

## Press release

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# Rapidly shifting geopolitical environment could test euro area financial stability

- Shifts in global trade policy lead to sharp increase in uncertainty, causing large spikes in financial market volatility
- Stretched valuations and low non-bank liquidity buffers leave financial markets vulnerable to further shocks
- Escalating trade tensions could adversely affect euro area firms and households, entailing credit risk for banks and non-banks
- Government finances may be negatively impacted by increased defence spending, although boost to growth cannot be excluded

A marked spike in uncertainty across global trade, defence, international cooperation and regulation policies could prove challenging for financial stability, according to the [May 2025 Financial Stability Review](#), published today by the European Central Bank (ECB). Frequent shifts and reversals in tariff policy, alongside significant changes in the geopolitical environment, could have major economic and financial impacts. While global macroeconomic imbalances remain a long-standing issue in the policy debate, it is not clear that tariffs are the best-placed policy instrument to address them.

“Rising trade frictions and related downside risks to economic growth are weighing on the outlook for financial stability”, said ECB Vice-President Luis de Guindos.

The significant increase in trade policy uncertainty and trade frictions triggered large spikes in financial market volatility and raised the risk of an economic slowdown.

Financial markets across the globe sold off at an unsettling speed in early April, and financial conditions tightened notably. While risky assets had fully recovered their initial losses by mid-May, markets are still highly sensitive to tariff-related news. Equity markets in particular remain vulnerable to sudden and sharp adjustments as valuations are still high and concerns over risk concentrations

persist. In an environment of heightened market volatility, euro area non-banks' liquidity and leverage weaknesses could be revealed, amplifying market shocks.

Euro area firms and households have seen their balance sheets improve in recent years, but trade tensions and a weaker growth outlook imply future headwinds. The euro area is a very open economy, and trade frictions will affect those companies that rely on foreign trade, with potential knock-on effects for households if trade-related corporate vulnerabilities are exposed and result in lay-offs. In such an environment, credit risk exposure may rise for euro area banks and non-banks, although banks' ability to absorb further asset quality deterioration should be supported by strong profitability and sizeable capital and liquidity buffers.

While sovereign debt-to-GDP ratios in the euro area have declined considerably after surging during the pandemic, fiscal fundamentals remain fragile in some countries. Plans to increase defence spending have the potential to boost economic growth if focused on productive investment, but could also pose risks given higher issuance needs at a time of rising funding costs. This higher defence spending, together with weaker growth and other structural challenges, such as those posed by climate change, digitalisation and ageing populations, could compound the already strained fiscal positions of some euro area governments.

In the current highly uncertain macro-financial and policy environment, preserving and strengthening the resilience of the financial system is key. In this context, macroprudential authorities should maintain existing capital buffer requirements and borrower-based measures to ensure sound lending standards. In addition, the growing market footprint and interconnectedness of non-banks calls for a comprehensive set of policy measures that will increase the resilience of the non-bank financial intermediation sector. Such resilience across the sector would also help to advance the integration of euro area capital markets.

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