RELEASE IN PART B5

Re: The political ramifications of the Greek/Europe an debt crisis

From: Jake Sullivan sullivanjj@state.gov

To: Anne-Marie Slaughter slaughtera@state.gov;Hillary Clinton HDR22@clintonemail.com

Subject: Re: The political ramifications of the Greek/Europe an 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'
Cc: Sullivan, Jacob J
Sent: Thu May 06 19:18:12 2010
Subject: The political ramifications of the Greek/European debt crisis

B5

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. B5 B5 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