



The Crisis in the Southern Periphery of the Euro Area – Spanish and Cypriot Examples

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Abstract

The paper deals with the problem of the debt crisis in Spain and Cyprus. Spain entered the European Communities after their establishment in the so-called second southern enlargement in 1986. Cyprus became a member of the EU in so far greatest enlargement in 2004. Spain joined the European Monetary Union in 1999, immediately after the establishment of euro. Cyprus uses euro since 2009. The Spanish and Cypriot economies have their own specifics that led to the debt crisis. The debt crisis has resulted in an economic recession that has been going on since 2008. Spanish government addresses the causes by adoption of restrictive measures, which do not stimulate economic growth. Recent evaluations of the Spanish economy are optimistic and predict a gradual overcoming of crisis from 2014. Debt crisis in Cyprus emerged from the specific economic structure of the country, which will require restructuring of the economy.

Keywords: Debt crisis, causes of crisis, impacts on Spanish economy, impacts on Cypriot economy.

1. Introduction

The introduction of the common currency of the European Union countries grouped in the euro area has many advantages and disadvantages. To ensure the stability of the common currency Member States of the European Union adopted Stability and Growth Pact, which established rules for financial discipline. Common currency began to operate in 2002 in twelve Member States of the European Union.

The debt crisis in the euro area raises many discussions among experts. Proponents of the theory of optimum monetary union are of the opinion that the creation of a monetary union in the European Union was the wrong decision, which must end in its collapse. In context with the crisis of the euro, it is oblivious of the benefits that a common currency brings its users.

In the opinion of many experts, is the current crisis in the euro area for several reasons. In the article, we mention the views of two renowned experts – Brigita Schmögnerová, former Minister of Finance of the Slovak Republic and Bernd Lucke, Professor of Economics at the University of Hamburg.

B. Schmögnerová defines three factors that led to the crisis in the euro area. For the first factor, she considers the financial crisis in the years 2008-2009 resulting in a bursting real estate bubble in Portugal, Greece, Ireland and Spain. Governments helped the indebted banks, which led to the growth of public finance deficits. For a second, considered a key cause factor built into the euro itself, fact that the creation of the euro area was a political project without real economic fundamentals. European Union Member States have decided to introduce a common currency, the euro, without creating a political union. Euro area Member States have different tax, budget and social policy resulting in a capital spillover among them. This leads to consequence in economic and social instability in the Member States. Unemployment is growing and social unrest arise, as exemplified today particularly by southern periphery of the European Union. For additional third factor, she considers financial sectors of the U.S. and UK attacking the euro through Greece (Schmögnerová, 2013).

Founder and chairman of the Alternative for Germany Bernd Lucke professor of economics at the University of Hamburg considers the introduction of the euro also politically motivated and fundamentally wrong decision. The common currency, the euro, and so-called rescue policy of providing massive loans from the European Stability Mechanism, the European Union has applied to the most heavily indebted states, segregates Europe in several dimensions. Indebted euro area Member States gave up their monetary policy, thus having no possibility to use devaluation of the national currency to regulate their economies. They are forced to accept stringent restrictive measures, which further slow economic growth, increase unemployment and decrease state budget revenues, leading to a further deepening of the crisis. The consequences of this policy are economic, social and political, which threaten European peace, freedom, prosperity and self-determination of nations. The euro is, according to Lucke, risk factor that threatens social stability, democracy and prosperity in Europe. (Lucke, 2013).

2. European Monetary Union

The European Union has 28 Member States from 1 July 2013. In 2002, 12 Member States of the Union started to use common currency euro and created a real European Monetary Union. This complex project requested, for the effective functioning of the common currency, adoption of rules with which compliance is mandatory for members of the euro area. Stability and Growth Pact requires euro area members to observe budgetary discipline. Annual budget deficit should not exceed 3% of GDP and total public debt should not exceed 60% of GDP (Baldwin and Wyplosz, 2008).

In recent years, the most problems in non-compliance with fiscal discipline – mainly crossing the budget deficit – face particularly countries, which geographically refer to as the southern periphery of the European Union – Portugal, Spain, Italy, Greece, Cyprus, and Slovenia. Reasons for indebtedness of these countries are different. One important factor is the global financial crisis, which led to a decline in economic growth and a decline in revenue to the state budgets of individual states. In addition, in these economies, there are specific reasons for their indebtedness, such as high military spending (Cyprus, Greece), inappropriate structure of the economy (Cyprus, Slovenia), and suchlike.

Table 1 Economic growth in five most indebted euro area countries

	Economic growth			Public debt as % of GDP		Budget deficit		Unemployment rate	
Country	2012	2013*	2014*	2007	2013	2012	2013	2007	2013
<i>Cyprus</i>	-2,3	-3,5	-1,3	58,8	93,1	-5,5	-4,5	4,0	13,7
<i>Greece</i>	-6,4	-4,4	0,6	107	122	-6,6	-4,6	8,3	27,0
<i>Spain</i>	-1,4	-1,4	0,8	36,3	95,8	-10,2	-6,7	8,3	26,9
<i>Portugal</i>	-3,2	-1,9	0,8	68,4	124	-5,0	-4,9	8,1	17,3
<i>Ireland</i>	0,7	1,1	2,2	25	93,1	-7,7	-7,3	4,6	14,6

Source: European Commission / * forecast

Eight years after introduction of euro as a legal tender, in 2009 in some euro area countries began to show negative phenomena, which could lead to a destabilization of the euro.

Causes of the crisis in the euro area countries have different character. Small economies of the euro area as Greece, Portugal, and Ireland and medium-sized economy of Spain ensured their economic growth by providing loans and by real estate boom.

3. Spain and the EU

Spain joined the European Communities in 1986 together with Greece, Ireland and Portugal. At that time, Spain belonged to the poorest countries of the Communities. Treaty on the functioning of the European Union assumed creation of the Cohesion Fund, which co-financed challenging infrastructure and environmental projects. Before joining the European Communities, Spain recorded between 1981-1985 average annual GDP growth of 0.86%. After entry into the EC in the period 1986-1990, GDP grew annually by 4.27%¹. In the pre-crisis period, the construction industry contributed to the GDP by 10%².

Engine of the Spanish economy is tourism and construction. In 2006, Spain built 760,000 new dwellings, which was more than in Germany, Italy and the UK together. In 2009, it was only 160,000³. The decline of the real estate boom led to a downturn in the economy. Victims of the crisis are small and medium enterprises, including construction companies. In 2008, Spain closed down 177,000 companies⁴. Spanish citizens owe to their banks on outstanding mortgages about 600 billion euros, representing about half of the Spanish GDP⁵. At present, Spanish citizens are very cautious about concluding contracts. Table 2 shows development of closing mortgage contracts.

Table 2 Collapse of the mortgage market in Spain⁶

Year	2006	2007	2008	2009	2010	2011	2012
<i>Closed mortgages</i>	1 342 171	1 238 890	836 419	650 889	607 535	408 461	274 715
<i>Annual change</i>	+6,72%	-7,69%	-32,48%	-22,18%	-6,6%	-32,76%	-32,74%

Another engine of the Spanish economy has been tourism. Spain after France was the second most visited destination in the world. Before the crisis, about 60 million foreign tourists visited the country annually⁷.

The global crisis has also hit this industry. Tourism employs in Spain up to two million workers, i.e. 11.5% of the employed and contributes 11% to the GDP. Yet in 2012, 50,000 jobs were cancelled in the sector⁸. The number of tourists who visit Spain begins to grow. In 2012, the number of tourists reached almost 58 of millions⁹.

Impetus for the emergence and deepening of the Spanish debt crisis was the credit policy. The Spanish government in an attempt to prevent the recurrence of crisis endorsed a reform, which aims to control credit policy of regional savings banks (cajas). Regional savings banks will have to revert to their original mission and provide loans only within their regions. During the construction boom, regional savings banks financed projects outside their regions and after the collapse of the real estate market in 2008, they recorded a huge loan losses. Regional savings banks in line with the reform must not have assets of more than 10 billion euros and deposit market share in the region should not be higher

¹¹ www.worldbank.org

² http://ekonomika.sme.sk/clanok_tlac.asp?cl=6705772

³ Radačičová, S.: Krize srazila ceny nemovitostí ve Španělsku o pětinu, Hospodářské noviny 24.1.2012

⁴ Radačičová, S.: Krize srazila ceny nemovitostí ve Španělsku o pětinu, Hospodářské noviny 24.1.2012

⁵ Radačičová, S.: Španěle požadují odpuštění dluhu z hypoték, banky nesouhlasí, Hospodářské noviny 4.3.2013

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⁷ http://openiazoch.zoznam.sk/cl/76458Kriza_tvrdo_dopadla_na_spanielsky_turisticky_priemysel

⁸ http://ekonomika.sme.sk/clanok_tlac.asp?cl=6705772

⁹ http://ekonomika.sme.sk/clanok_tlac.asp?cl=6705772

than 35%. If they exceed these limits, they will change to “ordinary commercial banks” and will have to meet capital and other criteria. Central Bank will have oversight of the “cajas”.

The Spanish government has committed itself to increase state budget revenues and reduce costs. In 2012, the government managed to increase, due to the increase in VAT, income tax, and corporate tax, 29% of the revenues of the state budget. Budget deficit in 2012 recorded 6.3% in Spain. In 2013, it should not fall, despite the measures taken, under 4.3%¹⁰.

Spain, like other euro area countries affected by the debt crisis, requested the European Union a bailout loan for the banking sector. The total amount of financial aid reached 41 billion euros¹¹. Spain still refuses the whole rescue package. Grant of financial assistance was to hold a banking reform.

Spain's economic problems persist. Country has a high unemployment rate, poor economic performance, high public and private debt, dysfunctional banks, weak competitiveness and external environment. In addition to objective reasons, government austerity measures affect poor economic performance. In this context, the European Commission is considering to extend the period for the Spanish budget deficit to reach 3% that the country should have achieved in 2014.

High unemployment rate (more than 26%) increases population of the country living in severe poverty. Since the outbreak of the crisis, the number has doubled and now reaches about 3 million people. Widening the gap between rich and poor also increases¹².

At the end of 2013, Spain began to show the first signs of recovery from the economic recession. In September 2013, the European Commission prepared an evaluation report, which notes that Spain managed to restore investor confidence. Because of this, banks are able to gain market funds to increase their liquidity under more favorable conditions. The process of bank restructuring continues, increasing their capital reserves. Thus, they do not need further help.

4. Cyprus and the EU

Cyprus became a member of the European Union in its biggest enlargement on 1 May 2004. Country began to use common currency, the euro, together with Malta and Slovenia as the first of the ten new Member States on 1 January 2008.

Cyprus belongs, together with Estonia, Luxembourg and Malta to the four smallest economies of the European Union. The number of the country's population reaches 1.15 million (www.cia.gov/library). Absolute annual GDP reaches 17.9 billion euros. GDP per capita is 21,100 euros. The composition of GDP consists of agriculture 2.4%, industry 16.7%, and services 80.9% (www.eurostat.eu). Services as the most important sector of the economy are represented mainly by the financial sector, tourism and construction. Cyprus differs from other Member States of the European Union in military spending reaching up to 4% of annual GDP, which significantly burdens the state budget (Tyriaki, 2012).

Cyprus with the tax rate for legal entities of 10% is regarded as a tax haven¹³. Low tax rates attracted to Cypriot banking sector deposits, which are eight times higher than its GDP¹⁴. The financial sector in the Cypriot economy plays a very important role. The volume of deposits compared to the annual GDP is 717%. Average of the European Union countries is 345%. In Luxembourg, banking sector represents 2,174%, 788% in Malta, 718% in Ireland, and 311% in Germany¹⁵.

The Cypriot banks cover 70 billion euros of interest deposits. It is estimated that more than half of these deposits include foreigners, especially Russians and British¹⁶. Russian legal entities and individuals have saved about 20 – 30 billion euros in the Cypriot banks. Foreign deposits in Cypriot banks accounted for 470% of the Cypriot GDP¹⁷.

4.1. Causes of Cypriot financial problems

The most important cause of the Cyprus problem – the finance deficit – is the large coherence with the Greek economy. Greece is the main trading partner, with whom 20% of foreign trade turnover realized, while the volume decreases¹⁸. Two largest banks – Cyprus Popular Bank and Laiki Bank – **were connected** to problematic Greece, which provided extensive loans to Greek companies and purchased Greek bonds. The value of Greek bonds in connection with the crisis in Greece had to be reduced or completely deducted. Cypriot banks in 2012, due to restructuring of Greek debt, have lost 4.5 billion euros¹⁹. Greek government bonds **now constitute** virtually worthless securities of 40% of the largest reserves of Cypriot banks²⁰. The value of Greek assets of Cyprus Popular Bank decreased from 3 billion euros to 700 million euros²¹. This bank has the largest exposure to Greek debt and drains a considerable part of the required financial assistance from the European Union and International Monetary Fund.

¹⁰ Španielsko možno znovu dostane viac času, EurActiv, 30.1.2013

¹¹ <http://www.engineering.sk/index.php/component/content/article/125-tasr/1557>

¹² <http://www.teraz.sk/ekonomika/spanielsko-kriza-chudoba-pocet-rast>

¹³ www.cia.gov/library/publications/the-wordl-factbook/geos/cy

¹⁴ Sládek, J.: Krize na Kypru Merklovou posílí, Hospodářské noviny 4.4. 2013

¹⁵ Hospodářské noviny 28.3.2013

¹⁶ Hospodářské noviny, 18.3.2013

¹⁷ Hospodářské noviny, 19.3.2013

¹⁸ Hospodářské noviny 5.3.2013

¹⁹ Hospodářské noviny 5.3.2013

²⁰ Hospodářské noviny 10.7.2012

²¹ Hospodářské noviny 3.7.2012

Cyprus since 2011 is unable to finance its deficit on bond markets. Country would have to pay for the bonds prohibitively high interest rates. Yields on 10-year Cypriot bonds have risen to more than 16%²². For Cyprus, there were two options for addressing the deficit of finances from external or internal sources. Funding from external sources amounted to a loan from the European Union, International Monetary Fund, and a loan from Russia. Loan from Russia should avoid control from Cyprus creditors and the introduction of austerity measures required by the European Union and the IMF.

By the end of June 2012, Cyprus needed 1.8 billion euros loan, i.e. about 10% of GDP to recapitalize the second largest bank in the country – Cyprus Popular Bank. Cyprus applied on 25 July 2012, as a fifth of euro area countries (after Greece, Ireland, Portugal and Spain) for a bailout loan from the European Stability Mechanism.

In March 2013, Cyprus needed to take another loan for 17.5 billion euros to rescue its finances, of which 10 billion was for bank rescue²³. Otherwise, there was a possibility of national bankruptcy and leaving the monetary union.

4.2. External financing of Cypriot deficit

In the first negotiations with the European Commission, the European Central Bank and the International Monetary Fund Cypriot officials refused to meet the requirement for the granting of a loan, which was to start the privatization of state property. On 19 March 2013, the Cypriot parliament rejected the conditions for financial assistance from the European Union and the IMF. Deputies rejected a proposal to the unprecedented tax of deposits of individuals and companies held in accounts in Cypriot banks. These conditions were considered extortion.

Cyprus had to accept the conditions of the ECB, the IMF and the European Commission to obtain a loan to rescue its economy. Negotiating representatives of the European Central Bank, European Commission and the International Monetary Fund decided to release 10 billion euro package that Cyprus needed to rescue the economy, while Cyprus must have contributed from its own resources with 6.7 billion euros. To obtain this amount Cyprus had to additionally tax all deposits in the two largest banks – Cyprus Popular Bank and Laiki Bank. The rescue plan envisages the introduction of a single extraordinary tax on bank deposits in excess of 100 000 euros. Deposits of up to 100 000 euros are compulsorily insured in the Member States of the European Union. Initially, this tax was to be fixed at 9.9%²⁴. Depositors whose deposits are encumbered by tax shall be compensated in the form of shares and bonds of banks with a fixed period of maturity²⁵.

Conditions of international aid – 1 billion euros from the International Monetary Fund and 9 billion euros from the European Stability Mechanism – imply an increase in corporate tax from 10% to 12.5%. Increase in income tax should bring 200 million euros to the state budget annually²⁶.

Actions leading to the taxation of deposits led to an outflow of cash and money transfers from Cypriot banks abroad. Disproportionate withdrawals of deposits from banks occurred, therefore daily withdrawals from accounts were limited, withdrawals from term deposits were prohibited, and it was forbidden to change checks into cash. All these restrictions temporarily restricted consumption and economic growth.

On 22 March 2013, the Cyprus Parliament adopted a plan to rescue the economy in the form of the supervision of the movement of capital laws, and establishing a solidarity fund. Act on the supervision of capital should protect the banks against uncontrolled withdrawal of deposits. Solidarity Fund will issue bonds for which the Cypriot government wants to guarantee state and church property, and, where appropriate, central bank reserves.

A special commission, that will examine the outflow of funds from the Cypriot banks before taxation, was created. In addition, the Commission should examine the circumstances on which the European Commission decided to restructure the Greek state debt. Conditions under which Cypriot banks obtained Greek government bonds are considered to trigger the problems of Cypriot economy.

4.3. Impacts of financial crisis on Cypriot economy

After receipt of financial assistance from the European Stability Mechanism and the International Monetary Fund, Cyprus needs to implement a range of restructuring measures. Measures can be divided into three categories. First, these measures will lead to a reduction in government expenditures. Second, they ensure higher government revenue. These measures can be considered an immediate emergency intervention into public finance of Cyprus. At the same time, the European Union calls for the country to change the structure of the economy in which the banking sector reaches 70% of the GDP.

In the area of budget expenditures reduction, the Cypriot government submitted some rigid austerity measures such as drastic reduction in the salaries of state employees and reducing pensions. To increase budget revenues, value added tax will increase from the original 17% to 19%. The corporate tax will increase from 10% to 12.5%. Property taxes and motor vehicles taxes are expected to increase²⁷. It should be noted that due to the crisis in Cyprus, real estate prices have dropped significantly, which means a decrease in tax collection on real estate.

Increase in corporation tax from 10% to 12.5% would bring additional 200 million euros to the state budget.

Cyprus will have to, in order to stabilize the economy and public finances, privatize telecommunications, power stations and seaports.

²² Hospodářské noviny 27.6.2012

²³ Hospodářské noviny 5.3.2013

²⁴ Vajs, M.:Cyperčania si za záchranu priplatia 900 miliónov eur Pravda 23.3.2013

²⁵ Pravda 5.4.2013

²⁶ Hospodářské noviny 18.3.2013

²⁷ Pravda 13.4.2013

The European Union and the International Monetary Fund recommended the Cypriot government gradual change in the structure of the economy, which is strongly linked to the financial sector. Cyprus sees the change in the structure of its economy skeptical. The island does not possess significant volumes of natural resources. Industries are underdeveloped and prospects for development of industries is practically unrealistic. Great importance to the economy is tourism. Its capabilities are, however, also limited. There are no conditions to attract more tourists. Attracting significant numbers of tourists would only be possible by providing quality services for incoming tourists, for example by building golf courses. Due to the lack of water is the possibility of increasing income from tourism unrealistic.

Cyprus has many health care facilities geared to provide services for international clients. Similarly, many high schools and universities provide education for foreign students. Also in this area, it appears that further development possibilities are exhausted. Restructuring of the economy in the future, however, will be the only possible way for further successful progress.

If Cyprus does not solve its financing of banks and public finances, there will be uncontrolled bankruptcy. Cyprus would have to leave the euro area, and at the cost of dramatic depreciation return to the Cyprus pound. Banking sector would collapse, unemployment would begin to grow, and the population as well as financial institutions would lose billions of euros.

Cypriot entrepreneurs will lose part of their savings through additional taxation of deposits. The volume of investments in the country will be reduced by these losses and the economic situation will worsen, as shown in the Table 3. Nevertheless, this variant of the rescue of the Cyprus economy should be viewed as a better option than bankruptcy. Additional tax deposits in banks will bring Cypriot businesspersons closer to taxation in the other Member States of the European Union, where tax rates are significantly higher.

Table 3 Economy of Cyprus

	2007	2008	2009	2010	2011	2012	2013	2014
GDP growth	4,1	3,8	-1,9	1,3	0,5	-2,3	-3,5	-1,3
Unemployment	5,1	3,6	5,5	6,5	7,9	12,1	13,2	14,2
Public debt	*	58,8	*	*	*	86,5	93,1	97,0

5. Conclusion

The European Monetary Union has been through, during its short-term functioning, extreme crisis caused by non-compliance with the Stability and Growth Pact. The debt crisis did not intervene in all countries using the common currency. Particularly euro area southern periphery countries were hardly hit – Italy, Spain, Greece, and Cyprus. To both examined countries – Cyprus and Spain – extensive funding in the form of loans from other euro area countries with less favorable conditions were shed. The absence of an economic union between the states of monetary union allows deformation of under regulated financial market and, ultimately causing debt crisis. Euro area countries most affected by the debt crisis were dependent on the financial assistance of the European Central Bank and other international institutions. Part of a financial assistance is also a requirement for the recovery of public finance, banking regulation and restructuring of their economies. It can be stated that the examined countries of southern periphery of the euro area gradually solve their debt problems and embark on a path of slow economic growth.

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