September 13, 2011

External Shock:

Euro Zone Sovereign Debt Crisis Threatens U.S. Recovery, Increases Risk of a Double-Dip Recession

U.S. policymakers should prepare for the increasing possibility that the euro zone sovereign debt crisis will worsen, threatening the anemic U.S. recovery and increasing the risk for a double-dip recession. The economies of the United States and the euro zone are interconnected by credit and trade flows – a crisis in Europe means a crisis in the United States. The current U.S. recovery is vulnerable. Real GDP grew at an annual rate of 0.7% in the first half of 2011; job creation has stagnated in recent months. Euro zone defaults or European bank failures could negatively impact the U.S. economy:

1. **U.S. financial institutions have $2 trillion of exposure to European banks.**[i]
   a. The U.S. money market industry had over $1 trillion (45% of total assets) of exposure to European banks at the end of July 2011.
   b. U.S. banks have $1.2 trillion of loan exposure to German and French banks alone.
2. **The threat of a Greek government default is rising and could precipitate a financial crisis in Europe.**
   a. Because the economic contraction in Greece has been worse-than-expected, the Greek government has been unable to raise sufficient revenue to meet its budget deficit targets with the IMF and euro zone member-states. It is unlikely Greek policymakers have the political will to enact further draconian cuts ("austerity fatigue"), and there is growing popular opposition in Germany and other core euro zone countries against further bailouts ("bailout fatigue").
   b. Market rates suggest the likelihood of a Greek default is high: two-year notes now yield 57.9%, five-year notes 31.6% and ten-year notes 19.5%; comparable German government bond rates are 0.37%, 0.86%, and 1.7%, respectively.
3. **European banks are heavily invested in euro zone sovereign debt.**
   a. British, German and French banks have over $1.5 trillion of collective exposure to the sovereign debt of peripheral euro zone countries.

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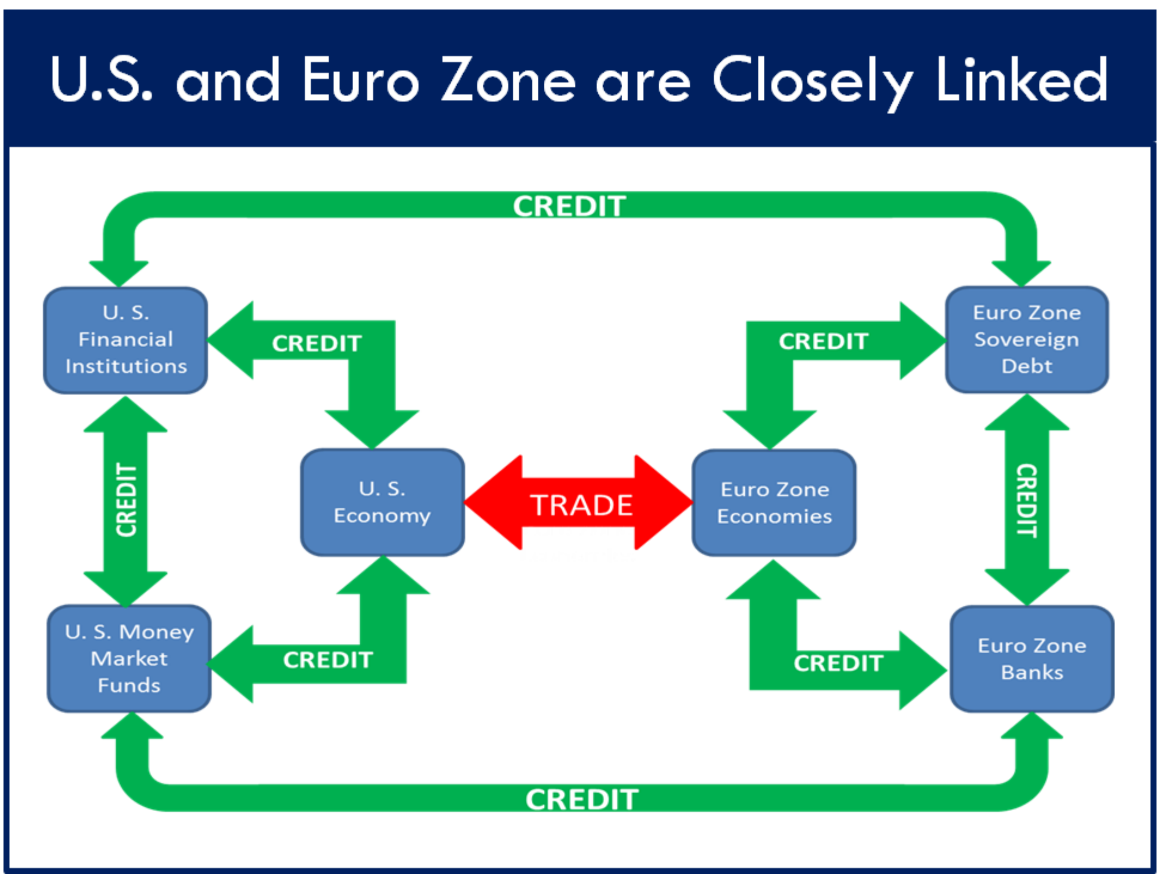
4. **Greek default could cause contagion across the euro zone and threaten the remaining "PIIGS" – Portugal, Ireland, Italy, and Spain – much like the failure of Lehman Brothers impacted the global banking system in the fall of 2008.**
5. **Any sovereign default would require European banks to take large write-downs on their assets.**
    a. An initial draft report by the International Monetary Fund estimates that European banks may face a capital shortfall of €200 billion ($272 billion).
6. **A financial crisis in Europe could significantly harm the U.S. economy.**
    a. Insolvent European financial institutions would create losses at U.S. banks and money market funds holding obligations of those European institutions. Losses may reduce U.S. business investment, as global investors become more risk averse, and may tighten U.S. credit conditions, as banks become more cautious.
    b. EU member-states are key trading partners – the U.S. exported $413 billion to the EU in 2010, representing 22.4% of total U.S. exports. A European financial crisis would reduce euro zone demand for U.S. exports.



[i] See Lachman, Desmond, "The Euro Threat to Obama," *Wall Street Journal* (September 9th, 2011).