Greek Fears Roil Markets

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LONDON—Symptoms of another bank liquidity squeeze are growing in Europe as fears of a Greek default continued to grip financial markets Monday and raised concern that the sovereign debt crisis will now spread to the region’s banks.

The cost of dollar liquidity has been soaring as yields paid by many governments and their banks leaped to new highs in tandem with default insurance costs. Safe-haven German bund yields fell to new record lows Monday, the euro continued its slide against major currencies and banking shares slumped, despite efforts by European officials to assure investors that a Greek sovereign debt default wasn’t on the way.

The yield on the 10-year bund fell to a fresh record low of 1.72%, according to Tradeweb, down 0.06 percentage point from Friday’s close, while 10-year gilt yields fell to 2.19%, down 0.07 percentage point, and 10-year Treasury yields fell 0.04 percentage point to 1.88%.

Greek two-year bonds remain in free fall and yields rose above 6% Monday, according to Tradeweb prices, compared with just a 0.4% yield on German two-year bonds.

Italian and Spanish 10-year bond yields rose despite renewed buying by the European Central Bank. Italy paid sharply higher yields on €11.5 billion ($15.71 billion) of three- and 12-month Treasury bills at auction Monday, ahead of a sale of up to €7 billion of bonds Tuesday. Italy paid an average yield of 4.153% on the 12-month T-bills compared with 2.959% at the previous auction, on Aug. 10.

The cost of insuring the debt of European governments and banks against default continued to rise to record highs with debt-insurance costs for French banks among the record-breakers, soaring on fears of an imminent credit rating downgrade.

Moody’s may cut ratings at BNP Paribas, Société Générale and Crédit Agricole SA, people familiar with the matter said over the weekend, bringing its rating for the sector in line with those of other credit rating firms.

"There is a strong climate of fear and all eyes are on developments in Greece," said Marc Ostwald, fixed-income research strategist at Monument Securities. "There is the possibility of a nasty shock before things get better."

Focus will be on a Greek Treasury bill auction later this month after Greece didn’t fully allocate the authorized amount at the second-day noncompetitive round of a €1 billion T-bill auction last week. Greece typically goes for the full amount during noncompetitive rounds, even though this isn’t normally necessary in order to meet its obligations. Greece is expected to release details this week for a 13-week T-bill auction due Sept. 20.

Greece’s government said Sunday it will impose a new property tax to cover a €2 billion shortfall in its budget targets this year. The move came after the government earlier raised its creditors’ wrath by resisting further measures to meet its targets, prompting a series of ultimatums from European Union officials who threatened to stop aid payments to the country unless it complied.
"From a risk-appetite perspective this currently looks to be but a small victory in an otherwise wholly unfavorable war," said Richard McGuire, senior fixed-income strategist at Rabobank, in a note.

Indeed, German Economy Minister Philipp Rösler said Europe could no longer rule out an "orderly default" for Greece in an opinion piece published Monday in Die Welt newspaper.

But Steffen Seibert, spokesman for German Chancellor Angela Merkel, said the possible introduction of insolvency rules for euro-zone countries should be considered only in the long run, and not as a solution to Greece's current debt crisis.

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Strategists have been scrambling to explain to clients how far this rout can extend, with some expecting a pause around the $1.32 area, but many bracing for a slide as low as $1.30. The options market, which traders use as a form of insurance against hefty shifts in the foreign-exchange market, shows that the market is expecting large declines. Options relating to the euro's moves against the dollar within a one-month horizon are now trading at the highest level since June 2010.

Reflecting ongoing tensions in the interbank lending market despite a surplus of liquidity, banks' overnight deposits with the ECB reached a new high for the year Friday for the third time in a week.

Banks deposited C$81.788 billion in the overnight facility Friday, the highest level since July last year, the ECB said Monday, a sign that they are increasingly turning to the ECB as a safe haven because they are wary of lending to one another.

Meanwhile, lending through the ECB's emergency overnight borrowing facility reached C$20 million Friday, far below the multibillion-euro sums borrowed overnight on some days this year.

The spread between the three-month euro interbank offered rate, or Euribor, and the three-month euro overnight index average rate—a barometer of banks' reluctance to lend money—also widened to 0.857 percentage point Monday from 0.782 percentage point Friday.

The spread is at its widest level in two years but unlike the previous spike, which followed the collapse of Lehman Brothers, it has widened despite lower fixings of Euribor, as swap rates have fallen at a faster clip on expectations that the ECB will cut interest rates.

ECB officials have sought to dispel concerns about rising tensions in the money market with President Jean-Claude Trichet saying last week liquidity isn't an issue for the banking sector as a whole.

On Monday, Bank of France Governor Christian Noyer came to the support of French banks, saying they have no liquidity or solvency problems, and that the ECB's refinancing operations are unlimited in amount.

"Whatever the Greek scenario, and so whatever provisions have to be booked, French banks have the means to deal with it," Mr. Noyer said in a short emailed statement.

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