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Why the United States Should Be Concerned About France's Banking Crisis

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After a wave of panic gripped French financial markets late last week, President Nicolas Sarkozy interrupted his summer vacation to call an emergency cabinet meeting and reassure the world that French banks were not on the "brink of disaster."[1]

Although it looks as if France's major banks are not in imminent danger of collapse, the undercapitalization of major European banks dramatically worsened following the global financial meltdown beginning in 2007, and it is now both a contributor to and casualty of the eurozone's growing sovereign debt crisis. Many of Europe's largest banks were prompted by their national regulators to buy the sovereign debt of fellow EU member states, only to see sovereign default become a real possibility. The European Union's long-running series of "stress tests" for Europe's banks lacks any real credibility and has substantively failed to increase market confidence.

The direct impact that the failure of a major European bank, or group of such banks, would have on the U.S. economy is dependent on the level of exposure and interconnectedness between said banks and the U.S. financial system; the consequences of the failure of any one bank are unlikely to be large. However, there is no doubt there would be harmful consequences as such a failure reverberated across the Atlantic, weakening U.S. financial institutions and the economy more generally.

Danger for French Banks. Societe Generale, BNP Paribas, and Credit Agricole—three of France's largest financial institutions—experienced a significant drop in share prices on Friday, plunging 15 percent, 9.5 percent, and 12 percent, respectively. Despite a knee-jerk 15-day ban on short-selling financial stocks implemented by Sarkozy, these banks remain hugely exposed to the sovereign debt of the so-called PIIGS countries (Portugal, Ireland, Italy, Greece, and Spain). As of March, the Bank for International Settlements stated that French banks own a total of €672 billion ($966 billion) of PIIGS debt.[2] French banks, like many other major European banks, were pressured to buy this debt and given dubious assurances by national regulators and governments that other nations' sovereign debt was virtually without risk, but the prospects for losses now seem substantial. Greece, Ireland, and Portugal's credit ratings have all been slashed to junk status, and French banks are massively leveraged on the back of this potentially worthless debt.

Portugal, Ireland, and Greece all received substantial international bailouts—and in Athens's case, a second bailout—in an attempt to buy time for the beleaguered euro and to stave off a major banking crisis in Europe. However, the markets are sending the message that they doubt these countries will make good on their debts in the long term, which

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will leave French (and German) banks with substantial losses. Furthermore, the European Central Bank (ECB) can provide only so much liquidity to banks as a stop-gap measure, as it did when it provided $500 million to an unidentified European bank last week. A contagion of panic selling could result in a major European banking crisis yet.

The Eurozone: Its Real Problems. National regulators and governments pushed banks to acquire European sovereign debt on the foolhardy notion that the EU will not allow the euro to fail. However, the future of the eurozone is dependent on resolution of at least two fundamental problems.

First, the eurozone is not growing. Growth for the entire 17-nation block was just 0.2 percent through the second quarter of 2011. Second, the richer northern countries, especially Germany, are not yet ready to form a full fiscal transfer union. Germans, understandably, remain hostile to the idea of working longer and harder to subsidize other—more profligate and less efficient—members of the eurozone. The summit held between Chancellor Angela Merkel and President Sarkozy last week sent the message that Germany is not yet ready to pay the tab that the euro is running up.

The only substantial outcome of the Merkel-Sarkozy summit—to implement an EU-wide Financial Transaction Tax (FTT)—received a giant thumbs-down from the markets. Furthermore, since the FTT is subject to a vote by all EU member states, it is unlikely that Britain's Prime Minister David Cameron will allow such a tax to be introduced in light of its disproportionately negative effect on the city of London. Thus, the only substantial outcome of the latest German-French summit was a dead end, as they knew it would be.

Why Should the U.S. Care? Bailout money given to Greece, Ireland, and Portugal—from the EU, EU member states, and the International Monetary Fund (IMF)—has been used to sustain flagging countries while recapitalizing Europe's banks. However, the U.S. has more than an indirect stake in this issue via its dominant membership of the IMF.

American banks have $678 billion in gross direct exposure to European banks, in addition to derivatives, loan guarantees, and other financial connections—though no one knows the net exposure.[3] It is hard to see how the failure of one bank—even a major one such as Societe-Generale—would have much impact on the U.S. economy. Yet in 2008, we saw how the near-failure of one U.S. bank—Bear Stearns—badly shook global financial markets, and the complete failure of a second, the relatively small Lehman Brothers, shook the markets to their very foundations. Thus, though the U.S. exposure appears modest, the risk of contagion is palpable, and the loss of confidence in the global banking system would be dramatic.

Time to Be Realistic About European Debt. The European Central Bank has spent hundreds of billions of euros buying time for financial markets by bailing out bad banks in Europe. However, providing liquidity to essentially insolvent banks is not a sustainable solution. A mechanism for winding down insolvent banks is badly needed in Europe.

Determining which banks are insolvent *could* be done by **meaningful** stress testing. However, the markets have already rendered their judgment on the EU's extant stress tests, which were seen as entirely rigged to reveal unrealistically positive results. Effective stress testing that counts the true level of sovereign debt should be formulated.

U.S. regulators seeking to increase the capital ratios of financial institutions should note that debt from certain EU countries seemed to be a risk-free investment not too long ago. They should recognize that changed circumstances could have the same effect on other asset classes. Today's seemingly safe asset may be a highly risky investment tomorrow.

U.S. Must Put Its Own House in Order. Proposals to introduce new EU taxes or ban short-selling will not solve the problems of the euro, which are many. The euro was specifically created without

1. The British newspaper *Mail on Sunday* made this claim and subsequently withdrew it after strong French objections.
2. Bruce Stokes, "European Banking Crisis Could Spread to U.S," *The Financial Times,* August 8, 2011, at *http://www.thefiscaltimes.com/Articles/2011/08/08/European-Banking-Crisis-Could-Spread-to-US.aspx#page1* (August 22, 2011).
3. *Ibid.*

a fiscal transfer mechanism so that prudent countries would not be forced to subsume the debts of imprudent ones, and at this time, EU elites lack the democratic mandate to introduce supranational economic governance.

The bloated Greek social welfare system and the excessive sovereign debt of the other PIIGS have driven a stake through the heart of the euro. The object lesson for the U.S. is also clear: If the next U.S. President wants to save the American dream, then he or she will need to reduce the national debt substantially and keep federal spending and taxes low.[4]

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4. Stuart Butler, Alison Acosta Fraser, and William Beach, "Saving the American Dream: The Heritage Plan to Fix the Debt, Cut Spending, and Restore Prosperity," Heritage Foundation *Special Report* No. 91, May 10, 2011, at *http://savingthedream.org/about-the-plan/plan-details/SavAmerDream.pdf.*