EUROPEAN CENTRAL BANK

EUROSYSTEM

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The overall outlook for financial stability has remained very challenging in the euro area. Significant financial market turmoil experienced late last year gave way to some respite in the early months of 2012 following resolute Eurosystem measures, against the background of cumulative political action geared towards a comprehensive strategy to address the causes of the euro area crisis. This relative calm, however, has proven to be fragile and renewed pressures have again emerged since April. Remaining vulnerabilities in the financial stability outlook demonstrate that there is no room for complacency in implementing needed adjustment, either on the part of governments or on that of banks. In particular, Member States should step up their initiatives to strengthen the fiscal and banking components of a robust monetary union.

The Financial Stability Review (FSR) June 2012 identifies three key risks to euro area financial stability:

1. A potential aggravation of the debt crisis for euro area sovereigns
2. Bank profitability risk stemming from weaker economic growth and associated higher credit and asset valuation losses
3. Excessive pace of deleveraging of the banking sector due to frontloaded changes to banks' business models

There remains a clear need for a continued focus on tackling the root causes of the crisis, and a comprehensive response remains key to decisively ending a spiral of systemic risk augmentation. Concretely, a proactive rigorous policy implementation is needed in five areas:

First, continued action is needed at the national level to *both* ensure fiscal discipline *and* accelerate structural reforms for growth and employment.

Second, an effective use of the financial backstops is needed to halt the downward spiral of self-fulfilling dynamics in the pernicious interplay between sovereign, banking and macroeconomic forces.

Third, durable changes to banking models must complement temporary Eurosystem support and provide lasting funding certainty, to accompany the strengthening of the capital base of European banks in the first half of 2012.

Fourth, continued progress is needed to eliminate political and economic uncertainty, not only to stem the forces of contagion but also to provide a more solid basis for markets to manage risk.

Fifth, measures to strengthen economic and fiscal surveillance, and to enhance governance, must be taken and not remain contingent on market-driven pressure – thereby providing credible reassurance that the crisis that has engulfed the euro area over the last few years will never be permitted to recur.

While these five areas provide the necessary critical foundations upon which a sustainable monetary union must be based, there is now a need to go beyond these areas and conceive a *banking union* as an integral counterpart of *Monetary Union*. Such an endeavour would clearly take time to implement and could require legal changes. But once in place, three critical objectives could be achieved:

First, strengthening the euro area-wide supervision of the banking sector in order to reinforce financial integration, mitigate macroeconomic imbalances and, therefore, improve the smooth conduct of the single monetary policy.

Second, breaking the link between banks and sovereigns – which significantly exacerbates the impact of any financial disturbance – also by establishing a European deposit guarantee scheme and resolution arrangements.

Third, minimising the risks for taxpayers through adequate contributions by the financial industry.

All in all, developments in the last few weeks have continued to illustrate the persistent negative interplay of key risks, and underscore the need for concerted and comprehensive decisions of Member States to put an end to the turbulence that has been affecting the euro area for over two years.

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