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Has Austerity Succeeded in Ameliorating the Economic Climate? The Cases of Ireland, Cyprus and Greece

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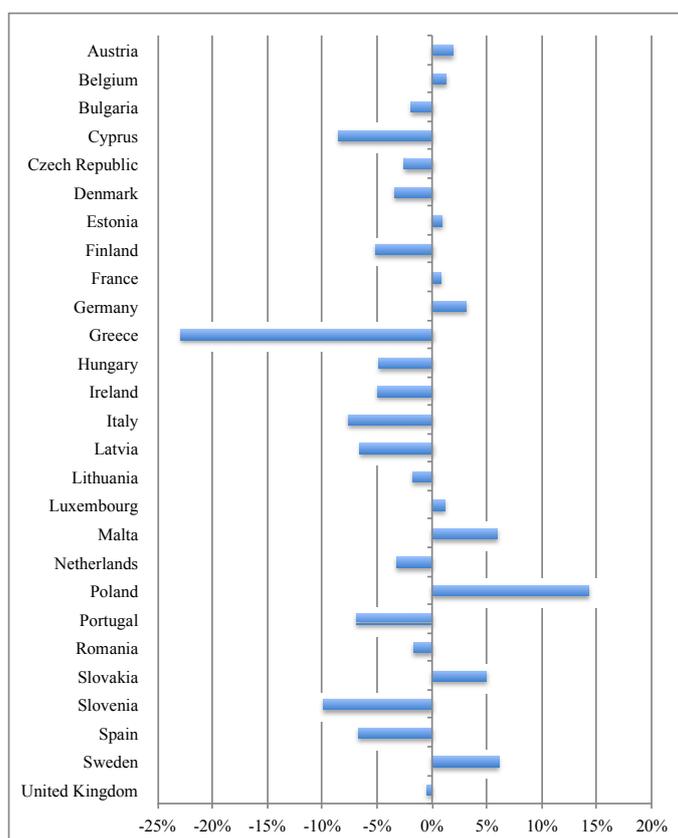
Abstract: The Great Recession that began in 2008 hit the economy of the European Union extremely hard. The year 2009 brought decline to the majority of the member states, inducing a desperate crisis management process. The few common EU-level crisis management measures that were implemented have brought about little success due to the modest volume of the common budget and the inertia of decision making attempting to harmonize often contradicting interests. As there was no credible crisis management at the EU level, most member states introduced their own set of measures. The efficiency of these was influenced by the economic performance of primary trading and investing partners, and by the volatility of the bond markets. In terms of economic performance, member states of the EU followed various paths and experienced various levels of recession in 2009, then various levels of upswing in 2010–2011, only to be hit by a second wave of recession of various extents after 2011. Although many member states took their own measures, general tendencies in crisis management can be defined. At first, the restoration of the functioning of the markets was targeted by generating additional demand through fiscal stimulus, but was then gradually replaced by imperative fiscal consolidation and austerity measures. The effectiveness of austerity programs is questionable: while the bond markets' volatility called for the correction of fiscal balances, tax hikes and governmental spending cuts tendentiously pushed back economic performance and postponed recovery, making economic growth possible only by increasing public debts. In this study, I present arguments in favour of the view that, in the current economic climate of the EU, prosperity could not be restored exclusively by austerity. Accordingly, I present case studies of the three member states with the largest increases in public debts: Ireland, Cyprus and Greece. My aim is to assess the efficiency of these member states' crisis management procedures: whether state interventions financed by public debt could result in economic recovery. I also argue that, given the current economic situation, the recovery in these member states in times of crisis is not foreseen.

Keywords: European Union; global crisis; crisis management; the Great Recession; austerity; stimulus

1. Introduction

After Europe's mostly prosperous decade in the 2000s, the year 2009 brought massive recession to the European Union member states, diminishing the GDP of the EU-27 by 4.3% in one year [1]. In the beginning, the nature of the crisis was difficult to diagnose: firstly, financial crises emerged, followed by real estate price bubble bursts in some states, followed by sovereign default crises in some of them. In terms of GDP, some member states (e.g., Poland, Sweden and Germany) seemed to withstand the effects of the crisis phenomenon, whereas others suffered consecutive years of recession (see Figure 1).

Figure 1. Change in real GDP at constant prices of EU-27 (percentage points, 2008–2013).



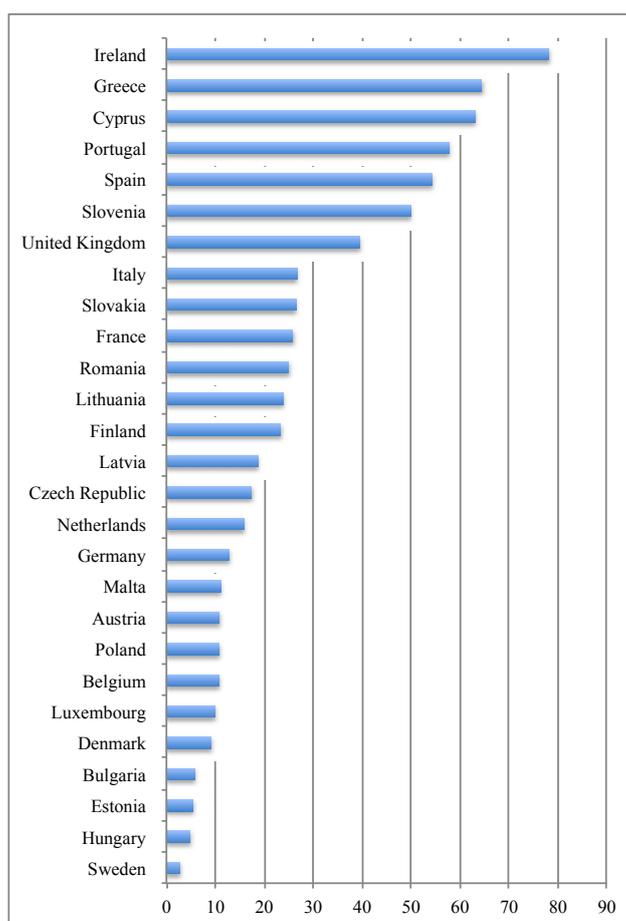
Source: Ameco Database [2].

Although recent economic forecasts from the EU are favourable [3–5], and the risks of sovereign defaults seem to be moderate due to bond market resilience [6], the structural foundations of the European Union are still under discussion: common monetary policy is often criticized, mostly because a strong common fiscal policy beside it is lacking, while expectations on economic convergence do not seem to actualize and social tensions are graver than ever [7–9].

In this paper, I examine the methodology of member state-level crisis management and present some arguments concerning the effective crisis management of the EU. I present three case studies: the

three member states with the greatest increase in public debt per GDP during the years of the crisis (2008–2013): Ireland, Greece and Cyprus (Figure 2). By analyzing these member states, I argue that, for EU member states in deep crisis, further austerity should not be advised. The first chapter shortly summarizes the effects of the crisis and the crisis management procedures in the European Union. The case studies are presented in the second chapter in order to reveal that austerity has been rather harmful and has most likely deepened the effects of the crisis further.

Figure 2. Change in general government consolidated gross debt (percentage points of GDP, 2008–2013).



Source: Ameco database [2].

2. Crisis Management Strategies

2.1. Emergence of the Crisis in the EU

Here a short review of the concepts explaining the emergence of the latest global financial crisis (also called the Great Recession) and its infiltration in the EU are presented. While various triggers of the crisis are often debated, they must be examined systematically in order to understand the mechanisms of crisis management procedures, and to support the efforts to set a successful agenda for a renewing European economic integration that is ideally more resistant to future crises. Subsequently, the EU member states' crisis management strategies, whether austere or stimulating, are presented. As stated before [10], most member states combined these and often created unique sets of crisis

management measures. However, there seems to be a pattern concerning stimulus and austerity phases. Initial fiscal positions of the member states have greatly determined the accessible crisis management tools (see Table 1). Regarding the Maastricht criteria and the excessive deficit procedures, the budgetary regulation of the EU has not been very flexible, thus leaving less room for stimulus in economies with weaker fiscal positions. However, a favourable initial fiscal position does not necessarily imply protection from a crisis, as the example of Spain shows [11], just as the examples of Cyprus and Ireland (also performing balanced budgets until 2008).

Table 1. Fiscal positions of the EU-27 in 2008.

Country	Public debt (% of the GDP)	Government balance (% of the GDP)	Country	Public debt (% of the GDP)	Government balance (% of the GDP)
Greece	112.90	−9.62	Spain	40.17	−4.46
Italy	106.09	−3.84	Sweden	38.80	1.51
Belgium	89.20	−2.13	Finland	33.94	2.47
Hungary	72.98	−4.63	Denmark	33.38	2.27
Portugal	71.69	−4.49	Czech Republic	28.70	−4.26
France	68.21	−4.23	Slovakia	27.86	−4.08
Germany	66.79	−0.88	Slovenia	21.96	−4.45
Austria	63.83	−1.87	Latvia	19.78	−5.60
Malta	60.91	−6.23	Lithuania	15.52	−5.31
Netherlands	58.46	−0.67	Luxembourg	14.44	2.66
United Kingdom	52.30	−5.01	Bulgaria	13.68	−0.18
Poland	47.11	−5.01	Romania	13.41	−7.89
Cyprus	48.89	−0.79	Estonia	4.54	−4.50
Ireland	44.50	−7.57			

Source: Ameco database [2].

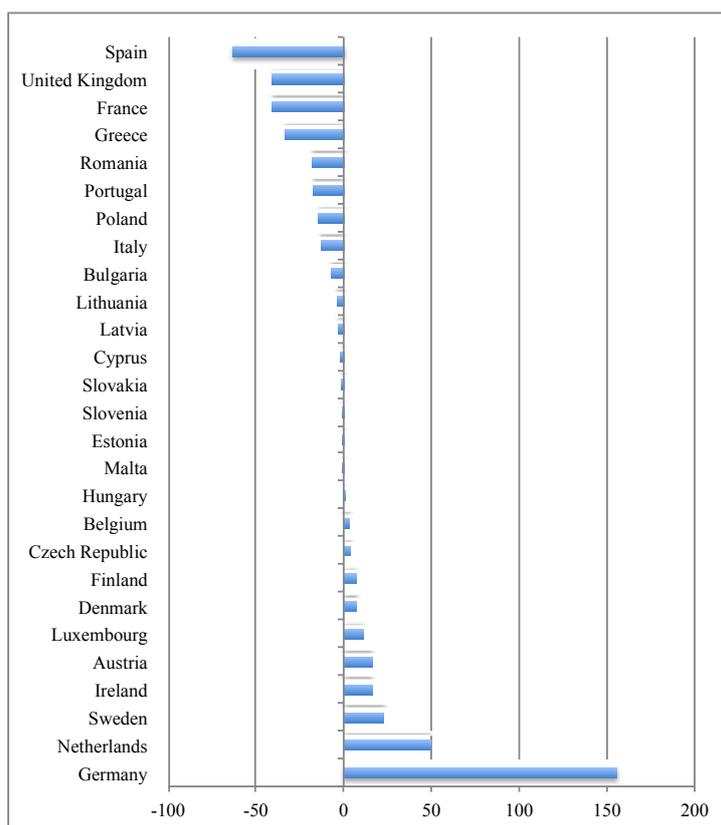
2.2. Reasons for the Crisis

It is broadly accepted that the Great Recession emerged as a financial crisis in the economy of the United States with the default of financial giant, Lehman Brothers, creating a shockwave in real estate markets and deepening the secondary mortgage market crisis. Prior to that, the efficiency of the global financing system was rarely questioned: markets were considered self-correcting, market failures were regarded irrelevant and risk management was thought to be highly developed. The financial crisis proved that these convictions were fundamentally wrong: mispricing of assets and significant market failures could indeed occur. As capital flows are globalized and the intoxication of financial assets spread quickly, panic and lack of confidence soon appeared in Europe as well because sovereign risks and bank credit risks became mutually dependent [12]. At the end of 2008, the effects of the crisis in the EU were still regarded as marginal and negligible. The first common, EU-level crisis management measures were optimistic: an intervention program stimulating aggregate demand and job markets was presented by the European Commission [13]. However, these anti-cyclical efforts have proved to be insufficient. Although some prestigious economists [14–17] had warned about the dangers of the

Eurozone not working as an optimum currency area, and as such, not being sufficiently resistant to asymmetric shocks and thus remaining vulnerable in times of crisis, these concerns were not taken seriously.

While the first phase of European crisis management (2008–2009) was calling for fiscal stimulus to avoid another Great Depression, bond markets forced interventions to change direction. Consequently, as the second phase of the crisis (2010–2011) unfolded, governments started to shift their priorities towards fiscal consolidation [18]. As sovereign refinancing costs started to rise, the internal deficiencies of the common market (e.g., intra-EU trade surpluses favouring the core member states [19] (Figure 3) or the ineffectiveness of the foreign direct investment-based development model in the Central European new member states [20]) were revealed. Economic policy turned towards reducing public debts even if there is no evidence that high public debt reduces economic growth [21]. Despite some of the leading economists of the EU claiming that the austerity policies have prevailed [22], Stiglitz notes [23] that the Eurozone crisis has not yet finished, and no return to normality can be expected until 2020.

Figure 3. Net exports of goods and services at current prices (billion EUR, 2008).

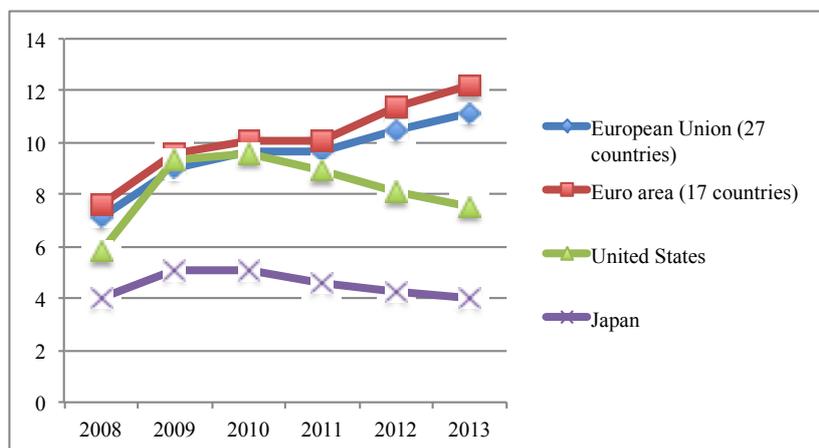


Source: Ameco database [2].

The growing effects of the primary financial (later debt-refinancing) crisis on the non-financial sector induced massive layoffs and halted recruitment all over Europe. Industrial capacities were downsized and spending was cut back drastically in the car industry, which seemed to be a largely elastic response to the first symptoms of the crisis [24]. Despite the subsequent attempts, the masses of people recently becoming unemployed could not successfully be diverted back to the labour markets;

unemployment remains a cause for concern in Europe and is, in fact, currently much higher than before the crisis (see Figure 4). Youth unemployment is especially problematic [25]. The further moderate rise in unemployment shows that recovery takes longer and risk management is less effective than in other similarly highly indebted economic regions (e.g., in the United States).

Figure 4. Unemployment in advanced economic regions (percentage of active population, 2008–2013).



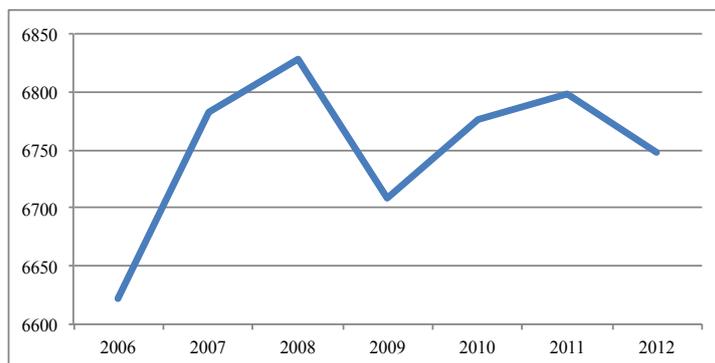
Source: Ameco database [2].

Increasing the size of social expenditures and the stimulus measures to accelerate the economy both had negative effects on government budgets: in 2009, several member states realized two-digit budgetary deficits. This problem undercut the creditors' confidence in most EU member states, which appeared in the downgradings by the significant credit-rating agencies¹, causing difficulties in renewing public debts at government bond auctions. Household behaviour was affected as well, mainly through decreasing labour incomes caused by layoffs, and then due to the restrictive economic policies which included cutbacks in social spending and tax hikes. All this resulted in years of recession in private consumption (see Figure 5), which forced the corporate sector to apply additional cutbacks on production. The consequence was a general shrinkage in all areas of the economy, smothering economic growth and potentially causing a prolonged recession [26]. Now in early 2014, many are concerned about slow recovery and possibilities of deflation in the Eurozone.

Crisis management procedures have been seeking to mitigate such complex phenomena, creating a double challenge for economic decision makers. On the one hand, stimulus programs became necessary in forms of subsidies, tax cuts and other incentives to counterweigh the effects of the crisis, while expenses of these measures have systematically been underestimated. On the other hand, a stable and disciplined fiscal policy became increasingly urgent at the same time. Runaway budgetary deficits called for the initiation of excessive deficit procedures in numerous member states (see Figure 6). As a consequence, investors' confidence dropped as government bonds were no longer considered risk-free. Given this situation, investors' confidence needed to be initially restored through balanced finances and accountability. I will now present the core ideas behind the major crisis management paradigms that affected the crisis management procedures of the member states.

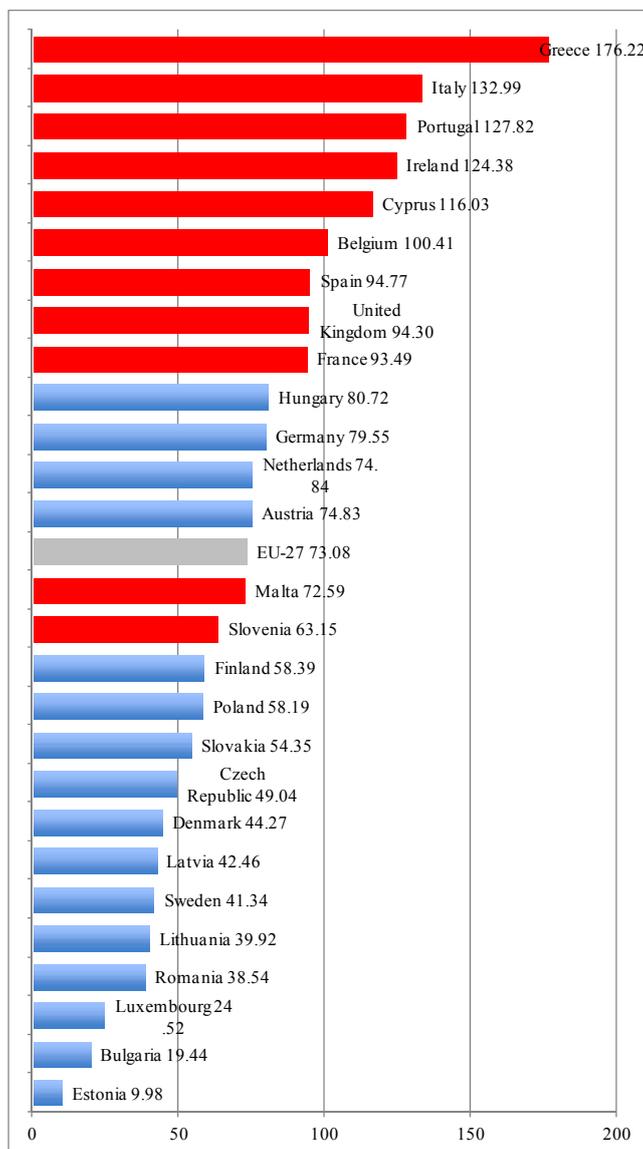
¹ Fitch Ratings, Moody's, Standard & Poor's.

Figure 5. Private final consumption expenditure of EU-27 at 2005 prices (billion EUR, 2006–2012).



Source: Ameco database [2].

Figure 6. Running excessive deficit procedures of the EU-28 (marked in red) as of 1 January 2013 (general government consolidated gross debt, percentage of GDP at market prices).



Source: Ameco database [2].

2.3. Austerity Policies

The goal of crisis management based on austerity is to restore market confidence. Supporters of this theory (e.g., Schäuble, De Grauwe, Alesina) often claim that the reason for a crisis is the disappearance of trust in the economy thus, accordingly, if confidence is regained, crediting would revive and investments would rise again. In addition, the theory contends that the primary way to restore investors' faith is to reach a well-balanced fiscal position in order to avoid insolvency and to guarantee the reimbursement of governmental bonds and their interests, and to involve new actors in financing [27]. Austerian economists usually oppose state intervention and stimulus by the government because, according to new classical macroeconomics, market actors are rational so economic policy is unable to achieve stimulus in a genuine manner. The aim of the state should be to maintain macroeconomic stability and preserve the market agents' confidence [28].

Austerian theory became dominant in the crisis management of European countries, as well. As DeLong emphasizes [29], according to the neo-Wicksellian equilibrium ($Savings[Y] - NX = \Delta Bond_holdings [i - \pi, \rho]$), the delta of bond savings can only be boosted by reducing the riskiness of bonds because the economy is in a liquidity trap and the existence of a common currency rules out the possibility of depreciation. From the budgetary year of 2009 onwards, most of the member states applied restrictive policies, rendering secondary importance to the social issues and the population's demand while assuming the risks of underemployment and slow economic growth. However, austerity measures have not brought overall success in all member states' crisis management strategies; some economists even blame the oversized austerity measures for inducing a prolonged recession (e.g., in Italy and Greece). In 2011, the public debt of Greece was partially written off and, in 2012, the European Stability Mechanism had to guarantee the purchase of the Spanish public debt bonds, as well. Therefore, in the current EU environment, even strict austerian economic policy can fail to completely restore the healthy functioning of the markets.

The most frequent criticism concerning austerity policies has been that they strangle economic growth: the expenditure cutting and investment-incentive effect of restoring creditors' confidence is counteracted by the income subtracted from the economy as investments are delayed and household consumption decreases [30]. All in all, the trust in austerity policies decreased in 2012 due to several factors, including the remission of the European economic climate and the refutation of the Reinhart–Rogoff theory, which had claimed that the indebtedness ceiling of 90% per GDP should be avoided at all costs because it significantly damaged economic growth. Additionally, the results of national elections favoured anti-austerian political forces claiming that the crisis management based on restriction was to be over and austerity policies should be replaced by programs of economic growth and job creation. Furthermore, austerity policies tend to cut education and healthcare costs, which can be harmful for long-run competitiveness [31]. However, some member states (e.g., the United Kingdom) have saluted the effects of their governments' coherent consolidation policy, which also appears in terms of GDP growth and the Economic Sentiment Index [32].

2.4. Stimulus Policies

Interventionist thoughts such as restoring aggregate demand by boosting state purchases became popular during the times of the Great Recession as a new approach to crisis management and, as a

consequence, the need for governmental investments and other interventions have become commonplace. The reason for this lies in the fact that corporations react to the fall in household consumption in a rather elastic way: the corporate sector, in the case of a declining demand, often cuts back production and partially lays off employees to restore its profitability. This then results in an even larger decrease in household spending. This self-inducing process can only be counterweighed by a single or a continuous positive shock in demand of a significant volume financed by public resources. Such interventive measures then give direct assignment to the actors in the market who thus become able to rehire the laid-off labour force and, while the private sector is deleveraging, the public sector can participate in spending [33].

However, there is a relatively new aspect in the current crisis: the high level of indebtedness, not only of the public, but also of the corporate and the household sectors. This condition seemingly narrows down the opportunities for governmental stimulus measures as the crisis hit in a state of already critical indebtedness. Since the adaption of the euro, the common currency cannot be devalued in times of economic despair set to a member state's own needs, which aggravated the crisis of the Eurozone countries even further.

The most emphasized criticism of stimulus crisis management relates to the previous argument, namely that it is considered hardly feasible in case of a high level of indebtedness, as is the current situation in most European economies. The market for governmental bonds usually punishes excessively deficient public finances and this indeed was the case for Europe: the year 2012 brought another wave of downgradings by credit-rating agencies while the yields of long-term bonds were quickly increased. One can quote the broken windows fallacy to compare stimulus policies to repairing of broken windows: while it has job creating and stimulating consequences, state intervention does not create real economic value. Moreover, they can only be financed by debts that have to be repaid later so the incomes created by intervention will disappear anyway as the government would have to recollect these revenues through tax increases in the future. In addition, government-financed investments are squeezing private investments, which seem to be levelling off in terms of macroeconomic indexes but are harmful for long-term competitiveness. To conclude, in times of macroeconomic instability and the real risk of default, austerity and balanced budgets do not have a practical alternative. In the European context, a general stimulus scenario would require the easing of the Maastricht criteria, which seems to be difficult in the current political environment. The plans of common economic stimuli and common European programs were overruled at the planning of the Multiannual Financial Framework of the EU for the period 2014–2020 [34].

2.5. Debt-Friendly Stimulus

While economists are mostly divided between austerity and stimulus policies, other views also exist. As Schiller² explains [35], the theory of debt-friendly stimulus is based on increasing taxes and raising government expenditures at the same time and at the same proportion. This theory, when applied heedfully, avoids Keynesian deficit spending and therefore eventually decreases the debt/GDP ratio. While tax cut-based stimuli and deficit spending does not seem effective due to the expectations

² Awarded the Nobel Memorial Prize in Economics (2013).

of future tax increases, an immediate tax increase along with the stimuli might be effective and acceptable to voters. While this idea resounded occasionally during the Eurozone crisis, it has remained mostly theoretical because only a few member states have managed to maintain acceptable levels of public debt in such a volatile environment and avoid the excessive deficit procedure (see Figure 6).

To conclude, most member states' governments preferred applying anti-cyclical incentives in the first years of the crisis and, when facing serious financing difficulties in 2009, cut back and returned to austerity measures (see Table 2). The years 2010–2011 brought about a relative relief in the economic climate while 2012 again witnessed recession in many member states of the EU. In 2013, thoughts on economic stimuli have seemed to triumph again, mainly due to the newly favourable economic climate, the permissive monetary policy of the European Central Bank and the fact that the ECB had started to function as lender of last resort by purchasing unfavoured governmental bonds [36]. By 2013, accordance concerning the common crisis management of the EU could still not be achieved, although various concepts have been brought to life (e.g., the Europe Plus Pact and the Six Pack). Nevertheless, the complete recovery has still not come and pre-crisis levels of prosperity have yet to be reached. The prospects of economic growth are still moderate; 1.4% economic growth is projected for the EU in 2014 (and 1.1% for the Eurozone, respectively), and the institutional foundations of the EU are still under construction with the gradual introduction of the banking union [37].

Table 2. Differences between crisis management strategies.

	Fiscal consolidation	Deficit spending	Debt-friendly stimulus
Aim	Restore creditors' confidence	Create jobs, stimulate consumption	Stimulate the economy without increasing in indebtedness
Tools	Augmentation of taxes, cutting social spending	Investments and the augmentation of redistribution	Proportional tax increases and government spending
Consequence	Economic growth	Public debt increase	Balanced budget
Effect on balance	Positive	Negative	Neutral

3. The Cases of Ireland, Cyprus and Greece

3.1. General Lessons from Crisis Management

The previous thoughts on crisis management all appeared in the numerous and vivid economic debates concerning the recession and the revitalization of the European economy. The modest volume of the common European budget has not allowed common, EU-level crisis management measures to be taken: while the assistance to save the financial sector in the first year of the crisis (including bank guarantees) in itself cost taxpayers 39% of the EU-27 GDP, the common EU budget only accounts for 1% of it [38]. Although the economic decisions of a member state influence other economies, there was no common strategy assigned; member state governments had to follow their own paths to balance the effects of the crisis. As concluded previously, there is no optimal crisis management path for every economy because the same measures have different effects. Moreover, the successfulness of crisis management measures deeply depends on international circumstances. The application of crisis

management strategies was hardened by numerous factors, including political challenges, frequent changes of government and the objection of voters. Accordingly, strategies and instruments had to be changed often. In this chapter, the crisis management strategies of those three member states are introduced which suffered greatly in the years of the crisis and witnessed quick increase of their public debts: Ireland, Cyprus and Greece. These economies are now projected to have a public debt of more than 120% of their GDP and could not avoid financial help from the IMF and the Troika of international lenders (European Central Bank, International Monetary Funds, and the European Commission). The crisis management measures applied by these three countries during the first and the second phases of the crisis are assessed in Table 3.

Table 3. Crisis management measures taken by Ireland, Cyprus and Greece.

	Ireland (2008–2009)	Cyprus (2008–2009)	Greece (2008–2009)	Ireland (2010–2011)	Cyprus (2010–2011)	Greece (2010–2011)
Making significant cuts in government spending	✓		✓	✓		✓
Raising taxes and customs	✓	✓	✓	✓	✓	✓
Decreasing taxes and customs		✓			✓	
Taking significant loans for the running expenses from markets			✓			
Taking significant loans from international organizations			✓			✓
Conducting extra taxation on the service sector						✓
Conducting bank bailouts	✓					
Enacting interventions in the job market	✓	✓	✓	✓	✓	✓
Creating stimulus programs on consumption		✓				
Taking other unique measures, such as privatization				✓		✓
Changing the regulation of public finances	✓	✓	✓			✓

Note: ✓ means that significant crisis management measures were taken in this field. Source: Own edition based on Kovács-Halmosi [39].

3.2. Ireland, the First Member State in Crisis

The country of Ireland is regarded as the first victim of the financial crisis with the burst of the real estate bubble in 2007, which marked the end of the rise of the Celtic Tiger. Once the best-performing

and most quickly modernizing member state of the EU, Ireland's previous growth path has proved to be extremely vulnerable. Real estate prices started to fall in 2006, resulting in a collapse in the construction industry, in an urgent need for elevated social expenditures and, as a result, in a general fallback in competitiveness [40]. The economic boom of previous years had generally been based on foreign direct investments and export-oriented production—and both these factors of growth proved fragile when the crisis erupted in 2008 [41]. Foreign capital reacted hectically to the first signs of economic slump, causing a typical developing market crisis. A bailout of the banking system became necessary in 2008, which created a shockwave through the entire economy and pushed Ireland into recession in 2008, with a 1.7% decline in annual GDP. This way, the country joined the group of the PIIGS countries (alongside Portugal, Italy, Greece and Spain) with respect to the risk of default [42]. The same year, the governing parties voted for an emergency budget to support bank guarantees in the price of minor tax increases and cuts to the health and education systems.

Concerning the crisis management measures, Ireland seems to have had access to more crisis management tools than others due to its favourable initial fiscal position (25% public debt and no budget deficit in 2007), but the general bank guarantee program of 2008 and the purchase of certain corrupted bank portfolios put huge pressure on public finances, resulting in a government deficit of 24.6% in 2009 and 18.7% in 2010. The need for the augmentation of government revenues became urgent in 2010, contrary to the first tax-reducing efforts of 2008 (by 2012, the total tax burden reached 50% again), while government spending reached extreme amounts. In 2010, when refinancing costs reached unsustainable levels and public finances were rendered too risky by credit-rating agencies, Ireland requested and received intervention from the Troika of international lenders [43]. This package consisted of an international aid of 85 billion euros, equalling 52% of the Irish GDP at that time.

With these international stabilization efforts, Ireland managed to maintain economic growth until the third quarter of 2011 when it entered into recession again, forming a W-shaped economic crisis. The social effects of the crisis were extremely sensitive. Since 2009, inequalities have increased quickly, and unemployment also peaked in 2010 at 14.7% of the active population [44]. Protests and social unrest became permanent in 2009, even after the Troika agreement, while net emigration in 2009 reached 34,500 persons, the highest figure since 1989. While public debt is expected to peak in 2015 at 125%, Ireland managed to exit the Troika bailout in December 2013, which was widely celebrated in the media as an important milestone and victory of restrictive crisis management [45].

As Callan *et al.* [46] emphasize, in the case of Ireland, the crisis resulted in elevated public debt and a large government deficit, not the other way round. In their view, austerity was one of the causes of indebtedness, so the consequences can hardly be cured with more restrictive measures. When analyzing macroeconomic data, we can see that, while Ireland enjoyed a favourable fiscal position and even if major inner economic problems developed already before the outburst of the crisis, the country can be regarded as one of the biggest losers of the crisis. As a member of the Eurozone, it could not use monetary tools to fight the negative effects of the crisis and, due to the huge need for the recapitalization of the banking sector, there was very little opportunity to stimulate private consumption or induce a debt-friendly stimulus. Therefore, while quick indebtedness was a consequence of bank savings, austerity measures were used to restore investors' confidence, resulting in the prolonged suffering of the household and corporate sectors. Although the GDP growth rate has been positive since 2011 and prospects remain positive, pre-crisis levels of real GDP could not yet be

restored (in 2013, it was still 7% below that of 2008) and the unemployment rate remains high (13.3% in 2013). Therefore, the social effects of the crisis seem to endure, as do the burdens of public debt. Moreover, the Economic Sentiment Index seems to be currently ameliorating, while the vast public debt is difficult to reduce without a boost of economic growth. It can therefore be concluded that the gradual diminishment of austerity measures is advisable.

3.3. The Case of Cyprus

The economy of Cyprus witnessed an intense economic growth during 1975–2008; however, this was mostly fuelled by extending the financial sector. In 2007, the country had a budget surplus of 3.5% and a government debt of 59% of GDP, which can be considered as a trouble-free fiscal position. Furthermore, Cyprus introduced the Euro in 2008, which gave an additional impetus to investments and economic growth. Even so, Cyprus has been considered a tax haven and is linked to the Greek and Russian economies in many ways, which has put the country in an extremely vulnerable condition during the years of crisis [47]. Two other factors aggravated the troublesome economic climate: the Evangelos Florakis Naval Base explosion, which influenced the tourism and shipping industries negatively, and the 50% “voluntary haircut” of Greek bonds, both of which occurred in 2011. These factors have proven lethal to an economy with such an oversized banking sector where assets represent *ca.* 800% of the country’s GDP.

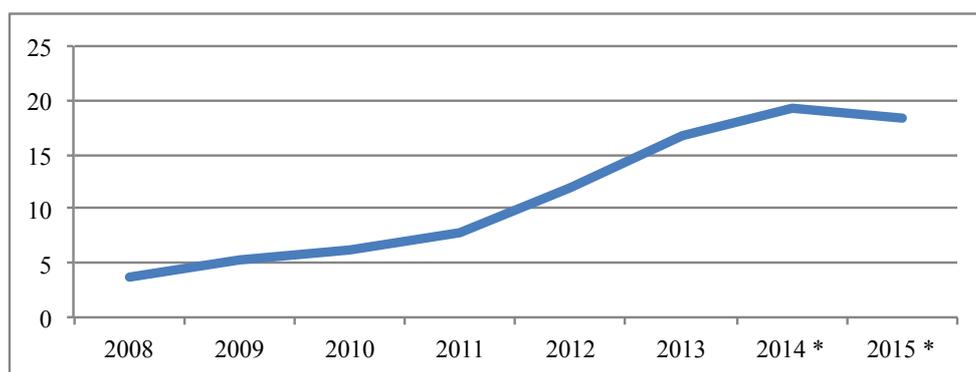
During the crisis years, the Cypriot economy, similar to that of Ireland, suffered a W-shaped recession. The economy shrank by 1.7% in 2009, followed by two years of modest growth, and fell into recession again in 2012. In 2009, the government budget balance turned negative and, in 2012, public debt reached 86% while the private sector debt soared towards 300% of GDP, the highest in the EU. Such structural distortions have left their mark on the real economy as well, with rising unemployment peaking at 12% in 2012. The key weaknesses of the Cypriot banking system were also revealed, namely that the deposits are directly linked to Greek bonds. The 50% haircut and the re-entrance of the economy into recession drove long-term interest rates up to 12% in 2011, and the government’s efforts to stabilize the banking sector became worrisome.

To ease these problems, economic stimuli generated by the government (increased social spending and subsidies) have appeared to be a lost case. With a mostly domestic-owned financial sector, it has turned out to be too difficult to attract foreign capital instantly (except for the Russian loans of 2.5 billion EUR in 2011). After subsequent tax increases, the continuous downgrading from credit-rating agencies, and the return of the recession, it became clear that an instant remission and the return of creditors’ confidence could not be achieved by additional austerity measures as numerous protests and the social resistance crippled the economy. In 2012, the Cypriot banks requested aid from the international lenders because additional financial assistance from the Russian government was not obtainable in spite of the huge amount of Russian deposits placed in Cypriot banks. Unlike the economy of Greece, Cyprus was not considered “too big to fail” by the Troika of international lenders, implying that, in the case of default, it would most likely not significantly shake the overall economy of the EU. Accordingly, the Troika declined constant intervention and proclaimed severe conditions. Two scenarios were elaborated to levy the deposits (taxing deposits over 100,000 EUR or taxing every

deposit), while bank accounts were temporarily frozen and the cash withdrawal from ATMs was limited [48].

In March 2013, the “restructuring” of savings was finally applied on bank deposits over 100,000 EUR as a condition for realizing the Troika intervention. Such a measure is considered extremely dangerous because it intensifies the lack of confidence in Europe’s other problematic banks and might serve as a dangerous precedent to other governments in the EU. This step can undoubtedly be regarded as a non-market-friendly action, though it has nevertheless brought about overall consolidation and relief in the markets as bond yields began to fall. In the first years of the crisis, some efforts were presented to stimulate the economy but, due to the modest role of the government compared to the size of the banking system, these stimuli remained ineffective and were soon replaced by fiscal consolidation. Cyprus is an example of the failure to restore creditors’ confidence through austerity; moreover, it is a country that could not be saved from insolvency, not even through coordinated international financial aid. Since the intervention, Cyprus’s economic prospects seem to have improved and, by 2015, economic growth is expected to be restored. Nevertheless, unemployment is five times higher than before the crisis, and savings continue to decline, thereby implying that the effects of the crisis are likely to be present for years to come (see Figure 7).

Figure 7. Unemployment in Cyprus (percentage of the active population, 2008–2015).



Note: projections marked with *; Source: Ameco database [2].

3.4. The Recession in Greece

With an almost 25% decline in real GDP, the crisis scenario in Greece is considered to be the most severe of the sovereign-debt crises of EU member states. Greece’s case has made it clear that, during the recession years of the crisis, continuous austerity packages of large sizes cannot be pushed through, especially when continuously accompanied by political unrest and social uprising and public debt cannot be paid back in its entirety. The triggers of the Greek crisis are well documented; the most important causes are identified by Gibson *et al.* [49]. Greece entered the crisis with elevated levels of public debt (113% in 2008), rising bond interest rates, and slow implementation of structural reforms that were regarded just as necessary already before the crisis [50]. All of these factors placed huge pressure on the government budget. Between 2001 and 2005, the yearly budget deficit was always over 5% and government spending was aimed at generating economic growth. In spite of the fiscal data being subjected to revision, Greek sovereigns were rated reliable by the credit-rating agencies until

early 2010, when numerous downgradings occurred. All this was aggravated by political instability, frequent tax evasion, crippling corruption, and a public sector of inadequate quality [51].

In April 2010, the Greek government requested EU/IMF financial aid of 110 billion EUR, which brought a severe wave of downgradings. The conditions of the Troika were to restore fiscal balance through austerity measures, to privatize government assets worth 50 billion EUR and to implement those long-due structural reforms. Subsequent tax increases and government spending cuts were set as a condition of international loans, which generated huge protests and wide social unrest. One year later, it became evident that the Greek tax system reacted very sensitively to the austerity measures so the supposed tax revenues could not be realized. While six different austerity packages were introduced between 2010 and 2012, including a freeze in salaries and a tax on pensions, income and real estate, further health and defence spending cuts and a cut in the minimum wage, public finances could not be put back on track, requiring further EU/IMF bailouts, while even more Greek public debt bonds were partially defaulted [52]. The forced 50% haircut of bonds can also be viewed as a non-market-friendly measure similar to the deposit tax in Cyprus. Public debates concerning the Greek exit from the Eurozone were constantly on the agenda during these years. Regarding government finances, expenditures could not be stabilized, and continuous tax increases did not result in the elevation of government revenues, leaving no room for economic stimulus [53]. Thus argue Alesina and Giavazzi [54], claiming that EU countries have realistic Laffer curves, implying that tax increases are ineffective. In the case of Greece, extensive tax evasion and illegal employment also jeopardize the outcomes. Reassuring solutions to the government debt crisis still could not be found, and investments could not begin to rise again. Government debt is currently peaking at 186% of the GDP, three times the value set by the Maastricht criteria. Although fiscal consolidation has been continuous since 2010, such high levels of public debt would take decades to reimburse; further defaults are therefore to be expected. Although Greek Prime Minister Antonis Samaras claimed that the crisis was over in early 2014 [55], the prospects of economic growth are poor and the unemployment rate continues to be one of the highest in the EU, stuck at a level higher than 25% since 2012. While the government is still combating the budget crisis (a 4.1% deficit even in 2013), the macroeconomic and social disaster continues and the threat of economic stagnation remains. Without the chance to restore competitiveness by currency depreciation, realizing an economic growth necessary to reimburse public debts seems questionable.

4. Summary and Conclusions

In this paper, I examined some of the recurring economic thoughts on the European/Eurozone crisis. While in early 2014 the economic climate tends to become optimistic and global recovery is expected in the EU, the restoration of the real economy and pre-crisis levels of employment seem distant. The positive prospects are in great part stemming in the global economic expectations and the slow evolution of EU institutions, mainly the banking union that creates more efficient risk-handling and capital flows in the financial markets. The crisis has unveiled some other structural imbalances of the EU as well, including the asymmetry in net exports and the suboptimal situation of monetary and fiscal decision making at different levels, which challenges the effectiveness of feasible crisis management for the majority of the member states.

Due to the lack of EU-level coordination and weak common fiscal instruments, EU member states had to launch their crisis management procedures themselves. The stimulus attempts during the first phase of the crisis were replaced by austerity programs in the second phase, although there is no empirical evidence that high public debt pushes back economic growth. Nevertheless, sovereign debt in the Eurozone has lost its risk-free status, and stiffly climbing interest rates in bond markets forced governments to implement austerity programs. This paper argues that these austerity programs were expected to restore confidence in the markets, but they could not completely fulfil their purpose. To prove this, three member states with the most increasing public debt were examined: Ireland, Cyprus and Greece. The case of Ireland shows that the public debt crisis was not the cause but one of the consequences of the financial crisis as it pushed the country from one of the most favourable fiscal positions into three-digit public debt, while the recapitalization of the financial sector left no possibilities for economic stimulus. The case of Cyprus reveals that continuous austerity measures could not restore investors' confidence either; in this single country, partial confiscation was set as a condition of international financial help. The case of Greece also proves that, in spite of continuous austerity packages dictated by international lenders, the reimbursement of high public debt seems unfeasible and haircuts in unsustainable public debt cannot be avoided. The macroeconomic values of the three member states are distant from their pre-crisis levels while their quick indebtedness will remain a burden for economic growth for several decades to come.

While further austerity appears ineffective for member states with such huge debts, other paths do not seem to be viable in the current economic framework of the EU. This implies that the current Eurozone crisis could not be fully solved with the current conditions, meaning that risk management and economic governance should not remain completely at the member state level. Moreover, further economic stimulus is discouraged due to the Stability and Growth Pact criteria, and financial aid from international investors can only be claimed if combined with severe austerity measures, provoking the opposition of voters and causing economy-crippling protests and social resistance. As monetary policy is rendered to the European Central Bank, the Eurozone member states cannot restore their competitiveness by currency devaluation and cannot decrease their public debts by inflation; these member states' growth prospects therefore remain weak. If the economic climate turns desperate again, depression would most likely return, leading to a call for the rethinking of the whole European crisis management framework—and even the general European economic policy framework—in order to prevent the occurrence or mitigate the effects of similar economic shocks in the future.

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Conflict of Interest

The author declares no conflict of interest.

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