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Soaring Bond Yields Tie Spain's Hands As Banks Struggle

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Fears that Spain must rely on an increasingly skeptical bond market to prop up banks threaten to worsen an already grim deficit outlook, sending borrowing costs sharply higher Wednesday.

Spanish depositors are losing confidence too and pulled out cash at a faster pace last month. Deposits of nonfinancial firms and households dropped in April by 31 billion euros to 1.625 trillion euros and are down by 103 billion euros from a year ago.

Outstanding loans are also trending lower as banks try to maintain capital, revealing no benefit to the real economy from the European Central Bank's massive liquidity injections.

"It's a sign of everyone running for safe havens," said Sherry Cooper, chief economist at BMO Financial.

U.S. stock indexes sold off with the 10-year Treasury yield tumbling to the lowest in at least 60 years. The Italian 10-year jumped above 6%, and Spain's neared 7%.

Greece has seen bank withdrawals ramp up in recent days as political turmoil makes a near-term euro exit a real possibility. The world's top trade

credit insurer halted coverage Wednesday for exporters shipping to that country on fears that it will leave.

Bank Bailout Bill

Shrinking Spanish deposits are the latest sign of bank sickness. Last week, Bankia said it needs 19 billion euros ($23.7 billion) from the government to stay afloat.

Madrid said it would raise money for Bankia's bailout by selling bonds, amid reports the ECB is cool to its plan to have Bankia get ECB money using Spanish bonds as collateral.

The central bank said it never received or rejected a formal proposal for such a proposal. But the yield on 10-year Spanish debt surged 21 basis points to 6.69%, sending potential bailout costs and budget deficits even higher.

"This is becoming more and more untenable," Cooper said.

Spain's deficit stood at 8.9% of GDP in 2011. The government aims to cut that to 5.3% this year and 3% in 2013 in the face of a severe recession, but those goals are looking more unrealistic by the day.

The European Commission warned Wednesday about bank bailouts' impact on deficits and said it's open to delaying the 3% goal to 2014 if Madrid submits a solid plan for getting there, spending by regional governments comes under control, and banks get healthier.

Debt Seen Soaring

Yawning deficits will also add to the debt, which Madrid said last month would surge to 78% of GDP this year from 68% in 2011. The European Commission puts it at 81% in 2012 and 100% in 2020 without policy changes.

"Public debt has become an emerging, rapidly increasing, imbalance in Spain," it warned, urging tax hikes and more labor market reform.

The EC also proposed a deposit insurance fund across Europe and using the eurozone's bailout fund to recapitalize ailing banks. But Germany is seen blocking any plans to tap emergency money.

China will not come to Europe's rescue either. State media confirmed Tuesday that the government "will not roll out another massive stimulus plan to seek high economic growth.

The European debt crisis has reached a point where country-by-country policies won't fix the problem, said **Bernard Baumohl, chief global economist at the Economic Outlook Group.**

Instead, some kind of Europewide aid comparable to the Marshall Plan is needed to prevent any country from leaving the eurozone and the cascading contagion in the rest of the currency union that would follow, he said.

"They've got to keep the 17 countries together," he said.

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