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TO: Interested Parties

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RE: Why Greece Matters

Why does Greece, with an economy the size of Indiana, matter? If Indiana were to default on its debt, Europe wouldn't care. Besides, Europe just agreed on a new bailout deal that is being hailed as a solution to Greece's debt problem. Isn't this solved?

We are skeptical that this latest bailout will be sufficient, and question whether it simply kicks the problem down the road. In this paper, we show what could happen if Greece's debt problem isn't solved and what it means for America.

Greece's problem is very simple: massive debts relative to its size that it cannot pay. The reason it matters ultimately comes down to this—Greece is connected to the world economy, including ours, like never before.

Think of Greece as a mountain climber. If Greece were climbing alone, it may slip and fall. That would be a tragedy for Greece, but only Greece. Instead, as a member of Europe's currency union—the Eurozone—Greece is tethered to other countries, banks, businesses, and people each on its own mountain ledge, potentially pulling everyone down in a heap. Due to the interconnectedness of the world financial system, a Greek default could lead to the following four economic landslides, each with their own collateral damage:

1. European banks that own hundreds of billions of dollars of Greek debt would take massive losses on these loans which means they have far less money to lend to people and businesses;
2. Investors would doubt the ability of other weak peripheral Eurozone economies, such as Portugal, Ireland, Spain, and Italy, to pay their debts, driving down the value of these countries' bonds. European banks would be forced to take even larger losses because the debt of these countries makes up a greater share of their portfolios then Greece's. If Greece is Indiana, Italy is California—a much more difficult bailout with deeper consequences for the rest of the world;
3. The euro itself could dissolve if one or more of these weaker countries are forced or decide to leave the euro. This could lead to an unruly break up of the world's second-most important currency, with a devastating impact on the global economy; and

4. American financial institutions that lend to European banks would take huge losses. This could cause a loss in confidence in the American financial system similar to the fall of Lehman Brothers in 2008, with severe implications for the overall U.S. economy and everyone from Wall Street bondtraders to widows on pensions.

This memo, the third in our Capital Markets Initiative series for policymakers, delves into these issues below.

Background: Why Greece is Greece

In 1997, before joining the Eurozone, interest rates on 10-year Greek government bonds stood at about 9.8%. These high rates reflected investors' views of Greece's economic stability at the time—which is to say, not at all positive. By way of comparison, rates on German bonds—considered the safest European bonds—averaged 5.7%.[1] In 2003, just two years after joining the Eurozone, Greece could borrow at roughly the same rate as Germany—4.3% for Greek and 4.1% for German government bonds.[2]

Yet nothing had fundamentally changed about Greece except one thing: membership in the Eurozone. There was a belief that rather than being on its own, Greece was part of the economic cocoon of Europe. Its debt was viewed as less risky because of a perception that the European Union would aid any euro nation in trouble. In addition, because entry in the Eurozone is contingent on a country having its economic house in order (manageable debt, low budget deficits and stable inflation), investors may have believed that Greece's economy was healthier than it truly was.

What happens to a country whose borrowing costs drop nearly six percentage points in six years? In Greece, private and public borrowing exploded. As the IMF points out, "with . . . markets not differentiating between countries, the credit boom became difficult to stop once it had started."[3]

According to the Carnegie Endowment for International Peace, lower borrowing costs and the expansion of domestic demand boosted tax revenues for Greece. But instead of saving these tax revenues for the inevitable slowdown in growth, Greece signifcantly increased spending, particularly on the public sector.[4] When the financial crisis hit in 2008, the economy plunged into recession and interest rates on newly issued Greek government debt soared.[5]

Lower growth further exacerbated the debt crisis, and once the country's economy started to contract, Greece's membership in the Eurozone limited its options to save itself from default. For example, it could not depreciate its currency (which would make exports cheaper) because Greece no longer has its own currency. It could not turn to a Greece Central Bank to take measures to adjust interest rates; they are now reliant on a European Central Bank.

The European Union and the International Monetary Fund (IMF) stepped in to provide a 110 billion euro loan package for Greece in May of 2010.[6] They hoped this would give Greece time to get its fiscal house in order and resume borrowing in the private markets on reasonable terms. However, the austerity measures that were imposed upon Greece as a condition of receiving the loan package further contributed to its deepening recession and worsening debt. In 2010, its economy actually contracted by 4.5%.[7]

Four Reasons Why Greece Matters

1) The Greece contagion could spread to European banks.

The extent of Greece's debt is large, but compared to the world economy or the $13.5 trillion Eurozone economy,[8] not enormous. Greece has about $465 billion in outstanding debt with roughly two-fifths held by Greek investors and banks and three-fifths held by foreign investors and banks.[9] German, French, and British banks are the largest foreign holders of Greek debt, with the United States owning a small amount.[10]

Greece recently passed an austerity package on June 29, 2011 that allowed it to receive another loan installment from the IMF and the European Union. However, Greece's economy cannot create the cash flows necessary to sustain their current debt burden. Which is why many question whether Greece can pay its debts in their entirety, leading to a default. It is similar to a homeowner who has a $5,000 mortgage with only a $4,000 monthly income.

If Greece defaults, European banks are holding—collectively—what could be several hundred billion dollars in bad loans. Imagine that you read in the papers that your local bank had an enormous portfolio of potentially bad loans. You might feel compelled to move your money to a safer place. That's what could happen with investors who have money in these large banks. They will get spooked and seek to remove their money which further threatens the solvency of these large European banks.

When banks become threatened with insolvency, they do not lend cash—they hoard it. They are compelled to increase their capital to cover potential losses and show investors that they have enough cash on hand to weather any approaching financial storm. This is especially true now, because European banks have not fully recovered from the financial downturn in 2008 and are still highly leveraged, meaning they have a high level of debt relative to their equity.[11]

If these European banks must focus on their balance sheets, they will not lend as much money to businesses and consumers. This means fewer new investments in plants, equipment, products, and hires; fewer loans for a car or a home in Europe.

As the IMF reports, "Restoring confidence in the Euro area's banking system is a prerequisite to turning the page on the crisis."[12] But a Greek default would have the opposite effect on confidence.

2) Greece is the tip of the iceberg for European sovereign defaults.

Greece currently has the worst credit rating of the 126 countries that Standard & Poor's rates, even worse than Pakistan.[13] But Greece is just the tip of the iceberg.

Countries such as Portugal, Ireland, Spain, and Italy—who combined have a total GDP almost 13 times the size of the Greek economy[14]—also saw interest rates drop upon entry into the Eurozone and are now facing similar debt crises. Markets tend to view these countries similarly, and financial commentators often refer to them together when discussing debt problems within Europe, referring to them collectively by their initials—PIIGS (Portugal, Ireland, Italy, Greece, and Spain).

For example, both Ireland and Portugal received large bailout packages from the European Union and IMF to avoid default. Both countries have large budget deficits, high unemployment, and negative economic growth over the last year. Spain, too, has a budget deficit over 9% and an unemployment rate above 20%.[15]

Of particular concern is Italy, the eighth largest economy in the world and third largest economy in Europe. Italy has a higher debt to GDP ratio than any European country besides Greece.[16] According to Thomas Mayer, chief economist with Deutsche Bank in Frankfurt, "Italy is the 850-pound gorilla in the room . . . It is too big to be saved by the rest of Europe. It is a weight they cannot lift."[17]

If Greece defaults, it would quickly affect the value of these countries' bonds. In fact, the current Greek turmoil is already affecting the value of these countries' bonds, with yields on Spanish and Italian bonds reaching the highest levels since the launch of the euro.[18] Given the much larger exposure of European banks to the debt of Ireland, Portugal, Spain, and Italy—the 90 major European banks that recently underwent a stress test conducted by the European Banking Authority have close to $1 trillion of exposure to these countries.[19] Lower values for these bonds would pose exponentially more problems for the financial health of these institutions, with increasingly dire consequences for the European economy.

In fact, the European Central Bank is worried that "A default in one country might cause a general banking system collapse in Europe," a concern shared by the new IMF Managing Director Christine Lagarde.[20]

3) The Euro could be at risk.

The euro is an experiment.

Through the Eurozone, it brought together 17 historic rival countries with different languages, cultures, and economic might to form a loose confederation of nations under one currency. Now it faces its first true crisis that goes to the very existence of the euro itself.

The euro was officially launched in 1999 to increase both the political and economic integration of Europe. Before its creation, each European country had its own currency, which—proponents of the euro argued—hampered the efficient movement of capital, goods, and services across the European continent. The euro was meant to reduce barriers to economic efficiency for those countries that chose to join the Eurozone.

According to the European Central Bank, since its inception, the euro has served to reduce transaction costs, increase price transparency, eliminate currency fluctuations, and keep interest rates low and stable for countries in the Eurozone—all of which created economic growth.[21]

However, the financial crisis exposed the weaknesses in the Eurozone. Some commentators have asserted that the euro may not be sustainable, arguing that a currency union with countries that have such varied economies as Greece and Germany was flawed at its inception and bound to fail. This is particularly true since this monetary union was not accompanied by a fiscal union—meaning the European Central bank controls monetary policy but has no control over the spending and tax policies of member nations. In addition, the European Union is not nearly as integrated as the United States where we are truly one nation and we expect one part of the country to help the other. The Eurozone is only 12 years old and is akin to the United States in 1801—a gangly collection of states searching for a common identity.

The euro is the second most important world currency, behind only the U.S. dollar as a reserve currency held by central banks around the world.[22] Additionally, many assets throughout the world are denominated in euros. If countries begin to leave the euro and revert to their former currencies, it could cause widespread havoc in world markets as countries and financial institutions that hold euro denominated assets face unknown repercussions.

European leaders that support the euro want to avoid these scenarios at all costs. This is one of the reasons why European leaders are so committed to avoiding a Greek default and have already used taxpayer dollars to assist Greece, Ireland, and Portugal. They are worried about the consequences a Greek default would have for the future of the euro, and intend to preserve it.

4) American financial institutions and the wider American economy are exposed.

American financial institutions—including investment banks, mutual funds, and brokerages—have only a trivial sum tied up directly in Greek debt. But U.S. financial institutions are tethered to European banks, and as a result, so are ordinary American investors.

There is a vast market of lending between financial institutions that involves enormous quantities of money. Each day, financial institutions lend top-rated companies, including highly-rated banks, trillions of dollars to keep the wheels of commerce running.[23] Many of these loans are very short term—some lasting only one day—and many come from the United States. Financial institutions allow ordinary Americans—through their pension funds, retirement accounts, and investment portfolios—to hold a portion of these loans through investment vehicles that are commonly known as *money market funds*.

Investors view money market funds as a safe investment, similar to bank deposits. That is because short-term lending to top-rated companies and banks is considered rock solid. Prior to 2008, only one money market fund had ever experienced a loss.[24] However, after Lehman Brothers failed, a major money market fund—the Reserve Primary Fund—suffered losses and investors fled. As The Wall Street Journal explains, "The fund 'broke the buck' as its net asset value fell below the $1 a share that money funds seek to maintain. For several days, the commercial-paper market, the lifeblood of global corporate finance, virtually halted."[25]

Many investors and regulators are worried about another loss for American money market funds, which own huge amounts of short term loans to European banks with exposure to European sovereign debt. In fact, "about 50 percent of the funds' $1.6 trillion in prime money market assets is in the debt of European banks."[26]

Some fear that the contagion of bad Greek loans would spread to the United States through these short term loans to European banks and its impact on money market funds, which could go from safe to bad in a matter of days. Significant losses in American money market funds would shatter investor confidence in U.S. financial markets. Like the financial crisis of 2008, consumers would pull back spending and possibly remove deposits from financial institutions; this would result in American banks tightening their lending in order to maintain enough cash on hand to weather the storm. A very reluctant and tapped U.S. federal government may be summoned again to provide liquidity to the lending markets. Less lending—in everything from car loans to bank-to-bank loans—means less economic activity and slower growth.

In addition, the European Union is the largest trading partner of the United States. In 2009, the United States exported $287 billion in goods and services to Europe, and European direct investment in the United States totaled over $120 billion.[27] Those numbers will be certain to fall as European economies falter. The debt crisis in Europe will also likely weaken the value of the euro which makes our exports more expensive, compounding the effects of decreased European demand for our products.

Conclusion

Because the world financial system is so interconnected, a Greek default—through financial contagion—could damage both the United States and world economy. How extensive will the damage be?

There are different responses to this question. Some view a Greek default as a doomsday scenario for America. "If Greece is just unable to pay its debts, we are going to see finance suddenly freeze up," said Gus Faucher, an economist at Moody's Analytics, a research firm." We are going to see huge drops in stock prices. Firms are going to get very cautious, very anxious again. They're going to lay people off. It's going to be very similar to what we saw in late 2008, early 2009, on top of what we already had. So it would be really disastrous for the American economy."[28]

However, not everyone is convinced that Greece matters a great deal to the U.S. Former IMF chief economist Raghuram Rajan has said, "If it (the debt restructuring) happens in a way that banks and markets are prepared for, even if not publicly but at least privately, it is very well containable."[29]

Whatever the eventual outcome of Greece's debt crisis, the current interconnectedness of the world financial system means that credit events in Europe—and other disruptions in financial markets throughout the world—will continue to have potentially disruptive consequences for the American economy. While American policymakers do not have much direct influence on events in Europe, they need to remain vigilant about the challenges that the interconnected financial system continues to pose for a strong American economic recovery.

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