

Germany's 'desperate' short ban triggers capital flight to Switzerland

A year ago, Germany's financial regulator BaFin warned that the toxic debts of the country's banks would blow up "like a grenade" once hidden losses from the credit crisis caught up with them.

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Published: 9:50PM BST 19 May 2010

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An internal memo at the time showed that BaFin feared write-offs might top €800bn (£688bn), twice the reserves of Germany's financial institutions. Nobody paid much attention. But the **regulator's shock move on Tuesday night to stop short trading**



Swiss francs - Germany's 'desperate' short ban triggers capital flight to Switzerland Photo: AFP

(<http://www.telegraph.co.uk/finance/financetopics/financialcrisis/7738144/Market-chaos-warning-after-German-ban-on-shorting.html>) on banks, insurers, eurozone bonds – as well as a ban credit default swaps (CDS) on sovereign debt – has left markets wondering whether the slow fuse on Germany's banking system has finally detonated.

BaFin spoke of "extraordinary volatility" and said CDS moves were jeopardising "the stability of the financial system as a whole". It is unsettling that the BaFin should opt for such drastic measures a week after EU leaders thought they had overawed markets with a €750bn rescue package and direct purchases of Greek, Portuguese and Spanish debt by the European Central Bank. BaFin's heavy-handed move seems to proclaim that the rescue has failed.

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"The market is left asking what skeletons are lurking in the cupboard," said Marc Ostwald from Monument Securities. The short ban follows a report by RBC Capital Markets that circulated widely in the City accusing German banks of failing to come clean on 75pc of their €45bn exposure to **Greek debt**

(<http://www.telegraph.co.uk/news/worldnews/europe/greece/>) .

German lenders have the lowest risk-weighted capital ratios in the world after Japan. They were slow to rebuild safety cushions after the sub-prime crisis, and now face a second set of losses on Club Med holdings. Reporting rules have let Landesbanken delay write-downs, turning them into Europe's "zombie" banks.

Even so, nothing adds up in this BaFin episode. Germany acted alone, prompting a tart rebuke from French finance minister Christine Lagarde. "It seems to me that one should at least seek the advice of the other member states concerned by this measure," she said. Brussels was not notified. The deep rift between Berlin and Paris has been exposed again, leaving it painfully clear the European Monetary Union still lacks the fiscal and governing machinery of a viable currency union.

Far from stabilising markets, **BaFin's move set off a nasty sell-off in credit markets**

(<http://www.telegraph.co.uk/finance/markets/7742134/Markets-crash-as-German-short-selling-ban-bites.html>) . Markit's iTraxx Crossover index – measuring risk in mid-level corporate bonds – jumped 57 basis points to 586. Markit said BaFin had caused liquidity to dry up in "febrile conditions". The Libor-OIS spread watched for signs of strain in interbank lending widened further.

If the purpose of BaFin's action was to drive wolfpack "speculators" off Greece's back, it failed. Yields on 10-year Greek bonds rose 37 basis points to 7.918pc. What it showed is that CDS contracts barely matter. The issue is whether "real money" investors such as the Chinese central bank are willing to buy Greek and Portuguese debt.

The short ban set off instant capital flight to Switzerland. BNP Paribas said €9.5bn flowed into Swiss franc deposits in a matter of hours on Wednesday morning.

The Swiss central bank intervened to hold down the franc. This caused the euro to shoot back up against the US dollar after an early plunge. The euro had already bounced off "make-or-break" technical support at \$1.2135, the 50pc "retracement" of its entire rise since 2000, but any rally is likely to be short-lived.

"As a German citizen, I wish to apologise for the stupidity of my government," said Hans Redeker, currency chief at BNP Paribas. He said the CDS ban deprives reserve managers of a crucial hedging tool for non-securitised loans and will scare away global investors needed to soak up Club Med bonds.

"The European market is likely to become utterly dysfunctional. Just as the market showed signs of stabilisation with real money starting to buy euros, the Germans have destroyed this glimmer of hope," said

Mr Redeker. "The BaFin ban is a desperate political move by a government battling for survival. Angela Merkel needs the support of the Left so she has given in to a witch-hunt against banks and speculators."

Six members of the FDP Free Democrats in Germany's ruling alliance are to vote against the EU's rescue fund. Chancellor Merkel must reach out to Social Democrats and Greens to secure a safe majority.

Mrs Merkel faced heckling as she tried to rally support for the EU rescue package in the Bundestag. "The current crisis facing the euro is the biggest test Europe has faced since the Treaty of Rome in 1957. This test is existential. The euro is in danger, and if we do not avert this danger, the consequences will be incalculable," she said.

Tim Congdon from International Monetary Research said deposit data from the ECB shows that there was a "major run" on Club Med banks in the second week of May. Some €56bn of interbank lending facilities were withdrawn, probably as citizens in the South switched funds to banks in the eurozone core. Bank reliance on the ECB lending window jumped by €103bn – or 22pc – in a week.

"It was extreme and very sudden, probably on Friday afternoon. The eurozone was undoubtedly in peril," he said.

The question raised by BaFin is whether underlying damage to the eurozone banking system runs even deeper than feared.

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