Euopean Financial Meltdown: Greek Default would be a Catastrophic Loss for German Banks

By Edward Harrison
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Apparently, Germany is now planning to make loans for Greece not just for 2010, but for 2011 and 2012 as well. This is a sea change in German thinking and is having a positive effect on all markets, with spreads on Greek debt and Greek sovereign CDS both coming in. I believe this indicates Angela Merkel understands the gravity of the situation and the impact a Greek default would have on Germany.

I noted that the Germans are now talking publicly about German bank exposure to Greek sovereign debt. And earlier today Yves Q. Smith noted that a Greek default would be a catastrophic loss for the lenders. She quotes from the S&P's press release on their downgrade of Greek debt to junk:

> The outlook is negative. At the same time, we assigned a recovery rating of '4′ to Greece's debt issues, indicating our expectation of "average" (30%-50%) recovery for debtholders in the event of a debt restructuring or payment default"

Now, we know that the German Landesbanks probably have a shed load of Greek debt on their books. Moreover, the state of their capital base is very precarious indeed. Think back to early last year when we were not discussing the potential impairment of Greek debt, but of losses related to US subprime and commercial real estate more generally. The Telegraph wrote a sensationalist story based on some leaked documents about the fragility of European banks. The details may be suspect but directionally, this is the real problem.

They wrote:

> **European bank bail-out could push EU into crisis**
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> A bail-out of the toxic assets held by European banks' could plunge the European Union into crisis, according to a confidential Brussels document.
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> "Estimates of total expected asset write-downs suggest that the budgetary costs – actual and contingent – of asset relief could be very large both in absolute terms and relative to GDP in member states," the EC document, seen by The Daily Telegraph, cautioned.
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> "It is essential that government support through asset relief should not be on a scale that raises concern about over-indebtedness or financing problems."

> The secret 17-page paper was discussed by finance ministers, including the Chancellor Alistair Darling on Tuesday.
>
> –Are European banks sitting on 16.3 trillion in toxic assets?, Credit Writedowns

So, this seems to be the impetus behind Germany's recent moves: it is well aware of the toxic assets still on its banks' books. The government wants to put an end to the funding problem for Greece which is really a liquidity crisis in order to buy time to protect its undercapitalised banking sector. At present, it seems they are looking to force their banks to take a haircut on Greek debtvia a voluntary restructuring.

However, Marshall Auerback has said:

> There's another point. Greece seems ready to "restructure", which I take to mean that the banks will take haircuts on Greek debt as there will be pricing transparency.
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> If Greece defaults, you can do extend and pretend – "well, we can't pay now, but we'll do so when we get this bailout", which effectively preserves the illusion. So the restructuring course is potentially more destabilising to the European banking system.

So, it is still far from clear what the best course of action is for the eurozone. From a political perspective, European cohesion is desirable. But the way the eurozone is presently structured is unworkable. The best we can hope for is a patch to fix the immediate liquidity problems followed by more thorough-going structural reform in Europe's monetary experiment.

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