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The Greek Debt Crisis: Overview and Implications for the United States

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Summary

Crisis Overview

Greece's economy has been in crisis since 2009. While concerns have focused on the sustainability of the government's debt, the crisis has also resulted in a general collapse of the Greek economy. Greece's debt level has increased from 103% of GDP to over 170% of GDP, its economy has contracted by 25%, unemployment has tripled to 25%, and the Greek banking system has become increasingly unstable. Although other Eurozone governments, the International Monetary Fund (IMF), and the European Central Bank (ECB) have taken a number of policy measures to contain the crisis, Greece continues to face serious economic challenges.

The economic crisis in Greece has also evolved into a broader political crisis in Europe that many analysts believe could represent the most significant setback in over 60 years of European integration. Analysts argue that the acrimonious debates among European leaders about the appropriate crisis response have heightened political tensions (especially between Germany and France) to a degree that could negatively impact the EU over the longer term. In particular, the crisis in Greece has exposed problems with the institutional architecture of the Eurozone, whose member states share a common currency and monetary policy, but retain national control over fiscal and banking policies.

Recent Developments and Outlook

Between mid-2014 and mid-2015, the Greek government was in a stalemate with other Eurozone governments and the IMF over disbursements of previously committed financial assistance. The Greek government wanted more flexibility on reforms and debt relief from European creditors. Meanwhile, European creditors, led by Germany, expressed frustration with Greece's repeated delays in implementing reforms and demanded further austerity measures. Elections in January 2015 of a new, far-left, anti-austerity Greek government heightened tensions considerably.

In late June 2015, the stalemate reached a critical point, as the Greek government was running out of cash. The Greek government closed the banks, imposed capital controls, and missed a payment to the IMF. In a July 5 referendum, more than 60% of Greek voters rejected reforms demanded by other Eurozone governments and the IMF. There was speculation that Greece might leave the Eurozone. On July 12, Eurozone heads of government reached an agreement to begin negotiating a third financial assistance package to Greece in exchange for reforms by the Greek government, while affirming Greece's membership in the Eurozone. The July agreement helped stabilize the economic situation in Greece in the short term, and paved the way for a bridge loan that Greece used to make overdue payments to the IMF.

Agreement on the terms of third package was reached in August. The Eurozone rescue facility will provide up to €86 billion (about $94 billion) to Greece over the next three years. The IMF has not made a financial commitment to the third program, and it is calling for debt relief for Greece. Longer-term, there is debate about whether the new program will resolve the crisis, allow Europe to continue "muddling through" the crisis, or ultimately result in a Greek exit from the Eurozone.

Issues for Congress

Impact on the U.S. Economy: Although direct U.S. exposure to Greece is limited, Europe as a whole is a major economic partner of the United States. Continuing uncertainty in Europe could threaten its financial stability and cause the dollar to strengthen, making U.S. exports less competitive.

IMF Involvement: Some analysts have been skeptical of IMF involvement in Greece, including extending large loans to a developed economy with unsustainable debt. Other analysts have argued that IMF financial assistance helped stem contagion of the crisis and ensure stability in the global economy.

U.S.-European Cooperation: The United States looks to Europe for partnership in addressing a range of global challenges. Political tensions in Europe and a focus on the Greek crisis could prevent the EU from focusing more intently on other key U.S.-European policy priorities, such as cooperation on Russia sanctions and concluding negotiations on the proposed Transatlantic Trade and Investment Partnership (T-TIP).

Contents

Figures

Contacts

Introduction

Since 2009, Greece has been grappling with a major economic crisis. The crisis has been rooted in concerns about the sustainability of Greece's public finances and high debt levels, but it has had broader effects on Greece's economy, including a collapse in economic growth, high unemployment, and instability in the country's banking system. Although the Greek economy is small, accounting for less than 2% of Eurozone gross domestic product (GDP), many policymakers and analysts are concerned about the potential contagion of the crisis in Greece to the rest of the Eurozone and the global economy. More fundamentally, the crisis has exposed problems with the institutional architecture of the Eurozone, whose member states share a common currency and monetary policy, but retain national control over fiscal and banking policies.[1]

What started and continues as an economic crisis in Greece has also evolved into a broader political crisis in Europe that many analysts believe could represent the most significant setback in over 60 years of European integration. In Greece and other European countries with struggling economies, public opposition to economic reforms widely viewed as unjustly imposed by other governments and institutions has fueled political instability and growing concerns about the democratic legitimacy of European institutions. Greece has had five different governments since 2009. Likewise, governments in more prosperous economies, such as Germany's, have faced mounting pressure to end financial assistance to what many voters perceive as profligate governments. Analysts argue that the resulting, fraught debates among European leaders about the appropriate crisis response have heightened political tensions to a degree that could negatively affect the EU over the longer term. Many have been particularly alarmed by the frictions between Germany and France, long regarded as the key proponents and drivers of the European integration project.

Some Members of Congress have expressed concern about the possible effects of the crisis in Greece on the United States. Although the direct financial exposure of the United States to Greece is limited, there are concerns about possible contagion that could be sparked by a further deterioration of the crisis and implications for the U.S. dollar. The role of the International Monetary Fund (IMF) in the crisis has also been controversial and, as the United States is the largest shareholder at the IMF, some Members have raised questions about oversight of U.S. policy at the IMF. Some Members have also raised the impact the Greek crisis has already and could increasingly have to constrain Europe's effectiveness as a partner for the United States, including on issues such as managing a resurgent Russia and the ongoing conflict in Ukraine. Committees in both the House and the Senate have held hearings on the crisis and issues relating to its impact on the United States, and have exercised congressional oversight of U.S. policy responses.

This report provides a brief overview of the crisis, including developments through July 2015 when questions about Greece's future in the Eurozone resurfaced and emergency negotiations resulted in a third financial assistance program for Greece. It also discusses potential implications

[1] The Eurozone refers to the 19 member states of the 28-member European Union (EU) that have adopted the euro as their national currency. The euro was introduced in financial markets as an accounting currency in 1999 and began physical circulation in 2002. The 19 member states of the EU that currently use the euro as their currency are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Spain, and Slovenia. The nine EU members that do not use the euro as their national currency are Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania, Sweden, and the United Kingdom.

of the crisis for the U.S. economy and U.S.-European cooperation on broader strategic and economic cooperation.

Overview of the Crisis

Build-up and Outbreak of the Crisis

As Greece prepared during the 1990s to adopt the euro as its national currency, its borrowing costs dropped dramatically (**Figure 1**). Investors were confident that the Eurozone, with eligibility requirements, a common monetary policy managed conservatively by the European Central Bank (ECB), and rules limiting deficits and debt, would bolster traditionally weaker economies, such as Greece.[2] The Greek government took advantage of lower borrowing costs, with government debt rising from 68% of GDP in 1990 to over 100% of GDP in 2006. However, the influx of capital to Greece and lax enforcement of rules related to public finances did not result in a fundamental change in how the Greek economy was managed or in investments that increased the competitiveness of the economy.[3] Instead, Greek governments used borrowed funds from private investors to pay for government spending and to offset low tax revenue, consistently running budget deficits through the 1990s and 2000s.

Greece's crisis was triggered in late 2009, when a newly-elected Greek government revealed that its predecessors had been underreporting government budget deficits. Questions about the sustainability of Greek public finances eroded investor confidence and shut the country out of financial markets, when Greece, like many other countries, was using expansionary fiscal policies to recover from the global financial crisis of 2008-2009. Without access to capital markets, uncertainty increased about whether Greece would be able to repay its debt. Investors also started taking a more critical look at the sustainability of public finances in other Eurozone countries, with the crisis eventually spreading to Ireland, Portugal, and Cyprus. There were also questions about possible contagion to Italy and Spain, the third and fourth largest economies in the Eurozone (after Germany and France). More broadly, the debt problems in such countries posed a threat to the European banking system, slowed economic growth, and contributed to increased unemployment in many European countries.

[2] EU members incorporated budget rules into the Stability and Growth Pact (SGP) they adopted in 1997 to coordinate economic policies in lieu of relying entirely on market forces. These fiscal rules restricted EU members to budget deficits of no more than 3% of GDP and a debt levels no higher than 60% of GDP. These rules were to be enforced with fines of 0.5% of GDP when countries failed over a number of years to meet the requirements. Greece was far from the only country that violated the rules. Germany and France were the first countries to violate the terms and opposed the application of sanctions. Some analysts argue that these early violations by the Eurozone's economic "heavyweights" and major decision-makers undermined the credibility of the fiscal rules going forward. For example, see Kiran Stacey, "Who Originally Broke the EU Fiscal Rules?: France and Germany," *Financial Times*, December 6, 2011.

[3] For example, see Daniel Gros and Cinzia Alcidi, "Adjustment Difficulties and Debt Overhands in the Eurozone Periphery," *Center for European Policy Studies*, Working Document No. 347, May 2011.

Figure 1. Yields on 10-Year Greek Bonds

Source: Global Financial Data.

Concerned about the systemic risks Greece could pose to the rest of the Eurozone and the broader international economy, other Eurozone governments and the IMF extended two financial assistance packages to the Greek government (in 2010 and 2012) totaling €240 billion (at current exchange rates, about $263 billion).[4] Financial assistance was disbursed in phases, contingent upon fiscal and structural reforms, which have been implemented to varying degrees. In particular, the Greek government has implemented a significant fiscal adjustment, shifting from a primary budget deficit (the deficit excluding debt payments) of 9.9% of GDP in 2009 to a primary budget surplus of 1.5% in 2014. However, concerns have been raised about the pace of structural reforms and privatization (for more information, see text box, "To What Extent has Greece Implemented Reforms?") Additionally, in 2012, Greece restructured debt held by private investors, with private investors taking substantial losses (about 75% on a net present value basis).

The ECB also took a number of actions to respond to the crisis in Greece and the broader Eurozone, including purchasing or pledging to purchase bonds in secondary markets (initially through the Securities Market Program [SMP] and later the Outright Monetary Transactions program [OMT]). It also injected more than €1 trillion (about $1.1 trillion) in low-cost, three-year loans (long-term refinancing operations, or LTROs) into more than 800 banks across the Eurozone. The ECB cut interest rates to record lows, and in March 2015, launched a new round of quantitative easing to help stimulate the Eurozone economy. The ECB's actions have been broadly credited with containing the Eurozone crisis and stabilizing Eurozone financial markets.

[4] Throughout the report, values denominated in euros are converted to U.S. dollars using current exchange rates (as of July 24, 2015: $1.0976 per €, Source: Federal Reserve). However, the exchange rate has fluctuated since the onset of the crisis (the euro has depreciated by 25% against the dollar between the beginning of 2010 and mid-2015), and dollar conversions should be viewed as approximations.

Over the five years since the onset of the crisis, Greece's debt exposed and exacerbated problems in its banking sector and resulted in a collapse of the economy. Since 2007, Greece's economy has contracted by nearly 25%,[5] a contraction some analysts believe is worse in relative terms than the Great Depression in the United States.[6] Unemployment has tripled to nearly 25% (above 50% for young people), and public debt has risen from 103% of GDP to over 170% of GDP, most of which is now owed to other Eurozone governments and institutions. In comparison, other countries in the Eurozone that experienced similar pressures are faring better. Ireland and Portugal, countries that also turned to the Eurozone and IMF for financial assistance, successfully concluded their programs, have returned to capital markets, and are in the process of repaying the IMF early.

To What Extent Has Greece Implemented Reforms?

A key source of debate is the extent to which the Greek government has implemented fiscal and structural reforms. On the fiscal side, there has been a substantial adjustment. In terms of the primary budget balance (government revenue minus expenditures, excluding debt repayments), the government has shifted from a deficit of 9.9% of GDP in 2009 to a surplus of 1.5% of GDP in 2014. However, in mid-June, the IMF raised concerns about the need for comprehensive reform of Greece's value added tax (VAT) and pension systems.[7] Analysts have expressed similar concerns about the VAT, including the need for a broader base and higher rates, among other issues. While Greece passed major pension reforms in 2010 and 2012 which increased the retirement age and cut pension benefits, expenditures on pensions still account for over 16% of Greece's GDP, high among European countries.[8] Some argue that additional reforms are needed, because older workers have largely been sheltered from reforms, Greece has a rapidly aging population, and the baseline for pension benefits was much more generous than those provided by other European countries.[9] Some experts have also noted the slow pace of privatization in Greece, which could help the government raise badly needed funds.[10] Tax evasion also remains problematic in Greece, with some analysts suggesting that it costs the government between €10 billion (about $11 billion) and €20 billion (about $22 billion) annually in tax revenues.[11]

There is also debate over the progress on structural reforms (reforms to make the economy more competitive). On one hand, successive Greek governments have made substantial progress as measured by the World Bank Group's *Doing Business* report, which compares business regulations and the protection of property rights across countries. Greece's ranking has improved dramatically, from #106 in the world in 2008 to #61 in 2014. In 2013, it was also named as one of the "top reformers" worldwide. Additionally, labor costs in Greece have also fallen by 15%-20% between 2010 and 2014, which lowers the cost of production and improves Greece's competitiveness.[12]

However, many analysts have expressed concerns that substantial additional reforms are needed. For example, in the *Doing Business* report, even with the reforms, Greece is now ranked just ahead of Russia (#62) and just below Tunisia (#60), far from most of its European peers (for example, Ireland is ranked #13 and Portugal #33). In 2013, the OECD conducted an 11-month investigation in cooperation with the Greek authorities into Greece's food processing, retail trade, building materials, and tourism sectors. As a result of their research, they found 555 "problematic" regulations and 329 provisions where changes could be made to foster competition.[13] Broad recommendations included repealing obsolete and outdated legislation, abolishing barriers to entry, and abolishing requirements to seek approval on prices from the government or industry associations. Other recommendations were more specific, such as lifting the five-

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[5] Macroeconomic data for Greece in this report is from the IMF World Economic Outlook Database, April 2015.

[6] Elena Holodny, "Greece's Economic Nightmare is Worse than the US' Great Depression," *Business Insider*, May 29, 2015.

[7] Olivier Blanchard, "Greece: A Credible Deal Will Require Difficult Decisions by All Sides," *IMF Direct*, June 14, 2015.

[8] Ibid.

[9] "Greek Pensions: Why They are A Flashpoint," *Economist*, June 18, 2015.

[10] For example, see Liz Alderman, "Privatizing Greece, Slowly but Not Surely," *New York Times*, November 17, 2012.

[11] Adéa Guillot, "Greece Struggles to Address its Tax Evasion Problem," The Guardian, February 24, 2015.

[12] Paul Krugman, "Internal Devaluation in Greece," *New York Times*, January 26, 2015.

[13] Organization for Economic Cooperation and Development (OECD), *OECD Competition Assessment Reviews: Greece*, 2014.

day restrictions on the shelf life of milk, liberalizing prices of over-the-counter medicines, and lifting the restriction that round-trip cruise ships from Greece must embark and disembark from the same port.

More generally, the OECD found that, "Despite recent reforms, Greek product markets remain among the most strictly regulated in the OECD area, hindering competition and preventing the price adjustments needed to support the recovery. This lack of competition is holding back the growth of productivity by limiting the entry and expansion of more productive and efficient firms, inhibiting foreign investment, and holding back innovation."[14] Such reforms, however, could be politically and culturally difficult to implement.

Recent Developments

Between mid-2014 and mid-2015, the second financial assistance program for Greece was derailed by a stalemate between the government and its Eurozone and IMF creditors. Key disagreements included the economic reforms tied to the disbursement of committed funds, particularly relating to taxes, pensions, and fiscal targets, and potential debt relief from other Eurozone governments in light of its unsustainable debt level and growing public dissatisfaction with austerity; many Greeks. The Greek government has asked for more flexibility on reforms and debt relief from European creditors in light of its unsustainable debt burden and growing public dissatisfaction with austerity; many Greeks viewed the demands of its creditors as humiliating and pointed out that most of the previous bail-out money went to repay debts, primarily to French and German banks, and not help the Greek economy. Meanwhile, European creditors, led by Germany, have expressed frustration with Greece's repeated delays in implementing reforms and what is viewed as Greece's lack of regard for abiding by the "rules" of the Eurozone.

Elections in January 2015 of a new, far-left, anti-austerity Greek government heightened tensions considerably. In June 2015, the stalemate between Greece and its creditors reached a critical point. The Greek government was running out of cash and resorting to exceptional measures to make debt repayments and cover obligations like paying pensioners and government salaries. On June 26, the Greek government called for a public referendum on reforms required by its creditors in order to unlock a final disbursement of €7.2 billion (about $7.9 billion) committed as part of its second financial assistance package. Concerns that Greece could leave the Eurozone accelerated a run on Greek banks, and on June 28, the government imposed capital controls, closed Greek banks, and limited ATM withdrawals. On June 30, the Greek government did not make a €1.5 billion (about $1.6 billion) payment to the IMF, becoming the first advanced country to fall into arrears with the IMF and the single biggest missed payment in the IMF's 60-year history. On July 5, voters in the referendum rejected the creditors' proposal, with more than 60% of voters voting "no."

Agreement on a Third Package

Between early- and mid-July, the Greek government, other Eurozone countries, and the IMF negotiated a path forward. A number of possible options were discussed. Broadly speaking, they fell into three major categories: (1) extend a third financial assistance package and require additional reforms in Greece, while keeping Greece in the Eurozone; (2) have Greece exit the Eurozone, either through a unilateral decision by the Greek government or a negotiated temporary suspension; or (3) keep Greece in the Eurozone, but provide more flexibility to the Greek

[14] Ibid., p. 3.

government in terms of debt relief and reforms (see textbox, "Options for Greece: What was Considered?" for more information).

Ultimately, on July 12, 2015, an agreement was reached by Eurozone heads of government to advance with essentially the first option outlined above: keep Greece in the Eurozone and provide a third financial assistance package to Greece, with no concrete debt relief at this time, although it may be possible in the future. The agreement in July was for a broad framework and key details have been negotiated in following weeks, including on the details of the third financial assistance package. Key provisions of July agreement include:[15]

- **A third financial assistance package.** The July agreement laid out a framework for providing a third financial assistance package for Greece. Over the following month, Eurozone governments negotiated the details of the third package, which was finalized in August. They agreed to provide up to €86 billion (about $94 billion) in new financial assistance to Greece over the next three years, with financing coming from the Eurozone's main rescue facility (the European Stability Mechanism, or ESM). Unlike the previous two programs for Greece, the IMF is not contributing financing at this time.
- **Wide-ranging reforms.** The Greek government implemented a number of reforms in the short term and committed to a number of reforms over the longer term. Reforms target a range of issues, including taxes, pensions, statistical reporting, the judicial system, market liberalization (such as Sunday sales and reforming pharmacy ownership and bakery regulations), privatizing the energy market, reforming collective bargaining, addressing banking sector weaknesses, and "de-politicizing" the public administration, among others. Several specific reforms needed to be passed by the Greek parliament in July to proceed with negotiations, which it did.
- **Transfer €50 billion (about $55 billion) in Greek assets to a new fund.** The new fund would oversee the sell-off of Greek assets, such as airplanes, airports, infrastructure, and government stakes in Greek banks and utility and electric companies, using the proceeds to recapitalize banks, pay off existing debt, and invest in the Greek economy. The fund is to be managed by Greek authorities under the supervision of relevant European institutions.
- **Possibility of future debt relief.** The agreement says that Eurozone countries "stand ready to consider, if necessary, possible additional measures (longer grace and payment periods)" to put Greece's debt on a sustainable path.
- **EU investments of €35 billion (about $38 billion) in Greece.** The European Commission is to work with the Greek government to mobilize up to €35 billion (about $38 billion) under various EU programs to invest in Greece over the next three to five years.

Options for Greece: What was Considered?

In July 2015, many different policy options were discussed and negotiated for responding to crisis in Greece. Broadly speaking, they fell into three major categories:

Option 1: Greece stays in the Eurozone, and a third financial assistance package is extended to Greece. The program would require the government to implement reforms, including a number of reforms before the program could go forward. In a position paper outlined by German Finance Minister Wolfgang Schäuble, he also

[15] Euro Summit Statement, Brussels, July 12, 2015.

suggested (controversially) that the program should require the transfer of €50 billion (about $55 billion) in Greek assets to an external fund, to be sold off (privatized) over time and pay down debt. This is essentially the option agreed to by Eurozone heads of government in mid-July.

This option was attractive because it would keep Greece in the Eurozone, and most economists agree that a Greek exit from the Eurozone would have disastrous short-term effects on the Greek economy. Continued Greek membership in the Eurozone would also limit possible contagion to other Eurozone countries and the broader international economy, by maintaining the credibility of the Eurozone as an irrevocable currency union. It would also require the Greek government to implement reforms to make its economy more competitive. However, many analysts raised concerns, because similar programs over the past five years have not resolved the crisis. New loans to Greece would likely cause its debt level, already unsustainable, to rise further, and these new loans would be used to repay existing debts, primarily to other Eurozone governments and institutions, rather than directly invest in or support the Greek economy. Additional fiscal cuts when Greece's economy is already in a deep recession could make it difficult for the economy to grow. Some of the required reforms, including the transfer of state assets to a fund overseen by European authorities, could undermine Greek sovereignty.

Option 2: Greece exits the Eurozone ("Grexit"). There were a number of different proposals about how this could be accomplished. For example, in his position paper, German Finance Minister Wolfgang Schäuble suggested that Greece could be temporarily suspended from the Eurozone for a five-year period, with possible debt restructuring by Eurozone governments and support of Greece through humanitarian and technical assistance. There was also speculation in Greece that it could unilaterally decide to exit the Eurozone. There was talk about a "soft" Grexit (Greece issues "IOUs," which circulate as a parallel currency with the euro) or a "hard" Grexit (Greece passes a law to introduce a new national currency and redenominates all bank deposits in the new currency). The Greek Finance Minister at the time, Yanis Varoufakis (who has since resigned), was reportedly working on a "secret" plan to develop a parallel payment system, in the event that Greece chose to exit or was pushed out of the Eurozone.

One of the main benefits to a new national Greek currency is that, in the longer term, it could help boost Greek exports and boost export-led growth. "Grexit" would also break a five-year cycle of financial assistance packages for Greece, which have increased Greece's debt burden and, some argued, have not translated into real structural reforms in the economy. If Grexit was accompanied by debt restructuring by Eurozone governments, it could provide the government with more flexibility in its fiscal policy. However, it's not clear how, technically, a Greek exit would be implemented; there are no provisions for a country leaving the Eurozone. Moreover, most economists agree that a Greek exit from the Eurozone would be extremely disruptive to Greece's economy in the short-term, for example by wiping out citizens' life savings, causing banks to fail, and making the purchase of even basic goods, like food, difficult. If Eurozone governments and institutions did not restructure Greek debt, Greece would likely default on their loans. In either case, they would likely face losses on their loans to the Greek government. Longer-term, the Greek government could have trouble containing inflation of the new currency. Some experts also worried that "Grexit" could harm the credibility not only of the Eurozone (which was meant to be irreversible), but also of the entire EU project.

Option 3: Greece stays in the Eurozone, but the Greek government is provided more flexibility. To some observers, the proposals offered to date ignore the most pressing issue facing Greece and the EU as a whole: the high rate of unemployment. As a result, they have suggested that a more effective policy would include a combination of significant debt relief and a relaxation or suspension of budget rules to allow for a coordinated EU-wide fiscal stimulus, while still requiring structural reforms. For example, the IMF and Treasury Secretary Jack Lew became more vocal in the need for debt relief for Greece in late June and early July.

Keeping Greece in the Eurozone with more flexibility would prevent the adverse economic consequences of Greece leaving the Eurozone, while also addressing Greece's unsustainable debt burden and high rate of unemployment. Debt relief could allow more expansionary fiscal policies in Greece and in the EU, which could help revive economic growth. If debt relief was tied to the implementation of economic reforms, it could continue to provide motivation for the reform agenda. However, by extending debt relief to Greece, other Eurozone governments would have to face losses on their loans to Greece, which could be politically difficult. Some argue that debt relief for Greece would violate EU law and a fiscal stimulus potentially could violate newly revamped EU fiscal rules. Also, some Europeans are concerned that providing debt relief to Greece could create "moral hazard" in the Eurozone – bailing out one country might mean that other countries would be less inclined to implement prudent policies in the future.

Prospects for the Third Package

In the short term, the July 2015 agreement helped stabilize the economic situation in Greece. It paved the way for a €7 billion (about $7.7 billion) bridge loan that Greece used to clear arrears with the IMF and make payments to the ECB. After the deal was outlined, the ECB also increased emergency liquidity assistance for Greek banks. The Greek government was able to partially reopen banks on July 20.

However, negotiations over the third financial assistance program were contentious. In June and July 2015, the IMF became more forceful in its assessment that Greece's debt is unsustainable and that debt relief is needed "far beyond what Europe has been willing to consider so far."[16] At the end of July, the IMF announced it could not participate in the third package at this time, even though its participation was formally requested by the Greek government and IMF involvement is strongly preferred by the Europeans. The IMF has said that it will consider participating after Greece has agreed on a comprehensive set of reforms and Eurozone governments have agreed on debt relief.[17] The agreement reached in August for the third program for Greece will be funded solely through Eurozone financing, whereas the previous two programs were funded jointly by other Eurozone governments and the IMF.

Analysts have raised a number of questions about July 2015 agreement, such as how much money will be raised from the new privatization fund, whether the Greek government will commit to a reform agenda that is acceptable to its Eurozone counterparts, and whether calls for debt relief for Greece will gain traction with other Eurozone governments. More broadly, some analysts have questioned whether a third program for Greece would be successful, or whether it merely repeats previous policy responses that have been unsuccessful.[18] There is debate about whether the new program will: (1) resolve the crisis; (2) allow Europe to continue "muddling through" the crisis; or (3) still ultimately result in a Greek exit from the Eurozone ("Grexit").

Economic Outlook for Greece and the Eurozone

The ongoing debt crisis in Greece has exposed significant fault lines in the conduct of economic policy and in the economic performance of Eurozone members. Although members of the Eurozone have experienced different levels of economic performance since the currency union's founding, the financial crisis and associated economic recession have widened the gap in economic performance among the Eurozone's members: for the Eurozone as a whole, real GDP is below pre-crisis levels and is projected by the IMF to remain around an annual rate of 1.5% for the near term.[19] In addition, Eurozone members face a challenging set of issues: (1) there are double-digit unemployment rates across the Eurozone as a whole and interest rates are close to zero; (2) persistently low rates of inflation raise the risk of economic stagnation; (3) business investment, a key factor in future economic growth, registers few signs of life; and (4) productivity and competitiveness gains have nearly disappeared.

The IMF also estimates that European banks have high levels of debt and €900 billion ($1 trillion) in nonperforming loans, with the majority of these loans concentrated in six of the Eurozone countries.[20] Such nonperforming loans limit the ability of Eurozone banks to provide credit and, therefore, act to reduce the effectiveness of quantitative easing and to restrain

[16] "Greece: Update on IMF Staff's Preliminary Public Debt Sustainability Analysis," IMF, July 14, 2015.

[17] Peter Spiegel, "Greece Disqualified from New IMF Bailout, Board Told," *Financial Times*, July 30, 2015.

[18] A report by Citi argued that the new program is "a poorly designed framework – we suspect that the 3rd bailout (like its predecessors) will suffer from inadequate implementation of supply-side reforms, insufficient debt restructuring, and over-optimistic macroeconomic assumptions." As reported in "Citi: Greece's Bailout Will 'Probably Fail'," *Financial Times*, July 17, 2015.

[19] International Monetary Fund, *World Economic Outlook*, April 2015, p. 48.

[20] The six countries are: Cyprus, Greece, Ireland, Italy, Portugal, and Slovenia, International Monetary Fund, *Global Financial Stability Report*, April, 2015, p. 19.

economic growth. Due to concerns over the EU's financial and economic health, the ECB began in late 2014 to tighten the rules defining capital and to notify the largest Eurozone banks, or those deemed to be systemically important, that they needed to increase their capital base above the formal regulatory requirements, further restraining credit availability in the EU.[21]

So far, policy responses to the crises have not succeeded in delivering the broad-based economic recovery that is necessary for countries such as Greece to revive their economies and meet their growth, employment, and fiscal objectives. Greece's Eurozone and IMF creditors have been pressing Greece to adopt increasingly more stringent reforms that may further depress the Greek economy in the short run and increase the relative burden of its already-large debt. In similar circumstances, nations often have relied on stimulative fiscal policies and exchange rate depreciation to spur domestic demand and improve their export competitiveness. Without the ability to devalue its currency, with uncertain prospects for deeper Eurozone integration, and faced with demands from its creditors to further reduce its fiscal spending, the way forward for Greece's economy is unclear. Over the short run, such a policy relies heavily on exports to stimulate economic growth, while future prospects rely on a resumption of European and global growth.

For some observers, the merit of an economic policy that stresses greater fiscal consolidation during a time of high unemployment and declining economic growth is debatable. There is general agreement, however, that structural reform is necessary for the Greek economy to achieve long-term sustainable recovery. Such reforms, however, may challenge deeply imbedded cultural norms and likely confront considerable public opposition.

Political Dynamics in Europe

Dynamics in Greece

The debt and broader economic crisis in Greece have shaken the Greek political system and fueled public resentment toward EU institutions and fellow Eurozone members. Since late 2009, the country has had five different governments, representing both sides of the political spectrum.[22] Each government has struggled—and two have collapsed—in the face of growing public pressure to halt the spending cuts and economic reforms that have been implemented in exchange for financial assistance from Eurozone creditors and the IMF.

Public opposition to these economic policies was the driving factor behind the election in January 2015 of current prime minster Alexis Tsipras and his anti-establishment Coalition of the Radical Left, or Syriza. Syriza won just over 36% of the vote, almost 10 percentage points more than the second-place center-right New Democracy Party (ND). Syriza's electoral victory, the first in its ten-year history, shocked a Greek political establishment that had been dominated by two large parties—the New Democracy Party and the center-left Panhellenic Socialist Movement (PASOK)—since the mid-1970s.

Tsipras took office following a campaign in which he pledged to fulfill two key priorities backed by a majority of Greek voters: (1) reverse austerity measures and secure debt relief from Greece's

[21] David Enrich, "European Regulators Pressure Big Banks to Increase Capital," *Wall Street Journal*, January 26, 2015; Caroline Binham and Martin Arnold, "Europe's Big Banks Will Need to Raise Capital Warns ECB," *Financial Times,* February 24, 2015.

[22] One of these, a caretaker government headed by Panagiotis Pikrammenos, was in place for one month after an inconclusive election result in May 2012 led to another election in June.

creditors; and (2) keep Greece in the Eurozone. Since taking office, Tsipras has repeatedly argued that implementing additional spending cuts and economic reforms without the promise of significant debt relief would condemn Greece to further economic calamity and violate the mandate he was given by voters. Tsipras has portrayed his decision in July to ultimately agree to creditors' terms for a third assistance package as choosing between the lesser of two evils, with the less desirable option being an exit from the Eurozone. Given Tsipras' and the Greek public's demonstrated opposition to the terms, many analysts question how committed the government will be to implement the required reforms. To win parliamentary approval of initial measures required by Greece's creditors, Tsipras has had to rely on support from his political opponents.

In the face of continued and possibly growing opposition to the new agreement from within Syriza, some Greek commentators predict that Tsipras could call snap parliamentary elections in the near term. Regardless of whether and when new elections are held, for the foreseeable future the Greek political landscape will continue to be dominated by fallout from the crisis. In particular, Greek voters increasingly view economic policies as being unjustly and undemocratically imposed on them by other Eurozone members, and especially by Germany. This has raised questions about democratic accountability in the EU and has revived intra-European tensions that some observers believe could pose a significant challenge to further European integration.

Dynamics in the EU

Recent events have taken the EU and Eurozone into uncharted territory; no Eurozone member has ever defaulted, and the Eurozone's founding treaty does not contain provisions for an exit from the currency union. Whatever the outcome, the crisis in Greece has significantly heightened political tensions and public dissatisfaction within the EU. Key European leaders have consistently reiterated German Chancellor Angela Merkel's conviction that "if the euro fails, Europe fails," reflecting their belief that possible "Grexit" from the Eurozone, the EU's flagship project, could seriously undermine the integrity of the Eurozone and even the EU itself.[23] However, governments in the Eurozone's strongest economies have also faced considerable public resistance to providing financial support to Greece, which critics argue has not exercised adequate budget discipline. Opinion polls suggest that a majority of Germans would support a Greek exit from the Eurozone.[24] In some countries, including France, Germany, and Italy, the broader Eurozone crisis and related economic stagnation have also boosted populist "euroskeptic" political parties that question the benefits of European integration.

Negotiations over the agreement for a third assistance package exposed deep disagreement among some Eurozone members over fundamental questions about the currency union's future. An apparent split between France and Germany, long considered the driving tandem force behind European integration, has been cause for particular concern for many analysts. While French and Italian leaders, among others, have emphasized the geopolitical and strategic importance of maintaining a unified Eurozone and EU, German, Dutch, Finnish, and other officials have stressed the importance of adhering to Eurozone fiscal rules.[25]

[23] German Chancellor Angela Merkel, as quoted by Andrew Higgins and Alison Smalle, "With Loan Deadline Looming, Europe Offers Greece a Last-Minute Deal," *New York Times*, June 29, 2015.

[24] "Europe's Reaction to Greece: 'Nein' vs. 'Peut-Être'," *The Economist*, July 6, 2015.

[25] The German finance minister's public proposal for a temporary "Grexit," was the target of particular criticism in the media and from Greece, France, and Italy, among others. See François Heisbourg, "The End of an Affair for France and Germany," *Financial Times*, July 15, 2015.

A widely reported perception of Germany, Europe's largest and most prosperous country, imposing further austerity and economic hardship on Greece against its will has raised questions about Germany's role as the Eurozone's de facto leader and whether it essentially has too much power. German leaders point out that Berlin also has the support of a number of other Eurozone members, including the Netherlands, Finland, Spain, and the Baltic States. Nonetheless, many analysts believe that lingering tensions and distrust related to the Greece crisis could cause lasting damage to the consensus-based structures and sense of EU solidarity that have been the driving force behind the European integration project.[26]

Political Outlook for Europe

The crisis in Greece is one of several challenges facing the Eurozone and EU that some analysts believe could contribute to halting or reversing at least some aspects of European integration for the first time since the end of the Second World War.[27] Among other dynamics related to the crisis, continued economic stagnation across the EU and Eurozone, the rise of euroskeptic political parties, and growing distrust and tensions among EU member states could have the potential to hurt the efforts to widen and deepen European integration. Questions about the democratic legitimacy of EU institutions, particularly in setting economic policy, could pose a particularly difficult challenge.

On the other hand, some observers counter that the crisis and other challenges currently facing the EU could produce some beneficial reforms and ultimately transform the bloc into a more effective and cohesive entity. They point out, for example, that in response to the crisis, the Eurozone and ECB have already taken a number of unprecedented steps to permanently increase fiscal policy coordination and provide financial support to struggling member state economies. Along these lines, key French and German officials have endorsed a strengthening of the Eurozone's political authority and democratic legitimacy, including through the creation of a Eurozone parliament, although the degree of support for this proposal among other Eurozone members remains uncertain.[28]

Implications for the United States

Europe is an important economic and political partner of the United States, and the impact of the crisis in Greece on the United States has been a key issue for Congress over the past five years. Since the early stages of the crisis, President Obama and key Administration officials have repeatedly called for a swift and robust response from Eurozone leaders, underscoring the economic and strategic importance to the United States of a strong and unified Eurozone that keeps Greece as a member.[29]

In recent months, the Obama Administration has urged other European countries to allow for greater flexibility towards Greece. In February 2015, President Obama expressed sympathy for the Greek government, saying there are limits on how far its creditors can press Athens to repay

[26] See Simon Nixon, "Greek Crisis Tests Eurozone's Durability," *Wall Street Journal*, July 15, 2015.

[27] Additional challenges include an influx of migrants from the Middle East and Africa, Russian aggression in Eastern Europe, and a planned referendum in the UK on continued EU membership.

[28] See, for example, Honor Mahony, "Hollande Calls for Vanguard of States to Lead Strengthened Eurozone," *EU Observer*, July 20, 2015.

[29] See, for example, Jack Ewing, "U.S. Urges European Leaders to Solve Greek Crisis Quickly," *New York Times*, May 27, 2105.

its debts while restructuring its economy.[30] Treasury Secretary Jack Lew, along with the IMF, has also become more vocal about the need for debt relief for Greece.[31] At the same time, the Administration has stressed that the Greek government needs to make progress on its reform agenda. At the G-7 summit in June 2015, President Obama stressed the importance of the Greek government taking "some tough political choices that will be good for them long-term."[32] However, while the Administration wields an influential voice on the crisis, it has ultimately found limited ability to affect policy decisions made by and among the EU member countries and institutions.

Implications for the U.S. Economy

For the United States, the impact of the Greek debt crisis is as uncertain as the crisis itself. On one hand, U.S. direct exposure to the crisis is limited: more than 75% of Greek debt is owed to Eurozone governments or institutions (**Figure 2**) and banks outside of Greece have cut their exposures to Greece by two-thirds since 2010 (**Figure 3**). On the other hand, the potential for a broader Eurozone crisis tends to multiply the importance of the Greek crisis. Over the short run, ongoing questions regarding the direction of the Greek economy and its status in the Eurozone may continue to impact financial markets. Under these circumstances, investors often turn to safe-haven investments. The combination of diverging monetary policies between the United States (tightening) and Europe and Japan (accommodative) and investor uncertainty has increased demand for the dollar and dollar-denominated assets. This increased demand for the dollar has caused the dollar to appreciate against both the euro and the yen and led to U.S. interest rates falling below the levels they would have reached otherwise. A weaker euro and yen relative to the dollar may boost exports from Europe and Japan at the expense of U.S. exports.

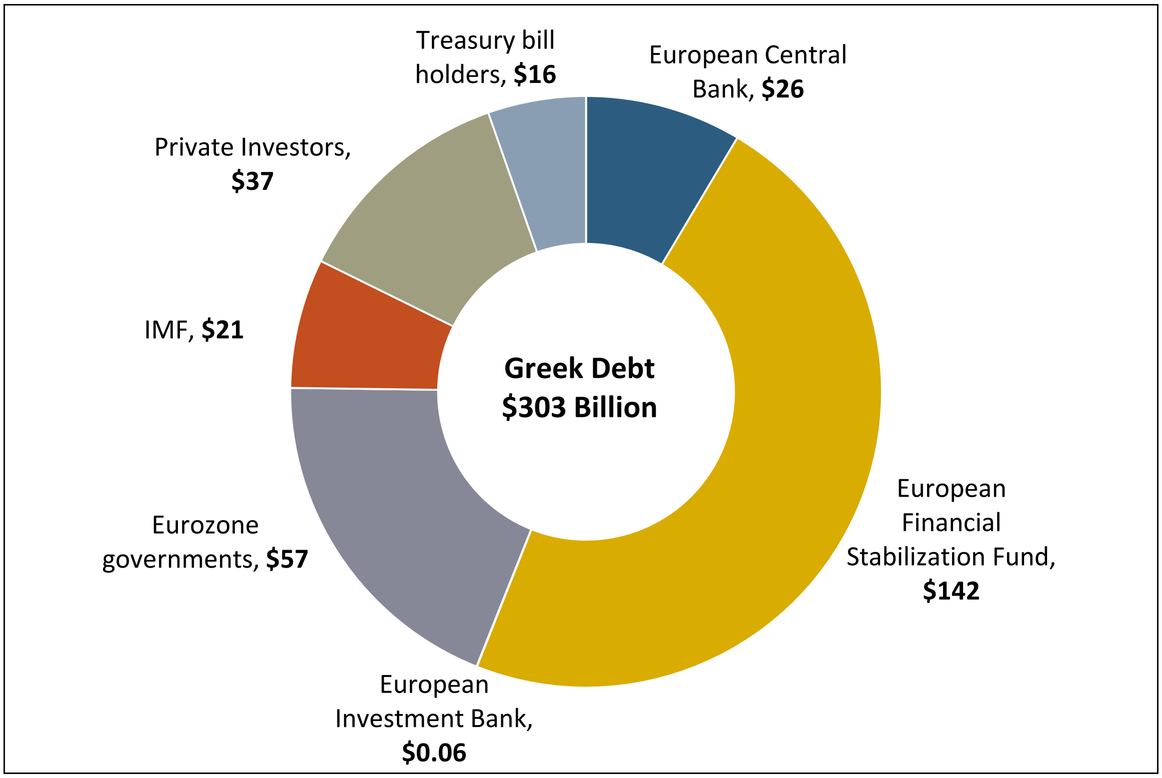
[30] Andrew Ackerman, "Obama Expresses Sympathy for New Greek Government," *Wall Street Journal*, February 1, 2015.

[31] Ian Talley, "U.S., IMF Step Up Calls for Europe to Restructure Greece's Debt," *Wall Street Journal*, July 8, 2015.

[32] "Obama Leading Chorus Telling Athens to Act," *The Guardian*, June 8, 2015.

Figure 2. Greece's Outstanding Debt

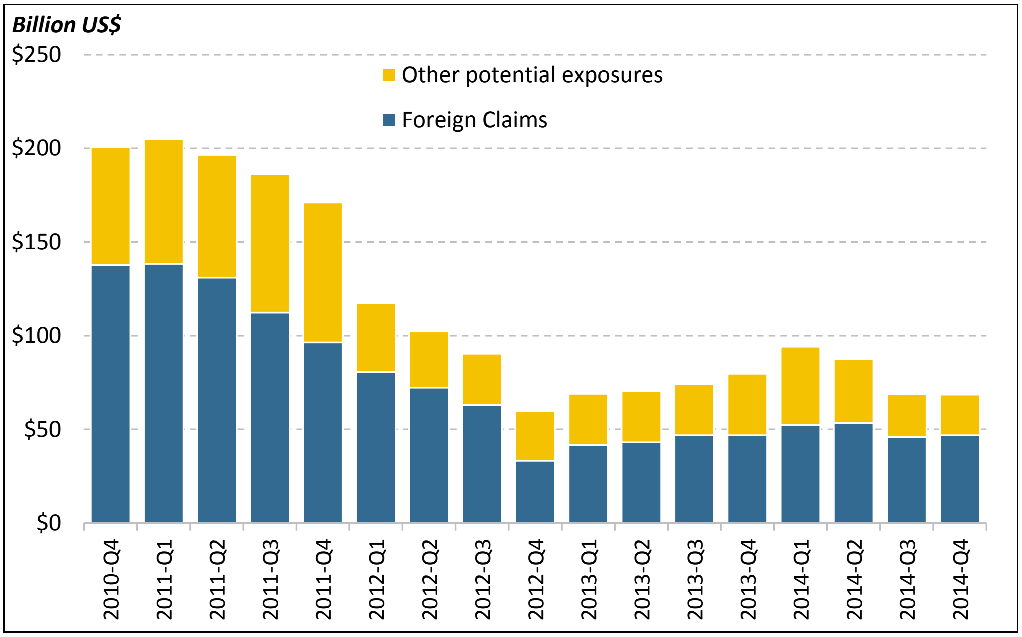
Billion US$



Source: Greece's Public Debt Management Agency; International Monetary Fund; the Irish Statute Book; European Commission, drawn from Charles Forelle, Pat Minczeski, and Elliot Bentley, "Greece's Debt Due: What Greece Owes When," *Wall Street Journal*, updated July 21, 2015.

Notes: Does not include bridge loan for Greece approved in July 2015. Figures converted from euros to dollars using the exchange rate on July 24, 2015 (1.0976 $/€, Source: Federal Reserve). Totals may not add due to rounding.

Figure 3. Foreign (Non-Greek) Bank Exposure to Greece



Source: Bank for International Settlements.

Notes: Foreign claims include claims on Greece's public and private sectors. Other potential exposures include derivatives contracts, guarantees extended, and credit commitments.

More broadly, the Greek debt crisis also is absorbing much of the attention of European policymakers and restraining their ability to focus on other important financial, economic and trade issues that affect a broad range of ties between Europe and the United States. Over the long term, a resolution of the Greek debt crisis, whether or not Greece stays in the Eurozone, could remove one important source of uncertainty in international financial markets. In such a case, demand for dollar-denominated assets potentially could ease as investors regain interest in euro-denominated assets. Increased demand for the euro relative to the dollar would tend to appreciate the value of the euro relative to the dollar. While a lower exchange value of the dollar would tend to improve the international price competitiveness of U.S. exports, it also would tend to increase the cost of U.S. imports. Depending on how quickly trade volumes responded to the change in the value of the dollar, the U.S. current account balance could worsen before it improved, delaying any stimulus to the U.S. economy.

A robust European economy is important for U.S. interests. The United States and EU have the world's largest trade and investment relationship. Trade with the EU accounted for 17.5% of total U.S. trade (both exports and imports) in 2014, and U.S. direct investment in the EU accounted for over half the total amount of U.S. direct investment abroad in 2013, while EU direct investment in the United States accounted for 70% of total foreign direct investment in 2013. The decline in the value of the euro relative to the dollar in 2015 and low interest rates in Europe have enticed U.S. firms to issue a large number of euro-denominated bonds in European capital markets in the first quarter of 2015, further deepening the financial relationship between the United States and Europe.[33]

[33] Moore, Phil, Does QE Stand for Quick Euros? *Euromoney*, June 2015, p. 100.

The proposed free trade agreement (FTA) currently being negotiated between the United States and EU, known as the Transatlantic Trade and Investment Partnership (T-TIP), has the potential to bolster growth in both economies. The comprehensive nature of the agreement could improve access by U.S. firms to important financial and services markets; it also might encourage broader structural reforms in Europe that could benefit a broad section of EU firms and consumers. T-TIP was intended to spark economic growth and job creation among countries on both sides of the Atlantic following the 2008-2009 global economic downturn resulting from the financial crisis. T-TIP was also initiated in part to assuage fears that the U.S. rebalance towards the Asia-Pacific was a rebalance away from Europe that would deemphasize the importance of Europe and the Atlantic alliance to U.S. foreign policy. Negotiations started in 2013 and are ongoing.

Implications for U.S. Participation in the IMF

Of the 188 members of the IMF, the United States is the largest financial contributor to the institution, and the United States has a leading role in shaping the IMF's lending programs.[34] IMF programs in Greece have been supported by the Obama Administration, but some Members of Congress have been concerned about whether these programs are an appropriate use of IMF resources.

Concerns have generally focused on the unusual nature of the programs, particularly that the IMF has not generally lent to developed countries in recent decades, and that the programs provide a large amount of financing relative to the size of Greece's economy. Additionally, there has been scrutiny of a specific decision by the IMF Executive Board in 2010. Generally, IMF staff had to certify that debt in a country is sustainable over the medium-term before going forward with a large program. The Board changed its lending policies to allow the Greece program to go forward, even though IMF staff could not certify that Greece's debt was sustainable in the medium term, due to concerns about potential spillover effects.[35] Critics argue that "looser" lending standards put the financial commitments of taxpayers in the United States and other countries to the IMF at risk, and some have argued that Greece's late payments to the IMF in June and July 2015 are evidence that IMF loans to Greece have been risky. Some analysts have argued that the IMF should revert to its previous lending safeguards, and that Congress should condition congressional approval of a funding and governance reform package at the IMF on this policy change.[36]

Proponents of the IMF programs in the Eurozone point out that the programs are consistent with the IMF's mandate of maintaining international monetary stability; the IMF has lent to developed countries in the past, if not recently; and that as a member of the IMF, Greece is entitled to draw on IMF resources. They also argue that the IMF has several safeguards in place to protect IMF resources, including making the disbursement of funds conditional upon economic reforms, and that the IMF has a strong historical record of countries meeting their repayment obligations. Proponents argue that IMF safeguards had to be changed in 2010 to allow the Greece program to go forward in order to protect international monetary stability and limit possible contagion of the

[34] For more on the IMF, see CRS Report R42019, *International Monetary Fund: Background and Issues for Congress,* by Martin A. Weiss.

[35] For example, see IMF, "Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement," June 2013; Paul Blustein, "Behind the Scenes at the IMF on a Fateful Day in the Greek Crisis,"

[36] For example, see John B. Taylor, "Obama and IMF Are Unhappy with Congress? Good," *Wall Street Journal*, February 13, 2014. For more on the IMF reform package before Congress, see CRS Report R42844, *IMF Reforms: Issues for Congress,* by Rebecca M. Nelson and Martin A. Weiss and CRS In Focus IF10134, *IMF Quota and Governance Reforms,* by Martin A. Weiss.

crisis in Greece to the rest of Europe and the broader economy. They also argue that other large programs for Eurozone countries, including Portugal, Ireland, and Cyprus, have been successful.

The concerns of some Members of Congress about IMF resources being used to "bailout" Greece and other Eurozone governments led to a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010 (P.L. 111-203). Section 1501 of the law requires U.S. representatives at the IMF to oppose loans to high- and middle-income countries with large public debt levels (greater than 100% of GDP) if it is "not likely" that they will repay the IMF. Prospective IMF loans to low-income countries are exempted from this requirement. If the IMF does approve a loan to a high- or middle-income country despite U.S. opposition, the law requires the Department of the Treasury to report regularly to Congress about various economic conditions in that country.

Implications for U.S.-European Cooperation

Many U.S. policymakers and analysts maintain that the Greece crisis has already and could increasingly constrain Europe's effectiveness as a partner for the United States. The EU is not only the largest U.S. trading and investment partner, but the institution and its member states are key U.S. allies on a range of global challenges, including Russian aggression in Ukraine, the Iranian nuclear program, and instability and terrorism in the Middle East and Africa. Political tensions in Europe and an almost singular focus on the Greek and broader Eurozone crisis arguably has and could continue to prevent the EU from focusing more intently on these and other key U.S.-European policy priorities.

A struggling Greece, especially outside the Eurozone, may also present significant security challenges for both Europe and the United States. As a long-standing member of NATO, Greece has been an important U.S. ally and source of stability in a broader Balkan region that has been beset by conflict over the past 20 years. The security implications for the United States of heightened instability in Greece could be compounded by Greece's geostrategic position near the Middle East and North Africa, as well as its long-standing tensions with Turkey. Greece, for example, is a primary entry point to Europe for a major influx of migrants from the Middle East and Africa, which has been a growing source of concern for the EU.[37] Finally, observers highlight the potential for a Greek government that feels spurned by its fellow EU member states to seek closer ties to Russia. During his time in office, Tsipras has emphasized the importance of Greece's close economic, political, and cultural ties to Russia and has spoken out against EU sanctions on the country—though Greece has agreed to support existing sanctions. For his part, Russian President Vladimir Putin has expressed a particular interest in boosting Russian investments in Greece's energy sector.

The Obama Administration has consistently asserted its opposition to "Grexit," viewing it as a significant threat not only to the credibility of the Eurozone but also to the broader EU. Some U.S. officials and analysts worry that although "Grexit" appears to have been averted in the short term, it could still loom in the longer term and pose a threat to European political and economic stability as well as the U.S.-EU partnership. Others suggest that despite its current political and financial problems, the EU will continue to "muddle through" and remain committed to close cooperation with the United States on a wide range of global challenges.

[37] For more information, see CRS In Focus IF10259, *Europe's Migration Crisis*, by Kristin Archick and Rhoda Margesson.

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