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The Credit Crisis Rages On; What caused Stock Markets to Plunge?

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Global Research, August 07, 2011
7 August 2011

Region: Europe
Theme: Global Economy

What caused global markets to plunge on Thursday?

Was it poor economic data in the US; the sudden slowdown in manufacturing, declining consumer spending, shrinking GDP and ongoing troubles in the housing market?

No. While the prospect of a double dip recession has pushed shares down for two weeks, Thursday's crash was all about Europe.

ECB chief Jean Claude Trichet touched-off a panic when he announced the Central Bank would resume its purchases of Irish and Portuguese debt, but made no indication that he'd buy bonds from struggling Italy and Spain. (Italy's 10-year sovereign bond has soared to over 6 percent in recent days signally deepening distress.) Investors took Trichet's announcement to mean that the ECB would not backstop the world's 3rd largest bond market (Italy), so bond yields would continue to go higher while banks throughout the EU would suffer devastating losses. That set off a firestorm in the bond market that quickly spread into equities sending global markets into a nosedive and wiping out $4.4 trillion in capital.

So, what does it all mean?

It means that nothing has changed since Lehman tanked 3 years ago. It means that the basic regulations that were put in place following the Great Depression have not been restored, so the financial system is just as unstable and crisis-prone as it was in 2008. We're back to Square 1. The banks are so undercapitalized that the ECB has to take emergency action to prevent a possible meltdown. Here's how the Financial Times sums it up:

> "Italy can afford to ignore rising bond yields for months. Europe's banks cannot wait. Worries about the banks, measured by the gap between euro forward rate agreements and overnight indexed swaps, are now worse than at the height of last year's panic over Greece. Eurozone bank shares were last this low in April 2009, just after the market bottomed." ("Dr Trichet's medicine leaves bitter after-taste", Financial Times)

So, Trichet's bond purchasing program is actually another bank bailout. But that's not how the media describes it. According to the MSM, this is a "debt crisis", as though the source of the trouble remains unknown. But it is known; the problem is the banks. The banks are 100% responsible. Here's a little background from an article titled "Euro Debt Crisis: Banks exposures to Italian bonds":

"European banks (including UK banks) holds EUR 167 bn of Italian bonds (mainly in France – 74 bn – and Germany – 39 bn). Italian banks and insurers holds 245 bn of public debt. Is we take all into account (insurers, asset managers…), the foreign exposures to the Italian public debt is close to 806 bn.

Economic Impacts

With Italy under fire, the crisis is moving from a relatively small and manageable problem to a potential financial disaster. If the value of the bonds continues to fall (spreads to widen), the losses for banks could soon become huge. The first one to suffer will be Italians. In this case, you have to take into account claims over local banks. Consequently, the foreign exposure climbs to more than EUR 250 bn, with an heavy weight for the French (close to 100 bn) and German banks (75 bn)." ("Euro Debt Crisis: Banks exposures to Italian bonds", Gecodia.com)

Okay; so if Trichet doesn't buy tens of billions in Italian bonds on the secondary market, then banks in Germany and France will lose tons of money and possibly end up in the ditch. That would trigger another global crisis, which has to be avoided at all cost, right? So the ECB has decided to load up on dodgy bonds in order to keep their prices artificially high sparing the banks any losses on their bad investments. Does that sound fair? That's been the pattern since Sept 15 2008 and it continues to today. The banks are not allowed to lose money.

Think of it like this: Let's say Joe Blow bought a house in 2005 for $400,000 believing the hype that "Housing prices can only go up". But by 2008, Mr Blow is underwater because housing prices have dipped and his house is only worth $300,000. Even worse, he has to put his house on the market fast because he just lost his job. So Blow is forced to sell his house for $300,000 and take a $100,000 loss. That's the way capitalism is supposed to work, right?

But the rules don't apply to the banks. If they win, they keep the profits. And if they lose, they get a bailout. And, of course, all of this has terrible consequences for the real economy because diverting capital into failing financial institutions (that should be restructured) constricts growth and productivity. It's no coincidence that the massive bank bailouts have been accompanied by belt-tightening measures that have pushed the broader economy to the brink of another recession. Propping up toxic assets–so they appear to be worth more than they really are– is a costly business that results in chronic high unemployment, flagging demand, and slow growth. Until the banks are restructured and their debts are written down, prosperity will remain elusive. This is from an article in The Economist:

"Concerns over bank funding are on the rise, as European banks in particular find it difficult to get hold of short-term funding. Analysts are keeping a close eye on the Euribor-OIS spread, which, in effect, measures how nervous European banks are about lending money to each other: that gauge is widening again. The amount of cash that euro-area banks deposited with the European Central Bank (which means, of course, that it is not being lent out to other banks) hit a six-month high this week.

Across the Atlantic, investors withdrew $66 billion from money-market funds in the week ending August 3rd, according to data from Lipper, a research firm. That is the second-largest net outflow on record…..money-market funds are pushing down hard on maturities.

One European bank boss said privately this week that he had never seen risk aversion this intense.

In response the ECB announced yesterday that it was reintroducing six-month unlimited funding to banks that wanted it, up from three-month loans currently." ("High Anxiety", The Economist)

Get the picture? We're at the beginning of a full-blown banking crisis. The banks are hoarding cash overnight at the ECB, money markets are seeing heavy withdrawals, gauges of market stress are elevated, and interbank lending is starting to sputter. If liquidity freezes up; it's "Game Over". The EU financial system will grind to a standstill and the global economy will go into freefall. That's why Trichet stepped in despite objections from German members of the ECB's governing council. It was the only way he could head off another catastrophe.

But the troubles are far from over. As Italian and Spanish bonds lose value, the capital cushion for German and French banks will get thinner and thinner. That will make funding more difficult in their repo operations (repurchase agreement) because the bonds they had been using as collateral, will have taken a haircut. When Trichet buys Italian or Spanish bonds, he is, in effect, providing a subsidy to the banks (by pushing down yields) and then charging it to workers who have to bear the brunt of savage austerity measures to make up the difference. This has nothing to do with free market capitalism. It's a straightforward transfer of wealth from one class to another. It's highway robbery.

Bottom line: The credit crisis rages on. The financial markets have not been reconfigured to reduce risk nor have the banks raised sufficient capital to withstand losses on their bad assets. The effort to regulate the system post-Lehman has mostly failed. More important, Big Finance now controls the policy levers on both sides of the Atlantic, which is why the EU and US are headed for a protracted period of economic stagnation, high unemployment and civil unrest.

Blame the banks.

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