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PRESS RELEASE

FINANCIAL STABILITY REVIEW DECEMBER 2012

The ECB's Financial Stability Review, published today, highlights a **tangible easing of euro area financial stability strains since the summer** that has been evident across various market indicators. The ECB's announcement of its Outright Monetary Transactions (OMTs) programme and the decisions taken by the European Council in June are fundamentally responsible for the improvement felt in the financial markets that has reduced the dispersion of yields and spreads of sovereign debt instruments. The agreement reached by the ECOFIN (and the European Council) on the establishment of a Single Supervisory Mechanism, centered in the ECB, is another important indication of the Monetary Union framework continuous improvement with positive consequences for future financial stability.

Nevertheless, key financial stability risks remain and there is no room for complacency. These potential risks stem from imbalances and vulnerabilities in the fiscal, macroeconomic and financial sector domains and they can be grouped into three categories:

- a. ***Possible aggravation of the euro area sovereign debt crisis, partly because of implementation risk for agreed policy measures at the national and EU level:*** a steady commitment to necessary adjustment by member countries, along with a determined implementation of European-level decisions to complete the strengthening of the institutional framework for Economic and Monetary Union (EMU), is necessary to avoid the materialisation of this risk.
- b. ***A further deterioration in bank profitability and credit quality owing to a weak macro-financial environment:*** fostering market confidence in the solidity of banks' balance sheets is paramount – and efforts at the national level to enhance the transparency of balance sheets, notably through strengthened asset quality reviews coordinated by supervisory authorities, are a key step towards easing existing banking vulnerabilities in the euro area.
- c. ***Fragmented financial markets amplifying funding strains for banks in countries under stress:*** the functioning of money and debt markets has remained impaired, notwithstanding ECB action, as the diffusion of aggregate liquidity has

been hindered by intertwined sovereign and counterparty credit risk concerns. Strides towards improving fundamentals at the national level, whilst simultaneously working to sever sovereign-bank feedback loops, are critical to resolving the pernicious fragmentation of funding and capital markets.

The systemic dimension of these possible risks originates not only from each of them individually, but also from potential amplification as a result of the interplay among them.

Timely ECB action to address risks to euro area price stability has been critical not only in ensuring the ECB's primary objective of keeping prices stable, but also in easing financial stress that had, at times, reached extreme levels. Most recently, the announcement of the Outright Monetary Transactions (OMTs) programme was crucial in underpinning a widespread narrowing of euro area sovereign spreads, accompanied by a more generalised calming of financial markets. ECB policy action cannot address the root causes of financial market fragmentation, but it has attenuated the symptoms – creating breathing space for governments and financial institutions to tackle the fundamental causes of the crisis.

Some progress has been made to date in addressing these root causes of stress – including the strengthening of the European fiscal governance framework, the improved adjustment efforts made by the different Member States, the reduction of the competitiveness and productivity gaps within EMU and the introduction of a sweeping and exhaustive global regulatory agenda. Notwithstanding the progress made to date, continued momentum is needed to improve the robustness of the financial system, while completing the foundations of EMU, in order to durably strengthen euro area financial stability.

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