Economic Commentary

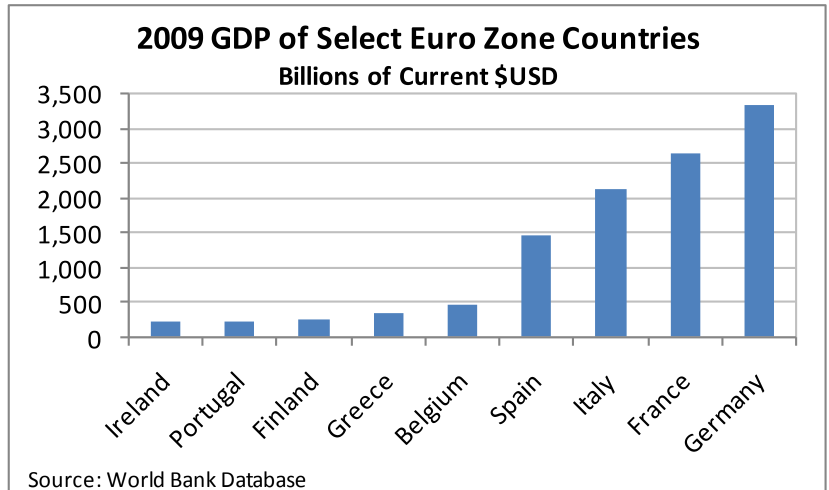
July 2011

A monthly look at Florida's Economy

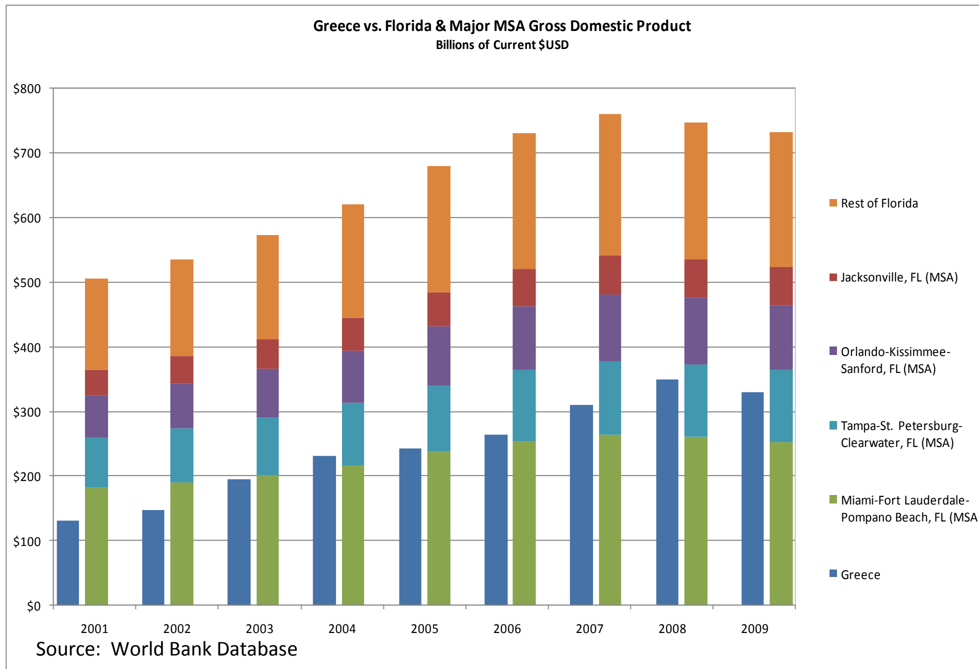
CENTER FOR Competitive Florida
A Florida TaxWatch Center of Excellence

Florida and the Financial Situation in Europe

The recent financial situation in Greece has caused an international unease that has affected financial markets all over the world. Although Greece has mostly dropped out of the news since its recent temporary bailout, the issue has not been solved for the long term. The impact of the instability in Greece on the U.S. and Florida's economies may be much larger than Greece's size would indicate. These effects could lead to a financial contagion among other Euro Zone countries. The graph to the right shows Greece's relative size in the Euro Zone by 2009 gross domestic product (GDP). As seen in the graph, Greece is far from being the largest economy in the Euro Zone, but it did have a larger GDP in 2009 than those of Ireland, Portugal, and Finland.

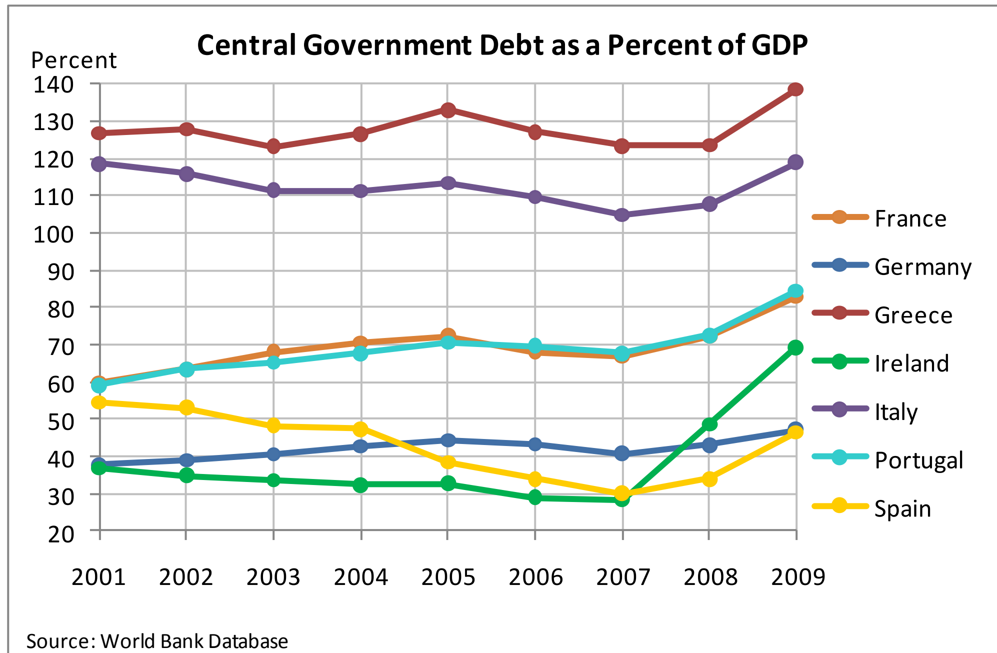


The graph below compares Greece's economy with that of Florida. One can see that Greece—as shown by the blue bar on the left of each pair in the graph—had a smaller GDP than the Miami-Ft. Lauderdale metropolitan statistical area (MSA) until 2004. The most recent data available from the World Bank shows that Greece's economy has grown significantly since its inclusion in the Euro Zone. In this period, Greece has had access to cheaper capital as a result of being part of the Euro Zone. Even though it has grown, Greece's GDP is still dwarfed by Florida's. Just the combined GDP of the Miami-Ft. Lauderdale MSA and Tampa-St. Petersburg-Clearwater MSA is larger than the GDP of all of Greece. So, the question must be—how does one country, whose entire GDP is less than half that of Florida, cause so much volatility in world financial markets?



The Florida TaxWatch Center for Competitive Florida....Resolving issues vital to Florida's global economic competitiveness.

There are a variety of answers to that seemingly simple question. The following are some of the most imminent concerns when beginning to unravel the extent of the current situation in Greece and the possibility of a looming financial contagion on other countries in and surrounding the Euro Zone area.

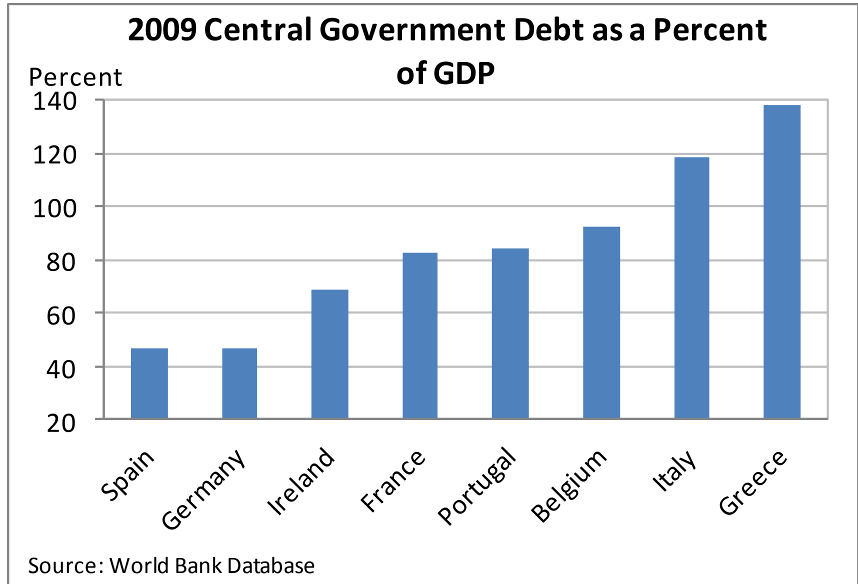


The Downward, Upward Path

The graph to the right shows the evolution of debt in the Euro Zone since 2001. One significant item shown is that Greece has historically kept the highest debt load (on a percentage basis) of any of the countries, with Italy following closely behind. Another key item shown on the graph is that since 2007, all of the countries' debt loads have risen, especially Ireland with a significant increase over the 2007-2009 timeframe. Recent estimates put the debt level of Greece at 160% of GDP. How can Greece sustain that kind of debt level? Quite frankly, it cannot, nor can any other country.

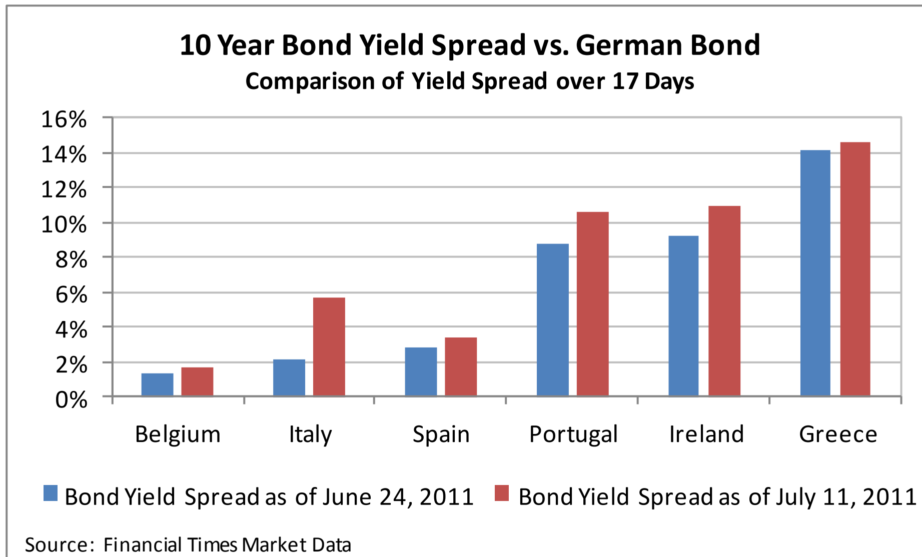
A Financial Contagion?

If Greece defaults, it is likely that other Euro Zone countries that are struggling financially will follow. The graph to the right shows the central government debt as a percent of GDP for select Euro Zone countries. One can see that Greece has the highest percentage of indebtedness of any of the Euro Zone countries. This graph uses 2009 data from the World Bank, the most recent data available. The combination of each Euro Zone country's national central bank makes up the European Central Bank (ECB). The ECB can be thought of as the main bank controlling all Euro reserves, assets, and government debt of the countries which compose it. According to the non partisan London based think tank, Open Europe, the ECB's ratio of capital to assets, is leveraged approximately 23 to 24 times, having only €82 billion in capital and reserves. If the ECB sees its assets fall 4.35 percent in value, then its entire capital base could be diminished. Spanish and Portuguese central banks have already been bailed out , with Greece being the most recent Euro Zone country to be financially restructured. If the financial contagion continues, which Euro Zone country is likely to be next to default?



The Probability of a Default

To estimate the probability of default one should investigate the "risk premium" on financial assets. For our purposes, we will look at the difference in interest rates between German bonds that have historically had lower risk and equivalent maturity bonds of Greece, Ireland, Portugal, Spain, Italy, and Belgium. These "bond yield spreads" indicate the higher interest rates required for these countries to obtain financing, compared to Germany, to offset the higher perceived risk. As seen in the chart below, the sections in blue show 10-year bond yield spreads versus German bonds from less than 3 weeks ago (June 24th, 2011). The red sections show the most up-to-date yield spreads available (July 11, 2011). Following the plan for Greece's bailout, it is clear that there should be great concern over the risk that is now held for debt default in other Euro Zone countries. In an earlier graph, Italy is shown to have the second-highest central government debt as a percentage of GDP next to Greece. Italy is waving a warning of default, as its 10-year bond yield spread versus German bonds has shot up to more than double what is was just three weeks ago. These yield spreads are at an all-time high.



What Does this Mean for the U.S.?

According to estimates from the Bank of International Settlements, at the end of 2010 European banks held an estimated $2 trillion in exposure to Greece, Portugal, Italy, Spain, and Ireland. The exposure of holding this debt is spread between European and U.S. banks, with U.S. exposure to these financially troubled Euro Zone countries estimated at as much as $800 billion. To fully capture the extent of damage this could inflict on the U.S. economy and the financial holdings of Euro Zone debt, one must take into account not only the debt, but also the ripple effect that would occur across financial institutions in the event of a default. This ripple effect would hurt U.S. money market funds that have invested heavily into those European banks' high-yielding, short-term debt holdings. Derivatives, such as credit default swaps and interest rate swaps, that are generally very high risk, will be heavily impacted. Many news outlets and economists have speculated that the impact of a Greek default and the subsequent effects on financial markets could match that of Lehman Brothers' 2008 bankruptcy, causing substantial damage to the world economy.

The Effect of Exchange Rate Volatility on Tourism and International Trade in Florida

The chain reaction of debt restructuring and its associated volatility that has been set off in the Euro Zone has additional serious implications for Florida's economy. According to the Office of Travel and Tourism Industries, a sector of the U.S. Department of Commerce's International Trade Administration, approximately 23 percent of all visitors to the U.S. from Europe come to Florida, second only to New York. With increasing volatility and financial instability of Euro Zone countries, the volatility of the value of the Euro may discourage those European citizens from traveling abroad. It could also discourage them from purchasing Florida exports and it may limit the possibilities of foreign direct investment in Florida by Euro Zone companies and individuals.

Florida TaxWatch Center for Competitive Florida

Chairman:

Mr. John Zumwalt, III
President
The Zumwalt Company

Board Members:

Mr. Marshall Criser, III
Chair, Florida TaxWatch
President-Florida
AT&T

Mr. Stuart L. Blumberg
President & CEO
Greater Miami & The Beaches
Hotel Association

Mr. John Byers
President & CEO
FPIC Insurance Group

Mr. Robert Coker
Senior Vice President
Public Affairs
United States Sugar Corporation

Mr. Doug Davidson
Market Executive
Bank of America Merrill Lynch

Mr. Stephen J. deMontmollin
Senior Vice President & General
Counsel
AvMed Health Plans

Ms. Nicki Grossman
Executive Director
Greater Ft. Lauderdale CVB

Mr. Ed Hannum
President & CEO
AvMed Health Plans

Mr. Arthur Hertz
Chairman & CEO
Wometco Enterprises, Inc.

Mr. Clayton Hollis
Vice President, Public Affairs
Publix Super Markets, Inc.

Ms. Glenda Hood
Former Secretary of State
Hood Partners, LLC

Mr. Richard Maladecki
President
Central FL Hotel & Motel Assoc.

Governor Bob Martinez
Senior Policy Advisor
Holland and Knight

Mr. David McIntosh
Trustee
Bluefield Ranch Mitigation Bank
Trust

Mr. John McReynolds
Vice Pres., Government Affairs
Universal Orlando Result

Ms. Michelle Robinson
President – SE Region/Public
Affairs, Policy, &
Communications
Verizon

Mr. Eric Silagy
Senior Vice President
Florida Power & Light

Mr. Robert Skrob
Florida Association of CVBs

Mr. David Smith
Immediate Past Chairman
President & CEO (*Retired*)
PSS World Medical

Mr. Bill Talbert
President & CEO
Greater Miami CVB

Economic Commentary written by **Jerry D. Parrish, Ph.D.,** Chief Economist, Director of the Center for Competitive Florida at Florida TaxWatch with the assistance of **Katie Furtick**, Research Assistant.

Marshall Criser, III, Chairman; **Dominic M. Calabro**, President, Publisher, and Editor.
Florida TaxWatch Research Institute, Inc.
www.FloridaTaxWatch.org
© Copyright Florida TaxWatch, July 2011

Florida TaxWatch acknowledges the expanded partnership and support of **Florida Power and Light Company** through named sponsorship of **Economic Commentary**.

The Florida TaxWatch Center for Competitive Florida....Resolving issues vital to Florida's global economic competitiveness.