Luis de Guindos: Financial stability in uncertain times

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the International Federation of Accountants' Chief Executives Forum, Amsterdam, 3 April 2025.

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Introduction

It is a pleasure to be taking part in the International Federation of Accountants' Chief Executives Forum today.[1] In line with the topic of the event, I will reflect on the risks and uncertainty that threaten financial stability and their implications for policymakers. I will be brief to allow enough time to take your questions.

Conceptually, risk is associated with situations where the exact outcome is unknown but the possible outcomes can be identified and their probabilities can be estimated reasonably well.[2] For the ECB, financial stability is defined as a condition in which the financial system is capable of withstanding shocks and the unravelling of financial imbalances. So, when assessing financial stability, we evaluate the likelihood of shocks materialising and their potential impact. Uncertainty, by contrast, refers to scenarios where it is impossible to define and measure outcomes and probabilities, often owing to a lack of information. While risk is quantifiable, uncertainty can be proxied at best.

The current environment

Uncertainty in the macro-financial and credit environment is currently exceptionally high, in a world being reshaped by significant shifts in geopolitics, international cooperation, global trade policy, financial regulation and the role of crypto-assets. At the same time, the scale of the defence investment foreseen in the EU is unprecedented and adds another significant layer of uncertainty to the current environment.

According to a news-based index[3], economic policy uncertainty in the euro area is currently more than three times the historical average.[4] Similarly, an index of trade policy uncertainty is more than eight times the historical average.[5] These levels are well above those seen during the pandemic.

Amid all of this uncertainty, the ECB's Governing Council decided to lower interest rates by another 25 basis points in March. The deposit facility rate is now at 2.5%, 150 basis points below its recent peak.

The disinflation process is well on track, with inflation developing broadly as expected. Headline inflation decreased further from 2.3% in February to 2.2% in March. According to recent data and in line with our projections, wage growth is moderating, which is helping services inflation to gradually decline. Most measures of underlying inflation suggest that inflation will settle at around our 2% inflation target, on a sustained basis.

But uncertainty surrounding the inflation outlook remains high, mainly on account of increasing friction in global trade. An escalation in trade tensions could see the euro depreciate and import costs rise, while much needed defence and infrastructure spending could raise inflation via aggregate demand. Geopolitical tensions could also lead to higher inflation owing to trade disruptions, rising commodity prices and energy costs. At the same time, lower demand for euro area exports and lower growth resulting from the impact of higher tariffs or geopolitical tensions could pose a threat to the economy, depress demand and push inflation down.

Weak economic growth remains a challenge for the euro area, even without any further shocks. ECB staff have again revised down their growth projections – to 0.9% for 2025, 1.2% for 2026 and 1.3% for 2027. The downward revisions reflect lower exports and ongoing weakness in investment. High uncertainty, both at home and abroad, is holding back investment, while competitiveness challenges are weighing on exports. Addressing these challenges in order to improve growth prospects is clearly more demanding in the current context of exceptionally high uncertainty about trade and economic policy.

Challenges when analysing financial stability

Our macroeconomic projections are not the only area where we face great difficulties navigating this environment of heightened uncertainty. Analysing financial stability also requires us to adjust our frameworks and use state-of-the-art tools to assess the financial system's capacity to withstand shocks under these conditions.

Analysing multiple scenarios is a powerful way to deal with situations of high uncertainty. It allows us to test the resilience of the financial system against various possible manifestations of financial stress. Shocks cannot be predicted, but drawing on a diverse array of indicators and a range of sensitivity analyses is essential for us to understand the nuances of the current uncertainty. It is also crucial that our various approaches include ways to measure sources of risk amplification and non-linearities. By combining hard data indicators with survey results and analyses based on micro data, we can achieve a more granular, diverse and timely understanding of the economic landscape. Such a comprehensive approach can enhance our ability to anticipate and respond to emerging challenges.

The main risks to financial stability in the euro area

In the current economic environment, we are observing marked vulnerabilities in financial stability. While banks remain in good shape, with sound solvency and liquidity indicators that are well above regulatory minimums, there are weaknesses in several other areas. First, elevated valuations and concentrated risks make financial markets susceptible to adverse corrections. Non-bank financial intermediaries have remained resilient to recent bouts of market volatility, but they are still quite heavily exposed to risky assets. Broader market shocks could cause sudden investment fund outflows or trigger margin calls on derivative exposures, unsettling markets and leading to abrupt price corrections. Second, sovereign indebtedness is a cause for concern at a time when defence spending is emerging as a priority in Europe, with different countries having very different amounts of fiscal space to respond. Despite the likely increase in debt servicing costs, public finances need to be managed in a growth-friendly way and ultimately be sustainable. Third, the corporate sector has demonstrated resilience but faces competitiveness challenges and is subject to emerging credit risk concerns, especially in the case of firms that are more exposed to the export sector and geopolitical risks.

Conclusion

In conclusion, an extraordinarily high level of uncertainty around economic and trade policy has been acting as a drag on markets and the economy alike. Financial intermediaries need to adapt their risk management tools in the face of new vulnerabilities and scenarios at a time when it is no longer possible to measure likely outcomes and probabilities. This environment calls for heightened vigilance, which is why we are exploring unconventional sources of risk and vulnerability and using a broader range of tools, such as sensitivity and scenario analyses, to assess the resilience of the financial system.

In terms of monetary policy, this uncertainty means we need to be extremely prudent when determining the appropriate stance. While most indicators point to inflation moving in the right direction, the environment of exceptional uncertainty requires us to stick even more closely to our data-dependent and meeting-by-meeting approach.

The European Union is at a crossroads. Defence policy requires a significant overhaul and challenges relating to trade and economic competitiveness need to be addressed. In addition to ramping up defence spending, we need to deepen and strengthen our Economic and Monetary Union with a true single market for goods and services that shores up our structural economic growth prospects, supported by a complete banking union and capital markets union.

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[1] I am grateful to Max Lampe for his contribution to this speech.

[2] Knight, F.H. (1921), *Risk, Uncertainty, and Profit*, Houghton Mifflin Company, Boston.

[3] Such indices are based on the frequency of specific words in news articles.

[4] Baker, S.R., Bloom, N. and Davis, S.J. (2016), "Measuring Economic Policy Uncertainty", *The Quarterly Journal of Economics*, Vol. 131, No 4, November, pp. 1593-1636.

[5] Caldara, D., Iacoviello, M., Molligo, P., Prestipino, A. and Raffo, A. (2020), "The economic effects of trade policy uncertainty", *Journal of Monetary Economics*, Vol. 109, January, pp. 38-59.