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Timebomb in Euroland: The Eurozone is Heading for a Crash.

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Global Research, August 28, 2011
Information Clearing House 28 August 2011

Region: Europe
Theme: Global Economy

Bank funding costs are rising, liquidity is being choked off, and interbank lending has started to stall. A full-blown crisis can still be averted, but leaders will have to knuckle down and resolve the political issues fast. Otherwise the 17-member monetary union will fracture and the euro will be kaput. Here's a clip from the Wall Street Journal:

"Commercial banks boosted their reliance on the European Central Bank, borrowing €2.82 billion ($4.07 billion) from an emergency lending facility on Tuesday … While the amount of borrowing is tiny … the increase from €555 million a day earlier, nonetheless suggest that some lenders are struggling to borrow from traditional funding sources."("Europe Banks Lean More on Emergency Funding", Wall Street Journal)

Sure, it's a pittance compared to the trillions floating around in the EU banking system, but the pattern is the same as it was in 2007 when the troubles began at French bank PNB Paribas. Back then, the problems seemed small, too, but things got out of hand quick. Over the following year, trillions in mortgage-backed securities (MBS) were downgraded forcing bigger and bigger losses on the bondholders, many of which were the nation's largest banks. The bloodletting dragged on until September 2008, when Lehman blew up and the whole financial system went into cardiac arrest. The Fed had to rush to Wall Street's rescue with $12 trillion in loans and other guarantees in hand just to keep the patient from croaking on the Emergency Room floor. Now it looks like history is repeating itself.

As the collateral the banks hold (mainly foreign sovereign bonds) continues to lose value, the banks will come under greater pressure making funding more costly and harder to get. In fact, the mad-scramble for short-term funding has already begun. Banks are hoarding capital just as they did after the Crash of '08, depositing larger and larger amounts in overnight accounts with the ECB in order to avoid lending to the other banks. All of this is taking a toll on consumer and household lending which will inevitably push eurozone GDP further into the red. The negative feedback loop into the real economy will send unemployment higher while further crimping business investment. This is from Businessweek:

"Despite the ECB's best efforts, some of Europe's banks may be inching toward insolvency. The cost of insuring the bonds of 25 European banks and insurers set a record high on Aug. 24 of 257 basis points, higher than the 149 basis-point spike when Lehman Brothers collapsed in the fall of 2008, according to the Markit iTraxx Financial Index of credit default swaps.

The banks aren't required to mark down most of their holdings of government debt to market prices. If they did, some would be forced to default or seek a bailout." ("How Long Can the ECB Prop Up Europe's Sick Banks?", Businessweek)

Are you kidding me? The banks are sitting on a mountain of garbage paper and EU regulators haven't even forced them to write down the losses. Is it any wonder why public confidence is at all-time lows?

U.S. money funds have been gradually reducing their exposure to EU banks due to worries about their collateral, much of which is bonds from Portugal, Italy, Ireland, and Greece (PIIGS). Eventually, these bonds will be pounded by downgrades and the banks will have to pony-up for the losses. That'll be the swan song for some of Europe's big name banks that are gravely undercapitalized. Of course, there could be a multi-trillion dollar bailout like in the US, but it's hard to imagine how that would work. After all, Germany has already rejected eurobonds; so why would they support the more offensive idea of bank bailouts? It just doesn't add up.

And, in case there's any doubt about German Chancellor Angela Merkel's contempt for eurobonds; here's what she said on Tuesday: "At this time — we're in a dramatic crisis — euro bonds are precisely the wrong answer…They lead us into a debt union, not a stability union. Each country has to take its own steps to reduce its debt."

Then she added this corker: "We are in no rush whatsoever to solve the crisis in Europe. We will not be swayed by market crashes or panics."

Hmmm. That doesn't sound like someone who appreciates the urgency of the moment. It sounds like someone who wants to teach the market "who's boss".

But Merkel's bravado doesn't change the fact that the EU bank funding system is on the fritz; liquidity is drying up, stress gauges are blinking red, and the banks are too scared to lend to each other. It just demonstrates the obtuseness of grandstanding politicians.

And, keep in mind that–while QE2 helped many of the European banks stockpile "rainy day" reserves in the US–those piles are beginning to dwindle as investors wise-up and head for the exits. They've seen this movie before, and it doesn't end well. Better to be safe than sorry.

Here's an excerpt from a report by Nomura that shows how liquidity is gradually being drained from the system:

"The USD cash buffer has been falling according to FED data from 889 billions USD on July 20 to 758 billions USD on August 3….In fact, according to the same report, there was a notable decline of 131 billions USD in two weeks, clearly a trend to watch…. ("Credit Terminal Velocity", Macronomics, Pragmatic Capitalism)

So, no, we're not at the panic-phase yet, but the situation is steadily deteriorating. As the run on the money markets continues, more banks have to go "cup in hand" to the ECB seeking loans to stay afloat. At the same time, ECB chief Jean-Claude Trichet will have to step up his sovereign debt purchasing program to prop up plunging bond prices to help tottering Greece and Co. stay upright. Otherwise, someone's going to go belly-up and take down a good portion of the EU financial system along with them.

So, it's a mess, and it's going to get a whole lot messier because eurozone banks need to roll over more than $4.5 trillion in the next two years and the funding flywheel is already gummed up. If there's not a political solution to the trans-EU fiscal issues in the next few months, there's going to be Hell-to-pay. When the credit markets start to freeze, bad things can happen fast.

This isn't the time for pompous pronouncements or footdragging. Policymakers need to make a choice and stick by it. Is there a future for the eurozone or not? It's that simple. Either implement the policies that will make the monetary union work or forget about it. But, for God sakes, don't just stand there while the markets rip the economy to shreds.

Do something!