POLICY CHALLENGES RELATED TO HIGH INFLATION

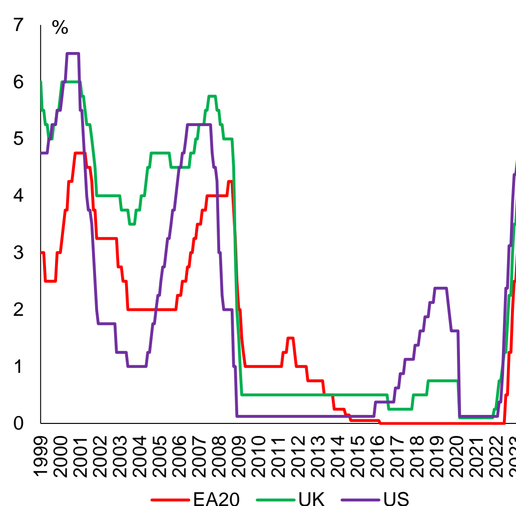
2. FISCAL AND MONETARY POLICY MIX

Persistently high inflation dynamics continue to require fiscal and monetary policy to work in tandem. After the highly supportive fiscal and monetary stances adopted during the COVID-19 crisis, the rise in inflation prompted a shift in policy. As the ECB embarks on the fastest-ever tightening of its monetary stance, fiscal policies have a role to play, steering away from an expansionary stance that could feed inflation, including by rolling back energy support measures. For some Member States, the need for a tighter fiscal stance is also reinforced by the high debt and deficit ratios. At the same time, there is a need for public authorities to continue support to the cost of living for the most vulnerable part of the population.

Monetary policy

The ECB has responded to the high inflation shock with the fastest-ever increase in policy rates since the creation of the monetary union. In 2021, inflation started to rise from a very low level on the back of COVID-19-related demand and supply mismatches and accelerated sharply in the wake of Russia's aggression against Ukraine. Starting in July 2022, the ECB increased its policy rates by a total of 450 basis points over 15 months **(Graph 2.1)**. Although current rates are close to historical highs, the hikes since June 2022 have been larger and faster than in past cycles. The ECB also brought its net asset purchases to an end. In March 2022, the ECB discontinued net asset purchases under the Pandemic Emergency Purchase Programme (PEPP), and those under the Asset Purchase Programme (APP) were concluded in June 2022 [4]. As inflationary pressures, as gauged by core inflation, remain high, the ECB monetary policy is expected to remain restrictive in order to achieve a return of inflation to the 2 % target. At the same time, the ECB has clarified that the future monetary policy path will be data-dependent.

Graph 2.1: **Central banks' key policy rates in the euro area compared to the UK and the US**



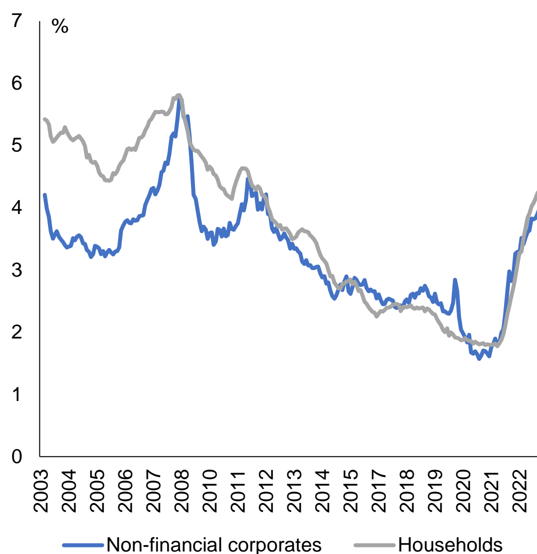
Source: Bank of International Settlements

The increases in policy rates have led to tightening financial conditions. The Commission's composite cost-of-borrowing indicators for non-financial corporations (NFCs) and households, which combines interest rates on all loans to corporations and all loans to households, started to increase in 2022, driven by significant increases in interest rates **(Graph 2.2)**. The tightening in financial conditions led to a drop in lending activities and, in particular, in housing loans, slowing down economic activity by affecting investments. Given the lags in the transmission of monetary policy, it is still challenging to determine the full impact. Model-driven assessments have estimated

(4) The reinvesting of the proceedings of maturing securities purchased under the APP was also stopped one year later, while reinvestments under PEPP are set to continue until the end of 2024.

that the euro area's real GDP growth could face a noticeable reduction due to monetary policy tightening, with an average decrease of about 2 ppt annually from 2022 to 2025 (Darracq Pariès et al., 2023).

Graph 2.2: **Cost of borrowing indicators**



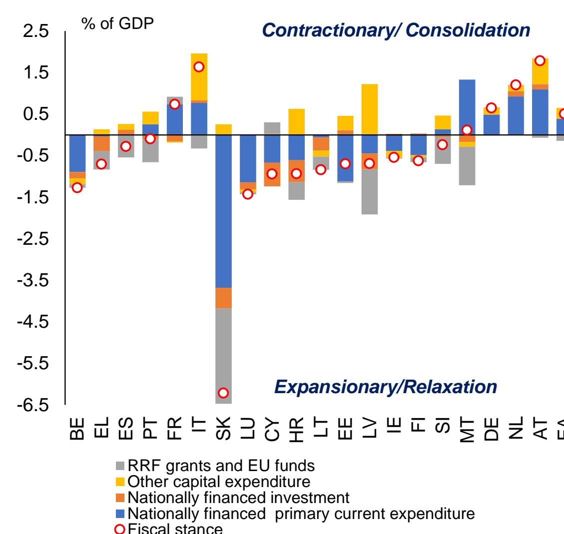
Source: European Commission

Sovereign spreads in the euro area have remained stable so far. By the end of 2021, in line with the expectations on the path of policy rates, 10-year government bond yields started to increase. In September 2023, government yields in euro area countries ranged between 2.5 % and 4.2 %, compared to a range of -0.4 % and 1.3 % in December 2021, thus implying a level shift of about 3 ppt. Overall, the transmission of rate hikes to sovereign bond markets since the start of the hiking cycle has not translated into an excessive widening of sovereign spreads. On the other hand, statistics on lending activities show some heterogeneity (see Section 4), suggesting that, in the longer term, the real impact of the monetary policy will differ across Member States.

FISCAL POLICY STANCE

The aggregate contractionary stance in 2023 supported the reduction in inflation. The euro area fiscal stance in 2023 is estimated to be contractionary, at ½% of GDP. Nationally financed net primary current expenditure has been reduced in 2023, largely due to the partial phase-out of energy-related measures, introduced in 2022, when they induced a sizable expansion. A reduction in government subsidies for private investment (other capital expenditure) also contributed to the contraction in 2023. Conversely, the expenditure financed by RRF grants and other EU funds is set to increase further, reducing the contractionary nature of the fiscal stance. This has supported investment, while public investment financed by national budgets has been preserved, making a neutral contribution. **(Graph 2.3).**

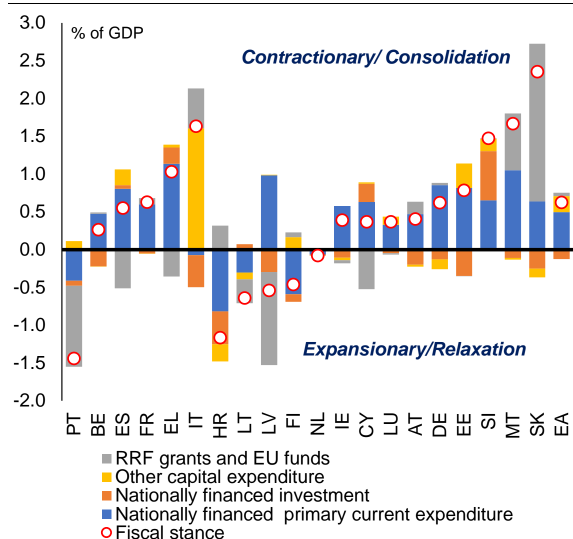
Graph 2.3: **Euro area fiscal stance in 2023**



Source: European Commission

In 2024, the fiscal stance is set to remain contractionary, with large heterogeneity across Member States. The Commission 2023 Autumn forecast indicates that the euro area fiscal stance would remain contractionary in 2024, by around ½% of GDP. There is a wide range across Member States, from a contractionary stance of more than 2% of GDP to an expansionary stance of 1.5%. Overall, the fiscal stance is expected to be contractionary or broadly neutral in most Member States **(Graph 2.4)**, while it is set to be expansionary in five Member States. A contractionary stance is projected in all high-debt Member States but Portugal.

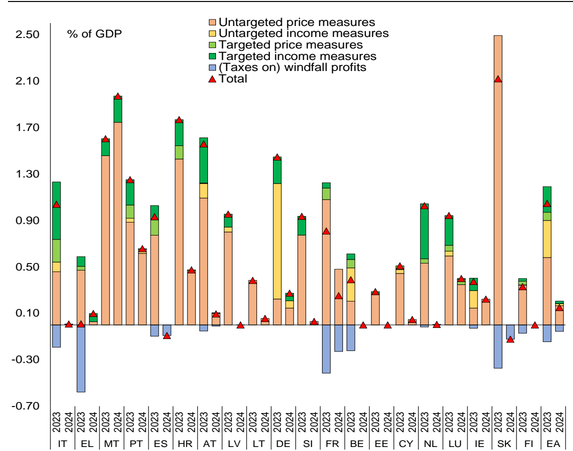
Graph 2.4: **Euro area fiscal stance in 2024**



Source: European Commission

Energy-crises related support measures, which remained sizeable in 2023 are expected to be almost completely phased out in 2024. Persistently elevated energy costs in 2023 have led many Member States to continue extending support to households and businesses. The Commission estimates that the total cost of such measures amounts to 1.0% of the euro area GDP in 2023, a slight decrease from 1.3% in 2022. Most of the measures are expected to be phased out in the next year, with a remaining budgetary cost of 0.2% of GDP in 2024 **(Graph 2.5)**.

Graph 2.5: **Budgetary cost of fiscal measures to mitigate the impact of energy price increases in 2023 and 2024**



Source: European Commission

IMPACT OF INFLATION ON PUBLIC FINANCES

The high inflation has an impact on public finances through both revenues and expenditures, with a strong impact of energy measures. On the revenue side, the favourable composition of economic activity, notably an increased share of consumption of goods, and the increase in prices in tax-intensive goods, in particular energy, resulted in sizeable windfall revenues last year. On the expenditure side, the price adjustment of social transfers, public wages and new public procurement will push nominal expenditures up over time. Meanwhile, the measures taken by Member States to support the economy in the face of high inflation had a strong impact on public finance developments. The lowering of VAT rates and excise duties on energy products reduced the revenue-to-GDP, and public subsidies, which have reached record levels during the COVID-19 crisis, remained high.

Going forward, the high inflation will lead to durable upward pressure on public expenditure. As the price adjustment of many public expenditure components occurs with a delay, the high inflation will continue exerting pressure on public expenditures in the coming years. In addition, after a decade of decreasing costs of debt financing, the interest expenditure-to-GDP ratio is expected to rise again. The average maturity of government debt in the euro area, which determines the speed of the transmission of higher interest rates to an actual increase in interest payments, is distributed around 8 years. In the medium-term, interest payments are thus set to weigh on public finances much more than what they did in the past, diverting resources from other priorities.

Public investment will continue growing, also supported by the RRF. In 2023, public investment in the euro area is expected to rise to 3.1% of GDP compared to 2.8% in 2019 and to further increase to 3.2% in 2024. This is consistent with the need to increase investment to support the green and digital

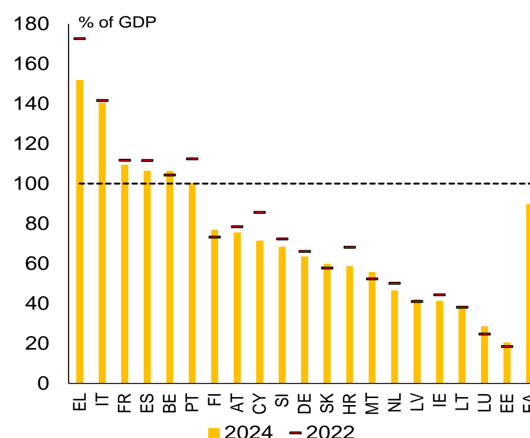
transition. In particular, around one-third of the projected increase between 2019 and 2024 is due to new investments financed by RRF grants.

In a context of reduced fiscal space, it is critical that investments represent value-for-money. Spending reviews can be useful tool to support fiscal policy objectives. By identifying and weighing efficiency gains and saving options, spending reviews can help free up fiscal space and reorient spending towards policy priorities ([5]). Spending reviews can also be usefully coupled to green budgeting practices to identify fiscal measures that are environmentally harmful. Cutting back on support to fossil fuel consumption and other environmentally harmful subsidies would yield significant budgetary gains and generate fiscal space. Aligning price incentives with climate neutrality, rewarding efforts to internalise environmental externalities and implementing the polluter pays principle are also key to create a level playing field for sustainable alternatives and to bolster the green transition.

DEBT DYNAMICS AND SUSTAINABILITY

The euro area public debt-to-GDP ratio is declining in 2023 and 2024, though from a high level. Over 2023 and 2024, the euro area debt-to GDP ratio is expected to decline by 2.8 pps., reaching 89.7% of GDP in 2024. Most euro area countries are expected to experience declining ratios, reflecting the effects of high inflation on nominal GDP (a favourable snowball effect). This effect is particularly strong in Member States with a high debt. Notably, between 2022 and 2024, public debt is predicted to decrease by around 21 pps. in Greece, by 14 pps. in Cyprus, and by 12 pps. in Portugal. Still, in 2024, six countries will continue to have debt ratios surpassing 100% of GDP, giving them limited fiscal space **(Graph 2.6)**.

Graph 2.6: **Public Debt to GDP ratio, 2024 vs 2022**



Source: European Commission

The debt projections for the upcoming years are subject to high uncertainty. Stochastic simulations, which apply a large range of macroeconomic shocks around the central scenario, suggest that euro area debt is likely to lie between 85% and 95% of GDP in 2024, and between 79% and 102% of GDP in 2028. Several factors weigh on fiscal sustainability. In particular, the less favourable macro-financial environment is expected to negatively affect public debt dynamics over the coming years. The increase in interest rates, notably prompted by heighted inflationary pressures, is progressively feeding into interest payments and the debt dynamics. Moreover, population ageing acts as a drag on potential growth, while increasing public spending. Against the background of uncertain growth prospects, also linked to the geopolitical environment, these risks point to the importance of implementing reforms and investment to relaunch growth potential and pursuing responsible fiscal policies. At the same time, other factors may mitigate fiscal sustainability risks. These factors include the lengthening of government debt maturities in recent years, stable financing sources and EU initiatives such as the Next Generation EU and the Recovery and Resilience Facility (RRF).

Fiscal sustainability, inclusive growth, and support to investment and reforms

([5]) Spending reviews yielded results in social security savings for 2022, for example allowing Spain to identify relevant saving options and Slovakia to potentially save up to 0.3% of GDP. See for example SK and ES Stability Programme 2023-2026.

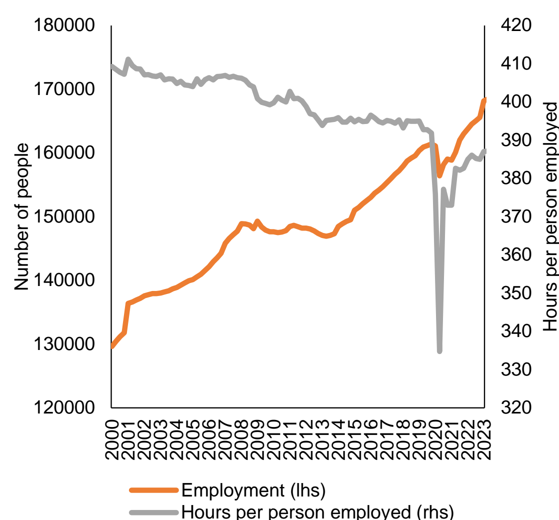
are the main objectives in the ongoing reform of the Economic Governance. With debt above the already elevated pre-pandemic levels and sustainability challenges remaining elevated and widespread across countries, a renewed emphasis on debt sustainability and economic growth is key. Given the challenging macroeconomic environment, Member States should adopt stable and credible debt reduction paths. The Commission's proposals for a reform of the Economic Governance Framework aim at promoting realistic, sustained and gradual fiscal adjustments guided by country-specific medium-term plans, while at the same time enhancing sustainable growth by incentivising reforms and investments.

3. WAGE DEVELOPMENTS AND DISTRIBUTIONAL IMPACT OF INFLATION

Labour markets developments

Labour markets in the euro area are performing well despite the slowdown in economic activity. Close to 170 million people were employed in the euro area in Q2 2023, the highest number ever **(Graph 3.1)**. Strong employment growth is supported by increasing labour supply. Despite an ageing population, the activity rate in the euro area returned to its long-term upward trend, after the temporary contraction during the pandemic. The unemployment rate stood at about 6.7% in 2022 and 6.5% in 2023 (until September) – the lowest rate recorded since the creation of the monetary union.

Graph 3.1: **Employment and hours worked in the euro area**



Source: Eurostat.

Average working hours have not fully recovered to pre-COVID levels, but resumed the steady downward trend. The number of working hours per person, which plummeted in 2020 due to confinement policies, recovered to a great extent to a level consistent with its long-run downward trend. A number of explanations are thought to explain this longer-term downward trend in average hours worked, including the rising importance of services characterised by a lower number of hours worked per worker. Additional factors keeping average hours below pre-2019 levels may include increased sick leave and labour hoarding by firms facing temporarily lower demand (Arce et al., 2023).

Recent developments are helping to bridge differences in labour market performance across the euro area. Compared to the pre-pandemic average, the drop in unemployment since 2022 has been greater in high-unemployment countries. The observed levelling up of unemployment rates across the euro area continues a trend observed before 2019, but may also have been reinforced by sectoral dynamics and the impact of the energy shock. More energy-intensive industries (e.g., manufacturing and transport), which performed well in the pre-crisis period recorded lower job creation [6] while low energy consumption sectors, and in particular services, performed better **(Graph 3.2)**. The energy price shock dampened employment growth primarily in high energy-intensive sectors.

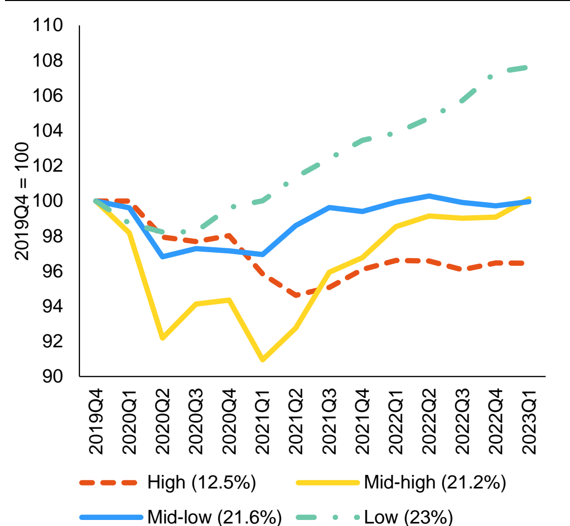
Labour and skill shortages are signs of a very tight labour market. In 2022 and early 2023 the euro area vacancy rate, i.e. the proportion of total jobs that are unoccupied or about to become vacant, hovered around 3% - the highest level since 2008. In July 2023, around 24.5% of firms reported labour as a factor limiting production [7] and 74% of SMEs

[6] For a more in-depth assessment of the impact of the energy price shock on employment see European Commission, 2023g.

[7] Compared to about 17% before the pandemic. Source: European Commission Business and Consumer Survey.

reported that they face skills shortages (Eurostat, 2023). Shortages are particularly strong in the services sector. Meanwhile, skill shortages have become major bottlenecks for some occupations, including ICT, construction, engineering and healthcare. Reducing skills shortages and mismatches, in particular by up- and re-skilling workers, can boost productivity and is essential to support the green and digital transition.

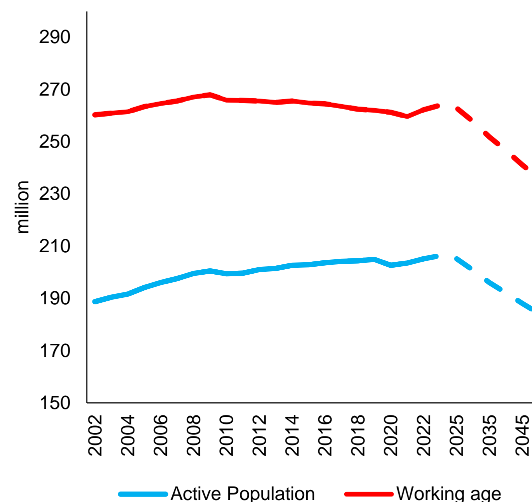
Graph 3.2: **Employment by industry according to the energy intensity of each industry (2019Q4=100)**



(1) Energy intensity is measured as Tera Joules per unit of value added. The different groups are defined classifying 55 sectors of the economy on the basis of the quartile of the sectorial distribution of energy intensity.
Source: Eurostat.

With a decreasing working age population, maintaining labour supply will remain a major long-term policy challenge. The working age population (20-64-year-olds) reached a peak of 272 million in 2009 **(Graph 3.3)**. It declined to 265 million in 2022 and is projected to continue falling to 258 million by 2030 ([8]). Population decline and ageing will cause GDP to decline in Member States to varying degrees. By 2030, demographic trends are expected to negatively affect the level of GDP in most euro area members, ranging from 0.2% in the Netherlands to 7.6% in Italy (European Commission, 2023b).

Graph 3.3: **Working age population and activity in the coming decades**



Source: EU Commission services based on Eurostat and OECD data and EUROPOP2023 population projections.

Policies to support labour supply can help address labour and skill shortages. Active labour market policies play a key role in boosting employment and labour force participation especially in groups with relative high inactivity (e.g., women and youth, particularly with migrant background) and easing the transition of workers and jobseekers in the labour market. Managed legal migration in shortage occupations could also help addressing labour and skill shortages, especially by targeting bottleneck occupations. Activating people of working age, in particular women, young and older people and people with migrant background; improving access to childcare and long-term care; reducing skills shortages: improving working conditions in certain sectors; and intra-EU mobility are vital for mitigating labour shortages in the euro area, but it will not suffice to meet needs in all shortage occupations (European Commission, 2023c). In complement to policies harnessing talents within the EU, including non-EU citizens already legally residing in the EU, legal migration from non-EU countries can help employers fill vacancies at all skills levels, including for occupations with a critical role for the EU economy and its green and digital

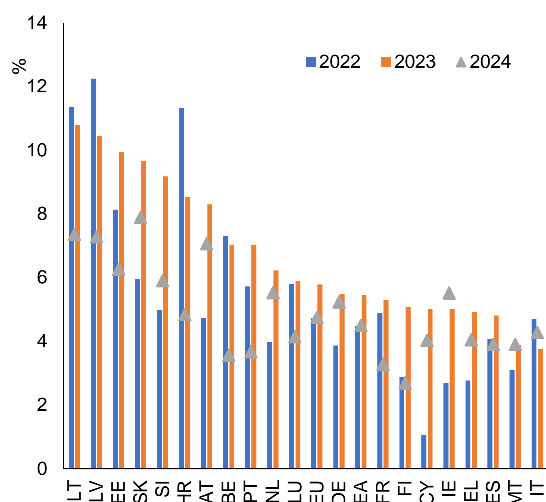
([8]) Eurostat's 2023 population projection.

transition in the context of the Green Deal Industrial Plan. Given the size of its labour market, labour migration to the euro area remains low in international comparison (European Commission, 2023d).

Wage developments

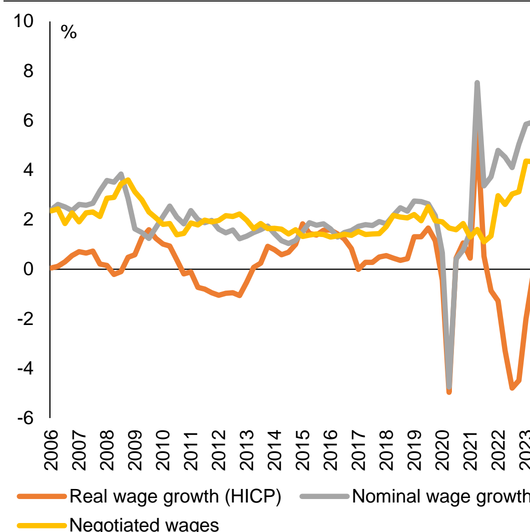
Increase in nominal wages are helping households to gradually recover purchasing power. In the euro area, nominal compensation per employee increased by 4.3% in 2022 **(Graph 3.4)** and by 5.4% in Q1 2023 (y-o-y), a record high for most Member States. However, in real terms, wages decreased by 3.5% in 2022 **(Graph 3.5)**, amid growing concerns for the adverse social consequences of purchasing power losses, especially for low-wage earners. Looking ahead, while nominal wage growth is likely to further increase over the next quarters, real wages are set to only increase from Q3 2023 onwards (European Commission, 2023e).

Graph 3.4: **Nominal compensation per employee (2022-24)**



Source: AMECO and Autumn 2023 Forecast.

Graph 3.5: **Nominal and real compensation for employee (y-o-y changes)**



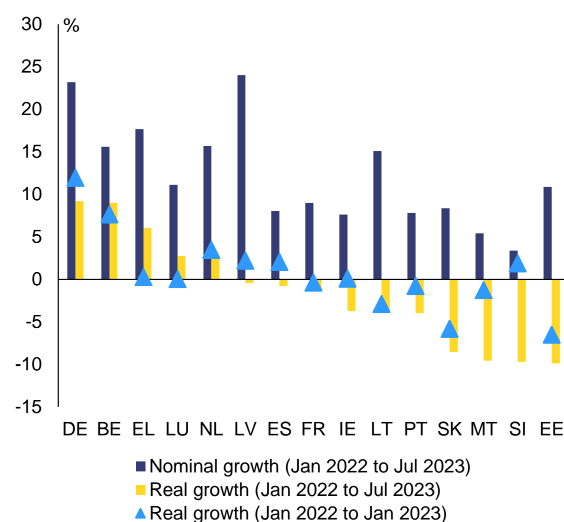
Source: Real wages are computed using the HICP index as deflator.

Increases in statutory minimum wages have partly mitigated the impact of high inflation on low-wage earners. Statutory minimum wages rose by more than 5% in nominal terms in all Member States in 2022 where such wages are in place, and even by more than 10% in around half of these countries **(Graph 3.6)**. Such increases in statutory minimum wages were the result of substantial increases throughout 2022, the January 2023 updates (9) and some updates in a few Member States after January 2023. They have largely compensated the impact of high inflation on the purchasing power of minimum wage earners in half of Member States with statutory minimum wages. The increases in 2022 reflected automatic indexation adjustments where such a mechanism is in place (e.g., Belgium, France or Luxembourg), as well as discretionary updates (e.g., Germany, Greece and the Netherlands) (Eurofound, 2023). Given the tight labour market, these increases have had no impact on minimum wage employment. However, they have resulted in a compression

(9) Minimum wages are often updated annually, at the beginning of the year. In January 2023, the largest increases were registered in Latvia, with an increase of 24%, and in Romania, Hungary, Poland, Lithuania, Croatia, Slovenia, Estonia, and the Netherlands, with increases between 10% and 20%.

of the wage scale which may put pressure on collective bargaining going forward.

Graph 3.6: **Minimum wage in Member States with statutory minimum wages**



(1) CY excluded as the statutory minimum wage was introduced in 2022. Real wages are computed using the HICP index as deflator.
Source: Eurofound.

Real wages are expected to recover gradually. Collective wage contracts are multi-year and staggered, implying an expectation for the ongoing wage acceleration to persist. This may in turn underpin the dynamics of inflation for some time. In addition, since end-2022, core goods and services have replaced energy and unprocessed food as the primary driver of headline inflation in the euro area (ECB, 2023a).

The increase in corporate profit leaves scope for adjustment in real wages in the concerned sectors with limited second-round effects on inflation. A fine balance needs to be struck between regaining the lost purchasing power for workers, especially those with low incomes, limiting second-round effects of wages on inflation, and avoiding competitiveness losses. As real wages recover, wage dynamics will increasingly contribute to domestic inflation. In particular, the dynamics of inflation will crucially depend on the way unit labour costs and unit profits interact **(Box 3.1)** ([10]). After their strong increase in recent years, unit profits are expected to decline in the course of 2023 and beyond providing a buffer for the increase in nominal wages and mitigating pressures on consumer prices. To the extent that wage setting across the euro area and the EU, in particular for new contracts, reflect an expectation that inflation will normalise over the medium-term, having a moderate impact on wage growth ([11]).

Social implications

The strong labour market and supporting policy measures have mitigated the impact of inflation on households' real disposable income. Household income declined by about 0.7% in the year ending in Q4 2022 **(Graph 3.7)**. Rising inflation which led to falls in the real compensation of employees and of the self-employed, and to falls in (net) social benefits. Policy measures – income measures or price measures -- mitigated the impact of high inflation and cushioned the drop in real disposable incomes. In Q1 2023, household incomes have rebounded in real terms (+0.5 %) as the decline in real wages was balanced by lower taxes, higher benefits and other transfers (European Commission, 2023e). A number of social indicators, including the number of people at risk of poverty or social exclusion, remained stable in 2022, reflecting the resilience of the labour market and the support mechanisms.

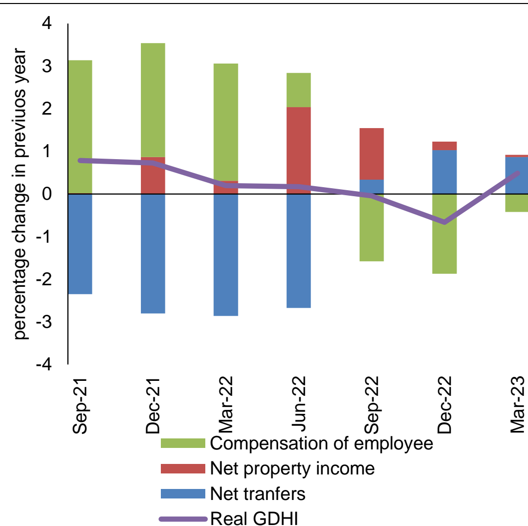
The rise in the cost of living had particularly strong impact on vulnerable groups. As low-income households spend a higher share of their income on food and

([10]) In absence of a decline in the profit share, any wage increases beyond productivity gains will lead to higher inflation, increasing the risk of loosening inflation expectations and ultimately forcing the central banks to tighten monetary policy more than otherwise would be the case. See also Arce et al. (2023).

([11]) Ex-post inflation indexation plays a relevant role only in a handful of countries (Belgium, Cyprus, Luxembourg, Malta).

energy, people at the bottom of the income distribution have experienced a higher increase in the cost of living than those at the top (1.7 pps higher on average). The gap varies considerably across countries – the widest gap is recorded in Latvia, where low-income households face an inflation rate almost 4pps higher than medium income ones (Caisl et al., 2023). Inflationary pressures were also stronger for older people and those living in rural areas due to their lower ability to adjust consumption. Because of the unequal impact on population groups, the financial distress among households in the lowest income quartile at EU level rose from 22.0% in July 2021 to 29.1% in September 2023, with the largest increases observed in Estonia (from 1% to 30%).

Graph 3.7: **Real gross disposable household income growth and its main components**

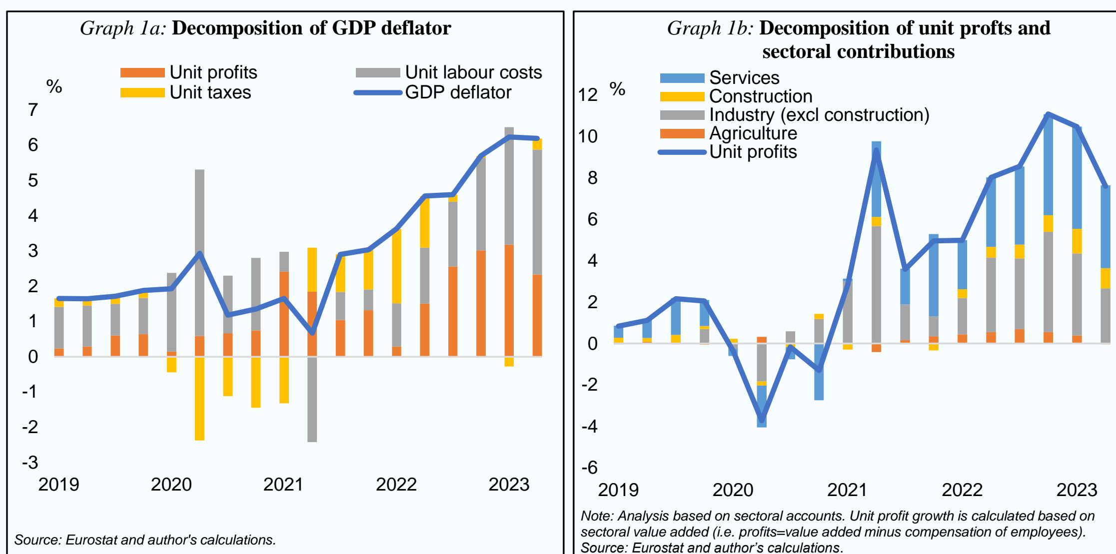


(1) GDHI, gross disposable household income in the EA20. The nominal GDHI is converted into real GDHI by deflating values using the deflator (price index) of household final consumption expenditure. Net transfers notably include net social benefits and taxes on income and wealth (negative contributions).
Source: Commission calculations based on Eurostat, National Accounts.

Although generally poorly targeted, energy measures effectively supported households. More than half of the energy support measures implemented by Member States consisted in price measures, which aim at reducing energy prices. Such measure were poorly targeted towards vulnerable households. While they do contribute to reduce inequality in real wages and in welfare, they do it at a much higher cost than more targeted income measures. Altogether, the measures implemented were able to mitigate, and in several Member States fully offset, the negative impact of higher energy price on real wage and welfare equality across income deciles (Amores et al., 2023).

Box 3.1: The increase in unit profits is a temporary phenomenon reflecting high inflation

High inflation has put the distribution of value added between profit, compensation of employees and taxes under the spotlight. A number of empirical studies ([1]) have highlighted the increase in unit profits that has accompanied the increase in inflation in 2022. Based on a decomposition of the GDP deflator, unit profits appear to have increased steadily in 2022, growing at a record 9.3% (year-on-year) in Q1 2023 before decreasing slightly in Q2 (**Graph 1a**). ([2]) Unit profits have increased across all euro area countries and sectors, albeit with wide variations. In 2021, the increase in unit profit was led by industry, including manufacturing, energy and utilities, as well as mining, but other sectors, including services, caught up in 2022 (**Graph 1b**). The mirror image of the rise in profit has been a lower share of value added going to labour income. Accordingly, concerns that the rise in inflation may translate into extraordinary profits in some sectors, to the detriment of workers, led some European governments to take policy action. A number of Member States announced windfall taxes on sectors including banks (e.g. Spain and Italy) and food distributors (in Portugal).



A higher inflation does not point to weak competition, nor does a higher level of competition necessarily translate in lower inflation. In fact, in the short run, the relationship between competition and inflation depends on the nature of the shock. An increase in input costs will typically result in higher inflation in more competitive environments, as firms cannot absorb costs inflation through lower margin (OECD, 2022). Second, market power affects the absolute price level rather than the price changes. Still, in a high-cost inflation environment, consumers may have more understanding for a firm increasing its prices and are less likely to punish a firm by switching to a competitor if price increase. Altogether, this suggests that, while increasing competition may reduce prices in the long-term, competition policy cannot be a prominent short-term anti-inflation tool.

Empirical studies confirm that the increase in unit profits mainly reflects the rapid pass-through of higher input cost into selling prices and the comparatively slower adjustment in wages. When input prices rise, and assuming that the ratio between selling price and production costs – the mark-up - remains constant, the nominal profit per unit produced will also increase by the same proportion. Accordingly, the observed increase in unit profits does not necessarily entail higher profit margins. Recent evidence for Belgium and Italy indeed suggests that mark-ups played no role in the recent increase in profits (Colonna et al., 2023). Meanwhile, wages are generally set contractually or renegotiated at fixed intervals and hence adjust more slowly to shocks than prices. The rising contribution of ULC and other wage indicators from 2022 onwards points to a lagged reaction of labour compensation and suggest that the increase in unit profits may be temporary (Graph A). This is consistent with evidence from the US which suggests that higher unit profits could be a by-product of strong demand in markets where firms are price-takers and prices have risen to match demand to limited supply or margins could have increased temporarily in anticipation of future cost increases (Glover et al., 2023).

([1]) See for example E. and E. Hahn (2023) and Hansen et al. (2023).
([2]) Unit labour costs are compensation of employees per unit of real GDP and unit profits are gross operating surplus over real GDP.

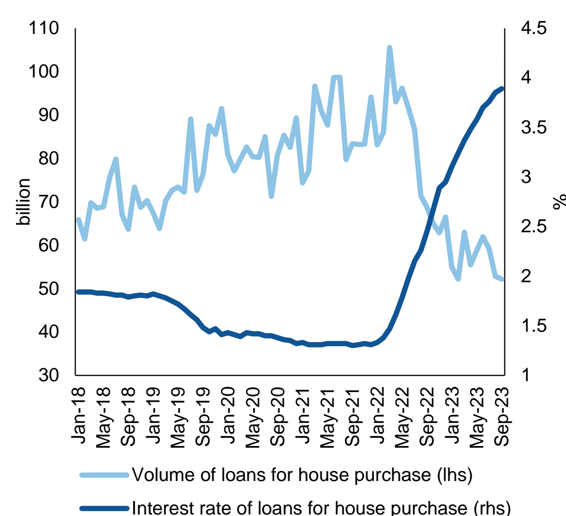
4. MACRO-FINANCIAL STABILITY

The euro area financial system has proven to be resilient, although tightening financial conditions may increase vulnerabilities. With the increase in interest rates and tighter credit conditions, the credit cycle has turned, both for households and corporates. Asset prices, and in particular real estate prices, are also coming under pressure. Although such an environment represents a challenge for financial institutions, the euro area financial sector has proven itself resilient, as euro area banks benefit from strong capital and liquidity buffers, as well as improved profitability. At the same time, the non-bank financial intermediation (NBFI) sector may be confronted with vulnerabilities. Further progress in the deepening of the European Economic and Monetary Union, including Banking Union and Capital Markets Union, would make the euro area even more resilient.

Credit conditions and dynamics

The tightening of monetary policy and lending standards coupled with lower credit demand led to a drop in new credit for both households and corporates. The total volume of new household loans for house purchase fell by 24% in the second semester of 2022 and by a further 18% in the first half of 2023. This reverses a multi-year upward trajectory that started in 2015 and reflects the sharp increase in borrowing costs **(Graph 4.1)**. The ECB's bank lending survey shows that the drop comes from falling demand for new credit, mainly due to the interest rate level. A deteriorating outlook for the housing market and lower consumer confidence has also had a significant impact on the demand for household credit. Meanwhile, new corporate loans also decreased by 4% in the first half of 2023.

Graph 4.1: **Cost of borrowing and volume of loans to households for house purchase**



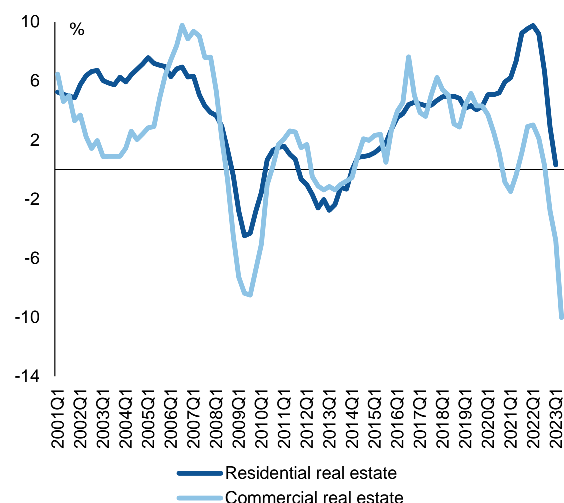
Source: ECB

Tightening financial conditions weigh on real estate prices. The euro area residential property market cycle appears to be at a turning point, as higher interest rates weigh on housing affordability. Residential real estate prices have been decreasing considerably since Q2-2022. In a number of Member States, including Luxembourg, Austria, Belgium, the Netherlands and Portugal, housing prices were far above the level suggested by fundamentals in 2022 ([12]). In the commercial real estate (CRE) sector, which is more sensitive to cyclical developments, price growth dropped sharply into negative territory **(Graph 4.2)**. The CRE market faces structural changes such as the impact of policies related to the green transition, a shift towards e-commerce and higher demand for flexibility in rentable office space (ESRB, 2023). Some of these changes may have been accelerated by the pandemic crisis and Russia's invasion of Ukraine. While the ongoing price correction is putting pressure on

([12]) For more detail see European Commission, 2023a.

investors, the speed and depth of the turn will determine the potential for stress on the financial system and the real economy (ECB, 2023b) ([13]).

Graph 4.2: **Residential and commercial real estate prices in the euro area**



(1) Year-over-year growth of nominal quarterly residential and commercial real estate prices
(2) Q2-2023 already available and included for the commercial property price indicator
Source: ECB

Asset quality has continued to improve but there are risks going forward. Banks' non-performing loan (NPL) ratios continued to decline – to historically low levels – although only marginally in the second half of 2022. At the same time, according to the ECB, early warning signs of asset quality deterioration became more pronounced, with some evidence of an increase in Stage 2 loan ratios ([14]) in 2022. They remain well above pre-pandemic levels and conceal considerable cross-country heterogeneity (ECB, 2023b). In the second half of the year, the ratio decreased slightly for non-financial corporations (NFC) loans while it continued to increase for households. Default rates have also recently shown an uptick for both corporate and retail exposures. The deterioration of economic dynamics and outlook in 2023 and higher interest rates may negatively impact asset quality.

Financial sector developments

The increase in interest rates has supported bank profitability but entails other risks. Banks' return on equity increased from an average of 1.9% at the end of 2020 to 6.8% at the end of 2022 **(Graph 4.3)**, supported by higher interest rates, low loan-loss provisions and, overall, a relatively slow adjustment of deposit rates. In 2023, the potential deterioration in asset quality could increase the cost of risk (losses and provisions). In addition, rising competition and a reallocation of funds from overnight to term deposits and wholesale funding might lead to an increase in funding costs, eroding profitability.

Capital levels and asset quality remain robust in the euro area banking sector. The Common Equity Tier (CET1) capital ratios of banks declined by 0.2 pps in 2022, to 15.7%, reflecting stronger lending and higher average riskiness of total assets. However, it stabilised at 15.8% in Q1-2023. In addition, the 2023 European Banking Authority (EBA) stress tests ([15]) confirmed the resilience of European bank's capitalisation, with capital ratios above the minimum requirements for almost all banks, even in an adverse scenario.

The banking sector holds substantial liquidity buffers and maintains strong funding ratios. Liquidity buffers mainly take

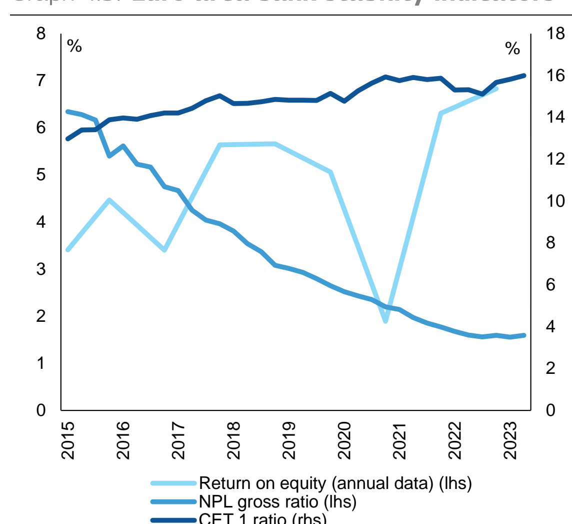
([13]) In 2023, the ESRB published a recommendation on vulnerabilities in the CRE sector in the EEA. Despite considering that there has been significant progress in closing CRE data gaps in recent years, such gaps persist in the CRE sector. See ESRB, 2022a.

([14]) Adopted in 2018, the International Financial Reporting Standard 9 (IFRS 9) aims to improve the recognition of banks' credit losses, on the basis of a more forward-looking estimation and loan-staging approach. Stage 1 consists of performing loans, Stage 2 underperforming loans that have seen a significant increase in credit risk, and Stage 3 credit-impaired loans.

([15]) The stress test involved 70 banks from 16 EU and EEA countries (of which 57 were euro area banks), covering 75% of the EU banking sector assets. Compared to the previous test, it included 20 additional banks and a detailed analysis on banks' sectoral exposures. See EBA, 2023.

the form of central bank reserves and government bonds. In addition, the high reliance on customer deposits and market funding via bonds (representing respectively around 50% and 15% of banks' liabilities in the euro area) helped increase the resilience of the euro area banks' funding base. Overall, banks' net stable funding ratios have declined only slightly since the end of 2021 and remain well above regulatory requirements. The gradual repayment of the ECB targeted long-term refinancing operations (TLTRO III) has so far not put strain on the funding ratios of banks.

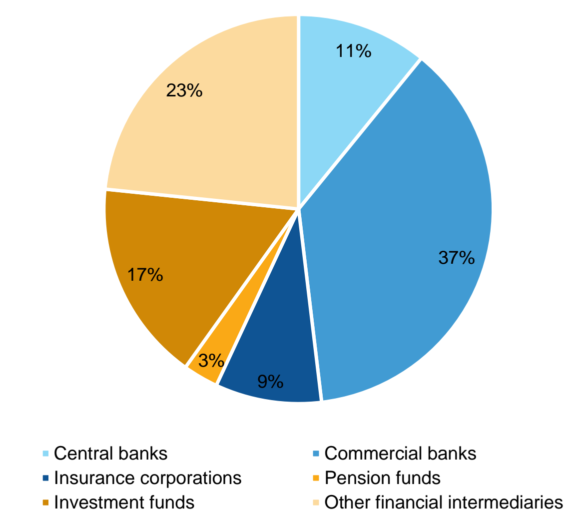
Graph 4.3: **Euro area bank stability indicators**



(1) NPL ratio covers gross non-performing debt instruments as a percentage of total gross debt instruments
Source: ECB

Meanwhile, the NBFI sector requires continued monitoring. The NBFI sector accounts for more than half of the assets of financial corporations' (including banks) in the euro area **(Graph 4.4)**. Assets of investment funds and other financial intermediaries account for about 40% of European financial sector assets. Non-bank credit granted to the NFCs stood at around 20% of external debt funding at the end of 2022, and more than 50% of newly-issued NFC debt was purchased by NBFIs. Credit risk in the aggregated NBFI sector declined during 2022 (ECB, 2023b). In addition, insurers' profitability and solvency remain robust in the euro area. Still, the NBFI sector remains vulnerable to price corrections due to macroeconomic uncertainty, a potential increase in the cost of risk, volatile markets and turning real estate cycle. The growing interconnectedness between NBFI and the banking sector means that distress in one sector may affect the financial system, with unwarranted effects on the real economy. Improving data quality and coverage of the NBFI sector to enhance its monitoring is therefore key for safeguarding financial stability (ESRB, 2022b).

Graph 4.4: **Euro area financial corporations (total asset share)**



Source: Eurostat

Deepening of the Economic Monetary Union and policies to improve financial stability

Macroprudential policy contributes to safeguard financial stability. In a high-uncertainty environment, with downside risks to economic growth, macroprudential policy can help strengthening resilience of the banking and financial system. In that respect, capital-based and borrower-based measures are complementary. According to the ESRB, macroprudential policies in several euro area Member States tightened between April 2022 and March 2023, including as regards capital buffers (ESRB, 2022c).

Progress in the Banking Union contributes to the resilience of the euro area's financial system. Ensuring financial stability

is crucial at a time of high inflation and tightening financial conditions. The banking turmoil caused by the failure of several mid-sized banks in the US and the collapse of a large Swiss-based bank in spring this year has recalled the importance of sound regulation and effective supervision, as well as of a predictable crisis management and and ensuring better protection of all depositors. In particular, the Single Supervisory Mechanism (SSM) plays an essential role in ensuring that banks are well prepared for and resilient to adverse economic and financial developments. The SSM has rapidly adapted to emerging supervisory challenges, as well as to unexpected adverse events, such as the COVID-19 pandemic and the Russian invasion of Ukraine and subsequent economic turmoil. As part of the work on the Banking Union, the Commission proposed a reform of the bank crisis management and deposit insurance framework in April 2023. It aims to broaden the applicability of resolution powers to mid-sized and smaller banks, while improving resolution funding arrangements, including by facilitating a more flexible use of national deposit guarantee funds. The review of the crisis management and deposit insurance should pave the way for further progress towards the completion of the Banking Union, including a European Deposit Insurance Scheme and deeper market integration.

NBFI vulnerabilities also highlight the need to strengthen the resilience of this sector from a macroprudential perspective. Structural vulnerabilities related to liquidity and leverage highlight the need to progress on policies aimed at enhancing liquidity preparedness to meet large margin and collateral calls in derivatives and repo markets, containing leverage-related risks, and tackling liquidity mismatch in open-ended investment funds.

Introduction of a digital euro could spur efficiency and innovation in the European payments markets, unlock benefits for the euro area economy, and foster the international role of the euro. The digital euro is a digital form of central bank money, which would offer consumers and businesses an additional choice for their payments everywhere in the euro area. The digital euro would be complementary to cash. Benefits include safeguarding the key role of risk-free public money for the monetary system and enhancing financial inclusion. Moreover, it could help support the digital transition, reduce fragmentation and promote innovation in the European payment system. In that context, the digital euro could support FinTech innovation by providing a common and pan-euro area standard on which innovative use cases, such as automated payments in a machine-to-machine environment, can be developed, while the digital euro's interoperability with the EU Digital Identity Wallet could provide for a seamless customer authentication process and add another layer of privacy in retail payments. A digital euro would also contribute to strengthening the international role of the euro and Europe's open strategic autonomy. On 28 June 2023, the Commission has adopted a legislative proposal that would establish the digital euro and regulate its essential aspects. The ultimate decision on its eventual issuance lies with the ECB, who could start issuing the digital euro after completion of the legislative process. In parallel with the retail digital euro, the ECB is engaging in exploratory work on the potential of new technologies for existing wholesale settlement systems.

Ratification of the amended European Stability Mechanism (ESM) Treaty would further strengthen the euro area's macro-financial stability architecture ([16])**.** The ESM reform was agreed in 2020 by Eurogroup members, however as the amended ESM Treaty has not yet been fully ratified, the reform has not been finalised. The ratification of the amended ESM Treaty would operationalise the ESM's financial backstop to the Single Resolution Fund (SRF), make crisis management arrangements more credible **(see Box 4.1)**. By providing a common backstop for the funds available to manage a bank crisis, the amended ESM

([16]) See the ratification details on the Agreement Amending the Treaty Establishing the ESM: https://www.consilium.europa.eu/en/documents-publications/treaties-agreements/agreement/?id=2019035&DocLanguage=en

Treaty would limit divergence in financial conditions.

Financial risks related to nature loss and climate change need to be further assessed and monitored. As regards climate change, the ECB/ESRB Project Team (ESRB, 2022d) emphasises the need for a macroprudential approach as regards systemic aspects of climate-related risk. In 2023, the European Commission mandated the European Supervisory Authorities and asked the ECB to undertake a coordinated one-off assessment of financial stability risks in line with the Fit-for-55 package. The outcome of that assessment, expected in Q4-2024/Q1-2025, will inform the future work programme of the Union in that area.

Box 4.1: **Financial architecture of the euro and role of the ESM**

The European Stability Mechanism (ESM) reform, agreed in 2020 by Eurogroup members, entrusts, among other changes, the ESM to become the backstop to the Single Resolution Fund once the amended ESM Treaty is fully ratified. With its contribution to the funds available in case of a bank resolution, the common backstop would help ensuring that the ability to provide funding for resolving banks is delinked from the creditworthiness of the Member State where a bank is located, thus limiting divergence in financial conditions. The introduction of a common backstop to the Single Resolution Fund would thus strengthen and add credibility to the euro area's crisis management toolkit. The proposed ESM reform aims to simplify and clarify the eligibility conditions to access ESM precautionary credit lines and it tasks the ESM with the monitoring of macro-financial risks in the euro area to prepare for potential adjustment programmes. However, as the amended ESM Treaty has not yet been fully ratified, the reform has not been finalised. In the meantime, following its accession to the euro area, Croatia joined the ESM in March 2023.

The amendments to the ESM Treaty have not addressed the issue related to its institutional nature. The ESM remains a purely intergovernmental body operating under public international law. Recently, European Court of Auditors (ECA) published a special report on the EU's financial architecture recommending that, once the ESM Reform is fully ratified, a broader reflection on a possible integration of the ESM in the EU legal framework takes place. ([1]) Before the ECA report, the case for an ESM integrated into the EU legal framework has been made on several occasions. For example, the "Five Presidents' report on completing the Economic and Monetary Union", issued in 2015, underlined that the ESM's intergovernmental structure entailed a complex governance and lengthy decision-making processes, and advised to integrate the institution within the EU Treaties. Similar positions were adopted by the European Parliament ([2]) when reflecting on the future of the Economic and Monetary Union.

In 2017, the European Commission presented a proposal to integrate the ESM in the EU legal framework through its transformation into a union body, the "European Monetary Fund". The Commission's proposal aimed at strengthening the institutional anchoring of the ESM and aligning its governance with other EU bodies through the introduction of qualified majority voting and increased accountability towards the European Parliament. Overall, the integration of the ESM into the EU legal framework could simplify the ESM's governance and make it more agile, allowing to respond to any unfolding crises more promptly and efficiently.

([1]) The ECA recommends that by 2025, the European Commission engages with the Council and the parliament with a view to finalise the integration of the ESM into the EU legal framework. See ECA, 2023.
([2]) See European Parliament, 2013.