



# Greece's Debt Crisis: Overview, Policy Responses, and Implications

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April 7, 2010

Congressional Research Service

7-5700

[www.crs.gov](http://www.crs.gov)

R41167

**CRS Report for Congress**

*Prepared for Members and Committees of Congress*

## Summary

Over the past decade, Greece borrowed heavily in international capital markets to fund government budget and current account deficits. The reliance on financing from international capital markets left Greece highly vulnerable to shifts in investor confidence. Investors became jittery in October 2009, when the newly elected Greek government revised the estimate of the government budget deficit for 2009 from 6.7% of GDP to 12.7% of GDP. There are now questions about whether Greece will be able to repay its maturing debt obligations and interest payments, totaling €54 billion (\$73 billion), in 2010. This report analyses the Greek financial situation and identifies its implications for the United States.

The debt crisis has both domestic and international causes. Domestically, analysts point to high government spending, weak revenue collection, and structural rigidities in Greece's economy. Internationally, observers argue that Greece's access to capital at low interest rates after adopting the euro and weak enforcement of European Union (EU) rules concerning debt ceilings facilitated Greece's ability to accumulate high levels of external debt.

During the crisis, the Greek government has sold bonds on international capital markets in order to raise needed funds, although investors have demanded high interest rates to compensate for the perceived risk of these investments. Greece's government has also unveiled, amidst domestic protests, austerity measures aimed at reducing the government deficit below 3% of GDP by 2012. At the end of March 2010, the Eurozone member states, led by Germany and France, announced after much debate that they would provide financial support to Greece if necessary and if accompanied by financial support from the International Monetary Fund (IMF). A common method for addressing budget and current account deficits, currency devaluation, is not possible for Greece as long as it uses the euro as its national currency. If the austerity measures and/or financial assistance from outside parties prove insufficient, Greece could be forced to default on its debt.

Greece's crisis has numerous broader implications. There is concern that Greece's crisis could spill over to other European countries with difficult economic situations, including Portugal, Ireland, Italy, and Spain. Additionally, Greece's crisis has raised questions about possible problems with the Eurozone, which has a unified monetary policy and diverse fiscal policies. It has also come to light that complex financial instruments may have played a role in helping Greece accumulate and conceal its debt. This has played into current debates about financial regulatory reform in the United States and the EU.

Greece's crisis could have at least five implications for the United States. First, falling investor confidence in the Eurozone could further weaken the euro, which would likely widen the U.S. trade deficit. Second, financial instability in the EU could impact the U.S. economy given the strong trade and investment ties between the United States and the EU. Third, \$14.1 billion of Greece's debt is held by U.S. creditors, and a Greek default would likely have ramifications for these creditors. Fourth, some point to similarities between the financial situation in Greece and the United States, implying that Greece's current crisis foreshadows what the United States could face in the future. Others argue that the analogy is weak, because the United States, unlike Greece, has a floating exchange rate and the dollar is a reserve currency. Fifth, the debate about imbalances within the Eurozone is similar to the debates about U.S.-China imbalances, and reiterates how, in a globalized economy, the economic policies of one country impact other countries' economies.

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## Introduction

Historically, financial crises have been followed by a wave of governments defaulting on their debt obligations.<sup>1</sup> Financial crises tend to lead to, or exacerbate, sharp economic downturns, low government revenues, widening government deficits, and high levels of debt, pushing many governments into default.<sup>2</sup> As recovery from the global financial crisis begins, but the global recession endures, some point to the threat of a second wave of the crisis: sovereign debt crises.<sup>3</sup>

Greece is currently facing a classic sovereign debt crisis. Greece accumulated high levels of debt during the decade before the crisis, when capital markets were highly liquid. As the crisis has unfolded, and capital markets have become more illiquid, Greece may no longer be able to roll over its maturing debt obligations. Some analysts have discussed the possibility of a Greek default, but the Greek government has introduced a variety of austerity measures, and European countries, led by Germany and France, have pledged financial assistance in conjunction with the IMF to prevent such a default.<sup>4</sup>

More generally, Greece's debt crisis has raised a host of questions about the merits of the euro, the currency used by 16 European countries including Greece. It has also raised questions about the prospects for future European integration, with some calling for more integration and others less. Some have also pointed to possible problems associated with a unified monetary policy and nationally diverse fiscal policies. Finally, Greece's debt crisis has implications for the United States. The United States and the EU have exceptionally strong economic ties, and a crisis in Greece that threatens to spill over to other Southern European countries, for example, could impact U.S. economic relations with the EU.

Given this context, congressional interest in Greece's debt crisis is high. Numerous congressional hearings in 2010 have referenced Greece's economic situation, including hearings before the House Committees on Appropriations, the Budget, Financial Services, Foreign Affairs, and Select Intelligence; the Senate Committees on Finance and Banking, Housing, and Urban Affairs; and the Joint Committee on Economics. House Financial Services Committee Chairman Barney Frank has also indicated that the committee may hold a hearing on Greece in Spring 2010.<sup>5</sup> Finally, Greece's economic situation was a major focus of discussion when Greece's Prime Minister George Papandreou met with congressional leaders in a visit to Washington, DC, in March 2010.<sup>6</sup>

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<sup>1</sup> Jon Hilsenrath, "Q&A: Carmen Reinhart on Greece, U.S. Debt and Other 'Scary Scenarios'," *Wall Street Journal*, February 5, 2010.

<sup>2</sup> Carmen Reinhart, "The Economic and Fiscal Consequences of Financial Crises," VoxEU, January 26, 2009.

<sup>3</sup> For more on the global financial crisis, see CRS Report RL34742, *The Global Financial Crisis: Analysis and Policy Implications*, coordinated by Dick K. Nanto.

<sup>4</sup> The IMF is an international organization tasked with ensure international financial stability. It makes short-term loans to countries facing balance-of-payments problems.

<sup>5</sup> U.S. Congress, House Committee on Financial Services, *The Future of Housing Finance*, 111th Cong., 2nd sess., March 23, 2010.

<sup>6</sup> Kerin Hope, James Politi, and Anna Fifield, "G20 to Look at Monetary Fund Initiative," *Financial Times*, March 9, 2010.

This report provides an overview of the crisis; outlines the major causes of the crisis, focusing on both domestic and international factors; examines how Greece, the Eurozone members, and the International Monetary Fund (IMF) have responded to the crisis; and highlights the broader implications of Greece's debt crisis, including for the United States.

## **Greece's Debt Crisis: Background**

During the decade preceding the global financial crisis that started in fall 2008, Greece's government borrowed heavily from abroad to fund substantial government budget and current account deficits.<sup>7</sup> Between 2001, when Greece adopted the euro as its currency, and 2008, Greece's reported budget deficits averaged 5% per year, compared to a Eurozone average of 2%, and current account deficits averaged 9% per year, compared to a Eurozone average of 1%.<sup>8</sup> In 2009, the budget deficit was more than 12% of GDP. Many attribute the budget and current account deficits to the high spending of successive Greek governments,<sup>9</sup> among other causes discussed below.

Greece funded these twin deficits by borrowing in international capital markets, leaving it with a chronically high external debt (115% of GDP in 2009).<sup>10</sup> Both Greece's budget deficit and external debt level are well above those permitted by the rules governing the EU's Economic and Monetary Union (EMU). Specifically, the EU's Stability and Growth Pact calls for budget deficit ceilings of 3% of GDP and external debt ceilings of 60% of GDP. Greece is not alone, however, in exceeding these limits. Of the 27 EU member states, 20 currently exceed the deficit ceiling set out in the Stability and Growth Pact.<sup>11</sup>

Greece's reliance on external financing for funding budget and current account deficits left its economy highly vulnerable to shifts in investor confidence. Although the outbreak of the global financial crisis in fall 2008 led to a liquidity crisis for many countries, including several Central and Eastern European countries, the Greek government initially weathered the crisis relatively well and had been able to continue accessing new funds from international markets. That said, the global recession resulting from the financial crisis put strain on many governments' budgets, including Greece's, as spending increased and tax revenues weakened.<sup>12</sup> Since late 2009, however, investor confidence in the Greek government has been rattled.

In October 2009, the new socialist government, led by Prime Minister George Papandreou, revised the estimate of the government budget deficit for 2009, nearly doubling the existing

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<sup>7</sup> The current account is the difference between exports and imports, plus net income payments and net unilateral transfers. By accounting identity, the current account is equal to net inflows of foreign capital. Current account deficits are financed by foreign capital inflows.

<sup>8</sup> IMF, *World Economic Outlook*, October 2009 and European Commission, DG Economic and Financial Affairs, [http://ec.europa.eu/economy\\_finance/publications/european\\_economy/public\\_finances\\_emu\\_en.htm](http://ec.europa.eu/economy_finance/publications/european_economy/public_finances_emu_en.htm).

<sup>9</sup> For example, see "A Very European Crisis," *Economist*, February 4, 2010.

<sup>10</sup> "Country Report: Greece," *Economist Intelligence Unit*, February 2010.

<sup>11</sup> Jacob Funk Kirkegaard, *Greece's Unlikely Disciplinarians: The European Commission and Europe's Bond Market Vigilantes*, Peterson Institute for International Economics, February 12, 2009, <http://www.piie.com/realtime/?p=1185>.

<sup>12</sup> For more about the effects of the global recession on government budgets, and how governments have tried to address these challenges, see CRS Report R41122, *Limiting Central Government Budget Deficits: International Experiences*, by James K. Jackson.

estimate of 6.7% of GDP to 12.7% of GDP.<sup>13</sup> This was shortly followed by rating downgrades of Greek bonds by the three major credit rating agencies. In late November, questions about whether Dubai World, a state-controlled enterprise, would default on its debt raised additional concerns about the possibility of a cascade of sovereign defaults for governments under the strain of the financial crisis. Countries with large external debts, like Greece, were of particular concern for investors. Allegations that the Greek government falsified statistics and attempted to obscure the level of its debt through complex financial instruments have also contributed to a drop in investor confidence.<sup>14</sup> Before the crisis, Greek 10-year bond yields were 10 to 40 basis points above German 10-year bonds. With the crisis, this spread increased to an all-time high of 400 basis points in January 2010 and is currently at 340 basis points.<sup>15</sup> High bond spreads indicate declining investor confidence in the Greek economy.

Despite falling investor confidence, the Greek government was able to successfully sell €8 billion (\$10.8 billion) in bonds at the end of January 2010 and €5 billion (\$6.8 billion) at the end of March 2010, albeit at high interest rates.<sup>16</sup> However, Greece must borrow €54 billion (\$73 billion) to cover maturing debt and interest payments in 2010, and there are concerns about the government's ability to do so.<sup>17</sup> At the end of March 2010, the Eurozone member states pledged to provide financial assistance to Greece in concert with the IMF, if necessary and if requested by Greece's government.

## **Possible Causes of the Crisis**

Greece's current economic problems have been caused by a mix of domestic and international factors. Domestically, high government spending, structural rigidities, and tax evasion helped Greece accumulate debt over the past decade. Internationally, the adoption of the euro and lax enforcement of EU rules aimed at limiting the accumulation of debt are also believed to have contributed to Greece's current crisis.

### **Domestic Factors**

#### **High Government Spending and Weak Government Revenues**

Between 2001 and 2007, Greece's GDP grew at an average annual rate of 4.3%, compared to a Eurozone average of 3.1%.<sup>18</sup> High economic growth rates were driven primarily by increases in private consumption (largely fueled by easier access to credit) and public investment financed by the EU and the central government. During the past six years, the central government's

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<sup>13</sup> "Is Greece Heading for Default?," *Oxford Economics*, January 29, 2010.

<sup>14</sup> For example, see Kerin Hope, Quentin Peel, and Tony Barber, "Greece Turns on EU Critics," *Financial Times*, February 13, 2009 and Louise Story et al., "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *New York Times*, February 14, 2009.

<sup>15</sup> "Fiscal Woes to Dog Greek Bonds Even if Aid Offered," *Reuters*, March 22, 2010.

<sup>16</sup> Exchange rate used in the memo is the exchange rate March 23, 2010: €1 = \$1.35. Source: European Central Bank, <http://www.ecb.int/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html>.

<sup>17</sup> Carrick Mollenkamp and Cassell Bryan-Low, "Greece Leaps One Key Hurdle," *Wall Street Journal*, March 5, 2010.

<sup>18</sup> At constant prices. IMF, *World Economic Outlook*, October 2009.

expenditures increased by 87%, while revenues only grew by 31%,<sup>19</sup> leading to budget deficits above the EU's agreed-upon 3% of GDP threshold. Observers identify a large and inefficient public administration in Greece, costly pension and healthcare systems, tax evasion, and a general "absence of the will to maintain fiscal discipline"<sup>20</sup> as major contributors to Greece's debt.

In 2009, Greek government expenditures accounted for 50% of GDP.<sup>21</sup> According to the OECD, as of 2004, spending on public administration as a percentage of total public expenditure was higher than in any other OECD member, "with no evidence that the quantity or quality of the services are superior."<sup>22</sup> Successive Greek governments have taken steps to modernize and consolidate the public administration. However, observers continue to cite over-staffing and poor productivity in the public sector as an impediment to improved economic performance. An aging Greek population—the percentage of Greeks aged over 64 is expected to rise from 19% in 2007 to 32% in 2060—could place additional burdens on public spending and what is widely considered one of Europe's most generous pension systems. According to the OECD, Greece's "replacement rate of 70%-80% of wages (plus any benefits from supplementary schemes) is high, and entitlement to a full pension requires only 35 years of contributions, compared to 40 in many other countries."<sup>23</sup> Absent reform, total Greek public pension payments are expected to increase from 11.5% of GDP in 2005 to 24% of GDP in 2050.

Weak revenue collection has also contributed to Greece's budget deficits. Many economists identify tax evasion and Greece's unrecorded economy as key potential revenue streams through which the government could improve its fiscal position. Some studies have estimated the informal economy in Greece to represent between 25%-30% of GDP.<sup>24</sup> Observers offer a variety of explanations for the prevalence of tax evasion in Greece, including high levels of taxation and a complex tax code, excessive regulation, and inefficiency in the public sector. Like his predecessor Constantine (Costas) Karamanlis, Prime Minister Papandreou has committed to cracking down on tax and social security contribution evasion. Observers note, however, that past Greek governments have had, at best, mixed success seeing through similar initiatives.

## **Structural Policies and Declining International Competitiveness**

Greek industry is suffering from declining international competitiveness. Economists cite high relative wages and low productivity as a primary factor. According to one study, wages in Greece have increased at a 5% annual rate since the country adopted the euro, about double the average rate in the Eurozone as a whole. Over the same period, Greek exports to its major trading partners grew at 3.8% per year, only half the rate of those countries' imports from other trading partners.<sup>25</sup>

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<sup>19</sup> *Update of the Hellenic Stability and Growth Programme*, Greek Ministry of Finance, January 2010. [http://www.mnec.gr/export/sites/mnec/en/economics/growth\\_programme\\_2005-8/2010\\_01\\_15\\_SGP.pdf](http://www.mnec.gr/export/sites/mnec/en/economics/growth_programme_2005-8/2010_01_15_SGP.pdf)

<sup>20</sup> *Ibid.*

<sup>21</sup> *Ibid.*

<sup>22</sup> Administration encompasses public services including: executive and legislative organs; financial and fiscal affairs; external affairs; foreign economic aid; general services; basic research; research and development; public debt transactions and other general services. "OECD Economic Survey: Greece," *OECD*, May 2007.

<sup>23</sup> "OECD Economic Survey: Greece," *OECD* July 2009.

<sup>24</sup> "Country Report: Greece," *Economist Intelligence Unit*, March 2009; OECD Economic Survey: Greece, July 2009; and Hellenic Foundation for Foreign and European Policy (ELIAMEP), *Economic Fact Sheet Greece 2009/10*, March 2010.

<sup>25</sup> "Is Greece Headed for Default?," *Oxford Economics*, January 29, 2010.

Some observers argue that for Greece to boost its international competitiveness and reduce its current account deficit, it needs to increase its productivity, significantly cut wages, and increase savings. As discussed below, the Papandreou government has begun to curb public sector wages and hopes to increase Greek exports through investment in areas where the country has a comparative advantage. In the past, tourism and the shipping industry have been the Greek economy's strongest sectors.

## **International Factors**

### **Increased Access to Capital at Low Interest Rates**

Greece's adoption of the euro as its national currency in 2001 is seen by some as a contributing factor in Greece's buildup of debt. With the currency bloc anchored by economic heavyweights Germany and France, and a common monetary policy conservatively managed by the European Central Bank (ECB), investors have tended to view the reliability of euro member countries with a heightened degree of confidence. The perceptions of stability conferred by euro membership allowed Greece, as well as other Eurozone members, to borrow at a more favorable interest rate than would likely have been the case outside the EU, making it easier to finance the state budget and service existing debt. This benefit, however, may also have contributed to Greece's current debt problems: observers argue that access to artificially cheap credit allowed Greece to accumulate high levels of debt. Critics assert that if the market had discouraged excess borrowing by making debt financing more expensive, Greece would have been forced to come to terms earlier with the need for austerity and reform.

### **Issues with EU Rules Enforcement**

The lack of enforcement of the Stability and Growth Pact is also seen as a contributing factor to Greece's high level of debt. In 1997, EU members adopted the Stability and Growth Pact, an agreement to enhance the surveillance and enforcement of the public finance rules set out in the 1992 Maastricht Treaty's "convergence criteria" for EMU. The rules call for budget deficits not to exceed 3% of GDP and debt not to exceed 60% of GDP. The Pact clarified and sped up the excessive deficit procedure to be applied to member states that surpassed the deficit limit. If the member state is deemed to have insufficiently complied with the corrective measures recommended by the European Commission and the Council of the European Union during the excessive deficit procedure, the process may ultimately result in a fine of as much as 0.5% of GDP.<sup>26</sup>

Following the launch of the euro, an increasing number of member states found it hard to comply with the limits set by the Pact. Since 2003, more than 30 excessive deficit procedures have been undertaken, with the EU reprimanding member states and pressuring them to tighten up their finances, or at least promise to do so. The EU, however, has never imposed a financial sanction against any member state for violating the deficit limit. The lack of enforcement of the Stability and Growth Pact has limited the role it can play in discouraging countries, like Greece, from running up high levels of debt.

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<sup>26</sup> *Resolution of the European Council on the Stability and Growth Pact*, Amsterdam, June 19, 1997, *Council Regulation (EC) 1466/97*, and *Council Regulation (EC) 1467/97*, [http://ec.europa.eu/economy\\_finance/sgp/legal\\_texts/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm).



The European Commission initiated an excessive deficit procedure against Greece in 2004 when Greece reported an upward revision of its 2003 budget deficit figure to 3.2% of GDP. In its report, the Commission indicated that “the quality of public data is not satisfactory,” noting that the EU’s statistical office, Eurostat, had not certified or had unilaterally amended data provided by the National Statistical Service of Greece since 2000.<sup>27</sup> Subsequent statistical revisions between 2004 and 2007 revealed that Greece had violated the 3% limit in every year since 2000, with its deficit topping out at 7.9% of GDP in 2004. The Commission also noted that Greece’s debt had been above 100% of GDP since before Greece joined the euro, and that the statistical revisions had pushed the debt number up as well. The EU closed the excessive deficit procedure in 2007, with the Commission pronouncing itself satisfied that Greece had taken sufficient measures, “mainly of a permanent nature,” and that the country’s deficit would be 2.6% of GDP in 2006 and 2.4% in 2007. The Commission also concluded that “the Greek statistical authorities improved their procedures,” leading to “an overall higher quality of data.”<sup>28</sup> The Commission opened a new excessive deficit procedure in 2009 when Greece’s 2007 deficit was reported at 3.5% of GDP, and that procedure is ongoing in the context of the current situation.<sup>29</sup> This points to a broader problem of a monetary union without a fiscal union, as discussed below in “Broader Implications of Greece’s Crisis.”

## Addressing the Crisis: Progress to Date

In an effort to restore investor confidence in the Greek economy, the Papandreou government has pursued a series of wide-ranging fiscal austerity measures. It remains unclear whether this combination of immediate spending cuts and tax increases will appease nervous investors enough to enable Greece to raise the money it needs to cover its budget and current account deficits. In the event that Greece is unable to raise these funds, Eurozone members have announced they will provide financial assistance to Greece in conjunction with the IMF, if necessary.

Some have suggested that, in addition to austerity and financial assistance from Eurozone member states and the IMF, Greece could finance its budget deficit and increase the competitiveness of its exports by exiting the Eurozone and adopting and devaluing a new national currency. However, most consider this an unlikely policy course as both Greek and European leaders appear committed to ensuring that Greece remain a Eurozone member and exiting the Eurozone would make future borrowing costs much higher for Greece. If the government is not able to address its budget deficit through fiscal austerity or financial assistance from a third party, it may be forced to default on its debt obligations.

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<sup>27</sup> European Commission, *Report from the Commission: Greece*, Brussels, May 19, 2004, [http://ec.europa.eu/economy\\_finance/sgp/pdf/30\\_edps/104-03/2004-05-19\\_el\\_104-3\\_en.pdf](http://ec.europa.eu/economy_finance/sgp/pdf/30_edps/104-03/2004-05-19_el_104-3_en.pdf).

<sup>28</sup> European Commission, *Recommendation for a Council Decision Abrogating Decision 2004/917/EC 9 on the Existence of an Excessive Deficit in Greece*, Brussels, May 16, 2007, [http://ec.europa.eu/economy\\_finance/sgp/pdf/30\\_edps/104-12\\_commission/2007-05-16\\_el\\_104-12\\_commission\\_en.pdf](http://ec.europa.eu/economy_finance/sgp/pdf/30_edps/104-12_commission/2007-05-16_el_104-12_commission_en.pdf).

<sup>29</sup> European Commission, DG Economic and Financial Affairs, *Stability and Growth Pact, Country-specific procedures*, [http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/greece\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/greece_en.htm).

## Greek Domestic Policy Responses

### Fiscal Austerity

Since taking office in October 2009, the Papandreou government has unveiled three separate packages of fiscal austerity measures aimed at reducing Greece's government deficit from 12.7% of GDP in 2009 to below 3% by 2012. In total, the measures are worth an estimated €16 billion (\$21.6 billion), or 6.4% of GDP.<sup>30</sup> The specific longer-term budget deficit targets established by the government are 8.7% of GDP in 2010; 5.6% of GDP in 2011; 2.8% of GDP in 2012; and 2% of GDP in 2013.<sup>31</sup> Greece's plan to achieve these targets is detailed in the country's Stability and Growth Programme, which was submitted to the European Commission (EC) on January 15, 2010, and approved by the EC on February 3, 2010, and in a follow-on report on implementation of the Programme submitted to the EC in March 2010.<sup>32</sup>

Eurozone member states have welcomed the Papandreou government's plans for fiscal consolidation. Some observers express concern, however, that the mix of tax increases and sharp spending cuts could lead to higher unemployment and deepen an ongoing recession in the country. The policy solutions to two of the major economic issues facing the Greek government—cutting large government budget deficits (which requires contractionary fiscal policies to address) and stimulating the economy during cyclical economic downturn (which requires expansionary fiscal policies)—are at odds with each other. Some question, then, how long the government will be able to count on public support for the contractionary measures in the face of a sharp recession.<sup>33</sup>

On March 3, 2010, Prime Minister Papandreou won parliamentary approval for the third and most far-reaching of his government's proposed austerity measures. The package was widely considered an attempt to address concerns in other Eurozone member states that the previously adopted measures did not go far enough. A significant percentage of the additional revenues to be generated from Greece's previously announced austerity measures were projected to come from a crackdown on tax evasion and improved collection of social security contributions. Among other things, the March measures aim to increase revenue through a rise in the value-added tax from 19% to 21%; tax increases on fuel, tobacco, liquor, and luxury products; and a one-off 1% tax increase on personal incomes of over €100,000 (\$136,000). The government has also announced a series of corporate, personal, and real estate tax reforms. On the expenditure side, most of the spending cuts announced this year focus on the civil service. The measures include a civil servant hiring freeze in 2010 with a 5:1 retirement/recruitment ratio for new public sector hires from 2011; a 10% cut in civil service salary allowances (bonuses); a freeze on state pensions; and a 30% cut in public sector supplementary pay (equivalent to about one month of pay).<sup>34</sup>

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<sup>30</sup> "Greece Economy: An Austere Future," *Economist Intelligence Unit*, March 9, 2010.

<sup>31</sup> Greek Ministry of Finance, *Update of the Hellenic Stability and Growth Programme*, January 2010. [http://www.mnec.gr/en/economics/growth\\_programme\\_2005-8/](http://www.mnec.gr/en/economics/growth_programme_2005-8/).

<sup>32</sup> Greek Ministry of Finance, *Update of the Hellenic Stability and Growth Programme*, January 2010; and *Report to the Implementation of the Hellenic Stability and Growth Programme and Additional Measures*, March 2010. Both available at [http://www.mnec.gr/en/economics/growth\\_programme\\_2005-8/](http://www.mnec.gr/en/economics/growth_programme_2005-8/).

<sup>33</sup> See, for example, "Greece Economy: An Austere Future," *Economist Intelligence Unit*, March 9, 2010.

<sup>34</sup> For more details on the Greek government's proposed austerity measures, see Greek Ministry of Finance, *Update of the Hellenic Stability and Growth Programme*, January 2010; and *Report to the Implementation of the Hellenic Stability and Growth Programme and Additional Measures*, March 2010. Both available at (continued...)

## Long-Term Structural Reforms

Prime Minister Papandreou has repeatedly emphasized the need for longer-term structural reforms to the Greek economy. To this end, he has proposed wide-ranging reforms to the pension and health care systems and to Greece's public administration. His government has also announced measures to boost Greek economic competitiveness by enhancing employment and economic growth, fostering increased private sector development, and supporting research, technology and innovation.

As mentioned above, the Greek pension system, considered one of the most generous in Europe, has long been a target of advocates of Greek economic reform. The Papandreou government has pledged both to reform pension institutions and to crack down on social security contribution evasion. At least one government official has been reported as saying that measures will include raising the average retirement age from 61 to 63 (the statutory retirement age in Greece is 65) and calculating pensions on the basis of lifetime contributions as opposed to the last five years of earnings, as is now the case with some civil service pension schemes.<sup>35</sup> Prime Minister Papandreou has announced a similar effort to tighten public regulation and strengthen accountability in what is widely considered an inefficient Greek health care system. His government also hopes to restructure Greece's public administration. This includes consolidating local governance structures by reducing the levels of local administrative authorities from five to three, reducing the number of Greek municipalities from 1,034 to 370, and reducing the legal public entities formed by local authorities from 6,000 to 2,000.

Some economists express concern that Greece's relatively drastic contractionary fiscal policies could hinder economic growth over the medium term. GDP contracted by 2% in 2009 and is forecasted to contract by 2.5% in 2010 and by 0.7% in 2011.<sup>36</sup> Registered unemployment reached 10.6% in November 2009, the highest level since March 2005, and is expected to increase in 2010. As of October 2009, 27.5% of young people (aged 15-24) in Greece were unemployed.<sup>37</sup> The Papandreou government hopes to counter these trends by attracting new foreign investment in Greece and by boosting exports of goods and services. In addition to advancing institutional reforms designed to more efficiently disburse Greek and EU investment and development funds, it intends to target sectors where it believes Greece has strong comparative advantages for trade and investment. These include its geographic location, particularly as a potential hub for regional trade and investment in energy and transportation networks; the renewable energy sector; and already strong global shipping and tourism sectors. Most agree, however, that the challenges to building sustainable economic growth are considerable. Greek exports dropped by close to 18% in 2009 and Greek businesses have become increasingly uncompetitive in domestic and international markets.<sup>38</sup>

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(...continued)

[http://www.mnec.gr/en/economics/growth\\_programme\\_2005-8/](http://www.mnec.gr/en/economics/growth_programme_2005-8/)

<sup>35</sup> "Greece/EU: Athens Frets under Financial Supervision," *Oxford Analytica*, February 17, 2010. A 2008 reform of the Greek pension system legally reduced the number of pension funds from 133 to 13 (with five basic funds and eight smaller and supplementary funds). However, some observers have noted that the 2008 reforms have yet to be fully implemented.

<sup>36</sup> "Country Report: Greece," *Economist Intelligence Unit*, March 2010.

<sup>37</sup> Hellenic Foundation for Foreign and European Policy (ELIAMEP), *Economic Fact Sheet Greece 2009/10*, March 2010; "Is Greece Heading for Default?," *Oxford Economics*, January 29, 2010.

<sup>38</sup> Hellenic Foundation for Foreign and European Policy (ELIAMEP), *Economic Fact Sheet Greece 2009/10*, (continued...)

Perhaps the most substantial challenge for the Papandreou government could be maintaining public and political support for its austerity and economic reform program. Papandreou's Panhellenic Socialist Movement (PASOK) came to office in October 2009 on a platform of "social protection" promising to boost wages, improve support for the poor, and promote redistribution of income. The measures he has since begun to implement in order to cut the budget deficit have required retreating from many of these campaign pledges, and could prove politically difficult to see through. Thus far, Papandreou appears to have maintained the support of the majority of Greeks. According to two separate February 2010 polls, however, 72% of Greeks support the Prime Minister and 65% of Greeks believe the austerity measures are overdue and necessary.<sup>39</sup> Nevertheless, thousands of public sector workers and their supporters have taken to the streets to protest the announced austerity measures, and more protests and strikes are scheduled.

The largest opposition party, the center-right New Democracy (ND) unseated by PASOK in the 2009 elections, has thus far supported Papandreou's fiscal consolidation proposals. However, it could be inclined to oppose future measures, particularly tax increases. Some long-time observers of Greece point out that the reform record of past Greek governments dating back to the 1980s is mixed at best. It remains to be seen whether the Papandreou government will maintain the public support and political will to see through its wide range of reform proposals.

## **Financial Assistance from the Eurozone Member States**

EU leaders and analysts have been engaged in an extensive debate about the possibility of other Eurozone member states providing financial assistance to the Greek government. On one hand, severe instability in the Greek economy, up to and including a default, could have considerable consequences for the EU, and especially the Eurozone. The crisis has contributed to a weakening of the euro's foreign exchange value during the first months of 2010, and some observers fear that a deepening crisis could spread across European bond markets and draw in countries such as Spain, Portugal, Italy, and Ireland. The cost of providing financial assistance to Greece is relatively low. Providing financial assistance to cover Greece's total outstanding debt (approximately €300 billion, or \$405 billion<sup>40</sup>) would add about 3% to the debt of the other Eurozone member states.<sup>41</sup> Moreover, it is believed that it would be unlikely that more than a small fraction of the full amount would need to be committed.

Beyond purely economic considerations, there is a significant political element to the EU debate. Monetary union, and the hope that the euro becomes a reserve currency, is seen by many proponents of a strong EU as a crowning achievement of European integration. Some observers, therefore, assert that the EU must maintain solidarity above all else, arguing that EU members, and particularly the large countries of the Eurozone, must not allow Greece to default, much less abandon the euro.

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(...continued)

March 2010.

<sup>39</sup> "Greece Economy: An Austere Future," *Economist Intelligence Unit*, March 9, 2010.

<sup>40</sup> "Is Greece Heading for Default?," *Oxford Economics*, January 29, 2010.

<sup>41</sup> Paul De Grauwe, "Crisis in the Eurozone and How to Deal with It," *CEPS Policy Brief No. 204*, February 2010.

On the other hand, there is little political appetite in the EU for providing financial assistance to Greece. Most EU countries are themselves struggling with difficult public finances, and many are exasperated at the idea of rescuing a member state that, in their perspective, has not exercised budget discipline, has failed to modernize its economy, and allegedly has falsified past financial statistics. In addition, many strongly wish to avoid setting a precedent by “bailing out” a member state that has not managed its finances well. Some observers argue that allowing Greece to default is preferable to an EU rescue package. Germany, the Eurozone’s largest economy and arguably its most influential national voice on economic policy, has been among the most skeptical member states. Polls show that a large majority of Germans are strongly against providing assistance to Greece.<sup>42</sup> Leading up to the March 2010 agreement, German Chancellor Angela Merkel repeatedly put a brake on EU discussions about formulating a rescue package for Greece, and has sought to dampen any expectations that financial assistance might be forthcoming.

While pushing Greece to implement drastic austerity plans, EU leaders initially sought to help temper the crisis by reassuring markets that the solvency of Greece is underwritten by its membership in the Eurozone, but without being able to offer many details about a potential rescue package. On February 11, 2010, following a meeting of the 27 national leaders, European Council President Herman van Rompuy stated “Euro area member states will take determined and coordinated action if needed to safeguard stability in the Euro area as a whole.”<sup>43</sup> One month later, on March 15, 2010, Eurozone finance ministers reportedly reached agreement on the general parameters of possible EU support, conveying that it would consist of “coordinated bilateral aid” from individual member states to Greece in the form of loans or loan guarantees. Such a course sidesteps concerns that had been raised about whether EU assistance to Greece would be legal under the EU’s Maastricht Treaty.<sup>44</sup> Some have argued that the Treaty’s so-called “no bail-out clause” prohibits EU assistance in this case. Others assert that the clause does not rule out voluntary member state-to-member state bilateral assistance, and that another clause in the EU treaty allows for the financial support of a member state in the event of “exceptional occurrences.”<sup>45</sup>

At the European Council meeting on March 25, 2010, EU leaders produced a more specific agreement about how a support mechanism for Greece would work. If Greece finds itself unable to borrow in commercial markets, the other members of the Eurozone could provide bilateral loans at market rates, supplemented by additional support from the IMF. Greece would still need to request activation of this mechanism—in that case, following assessments by the European Commission and the European Central Bank, activation would again require the unanimous consent of the Eurozone member countries.<sup>46</sup>

In any case, EU officials have been insistent that Greece implement tough austerity measures as planned, undertake reforms they view as long overdue, and correct deficiencies in the gathering

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<sup>42</sup> Ralph Atkins and Quentin Peel, “Germans Oppose Greek Aid, Poll Shows,” *Financial Times*, March 21, 2010.

<sup>43</sup> Ian Traynor and Graeme Wearden, “EU leaders reach Greek bailout deal,” *The Guardian*, February 11, 2010.

<sup>44</sup> The Maastricht Treaty, formally known as the Treaty on European Union, came into effect in November 1993. The treaty expanded the scope of political and economic cooperation among the then 12 member states, creating the structure of the modern European Union.

<sup>45</sup> “Treaty on European Union,” Article 104b.1 and Article 103a.2, <http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html>.

<sup>46</sup> “Statement by the Heads of State and Government of the Euro Area,” Brussels, 25 March 2010, [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/113563.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf).

and reporting of national statistics. From the EU's viewpoint, these conditions apply whether Eurozone assistance is provided or not. Most continue to view providing financial assistance to Greece as a last resort. In fact, high-level EU officials including Luxembourg Prime Minister Jean-Claude Juncker, who chairs the meetings of the Eurozone finance ministers, stated that they do not believe EU assistance will be necessary.<sup>47</sup> Following the announcement of the agreement on the parameters and conditions of the Eurozone-IMF "safety net," some officials and analysts assert that the market has been further reassured. EU and Greek officials also continue to note that Greece has not formally requested financial assistance from the Eurozone or the IMF.

## **Financial Assistance from the IMF**

At the onset of the Greek crisis, many EU officials were insistent that the Eurozone take ownership of the issue. Analysts asserted that it was important for the Eurozone to demonstrate its strength and credibility by taking care of its own problems. "Outside" intervention from the IMF has been viewed by many as a potential "humiliation" for the Eurozone, with officials at the European Central Bank, among others, strongly opposed to the prospect.<sup>48</sup> In late March 2010, however, the debate in Europe appeared to shift, with the door slowly opening for possible IMF involvement. Prior to the March 25, 2010, European Council meeting, Eurogroup Chairman Juncker acknowledged that a growing number of member states had come to favor a role for the IMF in a twin-track approach combining Eurozone and IMF instruments. In the end, IMF involvement was reportedly a key condition of Chancellor Merkel's willingness to compromise and agree to the "safety net" mechanism. Greek Prime Minister Papandreou had previously stated that Greece might turn to the IMF with a request for assistance if the EU failed to offer needed aid. Some economists have argued all along that the level of assistance that the IMF could provide to Greece, which is tied to member states' financial commitments to the IMF, would be too small on its own and should be part of a broader package of financial assistance provided by other Eurozone member states.<sup>49</sup>

Some argue that the policy reforms (conditionality) attached to IMF loans would lend additional impetus to reform and provide both the Greek government and the EU with an outside scapegoat for pushing through politically unpopular reforms. The EU would also make policy reforms a condition of loans, but the IMF is seen as more independent than the EU and has more experience in resolving debt crises than the EU.<sup>50</sup> In addition to providing financial assistance, the IMF also stands ready to provide the Greek government with technical assistance in handling the crisis.

## **Broader Implications of Greece's Crisis**

### **Contagion**

As mentioned, if Greece defaults, there is a risk of contagion to other Southern European countries, including Portugal, Ireland, Italy, and Spain (which, along with Greece, have been

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<sup>47</sup> Andrew Willis, "Greek support likely to be bilateral loans, says Juncker," *euobserver.com*, March 16, 2010.

<sup>48</sup> "Rebuilding Greece's Finances," *Economist*, February 4, 2010.

<sup>49</sup> Tony Barber, "Brussels Urges EU to Reach Greek Deal," *CNN*, March 19, 2010.

<sup>50</sup> "Rebuilding Greece's Finances," *Economist*, February 4, 2010.

nicknamed the “PIIGS” or “GIIPS”). Like Greece, these countries borrowed heavily during the credit bubble before the current global financial crisis and have encountered investors who are increasingly nervous about the sustainability of their debt. Already, movements in the yields on Portugal’s, Ireland’s, Italy’s, and Spain’s bonds have closely followed Greece’s.<sup>51</sup> Concerns about a spillover of Greece’s crisis to its neighbors are rooted in memories of the Asian financial crisis in 1997-1998, where it is believed that investor herding behavior contributed to the spread of the crisis throughout the region.<sup>52</sup>

Some argue that there are important differences among the “PIIGS” that would make contagion from Greece to these other European countries unlikely. It has been argued, for example, that the low levels of national savings in Greece and Portugal put these countries in the weakest financial position, at 7.2% of GDP and 10.2% of GDP respectively, compared to an EU average of approximately 20%.<sup>53</sup> Spain and Ireland, by contrast, are closer to the EU average at 19% of GDP and 17% of GDP, respectively, putting them in a stronger financial position.<sup>54</sup> Additionally, Ireland has begun to implement far-reaching austerity measures that were passed by its parliament in December 2009.<sup>55</sup> IMF Managing Director Dominique Strauss-Kahn is reported to have downplayed the possibility of spillover from Greece to Spain or Portugal, suggesting that a crisis in Greece could be largely contained to that country.<sup>56</sup> Contagion is viewed as unlikely if the EU and/or IMF provide financial assistance to Greece.

## **Complex Financial Instruments and Financial Regulation**

Through the crisis, it has come to light that the Greek government, underwritten by prominent financial institutions including Goldman Sachs, used complex financial instruments to conceal the true level of Greece’s debt.<sup>57</sup> For example, it is reported that Greece’s government exchanged future revenues from its highways, airports, and lotteries for up-front cash payments from investors. Likewise, it is reported that Greece’s government borrowed billions by trading currencies at favorable exchange rates. Because these transactions were technically considered currency swaps, not loans, they did not need to be reported by the Greek government under EU accounting rules. The Federal Reserve is currently investigating the role that Goldman Sachs and other U.S. financial institutions played in the build-up of Greece’s debt.<sup>58</sup>

The role of complex financial instruments in Greece’s debt crisis has led to some tensions between the United States and the EU over financial regulation. Some European leaders have called for tighter financial regulation, including a prohibition on derivatives that are believed to have helped create Greece’s debt crisis. Financial regulatory reform before Congress regulates,

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<sup>51</sup> Daniel Gros, “Greek Burdens Ensure Some Pigs Won’t Fly,” *Financial Times*, January 28, 2010.

<sup>52</sup> Saleheen Khana and Kwang Woo (Ken) Park, “Contagion in the Stock Markets: The Asian Financial Crisis Revisited,” *Journal of Asian Economics*, vol. 20, no. 5 (September 2009), pp. 561-569.

<sup>53</sup> Daniel Gros, “Greek Burdens Ensure Some Pigs Won’t Fly,” *Financial Times*, January 28, 2010. Italy is not discussed in this article.

<sup>54</sup> *Ibid.*

<sup>55</sup> “Country Report: Ireland,” *Economist Intelligence Unit*, February 2010.

<sup>56</sup> “Greek Woes ‘Unlikely to Spread,’” *BBC News*, March 8, 2010.

<sup>57</sup> Louise Story, Landon Thomas Jr., and Nelson D. Schwartz, “Wall St. Helped Mask Debt Fuelling Europe’s Crisis,” *New York Times*, February 14, 2010.

<sup>58</sup> Nelson D. Schwartz and Sewell Chan, “In Greece’s Crisis, Fed Studies Wall St.’s Activities,” *New York Times*, February 25, 2010.

but does not ban, derivatives. In a mid-March 2010 visit to Washington, DC, Prime Minister Papandreou vocally criticized “unprincipled speculators” for “making billions every day by betting on a Greek default.”<sup>59</sup>

## **European Integration**

Greece's debt crisis has also launched a number of wider debates about the EU's monetary union. Since the introduction of the euro in 1999, skeptics have pointed to a mismatch between the EU's advanced economic and monetary union and an incomplete political union. Even within the economic areas, where the EU is more tightly integrated, the Eurozone has a single monetary policy but 16 separate (if loosely coordinated) national fiscal policies. Critics argue that this arrangement is prone to problems and imbalances that threaten the viability of having a common currency. Others assert that the Greek crisis points to the need for stronger EU economic governance, at the very least in the form of a tighter and more enforceable Stability and Growth Pact. Going further, some proponents of deeper integration would like to use the crisis to launch a discussion about moving towards a more integrated EU-wide fiscal policy.

Additionally, some officials and analysts have proposed that the EU create a new European Monetary Fund (EMF) that would allow it to respond more smoothly to financial crises within individual member states in the future, operating much like the IMF but on a regional, rather than global, basis. There is some discussion that this would require a new governing treaty for the EU, which may be politically difficult to pass. Following the Asian financial crisis in 1997-1998, similar proposals for creating an institution like the IMF, but operating specifically within the region, were discussed but no such institution was created.

Finally, Greece's crisis has brought to light imbalances within the Eurozone. Northern European countries, such as Germany, have relied on exports for economic growth and pursued policies that aim to promote such export-led growth, such as wage moderation to keep the costs of production low and make exports competitive. Combined with conservative fiscal policies that promote high levels of savings, these countries have run large current account surpluses. In contrast, Southern European countries, like Greece, have had higher levels of wage growth and more expansionary fiscal policies, leading to less competitive exports and lower levels of savings. These countries have run large current account deficits and borrowed to finance these deficits.

Some argue that the Southern European countries now need to reduce their debt and increase savings, which translates to running current account surpluses.<sup>60</sup> Hopes for export-led growth may be difficult to realize, however, in the face of the global economic recession. Greece's reliance on tourism, which is highly affected by economic conditions (consumer spending on luxury items) and shipping, which is also affected by economic conditions (increased trade; low energy costs), raises real questions about trade providing much of a boost to the economy. Additionally, observers note that it is unclear whether the Northern European countries such as Germany are willing to take the steps necessary in their own domestic economies to reduce their levels of savings, curb exports, cut their current account surpluses, and promote this rebalancing

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<sup>59</sup> George A. Papandreou, *Remarks on Rising to the Challenge of Change: Greece, Europe, and the United States*, Brookings, March 8, 2010, [http://www.brookings.edu/~media/Files/events/2010/0308\\_greece/20100308\\_greece.pdf](http://www.brookings.edu/~media/Files/events/2010/0308_greece/20100308_greece.pdf).

<sup>60</sup> Philip Whyte, “Why Christine Lagarde is Right About Germany,” *Centre for European Reform*, March 26, 2010.



within the Eurozone.<sup>61</sup> How imbalances will be resolved within the Eurozone may be an important component of debates about EU integration in the future.

## **U.S. Economy**

In addition to shaping debates over regulatory reform, both between the U.S. and the EU as well as within the G-20 more broadly,<sup>62</sup> Greece's debt crisis could have at least five major implications for the United States. First, many expect that if investors lose confidence in the future of the Eurozone, and more current account adjustment is required for the Eurozone as a whole, the value of the euro will weaken.<sup>63</sup> A weaker euro would likely lower U.S. exports to the Eurozone and increase U.S. imports from the Eurozone, widening the U.S. trade deficit.<sup>64</sup>

Second, the United States has a large financial stake in the EU. The EU as a whole is the United States's biggest trading partner and hundreds of billions of dollars flow between the EU and the United States each year.<sup>65</sup> Widespread financial instability in the EU could impact trade and growth in the region, which in turn could impact the U.S. economy. On the other hand, instability in the EU may make the United States more attractive to investors and encourage capital flows to the United States. However, if the crisis is contained to Portugal, Ireland, Italy, Greece, and Spain, the effects on the United States would be smaller than instability in the EU as a whole.

Third, a Greek default could have implications for U.S. commercial interests. Although most of Greece's debt is held by Europeans (more than 80%), \$14.1 billion of Greece's debt obligations are owed to creditors within the United States.<sup>66</sup> Although not an insignificant amount of money, the relative size of U.S. creditor exposure to Greek bonds however is likely too small to create significant effects on the U.S. economy overall if Greece were to default.

Fourth, the global recession has worsened the government budget position of a large number of countries. Some argue that credit markets may have awakened to the magnitude of the debt problem due to the large number of countries that are involved and the extent of the budget deficits. For example, it is argued that there are strong similarities between Greece's financial situation and the financial situation in the United States.<sup>67</sup> Like Greece, it is argued, the United States has been reliant on foreign investors to fund a large budget deficit, resulting in rising levels of external debt and vulnerability to a sudden reversal in investor confidence. Others point out

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<sup>61</sup> Ibid.

<sup>62</sup> The G-20 is a forum for discussing economic policies among 20 major advanced and emerging-market countries. Following the financial crisis, financial regulation has been a major topic of focus at the G-20 meetings. For more on the G-20, see CRS Report R40977, *The G-20 and International Economic Cooperation: Background and Implications for Congress*, by Rebecca M. Nelson.

<sup>63</sup> Wolfgang Münchau, "Why the Euro will Continue to Weaken," *Financial Times*, March 7, 2010.

<sup>64</sup> This effect was highlighted by Greece's Prime Minister in remarks at Brookings. See George A. Papandreou, *Rising to the Challenge of Change: Greece, Europe and the United States*, Brookings, March 8, 2010, [http://www.brookings.edu/~media/Files/events/2010/0308\\_greece/20100308\\_greece\\_papandreou\\_remarks.pdf](http://www.brookings.edu/~media/Files/events/2010/0308_greece/20100308_greece_papandreou_remarks.pdf).

<sup>65</sup> For more on U.S.-EU economic ties, see CRS Report RL30608, *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, by William H. Cooper.

<sup>66</sup> "Is Greece Heading for Default?," *Oxford Economics*, January 29, 2010.

<sup>67</sup> For example, see Patrice Hill, "Bernanke Delivers Blunt Warning on U.S. Debt," *Washington Times*, February 25, 2010 and Anne Applebaum, "America's Debt Spiral Resembles Greece's Crisis," *Washington Post*, February 17, 2010.

that the United States, unlike Greece, has a floating exchange rate and its currency is a reserve currency, which alleviates many of the pressures associated with rising debt levels.

Fifth, debates over imbalances between current account deficit and current account surplus countries within the Eurozone are similar to the debates about imbalances between the United States and China. These debates reiterate how the economic policies of one country can affect other countries and the need for international economic cooperation and coordination to achieve international financial stability.

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