# Next Wave of Banking Crisis to come from Eastern Europe

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*European banks face an entirely new wave of losses in coming months not yet calculated in any government bank rescue aid to date. Unlike the losses of US banks which derive initially from their exposures to low-quality sub-prime real estate and other securitized lending, the problems of western European banks, most especially in Austria, Sweden and perhaps Switzerland arise from the massive volumes of loans they made during the 2002-2007 period of extreme low international interest rates to clients in eastern European countries.*

The problems in Eastern Europe which are just now emerging with full force are, if you will, an indirect consequence of the libertine monetary policies of the Greenspan Fed from 2002 until 2006, the period where Wall Street's asset backed securitization Ponzi Scheme took off.

The riskiness of these eastern European loans is now coming to light as the global economic recession in both east and west Europe is forcing western banks to pull back, refusing to renew loans or 'rollover' the credits, leaving thousands of borrowers with unpayable loan debts. The dimension of the eastern European emerging loan crisis pales anything yet realized. It will force a radical new look at the entire question of bank nationalizations in coming weeks regardless what nice hopes politicians in any party entertain.

Moody's Rating Service has just announced it 'might' downgrade a number of western European banks with large exposures to eastern Europe. On the report, the Euro fell to 2 and a half month lows against the dollar.

The Moodys report mentioned especially banks in eastern Europe owned by western European banks including specifically Raiffeisen Zenetralbank Oesterreich and Sweden's Swedbank. The public Moody's warning will now force western banks with subsidiaries in eastern Europe to dramatically tighten lending conditions in the east at just the time the opposite is needed to keep economic growth from collapsing and thereby setting off chair-reaction loan defaults. The western banks are caught in a devil's circle.

According to my well-informed City of London sources, the new concerns over bank exposures to eastern Europe will define the next wave of the global financial crisis, one they believe could be even more devastating than the US sub-prime securitization collapse which triggered the entire crisis of confidence.

As a result of the Moody's warning, west European banks will now likely be selective in supporting their subsidiaries. Moody's report noted that 'banks in countries that are associated with higher systemic risks might face reduced support.' Western European governments may also establish rules to ensure banks receiving state support are forbidden to aid foreign subsidiaries. This is already the case with Greek banks and the Greek

Government. The result is to make a bad situation far worse.

**The size of risks are staggering**

The amount of loans potentially at risk involve mostly Italian, Austrian, Swiss, Swedish and it is believed German banks. Once the countries of the former Soviet Union and Warsaw Pact declared independence in the early 1990's west European banks rushed in to buy on the cheap the major banks in most of the newly independent east countries. As US interest rate cuts after the stock crisis in 2002 pushed interest rates around the world to new lows, easy credit led to higher risk lending across borders in foreign currencies. In countries such as Hungary Swiss and Austrian banks promoted home mortgage loans denominated in Swiss Franc where interest rates were significantly lower. The only risk at the time was if the Hungarian currency were to devalue, forcing homeowners in Hungary to repay sometimes double the monthly amount in Swiss Francs. That is what has happened over the past 18 months as western banks and funds have dramatically reduced their speculative investments in eastern countries to repatriate capital back home where the mother banks had serious problems caused by the US banking catastrophe. In the case of the Polish Zloty, the currency has dropped in recent months by 50%. The volume of mortgages existing in foreign currencies in Poland is not known but London estimates are that it could be huge.

In the case of Austrian banks, the country faces a rerun of the 1931 Vienna Creditanstalt crisis which in chain-reaction spread to the German banks and brought Continental Europe into the economic crisis of 1931-33. At the recent EU Finance Ministers' meeting in Brussels, Austrian Finance Minister Josef Pröll reportedly pleaded with his colleagues to come up with a €150 billion rescue package for the banks in eastern Europe. Austrian banks alone have lent €230 billion there, equivalent to 70% of Austria's GDP. Austria's largest bank, Bank Austria, which in turn is owned by Italy's Unicredito along with the German HypoVereinsbank, faces what the Vienna press calls a 'monetary Stalingrad' over its loan exposure in the east. In a botter historic irony, Bank Austria bought the Vienna Creditanstalt in recent years in its wave of mergers.

According to estimates published in the Vienna financial press, were only 10% of the Austrian loans in the east to default in coming months, it 'would lead to the collapse of the Austrian financial system.' The EU's European Bank for Reconstruction and Development (EBRD) in London estimates that bad debts in the east will exceed 10% and 'may reach 20%.'

German Finance Minister Peer Steinbrück reportedly flatly rejected any EU rescue funds for the east, claiming it was not Germany's problem. He may soon regret that as the crisis spreads to German banks and results in far greater costs to German taxpayers. One of the most striking aspects of the present crisis which first erupted in summer of 2007 is the increasingly evident incompetence of leading finance ministers and central bankers from Washington to Brussels to Paris and Frankfurt and Berlin to deal resolutely with the crisis.

The London office of US investment bank, Morgan Stanley has issued a report estimating the total of western European bank lending to the east. According to the report Eastern Europe has borrowed a total of more than $1.7 TRILLION abroad from mainly west European banks. Much of that has been short-term borrowing of less than a year. In 2009 eastern countries must repay or roll-over (renew) some $400 billion, fully 33% of the region's total GDP. As global recession deepens the chances of that are fading by the day. Now western banks are refusing to roll-over such loans, under political pressure and financial pressure back home. The credit window in the east, only two years ago the source of booming profits for the west European banks, have now slammed shut.

Even Russia which a year ago had more than $600 billion foreign exchange reserves, is in a difficult situation. Russian large companies must repay or roll-over $500 billion this year. Russia has bled 36pc of its foreign reserves since August defending the rouble.

In Poland, 60% of all mortgages are in Swiss francs. The Polish zloty has just fallen in half against the Swiss franc. Hungary, the Balkans, the Baltics, and Ukraine are all suffering variants of this same story. As an act of collective folly – by lenders and borrowers – it matches America's sub-prime debacle. This crisis, for European banks comes atop their losses in US real estate securities. In is the next wave of the crisis that is about to hit. Almost all East bloc debts are owed to West Europe, especially Austrian, Swedish, Greek, Italian, and Belgian banks. Europeans account for an astonishing 74% of the entire $4.9 trillion portfolio of loans to emerging markets. They are five times more exposed to this latest crisis than American or Japanese banks, and they are 50pc more leveraged according to the IMF.

Whether it takes months, or just weeks, Europe's financial system now faces a major test and the situation is complicated by the fact that when the rules of the European Central Bank were finalized in the late 1990's, governments could not agree to surrender total national central banking powers to the new ECB. As a result, in this first test of the ECB in a systemic crisis, the bank is unable to act in the same manner as say the Federal Reserve and fiull the role of lender of last resort or to flood the markets with emergency stimulus.

By some estimates the European Central Bank already needs to cut rates to zero and then purchase bonds and Pfandbriefe on a huge scale. It is constrained by geopolitics – a German-Dutch veto – and the Maastricht Treaty. The EBRD estimates that eastern Europe needs at least €400bn in help to cover loans and prop up the credit system.

Europe's governments are making matters worse. Some are pressuring their banks to pull back, undercutting subsidiaries in East Europe. Athens has ordered Greek banks to pull out of the Balkans. The sums needed are beyond the limits of the IMF, which has already bailed out Hungary, Ukraine, Latvia, Belarus, Iceland, and Pakistan – and Turkey next – and is fast exhausting its own €155bn reserve, forcing it to sell its gold reserves to raise cash.

The recent IMF $16bn rescue of Ukraine has unravelled. The country – facing a 12pc contraction in GDP after the collapse of steel prices – is going towards default, leaving Unicredit, Raffeisen and ING facing disaster. Latvia's central bank governor has declared his economy "clinically dead" after it shrank 10.5pc in the fourth quarter. Protesters have smashed the treasury and stormed parliament.

Perhaps most alarming is that 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.

Clear at present is that for small-minded political reasons, Berlin is not going to rescue Ireland, Spain, Greece and Portugal as the collapse of their credit bubbles leads to rising defaults, or rescue Italy by accepting plans for EU 'union bonds' should the debt markets boycott Italy's exploding public debt, hitting 112% of GDP next year, just revised up from

101%.

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