EUROPEAN CENTRAL BANK

EUROSYSTEM

Press release

31 May 2023

Financial stability outlook remains fragile, ECB review finds

- Tighter financial conditions test resilience of households, firms, governments and property markets
- Financial markets are vulnerable to disorderly adjustments, given investment fund vulnerabilities, stretched valuations, high volatility and low liquidity
- Euro area banks robust to recent stress outside the euro area, but higher funding costs and lower asset quality may weigh on profitability

According to the May 2023 Financial Stability Review published today by the European Central Bank (ECB), the outlook for euro area financial stability remains fragile, in the context of recent banking stress outside the currency union.

While economic conditions have improved slightly, uncertain growth prospects paired with persistent inflation and tightening financing conditions continue to weigh on the balance sheets of firms, households and governments. Furthermore, an unexpected deterioration in economic conditions or financial tightening could lead to disorderly price adjustments in either or both financial and real estate markets.

"Price stability is crucial for durable financial stability," said ECB Vice-President Luis de Guindos. "But as we tighten monetary policy to reduce high inflation, this can reveal vulnerabilities in the financial system. It is critical that we monitor such vulnerabilities and fully implement the banking union to keep them in check."

Looking more closely at vulnerabilities, euro area firms face tighter financing conditions and uncertain business prospects. This could be particularly challenging for those firms that came out of the pandemic with greater debt and weaker earnings. At the same time, high inflation is hitting households – particularly those on lower incomes – by reducing their purchasing power and compromising their ability to repay loans. Demand for new loans, especially mortgages, declined sharply in the first

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quarter of 2023 in response to rising interest rates. While falling energy prices in recent months have reduced pressures on governments to fund additional fiscal support, public authorities nevertheless face rising funding costs.

Euro area real estate markets are undergoing a correction. In residential markets, house price increases have cooled considerably over the last few months, reducing overvaluation in the sector. While price adjustments have been orderly so far, they could turn disorderly if higher mortgage rates increasingly reduced demand. Commercial real estate markets remain in a downturn, facing tighter financing conditions and an uncertain economic outlook, as well as weaker demand following the pandemic. The ongoing correction could test the resilience of investment funds with interests in the commercial real estate sector.

Financial markets and investment funds remain vulnerable to asset price adjustments. Stretched valuations, tighter financing conditions and lower market liquidity might increase the risk of any adjustment becoming disorderly, particularly in the event of renewed recession fears. So far, investment funds have been largely unaffected by recent tensions in the US and Swiss banking sectors. This could change, however, if funds suddenly required liquidity, forcing them to sell assets quickly.

Euro area banks have also proved resilient to stresses in US and Swiss banks on account of their limited exposures. This resilience was supported by strong capital and liquidity positions resulting from regulators' and supervisors' efforts over recent years. It will be essential to preserve this resilience amid some concerns about banks' ability to build up capital. For example, higher interest rates reduce lending volumes and increase banks' funding costs, which may impair their profitability. Furthermore, there are already signs of deteriorating asset quality in loan portfolios exposed to commercial real estate, smaller firms and consumer loans. Banks may therefore need to set aside more funds to cover losses and manage their credit risks.

In this context, it is essential to complete the banking union and, in particular, to establish a common European deposit insurance scheme. Additionally, vulnerabilities in the non-bank financial sector require a comprehensive and decisive policy response in order to further increase trust in the financial system and its ability to withstand risks.

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