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European Debt Markets 'Face Second Credit Crisis'

Harry Wilson

Jan. 2 (Telegraph) -- European debt markets could be hit by a second credit crisis within months as fears grow over the huge volume of new bonds that must be sold by governments and banks in 2011.

Banks alone must refinance about €400bn (£343bn) of debt in the first half of the year, but add in the more than €500bn European governments must replace over the same period, as well as further hundreds of billions of euros of mortgage-backed debt maturing and there is the potential for chaos in the credit markets.

"What we are looking at here clearly has the potential to become a second credit crunch. However, this time it would be much worse than before," said Celestino Amore, founder of IlliquidX, which specialises in trading hard-to-price debt.

"Governments have been able to slow down the process, but the problems did not go away. There remains trillions of dollars of debt that must be refinanced or sold."

Mr Amore predicts a rush to sell assets, much like that which kicked off the first credit crunch in the summer of 2007. However, many fund managers and other large institutional investors are looking to reduce their exposure to bonds, leading to warnings that there will not be enough demand to buy all the debt banks and governments will need to sell.

Last week the Centre for Economic and Business Research said a new eurozone crisis was its top prediction for 2011, pointing out that Spain and Italy alone must refinance more than €400m of bonds in the spring.

Several banks are already understood to have created what one debt market banker described as "get ugly early strategies" in the hope they will be able to help their clients sell their bonds.

"I think you're going to see everyone rush to sell bonds very early in January, because no one wants to take the chance of missing whatever funding window is available," said the banker.

The chief executive of one major UK retail bank told The Sunday Telegraph that he thought things could get "sticky" in the first half and that his bank was accelerating its issuance plans.

The European Central Bank warned in its latest financial stability review published last month of a risk of "increasing competition for funding".

In particular, the ECB gave warning of the continued uncertain macroeconomic outlook and market concerns over the financial position of some peripheral eurozone countries.

The Bank of England has also issued similar warnings and last month said that UK and European banks remained vulnerable to "strains in funding markets".

"This reflects their continued dependence on short-term domestic and foreign currency wholesale funding and the challenge of refinancing or replacing substantial amounts of term loans and public sector support by the end of 2012," said the Bank in its latest financial stability report.

Credit Suisse analysts have pointed out that the funding position of European banks deteriorated in the second half of last year, putting more pressure on banks to sell even more bonds in the first half of 2011 if their funding is not to get "more stretched".

Credit Suisse added that funding was likely to be increasingly expensive for most banks, presenting problems in particular for large retail banks that were unable quickly to change the pricing of their products to reflect their higher funding costs.

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