Statement before the Senate Banking Subcommittee on National Security and International Trade and Finance

Economic Crisis: The Global Impact of a Greek Default

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June 25, 2015

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute

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Thank you Chairman Kirk, Ranking Member Heitkamp, and members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view.

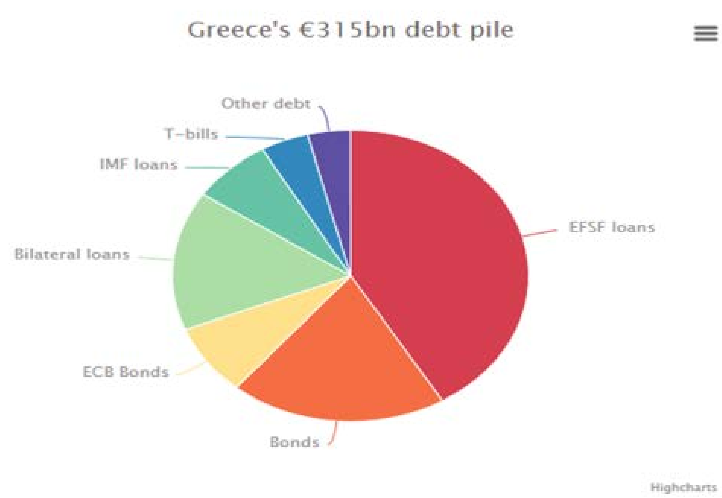
Introduction

Recent economic and political developments in Greece suggest that it is only matter of time before that country both defaults on its large public debt and imposes capital controls. Those developments could very well pave the way for Greece's exit from the Euro within the next twelve months. Were that to occur, one must expect that Greece's economic and political crisis will deepen, which could lead to that country becoming a failed state.

Europe is in a very much better position today than it was in 2012 to handle the immediate fallout from a Greek exit. However, a number of countries in the European economic periphery continue to experience weak economic growth at a time that they still have very high public and private sector debt levels. This makes them especially vulnerable to swings in investor sentiment once global liquidity conditions are normalized and once the perception becomes widespread that Euro membership is no longer irrevocable.

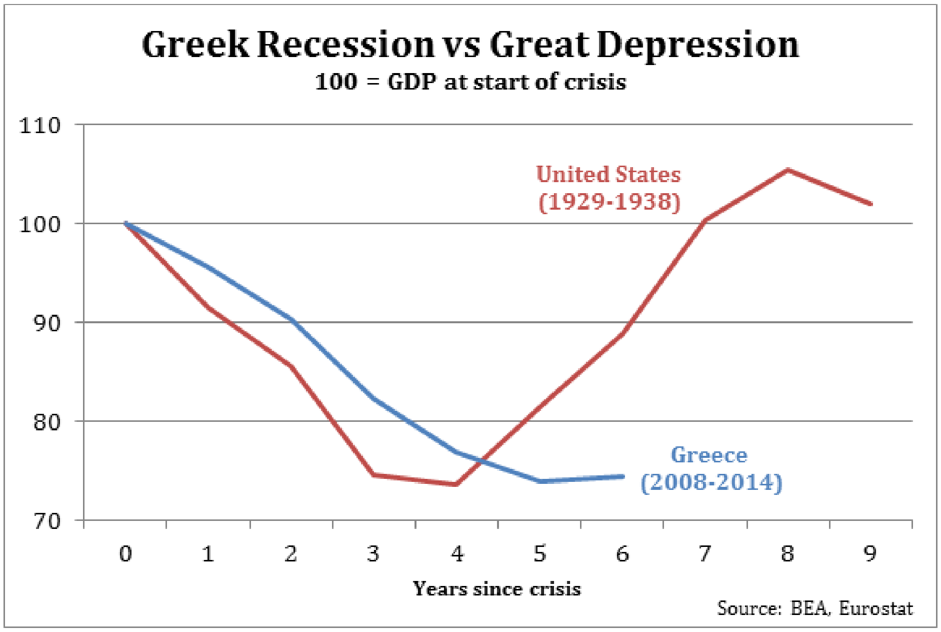
The implications of a Greek default for the United States are not to be underestimated. Immediate action by the European Central Bank (ECB) to limit contagion to the rest of the European periphery must be expected to further significantly weaken the Euro against the dollar that could have a material impact on the US trade balance. From a longer term perspective, should market financing for a country as highly indebted as Italy dry-up in the wake of a Greek exit, one should expect renewed tensions in global financial markets that could constitute a significant headwind to the US economic recovery. In addition, were Greece to become a failed state, a geopolitical price might be paid in the sense that Russia would have an opportunity to gain a firmer foothold in the Balkans.

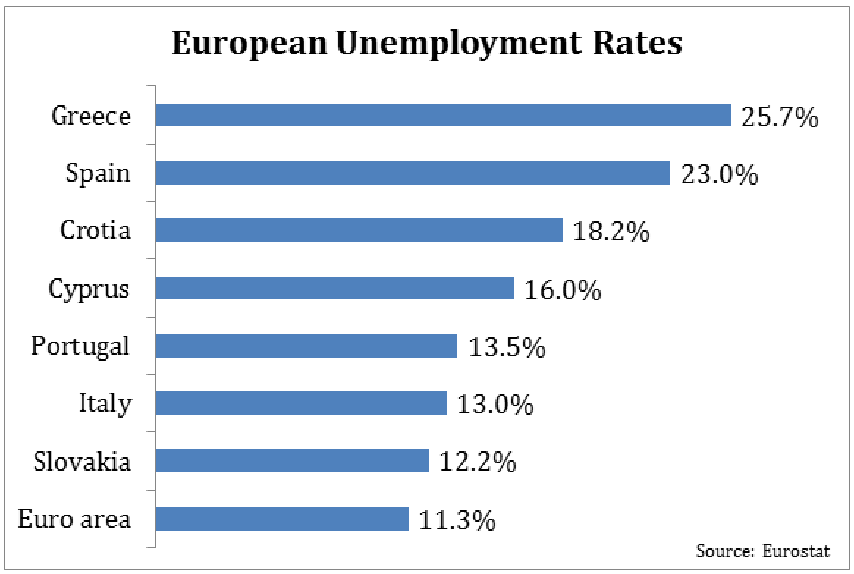
A deepening of Greece's economic and political crisis would further dent the credibility of the IMF, which has provided major financial support to Greece over the past five years and which has consistently underestimated the depth of the Greek economic depression.. It could also result in Greece's defaulting on the US$24 billion it owes to the IMF, which could have implications for the US taxpayer.



Greek economic and political backdrop

Over the past six years, Greece has experienced an economic depression on the scale of that experienced by the United States in the 1930s. Its economy has contracted by around 25 percent, its unemployment rate has exceeded 25 percent, and its youth unemployment has risen to over 50 percent. At the same time, despite five years of budget austerity and a major write-down of its privately owned sovereign debt, Greece's public debt to GDP ratio has risen to 180 percent.





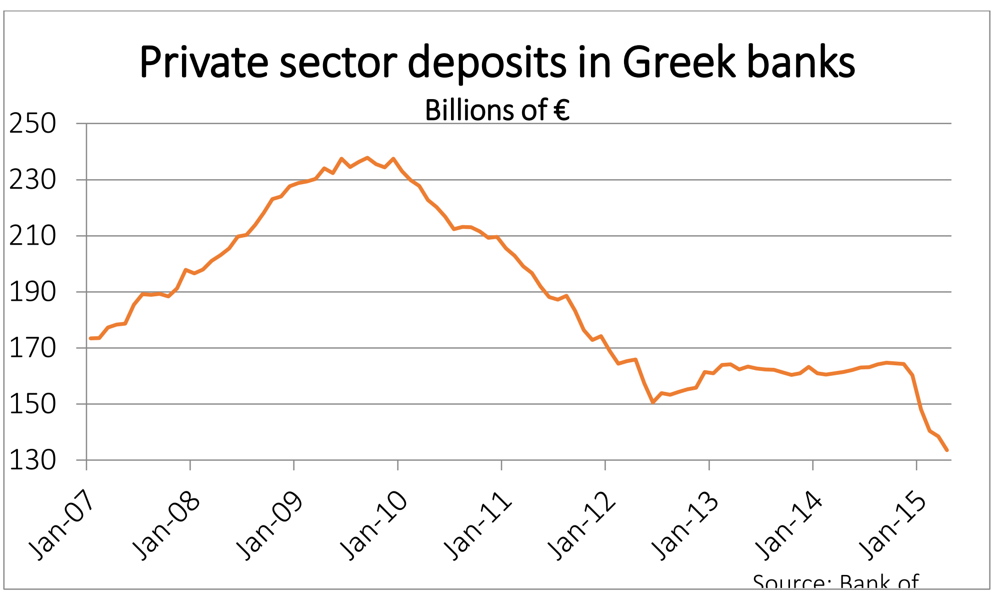
At the heart of Greece's economic collapse has been the application of draconian budget austerity within a Euro straitjacket. That straitjacket has precluded exchange rate depreciation or the use of an independent monetary policy as a policy offset to the adverse impact of budget belt-tightening on aggregate demand. To its credit, the IMF has conceded that in designing its economic program for Greece it had grossly underestimated the size of the Greek fiscal multipliers.

The deterioration in Greece's economy has given rise to the fragmentation of its politics and to a major anti-austerity backlash. This has been underlined by the decline in support for, Greece's two establishment political parties, New Democracy and PASOK from 70 percent in 2010 to around 25 percent at present. It has also been underlined by the rise of extreme political parties on both the right and the left side of the political spectrum as well as by the coming into office of the far-left Syriza government in January 2015. That government came into office on a platform of reversing the policies of budget austerity and structural economic reform that have been imposed on Greece by the IMF and Greece's European partners.

Negotiations with its creditors

Over the past five months, the Syriza government has been engaged in difficult negotiations with the IMF and EU on the release of much needed funds from its borrowing arrangement with those institutions. Until very recently, those negotiations have been characterized by large differences in positions over additional budget austerity and over pension and labor market reform that Greece's creditors are demanding of Greece in return for the release of those funds.

Since end-2014, in an atmosphere of heightened political uncertainty, Greece's economy has taken a renewed downturn while its public finances have moved from a small primary budget surplus to a primary budget deficit. At the same time, the Greek banking system has experienced a slow run on its bank deposits. These deposits have now fallen by around 20 percent since the start of the year and have required substantial European Central Bank support to keep the Greek banking system afloat.



This week the outlines of an agreement between Greece and its official creditors finally appears to be emerging that could release the funds so desperately needed to avoid a Greek default on the IMF and the ECB. However, it is highly questionable how long such an agreement will last. An essential component of that agreement appears to be yet another 2 percentage points of GDP in fiscal tightening over the next year and as much as 4 ½ percentage points of GDP in tightening over the medium term. A further weakness of that agreement is that it relies almost exclusively on tax increases to achieve its budget objectives and that it sorely lacks either pension or labor market reform that are much needed to promote economic growth.

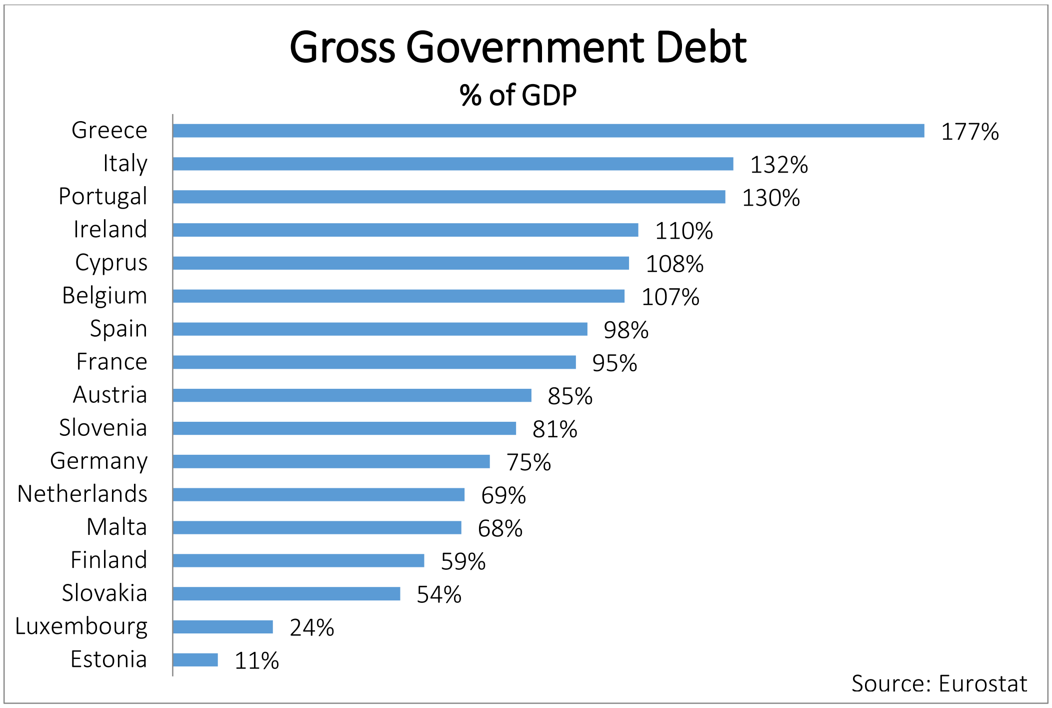
If past is prologue to the future, such an amount of budget tightening in a Euro straitjacket and such a high reliance on tax increases is almost certain to deepen Greece's economic depression. That in turn again risks putting the country's budget objectives out of reach. It also risks splitting the Syriza Party, which is already divided on the question of persisting with budget austerity and structural economic reform.

Containing Contagion

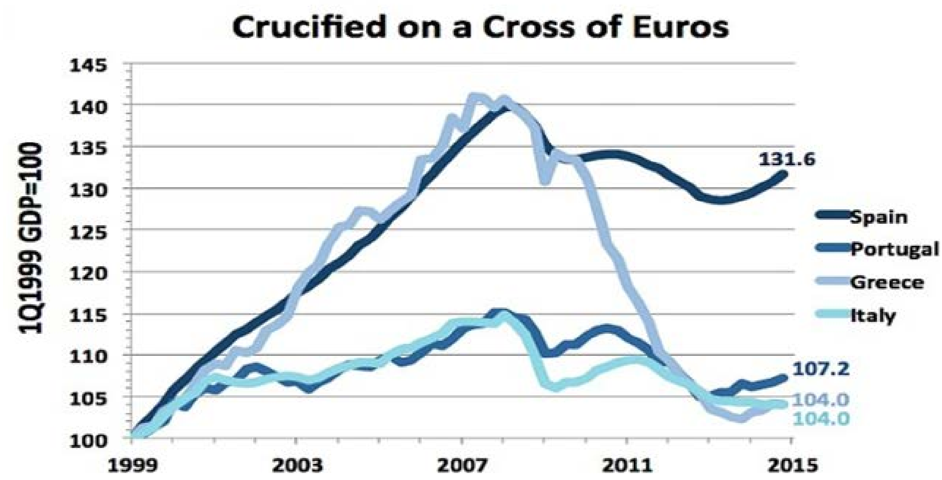
Europe is in a very much better position today than it was in 2012 to handle either a Greek default or a Greek exit from the Euro. It now has in place a EUR 500 billion European Stability Mechanism that can provide adequate financing to any Eurozone member that might come under market pressure. More important yet, the ECB now has in place an Outright Monetary Transaction facility that should allow it to do "whatever it takes" to maintain market stability in the event of a Greek exit. This should enable European policymakers to ring-fence the initial fallout from any eventual Greek exit, albeit at the probable cost of having to resort to the ECB's printing press.

While European policymakers now appear to be well-equipped to handle the immediate fallout from a Greek exit, they do not appear to be so well positioned to deal with the longer run damage that a Greek exit might cause to the Euro project. A Greek exit would signal very clearly to markets that Euro membership was no longer irrevocable. In addition, in the wake of large losses by Greek bank depositors, it would become apparent to bank depositors in the rest of the European economic periphery that the ECB was not always there to backstop the safety of such deposits.

Heightening the longer-run risks of a Greek exit on the rest of the European periphery, is the fact that the periphery is now characterized by significantly higher levels of public debt to GDP ratios than in 2012. It is also of concern that these countries remain characterized by very low growth rates and by price deflation, which makes it very difficult for these countries to grow their way out from under their debt mountains. In that respect, it does not help that countries in the economic periphery are all experiencing political backlashes against further budget austerity and structural economic reform.



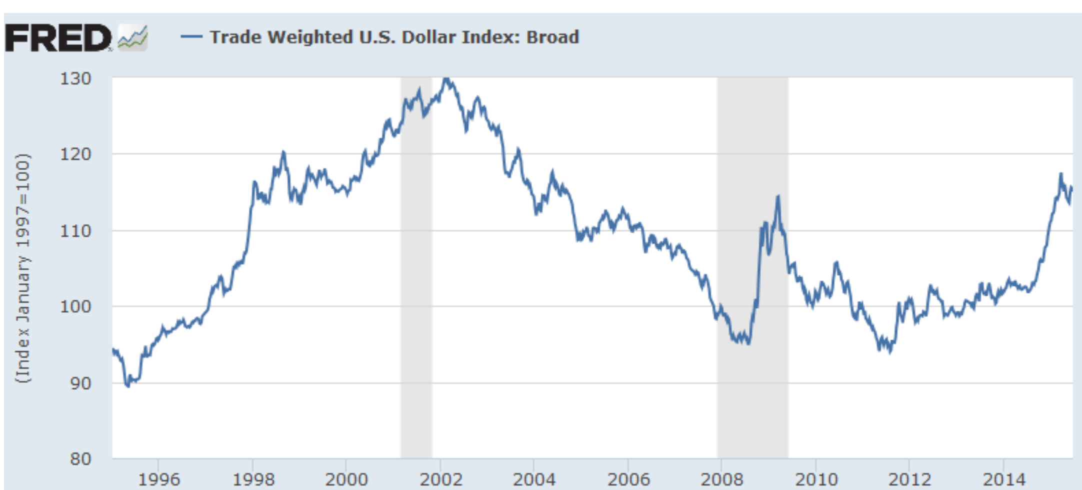
Italy's present position is particularly disturbing considering that the country has more than US$2 ½ trillion in public debt, making Italy the world's third largest sovereign debt market. Whereas at the start of the debt crisis in 2010, Italy's public debt to GDP ratio was 115 percent, today that ratio is around 135 percent. Meanwhile, since 1999 the Italian economy has shown no growth. It should perhaps come as no surprise that all of Italy's major political parties, other than the governing Democratic Party are now opposed to Euro membership. This is bound at some stage to turn the market's focus on Italy's shaky public debt dynamics.



Implications for the United States

Over time, a Greek exit could impose considerable economic and geopolitical costs on the United States. This could occur through the following three channels:

a. In the immediate aftermath of a Greek exit, one must expect a significant further depreciation of the Euro as the ECB took more forceful measure to prop up the European periphery and as investors fled to the safety of the dollar. This would have the effect of causing a further effective appreciation of the dollar that would come on top of a 15 percent such appreciation over the past year. As the Federal Reserve has noted, a strong dollar appreciation could constitute a significant headwind to the US economic recovery and could exert significant downward pressure on US headline inflation.

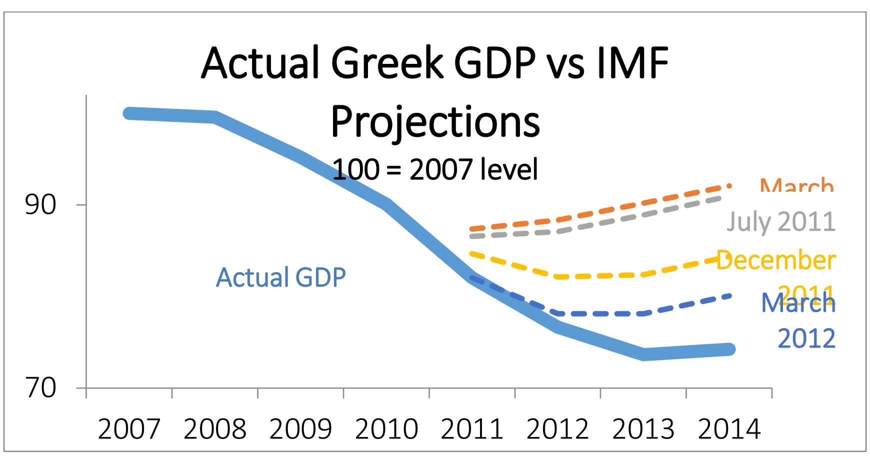


b. Any eventual spread of the Eurozone debt crisis to other countries in the European periphery, like Italy, Portugal, and Spain, could roil global financial markets and dent European household and investor confidence. This would be bound to impact the US economic recovery considering how integrated is the global financial system and how important the European economy is to US trade.

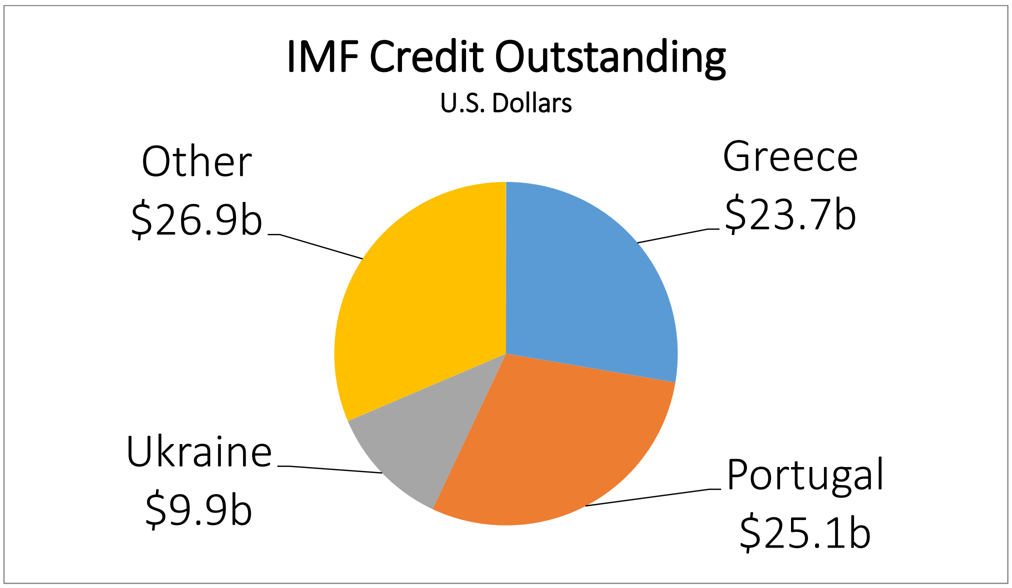
c. Should a Greek exit lead both to a souring of European-Greek relations and to the further erosion of Greek political stability, one could see a failed Greek state increasingly coming into the Russian orbit. Already the Syriza government is actively engaged with Moscow about the construction of a Russian gas-pipeline through Greece despite the US Administration's objections. A deepening of the Greek economic crisis is all too likely to bring Athens and Moscow closer together.

Consequences for the IMF

A Greek exit would have considerable implications for the IMF's credibility. It would inevitably raise questions as to the design of the IMF's Greek lending programs and as to the IMF's wisdom in loaning unprecedented amounts of money to Greece to keep it in the Euro at all costs. It will also be asked why the IMF did not foresee the depth of the Greek economic collapse as well as to what end was Greece put through years of austerity within a Euro straitjacket at the cost of sending its economy into a deep depression, when in the end it was forced to exit the Euro.



A Greek exit is also likely to involve Greece defaulting on the US$24 billion that the IMF has loaned to it. This would be of considerable concern considering that Greece together with Portugal and Ukraine account for around two-thirds of the total IMF loans presently outstanding. This will make it difficult for the IMF to make the case to Congress that US taxpayer money was not put at considerable risk by the IMF's lending practices.



It will also make it difficult for the IMF to defend its "exceptional access" lending policy that in effect removes limits on how much money the IMF can loan to an individual country. This will be particularly the case considering that over the past few years, very large scale IMF lending to Greece forestalled much needed debt restructuring in that country. In the process, it facilitated the exit of private sector creditors from that country by placing the global taxpayer very much on the hook in the event of a Greek default.