



The Eurozone Crisis: Overview and Issues for Congress

Rebecca M. Nelson, Coordinator

Analyst in International Trade and Finance

Paul Belkin

Analyst in European Affairs

Derek E. Mix

Analyst in European Affairs

Martin A. Weiss

Specialist in International Trade and Finance

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Summary

Crisis Overview

What started as a debt crisis in Greece in late 2009 has evolved into a broader economic and political crisis in the Eurozone and European Union (EU). The Eurozone faces four major, and related, economic challenges: (1) high debt levels and public deficits in some Eurozone countries; (2) weaknesses in the European banking system; (3) economic recession and high unemployment in some Eurozone countries; and (4) persistent trade imbalances within the Eurozone.

Additionally, the Eurozone is facing a political crisis. Disagreements among key policymakers over the appropriate crisis response, and a complex EU policy-making process are seen as having exacerbated anxiety in markets. Governments in several European countries have fallen as a direct or indirect result of the crisis.

Recent Developments & Outlook

Market pressure against several Eurozone countries increased during the summer of 2012, when there was concern that the crisis was spreading from Greece, Ireland, and Portugal, three relatively small economies, to Italy and Spain, the third- and fourth-largest economies in the Eurozone. Several developments in August and September have calmed markets, including: an announcement by the European Central Bank (ECB) for a new bond-buying program to hold down government bond interest rates; the September 12 German constitutional court ruling in favor of the permanent European rescue fund, with certain conditions; pro-Europe parties doing well in the Dutch elections; and the European Commission unveiling a proposal for a single banking supervisor.

Questions remain, however. ECB bond purchases are conditional on governments seeking programs from the European rescue funds, and implementing the economic reforms attached to that assistance. To date, neither Spain nor Italy has requested such a program. Additionally, pressure continues to build in Greece, with the Greek prime minister appealing to German and French leaders for more time to implement budget cuts and economic reforms. Some economists believe that Greece could require additional aid to avoid defaulting on its debt. Debates about a European banking union are also creating tensions among some European governments.

More broadly, many of the fundamental challenges in the Eurozone remain, including lack of economic growth, high unemployment, and internal trade imbalances; and many still question the Eurozone's future. More economists and policymakers are openly questioning whether Greece will remain in the currency union, and asking what other countries may follow if Greece exits. Others are optimistic that ultimately European leaders and institutions will do whatever is necessary to keep the Eurozone intact, and that the EU could emerge from the crisis stronger and more integrated.

Issues for Congress

Impact on the U.S. Economy: The United States has strong economic ties to Europe, and many analysts view the Eurozone crisis as the biggest potential threat to the U.S. economic recovery. U.S. Treasury officials have emphasized that U.S. exposure to the Eurozone countries under the most market pressure is small but that U.S. exposure to Europe as a whole is significant. Recently, the euro has fallen against the dollar; a weaker euro against the U.S. dollar could cause

the U.S. trade deficit with the EU to widen. Uncertainty in the Eurozone is creating a “flight to safety,” causing U.S. Treasury yields to fall, and volatility in the U.S. stock market.

IMF Involvement: In response to the crisis, some countries have pledged additional funds to the International Monetary Fund (IMF). The United States has not pledged new funds to the IMF as part of this initiative. Members of Congress may want to consider how to guarantee that the IMF has the resources it needs to ensure international economic stability while also exercising oversight over the exposure of the IMF to the Eurozone.

U.S.-European Cooperation: The United States looks to Europe for partnership in addressing a range of global challenges. Some analysts and policymakers express concern that the crisis could keep much of the EU’s focus turned inward and exacerbate a long-standing downward trend in European defense spending.

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Introduction

Since 2009, the European Union (EU) has grappled with a sovereign debt and financial crisis that many consider the biggest current threat to the global economy.¹ Analysts and investors are concerned that some Eurozone governments could default on their debt in a disorderly fashion;² that vulnerabilities in the European banking sector could trigger broad financial turmoil; that the Eurozone could enter a protracted economic recession; and that one or more countries could leave the Eurozone. The economic crisis has also become a political crisis. A number of national governments have fallen as a direct or indirect result of the crisis, and the crisis has strained relations among European leaders and institutions.

The Obama Administration has repeatedly called for swift and robust European responses—specifically advocating that more substantial financial assistance be made available to struggling economies. The United States has found, however, that it has limited ability to affect European policy decisions on this issue. Some Members of Congress have expressed concern about the possible effects of the crisis on the U.S. economy, the appropriate role of the International Monetary Fund (IMF) in the crisis, and the implications of the crisis for future U.S.-EU cooperation on foreign policy issues. Committees in both the House and the Senate have held hearings on the crisis and issues relating to its impact on the U.S. economy, and have exercised congressional oversight of U.S. policy responses.³

This report provides a brief analysis of the Eurozone crisis and issues of particular congressional interest. For broader analysis of the origins of the Eurozone and its future prospects, see CRS Report R41411, *The Future of the Eurozone and U.S. Interests*, coordinated by Raymond J. Ahearn. For discussion about sovereign debt in advanced economies, including a comparison of the Eurozone and the United States, see CRS Report R41838, *Sovereign Debt in Advanced Economies: Overview and Issues for Congress*, by Rebecca M. Nelson.

¹ There are 17 EU member states that use the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Spain, and Slovenia. The other 10 EU members have yet to adopt the euro or have chosen not to adopt the euro.

² An orderly default typically refers to a government working out a plan to restructure its debt with private creditors before missing or suspending payments. In contrast, a disorderly default typically refers to governments missing or suspending payments without previously working out a plan for repaying at least part of the remaining debt with creditors.

³ Recent congressional hearings include:

1. Senate Banking, Security and International Trade and Finance Subcommittee, September 22, 2011;
2. House Financial Services, International Monetary Policy and Trade Subcommittee, October 25, 2011;
3. House Foreign Affairs, Europe and Eurasia Subcommittee, October 27, 2011;
4. Senate Foreign Relations, European Affairs Subcommittee, November 2, 2011;
5. House Oversight, Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, December 15, 2011 (Part 1) and December 16, 2011 (Part 2);
6. Senate Budget, February 1, 2012;
7. Senate Banking, February 16, 2012;
8. House Financial Services, Full Committee, March 20, 2012;
9. House Oversight, March 21, 2012;
10. House Financial Services, Domestic Monetary Policy and Technology, March 27, 2012; and
11. Senate Foreign Relations, European Affairs Subcommittee, August 1, 2012.

Overview of the Eurozone Crisis

The Eurozone debt crisis began in late 2009, when a new Greek government revealed that previous governments had been misreporting government budget data. Higher than expected deficit levels eroded investor confidence, causing bond spreads to rise to unsustainable levels. Fears quickly spread that the fiscal positions and debt levels of a number of Eurozone countries were unsustainable. In May 2010, Greece received a financial assistance package (loans) from other Eurozone governments and the IMF in order to avoid defaulting on its debt. Investors became increasingly nervous about public finances in Ireland and Portugal, and, as their bond spreads rose, the two countries also requested European-IMF financial assistance packages that were finalized in December 2010 and May 2011, respectively.

European leaders and institutions have pursued a set of unprecedented policy measures to respond to the crisis and stem contagion, particularly to Italy and Spain, the third- and fourth-largest economies in the Eurozone. These policy measures, discussed in greater detail below, have failed to reassure markets for any sustained period of time, however, as the crisis has cycled through periods of relative calm followed by intense market pressure.

The economic crisis has increasingly become a political crisis as well. In Eurozone countries under the most market pressure, the crisis has provoked protests and backlash against austerity measures. In the economically stronger economies that have been providing financial assistance to the weaker economies, there has been resentment against what is perceived as “bailing out” other countries that have failed to implement “responsible” policy choices. Disagreements among key policymakers over the appropriate crisis response, and what many consider to be a slow, complex EU policy-making process, are seen as having exacerbated anxiety in markets.

Recent Developments

Summer 2012

Market pressure against Spain and Italy intensified in the summer of 2012. Concerns about Spain’s banking system came to a head, after it was announced that the government would need to rescue Spain’s fourth-largest bank (Bankia). In June 2012, European authorities announced plans for bank recapitalization in Spain of up to €100 billion (about \$130 billion).⁴ Additionally, political uncertainty in Greece after an inconclusive parliamentary election in May 2012 underscored the economic challenges facing the country. Although a second round of elections in June 2012 produced a Greek government that supports the current assistance package, uncertainty looms over whether it can meet its reform commitments and whether the current policy course will result in economic and political stability. In late June 2012, Cyprus’s government requested a financial assistance package, and some analysts were speculating that the governments of Spain and Slovenia could also ultimately require assistance.

At an EU summit on June 28-29, 2012, European leaders announced a new set of crisis policy measures. They resolved to create a single bank supervisor for the Eurozone, under which the European rescue funds would be allowed to inject cash directly into ailing Eurozone banks; and to use the rescue fund to buy Italian and Spanish bonds, in order to keep bond spreads down. The leaders also pledged €120 billion (about \$156 billion) to support “immediate growth measures.” Allowing the rescue funds to recapitalize banks directly is particularly important for Spain, whose banks could receive up to €100 billion (about \$130 billion).

On one hand, these measures were lauded for helping to break negative feedback loops between fragile, ailing

⁴ Throughout the report, values denominated in euros are converted to U.S. dollars using the exchange rate on September 21, 2012: €1 = \$1.2988. (Source: ECB). However, the exchange rate has fluctuated over the course of the crisis, and dollar conversions should be used as approximations.

Eurozone banks and indebted Eurozone governments under market pressure. For example, eventually allowing the European rescue fund to directly inject money into Spanish banks, rather than channeling the funds through the Spanish government, would mean that the money used to rescue Spanish banks would not count toward the Spanish government's overall debt level. The new emphasis on funding to support growth was also viewed by some as a necessary balance to the austerity measures being pursued in the periphery countries.

However, the positive market reaction to the summit announcements has been short-lived. For example, debates have emerged over whether Spain's government would or should be liable for bank recapitalization; Finland demanded collateral for contributing to the assistance package for Spain's banks; the Dutch government raised objections to the permanent European rescue fund being used to buy sovereign bonds on secondary markets; the European Central Bank (ECB) advocated imposing losses on some holders of bonds issued by the most troubled Spanish banks; and more than 150 German professors published an op-ed opposing the steps taken toward a banking union. There are questions about which measures agreed to at the summit will, in fact, be implemented. More definitive decisions on implementation are expected to be reached at a summit scheduled for October 18-19. At the end of July 2012, Spanish bond spreads reached new highs, renewing concerns that the Spanish government will require financial assistance.

In July 2012, amid growing market pressures, the president of the ECB, Mario Draghi, announced that the ECB stands "ready to do whatever it takes" to preserve the euro, sparking a market rally. In August 2012, the ECB clarified that it could buy short-term Italian and Spanish bonds in tandem with the Eurozone's rescue funds, if these countries commit to improving their economies and fiscal positions. Throughout the crisis, some analysts have called on the ECB to intervene more strongly in the crisis, arguing that it has unique flexibility and ability to respond aggressively to the crisis. At other times, the ECB has been criticized for doing too much and risking inflationary pressures.

September 2012

Although many analysts predicted that fall 2012 could be a turbulent time for the Eurozone, market pressure has eased considerably in September, due to several developments, including:

- the European Central Bank (ECB) released more details about its bond-buying program (called Outright Monetary Transactions, OMT) for governments accepting rescue packages and the associated required economic reforms;
- the September 12, 2012 German constitutional court ruling in favor of the permanent European rescue fund, with certain conditions;
- pro-Europe parties doing well in the Dutch elections; and
- the European Commission unveiled a proposal for a single banking supervisor, which some view as an initial step towards creating a European banking union.

Questions remain, however. ECB bond purchases are conditional on governments seeking rescue programs from the European rescue funds, and implementing the economic reforms attached to that assistance. To date, neither Spain nor Italy has requested such a program. Additionally, the situation in Greece remains difficult. The reform program is behind schedule, and Greek Prime Minister Antonis Samaras is appealing to German and French leaders for more time to implement budget cuts and economic reforms. Greece's main creditors remain divided on whether to grant the additional time, with French leaders appearing more supportive of the Greek position than the Germans. Some economists are forecasting that Greece could require additional aid to avoid defaulting on its debt. Disagreements also remain with respect to the contours of the proposed banking supervisory body, with Germany reportedly favoring a narrower authority than what has been proposed by the European Commission. More broadly, many of the fundamental challenges in the Eurozone remain, including lack of economic growth and high unemployment.

Causes of the Crisis

Many analysts agree that the crisis was caused by a set of common challenges facing some Eurozone countries, as well as factors specific to each country. The inflow of capital and subsequent build-up of public and private debt over the past decade into the Eurozone

“periphery” countries was a key factor in the build-up to the current crisis.⁵ As these countries prepared to adopt the euro and transitioned from national currencies to the euro, their bond spreads fell dramatically, converging to the interest rates paid by the traditionally stronger economies of Eurozone “core” countries. However, as the public and private sectors in the periphery countries took advantage of access to new, cheap credit, the capital inflows were not always sufficiently used for productive investments in the economy that could generate the resources with which to repay the debt. As a result, debt levels started rising. In some countries, this debt was concentrated in the public sector, such as in Greece, where public finances were severely mismanaged. In other countries, debt accumulated in the private sector—such as in Ireland and Spain, which had serious banking and real estate bubbles. The unsustainable nature of these debts was exposed during the global financial crisis of 2008-2009, when capital markets froze up and it became difficult for governments, households, and firms to access new loans and roll over existing debt. Additionally, the financial crisis and ensuing recession strained public finances, as government spending increased and tax revenues fell. In some cases, the government assumed private sector debt, perhaps most notably in Ireland, where the government guaranteed bank debt. Some governments verged towards default on their debt.

Capital inflows also fueled domestic demand, leading to high levels of growth in some countries, but also to inflation. Increasing prices in the periphery reduced competitiveness against other Eurozone countries, like Germany, which had pursued policies such as wage restraint that kept prices relatively low and bolstered exports. As a result, the periphery countries started running trade deficits, which were associated with borrowing, particularly from banks in the Eurozone “core,” especially German banks. Membership in the Eurozone constrained the ability of the periphery governments to respond to growing trade deficits. If the periphery countries had not been in the Eurozone, they could have reduced their trade deficits through currency depreciation, which would have helped bolster exports to other Eurozone countries and stem imports. Likewise, the periphery countries could have raised interest rates to slow economic growth in response to a potentially over-heating economy. But as members of the Eurozone, neither devaluation nor an increase in interest rates were available policy options for individual member states.

Although capital inflows contributed to the build-up of debt in the periphery, factors specific to each country also contributed to the current crisis. Greece is accused of having poor management of public finances, with rampant tax evasion and high government spending on public sector jobs and benefits, among other factors. Ireland, whose economic success had earned it the nickname “Celtic tiger,” had an oversized banking system. A government guarantee for Irish banks created a budget deficit of over 30% in 2010, causing public debt levels to rise by more than 40% between 2009 and 2010.⁶ Portugal’s economy has suffered from a lack of competitiveness, and was the slowest growing economy in the Eurozone during the “boom” decade preceding the global

⁵ During the crisis, it has become convention among some policymakers and analysts on both sides of the Atlantic to refer to a group of mostly southern European countries—Greece, Ireland, Italy, Portugal, and Spain—as the Eurozone “periphery,” in contrast to a group of mostly northern European countries, including Austria, Belgium, Germany, Finland, France, Luxembourg, and the Netherlands, referred to as the Eurozone “core.” In this context, periphery countries are those that have been under the most market pressure due to some combination of high public debt levels, large public deficits, and persistent trade imbalances, and core countries are those with generally stronger economies, which tend to have some combination of lower public debt levels, smaller fiscal deficits or surpluses, and trade surpluses. Although these terms mask important differences among countries in the periphery and the core, they are used in this memo to reflect current discussions.

⁶ International Monetary Fund (IMF), *World Economic Outlook*, April 2012.

financial crisis.⁷ Spain ran budget surpluses in the mid-2000s, and had relatively low public debt levels, but capital inflows fueled an unsustainable real estate bubble. Italy has a long history of high public debt, consistently running debt levels in excess of 100% of GDP in the “boom” years leading up to the financial crisis, making it vulnerable to tighter credit conditions.

Economic Challenges Facing the Eurozone

Today, many of the concerns related to the Eurozone focus on **high levels of public debt** and government deficits in some Eurozone countries. As mentioned, three Eurozone governments—Greece, followed by Ireland and subsequently Portugal—have had to borrow money from other Eurozone governments and the IMF in order to avoid defaulting on their debt. Even with this assistance, Greece still had to restructure its debt, resulting in substantial losses for private creditors, and investors are concerned that other governments could also restructure their debt, even though European officials have stressed that they consider Greece an exceptional case. Investors are also concerned about Italy and Spain, which due to their size are considered more systemically important than Greece or Portugal. Italy’s debt is larger than the combined debts of Greece, Ireland, Portugal, and Spain. As investors have become more nervous about Italy and Spain, they have demanded higher interest rates for buying and holding Italian and Spanish bonds. As the Spanish and Italian governments have rolled over their debt at these higher interest rates, their debt levels have risen further, and questions have emerged about the sustainability of public debt in these countries.

Compounding concerns about public finances in the Eurozone periphery are **weaknesses in the Eurozone’s banking system**. Many Eurozone banks hold “periphery” bonds, and many analysts are concerned that they do not have sufficient capital to absorb losses on their holdings of sovereign bonds should one or more Eurozone governments default or restructure their debt. The crisis has also triggered capital flight from banks in some Eurozone countries, and some banks are reportedly finding it difficult to borrow in private capital markets, causing some investors to fear a banking crisis in Europe that could have global repercussions.

Lack of economic growth in the Eurozone, particularly in the periphery, is making it hard for countries to “grow out” of their debts. In April 2012, the IMF forecasted that the Eurozone will dip back into recession in 2012, contracting by 0.3%, before resuming modest growth in 2013.⁸ The outlook for some countries is much worse. Greece’s economy is forecast to have contracted by nearly 20% between 2007 and 2012. Of the periphery countries, Ireland is the only country forecasted to grow (by 0.5%) in 2012; the others are forecasted to be in recession. Unemployment is particularly high in the Eurozone periphery, forecasted to be 19.3% in Greece and 24.2% in Spain in 2012. In Greece and Spain, more than half of young people of working age are unemployed.⁹

Persistent trade deficits in the periphery countries are also making it difficult for these countries to pursue export-led growth in response to the crisis. The periphery countries are undertaking structural reforms, such as liberalizing rigid labor markets, to make their economies more

⁷ International Monetary Fund (IMF), “IMF Outlines Joint Support Plan with EU for Portugal,” May 6, 2011.

⁸ International Monetary Fund (IMF), *World Economic Outlook*, April 2012.

⁹ Youth unemployment includes individuals between the ages of 15 and 24. OECD data as cited in Derek Thompson, “The Scariest Chart in Europe Just Got Scarier,” *The Atlantic*, July 10, 2012.

competitive and bolster exports, but the results of these policies may be borne out only over the long term. Some analysts contend that countries in the Eurozone “core” have undertaken few policy measures to boost domestic demand and raise prices, which would potentially help increase their imports from the periphery.

More broadly, the crisis has exposed **problems in the structure of the Eurozone**, which many economists have long debated. The Eurozone has a common monetary policy and currency, without creating a fiscal union, and therefore it does not have a centralized budget authority or system of fiscal transfers across member states. Possibly, under a tight fiscal union, a central budget authority could control spending in different Eurozone member states, and use fiscal transfers to smooth out asymmetric shocks within the Eurozone. Such measures are currently being debated in Europe, but are politically contentious.

Major Crisis Policy Responses

Over the past two years, European leaders and institutions have implemented a number of unprecedented policy measures to try to stop, or at least contain, the crisis. **A key policy response has been to provide countries and banks in crisis with financial assistance** (see **Table 1** for details on specific packages). Eurozone governments have created new rescue facilities to provide financial assistance to Eurozone governments and banks. The main lending facility currently in operation is the European Financial Stability Facility (EFSF), which can provide loans directly to Eurozone governments, finance bank recapitalization, or purchase government bonds on secondary markets. The EFSF is a temporary facility, and is in the process of being replaced by a permanent rescue fund, the European Stabilization Mechanism (ESM), but a court challenge in Germany delayed the launch of the ESM; a ruling on the fund’s compatibility with the German constitution was issued in September. The EFSF is providing loans to the governments of Greece, Ireland, and Portugal, in conjunction with financial assistance from the IMF. The rescue funds are also expected to provide assistance to Spanish banks. The government of Cyprus has also requested assistance, although no package has been finalized yet.

Countries in crisis are pursuing substantial economic reforms. Financial assistance from the European rescue facilities and the IMF comes with strings attached. The financial assistance is disbursed to countries in phases, only after the country reaches benchmarks on fiscal austerity and structural reforms. The IMF, in conjunction with representatives from the European Commission and the ECB (the so-called “troika”), helps the crisis countries design and monitor implementation of these reform programs. Although the Italian and Spanish governments are not receiving financial assistance, they have also undertaken fiscal and structural reforms in an effort to reassure markets.

The ECB has undertaken unprecedented steps to improve liquidity in the Eurozone banking system. Starting in May 2010, ECB began purchasing Eurozone government bonds on secondary markets in an attempt to stabilize bond yields. In August 2012, it announced a new, similar program to buy bonds for countries receiving economic assistance packages and implementing the reforms attached to the financial assistance. The ECB has also provided unprecedented flexibility in its short-term refinancing operations throughout the crisis. In December 2011 and February 2012, the ECB offered Eurozone banks low-cost, three-year loans, called “long-term refinancing operations” (LTROs), resulting in an injection of more than €1

trillion (about \$1.30 trillion) into more than 800 Eurozone banks.¹⁰ The ECB also cut interest rates to a record low, in an effort to boost the Eurozone economy.

Greece restructured its debt with private investors in order to alleviate its debt burden. In March 2012, the Greek government implemented what is being called the largest debt restructuring in history. About 97% of privately held Greek bonds (about €197 billion, or about \$256 billion) took a 53.5% cut to the face value (principal) of the bond, and the net present value of the bonds was reduced by approximately 75%.¹¹

European leaders have initiated reforms to economic governance. The failure to enforce rules limiting public debt levels and budget deficits is seen by many as a significant flaw in the EU's economic governance during the lead-up to the crisis. In response, the EU has adopted new legislation containing a series of measures that aim to increase the coordination and collective oversight of member state fiscal policies. In December 2011, EU leaders additionally announced the creation of a new "fiscal compact." The primary focus of the fiscal compact is to require national constitutions to be amended to reflect a requirement that government budgets be balanced or in surplus. In January 2012, leaders of 25 of the EU's 27 member states concluded a draft text on the agreement,¹² but it will take effect only once 12 countries have ratified the agreement at the national level.¹³

Although most of the crisis response has come from the Europeans, there have been some international policy responses. For example, the IMF is in the process of increasing its financial resources in order to be better equipped to respond to the Eurozone crisis, should other countries require assistance. As of June 2012, it had pledges of new assistance from more than 30 countries, totaling more than \$450 billion.¹⁴ The United States, the largest shareholder at the IMF, has not pledged any new resources to the IMF as part of this effort. Additionally, in May 2010, several central banks, including the U.S. Federal Reserve (the "Fed"), re-established temporary reciprocal currency agreements, known as swap lines. The Fed's swap lines, used previously during the global financial crisis of 2008-2009, aim to increase access to dollars in the global economy.

Despite the multi-pronged response to the crisis, policy-makers have been criticized as delivering too little, too late. Critics argue that the policy responses to date have failed to address some of the underlying causes of the crisis, such as fundamental problems in the architecture of the Eurozone; intra-Eurozone trade imbalances; and lack of competitiveness in the periphery countries. Additionally, they argue that the focus of the crisis response on austerity measures has come at the expense of growth, undermining the prospects for these countries to recover from the crisis. More broadly, critics have characterized the policy-making process in Europe as slow,

¹⁰ Throughout the report, values denominated in euros are converted to U.S. dollars using the exchange rate on August 21, 2012: €1 = \$1.2428. (Source: ECB). However, the exchange rate has fluctuated over the course of the crisis, and dollar conversions should be used as approximations.

¹¹ Landon Thomas Jr., "97% of Investors Agree to Greek Debt Swap," *New York Times*, April 5, 2012.

¹² The two abstaining countries are the Czech Republic and the UK.

¹³ As of September 25, nine governments had ratified the Fiscal Compact. See European Council, <http://www.consilium.europa.eu/policies/agreements/search-the-agreements-database?command=details&id=&lang=en&aid=2012008&doclang=EN%22>.

¹⁴ International Monetary Fund (IMF), "IMF Managing Director Christine Lagarde Welcomes Additional Pledges to Increase IMF Resources, Bringing Total Commitments to US\$456 Billion," Press Release No. 12/231, June 19, 2012, <http://www.imf.org/external/np/sec/pr/2012/pr12231.htm>.

piecemeal, and complex. They claim that failure to take more clear, decisive actions has increased, rather than reduced, anxiety in the markets.

Political Dynamics

Governments across Europe are facing growing public opposition to the crisis response. A combination of deep cuts in public spending, rising unemployment, and economic recession in several Eurozone member states has provoked sustained, large-scale protests. As a result of economic conditions related to the crisis and public dissatisfaction with the crisis response, governments in Greece, Ireland, Italy, the Netherlands, Portugal, Slovenia, Slovakia, and Spain have collapsed or been voted out of office after calling early elections. Leaders in some of the Eurozone's strongest economies, such as Germany, Finland, and the Netherlands, have faced considerable public and political resistance to providing financial support to weaker economies, with critics opposed to the idea of rescuing countries that have not, in their view, exercised adequate budget discipline.

Political leaders in Europe increasingly are being challenged to justify the national benefits of crisis response measures that are often perceived as being imposed by, and to the benefit of, outside interests. According to opinion polls, a majority of Europeans remain supportive of European integration and continue to view the European Union favorably. Within the Eurozone, however, less than half of poll respondents consider the euro "a good thing" (though most do not support an exit from the Eurozone).¹⁵ In some countries, public dissatisfaction both with current economic conditions and the crisis response may be boosting populist political movements that question the benefits of European integration and, in some cases, promote nationalist political agendas. In Greece, for example, the neo-fascist Golden Dawn Party (XA) won almost 7% of the vote in general elections in May and June 2012, allowing it to enter the national parliament. Nationalist parties that are skeptical of further European integration have also recently enjoyed a resurgence in Finland and several other EU member states. In Italy and Germany, new populist protest movements that have challenged the democratic legitimacy of the political establishment and decision-makers in Brussels have also had unexpected success in recent local and regional elections. In the view of some analysts, the emergence of such opposition movements could lead to greater political instability, making coalition governments more difficult to form and sustain, and increasing the likelihood that new governments could reject the European policy commitments made by their predecessors.

Although most European leaders say they remain committed to taking whatever steps necessary to maintain the integrity of the Eurozone and broader EU, their policy positions at the European level increasingly appear to be shaped by the aforementioned domestic political realities. The leaders of Spain and Italy, countries that have both enacted considerable austerity measures but are struggling with stagnant or negative economic growth and high unemployment, have been joined by French President François Hollande in calling for a more concerted European action to spur economic growth. They have also advocated steps to boost EU integration, such as the establishment of a banking union, as a way of resolving some of the underlying causes of the Eurozone crisis. In particular, the group has criticized what they perceive as a German-led policy response that has emphasized austerity and structural reform as the platform for future growth. For its part, the German government has been reluctant to endorse additional financial assistance

¹⁵ See, for example, The Pew Research Center – Global Attitudes Project, *European Unity on the Rocks*, May 29, 2012.

to what many German voters perceive to be profligate governments in southern Europe. German leaders have argued that closer economic integration must be accompanied by more powerful central surveillance and control over national economic policies. Some analysts see the ideas under discussion as leading toward a central EU budget authority—in effect, an EU finance ministry.

As negotiations continue on the crisis response, individual governments could continue to struggle to overcome domestic opposition to proposals that call for a further transfer of national sovereignty in the fiscal, financial, and political realm. Indeed, some analysts believe that the EU and Eurozone may have reached the maximum level of integration that is politically possible and argue that leaders will seek to maintain economic and political stability absent a significant degree of further integration.¹⁶ Others counter that, as has been the case in the past, a period of crisis will provide the impetus to overcome domestic political obstacles and advance European integration.¹⁷ Regardless, most analysts agree that reaching lasting consensus on additional crisis response measures, particularly those involving further European integration, will take time and face difficult challenges in the desire of many Europeans to preserve core elements of national sovereignty.

The Role of Germany and France

The governments of the Eurozone's two largest economies—Germany and France—have been at the forefront of the EU's crisis response. Since the beginning of the crisis, German Chancellor Angela Merkel has, with initial French backing, advocated a response predicated primarily on spending cuts, tax increases, and structural reform in exchange for financial support. The election on May 6, 2012, of a new French president, François Hollande of the Socialist Party, who had been sharply critical of the Franco-German-led response, has increased pressure on Germany to consider new approaches to promoting economic growth.

EU leaders continue to disagree on the extent to which Europe's more prosperous member states, like Germany, should provide financial support to lesser performing economies. Merkel, in particular, has faced criticism for failing to demonstrate clearer German support for other Eurozone member states. German officials have emphasized that Germany is, in fact, the largest national contributor to the Eurozone rescue fund. They add, however, that the prospect of guaranteed "bailouts" would create dangerous moral hazard, removing leverage and leaving little incentive for governments of poorly performing economies to enact politically unpopular reforms. French President Hollande has joined his Italian, Spanish, and Greek counterparts in calling for a relative easing of austerity and more economic stimulus to create jobs and growth. He has also advocated measures to pool the national debt of Eurozone member states by issuing so-called Eurobonds. Advocates of Eurobonds argue that such a mutualization of European debt would send a clear signal of Europe's commitment to support its common currency, relieving market pressure and providing the space and time necessary for national economic reforms to bear fruit.

The Merkel government has firmly opposed proposals to guarantee the debt of other Eurozone member states through Eurobonds or other similar schemes. Although Germany has agreed to consider new proposals to spur economic growth, Berlin continues to emphasize the need for national governments to reduce budget deficits and debt levels, largely through far-reaching fiscal austerity measures. In the German view, economic growth and economic convergence will not come without significant fiscal consolidation and economic reform. Accordingly, Germany and EU institutions have ensured that financial assistance to the Eurozone's struggling economies is contingent on the implementation of rigorous economic reform programs.

On the institutional level, one key point of contention between Germany and France remains the role of the ECB. German policymakers and ECB executives consistently highlight the importance of upholding the bank's foundational principles: political independence and a narrow mandate to maintain price stability. French leaders, on the other hand,

¹⁶ See, for example, Andrew Moravcsik, "Europe After the Crisis: How to Sustain a Common Currency," *Foreign Affairs*, May-June 2012; and Simon Tilford, "Has the Eurozone reached the limits of the politically possible?," Center for European Reform, July 12, 2012.

¹⁷ See, for example, C. Fred Bergsten and Jacob Funk Kirkegaard, "The Coming Resolution of the European Crisis: An Update," *Petersen Institute for International Economics*, June 2012.

have long envisioned a more activist ECB that would play the role of a “lender of last resort,” akin to the U.S. Federal Reserve. As the crisis has unfolded, French and other officials have at times argued that the ECB should broaden its mandate and provide more financial support to the Eurozone’s struggling economies. German and ECB officials, among others, have been reluctant to endorse such a policy shift, arguing, for example, that “central banks should not be called upon to finance states.”¹⁸

Some economists have questioned what they consider Germany and others’ narrow focus on austerity. They argue, for example, that severe budget cuts further impede economic growth and that policymakers should focus more on restoring economic competitiveness, particularly in the Eurozone periphery.¹⁹ Critics allege that the fiscal compact announced in December 2011 will do little to address growth and competitiveness issues in the short term. Some analysts explain the fiscal compact by noting that strong re-assurance of an enhanced economic governance framework is necessary to maintain political support in Germany for crisis response measures.

Outstanding Questions and Issues

Significant questions about the crisis include:

- **Will Spain’s government need a rescue package?** On top of concerns about negative growth, missed deficit targets, banking sector liabilities, and the national debt, recent revelations of significant problems with the finances of several regional governments have heightened concerns about the viability of Spain’s public finances (Spain’s regional governments control about 50% of the country’s public spending). The ECB has pledged to buy Spanish bonds in order to stabilize interest rates on Spain’s debt, but only if Spain’s government requests a program from the European rescue fund and adopts the economic reforms tied to the financial assistance. However, Spain’s Prime Minister Mariano Rajoy has been resistant to accepting “outside” conditions attached to a reform package. Many analysts view Spain, along with Italy, as pivotal in determining the course and outcome of the wider crisis. Will Spain’s government need to request assistance? Are there enough funds in the European rescue fund for a program for Spain’s government? If Spain needs a rescue package, will market pressures against Italy increase for a similar program?
- **What is the ECB’s capacity to calm markets?** Markets responded favorably to the ECB’s announcement that it would do “whatever it takes” to save the Eurozone and the subsequent pledge to buy Italian and Spanish bonds if these countries use the rescue funds and pursue the economic reforms attached to these funds. However, some question whether the expansion of the ECB’s holdings of periphery government bonds, both through the collateral posted by banks in refinancing operations and the sovereign bonds that the ECB has purchased on secondary markets, have weakened the ECB’s financial position. How will the ECB weigh concerns about financial stability with its holdings of securities of possibly questionable quality? How much latitude does the ECB have for quick and decisive action?
- **Can Greece remain in the Eurozone?** There are increasing fears that Greece may decide or be forced to exit the Eurozone. In May 2012, economists at Citigroup revised their estimated odds that Greece will leave the Eurozone in the next year or two upwards from 50% to between 50% and 75%, with a more specific prediction that Greece will exit at the start of

(...continued)

¹⁸ German finance minister Wolfgang Schäuble, as quoted in Marcus Walker and Charles Forelle, “Europe’s Options: Few, and Shrinking,” *Wall Street Journal*, October 22-23, 2011.

¹⁹ See, for example, Martin Wolf, “First Aid is not a Cure,” *Financial Times*, October 11, 2011.

next year (January 1, 2013).²⁰ As the reform program faces challenges and the Greek economy continues to contract, would Greece be better off with a national currency depreciated against the euro, in order to spark export-led growth, or would it create an unprecedented financial crisis in the country? If there is a disorderly Greek default or a Greek exit from the Eurozone, how can contagion to other Eurozone countries be prevented? Is the European-IMF financial “firewall” or “bazooka” large enough to provide financial resources to adequately defend Italy and Spain from contagion effects?

- **How can growth be restored in the Eurozone?** Many economists believe that, at the end of the day, economic growth will be the key driver to resolving the crisis. They fear that the focus of the policy response on austerity comes at the expense of growth. To address growth concerns, austerity measures have been paired with structural reforms aimed at improving competitiveness and boosting exports, but the benefits of these structural reforms may pay off only in the long term. Until the benefits of structural reforms set in, observers have asked how governments will “grow out” of their debts while imposing tough fiscal reforms. How will the recently announced “growth pact” help spur growth in the periphery countries? If the EU fiscal compact is adopted, will countries have the flexibility they need to respond to economic downturns in the future?
- **Can European leaders maintain public support for the crisis response?** Although a majority of Eurozone voters still appear to view membership in the EU favorably, enthusiasm for economic integration and the euro could be waning.²¹ Opposition to ongoing austerity measures has become more pronounced in some countries. Discontent with the crisis response was the main factor behind the outcome of Greece’s May 2012 election, and was also reflected in the result of the French election in the same month. The crisis was also a major issue in Dutch elections in September 2012. Italy, which is currently led by an unelected government of technocrats, must hold national elections by 2013. What effect will the elections in the Netherlands, Greece, France, and Italy have on the implementation of previously agreed crisis response measures? How long can European leaders implement response measures that may be opposed by a majority of their publics?
- **What other policy options are available to European leaders for resolving the crisis?** As market pressure intensifies, new proposals for responding to the crisis have resurfaced or emerged. In addition to a “Growth Pact,” there are proposals for creating bonds issued jointly by all 17 Eurozone countries (“Eurobonds”), and shifting oversight of Eurozone banks from national authorities to EU-wide authorities. How effective would these policies be in reducing market pressure on the Eurozone? How strong is the political support for these proposals, and what are the potential costs and benefits of such an approach? Are there other policy options?
- **How can trade imbalances within the Eurozone be corrected?** Some economists believe that the crisis, and the build-up of public debt in the periphery, is the result of fundamental, underlying trade imbalances within the Eurozone, but that the policy responses taken have failed to correct these imbalances. In particular, the focus has been on improving the competitiveness of the periphery countries, in order to lower their costs of production and bolster exports. Germany appears to be changing course, and letting wages rise modestly, which could help correct imbalances. Are there other policy measures that the Eurozone core

²⁰ For example, see Eva Szalay, “UPDATE: Citigroup Sees Greek Exit on Jan. 1, 2013,” *Dow Jones Newswires*, May 24, 2012.

²¹ See Pew Global Attitudes Project, *European Unity on the Rocks*, May 29, 2012, <http://www.pewglobal.org/2012/05/29/european-unity-on-the-rocks/>.

countries could pursue to become less reliant on exports for growth, and reduce their trade surpluses?

- **What are the implications for European integration?** On one hand, the crisis has prompted EU member states to move ahead with new and unprecedented agreements that serve to tighten economic integration, including the creation of the EFSF and ESM, legislation for more central surveillance of economic governance, and the proposed fiscal compact for greater economic coordination. The ECB has also expanded its role in significant new ways, and some argue that the solution to the crisis lies in moving ahead with a fiscal union, in which member states relinquish control over their national budgets. On the other hand, the crisis has also increased tensions among EU member states. The initial crisis debates centered on the legality and moral hazard of “bailouts,” and many people in the Eurozone core remain opposed to using taxpayer money to rescue what they consider profligate governments. At the same time, while many people in the countries receiving assistance may recognize the necessity of reform, many also resent the adoption of austerity programs they perceive as imposed on them by Brussels and Berlin. The tensions caused by the crisis have led some observers and officials into discussions on the desirability of expelling poor performers from the Eurozone; of withdrawing from the Eurozone in order to re-gain an independent monetary policy; or of creating a multi-speed EU in which a group of countries would proceed with deeper economic and fiscal integration.

Issues for Congress

Impact on the U.S. Economy

The Eurozone crisis poses risks to the U.S. economy. The United States and EU have the largest and most deeply integrated bilateral trade and investment relationship in the world. The United States and the EU combined accounted for almost 50% of world GDP, and more than 40% of the world’s trade in goods and services.²²

Exposure of the U.S. Financial System

The Eurozone crisis could impact the U.S. economy through a number of different channels. One possible channel is through the financial system and, in particular, the exposure of U.S. financial institutions to the Eurozone. One U.S. financial institution, MF Global Inc., filed for bankruptcy in October 2011 as a result of its exposure to the Eurozone, and developments in the Eurozone impact the U.S. stock market.²³ Modeling and quantifying the impact of a banking crisis in Europe on the U.S. financial system is difficult. When asked about the exposure of U.S. financial institutions to Europe in a Senate Budget Committee hearing, one witness responded, “I think the honest answer is I don’t know, and I don’t know anyone else who knows.”²⁴

²² 2010 data from World Bank, *World Development Indicators*, 2010. For more on U.S.-EU economic relations, see CRS Report RL30608, *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, by William H. Cooper.

²³ For more on MF Global, Inc. see CRS Report R42091, *The MF Global Bankruptcy and Missing Customer Funds*, by Rena S. Miller.

²⁴ Simon Johnson, Senate Budget Committee hearing, February 1, 2012. Simon Johnson is a professor at MIT and was formerly Chief Economist at the IMF.

One source of data on U.S. bank exposure is the Bank for International Settlements (BIS), which reports that direct and other potential U.S. bank exposure in March 2012 to Greece, Ireland, Italy, Portugal, and Spain totaled \$770 billion, or 7.5% of U.S. direct and other potential exposures overseas.²⁵ However, these data do not reflect hedges or collateral that U.S. banks may have in place to lower their exposures; do not capture the exposure of non-bank financial institutions (such as money market, pension, or insurance funds); and do not include how the crisis could be transmitted through the financial system, such as to U.S. banks that are exposed to French banks, that are in turn exposed to Greek banks.

According to the *New York Times* in January 2012, five large U.S. banks, including JPMorgan Chase and Goldman Sachs, have more than \$80 billion of exposure to Italy, Spain, Portugal, Ireland, and Greece, but use credit default swaps (CDS) to offset any potential losses by \$30 billion, putting their net exposure at \$50 billion.²⁶ An analysis by the Investment Company Institute, the national association of U.S. investment companies, finds that U.S. money market funds cut their exposure to the Eurozone by more than half, from 31.1% in May 2011 to 12.2% in June 2012.²⁷ An analysis by Fitch, a major credit rating agency, in November 2011 argues that large U.S. banks have been reducing direct exposure to stressed markets over the past year and that net exposures are manageable, but warns that U.S. banks could be “greatly affected” if contagion continues to spread to other Eurozone countries.²⁸

During a congressional hearing in October 2011, Treasury Secretary Geithner emphasized that direct exposure of U.S. institutions to the Eurozone countries and institutions under the most market pressure is small, but that exposure to Europe, as a whole, could be “a big deal.”²⁹ Secretary Geithner also stressed that the U.S. financial system is better capitalized than in 2009, putting it in a better position to weather potential shocks. In January 2012, the Securities and Exchange Commission (SEC) requested that banks provide a fuller and more consistent presentation of their European positions.³⁰ Additionally, in March 2012, the U.S. Federal Reserve released the results of a bank stress test for large U.S. banks that gauged, among other things, a hypothetical shock related to turmoil in Europe.³¹

Other Impacts on the U.S. Economy

Another channel through which the Eurozone could impact the United States is through trade and investment. The EU is the United States’ largest trading partner: about 20% of U.S. merchandise

²⁵ Exposure to public and private sectors. “Other potential exposures” includes derivative contracts, guarantees extended, and credit commitments. Bank for International Settlements (BIS), *Consolidated Banking Statistics*, “Table 9E: Foreign Exposures on Selected Individual Countries, Ultimate Risk Basis,” September 2012, <http://www.bis.org/statistics/consstats.htm>.

²⁶ Peter Eavis, “U.S. Banks Tally Their Exposure to Europe’s Debt Maelstrom,” *New York Times*, January 29, 2012.

²⁷ Emily Gallagher and Chris Plantier, “U.S. Prime Money Market Funds: Holdings of Eurozone Issuers,” *Investment Company Institute*, July 25, 2012, http://www.ici.org/viewpoints/view_12_mmf_europe_data_june.

²⁸ Joseph Scott, Christopher D. Wolfe, Thomas Abruzzo, “U.S. Banks – European Exposure,” *Fitch*, November 16, 2011.

²⁹ Congressional Quarterly, “Senate Banking, Housing, and Urban Affairs Committee Holds Hearing on the Financial Stability Oversight Council Annual Report as well as Votes on a Few Pending Nominations,” October 6, 2011, <http://www.cq.com/doc/congressionaltranscripts-3957612>.

³⁰ Andrew Ackerman and Liz Moyer, “SEC Asks for Debt Disclosure,” *Wall Street Journal*, January 10, 2012.

³¹ Federal Reserve Press Release, March 13, 2012, <http://www.federalreserve.gov/newsevents/press/bcreg/20120313a.htm>.

exports and about 30% of U.S. service exports go to the EU.³² U.S. exports to Europe could be impacted by the Eurozone crisis through changes in exchange rates and aggregate demand in Europe. Intensification of the crisis has undermined confidence in the euro, and the value of the euro has fallen against the dollar in recent months (it fell by about 7% between the start of 2012 to the end of July 2012).³³ A weaker euro against the U.S. dollar could cause U.S. exports to the Eurozone to decrease and U.S. imports from the Eurozone to increase. Additionally, the impact of the crisis and austerity measures on growth could result in depressed demand in Europe for U.S. exports, and for U.S. affiliates operating in Europe. Slower growth rates in Europe could also cause U.S. investors to look increasingly towards emerging markets for investment opportunities. On the other hand, a weaker euro could make European stocks and assets look cheaper and more attractive, bringing U.S. capital to the Eurozone. In July 2012, some U.S. companies, reportedly including Ford Motor Co. and Apple Inc., blamed disappointing profits on low spending by European consumers.³⁴

In addition, uncertainty in the Eurozone is creating volatility in U.S. stock markets and a “flight to safety,” causing U.S. Treasury yields to fall. Longer-term, a break-up of the Eurozone could have substantial implications for U.S.-European cooperation on economic issues.

U.S. Government Involvement

The Administration

Since the early stages of the crisis, the Obama Administration has repeatedly called for a swift and robust response from Eurozone leaders, and has been in contact with European leaders regularly throughout the crisis. For example, the Eurozone crisis was a central topic of discussion during the G-8 summit at Camp David in May 2012 and the G-20 summit in Los Cabos, Mexico, in June 2012. In remarks about the G-20 summit, President Obama stressed that the G-20 was an opportunity to hear from the Europeans about the progress they are making with the crisis and for the international community to stress the importance of decisive action, but that “the challenges facing Europe will not be solved by the G-20 or the United States. The solutions will be debated and decided, appropriately, by the leaders and the people of Europe.”³⁵

As the lead on international financial issues within the Administration, Treasury Secretary Geithner has also been in frequent contact with his European counterparts, even, unusually, attending a meeting of Eurozone finance ministers in September 2011, during which he urged stronger policy responses. Other Treasury officials have also been actively engaged in the Eurozone crisis. For example, in May 2012, Treasury Under Secretary for International Affairs Lael Brainard traveled to Greece, Germany, Spain, and France to discuss the crisis.

European reactions to the U.S. appeals have been mixed. Some Europeans have pushed back against perceived U.S. criticism while pointing out the United States’ own economic problems.

³² For more information, see CRS Report RL30608, *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, by William H. Cooper.

³³ It fell from 1.3061 dollars per euro on January 3, 2012 to 1.2089 dollars per euro on July 24, 2012. (Source: ECB.)

³⁴ Sam Schechner and Kate Linebaugh, *Europe’s Crisis Hits Profits*, *Wall Street Journal*, July 26, 2012.

³⁵ “Remarks by President Obama at Press Conference After G20 Summit,” Office of the Press Secretary, the White House, June 20, 2012.

They note, for example, that the IMF is forecasting the total U.S. government debt (including federal, state, and local) to be 107% of GDP in 2012, compared to 90% for the Eurozone as a whole.³⁶ While the United States wields an influential voice on the issue, it ultimately has limited ability to affect policy decisions made by and among the EU member countries and institutions.

The Federal Reserve

In May 2010, the U.S. Federal Reserve announced the re-establishment of temporary reciprocal currency agreements, known as swap lines, with several central banks. These swap lines had been previously used during the global financial crisis and aim to increase dollar liquidity in the global economy. They are designed in a way which minimizes exchange rate and credit risk to the Fed. The swap lines re-established in May 2010 were initially set to expire in January 2011, but have been extended a number of times due to continuing concerns about the crisis. In November 2011, the Fed also reduced the borrowing rate for the swap lines, in order to further ease strains in financial markets. As of September 19, 2012, \$14.7 billion was outstanding on these swap lines, compared to a high of \$583 billion during the global financial crisis in December 2008 (see **Figure 4**).³⁷ Additionally, as mentioned above, the Fed is currently conducting stress tests related to U.S. bank exposure to potential turmoil in Europe.³⁸

One source of concern about the swap lines is the impact that dollar swap agreements could have on the rate of U.S. inflation. Through the Federal Reserve, the United States has provided the ECB and other central banks with dollars to maintain stability in short-term money markets that European banks have used to fund much of their ongoing operations. In a swap transaction, dollars are exchanged for a foreign currency, say the euro, at a certain price for a specified period of time. As these swap arrangements are implemented and the foreign currency is exchanged for dollars, the supply of dollars increases, which in theory may boost the rate of inflation. The Federal Reserve has indicated, however, that it has a number of options to sterilize, or to offset, any increase in the money supply in order to suppress any inflationary pressures.

Role of the International Monetary Fund (IMF)

Of the 187 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.³⁹ IMF programs in Greece, Ireland, and Portugal have been supported by the Obama Administration, but some Members of Congress are 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 the economies. There are also concerns about whether the IMF will be repaid in full and on time. 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,

³⁶ International Monetary Fund (IMF), *World Economic Outlook*, April 2012.

³⁷ Federal Reserve, <http://www.federalreserve.gov/releases/h41/hist/h41hist13.htm>.

³⁸ For more on financial stability in the United States, see CRS Report R42083, *Financial Stability Oversight Council: A Framework to Mitigate Systemic Risk*, by Edward V. Murphy.

³⁹ For more on the IMF, see CRS Report R42019, *International Monetary Fund: Background and Issues for Congress*, by Martin A. Weiss.

if not recently; and that as members of the IMF, Greece, Ireland, and Portugal are 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.

In addition to the support to Greece, Ireland, and Portugal, pledges have been made to bolster the lending capacity of the IMF. Current pledges total more than \$450 billion.⁴⁰ The United States has not pledged any new funds to the IMF as part of this effort. As the biggest shareholder in the institution, the United States may want to consider how to balance, on the one hand, making sure that the IMF has the resources it needs to ensure stability in the international economy with, on the other hand, exercising oversight over the exposure of the IMF to Europe and any potential concessions that countries are looking for in exchange for providing financial assistance.

The Eurozone Crisis, the IMF, and Legislation in the 111th and 112th Congress

Member concerns about IMF resources being used to “bailout” Eurozone governments led to the passage of legislation in the 111th Congress as part of 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 Treasury Department to report regularly to Congress about various economic conditions in that country.

In the 112th Congress, continuing concerns about use of IMF resources in the Eurozone debt crisis likely contributed to the introduction of legislation in the House (H.R. 2313) and Senate (S.Amdt. 501; S. 1276). The legislation calls for rescinding the U.S. financial commitments to the IMF approved by Congress in 2009. The Senate voted against the amendment on June 29, 2011. This language was also included in a House draft of the FY2012 State and Foreign Operations Appropriations bill,⁴¹ but the language was not included in the final FY2012 appropriations legislation.⁴²

On December 15, 2010, the IMF Board of Governors agreed in principle to a package of reforms, including a doubling of IMF quotas, the IMF’s core source of funds, to about \$747 billion.⁴³ To be implemented, the reform package needs to be approved by member countries, including three-fifths of the members having 85% of the total voting power. IMF Managing Director Christine Lagarde has reportedly urged member countries to implement the reform package by October 2012.⁴⁴ However, the Obama Administration did not request any funds for meeting the U.S. commitment for the quota increase in the FY2013 budget request.

Implications for Broader U.S.-European Cooperation

The United States looks to Europe for partnership in addressing a wide range of global challenges, and some analysts and U.S. and European officials have expressed concern about the potential effects of the Eurozone crisis on U.S.-European political and security cooperation. Successive U.S. administrations have been proponents of a more integrated, outwardly focused EU, capable of playing a larger role in addressing global challenges. Over the last two decades, some analysts and policymakers have viewed the EU’s focus as largely introspective, with leaders

⁴⁰ International Monetary Fund (IMF), “IMF Managing Director Christine Lagarde Welcomes Additional Pledges to Increase IMF Resources, Bringing Total Commitments to US\$456 Billion,” Press Release No. 12/231, June 19, 2012, <http://www.imf.org/external/np/sec/pr/2012/pr12231.htm>.

⁴¹ http://appropriations.house.gov/UploadedFiles/FY12-SFOPS-07-25_xml.pdf.

⁴² P.L. 112-74.

⁴³ “Factsheet: IMF Quotas,” *International Monetary Fund*, September 13, 2011.

⁴⁴ Lesley Wroughton, “IMF Urges Members to Boost Funding Under 2010 Plan,” *Reuters*, December 22, 2011.

preoccupied with integration efforts, institutional arrangements, and treaty reforms. The Eurozone crisis appears to have again turned the main focus of the EU inward.

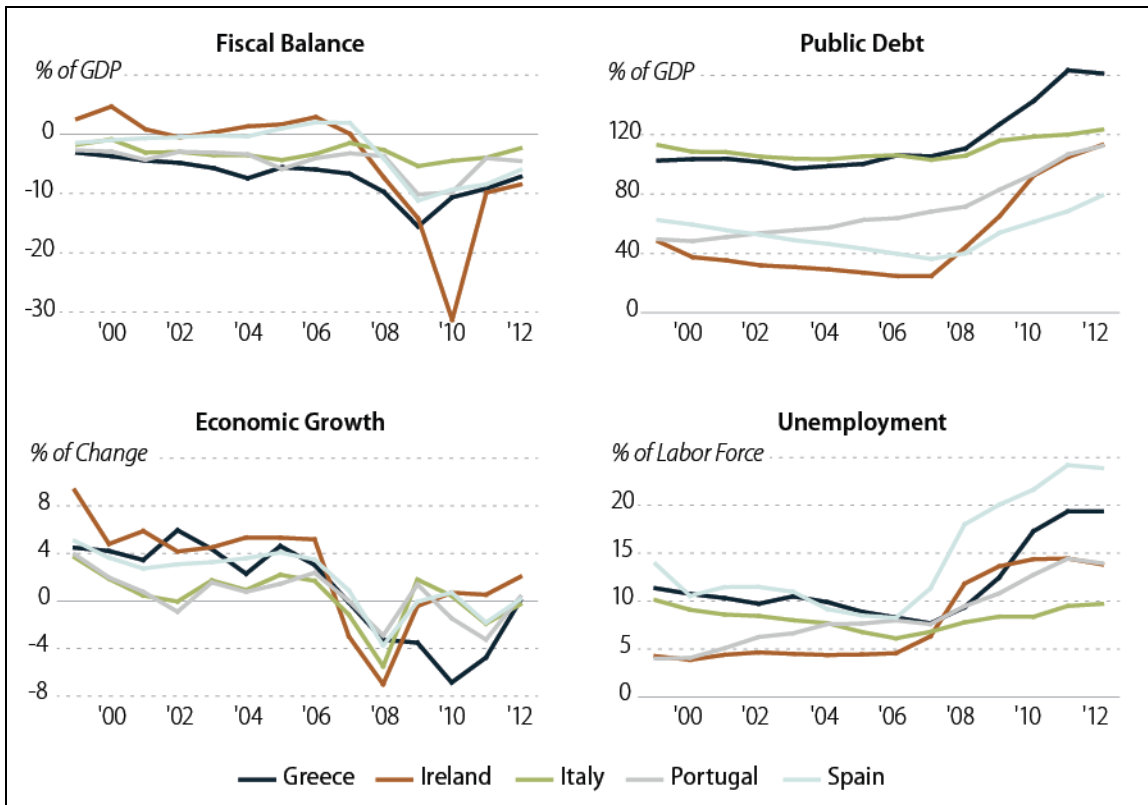
In addition, the crisis raises questions about future constraints on Europe's ability to use economic policies in pursuit of foreign policy objectives. The EU is the world's largest aid donor (counting common funds managed by the European Commission and bilateral member state contributions), accounting for roughly half of official global humanitarian and development assistance.⁴⁵ Some observers question whether the crisis could in the long term limit Europe's ability to continue providing such levels of foreign assistance or economic incentives aimed at boosting stability and prosperity in developing countries. Some commentators suggest, for example, that the Eurozone crisis has hindered the EU's ability to respond more robustly, both politically and economically, to the recent transformations in the Middle East and North Africa. The crisis could also exacerbate a long-standing downward trend in European defense spending and cast further doubt on Europe's willingness and capability to be an effective global security actor in the years ahead.

Despite Europe's own internal financial problems and preoccupations, others contend that the European countries and the EU have a proven track record of close cooperation with the United States on a multitude of common international concerns. The United States and Europe are working closely together to manage Iran's nuclear ambitions, have significantly strengthened their law enforcement and counterterrorism cooperation over the last decade, have recently concluded a successful NATO mission in Libya, and together continue to promote peace and stability in the Balkans and Afghanistan. As such, those of this view remain more optimistic that the Eurozone crisis will not significantly alter the EU's willingness or commitment to transatlantic cooperation.

⁴⁵ European Commission DG ECHO, http://ec.europa.eu/echo/funding/finances_en.htm, and European Commission, EuropeAid, http://ec.europa.eu/europeaid/infopoint/publications/europeaid/documents/259a_en.pdf.

Supplemental Figures and Charts

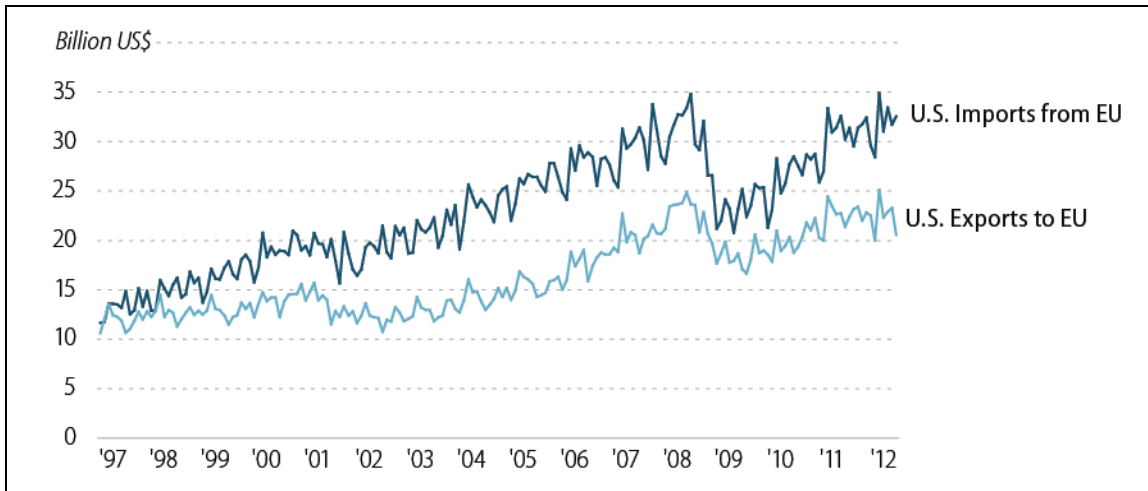
Figure I. Selected Economic Indicators for Eurozone “Periphery” Countries



Source: International Monetary Fund (IMF), *World Economic Outlook*, April 2012.

Note: Forecasted data starting in 2010 or 2011, depending on the country. Fiscal balance and public debt are for all levels of government (federal/central, state, local, or “general government”).

Figure 2. U.S.-EU Trade in Goods since 1997



Source: Census Bureau, "Trade in Goods with European Union," <http://www.census.gov/foreign-trade/balance/c0003.html>.

Notes: Does not include trade in services.

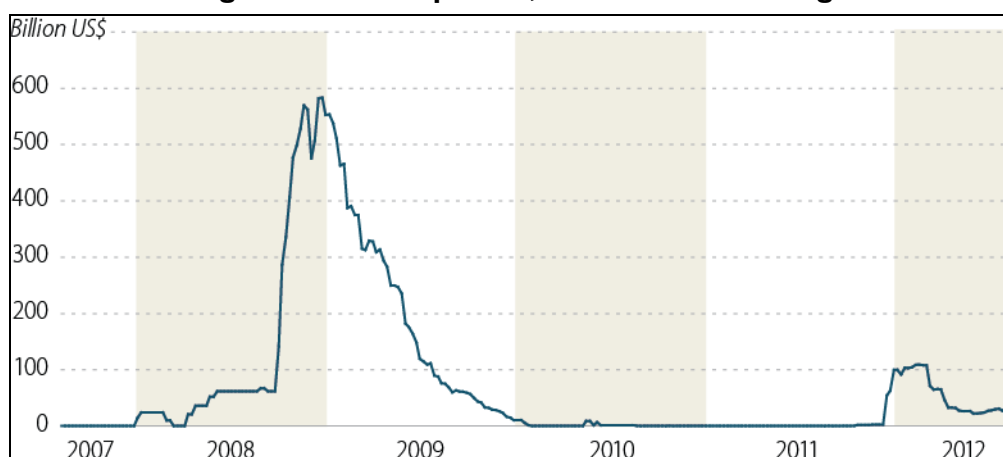
Figure 3. Euro/US\$ Exchange Rate since 2000



Source: Federal Reserve.

Notes: An increase in the €/€ exchange rate represents a stronger dollar relative to the euro; a decrease in the €/€ exchange rate represents a weaker dollar relative to the euro.

Figure 4. Fed Swap Lines, Amount Outstanding



Source: Federal Reserve.

Table I. Financial Assistance Packages for Eurozone Governments and Banks

	Date Agreed	European Commitment	IMF Commitment	Total Financial Commitment
Greece's government	May 2010 & March 2012 (sum of two packages) ^a	€198 billion (about \$257 billion)	€48 billion (about \$62 billion)	€246 billion (about \$320 billion)
Ireland's government	December 2010	€45 billion (about \$58 billion)	€22.5 billion (about \$29 billion)	€67.5 billion ^b (about \$88 billion)
Portugal's government	May 2011	€52 billion (about \$68 billion)	€26 billion (about \$34 billion)	€78 billion (about \$101 billion)
Spain's banks	July 2012	Up to €100 billion (about \$130 billion)	—	Up to €100 billion (about \$130 billion)

Source: International Monetary Fund; European Union.

Notes: Figures denominated in euros converted to dollars using exchange rate on September 21, 2012: €1 = \$1.2988 (source: ECB). Also, IMF programs are denominated in special drawing rights (SDRs), a unit of account used by the IMF and figures in euros and dollars fluctuate with exchange rates; values should be viewed as approximations. However, it should be noted that currency swings have been underway during the crisis and the dollar conversions have also fluctuated accordingly. Figures may not add due to rounding. Funds are disbursed in phases conditional on economic reforms; not all funds have been disbursed to date.

- a. Sum of resources committed in May 2010 and March 2012. The first program, announced in May 2010, committed €110 billion to Greece (€80 billion by the Europeans and €30 billion by the IMF). When the second program for Greece was finalized and announced in March 2012, not all the funds from the first program had been disbursed. Through new funds committed in the second program, plus undisbursed funds from the first program, Europeans committed €144.7 billion to Greece from 2012-2014. In March 2012, the IMF canceled their first program for Greece, with €10.1 billion in undisbursed funds, and announced a second program worth €28 billion, with disbursements expected between 2012 and 2016.

- b. The headline number for Ireland's financial assistance package in news reports is often €85 billion. This includes €17.5 billion from Ireland's cash reserves and other liquid assets. Resources used by national authorities in the crisis response are not included in the table.

Author Contact Information

Rebecca M. Nelson, Coordinator
Analyst in International Trade and Finance
rnelson@crs.loc.gov, 7-6819

Paul Belkin
Analyst in European Affairs
pbelkin@crs.loc.gov, 7-0220

Derek E. Mix
Analyst in European Affairs
dmix@crs.loc.gov, 7-9116

Martin A. Weiss
Specialist in International Trade and Finance
mweiss@crs.loc.gov, 7-5407