RELEASE IN PART
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From: Sullivan, Jacob J <SullivanJJ@state.gov>
Sent: Thursday, May 6, 2010 7:53 PM
To: Slaughter, Anne-Marie; H
Subject: Re: The political ramifications of the Greek/European debt crisis

I've asked AMS to have her team work up a nite note that we could send over tomorrow.

----- Original Message -----
From: Slaughter, Anne-Marie
To: 'HDR22@clintonemail.com' <HDR22@clintonemail.com>
Cc: Sullivan, Jacob J
Sent: Thu May 06 19:18:12 2010
Subject: The political ramifications of the Greek/European debt crisis

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As you know, the EU-IMF-USG consensus hope motivating the Greek bailout is that it will buy time for Spain, Portugal, etc. From widening credit spreads to falling stock prices, most relevant market indicators are responding with doubt. Former IMF Chief Economist and NYT Columnist (and influential blogger for bond traders) Simon Johnson has an important rejoinder to this consensus hope in today's NYT, full text pasted below. As the EU has no playbook for most of the pressing questions it faces, my staff is working to brainstorm as to the least bad of what are only sobering options.

This is long but worth it.

May 6, 2010, 6:11 amIt's Not About Greece AnymoreBy PETER BOONE AND SIMON JOHNSONLouisa Gouliamaki/Agence France-Presse — Getty Images Protesters waved flags from the Acropolis archaeological site behind banners in English and Greek hung in front of the Parthenon temple in Athens.Peter Boone is chairman of the charity Effective Intervention and a research associate at the Center for Economic Performance at the London School of Economics. He is also a principal in Salute Capital Management Ltd. Simon Johnson, the former chief economist at the International Monetary Fund, is the co-author of "13 Bankers."The Greek "rescue" package announced last weekend is dramatic, unprecedented and far from enough to stabilize the euro zone.The Greek government and the European Union leadership, prodded by the International Monetary Fund, are finally becoming realistic about the dire economic situation in Greece. They have abandoned previous rounds of optimistic forecasts and have now admitted to a profoundly worse situation. This new program calls for "fiscal adjustments" — cuts to the fiscal deficit, mostly through spending cuts — totaling 11 percent of gross domestic product in 2010, 4.3 percent in 2011, and 2 percent in 2012 and 2013. The total debt-to-G.D.P. ratio peaks at 149 percent in 2012-13 before starting a gentle glide path back down to sanity.This new program is honest enough to show why it is unlikely to succeed.Daniel Gros, an eminent economist on euro zone issues based in Brussels, has argued that for each 1 percent of G.D.P. decline in Greek government spending, total demand in the country falls by 2.5 percent of G.D.P. If the government reduces spending by 15 percent of G.D.P. — the initial shock to demand could be well over 30 percent of G.D.P.Obviously this simple rule does not work with such large numbers, but it illustrates that Greece is likely to experience a very sharp recession — and there is substantial uncertainty around how bad the economy will get. The program announced last weekend assumes Greek G.D.P. falls by 4 percent this year, then by another 2.6 percent in 2011, before recovering to positive growth in 2012 and beyond.Such figures seem extremely optimistic, particularly in the face of the civil unrest now sweeping Greece and the deep hostility expressed toward

Greece in some northern European policy circles.The pattern of growth is critical because, under this program, Greece needs to grow out of its debt problem soon. Greece's debt-to-G.D.P. ratio will be a debilitating 145 percent at the end of 2011.Now consider putting more realistic growth figures into the I.M.F. forecast for Greece's economy — e.g., with G.D.P. declining 12 percent in 2011, then the debt-to-G.D.P. ratio may reach 155 percent. At these levels, with a 5 percent real interest rate and no growth, the country needs a primary surplus at 8 percent of G.D.P. to keep the debt-to-G.D.P. ratio stable. It will be nowhere near that level. The I.M.F. program has Greece running a primary budget deficit of around 1 percent of G.D.P. in that year, and that assumes a path for Greek growth that can be regarded only as an "upside scenario."The politics of these implied budget surpluses remains brutal. Since most Greek debt is held abroad, roughly 80 percent of the budget savings the Greek government makes go straight to Germans, French and other foreign debt holders (mostly banks). If growth turns out poorly, will the Greeks be prepared for ever-tougher austerity to pay the Germans? Even if everything goes well, Greek citizens seem unlikely to welcome this version of their "new normal."

Last week the European leadership panicked — very late in the day — when it realized that the euro zone itself was at risk of a meltdown. If the euro zone proves unwilling to protect a member like Greece from default, then bond investors will run from Portugal and Spain also — if you doubt this, study carefully the interlocking debt picture published recently in The New York Times. Higher yields on government debt would have caused concerns about potential bank runs in these nations, and then spread to more nations in Europe.When there is such a "run," it is not clear where it stops. In the hazy distance, Belgium, France, Austria and many others were potentially at risk.

Even the Germans cannot afford to bail out those nations.Slapped in the face by this ugly scenario, the Europeans decided to throw everything they and the I.M.F. had at bailing out Greece. The program as announced has only a small chance of preventing eventual Greek bankruptcy, but it may still slow or avert a dangerous spiral downward — and enormous collateral damage — in the rest of Europe.The I.M.F. floated in some fashion an alternative scenario with a debt restructuring, but this was rejected by both the European Union and the Greek authorities. This is not a surprise; leading European policy makers are completely unprepared for broader problems that would follow a Greek "restructuring," because markets would immediately mark down the debt (i.e., increase the yields) for Portugal, Spain, Ireland and even Italy.The fear and panic in the face of this would be unparalleled in modern times: When the Greeks pay only 50 percent on the face value of their debt, what should investors expect from the Portuguese and Spanish? It all becomes arbitrary, including which countries are dragged down.Someone has to decide who should be defended and at what cost, and the European structures are completely unsuited to this kind of tough decision-making under pressure.In the extreme downside scenario, Germany is the only obvious safe haven within the euro zone, so its government bond yields would collapse while other governments face sharply rising yields. The euro zone would likely not hold together.There is still a narrow escape path, without immediate debt default and the chaos that that would produce:·

Talk down the euro — moving toward parity with the American dollar would help lift growth across the euroz one.·

As the euro falls, bond yields will rise on the euro zone periphery. This will create episodes of panic. Enough short-term financing must be in place to support the rollover of government debt.·

Once the euro has fallen a great deal, announce the European Central Bank will support the euro at those levels (i.e., prevent appreciation, with G-20 tacit agreement), and also support the peripheral euro zone nations viewed as solvent by buying their bonds whenever markets are chaotic.·

At that stage, but not before, the euro zone leadership needs to push weaker governments to restructure. That will include Greece and perhaps also Portugal. Hopefully, in this scenario Spain can muddle through.·

European banks should be recapitalized as necessary and have most of their management replaced. This is a massive failure of euro groupthink — including most notably at the political level — but there is no question that bank executives have not behaved responsibly in a long while and should be replaced en masse.To the extent possible, some of the ensuing losses should be shared with bank creditors. But be careful what you wish for. The bankers are powerful for a reason; they have built vital yet fragile structures at the heart of our economies. Dismantle with care.