CRS Insights

Economic Crisis in Greece
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June 29, 2015 (IN10295)

Background

Questions about whether Greece will stay in the Eurozone have resurfaced, as the government's stalemate with the International Monetary Fund (IMF) and Eurozone creditors has reached a critical point. Greece's economic crisis was triggered in 2009, when it was revealed that successive Greek governments had been misreporting data on its budget deficit. Questions about the sustainability of Greek public finances eroded investor confidence and shut the country out of financial markets, when it was still struggling to recover from the global financial crisis. The crisis in Greece spilled over to other Eurozone countries, including Ireland, Portugal, and Cyprus.

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 (about $270 billion). In 2012, Greece also restructured its debt, with investors taking substantial losses (75% on a net present value basis). The European Central Bank (ECB) initiated a series of policy measures, including providing liquidity support to Eurozone banks and purchasing or pledging to purchase government bonds in secondary markets, which were broadly credited with stabilizing market panic and limiting contagion.

More than five years after the onset, Greece's economy remains in crisis. Since 2007, its economy has contracted by nearly 25%, a contraction some analysts believe is worse in relative terms than the Great Depression in the United States. Unemployment has tripled to nearly 25%, and public debt has risen from 103% of GDP to 173% of GDP. Additionally, the assistance program has been in derailed by a stalemate between the Greek government and its creditors; no money has been disbursed by the Europeans or the IMF in nearly a year. Meanwhile, the economic situation in other Eurozone crisis countries, including Ireland, Portugal, and Cyprus, has stabilized.

Negotiations between Greece and its Creditors

The Greek government and its European and IMF creditors have been in tense negotiations for months over the final disbursement of funds from the second financial assistance package. Key issues in the negotiations include: (1) the policy reforms required of the Greek government tied to the disbursement, particularly relating to taxes, pensions, and fiscal targets; and (2) potential debt relief from European creditors that could help put Greece's debt on a sustainable path.

Greek Prime Minister Alexis Tsipras was elected in January 2015 pledging to reverse austerity measures and demand debt relief from European creditors. Meanwhile, European creditors, led by Germany, have expressed frustration with the Greek government's repeated delays in implementing reforms. Although resistant to writing down the value of the Greek debt, these creditors might be open to other options, such as extending maturities, that could lower the debt burden in the short-term. The two sides have exchanged a number of proposals, but it is not clear whether a final agreement will be reached.

If a deal is reached, it would unlock the final disbursement under Greece's second program, providing the government with €7.2 billion (about $8.1 billion). The government is perilously close to running out of cash and resorting to exceptional tactics to meet its obligations. However, even if Greece does reach a deal with its creditors, it is not seen as a long-term solution. Many analysts believe that the funds would only meet Greece's financing needs through the summer. Some believe that Greece needs a third financial assistance package, but it is not clear if there is political will in the Eurozone for a third Greek program.

Recent Developments

As negotiations between Greece and its Eurozone and IMF creditors break down, questions are being raised about whether Greece will default. In the short-term, analysts are focused on whether the Greek government will make two key upcoming debt payments: €1.5 billion (about $1.7 billion) due to the IMF on June 30 and €3.5 billion (about $3.9 billion) due to the ECB on July 20.

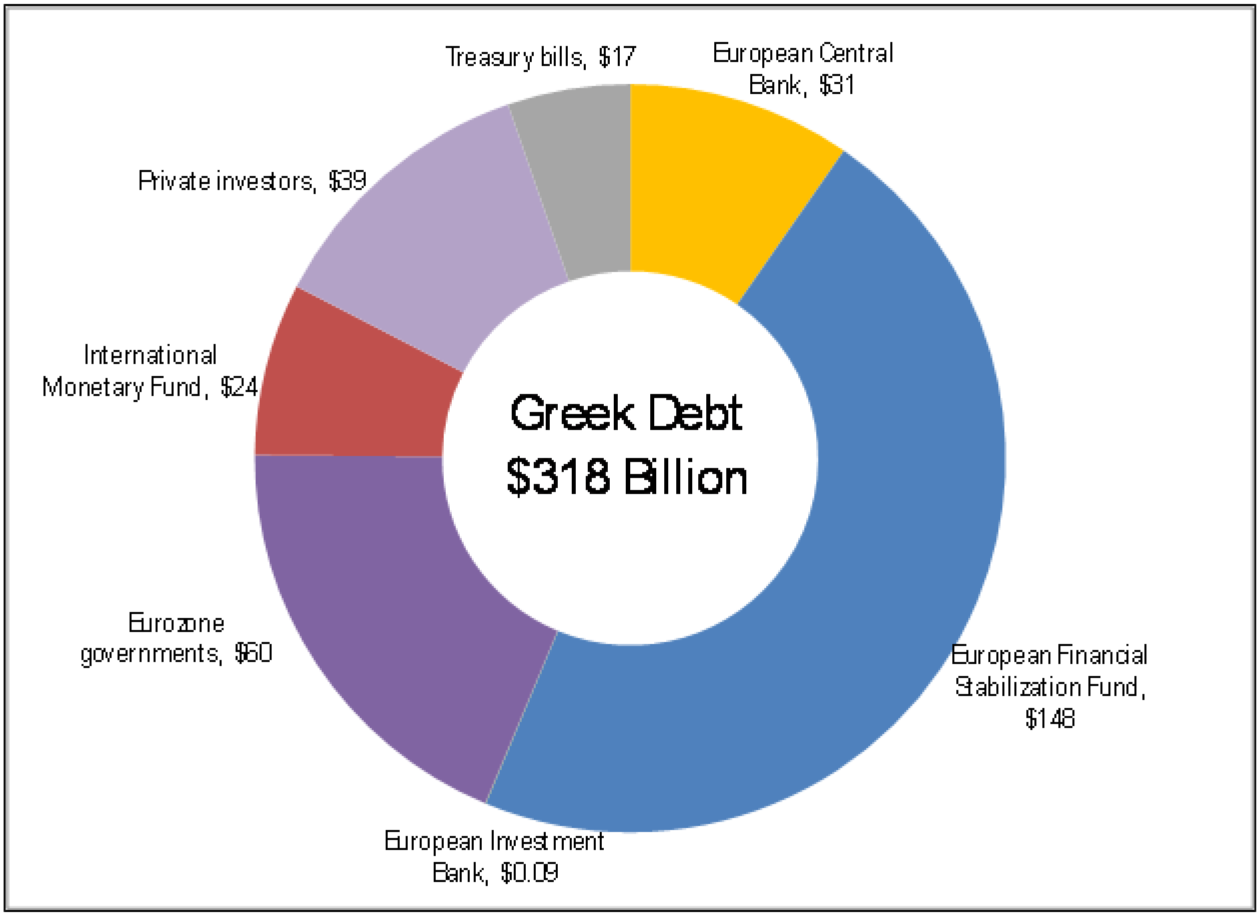
On June 26, the Greek government called for a referendum on new bailout terms offered by its international creditors, scheduled for July 5. On June 28, the ECB said that no new funds would be available for Greek banks, and Greece's Financial Stability Council, which includes banks, regulators, and the government, decided to impose capital controls and close Greek banks. The bank closures are to last through at least July 6. When markets reopened on June 29, stock markets worldwide responded negatively to the latest developments in Greece.

Most analysts now expect the Greek government to default on the IMF on June 30. A Greek default on the IMF would also be extremely unusual, and it would be the first advanced country to do so. If Greece does default on its debt, it is not clear whether it would stay in the Eurozone while trying to reach a new agreement or reintroduce a new national currency and exit the Eurozone ("Grexit").

Outside of Greece, the direct consequences of a Greek default would likely be borne primarily by official creditors (other governments and international institutions). Official creditors currently account for more than 80% of Greece's $318 billion in outstanding debt (**Figure 1**). There is greater uncertainty surrounding the potential contagion effects. Although Greece's economy is small, less than 2% of total Eurozone GDP, it is uncertain whether investors would differentiate between the economic challenges in Greece and other Eurozone crisis countries. Some analysts believe that even a default would raise questions about whether membership in the Eurozone is permanent for any of its members and could spark capital flight broadly across the Eurozone for safe havens like the United States. If investors started pulling out of Ireland, Portugal, Spain, and Italy, it would likely cause the dollar to appreciate and could trigger a substantial economic crisis with global ramifications. Other analysts argue that Greece has been effectively "ring-fenced," through efforts to strengthen the Eurozone banking system; the creation of Eurozone rescue facilities that can provide financial support during crises; and the ECB's active role in the crisis response.

Figure 1. Greece's Outstanding Debt

($ in billions)



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 June 19, 2015.

Notes: Figures converted from euros to dollars using the exchange rate on June 19, 2015 (1.1335 $/€). Source: Federal Reserve. Totals may not add due to rounding.