TESTIMONY BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Thank you, Chairman Kirk and Ranking Member Heitkamp, along with the other members of the sub-committee, for the opportunity to comment on the unfolding crisis in Greece and its global ramifications. I am currently a professor at Harvard Kennedy School. I suspect that I was invited today because, for more than a decade, my research has focused on various types of financial crises and their economic consequences, including international contagion. One of the main lessons emerging from this work is that, across countries and over time, severe crises follow a similar pattern.

I will organize my remarks around three connected topics: (i) developments in Greece, as these relate to the Greek government's potential default later this month or sometime this summer and the country's likely exit from the Eurozone in that event; (ii) the repercussions of such an exit on European economies, particularly periphery countries (Ireland, Italy, Portugal, and Spain); (iii) the possible broader repercussions of the crisis on the United States, global currency markets, and emerging market economies.

The situation in Greece

I will focus on the multiple possibilities of default. Even if events are arranged so that the Greek government meets its obligations to the International Monetary Fund at the end of this month, the probability of a default over the course of the summer looms large. There are many reasons why default appears probable. Consider the top two.

First, the widespread loss of confidence in the sustainability of the status quo has led to a sharp escalation in internal arrears (public and private). The private sector, concerned about the likelihood of an exit from the euro and a renewed contraction in economic activity, has increasingly defaulted on existing debts; about half of the bank loans are nonperforming and the share rises to more than ¾ if credit card debt is included. Tax payments are postponed or avoided, aggravating an already precarious fiscal position. The attempt to hoard euros by the citizenry is also manifest in the sharp escalation of deposit withdrawals. A very conservative estimate would indicate that deposits have fallen by around 45 percent since their peak in 2009. The combination of a rapidly shrinking deposit base and a staggering share of non-performing loans imply that the banking sector is near a bank holiday. The government is financing itself by not paying its bills, similar, for instance, to what transpired ahead of the Russian default of August 1998 or Argentina at the end of 2001. Also, general government deposits in the banking sector were off more than 40% at the end of April.

Second, the approximate 1.6 billion euro payment due to the IMF at the end of this month is only a fraction of the amounts coming due in July, August, and September, which total about 7, 5.6, and 6 billion euro, respectively. These payments are a multiple of current government cash balances. At present, Greece is allocating less than 2% of GDP to interest payments, so even another round of compromise from official creditors that would delay such payments would not free up significant resources, so at to deal with domestic arrears and external payments on maturing debts.

European contagion

A point of departure in assessing the current scope for contagion from a Greek default is

the absence of the "surprise" element.[1] In my work on contagion, I have found that "fast and furious" financial contagion is far more likely when the triggering crisis takes investors and governments by surprise.

There is no surprise here. Because the Greek drama has been unfolding over several years, private sector exposure to Greece (that is to say, outside of Greece) has declined sharply since the spring of 2010. Prior to the financial crisis, most Greek debt was in the hands of private external creditors (banks and nonbanks, as shown in Figure 1). Such financial links increased the odds of significant spillovers. During the past five years, official creditors (including the IMF and the European Central Bank) have absorbed Greek sovereign debts. Thus, at this time the scope for contagion via financial channels is limited. Real-side exposure to Greece via trade is not a new factor to consider, as Greek GDP has approximately contracted by 25% since the outset of the crisis, which an even bigger contraction in imports from the rest of Europe. Whether investors become indiscriminate and pull out of other European periphery countries in the event of a Greek default still remains a risk. The likelihood of such a scenario, however, is mitigated by the fact that a significant share of sovereign periphery debt (particularly Portugal and Ireland) is also in official hands, that these countries have been recovering much more rapidly than Greece, and that in such an event periphery Europe would receive support from the center and from the IMF.

Implications for the United States, global currency markets, and emerging market economies

The effects of a Greek default, probably in the context on an exit from the euro zone, on the United States are likely to be very limited in scope. Financial exposure, which was comparatively

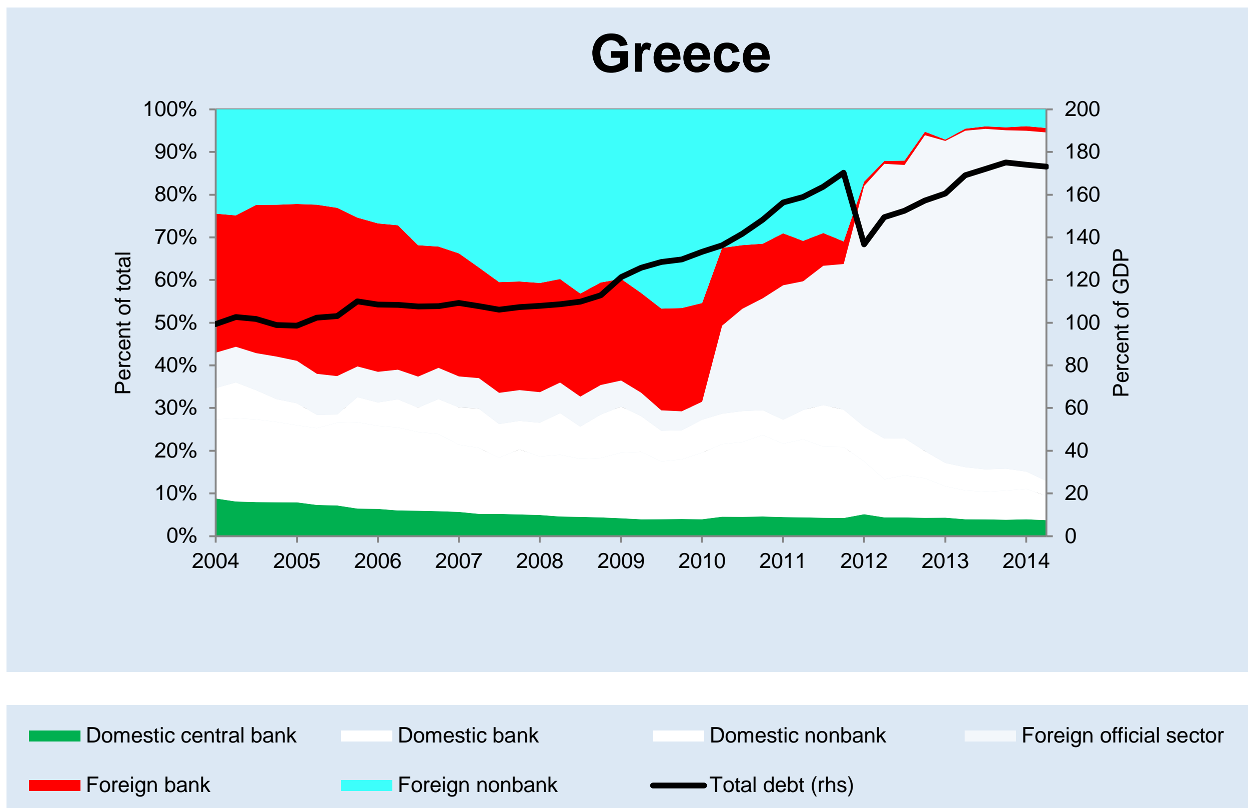
[1] See Kaminsky, Graciela L., Carmen M. Reinhart, and Carlos A. Végh "The Unholy Trinity of Financial Contagion," *Journal of Economic Perspectives*, Vol. 17(4), Fall 2003, 51-74.

marginal in the first place, is not a prevalent source of concern for US financial institutions. Nor is the Greek market a major destination for US exports. Predicting currency fluctuations is an elusive goal for economists, so take my observations with a healthy dose of skepticism. If a Greek default triggers substantial turmoil in Europe, we would see a flight to safety into US dollar assets, notably Treasuries. This has been the "standard" pattern of response in past waves of global volatility. If so, further appreciation in the U S dollar vís-à-vis the euro and most other currencies follows. In this setting, the potential adverse effects of an appreciating dollar would be largely felt by US manufacturing, not unlike the impacts already seen earlier this year.

In terms of broader consequences, an appreciating dollar may act as a headwind in the Federal Reserve's efforts to begin the process of pulling its policy interest rate off the zero lower bound. Also, many emerging markets with dollar-denominated external debt (whether these are public or private) would be other things equal, we worse off with further dollar appreciation.

Greece is already close to financial autarky. It relies almost entirely on support provided by the ECB and other official lenders. The gap between a de jure default and a de facto one has narrowed significantly. As a result, the next stage in this crisis may have limited consequences for the global economy.

Figure 1. Who Holds Government Debt, 2004-2014



Source: Arslanalp Serkan and T. Tsuda (2014). "Tracking Global Demand for Advanced Economy Sovereign Debt" *IMF Economic Review*, 62(3), 430-464.