Konrad-Adenauer-Stiftung e.V.

U.S.A.
DR. NORBERT WAGNER
MICHAL MACHNOWSKI

March 10th 2010

www.kas.de
www.kasusa.org

The Greek Financial Crisis: Fall-out in the US

Within the current economic downturn, the U.S. is considering the implications of a weakened European recovery, the debt crisis in Greece and its effect on the global economy. Questions remain as to whether the current factors are large enough to revive the financial crisis in the U.S. Almost every advanced country, including the United States, faces some combination of huge budget deficits, high debts, aging populations, and political paralysis. It is believed to be an unstable mix, and the current unpleasant choices confronting Greece await the U.S. and other wealthy nations in the near future.

The Greek economic crisis originated in the fears that Greece wouldn't be able to refinance bonds ($23 billion) maturing in April and May. If lenders balked, Greece would default on the bonds. A default would inflict losses on banks and other investors. A Greek default could undermine market confidence in other euro countries' ability to service their debts. Serial defaults would then threaten the global economic recovery.[1]

Greece's adoption of the euro contributed to the crisis. For years, with the dubious (but legal at the time) accounting provided by Goldman Sachs, Greece was able to borrow at low interest rates, with the prevailing assumption that the euro zone wouldn't allow one of its members to default, it would be rescued by the other members. But in practice, this is highly controversial. Considering that France and Germany both have high debts, would they be willing to foot another bill for an irresponsible neighbor?

One way for Greece to solve this on its own is to enact a harsh austerity that reduces borrowing. Greece has already pledged to cut government workers and to raise taxes on alcohol, tobacco and fuel. The other euro zone members want more, and their dilemma is that either rescuing or abandoning Greece is a gamble.[2]

Kenneth Rogoff, Professor at Harvard University, said that the austerity program enacted by the Greek government will prompt the E.U. to provide a bridge loan which won't be enough to save the country in the long run.[3] According to Professor Rogoff, investors will eventually demand higher interest rates to lend to countries around the world that have accumulated debt, including the U.S. The International Monetary Fund forecast last November that gross U.S. borrowing will amount to the equivalent of 99.5 percent of annual economic output in 2011. The U.K.'s will reach 94.1 percent and Japan's will escalate to 204.3 percent. "In rich countries-Germany, the United States and maybe Japan-we are going to see slow growth. They will tighten their belts when the problem hits with interest rates."

So far, according to Professor Rogoff, the concerns about the euro zone's ability to withstand the deteriorating finances of its member nations have outweighed the U.S.'s deficit troubles, propping up the dollar. "The

[1] Newsweek, the Real Greek Tragedy. By Robert Samuelson, February 19th, 2010

[2] http://www.newsweek.com/id/233880

[3] Bloomberg, Harvard's Rogoff sees sovereign defaults, 'painful' austerity. By Aki Ito and Jason Clenfield, February 24th, 2010

more they suck in Greece, the lower the euro goes, because it's not a viable plane. Clearly the dollar is going to go down against the emerging markets—there's going to be concern about inflation and the debt. The U.S. is in a state of paralysis in its fiscal policy, and monetary policy will tighten first, and I don't think it's the right mix. When they (Federal Reserve) start tightening monetary policy even a little bit, it's going to send shockwaves through the system. We always have sovereign risk crises in the wake of an international banking crisis, usually in a few years, and that's happening. Greece is only the beginning."

Fears of possible sovereign defaults in Europe have also focused new attention on the bloated U.S. budget deficit. With a record deficit for this year of $1.6 trillion, to be followed by $1.3 trillion in 2011, years of accumulated spending have resulted with a U.S. national debt of $12.3 trillion. Congress recently enlarged the statutory cap to over $14 trillion to accommodate even more borrowing.

Niall Ferguson, from the Financial Times, wrote in February that "On reflection, it is appropriate that the fiscal crisis of the west has begun in Greece, the birthplace of western civilization. Soon it will cross the channel to Britain. But the key question is when the crisis will reach the last bastion of western power, on the other side of the Atlantic."

However, according to Bill Fleckenstein from Fleckenstein Capital, the crisis is already hitting home. According to Treasury International Capital data for December, China not only has stopped buying U.S. Treasuries but has begun liquidating them (through the likely path of letting its holdings mature and run off). With Russia and China having reduced their dollar stakes, this will ultimately lead to a weaker currency and/or higher interest rates.[4]

Mr. Fleckenstein described a scenario where U.S. interest rates remain absurdly low while at the same time the market finances U.S. debt will be virtually impossible. Either the Federal Reserve will have to keep a bid in the Treasury or mortgage markets—which will ultimately put pressure on the dollar and push rates up—or the Fed will exit quantitative easing and it won't be long before rates start rising. "Given that the average maturity rate of the U.S. debt is under four years, we will see our own variation of Greek angst somewhere down the road."

In the wake of the ever growing U.S. deficits, U.S. House of Representative Majority Leader Steny Hoyer stated that the U.S. faces a Greek-style economic implosion if the U.S. doesn't get its debt under control.[5] "It is enough to look across the Atlantic at Greece's extreme economic crisis and understand; It can happen here, unthinkable as that may have been, if we don't change course, it will happen here."

Majority Leader Hoyer said that the U.S. proportion of public debt as a percentage of the gross domestic product is nearing a tipping point, and credit might start to dry up if tangible steps aren't taken. "We would not be the first to fail. Spain under the Hapsburgs. France under Louis XVI. The Ottoman Empire in the 19th century. The British Empire in the 20th. All of them, all of them, were crippled by borrowing, by interest payments, by debt. We, of course, are not exempt. In every era, these fiscal issues are questions of national security and national success."

Majority Leader Hoyer also cited a study by the Center on Budget and Policy Priorities to state that "tax cuts enacted under President Bush, the wars in Afghanistan and Iraq and the economic downturn together explain virtually the entire deficit over the next 10 years," disputing the charge that President Obama shares blame for the nation's fiscal decline.

---

[4] MSN Money, US will suffer its own Greek crisis. By Bill Fleckenstein, February 19, 2010

[5] Politico, Hoyer: Greece is the word. By James Hohman, March 1st, 2010

In fact, Majority Leader Hoyer insists that President Obama and Congress are taking the deficit seriously-President Obama's proposed budget would supposedly cut the deficit by more than half by 2013 and that health reform will also eventually reduce the deficit. The President's a bipartisan fiscal commission, which is currently being formed, will make recommendations that will force Congress into making tough but necessary fiscal choices.

Simon Johnson, a former chief economist at the International Monetary Fund and currently a professor at the Massachusetts Institute of Technology, said that the recent troubles in the euro zone might actually give the U.S. economy some breathing room-only if the U.S. takes steps to correct its own financial mess. [6] Mr. Johnson stated that the euro is seriously under pressure, reinforcing the dollar's role as the world's reserve currency. Despite the talk by China and other countries holding high levels of U.S. debt that they would need a new world currency, the euro is not going to replace the dollar anytime soon. "It means we will be able to run up more debt, markets will let us do that at lower interest rates, than they would have otherwise. This buys us time to tackle the medium-term issues-around healthcare spending, around Social Security and around a sustainable tax base." Like Majority Leader Hoyer, Mr. Johnson warned that foreign patience could hinge on the creation of a bipartisan U.S. Commission that would force Congress to vote on deficit-lowering recommendations, such as higher taxes or cuts in Social Security and Medicare.

Desmond Lachman, a Resident Fellow at the American Enterprise Institute, believes that a deepening in Europe's sovereign debt crisis would pose a major risk to a still fragile U.S. economic recovery.[7] "It would do so not simply by clouding U.S. export prospects through a strengthening of the dollar and a weakening of the European markets. Rather, it would do so mainly by destabilizing global financial markets and by intensifying the global credit crunch. A further pull back in bank lending is the last thing that the U.S. economy needs right now."

"In considering how a worsening in the Greek economic crisis might impact global financial markets, it is well to recall that in 2007 when a butterfly flapped its wings in as insignificant an economy as Iceland, shudders were felt throughout the financial world. Similar ripples were felt late last year when Dubai World appeared poised to default. If such small countries had an impact on global financial markets, how much more so should one expect a worsening in the Greek situation? Greece's sovereign debt alone should give cause for worrying about the negative impact on global economic markets that would result from an increased market perception that Greece will not be able to honor its sovereign debt obligations. What makes the Greek situation all the more worrisome is that any failure in Greece is bound to set off dominos falling in countries like Spain, Portugal, and Ireland. These countries too all suffer from the weakest of economic fundamentals. It is difficult to see how such an eventuality would not have a major negative impact on the European banking system as well as on the global financial system."

"Greece is likely to get a temporary reprieve from its crisis by the bailout now being actively discussed by European finance ministers. However, the very strong public opposition voiced in Germany to any Greek bailout would suggest that it will be difficult for European governments to orchestrate repeated bailouts of that country. This should give additional pause to the Federal Reserve in its contemplation of an early exit from its policy of extraordinary monetary policy easing."

However, not all assessments are as bleak as the ones provided above. James Galbraith, an economics professor at the University of Texas, claims that it's the home-grown economic problems that are

[6] Associated Press, Europe debt woes could infect US recovery. By Tom Raum, February 10, 2010
[7] http://www.aei.org/article/101659

more of a threat for the U.S. economy.[8] "The European situation is dire, but there is no compelling reason to think it will have a strong effect on the United States."

"If the Germans don't budge, there could be a new panic in anticipation of a Greek default. In that case, expect a falling euro, a renewed flight-to-quality and a new rise in the dollar. This could be somewhat of a problem. But the monetary authorities can quell panic if they want to, by buying up the euro until the markets calm down. The consequences of an actual Greek default, exit from the euro and devaluation are hard to figure precisely, since dominos could fall elsewhere in the Mediterranean basin. Banks could be in trouble. But it's hard to say why there would be much effect on bank lending inside the U.S.—it's already flat anyway."

"The problem the U.S. faces is, primarily, internal: the collapse in the housing wealth of the middle class and high unemployment. Dealing with these problems is now being made practically impossible by the calculated hysteria over budget deficits, highlighted today as President Obama has chosen a notorious Social Security cutter to be the Republican chair of his bipartisan commission. Europe might not derail the U.S. economy, but there is every reason to fear that our own policymakers will."

---

[8] http://economy.nationaljournal.com/contributors/Galbraith.php