



### REPUBLICAN STAFF COMMENTARY

## Greek Economic Crisis

*Growing Contagion Risk for U.S. Economy*

June 1, 2012

### Introduction

The Greek economic crisis is once again dominating world headlines. Following an indecisive election on May 6, 2012, Greek parliamentarians were unable to form a new government. Voters blamed the New Democracy party (center-right) and the Panhellenic Socialist Movement party (social democratic), which had alternated in government since 1974, for the economic crisis. Together, they received only 32.0% of the vote. Since no party or a coalition of parties was able to form a government, Prime Minister Panayiotis Pikrammenos will lead a “caretaker” government until new parliamentary elections are held on June 17, 2012.

The political chaos has ignited a nascent bank run in Greece. Greeks fear that Greece will exit the European Monetary Union (EMU), replace the euro with a newly issued drachma, and convert euro-denominated deposits in Greek banks into drachmas. If these events unfold, the foreign exchange value of the newly issued drachma would plummet, and price inflation would soar. To protect their wealth, Greeks are withdrawing their deposits from Greek banks and placing them in banks in Germany, Switzerland, the United Kingdom, and even the United States.

Ironically, this bank run increases the likelihood that Greece will exit the euro. Recently, the European Central Bank (ECB) suspended lending to four insolvent Greek banks until they received capital injections from the Greek government; and other Greek banks are rapidly exhausting their acceptable collateral to pledge to the ECB for lender-of-last-resort loans. Unless the European Union (EU), EU Member-States, or the International Monetary Fund (IMF) continue to make large transfer payments to Greece, Greek banks will run out of euros and close, precipitating Greece’s exit from the EMU.

A Greece-only exit from the EMU would have severely adverse economic consequences for Greece and mildly adverse economic consequences for the rest of the world, including the United States. However, there is a significant risk that Greece’s exit could become

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***A Greece-only exit from the EMU would have mildly adverse economic consequences for the United States.***

***If contagion were to occur, however, the United States may slip back into a recession.***

***After Greece joined the EMU in 2001, international financial inflows temporarily allowed the Greek government to fund an unsustainable rise in its budget deficit and debt and Greek households to fund an unsustainable level of consumption.***

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contagious, forcing other EMU Member-States, such as Ireland, Italy, Portugal, and Spain, to exit the EMU, abandon the euro, and reissue national currencies. If contagion were to occur, however, the EU Member-States would endure a severe recession, economic growth would slow in the rest of the world, and the United States may slip back into a recession.

### **What caused the Greek economic crisis?**

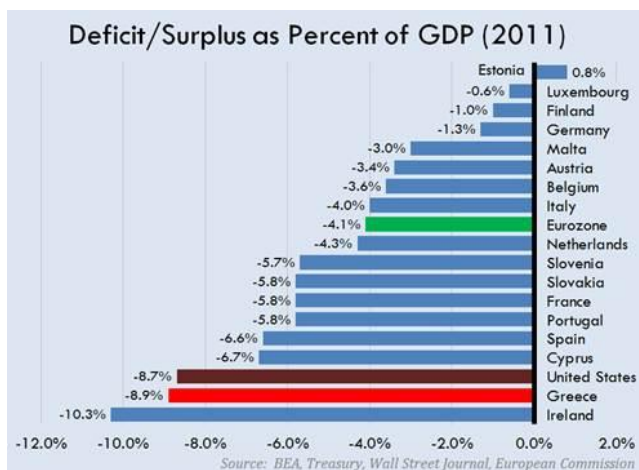
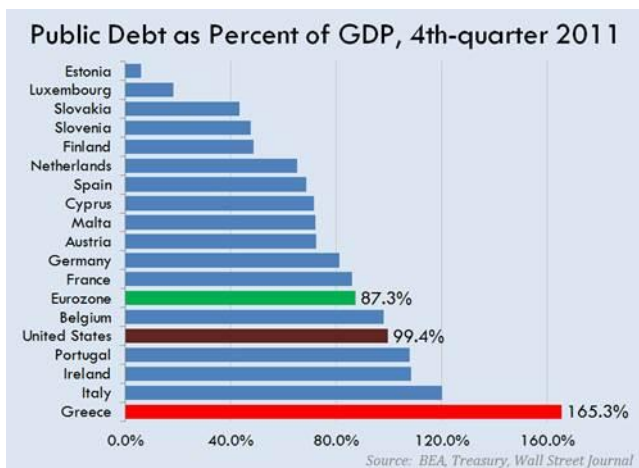
In 2001, Greece joined the EMU. The adoption of the euro encouraged banks and financial institutions in other EU Member-States to provide credit to the Greek government, businesses, and households on favorable terms. During the next eight years, international financial inflows temporarily allowed the Greek government to fund an unsustainable rise in its budget deficit and debt and Greek households to fund an unsustainable level of consumption.

According to the Congressional Research Service, “several deeply entrenched features of the Greek economy and Greek society ... have prevented sustained economic growth and created the conditions underlying the current crisis.”<sup>1</sup> Among these microeconomic weaknesses are:

- Pervasive state control of the economy that has promoted monopolies, limited competition, discouraged innovation and investment, and increased the cost of doing business;
- Overly generous unemployment compensation, old-age pension, and health care benefits (even by European standards) that have reduced labor force participation;
- A large and inefficient government sector;
- Endemic tax evasion; and
- Widespread corruption.

The adoption of the euro and subsequent international financial inflows masked Greece’s microeconomic weaknesses. Consequently, the gap in the international competitiveness between Greek businesses and businesses in other EU Member-States widened in the years leading up to the global financial crisis in the fall of 2008.

In 2009, the Greek government’s budget deficit soared to 16.8% of GDP, and its government debt ballooned to 129.1% of GDP.<sup>2</sup> Two years later in 2011, persistent double-digit budget deficits pushed government debt even higher to 169.1% of GDP.<sup>3</sup> At the same time, the size of the Greek economy shrank as real GDP has declined in every quarter from the first quarter of 2008 through the first quarter of 2012, having fallen nearly 17% cumulatively.



In the spring of 2010, ratings agency Standard & Poor's downgraded Greece's credit rating to junk status. Moody's followed suit in the summer of the same year. Between January 2010 and the end of 2011, Greek bond yields nearly quintupled from just over 5% to nearly 25% as international debt market participants became more concerned about the prospects of a Greek default.<sup>4</sup> As borrowing costs increased, the Greek government hit a fiscal "wall," and the economic crisis that has characterized the

past two years began.

### **What international assistance has Greece received?**

The combination of staggeringly high government budget deficits and debt and a falling real output (which reduces government revenues) have left Greece unable to pay its sovereign debt. As a result, a coalition of international entities known as the "troika"—including the European Commission (EC), the ECB, and the IMF—has extended two major financial assistance packages to Greece (see table on next page).

Funds from both the 2010 financial assistance package of €110 billion and the 2012 package of €158 billion are disbursed periodically subject to Greece achieving various financial and reform targets. For example, the March 2012 bailout demands Greece implement "further public spending cuts totaling a staggering 5½% of GDP in 2013 and 2014 that all too likely will only drive Greece further into economic depression."<sup>5</sup> Greek government attempts to reach these targets have caused significant social turmoil, including massive protests and ongoing labor union strikes.

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| EUROPEAN-IMF FINANCIAL ASSISTANCE PACKAGES FOR GREECE <sup>6</sup> |                                                    |                                                  |                                       |
|--------------------------------------------------------------------|----------------------------------------------------|--------------------------------------------------|---------------------------------------|
| Date Agreed                                                        | European Financial Assistance                      | IMF Financial Assistance                         | Total Financial Assistance            |
| May 2010                                                           | €80 billion<br>(about \$102 billion)               | €30 billion<br>(about \$38 billion)              | €110 billion<br>(about \$140 billion) |
| July 2011/<br>February 2012/<br>March 2012 <sup>7</sup>            | €130 billion <sup>8</sup><br>(about \$166 billion) | €28 billion <sup>9</sup><br>(about \$36 billion) | €158 billion<br>(about \$201 billion) |

**Notes:** Figures denominated in euros converted to dollars using exchange rate on May 16, 2012: €1 = \$1.2738 (Source: ECB). However, it should be noted that currency swings have been underway during the crisis and the dollar conversions have also fluctuated accordingly.

### **What must Greece do to solve its woes?**

Greece must simultaneously confront both short- and long-term challenges to enjoy sustainable long-term growth:

- Greece must pursue a program of fiscal consolidation to reduce its government budget deficit and stabilize the level of its government debt relative to GDP.
- Greece must implement major microeconomic reforms of its economy, including the comprehensive deregulation of labor and product markets, the privatization of state-owned enterprises, and the reduction of official corruption to reduce the cost of doing businesses and make Greek businesses internationally competitive relative to businesses in other EU Member-States.

### ***Fiscal Consolidation***

Greece's fiscal consolidation involves both tax increases and spending cuts. In its *Medium Term Fiscal Strategy 2012-2015*, the Greek Ministry of Finance projected that its fiscal consolidation plan consists of roughly 50% spending reductions and 50% higher revenue from tax increases, better tax collections, and other sources such as higher user fees and privatization receipts.<sup>10</sup>

Projected spending cuts have focused on shrinking the massive Greek civil service system and the other aspects of the government bureaucracy; however, it is difficult to determine whether many of the projected cuts have been or will be implemented.

Tax increases that have already been implemented included increasing the value-added tax a staggering 77% cumulatively in 2010 and 2011 and raising taxes on commodities such as fuel, tobacco, and alcohol. The Greek government sought additional revenues by selling

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some state-owned enterprises and enacting new laws aimed at reducing tax evasion.<sup>11</sup> In 2010, nearly one-third of taxes owed went unpaid in Greece.<sup>12</sup>

The Joint Economic Committee Republicans published a commentary, *Spend Less, Owe Less, Grow the Economy*, on March 15, 2011 that examined the empirical evidence on fiscal consolidations around the world. Biggs, Hassett, and Jenson (2010) found that successful fiscal consolidations were composed of at least 85% spending reductions and no more than 15% revenue increases. In successful fiscal consolidation plans, revenue increases were mainly from higher user fees and privatization receipts, not higher taxes. In contrast, unsuccessful fiscal consolidations were composed on average of 47% spending reductions and 53% revenue increases. Unsuccessful fiscal consolidation plans included significant tax increases.<sup>13</sup> Based on historical experience, Greece's tax-heavy fiscal consolidation plan is unlikely to achieve its budget deficit and debt reduction goals.

### ***Strategies to Increase International Competitiveness***

Reducing government spending and shrinking a bloated bureaucracy through fiscal consolidation is just one side of the equation. The other side is microeconomic reforms. To spark sustainable economic growth, Greece must remove the structural impediments that prevent Greek businesses from becoming internationally competitive.

There are three strategies that a country may use to try to increase the international competitiveness of its businesses: (1) currency depreciation, (2) microeconomic reform, and (3) "internal devaluation."

**Currency depreciation.** First, a country may loosen its monetary policy to reduce the foreign exchange value of its currency. Under this strategy, a decline in the foreign exchange value of a country's currency boosts import prices. The resulting domestic price inflation lowers real wages, provided a country's government and businesses do not give cost-of-living adjustments to workers. The prices for country's exports should decline in terms of foreign currencies to reflect this real reduction in domestic labor costs due to currency depreciation. In turn, declining export prices in terms of foreign currencies will help to make a country's businesses more internationally competitive. Consequently, a county's exports should grow, while its imports should shrink.

So long as Greece remains within the EMU, the currency depreciation option is foreclosed. Like all EMU Member-States, Greece has surrendered monetary policy to the ECB. Given the divergence among EMU Member-States, the ECB cannot pursue an appropriate monetary policy for the economic circumstances in every Member-State. The ECB has generally pursued a monetary policy targeted toward

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maintaining price stability in the slowly growing economies of France and Germany. The post-bubble recession might warrant a looser monetary policy in Greece. However, the ECB is unlikely to ease its monetary policy to the extent that an autonomous Greek central bank would because a looser monetary policy might provoke price inflation in France and Germany.

**Microeconomic reforms.** Second, a country may implement microeconomic reforms to boost the international competitiveness of its businesses. Such reforms include abolishing monopolies; privatizing state-owned enterprises; eliminating regulations that control market entry, prices, and output in specific industries; removing restrictions on foreign ownership and investment; liberalizing labor markets; and streamlining environmental, health, and safety regulations. In response to microeconomic reforms, domestic and international businesses increase their investment in new, more efficient buildings, efficient equipment, and software. The resulting technological advances, process innovations, and improved training boost labor productivity and reduce unit labor costs.

Overregulation and protectionism are primary factors pulling down Greece's rank to 100 out of 183 countries in the World Bank's 2012 rankings on the ease of doing business—one notch below the Republic of Yemen.<sup>14</sup> In contrast, Denmark ranked 5<sup>th</sup>, the United Kingdom 7<sup>th</sup>, Ireland 10<sup>th</sup>, Finland 11<sup>th</sup>, Sweden 14<sup>th</sup>, and Germany 19<sup>th</sup>. In subcategories, Greece ranked 135<sup>th</sup> in the ease of starting a business and 155<sup>th</sup> for protecting investors.

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The potential gains from microeconomic reforms in Greece are great. A study by private-sector think-tank IOBE found that opening up the nearly 70 closed-shop trades and professions in Greece could boost Greece's GDP by up to 17%.<sup>15</sup>

***However, the gains from successful microeconomic reforms take months, if not years, to be fully realized.***

However, the gains from successful microeconomic reforms take months, if not years, to be fully realized. For example, the comprehensive and successful “Hartz reforms” in Germany took over five years to be implemented. Although Greece must make many microeconomic reforms to boost economic growth and job creation over the long term, Greece may not be able to wait for the benefits of reform-stimulated investment to take hold.

**Internal devaluation.** That leaves Greece with one final option to increase the international competitiveness of Greek businesses over the short term. Greece must cut nominal wages to achieve real wage reduction through a process known as “internal devaluation.”

Unit labor costs in Greece have become disproportionately high relative to other EU Member-States. From 2000 to 2010, unit labor cost in Greece increased 45.5%, compared with 19.9% in the Eurozone, 14.9% in the EU, and 3.8% in Germany.<sup>16</sup> Greece's

minimum wage stands 50% higher than the minimum wage in Portugal, 18% higher than in Spain, and 5-7 times higher than in Romania and Bulgaria.<sup>17</sup> The high cost of production boosted Greece's harmonized unemployment rate, which stood at 18.8% in February 2012.<sup>18</sup> Cutting nominal wages is politically difficult and socially painful, but it would increase Greece's international competitiveness and place it on a stronger economic footing going forward.

### **Will Greece exit the euro?**

While the likelihood of Greece exiting the EMU was considered a "tail risk" in 2011, the prospects of an exit have increased significantly in the spring of 2012. Steven Englander of Citibank puts the probability of a Greek exit at between 50% and 75%. Economists at J.P. Morgan Chase put the probability of a Greek exit at 50%. The InTrade prediction market pegs the probability of an exit from the euro before the end of this year at 40% and prior to the end of 2013 at 60%.

The willingness of Greeks to support fiscal consolidation and microeconomic reforms has waned as the economic crisis has persisted. The two major parties, New Democracy and Panhellenic Socialist Movement, which approved the spending reduction conditions of the March EU-IMF bailout, were particularly hard hit in the Greek parliamentary election on May 6, 2012. The New Democracy party finished first and won 18.9% of the vote (108 seats). The Syriza party (a new socialist, anti-austerity party) finished second and won 16.1% of the vote (52 seats) on the contradictory pledge of keeping the euro, reversing the spending reductions promised to the troika, and adding 100,000 jobs to the Greek government payroll. The Panhellenic Socialist Movement party, which had led the previous government, finished a disappointing third and won 13.2% of the vote (41 seats). The Independent Greeks party (a new center-right, anti-austerity party that split from the New Democracy party) finished fourth and won 10.6% of the vote. The Communist Party finished fifth and won 8.5% of the vote (26 seats). The Golden Dawn party (an anti-immigrant, neo-fascist party) finished sixth and won 7.0% of the vote (21 seats). Finally, the Democratic Left party (a new social democratic party that split from the Panhellenic Socialist Movement party) finished seventh and won 6.1% of the vote (19 seats).

Regaining international competitiveness will require real wage reductions among Greek workers. As long as Greece retains the euro, these real wage reductions must occur through nominal wage cuts. However, if Greece were to exit the euro, the Greek central bank could allow the foreign exchange value of the drachma to drop. Price inflation, driven by higher prices of imported goods and services in terms of the drachma, could then reduce real wages without cutting nominal wages, provided the Greek government and businesses refrain from providing cost-of-living adjustments to Greek workers.

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***No party or coalition of parties could form a government after the Greek parliamentary elections on May 6, 2012, forcing another election on June 17, 2012.***

***Estonia provides Greece with a successful model for fiscal consolidation and “internal devaluation.”***

Pursuing a fiscal consolidation and an internal devaluation is politically unpopular and socially disruptive; however, it can be done successfully. For example, Estonia enacted a fiscal consolidation program amounting to nearly 16% of GDP cumulatively between 2008 and 2010, with 2/3 of the reform measures occurring on the expenditure side and 1/3 of the measures occurring on the revenue side.<sup>19</sup> After contracting in 2008 and 2009, the Estonian economy resumed growing in 2010. Given the social and political realities facing Greece, many economists and commentators now view such reforms as unattainable and, therefore, consider a Greek exit the most likely outcome of the current financial crisis.

The Greek predicament belies three major weaknesses in the EMU:

***Unlike the United States, the EMU does not provide automatic transfers among its Member-States based on their positions in the business cycle. In the United States, automatic fiscal transfers cushion the effects of having a common monetary policy when U.S. state economies are at different phases of the business cycle.***

- First, the EMU created a monetary union among disparate Member-States, but not a fiscal union that provides for automatic fiscal transfers among its Member-States based on their positions in the business cycle.<sup>20</sup> In contrast, the United States has automatic fiscal transfers among U.S. states based on their positions the business cycle through the operation of existing federal taxes and entitlement programs. For example, federal income and payroll tax collections will automatically fall, and federal outlays for entitlement benefits will automatically increase in a U.S. state that is experiencing an economic downturn relative to other states. The opposite occurs in a U.S. state that is experiencing an economic boom relative to other states. In the United States, these automatic fiscal transfers cushion the effects of having a common monetary policy when U.S. state economies are at different phases of the business cycle. Without automatic fiscal transfers, disruptive political battles occur whenever the EMU considers transferring funds from EMU Member-States in northern Europe to EMU Member-States in the Atlantic and Mediterranean fringes that are suffering recessions. This is an unsustainable feature of the EMU, which is why its founders often viewed the EMU as an intermediate step toward deeper fiscal integration in the EU.
- Second, for a monetary union to survive over time without a fiscal union, member-countries should have either (1) economies with highly synchronized business cycles, or (2) very flexible labor and product markets. Clearly, the economies of EMU Member-States do not have highly synchronized business cycles, and Greece, Italy, Portugal, and Spain have rigid labor markets.
- Third, a monetary union should allow the free migration of labor among its member-countries. While the citizens of any EU Member-State have the right to move to other Member-States to seek employment, language and cultural differences limit migration among EU Member-States especially for poorly educated, less skilled, monolingual individuals.



## **What are the economic consequences of Greece's exit from the EMU?**

If Greece were to exit from the EMU, the Greek government would default on its euro-denominated external debt and may redenominate euro-denominated domestic contracts between Greeks in drachmas. The Greek government may also invalidate euro-denominated international contracts between Greeks and foreigners. The Greek financial system would collapse, and Greece would nationalize its banks. For a time, the Greek economy may revert to barter until new drachma notes could be printed and circulated. Widespread rioting could occur as unpaid police and military personnel may be unwilling to maintain order. The Greek economy would continue to contract until the real unit production cost of Greek labor falls to an internationally competitive level, a Greek financial system is reestablished, and the foreign exchange value of the drachma stabilizes.

### ***Greece-only exit from the EMU***

A Greece-only exit from the EMU would pummel the Greek economy. Nevertheless, if the other EMU Member-States were to remain in the EMU, the adverse effects on the rest of the world would be limited.

After a Greece-only exit, Mark Cliffe, Chief Economist of the ING Group, estimated that the drachma would fall by 80% relative to the euro by year-end 2012. In Greece, real GDP would fall by 10.7% in 2012 (7.5 percentage points below the baseline forecast of a 3.2% contraction). The unemployment rate would rise to 21.8% by year-end 2012 (3.7 percentage points over the baseline forecast of 18.1%). Consumer price inflation would rise by 21.6% in 2012 (21.0 percentage points over the baseline forecast of 0.6% increase).<sup>21</sup>

A Greece-only exit would merely push the rest of the Eurozone into a moderate recession. In the Eurozone, real GDP would decline by 1.6% in 2012 (1.6 percentage points below the baseline forecast of no change). As a result, the unemployment rate would increase to 10.8% by year-end 2012 (0.8 of a percentage point above the baseline forecast of 10.0%).<sup>22</sup>

Outside of the Eurozone, the effects of a Greek-only exit would be more modest:

- In the United Kingdom, real GDP would be flat in 2012 (a percentage point below a baseline forecast 1.0% growth). The unemployment rate would increase to 8.5% at year-end 2012 (0.5 of a percentage point above the baseline forecast of 8.0%).<sup>23</sup>
- In the United States, real GDP would grow by 1.3% in 2012 (0.5 of a percentage point below a baseline forecast of 1.8%). The

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***After a Greece-only exit, the value of the drachma would fall by 80% relative to the euro by year-end 2012. In Greece, real GDP would fall by 10.7% in 2012, and consumer price inflation would rise by 21.6% in 2012.***

***After a Greece-only exit, real GDP growth in the United States would slow by 0.5 of a percentage point under forecast to 1.3% in 2012 and the unemployment rate would increase by 0.2 of a percentage point over forecast to 8.2% by year-end 2012.***

unemployment rate would increase to 8.2% at year-end 2012 (0.2 of a percentage point above the baseline forecast of 8.0%).<sup>24</sup>

- In Japan, real GDP would grow by 1.4% in 2012 (0.5 of a percentage point below a baseline forecast of 1.9%). The unemployment rate would increase to 5.0% at year-end 2012 (0.2 of a percentage point above the baseline forecast of 4.8%).<sup>25</sup>
- In the rest of Asia, real GDP would grow by 8.3 percent in 2012 (0.4 of a percentage point below the baseline forecast of 8.7%).<sup>26</sup>

### ***Contagion Risk from Greece's Exit***

The major risk to the United States is that Greece's exit would become contagious. Greece's exit could trigger bank runs in Ireland, Italy, Portugal, and Spain as their citizens seek to protect their wealth from domestic price inflation and the depreciation of foreign exchange value of reissued national currencies if these EMU Member-States also abandoned the euro. Like Greece, bank runs could make an exit from the euro a self-fulfilling prophecy. If Greece's exit from the EMU were to become contagious, not only would many banks in the EMU Member-States exiting from the euro fail, but banks in other EMU Member-States, such as Germany, with large exposures to the sovereign debt and debt of households and businesses in the exiting EMU Member-States, could fail.

Contagion beyond Greece would affect the United States through a number of channels:

- First, financial market participants still regard the U.S. dollar as the world's safe haven currency and U.S. Treasuries as the world's safe haven asset. Contagion beyond Greece would cause the foreign exchange value of the U.S. dollar to appreciate and U.S. Treasury yields to fall.
- Second, the growth of U.S. exports would decline from the combination of reduced European demand and a stronger U.S. dollar. The earnings and stock prices of U.S. non-financial multinational corporations that derive a large share of their sales and profits from Europe would decline. U.S. stock price indices would fall.
- Third, while large U.S. banks and other financial institutions have reduced their exposure to the sovereign debt of Eurozone Member-States and increased their capital, large U.S. banks and other financial institutions still have a significant exposure to the debt of European businesses and households. Although the losses associated with a European meltdown would not threaten the solvency of any large U.S. banks and other financial institutions, such losses would likely make them more risk adverse. The

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***Contagion would cause the foreign exchange value of U.S. dollar to rise.***

***Contagion would slow the growth of U.S. exports and cause U.S. stock prices to fall.***

***Contagion would widen the interest rate spreads between U.S. Treasuries and corporate bonds and would diminish credit availability for U.S. small businesses and households.***

interest rate spread between risk-free Treasuries and corporate bonds would widen. Credit availability for U.S. small businesses and households would diminish.

- Fourth, these factors would increase uncertainty among U.S. companies, slowing investment in new buildings, equipment, and software. In turn, this would slow private sector job growth.

***Contagion would deter job-creating business investment.***

### ***Break-up of the EMU; Reintroduction of national currencies***

To gauge the adverse economic effects of contagion, Cliffe examined the break-up of the EMU and the reintroduction of national currencies in all EMU Member-States. This maximally adverse break-up scenario is highly unlikely. However, estimating the adverse economic consequences of the break-up scenario provides a benchmark to judge the adverse economic consequences of various, far more likely contagion scenarios involving some combination of Ireland, Italy, Portugal, and Spain exiting the EMU after Greece.

Under the break-up scenario, Cliffe estimated that the Greek drachma would plummet by 80% against the German deutschmark by year-end 2012. The Portuguese escudo and the Spanish peseta would drop by 50% against the deutschmark; the Irish pound and the Italian lira would fall by 25% against the deutschmark; the Belgium franc and the French franc would decline by 15% against the deutschmark; and the Austrian schilling, the Finnish markka, the Luxembourgish franc, and the Dutch guilder would slide by 7.5% against the deutschmark. In contrast, the value of the Swiss franc and the U.S. dollar would strengthen against the deutschmark.<sup>27</sup>

The shock of a break-up of the EMU and reissuance of national currencies in all EMU Member-States would have serious global ramifications:

- Demand destruction would cause oil prices to fall to \$55 per barrel by year-end 2012 (\$40 per barrel less than the baseline forecast of \$95 per barrel).<sup>28</sup>
- Global equity markets would be rattled. By year-end 2012, share prices would decline by 35% in the Eurozone, 30% in the United States, 25% in the United Kingdom, and 9% in Japan.<sup>29</sup>
- The decline in house prices would accelerate. By year-end 2012, residential real estate prices would decline by 6.8% in the Eurozone (0.2 percentage points below the baseline forecast of a decline of 0.2%), 15.0% in United Kingdom (5.0 percentage points below the baseline forecast of a decline of 10.0%), and 1.5% in the United States (1.5 percentage points below the baseline forecast of no change).<sup>30</sup>

***A break-up would cause oil prices to fall to \$55 per barrel by year-end 2012.***

***A break-up would cause U.S. stock prices to drop by 30% by year-end 2012.***

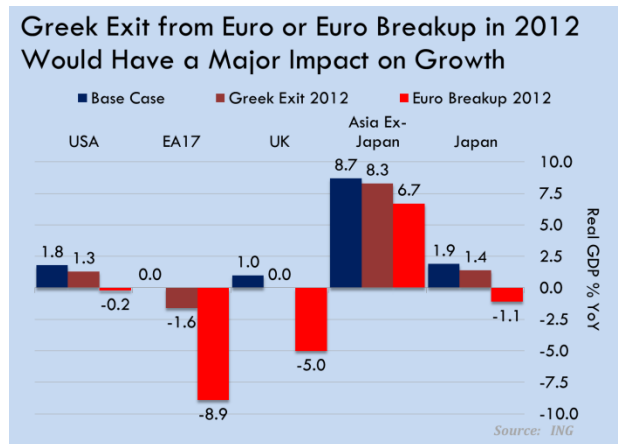
***A break-up would cause U.S. housing prices to decline 1.5% by year-end 2012.***

***A break-up would cause price inflation to soar in Greece, Ireland, Italy, Portugal, and Spain, but price deflation in Germany.***

***In the Eurozone, a break-up would cause real GDP to fall by 8.9% in 2012, and the unemployment rate to increase by 3.2 percentage points over forecast to 13.2% by year-end 2012.***

***In the United States, a break-up would cause real GDP to decline by 0.2% in 2012, and the unemployment rate would increase by 1.5 percentage points over forecast to 9.5% by year-end 2012.***

- A flight to credit quality would cause the yields on government bonds to fall in Germany, Japan, and the United States. In contrast, the yields on government bonds in Greece, Ireland, Italy, Portugal, and Spain would rise. Credit spreads for corporate over government bonds with similar maturities would substantially widen by year-end 2012 before beginning to reverse gradually. A widening of credit spreads implies a substantial reduction of credit availability to small businesses and households in the Eurozone, the United Kingdom, and the United States.<sup>31</sup>
- During 2012, consumer price inflation would rise substantially to 18.6% in Greece (18.0 percentage points above the baseline forecast of 0.6%), 9.5% in Ireland (8.5 percentage points above the baseline forecast of 1.0%), 10.3% in Italy (8.0 percentage points above the baseline forecast of 2.3%), 13.1% in Portugal (12.0 percentage points above the baseline forecast of 1.1%), and 12.9% in Spain (12.0 percentage points above the baseline forecast of 0.9%). In contrast, demand destruction would cause consumer price deflation of 0.9% in Germany (2.7 percentage points below a baseline forecast of an inflation rate of 1.8%).
- The Eurozone would suffer the worst recession since the Great Depression. In the Eurozone, real GDP would fall by 8.9% in 2012 (8.9 percentage points below the baseline forecast of no growth), and the unemployment rate would increase to 13.2% by year-end 2012 (3.2 percentage points above the baseline forecast of 10.0%).<sup>32</sup>
- In the United Kingdom, real GDP would fall by 5.0% in 2012 (6.0 percentage points below the baseline forecast of 1.0% growth), and the unemployment rate would increase to 10.8% by year-end 2012 (2.8 percentage points above to the baseline forecast of 8.0%).<sup>33</sup>
- In the United States, real GDP would decline by 0.2% in 2012 (2.0 percentage points below the baseline forecast of 1.8% growth), and the unemployment rate would increase to 9.5% by year-end 2012 (1.5 percentage points above the baseline forecast of 8.0%).<sup>34</sup>



- In Japan, real GDP would fall by 1.1% in 2012 (3.0 percentage points below the baseline forecast of 1.9% growth), and the unemployment rate would increase to 5.5% by year-end 2012 (0.7 percentage point above the baseline forecast of 4.8%).<sup>35</sup>
- In the rest of Asia, real GDP would grow by 6.7% in 2012 (2.0 percentage points below the baseline forecast of 8.7% growth).<sup>36</sup>

## **Conclusion**

A Greek decision to exit the EMU, abandoned the euro, and reissue the drachma does not pose a significant threat to the U.S. economy. Should an exit from the euro be confined to Greece, the adverse effects on the U.S. economy should be minimal. However, should the Greek exit spread to other EMU Member-States, the adverse effects on the U.S. economy would be significant, especially given the very tepid nature of the current recovery.

The most significant threats to the U.S. economy remain internal. If Congress and the Obama Administration fail to address the bloated size of federal spending and the rapid increase in federal government debt, the United States risks a loss of confidence in the U.S. dollar and a global financial crisis.

***If Congress and the Obama Administration continue to fail to address the bloated size of federal spending and the rapid increase in federal debt, the United States risks a loss of confidence in the U.S. dollar and a global financial crisis.***

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<sup>3</sup> Ibid.

<sup>4</sup> See: *Financial Times*, Interactive Timeline: Greed Debt Crisis (October 21, 2011), available at <http://www.ft.com/intl/cms/s/0/003cbb92-4e2d-11df-b48d-00144feab49a.html#axzz1uwy7g7z0>.

<sup>5</sup> Lachman, Desmond, "Mr. Obama's Greek Challenge," *Daily Caller* (May 15, 2012).

<sup>6</sup> Congressional Research Service; International Monetary Fund; European Union.

<sup>7</sup> A second rescue package for Greece was originally announced in July 2011, and was to provide €109 billion in official sector financing to Greece. However, the package was pending negotiations, and a revised package of €130 billion was announced in February 2012. The IMF approved its portion of the program in March 2012.

<sup>8</sup> The €130 billion (about \$166 billion) includes providing up to €30 billion (about \$38 billion) to private holders of Greek bonds participating in a write-down of Greek debt. In mid-March 2012, about €34 billion (about \$43 billion) from Greece's first program had not yet been disbursed by the Europeans. That money is still expected to be disbursed to Greece, and is in addition to the €130 billion (about \$166 billion) announced by the Europeans for Greece's second package.

<sup>9</sup> The first IMF program for Greece was canceled in March 2012; at the same time the second IMF program for Greece was announced. At the time, the first IMF program for Greece had about €10 billion (about \$13 billion) in undisbursed funds. Some argue that, then, the IMF was only committing, on net, additional funds for Greece totaling €18 billion (about \$23 billion) in the second program for Greece.

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<sup>36</sup> Ibid.