Stage Two of Europe's Credit Crisis: An Internal Bank and Sovereign Debt Crisis Combined

By Bob Chapman
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The crisis affecting Europe is nothing new. It goes back three years and the beginning of the credit crisis, 60% of the subprime CDOs, collateralized debt obligations, had been sold to European institutions. These were the mortgage bonds, which contained a variety of toxic waste, which the rating agencies, S&P, Moody's and Fitch, in collusion with banks and brokerage houses, had sold as AAA bonds, when in fact their ratings should have been considerably lower. The holders of these bonds in many instances became insolvent and had to be bailed out by capital injections from central banks, most of the funds were lent by the Federal Reserve.

These debt problems, as in the US, have never been resolved. Those companies and institutions have over the past three years been allowed to keep two sets of books.

Six months ago the Greek crisis arose adding another financial and economic problem not only for Greece, but also for four other euro zone members and their debt holders, namely banks and other sovereign debt holders.

You might say the current additional crisis was frosting on the cake, because unbeknownst to most, Europe has never emerged from its original crisis. We have now an internal bank and sovereign debt crisis combined. What is of passing interest is that the raters and sellers of the toxic waste, that started all this, have never been prosecuted nor pursued civilly.

European banks a year ago used a temporary ECB loan facility funded by more than $500 billion, which was in part funded by the Federal Reserve and has been due for the past two weeks. Needless to say, the introduction of the Greek crisis and the recognition of the problems in Portugal, Ireland, Italy and Spain have put European banking into a very compromised position. If the ECB liquidity is removed very simply the bottom could fall out. This is still a severe crisis with no solution in sight. What we have is crisis upon crisis caused in part by the US subprime crisis, but also the result of European credit expansion that began ten years ago and structural problems caused by one interest rate fits all within the euro zone. The cost of money fell during the past ten years due to perceived safety and guarantee that all euro zone debt would be equal to the quality of German debt. It did not work out that way and as it turned out Germany in varying degrees ended up carrying all the other members, especially when it came to balance of payments deficits.

In last weeks missive we cited the end of the one-year loan program for refinancing on July 1st. That now has been replaced by another facility. The new loans of $166 billion for three months and a $140 billion six-day facility and numerous other offerings now replace the original facility. The original one-year facility was for $557 billion. If you total the 3-month increments for a year at least $664 billion is available, plus the other goodies. The bottom line is more and more money is being lent into a failing system.

ECB President Jean-Claude Trichet in last week's press conference would not give any details on the current "stress test," but did say results would be published on July 23rd. He says there will be no quantitative easing, due to 1% interest rates. We wonder what he calls loans of $664 billion plus? This does not improve bank capitalization – it masks the lack of adequate capitalization and says nothing of their two sets of books.

Lenders under the ECB rule, one interest rate fits all, must have lost their sanity. In Spain in 2006, 700,000 homes were built, that was more than in the UK, France and Germany combined. Part of this was social engineering. A good many of them were for cheap housing for Latin American migrant workers. Today official unemployment is 21% and savings banks own almost 60% of all mortgages.

The availability of cheap money allowed banks to search for new markets. They had no compunction in making loans, because of the euro zone guarantee. It wasn't long before they were making many subprime loans and they were in way over their heads, especially in Eastern Europe.

Such strong guarantees and low profit margins tempted German banks and savings banks to use derivatives and to buy US CDOs, and other toxic assets.

No one thought about demographics and resale as the European birthrate collapsed.

There is much consternation over issuing bank interest rates in the interbank circuit. The secret is banks again do not want to lend to each other, because they do not trust each other. This is the wholesale money market known as LIBOR. The ECB has stepped in to augment lending, but the solution is to only temporary lend. If confidence doesn't return rates could shoot back up to near 5%. Last time the Fed came to the rescue, and it may end up that way again.

Contrary to what the IMF's experts think global growth is about to take another swan dive and all banks with problems won't be able to grow out of their problem. Making matters worse the clock is ticking. It is very obvious European banks are in serious trouble. Over the past year, if you add up all the loans received from the ECB, the total was $1.15 trillion.

In order to roll these loans and expand profits these institutions and the total economies have to have growth and that won't happen unless there is more quantitative easing, both in Europe as well as in the US and the UK.

We don't know how they expect to accomplish this in Europe under austerity programs. Remember as well that the euro zone consists of 16 members and the EU has 27 members of which the 16 are part of. Efforts are being made to coordinate another European centralized bank regulator, which to us is the antithesis of what is needed. The ECB wasn't able to prevent the fiasco of the past several years, so what makes the bureaucrats in Brussels and Frankfurt think a centralized regulator will work? Here we are back to more centralization. Europe has a banking crisis just like the UK and US have. They might consider fixing that first. Throwing temporary funds at insolvent institutions is not the answer. In the meantime banks still do not want to lend to each other and except for AAA companies they are reluctant to lend at all. The same syndrome is prevalent in the US, where business loans to small and medium sized businesses are off over 25%. This is a waiting game to see who goes under first. In addition, these banks, state banks, have issued $3.78 trillion in state debt. In order to pay back such loans governments have to reduce spending, which, of course, curtails growth. In socialist Europe governments make up a large part of overall spending.

We believe the austerity program will work long term, but in the interim Europe not only faces a giant debt to service, but also could easily fall into depression. If this happens the profits needed to help banks recover won't be there. The bottom line is Europe's banks, like those in the US and UK, are in a box and they cannot get out. Almost all of them are insolvent and no matter what they do there is no easy way out. Now you can understand why another war is being prepared. It is to be a major distraction from these terrible economic and financial problems.

If Europe thinks for one second that devaluing the euro deliberately is going to solve their problems they are mistaken. Their goods may be 15% cheaper, but if other economies are in a tailspin, they are not going to be able to be buyers. The US and the UK are good examples.

The ECB has been progressively facilitating the purchase of state bonds to cut budget deficits, which is really no solution to the problem. The big floaters of these bonds have been those in the deepest of trouble, who cannot pay the interest and principal. Again, European banks that are insolvent continue to create money out of thin air as all within the fractional banking system do. The easy money still flows, as again the day of reckoning is thrown into the future. Every bank in Europe is probably going under. There is no way for these debts to be repaid. The game being played in Europe is different than that being played in the US and UK, but in the end they are all going under.

Stage two of the credit crisis is well underway having been kicked off by our elitists in Wall Street, banking and Washington. You might call this blow back from the delaying tactics used over the past almost three years. As you can see, policymakers do not have things under control. Greece is failing and the exposure of the other PIIGS brought a new dimension to the frailty of the world financial system.

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