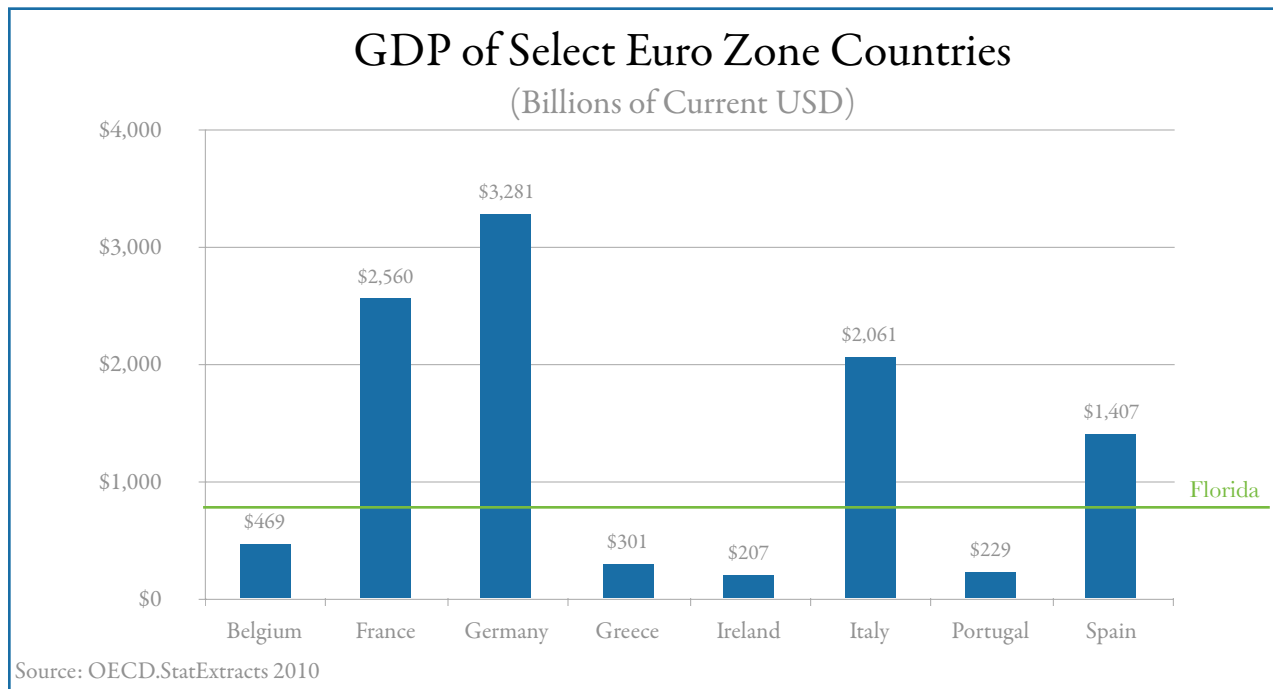


## Greece, the Euro Zone, and Florida

July 2011's *Economic Commentary* posed the question: "How does one country, whose entire GDP is less than half that of Florida, cause so much volatility in world financial markets?" The subject was Greece, and ten months later Greece is still a large part of the story.

The chart below shows the relative sizes of eight of the Euro Zone countries compared to Florida, with the GDP of Florida represented by the horizontal line. The chart shows that there are four Euro Zone countries that have larger GDPs than Florida's.

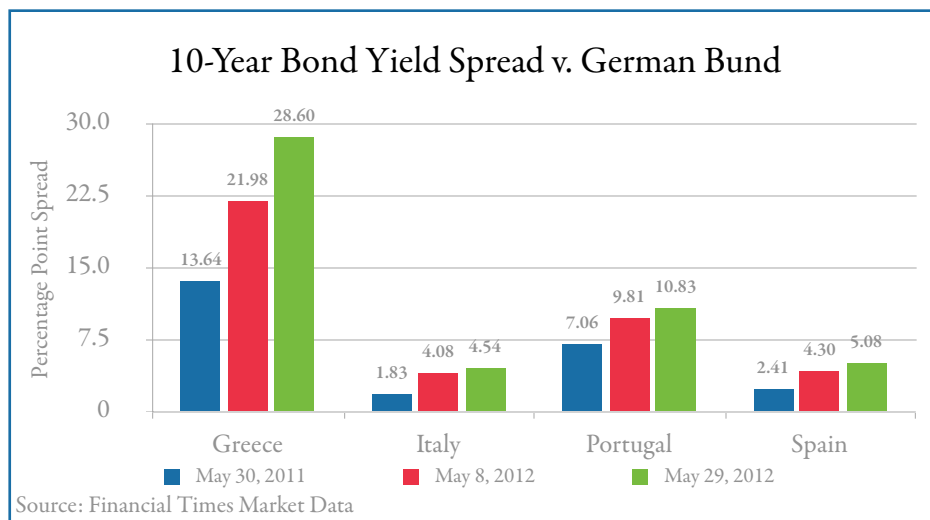


The great concern to financial markets is that there are issues in one of the larger economies in the Euro Zone that have the potential to increase the volatility in world financial markets unless it is controlled. The most recent of the larger countries to have financial issues is Spain, where there are serious concerns about the banking industry. Spain finds itself in a situation where the economy is stagnant, unemployment is near 25 percent overall and near 50 percent for its youth, and the government needs to bail out several banks to keep them solvent. Spain intends to fund the bank bailouts by borrowing, and its financial situation is causing borrowing costs to increase significantly.

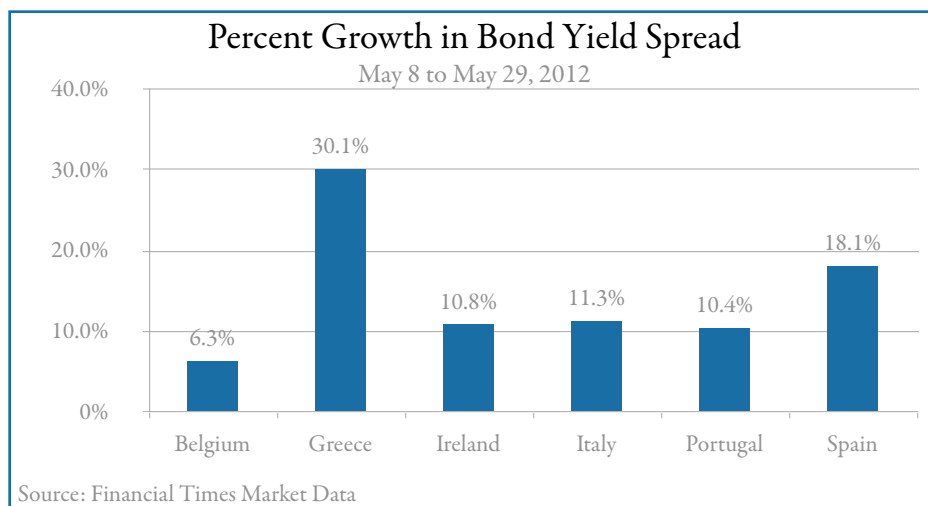
## Bond Rates Rising are a Dangerous Sign

One way to gauge the financial risk of loaning to any country is to analyze their bond yields. For the Euro Zone countries, the “bond yield spread” between all the countries and the German Bund (the German government’s federal bond) is a common measure of a country’s default risk.

The chart below shows the premium, in the form of bond yield spreads, that countries pay when issuing 10-year bonds. It is interesting that all of the countries’ bond yield spreads have increased over the last year. The chart also shows that Greece pays the highest premium of this group (the next-highest premium is paid by Portugal), and that premium has increased significantly since May 2011. Spain is one of three countries (with Italy and Greece) in this group whose bond yield spread has doubled over the past year. As one of the larger economies, this increase in interest rates creates a significant drain on Spain’s budget.



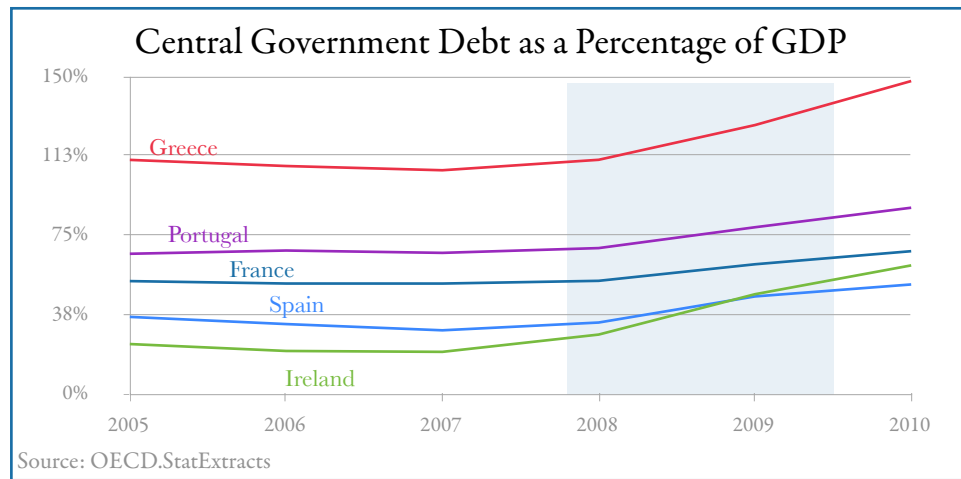
One of the key issues is the significant increase in all of these countries’ bond yield spreads during the last three weeks. Part of that increase is due to investors’ flight to quality by purchasing German Bunds, causing those rates to drop. However, a large part was the market’s evaluation of the default risk of Greece and Spain. The chart below shows that over the past three weeks, the bond yield spread for Greece has increased more than 30 percent, and Spain’s has increased more than 18 percent.



## Government Debt Compared to Size of Economy

The chart below shows the path of indebtedness of several Euro Zone countries since 2005. The light blue area shows the U.S. recession, which coincides with the time that most of the countries' debt-to-GDP ratio began

climbing. One significant item shown is that Greece has historically kept the highest percentage debt load of any of the countries. 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 during the 2007-2009 period. Although 2011 data is not yet available, estimates of Greece's current debt level are at 160% of their GDP, and Spain's is climbing quickly. This high debt-to-GDP ratio is a significant reason that Greece and Spain pay large risk premiums to borrow in the financial markets. Higher borrowing costs and the current banking crisis may well cause a default in Spain, a country many consider to be "too big to fail."

## What Does Greek Default Mean for the U.S.?

Given the upcoming elections in Greece, it is probable that Greece will exit the Euro Zone and go back to using its own currency. There is no mechanism for any country to leave the Euro, so it would likely cause a significant amount of volatility in the world's financial markets. The additional volatility will, in turn, cause more problems for the world's recovery from the recent recession, causing more delays in the business and personal investment expenditures upon which all recoveries are dependent. A potential exit of Greece from the Euro Zone will also have significant effects upon the value of the Euro. There would likely be significant volatility in exchange rates, as investors evaluate the positive and negative effects of Greece leaving the Euro. Positive effects would include that there will no longer be a need to bail out the Greek economy. Negative effects would include the losses that European financial institutions suffer, due to Greece's default on its debts. Another negative effect on the Euro would be that other countries, including Spain, may consider defaulting and leaving the currency union.

## The Effect on Florida

The effects on Florida of Greece leaving the Euro include the potentially severe amount of volatility in the currency markets, as well as other financial markets. This financial volatility will discourage even domestic investors to invest their capital in Florida. Additionally, volatility and a new valuation of the Euro exchange rate may discourage Euro Zone citizens from traveling abroad, or purchasing Florida exports, and it would likely limit the possibilities of foreign direct investment in Florida by Euro Zone companies and individuals. For Florida, this reinforces the need to continue to diversify our economy to be in a better position to handle these types of world financial events.

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