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Expert Roundup

Eurozone Problem for the United States

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The debt crisis that began in Greece and spread to other eurozone countries has served as a painful reminder of the risks associated with high public debt in a globalized financial system. The threat of contagion to countries outside Europe has divided experts on what the impact will be on the U.S. economy--whose debt is expected to rise to 90 percent of GDP by 2020. Some economists argue the U.S. economy will benefit from the eurozone crisis, since the euro's continued weakness will secure the U.S. dollar's status as a global reserve currency. Others say the U.S. debt problem will escalate if bloated entitlement programs go unaddressed. Some analysts argue the greater impact of the crisis will be on U.S. growth, which relies on market confidence and exports to Europe.

CMC Markets' Ashraf Laidi, Mesirow Financial's Adolfo Laurenti, the National Bureau of Economic Research's Carmen Reinhart and the American Enterprise Institute's Vincent Reinhart agree that the crisis buys the U.S. government time to tackle its debt--for better or worse. Of greater concern is the impact of the crisis on U.S. market confidence and growth, say the Carnegie Endowment's Uri Dadush and Invesco's Ron Sloan. Finally, American University's

Anna Gelpern says the crisis heightens the need for strong financial reforms that can "shield banks--and by extension the public--from government failure." *–Roya Wolverson, Staff Writer on Economics, CFR.org*

Ashraf Laidi, Chief Market Strategist, CMC Markets

The most common arguments against a destabilization of the U.S. economy by the eurozone sovereign debt crisis are 1) the activism of the U.S. federal government in mobilizing another TARP-like aid package for U.S. banks, 2) a compliant Federal Reserve willing to reopen the liquidity taps by buying (again) U.S. government bonds, and 3) the sole ability to print a currency in which globally held U.S. debt is denominated. These measures--enacted in 2008 and 2009--effectively restored confidence in U.S. and global financial markets. The 60 percent surge in equity markets since March 2009 offered a jolt of confidence, while government-stimulus programs helped cap the unemployment rate and revived the role of consumers in lifting the U.S. economy out of recession.

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To be sure, these solutions came at a cost. The Federal Reserve balance sheet swelled to a record $2.29 trillion as a result of purchasing government debt, while the U.S. debt ceiling was raised to $14.3 trillion, nearly triple the level of 2001. Currency and bond markets took notice. The U.S. dollar lost more than 20 percent of its value, and U.S. bond yields doubled throughout the stimulus period. Yet, as debt concerns escalated in the eurozone, the U.S. dollar benefited from flows exiting risky European currencies into the safety of U.S. treasury paper.

Today, German and French banks are exposed to as much as $900 billion in Greek and other eurozone countries' debt. This exposure could bolster speculative attacks on U.S. equities on the rationale that a deteriorating European economy could quash the recovery of the Chinese economic engine as well as the U.S. consumer. Under such a scenario, a double dip U.S. recession is a stark possibility. Yet, as long as the corroding euro retards the process of global currency diversification away from the greenback, the United States will have little difficulty continuing to finance its debt from overseas lending. The power of printing its own currency will deflect credit agencies' scrutiny from the United States, as they focus on more pressing cases in the eurozone and Britain.

Adolfo Laurenti, Deputy Chief Economist and Managing Director, Mesirow Financial

The 750 billion euro stabilization package implemented in the eurozone was instrumental in stopping the panic and restoring some semblance of order in increasingly volatile financial markets.

Nonetheless, upon closer scrutiny, the plan doesn't fix the structural fiscal imbalances that impair countries like Greece, Spain, Portugal, and to a lesser extent, Italy and Ireland. The massive aid package only buys time for these embattled states to execute much-needed corrective policies. In order to bring government spending under control, additional measures of fiscal tightening must be adopted.

The eurozone plan also buys some time for the United States. The sovereign debt crisis in the eurozone has reasserted the position of the dollar as the world's reserve currency. Yet the flight to safety out of Europe and the resulting strong demand for Treasury bonds should not be an excuse to delay action on our own weak fiscal position.

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The concern is twofold. In the short run, we need to pay for the cost of bailouts and stimulus policies that followed the financial crisis and the "Great Recession."

More importantly, long-term demographic trends make the burden of Social Security and Medicare unsustainable. Within a decade, American public finances will be under severe pressure to keep up with the exploding costs of our entitlement programs. Unless Congress resolves to undertake prompt and profound revision of the federal budget, the country may face dire consequences from our current profligate spending attitudes.

Thus, fiscal complacency is a major threat to the economic outlook for the United States. A slowdown in Europe will reduce our exports across the Atlantic, but the overall effect on the U.S. economy will be negligible when compared to the potential damage that a fiscal crisis may produce on our economy--if we let the opportunity to reduce our deficit and debt slip by.

The European malaise has given us some precious, borrowed time. We'd better not waste it.

Carmen Reinhart, Research Associate, National Bureau of Economic Research; and Vincent Reinhart, Resident Scholar, American Enterprise Institute

Recent weeks have shown that, although Greece may have a small footprint on global economic output, it casts a long shadow on financial markets. These funding difficulties have mostly resonated in the United States as a morality play. Borrowers with dubious prospects of repayment will ultimately be confronted by angry lenders.

The message has taken hold with such force domestically because our own fiscal path seems unmoored. While the current debt stock relative to national income, at 85 percent, does not directly trigger alarms, fiscal deficits run at 10 percent of income. More worrisome, public confidence that there are enough political leaders with the courage to arrest the process seems at a low ebb.

All true. But there was another message from Europe with equally profound implications. This was quieter and directed to an elite group controlling the official foreign exchange reserves of about a dozen sovereign governments, mostly located along the Asian Pacific Rim. Greece's funding problems and the continent's contagion established that the euro is not ready to be a reserve currency.

"Greece's funding problems and the continent's contagion

The economies in the world that are growing faster than the rest--China, India, and Korea, among others--are also saving more. After the Asian Crisis of 1998--a devastatingly deep *established that the euro is not ready to be a reserve currency."*

but localized predecessor to what the world just went through--those countries have been directing a good-sized share of that saving to building up foreign exchange reserves.

Reserve managers, however, do not buy foreign currencies. They buy the safest assets, government securities, denominated in those foreign currencies. Buying safe dollar-denominated assets is easy; they are called U.S. government securities. Buying safe euro-denominated assets has been revealed to be patently more difficult. Many gilt-edged bonds have an embossed "€" somewhere, but their repayment prospects differ according to where they were printed, say, in Germany or Greece. Simply put, U.S. government securities satisfy a need as a reserve asset that is less likely to be satisfied by those from Europe, at least for some time.

In these circumstances, any noble exhortation based on the European experience is likely to fall flat. As long as reserve managers are buying U.S. government securities, U.S. politicians will not be pressed to change their ways by financial markets. A benefit, but perhaps only for a time. Politicians who are not disciplined are not likely to show discipline on their own. Thus, the faltering of the euro as an asset class because of the bad behavior of some may enable bad behavior for longer here at home.

Uri Dadush, Director, International Economics Program, the Carnegie Endowment

The United States has a vital interest in assuring that the euro crisis is controlled. The EU represents 20 percent of U.S. exports. More than 50 percent of U.S. overseas assets are held in Europe, while close to 40 percent of Europe's foreign assets invested in the United States.

In fact, the euro crisis has already had a significant impact on the U.S. economy: Since late November, the euro has lost 17 percent of its value vis-à-vis the dollar, making U.S. exports less competitive, even as the Obama administration's goal is to double exports in five years. U.S. exports are also adversely affected by Europe's sluggish recovery--in the first quarter, European GDP was up only 0.3 percent on the same quarter a year before, compared to a 2.5 percent rise in the United States and 11.9 percent in China. U.S. investors in Europe should expect to take large balance sheet and income translation losses due to the lower euro.

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But the most important effects of the euro crisis on the United States will operate not through the real channels of trade and foreign direct investment, but through broader effects on confidence and banks. Stock market volatility (as measured by the VIX index) has more than doubled in the last two months, and the confidence that banks have in lending to each other--measured by the TED spread (the difference between three-month inter-bank lending rate and the yield on Treasury Bills) was as wide as 30.8 basis points at the end of last week, a nine-month high, up from this year's low of 10.6 basis points in March.

This is against a backdrop of a crisis largely confined thus far to Greece, a country accounting for a mere 2.6 percent of the eurozone GDP. Imagine what would happen if the crisis spread to Spain or Italy, countries five or six times larger. Though the exposure of U.S. banks to the most vulnerable countries in Europe is limited--about $176 billion, or 5 percent of their total foreign exposure--the indirect exposure is much larger, since U.S. banks do business with all the large international banks, which are themselves exposed to these vulnerable countries.

A spreading euro crisis would hurt U.S. interests in another way. Although U.S. government debt may increase in popularity initially due to a safe haven effect, a spreading crisis would likely eventually place the spotlight on rising U.S. debt as well, aggravating the country's unstable debt dynamics.

Ron Sloan, Chief Investment Officer, Invesco

The 2009 private sector debt crisis has morphed into the 2010 sovereign debt crises, as the private debt was swapped into government debt. In fact, the pea was just moved under a different shell in a replay of this classic scam. Deleveraging on this scale is going to take a long time, and not everyone has the patience for this. Hence, rioting in Greece.

The eurozone crisis begs the question of what will fuel the growth that an increasingly export-driven developed world needs. We can't all export to the smaller emerging world, and we can no longer count on significant growth within the developed world as new austerity measures become the rule of thumb throughout much of Europe. Once inventory restocking is finished, sustainable growth assumptions will have to move lower in the debt-laden developed world, and an emerging world that is increasingly moving to tighten its own fiscal and monetary policies.

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The eurozone crisis is really a growth crisis. Debt-laden companies and countries--including those in the United States--will lose many reinvestment/growth options. Without growth, social instability and economic volatility will follow. The euro is certainly at risk in its current configuration. Southern European countries are looking to revalue their way out of their crisis, and German and French citizens are becoming more resistant to the austerity measures required to save the euro. The developed world has absorbed two decades (the '80s and '90s) of social and economic tailwinds--driven by low interest and tax rates, inflation, and increasing consumption and leverage--that are now turning into headwinds. Deleveraging will be a long and messy process.

Anna Gelpern, Associate Professor of Law, American University

The crisis in Europe reinforces the central message of the past two years: Governments and financial institutions are locked in a dysfunctional loop. When banks and shadow banks go under, they draw in governments to protect credit flows, payment systems, and people's savings. When governments go under, they sink their creditors--banks, pension funds, insurance companies. Financial reform is essential not only to shield people from bank failure, but also to shield banks--and by extension the public--from government failure.

Greek banks and pension funds hold more than a quarter of Greek government debt. If Greece defaults, it wipes out popular savings and freezes credit essential to recovery.

"One lesson from Greece is that stronger financial reforms--on both sides of the Atlantic--may be

the surest way forward to manage sovereign distress."

Elsewhere, European banks, pension funds, and insurance companies hold over half of Greek debt. Thus default threatens the broader European financial system, needed to finance Greek growth. This is the same system that nearly collapsed in 2008 from the U.S. housing bust, and was deeply shaken by the failures of Lehman Brothers, Fortis and Dexia, and the Icelandic banking crisis. But it is also the system that benefited from the U.S. government support for AIG, which had sold credit derivatives to European banks, absorbing their risks so they could hold less regulatory capital.

This leads to a paradox: Even if Greek debt is deeply unsustainable, and even if Greek debt contracts contain relatively few barriers to restructuring, uncertainty about the effects of default on the financial systems threatens to reduce or eliminate the benefits of debt reduction. To be sure, links between governments and financial institutions were central in the crises of the 1980s and 1990s as well, but now no part of the global financial system can be presumed immune.

In the past, we had thought that the best way to ensure a timely and orderly sovereign debt restructuring was through reforming sovereign debt contracts, or sovereign bankruptcy. One lesson from Greece is that stronger financial reforms--on both sides of the Atlantic--may be the surest way forward to manage sovereign distress. That means boosting capital so firms can absorb losses, comprehensive resolution so conglomerates may die in peace, and transparent derivatives markets to reveal the true risks of default.

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