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The Looming Collapse of European Banking

By Gary North
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The banking system of Europe is at the edge of the abyss. A brief story by *The Telegraph* revealed this last week. The original was almost immediately deleted. A new version was substituted.

You can see the original headline on Google:

> European banks may need £16.3 trillion bail-out, EC document warns …

There are dozens of these links. I read the story last week. I saved the link. But, lo and behold, when I clicked my saved link on Monday morning, the story did not mention a specific figure.

There was a reason for this. The editors at *The Telegraph* had taken out the following paragraphs:

> European Commission officials have estimated that impaired assets may amount to 44pc of EU bank balance sheets. The Commission estimates that so-called financial instruments in the trading book total £12.3 trillion (13.7 trillion euros), equivalent to about 33pc of EU bank balance sheets.
>
> In addition, so-called 'available for sale instruments' worth £4trillion (4.5 trillion euros), or 11pc of balance sheets, are also added by the Commission to arrive at the headline figure of £16.3 trillion.

Fortunately, web sites around the globe have posted the deleted paragraphs.

Converted into dollars, £16.3 trillion euros are the equivalent of $25 trillion.

The original paragraphs can be found in several links in the Google list of headlines.

Why did the editors do this? A call from some government bureaucrat? Or the realization that the article might start a bank run? I think the latter. In either case, it's scary.

The current article begins with a lie: "Last updated: 6:34 GMT, 11 Feb 2009."

WHAT THE EUROPEAN ESTABLISHMENT IS FACING NOW

The original February 11 story was a shocker. The author claims to have seen a secret European Commission report. The report estimates that losses (write-downs) by European banks will be in the range of $25 trillion.

If true, then to save the banking system, European governments will have to find an extra $25 trillion, fast. There is only one source of such funding: the central banks, mainly the European Central Bank (ECB).

For comparison's sake, consider the $700 billion banking bailout in the United States last fall. Of this, only about half has been spent. That was sufficient bailing wire and chewing gum to keep the American banking system going. More will be needed, but so far, this has sufficed. The Federal Reserve did a lot of asset swaps in 2008 – Treasury debt for toxic assets – and pumped in an extra trillion dollars or so. But the system has held.

Adding these together – the increase in the monetary base and $350 billion in bailout money – the total is around $1.5 trillion. Then think "$25 trillion." This is a sobering thought for some, and a reason to get unsober, fast, for others.

The European Central Bank will have to serve as the lender of last resort. There are over a dozen national EC governments. How will they coordinate their respective bailouts? Think of a dozen Barney Franks and a dozen Nancy Pelosis. Think of a dozen Henry Paulsons. Think of a dozen Gordon Browns. Terrifying, isn't it?

Here is the story, as airbrushed by the editors.

> "Estimates of total expected asset write-downs suggest that the budgetary costs – actual and contingent – of asset relief could be very large both in absolute terms and relative to GDP in member states," the EC document, seen by The Daily Telegraph, cautioned.

Very large? That's it? Just very large? Twenty-five trillion dollars in losses are merely very large? That is twice the size of the gross domestic product of European Union.

It is not as though there is a lot of time to deal with this. Bank runs can take place very fast. What if Europeans try to pull out currency? There will not be enough currency. So, they will move their assets to American or Japanese banks. They will have to sell their domestic currencies to buy dollars and yen. The euro will crater.

> "It is essential that government support through asset relief should not be on a scale that raises concern about over-indebtedness or financing problems."

Wait a minute. If asset relief is not on this scale, then what will sustain a bankrupt European banking system? You are telling me that these banks are sitting on top of $25 trillion in losses, and this can be concealed? Does no one audit these banks?

> The secret 17-page paper was discussed by finance ministers, including the Chancellor Alistair Darling on Tuesday.
>
> National leaders and EU officials share fears that a second bank bail-out in Europe will raise government borrowing at a time when investors – particularly those who lend money to European governments – have growing doubts over the ability of countries such as Spain, Greece, Portugal, Ireland, Italy and Britain to pay it back.

National leaders apparently have a clear perception of the public's lack of faith in the in specific governments' ability to repay. But that does not answer the crucial question: "What are the depositors' fears regarding their individual banks?" It's one thing for a government to be unable to pay back loans over the next two decades. Of course they will not pay it back. No national debt is ever paid back. It is rolled over. It's another thing to deal with bank runs.

> The Commission figure is significant because of the role EU officials will play in devising rules to evaluate "toxic" bank assets later this month. New moves to bail out banks will be discussed at an emergency EU summit at the end of February. The EU is deeply worried at widening spreads on bonds sold by different European countries.
>
> In line with the risk, and the weak performance of some EU economies compared to others, investors are demanding increasingly higher interest to lend to countries such as Italy instead of Germany. Ministers and officials fear that the process could lead to vicious spiral that threatens to tear both the euro and the EU apart.

Ministers and officials have got the picture. They are facing a breakdown of Europe's economy. If the bailouts are insufficiently large in every nation to reduce depositors' fears regarding their banks, there will be a rush out of the euro and into dollars and yen. If the bailouts are sufficiently large to stem the tide on bank fears, then there will be a rush by bond investors out of government bonds. This will make the existing recession much worse.

If each country has widely different rates, the euro will break down. The poorer countries will borrow at low rates from the European Central Bank. The Germans will revolt. They could demand an end to the ECB, which will have become a welfare agency for the Mediterranean governments. That would end the euro. That would end the attempt to create a new European order. This thought brings to mind one of Johnny Mercer's masterpieces.

> So you met someone who set you back on your heels – goody, goody
> You met someone and now you know how it feels – goody, goody
> You gave him your heart too, just as I gave mine to you
> And he broke it in little pieces, now how do you do?
>
> You lie awake just singing the blues all night – goody, goody
> And you think that love's a barrel of dynamite
> Hooray and hallelujah, you had it coming to y'a
> Goody goody for him, goody goody for me
> I hope you're satisfied, you rascal you,
> I hope you're satisfied 'cause you got yours

But I digress.

> "Such considerations are particularly important in the current context of widening budget deficits, rising public debt levels and challenges in sovereign bond issuance," the EC paper warned.

These considerations are indeed important. But solutions are a lot more important. The report is 17 pages long. The solutions – if any – will be a lot longer.

SO FAR, SO GOOD

So far, the euro has not collapsed. It has fallen, but there is no rush for the exits. Why not? These answers come to mind.

1. The story is not true: no such document.

2. The document is wrong: banks are not really that much in the hole.

3. The banks are in the hole, but public faith in their governments remains high.

4. The report is true, but it is not believed by currency speculators.

5. The report is true, but currency speculators believe that the governments and central banks can handle it without major shifts in currency values.

European bank stocks have fallen since the article was published, but they are not in free-fall.

In my view, the European public still has faith that the governments and the central banks will successfully intervene to restore commercial banks. But if the original article was correct, that 44% of bank balance sheets have disappeared, then the public is living in la-la land. The entire structure of Europe's capital markets is at risk. Or, I should say, what remains of the capital markets is at risk.

How are governments going to replenish lost capital? It's gone. It's missing in action.

EASTERN EUROPE

Ambrose Evans-Pritchard has explained this is a *Telegraph* article published on February 15.

> If mishandled by the world policy establishment, this debacle is big enough to shatter the fragile banking systems of Western Europe and set off round two of our financial Gotterdammerung.

He was referring to loans to Eastern Europe. He used Austrian banking as the example.

> The European Bank for Reconstruction and Development (EBRD) says bad debts will top 10pc and may reach 20pc. The Vienna press said Bank Austria and its Italian owner Unicredit face a "monetary Stalingrad" in the East. . . .
>
> Stephen Jen, currency chief at Morgan Stanley, said Eastern Europe has borrowed $1.7 trillion abroad, much on short-term maturities. It must repay – or roll over – $400bn this year, equal to a third of the region's GDP. Good luck. The credit window has slammed shut.
>
> Not even Russia can easily cover the $500bn dollar debts of its oligarchs while oil remains near $33 a barrel. The budget is based on Urals crude at $95.

> Russia has bled 36pc of its foreign reserves since August defending the rouble.
>
> "This is the largest run on a currency in history," said Mr Jen.

This reminds me of the bankruptcy of Long-Term Capital Management in 1998. That hedge fund had bought ruble-denominated assets on a leveraged basis: 30 to one. When the Russian central bank failed to defend the ruble, LTCM went bust in a few days. It had to be bailed out by $3.6 billion in loans from New York banks. Today, the European banks are gutted, not a lone hedge fund.

Russia is going belly-up. It will have to liquidate most or all of its reserves of Western currencies. It has stopped buying U.S. Treasury debt. It is selling.

> In Poland, 60pc of mortgages are in Swiss francs. The zloty has just halved against the franc. Hungary, the Balkans, the Baltics, and Ukraine are all suffering variants of this story. As an act of collective folly – by lenders and borrowers – it matches America's sub-prime debacle. There is a crucial difference, however. European banks are on the hook for both. US banks are not.
>
> Almost all East bloc debts are owed to West Europe, especially Austrian, Swedish, Greek, Italian, and Belgian banks. En plus, Europeans account for an astonishing 74pc of the entire $4.9 trillion portfolio of loans to emerging markets.
>
> They are five times more exposed to this latest bust than American or Japanese banks, and they are 50pc more leveraged (IMF data).

This is the ringing of the bell. The bell of the Great Depression of the 1930's rang on Wall Street in October 1929. But that was not the cause of the Great Depression. The causes were these: (1) monetary base expansion in the 1920s, (2) the cessation of this expansion in 1929; (3) the governments' raising of tariff and trade barriers in 1930 all over the West, and (4) the collapse of the Austria's Credit Anstalt Bank in 1931. In the USA, we saw the first two, 2000–2007.

Central banks will inflate to keep any major bank from collapsing. But the trend is ominous. Russia and Eastern Europe are gonners. European banks that lent to them are, too. So is the purchasing power of the euro – and maybe even the actual euro. I can see Germany cutting and running sometime before 2011. Evans-Pritchard pulls no punches. This is a gutsy forecast.

> Whether it takes months, or just weeks, the world is going to discover that Europe's financial system is sunk, and that there is no EU Federal Reserve yet ready to act as a lender of last resort or to flood the markets with emergency stimulus.

If he is correct about the inability of the ECB to imitate the Federal Reserve System, this means a collapse of the banks. That means the collapse of Europe's economy.

> "This is much worse than the East Asia crisis in the 1990s," said Lars Christensen, at Danske Bank.

> "There are accidents waiting to happen across the region, but the EU institutions don't have any framework for dealing with this. The day they decide not to save one of these one countries will be the trigger for a massive crisis with contagion spreading into the EU."

He ends with this: "If one spark jumps across the eurozone line, we will have global systemic crisis within days. Are the firemen ready?"

The capital markets do not indicate agreement with his assessment. People still trust the banking system. Generally, I trust capital markets rather than journalists. But I think the report is too explosive to ignore. I think the optimism of investors is greater than the optimism of European bankers, bureaucrats, and newspaper editors.

CONCLUSION

The West's economy really is at the edge of a leveraged disaster. The politicians know only one answer: deficit spending. The central bankers have only on significant tool: monetary inflation. The speed of events is increasing.

The markets don't reflect this yet. This gives time to a few people to get out. But the vast majority cannot get out. There are too few escape hatches open.

Gary North [send him mail] is the author of Mises on Money. *Visit http://www.garynorth.com.He is also the author of a free 20-volume series,* An Economic Commentary on the Bible*.*

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