

ECB singles out Italy as risks to financial stability increase



Bloomberg/Frankfurt

The European Central Bank singled out Italy as an example of how quickly investors lose confidence in a government if they're confronted with policy uncertainty, as it said the risks to financial stability in the bloc have become "more challenging."

In its twice-yearly Financial Stability Review, the ECB said concerns relating to debt-sustainability and liquidity at investment funds have both risen since the previous report. Two other key risks – disorderly adjustments in financial markets, and the ability of banks to provide credit – were largely unchanged.

"Despite limited spillovers so far, the stress in Italian sovereign debt markets illustrates how quickly policy uncertainties and the ensuing sudden shift in market sentiment can unearth risks to financial stability via higher risk

premia and rising public debt sustainability concerns.”

Still, the ECB noted that contagion from Italy’s surging bond yields to other euro-area countries – unlike at the height of the financial crisis in 2012 – was limited.

ECB Vice President Luis de Guindos said in a press conference that the country’s bond spreads have fallen in response to signals recently that populists in Rome are ready to find a compromise with the European Commission. “I expect that at the end of the day the Italian government will reach an agreement.”

The ECB also said stress in emerging markets and trade tensions have added to downside risks to global growth, with the possibility of a cliff-edge Brexit posing an additional threat. At the same time, bank resilience has improved despite profitability remaining restrained. Momentum is building in real estate markets across the euro area, according to the ECB. “We start to see there’s some mild overvaluation,” Guindos said, after President Draghi last month labeled valuations in the prime commercial property market “stretched.”

In its report, the ECB said vulnerabilities are building in financial markets amid high valuations relative to risk. With a maturing global business cycle, a number of indicators appear to signal downside risks to asset prices, according to the report.

Emerging markets are particularly vulnerable. Higher interest rates in the US and rising trade tensions could spark more stress, after Argentina and Turkey saw bonds, stocks and currencies plunge over the summer months.

The FSR also highlighted risks outside the banking sector. After assets held by euro-area investment funds more than doubled in the past ten years, growing exposures to illiquid and risky securities make them vulnerable to potential shocks in global financial markets.