Fears grow over European banks

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Leaders of the G8 major economies meet over the next two days with the threat of a global financial crisis hanging over their heads as the turmoil in the euro zone worsens.

Every day brings the bankruptcy of Greece and its exclusion from the euro zone a step closer, with incalculable consequences for the European and global financial system, as fears grow over the viability of the banking system in a number of countries.

It is a measure of the depth of the crisis that three-and-a-half years after the collapse of the investment bank Lehman Brothers brought the world economy to the brink of disaster an entire country now faces bankruptcy. The global financial system again faces the prospect of collapse, despite the provision of trillions of dollars of bailouts and the supply of an ocean of cheap funds since 2008.

Global share markets fell sharply yesterday with the FTSE All-World equity index down a further 1 percent and predictions that stocks will fall further today.

Yesterday, the credit rating agency Moody's lowered its ratings on 16 Spanish banks, with a three-notch downgrade for the three major Spanish lenders. The decision followed a move by the agency last week to downgrade the rating of 26 Italian banks. Moody's said its latest decision was motivated by the deteriorating Spanish economy and the reduced credit-worthiness of the government.

In a sign of the growing crisis of the Spanish banking system, the government was forced to issue a statement saying there was no prospect of a run on the Bankia conglomerate. Bankia was in effect nationalised last week when the Spanish government converted its stake in the company to equity in an effort to shore up its position. Bankia was formed in 2010 through an amalgamation of seven regional banks with high levels of "toxic" assets on their books as a result of the collapse of the property market since 2008.

The government assurances on the viability of Bankia came after the Spanish newspaper *El Mundo* reported that customers had withdrawn €1 billion since the nationalisation last week.

Jose Goirigolzarri, who took over as Bankia's chairman last week, issued a statement that there had been no abnormal change in its deposits. "We are living through a period of extreme economic upheaval and in this difficult time over the past few days I wanted to say that Bankia has been able to operate virtually as normal. I wanted to make this point and also make the point that our clients should trust Bankia and feel safe because Bankia is an extremely solid entity. Not only do we say this as employees of the bank but so do the Bank of Spain and the government."

The very fact that Goirigolzarri felt compelled to make such a statement itself points to deepening difficulties. Whether such assurances have the desired effect remains to be seen, but no one has forgotten the assurances made last July when Bankia was launched on the share market amid claims that its problems had been solved. The shares had tumbled 45 percent by the time of the government takeover as foreign investors withdrew their money.

The extent of the crisis in the Greek banking system, which may well undergo an implosion if the country is forced out of the euro zone and returns to the drachma, was underscored by an announcement from the European Central Bank that it had excluded four unnamed Greek banks from its regular provision of liquidity. The ECB said the banks would now have to be provided with "emergency liquidity assistance" from the Greek central bank subject to ECB approval. A spokesman said the ECB "continues to support Greek banks."

Greek President Kaolos Papoulias has warned that the country's banks risk running out of money, posing a "threat to our national existence". He cited government documents showing that Greeks were withdrawing €100 million a day from the country's banks, with €1 trillion having been pulled out since the elections of May 6.

At the same time, the European Commission is continuing to insist that Greece must honour the austerity measures approved by the last Greek government and that there will be no renegotiation of terms. "We want Greece to remain part of our family, of the European Union," European Commission President Jose Barroso told a news conference. "That being said, the ultimate resolve to stay in the euro must come from Greece itself."

In other words, whichever way the Greek people vote in the fresh elections scheduled for June 17, any incoming government must carry out the dictates of the "troika"—the ECB, the European Commission and the International Monetary Fund—or funding will be withdrawn.

Speaking to reporters after a meeting of European Union finance ministers earlier this week, German finance minister Wolfgang Schäuble said Greece had to elect a government that continued to adhere to the international bailout program.

"If Greece … wants to remain in the euro then they have to accept the conditions," Schäuble said. "Otherwise it isn't possible. No responsible candidate can hide that from the electorate." The announcement of new elections "doesn't change the situation," he added.

In a major article headlined "Greece Can No Longer Delay Euro Zone Exit," the German magazine *Der Spiegel* pointed to some of the fears of the German government about the consequences of any retreat from its hardline insistence that the austerity program must be met.

"If the euro-zone countries do give in, the pressure for reform will also decline in other crisis-ridden countries. If that happens their debts will continue to rise, investors will flee from the euro and the entire currency union could break apart," the magazine stated. Such disintegration would inevitably drag down the German banking system.

Across the Atlantic, the US Federal Reserve is becoming increasingly concerned about the situation in Europe. Minutes from the April meeting of the Federal Open Market Committee released this week indicated that it intends to continue with its low-interest rate policy "at least through late 2014".

"Strains in global financial markets stemming from the sovereign debt and banking situation in Europe continue to pose significant downside risks to economic activity both here and abroad," the minutes noted. Those concerns can only have grown in the ensuing weeks.

While the official line is still that Greece must be kept within the euro zone, other preparations are being made. IMF chief Christine Lagarde raised the prospect of a Greek exit this week, saying she had to be prepared "technically" for anything and would seek to ensure that if an exit did take place it would be orderly.

"It is something that would be extremely expensive and would pose great risks but is part of the options that we must technically consider," Lagarde said.

But no one knows how a Greek exit from the euro zone would unfold or the extent of the financial chaos that would ensue on European and global financial markets. Official estimates put the exposure of global financial institutions in Greece at $536 billion, but the Institute for International Finance predicts the total cost to be around $1.2 trillion.

It has been estimated that if Greece does return to the drachma, its value would be cut by 50 percent against the euro. However, this is just a guess, and the risk is that the drachma could be caught in a devaluation vortex.

A Greek exit could well lead to a freeze in the entire European banking system, as banks refuse to lend to one another, not knowing the extent of their exposure to risky assets. As the American financier Warren Buffet once famously commented: "No one knows who's been swimming naked until the tide goes out." And it appears that a lot of "naked" swimming has been going on.

Writing in the *Business Spectator* this week, Australian commentator Robert Gottliebsen noted that "not far below the surface is a deep fear that a number of European and US banks have been stupid and entered into crazy derivative and/or investment plays. Because the world banking system is so interwoven no one knows who is broke and who is solvent, except we know that most European banks have no capital if you value their bond and other loans to market."

Those fears have undoubtedly been increased by the announcement earlier this month that JPMorgan Chase, previously regarded as one of the safest investment banks, had suffered a $2 billion loss on derivative trades.

Others are raising concerns about the political consequences of the insistence on the austerity program. Writing in the *Financial Times* this week, the biographer of John Maynard Keynes, Robert Skidelsky, noted that the Keynes, who burst into public prominence with his denunciation of the harsh economic terms imposed on Germany under the Versailles Treaty, had warned in 1923 that: "The absolutists of contract are the real parents of revolution."

"It is a historical irony," he wrote, "that European countries that avoided a repeat of the Great Depression after the banking crisis are now driving into the blind cul-de-sac that led to extremism in that earlier disaster. German historical memory has vivid recall for the hyper-inflation of 1920-23. But it is possible to forget that it was deflation and the Great Depression that brought Hitler to power in 1933. One of the great lessons of history is that sovereign debts must be managed in ways that do not destroy either the economy or the political centre ground."