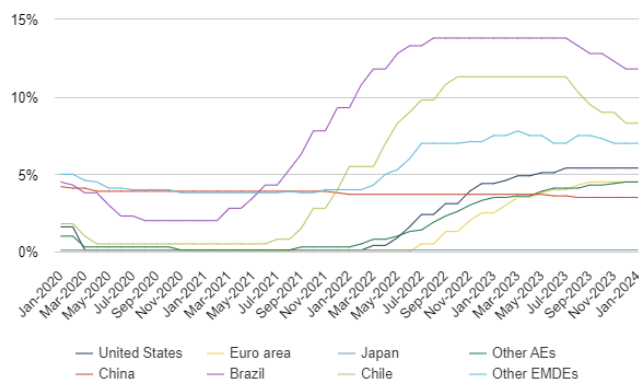


Macroeconomic environment and market sentiment

Elevated uncertainty underpins macroeconomic environment^[1]

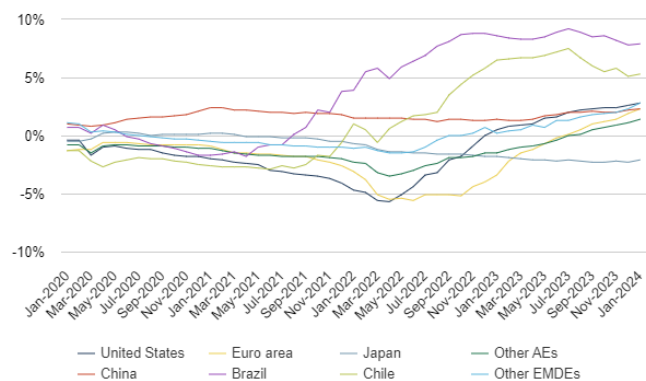
In a similar way to society and the economy more broadly, EU/EEA banks face elevated uncertainty. This is not least due to high geopolitical risks that also weigh heavily on economic growth. Furthermore, inflationary pressure has remained above central banks' target levels. Although interest rates stopped increasing, they are at historically rather elevated levels (Figure 1).

Figure 1a: Nominal policy rates worldwide



Source: IMF, May 2024

Figure 1b: Real policy rates worldwide



Source: IMF, May 2024

Economic activity in the EU has been subdued for five consecutive quarters, with real Gross Domestic Product (GDP) remaining at similar levels to Q3 2022. The EU economy has just avoided a technical recession. Latest Commission data points to 0.3% growth in Q1 2024 for the EU, with growth projections for 2024 at 1%. This is a slight improvement compared to the previously forecasted 0.9% growth for this year.^[2] There is also a slight uptick to 1.6% in 2025. Inflation rates are also expected to ease, dropping from 6.4% in 2023 to 2.7% in 2024^[3] and further to 2.2% in 2025 for the EU, and slightly higher than euro area (EA) expectations.

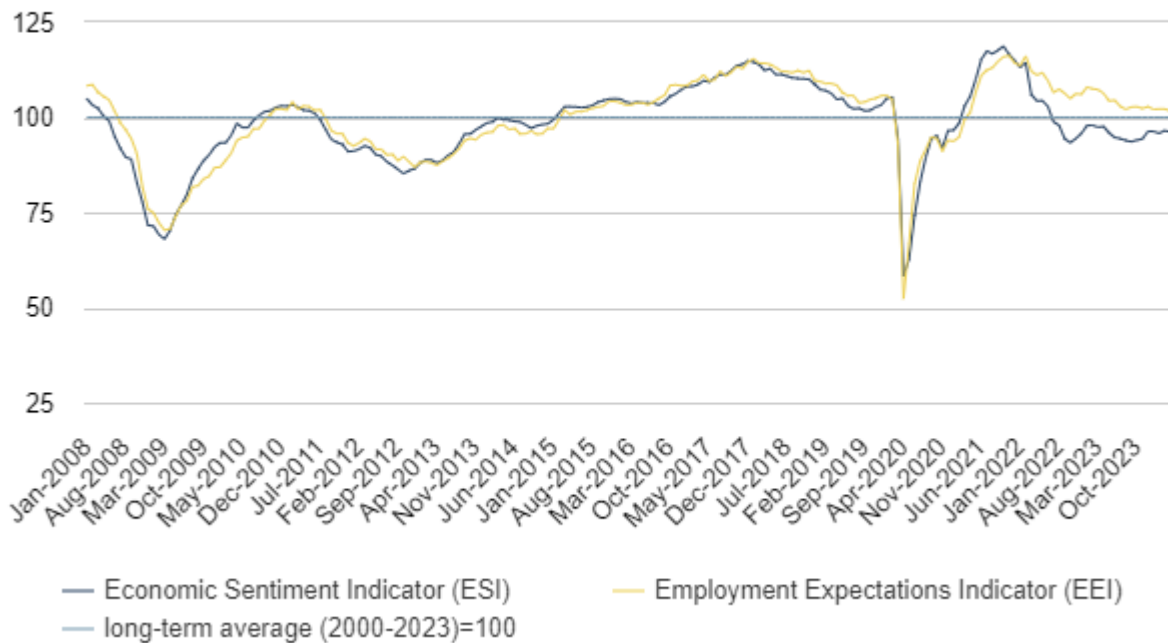
Despite a rather stagnant economy, the job market remained resilient in 2023. The unemployment rate for the EU has so far also remained at its record low of 6.0% in April this year.^[4] In 2023, wages continued to grow, albeit at a slower pace, with a 5.7% increase

in the EU and 5.2% in the EA compared to the previous year, primarily driven by the industrial sector. This deceleration in wage growth was widespread across various sectors and EU Member States. Despite this slowdown, wage growth is expected to continue as workers seek to regain lost purchasing power. This might adversely feed back into inflationary pressures again.

Monetary policy tightening has led to higher mortgage costs. This also caused refinancing challenges, increased bankruptcies, and reduced investment in both business and housing sectors.^[5] Public debt remains 4 percentage points (p.p.) above the pre-pandemic level, despite a significant reduction of the debt-to-GDP ratio in both the EU and EA last year, reaching 83% and 90% respectively.^[6] Regarding the private sector, the purchasing managers' index (PMI) for the EA increased to 51.7 in April from 50.3 in the previous month. The manufacturing sector continues to suffer, standing at 45.7, below other regions and the global index.^[7]

At global level, the PMI remained above 50 (52.4) in April, but still below the survey's long-run average of 53.2. Meanwhile, services, especially travel and tourism, continued to recover, while global manufacturing showed a slight improvement, at 50.3. This is in line with the results of 2023. In Q4, the global PMI for manufacturing remained in contraction at 48.9, weaker than Q3 2023. In accordance with this data, global growth is forecasted to reach 3.2% in both 2024 and 2025, keeping the same pace as the previous year. Expectations are that developed economies will perform slightly better than last year, whereas emerging market economies are expected to perform slightly worse (Figure 2).

Figure 2: EU Economic sentiment and employment expectations (seasonally adjusted)



Source: Commission Forecasts, May 2024

Yield contractions

Within this environment, the European sovereign bond market has seen a general decrease in yields and a tightening of spreads, despite significant sovereign debt issuances and the reduction of European central Bank (ECB) asset purchases. As an example, the yield on the German 10-year bund dropped from 2.85% to 2.2%, dipping to 1.9% in late December 2023 (Figure 3).^[8] Corporate bond spreads have in general dropped. Equity markets have been on the rise, showing confidence in monetary policy to lower inflation with minimal impact on growth. However, the spreads for the riskiest European corporate bonds have increased a bit, showing worries about the EU's weak economy and low growth prospects, which has had an impact on the credit risk of weaker firms. On interest rates, expectations are now for slower cuts by central banks than previously assumed. This follows rate cuts in the EA, Denmark, Sweden and several central and eastern European (CEE) countries.^[9] The future development of monetary policy will be an important driver defining many aspects in banks' risks and vulnerabilities.

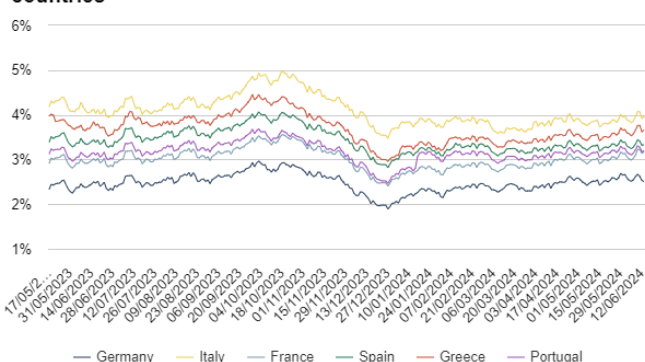
Figure 3a: EURO STOXX (SXXP) and EURO STOXX for banks (SX7E)

30/12/2022=100



Source: Bloomberg

Figure 3b: 10Y government yields of selected EU countries



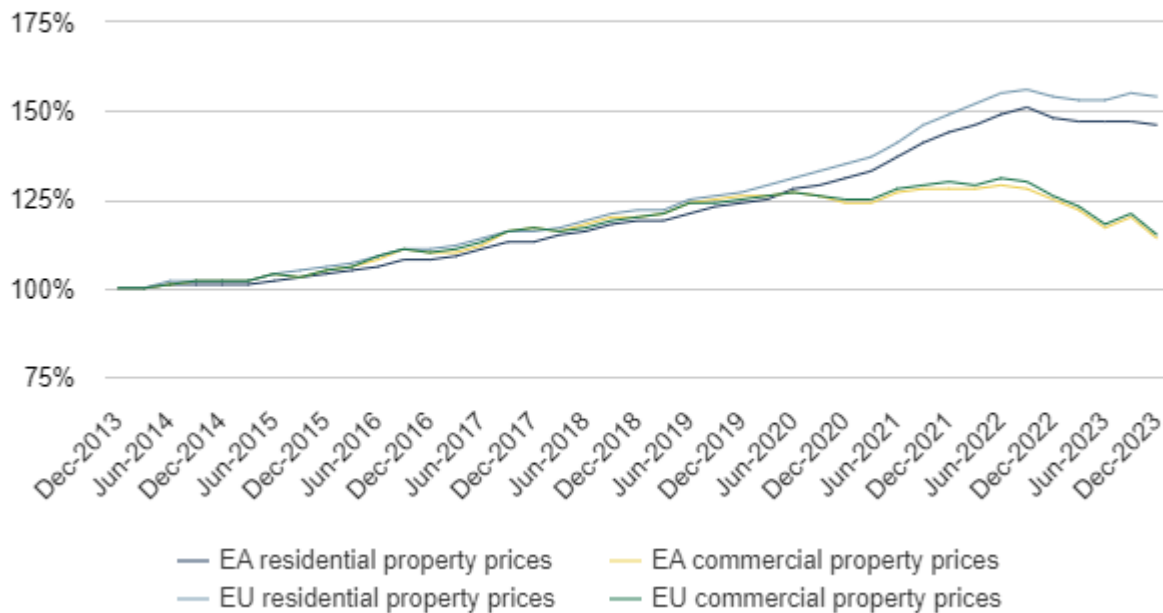
Source: Bloomberg

Real estate under scrutiny

The number of transactions in the CRE sector contracted in recent quarters. The lack of activity might continue affecting the sector in the near future, despite notable price corrections, with a decrease of 8.7% in Q4 2023 YoY.^[10] In particular, office space and lower-quality CRE assets are the segments that seem to suffer the most, as a result of a sharp drop in demand. While the office space segment has mainly been affected by the spread of teleworking and the consequent reduction in rental growth expectations, lower-quality CRE assets are not least affected by concerns about stricter energy efficiency requirements and higher capital expenditure costs (see Chapter 7 on CRE-related challenges and risks in more detail). The downturn of the real estate market might also have stronger repercussions on market stability, negatively affecting NBFIs significantly exposed to the segment (see Chapter 8; Figure 4).

Figure 4: Residential property vs commercial property prices in the EA and EU *

Q4 2013 = 100



Source: ECB

*Dec-2013 = 100. The price index for the EA and EU is calculated as the average of the price indices for the EA and EU (excluding the UK and Ireland).

The monetary policy tightening also influenced mortgage demand, negatively affected by increased borrowing costs, low consumer confidence and uncertainty in the housing market. In Q4 2023, the EU's housing market saw a slight rise in housing prices of 0.2% YoY with significant variation among Member States. In the same period, the EA saw a contraction in housing prices of 1.1% YoY. Housing prices have returned to a similar level to those in Q3 2022. However, a wide divergence in price trends was observed across EU Member States: the largest declines were recorded in Luxembourg (-14.4%) and Germany (-7.1%), while the largest increases were in Poland (+13.0%) and Bulgaria (+10.1%). From November 2023 to March 2024, borrowing costs have already decreased slightly, with the average interest rate dropping from 4.01% to 3.77%.^[11] Nonetheless, the volume of new home loans in 2024 remains low, not surpassing the previous year's levels. The tightening of financial conditions has caused a significant slowdown in residential real estate (RRE) investment, which could negatively impact future supply. Transactions have been low, with no significant increase in activity at the start of 2024.

[1] The focus here is mainly on economic and similar risks. There are others, such as environmental, social and governmental (ESG) related risks. They also play a major role for the banking sector, and are accordingly covered by the EBA's work, like in the development of the [Guidelines on the management of ESG risks](#).

[2] See the [winter edition of the European Commission Economic Forecast](#) from February 2024.

[3] See the [European Commission Spring 2024 Economic Forecast](#) from May 2024.

[4] See [Eurostat Unemployment Statistics](#).

[5] See the [IMF World Economic Outlook](#), April 2024.

[6] See the [European Commission Spring 2024 Economic Forecast](#) from May 2023.

[7] See [S&P Global Purchasing Managers Index](#).

[8] See the [European Commission Spring 2024 Economic Forecast](#) from May 2023.

[9] On rate cuts, see for instance the [European Commission Spring 2024 Economic Forecast](#) from May 2023. As examples for rate cuts, see for instance the [Swedish Riksbank's cut in May 2024](#), the National Bank of Poland rates with the last change in October 2023 and the [National Bank of Hungary's rate history](#).

[10] See the [ECB Financial Stability Review](#), May 2024.

[11] See the [European Commission Spring 2024 Economic Forecast](#) from May 2023.