

GREECE, PORTUGAL AND SPAIN - A TEST CASE FOR EUROPE IN 2011

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Abstract

Recent statistics clearly show that Greece, Portugal, Spain and other euro zone members have massive public deficits and that is why this entire means that euro's future is extremely delicate.

Until now, politicians have not come up with a concrete plan to solve the situation. In this matter, politicians in France, Germany and elsewhere have signaled that they'll provide some kind of back-up support, but only when Greece has really taken tough measures – possibly more than they have done already – to get the deficit down. Although that may be unsettling to some investors in the very short term, it's clearly good news for the euro in the longer term.

In our paper, the intention is to present the reasons why Greece, Portugal, Spain and other euro zone members have massive public deficits and what should other countries do in order to help them in the nearby future. For us, a great concern is also the reaction of the European Central Bank and what could this institution do in the benefit of European countries in general.

Keywords: public deficit, economic crisis, euro zone, European Central Bank, institution, competitiveness

Introduction

The study “Greece, Portugal and Spain - A Test Case for Europe in 2011” covers complex matters such as: the data provided by recent statistics about Greece, Portugal, Spain and other euro zone members that have massive public deficits and which means that the entire euro's future is extremely delicate; aspects regarding politicians that have not come up with a concrete plan to solve the situation, and in this matter, politicians in France, Germany and elsewhere have signaled that they'll provide some kind of back-up support, but only when Greece has really taken tough measures – possibly more than they have done already – to get the deficit down; problems that may be unsettling to some investors in the very short term, but could turn out to be favorable for the euro in the longer term.

That are the main reasons why, in our paper, the intention is to present the reasons why Greece, Portugal, Spain and other euro zone members have massive public deficits and what should other countries do in order to help them in the nearby future. For us, a great concern is also the reaction of the European Central Bank and what could this institution do in the benefit of European countries in general.

We strongly believe that all the ideas that we are going to present in our paper are extremely important because they present nowadays reality and try to bring along with the specialists' ideas new ideas that might bring improvement to the situation that has been created due to the economic crisis.

In order to provide an answer to the main matters of our paper, we have analyzed the situation that exists in France, Germany and the other big countries which have to provide help to other countries in need, such as Greece, Portugal and Spain. Furthermore, we have presented the position

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taken by the European Central Bank and the reasons that had lead to that position. We have considered also as being extremely important the position taken by politicians and the concrete plan that they took in order to solve the situation today. Of course, our main target was to find ways in which situations similar to the existing one can be avoided in the future. We have also mentioned which is the relation between the theme of our paper and the already existent specialized literature.

1. Greece, Portugal, Spain and other euro zone members and the massive public deficits

The first part of our study entitled “Greece, Portugal, Spain and other euro zone members and the massive public deficits” stresses the position that Greece, Portugal, Spain and other euro zone members that have great deficit problems are seen threw the yeas of other countries in the European Union or in the world. This part also highlights the main consequences of having a big financial deficit as a country that is part of the European Union and tries to emphasize the most frequent questions that the specialists have posed in regard to all these matters.

Nowadays, France, Germany and the other big countries need to provide help to other European countries that have a big public deficit. In this particular matter, France, Germany and the other big countries are going to require Greece, and any other country needing support, to put their own economy in order before receiving support from the others. It is generally known that the European Central Bank, which is technically subject to the EU treaties, is not allowed to bail out Greece, and that is the reason why the help would have to come from the other countries on a bilateral basis.

Firstly, we would like to present the situation of Greece. Of course, the problem that exists in Greece, for example, which has made investors nervous, has resulted in a safe haven flow out of Euros and into dollars. Politicians have not come up with a concrete plan to solve the situation, but they have signaled that they'll provide some kind of back-up support, but only when Greece has really taken tough measures, maybe even more than they have done already, to get the deficit down. Although that may be unsettling to some investors in the very short term, it's clearly good news for the euro in the longer term. Taking into account the situation that exists in Greece there is also a question about how high is the risk of payment default going to be. In this particular matter, specialists believe that the risk of payment default is going to be very small, though one can never say zero, because the financial markets are in continuous motion. Some analysts say that Greece is a test case for the European Union.

Secondly, our target is to present the situation of Spain. As Greece, Spain has also been facing a severe recession and major structural challenges, and that is the main reason why specialists believe that a recovery looks likely to be muted. For many years, the Spanish economy has outperformed its Euro area peers in terms of growth performance. Over the past decade, the growth of the Spain's gross domestic product (GDP) averaged 2.8 per cent compared to only 1.5 per cent in the Euro area as a whole. Even during the recent crisis, Spanish GDP has contracted somewhat less than in other Euro area countries, e.g. Italy or Germany. However, the relatively mild decline in GDP clearly masks the severity of the downturn. Domestic demand was down 12 per cent in the third quarter, compared to the third quarter in 2008. And the unemployment rate has surged from 8 per cent in 2007 to more than 19 per cent. While some of the larger Euro area economies exited recession already in the second quarter of 2009, the Spanish economy continued to contract in the third quarter. Of course, there are several reasons why the Spanish economy has been so severely affected. In this matter, specialists have stated that similar to the USA and the UK, Spain has experienced a housing boom and at the peak, 14 houses per 1000 inhabitants were built in Spain, compared to only 7 in the USA and 3 in the UK. This construction boom was financed to a significant extent by foreign borrowing. In 2007, the current account deficit to GDP ratio reached a peak of 11 per cent, which is very high by international standards and even far exceeded the US deficit. In particular, Spanish non-financial corporations' took up significant amounts of credit. And that is why, during 2007, their net borrowing (gross savings minus gross investment) reached minus 11 per cent of GDP. The debt of

households also increased markedly. The ratio of household liabilities to disposable income in Spain has become the highest among the large Euro area countries in recent years. Nowadays, Spanish households have increased their savings markedly and the savings rate has risen from around 10 per cent of disposable income at the beginning of 2008 to 18 per cent in the third quarter. Non-financial corporations have also lowered their dependency on external finance somewhat. As a result, the current account deficit has narrowed dramatically to around minus 3.5 per cent in the third quarter of 2009. At the same time, employment has been cut very sharply (minus 7.2 per cent in the third quarter of 2009, compared to the third quarter in 2008). Well known specialists believe that the extreme deterioration reflects two factors: the first one is Spain has the highest share of temporary workers in the European Union, and these can be dismissed easily and that is why the share of temporary employment has fallen from around 34 per cent in 2006 to only 26 per cent in 2009; the second one is that the downturn in the housing market has had a pronounced effect on construction employment and that is why construction employment has been falling for two years now, and accounts for around half the drop in total employment (emagazine.credit-suisse.com).

2. Possible scenarios for controlling the massive public deficits

The second part of our presentation entitled "Possible scenarios for controlling the massive public deficits" stresses the possible scenarios that one country should take into account in order to insure a better future and to avoid damage in the financial sector.

According to specialists, the current events surrounding Greece are leading to the creation of a kind of model, which will provide a broad framework in the situation in which other countries in the euro zone get into trouble. Portugal, Spain and Ireland may be affected, as well as Italy to a lesser extent, but the Greek case is very important, because it gives the possibility of creating a system offering some kind of residual support for weaker countries. In order to continue future studies, specialists must take into account that the euro encompasses strong economies like Germany and France on the one hand, and weak economies like Greece on the other and must try to balance the European Union economy. Of course, France, Germany and the stronger countries are prepared to help other countries in a deflation situation, but not inflation.

Firstly, in Greece or Spain's situation, there exist many opportunities which are both local and global: for example, locally, some investors are now looking at Greek or Spain bonds (the prices of which have fallen very sharply during the crisis) and wonder if they are now starting to offer value; for example, globally the equity prices have fallen generally during the crisis as well as the weaker euro. Of course, the worst of the crisis is now over and things will begin to stabilize, but there will be a risk of recurring bouts of instability from time to time, when some of the markets which have sold off can recover.

Secondly, taking into account Spain's situation in particular, recent figures show that unemployment is now stabilizing at a very elevated level, and we think it could start falling in coming months, business surveys have improved, but the improvement was clearly less pronounced than in other European countries, and as the process of debt reduction has further to run, we expect the road to recovery to be bumpy. The planned VAT hike from 16 per cent to 18 per cent next July and the abolition of the annual tax rebate of 400 Euro (per household) to reduce the budget deficit are the beginning of necessary fiscal restraints, which are likely to weigh on growth in coming years. Medium-term prospects do not look particularly encouraging either. A surge in the labor force driven by immigration was the major reason for the growth outperformance in recent years. From 2001 to 2008, the share of foreign workers increased from 3.6 per cent to 10.8 per cent. At the same time, productivity growth has fallen behind other large Euro area countries. Spanish competitiveness has deteriorated in recent years as unit labor costs have risen more strongly than elsewhere. A devaluation of the currency is not possible in a currency union, so competitiveness has to be regained through an increase in productivity or lower relative prices. Deflationary tendencies are becoming increasingly visible: In the producer price index, prices for consumer goods were down 0.5 per cent

in December (compared to December 2008). The prospects for Spain's housing market are also expected to be poor in the next few years. A recovery is nowhere in sight due to the challenging economic outlook, tighter credit, weak housing demand and the significant supply overhang in residential markets. The decline of housing demand in Spain started in 2007 and has intensified since then. For instance, the number of new and existing home sales is currently about 50 per cent to 70 per cent lower than their peak level. A pick-up in housing demand is unlikely in the short term given the high unemployment rate and credit constraints. During the past boom, banks have been willing and able to generate lending, which has fuelled housing demand. But the number of new mortgages on houses has dramatically fallen and hovers now around 50,000 mortgage properties per month compared to about 100,000 pre-crisis. A revitalization of mortgage credit is essential for a sustained recovery. There are some positive signs such as the pace of decline in mortgage lending abating and interest rates are at record low levels. However, for the time being, we think that mortgage credit growth is likely to remain sluggish. For example, the housing market is still highly oversupplied and the residential construction has played a major role in Spain's economic boom over the last decade, constituting around 8 per cent of output at the peak. The annual number of houses built more than trebled between 1997 and 2007 and, in 2006; Spanish housing starts were higher than in the UK and France combined. Since the beginning of the crisis in 2008, housing starts have dropped by about 70 per cent. Yet, according to estimates from R.R. de Acuña & Asociados – a Spanish real estate broker – the housing supply by the end of 2008 was about 1,600,000 units. This number includes new and existing unsold houses and supply under construction. At the current sales numbers of about 400,000 units per year, it would take four years to absorb all the stock. Most of these units are located in coastal regions and satellite towns close to large cities where construction has been the most active during the housing boom. Moreover, there are some risks that this oversupply situation could worsen as Spanish saving banks have recently started selling off their property portfolios due to regulatory changes. Banks and savings banks became large real estate owners in Spain by taking over thousands of homes used as collateral on defaulted loans. Bank of Spain decided last October to increase provision requirements on real estate assets held by financial institutions for more than a year from 10 per cent to 20 per cent, which is likely to lead to the sale of some of the bank's real estate holdings. However, detailed data on the bank's real estate holdings are scarce and it is difficult to assess the importance of this effect (emagazine.credit-suisse.com).

In regard to the data that we have hereby presented, we are still optimistic regarding the economic crisis that exists today in the world, because each crisis has brought new and improved techniques to ensure a better and prosperous development to the countries.

Conclusions

All in all, specialists expect an increase in the supply/demand imbalance and further house price declines. That is why, for example, in Spain's situation, the house price index has declined by only 9.5 per cent since its peak in the first quarter of 2008, and more over, according to some indicators, such as house price to disposable income, residential properties in Spain are still substantially overvalued. In the years previous to the economic crisis, specialists will have to learn how to balance the growth in Europe and not only there, but worldwide. The consumers should make also substantial contributions to growth, as well as the corporate sector and when the economy will stabilize there will be also regions in the global economy growing far faster than Europe, so it should be able to export to these markets.

As a first conclusion, countries must find places where the demand for European exports comes from. Asia is the fastest-growing region of the global economy, and becoming a large European trading partner. Central and Eastern Europe and the US are other important trading partners.

As a second conclusion, the European countries that can outperform must be helped in the nearby future. Among these countries there is also Germany who is growing the most quickly and who has one of the most volatile economies within the euro area, and had one of the most severe recessions. The German economy is very much driven by corporate spending and exports. It is likely to grow by 3% in 2010, while France is expected to grow 2% and Italy 1%. Countries such as Spain, Ireland and Greece will probably find things much more difficult and post much lower growth rates.

As a third conclusion, this acceleration in growth mean that the European Central Bank (ECB) will start to raise its benchmark interest rate during the course of 2011, due to the already existing data on the year 2010. That is why it is possible the ECB will raise its benchmark rate to 2% by the end of 2011 from 1% today.

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