OBSERVATION

TD Economics

May 23, 2012

WHAT WOULD GREEK EXIT MEAN FOR THE UNITED STATES?

Highlights

- A Greek exit from the euro zone looks inevitable, but Europe probably isn't willing to allow this to occur in the near-term.
- While Greece itself is very small and American exposure to the country relatively minimal, a Greek default and exit in the next few months would impact the U.S. through increased financial stress, a fall in exports – both with Europe and the rest of the world – and a hit to consumer and business confidence amid increased worries over the economic and financial outlook.
- If the only member to exit is Greece, financial volatility would increase, but the hit to U.S. economic growth would likely be short-lived and offset by faster growth once financial conditions normalize. In contrast, an exit by Greece that led to speculation or the realization of other countries following suit could lead to a global calamity.

Over the last several weeks we have received many questions about how a Greek exit from the euro zone could transpire. In a companion piece, we answer some of the core questions with respect to how a Greek exit could occur and what it might mean for Europe. In this piece we explore the financial and economic impacts on the United States.

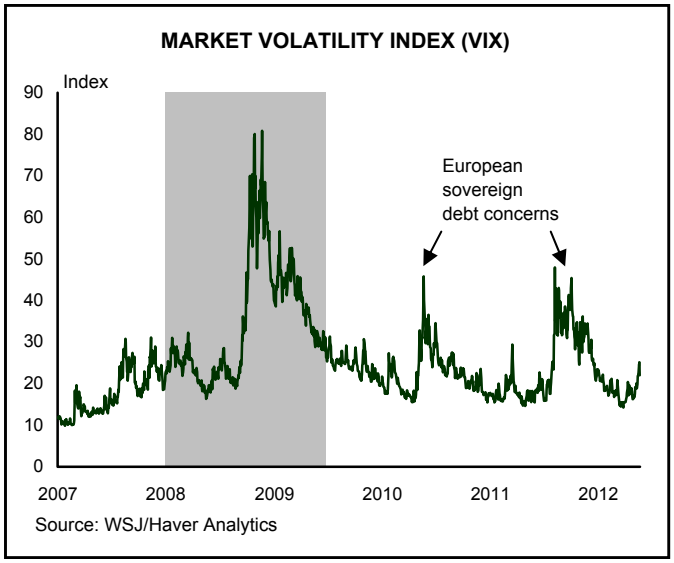
First, we must note that the situation in Europe has loomed large in our economic forecasts for some time. Our Quarterly Economic Forecast was built on the assumptions of a European recession and ongoing financial volatility. The knock-on direct effects included a lower profile of U.S. export growth, weakened domestic demand through reduced wealth and confidence, and more restrained credit conditions than would be the case absent of the economic and financial market uncertainty. The recent knee-jerk market reaction to Greek election results has seen an intensification of financial market volatility, as evidenced by a sharp rise in the value of the U.S. dollar and declines in equity markets. If this heightened state of tension persists, U.S. economic growth in the second half of this year is likely to be moderately weaker than we envisioned in our March forecasts. However, as long as Europe continues to muddle along with a patchwork of policy responses that prevents a large scale banking crisis, there would be no material downgrade to our U.S. economic outlook.

The more important question for the U.S. is what could happen in the extreme scenario, in which a Greek exit occurs in relatively short order and is not limited in its contagion to the broader European financial system. In the TD European report noted above, this is akin to scenarios 1.A.i or 2.A coming to fruition. Since the negative impact would be transmitted to the U.S. mainly through financial markets, we consider first the financial implications and then turn to the impact on the real economy.

U.S. Financial Market Fallout

Financial markets would bear the brunt of the initial fallout from a Greek exit. Financial market participants hate uncertainty, so the immediate response would be a flight to safety. U.S. Treasury yields

Beata Caranci, VP & Deputy Chief Economist, 416-982-8067
James Marple, Senior Economist, 416-982-2557



would drop, likely to new all-time lows. Likewise, bond yields for all but the "safest" euro zone nations (i.e. Germany) would increase. The outlook for German bonds is unclear, as they could sell off or benefit from flight-to-safety buying. The U.S. dollar will appreciate rapidly against the euro, as market participants question the sustainability of the economic pact among the remaining euro zone members. An aversion to risk would cause a steep drop in global equities and, by extension, the risk-premium on domestic corporate debt and bank stocks would rise as investors worry about counterparty risk and European-related losses.

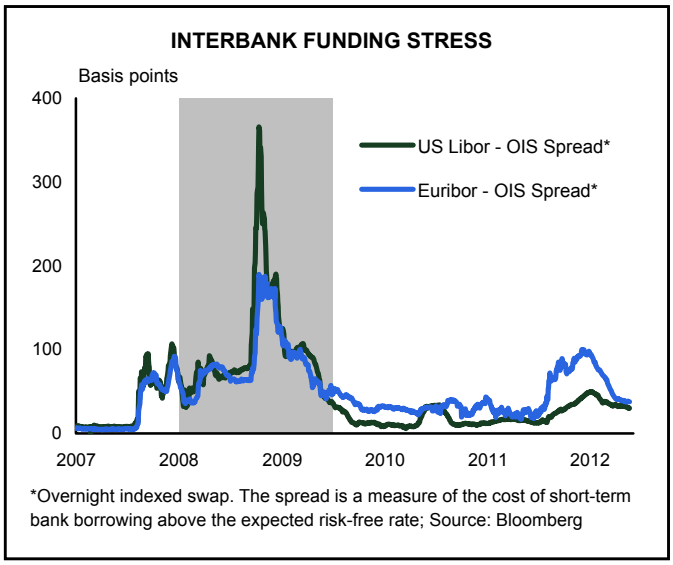
Fortunately, U.S. banks have had plenty of time to reduce their exposure to European debt over the last two years. As a result, domestic financial institutions would hopefully be able to withstand the market fallout. However, the magnitude of the impact on the U.S. financial system will depend in large part on the breadth of the European policy response. European policy makers would need to react swiftly and credibly to shore up their banking system in order to avoid a Lehman style calamity. They would need to implement policies to contain speculation that other countries would follow Greece in leaving the euro zone

Regardless of the policy response in Europe, increased strains on funding markets would precipitate a response from the Federal Reserve. As during the Lehman crisis, the Federal Reserve would likely do everything in its power to ensure adequate liquidity in the financial system. Actions by the Fed would likely include renewed efforts at lowering interbank funding costs through Term Auction Facilities and loans at the discount window. We would also expect to see a further increase in the size of the Federal Reserve's balance sheet.

Impact on the Real Economy

The effect of a Greek exit on the U.S. economy would be felt through trade and financial linkages, as well as a hit to business and consumer confidence. A worsening recession in Europe and a rising U.S. dollar implies a downward shock on U.S. exports. Exports to the European Union account for around 19% of total exports, while exports to euro zone are 13%. However, as a share of total GDP, exports to the euro zone represent just 1.3%. Even with a significantly worse euro zone recession, the direct impact on exports would, therefore, be relatively small.

We would be more concerned over the economic bite from indirect effects. The euro zone is an important trading partner with the rest of the world. A deeper recession in Europe would lead to slower growth elsewhere and this, in turn, would undermine broader export demand from the rest of the world. Financial market volatility would place added pressure on equity-related wealth, which would cause a slowdown in consumption growth. While interest rates are likely to move lower in the event of Greek default, they are unlikely to do much to entice businesses to part with record levels of liquidity to invest in an environment marked by financial volatility and heightened economic uncertainty. Investment intentions could remain sidelined until the European crisis was resolved. Similarly, heightened risk aversion among U.S. banks could reduce the credit available to small businesses and households, also offsetting the impact of lower interest rates.



Bottom Line

A disorderly or unplanned Greek exit from the euro zone would impact the U.S. through increased financial stress, a fall in exports, both to Europe and the rest of the world, and a hit to consumer and business confidence. Greece is small – representing only 2% of the euro zone. American financial institutions have already reduced much of their exposure to Greek debt and direct losses from a Greek default are likely to be relatively minimal. However, a Greek exit would entail significant losses to euro zone countries and their financial and business sectors and would increase uncertainty. Moreover, flight to safety behavior among global investors will push up the U.S. dollar and lead to significant declines in equity values. If the exit is limited to Greece – in other words, if policymakers are able to ring fence other periphery European countries – the hit to U.S. economic growth would likely be short-lived and made up by faster growth once financial conditions have normalized. If the exit is disorderly and followed by a run on other periphery European countries, it will pose a major downside risk to growth, likely enough to pull the U.S. into recession.

Beata Caranci
VP & Deputy Chief Economist
416-982-8067

James Marple, Senior Economist
416-982-2557