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The Euro Area Crisis and Turkey in the First Half of 2012

Evrydiki Fotopoulou, Erdal Tanas Karagöl

ABSTRACT

It has been almost four years since the global financial crisis started in 2008 and it has become an inherently European affair. One after another, weaker European economies seeing their growth plummeting have become unable to recover on their own and are resorting to loans from the International Monetary Fund (IMF), European Central Bank (ECB) and the European Union (EU). Already, Ireland, Greece and Portugal have requested full bailouts with Southern Cyprus as the newcomer, still under negotiation, while Spain has requested only partial assistance not acknowledging it may soon need full support. Many experts predict that Italy will follow suit as it is quite possible that it will be the next which without any access to credit markets to finance its needs. This policy analysis sheds some light on the current status of these countries: how the crisis was brought about, what measures they took, how have they performed thus far and what are the prospects for them. The role of the European Union is also being discussed in reference to the hesitant way it has addressed the problem and the cracks that appeared in the European establishment due to lack of mutual understanding and cooperation. In contrast to the weaker European economies, neighboring Turkey has managed to recover fast and exhibit positive signs that the economy is moving towards more sustainable growth rates while dealing with domestic vulnerabilities. This comparison serves as a reminder to reconsider both the usefulness of the single currency as well as whether Turkey's economy would benefit from closer ties with it, given that Europe faces a continued slowdown at least until 2014.

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THE EURO AREA CRISIS AND TURKEY IN THE FIRST HALF OF 2012

1. INTRODUCTION

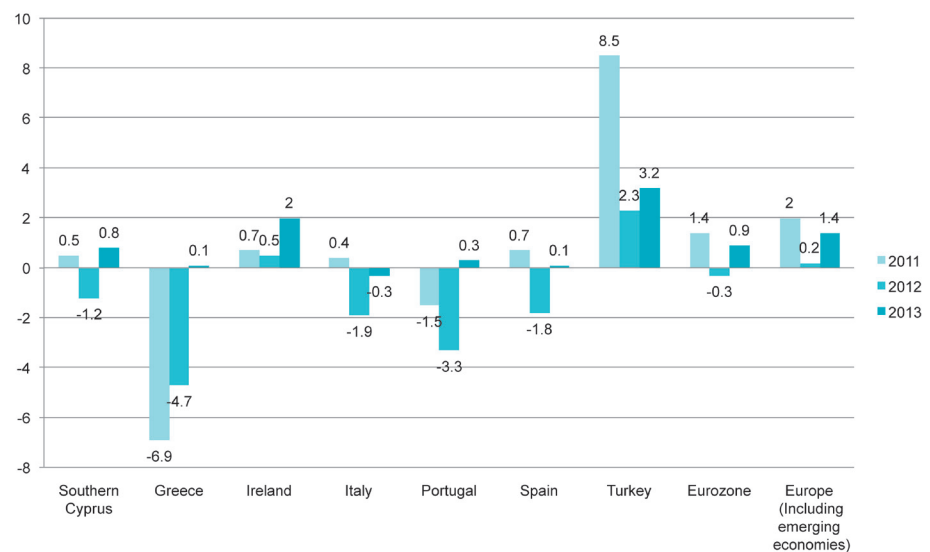
To date, Ireland, Greece, Portugal, Spain and Southern Cyprus (Greek Cyprus) have formally requested assistance from international institutions to manage their finances, while Italy also faces economic difficulties, highlighting the presence of structural economic dysmorphia in the EU. The IMF in April 2012 estimated that there will be stabilization in Europe, with most economies in track of recovery (see figure below), however recent data paint a different, less optimistic picture for the near future. In the following pages there will be given a brief analysis of the affected economies in the EU, and finally a comparison with Turkey as it becomes obvious that exit from the common currency for one of the members of the Euro area is a plausible threat.

The ECB determines the monetary policy for the entire Eurozone, where each member state is responsible for its fiscal and structural economic policies, overseen by the Stability and Growth Pact. Despite rapid expansion of cross-border lending with free flow of capital in the Eurozone, member states remain individually responsible for their national banking systems. The EU realized to some extent the danger and took a series of hesitant steps this year to provide greater fiscal discipline in response to the sovereign debt crisis, leading in stricter control over public finances by signing on March 2, 2012 the Treaty of Stability, Coordination and Governance in the Economic and Monetary Union. The treaty incorporates the Fiscal Compact under which the member states committed themselves to incorporate into national legal frameworks a balanced-budget rule and an automatic correction mechanism for deviations at national level. The European Commission presented in February its first Annual Alert Mechanism Report, designed to detect and correct situations of risk in order to reinforce surveillance of

Implementation of reforms with alignment of economic policies in the Eurozone through its governance system will be critical for re-establishing the credibility of the euro in international markets and prevent contagion in the area.

non-fiscal macroeconomic imbalance. The EU has taken a significant initiative regarding crisis prevention and resolution mechanisms with the establishment of the European Stability Mechanism (ESM) which would borrow directly to banks, without the intermediation of governments who would have to guarantee for the loans. The ESM required amendments to the Treaty on European Union, and it is expected to be fully operational as a permanent facility by September 2012, almost a year earlier than originally planned, with temporarily raised financial capacity (€500 billion) by unused funds of the European Financial Stability Facility (EFSF).

Graph 1. GDP Growth Estimate (Annual % Change)



Source: IMF (2012)¹

Implementation of reforms with alignment of economic policies in the Eurozone through its governance system will be critical for re-establishing the credibility of the euro in international markets and prevent contagion in the area. Beyond these structural and institutional uncertainties, the international role of the euro depends on the Eurozone's ability to regenerate economic growth. The speed and success of the EU and Euro area enlargement could improve this perspective, with the expansion of the currency zone towards emerging dynamic economies in the near future, making the euro anew a driver of growth. Europe is not flat in terms of economic structure; as the recession deepens the North-South divide will become more evident while possibly highlighting the need

1. IMF World Economic Outlook, p.53, April 2012, <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>

for each other as global partners.² Convergence between periphery and core economies will be essential to political cohesion and more effective monetary policymaking, hence true compliance with EU regulations. The inequality in policies and approach in effect created the breeding ground for the crisis in the first place; various subsequent external macroeconomic fiscal, financial and competitiveness-related imbalances built up by some economies revealed the true size of the problem. Consequently, instead of being confined to a few vulnerable economies, the crisis became systemic as a result of global interactions. The very accumulation of these imbalances and the difficulty of devising a widely accepted policy to deal with them is only a manifestation of substantial weaknesses in the European economic governance framework.

Despite ambitious estimates and the urgent need for a flexible crisis management mechanism to provide financial support to members in difficulty, the core of Europe has retorted in introspection and punishing rhetoric as an unaffected observer. As a result of lacking due attention the crisis becomes more widespread and deeper; the bigger the problem, the bigger the required response. Unfortunately the prospect of this big response is met by hesitation—even panic at times—by many European countries, as the following case studies prove.

Conversely, Turkey with its record recovery after a severe blow in the wake of the financial crisis was much better poised to face the situation, having learned a precious lesson after 2001, reforming and strengthening its banking sector. Despite lower economic growth it is still on a healthy trajectory and it outperforms many Euro area countries. Its challenges are common in the path of transformation from emerging to developed market economy, namely inflation, particularly in such an explosive area as the Middle East. Could Europe learn from Turkey's experience and could Turkey take heed and brace itself in order not to lose its comparative advantages and deal with its domestic divisions? And how much does Turkey need a weaker Europe at this stage?

2. TRAPPED ECONOMIES: IRELAND

Ireland was the first country to be hit by the 2008 financial crisis after 15 years of surprising growth and it was the second to ask for a bailout, as its banks were overexposed to the real estate sector which crashed. From September 2008 until November 2010, the moment that the government of Ireland officially asked for €85 billion from the IMF and the EU, the country had exhausted all options. Efforts to recapitalize its illiquid banks did not bear fruit as the true debt was much higher than the original estimate and austerity measures to increase government revenue for this purpose caused mass public reaction

Despite ambitious estimates and the urgent need for a flexible crisis management mechanism to provide financial support to members in difficulty, the core of Europe has retorted in introspection and punishing rhetoric as an unaffected observer.

2. World Economic Forum, "Euro, Yuan, Dollar Uncertainties: Scenarios on the Future of the International Monetary System", World Scenario Series, June 2012, http://www3.weforum.org/docs/WEF_FS_EuroDollarYuanUncertainties_Report_2012.pdf

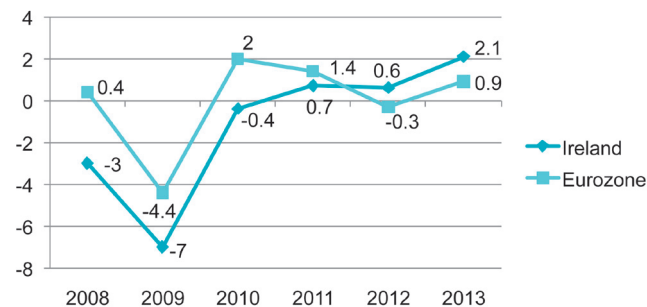
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and political turmoil,³ while the yields on government bonds soared. Unfortunately, this was to become a familiar story in the Eurozone, as one weak economy after another, fell into recession as feared. Out of the €85 billion loan, €10 billion were used for capitalization of banks, €25 billion for the banks' reserves and the rest to finance its budget deficit that had dramatically deteriorated after the government used its funds to support the banking sector.⁴ Since then the Irish economy has been struggling with challenges—particularly high unemployment rates—but managed to return to growth in 2011 as its implementation of the reform program has been quite consistent.

Economic Indicators Review

Irish GDP growth is slowly recovering. The IMF estimated that it will be 0.6% in 2012, slightly less than 2011 growth, and it is projected to stay positive in 2013 despite expanding recession in the Eurozone (Graph 2).

Graph 2. GDP Growth (Annual % Change)



Source: World Bank 2008-2010; IMF 2011-2013 estimates⁵

3. "Thousands march in day of anti-Budget protests", *The Irish Times Digital Archive*, 23th December 2010 <http://www.irishtimes.com/newspaper/frontpage/2008/1023/1224713994987.html?via=rel>

4. "Markets fall after Irish Republic 85bn bail-out", *BBC News*, 29th November 2010, <http://www.bbc.co.uk/news/business-11860879>

5. World Bank Data Bank Country indicators: Ireland and Euro area (2008-2010) http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.0&newReport=yes&ROW_COUNT=1&COLUMN_COUNT=4&PAGE_COUNT=2&COMMA_SEP=true; IMF World Economic Outlook Update: "Global recovery stalls, downturn risks intensify", 24th January 2012, p.53 available at: <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>

Ireland's government debt in the first quarter of 2012 stood at 108.5% of its GDP, the third highest percentage in the Eurozone and up 8.2% from a year prior.⁶ Ireland had the largest budget deficit in 2011 at 13.1% in terms of GDP, higher than government predictions, and still influenced by the bank recapitalization. Excluding transactions in support of the financial sector, the deficit was 9.4% of GDP—well below the target set by creditors of 10.6% of GDP, which enables access to international credit.⁷ Balance of payments remained negative in the first quarter of 2012, with higher exports and imports (twice as much as the exports) in May 2012.⁸ Domestic demand continued to decline, with prospects to improve in 2013,⁹ while total industrial production was better and inflation fell 0.2% in June compared to May 2012¹⁰. High unemployment is considered a major obstacle to Irish growth, but unavoidable at this stage of the economy. In July 2012, unemployment reached 14.8%.¹¹

The Outcomes so Far

July 2012 saw Ireland returning to international markets to access credit, which speaks of the increasing international trust, and the improvement of the economy. It is estimated that by 2014 Ireland will be able to fully fund itself. The country benefited from positive momentum generated by its 'Yes' vote on the Eurozone fiscal treaty in a referendum in May. Under such circumstances, the EU leaders' decision to see how its debt can be made more sustainable demonstrated that the efforts made were appreciated, stressing the importance of cooperation at this stage between creditors and debtors.¹² The IMF commission in July concluded that the Irish economy remains on track and it attributes the return to growth to Ireland's rigorous banking reforms as well as the adherence to the budget. Nevertheless, continuous support to the banking sector comes at a high price and it is the reason the government debt has recently risen considerably. The financial sector reforms have not been completed and raise specific concerns such as the deteriorating bank asset quality and restoration of profitability. A sound financial sector is essential to boost domestic demand, to make up for the weaker international trading environment, and to combat unemployment. Reductions in public wages, social welfare, the number of personnel and capital spending; a broader tax base; higher

The financial sector reforms have not been completed and raise specific concerns such as the deteriorating bank asset quality and restoration of profitability.

6. Eurostat News Release No: 111/2012: Euro Indicators: "Euro area government debt up to 88.2% of GDP", No., 23th July 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-23072012-AP/EN/2-23072012-AP-EN.PDF

7. Eamon Quinn and Matina Stevis: "Eurostat Sees Wider Irish Deficit", *The Wall Street Journal*, 23rd April 2012, <http://online.wsj.com/article/SB10001424052702303592404577361340426032250.html>

8. Central Statistics Office, Key Economic Indicators, <http://www.cso.ie/indicators/Maintable.aspx>

9. OECD Ireland- Economic forecast summary, May 2012, http://www.oecd.org/document/9/0,3746,en_33873108_33873500_45269961_1_1_1_1,00.html

10. Central Statistics Office, Key Economic Indicators, <http://www.cso.ie/indicators/Maintable.aspx>

11. Eurostat News Release No: 113/2012: "Euro area unemployment rate at 11.2%", 31st July 2012 http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-31072012-BP/EN/3-31072012-BP-EN.PDF

12. Jamie Smyth and Ralph Atkins: "Ireland returns to global bond markets", *The Financial Times*, 26th July 2012, <http://www.ft.com/cms/s/0/378e474a-d716-11e1-8e7d-00144feabdc0.html#ixzz21oGyolEs>



Ireland has made an honest effort to contain the problems of the banking sector, at a high price for social and public development.

taxes on capital and savings; and higher VAT make up much of the effectiveness of fiscal consolidation so far. Further measures, including a value-based property tax, will arrive in 2013. Although such policies are designed to provide stable revenue to the government, a high deficit ratio and unemployment persist.¹³

What Next?

Should the country stick to its course, it will likely be the first survivor of Europe's recession. Ireland has made an honest effort to contain the problems of the banking sector, at a high price for social and public development. International markets have rewarded the sacrifices, as Irish government bonds have been traded recently at better terms than Spanish and Italian ones.¹⁴ High unemployment can become a nightmare from the past, unless effectively managed with measures that on the one hand would not curb international competitiveness and on the other hand would allow for increased domestic consumption. As the financial sector is not yet able to be independent of the government credit line more caution is needed, in particular as the crisis spreads in Europe.

3. TRAPPED ECONOMIES: GREECE

Following a period of prosperity until 2004, and a period of slow-down in growth until 2008, Greece entered a period of crisis which quickly turned into a deep recession. The structural problems of the Greek economy were soon revealed resulting in international financial markets' loss of confidence in the country, leading to sharp downgrades of the country's credit ratings and excessive borrowing interest rates.

The chronic weaknesses of the Greek economy responsible for the economy's inability to regain momentum and fully implement reforms are, in brief:

- Massive public sector and uncontrollable public spending, which led to large fiscal deficit and debt.
- High dependency on foreign debt due to low domestic savings rate combined with high private consumption.
- Low competitiveness, largely as a result of the prevalence of the public sector, introvert development policy and outdated forms of transactions in the markets for goods, services and labor.
- Difficulty incorporating technology and innovation.

13. IMF: "2012 Article IV Consultation with Ireland- Concluding Statement of the IMF Mission", 18th July 2012, <http://www.imf.org/external/np/ms/2012/071812.htm>

14. Ibid, 12.

- Unfair and ineffective taxation system, favoring large firms while relying heavily on employees of the public sector and pensioners for tax revenue.
- Flexible and undeclared work.
- Limited and circumstantial commitment by the political leadership towards comprehensive reforms of the Greek economy.¹⁵

Lack of basic deficiencies in the field of economic improvement has combined with inefficient practices and failed policies that have led to elimination of the crisis management mechanism. As a result the compromise between national and supranational competencies has disappeared. Despite measures taken by the EU, the overall economic sentiment and trust has been considerably weaker throughout the continent following a persistent downwards course since 2008 as measured by the Business and Consumer Surveys of the European Commission in May 2012.¹⁶ In April 2010, the crisis peaked, and the Greek government decided to resort to the support mechanism offered by the EU, the ECB, and the IMF. Consequently, on May 3, 2010 the Memorandum of Economic and Financial Policies and the Technical Memorandum of Understanding were agreed between Greece and the lenders, in return for a loan of 110 billion euro in installments. Yet, both signing parties soon realized that this would not be enough, so a second €130 billion bailout package was finalized in March 2012 to prevent the exit of Greece from the Eurozone, hoping to remove the risk of contagion.

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Economic Indicators Review

GDP growth (Graph 3) shrank 6.3% in the first quarter of 2012. Industrial production declined 2.9% (May '11-May '12). In terms of volume, it declined 8.8% in 2011—the sharpest fall in the EU, continuing a downwards spiral in all sectors since 2008. Regarding the turn-over of industrial production there was a slight improvement in the first quarter of 2012 while investment was 14.5% of GDP, principally by the private sector. Gross government debt, the main problem of the economy, in 2011 was 165.4% of GDP¹⁷, the greatest in the EU and considerably higher than the target 153% for that year.¹⁸ In March 2012 it was dramatically reduced to 132.4% after a “voluntary haircut”.¹⁹

15. Eleni Patra: “Social Dialogue and collective bargaining in times of crisis: the case of Greece”, ILO working paper no. 38, February 2012, Industrial and Employment Relations Department, http://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---dialogue/documents/publication/wcms_174961.pdf

16. Bank of Greece: “Bulletin of Conjunctural Indicators”, May-June 2012, vol.144, Economic Research Department, Statistics Department, <http://www.bankofgreece.gr/BogEkdoseis/sdos201205-06.pdf>

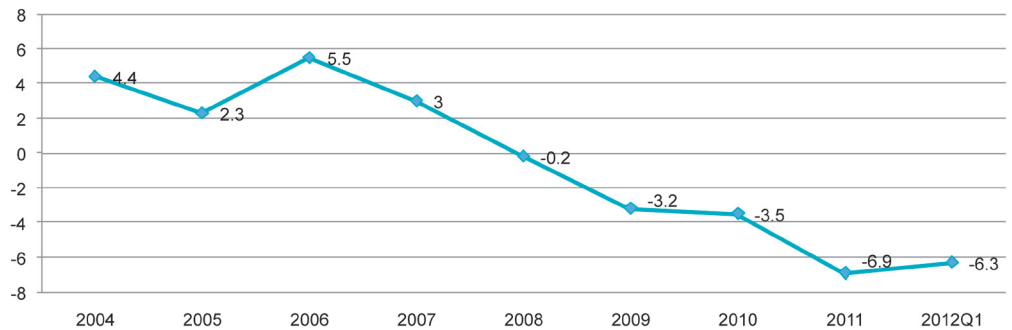
17. OECD: Greece-Economic Forecast Summary, May 2012, http://www.oecd.org/document/3/0,3746,en_33873108_33873421_45269891_1_1_1_1,00.html

18. Council of the European Union, “Legislative acts and other instruments: COUNCIL DECISION amending Decision 2010/320/EU of 10 May 2010 addressed to Greece with a view to reinforcing and deepening fiscal surveillance and giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit”, Public paper 17754/10, Brussels, 17th December 2010, http://www.eurozone.europa.eu/media/596778/edp_greece_20_december.pdf

19. Ibid, 6.

Major export destinations in 2011 were Italy, Germany, and Turkey, with exports to Turkey increasing by 108.1%.

Graph 3. GDP Growth (Annual % Change)



Source: Hellenic Statistic Authority (2012)²⁰

Current account balance persists at -9.8%. There was a marked improvement in exports in 2011 by 38.7% compared to 2010 -the biggest increase in the EU in 2011- driven by a sharp rise in the value of energy products and primary goods (Graph 4). Major export destinations in 2011 were Italy, Germany, and Turkey, with exports to Turkey increasing by 108.1%. Regarding imports, the biggest trade partner was Germany.²¹

Graph 4. External Trade Balance (Annual % Change)



Source: Hellenic Statistic Authority (2012)²²

*Provisionary data for 2011

20. Hellenic Statistical Authority: "The Greek Economy", 2012, http://www.statistics.gr/portal/page/portal/ESYE/BUCKET/General/greek_economy_28_05_2012.pdf

21. Ibid, 17.

22. Ibid, 17.

Gross savings were 3.2% of GDP, having plummeted (-16.7%) since 2010—a trend that continued in the first quarter of 2012.²³ In recent months, Greek banks have offered relatively favorable terms to attract more deposits, as their needs in liquidity increase. Estimates indicate €5 billion of withdrawn deposits (mass withdrawals took place since 2010) have been returned to the banks.²⁴ Fitch in May 2012 downgraded five Greek banks to CCC,²⁵ among them the parent companies of Finans Bank (NBG) and Eurobank Tekfen (EFG Eurobank Ergasias). Inflation as of June 2012 declined by 0.3% compared to May 2012 and currently sits at 1.3%—well under the 2.40% Eurozone average.²⁶ Still, unemployment sky-rocked to 22.6% in the first quarter of 2012 from 17.7% in 2011,²⁷ with Greek regions figuring high in the European regional unemployment statistics since 2011, in particular northern Greece.²⁸

Employment relationships in a country like Greece with strong, deeply-rooted labor unions and a tradition of fair-weather affiliation to political parties have been seriously damaged by the efforts of the government to implement the labor reforms agreed with the creditors, as in Spain. Greece has reduced public spending on resources available to job-seekers, further aggravating unemployment, putting at risk the long-term potential for economic growth. The Greek labor market remains one of the most protected in the OECD²⁹ as public sector pay is determined by law, according to the government's annual income policies. For the IMF, employment protectionism is directly linked to competitiveness—the solution is either producing more, or producing cheaper. With the current declining investment rates it will be rather difficult for Greeks to produce more; the only alternative would be a negotiation between social partners for the reduction of prices and wages, which has not taken place yet.³⁰

Is Greece another Argentina?

Since Greece fell into recession there have been many voices commenting on the analogies between the crisis in Argentina in 2001 and Greece today. There are a few similarities, but the fundamentals are quite different. Both countries adopted a fixed and overvalued exchange rate in order to reign over inflation, albeit harming domestic productive

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23. Ibid, 17.

24. "Systaseis gia periorismo ton epitokion katatheseon anamenetai na apeuthinei i Trapeza tis Ellados", *News.in.gr*, 12th July 2012, <http://news.in.gr/economy/article/?aid=1231204694>

25. "Fitch cuts Greek banks ratings to 'CCC'", *REUTERS*, 18th May 2012, <http://in.reuters.com/article/2012/05/18/text-fitch-cuts-greek-banks-ratings-to-c-idINDEE84H0EU20120518>

26. Tradingeconomics.com: Inflation rates-List by Country, <http://www.tradingeconomics.com/inflation-rates-list-by-country>

27. Ibid, 17.

28. Eurostat News Release No104/2012: "Unemployment in the EU27 regions", 4th July 2012 http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/1-04072012-BP/EN/1-04072012-BP-EN.PDF

29. OECD Indicators of Employment Protection, 2008, http://www.oecd.org/document/11/0,3746,en_2649_37457_42695243_1_1_1_37457,00.html

30. Ibid, 22.



The Greek government created a uniform e-prescribing system, enforcing co-payments for regular outpatient services of €5 and extension of co-payments to unwarranted visits to emergency departments.

capacity. Greece adopted the euro, and Argentina pegged the peso to the dollar. As there was already a chronic deficit in the balance of payments in both economies, their dependency on foreign capital flows to generate domestic demand led them in a dead end. From then on, the IMF in both cases (along with the EU and the ECB in the Greek case) suggested exactly the same sets of policies mainly focusing on a drastic cut of public spending and measures to increase competitiveness. Notably, there are three major differences between the two cases: first, Argentina was able to devalue its currency, whereas Greece could only do if it left the Eurozone and readopted the drachma. Second, the US intended to reduce moral hazard in international capital markets, and thus helped Argentina renegotiate its debt, but Greece's debt is mostly held by German, French, and UK banks already facing economic woes, while its creditors would rather make the country an example of sin and nemesis. These banks are less likely to negotiate again after the "haircut" in March 2012. Finally, the international economic sentiment in 2001 was much better amid predictions of a rapid return of growth than the gloomy 2012.³¹

The Outcomes so far

The economic indicators above paint a bleak picture of the economy and do not allow for much wishful thinking. Several economists, including Nouriel Roubini³², have predicted the so-called "Grexit" under the burden of huge debt, yet whether this will happen remains unclear as a new coalition government took over in June 2012. The weak bargaining position of the new government, headed by Antonis Samaras, can only change by complying with the reform program. A number of reforms have taken place, yet not extensively, while political parties vie in doing so with the least possible political cost at a time when Greeks have been experiencing a steep decline of living standards. Wages overall declined by 6.1% and the minimum wage was decreased by 19.1% from 2011.³³ Partial reforms were implemented in social insurance and pharmaceuticals, not so much as a matter of political will, but because the Greek national health system was in the brink of collapse. The Greek government created a uniform e-prescribing system, enforcing co-payments for regular outpatient services of €5 and extension of co-payments to unwarranted visits to emergency departments. It also introduced the use of generic drugs to reduce monopoly and corruption in the pharma-

31. This paragraph draws on: Pierpaolo Barbieri: "The Tragedy of Argentina", *Wall Street Journal*, Op-Ed, 19th April 2012, http://belfercenter.ksg.harvard.edu/publication/21951/tragedy_of_argentina.html; Pablo Nemiña : "IMF from Argentina to Greece: Similar but Different", 7th February 2012, available at: <http://www.brettonwoodsproject.org/art-569567>; Gros, Daniel: 'A tale of two defaults', CEPS Commentary, 12th July 2011, Archive of European Integration, University of Pittsburg, <http://aei.pitt.edu/32164/>

32. Nouriel Roubini: "Greece Should Default and Abandon the Euro", 16th September 2011, <http://pratclif.com/economy/roubini/Greece%20Should%20Default%20and%20Abandon%20the%20Euro%20-%20September%2015%202011.pdf>

33. Ibid, 16.

ceuticals sector. Other examples include the equalization of energy taxation in heating and diesel oil to fight fraud, the increase of VAT to 23% since September 2010, higher taxes in tobacco products and alcohol. As all of these measures harmed cartel interests there was strong reaction by the affected parties, while the “solidarity” emergency tax on all income caused a massive public outcry. There has been very little done regarding the pension system reform and the privatization of state assets, which according to the IMF would contribute considerably in bringing down government debt.³⁴

What Next?

Currently, the Greek coalition government is negotiating a further package of measures with the Troika (the committee of the EU, IMF, and ECB that is supervising reforms), hoping to save €11.5 billion over the next two years, in an effort to convince its lenders for the viability of its economy and ensure the release of the next tranche of the loan. Among the suggestions are the introduction of tuition fees for long-term university students (those who take longer than expected by the curriculum to complete their degree), extension of the compulsory military service to 12 months, reduction by 50% of the state’s contribution to clergy wages, and mergers of public organizations; however, more resources to cover the full amount are needed, and they will mostly likely be drawn from further pension and wage reductions and public sector lay-offs.³⁵ The prime minister has said he expects the economy to shrink by 7% this year and to not to return to growth until 2014—acknowledging the dangers of increasing austerity during a deep recession.³⁶ In such a climate, discussions about a possible Greek exit in the near future harm European stock markets, while the euro is in free fall. In spite of the efforts, *uncertainty* is the order of the day; as long as there are no visible results from the Greek side and it is suspected that the country has fallen behind its targets once more. Social pressure mounts within Greece as there is no visible solution, when the EU publically displays the deep fragmentation that exists from its very formation. It should be understood that exit from the Eurozone of any state would have unknown effects not only in the EU but the world too, as no economy exists in insulation. The problems of the Greek economy are not unique; they are common in many countries, reflecting inequalities of the core of Europe and the global financial system. So again for Greece, there is only uncertainty if not pessimism.

The problems of the Greek economy are not unique; they are common in many countries, reflecting inequalities of the core of Europe and the global financial system.

34. Mark Weisbrot and Juan Antonio Montecino: “More Pain, No Gain for Greece: Is the Euro worth the costs of pro-cyclical fiscal policy and internal devaluation”, Centre for Economic and Policy Research, February 2012, <http://gesd.free.fr/paingain.pdf>

35. “Didaktra stous eonious fitites kai afksisi stratiotikis thitias sto paketo metron”, *News.in.gr*, 13th July 2012, <http://news.in.gr/economy/article/?aid=1231204877>

36. “Greece recession will deepen, says Antonis Samaras”, *BBC News*, 24th July 2012, <http://www.bbc.co.uk/news/business-18958606>

The crisis in Portugal revealed structural deficiencies of the economy, which were broadly similar to those of Greece: credit-fueled growth, excessive public spending, highly protected labor, and low level of competitiveness.

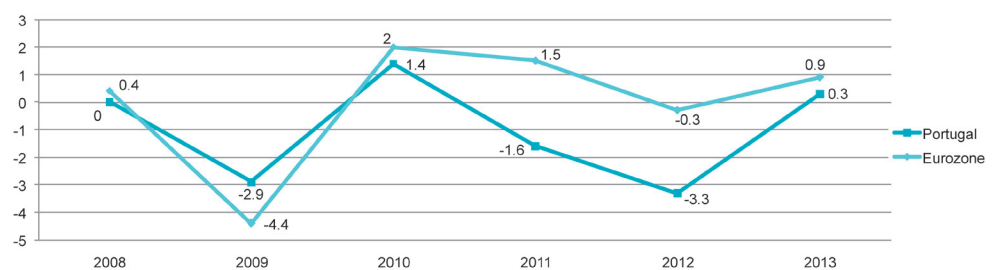
4. TRAPPED ECONOMIES: PORTUGAL

Portugal was the third country in Europe to be hit by the global financial crisis, and is currently in a period of fiscal consolidation to reduce its budget deficit. After three weeks of discussions the government formally turned to the EU, ECB, and IMF on May 4, 2011 for financial assistance, amounting to €78 billion to support its economy, including €12 billion for recapitalization of its banks. The request came shortly after Portugal's parliament was not able to vote earlier on austerity measures that would help put the economy back on track. The crisis in Portugal revealed structural deficiencies of the economy, which were broadly similar to those of Greece: credit-fueled growth, excessive public spending, highly protected labor, and low level of competitiveness. These fundamental characteristics cause recovery to take longer and make it more painful, despite the optimistic outlook of the last review mission of the creditors to Portugal in June 2012.³⁷

Economic Indicators Review

Portugal has been experiencing slow GDP growth over the last decade. Since late 2010, it has seen GDP collapse, falling to -2.2% in the first quarter in 2012 and expected by the IMF to decline further (Graph 5).³⁸

Graph 5. GDP Growth (Annual Changes)



Sources: 2008-2011 World Bank; 2012-2013 IMF estimates³⁹

37. IMF: "Statement by the EC, ECB and the IMF on the Forth Review Mission to Portugal", Press Release No. 12/203, 4th June 2012, <http://www.imf.org/external/np/sec/pr/2012/pr12203.htm>

38. IMF World Economic Outlook Update: "Global recovery stalls, downturn risks intensify", 24th January 2012, p.53 <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>

39. World Bank Databank, Country Indicators: Portugal and Euro area (2008-2011), http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.0&newReport=yes&IS_REPORT_IN_REFRESH_MODE=true&IS_CODE_REQUIRED=0&COMMA_SEP=true; IMF World Economic Outlook Update: "Global recovery stalls, downturn risks intensify", 24th January 2012, p.53, <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>

The OECD expects Portugal's economy to return to growth after mid-2013.⁴⁰ This comes as private consumption, domestic demand, and industrial production have been falling by parallel to household savings. Under such circumstances, it is no great surprise that the overall economic forecast is considerably lower than in the rest of the Eurozone.⁴¹ Government debt-to-GDP ratio stood at 111.7% in the first quarter of 2012—the third highest in the Eurozone and up 3.8% from the last quarter of 2011.⁴² The current account balance of Portugal stood at -0.7% in the first quarter of 2012.⁴³ In May 2012 inflation was at 2.7%, considerably lower than May 2011.⁴⁴ Unemployment in June 2012 was 14.8%⁴⁵ and it projects to increase to 16% as the recession deepens and labor reforms proceed,⁴⁶ becoming a major challenge to Portugal's long term growth at times when firms try to reduce indebtedness since high unemployment goes hand-in-hand with low domestic demand. Driven by fuel imports and diversification of destinations to non-European countries⁴⁷, exports in January-May 2012 were 9% higher than over the same period in 2011, whereas imports declined by 5.6%.⁴⁸

The Outcomes so Far

A few weeks ago creditors concluded their review mission to Portugal, and their findings about the structural adjustment program were positive overall. They concluded that the program proceeds faster than expected despite problems, especially raising unemployment and restoring international competitiveness of and trust to Portugal. The increase of exports in 2012 contributes towards this goal—it simultaneously counterbalances the effects of low domestic consumption. The mission experts expect that the GDP decline for 2012 will be slightly less than initially estimated while the fiscal deficit target remains attainable for 2012, as reforms of state-owned enterprises and public-private partnerships continue as planned. Portugal's efforts to improve public financial management and public administration, counter tax evasion, and expand the tax base will allow the economy to handle potential slippages effectively. Restructuring of the banking sector proceeds gradually, with liquidity controls, tight credit poli-

Portugal's efforts to improve public financial management and public administration, counter tax evasion, and expand the tax base will allow the economy to handle potential slippages effectively.

40. OECD: Portugal- Economic forecast summary, May 2012, http://www.oecd.org/document/41/0,3746,en_33873108_33873764_45270249_1_1_1_1,00.html

41. Banco de Portugal, Statistic Bulletin, p.20-22, July 2012, <http://www.bportugal.pt/en-US/Estatisticas/PublicacoesEstatisticas/BolEstatistico/Publications/BEJul12.pdf>

42. Ibid, 6.

43. Eurostat News Release No:110/2012: Euro Indicators: "EU27 current account deficit at 4.1bn euro", 19th July 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-19072012-AP/EN/2-19072012-AP-EN.PDF

44. Instituto Nacional de Estatística, Destaque: Síntese Económica de Conjuntura, May 2012, http://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=133298832&DESTAQUEStema=00&DESTAQUESmodo=2

45. Ibid, 11.

46. OECD: Portugal- Economic forecast summary, May 2012, http://www.oecd.org/document/41/0,3746,en_33873108_33873764_45270249_1_1_1_1,00.html

47. Ibid, 48.

48. Banco de Portugal, Statistic Bulletin, p.52, July 2012, <http://www.bportugal.pt/en-US/Estatisticas/PublicacoesEstatisticas/BolEstatistico/Publications/BEJul12.pdf>

cies, and enhanced monitoring ensuring that debtor firms are in position to fund their activities, as banks have a considerable burden of unserviceable loans.

What Next?

Portugal has been implementing reforms requested by its creditors to a satisfactory degree. Employment has been affected as noted above, and due in part to the overall slowdown in Europe, the employment situation is expected to worsen in the coming months. In addition to this, reforms associated with more socially and politically costly issues require more attention, as well as absolute devotion to the budget guidelines.⁴⁹ However, previously unforeseen events may impede Portugal's effort to recover, as the recession deepens across Europe. The interdependence of European economies, with the respective weakness of their banks in terms of controls and policy, considerably increase the spill-over effect of the crisis. Portugal still must face many challenges, primarily the growing public discontent, but the IMF maintains a positive outlook for the Portuguese economy.

Portugal still must face many challenges, primarily the growing public discontent, but the IMF maintains a positive outlook for the Portuguese economy.

5. TRAPPED ECONOMIES: SPAIN

Since 2007 the Spanish economy has experienced a marked decline. By 2008 it faced negative growth for the first time in 15 years and has struggled to recover since. The crisis was brought about by the collapse of the real estate market, with house prices down one fifth from their pre-crisis levels. The outlook remains negative through at least early 2013.⁵⁰ In 2012 a banking crisis erupted as malfunctioning banks were not prepared to deal with the losses inflicted on them by the real estate sector. Bankia, one of the major Spanish banks, required emergency recapitalization and is currently undergoing reform under strict supervision.⁵¹ Consequently, although GDP grew by 0.71% in 2011, it slowed down to 0.3% in the first quarter of 2012,⁵² and the Spanish government was forced to turn to the EFSF in June 2012 for financial assistance to reform its banking sector aiming to guarantee its survival.

An agreement on the terms of a partial bail-out was reached between the Spanish government, the ECB, EU and the IMF and the first tranche of the €100 billion pledged

49. Ibid, 39.

50. Standard and Poor's: "2012 Global Credit Outlook: Sovereign Debt Problems Weigh on a mostly Tepid Forecast", Global Rating Portal, 13th December 2011, <http://img.en25.com/Web/StandardandPoors/2012GlobalCreditOutlookSovereignDebtProblemsWeighOnAMostlyTepidForecast.pdf>

51. Banco de España: "Statement on the European bank recapitalisation plan", Press Release, Communication Department, 11th July 2012, Madrid, available at: http://www.bde.es/webbde/en/secciones/prensa/Notas_Informativ/anoactual/presbe2012_28e.pdf

52. Ministerio de Industria, Energía y Turismo: "Informe Anual", Subdirección General de Estudios, Analysis y Planes de Actuación, 29th June 2012, <http://www.minetur.gob.es/es-ES/IndicadoresyEstadisticas/Informes/InformesMITYC/Sectores/Informe%20Anual%202011%20%28S.G.%20Estudios%29.pdf>

for the rescue of Spanish banks was to become available at the end of July. Although the total amount needed will be not known until September, when Spanish banks will undergo a stress test, a first installment of €30 billion will be “mobilized as a contingency in case of urgent needs in the Spanish banking sector,” Eurogroup President Jean-Claude Juncker said.⁵³ Negotiations on the Spanish bank bailout have borne fruit as the Economic and Financial Affairs Council of the European Union (ECOFIN) further decided to accelerate the procedure in order to give the troubled Spanish government more time (until the end of 2014) to tame its budget deficit. This decision was prompted by a sharp increase on Spanish bonds’ yields ahead of the meeting for fear that there would be no ECOFIN agreement on the matter and the not-as-yet activation of the ESM. It should be noted that any amount used to bail out the banks will be added to Spain’s government debt, increasing it significantly unless the ESM is activated soon.⁵⁴ The case of Spain shows again how European leaders must accept collective responsibility for the currency union’s survival, before recession spreads further.

Economic Indicators Review

Despite the recession, the World Economic Forum ranks Spain 36th in global competitiveness for 2012—six places higher than 2011.⁵⁵ Nonetheless, since the beginning of 2012, the IBEX 35 lost 20% of its value, reflecting strict financing conditions and a low confidence environment.⁵⁶ The OECD estimates the budget deficit will fall to 3.3% in 2013, although economic contraction will continue throughout 2012 due to budgetary consolidation and deleveraging in the private sector, which both weigh on domestic demand. The public debt-to-GDP ratio at the end of 2011 was 68%, while GDP (Graph 6) is expected to fall 1.5% in 2012 and by a further 0.75% in 2013.⁵⁷ The economy’s performance in the first quarter of 2012 aligns with these predictions. This negative cyclical pattern is attributed to weak domestic demand, though the exports sector was, to some extent, able to correct for the loss.

The case of Spain shows again how European leaders must accept collective responsibility for the currency union’s survival, before recession spreads further.

53. Paul Geitner and Stephen Castle: “European Finance Ministers Agree to Speed up Bailout of Spanish Banks”, *The New York Times*, 10th July 2012, <http://www.nytimes.com/2012/07/10/business/global/daily-euro-zone-watch.html?pagewanted=all>

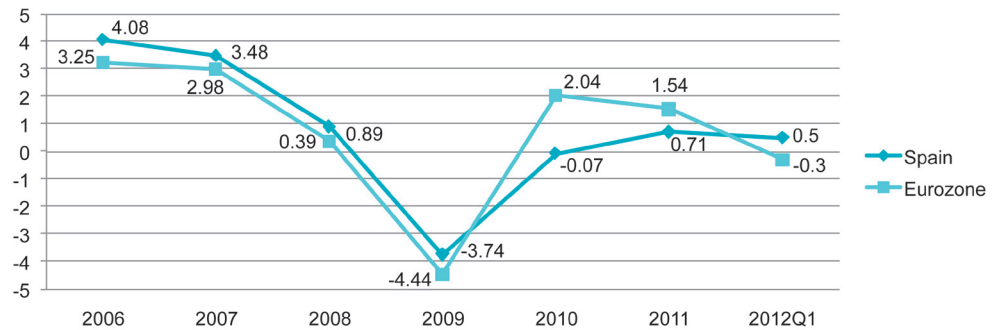
54. “Spanish Bailout Shows Europe’s Leaders Still Don’t Get it”, *Bloomberg News*, 11th June 2012, <http://www.bloomberg.com/news/2012-06-11/spanish-bailout-shows-europe-s-leaders-still-don-t-get-it.html>

55. World Economic Forum Global Competitiveness Index 2011-2012 Rankings, 2011, http://www3.weforum.org/docs/WEF_GCR_CompetitivenessIndexRanking_2011-12.pdf

56. Banco de España Economic Bulletin, April 2012, <http://www.bde.es/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/12/Abr/Files/be1204e.pdf>

57. OECD Spain Economic Forecast Summary, May 2012, available at: http://www.oecd.org/document/6/0,3746,en_33873108_33873806_45270278_1_1_1_1,00.html

Graph 6. GDP Growth (Annual % Change)



Source: World Bank; tradingeconomics.com (Eurozone 2012Q1); Banco de Espana (Spain 2012Q1)⁵⁸

The ongoing labor reform in Spain aims to increase competitiveness of the economy by dismantling collective bargaining and increasing firms' internal flexibility; however, the public has reacted negatively, with the violent miners' strike in early July only the most recent example.

Spain fell behind its target to reduce its budget deficit to 6% in 2011, as required by the stability program, which amounted to 8.5% of its GDP, as a result of inefficient monitoring of regional fiscal administration and adverse cyclical tendencies⁵⁹ and for the first quarter of 2012 amounted to €14.4 billion.⁶⁰ Spain's unemployment in 2011 was the highest in Europe— so high the Bank of Spain has argued that unless it is dealt with immediately, it will become a major impediment to the economy's recovery.⁶¹ In June 2012 unemployment was 24.8%—highest in Europe and more than double the European average.⁶² The ongoing labor reform in Spain aims to increase competitiveness of the economy by dismantling collective bargaining and increasing firms' internal flexibility; however, the public has reacted negatively, with the violent miners' strike in early July only the most recent example.⁶³ As a result of reduced employment and weak domestic demand, inflation remained below the Euro area average and continues its low course in 2012 (Graph 7).

58. World Bank Databank, Country Indicators: Spain and Eurozone, 2006-2010 http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.00&newReport=yes&IS_REPORT_IN_REFRESH_MODE=true&IS_CODE_REQUIRED=0&COMMA_SEP=true; Tradingeconomics.com: Eurozone Growth Estimate, <http://www.tradingeconomics.com/euro-area/gdp-growth>; Banco de Espana Economic Bulletin, April 2012, Madrid, available at: <http://www.bde.es/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/12/Abr/Files/be1204e.pdf>

59. Ibid, 56.

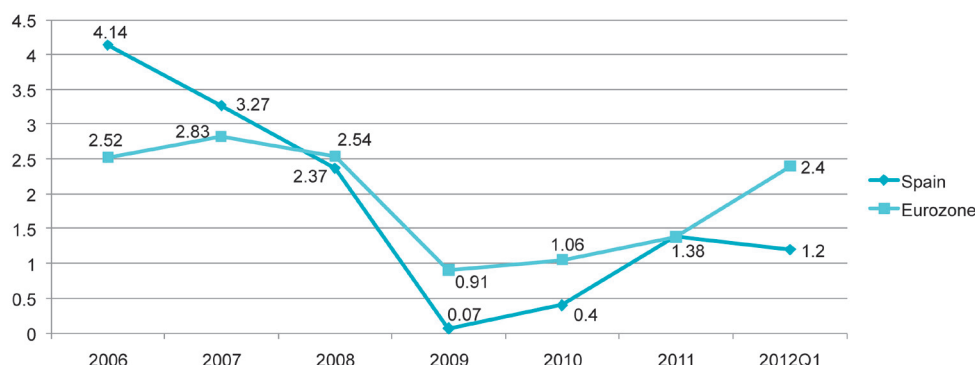
60. Ibid, 46.

61. Ibid, 46.

62. Ibid, 11.

63. "Spanish Police Clash with Protesting Miners", Reuters, 11.07.2012, available at: <http://in.reuters.com/article/2012/07/11/spain-miners-idINL6E8IB8OY20120711>

Graph 7. Inflation (GDP Deflator Annual % Change)



Source: World Bank (ibid) 2012Q1 data for Spain data Instituto Nacional de Estadística; for Eurozone Reuters⁶⁴

Both household debt and corporate debt declined in 2012, following a downwards path since 2011, although corporate debt still remains at particularly high levels. Low household consumption contributes significantly in the cyclical recession experienced of Spain, mostly due to declining savings, loss of employment and decrease of real estate portfolio value. In terms of foreign trade value in May 2012, exports were 3% higher led by growth in capital goods exports. Imports declined by 1.4% in May 2012 compared to January 2012.⁶⁵

The Outcomes so Far

Germany has just voted positively on the support to Spain, a crucial development in the bailout process as Germany is expected to provide one third of the funds needed—a sign of faith in Spain’s commitment to ensure its economy’s survival. At the same time, Spanish Prime Minister Mariano Rajoy presented to the parliament a new package of measures, including drastic cuts in public spending and further reforms in labor law, which prompted mass strikes around Spain.⁶⁶ Bank of Spain has pledged more austerity and stricter supervision of the banking sector, and the government has al-

A crucial development in the bailout process as Germany is expected to provide one third of the funds needed—a sign of faith in Spain’s commitment to ensure its economy’s survival.

64. Instituto Nacional de Estadística, Notas de Prensa: Índice de Precios de Consumo Abril 2012, 11th May 2012, <http://www.ine.es/daco/daco42/daco421/ipc0412.pdf>; “Oil cools eurozone inflation; Labour costs high”, *REUTERS*, 14th June 2012, <http://www.reuters.com/article/2012/06/14/eurozone-inflation-idUSL5E8HE5E920120614>; World Bank Databank, Country Indicators: Spain and Eurozone, 2006-2010 http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.00&newReport=yes&IS_REPORT_IN_REFRESH_MODE=true&IS_CODE_REQUIRED=0&COMMA_SEP=true;

65. Ministerio de Industria, Energía y Turismo, Statistics and Reports: Main Circumstantial Indicators, 17th July 2012, <http://www.minetur.gob.es/en-US/IndicadoresyEstadisticas/Paginas/Estadisticas.aspx>

66. Stephen Castle: “Spanish Borrowing Costs Surge, Reviving Worries About Euro Zone”, *The New York Times*, 19th July 2012, http://www.nytimes.com/2012/07/20/business/global/daily-euro-zone-watch.html?_r=1&hp



The condition of Spain highlights once more the dual nature of European structural fiscal inefficiency. It consists of a national and a European component, which cannot be separated and only may be balanced in the Eurozone as a single issue.

ready passed a series of laws to regulate the function of banks. Among them there are changes of minimum collateral requirements for monetary operations of banks and a new legal framework within which savings banks will be able to perform their operations through commercial banks or be transformed into special credit institutions. It has also tried to ease the real estate crunch by urgent measures to protect mortgagors without funds, including availability of rental housing to persons evicted and those subject to mortgage foreclosure flexibility measures. The thorniest subject remain the changes to labor law—especially given historically high unemployment—which have caused mass reactions from the public. Still, Bank of Spain stresses its importance for medium and long term growth. Exclusively for 2012, a special levy (8%) is imposed on dividends and foreign origin income derived from the transfer of equity securities of companies not resident in Spain. In addition to these measures, the central government has established a fund to assist with the financial troubles of local governments while providing more transparency and increased accountability.⁶⁷

What Next?

Despite Spain's renewed vows of austerity, markets still remain skeptical about its prospects, as shown by the persistently high bond yields since April 2012. As a reminder of Spain's combustibility, since July 19, 2012 the 10-year government bond yields have been above 7% while the country struggles to fully cover its needs in capital.⁶⁸ On July 23rd, the Spanish stock market regulator banned short-selling of shares for three months, in light of the extremely volatile European securities market that saw European stock markets sink.⁶⁹ Simultaneously there have been worries about the inability of local governments to fulfill their financial obligations, after the local government of Valencia asked for financial assistance from the central government, being unable to manage its growing debt. There are fears that other provinces will follow in the immediate future, a possibly detrimental development which in turn would deteriorate Spanish public finances, leading to a full bailout of the fourth largest economy in Europe. The condition of Spain highlights once more the dual nature of European structural fiscal inefficiency. It consists of a national and a European component, which cannot be separated and only may be balanced in the Eurozone as a single issue.

67. Ibid, 56.

68. Graeme Wearden and Julia Kollewe: "Eurozone crisis live: Germany approves Spain's bank rescue after poor Spanish auction", *The Guardian*, 19th July 2012, <http://www.guardian.co.uk/business/2012/jul/19/eurozone-crisis-spain-bond-auction>

69. Comision Nacional del Mercado de Valores Announcement, 23rd July 2012, <http://www.cnmv.es/Portal/verDoc.axd?t={ac1cd1c3-c0f2-45f4-b011-261662a0bd4e}>

6. TRAPPED ECONOMIES: ITALY

Italy has been experiencing sluggish growth rates over the last 20 years, regularly being locked in cyclical patterns that bring about negative growth. Italy up to this moment has mitigated the 2008 financial crisis, by introducing significant structural reforms since late 2011 while making progress in fiscal consolidation—slowly recovering from its worst post-war crisis and hoping for the low growth rate it had during the pre-crisis decade. The most recent evidence demonstrates clearly that the Italian economy is trapped once more in such a cyclical pattern, under pressure from weak European economies and the short term consequences of fiscal tightening advocated by its government. The ability of the Italian economy, already burdened with the second largest public debt in the EU, to access international credit was seriously impaired by the crises in Greece, Spain and Ireland, since it was expected by many to become the next victim of the crisis in a highly uncertain financial environment. In this light, Moody's downgraded Italy in mid-July 2012 to Baa2 from A3⁷⁰ creating a stir in Europe, out of fear of contagion. Contrary to expectations, and perhaps what kept the country relatively safe so far, the Italian response was to shift public expenditure to create some stimulus to areas with significant multiplier effects by means of budget-neutral measures along with early budgetary cautiousness. According to OECD predictions, activity seems likely to continue to decline over the next year, but it will increase in late 2013. Control of the sovereign debt will remain the biggest challenge to this endeavor.⁷¹

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Italian general government gross debt as a GDP ratio has risen from 105.7% in 2008 to 123.3% in the first quarter of 2012, the largest in Europe after Greece.⁷² Despite early predictions by the OECD that public debt would decline in 2013 to 115% after further tightening,⁷³ the IMF expects debt ratio instead to peak in 2013 at 123.4% while the economy will keep contracting well into 2013.⁷⁴ The decline reflected the fall in domestic consumption demand and investment; weak employment and real incomes; the fall in confidence; and only a slight improvement in credit conditions. As a result, in the second quarter of 2012, GDP continued to contract (Graph 8) by slightly more than half a percentage point compared with the previous period.

70. Moody's Investors Service, "Rating Action: Moody's downgrades Italy's government bond rating to Baa2 from A3, maintains negative outlook", 13th July 2012, available at: http://www.moody.com/research/Moodys-downgrades-Italys-government-bond-rating-to-Baa2-from-A3-PR_250567

71. OECD Italy Economic Forecast Summary, May 2012, http://www.oecd.org/document/45/0,3746,en_33873108_33873516_45268653_1_1_1_1,00.html

72. Ibid, 6.

73. OECD Economic Surveys: Italy, May 2011, <http://www.oecd.org/dataoecd/58/29/47769054.pdf>

74. "IMF says Italy to miss deficit targets for 2012, 2013", *REUTERS*, 17th April 2012, <http://www.reuters.com/article/2012/04/17/italy-finances-imf-idUSR1E8EG00Y20120417>

The most recent evidence demonstrates clearly that the Italian economy is trapped once more in such a cyclical pattern, under pressure from weak European economies and the short term consequences of fiscal tightening advocated by its government.

Foreign trade continued to be the driver of economic activity, while industrial production has declined considerably compared to 2011.

Graph 8. GDP Growth (Annual % Change)



Source: 2006-2009 World Bank; 2010-2013 IMF⁷⁵

Gross savings rate has declined in the first quarter of 2012, currently at 9.2% from 12% in 2008, parallel to a steady decline of gross investment rate.⁷⁶ Italy was affected by rising oil prices, and another increase in VAT will lead to temporarily higher inflation (above 3% over the first half of 2012).⁷⁷ Italy already has a quite low budget deficit, below the 3% maximum rule for Eurozone countries; yet the IMF forecasted that the country will miss its targets for both 2012 and 2013 due to weaker economic environment globally. The IMF still expects that country's primary balance would post a surplus of 3% of GDP in 2012 and 4% in 2013.⁷⁸ Foreign trade continued to be the driver of economic activity, while industrial production has declined considerably compared to 2011. It should be noted that non-EU markets account for 44% of exports and 46% of imports, with Turkey becoming a stronger trading partner. Exports to Turkey increased 17.1% over the last year (May 2011-May 2012)⁷⁹.

75. World Bank Databank, Country Indicators: Italy, http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.00&newReport=yes&IS_REPORT_IN_REFRESH_MODE=true&IS_CODE_REQUIRED=0&COMMA_SEP=true; IMF World Economic Outlook Update: "Global recovery stalls, downturn risks intensify", 24th January 2012, <http://www.imf.org/external/pubs/ft/weo/2012/update/01/>

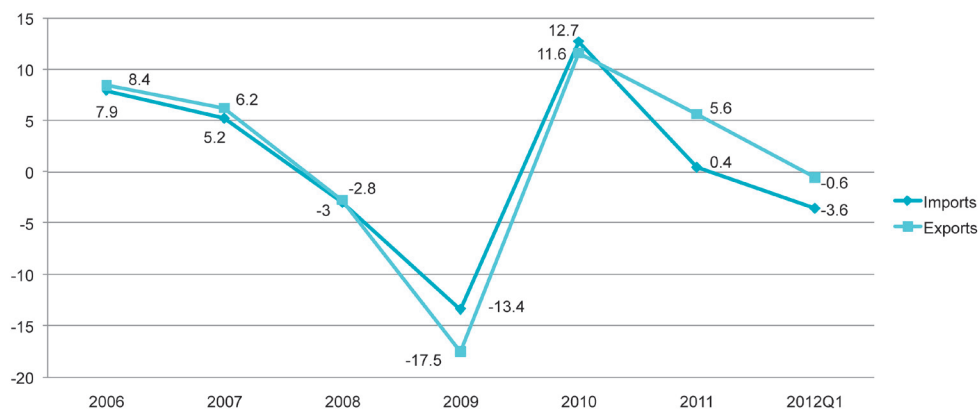
76. Istituto Nazionale di Statistica: Household Income and Savings and Non-financial Corporations Profits (1st quarter 2012), 6th July 2012

77. Banca d'Italia Bollettino Economico n.69, July 2012, http://www.bancaditalia.it/pubblicazioni/econo/bollec/2012/bolleco69;internal&action=_setlanguage.action?LANGUAGE=it

78. Ibid, 73.

79. Istituto Nazionale di Statistica, Commercio Estero, 16th July 2012, <http://www.istat.it/en/archive/66922>

Graph 9. Annual Imports- Exports Change (% GDP)



Source: Banca d'Italia (July 2012)⁸⁰

The average unemployment rate in June 2012, compared to Greece and Spain, remained relatively low at 10.8%—near the European average, with higher rates in the southern regions.⁸¹ However, absorption of young Italians into the workforce is rapidly becoming a concern for fear that an entire generation will end up unskilled.⁸² The OECD argues for educational and labor law reform that would provide suitable workforce with links to the market,⁸³ instead of providing a lifetime employment guarantee as a solution.

The Outcomes so Far

Italian Prime Minister Mario Monti, a renowned economist, leads a weak coalition government but has vowed to push forward the reform agenda before he steps down in 2013. Continuing structural reforms have already boosted longer-term prospects. Since 2008 Italy adopted a 3-year fiscal budgeting plan which allows it to monitor public expenditure more efficiently, embarking into a series of reforms, most prominently the gradual reform of the pension system with increased retirement age. He has managed to partially deregulate some professional services, taken measures against tax evasion, and proposed a reform of the labor market—still before parliament—which would set the foundations for a German-style apprenticeship and allow for more flexible employment.⁸⁴ While the overall economic environment remains discouraging, it will become more difficult to push for further reforms—in particular in the highly protected labor market.

80. Ibid, 75.

81. Ibid, 11.

82. Eric Sylvers: "Young Italians will struggle to find jobs", *The Financial Times*, 16th July 2012, <http://www.ft.com/intl/cms/s/0/9fb10f7a-c8fb-11e1-a768-00144feabdc0.html#axzz21RICfkqF>

83. OECD Economic Surveys: Italy, May 2011, <http://www.oecd.org/dataoecd/58/29/47769054.pdf>

84. Ibid, 81.

However, absorption of young Italians into the workforce is rapidly becoming a concern for fear that an entire generation will end up unskilled.



Southern Cyprus is one of the late arrivals in the single European currency and the latest country to ask for financial help from the EFSF and the IMF on June 25, 2012.

What Next?

As Spanish bond yields reached a record high and the euro a record low against the yen and the dollar on July 23, 2012, the Italian stock market plummeted, losing enough to raise alarm in Europe. Italy's stock market regulator banned the short-selling of shares in banks and insurers until July 27th in a bid to prevent further losses.⁸⁵ Sicily could become a point of weakness for Italy, as it had to receive emergency funding from the central government to avoid a default on its payments. Schools in many areas may not open in September, as municipalities such as Napoli find themselves in severe financial difficulties. The planned spending cuts and tax increases should further reduce the deficit in 2013, and Spain ambitiously aspires to eliminate it in 2014. Additional fiscal action may be needed, but prudent government assumptions about revenue from measures against tax evasion may provide a safety margin. With the primary budget balance recording a rising surplus, the debt ratio is projected to fall in 2013. Competitiveness could increase with reductions in real wages, reflecting productivity while keeping unemployment in check, especially in south Italy. Yet, these efforts may amount to little vis-a-vis investor panic about the future of the euro and viability of the EU as a monetary union too.

7. TRAPPED ECONOMIES: SOUTHERN CYPRUS

Southern Cyprus is one of the late arrivals in the single European currency and the latest country to ask for financial help from the EFSF and the IMF on June 25, 2012. Southern Cyprus at the moment heads the European Union, as part of the rotating presidency, a fact raising concerns about how it would be possible to negotiate its bailout agreement while being at the helm of the union that provides it. Southern Cyprus is a textbook contagion case, since its banks were greatly exposed to Greek bonds and have experienced heavy losses after the Greek government and its creditors agreed on a "voluntary haircut" in March 2012, as well as on loans made to businesses in Southern Cyprus, which have been severely hit by the recession in Greece, its biggest trading partner. The request for aid was prompted after the second largest bank in Southern Cyprus, Southern Cyprus Popular Bank, had to be urgently recapitalized by the government, shortly after Fitch downgraded Southern Cyprus sovereign credit status to "junk" status. It is estimated by the government that it will need one third of its GDP to rescue its troubled banks,⁸⁶ making it impossible to raise the funds it needed itself. The initial request was for €10 billion—almost half its GDP⁸⁷—yet the final amount may vary. Southern Cyprus in 2011 obtained a €2.5 billion euro loan from Russia, whose business people are important customers of Southern Cyprus's relatively large offshore financial sector of 10% corporate tax. In a bout

85. Graeme Wearden and Nick Fletcher: "Eurozone crisis live: markets tumble amid fears over Spain and Greece", *The Guardian*, 23rd July 2012, <http://www.guardian.co.uk/business/2012/jul/23/eurozone-crisis-spain-bond-yields1>

86. "Fitch Downgrades Cyprus Credit Grade to Junk", *Time Business*, 25th June 2012.; <http://business.time.com/2012/06/25/fitch-downgrades-cyprus-credit-grade-to-junk/>

87. World Bank Databank: Cyprus, <http://data.worldbank.org/country/cyprus/>

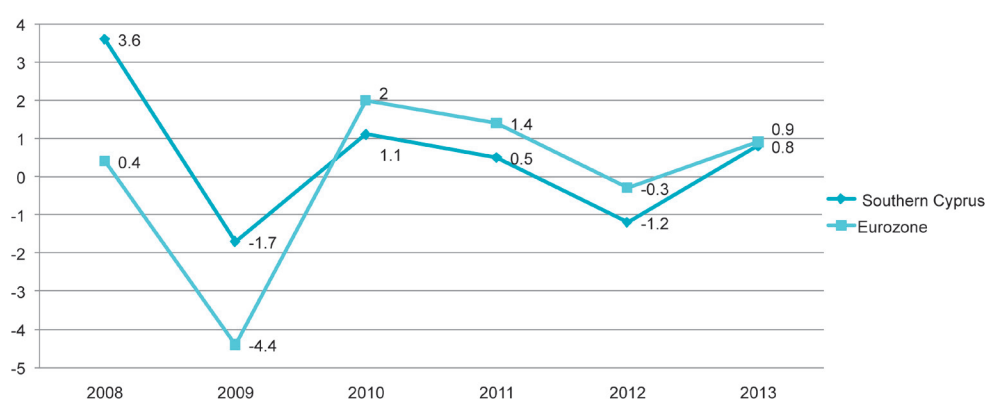
of romantic camaraderie, communist President Dimitris Christofias had hoped to secure another loan from Russia or China, parallel to the discussions for a loan from the EU and the IMF.⁸⁸ Recently Southern Cyprus started the second licensing round for the exploration of hydrocarbons in the shale deposits off the island's southern shore,⁸⁹ hoping that hydrocarbon exploitation will rejuvenate its economy.

Economic Indicators Review

Preliminary data for 2012 show that the budget deficit stands at -1.2% of GDP with inflation at 3.2% for the period January-April 2012,⁹⁰ persisting above the 2.4% EU average for the first quarter of 2012.⁹¹ The country continues to suffer from a foreign trade deficit in 2012. Exports fell 26.1% and imports fell 8.1% in the first quarter of 2012 compared with the same period last year.⁹² The IMF forecasts a slump in GDP growth for 2012 at -0.3% of GDP with a gradual recovery in 2013 (Graph 10). However, their estimates were based on data gathered prior to Southern Cyprus' request for financial assistance. Thus, it is likely that once the agreement is finalized estimates will be revised downwards.

The country continues to suffer from a foreign trade deficit in 2012. Exports fell 26.1% and imports fell 8.1% in the first quarter of 2012 compared with the same period last year.

Graph 10. GDP Growth (Annual % Change)



Sources: 2008-2010 World Bank; 2011-2013 IMF⁹³

88. Dan Bilefsky: "For Rescue Line, Cyprus Prefers a Russian Loan", *The New York Times*, 18th June 2012, <http://www.nytimes.com/2012/06/19/world/europe/cyprus-counts-on-its-close-ties-to-russia.html?pagewanted=all>

89. Cyprus Ministry of Commerce, Industry and Tourism, 2nd Licensing round- Hydrocarbon Exploration, http://www.mcit.gov.cy/mcit/mcit.nsf/dmlhcarbon_en/dmlhcarbon_en?OpenDocument

90. Central Bank of Cyprus: Monthly Economic Indicators, 31st May 2012, <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>

91. Eurostat News Release No:107/2012, Euro Indicators: 'Euro area annual inflation stable at 2.4% (June 2012)', 16th July 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-16072012-AP/EN/2-16072012-AP-EN.PDF

92. Eurostat News Release No:108/2012, Euro Indicators: "Euro area international trades in goods surplus of 6.9bn euro" (May 2012), 16th July 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/6-16072012-BP/EN/6-16072012-BP-EN.PDF

93. World Bank Databank, Country Indicators: Cyprus and Euro area, (2008-2010) http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.0&newReport=yes&IS_REPORT_IN_REFRESH_MODE=true&IS_CODE_REQUIRED=0&COMMA_SEP=true; IMF World Economic Outlook, p.53, April 2012, <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>



Turkey became the third-fastest growing economy among G20 countries, after China and Argentina, with 8.5 percent growth rate.

Southern Cyprus accounted for 20% of foreign direct investment in Russia in 2011, reflecting the fact that it is lately being used as a safe haven for Russian deposits, surpassing foreign direct investment from China.⁹⁴ Southern Cyprus was the recipient of more than €4.4 billion in capital flows in 2011.⁹⁵ In terms of government debt, in the first quarter of 2012 it stood at 74.6% of its GDP⁹⁶. Southern Cyprus' unemployment rate was 10.5% in June 2012, approximately at the European average.⁹⁷

What Next?

As the IMF field team concluded its visit, the government and creditors await the IMF's assessment of the amount required to support the Cypriot economy to commence the negotiations. The general understanding is that the requirements to bring the economy back into shape will not be different from the structural adjustment programs followed by Ireland, Portugal, Greece, and Spain—namely more austerity, reduced public spending, comprehensive reform of the banking sector, and measures to improve competitiveness. It has become obvious, though, from the Greek and Spanish experiences that these prescriptions are enough neither to contain nor to prevent the crisis from spreading in Europe. Will the only state with a communist leader in Europe be able to handle a bank-induced recession?

8. EMERGING ECONOMY: TURKEY

After having experienced a severe financial crisis that saw GDP growth collapse in 2001, Turkey made a series of painful and gradual reforms to strengthen its economy and protect it from such events in future, similar to those the weaker European economies are asked now to make by the same institutions. International consequence and a series of problems in the international financial sector brought yet another recession at the doorstep of Turkey in 2008, yet this time it was better equipped to deal with it. In late 2010, a new monetary policy was introduced to try and contain domestic demand without fueling capital inflows and excessive exchange rate appreciation. The Turkish economy further benefited from depreciated currency in 2011 that contributed to relatively lower inflation and raised its competitiveness. Turkey became the third-fastest growing economy among G20 countries, after China and Argentina, with 8.5 percent growth rate.⁹⁸ The quick rebound of GDP growth came with macroeconomic strings

94. Ibid, 87.

95. Central Bank of Cyprus, Statistics: Annual data of flows by country and investor sector, 2011, http://www.centralbank.gov.cy/nqcontent.cfm?a_id=11130

96. Ibid, 6.

97. Ibid, 11.

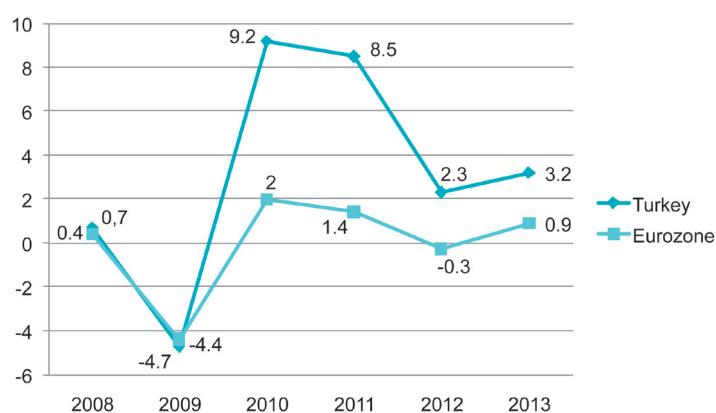
98. T.C. Başbakanlık, Hazine Müsteşarlığı, Public Debt Management Report 2012, <http://www.treasury.gov.tr/irj/go/km/docs/documents/Treasury%20Web/Research%26Data/Public%20Debt%20Management%20Report/Public%20Debt%20Management%20Report%20-%202012.pdf>

attached: the current account deficit widened and inflation remained high, revealing that Turkey is still quite dependent on international money flows. As the economy this year is projected to cool down amidst overall slower growth globally, the government will have more time to soften these effects.⁹⁹

Economic Indicators Review

As is evident from the graph below (Graph 11), the recovery of GDP in 2009 was outstanding and Turkey is expected to maintain growth rates much higher than those of the Eurozone.

Graph 11. GDP Growth (Annual % change)



Source: 2011-2013 IMF; 2008-2010 World Bank¹⁰⁰

GDP annualized growth in the first quarter of 2012 was 3.2%.¹⁰¹ The OECD estimates that it will increase slightly to 3.3% as a result of the rebalancing effect.¹⁰² The government debt-to-GDP ratio for 2011 was 39.40%¹⁰³ an indicator that aligns with EU accession criteria and is much better than most Eurozone countries. Chronic high inflation

99. OECD: Economic Survey of Turkey 2012, http://www.oecd.org/document/45/0,3746,en_2649_33733_50676909_1_1_1_1,00.html

100. World Bank Databank Country Indicators: Euro area and Turkey, (2008-2010) http://databank.worldbank.org/ddp/html-jsp/QuickViewReport.jsp?RowAxis=WDI_Series~&ColAxis=WDI_Time~&PageAxis=WDI_Ctry~&PageAxisCaption=Country~&RowAxisCaption=Series~&ColAxisCaption=Time~&NEW_REPORT_SCALE=1&NEW_REPORT_PRECISION=0.0&newReport=yes&ROW_COUNT=1&COLUMN_COUNT=3&PAGE_COUNT=2&COMMA_SEP=true; IMF World Economic Outlook, p.53, April 2012, <http://www.imf.org/external/pubs/ft/weo/2012/01/pdf/c2.pdf>

101. Türkiye İstatistik Kurumu: Gross Domestic Product I. Quarter 2012, Press Release No: 10850, 2nd July 2012, <http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=10850>

102. OECD Turkey Economic Forecast Summary, May 2012, http://www.oecd.org/document/34/0,3746,en_33873108_33873854_45270434_1_1_1_1,00.html

103. Tradingeconomics.com: Government Debt List by Country, <http://www.tradingeconomics.com/government-debt-to-gdp-list-by-country>

The government debt-to-GDP ratio for 2011 was 39.40% an indicator that aligns with EU accession criteria and is much better than most Eurozone countries.



Turkey has been consistent in improving its workforce through education in the past decade, but there have been low absorption rates for skilled and educated workers.

remains a primary challenge for the Turkish economy, as it persisted above 10% until May 2012 before falling in June to 8.9%—the first time ever below the 10% threshold.¹⁰⁴ This was more than triple the Eurozone average for the same period.¹⁰⁵ The current account deficit, another vulnerable area of the economy, was €12.4 billion for the first quarter of 2012—the fourth highest in Europe, after the UK, Spain, and Italy¹⁰⁶. Favorable exchange rates boosted trade. Exports in May 2012 rose 29.1% in volume led by higher exports of precious metals,¹⁰⁷ while import volume increased 7.2% compared with the corresponding month of 2011.¹⁰⁸ Turkish exporters diversified their markets early enough to realize profits from the Middle Eastern countries,¹⁰⁹ whose economies due to the ongoing instability and financial bottlenecks have come to a halt. At the same time, exporters have been reducing their exposure to Europe by more than a third where demand has been increasing vis-à-vis falling incomes, with top destinations the UK and Germany. As a result, the foreign trade deficit in April 2012 decreased by 27.3%,¹¹⁰ Unemployment in 2011 was 8.8%,¹¹¹ nevertheless the OECD draws attention to Turkey's low female participation in the work force, as well as the high rates of informal employment. Turkey has been consistent in improving its workforce through education in the past decade, but there have been low absorption rates for skilled and educated workers. In the long run, underused skilled personnel may become a lost opportunity to increase competitiveness, unless further reforms in labor legislation take place.¹¹² Turkey had until recently the most protected employment in the OECD.¹¹³ It is worth mentioning that the size of Turkey's informal labor market is such that it allows, at least in the private sector, considerable flexibility.

CONCLUSION

Turkey seems that it has learnt from past mistakes. The country still has some way to go, but it does so with big strides; traps exist in the path, such as overheating the economy, or tapping credit, both of which would make immediately the economy vulnerable. So far, it compares favorably with many European economies, although living standards are still lower than those of its European neighbors. Under such circumstances the fact

104. Türkiye İstatistik Kurumu: Consumer Price Index, June 2012, Press Release No: 10851, 3rd July 2012, <http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=10851>

105. Ibid, 90.

106. Ibid, 46.

107. Türkiye İstatistik Kurumu: Foreign Trade Statistics, April 2012, Press Release No:10827, 31st May 2012, <http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=10827>

108. Türkiye İstatistik Kurumu: Foreign Trade Indices, May 2012, Press Release No:10855, 10th July 2012, <http://www.turkstat.gov.tr/PreHaberBultenleri.do?id=10855>

109. Turkish Exporters Assembly: "Springtime for Exports", <http://www.tim.org.tr/en/news-recent-news-spring-time-for-exports.html>

110. Ibid, 106.

111. Ibid, 29.

112. Ibid, 98.

113. Ibid, 30.

that Turkey can change the value of its currency to manipulate economic performance is a key advantage compared to the Eurozone but this measure should be used with extra caution. Turkey was partly affected by the crisis, and to some extent is still being affected, notably via trade and capital flows. It has to stabilize its growth rate before securing its position as a leading emerging economy and face domestic challenges that may pose obstacles in the medium and long run. In this respect, the current financial crisis in Europe has two simple lessons for Turkey: first, Turkey should be able to reduce dependency on the EU and turn to new markets for foreign exchange-generating exports; second, reforms with a long term perspective bring rewards. It has become obvious that the weaknesses of the EU due to fragmentation often make it unable to offer viable solutions for structural economic problems to its members. It would be an interesting mental exercise to try and imagine how the Turkish economy would have dealt with the crisis had it been a member of the EU.

Europe finds itself in the middle of an existential crisis, whirling around the viability of the single currency. Years of efforts have not been enough to make south and north economies converge and the lack of any political will from the European authorities to address the situation decisively only serves to deteriorate the situation. After all, each case has its own characteristics and challenges- it would be a chimera, on the part of the rescue planners to believe that with the same measures all problems will be solved. For instance, Southern Cyprus' and Ireland's problems started from their banks, as opposed to Portugal and Greece which suffer from productivity failure. More flexibility from lenders would be a solution, as well as political agreement on the fact that it is not only some member states that do suffer, but the whole union. Obviously the crisis is political too, since it is precisely due to political inaction that the crisis spreads. In such moments leaders have the opportunity to make history, and in the past Europe had indeed many inspirational politicians to consolidate the European vision. This time it seems that there only strong individualistic tendencies in the European establishment. In the absence of such political response it is highly possible that more Eurozone countries may find themselves in need of rescue- speculators place their bets on Spain and Italy for the next full bailout, and Greece as the first to wave the Euro good-bye.

It would be an interesting mental exercise to try and imagine how the Turkish economy would have dealt with the crisis had it been a member of the EU.

It has been almost four years since the global financial crisis started in 2008 and it has become an inherently European affair. One after another, weaker European economies seeing their growth plummeting have become unable to recover on their own and are resorting to loans from the International Monetary Fund (IMF), European Central Bank (ECB) and the European Union (EU). Already, Ireland, Greece and Portugal have requested full bailouts with Southern Cyprus as the newcomer, still under negotiation, while Spain has requested only partial assistance not acknowledging it may soon need full support. Many experts predict that Italy will follow suit as it is quite possible that it will be the next which without any access to credit markets to finance its needs. This policy analysis sheds some light on the current status of these countries: how the crisis was brought about, what measures they took, how have they performed thus far and what are the prospects for them. The role of the European Union is also being discussed in reference to the hesitant way it has addressed the problem and the cracks that appeared in the European establishment due to lack of mutual understanding and cooperation. In contrast to the weaker European economies, neighboring Turkey has managed to recover fast and exhibit positive signs that the economy is moving towards more sustainable growth rates while dealing with domestic vulnerabilities. This comparison serves as a reminder to reconsider both the usefulness of the single currency as well as whether Turkey's economy would benefit from closer ties with it, given that Europe faces a continued slowdown at least until 2014.

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