A more resilient euro area navigates financial imbalances and macroeconomic instability

By Yasin Mimir, Lorenzo Ricci

25 October 2023

The euro area economy enters the current cycle of higher interest rates with relatively moderate levels of financial imbalances. Policy-makers have applied the lessons learned during the global financial crisis and the ensuing policy measures.

In this blog, we use a quantitative approach to examine the likelihood and macroeconomic implications of a rapid unwinding of financial imbalances in the euro area, as captured by credit and asset price developments. We find that the euro area, while not immune, now stands more resilient to an episode of financial turmoil compared to the past and to other economies – such as the US.

Strengthening the euro area's financial regulatory framework and institutional architecture has contributed significantly to this resilience. However, the journey is not over, and further progress is needed to reduce vulnerabilities and prepare for the new challenges and risks ahead.

Financial imbalances in the euro area are milder than in past episodes of financial distress

The accumulation of financial imbalances associated with elevated credit growth and high house prices could hamper future economic growth in modern economies and act as an

amplifier of macroeconomic shocks. [1] Assessing euro area financial vulnerabilities becomes particularly pertinent amidst current tightening financial conditions and following a prolonged low interest-rate environment. As discussed in the ESM blog on financial stability and risks to growth in the euro area, the recent tightening of financial conditions in the euro area signals near-term risks that could undermine growth prospects.

Credit expansion in the euro area has been less vigorous in the last decade compared to the years preceding the global financial crisis. It has also been more contained than in other economies, like the US (see Figure 1a). House prices in both the US and the euro area have shown dynamism similar to that seen in the early 2000s and during the pandemic (see Figure 1b). Five-year average growth of real house prices seems to have peaked towards the end of 2021 for the euro area and in the second quarter of 2022 for the US, before gradually moderating in both economies. It is too early to judge if the recent fall in house price growth is temporary or the start of a deeper and more protracted decline. A correction of housing prices presents a risk, but it will be more severe if it comes in tandem with high credit growth.

Figure 1a and b: Lower financial vulnerabilities in the euro area compared to pre-global financial crisis

Notes: These figures show five-year average growth in real credit and real house prices. Credit is defined as monetary financial institutions lending to the private sector.

Source: ESM calculations based on European Central Bank, Centre for Economic Policy Research-Euro Area Business Cycle Network, Federal Reserve Board, and Organisation for Economic Co-operation and Development data

Lower imbalances reduce likelihood and severity of a financial downturn

We use a quantitative regime-switching macroeconomic model, explained in a technical annex to this blog , to assess the impact of financial imbalances. Our analysis shows that for both the euro area and the US the imbalances accumulated so far point to the limited likelihood overall of an acute contraction in gross domestic product (GDP), and less than half the level witnessed just before the global financial crisis hit (see Figure 2a).

Since exiting the euro crisis, the probability of financial turmoil in the euro area has gradually increased, driven by factors such as house prices, credit growth, equity prices, and interest rates, with broadly similar contributions from each of these factors. More recently, this probability has declined as financial vulnerabilities have begun to gradually adjust (see Figure 2a).

A simple comparison with the US shows that a sharp rise in house prices followed by more dynamic credit growth are the main factors behind the higher probability of a potential financial downturn in the US (see Figure 2b).

Figure 2a and b: Risk of a financial downturn in the euro area is limited compared to pre-global financial crisis

Note: We estimate the probability of a financial downturn starting (defined as future GDP shortfall) based on standard macro and financial variables using a sample of advanced economies.

Source: ESM calculations based on European Central Bank, Centre for Economic Policy Research-Euro Area Business Cycle Network, Federal Reserve Board, and Organisation for Economic Co-operation and Development data

The model explicitly considers nonlinearities arising from financial vulnerabilities during distress episodes in order to assess both the likelihood and the macroeconomic effects of counterfactual scenarios involving an abrupt rebalancing of financial woes. It also captures the capital position of the banking sector that is subject to regulatory capital requirements.

In this model, the *probability* of an episode of financial turmoil increases with pre-existing imbalances in private credit, house prices, equity prices, and interest rates (in real terms). In addition, the *severity* of such turmoil, if materialised, can be amplified by the degree of imbalances in private credit. Credit growth matters because it affects investment in real estate, i.e. level of construction activity, as well as the exposure of banks. If a construction boom is fuelled by bank credit, the entire banking sector can be at risk if the boom implodes, as was the case in some countries during the past crisis.

According to our counterfactual scenario analysis, a sudden unwinding of existing imbalances would have a more limited impact now than during the global financial crisis due to the more contained level of imbalances and the stronger banking sector in the euro area. If a financial turmoil were to be triggered by an adverse shock, for example, a loss of confidence in the banking sector, a spike in credit spreads, and the ensuing credit contraction and house price correction would lead to output losses and reduced inflation (see Figures 3a and 3b for impact on real GDP and inflation).

Figure 3a and b: Macroeconomic effects of a sharp unfolding of financial imbalances are relatively contained

Notes: Results are based on simulations with an estimated structural macroeconomic model for the euro area with nonlinearities stemming from financial imbalances (similar to Kockerols, Kravik and Mimir, 2023). Reported numbers reflect the end-of-year figures. Year 1 refers to the year when the financial turmoil happens and Year 2 refers to the year after. "Financial turmoil with recent vulnerabilities" assumes a transition to a financial crisis state in Q1-2022, described as a sharp rise in household and corporate lending spreads together with reductions in credit supply to households and businesses, under the level of financial imbalances in Q1-2022 with no policy change assumption. "Financial turmoil with pre-global financial crisis vulnerabilities" assumes a transition to a financial crisis state in Q1-2022 under the level of financial imbalances up until Q2-2008 with no policy change assumption.

Source: ESM

Given the more contained level of financial imbalances in the euro area recently compared to the pre-global financial crisis era, and the more robust position of the banking sector, the output loss and the reduction in inflation would be comparatively much lower. These results suggest that the financial regulatory framework in the euro area has improved significantly compared to before the crisis.

Enhanced regulatory framework contributed to euro area resilience, but challenges remain

In navigating the tides of uncertainty, prudence and continued focus on the euro area's financial vulnerabilities are crucial. The euro area faces a critical juncture as it grapples with challenges stemming from the pandemic and the war in Ukraine, while also facing the sharpest tightening of monetary policy since the creation of the euro area. Thanks to the enhanced financial regulatory framework due to the lessons learned from the global financial crisis, financial vulnerabilities arising from credit and house prices have remained contained, reducing the probability of an systemic crisis and the impact of financial turmoil.

However, the journey is not over, as challenges remain and risks in a volatile geo-economic environment lie ahead. First, advancing the institutional framework, which includes finalising banking union and securing the common backstop with the ESM treaty ratification, will significantly enhance the resilience of the euro area's financial structure. Second, we must remain vigilant as new vulnerabilities emerge, particularly within the non-banking financial sector, calling for an enhanced regulatory framework and close monitoring. These improvements will

enable the euro area to better cope with an uncertain macroeconomic environment characterised by external shocks.

Acknowledgements

The authors would like to thank Pilar Castrillo and Rolf Strauch for their valuable comments and contributions to this blog post, Raquel Calero and Anabela Reis for their editorial review, and Peter Lindmark for his contribution to creating the interactive charts.

Technical Appendix

TECHNICAL APPENDIX - A more resilient euro area navigates financial imbalances and macroeconomic instability
211 KB

Further reading

Gerdrup, K. R., Hansen, F., Krogh, T., and Maih, J. (2017). Leaning Against the Wind When Credit Bites Back. International Journal of Central Banking, 13(3), 287-320.

Kockerols, T., Kravik, E. M. and Mimir, Y. (2023), " Leaning against financial cycles with occasional crises", ESM Working Papers, No. 56.

Castrillo, P., Iseringhausen, M. and Strauch R., " Financial stability and risks to growth in the euro area: where do we stand?" ESM blog, April 3, 2023

Fioretti, P., Skrutkowski, M. and Strauch R., " Commercial real estate and financial stability – this time, it's different." ESM blog, August 10, 2023

Jorda, O., Schularick, M. and Taylor, A.M. (2013), “When Credit Bites Back”, Journal of Money, Credit and Banking, Vol. 45, p. 3-28.

Jorda, O., Schularick, M. and Taylor, A.M. (2016), “The Great Mortgaging: Housing Finance, Crises and Business Cycles”, Economic Policy, Vol. 31 (85), p. 107–152.

Mascher, N., Sole, J. and Strauch R., “ Fast and furious ...but tameable: Lessons from the recent banking turmoil for the EU.” ESM blog, May 24, 2023

Footnotes

[1] Jorda, O., Schularick, M. and Taylor, A.M. (2013), “When Credit Bites Back”, Journal of Money, Credit and Banking, Vol. 45, p. 3-28.

Subscribe to the blog