

Euro Area Warned That Shock-Proof Markets Won't Be Forever

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(Bloomberg) -- Financial markets have proved remarkably resistant to the political shocks of Brexit and the U.S.

presidential election. It won't always be so, a study from the European Central Bank shows.

The research analyzes the reaction to the U.K.'s vote to leave the European Union and Donald Trump's victory. It finds that while an index of global economic policy uncertainty climbed to an all-time high at the end of 2016, market volatility as measured by the VIX index remained low.

Historically, high economic-policy uncertainty has a strong correlation with financial-market volatility. But the current becalmed state of markets shouldn't be interpreted as a sign that this relationship has broken down, say the study's authors, Thomas Kostka and Bjoern van Roye.

For a start, Britain's Brexit vote prompted a quick response from the nation's central bank, which cut the key interest rate, revived asset purchases and pledged to act again if needed.

"In the U.K., the Bank of England responded strongly to the outcome of the referendum, averting a tightening in financial conditions."

In the U.S., the financial shock stemming from Trump's election came amid an economic upturn that cushioned the blow, and the expectation that however uncertain his policies might be, they would probably be good for companies.

"The rally in U.S. risky asset prices reflected the strong situation of the U.S. business cycle, reinforced by expectations about business and financial sector-friendly policies from the new administration."

The study follows other theories over why volatility is so low, and concludes with a look at what this might mean for the euro area, should an avowed opponent of the single currency gain power, or should the debt crisis in a member country heat up again.

"The main lesson to be learned from a euro-area financial stability perspective is that similarly large economic-policy uncertainty shocks could, in the absence of offsetting shocks, seriously tighten domestic financial conditions and raise risk premia."

So far this year, the currency bloc has managed to avoid anti-euro politicians coming to power in the Netherlands and France. If anything though, the region's history has shown that the next crisis is always just around the corner. The next focal point could come as early as Monday, when euro-area finance ministers meet in Brussels to try yet again to break an impasse on lightening Greece's debt burden.

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