

How Many European Banks Are Insolvent?

Is the European banking system solvent? How many European banks are insolvent? If one marks to market the value of all the assets of each European bank, how many would remain solvent? The volatility of 5 year French government bonds is over 6%. The volatility of 5 year Italian government bonds is over 15%. The risk free treatment of sovereign bonds on bank balance sheets is no longer adequate. Any rational analysis of European bank balance sheets must conclude that the minimum capital requirements under Basel 3 would place most banks at the brink of insolvency if not beyond it. Money market liquidity has dried up and if not for the significant credit offered to the banks by the ECB, Libor OIS spreads would be far wider than they are today. But liquidity is only one issue. Solvency is a separate issue which Europe's banks face today. It is not clear how much longer the current situation can continue. Europe needs to find several trillion Euro, estimates range from 1 to 5, and some wilder ones even more. A 2.5 trillion Euro estimate seems reasonable for a back of envelope calculation. It has to find this somehow, by borrowing it from someone, expropriating it from someone, or by printing it from thin air, but it needs to find this money now.

The ECB understands the scale of the problem and it is only a matter of time before they will be forced, hopefully before but more probably after a significant bank runs aground.

Debt monetization is not ideal and it looks as if the market has forced the ECB to do the wrong thing, by making it the right thing to do. If they do do it, the long term implications for fiscal restraint and price stability will be threatened. If they don't do it, a number of banks will be forced into state ownership. But given the Eurozone's unique structure, how will taxpayers pay for the nationalizations? Even these will be no more than sleight of hand until inflation, hopefully not of the hyper variety erodes the value of debt.