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ECB warns of global contagion risks

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The European Central Bank has warned that the eurozone debt crisis could spread to engulf further member states, creating risks to financial stability that could reverberate around the world

"Contagion of euro area sovereign debt strains remains the most pressing risk for financial stability in the euro area, the European Union and even across the globe," said the ECB's latest eurozone financial stability review, released on Monday.

The comments hinted at ECB concern over politicians' failure to bring the crisis under control, and at the danger of countries' fiscal austerity plans being derailed by domestic politics. Separately, Mario Draghi, ECB president, told the European parliament in Brussels that draft changes to European treaties strengthening fiscal rules were a "first step" but could be "made much better". Many EU leaders believe that Mr Draghi's approval of the treaty's "fiscal compact" is a prerequisite to more ECB intervention in eurozone bond markets.

According to the ECB, eurozone bond market volatility had reached levels seen after the collapse of Lehman Brothers investment bank in 2008 – and were higher than in May 2010, when the eurozone crisis last reached a peak . Its report said the eurozone countries most vulnerable to contagion were those with weak public finances and financial systems – without naming examples.

Overall risks to eurozone financial stability had "increased considerably" in the second half of 2011, the ECB concluded. Presenting the report in Frankfurt, Vitor Constâncio, vice-president, said the ECB had not considered the possibility of a eurozone break-up because such a scenario was "unthinkable" - a view echoed by Mr Draghi in Brussels.

But even the exit of a single member would have unforeseeable consequences, Mr Constâncio warned. "The dynamics of such a huge event cannot really be predicted and could be very dangerous indeed," he said.

Other risks to eurozone financial stability, according to the ECB, include funding strains in the banking system, which the ECB will seek to address this week with its first offer of unlimited three-year loans to banks. The rise over the past six months in the estimated probability of two large eurozone banks defaulting simultaneously “has been sharper and larger than in the past, pushing this measure of systemic risk to heights not observed since its inception in 2007”, the ECB review said.

Mr Constâncio also highlighted the risk of credit tightening hitting the real economy.

The financial stability review said the swift implementation of fiscal rules and rescue mechanisms agreed at the European summit earlier this month would mitigate “considerably” the risk of the debt crisis spreading.

However, it cited a number of possible “triggers” for an escalation. Most importantly, it said, any “protracted domestic political uncertainty in vulnerable countries”, combined with a lack of progress in fiscal consolidation, “would further undermine confidence in the adjustment process”.

Other possible triggers might include bad news about banks’ profitability or solvency, credit rating downgrades for eurozone countries or banks or uncertainties linked to eurozone governments’ attempts to impose losses on Greek bondholders via “private sector involvement”.

Another risk, the ECB said, was that eurozone politicians would fail to make effective use of the European Union’s bail-out fund, the European Financial Stability Facility.