



EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review

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SUERF

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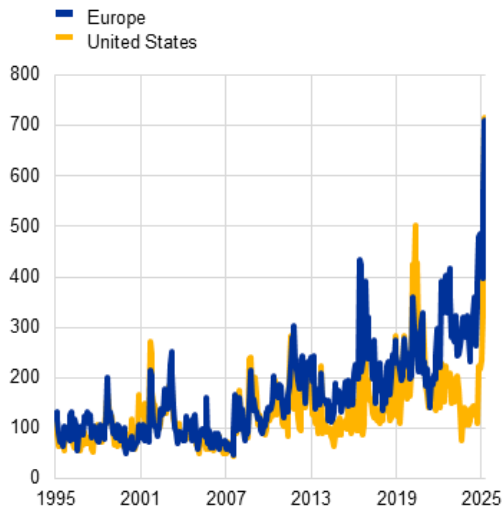


What's new since November 2024?

- Economic policy uncertainty reaches even higher levels, with Europe now surpassing the US
- Rethinking on matters of trade, defence, international cooperation and regulation
- Global imbalances at the forefront, with tariffs aimed at addressing them risking disorderly adjustment

Economic policy uncertainty

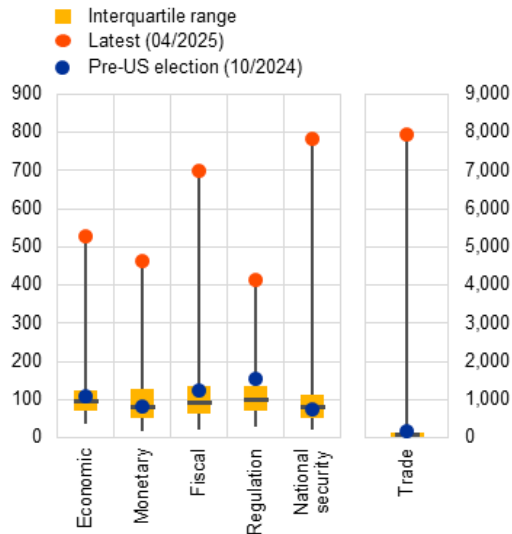
Jan. 1990-Apr. 2025, indices



Source: policyuncertainty.com.

Breakdown of economic policy uncertainty for the United States

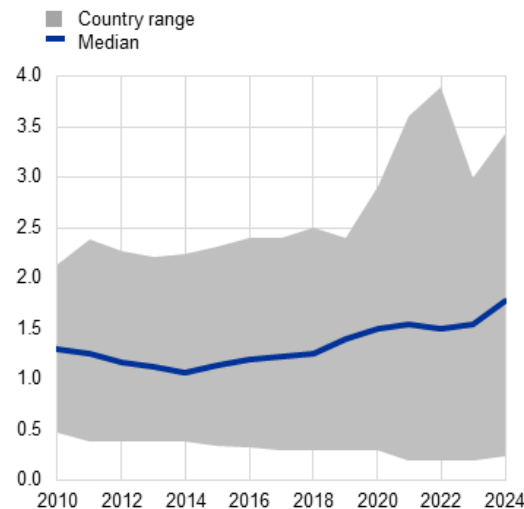
Jan. 1985-Apr. 2025, indices



Source: Baker, Bloom and Davis (2016).

Defence expenditure

2010-2024, percentages of GDP



Source: NATO.

A rapidly shifting geopolitical environment could test euro area financial stability

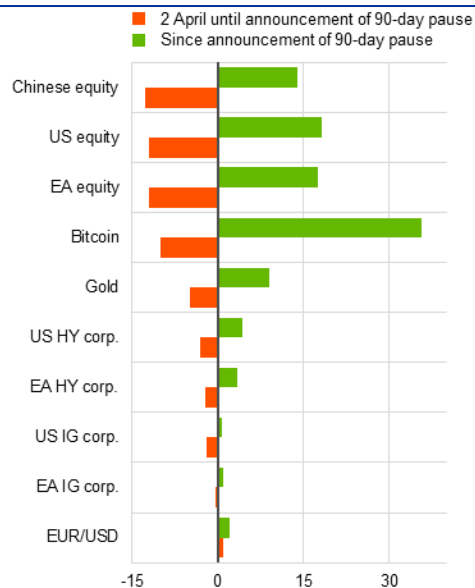
- 1 Sharp adjustments in financial markets risk becoming disorderly, particularly if the declining liquidity of non-banks amplifies price swings
- 2 Escalating trade tensions could challenge euro area firms and households, translating into credit risks for banks and non-banks
- 3 A combination of weaker 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

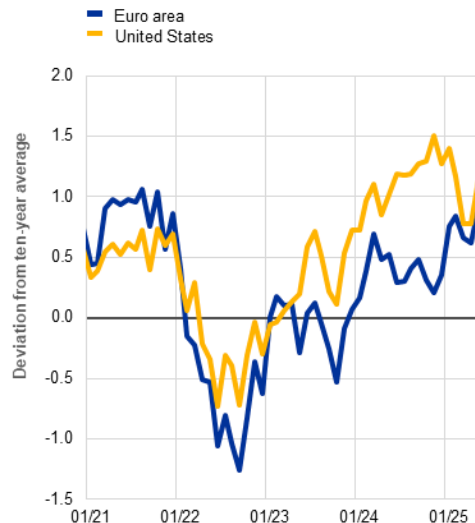


Sources: Bloomberg Finance L.P. and ECB calculations.

Notes: 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.

Equity valuations

Jan. 2021-May 2025, z-scores

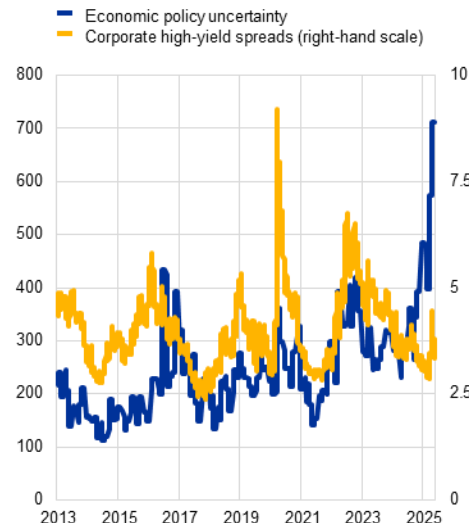


Sources: Bloomberg Finance L.P. and ECB calculations.

Note: z-scores calculated on data since January 2015. Lines show the average of z-scores of five valuation indicators for the S&P 500 and the Euro Stoxx index: P/B ratio, 12m forward PE ratio, long-term PE ratio, P/E/G-ratio, and 5-year excess CAPE yield.

Euro area corporate bond spreads and economic policy uncertainty

1 Feb. 2013-13 May 2025, index, pp.



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

1. Sharp adjustments in financial markets risk becoming disorderly

- Yet-to-be-concluded trade conflict at risk of escalation, bringing fears of global recession
- Market reactions were sharp and broad-based, triggering higher volatility and tightening financial conditions

EURO STOXX 50 and S&P-500

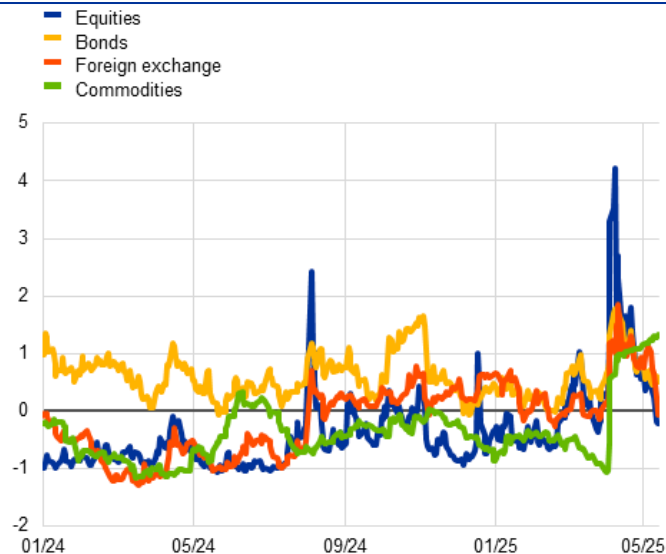
2 Jan. 2024-13 May 2025, indices: 2 Jan. 2024 = 100



Source: Bloomberg Finance L.P.

Market volatility in equity, foreign exchange, commodity and bond markets

1 Jan. 2024-13 May 2025, z-scores



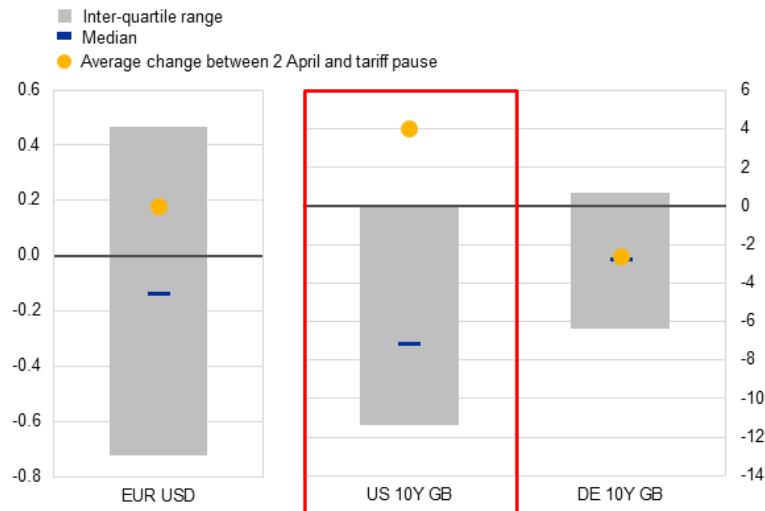
Source: Bloomberg Finance L.P.

1. Sharp adjustments in financial markets risk becoming disorderly

- Financial markets continued functioning smoothly, but they remain extremely sensitive to trade policy-related news

Safe-haven returns during periods of equity market stress

2 Jan. 1990-13 May 2025, left-hand scale: percentages, right-hand scale: basis points

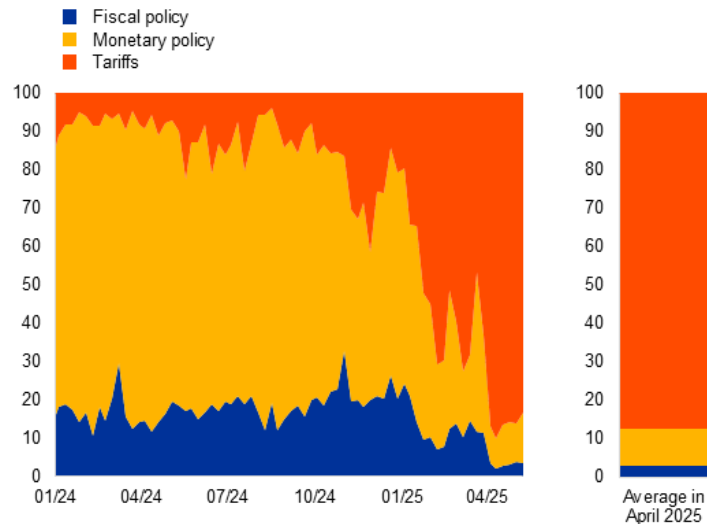


Sources: Bloomberg Finance L.P. and ECB calculations.

Notes: 10-year sovereign bond yields for the US and Germany. Government bond yield and EUR/USD return distributions are contingent on daily returns of the S&P500 being negative and two standard deviations below average.

Number of Bloomberg news stories

1 Jan. 2024-9 May 2025, percentages



Sources: Bloomberg Finance L.P.

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

1. Sharp adjustments in financial markets risk becoming disorderly

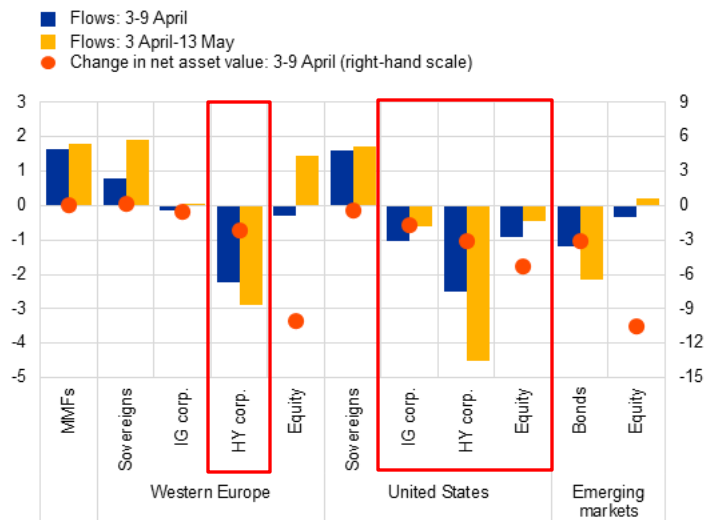
- Pro-cyclical outflows from funds invested in US assets and high yield corporate bonds, with higher volatility triggering margin calls on equity derivatives
- Liquidity vulnerabilities of some investing styles remain a source of concern for fire-selling

Cumulative flows and performance of euro area investment funds, by investment focus

3 Apr.-13 May 2025, percentages of total net assets

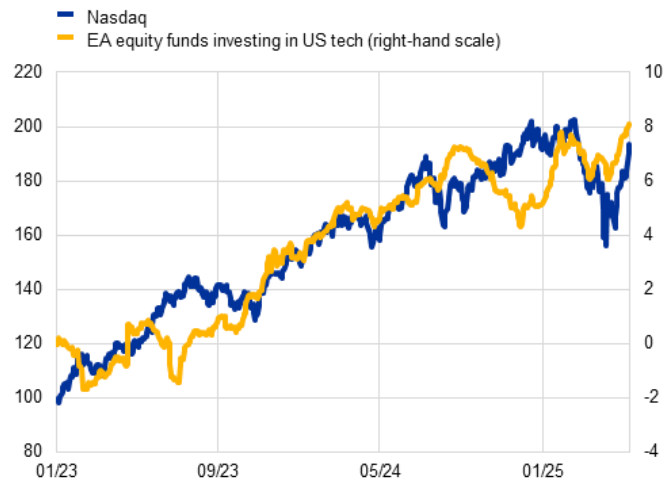
Nasdaq index and cumulative flows into euro area equity funds

2 Jan. 2023-13 May 2025; index: 2 Jan. 2023 = 100, percentages of total net assets



Sources: EPFR Global and ECB calculations.

Notes: IG stands for investment grade and HY stands for high yield.



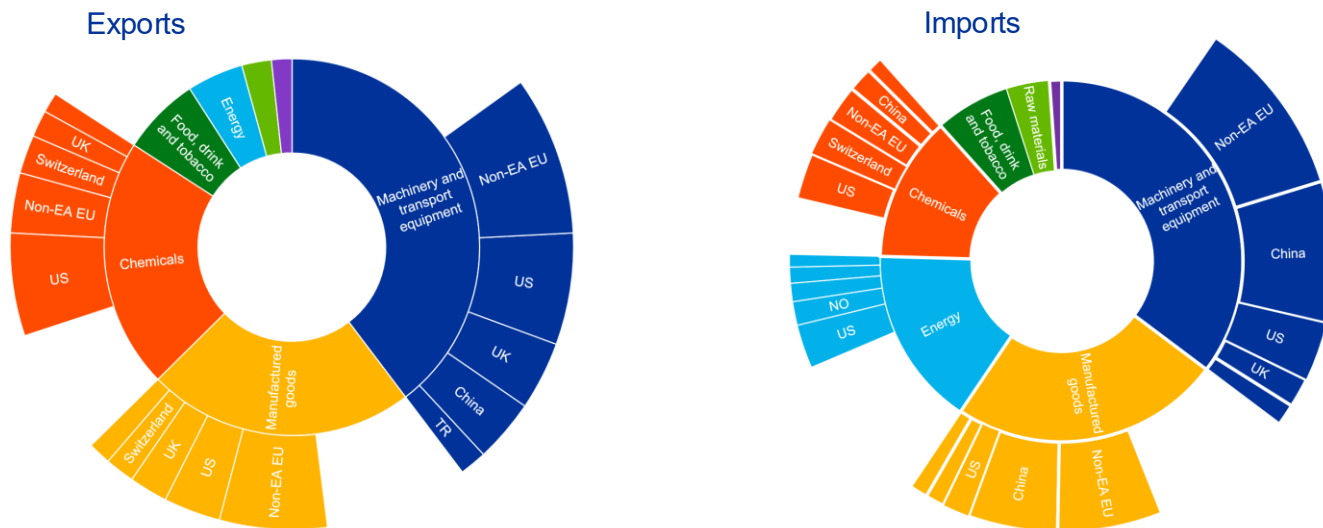
Sources: EPFR Global and Bloomberg L.P.

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

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

2024, shares

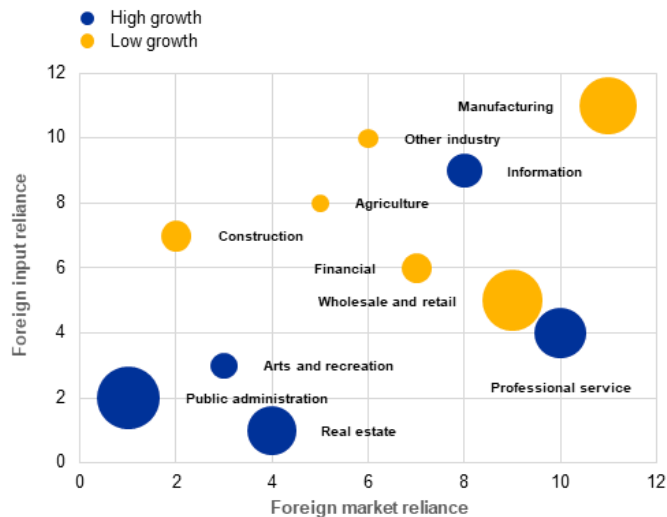


Sources: Eurostat and ECB calculations.

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

- Vulnerabilities are large for manufacturing firms with high foreign input and market reliance, given weak recent growth
- If firm vulnerabilities unravel, a virtuous circle could reverse, with lay-offs rising, challenging households

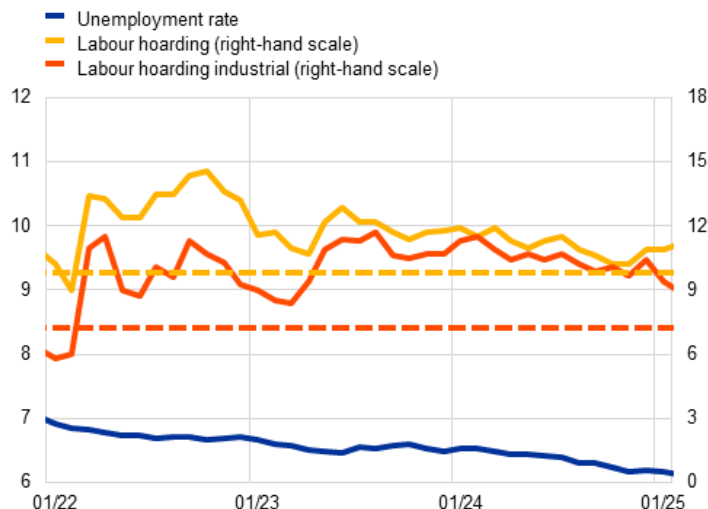
Foreign trade reliance of economic sectors in the euro area Q4 2024, risk score



Sources: Eurostat, OECD and ECB calculations.

Notes: Bubble sizes indicate the share of gross value added in Q4 2024. High- and low-growth sectors are defined as sectors with gross value-added changes above and equal or below to the Q4 2024 median value, respectively. Sectors defined according to NACE codes

Unemployment and labour hoarding Jan. 2022-Mar. 2025, percentages

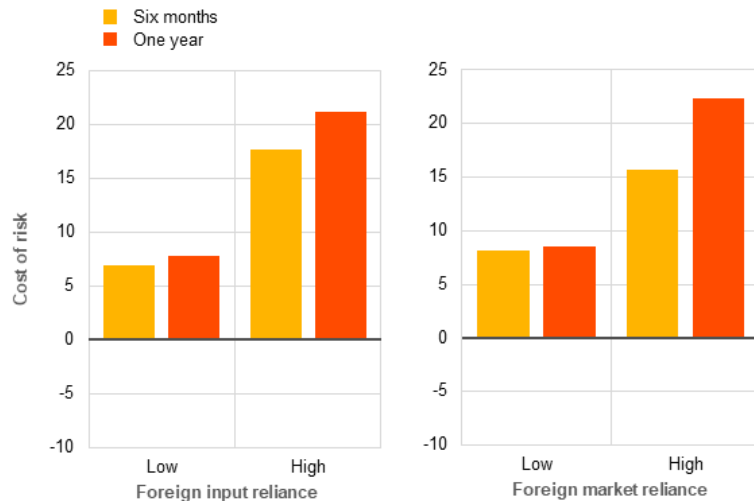


Source: European Commission.

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

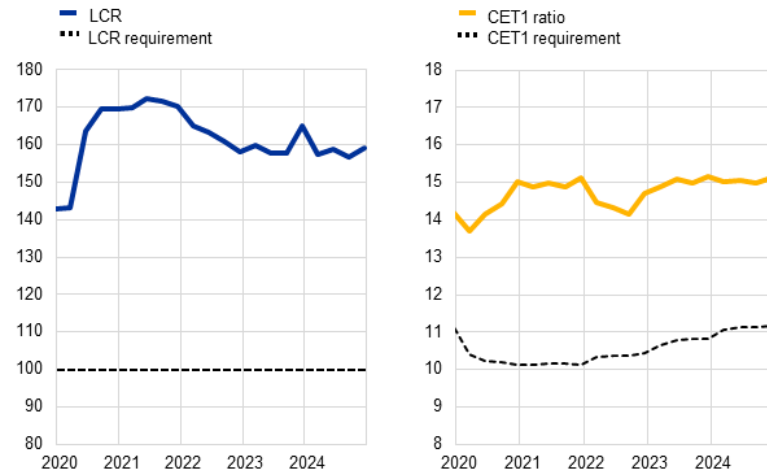
- Asset quality likely to worsen, with stronger impacts on banks exposed to foreign trade-reliant sectors
- Strength of profitability, capital and liquidity buffers supports banks' ability to absorb rising credit risk

Impact of trade policy uncertainty on banks' cost of risk, by exposure to sectors with foreign input and market reliance
basis points, 1 standard deviation shock



LCR and CET1

Q1 2020-Q4 2024, percentages



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.

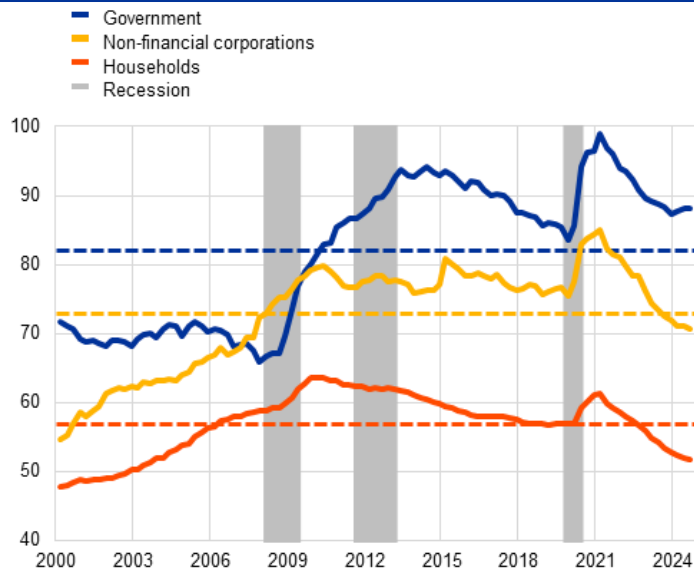
Sources: ECB (supervisory data, SHS).

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

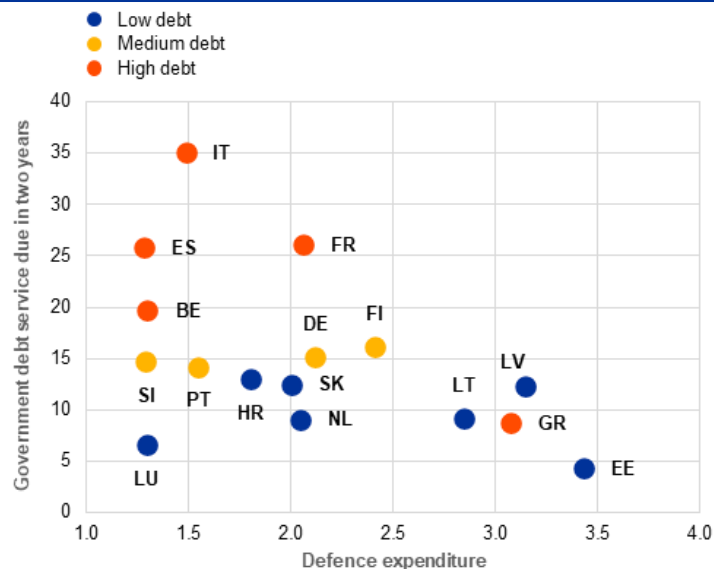


Sources: Eurostat and ECB (QSA, MNA, GFS).

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

Defence expenditure and debt service across euro area countries

2024, Mar. 2025, percentages of GDP



Sources: NATO and ECB (GFS).

Note: "Defence expenditure" refers to 2024 defence expenditure estimates.

Macroprudential policy considerations

Preserving resilience of banks and non-banks while ensuring smooth functioning of financial markets is essential in an uncertain environment

For banks



Maintain macroprudential buffers, ensure releasability and usability

Scope to simplify the supervisory and regulatory framework *without* compromising resilience

Support for the implementation of elements outstanding of Basel III reforms

For non-banks



Strengthen NBFIs policy framework from a macroprudential perspective

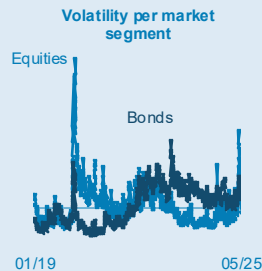
Introduce additional policy tools to address liquidity mismatch in open-ended funds and close regulatory gaps for leveraged funds regulated under the UCITS Directive

Progress with the European Commission's savings and investment union strategy

A rapidly shifting geopolitical environment could test euro area financial stability

1

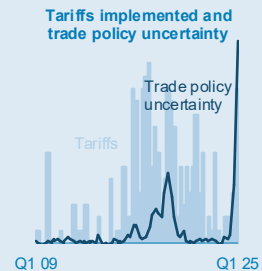
Sharp adjustments in financial markets risk becoming disorderly, particularly if the declining liquidity of non-banks amplifies price swings



- 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



- Escalating trade tensions coupled with weak cyclical conditions may translate into higher corporate insolvencies, especially in tariff-sensitive industries.
- Weaker than expected growth outcomes 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



- 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.

Background slide

Boxes and Special Features

Special Feature A – Just another crypto boom? Mind the blind spots

Special Feature B – Risks to financial stability from trade tensions

Box A – How spillovers from US developments differ across euro area equity sectors

Special Feature C – Navigating financial stability in an ageing world

Chapter 1 – Box 1 – Cyber threats to financial stability in a complex geopolitical landscape

Chapter 2 – Box 2 – What does the record price of gold tell us about risk perceptions in financial markets?

Chapter 3 – Box 3 – The deposit franchise value of euro area banks

Box 4 – Digital banking: how new bank business models are disrupting traditional banks

Chapter 4 – Box 5 – Examining the dynamics of liquid asset holdings in the non-bank financial sector

Box 6 – Private markets: risks and benefits from financial diversification in the euro area