The Eurozone Crackup

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> "We believe that the market has now entered a major downtrend. It is a mistake to dismiss the slide we've seen to date as mindless and devoid of fundamentals as many strategists maintain. These are not just scary headlines—-they are scary fundamentals…. There will undoubtedly be some more sharp rallies that will be interpreted as new bull markets. In our view, however, the bear market has only begun, and has a long way to go."
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> — Comstock Partners, "Bear Market Rally Far From Over", Pragmatic Capitalism

A toxic combo of poor economic data in the US and a widening credit crunch in the eurozone has sent stocks plunging for a 4th consecutive week. On Friday, the Dow Jones Industrials fell 172 points as jittery investors exited equities for the safe haven of cash and government debt. Global equities have lost more than $6 trillion in the last month alone while the yield on the benchmark 10-year Treasury dropped to a record 1.99 per cent on Thursday. The low yields on Treasuries indicate the growing fear that troubles in the EU are reaching a crisis-phase. Political gridlock has increased volatility and triggered a slow-motion run on the EU banking system. The same process unfolded in the US for a full year before Lehman Brothers collapsed (from July 2007 to Sept 2008) putting the financial system into a death-spiral. Now it's Europe's turn. This is from the Wall Street Journal:

"A dramatic sell-off in European financial markets on Thursday renewed fears that Europe's banks are too weak to withstand the Continent's debt crisis, increasing the chances that the region's leaders will be forced to pursue radical steps toward fiscal union in order to preserve their single currency….

"That realization has in recent days prompted Germany, the region's economic powerhouse and an opponent of fiscal union, to reconsider proposals that would force it to accept responsibility for the debts of its neighbors. Thursday's markets rout, the worst in Europe in more than two years, suggests Berlin and Paris may have to act quickly. If investors lose confidence in the region's banks, Europe's financial system could seize up, tipping the euro zone into another recession." (" Renewed Fears Europe's Banks Too Weak To Withstand Debt Crisis", Wall Street Journal)

The situation is progressively getting worse. Money markets, commercial paper and the repo markets–where banks get their funding–are all under pressure. The time to act is now, but EU leaders remain frozen in the headlights.

The only way to save the 17-member monetary union is through greater integration, that means a central fiscal authority that can help to level the playing field between the richer and poorer countries. But many of the countries–particularly Germany–do not want to create a fiscally viable EU because it would require them to subsidize the weaker states via eurobonds which they oppose. And, there's the rub; without Germany on board, the banks will be forced to write down the losses on the bonds they hold, which will erode their capital and spark another credit crisis.

Presently, the ECB is purchasing the sovereign debt of countries in the south to prevent a freeze in the credit markets. But the ECB is operating on an emergency-only basis and does not have the institutional authority to implement the same policies in normal times. This band-aid approach has investors worried, which is why they continue to move money out of money markets to deposit accounts or risk-free assets like US Treasuries.

Last week's Merkel-Sarkozy Summit ignited a stock market selloff when the two EU leaders failed to agree to a course of action. Both heads-of-state rejected the idea of eurobonds which would have resolved the main issue and calmed the markets. Instead, they pushed for more half-measures which merely forestall the eventual day of reckoning. Here's an excerpt from Der Spiegel:

"….the two leaders are rejecting demands for two other proposed measures, including increasing the volume of the €440 billion ($634 billion) euro rescue fund and issuing so-called "euro bonds" common to all euro-zone countries…..

"Merkel and Sarkozy have … marked out the limit of what is currently possible in the European Union without violating (the Lisbon Treaty). … But even the proposed economic government doesn't really offer much — just as has happened with all the previous efforts aimed at coordinating the economic policies of (EU) member states. That's because it is non-binding, and that hasn't worked yet."…
("Merkel-Sarkozy Plan Already on Shaky Footing", Der Spiegel)

Domestic politics make it impossible for Merkel to agree to the concessions that are needed to strengthen fiscal unity. That's why the markets are in a frenzy, because the eurozone–in its present configuration– is doomed and investors know it. But how will that effect the EU banking system which is loaded with sovereign bonds from the weaker states? Will the massive haircuts and billions in losses lead to another meltdown?

Austerity measures have accelerated debt-deflation dynamics in the PIGS (Portugal, Italy, Greece, Spain) and increased their ballooning deficits. Struggling countries with high unemployment need fiscal stimulus and pro-growth policies that increase spending and boost revenues. Unfortunately, officials at the ECB and IMF see things differently. They believe that years of agonizing belt-tightening and social unrest will lead to prosperity; that contraction will lead to expansion. It's madness. Slashing spending in Greece, Portugal, Italy, and Ireland, has done what many economists predicted from the very beginning, it's looped back to Germany precipitating a sharp dropoff in GDP. Here's a clip from Tuesday's Financial Times:

"German economic growth slowed to a near standstill in the second quarter of this year, dealing a further, unexpected blow to the crisis-hit eurozone.

The surprisingly-sharp deceleration in activity in Europe's largest economy hit overall eurozone growth and intensified fears about the global slowdown. It also threatened to complicate the challenge facing the region's policymakers as they seek to combat its escalating debt crisis." ("Germany adds to eurozone's woes", Financial Times)

So, now the contagion has spread from the perimeter to the core pushing the eurozone back into recession and, most likely, another financial crisis. Bad ideas have consequences. The EU is headed for a hard landing followed by years of high unemployment and stagnation.

The situation is more serious than it's being portrayed in the media. This looks like the beginning of a full-blown credit freeze. Here's an excerpt from an article in IFR:

"Options are rapidly running out for Europe's ailing mid-tier banks as nervous creditors pull the plug on once-vital sources of funding in response to growing sovereign contagion worries, sowing the seeds of an imminent liquidity crisis at the heart of the eurozone.

With bond markets shut and investors unwilling to buy asset-backed securities, the repo market – for some banks the sole remaining source of private funding – has become the most recent tap to run dry, with some investment banks pulling credit lines worth tens of billions of euros in recent weeks…("Credit taps run dry for European bank", International Finance Review)

So, the extreme volatility we've seen recently in the stock markets has more to do with deteriorating conditions in the credit markets than it does with the more generalized slowdown in economic activity. When the credit markets begin to tighten, the entire financial system begins to teeter; which is why the bank funding markets are blinking red, because investors see that policymakers are hamstrung and won't take the steps necessary to fix the flaws in the system. That's why the bank run continues apace. Here's an excerpt from Thursday's Wall Street Journal:

"The Federal Reserve Bank of New York, which oversees the U.S. operations of many large European banks, recently has been holding extensive meetings with the lenders to gauge their vulnerability to escalating financial pressures. The Fed is demanding more information from the banks about whether they have reliable access to the funds needed to operate on a day-to-day basis in the U.S. and, in some cases, pushing the banks to overhaul their U.S. structures, the people familiar with the matter say.

Officials at the New York Fed "are very concerned" about European banks facing funding difficulties in the U.S., said a senior executive at a major European bank who has participated in the talks.

Regulators are seeking to avoid a repeat of the 2008 financial crisis, when the global financial system began to seize up. This time the worry is that the euro-zone debt crisis could eventually hinder the ability of European banks to fund loans and meet other financial obligations in the U.S. While signs of stress are bubbling up, the problems aren't yet approaching the severity of past crises." ("Fed eyes EU banks", Wall Street Journal)

Get the picture? The markets are so interconnected that a meltdown in the EU will take down banks and financial institutions in the US simultaneously. And the EU doesn't have an institution like the Fed that can breezily write a blank check covering the whole system. If there's a large-scale bank run, the house of cards will fall and the economy will crumble.

This is from the IFR again:

"According to the European Banking Authority, the region's banks have €4.8trn of wholesale and interbank funding expiring this year and next….

The closure of traditional credit lines is a clear sign that concern about European sovereign debt has infected the region's banks. Many in the region are big holders of the debt of their respective governments. According to the EBA stress tests published in July, the 90 banks it surveyed held a total of €326bn in Italian government debt, €287bn of Spanish public debt, and €215bn of French debt.

"Everyone has been cutting their exposure," said the head of another European investment bank. "It started with Greece, then Spain and now Italy. People don't want to do business with these banks. Many of them have good underlying businesses, but they are stuffed." ("Credit taps run dry for European bank", International Finance Review)

It's deja vu all over again; the fear, the downgrades, the denials, and finally, the crash. Last Thursday, an unidentified European bank was unable to get funding the traditional way and had to turn to the ECB for $500 million of emergency funding. The news sent tremors through Wall Street where stocks went into an immediate 400 point nosedive. We've seen this movie before in 2008, and it doesn't end well.

Funding costs are rising for EU banks and interbank lending is beginning to slow. The spreads on credit default swaps for sovereign bonds continue to get wider while in the last 7 weeks $420 billion has been transferred into low-interest government insured bank deposits. More banks are depositing money overnight with the ECB rather than with other banks.

What does it all mean?

It means the system is under great stress and beginning to slow down. It means investors have lost faith in the ability of policymakers to fix the system. It means there's a panic underway and people are moving into cash. It means the eurozone is headed for a crackup. It means we are on the brink of another financial crisis.

"As the former European Commission chief Jacques Delors said on Thursday, "Open your eyes: the euro and Europe are on the edge of the precipice."