Brexit and the Financial Derivatives Time Bomb

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Brexit could trigger a $500 trillion derivatives meltdown, by forcing the EU to allow insolvent member governments and banks to write down debt. Italy is in financial crisis and is already petitioning for that concession. How to avoid collapse of the massive derivatives house of cards? Alternatives are considered.

Sovereign debt – the debt of national governments – has ballooned from $80 trillion to $100 trillion just since 2008. Squeezed governments have been driven to radical austerity measures, privatizing public assets, slashing public services, and downsizing work forces in a futile attempt to balance national budgets. But the debt overhang just continues to grow.

Austerity has been pushed to the limit and hasn't worked. But default or renegotiating the debt seems to be off the table. Why? According to a June 25th article by Graham Summers on ZeroHedge:

> . . . EVERY move the Central Banks have made post-2009 has been aimed at avoiding debt restructuring or defaults in the bond markets. Why does Greece, a country that represents less than 2% of EU GDP, continue to receive bailouts instead of just defaulting?

Summers' answer – *derivatives:*

> [G]lobal leverage has exploded to record highs, with the sovereign bond bubble now a staggering $100 trillion in size. To top it off, over $10 trillion of this is sporting negative yields in nominal terms. . . .
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> Globally, over $500 trillion in derivatives trade [is] based on bond yields.

But Brexit changes everything, says Summers. Until now, the EU has been able to reject debt forgiveness as an alternative, using the threat of financial Armageddon if the debtor country left the EU. But Britain has left, and Armageddon hasn't hit. Other Eurozone nations can now threaten to do the same if they don't get debt forgiveness or a restructuring.

The First Domino – Italy

That has evidently started happening, with Italy as the first challenger of EU rules. On June 27th, Ambrose Evans-Pritchard reported in the UK Telegraph that the first serious casualty of the Brexit contagion had struck. The Italian government is preparing a €40 billion rescue of its financial system, as Italian bank shares collapse. The government is now studying a direct state recapitalization of Italian banks, to be funded by a special bond issue. They also want a moratorium of the bail-in rules and bondholder write-downs, although those steps are prohibited under EU laws.

According to a [June 28th editorial on ZeroHedge] titled “The First Casualty of Brexit”:

> The likely outcome is that Italy’s [prime minister] Renzi will be “forced” to take matters into his own hands and enact a unilateral sovereign rescue of the Italian banking system in defiance of the EU, unless he wins concessions soon from Brussels. Those who know him say he will not go down in flames for the sake of European ideological purity.
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> As a result, Brexit will be just the scapegoat used by Renzi and Italy to circumvent any specific eurozone prohibitions. And if it fails, all Renzi has to do is hint at a referendum of his own. Then watch as Merkel scrambles to allow Italy to do whatever it wants, just to avoid the humiliation of a potential “Italeave.”

Behind the Italian Collapse: Brexit or Bail-ins?

The ZeroHedge editorial questions whether Brexit was actually the cause of the Italian collapse. The banks were already in serious trouble. A good crisis was just needed so that EU rules could be suspended without admitting they were unworkable all along; and Brexit fit the bill. But the real trigger of the collapse seems to have been the bail-in scheme implemented in January 2016. According to ZeroHedge:

> The new bail-in reform this year has brought matters to a head, catching EU authorities off guard. It was intended to protect taxpayers by ensuring that creditors suffered major losses first if the bank gets into trouble, but was badly designed and has led to a flight from bank shares. The Bank of Italy has called for a complete overhaul of the bail-in rules.
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> . . . The banking squeeze has become politically explosive in Italy after thousands of small depositors were wiped out at four regional banks late last year. They were classified as junior bondholders even though most of them were just ordinary savers who did not realize what was being done with their money.

The bail-in scheme was supposed to shift losses from governments to bank creditors and depositors, but it has served instead to scare off depositors and investors, making shaky banks even shakier. On top of that, heightened capital requirements have made it practically impossible for Italian banks to raise capital. According to Lorenzo Cordogno, former director general of the Italian Treasury, the result has been that the ECB is “unwittingly destabilizing the banks in an overzealous attempt to make Europe’s banks safer.”

But EU rules have been flexible in “emergencies.” Before the Eurozone debt crisis of 2011-12, the European Central Bank was forbidden to buy sovereign debt. Then Greece and other southern European countries got into serious trouble, sending bond yields (interest rates) through the roof. But default or debt restructuring was not considered an option. The ECB finally got on the quantitative easing bandwagon and is now buying government debt along with other financial assets at the rate of €80 billion per month.

According to Evans-Pritchard, Brexit has not yet caused serious trouble in the debt markets, because this new QE policy has allowed the ECB to cap bond yields. Rather than deal with a very awkward Italeave, the EU could cave on its bail-in and bailout rules as well.

Time for a Reset

That may get Italy out of the woods, but the system is clearly broken. A $500 trillion derivatives time bomb poised atop a $100 trillion mountain of debt is not a stable situation. It's time to push the reset button, but how? Bailouts and bail-ins have been tried and proved wanting. But a debt "jubilee" – simply canceling the debt – would devastate creditors and collapse the massive derivatives bubble.

All else having failed, it may be time to do what should have been done all along: convert "sovereign debt" into "sovereign money." The "event of default" triggering a derivatives meltdown can be avoided by simply paying the debts with money issued by the government.

A government oppressed by "sovereign" debt is not really sovereign. A sovereign government has the power to issue money and need not go into debt at all. But EU member governments have lost that sovereign power. They are unable to issue their own money or borrow money issued by their own central banks. If they leave the EU, they can get that power back for future expenditures; but their existing debt is in euros, and only the ECB has the power to convert bonds into euros.

In fact that is what it does when it buys government bonds with QE. The problem with QE as currently practiced is that the bonds remain on the central bank's books, "sterilizing" their effect on the market. The idea is to be able to sell them back into the market should inflation become a problem. But that means the bonds are still counted as debt for purposes of balancing national budgets, forcing continued austerity, cutbacks and privatization. If the bonds were bought back and voided out, national governments would be free to spend again. QE doesn't need to be unwound by selling bonds into the market. If the money supply grows too large, money can be pulled back with taxes, interest or fees.

The invariable objection to paying off the debt with central bank-issued money is that it would lead to hyperinflation. But would it? Government bonds are already classified as "near money" – so liquid that they are readily exchangeable for cash. Turning them into cash is little different from moving money from your savings account to your checking account. One draws interest and the other doesn't, but cashing out the savings account doesn't make you any richer than before. It doesn't propel you to spend more on goods and services, driving consumer prices up.

If people and governments *were* incentivized to spend more, however, that would actually be a good thing. Consumer markets need more demand today. The way to stimulate economies is to get money into the pockets of people who will spend it. Demand (money) stimulates supply (productivity). Before QE can stimulate the real economy, it has to make it into the real economy. If the goal of the EU is to hold itself together and avoid a derivatives meltdown, some QE that actually got into the hands of the people could be just the ticket.

Ellen Brown is an attorney, Founder of the Public Banking Institute, and author of twelve books, including the best-selling [Web of Debt](). Her latest book, [The Public Bank Solution](), explores successful public banking models historically and globally. Her 300+ blog articles *are at EllenBrown.com. She can be heard biweekly on "It's Our Money with Ellen Brown" on PRN.FM.*

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