THE EUROPEAN UNION EXPOSED TO THE RISK OF THE SOVEREIGN DEBT CRISIS. CASE STUDY: SPAIN AND PORTUGAL

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Abstract:

The global economic crisis, intensely debated, started almost six years ago, subjected the EU to new resistance tests because of the macroeconomic imbalances in the Euro Zone, generated by the increase of sovereign debts, especially in the PIIGS countries (Portugal, Ireland, Italy, Greece, Spain). The situation has degenerated because of the lack of legal leverages through which the member countries should be forced to correct the fiscal imbalances and to meet the macroeconomic convergence criteria imposed. The Treaty on Fiscal Governance in the EU, signed on 2 March 2012, appears to be the key to the macroeconomic recovery in the Euro Zone, due to the more severe budgetary discipline it imposes.

This paper, by means of deductive analysis and causal explanations, outlines the current economic situation of the Euro Zone, under the impact of the member countries' sovereign debt crisis, focusing on Spain and Portugal. In addition to reliable statistics, the paper also presents the EU's economic recovery strategy that anticipates its future. Unfortunately, the perspective of the Euro Zone is still in a fairly high degree of uncertainty, strongly influenced by the economic development of the member countries and by solving the problems they face. Spain and Portugal are the actual example.

Key words: *EU; economic crisis; GDP; sovereign debt*

JEL classification: O1; O4

1. Introduction

The EU is going through a difficult period in which the effects of the sovereign debt crisis recorded by some countries of the Euro Zone are still affecting the EU's stability and economic growth. The main fault lies with the PIIGS countries (Portugal, Ireland, Italy, Greece, Spain), which have lost control over the sovereign debt ceiling and have submitted the EU's macroeconomic stability to a maximum risk since 2011. The EU leaders have recognised the risk of contamination for other countries as well, and also the lack of legal leverages through which the guilty countries are held responsible for the situation created. The idea of amending the Lisbon Treaty was heavily debated in order to establish a stricter budgetary discipline within the Euro zone member countries, for each country to be held responsible if it does not comply with the Stability Pact. More precisely, these states can be automatically sanctioned or be placed under the supervision of the European institutions. The talks resulted in the signing of the Treaty of fiscal governance, on 2 March 2012, by the Member States, except the United Kingdom and the Czech Republic. A year and a half after signing the treaty, the EU is still in economic recession. The Gross Domestic Product (GDP) in the Euro zone shrank by 0.50 % in the second quarter of 2013 as compared to the same period last year. The biggest GDP contraction occurred in March 2009, of 5.20 %, and the highest growth, of 5%, occurred in March 1995 (Trading Economics, 1). The data presented by Eurostat show a spectacular increase in the Euro zone governmental debt, which reached a historical high of 92.2 % of the GDP in the first quarter of 2013. The Euro zone remains a major player on the world economic stage, the second after the USA. The 17 member countries participate differently in making the GDP of the area and the largest contribution is made by Germany (26%), France (21%), Italy (16%) and Spain (11%). A study in the EU countries shows a downward trend of the composite annual index *Living Standards, Labour and Social Inclusion Index* for several European countries, including Spain and Portugal. This situation that we find in most European countries, can be partly explained by the economic-financial crisis, which occurred during the period under review

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(Dindire, 2012, pp. 28-34). There is no doubt that the high degree of synchronisation of the international crisis and the Euro Zone peculiarities affected the two economies and slowed down the pace of the economic recovery.

2. Spain

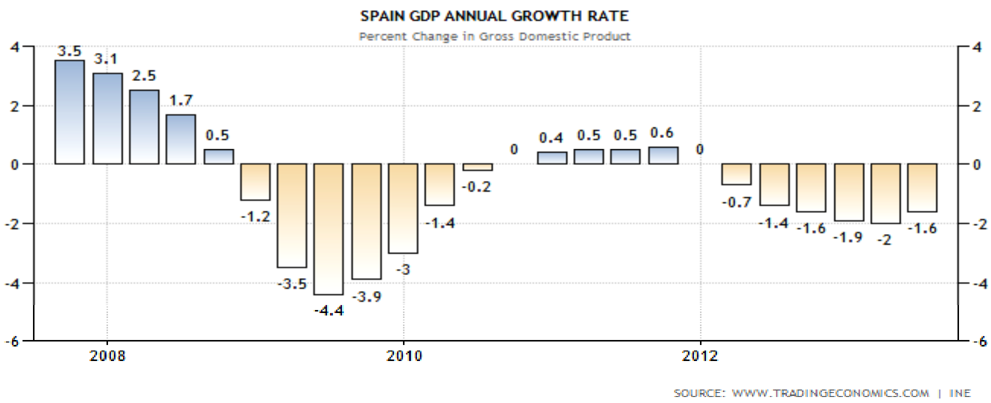
Since joining the EU (1986) to the start of the sovereign debt crisis, the Spanish economy has experienced rapid growth and diversification, the *engine* being *the foreign direct investments and the consumer demand* (Voicu I.I., Talmaciu I., 2012, p. 294). The domestic market dimension (46.2 million inhabitants) and the strategic positioning place Spain among the ideal destinations for starting international affairs. For this, the period 2010-2013 was marked by *extensive structural reforms* after the biggest economic downturn recorded in 2008-2010, considered by specialists unprecedented and which, unfortunately, continued in the subsequent years, including the first half of 2013. Basically, the economic boom recorded in the real estate and construction field, until the crisis, has pushed the country into a deeper recession than in many other European countries, considered of a *W type*.

2.1. The GDP evolution under the impact of the sovereign debt crisis

The current economic situation shows that the application of the broad governmental structural reforms process has not reached, not even by far, the expected results and the economy contracted markedly.

Spain has a large economy, strongly oriented towards services, the fourth in the Euro zone, with a strong and diversified manufacturing industry, with a GDP equivalent to more than 2% of the world economy. By sectors of activity, *the GDP has the following structure*: 73.6% services, 11.6 % industry, 9.3 % construction, 2.9 % energy, 2.6% agriculture, livestock, fisheries (Trading Economics, 2). Spain is *the third largest exporter of wine, fruits and vegetables*, one of the biggest tourist destinations in the world and the second European one, after France. *The foreign trade* records deficits, being strongly oriented towards the EU: 70 % of exports and 59 % of imports.

Table no. 1



In the period 1996-2013 Spain's GDP grew at an average annual rate of 2.25 %, with a peak of 5.8 % in March 2000 and with the largest decrease in June 2009 of 4.40 %. The effects of the crisis affected the Spanish economy, which continued to record a downward trend, including the first half of 2013. Thus, in the second half of this year, the GDP contracted by 1.6 % as compared to the same period of the previous year, the economy continuing to face serious structural problems.

2.2. The country with the highest unemployment rate in the EU

Since 2008 Spain was the country with *the highest unemployment rate in the EU,* in January 2012 it reached the level of 22.85% (Trading Economics, 3). Basically, in 2010 the unemployment rate in Spain was twice the average in the Euro zone (Global economic conjuncture, 2011, p. 76), and in December 2011 it exceeded twice the EU average (Global economic conjuncture, 2012, p. 95).

Table no. 2

Out of the total number of the unemployed, 40% are recorded as long term unemployed, and the youth unemployment has exceeded 46% (The Economist, 2011), indicator which has also increased on the overall OECD by 30%, but in Spain it has doubled as a percentage (The Economist, 2013). In the second quarter of 2013, the unemployment rate fell by nearly a point as compared to the first quarter, reaching 26.26 %. If in June 2007 this indicator recorded the lowest value, namely 7.95 %, in March 2013 it reached a record level of 27.20 %. The growing rate of unemployment and the payments of the subsequent benefit create major problems to the Spanish authorities.

2.3. Other issues with major economic implications

Moreover, *the public debt* has exceeded 60% of the GDP, *the budgetary deficit*, although declining as compared to the previous year, it was the third largest after that of Ireland and Greece, and the *labour productivity* continued to be below the EU average. *Taxation* in Spain is lower as compared to that of other EU countries, however, the fiscal consolidation appreciated by experts as crucial for enhancing trust among national officials and foreign investors contribute to the braking, on short term, of the economic recovery so necessary for generating new jobs (Global economy conjuncture, 2011, p. 84). For correcting the *budgetary deficit*, the current austerity measures focus on decreasing budget spending and increasing tax revenues from taxes, without violating the *principle of proportionality*. Basically, there must be a fair relation between the tax payers' ability to pay and the level of taxation.

The prognosis of the European Commission on the Spanish *budgetary deficit* for 2013 is of 6.3% of the GDP, but its level reached 6.5% in the first half of the year. Spain's commitment to correct this indicator by the end of 2014, when the level should not exceed 3% of the GDP, seems impossible to meet in the current context. The Standard & Poor's Financial Rating Agency estimates that Spain's economy will shrink by 1.5 % in 2013 and then it will recover slowly, reaching an increase of approximately 0.6% in 2014 (Capital.ro, 2013). Nevertheless, *the public debt* reached in June 2013 a new record level of 92.2% of the GDP, according to the figures released by the Central Bank of Spain, surpassing by 0.8 points the maximum ceiling set by the government, being by 15% higher than the same period of the previous year. This leads to decreased investor confidence in the country's ability to pay its debts; it increases the cost of borrowings on the foreign markets and reduces the governmental bond yields. Estimates show that public debt could reach 100% of the GDP in the next three years.

2.4. Conclusions

In this context, Spain's coming out of the crisis and economic recovery is a very difficult process, highly influenced by a number of **internal and external causes**, which make the country highly vulnerable in the coming years:

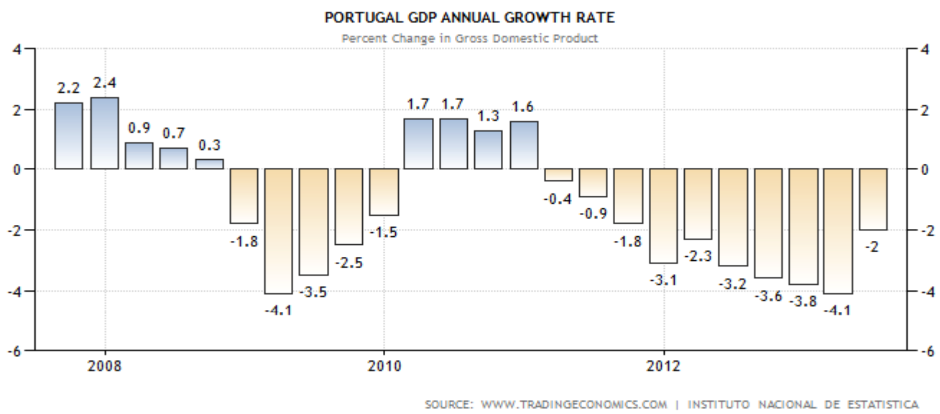
- Unemployment rate, which is out of control and came to unacceptable rates;
- Decrease of domestic consumption;
- Reduction of productive investment;
- Lack of strong levers for fiscal consolidation;
- Vulnerability of the financial-banking system, still exposed to risks generated by the real estate and construction sector;
- Decreased confidence of the population in the Euro currency and the rise in Euroscepticism;
- Growing budgetary deficit, unsustainable;
- Very high level of the public debt;
- Difficult access to crediting and refinancing of individuals and businesses;
- High cost of borrowings on the foreign markets;
- Foreign investors' decreased confidence in the Spanish economy as a result of the existing risks;
- Growing trade deficit as a result of the dependence on imports, especially on fuel and high value-added products;
- Increase of the world price per barrel of oil;
- The slowdown in the global economic growth because of the decrease in the volume of international trade.

3. Portugal

Portugal recorded in the past decade the slowest economic growth in the Euro zone, defined by an average annual rate of just 1%, because of some structural problems that persisted in the economy (Voicu I.I., Talmaciu I., 2012, p. 294). For this reason, Portugal has become extremely vulnerable to the effects generated by the global economic crisis, recording: high *budgetary deficit*, growing *public debt* and a very high rate of *unemployment*. Furthermore, Portugal is part of the PIIGS countries that have fuelled the growth of sovereign debt in the Euro zone, since 2008, thus generating large macroeconomic imbalances in the EU.

3.1. Evolution of GDP in the context of the current economic crisis

Table no. 3



Portugal has become a diversified economy and increasingly based on services, after the accession to the EU (1986). The attraction of the *European funds* and *foreign capital* was the main basis through which the economic structure could modernise itself so quickly, and the industry could restructure itself. Over the past two decades, the successive governments have privatised many state-controlled firms and have liberalised the key areas of the economy, including the financial and telecommunications sectors. *The services sector* has experienced the fastest growth and diversification, participating with 74.5% to the GDP, out of which the trade, the restaurants and the hotel industry represents almost 20%. If in 2001, 35% of the active population worked in the tertiary sector, in 2011 the share was nearly of 63%. *The secondary sector* participates with 23.4% to the GDP and is dominated by the manufacturing industry, while *the primary sector* (agriculture, forestry and fishing) has reduced its weight in the past 10 years to 2.1 % of the GDP. Practically, Portugal's *GDP* increased during 1996-2013 with an average annual rate of 1.24%, in the context in which the average growth in the Euro zone was of 1.65%. Based on the economic crisis, in March 2009 the largest contraction in the GDP, of 4.10%, was recorded, and in December 1998 the largest increase up to date (5.6%). The downward trend of the GDP continued in the second quarter of 2013 when it fell by 2 % as compared to the same period of the previous year.

3.2. Unemployment - a high risk indicator

Table no. 4

The labour market recorded a deteriorating trend after the start of the global economic crisis, as in 2011, *the unemployment rate* reached the record level of 1998, of 12.9% of the total of the active population (Global economic conjuncture, 2012, p. 103). The situation has worsened steadily and in the first half of 2013 the unemployment reached the maximum historical level of 17.7%. Although in the second half of 2013 there was a slight decrease, up to 16.4%, this indicator remains at alarming levels, defining an extremely vulnerable labour market. Portugal is facing the highest level of unemployment in its history, ranked third in the EU, after Spain and Greece.

3.3. Other issues with economic implications

In 2011, although Portugal avoided the economic collapse by receiving financial aid from the EU and IMF, it entered a strong recession. The lenders have imposed nevertheless *strict conditionality* to the Portuguese government: reducing the budgetary deficit to 5.9% of the GDP in 2011, as compared to 8.6% in 2010 and to 3% of the GDP by 2013 (Global economy conjuncture, 2011, p. 88). Heavily indebted, Portugal is under Troika demands and the austerity measures imposed have affected *the purchasing power* of the Portuguese and have generated *the decrease of the domestic demand*.

Foreign trade is highly deficient, orientated in an overwhelming percentage towards the EU (72%), the main partners being: Germany, Spain and France. The trade in services is in excess, tourism holds 50% of export, and for import and communications services, computer science and trade 35%. *The budgetary deficit* reached in December 2009 a historic high of 10.2% of the GDP and in 2012 it was of 6.4%. The representatives of the Portuguese government asked the international creditors to revise the budgetary deficit target for 2014 from 4% of the GDP to 4.5%. For 2013 the target is 5.5%.

Portugal has recorded *a growing public debt* from 93.3% of the GDP in 2010 to 123.6% in 2012. In the period 2011 - 2012 Portugal was downgraded by Moody's, Fitch and Standard & Poor's, becoming the "junk" country (high risk investments), that is to say subject to speculative investments, due to the high levels of sovereign debt and increased risks for the austerity programme established by the government. The international loan of 78 billion Euros from 2011 further requires extreme austerity measures for Portugal. The increase in working hours for civil servants from 35 to 40 hours per week was highly contested and currently the decrease by almost 10% of the civil servants' pensions, larger than 600 Euros per month, affects 300,000 people and has generated great controversy. This last measure alongside with others will reduce by over 1 billion Euros the 4.4-billion Euro deficit that the Pension Fund of the Portuguese civil servants currently holds. By the end of 2014 Portugal has pledged to reduce the public spending by 4.7 billion Euros and the imposed austerity measures have given rise to an endless string of protests of the workers, retired people and the unemployed.

3.4. Conclusions

Portugal still remains severely affected by the crisis and by *reducing taxation* for foreigners it was turned into a true tax haven for the private retired people of the EU. The real estates are 30% cheaper as compared to 2011, while banks provide loans on favourable terms to foreigners. Virtually, Portugal's economic recovery with the help of foreigners seems to become a strategic objective of the government. *The austerity measures package* imposed by the government has lead to *the decrease of the purchasing power, of consumption and of investment.*

The business representatives and those of the trade unions still remain sceptical about the economic recovery of the country and they think it will take extra financial help or even a sovereign debt restructuring programme. Most Portuguese are for the renegotiation of the International financial aid, implemented in the past two years, considering that the economic situation continued to worsen. As a result, Portugal could become the second country after Greece, which comes into economic collapse, the analysts considering that the tensions in the political arena have worsened the country's economic problems. For the following years, Portugal remains under the pressure of the following **internal and external causes** that hinder the economic recovery:

- Inconsistency in the economic and administrative reforms;
- Economic policy errors;
- Reduced financial credibility;
- Vulnerability of the financial-banking system;
- Deterioration of the public finances starting with 2009;
- Poor productivity;
- Decreased purchasing power, of the domestic consumption and of investment;
- Increase of unemployment – a rigid labour market;
- High costs of the pension system;

- Increase of the sovereign debt as a result of contracting the economy;
- High cost of borrowings on the foreign markets;
- Reducing the demand on the foreign markets – reducing the exports;
- Increasing the oil price and the dependence on imports.

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