AMERICAN EXPOSURE

to the European Financial Crisis

GPF GEOPOLITICAL FUTURES

American Exposure to the European Financial Crisis

Summary

The Italian banking crisis we predicted nine months ago is here. The question is no longer whether there will be an Italian banking crisis; it is how badly the rest of the world will be affected. We will continue to track these developments as they unfold, but we must now look ahead: What ramifications will Italy's troubles have on the United States? This report attempts to answer that question in some detail, but our main finding is the following.

The US is not appreciably exposed to the Italian banking crisis directly. Moreover, the US is not heavily dependent on exports and its direct financial exposure to Italy in general is limited. The problem for the US is that it is much more exposed to France and Germany, which have significant positions in Italy despite the best efforts of their banks in recent years to reduce exposure to Italy.

All the while, lingering in the background is the question of how the intricate and very large system of derivatives contracts and trading activities will respond as the banking crisis in Italy begins to seep into other countries. It is impossible at this point to say definitively what the US exposure to this larger issue is, but it is possible to say that US financial institutions are wrapped up in this global system just as much as the European banks. If weakness in the Italian banking system triggers a deeper systemic crisis, the US will not be able to avoid it.

How We Got Here

The Italian banking crisis is accelerating. Nine months ago, when we forecast these developments, it was hard to get information in the mainstream English-language press about the situation. Now, there is no shortage of information with new updates given on an almost weekly basis. Some focus on negotiations between Italy and Brussels (who still, over a year and a half after realizing that there was a problem, cannot come to a solution satisfactory for both sides). Others focus on small moves in the Italian banking sector—UniCredit selling modest stakes in Bank Pekao and FinecoBank to raise capital, or new rounds of funding for the Atlante fund, which has already used up half of its initial funds of 5 billion euros ($5.6 billion) to purchase Banca Popolare di Vicenza and Veneto Banca. But Italy still has roughly 17 percent non-performing loans, and even if something could be done, neither Italy nor the European Union seems capable of agreeing on what the "something" is or how it should be done.

Less visible, but also emerging, is a parallel crisis in the eurozone's largest economy. Germany is sitting on an export bubble. German production of capital goods is falling. German companies like Siemens are laying off workers. Some German banks, faced with bad shipping industry loans and low interest rates, are in danger of defaulting. Bigger German banks, like heavyweight Deutsche Bank, are operating billions of dollars in the red with a horizon for "recovery" that is years away. All the while, Germany continues to depend on exports for 46.9 percent of its GDP, according to World Bank data, while telling itself a fairy tale about how domestic consumption will be able to replace the demand from China that has fallen off a cliff, and the demand from Europe, which may be approaching the cliff's edge. Thus far US and UK imports have helped compensate for the slowdown elsewhere, but the UK just showed the Germans what they really think of the EU, and the US cannot keep consuming German goods at current levels indefinitely.

These problems converge because the Germans can no longer afford to deal with Italy alone. The size of the Italian problem, coupled with Germany's potentially enormous banking problems, make significant German help difficult. The only entity that can help out is the European Central Bank by printing money. In the past, this would have hurt German interests. As Germany deteriorates, it may become an option.

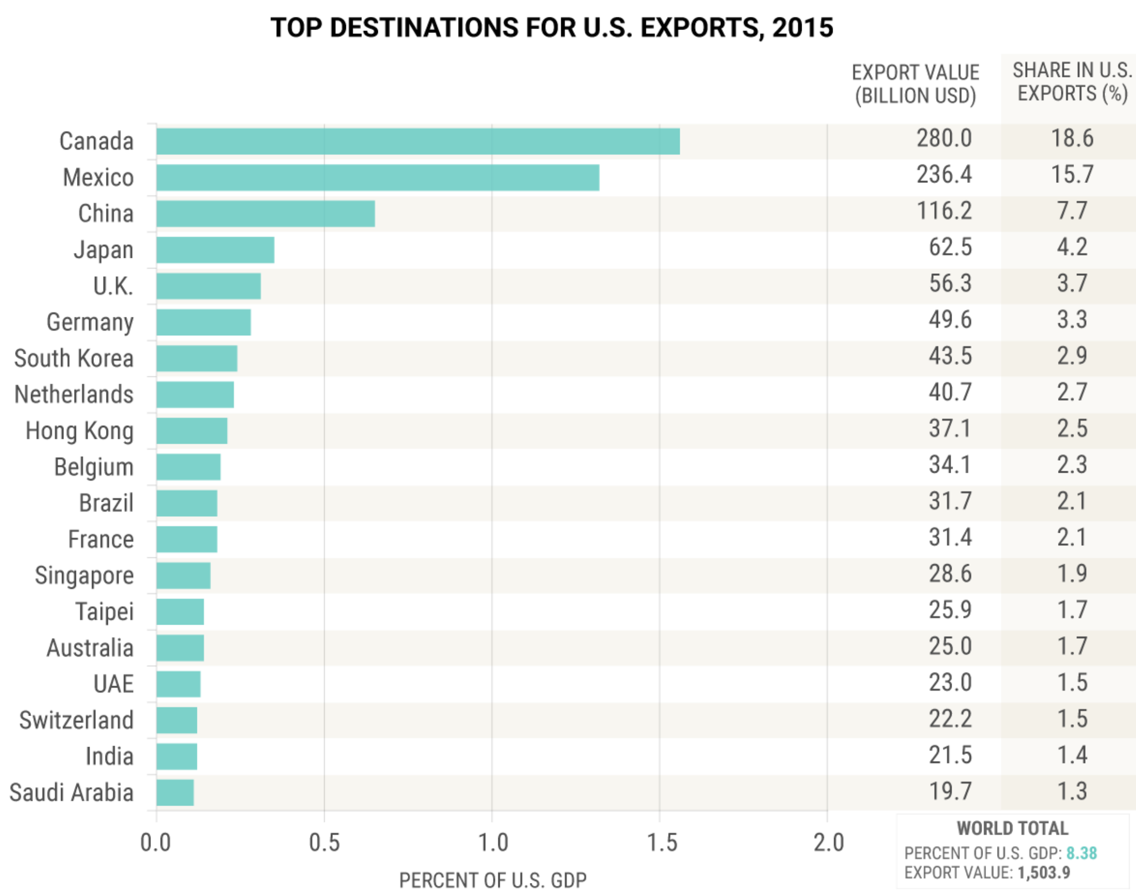
The US has thus far been insulated from the effects of these crises. There was some concern after a weak jobs report in May that the US was headed for a recession fast, but in June, US employers added 287,000 jobs—beating expectations. On August 15, the Dow Jones closed at an all-time high of 18,636. The yield curve on short-term and long-term US treasury bonds has been slowly flattening since the beginning of the year, but the spread hasn't yet reached the point where it would be safe to predict a recession in the next eight to twelve months. We think there is reasonable chance of a recession in the US at some point in 2017, but that will not be because of problems in Europe. It will be because that is part of the normal cycle of the American economy. When it does happen, whether in 2017 or slightly later, it will thrust Germany directly into the limelight.

The US has not really been affected yet by what is going on in Europe. Even the shock of Brexit has faded into the past, judging by how well US markets are doing. The US, however, will not stay insulated from economic troubles abroad indefinitely, especially as the Italian banking crisis progresses. Italy is not Greece or Cyprus. Italy is the fourth largest economy in Europe, and that means that bailing it out would require massive amounts of capital that the Germans have no desire (nor political imperative) to spend. It also means that the world is much more exposed to crisis in Italy because many major financial institutions with global reach—Deutsche Bank, Crédit Agricole, BNP Paribas and Santander, just to name a few—will all feel Italy's crisis acutely.

We think that the US will be more resilient in the face of these crises than European countries, but that does not mean that the effects in the US will be negligible. In fact, they have the potential to be quite dire. Some major US players saw this coming and have already taken steps to reduce their exposure. However, others are indirectly exposed—by way of France and Germany—to what happens in Italy and could suffer financial losses as a result.

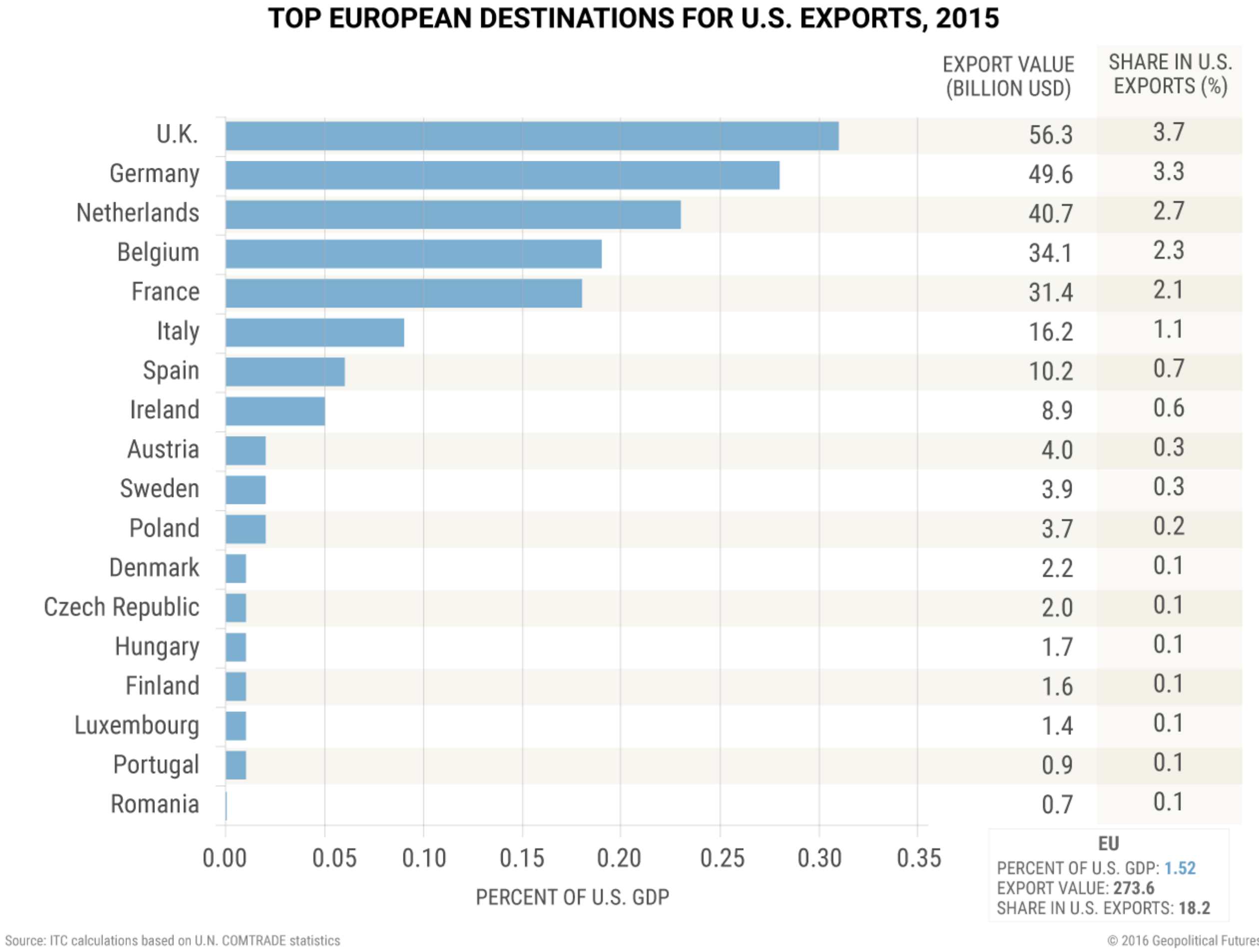
The US Export Crisis Shield

The first place we turned to examine the potential impact of Italy's banking crisis and a subsequent general slowdown in the European economy was US exports to Europe. The US is, in effect, shielded from a significant decrease in demand for its exports because its economy does not depend on exports. According to the World Bank, exports of goods and services made up only 12.6 percent of US GDP in 2015. Restrict that to products and the figure is 8.3 percent, according to U.N. Comtrade data.

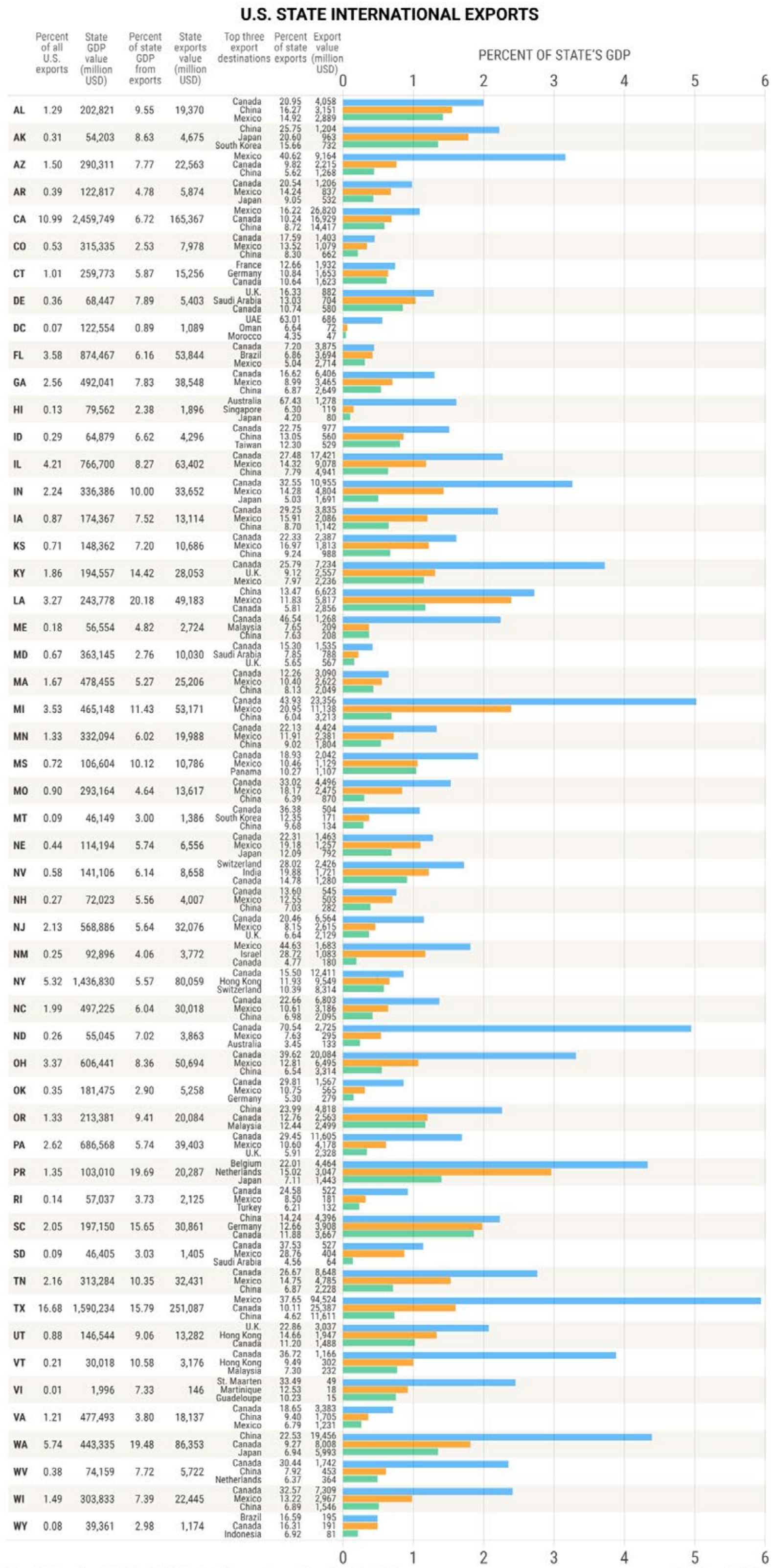


Source: ITC calculations based on U.N. COMTRADE statistics

The graphic on the previous page shows that the US does not depend on exports nor does it have a high export dependency on any one country. Canada was the top export destination for US goods in 2015, with exports worth almost $280 billion. That still only constituted 1.5 percent of US GDP. Exports to the UK and Germany are fifth and sixth on the list, but only constitute 0.6 percent of US GDP combined.



Still, the United States is a large, diverse country. There was the possibility that perhaps individual states were significantly dependent on exports in a way the entire country was not.



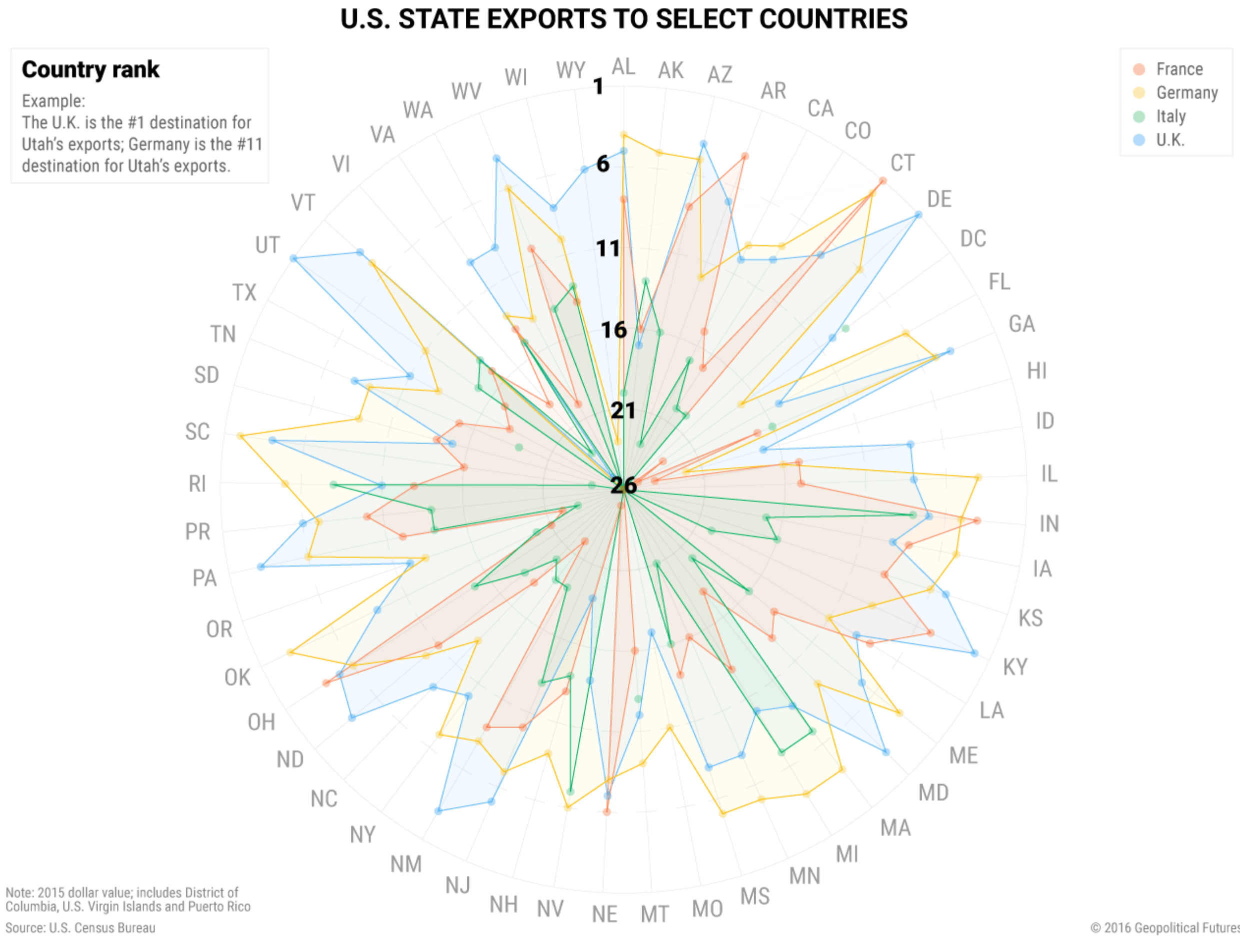
	Percent of all U.S. exports	State GDP value (million USD)	Percent of state GDP from exports	State exports value (million USD)	Top three export destinations	Percent of state exports	Export value (million USD)
AL	1.29	202,821	9.55	19,370	Canada China Mexico	20.95 16.27 14.92	4,058 3,151 2,889
AK	0.31	54,203	8.63	4,675	China Japan South Korea	25.75 20.60 15.66	1,204 963 732
AZ	1.50	290,311	7.77	22,563	Mexico Canada China	40.62 9.82 5.62	9,164 2,215 1,268
AR	0.39	122,817	4.78	5,874	Canada Mexico Japan	20.54 14.24 9.05	1,206 837 532
CA	10.99	2,459,749	6.72	165,367	Mexico Canada China	16.22 10.24 8.72	26,820 16,929 14,417
CO	0.53	315,335	2.53	7,978	Canada Mexico China	17.59 13.52 8.30	1,403 1,079 662
CT	1.01	259,773	5.87	15,256	France Germany Canada	12.66 10.84 10.64	1,932 1,653 1,623
DE	0.36	68,447	7.89	5,403	U.K. Saudi Arabia Canada	16.33 13.03 10.74	882 704 580
DC	0.07	122,554	0.89	1,089	UAE Oman Morocco	63.01 6.64 4.35	686 72 47
FL	3.58	874,467	6.16	53,844	Canada Brazil Mexico	7.20 6.86 5.04	3,875 3,694 2,714
GA	2.56	492,041	7.83	38,548	Canada Mexico China	16.62 8.99 6.87	6,406 3,465 2,649
HI	0.13	79,562	2.38	1,896	Australia Singapore Japan	67.43 6.30 4.20	1,278 119 80
ID	0.29	64,879	6.62	4,296	Canada China Taiwan	22.75 13.05 12.30	977 560 529
IL	4.21	766,700	8.27	63,402	Canada Mexico China	27.48 14.32 7.79	17,421 9,078 4,941
IN	2.24	336,386	10.00	33,652	Canada Mexico Japan	32.55 14.28 5.03	10,955 4,804 1,691
IA	0.87	174,367	7.52	13,114	Canada Mexico China	29.25 15.91 8.70	3,835 2,086 1,142
KS	0.71	148,362	7.20	10,686	Canada Mexico China	22.33 16.97 9.24	2,387 1,813 988
KY	1.86	194,557	14.42	28,053	Canada U.K. Mexico	25.79 9.12 7.97	7,234 2,557 2,236
LA	3.27	243,778	20.18	49,183	China Mexico Canada	13.47 11.83 5.81	6,623 5,817 2,856
ME	0.18	56,554	4.82	2,724	Canada Malaysia China	46.54 7.65 7.63	1,268 209 208
MD	0.67	363,145	2.76	10,030	Canada Saudi Arabia U.K.	15.30 7.85 5.65	1,535 788 567
MA	1.67	478,455	5.27	25,206	Canada Mexico China	12.26 10.40 8.13	3,090 2,622 2,049
MI	3.53	465,148	11.43	53,171	Canada Mexico China	43.93 20.95 6.04	23,356 11,138 3,213
MN	1.33	332,094	6.02	19,988	Canada Mexico China	22.13 11.91 9.02	4,424 2,381 1,804
MS	0.72	106,604	10.12	10,786	Canada Mexico Panama	18.93 10.46 10.27	2,042 1,129 1,107
MO	0.90	293,164	4.64	13,617	Canada Mexico China	33.02 18.17 6.39	4,496 2,475 870
MT	0.09	46,149	3.00	1,386	Canada South Korea China	36.38 12.35 9.68	504 171 134
NE	0.44	114,194	5.74	6,556	Canada Mexico Japan	22.31 19.18 12.09	1,463 1,257 792
NV	0.58	141,106	6.14	8,658	Switzerland India Canada	28.02 19.88 14.78	2,426 1,721 1,280
NH	0.27	72,023	5.56	4,007	Canada Mexico China	13.60 12.55 7.03	545 503 282
NJ	2.13	568,886	5.64	32,076	Canada Mexico U.K.	20.46 8.15 6.64	6,564 2,615 2,129
NM	0.25	92,896	4.06	3,772	Mexico Israel Canada	44.63 28.72 4.77	1,683 1,083 180
NY	5.32	1,436,830	5.57	80,059	Canada Hong Kong Switzerland	15.50 11.93 10.39	12,411 9,549 8,314
NC	1.99	497,225	6.04	30,018	Canada Mexico China	22.66 10.61 6.98	6,803 3,186 2,095
ND	0.26	55,045	7.02	3,863	Canada Mexico Australia	70.54 7.63 3.45	2,725 295 133
OH	3.37	606,441	8.36	50,694	Canada Mexico China	39.62 12.81 6.54	20,084 6,495 3,314
OK	0.35	181,475	2.90	5,258	Canada Mexico Germany	29.81 10.75 5.30	1,567 565 279
OR	1.33	213,381	9.41	20,084	China Canada Malaysia	23.99 12.76 12.44	4,818 2,563 2,499
PA	2.62	686,568	5.74	39,403	Canada Mexico U.K.	29.45 10.60 5.91	11,605 4,178 2,328
PR	1.35	103,010	19.69	20,287	Belgium Netherlands Japan	22.01 15.02 7.11	4,464 3,047 1,443
RI	0.14	57,037	3.73	2,125	Canada Mexico Turkey	24.58 8.50 6.21	522 181 132
SC	2.05	197,150	15.65	30,861	China Germany Canada	14.24 12.66 11.88	4,396 3,908 3,667
SD	0.09	46,405	3.03	1,405	Canada Mexico Saudi Arabia	37.53 28.76 4.56	527 404 64
TN	2.16	313,284	10.35	32,431	Canada Mexico China	26.67 14.75 6.87	8,648 4,785 2,228
TX	16.68	1,590,234	15.79	251,087	Mexico Canada China	37.65 10.11 4.62	94,524 25,387 11,611
UT	0.88	146,544	9.06	13,282	U.K. Hong Kong Canada	22.86 14.66 11.20	3,037 1,947 1,488
VT	0.21	30,018	10.58	3,176	Canada Hong Kong Malaysia	36.72 9.49 7.30	1,166 302 232
VI	0.01	1,996	7.33	146	St. Maarten Martinique Guadeloupe	33.49 12.53 10.23	49 18 15
VA	1.21	477,493	3.80	18,137	Canada China Mexico	18.65 9.40 6.79	3,383 1,705 1,231
WA	5.74	443,335	19.48	86,353	China Canada Japan	22.53 9.27 6.94	19,456 8,008 5,993
WV	0.38	74,159	7.72	5,722	Canada China Netherlands	30.44 7.92 6.37	1,742 453 364
WI	1.49	303,833	7.39	22,445	Canada Mexico China	32.57 13.22 6.89	7,309 2,967 1,546
WY	0.08	39,361	2.98	1,174	Brazil Canada Indonesia	16.59 16.31 6.92	195 191 81

Click to enlarge

This graphic breaks down how much each US state depends on exports. There are a few that stand out right away—20 percent of Louisiana's GDP comes from exports, 19 percent of Washington's, and 16 percent of Texas.' The top export destinations for all three are, in various orders: Canada, Mexico, and China. As the graphic above shows, this is true for most US states. For the states where it isn't true (like Connecticut, whose number one export partner is France), the percentages are still extremely low: exports to France only make up 1 percent of Connecticut's GDP, exports overall only make up 6 percent of Connecticut's GDP, and Connecticut's share in US exports is only 1 percent.

The map below makes a similar point by showing simply the top export partner for each state.

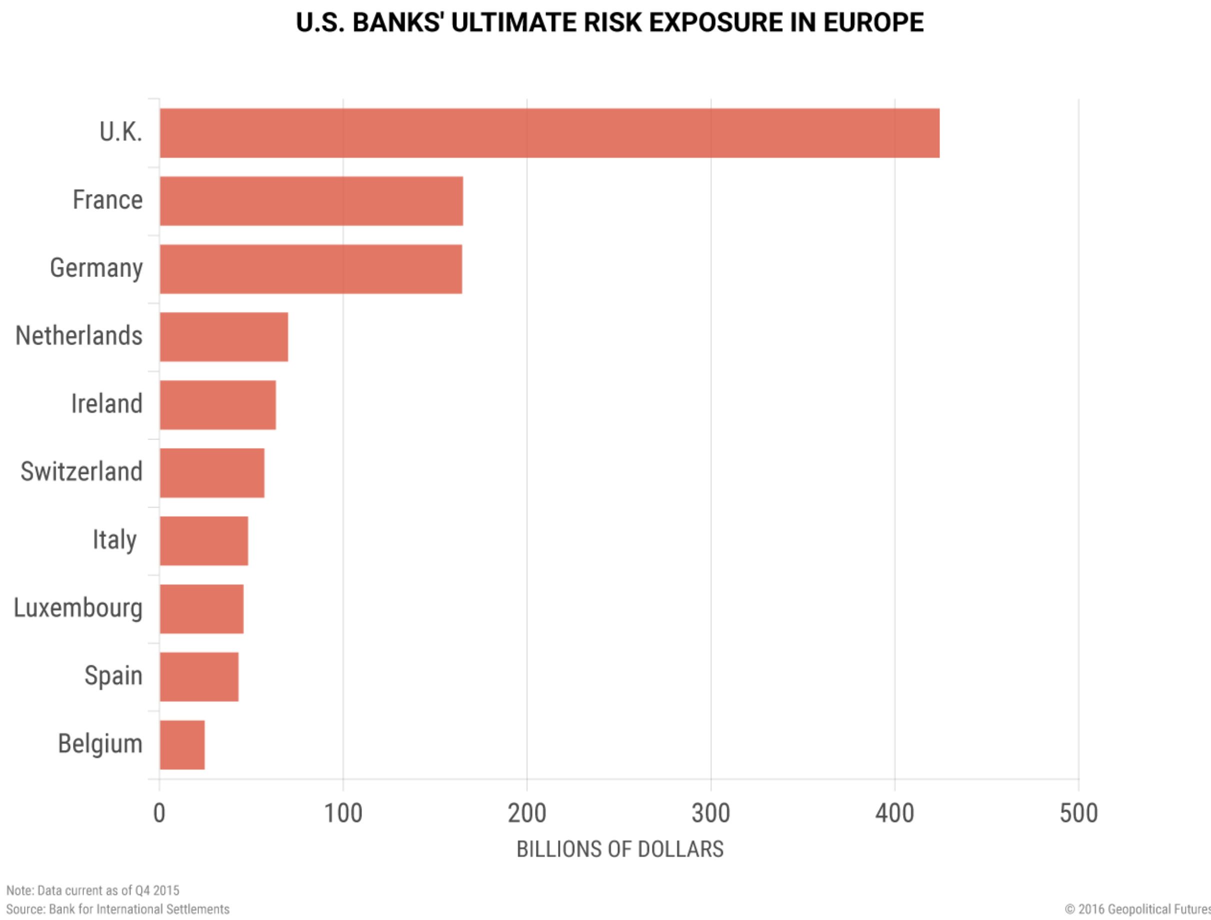
To get a sense of just how protected individual US states are from export disruptions to Italy, the UK, Germany, and France, we made the following graphic, which shows where these four countries rank as export partners for all 50 US states. With a few exceptions, the UK, Germany, and France are all minor export partners for US states—and Italy does not crack the top five export destinations for any US state.



In terms of exports, therefore, the US is fairly well insulated from events in Europe. Decreased demand from China, and not from Italy or other European countries, has the most potential to hurt the US economy. Even then, the fact that the US does not depend on exports to the same extent as countries like Germany means that the impact of decreased demand from China is not hurting the US nearly as much as it is hurting Germany.

US Financial Exposure to Italy

At first look, direct exposure of US banks to Italy is not terribly troubling.



According to the Bank for International Settlements (BIS), outstanding US claims in Italy were worth $47.7 billion at the end of 2015. That is good enough to rank as US banks' seventh largest exposure in Europe, but it is still only a fraction of the exposure the US has to the UK ($423.9 billion), France ($164.7 billion), and Germany ($164.1 billion). In other words, the US is nine times more exposed to the UK than Italy and almost four times as exposed to both France and Germany.

The three largest banks in the US are JPMorgan Chase, Bank of America, and Citigroup. Their balance sheets also bear out the fact that US banks are relatively insulated from the Italian financial sector. Of the top 20 countries that each of these three banks are exposed to, Italy is ranked 14th for JPMorgan Chase, 15th for Bank of America, and 18th for Citigroup. JPMorgan Chase's foreign exposure to its top 20 countries is $269 billion; its exposure to Italy is $6.8 billion. The ratio is similar for Bank of America, where Italy represents 2.5 percent ($5.3 billion) of foreign exposure, and Citigroup, where Italy represents 2.2 percent ($16.2 billion) of foreign exposure.

U.S. BANK EXPOSURE BY COUNTRY (NET)

BILLION USD

BANK OF AMERICA		JPMORGAN CHASE		CITIGROUP	
U.K.	53.2	U.K.	46.7	U.K.	121.0
Brazil	15.7	**Germany**	**30.7**	Mexico	71.7
Canada	14.7	**France**	**26.2**	Cayman Islands	61.2
Japan	14.4	Japan	21.1	**Germany**	**45.6**
Germany	**13.4**	China	18.5	**France**	**44.7**
China	10.5	Canada	17.1	South Korea	42.8
India	10.4	Australia	13.6	Japan	36.8
Australia	9.5	Netherlands	12.4	China	35.1
France	**8.7**	India	12.1	India	35.0
Netherlands	7.6	Brazil	11.1	Singapore	31.8
Hong Kong	7.6	Switzerland	9.5	Australia	31.3
South Korea	6.9	South Korea	7.7	Netherlands	30.3
Switzerland	6.3	Hong Kong	6.8	Brazil	28.8
Belgium	5.5	**Italy**	**6.8**	Hong Kong	28.1
Italy	**5.3**	Luxembourg	6.5	Switzerland	27.4
Mexico	5.1	Spain	5.4	Canada	21.2
Singapore	4.7	Singapore	4.4	Taiwan	19.5
Turkey	3.1	Sweden	4.2	**Italy**	**16.2**
Spain	3.1	Mexico	4.2		
UAE	3.0	Belgium	4.0		

Note: Data as of Dec. 31, 2015
Sources: Bank of America
JPMorgan Chase
Citigroup

Examining the insurance industry is another way of getting at US exposure to Italy's banking crisis. And here too, on the surface, there seems to be relatively low exposure. Even back in 2011 and 2012, as parts of the eurozone were in crisis, US Treasury reports noted that US insurance industry exposure to Italy was under $3 billion—dwarfed by over $11 billion in exposure to Ireland and almost $6 billion in exposure to Spain. That trend has continued. According to the National Association of Insurance Commissioners' 2014 annual report (the latest available), that exposure has decreased in recent years. Italian bonds constituted just 1 percent of the US insurance industry's exposure to EU countries at the end of 2014, and just 1 percent of foreign stock exposure.

A last measure of US insulation from Italy's woes is the exposure of US money market funds (MMFs) to Italy. A 2011 Treasury report indicated US prime MMF exposure to Italy was $52 billion, and government MMF holdings only included $1 billion worth of Italian securities. The latest data available on MMF exposure (which companies have been required to file monthly with the SEC since 2010), doesn't even list Italy as a significant holding. If any MMFs are holding Italian securities, they have been relegated to the relatively small category of "other"—which accounted for just $8.5 billion as of May 2016.

PRIME MONEY MARKET FUNDS' HOLDINGS

JUNE 2011

REGION/COUNTRY	TOTAL PORTFOLIO SECURITIES (PERCENT)
Americas	38.92
Canada	8.40
Chile	0.01
U.S.	30.50
Venezuela	0.01
Asia and Pacific	11.92
Australia/NZ	6.67
India	0.03
Japan	5.17
South Korea	0.01
Malaysia	0.01
Singapore	0.03
Europe	49.01
Austria	0.23
Belgium	0.62
Denmark	0.72
France	**14.55**
Germany	**5.91**
Italy	**0.52**
Luxembourg	0.08
Netherlands	5.52
Norway	0.73
Spain	0.74
Sweden	3.95
Switzerland	4.33
Turkey	0.01
U.K.	11.10
Supranational	0.19
TOTAL	100.00

MAY 31, 2016

REGION/COUNTRY	TOTAL PORTFOLIO SECURITIES (BILLION USD)
Americas	424.8
Canada	133.1
U.S.	291.8
Asia and Pacific	228.7
Australia/NZ	54.4
China	6.6
Japan	152.9
Singapore	14.9
Europe	486.9
Austria	5.7
Belgium	15.3
Denmark	3.7
France	**153.2**
Germany	**37.6**
Netherlands	35.3
Norway	34.5
Sweden	103.3
Switzerland	37.7
U.K.	60.8
Supranational	1.4
Other	8.5
TOTAL	1,150.4

Note: The data reported changed from dollars to percentages between 2011 and 2016.
Source: Investment Company Institute

This limited financial exposure to Italy combined with low exporter dependence helps explain why the US has felt a limited impact, if any, from the problems that are beginning to cascade in the Italian banking sector. However, there are three significant challenges lurking that have the potential to fall like dominoes as the Italian banking crisis kicks into full gear—and these dominoes will have a far greater impact on the US.

France and Germany

France and Germany are on the front line of the Italian banking crisis and are deeply exposed to the Italian economy in general. The US is exposed to France and Germany, and if Italy's banking problems do not remain confined to Italy—which seems very unlikely from our perspective—it is at that point the problem will really begin to manifest in the US.

US exposure to the UK is also substantial, but as the UK is far less exposed to Italy, we have not addressed US exposure to the UK in this report.

CONSOLIDATED POSITIONS ON COUNTERPARTIES RESIDENT IN ITALY

	TOTAL (claims on an immediate counterparty basis)	TOTAL (ultimate risk basis)	DERIVATIVES CONTRACTS	GUARANTEE EXTENDED	CREDIT COMMITMENT
Australia	609	699	138	220	18
Austria	6,276	6,566	75	151	257
Belgium	8,192	9,169	-	-	-
Brazil	927	-	-	-	-
Canada	1,200	1,301	372	-	-
Chile	2	2	-	-	-
Chinese Taipei	225	220	-	6	40
Finland	-	-	-	-	-
France	**278,091**	**279,965**	**11,620**	**14,817**	**31,913**
Germany	**91,573**	**92,717**	**12,466**	**33,324**	**1,463**
Greece	310	311	19	-	-
Ireland	1,718	1,759	-	-	-
Italy	-	-	-	-	-
Japan	29,588	30,474	15	1,000	4,901
South Korea	438	418	-	193	1
Mexico	12	-	-	-	-
Netherlands	28,230	28,458	-	-	-
Panama	5	-	-	-	-
Spain	48,573	49,360	2,270	5,584	5,454
Sweden	639	496	641	414	299
Switzerland	20,603	19,656	6,605	7,229	1,582
Turkey	76	98	-	-	-
U.K.	31,916	32,892	12,138	46,355	6,989
U.S.	**50,224**	**47,744**	**22,419**	**83,932**	**9,468**

MILLION USD

Source: Bank for International Settlements

The table above from the BIS shows exposure for all banks to Italy. The US, as we noted, has direct exposure of $47.7 billion according to this data. France has exposure of $280 billion, and Germany has exposure of $92.7 billion. The France figure is particularly eye-catching, and even more striking, because at the end of June 2011, French exposure to Italy was $416.4 billion. So French banks in particular have anticipated the crisis in Italy, and have managed to pull back their exposure by 32.7 percent. Even so, their direct bank exposure is particularly high.

Crédit Agricole, for instance, notes in its 2015 annual report that Italy constitutes 26 percent of total exposures at default for the bank. Société Générale is coyer in its 2015 annual report; it only indicates Italy contributing 2.4 percent (17.6 billion euros) to total exposure at default for the bank. However, this is only sovereign exposure. Credit exposure is not broken down by country, but "Western Europe excluding France" is a category of its own and accounts for 21 percent of the bank's credit exposure—151.6 billion euros. Obviously, Germany and other Western European countries make up some of that total, but Italy no doubt makes up a fair chunk as well. France's largest bank, BNP Paribas, notes that Italy contributes 15.4 percent to its gross exposure at default (137.9 billion euros).

As for Germany, we looked closely at Deutsche Bank. Net credit risk exposure to Italy was 13.3 billion euros at the end of December 2015, according to Deutsche Bank's annual report. Its gross position in Italy is 35.4 billion euros.

The US is, in turn, exposed to Germany and France. US banks' combined exposure to Germany and France was $325.8 billion according to the BIS. France and Germany represent 21.1 percent of JPMorgan Chase's foreign country exposures, 10.6 percent of Bank of America's, and 12.3 percent of Citigroup's. Meanwhile, the US insurance industry's exposure to French bonds was 12 percent of their total investments ($29.6 billion) and German bonds were 4 percent ($10.7 billion). Prime MMFs held $168.4 billion of French securities (second highest after US securities) and $37.6 billion worth of German securities.

This demonstrates some of the linkages that the US has with Germany and France and how Italy's woes have the potential to affect US positions. Already, major German and French banks have been under pressure. Low interest rates have kept profits down, the slowing of exports has hurt Germany in particular, and there have been layoffs in banks in both countries. French and German banks have moved to reduce their exposure to Italy, but the exposure remains high, and that has the potential to feed back on the US.

The Achilles' Heel: Off-Balance-Sheet Items, Credit Default Swaps, and Derivatives

Thus far, even the German and French risks should not by themselves induce terror. For a general frame of reference, the top 10 banks in the US have assets of $10.1 trillion, and according to the World Bank, the ratio of liquid reserves to bank assets in the US at the end of 2014 was 16.7 percent. That means that the 10 largest banks in the US have liquidity of roughly $1.7 trillion. Even if Italy defaulted on 100 percent of total US exposure as defined by the BIS, US banks would be able to cope. Obviously, it would be even worse if German and French banks had similar problems, but the figures create a picture of moderate to severe difficulty—not of catastrophe.

Lurking behind all of this, however, are things like credit default swaps, various other derivatives, and various off-balance-sheet items. The scariest part of these variables is that they are extremely difficult to quantify accurately. Take Deutsche Bank for example. Deutsche Bank had 52 trillion euros worth of derivatives on the books as of the beginning of 2015. Deutsche Bank breaks that down into 634.4 billion euros of positive market value, and 615.3 billion euros of negative market value, which brings the net market value to a much more digestible 19.1 billion euros.

The problem here, however, is that one must take Deutsche Bank's and others banks' words on their accounting. That means the extent to which these derivatives are assets or liabilities is uncertain at best. Many bank assets are bundled into credit default swaps or other derivatives contracts that get bundled and traded so many times that the institution holding the asset does not have a good idea of the value of the contract in the first place.

This is also, to a lesser extent, true of off-balance-sheet items. Banks have to report these off-balance-sheet items despite the ill-fitting name, but the details are scant. Bank of America's 2015 annual report shows total contractual obligations of off-balance-sheet arrangements to be $397.6 billion. Basic details about what they are, who holds them, and where these contractual obligations are located are not provided in Bank of America's (or any other bank's) reports.

One way to try and get around this is to go back to the BIS data, which includes other potential exposures in the categories of derivatives contracts, guarantees extended, and credit commitments. One of the most striking observations about US exposure to Italy in the BIS data is that, while claims themselves are worth $47.7 billion, US derivatives contracts, guarantees extended, and credit commitments in Italy outweigh every other country listed—even France.

CONSOLIDATED POSITIONS ON COUNTERPARTIES RESIDENT IN ITALY

	TOTAL (claims on an immediate counterparty basis)	TOTAL (ultimate risk basis)	DERIVATIVES CONTRACTS	GUARANTEE EXTENDED	CREDIT COMMITMENT
Australia	609	699	138	220	18
Austria	6,276	6,566	75	151	257
Belgium	8,192	9,169	-	-	-
Brazil	927	-	-	-	-
Canada	1,200	1,301	372	-	-
Chile	2	2	-	-	-
Chinese Taipei	225	220	-	6	40
Finland	-	-	-	-	-
France	**278,091**	**279,965**	**11,620**	**14,817**	**31,913**
Germany	**91,573**	**92,717**	**12,466**	**33,324**	**1,463**
Greece	310	311	19	-	-
Ireland	1,718	1,759	-	-	-
Italy	-	-	-	-	-
Japan	29,588	30,474	15	1,000	4,901
South Korea	438	418	-	193	1
Mexico	12	-	-	-	-
Netherlands	28,230	28,458	-	-	-
Panama	5	-	-	-	-
Spain	48,573	49,360	2,270	5,584	5,454
Sweden	639	496	641	414	299
Switzerland	20,603	19,656	6,605	7,229	1,582
Turkey	76	98	-	-	-
U.K.	31,916	32,892	12,138	46,355	6,989
U.S.	**50,224**	**47,744**	**22,419**	**83,932**	**9,468**

MILLION USD

Source: Bank for International Settlements

US derivatives contracts and guarantees extended in Italy total $106.4 billion—which changes the potential for overall US exposure to Italy. The US exposure to Germany and France when defined as derivatives contracts and guarantees extended, just according to the BIS data, adds up to $365.5 billion.

The BIS warns that it would be a mistake to take those numbers as the gospel truth about what derivatives contracts US banks hold in Italy and the number of credit default swaps changing hands for a few reasons. Most important, credit default swaps are not the only items included in these categories because the BIS data does not take into account other financial entities—like insurance companies or hedge funds—and because reporting depends on whether the reporting bank actually owns the underlying security. In practical terms, that could mean the risk is lower or higher, and based on recent history, assuming the latter is a safer bet.

Some financial observers were able to anticipate the 2008 subprime mortgage crisis because they were able to get their hands on which loans were being bundled into securities. By inspecting the situation of the home being purchased, the loan being given, and the status of payments on the mortgage, it was possible to see that there were a number of duds being packed into what were thought to be perfectly secure assets. The items and contracts being dealt with here are much more difficult to pin down, which is partly what makes their true risk difficult to gauge.

What can be said is that the volume of derivatives trading is extremely high, the asset qualities of these various securities are unclear (even at times to the institutions that are holding them), and it is into this house of cards that the Italian banking crisis threatens to blow. If the issue was simply traditional banking activities, the US would have substantial enough exposure to what is happening in Italy (via France and Germany) to feel the effects. Factor in the unknowns around these various other trading activities and it is possible to imagine a crisis that could spread very quickly through the global financial system.

During the 2008 crisis, the great unknown was derivative exposure and the lack of clarity about how assets were leveraged. That uncertainty alone is a problem. Nevertheless, in terms of relative exposure, the US was disproportionately exposed in 2008. From indirect evidence, which is inherently uncertain, we judge the United States' exposure to be far less than it was in 2008 to subprime mortgages. Consequences for the US might be somewhat more severe than the direct numbers indicate, but it would surprise us if they were consequentially greater.

Conclusion

One of the great multiplier effects in the European Union's handling of the Italian banking system is both political and institutional. Europe's finances are linked by proximity and by a long history of financial linkages. It is a problem that can only be solved collectively. However, Europe does not have collective interests. Each major country pursues its own path. In addition, Europe's decision-making structure is opaque. It is not clear what is up to nations and what is controlled by the EU. In addition, it is not clear who in the EU has the authority to make decisions. National interests and complex processes combined in Greece to prolong decision making and prevent solutions. Nothing has changed since then, which compounds the matter.

Historically, the United States has moved at a different speed in dealing with these matters than Europe. The different decision-making tempo and the outside possibility that the derivative and leveraging exposure of the United States is worse than estimated has the potential to create a major political crisis between the US and the EU.

The locus of the 2008 financial crisis was in the United States, and rapid decision making was possible, even if the decisions made were controversial—then and now. The locus of the crisis we are describing will be in Europe, and the greater American exposure to Europe, the greater American pressure will be on Europe to act decisively. Since Europe seems incapable of rapid decision making, this could create a collision with the United States.

Ultimately, the US is not appreciably exposed directly to the Italian banking crisis. However, the US is deeply exposed to other major Western European countries, particularly France and Germany. The Italian crisis will have deep ramifications, especially for these two countries, and that in turn means that, indirectly, the US economy will feel significant effects from the overall crisis. Looming over it all is the question of derivatives, a question that is all the more ominous because its answer is ambiguous at best. Indirect evidence suggests that this is worse than what the official numbers say, but not so severe as to put the US directly in the path of the coming storm.

In our view, the US will be something of an on-looker this time. While the US will certainly feel the effects of a deeper crisis in Europe, European uncertainty in its response will not create a subsequent political crisis between the US and the EU. Still, the possibility should be borne in mind, depending in large part on how hard the American financial system is hit. Even minor pain and anxiety could cause the US to find the European approach intolerable. Financial crises of this magnitude are not solved by markets but by political systems, which are sensitive to these crises in very different ways than the financial system.