The Eurozone Crisis: Overview and Issues for Congress

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Summary

Crisis Overview

What started as a debt crisis in Greece in late 2009 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.

The economic crisis also turned into a political crisis. A combination of deep cuts in public spending, rising unemployment, and economic recession has provoked large-scale protests in several Eurozone countries, and several governments have fallen as a direct or indirect result of the crisis. Additionally, disagreements among key policymakers over the appropriate crisis response and a complex EU policy-making process are seen as having exacerbated the crisis.

Recent Developments and Outlook

Market pressure against the Eurozone eased considerably in the fourth quarter of 2012 and the start of 2013, but uncertainty increased in February and March 2013, particularly driven by developments in Cyprus. The sentiment that the crisis had "turned a corner" at the end of 2012 was largely driven by the European Central Bank (ECB) and its new bond-buying program. Announced in September 2012, the program has not yet been triggered but is viewed by many as successful in restoring market confidence, particularly in Italy and Spain, the third and fourth largest economies in the Eurozone. Other developments helped calm markets, including debt restructuring in Greece and Ireland and progress towards creating a Eurozone "banking union."

The crisis flared in February and March 2013, highlighting the continuing challenges facing the Eurozone. The February 2013 election in Italy failed to produce a clear winner, raising concerns that political instability could heighten investor unease about the country's fiscal position. In March 2013, Cyprus's banking crisis came to the forefront. A tentative assistance package that included taxing depositors was rejected by the Cypriot parliament. After a week of tense negotiations, a new agreement was reached that does not tax small depositors. Although the new agreement is broadly expected to be finalized without problems, concerns persist about potential contagion to other Eurozone countries.

More broadly, fundamental challenges in the Eurozone remain, including lack of economic growth, high unemployment, and internal trade imbalances. Analysts disagree about the likely outcome of the crisis. Some analysts argue that the Eurozone will be able to "muddle through," making incremental changes without changing the structure of the Eurozone. Others argue that European leaders and institutions will reform, and that the EU could emerge from the crisis stronger and more integrated. Others still have not ruled out some countries, particularly Greece, exiting the Eurozone, although improved market sentiment has limited discussions about a potential Eurozone breakup.

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 one of the biggest potential threats to the U.S. economic recovery. Additionally, the crisis has bolstered interest in U.S.-EU trade and investment

liberalization, to bolster both economies. In February 2013, the Administration and EU officials announced plans to launch talks on a Transatlantic Trade and Investment Partnership (TTIP).

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 and to exercise 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 faced a sovereign debt and financial crisis that many consider one of the biggest current threats to the global economy.[1] Concerns have focused on the sustainability of public deficits in some Eurozone countries, but the Eurozone has also faced a number of related economic challenges, including weaknesses in the Eurozone banking system, slow or negative economic growth, rising unemployment, and persistent trade imbalances within 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. The crisis has bolstered interest in trade and investment liberalization between the United States and the EU, as a way of promoting economic recovery in both economies. In February 2013, the Obama Administration and EU officials announced plans to launch talks on a Transatlantic Trade and Investment Partnership (TTIP).

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.

This report provides a brief analysis of the Eurozone crisis and issues of particular congressional interest. 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 (name redacted).

Overview of the Eurozone Crisis

The Eurozone crisis broke in late 2009, when a new Greek government revealed that previous governments had been misreporting government budget data. Fears quickly spread that the fiscal positions and debt levels in a number of Eurozone countries were unsustainable. In May 2010, Greece received a financial assistance package 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 borrowing costs increased, the two countries also requested European-IMF financial assistance packages, finalized in December 2010 and May 2011, respectively. Weaknesses in the Eurozone banking system, economic contraction and rising unemployment in the periphery countries, and persistent trade imbalances within the Eurozone compounded concerns about public finances in some Eurozone periphery countries. Greece required a second assistance package, finalized in March 2012.

[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.

Over the past two years, 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. Described in greater detail below, the response measures have been broadly characterized as failing to provide a comprehensive and clear policy response to the crisis, with the crisis cycling through periods of relative calm followed by intense market pressure. However, a pledge by the European Central Bank (ECB) in September 2012 to intervene more aggressively has been credited with sustaining improved market sentiment, with many analysts remarking that the crisis may have "turned a corner." Still, many challenges remain, particularly related to slow or negative economic growth and high unemployment. Recent developments in Italy and Cyprus could also undermine recent market stability.

The economic crisis has also turned into a political crisis. For 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, there has been resentment against what is perceived as "bailing out" other countries that have failed to implement "responsible" policy choices. Governments in many European countries have fallen as a direct or indirect result of the crisis. Additionally, disagreements among Germany, France, and the ECB over the appropriate crisis response, and complex EU policy-making processes, are seen as having exacerbated anxiety in markets.

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. Additionally, the crisis has illustrated the policy constraints facing the governments of struggling Eurozone countries in responding to the crisis: as members of the Eurozone, they cannot use currency depreciation to promote export-led growth, which some argue has been helpful for other countries, such as Iceland, in reviving economic growth following financial crises.

Causes of the Crisis

As Eurozone "periphery" countries prepared to adopt the euro in 2002, their bond spreads fell dramatically, converging to the interest rates paid by the traditionally stronger economies of Eurozone "core" countries.[2] The periphery countries took advantage of access to new, cheap credit, but capital inflows were not always sufficiently used for productive investments that could

[2] The euro was introduced in financial markets in 1999 but did not enter into circulation until 2002. 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.

generate the resources with which to repay debt. As a result, debt levels started rising. In some countries, debt was concentrated in the public sector while in others, debt accumulated in the private sector. Public sector debt was most problematic in Greece, Portugal, and Italy. 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. Portugal also consistently ran deficits in the years leading up to the crisis, in addition to having an economy that suffered from a lack of competitiveness and one of the slowest growth rates in the Eurozone. Italy has a long history of high public debt, consistently running debt levels in excess of 100% of GDP in the years leading up to the financial crisis, although its fiscal balance has been relatively strong. Private sector debt was more problematic in Ireland, Cyprus, and Spain. Ireland and Cyprus developed large banking sectors, and Spain developed a real estate bubble.

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 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 and French banks. As members of the Eurozone, the periphery countries could not depreciate their currencies in response to the growing trade deficits.

The unsustainable nature of the periphery's debt and trade deficits was exposed during the global financial crisis of 2008-2009, when capital markets became less liquid, making it difficult for governments, households, and firms to continue borrowing. Additionally, the financial crisis and ensuing recession further strained public finances, as government spending, such as on unemployment programs, increased and tax revenues fell. In some cases, the government also assumed private sector debt, most notably in Ireland where the government guaranteed bank debt.

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. 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.

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. Cyprus's banks, for example, were hit hard by Greece's debt restructuring. 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 and rising unemployment in the Eurozone, particularly in the periphery, is making it hard for countries to "grow out" of their debts and highlighting the social toll of the crisis. After growing by 1.4% in 2011, the European Commission forecasts that the Eurozone contracted by 0.6% in 2012 and will contract by 0.3% in 2013, before resuming growth in 2014.[3] Eurozone-wide unemployment is also forecasted to rise from 10.2% in 2011 and 11.4% in 2012 to 12.2% in 2013. The periphery countries have been particularly hard hit. Economic contraction has been most severe in Greece, which contracted by 7.1% in 2011 and 6.4% in 2012, and Ireland is the only periphery country whose economy is thought to have grown in 2012. Greece and Spain have the highest levels of unemployment in the Eurozone, at 24.7% and 25.0%, respectively, and youth unemployment is much higher.

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 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.

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, starting with a temporary facility (the European Financial Stability Facility [EFSF]), and subsequently, a permanent facility (the European Stabilization Mechanism [ESM]), which will have a lending capacity of €550 billion (about $720 billion) when it is fully capitalized. European rescue funds are providing loans to the governments of Greece, Ireland, and Portugal, in conjunction with financial assistance from the IMF.[4] An agreement by the Europeans to provide assistance to Cyprus has also been approved in March 2013, after tense negotiations, and is expected to be finalized in the third week of April 2013. The IMF has indicated that it will contribute funds to the effort, although the amount has not been publicly announced. In addition, the Eurozone rescue funds are also providing assistance to Spanish banks.

Countries in crisis are pursuing substantial economic reforms. Financial assistance from the European rescue facilities and the IMF comes with strings attached; it 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.

[3] Real GDP growth (adjusted for inflation). European Commission, *European Economic Forecast*, Winter 2013, http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee1_en.pdf.

[4] Throughout the report, values denominated in euros are converted to U.S. dollars using the exchange rate on March 15, 2013: €1 = $1.3086. (Source: ECB). However, the exchange rate has fluctuated over the course of the crisis, and dollar conversions should be used as approximations.

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 bring down borrowing costs and stabilize bond yields. In September 2012, it announced a more ambitious bond-buying program, called outright monetary transactions (OMT), to buy government bonds on secondary markets 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 $1.3 trillion) into more than 800 Eurozone banks. The ECB also cut interest rates to a record low, in an effort to boost the Eurozone economy.

Debt restructuring has also alleviated debt burdens for Greece and Ireland. 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 $258 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%.[5] However, concerns lingered about the amount of Greek debt owed to official creditors (Eurozone governments and the IMF). In November 2012, at the prodding of the IMF, Eurozone leaders agreed to measures to soften the terms of bilateral official loans to Greece, by lowering the interest rate and extending loan maturities, among other measures. Similarly, in February 2013, the Irish government restructured debt associated with the emergency bank support it provided in 2010, primarily through maturity extensions.

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 include balanced budget amendments. Eurozone leaders have also taken steps towards creating a "banking union" by transferring bank supervision from national regulators to the ECB.

Although most of the crisis response has come from the Europeans themselves, 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.[6] 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.

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

[6] 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.

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

Political Dynamics

Governments across Europe have faced sustained 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 recurring, 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 have been 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 EU 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).[7] In some countries, public dissatisfaction 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 entered the national parliament following the general elections of May and June 2012. Nationalist "euro-skeptic" parties have recently gained ground in Finland and several other EU member states. In Italy and Germany, new populist protest movements that have challenged the democratic legitimacy of the national and EU political establishments have had unexpected success. 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 policy commitments made by their predecessors. Although most European leaders say they will take whatever steps necessary to maintain the integrity of the Eurozone and the EU, domestic political pressure also shapes national policy positions at the European level.

The crisis has challenged European political solidarity, exposing some divergent policy preferences and differing visions for the future of European integration. The leaders of Spain and Italy, countries that have both enacted considerable austerity measures but are struggling with

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[7] See, for example, The German Marshall Fund of the United States, *Transatlantic Trends 2012*.

stagnant or negative economic growth and high unemployment, have been joined by French President François Hollande in calling for more concerted European action to spur economic growth and increase competitiveness in the periphery economies. The calls from Italy, Spain, and France come amidst growing criticism for what many perceive as a German-led policy response that has emphasized austerity and structural reform as the platform for future growth. For many analysts, the outcome of the February 2013 Italian election was just the most recent example of the widespread public dissatisfaction with this approach. For its part, the German government has been reluctant to endorse additional financial assistance 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. In the German view, economic growth and economic convergence will not come without significant fiscal consolidation and economic reform. Germany has also opposed proposals to mutualize European debt ("Eurobonds") and to encourage more stimulus-oriented policies from the ECB.

Many economists and some European leaders argue that a lasting resolution to the crisis will require more European integration, particularly in the area of fiscal and broader economic policy. On the other hand, individual governments could continue to struggle to overcome domestic opposition to proposals that call for a further transfer of national sovereignty. 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.[8] 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.[9]

There has also been renewed speculation about the emergence of a more multi-tier Europe with varying levels and speeds of integration. For example, tighter economic, and even political, integration might proceed within the "core" of Eurozone countries, with participation depending on the willingness and ability of individual member states.[10] This notion has created some anxieties and tensions for non-euro members of the EU, however, who are concerned at the prospect of losing their place at the table and being sidelined by a "Eurozone caucus" whose decisions impact the entire EU single market. Strains over "Europe" have become especially pronounced with regard to the UK-EU relationship, where tensions have grown to the point that many observers speculate the UK is on a path to exiting the EU.

Current Status

Market pressure against the Eurozone eased considerably in the fourth quarter of 2012 and the start of 2013, with some analysts suggesting that the Eurozone has "turned a corner." The ECB is largely credited for the improved outlook, in particular, as a result of its new bond-buying

[8] 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.

[9] 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.

[10] See, for example, Katinka Barysch, *A multi-tier Europe? The political consequences of the euro crisis*, Centre for European Reform, December 7, 2012, http://www.cer.org.uk/publications/archive/briefing-note/2012/multi-tier-europe-political-consequences-euro-crisis.

program (OMT) announced in September 2012. Under OMT, the ECB pledged to purchase unlimited short-term government bonds on secondary markets, but only for governments that requested assistance from the Eurozone rescue funds, committed to economic reforms overseen by the IMF, and maintained market access. The program implicitly targeted Italy and Spain, but since neither government has requested assistance from the Eurozone rescue funds or turned to the IMF for a program, no bond purchases have been made under the OMT program to date. However, the ECB's public commitment of support bolstered market confidence and caused Italian and Spanish bond yields to fall, putting the debts of these countries on a more sustainable path. To a lesser extent, other recent developments have also bolstered the Eurozone's outlook, including Eurozone lenders softening the terms of loans to Greece; debt restructuring in Ireland; and some Eurozone banks beginning to repay emergency loans from the ECB. Against this backdrop, however, many analysts cautioned that continued lack of economic growth, rising unemployment, and banking sector vulnerabilities meant that the crisis in Europe was far from over.

In February 2013 and March 2013, the Eurozone crisis cycled back into a period of uncertainty, fueled by recent developments in Italy and, in particular, Cyprus. In February 2013, a general election in Italy failed to produce a clear winner, leading many analysts to worry that political instability might heighten investor unease about the country's fiscal position. Some analysts believe that the election results underscore the continuing unpopularity of austerity measures in the periphery more broadly, and that the periphery countries may reach a breaking point in their ability or willingness to continue with austerity policies. There are also concerns that Italy is "too-big-to-fail," and that Eurozone rescue funds may not be big enough to "rescue" Italy should a period of political instability deteriorate economic conditions.

Concerns about the stability of public finances and banks in Cyprus came to the forefront in March 2013. Similar to Ireland and Iceland, Cyprus has a large banking sector, more than 8 times larger than the country's GDP. Cypriot banks were heavily exposed to Greece, and Cypriot banks suffered substantial losses when Greece restructured its private sector debt in 2012. Given the size of the banking sector relative to the Cypriot economy, the Cypriot government did not have the resources to rescue its banks. The Cypriot government had been able to stay afloat through a €2.5 billion (about $3.25 billion) loan secured from the Russian government in October 2011. The Russian government was willing to lend this money because, among other reasons, many wealthy Russians are believed to have sizeable deposits in Cypriot banks.

In March 2013, Cyprus turned to fellow Eurozone member states and the IMF for a financial assistance package. A tentative agreement between the Cypriot government, the Europeans, and the IMF was unanimously rejected by the Cypriot parliament. Backlash largely focused on a proposed tax on all bank deposits in Cyprus, including deposits under €100,000 (about $130,000) that are protected by European deposit insurance. Other Eurozone member states had supported the tax to lessen their share of the "bailout," insisting that Cyprus raise approximately €5.8 billion (about $7.5 billion) on its own in order to qualify for assistance. One reason for this condition was that the European assistance to Cyprus was perceived by some Europeans, especially in Germany, as benefitting wealthy Russians using Cypriot banks to launder money. The Cypriot government had supported the tax on small depositors to lessen the burden on large depositors, in order to ensure Cyprus's future as an off-shore banking center.

The following week was marked by uncertainty and tense negotiations: Cypriot banks were closed; the parliament passed emergency legislation on bank resolution and capital controls; the Cypriot finance minister and president flew to Moscow to appeal for assistance; and the ECB threatened to cut off emergency support to Cypriot banks if a new deal was not reached by March 25, 2013. A new agreement between Cyprus, the Europeans, and the IMF was reached by the ECB deadline. It includes loans of €10 billion (about $13 billion) to the Cypriot government from the European rescue fund. It would also split Cyprus's second largest bank (Laiki) into a "good bank" and a "bad bank." Bank deposits under €100,000 (about $130,000) will be fully protected, but bank deposits in Laiki over that threshold are expected to face substantial losses. The Cypriot government also committed to increasing its efforts in the areas of fiscal consolidation, structural reforms, and privatization. Technical details of the agreement need to be finalized, with European financial assistance to Cyprus expected to be formally approved in April 2013. The IMF has also indicated that it will participate in the new agreement, but the amount has not been publicly announced.

Cyprus's economy is small, accounting for 0.2% of Eurozone GDP,[11] but some fear the crisis in Cyprus could have spillover effects to other parts of the Eurozone, particularly to Spain and Italy, as has been the case with Greece. To date, however, contagion of Cyprus to other Eurozone countries has been limited. European leaders have stated that the Cypriot assistance package serves as a model dealing with failing banks in the Eurozone, applauding that the package for shifting burden from taxpayers to private investors.

Outlook

Many analysts agree that ultimately there are three broad possible outcomes of the crisis: (1) the Eurozone "muddles" through the crisis, implementing piecemeal reforms but remaining largely in its current structure; (2) substantial reforms to the Eurozone architecture are implemented, leading to greater economic and political integration; or (3) the crisis leads to a splintering or break-up of the Eurozone, with one or more countries abandoning the euro.

Some analysts believe that the Eurozone will make it through the crisis by "muddling through," which many argue is the primary strategy used to handle the crisis over the past two years and will be the path forward out of the crisis. Although new institutional arrangements being proposed could increase integration among European countries, they argue that the result will fall short of a creating a full fiscal or political union and that the Eurozone will emerge from the crisis largely in its current form. Some have expressed concern that if the Eurozone does emerge from the crisis in its current form, the underlying problems with its architecture that led to the current crisis would not be addressed. Failure to address these issues, including better coordination of fiscal policies at the European level and correction of the imbalances within the Eurozone that developed over the past decade, may mean that similar crises lie ahead.

Other analysts contend that the only way to ultimately stabilize the Eurozone is to move towards deeper integration, by transferring powers from national to EU or Eurozone-level authorities. There is some evidence that the crisis response could be moving in this direction. There are various proposals by analysts and European policymakers for increasing fiscal, banking, and/or political integration within the Eurozone. The June 2012 resolution to create a single banking supervisor for the Eurozone was a step towards a "banking union," although many have argued it should be strengthened through Eurozone-wide deposit insurance and cross-border resolution. In general, countries disagree about which areas should be tightly integrated and how deeper

[11] International Monetary Fund (IMF), *World Economic Outlook*, October 2012.

integration should be achieved, and in what order. The German government, considered the key player in these discussions, at times has advocated for greater European-level oversight of national budgets, but has ruled out collectivizing Eurozone debt. Some Germans are concerned that, for example, creating bonds that are issued jointly by Eurozone states ("Eurobonds"), would increase Germany's borrowing costs and further "bail out" countries that are not making tough policy choices. Some French policymakers, by contrast, have supported the creation of Eurobonds, but have expressed concerns about ceding control over national budgets to European authorities. There are also questions about whether European leaders can secure the domestic support that they would need to advance European integration and empower European institutions.

Still others view the break-up of the Eurozone, once considered unthinkable, as a potential outcome of the crisis. The Eurozone could break apart if periphery countries decide to leave the Eurozone, or are pushed out by other Eurozone countries, or if the economically-stronger Eurozone countries choose to leave the Eurozone. The biggest benefit to periphery countries from a break-up of the Eurozone would be a depreciated currency against their major trading partners in Europe. This could help them regain competitiveness, spurring exports and economic growth. However, the obstacles to a break-up of the Eurozone are substantial. Analysts have debated, without reaching a broad consensus, how a break-up could be completed without triggering capital flight and a major banking crisis. The periphery countries' debts are denominated in euros, and leaving the Eurozone in favor of depreciated national currencies could significantly raise the value of their debts in terms of national currency. Additionally, leaving the Eurozone would likely strain the country's political relations with other countries in the EU, and could possibly even lead to a country having to leave the EU. In general, there is less discussion about a potential breakup of the Eurozone since market conditions have improved in recent months.

Issues for Congress

Implications for the U.S. Economy

The United States and EU have the largest and most deeply integrated bilateral trade and investment relationship in the world. Together, they account for almost 50% of world GDP, and more than 40% of the world's trade in goods and services. Throughout the crisis, Members of Congress have expressed concerns about the substantial implications of the crisis for the U.S. economy.

During the 112th Congress, Treasury Secretary Geithner testified before Congress that direct exposure of U.S. financial 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."[12] He 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 contrast, other witnesses before Congress, such as the former Chief Economist at the IMF, Simon Johnson, have raised questions about how completely U.S. regulators understand the exposure of U.S. financial institutions to Europe. When asked about the exposure of U.S. financial institutions to Europe in a Senate Budget Committee hearing,

[12] Senate Banking, Housing, and Urban Affairs Committee, Hearing on the Financial Stability Oversight Council Annual Report as well as Votes on a Few Pending Nominations, October 6, 2011.

he responded, "I think the honest answer is I don't know, and I don't know anyone else who knows."[13]

One public source of data on U.S. bank exposure is the Bank for International Settlements (BIS).[14] According to BIS, U.S. bank claims on Greece, Ireland, Italy, Portugal and Spain (public and private sector) totaled $143 billion in September 2012; other potential exposures of U.S. banks to these countries totaled an additional $625 billion. Overall, direct and other potential U.S. bank exposure in September 2012 to Greece, Ireland, Italy, Portugal, and Spain was 7.6% of U.S. bank foreign claims and other potential exposures overseas.[15] However, many questions have been raised about how complete a picture the BIS data provides of U.S. exposures. BIS 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.

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 exports and about 30% of U.S. service exports go to the EU.[16] 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 at times has undermined confidence in the euro, although the euro has appreciated against the dollar in recent months as the crisis has stabilized (see **Figure 3**). 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.[17] In general, the Eurozone crisis has bolstered interest in trade and investment liberalization between the United States and the EU, as a way of promoting economic recovery in both economies, as discussed in greater detail below.

More broadly, the crisis may have impacted growth in the United States: in June 2012, Goldman Sachs estimated that the crisis may reduce U.S. growth by up to 0.4 percentage points in 2012 and up to 1.4 percentage points cumulatively.[18] Uncertainty in the Eurozone has also created volatility in the U.S. stock market. One offsetting factor is that the crisis has created a "flight to safety," causing a flow of capital to U.S. Treasuries, resulting in falling rates.

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

[14] Bank for International Settlements (BIS), *Consolidated Banking Statistics,* "Table 9E: Foreign Exposures on Selected Individual Countries, Ultimate Risk Basis," January 2013, http://www.bis.org/statistics/consstats.htm.

[15] "Other potential exposures" includes derivative contracts, guarantees extended, and credit commitments.

[16] For more information, see CRS Report RL30608, *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, by (name redacted).

[17] Sam Schechner and Kate Linebaugh, Europe's Crisis Hits Profits," *Wall Street Journal*, July 26, 2012.

[18] Jan Hatzius et al., "US Growth in Low Gear," *Goldman Sachs*, June 1, 2012.

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."[19]

European reactions to the U.S. appeals for stronger policy measures have been mixed. Some Europeans have pushed back against perceived U.S. criticism while pointing out the United States' own economic problems. 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 94% for the Eurozone as a whole.[20] While the United States wields an influential voice on the crisis, it ultimately has limited ability to affect policy decisions made by and among the EU member countries and institutions.

Some analysts have stressed that one low-cost policy option for the United States to help energize growth in Europe, as well as at home, is through a U.S.-EU agreement to reduce trade and investment barriers. In February 2013, the Obama Administration, the European Commission, and the European Council announced that the United States and the EU plan to launch negotiations on a Transatlantic Trade and Investment Partnership (TTIP).[21]

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 March 13, 2013, $8 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**).[22]

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[19] "Remarks by President Obama at Press Conference After G20 Summit," Office of the Press Secretary, the White House, June 20, 2012.

[20] International Monetary Fund (IMF), *World Economic Outlook*, October 2012.

[21] "Statement from United States President Barak Obama, European Council President Herman Van Rompuy, and European Commission President José Manuel Barroso," White House, Office of the Press Secretary, February 13, 2013, http://www.ustr.gov/about-us/press-office/press-releases/2013/february/statement-US-EU-Presidents.

[22] Federal Reserve, http://www.federalreserve.gov/releases/h41/hist/h41hist13.htm.

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 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.[23] 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, 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.[24] 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.

[23] For more on the IMF, see CRS Report R42019, *International Monetary Fund: Background and Issues for Congress*, by (name redacted).

[24] 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.

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,[25] but the language was not included in the final FY2012 appropriations legislation.[26]

The 113th Congress could consider IMF legislation to meet commitments made by the Obama Administration to double IMF quotas, the IMF's core source of funding, while rolling back U.S. commitments to a supplementary fund at the IMF, the New Arrangements to Borrow (NAB). For more information, see CRS Report R42844, *IMF Reforms: Issues for Congress*, by (name redacted) and (name redacted).

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 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.[27] 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.

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

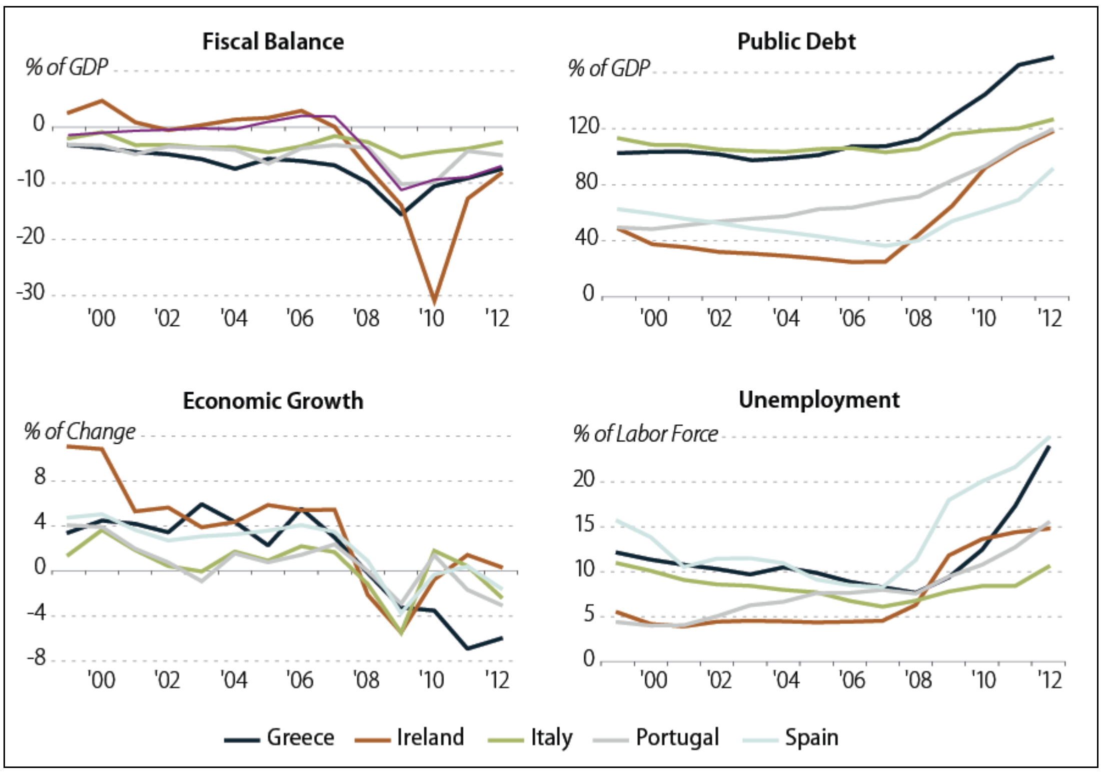
[26] P.L. 112-74.

[27] 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.

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. Additionally, 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, concluded a successful NATO mission in Libya in 2011, 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.

Supplemental Figures and Charts

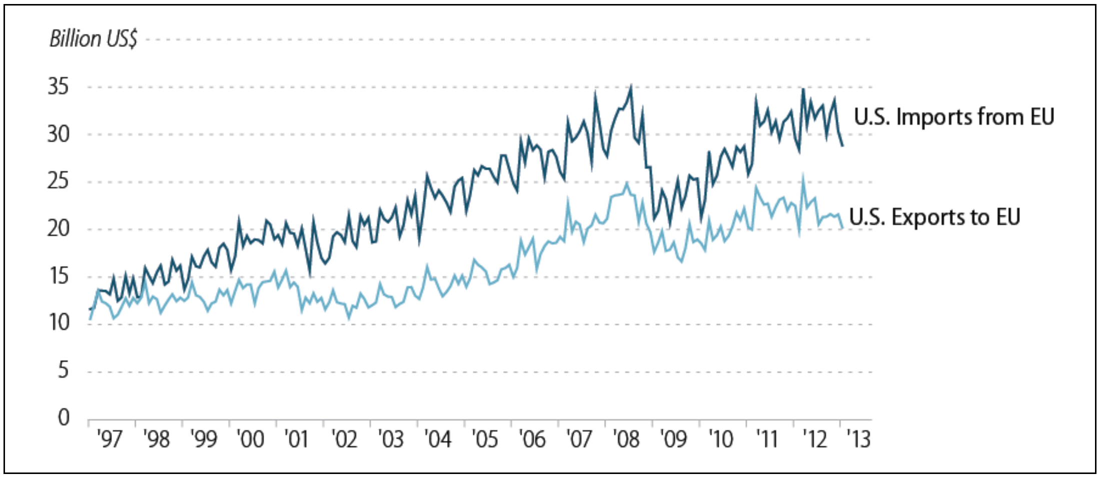
Figure 1. Selected Economic Indicators for Eurozone "Periphery" Countries



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

Note: 2011 and 2012 data are forecasts. 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: U.S. Census Bureau, "Trade in Goods with European Union," http://www.census.gov/foreign-trade/balance/c0003.html.

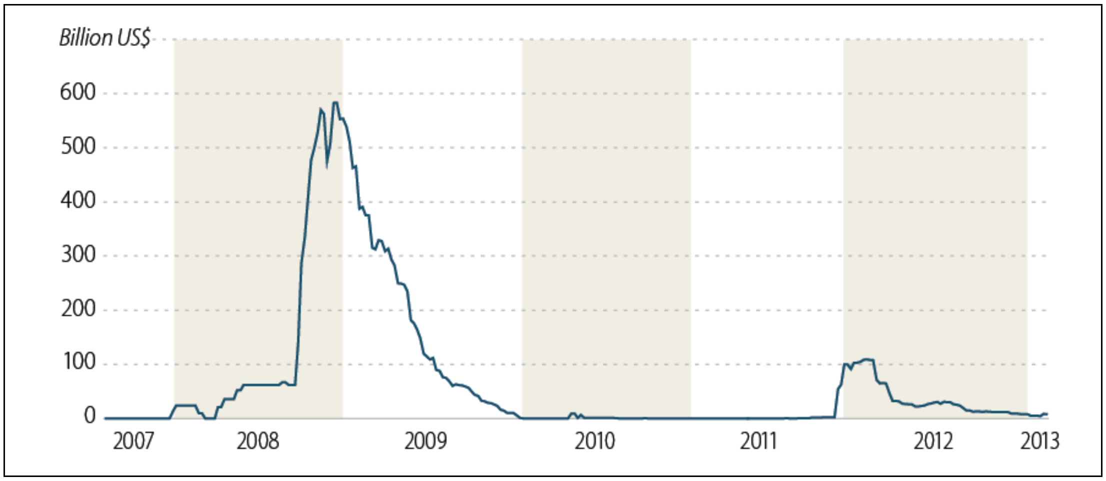
Notes: Does not include trade in services.

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 1. 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 $259 billion)	€48 billion (about $63 billion)	€246 billion (about $322 billion)
Ireland's government	December 2010	€45 billion (about $59 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 $102 billion)
Spain's banks	July 2012	Up to €100 billion (about $131 billion)	—	Up to €100 billion (about $131 billion)
Cyprus's government	March 2013	€10 billion (about $13 billion)[c]	The IMF has indicated it expects to contribute to the package, but has not yet announced an amount[d]	To be determined, pending IMF action

Source: International Monetary Fund; European Union.

Notes: Figures denominated in euros converted to dollars using exchange rate on March 15, 2013: €1 = $1.3086 (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 program is being negotiated for Cyprus but amounts are not yet finalized.

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.

c. Eurozone finance ministers expect the European Stability Mechanism (ESM) Board of Governors to formally approve the proposal by the third week of April 2013.

d. Christine Lagarde, IMF Managing Director, "IMF Statement on Cyprus," International Monetary Fund Press Release No. 13.91, March 24, 2013.

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