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Global Markets Gyrate on Fears of Europe's Spreading Financial Crisis

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Global stock markets were extraordinarily unstable Tuesday, as fears about the expanding European financial crisis and the possibility of military conflict on the Korean peninsula combined to shake investors.

Anxiety is growing about the state of the European banking system in the wake of the Bank of Spain's takeover of a savings bank this past weekend. A currencies portfolio manager in London commented to the Wall Street Journal, "The spotlight has shifted from Greece … towards Spain, Portugal and the banks." The International Monetary Fund issued a stern report on Spain Monday, demanding that the social democratic government of Prime Minister José Luis Rodríguez Zapatero take on a "dysfunctional labor market."

London's FTSE index 100 lost 2.5 percent, closing below 5,000 for the first time since October 2. "We haven't just dropped below 5,000, we've crashed through it," an analyst told the Financial Times. Shares of Lloyds, the partially nationalized bank, fell by 9 percent, while Royal Bank of Scotland and Barclays shares both fell 6 percent.

Wall Street's Dow Jones Industrial Average plummeted by 2 percent Tuesday morning, or more than 200 points, before recovering to close down only 22 points, at just over 10,000. The Dow Jones average has not closed below that mark since February 8 of this year.

The leading French index, the CAC, fell 2.9 percent, and Frankfurt's DAX lost 2.34 percent. In Madrid, the stock market was down 3.05 percent and Milan's fell 3.4 percent.

In Asia, markets plunged generally to six-month lows. Hong Kong's Hang Seng Index fell 3.5 percent and Japan's Nikkei 225 Index dropped 3.1 percent. The Shanghai Composite Index declined nearly 2 percent.

The Indian rupee dropped against the dollar to its lowest level in nearly eight months and the benchmark 30-share Sensex fell below the 16,000 mark for the first time in three months.

Markets were down in Australia as well, with the S&P/ASX 200 Index falling by 3 percent to its lowest level since last August. The Sydney Morning Heraldcommented, "The Australian sharemarket has lost close to $150 billion in value this month, as investors fret that Europe's debt crisis might derail the global recovery."

The euphoria on the markets in the wake of the announcement May 10 of a €750 billion ($955 billion) European bailout has long since dissipated, replaced by "mind-numbing" volatility, in the words of one portfolio manager.

Anxiety is rife in financial circles that Spain will be next to face a Greek-style crisis, and that its Socialist Party government may not have sufficient "political will" to impose the brutal austerity measures demanded by the markets in the face of working class resistance. Comment after comment in the business press points to the spread of the crisis throughout the eurozone, and specifically the potential for major bank bailouts and write-downs in Spain.

This past weekend, the Bank of Spain took over the operations of CajaSur, a savings bank run by the Catholic Church in Cordoba, in southern Spain. The bank, which lost €596 million in 2009, was undone by the collapse in construction and property values. It had some €2.2 billion in outstanding bad loans, according to reports.

The bank is relatively small, but investors fear that its condition is symptomatic of broader problems in the Spanish banking system. Four other savings banks reported a merger, under pressure from the government in Madrid, which has given the "cajas" until the end of June to apply for help from a rescue fund.

In a note May 24, Santiago Lopez, an analyst at Credit Suisse Group AG, commented that the seizure of CajaSur "may raise concerns for the financial system, for the sovereign risk profile and for the economy in general."

The Wall Street Journal cited the remarks of Hans Redeker, chief currencies analyst at French bank BNP Paribas: "This is not about Greece any more… It's about the European currency union and how it's kept together."

The New York Times quoted the global head of currency strategy for Brown Brothers Harriman & Company, Marc Chandler, to the same effect. Chandler wrote in a note, "If there was a doubt about it, there isn't any more… The European debt crisis is not simply a Greek phenomenon." Ben Potter at IG Markets referred to concerns "that European banks—notably those in Spain—may be staring into something of an abyss."

The sharp rise in the three-month London Interbank Offered Rate (Libor), an interbank lending rate, which climbed Tuesday for the 11th consecutive day to a 10-month high, provoked particular concern. The Spanish banking failure has apparently deepened fears that financial institutions will begin, once more, to doubt each other's creditworthiness.

Commented Andrew Willis in the Globe & Mail, "In the wake of CajaSur's failure, the cost of interbank loans is rising. This feels very much like the credit crunch of 2007, when financial institutions simply stopped trusting one another, and borrowing costs soared."

Various commentators pointed to the possibility that the so-called 'economic recovery' was in danger of faltering. Arnab Das, an associate of economist Nouriel Roubini, suggested that "there is a chance of a double dip in Europe, and in the US the risk is that growth will falter."

"Greece is the tip of the iceberg," Das told CNBC Monday. "There is now a major risk of contagion towards countries like Spain and even the UK is highly indebted. Austerity measures will force growth lower, this will hit corporate profitability."

In the face of the crisis, the universal response of governments and international financial institutions is to demand that the working population pay the cost through the destruction of jobs, living standards and social programs.

The International Monetary Fund in its May 24 report insisted that “Spain’s economy needs far-reaching and comprehensive reforms.” In the name of “increased competitiveness and employment,” the IMF is demanding the dismantling of the welfare state and an end to “inflexible” labor practices.

The US-dominated organization insists that a “radical overhaul of the labor market is urgent,” and argues for changes in the “wage bargaining system, which [currently] hamstrings wage and firms’ flexibility,” for “lowering severance payments to at least EU average levels,” for “boosting wage flexibility and employment,” and so on.

The report praises the Zapatero government for its recent fiscal package, which takes “concrete and bold measures, such as cutting public sector wages.” It also calls for “bold pension reform,” such as “raising the retirement age to 67.”

In the US, leading figures are issuing similar warnings and threats. Former Federal Reserve Chairman Paul Volcker, who is a special adviser to Barack Obama, told an audience May 18 that time was “growing short” to tackle America’s fiscal woes.

“Little has happened to allay my concerns” raised five years ago, said Volcker, chairman of the president’s Economic Recovery Advisory Board, that “dangerous and intractable” problems were arising in the US.

He clarified what he meant by “dangerous and intractable” problems during the dinner at the Stanford Institute for Economic Policy Research in California. “There are serious questions, most immediately about the sustainability of our commitment to growing entitlement programs.”

Volcker urged the US political establishment to adopt “the same sense of urgency” as European governments now implementing austerity measures.

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