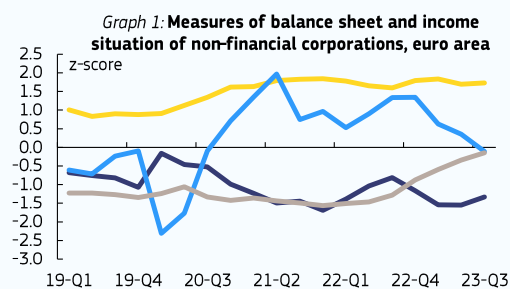


Box 1.2: EU non-financial corporations in a challenging economic environment

Relatively healthy balance sheet positions and strong policy support helped non-financial corporations (NFCs) weather the pandemic and energy shocks. Still high input costs, tight monetary conditions and slowing demand are now testing the resilience of the corporate sector. Latest available data indicate a marginal, though manageable, deterioration in banks' aggregate asset quality. However, real time information from financial markets points to decreasing credit risk in some corporate segments. Still, at the lowest end of the credit quality spectrum concerns about defaults remain.

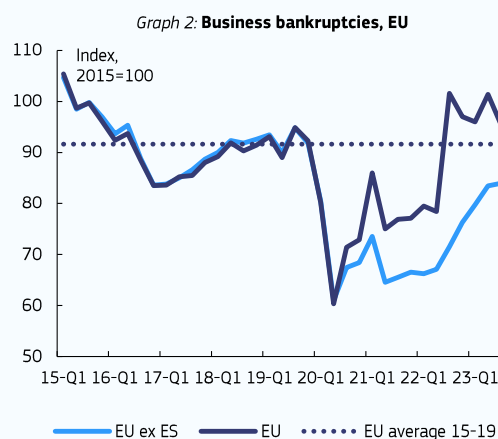


Note: The z-scores are used as measures for leverage ratio (debt securities and loans/equity), liquidity (short-term assets/ short-term liabilities), profit share (operating surplus/gross value added), interest ratio (interest payment/gross value added) are computed by subtracting the mean from a data value and dividing by the standard deviation. Mean and standard deviation are calculated from 2000.

Resilient corporate balance sheets have been a key element of the post-pandemic recovery. EU non-financial corporations entered the pandemic crisis in a solid position. According to sector accounts, debt-to-equity ratios were at historically low levels. Liquidity ratios were also relatively high, against the background of supportive financial conditions. The exceptional policy response during the pandemic was crucial in preserving healthy corporate balance sheets, allowing them to retain their equity and liquidity positions without accumulating high debt levels. ⁽¹⁾ In 2023-Q3, leverage and liquidity ratios remained roughly at pre-pandemic levels, while the ratio of debt to gross operating surplus started decreasing in 2021.

Skyrocketing energy prices, rising labour costs and surging interest rates have, however, weighed on firms' profitability. The post-pandemic rebound lifted profitability, further improving firms' positions. The phasing out of pandemic-related support measures, surging energy prices, rising interest rates and increasing labour costs have, however, taken a toll on corporate earnings. The profit share has been declining since the beginning of 2023, and the ratio of gross operating surplus to interest spending, a proxy for corporates' debt service capacity, has dropped since mid-2022 (see Graph 1).

Business bankruptcies in the EU have registered a broad-based increase in recent quarters. The policy response to the pandemic crisis also included temporary changes to insolvency procedures and bankruptcy moratoria. These, in addition to the judicial backlog accumulated during the lockdowns, kept bankruptcies low until the third quarter of 2022, when their number surged briskly. Thereafter, this number has fluctuated above its pre-pandemic long-term average, with the latest available quarterly reading for 2023-Q3 showing a slight moderation. These developments, however, are heavily distorted by individual countries, especially Spain that has an important weight in the EU aggregate and underwent an important revision in the legal insolvency framework implemented in September 2022. ⁽²⁾ This legislative change resulted in



⁽¹⁾ See IMF (2021), Departmental Paper No 2021/015, [Who Bore the Brunt of the Pandemic in Europe? Shifting Private Stress to the Public Sector](https://www.imf.org/en/Publications/Departmental-Papers/Issues/2021/015/Who-Bore-the-Brunt-of-the-Pandemic-in-Europe-Shifting-Private-Stress-to-the-Public-Sector) (imf.org)

⁽²⁾ Two additional factors might bias bankruptcies data in Spain: the large share of natural persons amongst insolvency procedures and a change in the statistical institution preparing Spanish statistics as of 2021.

(Continued on the next page)

Box (continued)

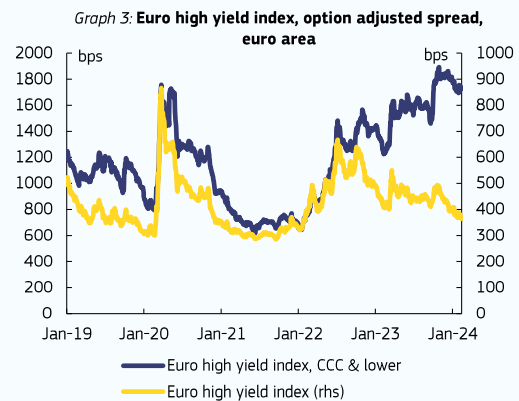
a sharp increase in bankruptcy declarations in 2022-Q3, which reverted towards long-term trends in following quarters. Excluding Spain, the number of bankruptcies across the EU moved up less abruptly, but has kept creeping up towards the pre-pandemic average (see Graph 2). In 2023-Q3, the number of bankruptcies (compared to the same quarter of the previous year) increased further. In Germany and France it exceeded pre-pandemic levels. ⁽³⁾ While these developments deserve careful monitoring, they represent a rebalancing after several years of policy-induced subdued bankruptcy activity.

Survey results suggest that vulnerabilities in the corporate sector are increasing. The ECB’s bi-annual Survey on the Access to Finance of Enterprises (SAFE) in the euro area, allows to identify financially vulnerable firms. These are defined as firms facing (i) lower turnover, (ii) decreasing profits, (iii) higher interest expenses, and (iv) a higher or unchanged debt-to-assets ratio. The share of financially vulnerable enterprises surged in the acute phase of the pandemic, but came down during the post-pandemic rebound. In the latest survey (covering the period from April to September 2023), the share jumped to 9% (compared with 6% in the previous round), close to the levels seen during the outbreak of the COVID-19 pandemic. ⁽⁴⁾ This important increase in financial vulnerability heralds a likely increase in the number of bankruptcies in the near-to-medium term.

Growing vulnerabilities and rising bankruptcies have so far resulted in only a marginal deterioration of banks’ asset quality. So far, banks reported only a marginal deterioration in credit quality. In 2023-Q3, the share of loans that deteriorated significantly in quality since initial recognition but still does not offer objective evidence of a credit loss event – i.e. stage 2 loans – is below the peak of 2022-Q3, but still relatively high. The euro area banking sector, moreover, appears able to absorb a potential deterioration of asset quality. The volume of non-performing loans has so far been stable at historically low levels, while on average the banks’ capital and liquidity positions remain strong.

Real time signals from financial markets point to decreasing credit risk.

Several metrics of credit risks have been receding in recent months. Aggregate Credit Default Swaps (CDS) indices are a good proxy of financial markets’ assessment of credit risk. In late January, the Itraxx Crossover – i.e. the key European benchmark index covering CDSs of European high-yield (speculative grade) corporates – decreased further since its peak in October 2023, standing well below stress levels (established threshold of 600 bps.). Spreads between investment and speculative grade corporate bonds – another metric of credit risk – also narrowed (see Graph 3), after reaching “stressed” levels in the third quarter of 2022. These real-time indicators suggest that default risks are receding, even if the signal is limited to larger corporations with publicly listed equity and/or debt instruments. Credit spreads at the lowest end of the credit quality spectrum (i.e. corporations with CCC rating or lower) have been moving upward. The low-quality credit segment remains relatively small in EU financial markets, but these divergent developments suggest that amidst an overall improved credit outlook, weaker corporations still face significant challenges.



⁽³⁾ The increase must be seen against the background of a large increase in the number of new businesses over the same period: since the pandemic, the large gap between stagnating bankruptcies and buoyant business registration resulted in rapid expansion of the number of businesses, especially in Germany.

⁽⁴⁾ See ECB (2023), [Survey on the Access to Finance of Enterprises in the euro area - April to September 2023](#)