

The Looming European Banking Crisis

Ross Welcome to Renegade Inc. For many years, all European banks have been in poor shape. The Corona pandemic has merely exposed the glaring fault lines of some of the world's most clunky and inefficient banking systems. The question we should all be asking is, after the bailouts of 2008, are we all now prepared for the European bail 'ins' of the 2020s?

Ross Alex Krainer, great to have you here on Renegade Inc.

Alex Krainer .Many thanks for having me, Ross.

Ross Is there an upcoming European banking crisis?

Alex Krainer Well, I have to tell you, Ross, for a good many years I was convinced that it was inevitable, that it was imminent. And it is still hasn't come. Deutsche Bank has been in terrible shape for many years since at least 2012, even since the last financial crisis. Same thing for Societe Generale, for Tesla Sao Paolo, for Royal Bank of Scotland and so forth. These banks are in a weaker shape than they were before the 2008 financial crisis. They are still around. They're still not bankrupt. And I was wondering why. And I think that finally, I suspect that they're being backstopped. I mean, that's pretty obvious. But they're being backstopped by the ECB and its various global facilities. And one thing that I remembered from growing up in the socialist world, I grew up in former Yugoslavia. Even though our economy was in terrible shape during the 1980s, we never had any banking failures. There was no banking crisis.

Ross Why is that?

Alex Krainer Well, I think the reason is because if a bank was about to go bust, the central bank, the government, just printed out the money that the bank needed to, you know, tie up its books. And so the bank continued functioning. I think we've seen this in a pretty obvious example now in the United States with the repo crisis that started sometime in September. When the repo crisis started - I don't know if it's necessary to explain this in detail - but it was obvious that one or more banks in the system were in such a bad shape that their peers would not lend them money even overnight, even though this was a very good, very easy, lucrative business for them.

Ross Right.

Alex Krainer So at the point where banks can not secure necessary funds overnight in the repo market, that's a very strong indicator that one of them is in really deep trouble, on the verge of bankruptcy, if not bankrupt, or maybe more than one of them. So what happened is that the Fed stepped in and started a massive repo bailout programme, which is ongoing, and which with the Covid pandemic crisis, even increased from about 200 billion dollars to over a trillion and a half. I suspect that the same is happening with the European banks, that the ECB is providing them the necessary funds to continue operating, whether they're buying their bonds, whether they're giving them various credit facilities, we'll get to find out

eventually. But this thinking kind of led me to believe that maybe we will not have a banking crisis. Maybe the banks will just be bailed out to the extent necessary by the central banks.

Ross Is that possible? Because, I mean, what you're saying is QE infinity, that you just keep creating money on a digital keypad or printing it and then just keep flooding this liquidity into the system. I mean, surely at some point there's a day of reckoning?

Alex Krainer Well, yes, that's entirely possible. But let me remind you, in 2012, the Federal Reserve invited the economist Robert Wenzel to give them a speech. Basically, Robert Wenzel's message to the Federal Reserve Board of Governors was that you have two choices. Either you continue printing to no end or if you stop printing, you're gonna have a massive economic crisis on your hands. So the Federal Reserve tried to taper their quantitative easing programmes in 2018. And at the end of 2018, we had a 20 percent stock market crash and it was obvious that the economy was going to grind to a halt. And so what we saw in January 2019 was that the Federal Reserve abruptly reversed itself, ramped up quantitative easing again, the government increased their deficit spending, and then the economy went back to growth and the equity and other asset markets continued to rise. I think this was a very good case telling us that the central banks have no choice. If they stopped the QE, we're going to have a very severe economic crisis, probably a depression, the likes of which we haven't experienced, probably worse than what we had in the 1930s. So their only choice is to continue with QE and to go as far as they can. And that usually leads to high inflation. But it's either their banks fail or we have high inflation. And their banks failing is they're taking the hit, inflation is everybody else taking the hit. So I think that their choice has been clear.

Ross You made that comparison earlier about American banks and European banks. European banks get more than two thirds of their credit from the banking system. And that is a very big contrast to American firms who take less than one third of their credit from banks. Does that mean that if the European banking system does seize up, gum up, explode, whatever it might do, ultimately, the real economy is in massive trouble because those firms can't get credit lines to be able to make goods to sell?

Alex Krainer Well, I think that that's probably correct what you said. And I think that's an added reason that the central banks, the ECB specifically, does not really have a choice to taper their quantitative easing. And the one thing that has become quite clear from studying the inflation episode through history is that inflation has to always accelerate. And what I mean by that is I'm not talking about price inflation. I'm talking about monetary inflation, that meaning the central bank creating new money, then circulating it into the economy. The bulk of that is going to go to the largest corporations into banks. Less and less of that is going to provide credit for small businesses and for households. But without the large corporations staying in business, the perception is that there's going to be a very serious unemployment crisis and social problems. And so, therefore, I think that the central bankers have pretty much painted themselves into a corner. So to save banks, to save corporations, I think they have no choice but to continue quantitative easing. And I also believe that quantitative easing is larger than what they tell us. And the reason why I suspect it is because when you look at the bailouts that happened at the end of 2008, for example, in the United States, they told us that the bailouts totalled about six billion dollars, I think. Then the Government Accounting Office found that actually they provided more than 16 trillion dollars to the banking system in bailouts. And then this publication online called Wall Street On Parade tallied it up to more

than 29 trillion dollars which are insane amounts. What they tell us is that the bankers are not being transparent with us, that the data we have, and that we're of, that we read in the media is probably the tip of the iceberg of what is actually taking place.

Ross You've described it in great detail and given us some excellent insight. One question, if bankers are presiding over this slow motion train wreck, if you like, is the leadership their necessary to be able to turn this around and get Europe, specifically, out of this crisis? And who I'd really begin with, is Christine Lagarde, president of the European Central Bank. You know, the chat is always that she's a veteran of these debt crises so therefore, the best and most steady hand at the tiller. Is that true?

Alex Krainer No, I wouldn't characterise it like this. I believe that she's simply an apparatchik. She is executing the policy that is handed down to her. I don't think that she has very much discretion to decide what's going to be done or not. In spite of the fact that she's not an elected official so she doesn't have to worry about being re-elected. But I believe that the banking establishment that is in control of the situation in Europe is not individuals that we see as leaders. We have global systemically important banks which are listed by the Bank of International Settlements. I think that their stability, their business, their continuity of business, is imperative. And I think that the euro and the European political process is going to be subordinate to that. And so the policies I believe, will favour the banks and large corporations. And the political leadership - let's call it the bureaucratic leadership, because I think that it's more correct to call Christine Lagarde a bureaucrat than politician. I think that they will simply execute that plan. And the plan is simply a choice between QE or a deflationary debt spiral.

Ross You mentioned apparatchiks and the fact that you grew up under a socialist regime in the former Yugoslavia and you see great similarities between what happened there and what is currently happening across Europe. Can you tell us what those similarities are?

Alex Krainer During the socialist era in former Yugoslavia - and I was born in 1970, so essentially for as long as I can remember, we had inflation, which during the 70s was, let's say, moderate. But even I as a child noticed it, you know, the things like bread and milk cost slightly more every year. But we came to the 80s and mid 80s. And by that time, inflation rates were very, very high. As I mentioned to you, we had no unemployment. We had no banking crisis. There was no bank run. There were no long lines in front of banks because the system insulated itself against the market forces. When I say insulated, I mean quote unquote, because large state enterprises didn't have to go bankrupt. Banks didn't have to go bust. They simply received monetary emissions as needed to continue operating. I remember when I was young, my mother told me she ran a refining operation in our city or oil refining operation, and she told me that her operations team could easily do the job that they had to do with five people. But she had 16 people working her. There was no inclination on any side to make it more efficient and to let go of eleven surplus people. They continued employing 16. But the cost of this, the cost of issuing the cash, the money, to keep all these inefficient systems afloat was inflation because too much money was being circulated in the system. And so I think that this is the model that is being now copied both in the United States and in Europe and in Japan. And I think that as we see, we have something like 20 percent of all the large corporations listed in the world are now zombies who cannot even pay the interest on their on their debts, from their profits. And they're being kept alive with money emissions that they're

receiving via credit or bond purchases. And I think in this case, as in the socialist world, the price will be inflation, which means that ordinary people, people who save, people who have a pension plans, will end up bearing the cost of this.

Ross Alex, in that first half you mentioned as opposed to sorting the banking system out, actually what's happened is banks, policy makers, governments, have painted themselves into a corner and it's going to be the man, woman on the street who'll be thrown under the bus when this crisis hits. And the mechanism for throwing them under the bus is inflation. How can the average hard working wife, husband, father, mother, protect themselves from what's coming down the track?

Alex Krainer Well, I think that for the average person, it's relatively difficult. I think that when inflation accelerates, the type of assets that might offer you some degree of protection from inflation is to own a little bit of gold bullion. I'm not in the camp of stacking up and hoarding large amounts of metal, gold, silver and so forth. But I think it's just important to have enough to cover you over for several months worth of expenses. Owning a piece of land that can be converted to agricultural production is a good idea. And then generally, you know, hard assets. I would also like to point out that even though many people think that owning stocks is good protection from inflation, that's not really the case. Stocks tend to lose value in inflations and in hyperinflations, you end up with basically a total loss.

Ross And more practically, because you've seen an economic system fall apart in the former Yugoslavia, what advice or insight would you give as this system shudders to a halt?

Alex Krainer Well, I'm actually not entirely sure. You know, there are significant differences between the socialist system we had and the neoliberal system that is generally applied in most of the Anglophile Anglo American economies and increasingly in Western Europe. And the difference, which is quite critical, is that in the socialist world what happened is that the new money creation was effectively distributed from the bottom up, meaning, as I told you, large corporations kept their employees on. Companies kept their employees on. Money was printed up to be able to distribute salaries. So people had money to spend, it's just that the money was buying less and less. And I think that in the neoliberal regimes, the money is being distributed top down. And so it ends up boosting asset prices. It ends up boosting the stock markets. It ends up boosting bonds. Much less of it ends up circulating to the bottom where people actually get spending power, the purchasing power. So I think it's going to be more difficult under the neoliberal system than it was under the socialist system. But these differences are actually quite important and quite subtle. And I do think that they are worth analysing a little bit because we will need a better understanding of how the monetary system works going forward, especially because I think, as Mervyn King said, we have the worst monetary system of all possible systems now, and it's going to have to be reformed. And how we reform this system will determine the future of humanity and the world that our children will end up living in.

Ross Alex, we'd love to have you back to talk about how to reform this. Thank you very much for your time.

Alex Krainer Pleasure. Thank you.

Ross Tuomas, great to have you here at Renegade Inc.

Tuomas Malinen Thank you. Nice to be here.

Ross You have for many years, really, been predicting that the eurozone banks are in huge amounts of trouble. Can you give us a specific date of when the next banking crisis across the eurozone is going to happen?

Tuomas Malinen Specific date, no. But I consider it to be a matter of weeks or at max, months.

Ross Wow! Why do you think that?

Tuomas Malinen Well, the stresses this year have been so massive. I think we'll go more into the specifics why we are here a bit later. But the hit of the coronavirus pandemic, economically, has been so massive in Italy and Spain, which are the weakest links in the European banking family, that it will almost guarantee to start from there during the fall or winter.

Ross Now, prior to the Corona virus pandemic, what was going to happen were stress tests were going to be given to the European banks. And the figure that the bank regulators decided would be the worst case scenario was around 4.3 percent. We're now north of 10 percent when it comes to stress testing these banks. What does that mean practically?

Tuomas Malinen Well, that the crisis is very close, basically. It basically means that there is no way of avoiding it. So if you look at the specifics of the October stress test of the ECB, that they basically found that in recession-like conditions, half of the big European banks will not survive. And this is not a recession-like condition anymore. This is more like a depression-like condition, if you look at just the economic figures. So, the hit has been so massive. And we have heard rumours inside the European banking community that the authorities are working very hard to try to avoid any mistrust issues to surface, but they are definitely boiling under the surface. If you just think about the recapitalisation needs of the Italian banks, which were estimated to be around three to 400 billion U.S. dollars in just last spring, and now they must be way north of five hundred billion. So there are massive amounts of capital that will be needed to stabilise the banks, especially in Italy. And we just don't have the money, or the Italian government, specifically, doesn't have the money.

Ross We'll come to counter-party risk in a second. Let's just talk a little about how do you choose who you save? Christine Lagarde is sitting there. What is it, sort of pin the tail on a donkey? That one, but not this one? And then the moral hazard that comes with this. How do the leadership choose who to save and who not to?

Tuomas Malinen Well, actually in a banking crisis, the central bank, really, is not the entity who saves anyone. It's the governments. What happens in a banking crisis, you have a collapse in trust in the interbank markets or in the deficit for markets. So basically, you know, people come in and queue and take the money out. And this is something the central bank really cannot stop. So the only thing that it can do, the only entity that can do something, is the government by providing recapitalisation of the banks or taking them over, basically. So

now you mentioned it, I'm not actually a hundred percent sure, but the ECB cannot take or any bank. It's a national authority to do that. So your question from Christine Lagarde is actually not so valid. You should ask the same questions on the head of the nation states.

Ross If nation states and the heads of nation states have to make a choice of who to save and who to throw under the bus, how on earth do they make those decisions? Because we know when governments get involved with picking winners and trying to manipulate markets, it never ends well.

Tuomas Malinen Yeah, that's true. Yeah, actually, there is a simple rule of thumb for the authorities to choose the bank. If the crisis is so large that it threatens the whole banking sector, you save the bank which has the largest reach in your country. So it has the most offices and stuff like that. So you save the most important bank.

Ross But they are often the most inefficient. And now we're back to too big to fail and too big to jail.

Tuomas Malinen Yeah, that's true. That's true. But actually, there is a very good example of how to purge the moral hazard from the system and not to aggravate the problem of too big to fail from the 1990s banking crisis of the Nordics. So for example, back in those days, back in the early 1990s, Finland had the biggest crisis. We had one of our major banks go under. But that was the only bank that actually went under. We recapitalised the banks but with punitive terms. So banks cut capital. They were punished if they were asked, if they were required to capital. And this told the banks that you really need to have your base in order. And it worked. If you look at the 2008 financial crisis, only very few Nordic banks and basically none of the Finnish banks were in trouble because they kept away from the exotic financial products. They were taught a lesson in the early 1990s crisis. So we already have a kind of game play for the banking crisis that is coming. We just have to look in the Nordics example of the 1990s.

Ross Let's talk about counter-party risk. Now, I know it's almost impossible to work out who's holding what, especially now. But people are looking at the eurozone and the banks across the eurozone and they're thinking, oh, well, that's a eurozone problem. And what they don't realise is if they're in New Zealand or Australia, if they're in America or South America, they still will be affected because once this house of cards goes down, there will be a domino effect. True or false?

Tuomas Malinen Yeah, yeah. That's completely true because Europe holds the biggest concentration of the global systemically important banks. If people in these countries start to look which banks operate in their countries, they notice that they might have Credit Suisse or Credit Agricole or HSBC. And banks like that are operating in their countries. And they are all European banks. So the thing is, when the European banking sector gets in trouble, it goes global very fast because these banks are also counter-parties in the banking markets and sectors of other countries.

Ross People intuitively know that there's something wrong, though. How are they able to protect themselves from what's coming down the track?

Tuomas Malinen Well, in a banking crisis, the most important thing to understand is that in the modern banking systems the cards you use and all the digital payment systems, they will shut down very fast. So you will need to hold cash. We have urged our clients to hold at least two weeks worth of cash, preferably a months worth of cash. And if you have a lot of money, then you should consider investing that in physical gold. The one thing that people do not understand that after the 2008 crisis, global authorities put in place legislation that allows the use of their depositor funds in bank recapitalisation. What this means that one day you might have 10,000 euros in the bank, and the next day they will notice that you will only have 5,000. Not a great example, but still. And especially those that hold large amounts like over the deficit guaranteed limit in the European countries, those funds are directly threatened by the crisis because it's very likely that those funds will be used to recapitalise the banks because the world countries are so heavily indebted that they cannot really recapitalise the banks in other ways. This is something that in the past has not been discussed enough because there is a true risk that people will lose money while holding them in the banks.

Ross In 2008, through to now, we've heard all about bail outs. What you're talking about are bail ins. Is that not right?

Tuomas Malinen Yes.

Ross And a bail in is using people's cash to refloat those businesses after they've been so either reckless, inefficient or exposed to products that they should never have been involved with.

Tuomas Malinen True. And if you don't believe that this will happen, just look at the example of Cyprus banks in 2014-15. And many of the holders of deposits lost a lot of money because the money was used to recapitalise the banks. So we have the legislation and we have also examples of how they use it. So people should be aware of this risk.

Ross What does the economy and society look like on the other side of this banking crisis?

Tuomas Malinen Completely different. I don't think we'll have smaller banks. Probably central banks in their current state are gone. We hopefully will have a more free economy and society, too. So, yeah. And I think national issues will become more important than European body issues. So it's a brave new world for sure. But I'm optimistic that it will be better than the one we are in now.

Ross Tell us why you're optimistic and tell us why it will be better because we need a bit of optimism around here.

Tuomas Malinen That's true. I mean, I've been doing academic research on the banking crisis for ten years. And what is really remarkable is that you basically always recover from them if you choose the right options in the crisis. And the crisis also makes it possible to restructure the economy and the society, the political system. You can search out the corruption. You know, you can do all kinds of important stuff in a crisis. You just have to seize the moment and understand that the crisis will end if we do this and this and this, and we might have a better economy, a better society as a result of that. It's all what we decide to do in a crisis.

Ross Tuomas Malinen, thank you very much for your time.

Tuomas Malinen Thank you. It was a pleasure to be here.