EUROPEAN CENTRAL BANK

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The overall economic and financial situation is still fraught with risks for financial stability. The main source of concern stems from the interplay between sovereign debt problems and vulnerabilities in segments of the euro area banking sector. Another important source of risk is the re-emergence of global imbalances and the possibility of their disorderly unwinding. These two vulnerabilities have the potential to generate negative surprises of potential systemic importance. This issue of the Financial Stability Review assesses these risks and points to appropriate actions to avoid them or to mitigate their effects.

It is, however, important to underline that, should the current consensus baseline macroeconomic scenario for the euro area, which assumes moderate growth, materialise, the euro area financial sector is expected to further strengthen its resilience and profitability in the period ahead. This assessment is supported by several important developments: first, decisive actions taken at the EU level by Member States – including additional financial backstop mechanisms set up by governments – and by central banks to support financial stability; second, fiscal consolidation efforts by Member States; and third, increased transparency concerning financial institutions' asset exposures.

Main risks for euro area financial stability	
Outside the financial system, the main sources of risk for euro area financial stability include the possibility of:	Concerns about the sustainability of public finances, with the potential for further adverse feedback between public finances, macroeconomic growth and financial sector developments A resurgence of global imbalances and the risk of a disorderly unwinding of those imbalances Pockets of vulnerability being revealed in euro area non-financial corporations' balance sheets, because of high leverage, low profitability and difficult financing conditions

	Greater-than-expected euro area household sector credit losses if unemployment remains high for a prolonged period, or surprises to the upside
Within the euro area financial system, important risks include the possibility of:	A renewal of strains on financial systems, because of heightened funding vulnerabilities and dampened profitability prospects Vulnerabilities of some financial institutions associated with concentrations of lending exposures to commercial property markets being revealed Heightened financial market volatility if macroeconomic outcomes fail to live up to market expectations

All in all, significant actions taken by euro area governments in the spring and summer of 2010 to bolster confidence in the financial sector were important to contain systemic risk in the euro area. This notwithstanding, given the potential for continued adverse feedback between weak public finances and financial sector vulnerabilities in many parts of the euro area, there is no room for complacency. Strong commitments by governments to rein in public sector imbalances and to implement measures that support the competitiveness of and confidence in the euro area economy are necessary to ensure financial sector soundness in the future. At the same time, banks should use opportunities available to bolster their capital buffers, including the transitional period to the Basel III rules, to further improve their resiliency towards possible shocks in the period ahead.

In an environment of divergent financial market developments across the euro area, the timing and phasing of exit from remaining public sector support measures pose particular challenges. Swift and decisive steps must be taken to address imbalances in those parts of the euro area financial system where they have been accumulating. In particular, the continuing dependence of a limited number of financial institutions on public support in some countries means that action is needed by the responsible authorities in the form of restructuring, de-risking and, where necessary, downsizing of the balance sheets of such firms. At the same time, in those parts of the euro area where long-term interest rates have declined to very low levels, partly reflecting safe-haven capital inflows, risks associated with a renewed search for yield could be developing. The relevant authorities need to remain particularly vigilant to prevent new imbalances from developing and further complicating the delicate balance that is facing policy-makers in the period ahead. The importance of getting the timing of exit from public support measures to the financial sector right should not be underestimated. Withdrawal of public support must proceed with caution and care, so as not to spark a setback to financial stability which would ultimately threaten the economic recovery.

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