What's the big deal with Greece? Debt Default and Its Repercussions in the U.S.

By Prof. Patrick Van Horn
Global Research, October 19, 2011
Bankrate.com 25 September 2011

Region: Europe, USA
Theme: Global Economy

Financial markets are intensely focused on the events unfolding in Greece. Markets seem concerned that once again Greece will not be able to satisfy the austerity requirements their last loan required for further loans. If they are not able to satisfy those concerns, it is possible that the European countries who are considering extending the loans would decide not to lend any more money.

But why are financial markets, including those in the U.S., concerned with what happens in Greece? And will the current actions really have an effect?

In order to understand why the world is so focused on the possible debt default of a small economy, it is important to understand the links of the international financial system. Much of the debt Greece has issued is held by European banks. The International Monetary Fund, or IMF, estimates that 65 percent of the outstanding amount of Greek government debt is held by institutions outside of Greece. According to the Bank for International Settlements, or BIS, European banks hold a little over $136 billion in Greek debt, public and private. Breaking that number down, it comes to $84 billion in private debt and $52 billion in government debt. Obviously a default on Greek government bonds would seriously affect banks in Europe.

French banks hold $56 billion of Greek debt, and $15 billion of that is government debt issued by the Greek government. German banks hold $34 billion of the total Greek debt, or nearly 25 percent. This is the reason Germany and France have been leading efforts to develop and maintain aid to the troubled nation. Default or even restructuring of Greek debt would have serious implications for the financial health of many European banks.

Recently, The European Central Bank conducted stress tests of the banks in Europe, and eight banks failed. The stress test consists of assessing how the banks would fare under different economic scenarios, and if the banks become insolvent under these scenarios, they fail the stress test. The fact that eight banks failed the tests, which have been scrutinized for being too lax in the assumptions they make, indicate a very fragile banking system in Europe. If Greece was to default, or even dramatically restructure their debt, this could cause a shock to the European financial system that would not only be felt in Europe, but the U.S., too.

Banks in the U.S. are exposed to European banks and derivatives. Even if a bank in New York City does not hold a bond issued by the Greek government, they would no doubt be adversely affected by a default or restructuring. Given the fact that many banks here are still climbing their way out of the financial crisis, a default in Greece could very easily send shock waves through the international financial system. The system is is still recovering from the 2008 crisis, and further troubles could lead to a wave of failures of banks and other financial institutions.

This is not the first time a default in Europe has led to a crisis abroad, reaching the United States. In 1931, Germany defaulted on their government bonds they had issued to fund their reparation payments for World War I. At the time, banks in New York City were the main lenders to Germany, with over $1 billion dollars in loans active at the time of default. This was a substantial amount of funds at the time. My own research, coauthored with Gary Richardson, finds that no banks in New York City failed or refused account activity to their clients in Germany. Instead, they honored deposit accounts on behalf of foreign clients, restructured their loan payments, and even extended lines of credit to German clients. This created the feeling that banks in the U.S. were not in danger of contagion of the events in Germany. Unfortunately, this time, the banks in New York don't seem to be in the position to absorb that kind of a crisis, no matter what they are saying publicly.

Patrick Van Horn *is an assistant professor of economics at the New College of Florida in Sarasota and received his Ph.D. from the University of California, Irvine. His research specialties are bank liquidity in financial crises and the effects of bank regulation on bank portfolios.*