



BRIEFING PAPER

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Greek debt crisis: background and developments in 2015

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Summary

After months of fruitless negotiations, Greece's future in the Eurozone was saved after a last-minute three-year loans-for-reforms agreement was reached in July 2015.

New three-year Eurozone bailout programme of €86 billion agreed

At a 12 July 2015 meeting of Eurozone leaders, a provisional agreement was struck on a third Eurozone bailout programme which could provide up to €86 billion in loans for Greece over three years. These all-night talks were at times fractious and reportedly came close to ending without agreement (and likely Greek departure from the Eurozone).

Formal negotiations – the “Memorandum of Understanding” – on the detail of the programme were concluded in mid-August. It requires Greece to implement reforms including changes to pensions and market-based reforms of the economy designed to make it more competitive. The first loan payment to Greece of €23 billion (including €10 billion reserved for bank recapitalisations) was made on 20 August. Greek Prime Minister Alexis Tsipras called a September election, after his Syriza party had become divided over the new bailout deal. Syriza won the election, with Alexis Tsipras back as Prime Minister.

Failure of previous talks led to capital controls and Greece defaulting on the IMF

Prior to this new three-year deal, negotiations on the final instalment of funds (of €7.2 billion) as part of the second bailout programme ended in failure in late June. The Greek government called a referendum on proposals from its creditors – the Eurozone, International Monetary Fund and European Central Bank – for this money. The electorate rejected the terms, backing the government's position (a week later the new three-year agreement was reached).

Other Eurozone countries viewed the decision to hold a referendum as tantamount to Greece breaking off negotiations. As a result, the second Eurozone bailout programme, and the funds earmarked from this, expired on 30 June. This exacerbated Greece's funding problems and led to it defaulting on a €1.5 billion debt repayment to the IMF at the end of June (since paid).

The European Central Bank also froze its emergency funding of Greece's banks, leading to Greece having to introduce capital controls to stop money leaving its banks. Foreign transactions were also severely limited and banks were shut (for three weeks). All this has had serious negative effects on the economy, which has likely fallen into recession again.

Consequences of Greece leaving the Eurozone

The newly-agreed €86 billion Eurozone bailout programme reduces the short-term likelihood of Greece leaving the Eurozone. Nevertheless, many think that over the medium-term ‘Grexit’ is still possible. Most economists expect the impact from this on the UK would come via financial markets and through the impact on the Eurozone economy.

Background to crisis

Greece's economy has undergone a severe recession since the debt crisis began, with the economy over a quarter smaller now than it was in 2008. Two international bailout programmes in 2010 and 2012 have provided a total of around €216 billion (£154 billion) in financial aid to Greece. Attached to these loans have been stringent conditions designed to reduce the budget deficit and improve economic competitiveness.

Against this backdrop of continued severe economic and social pain, the radical left-wing Syriza party, who promised to reject the austerity measures, won the January 2015 election beating the incumbent centre-right New Democracy party.

1. Background

1.1 2010 and 2012 bailouts

Greece's long-standing public debt problem became a crisis at the start of 2010. In the face of rising government borrowing costs, the country first requested international assistance in April 2010. The €110 billion (£79 billion¹) Eurozone-International Monetary Fund (IMF) loans agreement it received came with strict conditions on economic policy and reform designed to make the Greek economy more competitive. A worsening recession and rising public opposition to further austerity meant the Greek government struggled to meet the conditions of the agreement. Meanwhile, the prospects of it returning to borrow on the open market by 2012, as originally envisaged, became increasingly hopeless.

A second package of financial assistance was agreed with the Eurozone and IMF in February/March 2012 and was a more complicated arrangement than the first. As well as the traditional 'loans and austerity', the second bail-out involved Greece's private sector creditors taking losses – totalling around €100 billion (£71 billion) – on their holdings of Greek sovereign debt: this followed from a belated recognition that no amount of austerity and loans on their own could put Greece's debt burden at the time on a sustainable footing.² The second bailout brought the total combined financial assistance to around €240 billion (£171 billion).³

1.2 Economic depression

The economy entered recession in 2008 and saw persistent contractions in economic activity until 2014, when growth finally returned. Overall, real GDP has fallen by over 27% since the depression began.⁴ During the Great Depression, the US economy shrank by a similar magnitude: 26% between 1929 and 1933.⁵ (By way of comparison, the UK's economy shrank by 6% during the 2008/2009 recession.)

¹ This briefing uses the exchange rate of €1.40 per £1 as of 19 Jun 2015.

² For more on this "private sector involvement" see Reserve Bank of Australia Statement on Monetary Policy, "[The Greek Private Sector Debt Swap](#)", May 2012

³ For more see the Library Note [The eurozone crisis – rescuing Greece](#), May 2012

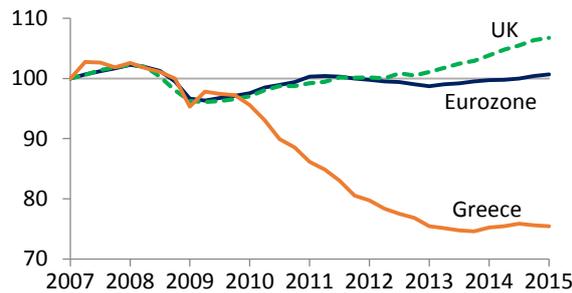
⁴ Hellenic Statistics Authority (Elstat), [table 6 – quarterly GDP](#) [accessed 30 Jul 2015]

⁵ US Bureau of Economic Analysis, [National Income and Product Accounts Tables, table 1.1.3 real GDP](#) [accessed 5 Aug 2015]

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Greece - GDP (Q1 2007=100)

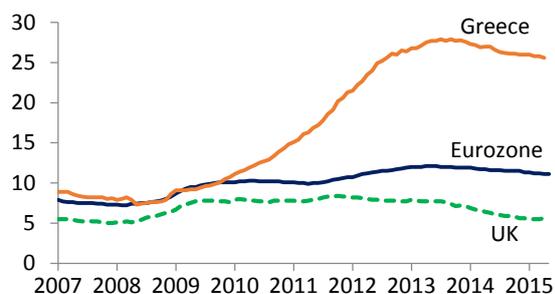
Quarterly data (Eurostat)



The fall in output has led to a steep fall in living standards and social conditions. The unemployment rate increased from around 8% in 2008 to 28% in mid-2013, before falling back slightly to a little below 26% by mid-2015. The youth unemployment rate rose to nearly 60% in 2013 and was still at 53% in mid-2015.⁶

Greece - Unemployment rate (%)

Monthly data (Eurostat)



The number of people in work fell by around one million – a 23% decline in the employed population. Wages have declined, poverty has increased and deprivation has risen.⁷ It's no surprise then that many people in Greece are unhappy – three-fifths of people say they are not satisfied with the life they lead (the EU average is one-fifth) and three-quarters say that the financial situation of their household is bad (the EU average is just over one-third).⁸

In 2014 the economy did show signs of stabilising. Growth had returned, with quarterly expansions in GDP during each of the first three quarters of the year. The Greek government was even able to sell some bonds, for up to five years, to investors for the first time in four years.

⁶ Eurostat, [Unemployment rate by age](#)

⁷ European Commission, [2014 Employment and Social Developments in Europe Review](#), 15 Jan 2015, pages 269 and 308

⁸ European Commission, [Eurobarometer 81](#), carried out November 2014. Figures on satisfaction based on the question "On the whole are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the life you lead?" – 41% of people in Greece were very satisfied or fairly satisfied, compared with 79% across the whole European Union. Figures on financial situation are based on the question "How would you judge the current situation in each of the following? The financial situation of your household" – 25% of people in Greece said it was good or very good, compared with 65% across the European Union.

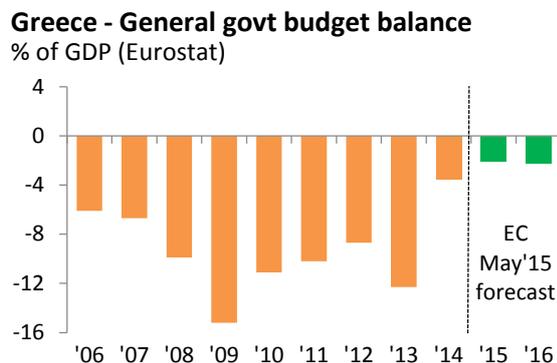
1.3 January 2015 Greek elections and Syriza's platform

Despite the tentative signs of economic recovery, the years of economic depression, high unemployment and austerity led to the radical left-wing Syriza party winning the 22 January 2015 general election, beating the incumbent centre-right New Democracy party. Syriza fell two seats short of an overall majority in parliament and thus formed a coalition with the right-wing Independent Greeks who share their anti-austerity views. Syriza's leader, Alexis Tsipras, became Prime Minister.⁹

Syriza campaigned against the conditions attached to the bailout agreements and pledged to reverse many of the austerity measures introduced in recent years, such as the 22% reduction in the minimum wage. It believes, along with a number of economists,¹⁰ that the cutting of public spending and tax increases introduced in order to attempt to reduce Greece's large budget deficit had been counterproductive. It argues that this led the economy into a vicious negative spiral of weaker demand causing weaker public finances, in turn resulting in the imposition of even tougher austerity conditions.

Syriza in its campaign pledged to stop dealing with the 'Troika' of the European Commission, the European Central Bank (ECB) and the IMF, who have overseen the bailout funds and imposed the conditions associated with them (known as the Memorandum of Understanding).

Syriza said its vow to renegotiate the terms of the bailout agreement would also include a request for debt relief. Greece's stock of government debt is the second highest in the world at over 175% of its GDP,¹¹ or €317 billion (£226 billion), the majority of which is owed to the Eurozone bailout funds and therefore ultimately to the other Eurozone countries.¹² Syriza has said it is committed to keeping Greece in the Eurozone.



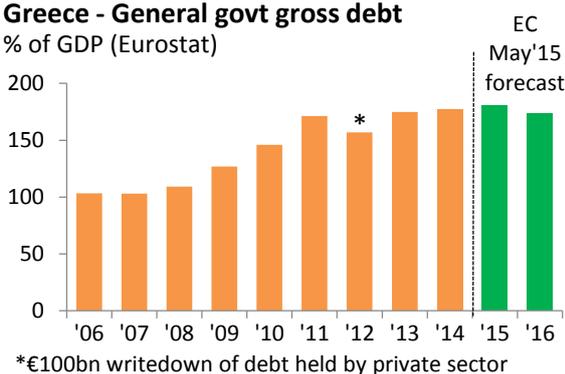
⁹ For more on the election see Library note [Greece's new anti-austerity coalition](#), 28 Jan 2015

¹⁰ For example [Simon Wren-Lewis](#), [Martin Wolf](#) or [Paul Krugman](#); not all economists agree with this view

¹¹ IMF [estimates](#) of gross debt for 2014. Japan has the highest debt ratio at 246% of GDP.

¹² "[Greece Seeks Third Debt Restructuring: Who's on the Hook?](#)", Bloomberg, 2 Feb 2015

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2. Failure to complete the bailout programme in June 2015

€7.2 billion was available to Greece from the second bailout programme should a reforms-for-cash deal have been formally approved by the Eurozone, IMF and European Central Bank by the end of June 2015. The failure of the Greek government and its creditors to agree on what reform measures would be introduced in Greece in return for the additional funding led to the programme expiring without Greece receiving these funds.

2.1 Overview of bailout programmes

The first bailout in 2010 was cut short by the need for a larger second bailout in 2012. In total, the first bailout provided Greece with €73.0 billion (€52.9 billion from other Eurozone countries and €20.1 billion from the IMF).

The second bailout programme, started in March 2012 and provided Greece with an even larger loan. By the time Syriza came to power in January 2015, a total of €142.7 billion had been provided to Greece (€130.9 billion from other Eurozone countries¹³ and €11.8 billion from the IMF).¹⁴

A sizeable portion of the bailout funds went towards servicing Greek debt. An analysis by the well-regarded MacroPolis website, which provides analysis on Greek political and economic developments, calculated that “roughly half of the financing – around €120 billion was for debt servicing.”¹⁵ A further €35 billion was used to “sweeten” the debt writedowns of private sector debt at the time of the second bailout in 2012. €48 billion was used to recapitalise Greek banks, while around €27 billion, or 11% of total funding, went to the Greek state’s operating needs.

2.2 Negotiations over last €7 billion of funding linked to second programme

Under the terms of this second financial assistance package, the release of each loan disbursement to Greece had to be approved by both the European Commission via the Eurogroup (of Eurozone finance ministers) and the IMF’s Executive Board. Prior to this decision, European Commission, European Central Bank (ECB) and IMF staff conducted joint review missions to Greece in order to monitor compliance with the terms and conditions of the programme.¹⁶ Their fifth review began in

¹³ €10.9 billion from the bailout fund was allocated for bank recapitalisations. This money was returned to the EFSF (a Eurozone bailout fund) before the bailout expired and is not included in these calculations.

¹⁴ The European Central Bank (ECB) also purchased Greek government bonds under its Securities Markets Programme. It held €33.9 billion in these bonds [by end 2012](#).

¹⁵ Yiannis Mouzakis, “[Where did all the money go?](#)”, Macropolis, 5 Jan 2015

¹⁶ European Commission, [Financial assistance to Greece](#) [accessed 30 Jul 2015]

September and was still ongoing when the Syriza-led government took office in Greece in January 2015.

The loan programme between Greece and the Eurozone bailout fund, the European Financial Stability Facility (EFSF), was due to expire on 28 February 2015.¹⁷ The final tranche of loans worth €1.8 billion from this fund was only to be provided after the latest review was concluded successfully.¹⁸ An associated €1.9 billion held by the ECB,¹⁹ and a further €3.5 billion from the IMF²⁰ would also be available after the review was completed, providing a potential total of €7.2 billion (£5.1 billion) in funding to Greece.

2.3 Extension of bailout until end June 2015

With the 28 February 2015 deadline looming, the new Greek government and its Eurozone counterparts began discussions on how to proceed. The main forum for negotiations is the Eurogroup – a meeting of the finance ministers of the 19 Eurozone countries.

On 20 February 2015, the Eurogroup came to a deal that would extend the financial assistance programme to Greece for four months, up until 30 June.²¹ The provisional terms of this agreement were:

- The current **bailout programme would continue**, with its deadline extended from 28 February to 30 June, in order for the “institutions” of the European Commission, IMF and ECB to complete their review and subsequently disburse the €7.2 billion in funding to Greece (no money to be paid until then).
- **No reduction in debts** - Greece was to honour all of its financial obligations to those they have borrowed from.
- The **primary budget surplus target** – the government budget balance excluding debt interest payments – for 2015, which had been 3% of GDP, was scrapped and would now take “economic circumstances in 2015 into account”. A lower surplus, in theory, allows for higher government spending levels or lower levels of taxation.
- **Economic reforms to continue** - Greece commits to a “broader and deeper structural reform process”. Any reforms must be approved by the institutions (EC/IMF/ECB) who determine whether they are sufficient for them to complete their review and allow the €7.2 billion in bailout funding to be disbursed to Greece. This was meant to be completed by the end of April.

¹⁷ The agreement between Greece and the IMF runs until March 2016.

¹⁸ EFSF press release, “[EFSF Board of Directors extends MFFA for Greece until 30 June 2015](#)”, 27 Feb 2015

¹⁹ These are profits [generated](#) from the ECB’s holding of Greek bonds, which were purchased in previous years

²⁰ IMF staff report, “[Greece: Fifth Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Waiver of Nonobservance of Performance Criterion and Rephasing of Access](#)”, Jun 2014, p55, table 13, “fifth review”

²¹ [Eurogroup statement on Greece](#), 20 Feb 2015

- **No “unilateral changes”** from Greek government stopping Syriza from implementing a number of the measures it had campaigned on during the election.²²
- **Bank recapitalisation fund moved to Eurozone bailout fund** - funds of €10.9 billion (£7.8 billion) to support Greek banks moved from the Hellenic Financial Stabilisation Fund (HFSF) to the EFSF (Eurozone bailout fund) until the end of June and would still be available to Greek banks if needed. Greece had originally floated the possibility that it may want to use these funds for purposes other than bank recapitalisations.
- **Possible follow-up arrangement** - the Eurogroup statement also mentioned that this extension can “bridge the time” – a term favoured by the Greek government – for discussions on the possibility of introducing another financial assistance programme once the current one ended at the end of June.

This provisional agreement was viewed by most observers as a “defeat” for the Greek government given that most of its original demands that helped it get elected were not included.²³ For instance, *The Economist* concludes that “Greece drop[ped] nearly all its demands”.²⁴ It appears that heightened concerns over the health of Greek banks pressured the government to come to an agreement as quickly as possible.²⁵

Greek Prime Minister Alexis Tsipras and the then Finance Minister Yanis Varoufakis said shortly after that this provisional agreement broke the cycle of austerity that previous Greek governments had acquiesced to by introducing some flexibility to the conditions of the loans. However, this provisional deal still needed to be formally signed, agreed and implemented.

Preliminary reform plans approved in late February 2015

As per the agreement of 20 February, the Greek authorities submitted their initial set of reforms to the Eurogroup of Eurozone finance ministers on 23 February. These included a commitment to reform value-added tax (VAT) policy in order to boost revenues, fight corruption, reduce the number of government ministries, review and control public spending, and commit to not roll back privatisations that had been completed.²⁶

The Eurogroup approved this list of measures on 24 February, noting that this was “a valid starting point” toward a more detailed list of policies that would need to be agreed by the end of April.²⁷ Where necessary, national parliaments of Eurozone members including

²² This is summarised in their “[Thessaloniki programme](#)” of policies to reverse past austerity measures

²³ For a summary of opinion see “[Tsipras Tamed as Economists Declare Greece Loses Austerity Fight](#)”, Bloomberg, 23 Feb 2015

²⁴ “[Greece and Europe: Outgamed](#)”, *The Economist* online, 21 Feb 2015

²⁵ *ibid.*

²⁶ [Greek government reform agenda sent to Eurogroup](#) (23 Feb 2015), via the Financial Times online

²⁷ Eurogroup, [Eurogroup statement on Greece](#), 24 Feb 2015

Germany, approved this extension to the bailout (the Greek government decided not to put the extension agreement to a parliamentary vote).

The IMF and ECB also signalled their approval of the Greek measures, although both expressed some reservations and emphasised that the measures were only a starting point.²⁸ Work then continued on more detailed plans for these reforms.

2.4 Failure to agree a more detailed plan

Talks between the Greek government and its creditors (the European Commission via the Eurogroup (of Eurozone finance ministers), the ECB and IMF) continued for months without an agreement being reached. Reform proposals from the Greek government were rejected by creditors as being insufficient, while the Greek government rejected creditors' proposals for imposing too much austerity.²⁹

The Syriza-led government didn't want to agree to what it felt was a continuation of past disastrous austerity policies and faced internal agitation from within the party to refuse such an agreement. Meanwhile, the other Eurozone countries and the IMF were reluctant to lend more money to Greece if it didn't commit to reforming its economy and improving its public finances.

The main areas of disagreement were in the following areas:

- **Pensions** – creditors wanted further reforms to the pensions system, seen by many as overly generous.³⁰ The Greek government rejected this characterisation and noted the large cuts the austerity programme had already made to pensions.
- **Value-added tax (VAT)** – creditors wanted to apply a higher VAT rate to some goods and services. At the time of negotiations there was a standard rate of 23%, and two reduced rates of 13% and 6.5%. The Greek government was reluctant to raise VAT rates on items such as food and electricity, which were at the lower rates.³¹
- **Debt reorganisation** – the Greek government proposed that the Eurozone bailout fund buys the €27 billion Greece owes the ECB, allowing it more time to repay this debt.³² This plan was rejected by creditors.
- **Budget targets** – the original bailout deal contained a target for Greece to run a 3% of GDP surplus on its budget balance excluding debt interest payments (the 'primary surplus') in 2015. The deal to extend the bailout removed this target but did not

²⁸ ECB, [ECB letter to the Eurogroup](#), and IMF, [Letter by IMF Managing Director Christine Lagarde to the President of the Euro Group on Greece](#), both 23 Feb 2015

²⁹ See for instance: "[Greece fails to reach initial deal on reforms with lenders](#)", Reuters, 31 Mar 2015, and "[Greek Proposal on Bailout Standoff Not Acceptable, European Officials Say](#)", Wall Street Journal, 9 Jun 2015

³⁰ "[Starting to list: Greece and its creditors](#)", *The Economist*, 4 Apr 2015

³¹ "[Plan on the cards for flat VAT rate of 18 pct](#)", Kathimerini (Greek newspaper) online English edition, 28 Apr 2015

³² 18 June 2015 [blog post](#) by then Greek Finance Minister Yanis Varoufakis

replace it. A smaller surplus would allow the Greek government to spend more or tax less. The difference between the two sides on the new target was relatively small at 0.5% of GDP per year.³³

- **Labour market** – creditors proposed further reforms to make it more flexible, while the Greek government wanted to rehire some of the public sector workers laid off under the austerity programme and to raise the national minimum wage (which was cut by 22% as part of the bailout programmes).³⁴

As well as the clear ideological divide between the two parties, the negotiations appear to have been acrimonious at times. For example, the then Greek Finance Minister Yanis Varoufakis' attitude to negotiations did not go down well with a number of his counterparts, with a number of unfavourable stories about him circulating in the media.³⁵

With the 30 June expiration of the bailout programme approaching, proposal and counterproposal were sent between the two parties during June 2015.³⁶ Some reports suggested that by 26 June the differences between the two parties on issues such as pensions and VAT were relatively small.³⁷

Nevertheless, a plan proposed by creditors to extend the bailout programme for five months and provide €15.5 billion in funding (none of it new) to Greece was rejected by the Greek government on 26 June, stating the reform plans linked to this proposed extension would be deeply recessionary.³⁸

Later that night, Prime Minister Tsipras announced that Greece would hold a referendum on 5 July 2015 on whether to accept or reject a recent proposal from the creditor institutions.³⁹ The bailout programme, along with the €7.2 billion in funding tied to it, subsequently expired on 30 June.

The referendum and its consequences are examined in the next section.

³³ "[Extension granted: Greece's debt negotiations](#)", *The Economist*, 4 Jun 2015

³⁴ "[Greece deal: Seriously, what's holding it up?](#)", CNBC online, 8 May 2015

³⁵ See for example, "[Varoufakis has achieved one thing – uniting resentment from poorer nations](#)", *Guardian*, 1 May 2015; Mr Varoufakis' has responded to these stories in a blog post, "[The truth about Riga](#)", 24 May 2015

³⁶ For example, FT Brussels Blog, "[Leaked: Greece's new bailout counterproposal](#)", 26 Jun 2015 and Reuters, "[Greek minister says two or three issues remaining in debt talks](#)", 24 Jun 2015

³⁷ *Guardian*, "[Greece crisis: Creditors to work on Plan B – as it happened](#)", 26 Jun 2015

³⁸ "[Greece debt crisis: Athens rejects five-month bailout extension](#)", BBC News online, 26 Jun 2015

³⁹ The European Commission subsequently published a version of their proposals from the evening of 26 June at http://europa.eu/rapid/press-release_IP-15-5270_en.htm

3. July 5 referendum and associated events

The Greek government held a referendum on the terms of a loans-for-reforms deal offered to it by its creditors. Other Eurozone countries viewed this as Greece breaking off negotiations. The second Eurozone bailout programme, and the funds earmarked from this, expired. This exacerbated Greece's funding problems and led to it defaulting on a €1.5 billion debt repayment to the IMF at the end of June.

The European Central Bank froze its emergency funding of Greece's banks, leading to Greece having to introduce capital controls to stop money leaving its banks. The Greek electorate decisively voted against the terms of the now-defunct bailout proposal, backing its government's position.

3.1 Referendum and end of negotiations

Late on Friday 26 June, the Greek Prime Minister, Alexis Tsipras, announced that Greece would hold a referendum on Sunday 5 July on whether to accept or reject a recent loan-for-reforms proposal from the creditor institutions.⁴⁰ He and his government advocated a 'No' vote, rejecting the terms of the proposals.

This followed a series of proposal, counterproposal and intense negotiations in previous weeks and came ahead of a summit of Eurozone finance ministers (the Eurogroup) the following day.

At the previously-scheduled meeting of the 19 Eurozone finance ministers – the Eurogroup – on Saturday afternoon (27 June), the Greek government asked for the bailout programme to be extended for a week so that it wouldn't expire as scheduled on 30 June, before the referendum.⁴¹ This was rejected by the other 18 Eurozone members, who blamed Greece for rejecting their proposals and breaking up negotiations.⁴²

The other 18 Eurozone members also stated that as the bailout programme was to expire on Tuesday 30 June, the remaining funds from this second bailout due to be given to Greece would now also expire. This is indeed what happened.

Therefore it was not entirely clear what people were voting for or against in the Greek referendum, given that the creditors proposal was no longer on the table following the end of the bailout programme on 30 June.

The referendum vote could best be seen as a way for the government, in the event of a 'No' vote, to show its creditors that its position was supported by the Greek population. Although not formally on the table,

⁴⁰ "[Greece's Tsipras calls referendum to break bailout deadlock](#)", Reuters, 27 Jun 2015

⁴¹ Yanis Varoufakis' personal blog, "[As it happened – Yanis Varoufakis' intervention during the 27th June 2015 Eurogroup Meeting](#)", 28 Jun 2015

⁴² Eurogroup website, [summary of 27 June 2015 meeting](#)

these proposals could have formed the basis of a new deal, if there was a 'Yes' vote.

The referendum may have also been called due to discontent within the ruling Syriza party, and to avoid the possibility of any agreement with creditors leading to a serious split within the party.⁴³

3.2 Bank holiday and capital controls introduced

Following the referendum announcement and the decision by the Eurogroup to essentially suspend negotiations with Greece and let the existing bailout programme expire, the European Central Bank (ECB) did not increase its emergency funding of the Greek banking system.

This decision, together with customers continuing to take money out of banks over the weekend of 26/27 June, meant that banks were in danger of becoming insolvent when they opened on Monday. In order to avoid this, capital controls limiting how much money could leave Greek banks were introduced. Banks were also closed from Monday 28 June and the Athens stock market was also shut.

The problems with the Greek banking system and more on the measures introduced following the referendum announcement are covered in the [next section](#) of this briefing.

3.3 Government funding issues and default on IMF loan

The Greek government is unable to access international financial markets to borrow money at a sustainable rate of interest (hence the need for the bailout loans). As of the end of June 2015, the last time Greece received any money from a bailout programme was August 2014.

The government up to this point managed to keep up with its debt repayments and its domestic obligations to pay social security and salaries via a combination of measures. These included:

- delaying payments to firms that supply the state;⁴⁴
- ordering public entities to transfer their cash reserves to the Bank of Greece (worth about €600 million);⁴⁵
- meeting a €750 million repayment to the IMF in mid-May by drawing down Greece's reserves at the IMF.⁴⁶

⁴³ Sebastian Budgen and Stathis Kouvelakis, "[Greece: The Struggle Continues](#)", *Jacobin* magazine, 14 Jul 2015

⁴⁴ "[Putting off payments led to Q1 budget primary surplus](#)", Kathimerini (Greek newspaper) online English edition, 17 Apr 2015

⁴⁵ "[ECB Spares Greece for Now as Schaeuble Seeks Substance on Plans](#)", Bloomberg, 12 May 2015 and Bruegel think tank, "[Greece's hot summer](#)", 14 May 2015

⁴⁶ "[Greece taps reserves to pay IMF loan](#)", BBC News, 12 May 2015

Greek government ministers repeatedly said that if the government had to choose, it will prioritise paying pensions and salaries rather than its foreign debt repayments.⁴⁷

This came to pass on 30 June when Greece missed a €1.5 billion loan payment to the IMF. This was originally due to be paid in four instalments over the course of June, but Greece didn't make the first payment in early June, instead using an obscure IMF rule which allowed it to bundle all payments due in June into one payment.

This was the first time a developed economy had ever defaulted on a loan from the IMF.⁴⁸ The IMF is usually viewed as the most senior creditor in the world. In other words, even if a country defaults on its debts to others it still pays back the IMF.

Another funding squeeze loomed immediately after the financial assistance programme ended at the end of June 2015. Greece needed to repay the ECB €3.5 billion on 20 July and €3.2 billion on 20 August for expiring Greek bonds the ECB owned.

3.4 Referendum result and aftermath

Greek voters decisively backed 'No', with 61% of the electorate backing the government's position rejecting previous draft proposals from its creditors.

A number of other Eurozone leaders framed the referendum as a vote on whether Greece should stay in the euro. This view was rejected by the Greek government, who said the 'No' vote would boost chances of receiving a favourable deal with creditors, when negotiations resumed following the vote.

On 6 July, the day after the referendum, Greek finance minister Yanis Varoufakis resigned. His negotiating style had irked fellow Eurozone finance ministers, and many thought that his departure may make it easier for a deal to be struck. Euclid Tsakalotos succeeded Mr Varoufakis as the new finance minister.

Crucially, for the first time in five years Greece was now not involved in a Eurozone bailout programme. The second bailout programme, and the remaining funding that was available to Greece, expired on 30 June 2015. This meant that a new, detailed third programme needed to be negotiated for Greece to receive financial assistance.

In the meantime, the government's funding problems grew and the banking system was in even deeper trouble than before, completely reliant on the ECB to continue to provide emergency financing, despite the imposition of capital controls and the closure of bank branches.

⁴⁷ "[Varoufakis: Greece would prioritise pensions and salaries over IMF payment](#)", Reuters, 20 May 2015

⁴⁸ A full list of other countries that have defaulted on the IMF (as of Oct 2014) are available in [table 6.3](#) of the IMF's *Financial Operations 2014* publication

4. Greek banking system and capital controls

The weakness of the Greek banking system means that it is reliant on the European Central Bank for emergency funding. The large outflow of deposits from its banks over the course of 2015 has exacerbated the crisis. Banks were shut for three weeks and capital controls were introduced in late June in order to stop Greek banks running out of money.

4.1 Greek banks reliant on funding from the ECB

Greek bank balance sheets are plagued with very high levels of non-performing loans (where the borrower is not making repayments to the bank); the IMF estimates that 34% of the total value of all loans provided by Greek banks at the end of Q4 2014 were non-performing.⁴⁹ Greek banks also hold a large quantity of Greek government debt.

Shut out of the interbank lending markets, Greek banks are heavily dependent on funding from the European Central Bank. Although the ECB on 4 February 2015 stopped accepting Greek bonds as collateral for funding, it still provides a final lifeline to Greek banks through its Emergency Liquidity Assistance (ELA) programme.⁵⁰ This channels a fixed amount of funds to the Greek central bank which is then available to Greek Banks. ELA funding is intended to be temporary and for solvent banks only.⁵¹ Changes to ELA funding need to be approved by two-thirds of the ECB Governing Council.⁵²

The ECB raised the cap on ELA funding to Greece in stages from around €60 billion initially in early February to €89 billion by 26 June, just before the announcement of the referendum.⁵³

4.2 Bank holiday and capital controls implemented on 29 June 2015

Increases in ELA funding are crucial for Greek banks in order for them to fund an outflow of customer deposits. The ELA cap was raised frequently by the ECB in June 2015 in order to meet accelerating

⁴⁹ IMF, Financial Soundness Indicators, [Cross-country tables – latest available data](#) [accessed 3 Aug 2015]

⁵⁰ ECB press release, "[Eligibility of Greek bonds used as collateral in Eurosystem monetary policy operations](#)", 4 Feb 2015

⁵¹ "[Bank funding powers make Greece vulnerable to ECB pressure](#)", Reuters, 15 Feb 2015

⁵² The main decision-making body of the ECB [comprised of](#) six Executive Board members and the heads of the 19 national central banks; at any one time 21 members have [voting rights](#) – the six Executive Board members and 15 out of the 19 national central bank governors (these are rotated)

⁵³ "[ECB Said to Allow Greek Banks 59.5 Billion Euros Emergency Cash](#)", Bloomberg, 5 Feb 2015 and "[Exclusive: ECB rejected Greek funding line request for extra 6 billion euro - sources](#)", Reuters, 29 Jun 2015

outflows of deposits, with the Greek government and its creditors still unable to come to an agreement that would release €7.2 billion in bailout funds to Greece. For example, reports say outflows topped €1 billion per day on 18 and 19 June.⁵⁴

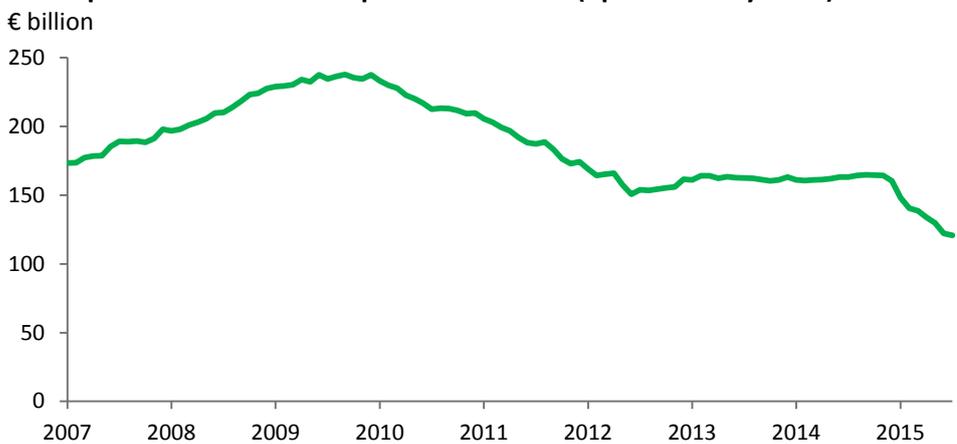
As the 30 June deadline to reach a deal approached further outflows of deposits occurred. This left Greek banks needing more money from the ELA to plug the gap.

Box 1: Deposit outflows from Greek banks

Private sector deposits in Greek banks have fallen by €42 billion, or 25%, in the seven months to the end of June 2015, to its lowest level in more than a decade. This is likely a result of the uncertainty surrounding the January election and the subsequent negotiations on the future of the bailout. In June alone, at the crisis deepened, almost €8 billion in deposits were withdrawn.⁵⁵

The Bank of Greece has stated that the money that is being withdrawn from banks is largely being hoarded in cash and not being moved abroad.⁵⁶

Greek private sector bank deposits since 2007 (up to end-July 2015)



Note: Private sector refers to deposits held by corporations and households, i.e. excluding govt
 Source: Bank of Greece statistics for deposits by sector, August 2015

Following the announcement of the referendum and the decision by other Eurozone finance ministers to essentially suspend negotiations with Greece and let the existing bailout programme expire, the ECB decided to keep providing the Greek banking system with ELA. However, the ECB crucially did not increase it from its previous level of €89 billion.

This decision, together with customers continuing to take money out of banks over the weekend of 26/27 June, meant that in order to keep banks from becoming insolvent capital controls limiting how much money could leave Greek banks were introduced. Banks were also closed from Monday 29 June, as was the Athens stockmarket.

⁵⁴ ["European Central Bank Increases Emergency Lending to Greece as Deposit Flight Mounts"](#), Wall Street Journal, 19 Jun 2015

⁵⁵ Bank of Greece statistics, [Deposits by sector](#), Aug 2015

⁵⁶ Bank of Greece, ["The Bank of Greece Report on Monetary Policy 2014-2015"](#), 17 Jun 2015

The bank holiday and capital controls were formally announced on Sunday 28 June by Greek authorities. This involved:

- banks being closed;
- cash withdrawals from ATMs being limited to €60 per day per bank card (foreign cards are exempt from this limit); and
- only foreign transactions approved by a new government committee will be approved (money is allowed to come into Greece from abroad). Domestic electronic transactions were not affected according to the government.⁵⁷

4.3 Banks reopened but capital controls remain

Following the 12 July agreement in principle for a third Eurozone bailout agreement, the ECB raised its emergency funding via its ELA programme for the Greek banking system to above €90 billion. This eased the pressure somewhat, allowing for banks to open their doors – and the Athens stockmarket to reopen – for the first time in three weeks on 20 July.⁵⁸

The reduction in uncertainty following the bailout deal has led to the stabilisation of deposit outflows from Greek banks. Following requests from the Greek central bank, the ECB has reduced its emergency funding to the Greek banking system. As of 13 October, the ELA limit stood at €87.9 billion.⁵⁹

Capital controls, however, remain in place although they were eased somewhat on 20 July. Cash withdrawals are limited to €420 per week (instead of €60 per day) and restrictions of purchases of foreign goods and services have been eased.⁶⁰

⁵⁷ [“What Are Greece's Capital Controls?”](#), Bloomberg, 29 Jun 2015

⁵⁸ [“Greece reopens banks and pays off some debt in first steps towards normality”](#), Guardian, 20 Jul 2015

⁵⁹ Bank of Greece press release, [“ELA-ceiling for Greek banks”](#), 7 Oct 2015

⁶⁰ [“Capital controls are eased but companies see it as insufficient”](#), Kathimerini (Greek newspaper) online English edition, 31 Jul 2015

5. Third bailout programme negotiations

At a 12 July 2015 meeting of Eurozone leaders, a provisional agreement was struck on a third bailout programme for Greece which could total up to €86 billion in loans over three years. Formal negotiations on the detail of the programme were concluded in mid-August.

These talks fleshed out the detail – in a “Memorandum of Understanding” – of the terms of the financial assistance package agreed in principle on 12 July. It requires Greece to implement a reform agenda including changes to the pension system and market-based reforms of the economy to make it more competitive. The first loan payment of the programme was provided to Greece on 20 August.

5.1 Post-referendum developments

In the week following the 5 July referendum, the Greek government made a formal request to the European Stability Mechanism (the Eurozone bailout fund) for loans in return for “comprehensive” reforms. The requested financial assistance programme would be last for three years and be its third bailout package since 2010.⁶¹

Following an emergency meeting of Eurozone leaders on 7 July, president of the European Council Donald Tusk announced that there would be a meeting of Eurozone finance ministers (the Eurogroup) on 11 July followed by another meeting of Eurozone leaders on 12 July.⁶² A meeting of all 28 EU leaders was also scheduled for later on 12 July. This was significant because it signalled that should a deal not be reached, all EU leaders – and not just those in the Eurozone – would be needed to discuss providing humanitarian assistance to Greece following the then likely Greek exit from the Eurozone.⁶³

Mr Tusk made it clear that these meetings would be the final chance for an agreement to be reached:

The stark reality is that we have only five days left to find the ultimate agreement. Until now, I have avoided talking about deadlines. But tonight I have to say loud and clear that the final deadline ends this week.⁶⁴

In short, Greece would be on the way out of the Eurozone if no agreement was reached on the weekend of 11-12 July.

ECB threatens to remove emergency bank funding

In the week before the weekend summits, the European Central Bank (ECB) left unchanged the emergency funding – Emergency Liquidity Assistance (ELA) – it was providing to keep the Greek banking afloat. The ECB warned that it would be obliged to cut off all emergency

⁶¹ “[TEXT-Greece's request for a 3-year loan facility to the ESM](#)”, Reuters, 8 Jul 2015

⁶² European Council, “[Remarks by President Donald Tusk after the Euro Summit of 7 July 2015 on Greece](#)”, 7 Jul 2015

⁶³ Guardian, [Greece Crisis Live Blog: 10.07pm entry](#), 7 Jul 2015

⁶⁴ Ibid.

assistance if there was no prospect of a deal.⁶⁵ In addition, Greece had a €3.5 billion debt repayment due to the ECB on 20 July and still owed the IMF €1.5 billion from its missed repayment due on 30 June.

This would probably have necessitated the Greek authorities having to issue IOUs (a form of parallel currency) or explicitly introduce a new currency to recapitalise the banks. Either way, this would probably eventually lead to Greece formally leaving the Eurozone (see section 7 for more on the potential consequences of 'Grexit').

5.2 July 12 agreement to start third bailout

The Greek government presented its reform proposals to its creditors on 9 July. These involved things that were included in the previous proposals from creditors and rejected in the referendum only a few days earlier, including raising VAT on a number of items and concessions on pension reform.⁶⁶ The Greek parliament approved these plans early on Saturday morning, 11 July.⁶⁷

The Eurogroup meeting of finance ministers on 11 July ended without a breakthrough. The meeting was meant to lay the groundwork for Eurozone leaders to agree a deal the following day. However, some countries including Germany and Finland, citing the lack of trust they had in Greek government promises, pushed for further concessions. Eurogroup president Jeroen Dijsselbloem said talks had been "very difficult".⁶⁸

Given these difficulties and the likelihood that the Eurozone leaders' summit would extend into the night, the proposed meeting of all 28 EU leaders was cancelled.

A further meeting of the Eurogroup was held on Sunday morning 12 July, followed in the afternoon by the summit of Eurozone leaders.

It emerged in a leaked draft statement from the discussions that creditors were demanding Greece pass a series of reforms in the following week before they would agree in principle to a new three-year €82-€86 billion loan. The draft also contained the option – not agreed by all creditor countries – that in the event of no agreement being reached, Greece could be offered a "time-out" from the euro to restructure its debt.⁶⁹

As talks extended into the evening and then into the early hours of Monday morning, the prospects of a deal being reached were receding and those of Greece leaving the Eurozone were growing.

Then, at around 9am on Monday 13 July, after 17 hours of negotiations, an agreement was reached.⁷⁰

⁶⁵ "No deal, no liquidity, ECB's Noyer tells Greece", Reuters, 8 Jul 2015

⁶⁶ "Leaked: Greece's new economic reform proposal", FT Brussels Blog, 10 Jul 2015

⁶⁷ "Greece debt crisis: MPs back bailout reform plan", BBC News online, 11 Jul 2015

⁶⁸ Eurogroup, [Eurogroup 11/7/2015](#)

⁶⁹ Ed Conway, Sky News Economics Editor, Twitter account, [5.42pm \(UK\) 12 Jul 2015](#)

⁷⁰ European Council statement, [Remarks by President Donald Tusk after the Euro Summit of 12 July 2015 on Greece](#)

Terms of the agreement

The deal that was reached was an agreement in principle for a third bailout programme of loans totalling around €82-€86 billion to Greece in return for a series of reform packages. Formal negotiations on the terms of the full legal memorandum of understanding between Greece and the European Stability Mechanism (ESM), the Eurozone bailout fund, would now be able to proceed should a number of conditions first be met.

These conditions involved the Greek parliament legislating for a series of measures, including VAT increases and some pension reforms (see next section below for more).

Should these conditions be met, the terms of the agreement set out what is broadly expected of Greece in order to secure the loans it requires (the details were agreed later as part of the formal negotiations):

- comprehensive reforms of the pension system that will save the state money;
- “ambitious product market reforms” including Sunday trade, and opening up “closed professions” to competition;
- privatisation of the electricity transmission network (unless other alternatives can be agreed);
- reforms to de-regulate the labour market; and
- to take measures to strengthen the financial sector.⁷¹

In addition, a significant privatisation programme would be introduced. “Valuable Greek assets” will be transferred to a fund based in Greece which will then “monetize the assets” via privatisations and investing those assets. This revenue, targeted at €50 billion over the three years of the bailout programme, will be used to recapitalise Greek banks (€25 billion), with any remaining money raised split equally for investment in Greece and used to reduce Greek debts.⁷²

This measure was controversial and almost scuppered the deal entirely. The original German proposal for this €50 billion fund of Greek assets called for it to be based not in Greece but in Luxembourg. This was anathema to the Greek Prime Minister Alexis Tsipras. A report in the *Financial Times* stated that a disagreement between Mr Tsipras and Angela Merkel, the German Chancellor, on the size and purpose of this privatisation fund led to both deciding that no deal could be reached. The report suggests that only an intervention from Donald Tusk, European Council president, managed to restart discussions and facilitate the compromise.⁷³

The Greek government did get a commitment from the Eurogroup to keep the possibility of debt relief on the table:

⁷¹ European Council statement, [Euro Summit Statement 12 July 2015 \[pdf\]](#)

⁷² Ibid. and Eurogroup, [Press remarks by J. Dijsselbloem, President of the Eurogroup after the Eurozone summit of 12 July 2015](#)

⁷³ [“Greece talks: ‘Sorry, but there is no way you are leaving this room’”](#), Financial Times, 13 Jul 2015

[...] the Eurogroup stands ready to consider, if necessary, possible additional measures (possible longer grace and payment periods) aiming at ensuring that gross financing needs remain at a sustainable level.⁷⁴

However, the statement clearly rules out any explicit debt reductions. In other words, the total value of debt repayments will not be lowered, just the time Greece has to make the repayments may be extended.

Analysis and reaction to agreement

Most commentators thought the Greek government and Prime Minister Tsipras had conceded significant ground in order to get an agreement and keep Greece in the Eurozone.⁷⁵ Many noted that the terms of the deal were harsher than those offered by creditors at the end of June that were rejected by the government and the Greek electorate in the referendum.

On the other hand, negotiations this time around were for an entirely new bailout agreement with a substantial greater amount of money being offered over a three-year period. The talks in June were related to a final instalment on the second bailout programme, which expired on 30 June. Therefore, perhaps it is not surprising that other Eurozone nations were after stricter conditions for this larger loan.

Mr Tsipras stated that negotiations were difficult but he claimed some successes too: financing over the medium-term, the potential for debt relief and stopping the €50 billion fund of Greek assets being based outside of Greece.⁷⁶

He agreed that it was a “bad deal” but the best available given the circumstances. He argued that the alternative of the Greek banking system collapsing would have been worse:

The hard truth is this one-way street for Greece was imposed on us. [...]

A disorderly default would not only have led to a collapse of the banking system and a disappearance of all deposits, but it would force you to print a currency which would be drastically devalued because there is no reserve to support it.⁷⁷

Now that an agreement has been reached, focus shifted to whether it would be implemented given the anti-austerity rhetoric from the Syriza. Also, there are question marks over how accommodating some Eurozone countries such as Germany, Finland and Slovakia will be if there is any slippage or watering down of any of the terms of the agreement in the years ahead.

⁷⁴ European Council statement, [Euro Summit Statement 12 July 2015 \[pdf\]](#)

⁷⁵ See for example, FastFT, “[Now what? Reactions to the Greek deal](#)”, 13 Jul 2015

⁷⁶ Guardian, Greek crisis live blog [13 Jul 2015 12:20pm entry](#)

⁷⁷ “[Greek PM: bailout deal must be implemented, even if “one-way street”](#)”, Reuters, 14 Jul 2015

5.3 National parliaments give green light for formal negotiations to begin

As part of the 12 July agreement in principle, the Greek parliament needed to legislate in a number of areas in order for the other Eurozone countries to mandate the start of formal negotiations over the bailout programme.

On the night of 15 July, the Greek parliament passed a package of laws as required. These included:

- Raising VAT on a number of goods and services (including restaurants) to the standard 23% rate;
- the abolition of the 30% discount on VAT for Greek islands;
- reforms of pension entitlements.⁷⁸

On 17 July, the German parliament voted to give the go ahead for formal talks for the bailout programme to begin. Other parliaments who were also legally required to give a mandate for talks to begin did so.

On the night of 22 July, the Greek parliament passed additional legislation that was required as part of the 12 July agreement.⁷⁹ These measures included reforming the civil justice system and implementing the EU's bank recovery and resolution mechanism – new rules on how Member States should deal with troubled financial institutions.⁸⁰

As a result, official talks between Greece and its creditors in drawing up a full memorandum of understanding – the legal terms – of the loan could begin.

5.4 EU bridging loan to Greece

While the necessary steps to start formal negotiations on the loan from the European Stability Mechanism (ESM) were being taken, Greece still had severe funding issues. It was €2 billion in arrears to the IMF (€1.5 billion from the end of June and a further €456 million on 13 July⁸¹) and was required to make a debt repayment of €3.5 billion to the ECB on 20 July.

No money from the ESM was distributed to Greece until a full legal agreement had been reached. This was expected to take at least a few weeks. In the meantime, an alternative funding arrangement was needed.

This was achieved via a 'bridging loan' of €7.2 billion (£5.1 billion) agreed by EU member states and paid to Greece on 20 July.⁸² In a matter of hours it was used to pay off its €2 billion arrears to the IMF

⁷⁸ "[Greece debt crisis: Eurozone deal laws backed by MPs](#)", BBC News online, 16 Jul 2015

⁷⁹ "[Creditors to start talks after Greece passes bailout bill](#)", AFP, 23 Jul 2015

⁸⁰ EU [Directive 2014/59/EU](#). For more see the Library briefing paper, [European banking union](#)

⁸¹ IMF press release 15/334, [Statement by the IMF on Greece](#), 13 Jul 2015

⁸² Council of the EU press release, "[EFSM: Council approves €7bn bridge loan to Greece](#)", 17 Jul 2015

and make a €3.5 billion debt repayment to the ECB.⁸³ If Greece had failed to repay the ECB on time, it is likely that the ECB would have heavily reduced, or withdrawn entirely, the emergency funding it was providing to keep the Greek banking system afloat.

The €7.2 billion loan came from the European Financial Stability Mechanism (EFSM), a temporary €60 billion fund underpinned by the EU budget and therefore potentially involving some liability for non-Eurozone member states including the UK.⁸⁴ (€46.8 billion of the EFSM had previously been lent to Ireland and Portugal.)

The €7.2 billion loan had a maximum maturity of three months and was repaid when the full terms of the ESM agreement between Greece and the other Eurozone countries were completed.

Box 2: Financial protection from losses for UK and non-Eurozone states

The decision to provide this loan to Greece also provided financial protections to the UK and other non-Eurozone EU states. Should any losses have accrued on this loan then non-Eurozone countries would have been reimbursed fully by Eurozone member states [emphasis in original text]:

Full safeguards for non-euro area member states

A mechanism has been designed so as to ensure that **non-euro area member states do not carry any risk**. Under the decision, the exposure of non-euro area member states will be fully guaranteed by liquid collateral under legally binding arrangements. If Greece were unable repay the loan in accordance with its terms, any liabilities incurred by non-euro area member states would be immediately reimbursed.⁸⁵

The European Commission have also agreed to change EU regulations for the future use of the EFSM so that financial guarantees for non-Eurozone member states are always provided when a Eurozone country receives financial aid. In other words, as with the €7.2 billion loan, non-Eurozone countries including the UK will now not be liable for any potential losses from EFSM loans to Eurozone nations. This change was formally adopted on 4 August 2015.⁸⁶

5.5 Negotiations on final deal

With all the pre-conditions completed, negotiations began on the terms of the up to €86 billion (£61 billion) bailout. Talks between the Greek government and the “quartet” of creditor institutions - the European Commission, European Central Bank, IMF and European Stability Mechanism (the Eurozone bailout fund) – were completed in a few weeks. This was quicker than some had thought likely, with creditors praising the Greek authority’s attitude to negotiations.⁸⁷

These talks fleshed out the detail – in a “Memorandum of Understanding” – of the terms of the financial assistance package agreed in principle following the 12 July Eurozone leaders’ summit. A staff level agreement was completed on 11 August.

⁸³ ECB Twitter account, [5.31pm \(UK time\) 20 Jul 2015 tweet](#) and IMF press release 15/344, [Statement by the IMF on Greece](#), 20 Jul 2015

⁸⁴ European Commission, [European Financial Stabilisation Mechanism \(EFSM\)](#)

⁸⁵ Council of the EU press release, [“EFSM: Council approves €7bn bridge loan to Greece”](#), 17 July 2015

⁸⁶ Council of the EU press release, [“EFSM revised to shield non-euro area countries from risk”](#), 4 Aug 2015

⁸⁷ Eurogroup, [Eurogroup statement on the ESM programme for Greece](#), 14 Aug 2015

The Greek parliament approved the terms of the bailout on 14 August, and the Eurogroup of Eurozone finance ministers did likewise later the same day.⁸⁸ Shortly afterwards, the few Eurozone countries that required their parliaments to approve the deal (including Germany) had done so.

On 19 August, the European Commission and Greece formally signed the Memorandum of Understanding for the bailout programme.⁸⁹ The first loan instalment was then provided to Greece (see below for more), before it was due to make a €3.2 billion debt repayment to the ECB on 20 August.

5.6 Terms of the bailout programme

The terms of the Memorandum of Understanding – the detailed policies that Greece is required to implement in return for financial assistance – are very similar to those agreed in the 12 July Eurozone leaders' summit statement (summarised in section 5.2 above). Greece is expected to implement a reform agenda including:

- Reform of the pension system, removing exemptions and ending early retirement;
- De-regulate labour and product markets, with the aim of increasing competition, competitiveness and investment in the economy;
- Tackle tax evasion and fraud and improve tax administration;
- Fight corruption by improving efficiency of the public sector and judiciary;
- Implement a strengthened privatisation programme, including setting up a fund containing Greek assets that will either be sold or used to earn financial returns;
- Improve financial stability by strengthening the banking sector.

The programme also calls for Greece to run a public sector budget surplus excluding debt interest payments (a primary surplus) over the 'medium term' of 3.5% from 2018. If it does so, the debt-to-GDP ratio will likely decline. However, due to the weak economy Greece is expected to have a budget deficit this year. As such, the terms of the deal call for a gradually improving primary surplus of -0.25% in 2015, 0.5% in 2016 and 1.75% in 2017. Even this 2015 target is ambitious. The agreement requires Greece to introduce a supplementary budget in October 2015 that will either cut spending or raise revenues in order to hit the agreed budget target.

Financial assistance

In return for implementing this agenda, Greece will receive loans of up to €86 billion (61 billion) over a three-year period. This will be distributed in a series of tranches, following reviews conducted by Greece's creditors of the progress of its reforms.

⁸⁸ Eurogroup, [Eurogroup statement on the ESM programme for Greece](#), 14 Aug 2015

⁸⁹ European Commission, [Financial assistance to Greece](#) [accessed 17 Sep 2015]

The first loan tranche from this third bailout is worth €26 billion (£19 billion) and will be distributed in a few stages.⁹⁰ Upon official approval of the programme from all Eurozone countries, €13 billion was provided to Greece on 20 August. This allowed Greece to make a €3.2 billion debt repayment to the European Central Bank due on this day and repay the €7.2 billion bridging loan from the EU's EFSM fund (see section 5.4 above for more).⁹¹

A further €10 billion was also provided on 20 August for bank recapitalisation. This money will be kept within the European Stability Mechanism (ESM), the Eurozone bailout fund, until it is needed.

An additional €3 billion will be available for disbursement in autumn 2015 following the implementation of "key milestones" (read: reforms) included in the Memorandum of Understanding.

A second loan tranche of up to €15 billion will be available for bank recapitalisation after the first creditors' review of the programme's progress.

The IMF are not initially involved in this programme. It still has an ongoing bailout programme with Greece scheduled to run until March 2016. Some Eurozone countries, including Germany, are keen on the IMF's participation in this third bailout. If it did so it would provide some of the €86 billion in loans earmarked for Greece (probably between 10% and 30% of this), lowering the amount the Eurozone would have to contribute.

The IMF has said it will only participate if Greece receives some form of debt relief. The possibility of debt relief for Greece is included in the Memorandum of Understanding although writing off some of the debt owed to other Eurozone countries is explicitly ruled out. Instead, debt relief could take the form of delaying when Greece has to repay the debt it owes.

For more on the IMF's role and Greece's debt sustainability, see sections 6.2 and 6.3, respectively.

Implementation of deal

Now that the details of the programme have been agreed and signed off, the focus shifts on to its implementation. Will the Greek government implement the austerity and market-based reforms called for? Will a successful implementation of the deal actually improve Greece's public finances and economic prospects?

⁹⁰ Eurogroup, [Eurogroup statement on the ESM programme for Greece](#), 14 Aug 2015

⁹¹ ECB Twitter account, [4.46pm \(UK time\) 20 Aug 2015 tweet](#)

6. Important issues

While the third Eurozone bailout programme worth up to €86 billion has been agreed, there are still a number of important issues that will help shape its success or failure and, more broadly, Greece's future. Some of these are examined in this section.

6.1 Political situation in Greece

The day Greece received its first instalment of loans from the newly-signed third Eurozone bailout agreement, the Greek Prime Minister, Alexis Tsipras, resigned and called for new elections to be held on 20 September.

This followed splits within the radical left-wing Syriza party, who are the senior party in the Greek governing coalition, elected in January 2015. A significant minority of Syriza MPs were unhappy with the Prime Minister for accepting the terms of the new bailout agreement and voted against it in parliament (see box for more details of the split within Syriza).

With his government unable to command a majority without the help of opposition parties, Mr Tsipras called for new elections for September 2015. He also stated that his mandate from the January elections had been exhausted and that given the terms of the new bailout deal, which were worse than he had expected January, the Greek people should have their say.⁹²

Shortly after this announcement, many of the Syriza rebels unhappy with the terms of the bailout deal, broke away and formed a new political party called Popular Unity. They promised to fight against the austerity measures and called for the cancellation of some of Greece's debt.⁹³

September 2015 election

The 20 September 2015 general election saw Syriza returned to power with 35.5% of votes, compared to 28.1% for their main rival the centre-right New Democracy party. In the 300-seat parliament, Syriza has 145 seats (50 bonus seats are awarded to the party with the highest vote share).⁹⁴ Syriza formed a coalition with the small right-wing Independent Greeks, as they had done after the January 2015 election, with Syriza leader Alexis Tsipras back as Prime Minister. In other words, continuity of government was retained.

Therefore the risk that political uncertainty could make implementation of the new bailout deal more difficult has eased after the election. It can be argued that as Syriza has lost some of its most radical MPs, it may be easier for Prime Minister Tsipras to exert control of his party, and thus

⁹² "[Greece crisis: PM Alexis Tsipras quits and calls early polls](#)", BBC News, 20 Aug 2015

⁹³ "[Greek crisis: Syriza rebels form Popular Unity party ahead of election](#)", Guardian, 21 Aug 2015

⁹⁴ Greek Ministry of the Interior, [Parliamentary elections September 2015](#)

the prospects of the bailout agreement being implemented and lasting the full three years may be strengthened.

Box 3: Evolution of dissent within Syriza

The radical left-wing Syriza party, the senior party in the Greek governing coalition, is itself a coalition of radical left-wing groups, and contained some members who are resolutely against any climbdowns from the stance it took during the January 2015 election campaign. Already in February, following a preliminary Eurogroup agreement, a few members of Syriza expressed their anger at what they saw as the party's failure to honour its election commitments.⁹⁵

The party's radical Left Platform grouping regularly voiced their displeasure at the "blackmailing tactics" of Greece's creditors and have influence on the party via its Central Committee.⁹⁶ This group wanted the government to reject any agreement that cuts pensions or workers' rights. Some members of the Left Platform also suggested Greece should default on its debt and leave the Eurozone.⁹⁷

In the wake of the 12 July agreement in which Syriza leader and Prime Minister Alexis Tsipras accepted a deal that went against a large part of his and his party's past anti-austerity commitments, a number of Syriza MPs rebelled against the government.

In two votes, on the nights of 15 July and 22 July, the Greek parliament passed a package of laws as required in order to start formal talks on the new bailout of up to €86 billion. On 14 August, a further vote approved the conditions in the draft Memorandum of Understanding underlying the bailout programme. Between 35 and 40 Syriza MPs – out of 149 – failed to vote for each of these legislative packages. A large part of the opposition, however, voted with the government to ensure comfortable majorities in all instances.⁹⁸

The vociferous criticism of the new bailout agreement eventually led to the creation of a rival political party called Popular Unity led by former members of Syriza's Left Platform.⁹⁹ In the September 2015 general election Popular Unity failed to meet the 3% of the popular vote threshold required to enter parliament and therefore does not have any MPs.

6.2 IMF involvement in third bailout package

The 12 July 2015 agreement for a third Eurozone bailout package includes a passage stating that Greece will "request continued IMF support (monitoring and financing)" once the IMF's current loan programme ends in March 2016 (the IMF has paid out around €12 billion out the €28 billion available).¹⁰⁰

Some Eurozone countries, notably Germany, are keen on the IMF's continued involvement alongside the new Eurozone bailout that will run until 2018. The head of the European Stability Mechanism (where the Eurozone's bailout loans will come from) has said that he expects about €50 billion of the approximately €86 billion total bailout to ultimately come from the ESM.¹⁰¹ The rest could come from privatisation proceeds,

⁹⁵ ["Greek bailout: Government reveals economic reforms – but Syriza dissenters says it has gone back on its election promises already"](#), Independent, 23 Feb 2015

⁹⁶ ["SYRIZA's Left Platform makes gains but proposal voted down"](#), Kathimerini (Greek newspaper) online English edition, 25 May 2015

⁹⁷ ["Greece's Governing Syriza Party Divided Over Debt Terms"](#), Wall Street Journal, 25 May 2015

⁹⁸ ["Greek PM Tsipras rallies Syriza backing before bailout vote"](#), Reuters, 22 Jul 2015

⁹⁹ ["Greece's Syriza Will Hold Emergency Congress in September"](#), Wall Street Journal, 30 Jul 2015

¹⁰⁰ European Council statement, [Euro Summit Statement 12 July 2015 \[pdf\]](#)

¹⁰¹ ESM, transcript of [16 July Interview of ESM MD Klaus Regling with ARD Morgenmagazin](#)

a return of profits made by the European Central Bank from its holdings of Greek debt and loans from the IMF.¹⁰²

The IMF – along with the European Commission, ECB and ESM – were involved in negotiating the terms of the new bailout with the Greek government. However, the IMF is reluctant to provide further loans itself unless Greece receives some debt relief given Greece’s current high levels of debt.

The IMF has repeatedly called for debt relief for Greece and has said that it would only support a loan programme that offers medium-term sustainability.¹⁰³ A 14 July report published by the IMF on Greece’s debt stated that public debt has become unsustainable and that debt relief is needed.¹⁰⁴

If there is no IMF involvement in this third bailout programme, then the ESM, and therefore the other Eurozone countries, would have to provide larger loans to Greece. This could make Germany a less willing participant in the programme and less likely to give the go-ahead for future loan instalments to Greece.

The new ESM agreement has now begun without the IMF.¹⁰⁵ There is the possibility that after the first review of the ESM programme, some form of debt relief could be granted to Greece by the Eurozone. This would then enable the IMF to take part in the third bailout programme in 2016.

6.3 Debt sustainability and debt relief

As noted in section 1.3, Greece has one of the highest public sector debt levels in the world at around 175% of its annual economic output (or €317 billion).

Unlike other advanced economies (such as the UK), most of Greek’s stock of debt is owed to “official institutions” such as the IMF, European Central Bank and other Eurozone countries as part of their bailout programmes. This is partly the result of private sector creditors taking losses of around €100 billion (£74 billion) on their holdings of Greek debt in 2012 (prior to the second bailout programme being agreed).

The radical left-wing Syriza-led government, and most economists, have argued that this debt burden is simply unsustainable and that some form of debt relief is needed.

Some, however, argue that one shouldn’t look at the overall debt figure but instead focus on the annual cost of servicing that debt. In other words, what is the actual cost of holding this debt. As most of the debt is owed to other Eurozone countries and the financial terms of these

¹⁰² For more see FT Brussels Blog, “[Who will pay for Greece’s new €86bn bailout?](#)”, 17 Jul 2015

¹⁰³ For example, IMF, [Transcript of a Conference Call by an IMF Official on Greece](#), 30 Jul

¹⁰⁴ IMF, [Greece: An Update of IMF Staff’s Preliminary Public Debt Sustainability Analysis](#), 14 Jul 2015

¹⁰⁵ Although the IMF’s current, second, bailout programme is ongoing until in March 2016. But this is likely to be aborted if it joins the Eurozone’s third bailout.

loans are very favourable, with very low interest rates and very long durations (some loans aren't due to be fully repaid until 2054), annual debt interest payments aren't so onerous. The OECD estimates that in 2015 this amounts to 4.1% of GDP in Greece, comparable to Portugal (4.2%) and Italy (4.0%) but higher than most OECD countries (the UK figure is 2.5%).¹⁰⁶

The IMF believes that Greek public sector debt is unsustainable and has repeatedly called for debt relief. A 14 July debt sustainability analysis from IMF staff unequivocally states this:

The financing need through end-2018 is now estimated at Euro 85 billion and debt is expected to peak at close to 200 percent of GDP in the next two years, provided that there is an early agreement on a program. Greece's debt can now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far.¹⁰⁷

The analysis blames previous Greek government for failing to implement reform measures in past bailout programmes which it says led to higher debt levels. It also notes that the closure of banks (for three weeks) and imposition of capital controls have "extract[ed] a heavy toll on the banking system and the economy" and resulted in deterioration in debt sustainability.

The 12 July Eurozone leaders' summit, where a deal was in principle agreed to a new third bailout programme, stated that some form of debt relief could be granted to Greece by the Eurozone. It explicitly notes that "nominal haircuts on the debt cannot be undertaken", meaning none of Greece's debt will simply be written off.¹⁰⁸ Instead, debt relief is likely to take one of the following forms:

- Longer grace periods, pushing back the date of when Greece makes its first loan repayment;
- Extending the duration of the loans from the bailout programmes, meaning Greece has longer to pay back the loans (loan durations are already very long);
- Lowering the interest rate of the loans Greece has to repay, although there isn't much scope to lower them much further as they are already very low.

All these options lower Greece's annual debt interest repayments but do reduce the cash value of the loans it has to repay. The text of the Euro summit agreement also states that these measures would only be available to Greece once it has implemented a series of reforms and after the first review of the new bailout programme has been conducted successfully. If all goes to plan, this would probably be during the last few months of 2015.

¹⁰⁶ OECD Economic Outlook June 2015, [Annex table 31](#) [access 13 Aug 2015]

¹⁰⁷ IMF, [Greece: An Update of IMF Staff's Preliminary Public Debt Sustainability Analysis](#), 14 Jul 2015

¹⁰⁸ European Council statement, [Euro Summit Statement 12 July 2015 \[pdf\]](#)

6.4 Economy

The imposition of capital controls and the three-week closure of banks in late June are likely to have had a serious effect on the economy by restricting business activity. Indeed, early evidence from business surveys for July show a collapse in trade and confidence.¹⁰⁹

Firms have been severely restricted in what they can import, businesses can't get loans from banks, and consumers and businesses will be reluctant to make large purchases or investments in such conditions.

Analysis conducted by the European Commission, European Central Bank and the ESM bailout fund forecast Greece's economy to contract by 2.3% in 2015, with a further fall of 1.3% in 2016, before growth of 2.7% in 2017.¹¹⁰ In May 2015, the European Commission forecast growth of 0.5% in 2015 and 2.9% in 2016.¹¹¹

The weakening economy will lead to falling tax receipts, putting further pressure on the public finances. This is recognised in the bailout agreement as agreed by the creditor institutions and Greece, which calls for primary budget balances – government spending excluding debt interest payments, minus tax revenues – of a deficit of 0.25% of GDP in 2015, and surpluses of 0.5% in 2016, 1.75% in 2017 and 3.5% in 2018 and beyond.¹¹² These are much lower targets than in the previous bailout agreement, reflecting the deterioration in economic conditions.

6.5 Banking sector recapitalisation

One of major issues that has to be addressed in the bailout programme is the need to recapitalise the Greek banking system. This is largely due to the high levels of non-performing loans it has on its books. These are loans where the borrower is not making repayments to the bank who issued the loan.

IMF data for end 2014 estimate that 34% of the total value of loans were non-performing.¹¹³ The imposition of capital controls in late June (see section 4 for more) and its negative impact on the economy will likely result in this figure rising. The consequence is that banks require more capital to absorb future losses arising from these loans.

The terms of the third Eurozone bailout programme state that Greek banks require up to €25 billion in additional capital and that capital shortfalls should be addressed fully by end 2015.¹¹⁴ An Asset Quality

¹⁰⁹ For example, the Markit survey of purchasing managers in the manufacturing sector [showed](#) a record contraction in July.

¹¹⁰ [Debt sustainability analysis](#) conducted by European Commission, ECB and ESM, leaked to [Wall Street Journal](#), 13 Aug 2015

¹¹¹ ["Greece creditors raise 'serious concerns' about spiralling debt levels"](#), Guardian, 13 Aug 2015

¹¹² European Commission, [Spring 2015 Economic Forecast](#)

¹¹³ Leaked copy attained by Financial Times of [staff level draft agreement of Memorandum of Understanding for a three-year ESM programme](#), 11 Aug 2015

¹¹⁴ IMF, Financial Soundness Indicators, [Cross-country tables – latest available data](#) [accessed 3 Aug 2015]

¹¹⁵ Leaked copy attained by Financial Times of [staff level draft agreement of Memorandum of Understanding for a three-year ESM programme](#), 11 Aug 2015; Eurogroup, [Eurogroup statement on the ESM programme for Greece](#), 14 Aug 2015

Review and stress tests of the banking sector will be conducted later in 2015 to determine more specifically the steps to be taken.¹¹⁵

6.6 Upcoming debt repayments

With the agreement of the new bailout programme, Greece will be able to make forthcoming debt repayments, at the very least over the rest of 2015.

Greece cleared its arrears with the IMF on 20 July. It has a further €2.0 billion in debt repayments to the IMF due over the rest of 2015 (from September 17).¹¹⁶

Greece also has to roll over billions in short-term government debt (treasury bills) over the rest of 2015, but these are mostly held by domestic banks, who will likely renew these loans when they mature.

¹¹⁵ For more see comment pieces from George Magnus, "[Greek crisis: can the deal be banked?](#)", Prospect magazine, 11 Aug 2015; and Hugo Dixon, "[How to fix Greece's banks](#)", Reuters Breakingviews, 10 Aug 2015

¹¹⁶ "[Greece's Debt Due: What Greece Owes When](#)", Wall Street Journal, 7 Aug 2015

7. What if Greece leaves the Eurozone?

The newly-agreed €86 billion Eurozone bailout programme reduces the short-term likelihood of Greece leaving the Eurozone. Nevertheless, many think that over the medium-term 'Grexit' is still possible. This section investigates the consequences of Grexit on the Eurozone and UK economies.

7.1 Banking system would be the most likely trigger for Grexit

The banking system is the most likely channel through which Greece would be forced to leave the Eurozone. The European Central Bank (ECB) is providing substantial amounts of emergency funding and capital controls are in place (see section 4 for more). Although not likely while the bailout programme is seen as working, if the ECB decided to reduce or withdraw its emergency funding the Greek government may have to create a parallel currency to the euro to provide money to Greek banks.

In addition, with the Greek government short of money, at some point it might be unable to pay salaries, state benefits and suppliers with euros and instead issue IOUs (a form of parallel currency). In theory, the IOUs would have the same value, being backed by government. However, given the circumstances in which they were issued, those receiving them would likely prefer to be paid in euros. As a result, an unofficial exchange rate would develop between IOUs and euros, with IOUs worth less.¹¹⁷

IOUs could likely only be used as a short-term measure, as confidence in this new monetary system would likely be low.¹¹⁸

In a scenario where Greece introduced IOUs and capital controls were in force, the likelihood is that this would not be sustainable nor necessarily desirable for Greece. This then may lead to Greece formally leaving the Eurozone and introducing a new currency.

This new currency would probably depreciate significantly against the euro (estimates vary, but some suggest it could fall by as much as 50%). This would make it much more expensive for Greece to import goods and services from abroad and therefore lead to a rise in inflation. Most economists expect the Greek economy to suffer another steep recession if it did leave the Eurozone.

How much debt Greece would actually default on would depend on a number of factors. But we know that the ECB, IMF and other Eurozone countries hold around three-quarters of all Greek debt. Germany, as the

¹¹⁷ "[Here's the brutal reality for ordinary Greeks if the government defaults](#)", Business Insider, 19 May 2015

¹¹⁸ For more on IOUs, or scrip, see "[Scrip tease: Greece could alleviate its shortage of cash by issuing IOUs, but only for a time](#)", The Economist, 26 Apr 2015

largest economy in the Eurozone, may face total losses of over €50 billion and possibly more.¹¹⁹

Nevertheless, there appears to be greater confidence than there was a few years ago that a Greek exit could be contained, due to banks reducing their exposure to Greece, and the ECB now able to intervene in financial markets and buy government bonds of countries facing high borrowing costs.

There is, though, disagreement among economists and commentators on the extent of possible 'contagion' spreading to other Eurozone countries and to the wider Eurozone economy. Some feel that once it has been shown that being in the Eurozone is not irrevocable, the Eurozone's credibility will be permanently damaged.¹²⁰

7.2 Impact on Eurozone and UK

The direct impact on the UK economy of Greece leaving the Eurozone ('Grexit') would probably be small. Greece, for instance, accounts for only 0.6% of total UK exports and its economy accounts for less than 2% of total Eurozone GDP.¹²¹

The UK, however, would likely be affected indirectly via the financial markets and via the wider Eurozone economy.

Financial system

The impact on the financial markets of Grexit would depend on whether it was viewed as orderly or disorderly. An orderly exit might involve the EU institutions making commitments to help Greece transition to its new currency, while pledging to support other Eurozone countries - and banks - who might now come under pressure. Such a scenario may limit the contagion and result in only a short term reaction in markets.

A disorderly Grexit where Greece is forced to introduce a new currency, perhaps shortly after the collapse of its banking system, and with minimal intervention by European authorities, could lead to a prolonged reaction on financial markets. Although British banks exposure to Greece is relatively small, the UK's large financial sector could still be impacted via contagion in the wider Eurozone financial system.

Eurozone economy

Another channel through which Grexit could affect the UK economy would be via the Eurozone economy. The UK exports 39% of its goods and services to the Eurozone and many UK businesses have deep connections with it. Falling business and consumer confidence could knock the Eurozone back into recession.

¹¹⁹ "The Greek debt: what creditors may stand to lose", Guardian, 19 Jun 2015

¹²⁰ See for instance, Robert Peston, BBC News economics editor, blog post "[How serious for us is the Greek tragedy?](#)", 16 Apr 2015

¹²¹ ONS, [Pink Book 2014](#), table 9.3; data for 2013 (latest available on 22 Jun 2015) and Eurostat, [national accounts figures for 2014](#) [accessed 22 Jun 2015]

Confidence in the UK may also be hit given the uncertainty, potentially causing businesses to hold back investments and consumers to rein in spending.

Contingency plans

In May, the Bank of England Governor Mark Carney stated that the Bank is not complacent about risks to the UK economy resulting from a Greek Eurozone exit, but doesn't believe the impact would be large:

...an intensification of the Greek crisis would have an impact on global growth and would have a modest impact on UK growth.¹²²

In June, Chancellor George Osborne has also stated that the government has taken steps to limit the impact of Grexit:

In the UK we've taken the measures to increase our economic security so we can deal with risks like this from abroad. And clearly now we must go on and complete that plan.¹²³

¹²² [Bank of England Inflation Report Q&A](#), 13th May 2015, page 24

¹²³ ["Osborne: EU must 'prepare for the worst' in Greek crisis"](#), ITV News, 19Jun 2015

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