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

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Summary

Crisis Overview

Since 2009, Greece has grappled with a serious debt crisis. Most economists believe that Greece's public debt, 180% of Greek gross domestic product (GDP), is unsustainable. The ramifications of the debt have been felt throughout the Greek economy, which contracted by 25% from its precrisis level. A fifth of Greeks are unemployed, with youth unemployment at nearly 50%, and the Greek banking system is unstable. Although other Eurozone governments, the International Monetary Fund (IMF), and the European Central Bank coordinated a substantial crisis response, Greece continues to face serious economic challenges.

The economic crisis in Greece is also one of several major challenges currently facing the 28-member European Union (EU) that have heightened concerns about the legitimacy and structure of the EU and its institutions and raised questions about the bloc's future shape and character. Acrimonious debates among European leaders about the appropriate response to the Greek crisis and other challenges have heightened political tensions in Europe that could negatively affect 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

In the short term, attention is focused on whether the Greek government can make €6.3 billion (about $6.7 billion) in debt payments falling due in July. The Greek government and European creditors are in negotiations to unlock disbursements of financial assistance to the Greek government that would allow it to make the July repayments. If an agreement cannot be reached, Greece may again default on its debt.

A key issue in current negotiations is the role of the IMF. The IMF did not participate in the third rescue package for Greece, but left open the possibility of doing so at a later date. The IMF is pushing the Greek government to implement pension and tax reforms and pushing European creditors to grant debt relief to Greece.

After seven years through the crisis, how the crisis will ultimately be resolved remains unclear. Possible scenarios could include (1) Europeans continue to "muddle through" the crisis, providing financial assistance to Greece in exchange for reforms, while keeping Eurozone membership intact; (2) Europeans provide greater flexibility to Greece on debt relief and reforms, allowing Greece to grow out of the crisis while maintaining membership in the Eurozone; or (3) an eventual splintering of the Eurozone, with Greece choosing or being forced to leave the euro in favor of a national currency ("Grexit").

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. The pace of economic recovery in the Eurozone and in Greece is expected to pick up, albeit at a still relatively low rate, but should ease some of the pressure on financial stability and on the dollar.

IMF Involvement: Some analysts criticize IMF involvement in Greece, particularly extending large loans when questions surrounded the sustainability of Greek debt. Other analysts argue that IMF programs in Greece were critical for stemming contagion and ensuring 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 deterring Russian aggression in Ukraine and Eastern Europe and responding to conflict in the Middle East and North Africa.

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Introduction

Since 2009, Greece has grappled with a serious debt crisis. Most economists believe that Greece's public debt, 180% of Greek gross domestic product (GDP), is unsustainable.[1] The ramifications of the debt have been felt throughout the Greek economy, which contracted by 25% from its precrisis level.[2] One in five Greeks is unemployed, with youth unemployment at nearly 50%, and the Greek banking system is unstable.[3] The Greek government has received three financial assistance packages, funded by European creditors and the International Monetary Fund (IMF) in 2010 and 2012, and again by European creditors in 2015. The European Central Bank (ECB) has taken unprecedented policy measures in response to the crisis. Greece concluded the largest debt restructuring with private creditors in history in 2012, in addition to cutting public spending significantly and pledging a host of policy reforms throughout the crisis.

Between 2010 and 2013, the crisis in Greece spilled over to Ireland, Portugal, and Cyprus, which negotiated financial assistance packages, and threatened Spain and Italy. While these economies have largely stabilized, the Greek economy remains in crisis. Questions persist about Greece's ability to meet debt repayments, the terms under which European creditors and potentially the IMF would continue to provide support to Greece, the willingness of European creditors to provide debt relief to Greece, and economic reforms that could put Greek public finances on a sustainable path and jumpstart growth.

More broadly, 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. Even as Greek and European leaders have reiterated throughout the crisis their commitment to keeping Greece in the Eurozone, some analysts argue that Greece exiting the Eurozone and adopting a national currency ("Grexit") could provide the government with greater autonomy and flexibility for responding to the crisis. Other analysts argue that abandoning the euro in favor of a national currency would result in a chaotic transition and acutely exacerbate the economic situation in Greece.

What started and continues as an economic crisis in Greece has also become one of a broader set of challenges facing the 28-member European Union (EU) that many analysts believe collectively represents the most significant setback in over 60 years of European integration.[4] 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 seven 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.

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

[1] IMF, *World Economic Outlook*, April 2017.

[2] Ibid.

[3] Ibid., Eurostat.

[4] These challenges include the United Kingdom's vote in 2016 to leave the EU, an ongoing influx of refugees and migrants, and Russian aggression in Eastern Europe. See CRS Report R44249, *The European Union: Current Challenges and Future Prospects*, by Kristin Archick.

responses. In terms of impact on the U.S. economy, Greece is a small economy, accounting for 2% of Eurozone GDP, and the direct financial exposure of the United States to Greece is limited. Many experts agree that potential contagion effects from the crisis in Greece to the broader Eurozone and global economy have largely been contained. While the rate of economic growth is expected to rise in both the Eurozone and in Greece, the legacy of fiscal consolidation and other economic reforms has left the country with declining incomes and an unemployment rate above 20%. Members have also raised questions about the role of the IMF in responding to the crisis, and whether IMF programs put U.S. taxpayer contributions to the IMF at risk. 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.

This report provides a brief overview of the crisis, including negotiations between the Greek government, European creditors, and the IMF. It also discusses potential implications of the crisis for the U.S. economy and U.S.-European cooperation on broader strategic and economic cooperation.

Overview of the Crisis

Buildup 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.[5] 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.[6] 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,

[5] 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 decisionmakers 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.

[6] 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.

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.

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 $257 billion).[7] 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 10.1% of GDP in 2009 to a forecasted primary budget surplus of 1.8% in 2017.[8] However, concerns have been raised about the type of fiscal reforms and the pace of structural reforms (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

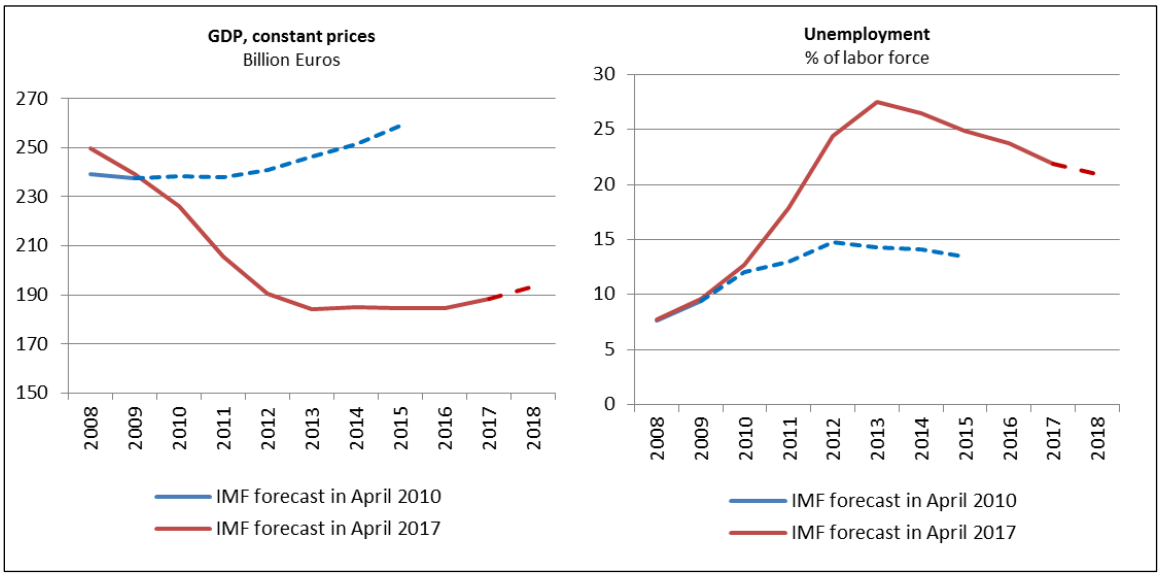
[7] Throughout the report, values denominated in euros are converted to U.S. dollars using current exchange rates (as of March 31, 2017: $1.07 per €, Source: Federal Reserve). However, the exchange rate has fluctuated since the onset of the crisis (the euro has depreciated by 25% against the dollar between the beginning of 2010 and mid-2015), and dollar conversions should be viewed as approximations.

[8] IMF, *World Economic Outlook*, April 2017.

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.

Over the seven 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, far worse than expected at the outset of the crisis (**Figure 2**). Since 2008, Greece's economy has contracted by 25%, a contraction in economic output that has lasted longer than the contraction during the Great Depression in the United States; unemployment has nearly tripled to nearly 21% (nearly 50% for young people); and public debt has risen from about 100% of GDP to over 180% of GDP, most of which is now owed to other Eurozone governments and institutions.[9] In comparison, other countries in the Eurozone that experienced similar pressures are faring better. Ireland, Portugal, and Cyprus, countries that also turned to the Eurozone and IMF for financial assistance, successfully concluded their programs and have returned to capital markets.

Figure 2. Greece: GDP Growth and Unemployment



Source: IMF, *World Economic Outlook*, April 2010 and April 2017.

Notes: Dashed lines indicate forecasted data.

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

[9] IMF, *World Economic Outlook*, April 2017; IMF, *Greece: 2016 Article IV Consultation*, February 2017, p. 5.

of 10.1% of GDP in 2009 to a surplus of 0.1% of GDP in 2016. In February 2017, the IMF forecast that based on current policies, Greece will achieve a primary fiscal surplus of 1.5% of GDP over the medium and long term, which the IMF argues is appropriate, although European creditors are pushing for a surplus of 3.5% of GDP by 2018.

However, the IMF also argues that Greece should seek more growth-friendly and equitable fiscal policies, particularly on pensions and taxes.[10] The Greek pension system has a record high deficit (10.5% of GDP, almost four times the Eurozone average), half of Greek wage earners are exempt from personal income tax, and unpaid taxes to the government amount to about 70% of GDP. Some experts have also noted the slow pace of privatization in Greece, which could help the government raise badly needed funds.[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 2016. In 2013, it was also named as one of the "top reformers" worldwide. Additionally, labor costs in Greece fell 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 Costa Rica (#62) and just below Kosovo (#60), far from most of its European peers (for example, Ireland is ranked #18 and Portugal #25). Additionally, in 2017, the OECD released an independent policy assessment to identify rules and regulations that may hinder competitive and efficient functioning of markets in specific sectors of the Greek economy (e-commerce, construction, media, wholesale trade, and specific manufacturing subsectors such as chemicals and pharmaceuticals).[13] The report makes 356 recommendations on specific legal provisions that should be abolished or amended, which the OECD estimates could have a positive impact on the Greek economy of around €414 million (about $442 million).

More broadly, the report finds that "despite these recent reforms, Greece's product markets remain among the most heavily regulated in the OECD. These structural flaws adversely affect the ability of new firms to enter markets and hamper innovation, efficiency, and productivity. Weak competition and barriers to entry result in less choice and higher prices for Greek consumers, less investment for the Greek economy and fewer jobs." Such reforms may be politically and culturally difficult to implement, however.

Key Developments in 2015: The Third Package

The Greek crisis reached a critical juncture during the summer of 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. 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 bailout money went to repay debts, primarily to French and German banks, and not to 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

[10] IMF, *Greece: Priorities for a Return to Sustainable Growth*, February 7, 2017.

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

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

[13] OECD, *OECD Competition Assessment Reviews: Greece (Preliminary version)*, 2017.

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 $7.7 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, 2015, voters in the referendum rejected the creditors' proposal, with more than 60% of voters voting "no."

Between early and mid-July 2015, 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 government in terms of debt relief and reforms. Ultimately, on July 12, 2015, an agreement was reached by Eurozone heads of government to advance with the first option: keep Greece in the Eurozone, provide a third financial assistance package to Greece (up to €86 billion, about $92 billion), and mandate wide-ranging reforms in the Greek economy, while providing no concrete debt relief.[14]

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."[15] 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.[16]

In the short term, the July 2015 agreement helped stabilize the economic situation in Greece. It paved the way for a €7 billion (about $7.5 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. However, even as the agreement on the third program was finalized, analysts questioned whether it would be successful or whether it would repeat previous policy responses that have been unsuccessful.[17]

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

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

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

[17] 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.

Recent Developments

Although the third package stabilized investor panic about a possible Greek exit from the Eurozone through 2016, continuing disagreements between the Greek government and European creditors repeatedly delayed disbursements of funds to the Greek government. Greece needs these funds to make a €6.3 billion (about $6.7 billion) debt payment falling due in July.[18] If an agreement cannot be reached, Greece may again default on its debt.

In current negotiations over financial assistance, a key issue is the role of the IMF. In the summer of 2015, the IMF declined to participate in the third financial assistance package for Greece funded by the European rescue fund (the European Stability Mechanism, ESM), due to concerns about Greece's debt sustainability and reform commitments. European creditors, including Germany, want the IMF to be involved in the program, citing the IMF's expertise in responding to economic crises. The IMF left open the possibility of participating if Greece agreed to a comprehensive set of reforms and Eurozone governments agreed on substantial debt relief for Greece. Some expected the IMF to make a decision about Greece's third program by the end of 2016, but no decision has been taken to date. It is not clear whether some countries, including Germany and the Netherlands, will approve further ESM disbursements to Greece without an IMF "stamp of approval."

The IMF has asked for pension and tax reforms in Greece (see text box, "To What Extent has Greece Implemented Reforms?"), which it views as necessary for putting fiscal policies on a sustainable trajectory going forward. It is also asking European creditors to grant debt relief for Greece. Even with additional reforms, the IMF believes that Greece's economy neither can nor will grow out of its debt problem and that European partners need to provide substantial debt relief for Greece. European assistance to Greece is in the form of loans, and writing off any principal is widely viewed as a political nonstarter in Europe. The IMF argues that debt relief could be achieved through extensions of maturity and grace periods and lower interest rates.

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 widened the gap in economic performance among the Eurozone's members. For the Eurozone as a whole, low oil prices, an accommodative monetary policy by the ECB, and stronger exports due to a weakened Euro have added to a weak cyclical recovery amid projections of slightly improved economic conditions in 2017: the OECD projects the annual Eurozone growth rate will remain around 1.6% through 2018.[19] The WTO also is projecting that global trade volumes will improve and grow at an annual rate of 2.8% in 2017, which would provide a stimulus to both the Eurozone and the Greek economies. Nevertheless, the WTO argues that its forecast is constrained by uncertainty over the direction of the global economy and government action on monetary, fiscal, and trade policies.[20]

In addition, Eurozone members face a challenging set of issues: (1) rates of unemployment and debt remain high across the Eurozone as a whole; (2) interest rates and inflation are projected to remain low, contributing to the risks for low rates of economic growth; (3) business investment, a

[18] "Greece's Creditors are Now the Main Impediment to Solving the Country's Woes," *Economist*, February 18, 2017.

[19] Organization for Economic Development and Cooperation (OECD), *Interim Economic Outlook*, March 7, 2017, p. 1.

[20] World Trade Organization (WTO), *Trade Recovery Expected in 2017 and 2018, Amid Policy Uncertainty*, April 12, 2017.

key factor in future economic growth, remains low; and (4) productivity and competitiveness gains have nearly disappeared. In its 2016 assessment of the Eurozone, the IMF concluded that the area is "at a critical juncture. Without more decisive actions to boost growth and strengthen the monetary union, the euro area remains at risk of instability and repeated crises of confidence."[21] The IMF urged the Eurozone members to take actions in a number of areas, including the following:

- Members should prioritize structural reforms, especially in product and labor markets.
- Members with the fiscal ability to do so should promote investment and structural reforms.
- The ECB should maintain its monetary easing stance and be ready to ease monetary conditions further if inflation remains below the desired level.
- Members should move forward in completing the capital markets union and strengthen bank balance sheets.[22]

In its 2017 assessment of Greece, the IMF concluded that the Greek economy will grow by about 0.4% in 2016 and 2.7% in 2017. It also argues that Greece needs to take a number of actions to stabilize its economy, but that Greece did not require additional cuts in fiscal spending "at this time" beyond what it currently is doing.[23] The IMF concluded that Greece faces four main challenges in order to achieve long-term economic stability:

- Greece has made progress in reducing government spending, but needs to take additional steps to reduce public sector wages and pensions, instead of additional tax increases on narrow tax bases within the economy.
- Greece has an ineffective tax administration system that frequently is subjected to political interference. As a result, this system has been unable to enforce tax collections and has adopted various programs that have acted to effectively weaken the incentives for Greeks to pay taxes.
- The IMF estimates that Greek banks are stronger and more resilient than they were before the 2008-2009 global financial crisis with higher and better-quality capital levels. Nonetheless, weak bank profitability is a challenge. Banks generate profits to sustain capital levels through adverse economic cycles, support future expansion of their balance sheets, meet future increases in regulatory requirements, and pay dividends to shareholders.
- Greece implemented reforms to increase labor market flexibility, which reduced labor costs and narrowed Greece's wage-competitiveness gap relative to its trading partners. However, parallel reforms intended to address rigidities in product markets have not generated the hoped-for increases in productivity and competitiveness, due to slow implementation in the face of strong opposition from vested interests.[24]

In 2015, the IMF concluded that Eurozone banks' returns on assets had only partially recovered from the financial crisis, with Eurozone institutions earning less than half their previous levels,

[21] IMF, *Euro Area Policies: 2016 Article IV Consultation*, July 2016, p. 1.

[22] Ibid., p. 1.

[23] IMF, *Greece: 2016 Article IV Consultation*, February 2017, p. 1.

[24] Ibid., pp. 8-10.

and having high levels of debt. The banks also had €900 billion ($1 trillion) in nonperforming loans, with the majority of these loans concentrated in six of the Eurozone countries.[25] 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 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.[26]

Policy responses have fallen short 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 are attempting to balance requirements for Greece to adopt additional reforms that may constrain growth in the Greek economy in the short run while not impeding economic activity. In similar circumstances, nations often have relied on stimulative fiscal policies and exchange rate depreciation to spur domestic demand and improve their export competitiveness. Euro depreciation is helping to increase exports and provide a mild stimulus to the economy. For Greece, however, given the inability to devalue its own currency, uncertain prospects for long-term deeper Eurozone integration, and the unwillingness of its creditors to revalue or forgive a large part of its outstanding debt, the way forward for its economy is unclear. Future prospects rely most heavily 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 some structural reforms are necessary for the Greek economy to achieve long-term sustainable recovery. Such reforms, however, may challenge deeply embedded cultural norms and likely will continue to confront considerable public resistance.

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 2009, the country has had seven different governments (including three caretaker governments).[27] Each has struggled—and three have collapsed—in the face of public and political 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 antiestablishment Coalition of the Radical Left, or Syriza. Syriza's electoral victory, the first in the party's 10-year history, shocked a Greek

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

[26] 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.

[27] 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.

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 an election campaign in which he pledged to reverse austerity measures and secure debt relief from creditors, but keep Greece in the the Eurozone. This position ultimately proved untenable—Greece's creditors insisted that the government continue fiscal and structural reforms in exchange for the financial assistance Greece needed to stay in the Eurozone. Tsipras portrayed his decision in July 2015 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. Many in the Syriza party opposed the decision and withdrew their support for Tsipras. Faced with this loss of confidence, but buoyed by his apparent continued popularity with Greek voters, Tsipras chose to resign and seek a new popular mandate by calling a snap parliamentary election in September 2015.

To the surprise of some analysts, Tsipras prevailed in the September 2015 election and formed the government that remains in place today. Analysts viewed Tsipras's second electoral victory as a sign that although many Greek voters oppose the austerity measures implemented at the behest of Greece's creditors, they also firmly support Greece's continued membership in the Eurozone. However, public support for Tsipras has fallen as he has implemented a series of tax increases and spending cuts in order to secure continued financial assistance from Greece's EU creditors. Some analysts question how long Tsipras can maintain support for his government's policy course. His ability to weather dissent could depend on the concessions he can win from Greece's creditors, particularly in the form of debt relief.

Dynamics in the EU

The crisis in Greece brought 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 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.[28] 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 have suggested that a majority of Germans would support a Greek exit from the Eurozone.[29] 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, was cause for particular concern for many analysts. While French and Italian leaders, among others, have emphasized the geopolitical and strategic importance of

[28] 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.

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

maintaining a unified Eurozone and EU, German, Dutch, Finnish, and other officials have stressed the importance of adhering to Eurozone fiscal rules.[30]

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.[31]

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. Chief among these is the United Kingdom's vote in 2016 to leave the EU.[32] 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 also 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.

In contrast, 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.[33]

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 seven years. During the Obama Administration, President Obama and key Administration officials 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

[30] 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.

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

[32] Additional challenges include an influx of migrants from the Middle East and Africa, and Russian aggression in Eastern Europe. See CRS Report R44249, *The European Union: Current Challenges and Future Prospects*, by Kristin Archick.

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

member.[34] However, while the Obama Administration wielded an influential voice on the crisis, it ultimately found limited ability to affect policy decisions made by and among the EU member countries and institutions. In the early days of the Trump Administration, Treasury Secretary Steven Mnuchin stated he views the Greek crisis as primarily a European issue and is encouraging the IMF to hold a "hard line" on Greece.[35]

Implications for the U.S. Economy

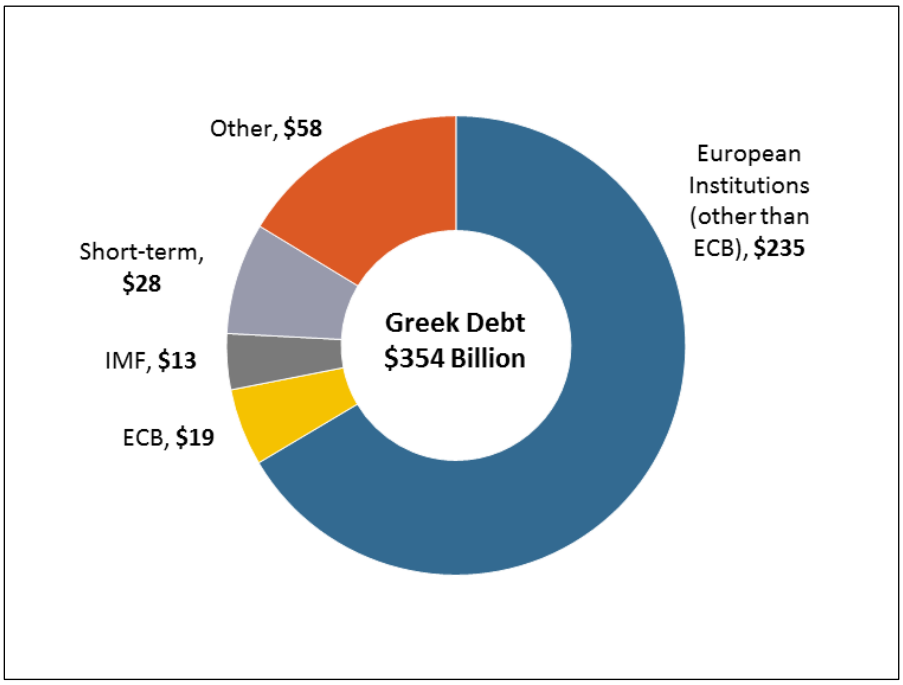
For the United States, the impact of the Greek debt crisis is uncertain. On one hand, U.S. direct exposure to the crisis is limited: more than 75% of Greek debt is owed to Eurozone governments or institutions (**Figure 3**), and banks outside of Greece have cut their exposures to Greece by roughly 85% since 2010 (**Figure 4**). On the other hand, the potential for a broader Eurozone crisis tends to multiply the importance of the Greek crisis. These concerns are being temporarily overshadowed by the still-evolving unprecedented exit of the UK from the EU, referred to as Brexit. Over the short run, financial markets will closely monitor a number of issues, including (1) potentially diverging monetary policies between the Federal Reserve and the ECB; (2) ongoing questions regarding the direction of the Greek economy; and (3) and the economic impact of Brexit. 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 increases demand for the dollar and dollar-denominated assets. This increased demand for the dollar causes the dollar to appreciate against both the euro and the yen and can cause U.S. interest rates to fall below the levels they would reach otherwise. A weaker euro and yen relative to the dollar may boost exports from Europe and Japan at the expense of U.S. exports.

[34] See, for example, Jack Ewing, "U.S. Urges European Leaders to Solve Greek Crisis Quickly," *New York Times*, May 27, 2015.

[35] Ian Talley and Rebecca Ballhaus, "Mnuchin Comments Imply U.S. Wants IMF to Stick to Hard Line on Greece," *Wall Street Journal*, February 23, 2017.

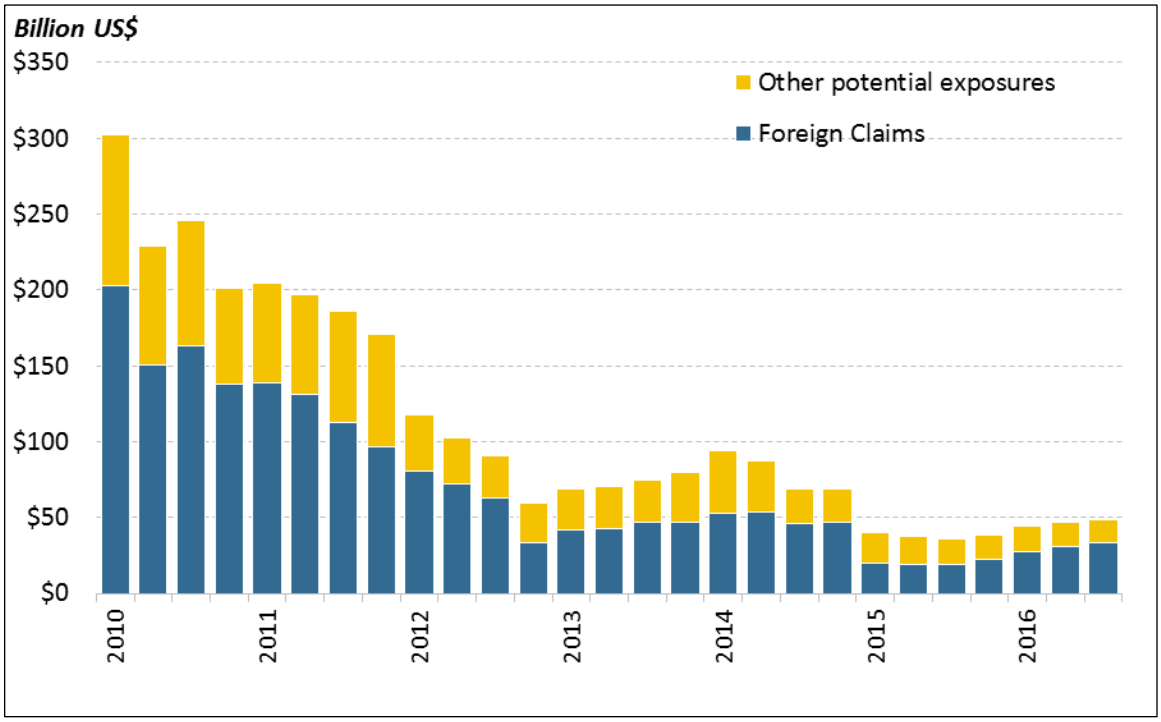
Figure 3. Greece's Outstanding Debt

Billion U.S. $, 2017



Source: International Monetary Fund.

Figure 4. Foreign (Non-Greek) Bank Exposure to Greece



Source: Bank for International Settlements.

Notes: Data are for consolidated international bank claims on an ultimate risk basis, accessed on April 5, 2017. Foreign claims include claims on Greece's public and private sectors. Other potential exposures include derivatives contracts, guarantees extended, and credit commitments. Countries reporting to BIS include Australia, Austria, Belgium, Canada, Chile, Chinese Taipei, Finland, France, Germany, Greece, Hong Kong, Italy, Japan, the Netherlands, Norway, Portugal, Singapore, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

More broadly, the Greek debt crisis and Brexit are 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 19% of total U.S. trade (both exports and imports) in 2016, and U.S. direct investment in the EU accounted for over half the total amount of U.S. direct investment abroad in 2015, while EU direct investment in the United States accounted for 70% of total foreign direct investment in 2015. The decline in the value of the euro relative to the dollar in 2015 and 2016 and low interest rates in Europe have enticed U.S. firms to issue a large number of euro-denominated bonds in European capital markets, further deepening the financial relationship between the United States and Europe.[36]

The proposed free trade agreement (FTA) that was 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 potentially 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 toward 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 uncertain.

Implications for U.S. Participation in the IMF

Some Members of Congress have been concerned about whether IMF programs in Greece have been an appropriate use of IMF resources and adequately protected U.S. taxpayer contributions to the IMF.[37] The United States generally has a leading voice at the IMF, as the institution's largest shareholder. 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.

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

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

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 was sustainable over the medium term before approving a program that exceeded normal limits on the size of IMF financing (referred to as "exceptional access" to IMF financing). In May 2010, the Board changed its lending policies to allow the first Greek 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.[38] Critics argue that the policy change inappropriately relaxed IMF lending standards and put the financial commitments of taxpayers in the United States and other countries to the IMF at risk.[39] They point to Greece's missed payments to the IMF in June and July 2015 as evidence that IMF loans to Greece have been risky, even though they were later repaid.[40]

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; that 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 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.

Concerns about IMF resources being used to "bail out" Greece and other Eurozone governments have led to legislation. In 2010, a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 1501 of P.L. 111-203) required 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.

Additionally, in December 2015, Congress conditioned U.S. participation in a broader reform package at the IMF on repeal of the 2010 policy change that allowed the Greek program to go forward despite concerns over the sustainability of its debt (P.L. 114-113).[41] In response to the legislation, the IMF repealed the policy change, and the reform package became effective in January 2016.[42] The legislation also touched on a number of other issues raised by the IMF programs in Greece and other Eurozone countries, including new reporting requirements related to IMF cofinancing arrangements, seniority of IMF financing, and exceptional access to IMF financing, among other issues.

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[38] 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," CIGI, July 7, 2015.

[39] For example, see John B. Taylor, "Obama and IMF Are Unhappy with Congress? Good," *Wall Street Journal*, February 13, 2014.

[40] For example, see Peter Eavis, "Greece is Placed in 'Arrears,' as the IMF Spells 'Default,'" *New York Times*, June 30, 2015.

[41] 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 and Rebecca M. Nelson.

[42] IMF, "IMF Survey: IMF Reforms Policy for Exceptional Access Lending," January 29, 2016; IMF, "Press Release: Historic Quota and Governance Reforms Become Effective," January 27, 2016.

Legislation in the 115th Congress

In March 2017, Representative Huizenga introduced the IMF Reform and Integrity Act (H.R. 1573), which seeks to address some of the issues raised by the IMF programs in Greece. For example, the bill would enact changes in the following areas, among other objectives:

- **Cofinancing arrangements.** The cofinancing arrangement between the IMF and European creditors (who, along with the ECB, are referred to as the "troika") in Greece is unusual and has been controversial. Some analysts argue that it constrained the IMF's policy response to the crisis, ultimately risking IMF resources in the process. Others argue that cofinancing arrangements were an important policy tool that allowed the IMF to leverage funds and minimize its own exposure during financial crises. H.R. 1573 would direct the U.S. Executive Director at the IMF to oppose IMF programs that would be cofinanced with other multilateral organizations in specific instances, particularly when IMF financing is not made explicitly senior to financing from other multilateral organizations. It would also direct the U.S. Governor of the IMF, under certain circumstances, to oppose any increase in IMF resources if the Fund has recently approved financing in conjunction with another multilateral organization.
- **Unsustainable debt**. Some analysts argue that the IMF should not have proceeded with two successive Greek programs when IMF staff could not certify with high probability that Greek debt was likely to be sustainable over the medium term. Other analysts argue that the IMF required the flexibility to fund a program in Greece in order to avoid a systemic crisis as the global economy struggled to recover from the global financial crisis of 2009-2010. H.R. 1573 would direct the U.S. Executive Director at the IMF to oppose IMF programs for countries whose public debts are not likely to be sustainable in the medium term.
- **Changing IMF lending criteria.** The IMF decision to change its criteria for granting exceptional access to IMF financing to allow the Greek program to go forward has been criticized, although some argue it was necessary to stem spillover of the crisis. H.R. 1573 would prohibit the U.S. Executive Director at the IMF from supporting a change in the criteria used by the Fund to grant exceptional access to IMF financing under specific instances.

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 a 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. 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.

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