EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review
May 2025

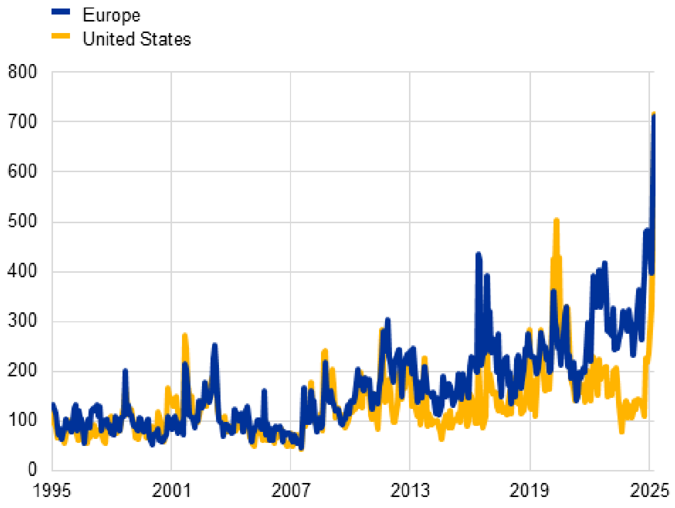
Press briefing

21 May 2025

What's new since November 2024?

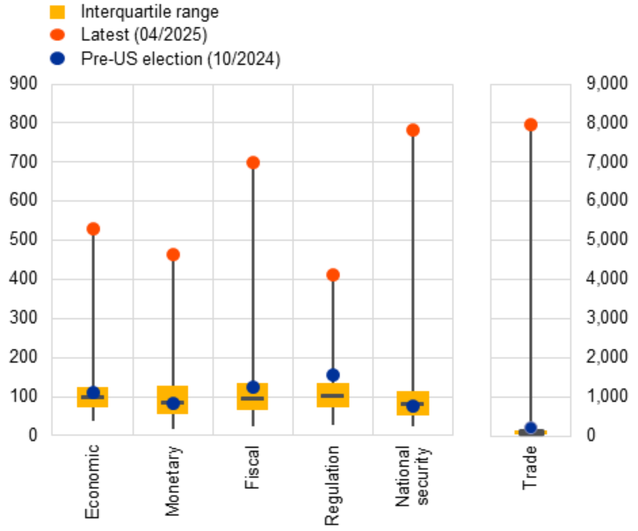
- Economic policy uncertainty on the rise
- Broad rethink of trade, defence, international cooperation and regulation
- Global imbalances a long-standing issue, but not clear that tariffs are best way to address them

Economic policy uncertainty
Jan. 1990-Apr. 2025, indices



Source: policyuncertainty.com.

Breakdown of US economic policy uncertainty
Jan. 1985-Apr. 2025, indices



Source: Baker, Bloom and Davis (2016).

A rapidly shifting geopolitical environment could test euro area financial stability

1 | Sharp adjustments in financial markets risk becoming disorderly, particularly if the declining liquidity of non-banks amplifies price swings

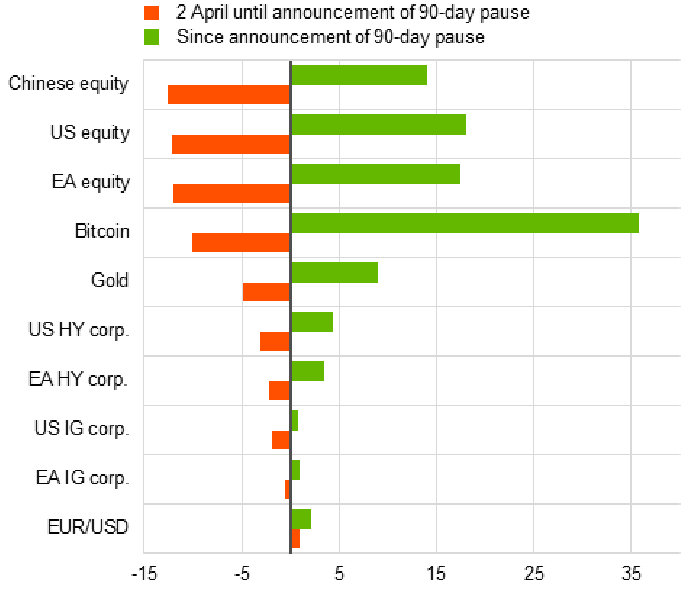
2 | Escalating trade tensions could challenge euro area firms and households, translating into credit risks for banks and non-banks

3 | A combination of weaker growth, defence spending needs and other structural challenges could compound prevailing pressures on sovereign finances

1. Sharp adjustments in financial markets risk becoming disorderly

- Escalating trade tensions triggered a sell-off of risky assets and higher financial market volatility
- Global portfolio rebalancing compressed euro area equity risk premia, but credit spreads widened

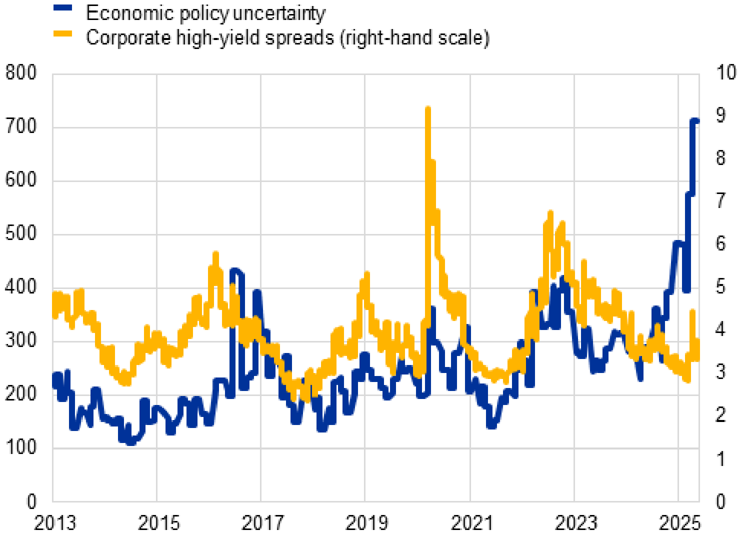
Returns across major asset classes
2 Apr.-13 May 2025, percentages



Sources: Bloomberg Finance L.P. and ECB calculations.

Note: Calculation periods differ as a 90-day pause on “reciprocal” tariffs was announced at midnight CET on 9 April, when markets for some of the asset classes depicted were closed.

Euro area corporate bond spreads and economic policy uncertainty
1 Feb. 2013-13 May 2025, index, percentage points

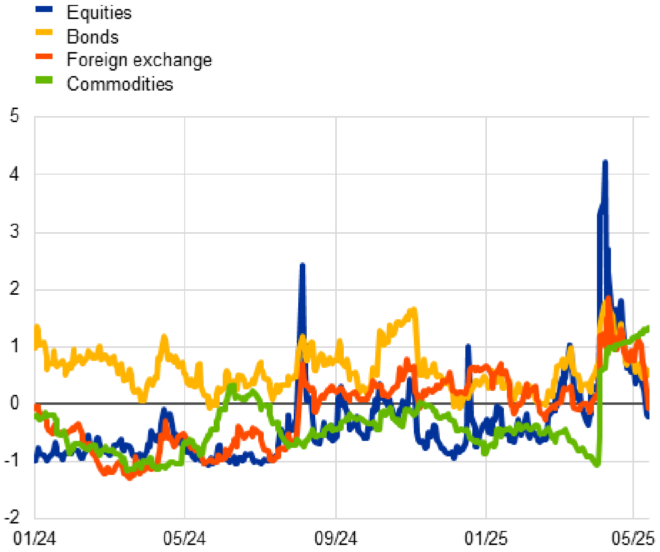


Sources: Bloomberg Finance L.P., Baker, Bloom and Davis, and ECB calculations.

1. Sharp adjustments in financial markets risk becoming disorderly

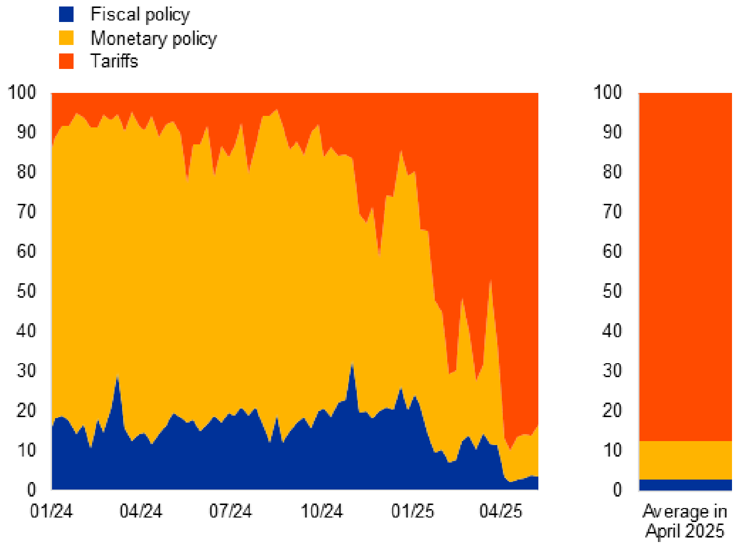
- Market reactions were sharp and broad-based, driving up volatility and tightening financial conditions
- Financial markets continued to function smoothly, but remain very sensitive to trade policy-related news

Market volatility in equity, bond, foreign exchange and commodity markets
1 Jan. 2024-13 May 2025, z-scores



Source: Bloomberg Finance L.P.

Number of Bloomberg news stories
1 Jan. 2024-9 May 2025, percentages

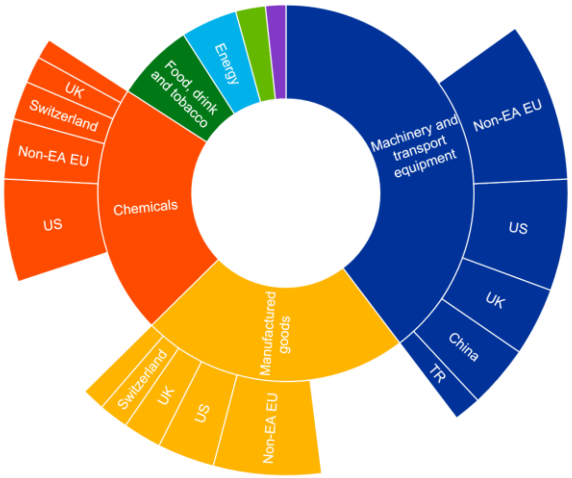


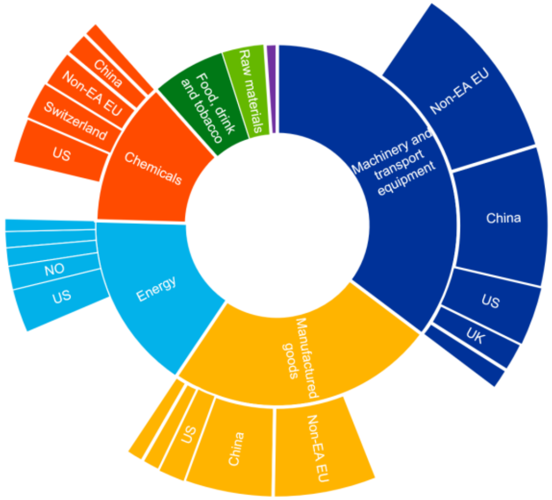
Source: Bloomberg Finance L.P.
Notes: Weekly number of news articles published on Bloomberg tagged with fiscal policy, monetary policy or tariffs. Expressed as a share of total number of articles on the three topics.

2. Escalating trade conflict could challenge euro area firms and households

- Euro area firms in several trade-sensitive sectors vulnerable to US tariffs both directly and indirectly …
- … as trade flows from third countries, initially intended for US markets, could be diverted towards the EU
- Vulnerabilities are large for manufacturing firms with high foreign input and market reliance

Share of exports and imports, by industry and top trading partners of euro area countries
2024, shares



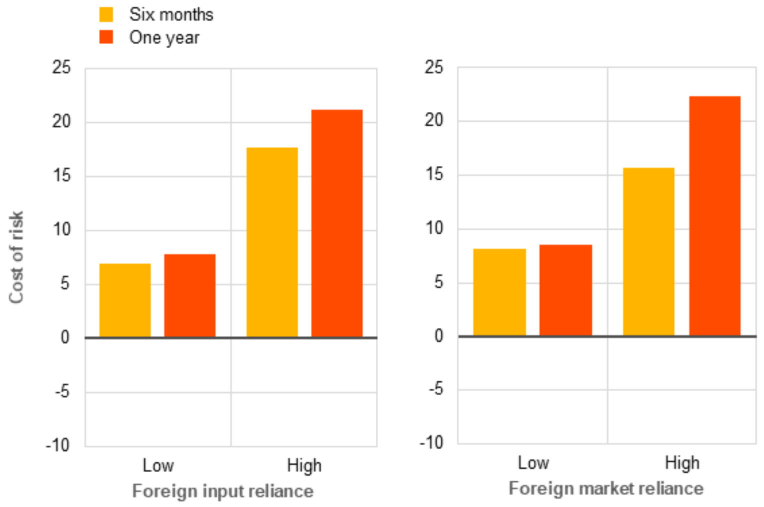


Sources: Eurostat and ECB calculations.

2. Escalating trade conflict could challenge euro area firms and households

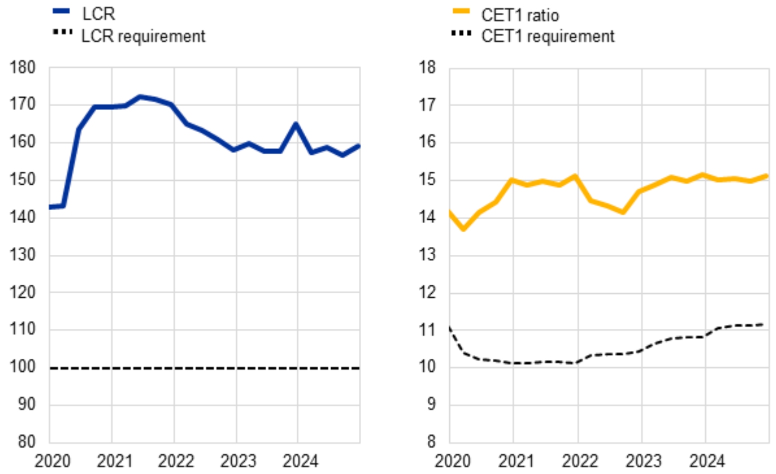
- Asset quality likely to worsen, with stronger impacts on banks exposed to foreign trade-reliant sectors
- Strength of profitability, capital and liquidity buffers supports banks' ability to absorb rising credit risk

Impact of trade policy uncertainty on banks' cost of risk, by exposure to sectors with foreign input and market reliance
Impact of a one standard deviation shock in basis points



Sources: ECB (supervisory data), OECD, Eurostat, Bloomberg Finance L.P., Caldara et al. (2020) and ECB calculations. Notes: Impulse responses across different time horizons to a 1 standard deviation trade policy uncertainty shock, based on panel local projections exploiting quarterly data from Q1 2015 to Q3 2024. A bank is classified as highly exposed in foreign input (FIR) or market reliance (FMR) if it falls within the top quartile.

LCR and CET1
Q1 2020-Q4 2024, percentages



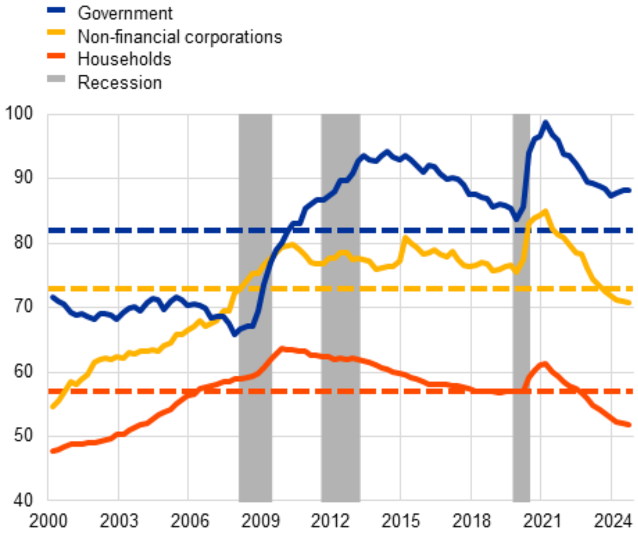
Sources: ECB (supervisory data, SHS).

3. Weak growth and defence spending needs put pressure on sovereign finances

- Fiscal capacity to address economic growth risks stemming from trade frictions is limited in some countries
- If well-targeted, defence spending might unlock positive growth effects, but it could also pose challenges for highly-indebted sovereigns

Indebtedness of sovereigns, firms and households

Q1 2000-Q4 2024, percentages of GDP

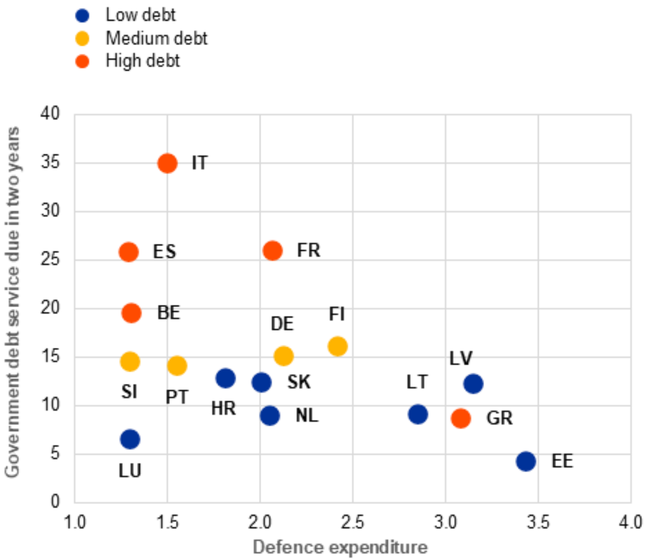


Sources: Eurostat and ECB (QSA, MNA, GFS).

Note: The horizontal lines represent the long-term average of the period.

Defence expenditure and debt service across the euro area

2024, Mar. 2025, percentages of GDP



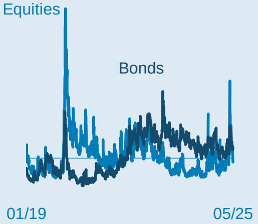
Sources: NATO and ECB (GFS).

Note: “Defence expenditure” refers to 2024 defence expenditure estimates.

A rapidly shifting geopolitical environment could test euro area financial stability

1 Sharp adjustments in financial markets risk becoming disorderly, particularly if the declining liquidity of non-banks amplifies price swings

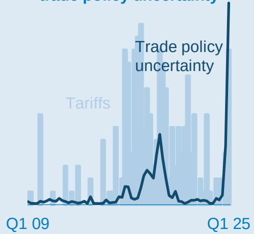
Volatility per market segment



- In a highly volatile environment, financial markets saw significant abrupt adjustments following the announcement of US tariffs.
- Financial markets remain highly sensitive to news related to tariffs and other policies, with further volatility likely going forward.
- So far market functioning has held up well, but adjustments could become disorderly.
- Vulnerabilities related to liquidity mismatch and leverage in parts of the NBFI sector could amplify market-wide shocks due to forced asset sales.
- Real estate markets show signs of recovery but face headwinds from elevated uncertainty.

2 Escalating trade tensions could challenge euro area firms and households, translating into credit risks for banks and non-banks

Tariffs implemented and trade policy uncertainty



- Escalating trade tensions coupled with weak cyclical conditions may translate into higher corporate insolvencies, especially in tariff-sensitive industries.
- Weaker than expected growth outturns and deteriorating labour market conditions could erode some households' debt servicing capacity.
- Banks with high exposures to trade-sensitive industries could face worsening asset quality in the event of deteriorating corporate fundamentals.
- Banks may face higher provisioning costs, but solid profits and robust solvency and liquidity positions support their ability to absorb higher NPLs.
- Weak economic growth coupled with rising trade frictions have led to a worsening credit risk outlook, exposing the NBFI sector to revaluation losses.

3 A combination of weaker growth, defence spending needs and other structural challenges could compound prevailing pressures on sovereign finances

10-year government bond yields

- A shifting geopolitical paradigm entails higher defence spending needs for euro area sovereigns.
- Greater defence spending could unlock positive growth effects if well targeted but could pose risks from higher issuance needs and rising funding costs.
- Fiscal capacity to address any risks to economic growth might be limited by high public debt levels in some countries.
- Cyclical headwinds, together with structural challenges such as ageing, may complicate the path towards fiscal consolidation.
- Any repricing of sovereign risk could spill over to the corporate and financial sectors via rating downgrades and higher funding costs.