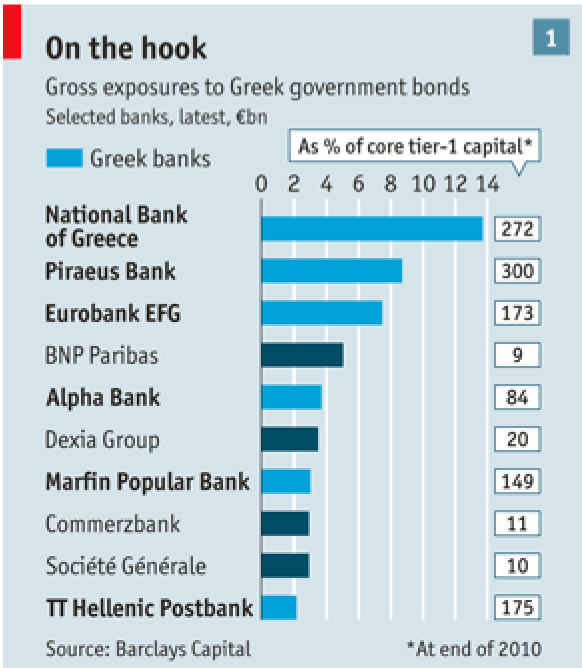
Fear of fear itself
Is this Europe's Lehman moment?
***The Economist*, Jun 23rd 2011**

CONTAGIOUS diseases are usually dealt with by isolating the patient, lest he infect anyone else, and then by trying to treat the illness. Isolation is not always possible with physical ailments; with financial ills, it almost never is. With the Greek government perilously close to default, investors and policymakers are wondering whether European banks have caught something nasty. Many are comparing the choices facing the euro zone and the IMF to those faced by the American Treasury and the Federal Reserve in the days before Lehman Brothers collapsed in 2008, causing a seizure in the global financial system.

The comparison is not exact. The Greek government owes more than €300 billion ($435 billion); Lehman's balance-sheet before its failure was $613 billion. The chief difference, though, lies in complexity rather than in scale. Wall Street's fourth-largest investment bank was at the centre of tens of thousands of interconnected trades that were hidden from view and difficult to value. Its fall caused panic because others in the markets had no way of knowing who the counterparties to its trades were and whether Lehman owed them so much that they too might fail.

That ought not to be true of Greece. It has far fewer creditors: two-thirds of its debt is probably held by about 30 institutions. And whereas Lehman's exposures were hidden from public view, Greece's are largely out in the open and are also reasonably easy to value. The more light has been shone into the dark vaults of banks holding Greek government debt over the past year, the more markets have been reassured that few, if any, foreign banks are dangerously exposed.



According to public data collected by Barclays Capital, an investment bank, few foreign banks' holdings of Greek government bonds are worth even 10% of their capital (Greek banks are a different matter: see chart 1). That means they should comfortably withstand the substantial losses that might arise if Greece said that it would repay less than 100 cents on the euro. Softer forms of default, such as extending the maturities of existing bonds, would probably cause almost no harm to the financial system, especially if the interest payments remained the same as when the bonds were issued.

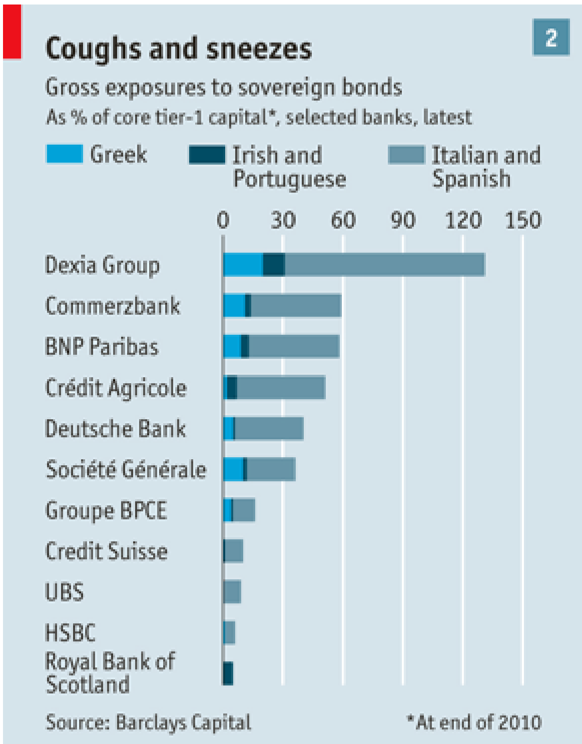
Holdings of bonds do not tell the full story of banks' exposure to Greek government debt. By buying credit-default swaps (CDSs), which are essentially insurance policies against a default, banks are likely to have shifted some risk to insurers or investment funds that are less important to the financial system as a whole. Some banks, however, will have sold CDSs.

Across the entire financial system these CDS exposures largely net off, Barclays reckons, and collateral and margin-calls should have reduced the outstanding exposures to relatively small amounts. However, not everyone will end up with a net position close to zero. It is reasonable to suppose that there would be some large losses (and some large gains) on CDS contracts if Greece stopped paying its bills. Quite where these would emerge is causing some worry in markets.

Bank regulators have made progress in publishing information on exposures. Banks themselves have been giving quarterly or half-yearly updates on their ownership of Greek bonds. But weaker banks have been the most reluctant to come clean: public data on their holdings are a year out of date. Were panic to seize the banking system, regulators could do much to restore calm by releasing information they have collected in the past three months as part of "stress tests" of Europe's banks.

Government bonds are not the only assets on which foreign banks could lose money in Greece. Loans to Greek companies, made either directly or by their Greek subsidiaries, might also go bad. Foreign insurers as well as banks might suffer contagion, because they also own Greek government bonds. However, because Greece's insurance market is relatively small, most foreign insurers would have correspondingly small amounts of Greek debt.

The hard numbers alone thus suggest that a Greek default would do little lasting harm to the rest of Europe's financial system. Yet investors act on fear as well as figures. What is more worrying for Europe's policymakers is the thought that Greece's affliction would spread not just to foreign banks but to foreign governments. Just as Lehman's collapse told investors that a Wall Street bank could fail, a Greek default would tell them that a Western government could renege on its debts: Greece would be the first developed country to default for 60 years.



The European Central Bank (ECB) opposes a restructuring of Greek debt partly because of the risk that investors would then desert other troubled countries on the euro area's periphery. At the very least, their bond yields, which have already been rising, would climb further. They might also be pushed towards default.

First and second in line would be the next-wobbliest members of the euro zone: Ireland, whose government has debts of around €150 billion, and Portugal, which owes €160 billion. Partly because they have also reduced their holdings of Irish and Portuguese bonds, European banks should be able to cope if these countries joined Greece in default or in restructuring their debts. However, if contagion were to spread to Spain or Italy, and banks had to accept losses on their governments' bonds, the sums would look grim even for some banks outside the affected countries (see chart 2). Italy owes €1.8 trillion, or 120% of a far bigger GDP than Greece's, Ireland's or Portugal's. Spain's debts amount to €640 billion.

Another cause for unease is European banks' reliance on short-term wholesale financing from outside the continent. Fitch, a ratings agency, reckons that roughly half the cash entrusted to big American money-market funds is lent on to European banks. This is skittish money that can be gone in a trice.

Banks in vulnerable countries have already found money-market funding harder to come by, or at least dearer. Huw van Steenis of Morgan Stanley notes that a year ago, when European regulators last conducted stress tests, their "adverse" scenario assumed a fall in retail banks' earnings, before loan-loss provisions, of about 5%. "Almost every peripheral or southern European bank we've looked at underperformed [that] case," because of a rise in the cost of wholesale funding and deposits. Spanish banks have been turning increasingly to the ECB for funding, drawing €57 billion at the end of May compared with €42 billion in March.

Worse than jitters in the money markets would be a loss of faith by depositors. The Bank of Greece thinks that in the first four months of the year Greek banks lost deposits at the rate of €2.8 billion a month.

Kill or cure?

What might happen if Greece defaults depends largely on how policymakers behave: the costs of contagion need not be big if panic does not take hold. The ECB could counter money-market flight, for instance, by supplying more liquidity, as the Fed did after Lehman crashed. It could also reopen the foreign-exchange swaps set up with the Fed during the crisis.

Some good ideas are already being discussed. One is to conduct credible stress tests and recapitalise banks that fail. On June 17th the IMF urged European regulators to speed up recapitalisation, warning that there is still a tail of weak banks.

Another idea is to increase the capacity for providing liquidity to countries on the periphery that seem solvent, yet risk being caught in the fallout from a Greek default. On June 20th the European Union restructured its interim bail-out fund, increasing its lending capacity to €440 billion from an effective limit of €260 billion by getting France, Germany and others to guarantee more of its debt. EU officials also encouraged the flow of private credit to Ireland, Portugal and Greece by saying that the fund would not be repaid before other lenders if debts were restructured.

Some policies, though, might cause trouble. The ECB has threatened not to accept Greek government bonds as collateral if the country's debt were restructured. If it carried out that threat, a liquidity crisis in Greece, bank runs and other mayhem could ensue. "It would be almost like an act of war," says a senior executive at a Greek bank. "I don't think that they'd pull the plug."