



EUROPEAN CENTRAL BANK

*The outlook for financial stability
in the euro area*

*Presentation by
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Outline

I Financial stability and the ECB

II Areas of vulnerability

- *Global macro-financial environment*
- *Financial markets*
- *Exposures to euro area non-financial sectors*
- *Financial institutions*

III Overall assessment

The concept of financial stability

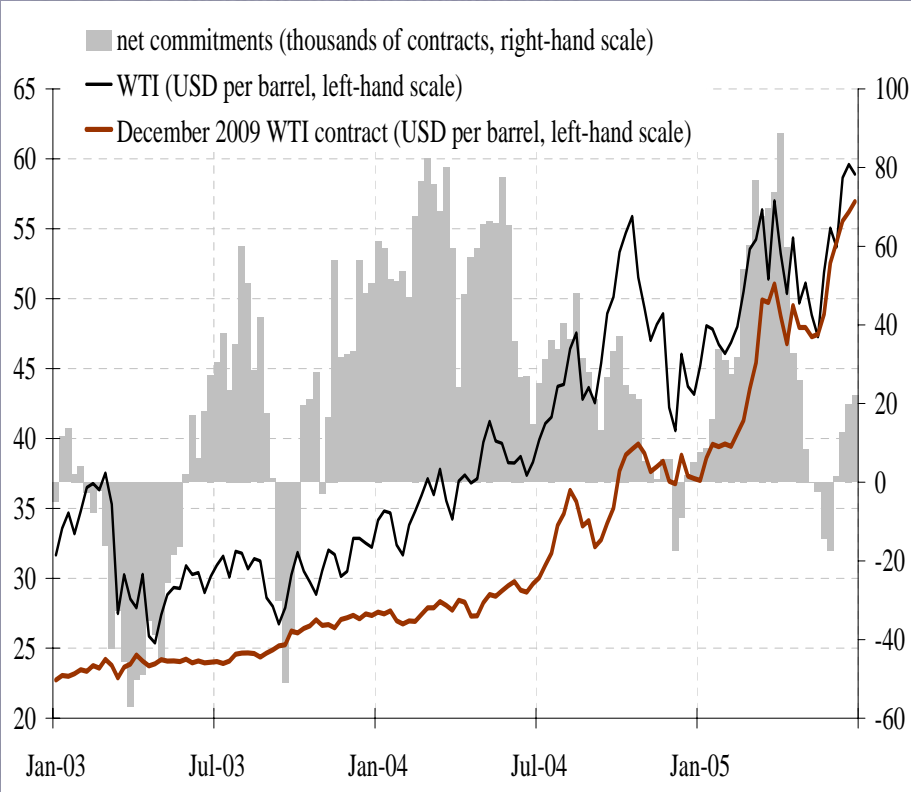
- The basic components of financial system should be jointly capable of absorbing adverse disturbances
- Financial system is assisting economy with a smooth and efficient allocation of financial resources from savers to investors
- Financial risk is being
 - assessed,
 - accurately priced, and
 - efficiently managed

Financial stability mandate

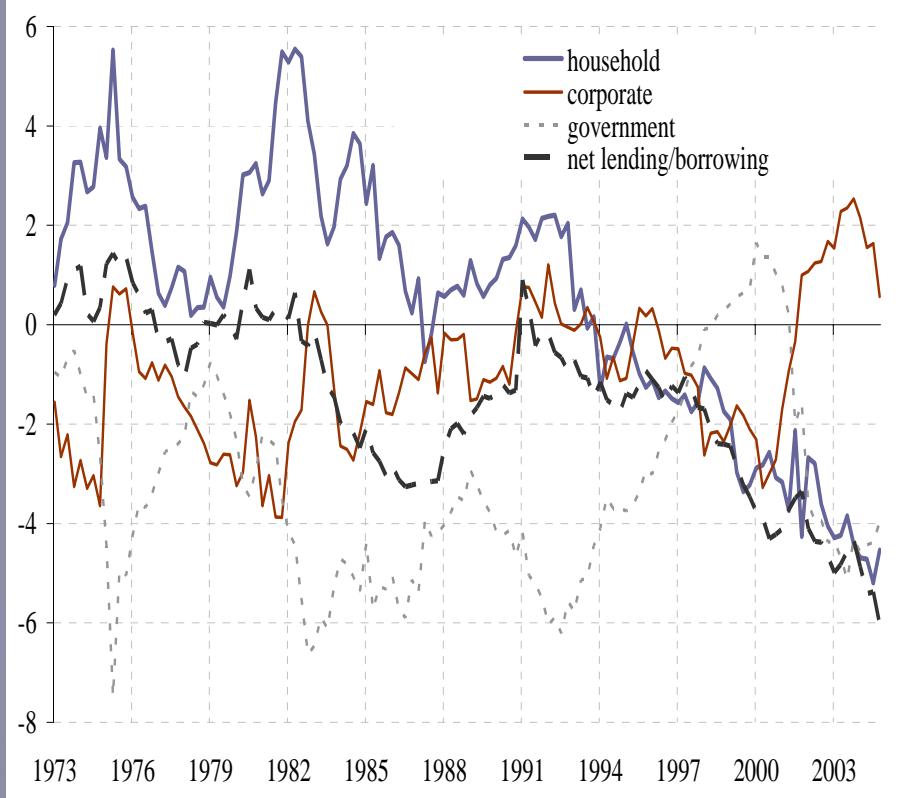
- Treaty base - Article 105(5)
- December 2004: First ECB Financial Stability Review published
- Governing Council has regular semi-annual discussions of financial stability issues on the basis of a Financial Stability Review
- ECB Financial Stability Review published twice a year in June and December

Global macro-finance – Oil prices and US imbalances

Net Evolution of Chinese crude oil imports and oil prices

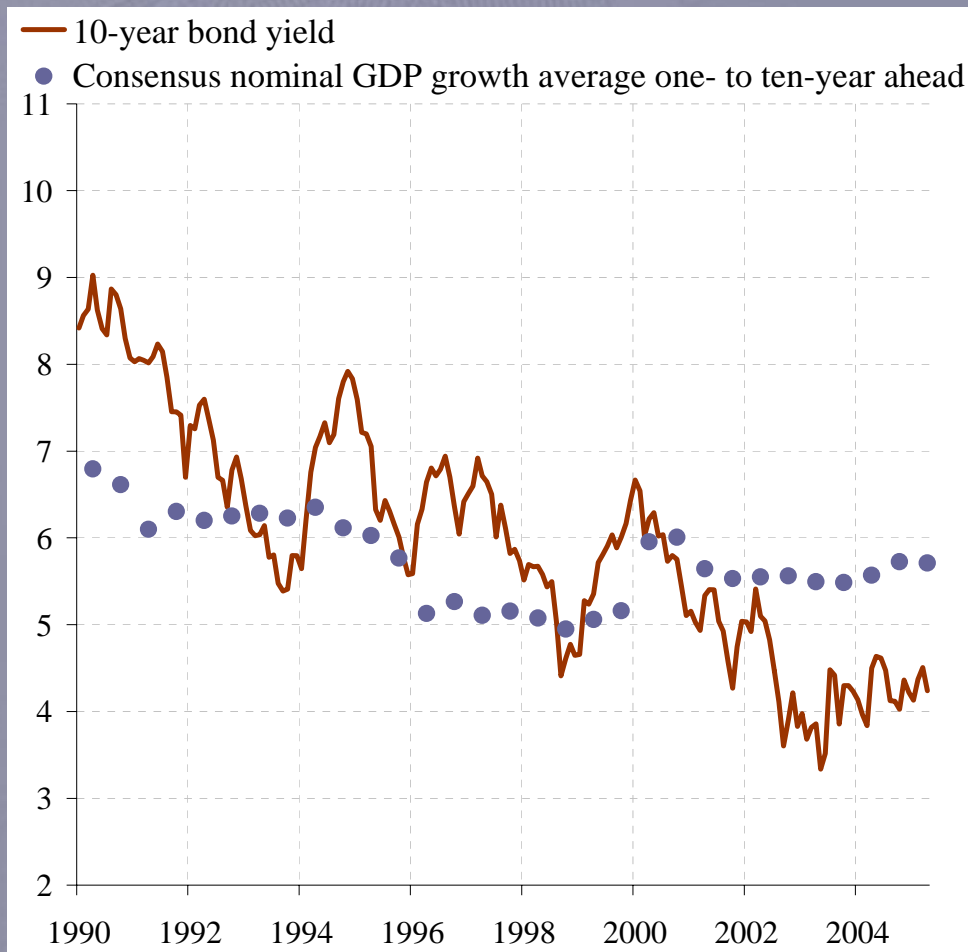


Net lending/borrowing of the US economy (% of GDP)

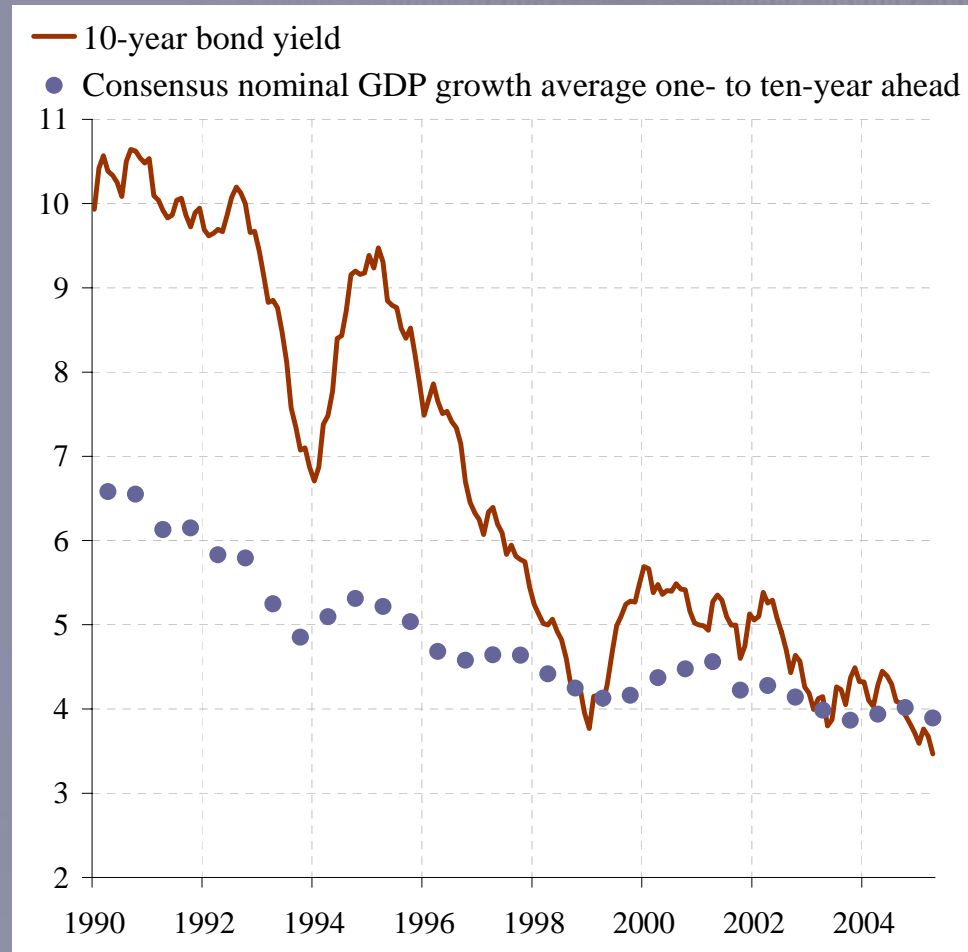


Financial markets – *low long-term bond yields*

US ten-year bond yield and consensus ten-year nominal GDP growth expectations (%)



Euro area ten-year bond yield and consensus ten-year nominal GDP growth expectations (%)

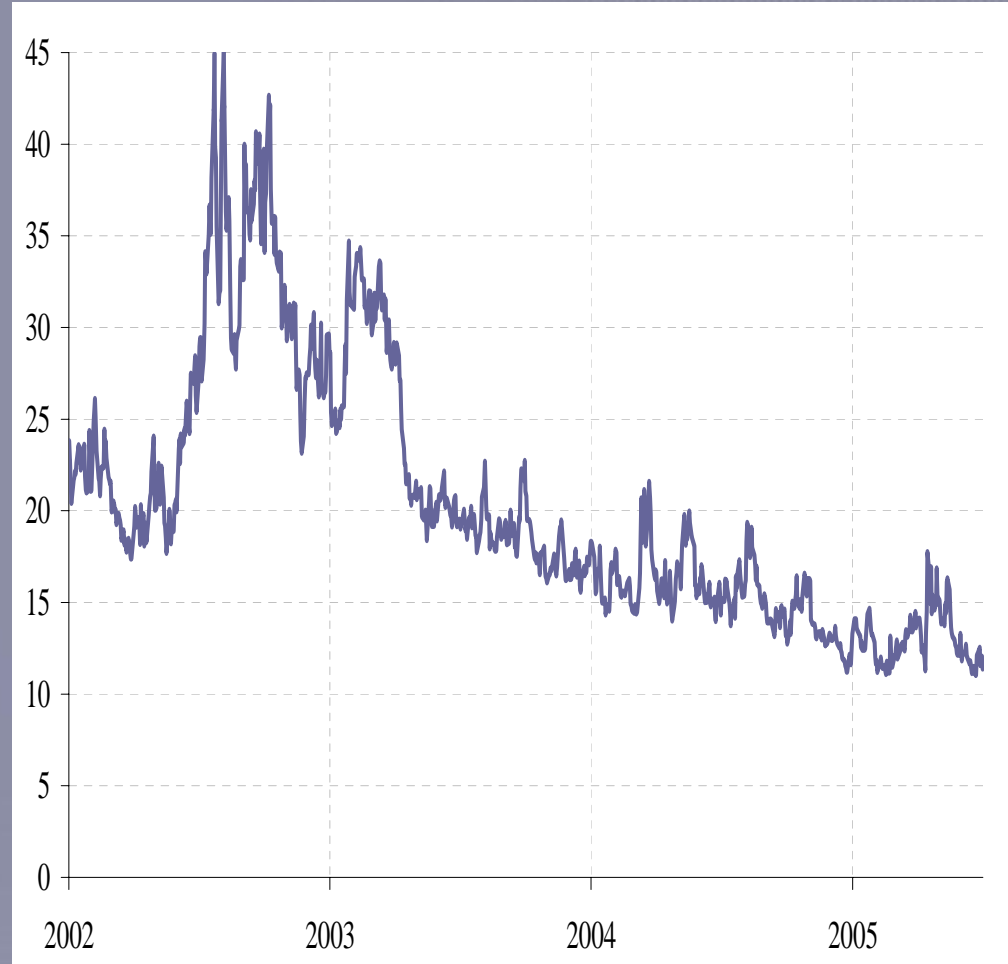


Financial markets – *Risks in corporate bond equity markets*

Spread of corporate bonds issued by US industrial companies

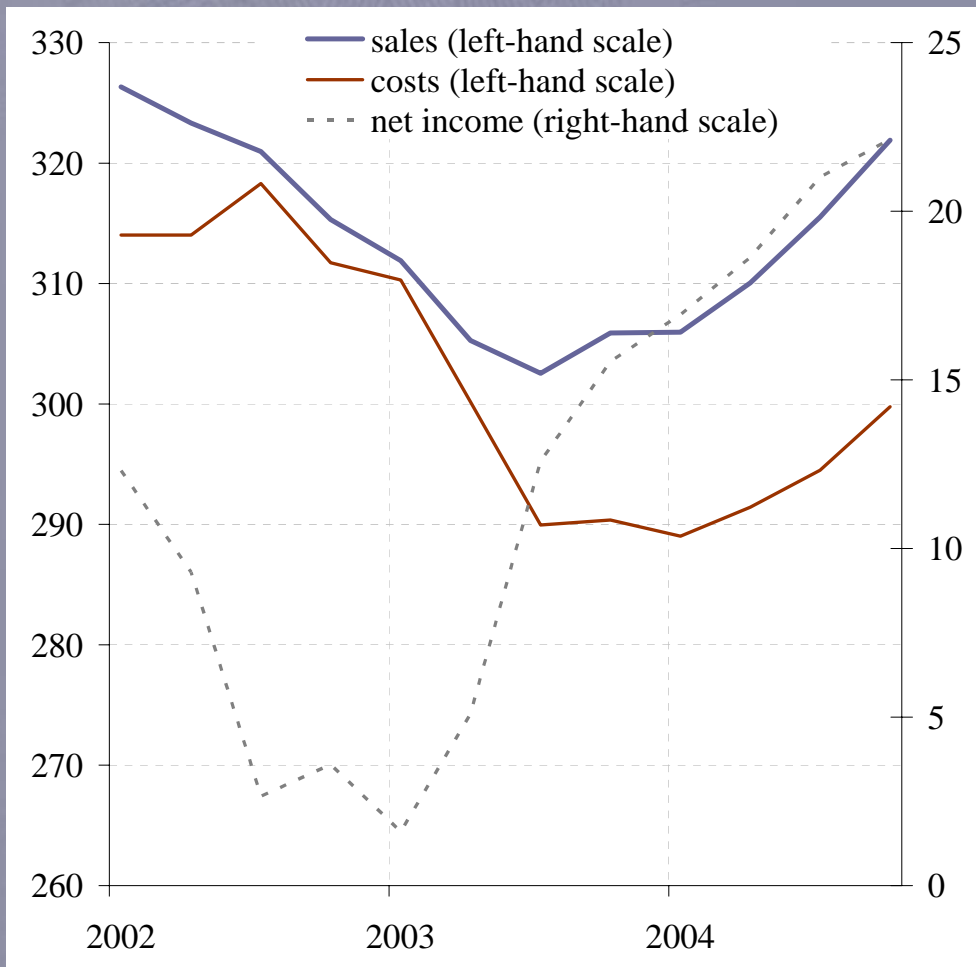


VIX implied volatility in the US stock market

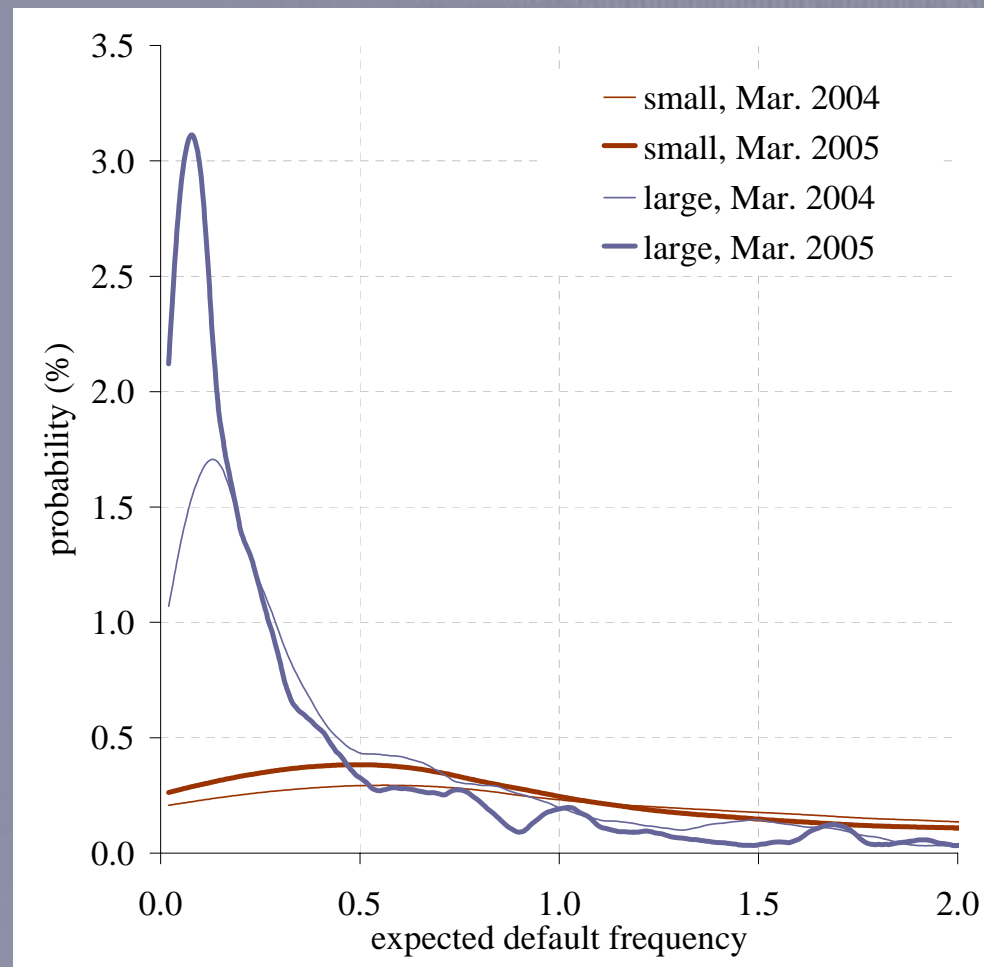


Euro area sectoral balances: *corporate sector*

Costs, sales and profits of Dow Jones EURO STOXX 50 companies (EUR billions)



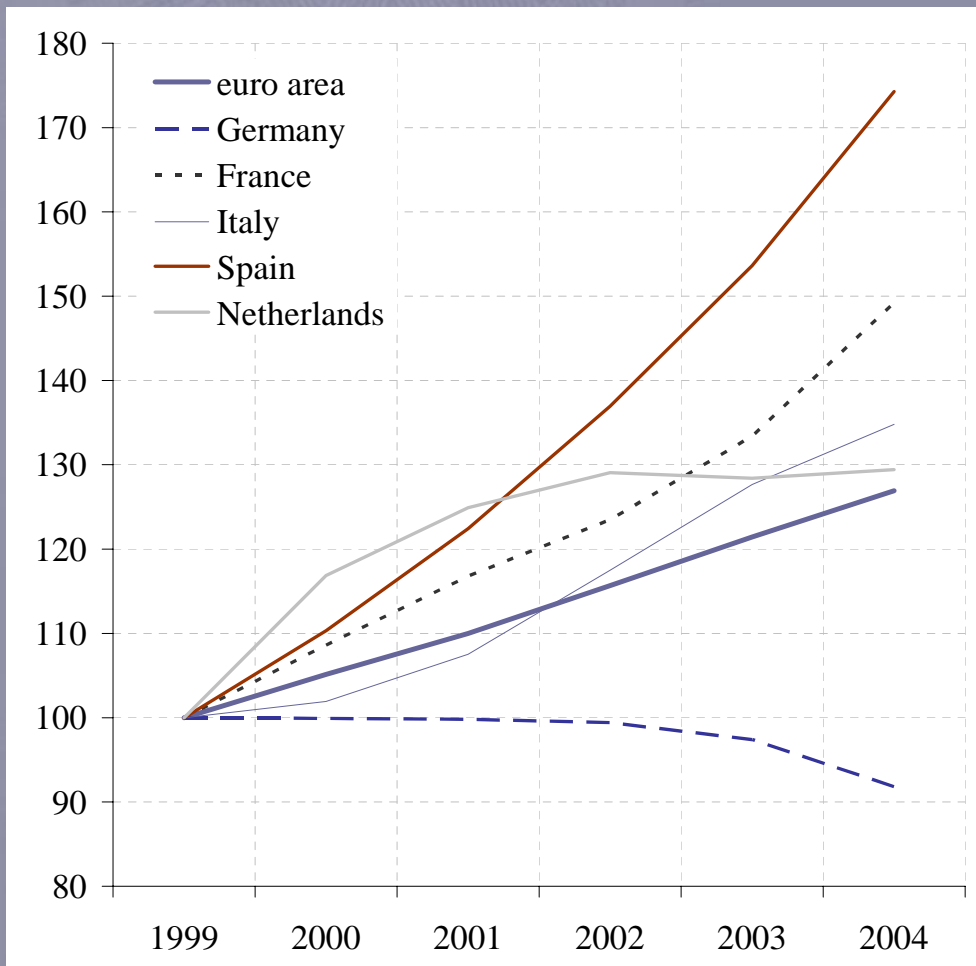
Expected default frequency distributions for large and small euro area firms



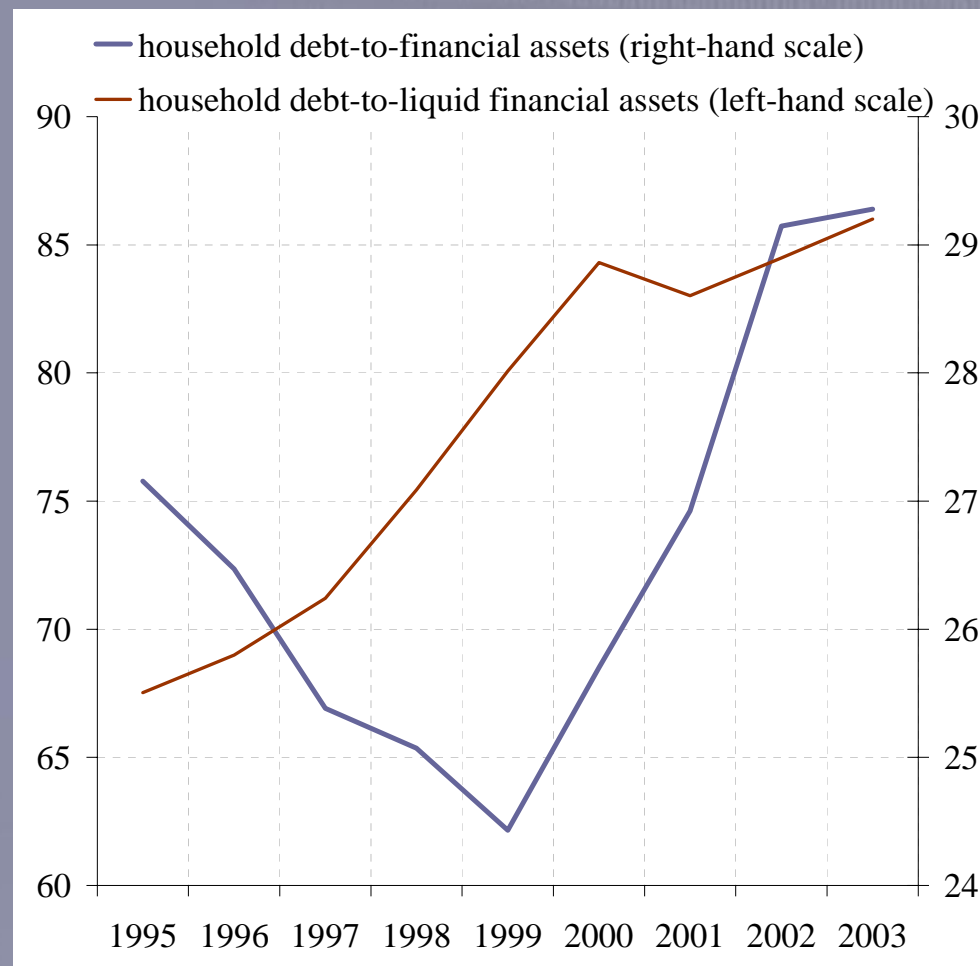
Euro area sectoral balances: *households*

Balance sheets and risks expand further

House price-to-rent ratios in the euro area
(index: 1999 = 100)



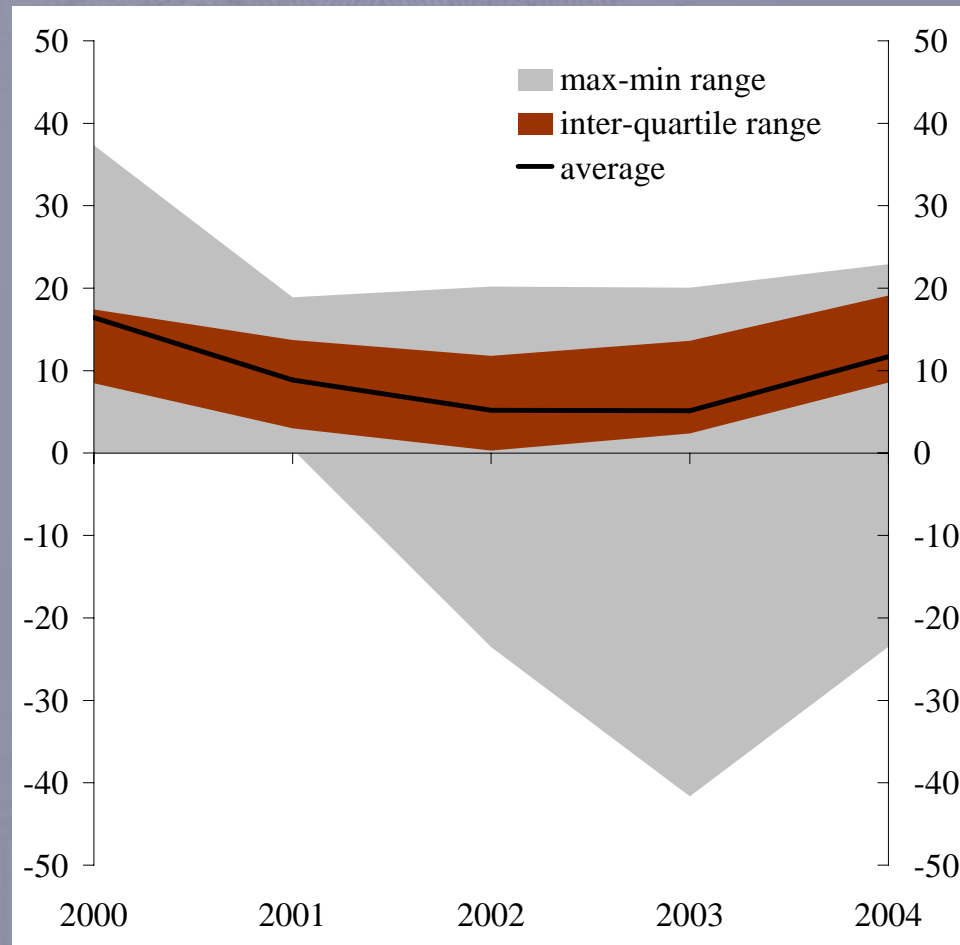
Household debt-to-financial and liquid
financial assets (%)



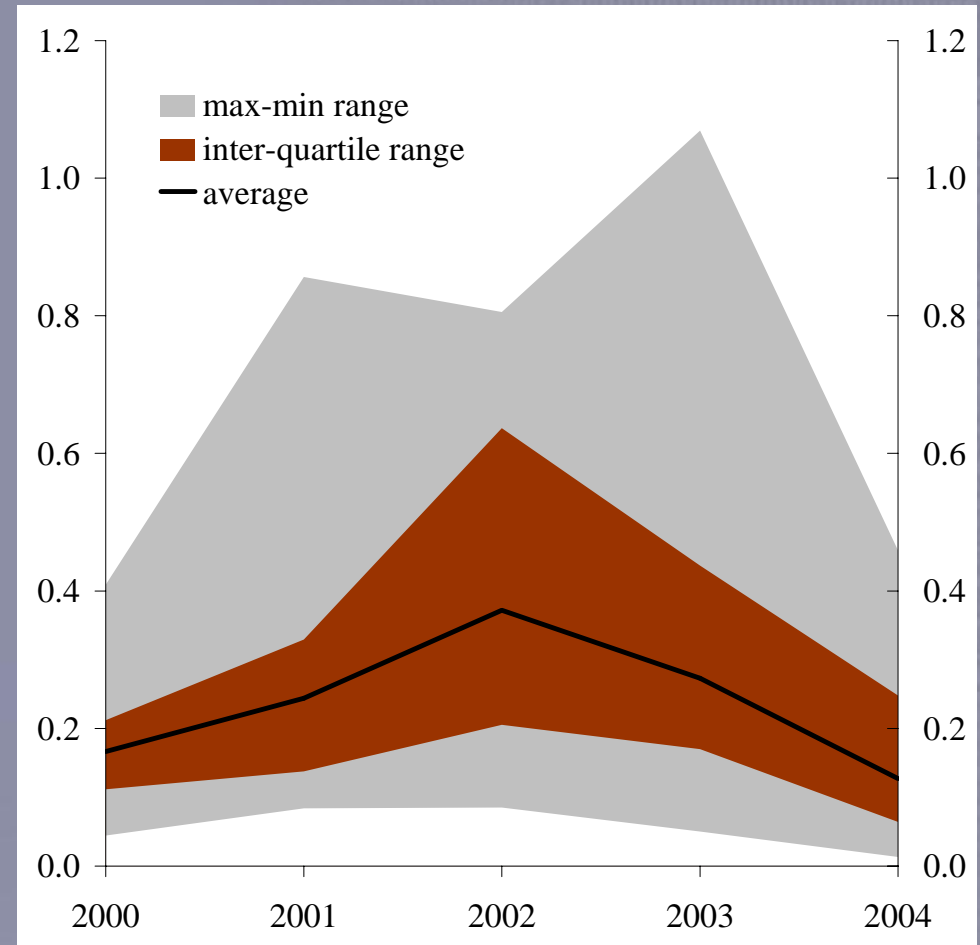
Financial institutions – banks

Broad recovery of profitability and lower provisioning

Return on equity (ROE) of large euro area Institutions (%)



Loan loss provisions of large euro area institutions (% of total assets)



Outlook for risks: *main sources of uncertainty*

Financial fragility may increase if:

- Markets abruptly reassess risks, especially credit risks
- Global rebalancing becomes disorderly
- Oil prices remain persistently high
- Further gains in house prices increase the risk of correction
- Low levels of provisioning prove to be inadequate

Positive developments and overall assessment

Capacity to absorb shocks is larger than in the past:

- Wider international risk sharing
- Low interest rates have strengthened household and corporate balance sheets
- Efficient risk transfer
- The robustness of financial institutions have improved

Overall assessment:

- Although the likely outcomes are bi-modal, it seems that risks to financial stability in the euro area are finely balanced at present