balance sheet adjustment process following the global financial crisis could have contributed to an unusually high degree of bank disintermediation in favour of market issuance by the corporate sector.

Chart B Synchronisation of non-financial corporations' bond issuance across countries

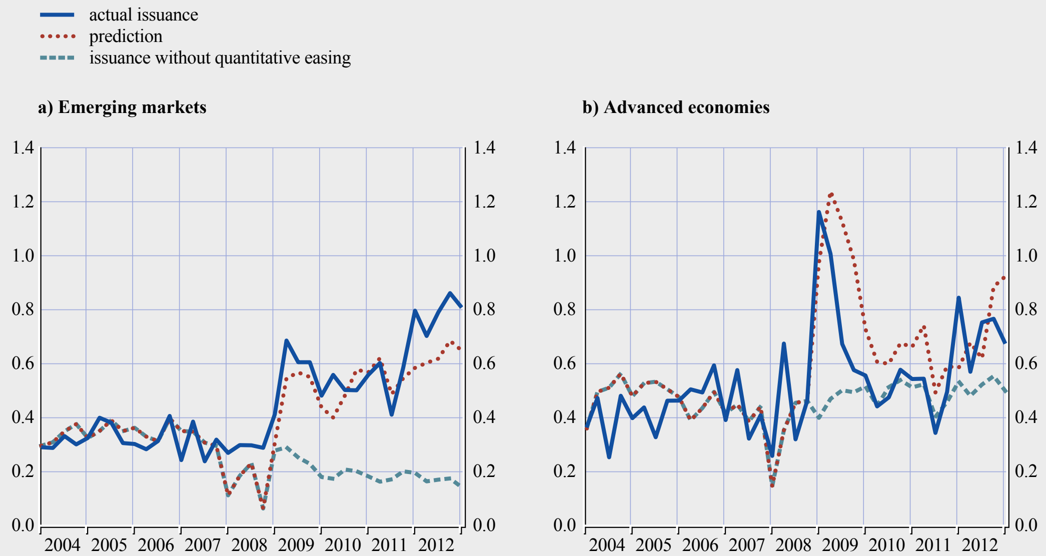
(2000 – 2013; percentage of total number of countries)



Source: Dealogic.
Note: Sample includes 18 emerging market and 19 advanced economies (excluding the United States).

Chart C Global bond issuance by non-financial corporations – actual and estimated impact of US quantitative easing

(Q1 2004 – Q1 2013; percentage of GDP)

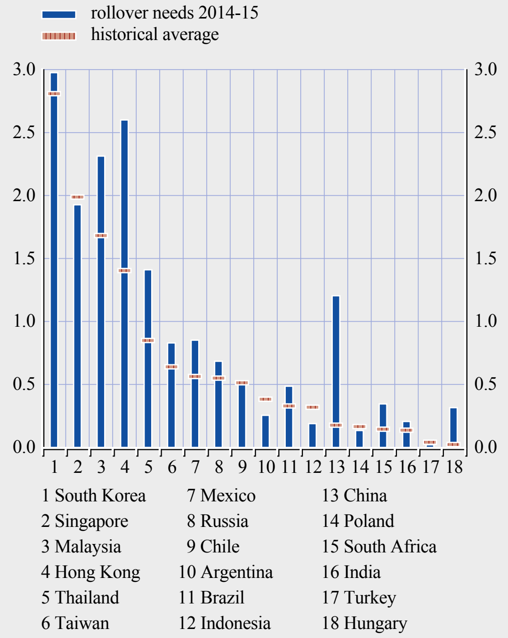


Source: Lo Duca, M., Nicoletti, G. and Vidal Martinez, A., "Global corporate bond issuance: what role for US quantitative easing?", *Working Paper Series*, No 1649, ECB, March 2014.
Note: Analysis excludes the United States.

One way of quantifying the impact of quantitative easing on global bond markets is to conduct a counterfactual analysis on the basis of a panel regression framework.[1] The results suggest that if securities held on the Federal Reserve System's balance sheet had been held steady at their level in the fourth quarter of 2008, EME issuance would have been approximately half of their actual issuance since 2009, with the gap increasing in late 2012. In advanced economies, bank deleveraging contributed to a greater need for alternative financing for non-financial corporations after 2009, while the impact of quantitative easing was smaller than in EMEs and concentrated in early 2009, mainly as a reflection of portfolio rebalancing related to the first wave of purchases of mortgage-backed securities by the Federal Reserve System after 2009.[2]

Chart D Non-financial corporations' bond rollover needs in selected emerging economies in 2014 and 2015

(percentage of GDP; annual average)



Source: Dealogic.
Notes: Non-financial corporate bonds maturing by the end of 2015. The "historical average" refers to the period 2000-12.

The results suggest that the Federal Reserve System's ongoing tapering of its quantitative easing programme might curtail EMEs' corporate bond issuance. Such an effect could be amplified by possible rollover risks. Corporate bond rollover needs for 2014 and 2015 are high compared with the historical average in a number of countries (see Chart D). In this respect, EMEs with higher refinancing needs are most exposed to rollover risks, mainly China, Hong Kong SAR, Malaysia and Thailand, but to a lesser extent also Brazil, Hungary, South Korea, Mexico, South Africa and Russia, with the latter currently also exposed to heightened political risks.

All in all, just as the quantitative easing in the United States seems to have played an important role in driving issuance activity in global corporate bond markets over recent years, the tapering of the Federal Reserve System's quantitative easing programme might have the opposite impact. Amid significant rollover needs in a number of key EMEs, close monitoring of developments will be required as regards the prospective repercussions of this on global bond markets and, by extension, euro area financial stability.

1 A panel model investigates this issue by relating bond issuance by non-financial corporations to US quantitative easing in 19 advanced economies – excluding the United States – and 18 EMEs after controlling for a number of domestic and global factors that might affect bond issuance, including controls for investors' risk aversion (using the VIX), countries' growth prospects and bank deleveraging. For more details on the methodology, see Lo Duca, M., Nicoletti, G. and Vidal Martinez, A., "Global corporate bond issuance: what role for US quantitative easing?", *Working Paper Series*, No 1649, ECB, March 2014.
2 The presented charts correspond to a scenario in which it is assumed that the US ten-year yield and the VIX remain at their historical averages. In the cited paper, different assumptions are also examined with very similar results: bond issuance in EMEs has been substantially more influenced by the US large-scale asset purchase programmes than bond issuance in advanced economies.

Recent economic trends in major **advanced economies** outside the euro area, including the United States, Japan and the United Kingdom, indicate a gradual recovery ahead, but risks to global growth remain tilted to the downside. In particular, still weak (albeit improving) labour market conditions, continued balance sheet adjustment in the financial and non-financial private sectors and a process of fiscal consolidation that is still incomplete in several countries continue to weigh on near-term growth prospects. However, most such growth-restraining factors are expected to dissipate, as continued strong monetary policy support, further improving financial market conditions and a gradually waning drag from fiscal consolidation slowly translate into firming economic activity.

Continued recovery in advanced economies…

In the **United States**, the ongoing recovery lost some momentum in early 2014, but, given that this was mainly weather-related, the pace of the recovery in output and employment is expected to pick up going forward owing to easing headwinds from fiscal tightening and household deleveraging. The upturn in economic activity continues to be bolstered by a monetary policy stance which remains highly accommodative despite the tapering of asset purchases. At the same time, short-term fiscal risks have abated given the debt ceiling extension until March 2015. Strongly increasing delinquency rates on student loans that are directly extended or guaranteed by the federal government may imply some additional, but manageable, fiscal risks. A financial stability risk relates to the strong growth in mortgage real estate investment trusts, which rely 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.

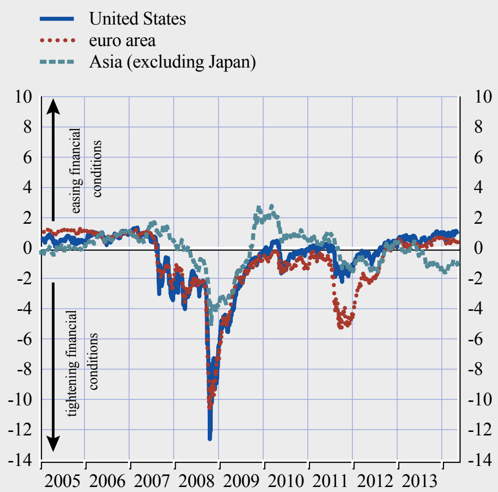
… but downside risks remain

In **Japan**, the economy surged in the first quarter of 2014, ahead of the consumption tax hike in April. Fiscal policy support should help bolster activity going forward and offset some of the expected drop in demand following the consumption tax increase in April and again in 2015. Despite these tax hikes, fiscal risks remain. The high level of public indebtedness, which is likely to rise further over the medium term, represents a risk for both the sustainability of public finances and financial stability. Japanese banks' domestic government bond holdings are sizeable, despite having dropped since late 2012, and account for some 16% of their total assets. Thus, any major risk reassessment by financial markets may have an adverse impact on Japanese banks' profitability and solvency.

The **United Kingdom** has experienced robust economic growth recently, which has continued in early 2014. However, weak productivity developments, the ongoing process of balance sheet repair in the private and public sectors, and subdued dynamics in real household income will weigh on economic activity, which is set to decelerate slightly over the medium term. The continued recovery in property markets could provide some relief for highly indebted households in the short run, but in an

Chart 1.5 Financial conditions in selected advanced and emerging market regions

(Jan. 2005 – May 2014; number of standard deviations)



Source: Bloomberg.
Notes: Bloomberg's financial conditions index tracks overall stress in the money, bond and equity markets. Yield spreads and indices are combined and normalised. The values of this index are Z-scores, which represent the number of standard deviations by which financial conditions are above or below the average level of financial conditions observed during the pre-crisis period from January 1994 to June 2008.

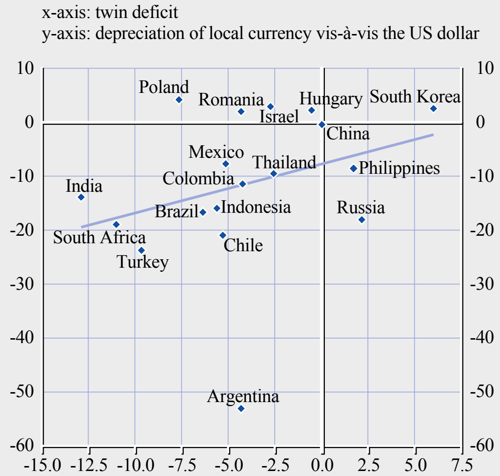
environment of low interest rates, it may also increase the risk of unsustainable debt dynamics in the longer term.

Emerging markets have lost further momentum

In contrast to the gradually improving economic outlook in major advanced economies, **emerging economies** have lost further momentum, while also experiencing renewed tensions at the beginning of the year. Financial conditions have remained tight in emerging economies (see Chart 1.5) with the start of the Federal Reserve System's tapering of its quantitative easing programme and the weakening economic growth outlook in major emerging economies, including continued concerns related to the stability of China's financial system. Emerging economies with poorer (domestic and external) fundamentals, weak policy credibility and more limited policy space to absorb adverse shocks proved to be more vulnerable to shifts in investor sentiment. Such idiosyncratic concerns became manifest in capital flow reversals and strong currency depreciations in several countries (see Chart 1.6). That said, the global implications of these emerging market tensions should remain limited, provided that the turmoil does not intensify and remains confined to a small number of countries. By contrast, a more widespread and sustained emerging market stress may entail significant downside risks to the global recovery, and to euro area growth prospects, in particular if the current period of slowdown turns out to be symptomatic of deeper structural problems across a wider set of emerging economies.

Chart 1.6 Twin deficit and currency depreciation in selected emerging economies

(2013; percentage of GDP; percentage change vis-à-vis the US dollar)



Sources: IMF, ECB and ECB calculations.
Notes: The twin deficit is defined as the combined current account and budget deficit. Depreciation of local currency vis-à-vis the US dollar covers the period between early May 2013 and the end of March 2014.

Economic activity in emerging Europe benefits from euro area recovery…

Akin to developments seen in mid-2013, the impact on **emerging European economies** – notably the EU countries in central and eastern Europe – of the Federal Reserve System's decision to gradually reduce asset purchases, as well as that of the renewed emerging market tensions in early 2014, was limited. Even though not entirely cushioned against these events, generally sounder fundamentals, relatively subdued capital inflows to date and the early stage of economic recovery in most countries may explain a milder reaction relative to other emerging markets. The macroeconomic impact of the Russia-Ukraine tensions has been contained too (see Box 3), given rather limited direct export linkages, the lack of disruption in Russian gas exports to the region and confined financial market spillovers to date. However, a further escalation of events could potentially prove highly disruptive for the region. Given strong trade and financial links with the euro area, economic activity in the region is expected to benefit from the ongoing euro area recovery, but also from a gradual strengthening of domestic demand. However, the outlook in several countries is constrained by the fact that the process of balance sheet adjustment in both the private and public sectors is still incomplete. In spite of improved economic activity, credit growth remains muted in most countries, while a continued elevated level of non-performing loans and persistent currency mismatches in some countries continue to represent a financial stability risk going forward. At the same time, foreign banks, while being more selective in their strategies at the country level, are continuing to adjust towards a more self-sustained and domestically funded business model that should help mitigate risks to financial stability in the region.

Box 3

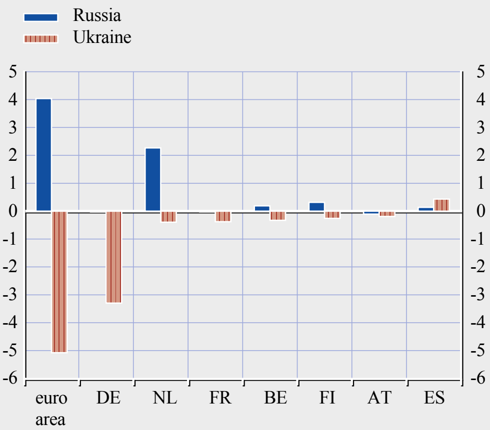
FINANCIAL STABILITY IMPLICATIONS OF THE CRISIS IN UKRAINE

Geopolitical tensions related to developments in Ukraine have been on the rise in recent months. The potential for such tensions to spill over into a larger conflict has given rise to short-lived bouts of financial market jitters against a backdrop of considerable political uncertainty. While the human and social costs of the crisis in Ukraine are clear, financial stability risks are harder to assess, given the still-evolving situation. Nonetheless, an analysis of direct euro area exposures can be illustrative in gauging the prospective economic and financial impact.

The direct *economic* impact on the euro area could be felt mainly through the trade channel, with related negative implications for euro area exports and, ultimately, economic growth. This channel seems relatively important in the case of Russia, while trade links to Ukraine appear to be much less relevant. The importance of the channels varies strongly by direction, with the euro area accounting for 40% of Russian merchandise exports and 30% of imports, while the corresponding figures for the euro area (net of intra-euro area trade) are below 10% for both exports and imports.[1] Russia therefore runs a trade surplus with the euro area as a whole, while the opposite is true for Ukraine (see Chart A). The interdependencies are concentrated in the energy area, with 18% of gas imports and 27% of oil imports by the euro area originating from Russia, which in turn constitute about half of Russia's commodity exports by value.

Chart A Merchandise trade balances for Russia and Ukraine vis-à-vis selected euro area countries

(percentage of 2013 GDP)

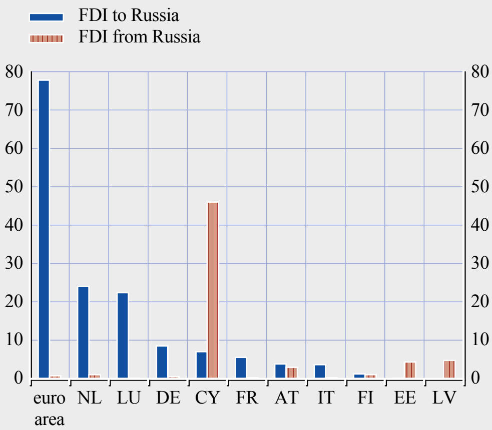


AT – Austria
BE – Belgium
DE – Germany
ES – Spain
FR – France
FI – Finland
NL – Netherlands

Source: IMF Direction of Trade Statistics.
Note: A positive balance indicates a trade surplus, i.e. the exports from Russia or Ukraine to a particular euro area country exceeding the imports from that country.

Chart B Country shares of total inward foreign direct investment in 2012

(2012; percentage of total)



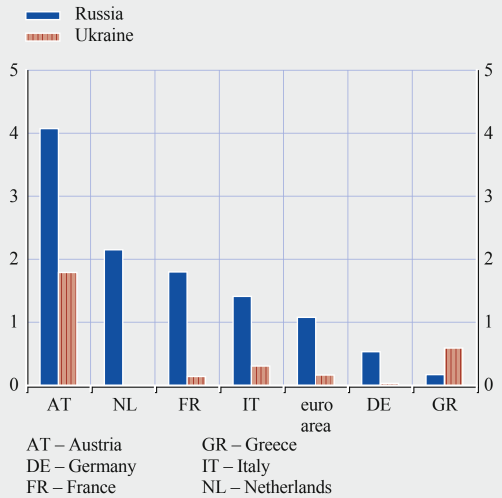
AT – Austria
CY – Cyprus
DE – Germany
EE – Estonia
FI – Finland
FR – France
IT – Italy
LU – Luxembourg
LV – Latvia
NL – Netherlands

Source: IMF Coordinated Direct Investment Survey.
Note: "FDI to Russia" refers to the share of individual euro area countries in the stock of inward foreign direct investment to Russia; "FDI from Russia" refers to Russia's share in the inward foreign direct investment stock of the respective euro area countries.

1 A similar pattern holds for the euro area and Ukraine, although the importance of that channel is dwarfed by Ukraine's exposure to Russia.

Chart C Foreign claims of BIS-reporting banks from selected euro area countries vis-à-vis Ukraine and Russia

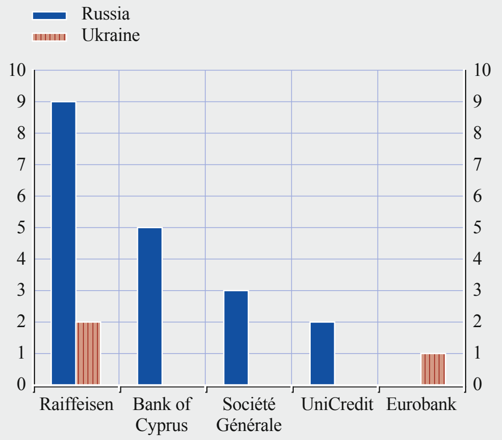
(Q4 2013; percentage of GDP, ultimate risk basis)



Sources: BIS consolidated banking statistics and ECB calculations.
Note: Data for Austria and France on Ukraine refer to the latest publicly available data.

Chart D Selected euro area banks' exposures at default to Ukraine and Russia

(Q2 2013; percentage of total exposures at default)



Sources: EBA's 2013 transparency exercise and ECB calculations.
Notes: Exposure at default is defined as the sum of on-balance sheet exposures and the credit conversion factor of off-balance sheet exposures as per COREP definitions. See also footnote 2 for a discussion of the included sample.

The bulk of *capital flows* to Russia come from the euro area, while flows from Russia to the euro area, and those to and from Ukraine, are small in the aggregate. The euro area accounted for almost 80% of foreign direct investment (FDI) and 50% of the portfolio investment in Russia at the end of 2012, while the corresponding weights for Russia in the euro area were less than 1% in both investment categories. A notable exception is Cyprus, where almost 50% of inward FDI originates from Russia (see Chart B).

Concerning the direct *financial* channels, euro area bank exposures to Russia and Ukraine are significant for some countries and a few individual banks. Exposures exhibit considerable heterogeneity across countries, with Austria, France, Italy and the Netherlands displaying relatively large exposures (see Chart C). Four euro area banks have considerable exposures to Russia, while two banks are significantly exposed to Ukraine (see Chart D).[2] The largest exposures are, in general, recorded towards the non-financial private sector, while claims on banks and the public sector are relatively smaller.

The impact on the euro area has been contained so far as financial market reactions have been muted amid continuously high risk appetite, steady energy prices and largely unabated trade flows. Absent interruption of trade relations with Russia, direct economic effects can be expected to be small going forward. Financial stability risks could, however, mount over time owing to deteriorating economic developments in Russia and Ukraine, such as negative GDP growth, exchange rate depreciations and capital outflows. Such developments could have negative

2 Data collected through the EBA transparency exercise may understate banks' emerging market-related exposures as they were reported to the EBA to a minimum of (i) 90% of total exposure at default, and (ii) top ten countries in terms of exposure. Accordingly, banks which have, for example, low exposures to EMEs relative to their own total exposure, but high EME exposures in absolute terms when compared to other individual banks, are not included in the analysis. In other words, the analysis mainly captures banks' whose business model is tilted towards banking in EMEs.

effects on profit generation and credit quality for individual euro area banks with high exposures to these countries. Likewise, indirect effects – for instance, through trade and financial linkages with third countries – could lead to other propagation mechanisms. Ultimately, cumulating all such effects suggests that direct exposures represent only a fraction of the potential impact, thereby warranting continued close financial stability monitoring of these geopolitical tensions.

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

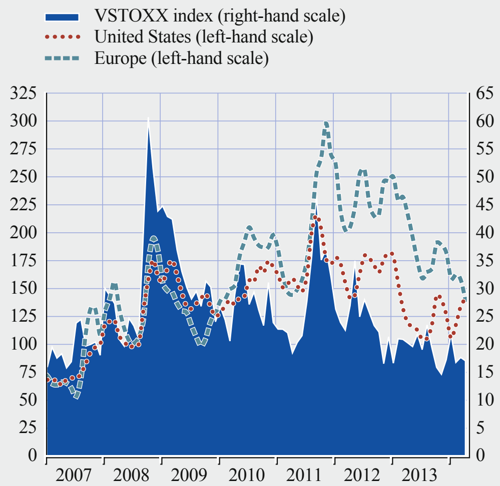
In contrast to developments in emerging Europe, several emerging economies in Asia and **Latin America** experienced more pronounced tensions in early 2014 as a result of the continued global repricing of risk in the context of the US Federal Reserve System's tapering. Capital outflows and downward pressures on local currencies were symptomatic of a further tightening of financial conditions, in particular in countries with higher underlying vulnerabilities and external financing requirements. At the same time, several economies in both regions face supply-side constraints amid limited room for policy manoeuvre, while structural problems continue to act as a drag on growth in some countries. In both regions, risks to the outlook remain tilted to the downside, with several countries in the late stage of the credit cycle. In this context, recent years' rapid credit growth may represent a challenge to a number of countries in the context of slowing economic growth, the normalisation of external financial conditions and the shift in the composition of financing away from bank lending towards unregulated or less-regulated market segments outside (but with strong linkages to) the banking sector.

The global recovery remains fragile despite falling uncertainty…

All these developments combined suggest a muted global recovery which is uneven across regions and countries. The recent benign financial market sentiment and the relatively low levels of economic policy uncertainty in both the United States and Europe (see Chart 1.7) may mask the fragility of the recovery. With risks remaining tilted to the downside, underlying vulnerabilities continue to pose a threat to economic recovery across the globe. A major global vulnerability relates to persistent real and financial global imbalances, which are still high by historical standards, although they have narrowed markedly since the onset of the global crisis. The high pro-cyclicality of this rebalancing highlights the need to also address persistent structural deficiencies. In addition, despite marked price corrections in some (mostly safe-haven) commodities in the course of 2013 (see Chart 1.8), high and – amid the renewed flare-up of geopolitical tensions (such as the current tensions between Ukraine and Russia) – possibly further rising commodity prices may add to the downside risks. This said, these predominantly supply-side upward pressures on commodity prices may to some extent be counterbalanced by demand-side factors such as the slowdown in growth

Chart 1.7 Economic policy uncertainty in the United States and Europe

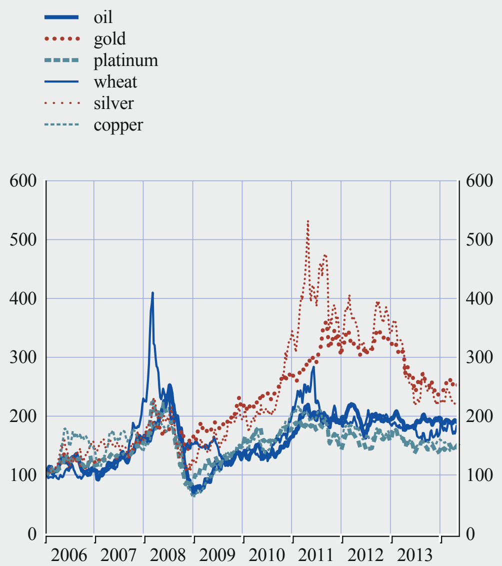
(Jan. 2007 – Apr. 2014; points; three-month moving averages; percentages)



Sources: Baker, S., Bloom, N. and Davis, S.J., at www.policyuncertainty.com, and Bloomberg.
Notes: Europe refers to the five largest European economies, namely 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 component only. The VSTOXX is based on the EURO STOXX 50 Index options traded on Eurex. It measures implied volatility on options with a rolling 30-day expiry.

Chart 1.8 Selected commodity price developments

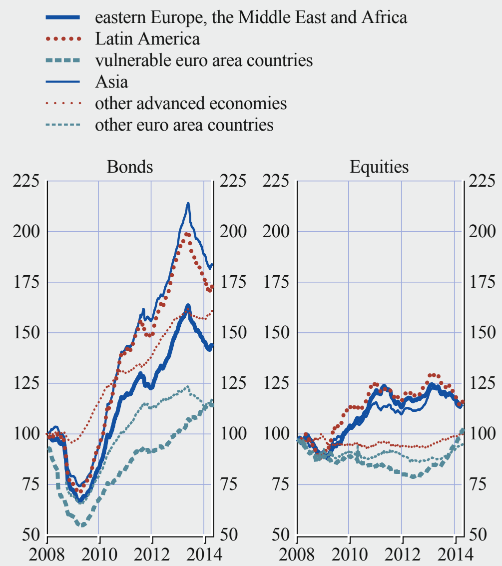
(Jan. 2006 – May 2014; index: Jan. 2006 = 100)



Source: Bloomberg.

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

(Jan. 2008 – May 2014; index: Jan. 2008 = 100)



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

dynamics in major emerging economies. Lastly, as reflected by the resurfacing tensions in bond, equity and foreign exchange markets in emerging economies in early 2014, the risk of a sudden, disorderly and possibly more broad-based unwinding of global search-for-yield flows and related potential global exchange rate movements in the context of the incipient exit from unconventional monetary policies by some major central banks remains a cause for concern – especially in regions and market segments which have seen ample inflows during the last couple of years (see Chart 1.9).

... with related risks to euro area financial stability

All in all, macro-financial risks to euro area financial stability appear to be increasingly stemming from outside the euro area, in contrast to internal risks in previous crisis-ridden years. These external risks predominantly relate to the uncertainties surrounding the economic prospects of major emerging economies and the related potential slowdown in foreign demand, as well as the sustainability of the economic recovery in advanced economies outside the euro area. At the same time, the prospective real economy counterpart of any potential unwinding of search-for-yield flows continues to represent a key risk going forward. That said, several macro-financial risks also continue to originate from within the euro area. In particular, the ongoing process of balance sheet adjustment in both the financial and the non-financial sectors in several countries, a possible resurfacing of sovereign tensions, heightened political risks coupled with insufficient reform implementation, and continued (albeit diminishing) fragmentation in the real and financial realms still weigh on the underlying euro area growth momentum. Ultimately, the materialisation of any of these risks, or of a combination thereof, may translate into heightened credit losses for banks, with negative repercussions for asset quality, profitability or solvency. However, higher loan loss provisioning by banks and considerably strengthened capital buffers should increase the resilience of intermediation in a still fragile macro-financial environment.

1.2 A FURTHER MARKED FALL IN SOVEREIGN STRESS AMID CONTINUED ADJUSTMENT OF UNDERLYING VULNERABILITIES

Sovereign stress in the euro area has fallen considerably…

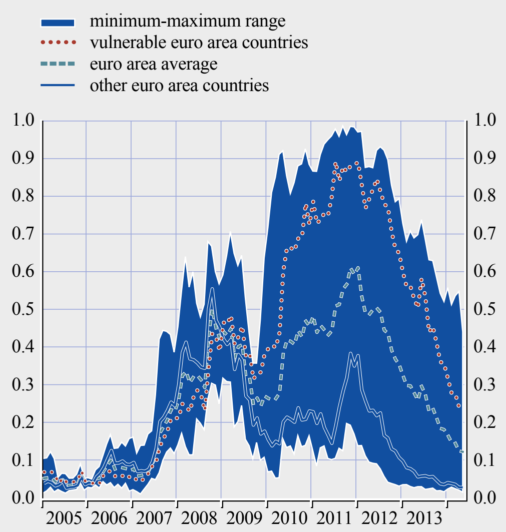
Sovereign stress in the euro area has continued to decline, reaching lows not seen since 2009 or even earlier (see Chart 1.10). At the same time, fiscal adjustment has continued, reinforced by a firming economic recovery. Of particular note, 2013 fiscal outcomes beat targets in all EU-IMF programme countries at that time, i.e. Cyprus, Greece, Ireland and Portugal. In addition, the aggregate euro area **fiscal deficit**, at 3.0% of GDP, came out somewhat better than expected six months ago. Meanwhile, Ireland, Portugal and Spain have successfully exited their support programmes (limited to the financial sector in the case of the latter). With an outlook of continued fiscal adjustment in 2014, a promising cycle of upgrades to sovereign and bank ratings, and/or to the outlook for these ratings, has started in some euro area countries, including Cyprus, Greece, Portugal and Spain.

… though imbalances remain…

Despite progress to date in reducing fiscal and macroeconomic imbalances, sizeable reform commitments still need to be implemented. There are signs that fiscal adjustment risks remain pro-cyclical, with the recent relative calm in euro area financial markets having the potential to breed complacency in terms of fiscal consolidation and structural reforms. The European Commission found that the progress made in the 2013 European Semester in terms of the country-specific structural and fiscal reform recommendations was limited overall. This finding was underlined further by the 2014 Annual Growth Survey, which stressed that substantial structural reforms, mainly those supporting growth in the short to medium term, are still necessary in the euro area. Moreover, the macroeconomic imbalance procedure suggests that, while overall imbalances have continued to adjust across the euro area, the high levels of private and public indebtedness leave several countries in vulnerable positions. More specifically, the Commission identified 11 euro area countries with macroeconomic imbalances, including "excessive" imbalances in Italy and Slovenia.

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

(Jan. 2005 – May 2014)



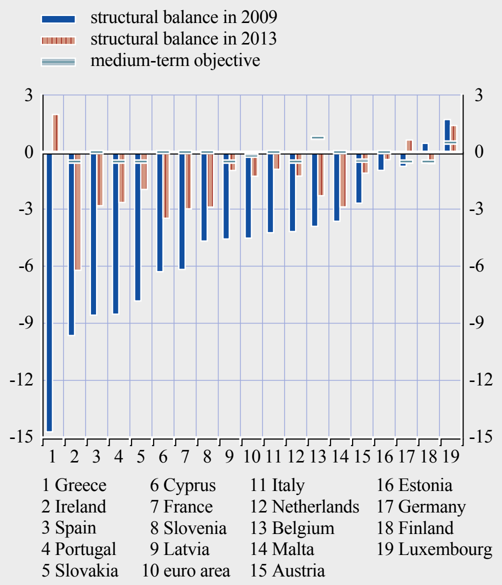
Sources: ECB and ECB calculations.
Notes: Aggregation of country indicators capturing several stress features in the corresponding government bond markets (changing default risk expectations, risk aversion, liquidity risk and uncertainty) for vulnerable (Greece, Ireland, Italy, Portugal and Spain) and other (Austria, Belgium, Germany, Finland, France and the Netherlands) 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.

… presenting continued risks to public debt sustainability

In terms of fiscal commitments, sizeable structural adjustments are still needed in most countries to put public debt on a firmly declining path. Many euro area countries are still far away from the medium-term objective of a close-to-balanced structural budget, despite the progress achieved in recent years (see Chart 1.11). In some of the euro area's largest economies, notably France, Spain and Italy, nominal deficit outcomes in 2013 fell somewhat behind the targets set under the excessive deficit procedure or their stability programmes. Moreover, the 2014 draft budgetary plans, as reviewed by the Commission in late 2013, revealed only limited additional structural consolidation and

Chart 1.11 Developments of structural budget balances across the euro area

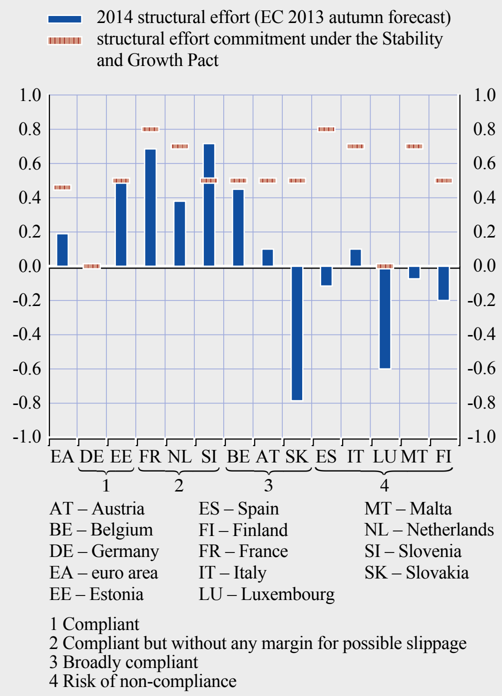
(percentage of GDP)



Sources: European Commission AMECO database, European Commission spring 2014 economic forecast and ECB.

Chart 1.12 Initial assessment of 2014 draft budgetary plans versus commitments made under the Stability and Growth Pact

(percentage of GDP)



Sources: European Commission and ECB.
Notes: Based on the European Commission's mid-November 2013 assessment of the 2014 draft budgetary plans of non-programme euro area countries. Luxembourg, Germany and Austria have meanwhile submitted revised draft budgetary plans following the investiture of new governments. For the first two countries, the draft budgetary plans were assessed to be fully compliant with the Stability and Growth Pact, while a risk of non-compliance under the Pact's preventive arm was found for Austria.

were at risk of falling short of commitments under the Stability and Growth Pact in five countries (see Chart 1.12). In early March the Commission also issued "autonomous recommendations" – a new surveillance instrument introduced under the two-pack regulations – for Slovenia and France to signal the risk of non-compliance with the 2015 excessive deficit procedure deadlines and to ask for additional consolidation measures.

Fiscal deficit is forecast to drop below 3% in 2014

Under current government plans, the aggregate euro area fiscal deficit is due to fall below the 3% Maastricht threshold this year – for the first time since 2008. According to the European Commission, if current budgetary plans are adhered to, the budget deficit for the euro area should decline from 3.0% of GDP in 2013 to 2.5% in 2014, and further to 2.3% in 2015. Compared with the Commission's forecast of six months ago, the deficit path has improved in most countries, owing, inter alia, to a permanent base effect from 2013, and in some countries, additional consolidation measures, particularly for 2015. Compared with the 2013 outcome, 2014 fiscal balances are expected to improve or remain broadly unchanged in the majority of countries (see Chart 1.13). However, absent additional fiscal consolidation in the context of the 2015 budgetary process, the fiscal balances are projected to deteriorate again in 2015 in seven euro area countries, despite further improving economic conditions.

Financial sector support remains part of the story, notably in Greece and Slovenia where the impact of extraordinary one-off bank recapitalisation costs incurred in 2013 is subsiding. More generally, an unwinding of financial sector support is expected to contribute positively to the improvement of fiscal positions in 2014, although additional support measures may continue to weigh on public finances in several countries, mainly in Slovenia and Austria. Going forward, bail-in and bank resolution frameworks will probably exert a strong influence on any such prospective public capital injections into banks.

Fiscal balances less affected by support to the financial sector in 2014

Despite progress in fiscal adjustment, the aggregate euro area **public debt**-to-GDP ratio has still been rising, but is expected to peak in 2014, at 96% of GDP. A move to a primary balance surplus is projected to contribute to debt reduction in 2015, for the first time in seven years. That said, compared with 2014, public debt levels are projected to increase further in seven euro area countries in 2015, barring additional fiscal consolidation measures. Compared with 2013, in almost all countries facing a projected increase in debt, the primary deficit and the deficit-debt adjustments are the main factors behind the rise in public indebtedness (see Chart 1.14).

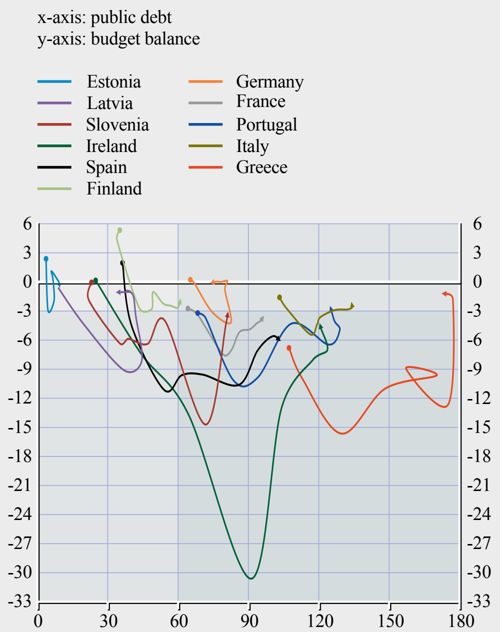
Public debt is expected to peak in 2014, but to then decline, albeit gradually, from very high levels

Given the significant challenges that remain with respect to putting the high debt ratios on a firmly declining path, the continued implementation of fiscal and structural reforms is crucial for both debt sustainability and economic recovery. It should also help create sufficient fiscal space to support credible national backstops for banking sector distress. In this context, the banking union has the potential to reduce risks to public finances, in particular, over the medium term by mitigating the negative feedback loop between banks and sovereigns. While agreement has been reached on the establishment of the Single Resolution Fund for the financing of the orderly resolution of non-viable banks, the modalities of its common backstop, which could include public financing, are still under discussion.

Reform commitment remains crucial, including completing EMU

Chart 1.13 Budget balances and public debt levels in selected euro area countries

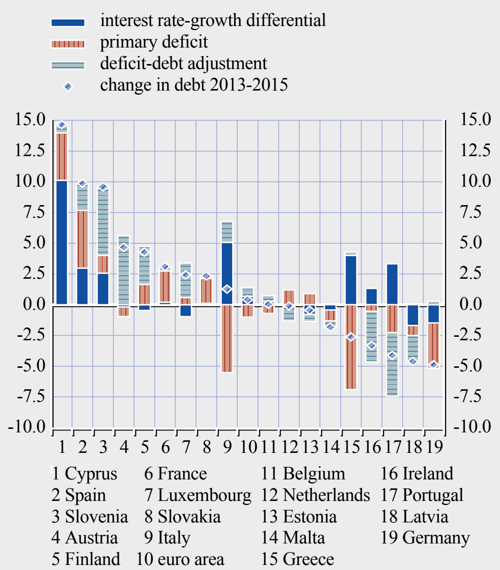
(2007 – 2015; percentage of GDP)



Source: European Commission spring 2014 economic forecast.

Chart 1.14 Changes in public debt levels across the euro area over 2013-15

(2013 – 2015; percentage points of GDP)



Source: European Commission spring 2014 economic forecast.

In this context, newly designed bail-in and bank resolution frameworks should help avoid moral hazard and limit any potential fiscal implications.

Financing needs remain sizeable in some countries in 2014

The crisis has vividly illustrated that severe financial stability risks can stem from liquidity strains, as well as from perceived credit risks. An analysis of **sovereign financing** needs suggests that the gross financing needs for 2014 as a whole (including redemptions so far) remain significant in many euro area countries (see Chart 1.15), as reflected in securities redemption data up to the end of March 2014. Maturing sovereign debt in the near-to-medium term remains considerable in the euro area as well, albeit with major cross-country differences. At the end of March 2014, securities with a residual maturity of up to one year accounted for 21% of total outstanding debt securities in the euro area, or 15.4% of GDP. Around one-third of outstanding debt securities will mature within two years, and some 60% within five years. The average residual maturity of outstanding euro area government securities was 6.4 years, ranging from 3.1 years in Cyprus to 12.3 years in Ireland.

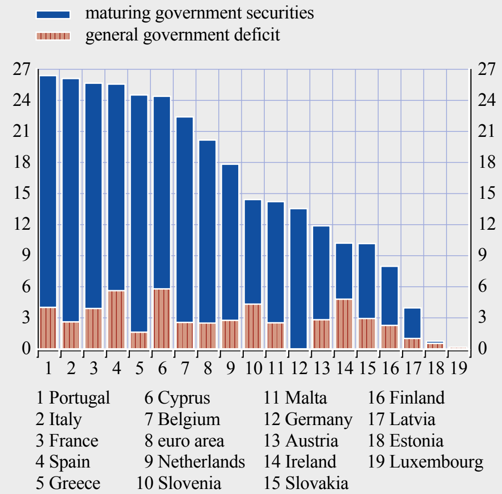
Recourse to financial assets may mitigate financing needs

Sovereign financing needs could be alleviated to some extent by recourse to existing financial assets. The consolidated financial assets held by euro area general governments averaged some 37.4% of GDP at the end of 2013, with some variation across countries. At the same time, the market value of consolidated general government liabilities in the euro area amounted to 104.1% of GDP (see Chart 1.16), yielding net financial liabilities of around 66.7% of GDP.

In general, the shock-absorption capacity of financial assets for smoothing governments' financing needs depends on their liquidity and marketability, which is arguably inversely related to sovereign stress. In this vein, long-term financial assets held by public institutions, such as pension funds or other special general government entities, can in principle not be used for servicing central government debt.

Chart 1.15 Maturing government debt securities and projected deficit financing needs of euro area governments in 2014

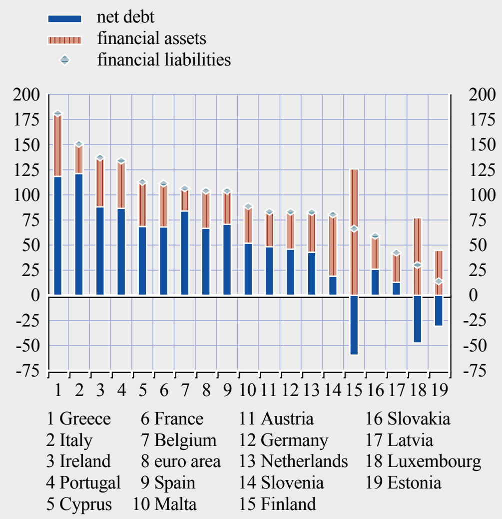
(percentage of GDP)



Sources: European Commission spring 2014 economic forecast, ECB and ECB calculations.
Notes: Gross financing needs are estimates of government debt securities maturing in 2014 (already redeemed and outstanding as at the end of March) and the government deficit. The estimates are subject to the following caveats. First, they only account for redemptions of debt securities, while maturing loans are not included. Second, some government securities do not fall under 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 March 2014 are not fully reflected in the data.

Chart 1.16 Euro area governments' net debt, financial assets and financial liabilities

(Q4 2013; percentage of GDP)

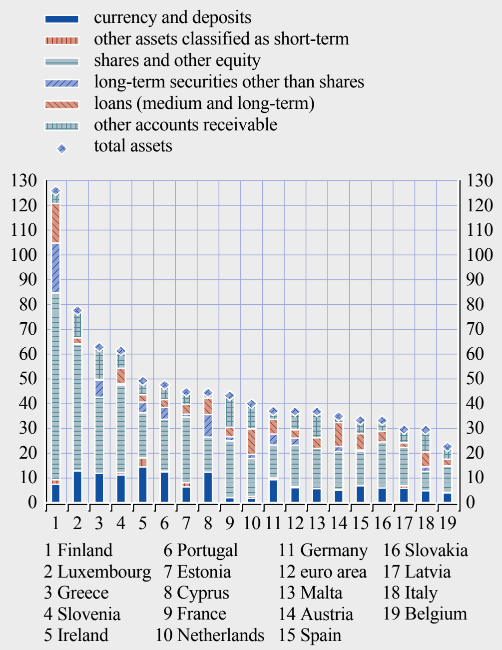


Sources: Eurostat, national sources and ECB calculations.

By contrast, short-term liquid assets, such as currency and deposits, which amounted to 6.1% of GDP at the aggregate euro area level (see Chart 1.17), can be more easily used to cover short-term financing needs. Shares and other equity accounted for the largest part of financial assets in most euro area countries, averaging 16.8% of GDP at the euro area level. However, cross-country heterogeneity is high in this respect, ranging from 7.8% in Italy to 75.3% in Finland. In the latter country, a sizeable proportion of total financial assets is held in employment pension schemes and other social security funds, which are part of the general government. Another major component of financial assets is "other accounts receivable", which incorporates various claims of the general government vis-à-vis the rest of the economy, including tax arrears towards the government. This component – in which the degree of liquidity for individual items can vary considerably – reached 7.3% of GDP at the aggregate euro area level, ranging from 2.2% in Cyprus to 13% in Greece. In sum, financial assets of governments are an important element in assessing sovereign liquidity and debt sustainability problems.

Chart 1.17 Structure of euro area governments' financial assets

(Q4 2013; percentage of GDP)



Sources: Eurostat, national sources and ECB calculations.
Note: Other assets classified as short-term include short-term securities other than shares, short-term loans and monetary gold.

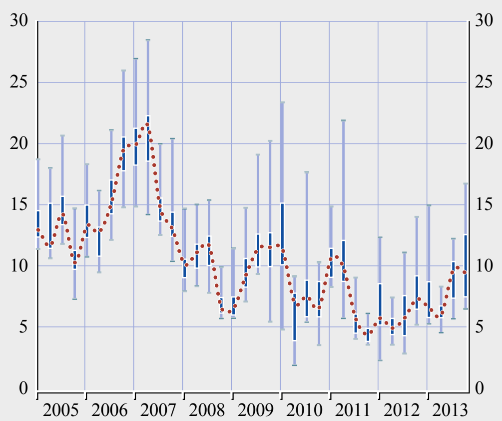
1.3 IMPROVED EARNINGS OUTLOOK TO SUPPORT ONGOING BALANCE SHEET ADJUSTMENT IN THE NON-FINANCIAL PRIVATE SECTOR

Improving economic conditions mitigate income and earnings risks

Income and earnings risks for the euro area non-financial private sector have subsided somewhat, as a result of gradually improving macroeconomic conditions. The income situation of *households* continues to stabilise as economic recovery takes root. Credit risk stemming from household balance sheets across the euro area appears to be falling, as signalled by a continued normalisation in the distance-to-distress indicator following historical lows seen at the height of the euro area sovereign debt crisis at the turn of 2011/12 (see Chart 1.18). At the same time, euro area households' expectations regarding their financial situation have improved further and are now back to levels seen before the unfolding of the euro area sovereign debt crisis in the second quarter of 2010. This comes as underlying changes in

Chart 1.18 Households' distance to distress in the euro area

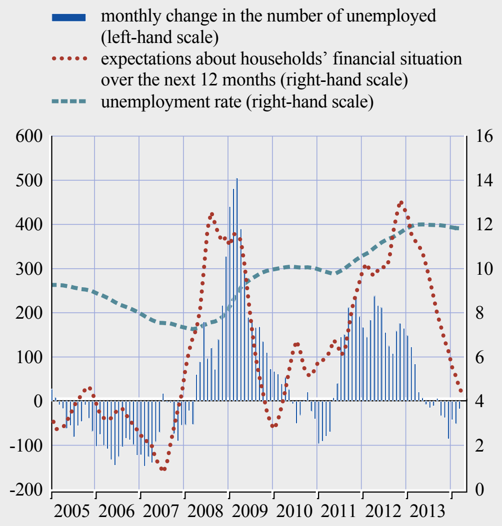
(Q1 2005 – Q4 2013; number of standard deviations from mean)



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 methodological details, see Box 7 in *Financial Stability Review*, ECB, December 2009.

Chart 1.19 Expectations about households' financial situation and changes in the number of unemployed in the euro area

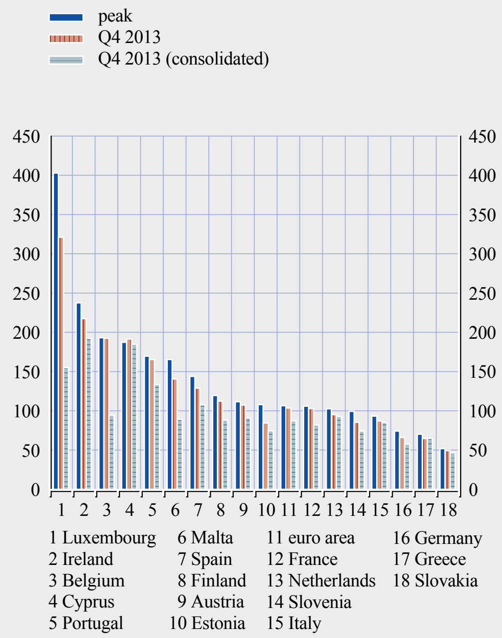
(Jan. 2005 – Apr. 2014; number in thousands, seasonally adjusted; percentages; percentage balances; three-month moving averages)



Sources: European Commission Consumer Survey and Eurostat.
Note: Expectations about households' financial situation are presented using an inverted scale, i.e. an increase (decrease) of this indicator corresponds to less (more) optimistic expectations.

Chart 1.20 Indebtedness of the non-financial corporate sector across the euro area

(Q4 2013; amounts outstanding; percentages of GDP; unconsolidated data unless otherwise stated)



Sources: ECB and ECB calculations.
Notes: The peak denotes the maximum value between Q1 2000 and Q4 2013. Unconsolidated debt is defined as loans, debt securities and pension fund reserves, but also includes cross-border inter-company loans, which may be meaningful in countries where international holding companies are traditionally located (e.g. Belgium, Ireland and Luxembourg). Consolidated debt is defined as loans (excluding inter-company loans), debt securities and pension fund reserves.

the number of unemployed signal that the unemployment rate may have peaked at the aggregate euro area level (see Chart 1.19). Nevertheless, labour market conditions continue to be weak in vulnerable euro area countries, thereby further weighing on households' income prospects. Reduced saving capacities, as reflected by decreasing (e.g. Ireland, Spain) or negative (i.e. Greece) saving rates, also render households in some countries vulnerable to renewed adverse income shocks.

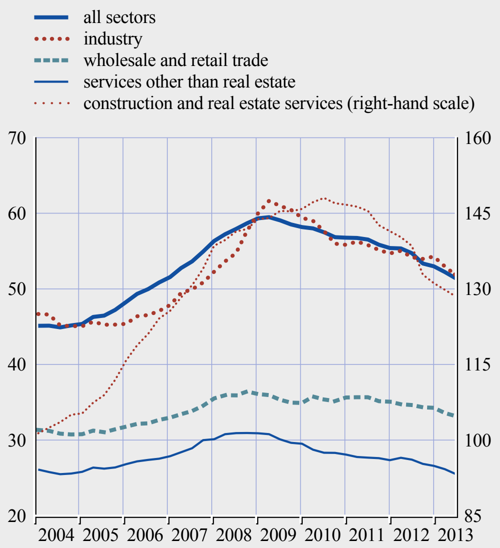
The profitability of euro area *non-financial corporations* has also benefited somewhat from gradually improving economic conditions, although it remains muted. Gross operating income has picked up slightly, amid lower negative earnings growth per share and falling expected default frequencies for listed firms. While these signs are promising, corporate earnings in the euro area are expected to rise only slowly, with firms' capacity to bolster capital through retained earnings likely to remain contained.

Private sector indebtedness remains high, but gradually adjusting…

Despite gradually improving income and earnings prospects, legacy balance sheet issues continue to weigh on the aggregate euro area non-financial private sector, notably in the corporate sector. Average euro area **indebtedness** stood at 64.4% of GDP for euro area households at the end of 2013, and at 103.6% for non-financial corporates, even though – at some 87% of GDP – the latter figure is much lower on a consolidated basis (see Chart 1.20). However, signs of a gradual balance sheet adjustment are apparent, even if the adjustment process may seem to have been rather modest at the aggregate euro area level to date, since household and non-financial corporate indebtedness only reached its peak in 2010. This reflects both the usual pattern of somewhat delayed debt deleveraging, i.e. the lagging pattern of bank credit around turning points in economic activity, and the sharp contraction in real GDP, i.e. the so-called "denominator effect".

Chart 1.21 Ratio of MFI loans to gross value added across euro area sectors of non-financial economic activity

(Q1 2004 – Q3 2013; percentages)



Sources: ECB and ECB calculations.
Notes: Sectors are defined according to the NACE Rev.2 classification. Data are based on outstanding MFI loans and the four-quarter moving sum of the gross value added.

… amid a continued high degree of cross-country heterogeneity

The process of deleveraging to date suggests that the speed of adjustment has been greatest in individual countries or sectors of economic activity that had accumulated large amounts of debt in the run-up to the crisis, and were accordingly most severely affected by it. For example, substantial progress has been made in terms of corporate deleveraging in Spain, Estonia and Ireland (see Chart 1.20), while in other countries like Portugal and Cyprus, weak economic activity to date has limited the reduction of corporate debt levels. The same pattern is true at the sectoral level, whereby overindebted sectors have tended to adjust more markedly than less indebted ones. In fact, at the aggregate euro area level, corporate indebtedness has dropped considerably in the construction and real estate services sector since its peak in 2010 (see Chart 1.21), in particular driven by adjustment in countries that experienced housing booms prior to the financial crisis, such as Estonia, Ireland and Spain.

The gradual economic recovery and the related improvements in households' and non-financial corporations' income and earnings situation is expected to help the ongoing process of balance sheet repair. Still, this will be a longer-term process, in particular in the household sector given continued weak labour market conditions in some countries. In countries with highly indebted non-financial private sectors, the deleveraging process may also continue for some time going forward, reflecting both firms' balance sheet restructuring and banks' selective credit standards. A sustained economic recovery, coupled with an enhanced restructuring process in the financial and non-financial sectors, seems vital for households and firms to be able to repair their balance sheets more swiftly.

Favourable interest rate environment facilitates debt servicing

In the current environment of low interest rates, together with the low cost of market-based funding, average household and non-financial corporate interest payment burdens have touched record lows. Relative price adjustments across countries may present debt servicing challenges in cases where a fall in the price level contributes to a rising real debt burden. At the same time, however, the low interest rate environment is helping to bolster households and firms' debt servicing capacities and the restructuring of balance sheets. Ongoing balance sheet repair should help offset the challenges related to an eventual normalisation of interest rates and the ensuing rise in debt servicing burdens. Such challenges might be greatest for those countries where loans with floating rates or rates with rather short fixation periods preponderate. That said, a higher debt service burden for borrowers in a rising interest rate environment is likely to be partly offset by the positive impact of an economic recovery on households' and firms' income and earnings situation.

Lending to the non-financial private sector remains muted amid a continued improvement in financing conditions

Lending flows to the non-financial private sector have remained muted, reflecting a combination of ongoing balance sheet repair across the financial and non-financial sectors and related disintermediation forces. On average, bank lending to euro area *households* has remained subdued, but appears to have stabilised amid a continued high degree of cross-country heterogeneity (see Chart 1.22). Looking at the components of bank lending by purpose, modest annual growth in loans for house purchase is offset by a drop in consumer loans and other types of lending. Nevertheless, in line with the gradual economic recovery, the April 2014 euro area bank lending survey suggests further improvements in the financing conditions for households, as reflected by the net easing of credit standards on loans to households and the net increase in demand for such loans.

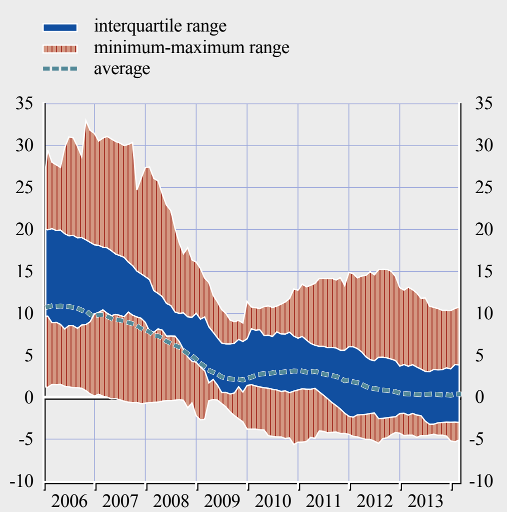
Credit supply constraints appear to be easing, particularly for housing loans and, to a lesser extent, for consumer loans. Improving supply-side conditions indicate not only a reduction in the cost of funds and in balance sheet constraints for banks, but also improved expectations regarding the economic and housing market outlook (and, by extension, consumers' creditworthiness). In terms of credit demand, improving housing market prospects and consumer confidence have translated into a small net increase in the demand for both housing loans and consumer credit.

A drop in bank lending to non-financial corporations…

Corporate loan growth has shown fewer signs of returning vigour, amid ongoing disintermediation. The net external financing of euro area *non-financial corporations* continued to fall in early 2014 (see Chart 1.23), partly driven by investment dynamics remaining muted. The latest euro area bank lending survey suggests that demand for corporate loans in the euro area has continued to contract, albeit at a slower pace. This largely reflects lower financing needs for investments, but the

Chart 1.22 MFI lending to euro area households

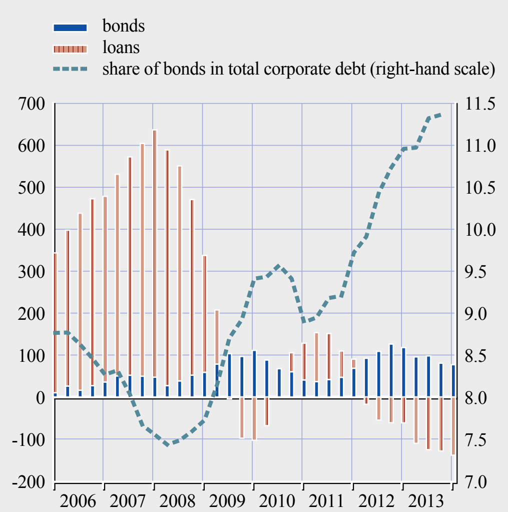
(Jan. 2006 – Mar. 2014; percentage change per annum)



Source: ECB.
Note: Data adjusted for securitisation.

Chart 1.23 External financing of euro area non-financial corporations

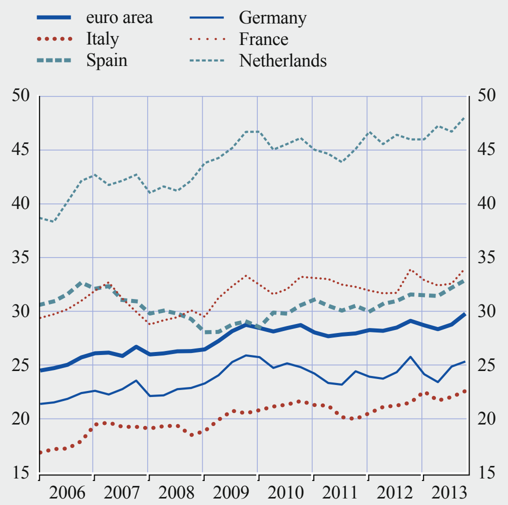
(Q1 2006 – Q1 2014; EUR billions; net annual flows; percentage)



Sources: ECB and ECB calculations.

Chart 1.24 Liquidity position of non-financial corporations in selected euro area countries

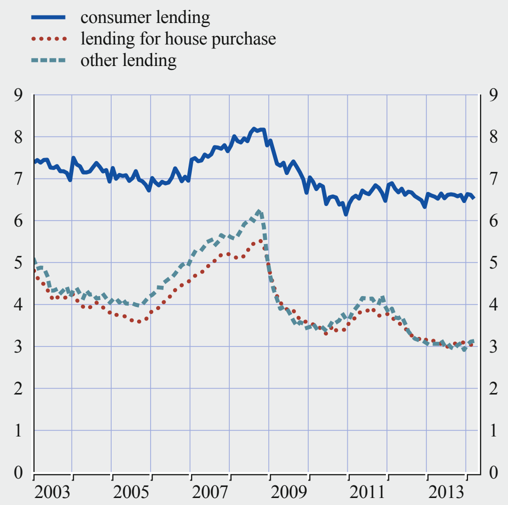
(Q1 2006 – Q4 2013; percentage of GDP)



Sources: ECB and ECB calculations.
Note: Liquidity is defined as the sum of currency and deposits, short-term securities and mutual fund shares.

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

(Jan. 2003 – Mar. 2014; percentages)



Source: ECB.

availability of internal funds and the shift towards market-based debt issuance appear to also play a role in explaining the subdued demand for bank loans. While the net tightening of euro area banks' credit standards for loans to non-financial corporations has continued to decline, developments by firm size showed that the decline in the net tightening of lending criteria for firms was more marked for loans to small and medium-sized enterprises (SMEs), for which banks reported a slight net easing for the first time since mid-2007.

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

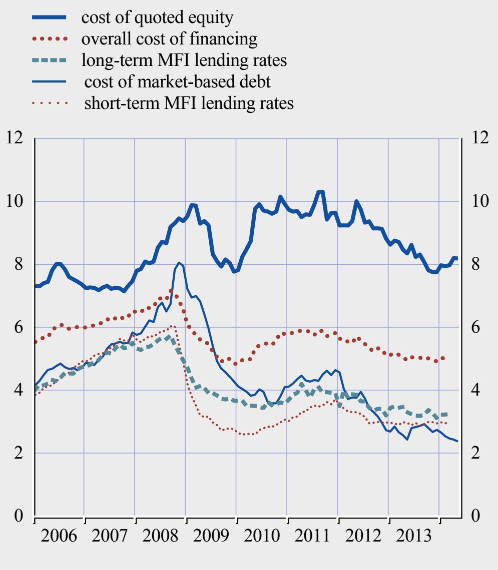
While corporate disintermediation has continued, on aggregate the issuance of market-based debt has fallen short of compensating for the decline in new MFI loans to non-financial corporations (see Chart 1.23). This development also has a distributional counterpart, as diversification of funding sources has mainly remained limited to larger corporations, and to those which are mostly domiciled in countries with more developed corporate bond markets. At the same time, firms which are more dependent on bank funding, like SMEs and firms located in more vulnerable countries, have continued to face tight (albeit improving) credit supply conditions. The latest survey on SMEs' access to finance shows that financing conditions for SMEs have continued to diverge across the euro area, with persistent financing obstacles for SMEs in countries more strongly affected by the crisis.

… and high corporate liquidity

While the availability and cost of external finance has been mixed, non-financial corporations have built up internal funds steadily, with liquidity buffers at historical highs in several countries. Liquidity holdings of euro area non-financial corporations have risen gradually over recent years, reaching, on average, almost 30% of GDP at the end of 2013, with some degree of cross-country variation across the euro area (see Chart 1.24). These high liquidity buffers may reflect the lack of investment opportunities, but to some extent also precautionary motives (i.e. mitigating the risk of limited access to external financing in the future) in the context of a low opportunity cost of holding liquid assets and continued credit supply constraints in some countries.

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

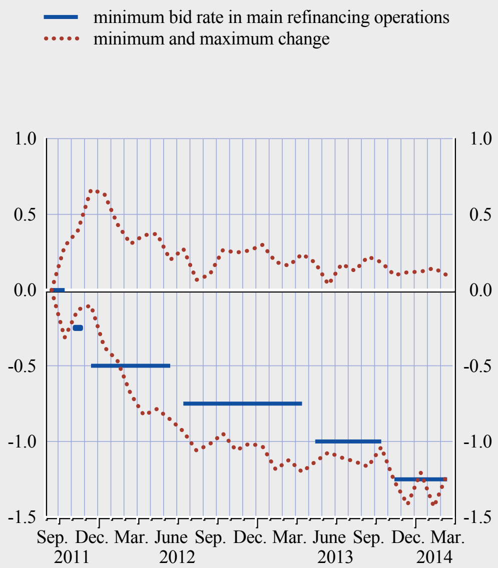
(Jan. 2006 – May 2014; percentages)



Sources: ECB, Merrill Lynch, Thomson Reuters and ECB calculations.
Note: The overall cost of financing for non-financial corporations is calculated as a weighted average of the cost of bank lending, the cost of market-based debt and the cost of equity, based on their respective amounts outstanding derived from the euro area accounts.

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

(Sep. 2011 – Mar. 2014; cumulative percentage point changes)



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

Financing costs have continued to drop, but the monetary transmission mechanism is still impaired…

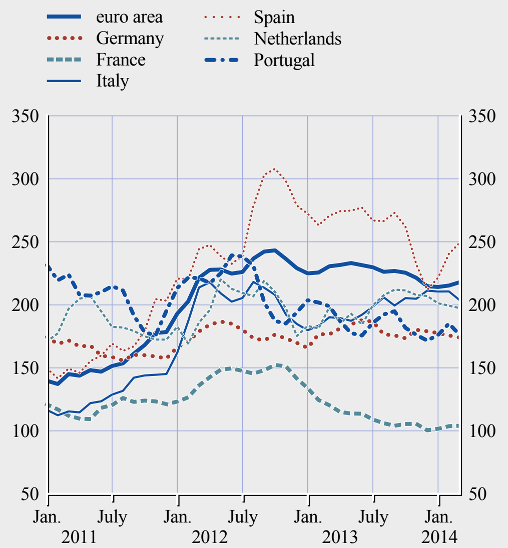
Funding costs for the euro area non-financial private sector have continued to decline across most business lines, maturities and funding sources. Financing costs for euro area *households* are now at their lowest levels – since the reporting of harmonised euro area bank lending rates began in 2003 – for all categories of lending except consumer credit (see Chart 1.25). Similarly, overall financing costs for *non-financial corporations* have continued to fall across most external financing sources (see Chart 1.26), supported by a low interest rate environment and benign financial market conditions. Bank lending rates have continued to decline marginally, but the latest cuts in monetary policy rates have not yet been fully passed through (see Chart 1.27).

… as suggested by continued cross-country heterogeneity

At the same time, fragmentation in lending conditions persists across countries, despite having decreased since the height of the euro area sovereign debt crisis. The cross-country divergence in the euro area, as measured by the range between the lowest and highest interest rate charged on loans to households, has remained at elevated levels, reflecting different country-specific risk constellations and persisting fragmentation in some euro area countries. The same holds true for corporates, where lending rates continue to vary widely across the euro area. On the one hand, this may be explained by the deteriorating creditworthiness of some corporations in more vulnerable jurisdictions owing to prolonged weak economic activity and strong uncertainty regarding the growth outlook, inducing banks to charge higher risk premia. 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.

Chart 1.28 Spread between lending rates on very small and large loans to non-financial corporations in selected euro area countries

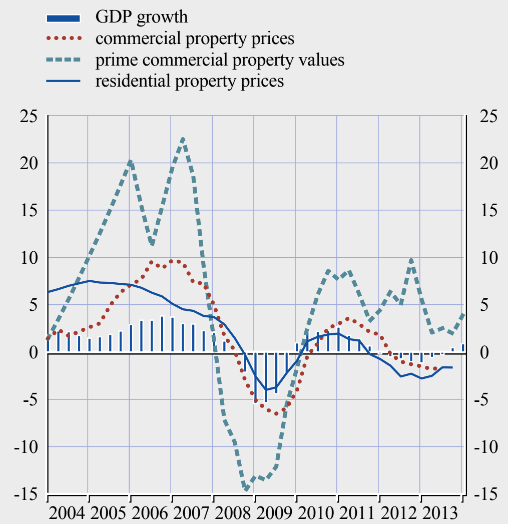
(Jan. 2011 – Mar. 2014; basis points; three-month moving averages)



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 – Q1 2014; percentage change per annum)



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

The availability and cost of non-financial corporations' funding is dependent on the firm size

An improvement in aggregate euro area financing conditions has also been reflected by a declining spread between bank lending rates for very small loans and those for large loans to non-financial firms in most of the larger euro area economies (see Chart 1.28). At the same time, the marked 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 more vulnerable countries. In part, these spreads may also reflect the fact that SMEs are more dependent on their respective domestic banking sectors than larger firms that have better access to global financial markets. Developments in firms' financial conditions continue to vary depending on firm size. According to the ECB's latest survey on the access to finance of SMEs in the euro area, the financial situation for large firms appears to remain more favourable than for SMEs as they reported an increase in turnover and profits. In addition, the success of large firms when applying for a bank loan was higher than for SMEs, indicating that large firms have better access to finance overall than SMEs.

Overall muted property market dynamics…

Aggregate euro area **property market** developments remained muted towards the end of 2013. Residential property prices have continued to decline at the aggregate euro area level, amid some signs of a turnaround in some more vulnerable euro area countries. Commercial property markets have shown further signs of stabilisation overall, with broadly unchanged prices compared with the previous year (see Chart 1.29).

… though ebullience of prime commercial property

Zooming in on the commercial segment, however, price dynamics suggest a growing bifurcation between strong price increases in the *prime* segment (e.g. office and retail space in capital cities) and relatively moribund developments in the *non-prime* segment. In conjunction with these price increases, underlying transaction volumes in commercial property markets have risen steadily since

2009 (see Chart 1.30), underpinned by a surge in cross-border investment – in particular from non-European investors – which accounted for almost half of the total volume in the euro area in the final quarter of 2013. Foreign demand was particularly strong for property in Spain, Italy and Ireland. This could be a sign of a hunt for higher-yielding investments in a low interest rate environment, including from foreign real money investors, in particular Asian investors and sovereign wealth funds.

Fragmentation at the country level persists, amid signs of a turnaround in some countries

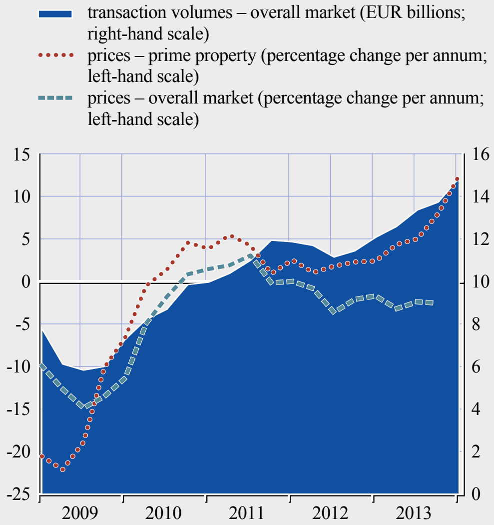
Notwithstanding developments in the prime commercial segment, property prices have shown a traditional tight link with underlying economic conditions across both residential and commercial market segments overall, with a high degree of cyclicality underlying persistent fragmentation at the country level. Commercial and residential property prices continued to drop, mainly in more vulnerable euro area countries like Cyprus, Greece, Portugal and Spain, but also in the Netherlands. By contrast, prices were still on the rise in Austria, Belgium, Finland and Germany – while after a major multi-year adjustment in residential and commercial property markets, country-level data suggest a bottoming-out at low levels and an ensuing recovery in some countries, notably Ireland. While country-level developments have often remained relatively modest, strong house price growth in large urban areas or capital cities (e.g. in Germany and Austria) have contrasted with comparably subdued price movements in other regions. Indeed, the risk remains that strong house price growth may ripple to surrounding areas, as often witnessed in previous house price booms.

Overvaluation remains a concern in some countries

Similarly to price dynamics, valuations in euro area property markets also show a large degree of cross-country heterogeneity. According to such metrics, residential property prices for the euro area as a whole are broadly in line with fundamentals, while commercial property valuation estimates are still somewhat above their long-term average. Moreover, these aggregate developments mask strongly diverging country and regional dynamics.

Chart 1.30 Commercial property price changes and investment volumes in the euro area

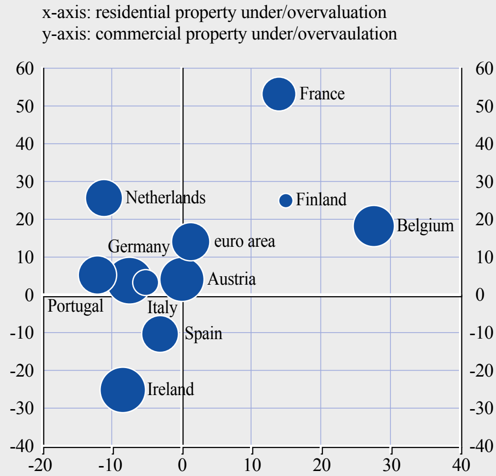
(Q1 2009 – Q1 2014; EUR billions; percentage change per annum; average of price changes in Austria, France, Germany, Ireland, the Netherlands and Spain)



Sources: DTZ Research, ECB, experimental ECB estimates based on IPD and national data and Jones Lang LaSalle.
Note: Four-quarter moving average of investment volumes.

Chart 1.31 Estimated over/undervaluation of residential and prime commercial property prices across the euro area

(Q1 2014; percentages)

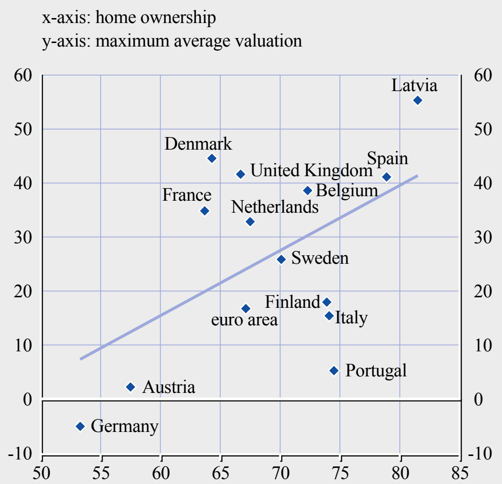


Sources: Jones Lang LaSalle, ECB and ECB calculations.
Notes: The size of the bubble reflects the expected change in real GDP growth in 2014. Estimates for residential property prices refer to Q4 2013 and are based on four different valuation methods: price-to-rent ratio, price-to-income ratio and two model-based methods. For details on the methodology, see Box 3 in *Financial Stability Review*, ECB, June 2011. For further details on valuation estimates for prime commercial property, see Box 6 in *Financial Stability Review*, ECB, December 2011.

Residential and commercial property market valuations have fallen significantly from previous peaks in a number of countries such as Ireland and Spain, as the continued unwinding of pre-crisis excesses has brought prices down to the level suggested by the underlying values or even lower. By contrast, estimated overvaluation remains high in both market segments in Belgium, Finland and France (see Chart 1.31). Similar disparities may emerge at the regional level, as suggested, for example, by the estimated noticeable overvaluation of residential property in some large German cities. While the above signals provide some insight into prospective trends, such valuation estimates are surrounded by high uncertainty as they do not take into account country-level specificities, such as fiscal treatment or various structural aspects of housing. For example, the rate of home ownership is positively correlated, albeit weakly, with the degree of maximum overvaluation experienced in euro area economies over the past decade (see Chart 1.32).

Chart 1.32 Maximum average valuation of residential property prices and home ownership ratios in selected EU countries

(2012; percentages)



Sources: Eurostat, ECB and ECB calculations.
Notes: The maximum average valuation is calculated as the maximum of the average of the four valuation indicators over the period from Q1 2000 to Q4 2013. Valuation estimates are based on four different valuation methods: price-to-rent ratio, price-to-income ratio and two model-based methods. For details on the methodology, see Box 3 in *Financial Stability Review*, ECB, June 2011.

All in all, the outlook for euro area property markets is expected to remain muted on aggregate, with the risk of potential corrections in some countries contrasting with emerging housing market recovery in others. Given a high correlation with the business cycle, a key downside risk to property markets relates to the pace of economic recovery, alongside any prospect for a potential increase in risk aversion and the related rise in long-term benchmark interest rates. Clearly, housing finance is a key conduit for such risks, given the potential to destabilise the debt servicing capacity of both households and commercial property investors. Given the leveraged nature of property lending, newly available macro-prudential real estate tools may help to counteract such risks for both banks and borrowers in the future.