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Subcommittee on National Security and International Trade and Finance

"Economic Crisis: The Global Impact of a Greek Default"

Hearing Testimony of Matthew J. Slaughter

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Introduction

Sub-Committee Chairman Kirk, Ranking Member Heitkamp, Committee Chairman Shelby, Ranking Member Brown, and fellow Members, thank you very much for inviting me to testify on these important and timely issues of how a default by Greece on its sovereign debt would impact the United States and overall global economy.

My name is Matt Slaughter, and at the Tuck School of Business at Dartmouth I am the incoming Paul Danos Dean, the Earl C. Daum 1924 Professor of International Business, and the founding Faculty Director of the Center for Global Business and Government. From 2005 to 2007 I also served as a Senate-confirmed Member on the President's Council of Economic Advisers, where my international portfolio spanned topics such as currencies, international trade and investment, and the competitiveness of the U.S. economy.[1] More recently I was a founding member of the Squam Lake Group, a non-partisan group of 15 academics who came together to offer guidance on reform of financial regulation amidst the World Financial Crisis.[2]

At the time of writing this testimony, the outcome of the latest chapter of the Greek-debt saga is still being written. Prime Minister Alexis Tsipras has just flown to Brussels to meet with fellow government leaders, at least some of whom have objected to his latest compromise offer. There are many fluid and undefined issues about the immediate situation, none of which this testimony will address. Rather, I will make three main points about the consequences of a Greek default: one focused on the short term, one focused on the medium term, and one on the long term.

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[1] In the past two years, I have not received any Federal research grants. In addition to the above Tuck positions, currently I am also a Research Associate at the National Bureau of Economic Research; an adjunct Senior Fellow at the Council on Foreign Relations; a member of the advisory committee of the Export-Import Bank of the United States, a member of the academic advisory board of the International Tax Policy Forum; and an academic advisor to the McKinsey Global Institute. For many years I have consulted both to individual firms and also to industry organizations that support dialogue on issues of international trade, investment, and taxation. For a listing of such activities, please consult my curriculum vitae posted on my web page maintained by the Tuck School.

[2] The book our Group co-authored that discusses the challenges in understanding and aiming to prevent financial crises is *The Squam Lake Report: Fixing the Financial System,* with Kenneth R. French, Martin N. Baily, John Y. Campbell, John H. Cochrane, Douglas W. Diamond, Darrell Duffie, Anil K Kashyap, Frederic S. Mishkin, Raghuram G. Rajan, David S. Scharfstein, Robert J. Shiller, Hyun Song Shin, Matthew J. Slaughter, Jeremy C. Stein, and Rene M. Stulz; Princeton University Press, June 2010.

1. In the short term, a Greek default would surely trigger additional short-term pain on the Greek economy. Through various channels, it would very likely dampen overall economic activity in the Eurozone—and thus, albeit to a lesser extent, the rest of the world. And, there is some small but non-zero chance that it would trigger another world financial crisis of the magnitude of the World Financial Crisis of 2008-2009 triggered by the default of the U.S. investment bank, Lehman Brothers.
2. In the medium term, a Greek default would raise the risks of additional highly-indebted and struggling countries exiting the Eurozone. This elevated risk would tend to dampen economic activity within Europe and beyond, through channels similar to those cited above. And, arguably even more than Greece—because of how small it is—these future exits would bring greater chances of triggering financial crises.
3. In the long term, a Greek default is largely irrelevant to the fundamental challenge still facing Greece and every other advanced country: how to foster growth of jobs, incomes, and output in societies with aging populations and looming entitlement pressures. The current Greek crisis, however it is resolved, does nothing to address this fundamental long-term problem facing much of the global economy. Indeed, by crowding out the attention of policy and business leaders, the current crisis aggravates this looming long-term problem.

The Short-Term Default Consequences: Definite Economic Downturn, Possible Crisis

In the short term, a Greek default would surely trigger additional short-term pain on the Greek economy. In the past five years Greece has sustained a Great Depression-scale contraction. Gross Domestic Product has fallen by nearly 30%. Unemployment spiked to about 26%, with unemployment of those aged 25 and younger peaking at a staggering 50%. Nearly all wages have fallen by double-digit percentages. That said, in the past year many economic indicators have stabilized and some have turned positive. For example, GDP has expanded slightly.

In whatever form it might take, a default would contract the Greek economy further. A main contractionary mechanism would likely be a wave of bank runs and thus bank closures, with knock-on bankruptcies beyond the financial sector, amidst the turmoil of reintroducing the Greek Drachma when no treaties, laws, or precedents for how to reconvert all payment flows, assets, and liabilities out of Euro denomination. This turmoil would sharply curtail consumption and investment demand in Greece, which in turn would drive down short-term output and employment. The scale of this contraction is difficult to predict, but double-digit declines are conceivable. Over time, recovery in Greece would be facilitated by a sharp devaluation of the drachma relative to the Euro and to other global currencies—and thus a boost in export demand as Greek goods and services (such as tourism) become less expensive to foreign customers. This export fillip would almost surely be swamped in the short term, however, by contractions in consumption and investment demand.

This Greek economic contraction would very likely dampen overall economic activity in Europe—and thus, albeit to a lesser extent, the rest of the world. Through the usual linkages of international trade and investment, however, the scale of this worldwide dampening would be slight. The basic reason for this is that the Greek economy is quite small. 2014 GDP in Greece was about $244 billion (down from a pre-crisis peak of about $342 billion). This was about one

third of 1% of worldwide GDP in 2014 ($77.3 trillion, according to the International Monetary Fund). Greece is about the size of the economy of Louisiana or Connecticut. As such, however large a default-induced contraction in Greece might be, it simply would not be very large relative to the overall world economy. A further 10% contraction of the Greek economy would be about 1/30th of 1% of the total world economy.

The knock-on effects of reduced European or U.S. exports to Greece—and thus reduced capital investment in these countries—would be similarly quite small. In 2014 the United States exported $205.9 billion in goods to the Eurozone. This amount was about 12.8% of total U.S. goods exports—which, in turn, were about 9.3% of total U.S. 2014 GDP of $17.4 trillion. Imagine that a default shrinks by 10% all spending by Greek households and businesses—and that, implausibly, all that spending reduction came in the form of fewer purchases from U.S. exporters. This drop in U.S. exports of about $20 billion would constitute only about 1/10th of 1% of U.S. GDP. Yes, that would be a lot of money to the American businesses hit with canceled orders. But for the economy overall, this drop in exports would fall within the usual measurement error in the GDP measures produced by the U.S. Bureau of Economic Analysis.

The one possible economic impact of a Greek default that paradoxically might be most important yet is most difficult to quantify is there is the small but non-zero chance that default triggers another financial crisis of the magnitude of the World Financial Crisis of 2008-2009 triggered by the default of the U.S. investment bank, Lehman Brothers.

There are sound reasons not to expect such a crisis. Today the majority of Greek sovereign debt is owned not by banks and other private investors but rather by public entities: other sovereign governments, the IMF, and the ECB. Eurozone banks today have stronger balance sheets than in years, thanks to changes including capital accumulation as part of regulatory stress tests. And, the ECB is currently implementing its own "quantitative easing" program of buying substantial amounts of member-country sovereign debt, one impact of which is to support confidence in financial markets and in the broader economy. All of this means that the losses of default would be borne by other governments (and, implicitly, their taxpayers) rather than by banks—and, to the extent that banks would incur some losses, they are better positioned today to absorb those losses without destabilizing runs and/or sharp credit contractions.

All this said, no one really knows what will happen in global capital markets if Greece defaults and/or exits the Eurozone. All the world's ex ante analysis, meticulous and thoughtful though it may be, simply has no historical precedent as a guide. Before Lehman died, as its stock price slid and as creditors and other counterparties jogged, wise voices intoned that a medium-sized U.S. investment bank could do only so much damage. Those wise expectations were proven very wrong as traders and counterparties reacted in diverse and unexpected ways, which in turn triggered asset-price movements and co-movements that even today we do not fully understand. No one can plausibly rule out such destabilization in the wake of a Greek default. Imagine a massive post-default panic to sell the debt of Spain, Portugal, and Italy—and to then buy U.S. Treasurys—that leaves illiquid one of the world's largest and most-heavily-leveraged hedge funds. As all its counterparties lose confidence in it and in each other, a post-Lehman lending freeze could again materialize around the world in another financial crisis.

The Medium-Term Default Consequences: Greater Risks of Further Euro Exits

In the medium term, a Greek default would raise the risks of additional highly-indebted and struggling countries exiting the Eurozone. A Greek default accompanied by an exit from the Eurozone would set a precedent that had been intended to be an impossibility: of a Eurozone member reverting to its own sovereign currency.

Currency unions such as the Eurozone function much like regimes in which member countries fix their currency values yet maintain separate currencies. For example, in either regime each member country cannot freely increase or decrease its money supply based on conditions in its own country alone. The main advantage of currency unions is—or so it is often hoped by their creators—irrevocability that eliminates the possibility of the speculative attacks that so often have bedeviled fixed-exchange-rate regimes. Indeed, a major impetus for creating the Euro in the late 1990s was the early-1990s turmoil of waves of speculative attacks against the Exchange Rate Mechanism (in which many member countries effectively chose to fix the value of their currencies to the German Deutschmark). The British Pound, for example, was ejected from the ERM and floated in September of 1992 when speculators such as George Soros forced the Bank of England to relent its fix after sustaining losses of tens of billions of Pounds.

A "Grexit" would shatter the intended permanence of the Euro and would revive the idea that Eurozone countries can create and print their own currencies. Quite simply, afterward no government official could credibly claim that the Grexit was a one-off event never to be repeated. Investors and politicians alike would focus more on the actions of the Grexit, not on any words thereafter.

How likely is it that in the years ahead another Eurozone country would exit the Eurozone? That is impossible to predict, but surely post-Grexit this likelihood would be higher than before. And, the pressures for additional exits would arise from two forces—potentially interrelated. One is investors demanding higher interest rates from countries they perceive to be possible exitors. The other is fringe parties—already surging in countries such as Spain, with radical party Podemos—that might speak favorably about, and follow the polices of, Syriza in Greece.

One important indicator will be whether or not Eurozone countries manage to spur faster economic growth, as is discussed below. Countries lacking such policies—perhaps partly because of fringe parties coming to power—will be countries where interest rates rise, as they did in many weak Eurozone countries in 2010 and 2011. The combination of higher interest rates and all the related uncertainty would tend to depress hiring and economic growth, and thereby would trigger a dynamic not unlike that of Greece in recent years. The broader global economy would suffer from slowdowns (or outright recessions) in these countries, through the trade and investment linkages outlined above.

And any future exits from the Euro would surely bring greater chances of triggering the financial crises described above, because of how much larger and interconnected other countries are compared to Greece. Yes, a Grexit might not spark crisis. But what about an exit by Spain or by Italy?

The Long-Term Default Consequences: From Where Will Growth Come?[3]

In the long term, a Greek default is largely irrelevant to the fundamental challenge still facing Greece and every other advanced country: how to foster growth of jobs, incomes, and output in societies with aging populations and looming entitlement pressures. In this sense, the default question is not the most important question facing Greece today. Rather, that honor goes to a different question: Will the Syriza government—or any government after it—be able to foster growth in Greece's labor force, capital investment, and productivity?

For any country on the planet, long-run economic growth requires an ability to accumulate some combination of labor, capital, and productivity. Yes, policy to support aggregate demand through efforts like ECB quantitative easing is important to employ currently idle people and capital. And, yes, the outcome of this week's debt-renegotiation game of chicken will influence companies' investments and innovativeness in Greece. But what will ultimately create sustainable economic recovery and hope in Greece is growth in its economic potential thanks to growth in some combination of these three factors. Without policies to spur their growth, no amount of debt renegotiation or forgiveness will matter.

It is useful to remember precisely how and why the Greek economy plummeted. There were years and years of economic mismanagement, which was never reflected in the country's official statistics (statistics that were later revealed to be highly compromised). A handmaiden of the mismanagement was widespread corruption and highly-restrictive regulation that protected well-connected groups and stifled entrepreneurship. Here is one example among many: in 2013, the government acknowledged 343 professions had been effectively closed to outsiders.

Syriza tapped into a wellspring of resentment over the country's economic woes; Prime Minister Alexis Tsipras has pledged to "bring an end to the vicious circle of austerity." But the reforms announced thus far since his recent election are not obviously policies aimed at long-run growth: raising the minimum wage by 10%, reversing public-sector layoffs, and halting privatization. There has been discussion of raising taxes on hotels—one of the few sectors that remains healthy—and even restricting their ability to offer all-inclusive packages.

Regardless of how Greece and its creditors resolve their differences, the country will still face long-term growth challenges that must somehow be addressed. For example, its total population fell by about 200,000 people between 2001 and 2012 (and has surely declined even more since then)—a function of low birthrates, low immigration, and high out-migration. The median age is also projected to be 43.5 this year (an increase of 10 years since 1970), which is one of highest in the world. Demographically, Greece has quickly become like already-shrinking Japan. And who is fleeing Greece are almost surely the more-talented, more-dynamic of its workers.

Greece is also saddled with low levels of innovation and very low spending on research and development. Increasing that spending—e.g. by continued deregulation of the economy to incentivize private R&D spending and investment—could deliver a number of benefits: spurring

[3] Much of this sub-section is excerpted from "The Most Important Question Facing Greece," The Slaughter & Rees Report, February 2, 2015, available at http://cgbg.tuck.dartmouth.edu/news-events/blog/slaughter-rees-report-the-most-important-question-facing-greece.

domestic innovation, keeping Greek companies in Greece, attracting immigrants and foreign direct investment, and perhaps even persuade some of the millions of Greeks living abroad to return to their ancestral home.

Greece has made some growth progress; for example, it has improved its position in the World Bank's Doing Business rankings from 109 in 2011 to 61 today. No other country has come close to achieving this improvement over the past four years. One encouraging sign: Uber, which is in the crosshairs of regulators throughout the world, has been operating freely in the country thus far in 2015.

But so much work remains if Greece is to raise its potential for long-term growth in output, jobs, and incomes. One place to start would be working through the 555 regulatory restrictions that the OECD, working in partnership with Greek authorities, identified as undermining competition and handicapping the Greek economy.

Greece's experience over the past few years is a potent reminder to countless other countries that anti-growth public policies today have consequences that can accumulate far into tomorrow. And those consequences are intensified when capital and labor can move around the world to where it is welcomed and rewarded. Lest we all wag our fingers at Greece as uniquely profligate, keep in mind that the dynamic of aging populations and looming entitlement pressures—all approaching when in recent years public debt has already spiked and economic growth has already slowed—faces many advanced countries today.

According to the IMF, gross public debt as a share of GDP has surged pretty much everywhere in the wake of the World Financial Crisis. From 2007 to 2014 it increased in the United States from to 67.2% to 104.8%, in the Eurozone from 66.4% to 94.0% (e.g., in Italy from 103.1% to 132.1%), and in Japan from 183.0% to a staggering 246.4%.

What is Europe, for example, to do? Even ECB President Mario Draghi knows that ballooning the ECB balance sheet would accomplish only so much. Economic sluggishness across the continent reaches back decades. Consider this stunning statistic: total factor productivity (TFP)—which reflects the efficiency of capital and labor used together, and growth of which is central to long-run growth in output, jobs, and wages—is *lower* today in France, Italy, Spain, and Germany than it was in 1980. The U.S. TFP increase during this period has been about 35%.

Boosting TFP tends to require long-term, wise investments in areas including education, skilled immigration, and competition—both domestic and international—in product markets, labor markets, and capital markets. In a recent interview Mr. Draghi acknowledged that "progress on the important structural reforms—more flexible labor markets, less bureaucracy, lower taxes—is clearly too slow." Asked to specify which Eurozone countries need to prioritize these reforms, he didn't mince words. "All of them."

And what is the United States to do? U.S. productivity growth has slumped in recent years to many-decade lows. Output per worker hour in the U.S. non-farm business sector grew in the four years of 2011-2014 by just 0.2%, 1.0%, 0.9%, and 0.7%, respectively. Contrast this with the late 1990s and early 2000s: in the decade of 1995-2005, productivity growth averaged 3.0%

per year. This surge was widely visible in accelerated growth in U.S. GDP, jobs, and worker earnings. At one point in 2000, U.S. unemployment dipped to just 3.9% and for several years during this period earnings rose briskly for all U.S. workers—even less-skilled workers including high-school dropouts. These large economic gains spread even to the U.S. government, for which unexpected surges in tax receipts led to federal-budget surpluses from 1998 through 2001, the first in generations.

America today continues to confront a competitiveness challenge of too little economic growth, of too few good jobs, and of real earnings for most of those working not rising. The good news is there is a future in which America can create millions of good jobs connected to the world via international trade and investment. Doing so will require bold and thoughtful U.S. policies, however, that extend beyond fiscal and monetary stimulus whose viability and impact are questionable. Productivity growth to spur growth in output, jobs, and incomes for American workers is within reach—but only if America finds a way to pursue wise policies such as business-tax reform that reduces rates and complexity, high-skilled immigration expansion, trade and investment liberalization, and sound investments in public infrastructure.

Conclusion

Greece has a glorious past. If it can use the ongoing crisis as an opportunity to transform its economy, and unlock economic opportunity, it could have a glorious future as well. Debt discussions of today must not obscure the deeper reforms that are needed for attaining that future. The current Greek crisis, however it is resolved, does nothing to address the fundamental long-term problem of how to accelerate economic growth. Indeed, by crowding out the attention of policy and business leaders, the current crisis aggravates this looming long-term problem.

The same is true for so many other advanced countries in the world, including the United States. Wise leaders will reflect on Greece, not as a unique outlier but rather as a sobering leading indicator for the challenges that are approaching.

Thank you again for your time and interest in my testimony. I look forward to answering any questions you may have.