May 2023
Financial Stability Review

Press briefing
An improved but uncertain economic outlook amid persistent inflationary pressures

- Despite some improvement at the turn of the year, weak macro-financial prospects remain a challenge.
- Banking sector stresses in the US and Switzerland had limited spillover to large euro area banks, financial markets and sovereigns.

**Real GDP growth and inflation forecasts for the euro area and United States in 2023**
10 January 2022-23 May 2023, percentages

**Near-term financial stress indicators for banks, financial markets and sovereigns**
2 January 2019-23 May 2023, percentages, probability of default (banks)

**Source**: Consensus Economics.

**Notes**: LCBGs stands for large and complex banking groups.
Euro area financial stability outlook remains fragile

1. High valuations and low market liquidity make markets vulnerable to negative surprises
2. Resilience of corporates, households and sovereigns is being tested by higher interest rates
3. Euro area banks resilient to stress, although liquidity and asset quality concerns are surfacing
Financial markets vulnerable to disorderly adjustments amid high valuations and less ample liquidity

- Risk premia in financial markets are compressed, in both absolute and relative terms
- Decline in market liquidity leaves financial markets more vulnerable to adverse dynamics

**Equity and credit risk premia for the euro area and the United States**

*January 2009-May 2023, percentages, basis points*

**Composite indicators for euro area bond market liquidity**

*Q1 2012-Q1 2023, z-scores*

Sources: Bloomberg Finance L.P. and ECB calculations.

Notes: Risk premia calculated as 5-year cyclically adjusted price earnings yield for the EURO STOXX less 5-year real (inflation swap adjusted) German government bond yield; credit risk premia calculated as option-adjusted spread for EUR-denominated BBB-rated corporate bonds with residual maturities of 5-7 years.

Note: Market liquidity indicators comprise tightness, immediacy, depth, breadth and resilience indicators.
Liquidity and credit risks in the non-bank financial intermediation sector remains high

- Banking sector stresses and market volatility have had limited impact on investment flows, as funds are gradually de-risking
- Low liquid asset holdings remain a source of risk for forced asset sales in adverse market conditions

Cumulative daily euro area money market, bond and equity fund flows
1 March-23 May 2023, percentage of total net assets

Share of high-quality liquid assets in total securities holdings, by sector
Q1 2014-Q4 2022, percentages

Sources: ECB, S&P Global Market Intelligence, European Commission and ECB calculations.
Sovereign and corporate vulnerabilities remain elevated as financial conditions tighten

- Over time, higher interest rates are likely to put pressure on sovereigns, notably those with high rollover needs
- Rapidly declining corporate interest coverage ratios suggests highly indebted firms are being tested by tightening financial conditions

Gross debt service of government securities due over the next 12 months
April 2023, percentages of GDP

Change in corporate interest coverage ratio and drivers
Q1 2004-Q4 2022, percentage point changes

Sources: ECB and ECB calculations.
Note: Sovereign debt servicing needs capture all marketable securities instruments and all original maturities with residual maturity of less than 1 year.

Sources: ECB and ECB calculations.
Note: The interest coverage ratio is defined as the ratio of gross operating surplus to gross interest payments before the calculation of FISIM (financial intermediation services indirectly measured).
The euro area property market cycle is turning

- Residential real estate cycle has shifted into correction mode, as higher interest rates weigh on affordability
- Increasing challenges for commercial real estate, with cyclical factors compounding structural changes in demand

**Euro area residential property price growth**
Q1 2006-Q4 2022, annual percentage changes

**Euro area commercial property values and transaction volumes**
Q1 2009-Q1 2023, annual percentage changes

Sources: ECB and ECB calculations.
Note: Previous crisis episodes include the global financial crisis and the euro area sovereign debt crisis.
Euro area banks have proven resilient to bouts of US/Swiss bank stress

- Strong fundamentals at the sector level have helped insulate euro area banks from US and Swiss banking sector stresses
- Funding liquidity for euro area banks has been showing signs of deterioration, however

Aggregate liability structure of euro area significant institutions
Q4 2022, percentages

Composite funding liquidity index for euro area banks and driving risk factors
Q1 2016-Q4 2022, z-scores

Sources: ECB and ECB calculations.

Funding and asset quality headwinds may weigh on future bank profitability

- Higher funding costs will inevitably pass through to bank funding instruments
- Incipient signs of deteriorating asset quality may also create challenges going forward

Bank funding costs, by type of instrument
2 January 2020-23 May 2023, percentages

Stage 2 ratios, by loan type
Q1 2018-Q4 2022, percentages

Sources: Refinitiv and ECB calculations.
Note: The latest observation for data on deposits is 31 March 2023.

Sources: Bloomberg Finance L.P. and ECB.
Financial conditions are testing the non-financial sector’s debt servicing ability

- Inflation fuelling tighter financial conditions
- Risk of a disorderly property price correction
- Uneven corporate recovery
- Sovereign funding costs set to increase

Higher bank funding liquidity and credit risk

- Looming asset quality concerns
- Muted lending activities
- Lingering cost inefficiencies
- Rising cyber risks

Markets remain vulnerable amid elevated rate volatility

- Sticky inflation may add volatility
- Recession fears re-emerge
- Equity risk premia may widen
- Global risks are rising

Active use of prudential policies in recent years means the euro area banking system is well-placed to withstand shocks.

Targeted macroprudential policy action and completion of the banking union could further enhance resilience.

Structural vulnerabilities in non-banks continue to require a comprehensive and decisive policy response.