Failure to save East Europe will lead to worldwide meltdown

The unfolding debt drama in Russia, Ukraine, and the EU states of Eastern Europe has reached acute danger point.

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If mishandled by the world policy establishment, this debacle is big enough to shatter the fragile banking systems of Western Europe and set off round two of our financial Götterdämmerung.

Austria's finance minister Josef Pröll made frantic efforts last week to put together a €150bn rescue for the ex-Soviet bloc. Well he might. His banks have lent €230bn to the region, equal to 70pc of Austria's GDP.

"A failure rate of 10pc would lead to the collapse of the Austrian financial sector," reported Der Standard in Vienna. Unfortunately, that is about to happen.

The European Bank for Reconstruction and Development (EBRD) says bad debts will top 10pc and may reach 20pc. The Vienna press said Bank Austria and its Italian owner Unicredit face a "monetary Stalingrad" in the East.

Mr Pröll tried to drum up support for his rescue package from EU finance ministers in Brussels last week. The idea was scotched by Germany's Peer Steinbrück. Not our problem, he said. We'll see about that.

Stephen Jen, currency chief at Morgan Stanley, said Eastern Europe has borrowed $1.7 trillion abroad, much on short-term maturities. It must repay – or roll over – $400bn this year, equal to a third of the region's GDP. Good luck. The credit window has slammed shut.

Not even Russia can easily cover the $500bn dollar debts of its oligarchs while oil remains near $33 a barrel. The budget is based on Urals crude at $95. Russia has bled 36pc of its foreign reserves since August defending the rouble.

"This is the largest run on a currency in history," said Mr Jen.

In Poland, 60pc of mortgages are in Swiss francs. The zloty has just halved against the franc. Hungary, the Balkans, the Baltics, and Ukraine are all suffering variants of this story. As an act of collective folly – by lenders and borrowers – it matches America's sub-prime debacle. There is a crucial difference, however. European banks are on the hook for both. US banks are not.

Almost all East bloc debts are owed to West Europe, especially Austrian, Swedish, Greek, Italian, and Belgian banks. En plus, Europeans account for an astonishing 74pc of the entire $4.9 trillion portfolio of loans to emerging markets.

They are five times more exposed to this latest bust than American or Japanese banks, and they are 50pc more leveraged (IMF data).

Spain is up to its neck in Latin America, which has belatedly joined the slump (Mexico's car output fell 51pc in January, and Brazil lost 650,000 jobs in one month). Britain and Switzerland are up to their necks in Asia.

Whether it takes months, or just weeks, the world is going to discover that Europe's financial system is sunk, and that there is no EU Federal Reserve yet ready to act as a lender of last resort or to flood the markets with emergency stimulus.

Under a "Taylor Rule" analysis, 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.

But I digress. It is East Europe that is blowing up right now. Erik Berglof, EBRD's chief economist, told me the region may need €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 $200bn (€155bn) reserve. We are nearing the point where the IMF may have to print money for the world, using arcane powers to issue Special Drawing Rights.

Its $16bn rescue of Ukraine has unravelled. The country – facing a 12pc contraction in GDP after the collapse of steel prices – is hurtling towards default, leaving Unicredit, Raffeisen and ING in the lurch. Pakistan wants another $7.6bn. 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.

"This is much worse than the East Asia crisis in the 1990s," said Lars Christensen, at Danske Bank.

"There are accidents waiting to happen across the region, but 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."

Europe is already in deeper trouble than the ECB or EU leaders ever expected. Germany contracted at an annual rate of 8.4pc in the fourth quarter.

If Deutsche Bank is correct, the economy will have shrunk by nearly 9pc before the end of this year. This is the sort of level that stokes popular revolt.

The implications are obvious. 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 take fright at the rocketing trajectory of Italy's public debt (hitting 112pc of GDP next year, just revised up from 101pc – big change), or rescue Austria from its Habsburg adventurism.

So we watch and wait as the lethal brush fires move closer.

If one spark jumps across the eurozone line, we will have global systemic crisis within days. Are the firemen ready?

http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/4623525/Failure-to-save-East-Europe-will-lead-to-worldwide-meltdown.html