I MACRO-FINANCIAL AND CREDIT ENVIRONMENT

__Macro-financial conditions__ remain fragile in the euro area, with a very modest economic recovery contrasting with generally robust financial market sentiment. At the country level, fragmentation of the real economy continues to weigh on the underlying growth momentum despite further progress in euro area rebalancing. Risks surrounding the fragile, low nominal growth environment appear to have risen. In particular, geopolitical tensions – despite a limited global impact to date – have the potential to reignite risk aversion in financial markets and potentially also trigger a broad-based adjustment in global capital flows. Ultimately, uncertainties regarding the pace and sustainability of economic recovery in both emerging and advanced economies within and outside the euro area remain – amid continued macro-financial vulnerabilities and structural reform needs along the path to normalisation of macroeconomic policies in some major advanced economies.

Euro area __sovereign stress__ has remained contained amid further improving market sentiment towards more vulnerable euro area economies, as well as some gradual strengthening in cyclical economic conditions and the ongoing adjustment of fiscal fundamentals. Risks nonetheless have increased in the current fragile growth environment, with related challenges for several countries in durably restoring the sustainability of public finances in the context of a prolonged period of low inflation and heightened downside risks to the economic outlook.

The weak economic recovery to date has also entailed challenges for the __non-financial private sector__, given muted developments in income and earnings. At the same time, household and corporate indebtedness remain high in several euro area countries. Financing conditions for euro area households and firms continued to ease, while recently introduced unconventional measures by the Eurosystem will help further reduce persistent fragmentation across countries and firm sizes. With time, a strengthening macroeconomic recovery should gradually translate into improved income and earnings prospects for households and non-financial corporations, which – together with the favourable interest rate environment – should help support the ongoing process of balance sheet repair.

In this environment, overall developments in euro area __property markets__ have shown incipient signs of recovery, in particular driven by a turnaround in some countries and market segments with considerable post-crisis adjustments. Nonetheless, fragmentation across countries and different property types remains pronounced, albeit declining in terms of both price developments and valuations. The ongoing hunt for yield in prime commercial property, a weaker than expected economic recovery as well as possible corrections in some jurisdictions and regions with signs of overvaluation still represent risks to financial stability going forward.

1.1 ONGOING MODERATE RECOVERY, BUT DOWNSIDE RISKS ON THE RISE

A loss of economic momentum…

The economic recovery has continued in the **euro area** in 2014, but has lost some of its momentum amid a softening in some major euro area countries towards the middle of the year. Aggregate euro area economic growth continued to be supported by domestic demand, which benefited from favourable real income developments and financing conditions. The economic recovery has been also buttressed by further reduced macroeconomic uncertainty, with all the different types of uncertainty now below their long-run average despite some pick-up in financial market uncertainty more recently (see Chart 1.1).

… but the recovery continues at a modest pace…

The recent slowdown in momentum notwithstanding, the economic recovery in the euro area is expected to continue on a moderate upward path in the medium term. Support stems from an accommodative monetary policy stance (notably including the standard and non-standard

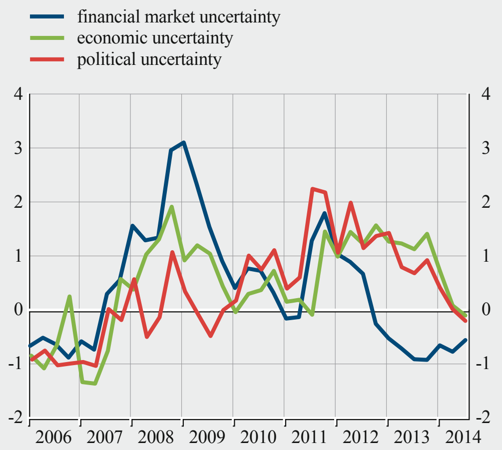
Eurosystem measures introduced in June and September 2014), favourable financial market conditions, recovering world trade, a depreciation of the euro, gradual improvements in the labour market as well as continued fiscal consolidation and structural reforms in several euro area countries. The September 2014 ECB staff macroeconomic projections for the euro area indicate annual real GDP growth of 0.9% for 2014 – somewhat lower than the 1.1% projected back in June and corresponding to a similar downward revision to the outlook of professional forecasters.

… amid increasing downside risks

The economic recovery remains fragile going forward in the light of increasing downside risks to the economic outlook (see Chart 1.2). Over the short to medium term, several factors could weigh significantly on the underlying euro area growth momentum, including the heightened geopolitical tensions across the globe, the still ongoing process of balance sheet repair in the financial and non-financial private sectors and the continued need for further fiscal

Chart 1.1 Economic, political and financial market uncertainty in the euro area

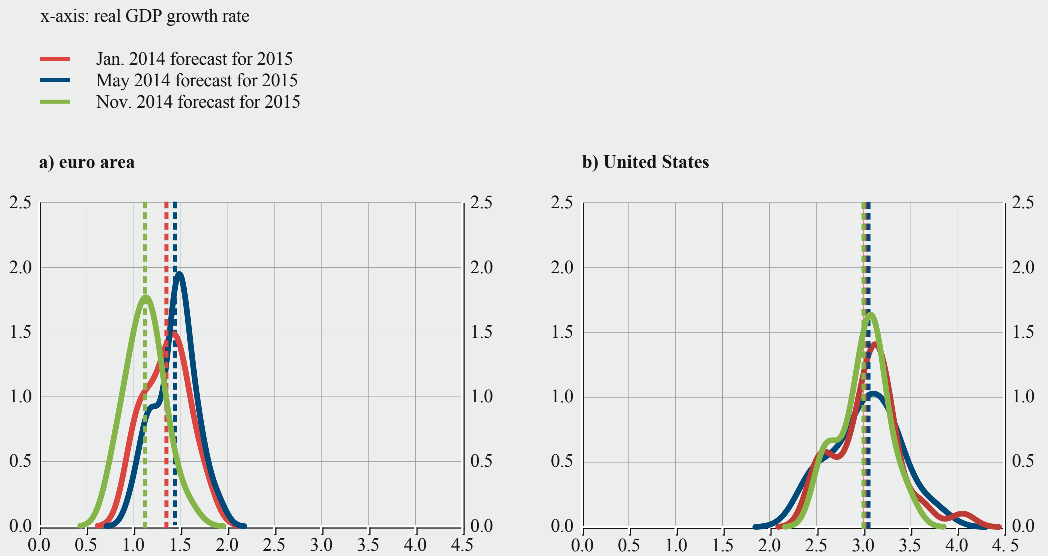
(Q1 2006 – Q3 2014; standard deviations from average over 1996-2014)



Sources: Consensus Economics, Eurostat, Baker, Bloom and Davis (2013), European Commission and ECB calculations.
Notes: Based on households' and firms' perceived uncertainty about the future economic situation taken from surveys (*economic*), various financial market indicators (*financial market*) and economic policies (*political*). For further details on the methodology, see "How has macroeconomic uncertainty in the euro area evolved recently?", *Monthly Bulletin*, ECB, October 2013.

Chart 1.2 Distribution of the 2015 real GDP growth forecasts for the euro area and the United States

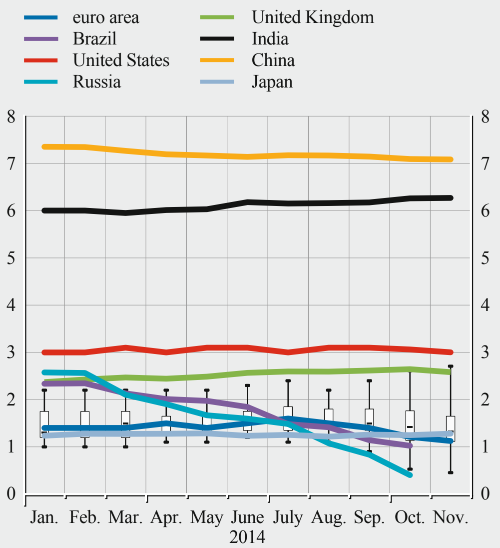
(probability density)



Sources: Consensus Economics and ECB calculations.

Chart 1.3 Evolution of forecasts for real GDP growth in selected advanced and emerging economies for 2015

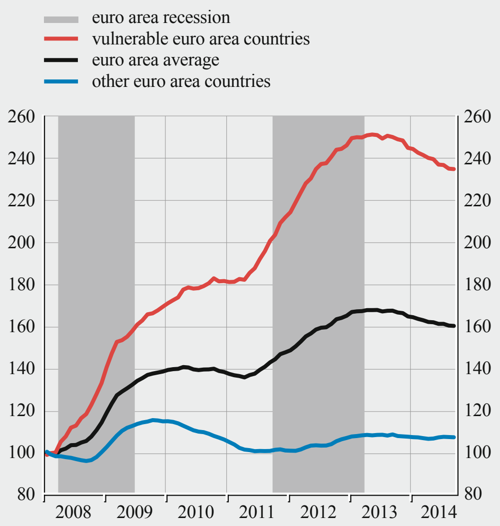
(Jan. 2014 – Nov. 2014; percentage change per annum)



Sources: Consensus Economics and ECB.
Note: The chart shows the minimum, maximum, median and interquartile distribution across the 11 euro area countries surveyed by Consensus Economics (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain).

Chart 1.4 Developments in the number of unemployed across the euro area

(Jan. 2008 – Sep. 2014; index: Q1 2008 = 100)



Sources: Eurostat and ECB.
Note: Vulnerable euro area countries include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

consolidation in some countries. That said, the economic outlook for the euro area remains subdued in comparison to the growth prospects of other major advanced and emerging market economies (see Chart 1.3).

Real fragmentation remains a cause for concern…

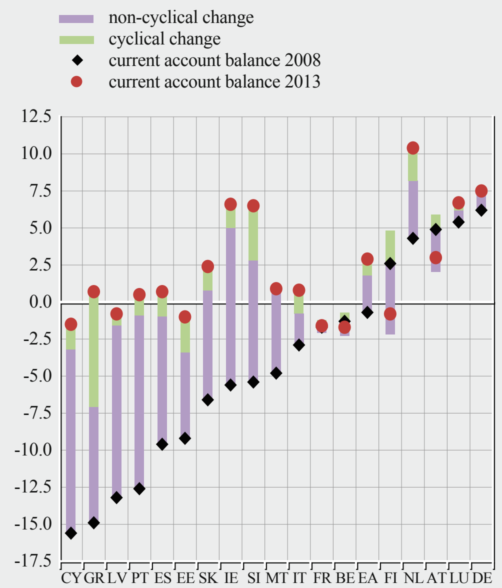
At the euro area country level, real fragmentation – albeit significantly lower than during the euro area sovereign debt crisis – remains a cause for concern, with more recently some signs of a renewed widening in the cross-country dispersion of growth rates. Moreover, labour market conditions are still very divergent within the euro area, as high unemployment in more vulnerable countries contrasts with relatively benign labour market conditions in other euro area economies (see Chart 1.4). This heterogeneity continues to highlight the need for employment-enhancing structural reforms with a view to fostering an inclusive economic recovery.

… despite the ongoing rebalancing in the euro area

Efforts to restore competitiveness are ongoing in a number of euro area countries. The overall competitiveness of more vulnerable euro area countries has improved considerably since the onset of the crisis, as indicated by major current account corrections. A large part of the underlying adjustment has been of a non-cyclical nature and is therefore likely to be sustained (see Chart 1.5). In the context of the ongoing rebalancing, structural reforms have proven decisive for competitiveness gains in several vulnerable euro area countries, as shown by notable improvements in global competitiveness rankings, for example in Greece and Portugal (see Chart 1.6). Still, structural reforms need to continue in order to help further reduce the real and financial fragmentation across the euro area, to enhance the euro area's medium-term growth potential and to further narrow the still sizeable, albeit diminishing, negative output gaps, particularly in vulnerable euro area economies.

Chart 1.5 Current account rebalancing across the euro area

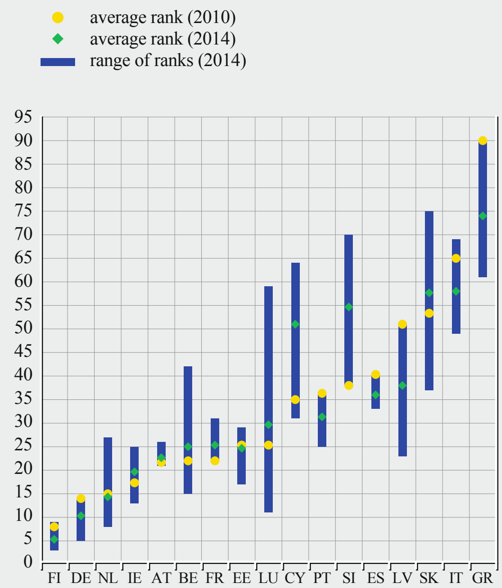
(2008 – 2013; percentage of GDP)



Sources: ECB and ECB calculations.
Notes: The estimates of cyclical and non-cyclical changes are based on a current account model in the vein of the IMF's External Balance Assessment. For further details see *External Balance Assessment Methodology: Technical Background*, Research Department, IMF, June 2013.

Chart 1.6 Changes in competitiveness across the euro area

(2010, 2014; ranks)



Sources: World Bank, International Finance Corporation, World Economic Forum, Transparency International and ECB calculations.
Notes: The average rank represents the simple average of the country's rank in Transparency International's Corruption Perceptions Index (2013, 2010), the World Economic Forum's Global Competitiveness Report (2014-15, 2010-11) and the World Bank/International Finance Corporation's Ease of Doing Business (2015, 2011) rankings.

Global recovery continues along a gradual but uneven growth path

A gradual recovery in **global economic activity** has continued. Economic momentum in advanced economies strengthened further, albeit at an uneven pace across regions, while growth in emerging markets has also rebounded after a temporary dip in 2013. The accommodative monetary policy stance in advanced economies – though showing signs of divergence – has continued to provide vital support to a fragile economic recovery. Notwithstanding the recent rise, overall volatility appears to have remained subdued in global financial markets (see Chart 1.7). In particular, emerging markets have witnessed a drop in financial market pressures (see Chart 1.8), as improved global risk sentiment has encouraged capital flows back to emerging markets following intermittent turbulences since mid-2013. While global growth is expected to pick up gradually, risks to the global outlook remain tilted to the downside. Heightened geopolitical risks, persistent macroeconomic and/or financial imbalances, as well as a sharp repricing of risk with ensuing corrections in asset prices and a potential disorderly unwinding of capital flows, could have negative repercussions for the global economy.

Economic momentum in advanced economies is firming slowly…

Zooming in on the main global economic regions, economic momentum in many **advanced economies** outside the euro area is firming slowly, despite short-term volatility. Recent trends indicate a continued recovery ahead, but the pace of progress varies across countries, as still weak labour market conditions, continued balance sheet adjustments in the financial and non-financial private sectors and a still incomplete process of fiscal consolidation continue to weigh on near-term growth prospects in several countries. Beyond the support of accommodative monetary policies, economic growth in advanced economies will increasingly benefit from waning private sector deleveraging and fiscal drag, enhanced confidence and falling unemployment.

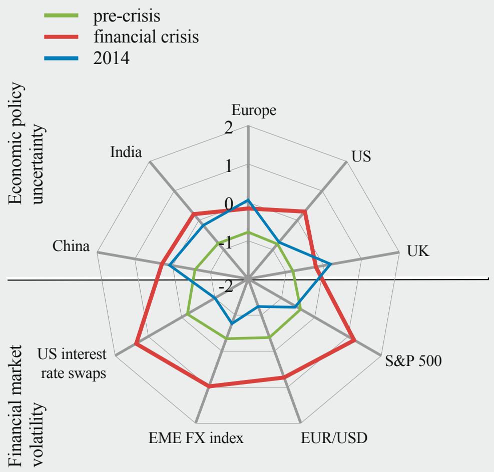
… but risks continue to be tilted to the downside

In the **United States**, the economic recovery has gained traction after a weather-related weak start to 2014, supported by favourable housing and labour market developments. Notwithstanding some temporary increase in volatility in October, financial conditions have eased further, with indicators of financial stress at or near all-time lows. In the context of generally improving economic prospects, the Federal Reserve concluded its asset purchase programme in October, while preserving a highly accommodative monetary stance, as reflected by the low target range for the federal funds rate and the expected maintenance of its longer-term securities holdings at sizeable levels. Looking ahead, economic activity should become more sustained due to the ongoing recovery in labour and housing markets, accommodative monetary and financial conditions, as well as fading headwinds from fiscal policy and household deleveraging, with the household debt-to-income ratio now having arguably returned to levels closer to equilibrium.[1]

In **Japan**, the economy contracted strongly in the second quarter of 2014, as demand rebalanced after the VAT hike in April and the frontloaded spending in the first quarter. Growth is expected to resume towards the end of 2014 supported by accommodative monetary policy, including a newly adopted set of measures taken at the end of October. Despite the consumption tax rise, fiscal challenges remain and fiscal consolidation over the medium term remains a necessity to ensure long-term debt sustainability. In addition, banks' sovereign exposure, albeit declining, remains a concern for the profitability and solvency of the

Chart 1.7 Financial market volatility and economic policy uncertainty

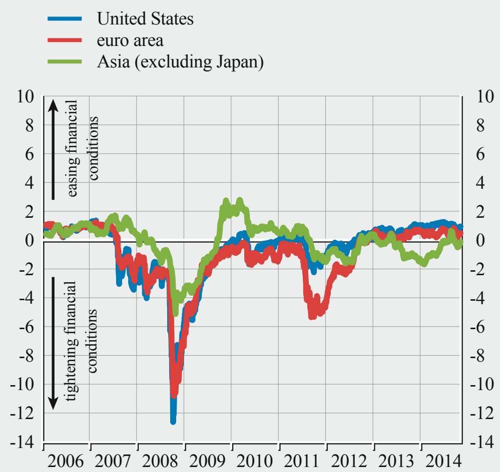
(2003 – 2014; number of standard deviations)



Sources: Haver Analytics, Bloomberg, ECB and Baker, Bloom and Davis (2013).
Notes: The chart shows differences in the number of standard deviations between the values of each indicator over three different periods and the average of 2003-14. The pre-crisis period refers to January 2003 – August 2007. The financial crisis period refers to August 2007 – December 2009, while 2014 refers to available observations this year. Series above the horizontal line are measures of economic policy uncertainty from Baker, S., Bloom, N. and Davis, S., "Measuring Economic Policy Uncertainty", Chicago Booth Research Paper No 13/02, January 2013. Below the line, implied volatilities on three-month USD/EUR options, the JPMorgan emerging market FX index, the S&P 500 and US interest rate swaps are shown.

Chart 1.8 Financial conditions in selected advanced and emerging market regions

(Jan. 2006 – Nov. 2014; number of standard deviations)



Source: Bloomberg.

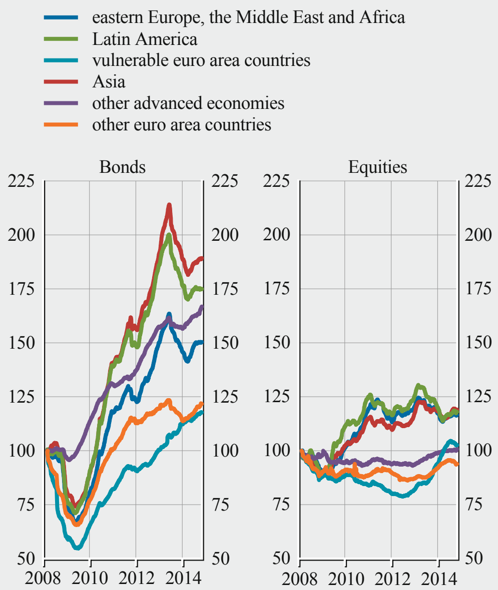
1 For further details, see Albuquerque, B., Baumann, U. and Krustev, G., "Has US household deleveraging ended? A model-based estimate of equilibrium debt", *Working Paper Series,* No 1643, ECB, March 2014.

Japanese banking sector, in case of a repricing of risk in financial markets and the related potential increase in government bond yields.

The **United Kingdom** maintained its strong growth momentum in the first half of 2014, buttressed by rising household confidence, improving labour market conditions and a buoyant housing market. Leading indicators point to a growth moderation in the short run, while structural factors, such as the need for further balance sheet repair in the private and public sectors, will weigh on economic activity over the medium term. Headwinds also relate to ongoing geopolitical risks and the sharp housing market recovery that may provide some relief for highly indebted households, but may also render them more vulnerable to potential corrections in property markets.

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

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



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

Emerging markets are recovering as financial tensions subside

Emerging markets have benefited from easing financial market pressures in recent months, as reflected by lower sovereign bond spreads, stabilising equity prices and renewed capital inflows into some of those countries that were more affected by the bouts of volatility in 2013 and early 2014 (see Chart 1.9). This was underpinned by progress in reducing macroeconomic imbalances in some of the more vulnerable economies, also bolstering investor confidence. In tandem with reduced financial stress, economic activity rebounded in several countries, even though remaining rather subdued relative to past years' experience. Going forward, growth in some emerging economies is likely to be restrained by structural factors, such as infrastructure bottlenecks and capacity constraints, while in other countries that were highly dependent on capital inflows, activity is likely to be dampened as economies rebalance and adjust to tighter financial conditions and the expected adjustment of US monetary policy. In the latter context, depleted foreign exchange reserves after the 2013-14 tensions may render some emerging economies with larger external imbalances more vulnerable.

Growth outlook in emerging Europe benefits from gradual euro area recovery

The economic recovery continued in most **emerging European economies**, notably the EU countries in central and eastern Europe, supported by strong exports and domestic demand. The impact of the Ukraine-Russia crisis on the region has remained contained to date, given rather limited direct trade linkages and contained financial market spillovers. Still, the main downside risk to the region's economic recovery is related to a further escalation of this conflict, which could also lead to a deepening of sanctions between the EU and Russia. Given strong trade and financial linkages, economic activity in the region is expected to benefit from the ongoing gradual euro area recovery, but also from a further strengthening of domestic demand. However, the outlook for domestic demand in several countries continues to be constrained by a still incomplete process of balance sheet adjustment in the private and public sectors, which in some countries is further complicated by existing currency mismatches. In spite of improved economic activity, credit growth remains subdued in most countries amid a still elevated level of non-performing loans and the ongoing deleveraging by foreign banks. At the same time, foreign banks have continued to adjust towards a more self-sustained and domestically funded business model that should help mitigate risks to financial stability in the region.

Economic activity has rebounded in Asia, but lost momentum in Latin America

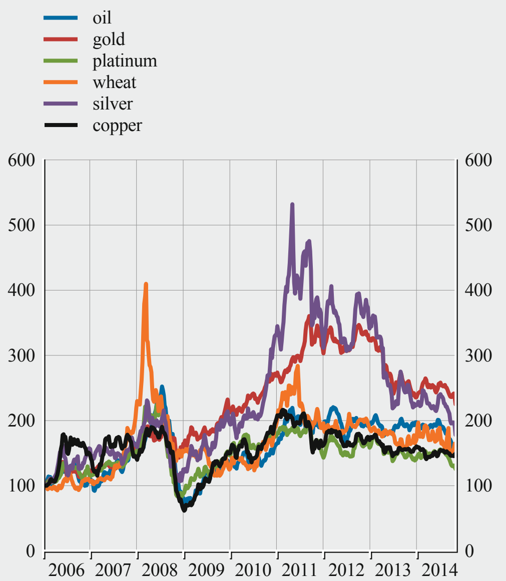
Following a period of weak growth, economic momentum has strengthened in **emerging Asia**, particularly in India and some other emerging Asian economies, where growth prospects have started to improve following corrections in external imbalances and structural reforms, although growth in China has weakened lately. Looking ahead, a gradual moderation in regional growth dynamics is expected, mainly in China, where high credit growth and leverage, as well as a strongly expanding shadow banking sector, require close monitoring. A slowdown in China would have knock-on effects for other Asian economies with close trade and financial links, but downside risks continue to relate to larger than expected spillovers from capital outflows linked to Federal Reserve tapering. Economic activity in **Latin America** has lost some traction in 2014 and growth has become more uneven across economies. In Brazil, the economy dipped into outright recession following three years of weak growth, while a deeper recession is underway in Argentina, where the outlook has deteriorated further after the debt default in July. The region is expected to undergo a period of subdued growth before gradually benefiting from improved external demand. Risks to the outlook remain tilted to the downside. The main concerns relate to a further tightening of external financing conditions, a more pronounced decline in commodity prices and the risk of a prolonged period of weakness in economic activity in Brazil.

Rising geopolitical tensions represent an increasing cause for concern…

Overall, a moderate but uneven global recovery across countries and regions is expected, with inherent fragilities being somewhat masked by continued benign financial market sentiment. Risks remain tilted to the downside as long-standing and newly emerging underlying vulnerabilities continue to pose a threat to recovery across the globe. Alongside persistent real and financial **global imbalances**, which remain high in a historical context despite having narrowed markedly since the onset of the global crisis, the recent intensification of **geopolitical tensions** represents an increasing cause for concern – this not only in the context of the still ongoing Ukraine-Russia crisis, but also related to other recent incidents in the Middle East. These tensions have the capacity to trigger a spike in commodity prices that may endanger the global recovery and also contribute to preserving global imbalances. This said, intensified geopolitical risks have had a largely muted effect on commodity markets to date (see Chart 1.10), with oil and non-oil commodity prices generally declining over the past months driven by short-run supply-side (e.g. limited disruptions to oil production, emergence of alternative production techniques) and demand-side (e.g. moderate global growth, buoyant risk appetite) fundamentals, which have offset upward pressures related to heightened

Chart 1.10 Selected commodity price developments

(Jan. 2006 – Nov. 2014; index: Dec. 2005 = 100)



Source: Bloomberg.

geopolitical risks. Lastly, the risk of a disorderly and broad-based **unwinding of global search-for-yield flows** as a result of a faster than expected exit from unconventional monetary policies by some major central banks in advanced economies remains a cause for concern.

... with related risks to euro area financial stability

In sum, important macro-financial risks to euro area financial stability stem from global factors, including rising geopolitical tensions as well as uncertainties regarding the pace and sustainability of the economic recovery in emerging and advanced economies. Most notably, the risk of possible renewed tensions in global financial markets coupled with a potential unwinding of search-for-yield flows continues to represent a cause for concern. At the same time, macro-financial risks also continue to originate from within the euro area in a fragile, low nominal growth environment. In particular, the still ongoing process of balance sheet adjustment in both the financial and non-financial sectors in several countries and continued (albeit diminishing) real and financial fragmentation still weigh on euro area growth momentum.

Box 1

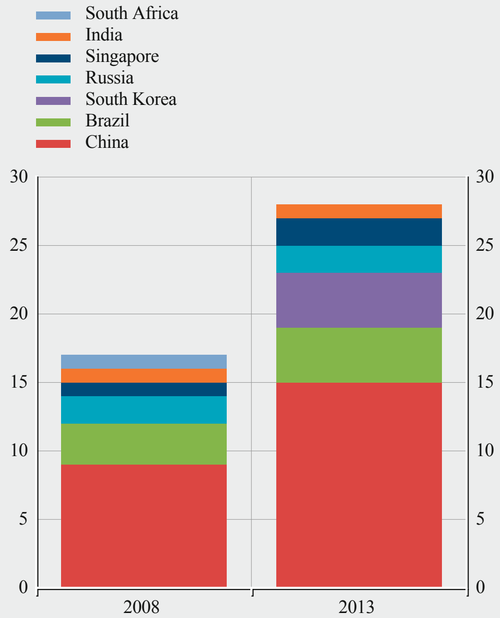
DOES THE GROWING IMPORTANCE OF EMERGING MARKET BANKS POSE A SYSTEMIC RISK?

One side effect of the global financial crisis has been strong growth in the weight of emerging market banks in the global financial system. Indeed, financial deepening in emerging markets has accelerated in recent years as the financial crisis has triggered both increased capital flows to these economies, as well as deleveraging of banks in advanced economies. By the end of 2013, 28 of the 100 largest banks globally were headquartered in emerging markets, compared with 17 only five years earlier (see Chart A). As the resulting geographical structure of the global financial system has evolved, the monitoring of risks clearly also needs to be adapted.

Tracking the main regions exhibiting a rapid expansion of financial sector size, banks from six emerging market economies (EMEs) are represented in the set of the 100 largest banking groups worldwide – i.e. China (15), Brazil (4), South Korea (4), Singapore (2), Russia (2) and India (1). Also, the market capitalisation of emerging market banks has almost quadrupled since the peak of the financial crisis and accounted for 35% of global bank market value just before the onset of the "taper tantrum" in May 2013 (see Chart B). Against this background, the purpose of this box is to provide empirical evidence about whether or not, in line with the share of the emerging market financial sector in world markets, their systemic importance for the global financial system has increased over the recent past.

Chart A Number of emerging market banks in the world's 100 largest banks by total assets

(number of institutions)

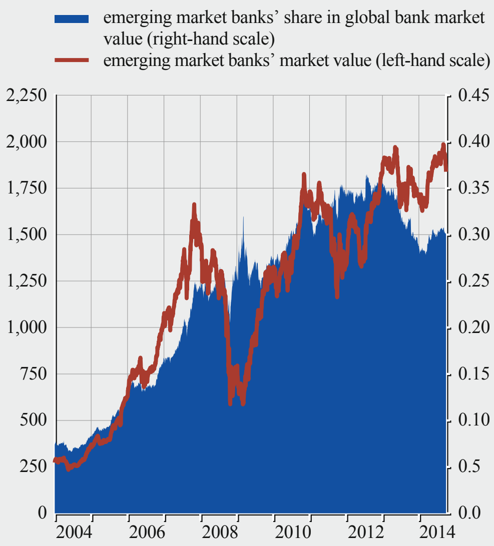


Source: relbanks.com

To gauge the systemic importance of emerging market banks, two popular measures of conditional risk (co-risk) can be employed: the conditional value at risk (CoVaR) and the conditional expected shortfall (CoES).[1] These measures capture tail dependence between equity price return distributions of individual institutions and the financial system as a whole. In this application, the two metrics represent, respectively, the value at risk (VaR) and the expected shortfall (ES) of the global banking system conditional on a particular emerging market bank being in distress.[2]

Chart B Emerging market banks' market capitalisation and share in global bank market value

(Jan. 2004 – Sep. 2014; USD billions; percentages)



Source: Datastream.

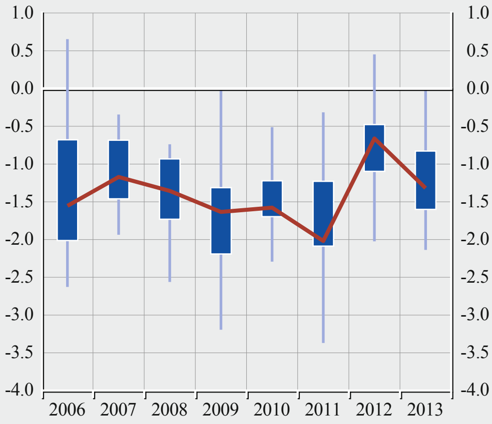
The model estimates suggest that, despite rapid growth in emerging market banks, there has not been a meaningful increase in the systemic importance of emerging market banks for the global banking system.[3] In fact, the two co-risk measures indicate that, at times when emerging market banks were at risk, the global banking sector experienced a median loss in the range of one to two times of the daily standard deviation prevailing in the respective calendar year (see Charts C and D). The evolution of the two co-risk measures over time does not exhibit a downward-sloping trend, i.e. more negative returns for the global banking sector during periods of financial stress among emerging market banks. If anything, the co-risk measures have, in recent years, moderated towards lower conditional losses in global banking sector prices, whereas they peaked in periods of global or euro area market turbulence in 2008, 2009 and 2011.[4]

Overall, the empirical evidence confirms earlier findings in the literature suggesting that tail dependence measures, like standard correlation coefficients, tend to increase globally in periods of global market turbulence. At the same time, the above findings are consistent with recent studies on emerging market banks which find that the global footprint of emerging market banks has remained regionally confined so far.[5] Notwithstanding this finding, a changing geographical importance of global financial institutions requires close monitoring given the prospect that market prices underlying these empirical measures may adapt in ways that cause past empirical

1 See Brunnermeier, M. K. and Adrian, T., "CoVaR", *Federal Reserve Bank of New York Staff Reports*, No 348, September 2008 (revised in September 2011).
2 CoVaR/CoES are measures of the excess loss of the euro area banking system at the tail of a bank i's return distribution, implied by the bank's individual VaR/ES at the q^{th} percentile, relative to its median.
3 The sample of emerging market banks is composed of the three largest, non-foreign-owned, listed banks (in terms of total assets) from six EMEs which have systemically relevant financial sectors according to the IMF as well as three advanced Asian economies that exhibit a high degree of integration with the banking sector in emerging Asia.
4 A major caveat of this CoVaR/CoES approach is that any interdependence of price movements between emerging market banks and the global financial system may also stem from global factors. At the same time, the presented set-up largely rules out the possibility of reverse causality (i.e. that shocks to the global banking sector determine price movements of emerging market banks).
5 See Van Horen, N., "Branching Out: The Rise of Emerging Market Banks", in Reuttner, I. (ed.), *The Financial Development Report 2012*, World Economic Forum, New York, 2012; and BIS, "EME banking systems and regional financial integration", *CGFS Publications*, No 51, Committee on the Global Financial System, March 2014.

Chart C Daily value at risk of the global financial system conditional on EME banks at risk ($\Delta CoVaR_{1\%}^{system|i}$)

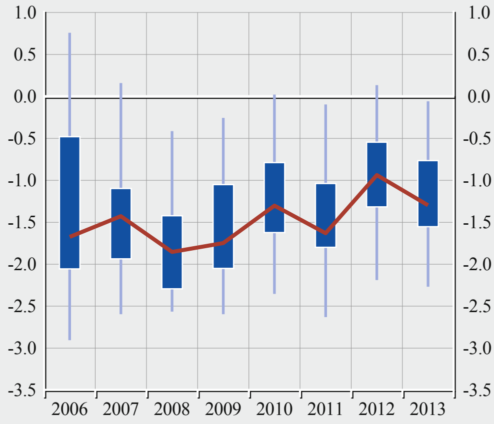
(2006 – 2013; percentage of daily standard deviation)



Sources: Bloomberg and ECB calculations.
Notes: The charts depict the distribution and the median CoVaR/CoES estimates based on eight non-overlapping annual samples of daily observations from 2006 to 2013. The black line represents the median of the 26 EME banks' daily $\Delta CoVaR_q^{system|i}$/ $\Delta CoES_q^{system|I}$ in per cent of the daily standard deviation of the global banking sector's return distribution. A negative (positive) value represents a conditional loss (gain). The blue box represents the 25% to 75% quantile of banks. The blue vertical lines represent the minimum and the maximum estimates.

Chart D Daily expected shortfall of the global financial system conditional on EME banks in distress ($\Delta CoES_{1\%}^{system|I}$)

(2006 – 2013; percentage of daily standard deviation)



Sources: Bloomberg and ECB calculations.
Notes: The charts depict the distribution and the median CoVaR/CoES estimates based on eight non-overlapping annual samples of daily observations from 2006 to 2013. The black line represents the median of the 26 EME banks' daily $\Delta CoVaR_q^{system|i}$/ $\Delta CoES_q^{system|I}$ in per cent of the daily standard deviation of the global banking sector's return distribution. A negative (positive) value represents a conditional loss (gain). The blue box represents the 25% to 75% quantile of banks. The blue vertical lines represent the minimum and the maximum estimates.

regularities to break down. Moreover, while a mainly regional footprint may limit the prospect of systemic risk at the global level, regional aspects may nonetheless be relevant for euro area financial stability. Emerging market banks located in EU neighbouring countries have recently intensified their financial linkages with the euro area/EU, for instance by setting up offices in the EU and by participating actively in deposit gathering and loan operations in the region. Given that financial stress among emerging market banks can be transmitted to the euro area via both direct and indirect exposures, significant emerging market banks in general can have financial stability repercussions on the euro area financial sector.

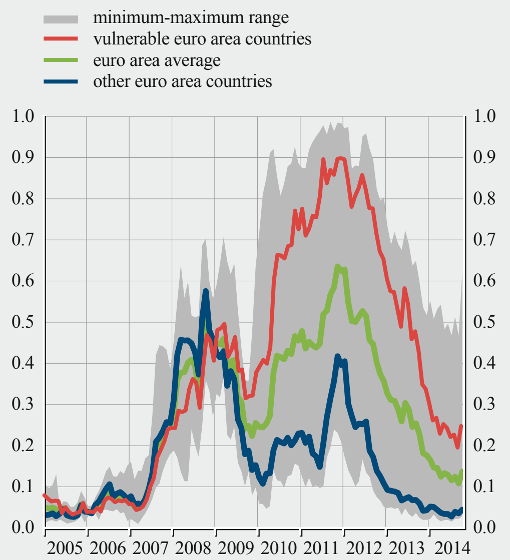
1.2 STRUCTURAL REFORM AND FISCAL CONSOLIDATION NEEDS REMAIN HIGH, DESPITE CONTAINED SOVEREIGN STRESS

Sovereign stress in the euro area has remained contained…

Sovereign stress in the euro area has remained contained, with the composite indicator of systemic stress in sovereign bond markets being close to levels last seen before the financial crisis despite a small uptick more recently (see Chart 1.11). While fiscal positions are generally on a more solid footing than at the height of the sovereign debt crisis on account of consolidation efforts, gradually strengthening economic growth and favourable financing conditions, further reform progress over the past six months has been uneven across euro area countries. In terms of fiscal adjustment, in some countries (e.g. Cyprus, Ireland and Spain) various reform and administrative measures have started to bear fruit and tax revenues have grown more strongly than initially expected. At the same time, most recent incoming macroeconomic data have shown a loss of economic momentum amid uncertainties surrounding the reform process in some euro area countries.

Chart 1.11 Composite indicator of systemic stress in euro area sovereign bond markets (SovCISS)

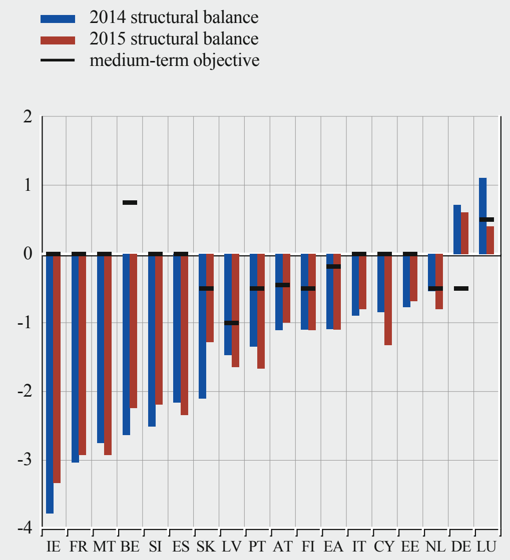
(Jan. 2005 – Oct. 2014)



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.

Chart 1.12 Structural balances and medium-term fiscal objectives across the euro area

(2014, 2015; percentage of GDP)



Sources: European Commission autumn 2014 economic forecasts and 2014 national stability programmes.
Notes: Greece does not have an updated medium-term fiscal objective and is not shown in the chart (its structural surplus is estimated in the European Commission's forecast at 2.0% in 2014 and 1.6% in 2015).

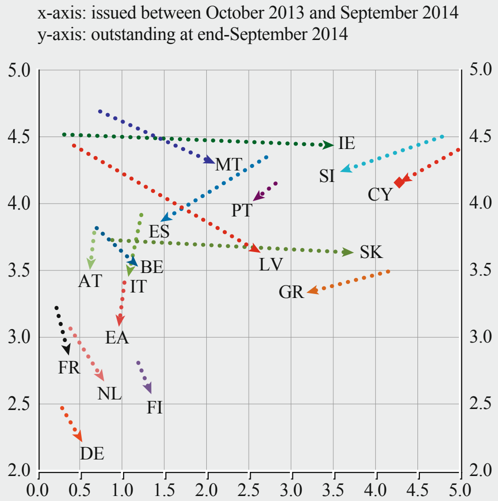
Given the progress made with correcting fiscal imbalances, the focus has increasingly moved towards a more growth-friendly composition of consolidation. In this respect, several governments have recently announced or approved income tax cuts (e.g. Spain and the Netherlands), while planning to stay within their nominal fiscal targets. At the same time, other countries will most likely miss their 2014 fiscal targets mainly on account of weaker than expected macroeconomic developments.

… despite continued vulnerabilities

Despite the progress made to date in reducing fiscal and macroeconomic imbalances, sovereign risks remain elevated. *First*, room for fiscal manoeuvre tends to be limited to a small number of euro area countries, as government debt levels continue to be high and still rising in many countries. This limits considerably the scope for fiscal stimulus through cuts in taxes without corresponding compensatory measures on the spending side. Any delay in debt stabilisation can affect countries' creditworthiness, as recently stressed by major rating agencies. Moreover, despite the progress achieved in the past years, many euro area countries are still far away from their medium-term objective of a close-to-balanced structural budget (see Chart 1.12). For the euro area as a whole, the improvement in the structural balance is expected to fall considerably short of the Stability and Growth Pact's requirements, with Germany being the only euro area country that is expected to over-achieve the requirements under the Pact in 2014 and 2015 (see Chart 1.12). *Second*, sizeable reform commitments remain to be implemented, as highlighted in the past European Semester given only minor advances over the last six months. In line with the country-specific recommendations adopted by the ECOFIN Council in July 2014, several governments have cut the high tax wedge on income to promote employment and long-term growth, but deeper structural reforms, particularly those in the labour and product markets or pension systems, would bring long-term benefits without endangering fiscal solvency. At the same time, even in countries with limited fiscal space, fiscal policy can still support economic recovery by altering the composition of the budget – in particular by simultaneously cutting distortionary taxes and unproductive expenditure. *Third*, while alleviating fiscal costs, the currently low sovereign yields on the outstanding debt in many euro area countries (see Chart 1.13) may expose some countries to sudden flow reversals, especially if macroeconomic developments or reform efforts turn out to be less favourable than currently envisaged.

Chart 1.13 Average nominal yields on debt securities issued by euro area governments

(Sep. 2014; percentage per annum)



Source: ECB.
Notes: The connecting dotted lines map the evolution over the past year. Yields are averages, weighted with the amount of outstanding, and respectively, newly issued securities. Issuances over the past year reflect, inter alia, an extension of maturities in several countries with longer-dated securities bearing higher yields.

Fiscal deficit is forecast to drop further in 2014 and 2015…

Against this background, under current government plans, the aggregate euro area **fiscal deficit** would continue to fall and stay below the 3% Maastricht threshold. According to the Commission's autumn 2014 forecast, the budget deficit for the euro area (18-country aggregate) will fall from 2.9% of GDP in 2013 (following a positive revision of 0.1 percentage point implied by the transition to the European System of Accounts 2010) to 2.6% in 2014 and 2.4% in 2015. After the incorporation of fiscal measures underlying governments' 2015 draft budgetary plans, structural balances are projected to deteriorate in half of the euro area countries and to remain flat for the euro area aggregate. However, cyclical developments and temporary factors are seen to be supportive to fiscal positions in 2015 so that headline balances follow a more favourable path in most euro area countries. Compared with the Commission's spring 2014 forecasts, the short-term fiscal outlook deteriorated marginally for the euro area aggregate, triggered by larger deteriorations in France, Italy, Portugal and Finland.

… as support to the financial sector weighs less on public finances

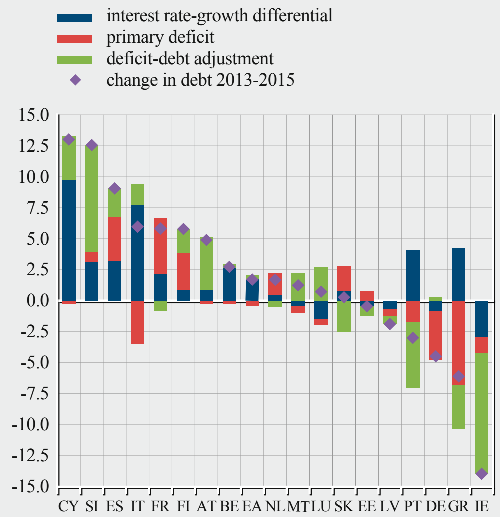
The unwinding of financial sector support is expected to contribute to the improvement of fiscal balances in 2014 and beyond in many countries. In Greece and Slovenia, the bank recapitalisation costs of 2013 were a one-off. In Portugal, the cash reserves earmarked for potential support to the financial sector were used in mid-2014 as a loan to the Portuguese Resolution Fund for use in the isolated bail-in case of Banco Espirito Santo. Going forward, bail-in and bank resolution arrangements based on the provisions of the Bank Recovery and Resolution Directive and the Single Resolution Mechanism, as well as, more generally, steps taken at the European level towards a banking union, might imply a new paradigm relative to the last years, notably with regard to the sovereign-bank nexus. The explicit and transparent framework for sharing resolution costs with bank creditors along with a Single Resolution Fund clearly has the potential to reduce prospective contingent liabilities of any given country vis-à-vis its banking sector.

Public debt is expected to peak in 2015 and decline gradually thereafter…

Despite progress in fiscal adjustment, the **public debt**-to-GDP ratio for the euro area (18-country aggregrate) is still rising, but is projected in the Commission's autumn 2014 forecast to peak in 2015 at 95% of GDP. This is mainly attributable to adverse interest rate-growth differentials and deficit-debt adjustments, which are expected to exceed the primary surplus projected as of 2014. As these two inhibiting factors are expected to wane, the public debt ratio for the euro area as a whole is projected to decline as of 2016 for the first time since 2008. At the country level, public debt ratios remain on an increasing path in the majority of euro area countries (see Chart 1.14).

Chart 1.14 Changes in public debt levels across the euro area between 2013 and 2015

(2013 – 2015; percentage points of GDP)



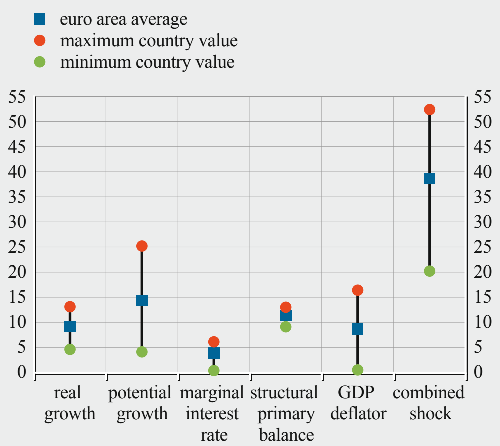
Source: European Commission autumn 2014 economic forecast.

… but uncertainties relating to sovereign debt sustainability persist

Regarding debt sustainability, the most important risks across the euro area relate to the potential complacency in terms of fiscal adjustment and structural reforms, a slowdown in economic growth dynamics and a prolonged period of low inflation.[2] Such developments would impede the debt-servicing abilities of sovereigns, in particular of those which currently face heightened market optimism and downward rigidities in fiscal positions. Simulation results suggest that a combined lasting shock of lower growth, higher yields and worsened structural balances, which could emerge from a lack or reversal of structural reforms and fiscal consolidation efforts, would put debt sustainability at risk (see Chart 1.15). In general, the higher the debt levels and the deeper the economic and institutional rigidities, the less resilient countries are to adverse shocks.

Chart 1.15 Reaction of the public debt ratio to standardised macro and fiscal shocks

(percentage points of GDP)



Source: ECB.
Notes: The chart shows the reaction of the debt ratio for the euro area average and the individual countries' range as of 2024 to standardised (1 percentage point) adverse shocks to real growth (for three years), potential growth, the marginal interest rate, the fiscal position (structural primary balance), the GDP deflator, and a combined shock of the above. The shocks are permanent (the three-year real growth shock translates into partial potential shock deterioration) and are applied as of 2015. The deterministic debt simulations are conducted in a partial equilibrium framework, which takes into account feedback effects between fiscal, macro and financial variables.

Financing needs remain sizeable in several countries in 2015…

The euro area sovereign debt crisis has illustrated that alongside perceived credit risks liquidity strains in the public sector may also pose a risk to financial stability. In fact, **sovereign**

2 For more details on the financial stability challenges posed by very low rates of consumer price inflation, see Box 1 in *Financial Stability Review*, ECB, May 2014.

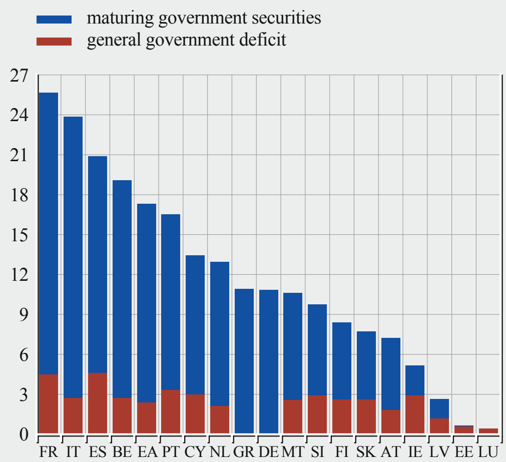
financing needs for 2015 remain significant in many euro area countries (see Chart 1.16), according to securities redemption data up to September 2014. Maturing sovereign debt in the near-to-medium term remains high in the euro area too, albeit with major cross-country differences. As at end-September 2014, securities with a residual maturity of up to one year accounted for about 20% of total outstanding debt securities in the euro area or 15.5% of GDP. The average residual maturity of outstanding euro area government securities was 6.3 years, with the residual maturities ranging from 3.2 years in Cyprus to 12.0 years in Ireland.

... but available financial assets may mitigate financing needs

Sovereign financing needs may – to some extent – be alleviated by resorting to existing financial assets. The consolidated financial assets held by euro area general governments averaged some 36.7% of GDP at the end of the first quarter of 2014, with some variation across countries. At the same time, the market value of consolidated general government liabilities in the euro area was 104.3% of GDP, yielding net financial liabilities of 67.6% of GDP.

Chart 1.16 Maturing government debt securities and projected deficit financing needs of euro area governments in 2015

(percentage of GDP)



Sources: European Commission autumn 2014 economic forecast, ECB and ECB calculations.
Notes: Gross financing needs are estimates of government debt securities maturing in 2015, based on ECB data as at end-September 2014, and the Commission's government deficit projections for 2015. The estimates are subject to the following caveats. First, they only account for redemptions of debt securities, while maturing loans are not included. Second, estimates disregard that some maturing government securities are held within the government sector. Finally, refinancing needs corresponding to short-term debt issued after September 2014 are assumed to be the same as in the fourth quarter of 2014, which may imply an overestimation for some countries.

1.3 GRADUALLY IMPROVING FINANCING CONDITIONS IN THE NON-FINANCIAL PRIVATE SECTOR, BUT VULNERABILITIES REMAIN

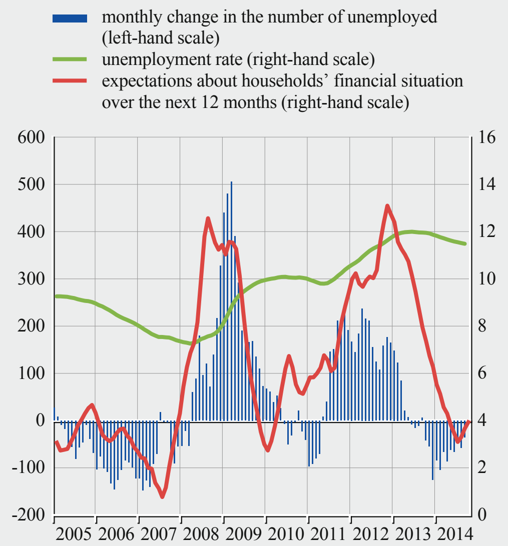
Gradual economic recovery alleviates income and earnings risks somewhat

While recovering somewhat amid moderately improving macroeconomic conditions, **income and earnings** for the euro area non-financial private sector have remained sluggish. The income situation of *households* appears to have stabilised further, but disposable income dynamics have remained muted and households' financial situation expectations have become somewhat less optimistic as the economic recovery has shown signs of losing some of its momentum. While there are tentative signs of improvements in labour market conditions at the aggregate euro area level (see Chart 1.17), the situation continued to be particularly weak in vulnerable euro area countries, thereby further weighing on households' income prospects. As signalled by a distance-to-distress indicator capturing household balance sheet risks, overall credit risks from household balance sheets in the euro area have increased somewhat in the last quarters, but are still much less pronounced than during the stressed conditions of the euro area sovereign debt crisis (see Chart 1.18).

Similar to households, the earnings-generating capacity of euro area *non-financial corporations* has improved somewhat driven by the gradual economic recovery to date, yet corporate profitability has remained muted. Gross operating income has picked up slightly, amid lower negative earnings growth per share and expected default frequencies for listed firms close to pre-crisis lows. Being a function of overall macroeconomic developments, corporate earnings in the euro area are expected to rise as the

Chart 1.17 Expectations about households' financial situation and changes in the number of unemployed in the euro area

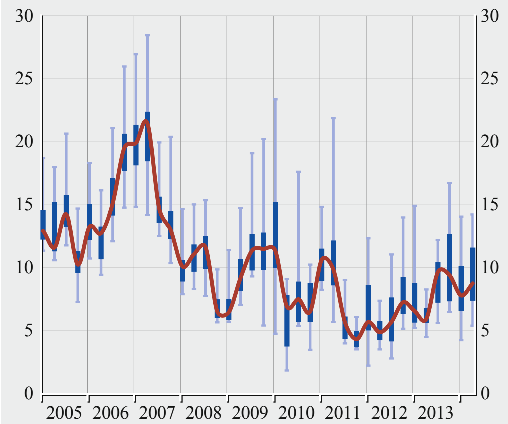
(Jan. 2005 – Oct. 2014; number in thousands, seasonally adjusted; percentages; percentage balances; three-month moving averages)



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 1.18 Households' distance to distress in the euro area

(Q1 2005 – Q2 2014; number of standard deviations from mean)



Sources: ECB, Bloomberg, Thomson Reuters Datastream and ECB calculations.
Notes: A lower reading for 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 of the indicator, see Box 7 in *Financial Stability Review*, ECB, December 2009.

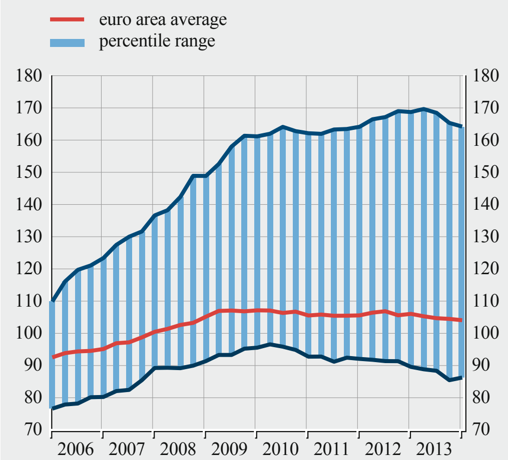
economic recovery gathers pace, though there is a risk that firms' capacity to retain earnings may remain weak until this materialises.

Private sector indebtedness remains elevated amid continued heterogeneity at the country and sector levels

Despite the projected gradual improvement in income and earnings prospects, legacy balance sheet issues continue to weigh on the aggregate euro area non-financial private sector. On average, euro area households' indebtedness amounted to some 64% of GDP, while for non-financial corporations the number is more elevated, at 104% of GDP (or some 90% of GDP on a consolidated basis). However, a gradual balance sheet adjustment is underway, even if the adjustment to date may seem rather modest at the aggregate euro area level (see Chart 1.19). Indeed, a much more nuanced picture emerges at the level of individual countries or sectors of economic activity. When tracking private sector (in particular corporate) deleveraging at the country level, the pace of adjustment differed considerably across the euro area, with

Chart 1.19 Indebtedness of the non-financial corporate sector in the euro area

(Q1 2006 – Q1 2014; percentage of GDP; unconsolidated)



Sources: ECB and ECB calculations.
Notes: Based on ESA 95 standards. Debt includes loans, debt securities and pension fund reserves. The chart shows the average non-financial corporate indebtedness in the euro area and the interquartile distribution (25th and 75th percentile) across individual euro area countries.

deleveraging being more pronounced in countries which had accumulated large amounts of debt in the run-up to the crisis. The same pattern emerges at the sector level, whereby overindebted sectors, such as the construction and real estate services sector, continue to deleverage more strongly than less indebted ones such as industry or wholesale and retail trade.

Favourable interest rate environment facilitates debt servicing

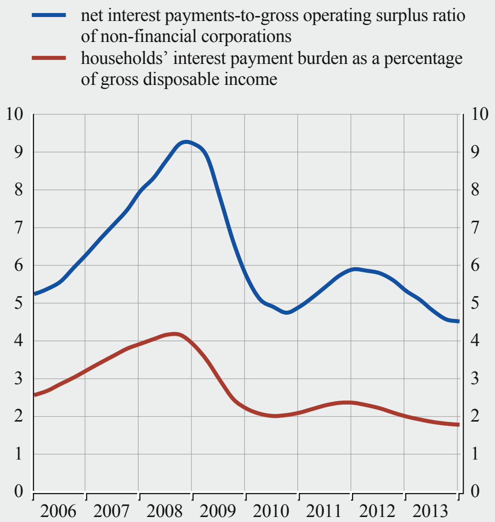
In the current environment of low interest rates and a low cost of market-based funding, households' and non-financial firms' interest payment burden has remained at record lows (see Chart 1.20). Borrowers in countries with ongoing relative price adjustments, however, have seen some rise in their real debt burden amid recent low inflation outturns. In terms of risks, the ongoing process of balance sheet repair should help offset the challenges related to an eventual normalisation of interest rates and the ensuing rise in the debt servicing burden. Such challenges might be greatest for those countries where loans with floating rates or rates with rather short fixation periods predominate. 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

Bank lending flows to the non-financial private sector have remained muted, partly reflecting the ongoing balance sheet repair in both the financial and non-financial sectors. On average, bank lending to euro area households has remained subdued, mirroring sluggish dynamics of household income, high levels of unemployment and housing market weakness in some countries. However, rather heterogeneous developments at the country level form the basis of this relatively weak aggregate picture (see Chart 1.21). Looking at the components of bank lending by purpose, modest annual growth in loans for house purchase has been offset by a continued drop in consumer loans and other types of lending. Nonetheless, in line with the gradual economic recovery, the October 2014

Chart 1.20 Interest payment burden of the euro area non-financial private sector

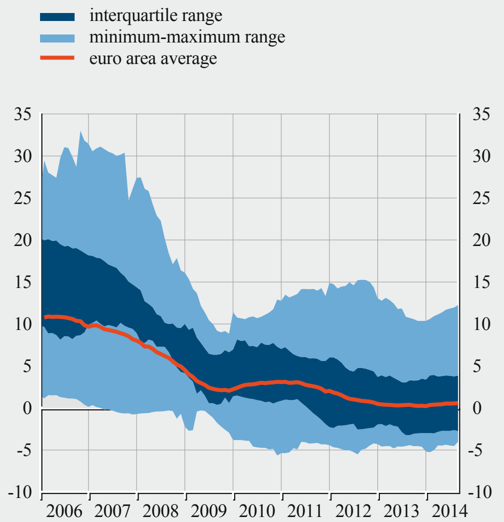
(Q1 2006 – Q1 2014; four-quarter moving sums; percentages)



Sources: ECB and Eurostat.
Note: Based on ESA 95 standards.

Chart 1.21 MFI lending to euro area households

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



Source: ECB.
Note: Data have been adjusted for securitisation.

euro area bank lending survey suggests further improvements in households' financing conditions, as reflected by the continued easing of credit standards on loans to households and the further net increase in demand for such loans.

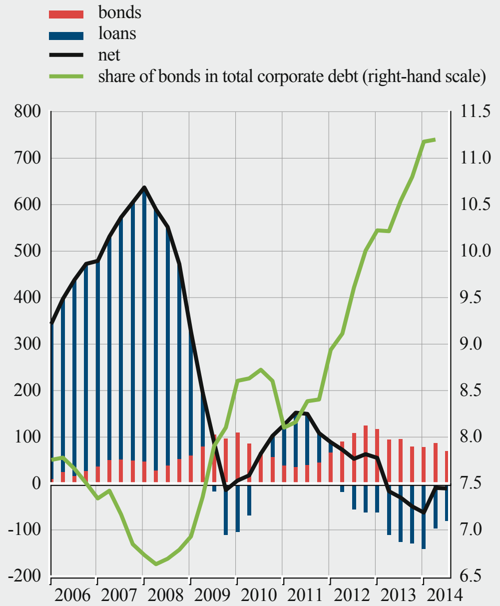
Cross-country disparities in supply conditions fell overall for loans to households, thus pointing to a decrease in financial market fragmentation. Supply-side constraints appear to be easing particularly for consumer loans and other lending to households, and to a lesser extent also for housing loans. Improving supply-side conditions reflect lower pressures from cost of funds and balance sheet constraints, but competition has also contributed to the net easing of credit standards, mainly for loans to households for house purchase. By contrast, a re-emergence of risk concerns had a slightly restrictive impact on credit standards for both housing and consumer loans. At the same time, improving housing market prospects and consumer confidence have translated into a continued net increase in demand for housing loans and consumer credit.

A drop in bank lending to non-financial corporations is partly offset by the issuance of market-based debt…

The net external financing of euro area non-financial corporations continued to fall, albeit at a slower pace than in recent quarters (see Chart 1.22). Corporate disintermediation continued, but the issuance of market-based debt still fell short of offsetting the decline in new MFI loans to non-financial corporations. However, funding substitution has remained limited to larger corporations and predominantly those which are domiciled in countries with more developed corporate bond markets (e.g. Germany and France), while small and medium-sized enterprises (SMEs) and large firms located in more vulnerable countries remained more dependent on bank funding. That said, the results of the latest euro area bank lending survey suggest that underwriting terms for corporate loans have continued to improve, as reflected by easing credit standards, in particular for large firms. Similarly to household loans, supply-side conditions for corporate loans point to decreasing fragmentation across countries. Demand for corporate loans in the euro area continued to rise, although cross-country heterogeneity has remained considerable. Increased demand largely reflects higher financing needs, mainly for mergers and acquisitions and debt restructuring, while financing needs related to fixed investment dampened demand for loans to euro area enterprises. Firms' internal financing capacity and the issuance of debt securities by non-financial corporations contributed negatively to loan demand. Alongside improving supply and demand-side conditions, targeted Eurosystem measures to revive lending, i.e. the targeted longer-term refinancing operations or the asset-backed securities and covered bond purchase programmes, should promote the recovery of credit going forward, while at the same time contributing to a further decrease in funding costs for non-financial firms in the euro area.

Chart 1.22 External financing of euro area non-financial corporations

(Q1 2006 – Q3 2014; EUR billions; net annual flows)



Sources: ECB and ECB calculations.

… amid high corporate liquidity

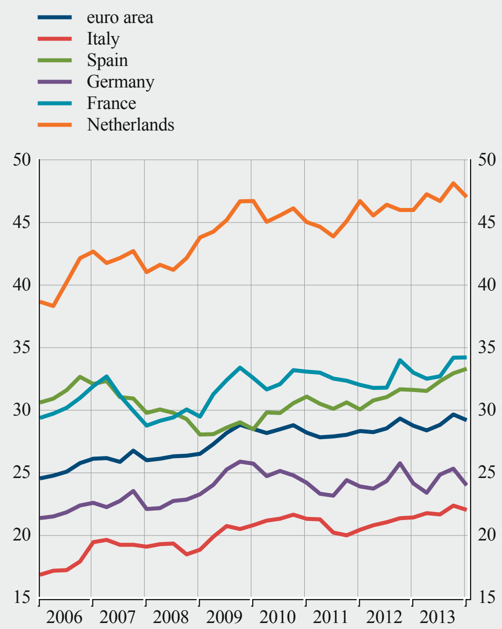
Corporate liquidity has remained at record highs in several euro area countries, suggesting that non-financial firms can also rely on internal funds as a financing source in addition to loans and debt securities. Firms' liquidity holdings reached almost 30% of GDP in early 2014, but amid a large degree of cross-country variation across the euro area (see Chart 1.23). These high liquidity buffers may reflect a lack of investment opportunities, 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.

Funding costs have touched record lows on average…

Nominal **funding costs** of the euro area non-financial private sector have continued to decline across most business lines, maturities and funding sources. Nominal financing costs for euro area *households* reached their lowest levels since the start of the reporting of harmonised euro area bank lending rates in 2003 for all categories of lending except consumer credit, while real funding costs have remained broadly unchanged since early 2014 (see Chart 1.24). Likewise,

Chart 1.23 Liquidity position of non-financial corporations in selected euro area countries

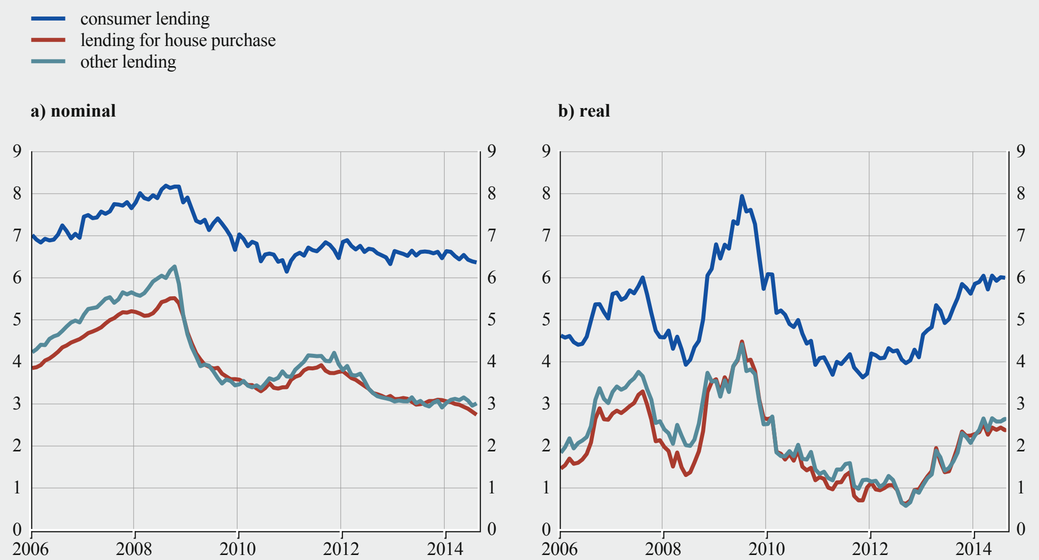
(Q1 2006 – Q1 2014; percentage of GDP)



Sources: ECB and ECB calculations.
Notes: Based on ESA 95 standards. Liquidity is defined as the sum of currency and deposits, short-term securities and mutual fund shares.

Chart 1.24 Euro area bank lending rates on new loans to households in nominal and real terms

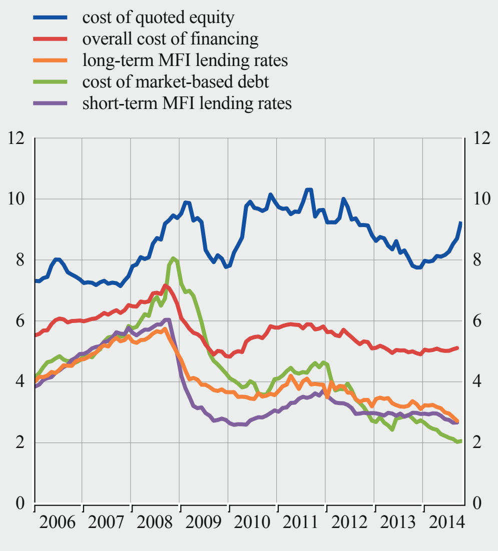
(Jan. 2006 – Sep. 2014; percentages)



Source: ECB.
Note: Real bank lending rates are calculated by deflating nominal lending rates with the Harmonised Index of Consumer Prices.

Chart 1.25 Nominal cost of external financing of euro area non-financial corporations

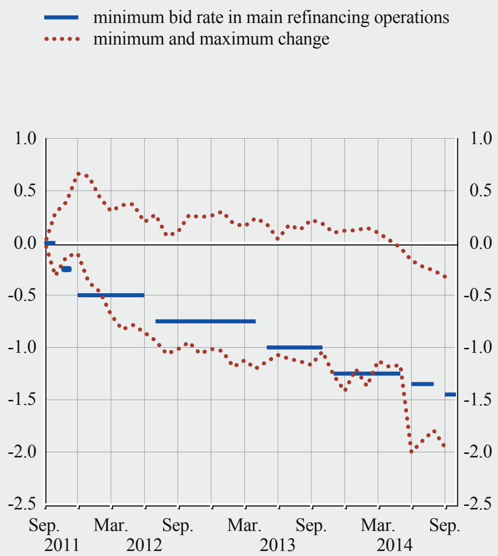
(Jan. 2006 – Oct. 2014; percentages)



Sources: ECB, Merrill Lynch, Thomson Reuters Datastream 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 1.26 The ECB policy rate and the composite cost-of-borrowing indicator for non-financial corporations

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



Sources: ECB and ECB calculations.
Notes: 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.

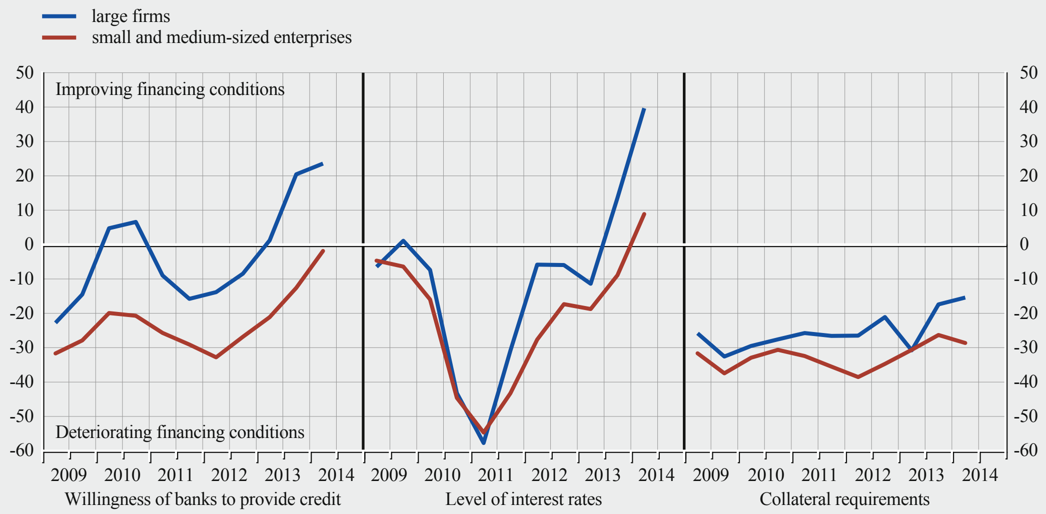
non-financial corporations' overall financing costs have continued to fall across most external financing sources (see Chart 1.25), supported by a low interest rate environment and favourable financial market conditions. Bank lending rates have declined further across the maturity spectrum, though the latest easing in monetary policy rates remains yet to be fully passed through (see Chart 1.26). At the same time, the cost of equity has increased since early 2014 amid ebullient equity markets and rising equity risk premia in many countries – a development which contrasts with a continued fall in the cost of market-based debt.

… but fragmentation in lending conditions persists across countries and firm sizes

Fragmentation in both nominal and real lending conditions persists, despite having decreased since the height of the euro area sovereign debt crisis. The cross-country heterogeneity 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 afflicting some euro area countries. The same holds true for firms, where lending rates continue to vary widely across the euro area. At the same time, developments in firms' financial conditions continue to vary also in terms of *firm size*. The strong difference between the loan pricing conditions for small and large firms, which primarily results from the divergence in firm-specific risks, highlights the still less favourable conditions faced by small firms, particularly in more vulnerable countries. In addition, according to the ECB's latest survey on access to finance of enterprises in the euro area, banks' willingness to grant a loan continues to be higher for large firms (see Chart 1.27). This is also corroborated by the fact that the success of large firms when applying for a bank loan was higher than for SMEs, indicating overall better access to finance of large firms compared with SMEs. Finally, collateral requirements also appear to be less strict for large firms than for SMEs.

Chart 1.27 Financing conditions of euro area SMEs in comparison with large firms

(H1 2009 – H1 2014; net percentages of respondents; changes over the past six months)



Source: ECB calculations based on the survey on access to finance of enterprises (SAFE).
Note: The level of interest rates and collateral requirements are presented using an inverted scale.

Euro area property markets show signs of an incipient recovery…

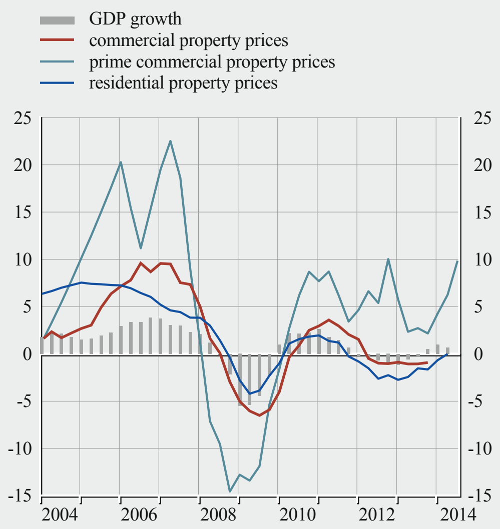
Mirroring overall macroeconomic trends, the overall development of euro area **property markets** remained subdued in the first half of 2014, but with signs of a recovery in some countries. Residential property prices have stabilised on an annual basis at the aggregate euro area level, following a sharp turnaround in some euro area countries that experienced significant price corrections in recent years. Similarly, euro area commercial property markets have shown further signs of stabilisation, but the underlying price dynamics in the prime and non-prime segments continued to diverge strongly (see Chart 1.28).

… amid a continued ebullience in prime commercial property markets

Prime commercial property (i.e. modern retail and office buildings in metropolitan areas) continued on its ebullient course in the context of the current low yield environment and the related ongoing search for yield. Accordingly, investment activity in commercial property markets has remained buoyant in recent quarters, with underlying transaction volumes reaching multi-year highs (see Chart 1.29). Activity has been increasingly driven by domestic investors, but foreign – in particular non-European – investors have remained active as well. Increased investor interest went hand in hand with a broad-based decline in yields on prime commercial property. Perhaps most noteworthy, the significant pick-up in demand

Chart 1.28 Euro area commercial and residential property values and the economic cycle

(Q1 2004 – Q3 2014; percentage change per annum)



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

for commercial property in countries that had previously witnessed pronounced price declines, such as Ireland and Spain, has also contributed to narrowing yield dispersion across the euro area.

In terms of property price dynamics, fragmentation at the country level has been declining, particularly in the prime commercial segment where most recently almost all euro area countries have seen an increase in prices. By contrast, residential property prices continued to drop – to varying degrees – in countries such as Cyprus, Greece, Italy and Slovenia. This illustrates the high degree of cyclicality of commercial property prices which tend to be more volatile and track the economic cycle with greater amplitude than residential property prices. That said, after a major multi-year adjustment, country-level data suggest a sharp rebound in residential and commercial property markets in some countries, notably Ireland. At the same time, country-level developments often mask underlying regional disparities, with strong house price growth in metropolitan areas and comparably subdued price movements in remaining regions (e.g. Austria, Germany and Ireland), highlighting the risk that strong house price growth could potentially ripple out to surrounding areas. So far there are no signs of the ongoing recovery or the regional buoyancy of euro area residential property markets translating into buoyant housing loan growth (see Chart 1.30), suggesting some transitory phenomena such as pent-up demand from cash buyers and the presence of foreign buyers in certain (mainly high-priced) market segments, especially in some large cities.

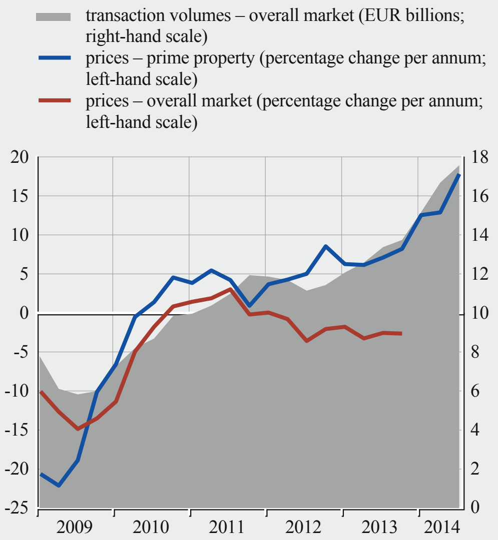
Fragmentation at the country and regional levels persists, although diminishing

In terms of valuations, for the euro area as a whole, residential property prices are broadly in line with fundamentals, but valuation estimates for prime commercial property are still somewhat above their long-term average. However, property markets are inherently local, so that such aggregates belie heterogeneous developments at both the country and regional level. Residential and prime commercial property valuations

Overvaluation is a concern in some countries…

Chart 1.29 Commercial property price changes and investment volumes in the euro area

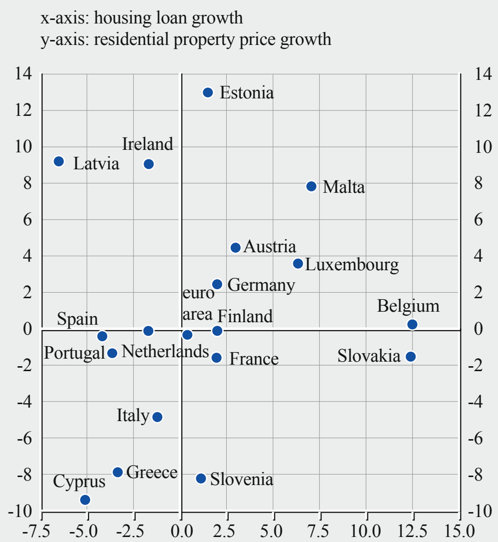
(Q1 2009 – Q3 2014; average of price changes in Austria, France, Germany, Ireland, the Netherlands and Spain)



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 1.30 Residential property price and housing loan growth across the euro area

(H1 2014; percentage change per annum)

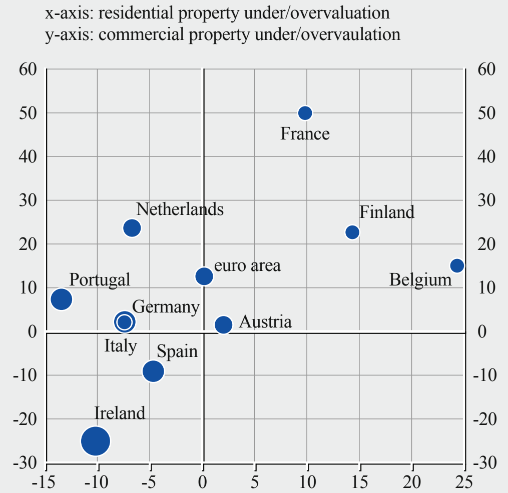


Sources: ECB and ECB calculations.
Notes: Bank lending data are not adjusted for securitisation. Securitisation may play an important role in some countries, for example Belgium, where the time series adjusted for securitisation would result in annual housing loan growth of 3% for the first half of 2014.

have come down considerably from previous peaks in several countries (e.g. Ireland and Spain) as the unwinding of pre-crisis excesses brought prices down to or below the level suggested by underlying values. By contrast, estimated overvaluation has remained high in both market segments in Belgium, Finland and France (see Chart 1.31). Similar disparities may emerge at the regional level, as reflected by the estimated significant overvaluation of residential property in some large cities in Germany and Austria. It is worth emphasising though that valuation estimates are surrounded by a high degree of uncertainty as they do not capture country-level specificities, such as fiscal treatment or various structural property market characteristics.

Chart 1.31 Estimated over/undervaluation of residential and prime commercial property prices in selected euro area countries

(Q2 2014; percentages)



Sources: Jones Lang LaSalle, European Commission, ECB and ECB calculations.
Notes: The size of the bubble reflects the projected change in real GDP growth in 2015. Estimates for residential property prices refer to Q1 2014 for Finland, Germany, Ireland, the Netherlands and Portugal and are based on four different valuation methods: price-to-rent ratio, price-to-income ratio and two model-based methods. For details of the methodology, see Box 3 in ECB, *Financial Stability Review*, June 2011. For further details on valuation estimates for prime commercial property, see Box 6 in ECB, *Financial Stability Review*, December 2011.

… while risks remain tilted to the downside

A key downside risk to euro area property markets relates to a weak or stalling economic recovery, given the high cyclicality of many property market segments. Indeed, a negative economic shock could create at least three challenges: first, to those commercial property investors who are already confronted with difficulties (e.g. those in negative equity positions due to prices being below previous years' peaks); second, as a trigger for house price corrections in countries with signs of overvaluation (or it could reverse the ongoing recovery in others); and third, for debt servicing in countries with a highly indebted household sector. From a financial perspective, a potential increase in global risk aversion and the related rise in long-term interest rates could affect the debt servicing capacity of both households and commercial property investors via the more limited availability and higher cost of funding, thereby contributing to rising rollover risks and aggravating the interest payment burden. The numerous property-related instruments in the newly acquired macro-prudential toolkit may help alleviate any future cyclical challenges, while also contributing to increasing the resilience of banks and their borrowers.