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Global markets fall as fears grow over Spanish debt crisis

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Global equity markets experienced a significant sell-off yesterday amid fears that the Spanish crisis is rapidly worsening and Greece may soon be forced out of the euro zone, setting off a new round of financial turmoil.

Less than one month ago, European leaders emerged from a summit meeting expressing confidence that a way had been found to inject money into the Spanish banking system without increasing the sovereign debt burden of the government. That solution has been exposed as a fiction. The latest crisis has come in the wake of the signing Friday of an agreement to provide €100 billion to the Spanish banks that makes clear the government is on the hook for the full amount.

Markets in Europe fell Monday by between 2 and 3 percent, with the Spanish market down more than 5 percent. The fall would have been even steeper but for the imposition of a ban on short-selling by Spanish and Italian authorities. In the US, the Dow plunged 200 points on opening before ending the day more than 100 points down.

Even more significant were the shifts in bond markets. Reflecting the growing fears over Europe, the yield on US 10-year treasury bonds fell to a record low of 1.396 percent during the day's trading.

The interest rate on Spanish 10-year bonds hit a new euro era high of 7.56 percent, well above the level of 7 percent generally considered to be unsustainable over the long term. But it was the movement in the shorter-term bonds that pointed even more dramatically to the intensification of the crisis.

Up to now, the Spanish government has been able to counteract the rise in long-term yields by raising money through the sale of shorter-term bonds where interest rates have been lower. But that tactic may soon be no longer possible. Yesterday, yields on Spanish two-year bonds jumped by 78 basis points–the biggest one-day increase since the crisis began–to reach a euro era high of 6.54 percent.

As an article in today's *Financial Times* noted, the "flattening of the yield curve", in which long- and short-term rates tend to converge, has "fearful implications for Spain." Analysts quoted by the newspaper said there was a "sense that things are out of control in Spain."

Adding to the turmoil was the request by the Valencia region last Friday for emergency assistance from the central government in Madrid. It is expected to be followed by requests from as many as six other regional governments, including Catalonia, which has an economy the size of Portugal. The 17 Spanish regions have almost €16 billion of debts to refinance in the second half of the year.

Spain is caught firmly in the grip of a vicious circle as the slump in the economy exacerbates the debt crisis, leading to further spending cuts that in turn push the economy further into recession. The Bank of Spain reported that the economy had contracted 0.4 percent in the three months to June compared to the previous quarter, and that Spain would remain in recession at least until 2014.

The intensification of the crisis means it is highly likely that Spain will be subject to a so-called "bailout" and placed under the direct control of the "troika", comprising the European Commission, the European Central Bank and the International Monetary Fund. This will mean still further cuts and austerity measures on top of those set down in the €65 billion package announced by the Spanish government last week.

Talks will be held later today between Germany's finance minister Wolfgang Schäuble and his Spanish counterpart Luis de Guidos on "the future in Spain". De Guidos told the Spanish parliament on Monday that in the present situation of "uncertainty and volatility", the only way to act went "well beyond the capacity of governments."

The rating firm Moody's considers that a Spanish bailout operation is increasingly likely. It has lowered its credit rating outlook for Germany, the Netherlands and Luxembourg to negative because of what it called "rising uncertainty" about the European debt crisis. Citing an "increasing likelihood" of the need for collective support for countries such as Spain and Italy, Moody's shifted its outlook for the continent's stronger economies because "this burden will likely fall most heavily on more highly rated member states if the euro area is to be preserved in its current form."

On top of the crisis in Spain, the market turmoil is being fuelled by the growing signs that Greece may soon be ejected from the euro zone. The German weekly magazine *Der Spiegel* has reported that the IMF is no longer prepared to provide financial aid, sparking fears that the Greek government could run out of money by September.

The report has been denied by the IMF, which said that it was continuing to support Greece. A team from the troika is starting discussions with Greek government and financial authorities in Athens today to enforce the program of cuts and austerity measures under the bailout program.

While the IMF has formally denied the *Spiegel* report, there are other signs that Greece could be cut off from the supply of funds. On Friday, the European Central Bank said it would no longer accept Greek bonds as collateral on loans until it had received a full report from the troika. This is not expected until at least September.

Over the weekend, Germany's economy minister, Philipp Rösler, told radio broadcaster ARD that Greece was unlikely to be able to meet its commitments to international creditors. Should that prove to be the case, he said, Athens would not receive any more money. "What is clear," Rösler said, is that "if Greece doesn't fulfil those conditions, then there can be no more payments."

Asked about the consequences of such a move, he added that for him as well as others, "a Greek exit from the euro zone has long since lost its horror."

While Rösler does not express the official view of the German government–he is a member of the junior coalition partner, the Free Democratic Party–his views do reflect a shift by sections of the European political elite. Having spent the last two years ensuring that the major portion of Greek debt was transferred from privately-owned banks and financial institutions to government authorities, they may be prepared to cut Greece adrift.

The economic, financial and social chaos this would unleash would have the advantage of providing an example to the people of Spain, as well as other countries, as to what to expect if the demands of the EU (and the banks) are not carried out.