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THE WAY OUT OF THE CYPRUS ECONOMIC CRISIS

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SUMMARY

"THE EUROGROUP DECISIONS CAME AS A SHOCK LEADING TO SERIOUS DISRUPTIONS"

Cypriots were well aware of the serious problems their economy had been facing. Fiscal rationalization had essentially started in December 2012. The new government that came in on 2 March 2013 was preparing for a gradual paradigm shift expecting solidarity and support. Instead, the Eurogroup decisions came as a shock leading to serious disruptions. The financial restrictions imposed are much worse than those in the immediate aftermath of the 1974 Turkish invasion and occupation of 37.4% of the country. Effectively ,the Troika decisions have pushed Cyprus from a recession to a depression.

Cypriots feel that their country has been treated harshly and was used as an experiment. The harshness was also related with misperceptions created over time about Cyprus; for example, that it was a money laundering centre, a casino economy, and above all that it caused the European Union (EU) recurring headaches. On its own part, Cyprus had failed to produce a narrative to address issues conclusively.

Cyprus will find it very difficult to exit the crisis within the framework of the philosophy of the Memorandum of understanding and the current architecture of the euro area because of:

1. A huge fiscal cliff;

2. A great negative wealth effect;

3. Serious internal and external restrictions to capital flows imposed on a crippled financial sector.

The crisis can be addressed within the architecture of the euro area only if the EU changes fundamentally its philosophy. This would involve a generous Marshall plan, allowing the country to have temporary discretionary fiscal policy, unconditional access to Emergency liquidity assistance (ELA) and a relaxation of the internal financial controls. In their absence, inevitably, Cyprus would have to seriously examine the possibility of a temporary exit from the euro area and the introduction of a national currency. The policy plan could also combine elements of Roosevelt's policy in the 1930's to address the US depression and Reagan's philosophy in the 1980's to stimulate the economy. Such a strategic mix would include an expansionary fiscal policy allowing for deficits in the immediate short run as well as tax decreases. The country would need to move gradually toward fiscal rationalization while looking into new engines of growth and for a new economic paradigm.

Cyprus aside, it would be important for the EU to revisit the policies pursued in relation to the European South as a whole. Indeed, in order to effectively address the European debt crisis and promote further integration, a new European paradigm is required.

TABLE OF CONTENTS

INTRODUCTION

Cyprus experienced a systemic failure almost at all levels. Eventually, the crisis was worsened by exogenous factors including the decisions of the Troika. The policy paper[1] focuses on the Cypriot economic crisis and the efforts of the Cypriot government to tackle it. It also addresses the challenges faced by the Cypriot economy and assesses two major scenarios for overcoming them. Within this framework, the problems which led the country to a solvency crisis are briefly outlined. The first scenario for addressing the crisis is within the philosophy of the Troika, the existing Memorandum and the current architecture of the euro area and the second within the framework of a temporary exit from the euro area and the adoption of a new economic policy. The paper analyses the implications of the two scenarios and puts forward the key conclusions and some suggestions for further research.

The overall analysis leads to similar concluding points with scholars and think tanks which argue that the pursued policy of the Troika creates more problems than it solves and that it is undermining the European project. The paper also aspires to contribute to the revisiting of particular policies in a way that would eventually lead to the strengthening of European integration.

1. Current situation

1.1. The context

Cypriots were aware of the serious problems their economy had been facing and that the inevitable bailout agreement – which turned into a bail-in as well - was going to be austere. There was a willingness to address these problems substantively. Fiscal rationalization had essentially started in December 2012. The new government which took over on 2 March 2013 had begun to push further. Eventually, the political climate was such that the people were prepared for a gradual paradigm shift. In this effort, Cyprus and the new government in particular had expected the solidarity of the Eurogroup and above all of Berlin.

The endogenous multidimensional problems that had accumulated over time were largely the result of the inadequacy of the wider economic, social and political system. At the same time, external factors - such as the banking crisis, the interconnection of the Cypriot and the Greek economy, the euro area debt crisis and the euro area architecture - worsened the situation. All this time, of course, the austerity policy of Germany has been adversely affecting economic activity and prospects in the euro area.

The March 2013 actions and decisions of the Eurogroup came as a shock. On 16 March 2013, the European partners, the IMF and the Cypriot government reached an agreement for a Cyprus program. As part of the deal, a one-time bank deposit levy of 6.75% for deposits less than €100,000 and 9.9% for those with greater sums was considered. The measures estimated to raise about €6 billion. The deal was rejected by the Cypriot Parliament on 19 March 2013. A final agreement was reached on 25 March; this involved the closure of the most troubled Popular Bank while the country's largest bank, the Bank of Cyprus was to be restructured. The rescue package of the Bank of Cyprus included a deposit haircut for accounts over €100,000 (the final amounts of the haircut are still not defined - it is estimated to be around 50%) and the absorption of good assets and deposits below €100,000 of Popular Bank and its Emergency liquidity assistance (ELA) obligations.

1. This policy paper draws from A. Theophanous "THE CYPRUS ECONOMY AT CROSSROADS - Coming out of the crisis" (in Greek), with the contribution of a working team, Center for European and International Affairs, Policy Paper Series, No. 1/2013, May 2013, Nicosia, Cyprus. The author would like to thank Kyriakos Antoniou for his valuable help.

Furthermore, all Cypriot banking operations in Greece were sold at relatively low prices at the request of the Troika[2]. The objective was to reduce the systemic influence of Cyprus in Greece.

The agreement also provided a loan of €10 billion for the period 2013-16; the remaining €7.5 billion were to be raised from Cyprus. Nevertheless, the way this was done has created much more damage. The policies pursued should not be judged only by alleged perceptions of trying to protect tax payers but also by the effects on the ground. The comprehensive package is such that Cyprus is in a situation with less liquidity and more uncertainty.

Cyprus' program is characterized, for the first time, by the participation of the depositors in the rescue package. According to the European Union (EU) and the International Monetary Fund (IMF) policy makers the "deposits haircut" had to be implemented to make foreign investors (mainly Russians) who benefited from the high interest rates provided by Cypriot banking sector and the favourable regulation scheme contribute to the rescue package. The EU and especially Germany considered it as unacceptable that their taxpayers had to pay in order to save Russian deposits. However, the reality is that Cyprus was used as an experiment of subsequent bank rescues[3]. It is highlighted that the decisions of the Eurogroup concerning the "bank rescues" are backfiring. In the period of April-May 2013 it is estimated that about €107 billion deposits fled from the euro area (about €41 billion from euro area residents and €66 billion from non euro area residents) demonstrating the uncertainty of depositors and investors[4].

In reality what has happened is an unprecedented attack on Cyprus' financial sector that takes the country back decades. The Eurogroup decisions have paralyzed the financial system of the country. The financial restrictions and the damage in economic terms are much worse than those imposed in the immediate aftermath of the 1974 Turkish invasion and occupation of 37.4% of the territory of the country. For example, Cypriots today cannot break a notice deposit in any financial institution under any circumstances.

The banking system of Cyprus has been cut to pieces and its public robbed with a viciousness that raises serious questions about the existing value system in the EU. Inevitably there are serious disruptions on all aspects of life. The Troika decisions on Cyprus have pushed the country from a recession to a depression. The euphoria that existed in Cyprus before the accession to the EU has therefore turned into deep bitterness.

"THE TROIKA DECISIONS HAVE PUSHED CYPRUS FROM A RECESSION TO A DEPRESSION"

Over time, severe misperceptions had been created about Cyprus. For example, that it was a money laundering centre, a casino economy, and above all that it was a state that caused the EU recurring headaches. It should be stressed that Cyprus had passed relevant legislation and made a systematic effort to control illegal activities about money laundering. It can also be said that Cyprus was in a better position than most European countries, including Germany, in relation to the anti-money laundering (AML) index[5]. Some quarters in the EU had - quite remarkably - held a grudge that in 2004 the Greek Cypriots had rejected the UN plan for the solution of the Cyprus problem. Cyprus was also a victim of its own inability to adjust and position itself in a very difficult political and economic environment.

1.2. The economic realities on the ground

The economy had many distortions and there was mismanagement at almost all levels. The banking mismanagement and crisis were part of the wider deficiencies. The outdated economic paradigm and the absence of new engines of growth contributed to the downfall. Indeed, it is indicative that the broad public and banking

2. Memorandum of understanding on Specific Economic Policy Conditionality, 12 of April 2013.
3. As the German Finance Minister Wolfgang Schaeuble said on April 21, 2013 in an interview in the business magazine Wirtschaftswoche "The model of participation of shareholders, creditors and unsecured deposits should be the usual practice where a financial institution presents problems".
4. European Central Bank, "Monthly Bulletin July", July 2013.
5. It is noted that the paragraph 1.17 of Memorandum reported that Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report. Furthermore, a research of the Center Basel Institute of Governance indicates that Cyprus has a lower rating than many European countries such as Germany which is in 68th place on the list for AML index while Cyprus is in 114th among 144 countries.

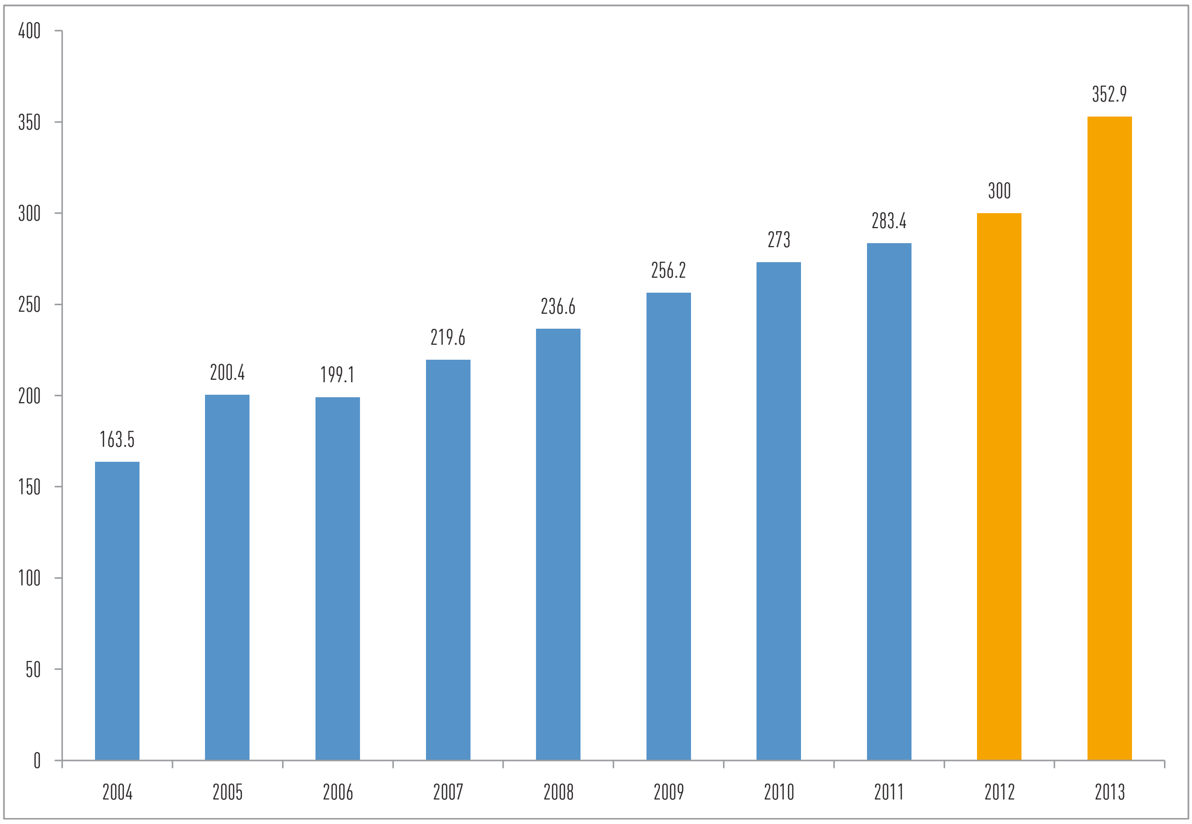
sector have been offering superior terms of employment than the rest of the economy. This has led to overstaffing and inefficiencies in these sectors. Furthermore, the economic model of Cyprus, highly based on services, led to the descending competiveness and neglect of the secondary and primary sectors. In addition, the economy could not create enough high value added jobs for a growing member of Cypriot professionals with higher qualifications. The political leadership also proved incapable to confront these problems. In short, what took place was a major failure of the entire system.

The Cypriot crisis peaked as a result of the excesses of the banking sector which took place simultaneously with the deterioration of fiscal indicators. The housing bubble and the surge of loans to the private sector which reached approximately 300% of gross domestic product (GDP) by the end of 2012 were related with these developments. These figures are indicative of the fact that the society lived beyond its means. There was also insufficient understanding of the rules of a monetary union in which the leading country, Germany, was pursuing a very austere fiscal policy.

The interconnection with the Greek economy proved to be fatal. Unfortunately, the impact of the Greek debt haircut in October 2011 was devastating for the Cypriot economy. The two biggest banks lost approximately €4.5 billion (more than 25% of GDP). The huge loan portfolios of the two banks - Popular Bank and Bank of Cyprus in Greece (approximately €23.6 billion) - and the disproportionate investment they made in Greek government bonds are also highlighted.

The private debt to GDP ratio shows the superficial prosperity of Cypriot enterprises and households while they piled up huge amounts of debt. As Diagram 1.1 shows, during the period 2008-2011 there was an increase in the debt of the private sector by about 50% of GDP. The projections for 2013 are ominous as it is expected to reach 352.9% of GDP by the end of 2013.

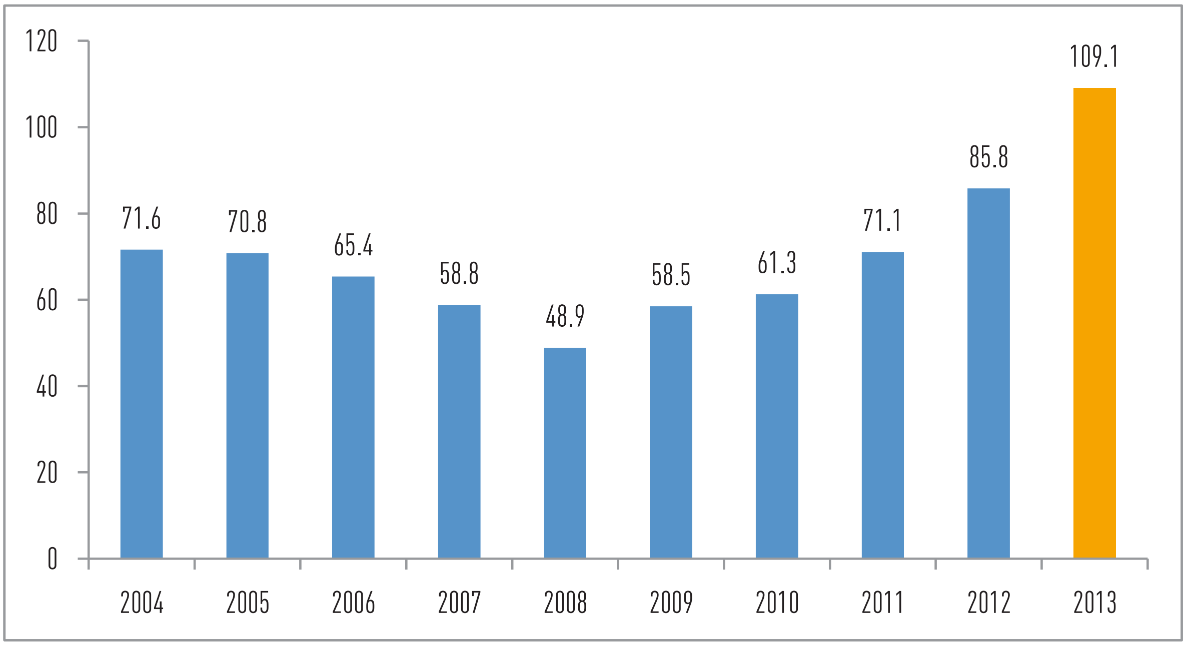
Diagram 1. 1 - Private debt in % of GDP



From various sources (Compilation by Andreas Theophanous and Kyriakos Antoniou)

Diagram 1.2 shows that the public debt followed a downward trend from 2004 reaching 48.9% of GDP in 2008. Thereafter the public debt shot up reaching 85.8% of GDP in 2012. Although the public debt of Cyprus is less than the average public debt of the EU countries, the important element (in this case) is the mode of growth of the public debt and the whole dynamic. Within just four years the public debt increased by 38% of GDP. This was the outcome of fiscal expansion as well as borrowing to cover the increasing balance of payments deficit. Indeed Cyprus was spending beyond its means. This upward trend will continue after the loan agreement between the government and the Troika. The public debt to GDP ratio is expected to reach around 110% in 2013. The IMF projections using the baseline scenario about the debt sustainability anticipate a peak at 126 % of GDP in 2015. Assuming full implementation of the program the debt ratio is projected to fall reaching about 105% of GDP by 2020 (IMF 2013). This is the optimistic scenario.

Diagram 1. 2 - Public debt in % of GDP



From various sources (Compilation by Andreas Theophanous and Kyriakos Antoniou)

It is noted that in the end of 2012 the public debt was roughly equally split between domestic and foreign debt.

Table 1.1 shows the long downhill of the fiscal deficit that started in 2009 and peaked in 2011 when it reached 6.3% of GDP. The fiscal deficit remained at the same level in 2012.

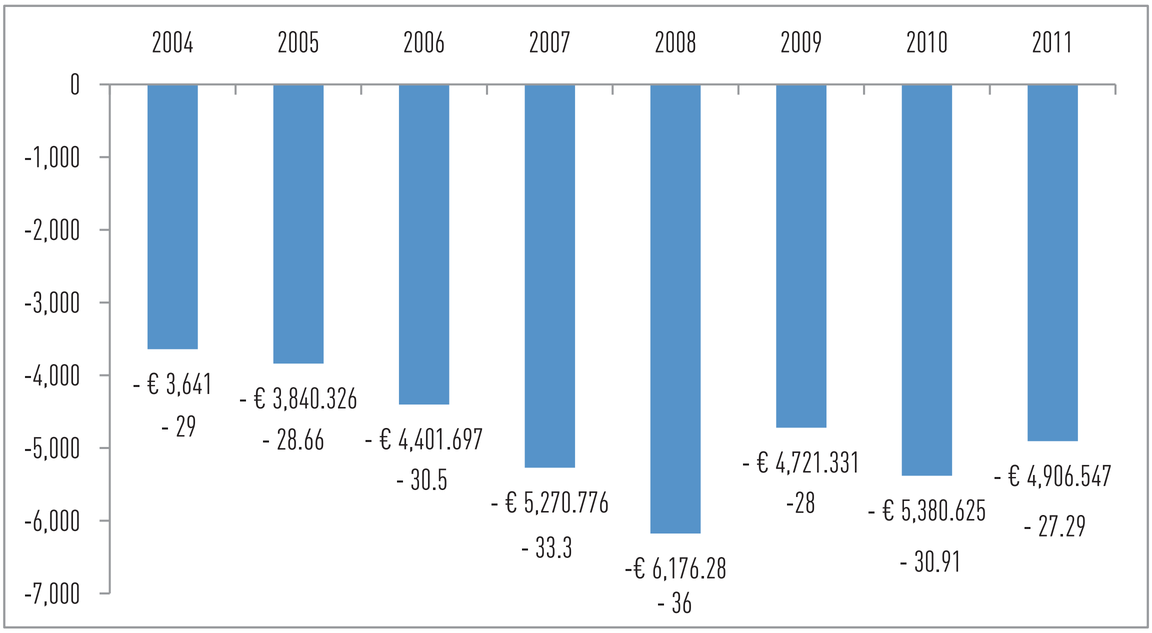
Table 1. 1 - -Government deficits (-) and surpluses (+) in % of GDP

YEAR	2004	2005	2006	2007	2008	2009	2010	2011	2012
Cyprus	-4.1	-2.4	-1.2	3.5	0.9	-6.1	-5.3	-6.3	-6.3

Source: Eurostat (2013)

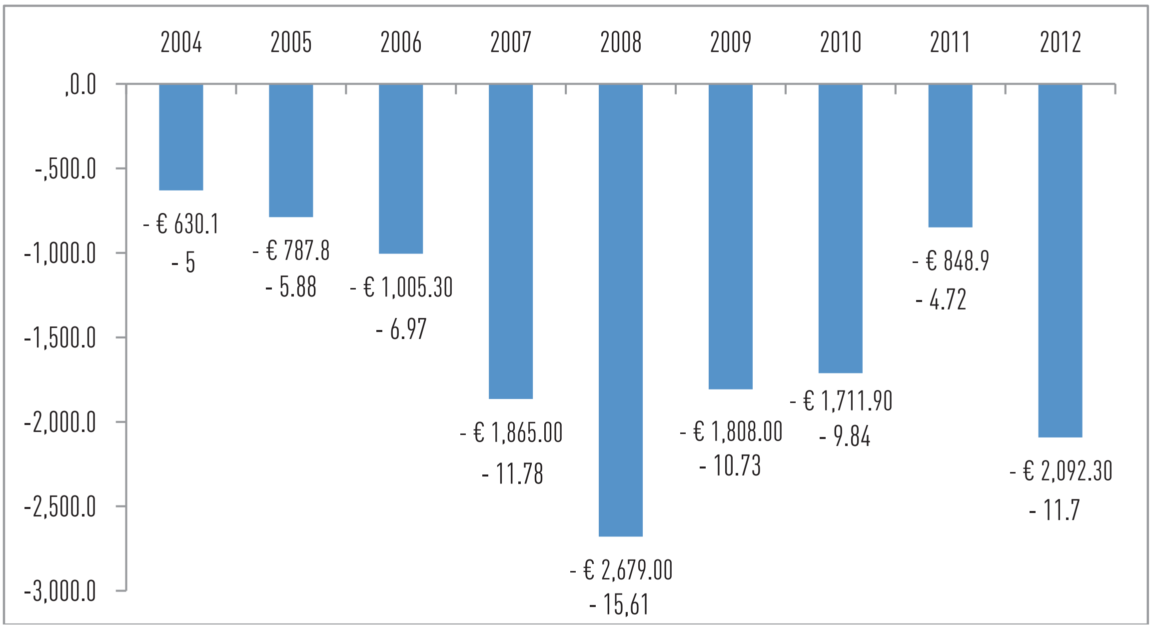
Diagrams 1.3 and 1.4 show the plight position of Cyprus in relation to the trade balance and balance of payments. Cyprus had always maintained trade deficits. These were covered by the services sector. In the last few years though the eroding competitiveness of the Cypriot economy led to sustained balance of payments deficits.

Diagram 1.3 - Trade balance in € million and in % of current prices of GDP



Source: Eurostat (2013)

Diagram 1.4 - Balance of payments in € million and in % of current prices of GDP



Source: Central bank of Cyprus (2013)

Be that as it may, the size and scale of the problems were manageable and could have been addressed with a gradual approach. However, the Troika chose a brutal approach to rationalize the Cypriot economy bringing a fatal blow in the financial sector and dragged the economy from recession into a depression.

2. The major pillars of the Memorandum of understanding and the implications

2.1. The philosophy of the Memorandum

In the case of Cyprus, the Troika's philosophy introduced the "bail in" to complement the "bail out". The idea was that apart from the money that the Troika would lend, the country would also "participate" in its rescue effort. This was also associated with a shock approach for the financial system, draconian fiscal discipline and strict austerity. The Troika's policies already have had cataclysmic effects, such as loss of wealth, higher unemployment, reduction of wages, increased taxes, reduced social benefits and the shrinking of the welfare state. Although only three months have passed since March the statistics are indicative. Cyprus registered the highest increase in the unemployment rate in the EU compared with a year ago; it increased from 15.1% in March 2013 to 16.3% in May 2013. Furthermore, there was a scaled reduction in the salaries of public and broader public sector employees and pensioners. Salaries in the private sector decreased at a much higher rate. At the same time there was a loss of wealth from the resolution of the Popular Bank, the haircut of accounts over €100,000 in Bank of Cyprus and the pension funds. Moreover, new information everyday points to an extremely difficult and, indeed, depressing environment.

2.1.1. Banking sector

The Troika considers the banking sector as the main problem of the Cypriot economic model. The domestic banking sector represented until recently 550% of GDP. On March 22, 2013 under the mandate of the Troika, the Parliament voted legislation including the following measures:

- the carve-out of the Greek operations of the largest Cypriot banks;
- the resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus and;
- the recapitalization of the Bank of Cyprus through a debt to equity conversion, without the use of public money (the so called "deposits haircut");
- As a result of these actions the Cypriot banking sector was downsized immediately and significantly to 350% of GDP.

Other provisions include the categorization of all loans past due by more than 90 days as non-performing loans, the maximum period of 1.5 years for the seizure of property that was mortgaged against a nonperforming loan (this period could be extended for a period 2.5 years for the primary residence) from the initiation of legal or administrative proceedings (paragraph 1.5)[6]. As a consequence there will be a constant accounting devaluation of banks' balance sheets. This will also be associated with a process of resolution of enterprises and bankruptcies of individuals. The banking system will be subject even to fluctuations in property values, incomes and unemployment. It is obvious that the banking sector, in which previously the supervision was inadequate, will enter a period of supervision which corresponds to a more controlled economy than in a free market economy and where the significant decisions will be taken by the bureaucracy of the Troika.

6. Where "paragraph" is stated it means the specific paragraphs of the Memorandum of understanding.

2.1.2. Fiscal policy

In relation with the Memorandum agreed on 23 November 2012 with the previous government, the Troika requested additional measures for the state budget of 2013 worth of approximately € 351 million (2.1% of GDP). Among the measures in order to increase government revenue is the property taxation of at least €75 million (paragraph 2.2), increase of the statutory corporate income tax rate to 12.5% (paragraph 2.3) and increase of the tax rate on interest income to 30% (paragraph 2.4).

Moreover, the provisions of the Memorandum include a series of new measures to reduce government expenditure on various housing schemes by at least € 36 million (paragraph 2.9). There will also be a scaled reduction in emoluments of public and broader public sector pensioners and employees (paragraph 2.11) . The total cuts in wages and pensions of the public and wider public sector are shown in the table below:

Table 2.1 - Total cuts in wages and pensions of the public and wider public sector for 2013

0-€1000	0.8%
€1001-€1500	7.3%
€1501-€2000	9.3%
€2001-€3000	10.5%
€3001-€4000	13.0%
€4001+	14.5%

Source: Compilation by Andreas Theophanous and Kyriakos Antoniou from the Memorandum of understanding

The target set by the partners of the Cypriot support program is to achieve a primary surplus[7] of 3% of GDP in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter. However, this is largely based on calculations before the destruction of the banking system, thus, are expected to be debunked.

2.1.3. State-owned enterprises and privatization

The provisions of the Memorandum are clear about the steps that the Cypriot authorities should follow in the case of the state-owned enterprises and privatization (paragraphs 3.5 and 3.6): the Cypriot authorities will initiate a privatization plan to help improve economic efficiency through enhanced competition and encouragement of capital inflows, and to help restoring debt sustainability. The privatization plan has to be in consultation with the Troika and implemented by the fourth quarter of 2013. The privatization plan is calculated to raise €1.4 billion by 2018.

The Troika believes in privatization and the clearance of state assets, including the profitable ones. A restructuring plan and a strategic partnership with the private sector would provide stable long-term government revenue helping Cypriot authorities to re-build the economy. Nevertheless, privatization will lead to private monopolies, eliminate the social role of these enterprises and also cause social turmoil.

2.2. Implications of the implementation of the Troika philosophy

A major question that is raised is whether Cyprus can get out of the depression within the framework of the philosophy of the Memorandum and the current architecture of the euro area. Unfortunately this is not possible because of three major factors:

7. The primary budget surplus arises from the subtraction of public expenditure by public revenues excluding interest payments on its debt.

- A huge fiscal cliff;
- A great negative wealth effect as a result of the decision of the Eurogroup in March 2013 and the developments thereafter;
- Serious internal and external restrictions to capital flows and a crippled financial sector.

The Troika's austerity is likely to push the country into chaos from which there will be no way out. Inter alia, the implementation of the Memorandum will cause a huge increase in unemployment, demographic outflows, deep and persistent wage cuts, tax increases, untamed public and private debt and above all misery and social disintegration. The high public debt will lead to new memoranda while the growing indebtedness of households and businesses will lead to property divestment and social fabric dissolution. This inevitably will lead to a social economic and political explosion.

> "THE CRISIS CAN BE ADDRESSED WITHIN THE ARCHITECTURE OF THE EURO AREA ONLY IF THE EU CHANGES ITS PHILOSOPHY AND APPROACH"

The crisis can be addressed within the architecture of the euro area only if the EU changes fundamentally its philosophy and approach. This would involve a very generous Marshall plan (up to €4.5 billion)[8], allowing the country to have discretionary fiscal policy (including higher deficits) until it exits the crisis; sustained access to ELA and relaxation of the internal financial controls. In the absence of such an approach inevitably Cyprus has to seriously examine the possibility of temporary exit from the euro area and the introduction of a national currency.

2.2.1. Fiscal deficit

Cyprus was not characterized by fiscal discipline; not surprisingly the fiscal deficits culminated in 6.3% of GDP in 2011 and 2012. The strategy chosen by the Troika to promote balanced budgets does not differ from the rest of the troubled European periphery. This revolves around the imposition of extreme fiscal austerity. The deficit reduction is expected to be achieved gradually not through growth but through reductions in wages and pensions (internal devaluation), cuts in benefits, tax increases and unprecedented pressure on society. It is doubtful whether this objective will be achieved even with these draconian measures. Instead the crisis will deepen and economic indicators will worsen.

2.2.2. Inflation, purchasing power of wages and interest rates

With the beginning of the implementation of the Troika philosophy, Cyprus has entered into a depression. Despite the reduction of prices, the purchasing power of wages will be decreased as salary cuts are/will be greater. Unfortunately, there are/will be many unemployed workers with zero wage purchasing power. Interest rates will also be reduced and gradually move in line to the ones existing in the northern euro area countries.

2.2.3. Gross domestic product and repercussions on the public and private debt

The adoption of the Memorandum has dramatic repercussions on the GDP. The GDP is expected to shrink substantially mirroring the devastation of economic production. The expected significant reduction of the GDP will lead by the end of 2013 to the increase of private debt to GDP ratio of Cyprus up to 350% and the public debt to GDP ratio up to 110%.

The implementation of the Memorandum will have devastating impact on businesses and households as many of them will go bankrupt. It is inevitable that the depression is leading to a situation where it will be impossible for both the public and the private debt to be served.

8. This is the amount that the Cypriot Banks lost from the "Greek debt haircut".

2.2.4. Unemployment and immigration

As the philosophy of the Memorandum focuses on draconian austerity – including raising taxes, cutting wages and benefits - there will be negative impact on economic activity. This will lead to high unemployment and the rate of immigration, especially among young university graduates, is expected to rise. The implications will be devastating.

2.2.5. The trade balance, the current account balance and the balance of payments

Under the framework of the Memorandum there will be an improvement in the index of the trade balance basically due to the depression. In the same line, reducing the trade balance deficit will have a positive impact on the current account balance. These developments will also lead to a reduction on the balance of payments deficit. With the Memorandum policy Cyprus cannot anticipate relative improvements of these indicators under conditions of social prosperity. The improvement of indicators will essentially be the outcome of the pauperization of society. This is being also mirrored in the index of Unit Labor Cost (ULC). According to the projections of the Eurostat the ULC in Cyprus is expected to decline in the coming years in contrast to the average ULC in the rest of the euro area[9]. This is a corollary of the Memorandum which transfers the problem to workers, demonstrating the disadvantage of Cypriots in relation to the average citizens of the euro area in the coming years.

2.2.6. The foreign and domestic public debt and its implications

The €10 billion external loan will lead to the increase of the foreign public debt without the encouragement of economic activity. The public domestic debt is not expected to increase since the state already absorbed almost all the liquidity of the domestic market (e.g. from deposits and pension funds). Given the depression conditions, the viability of the public debt as a whole will be at stake.

3. The main pillars of the temporary exit from the euro area and the prospects: a better option?

3.1. The rationale for the alternative option and the fundamental pillars of the new economic policy

Given that Cyprus is already *de facto* outside the euro area it should seriously consider the adoption of a national currency. The proposed temporary exit from the euro area stems from the realization that the enormous problems will deepen further with the current economic and political architecture.

The adoption of a national currency would enable the short-term revival of the economy. It would immediately have a direct positive impact on tourism and the real estate sector. But above all the national currency would allow Cyprus to have discretionary fiscal policy and monetary policy.

> “THE ADOPTION OF A NATIONAL CURRENCY WOULD ENABLE THE SHORT-TERM REVIVAL OF THE ECONOMY”

Certainly, several risks arise such as the possibility of high depreciation of the new currency and inflationary pressures. Under such circumstances there would be growing uncertainty. Nevertheless, taking such a risk is an outcome of the desperate situation Cyprus has found itself following the decisions of the Eurogroup in March 2013. Thus, if under the existing situation the exit from the crisis is impossible, by definition, the adoption of the national currency is imperative. It is also acknowledged that the national currency is a necessary but not sufficient condition for a new promising economic course. Indeed,

9. It is noted that the ULC in Cyprus rose above the euro area average only after the adoption of the euro showing the decline competiveness of Cyprus.

Cyprus requires structural reforms[10] and above all a viable paradigm which would include new engines of growth[11].

The overall outcome of the implementation of the alternative option would depend on several factors. The broader possible consensus within the country as well as a decisive and credible government is a necessary but not sufficient condition for success. This could be the outcome of an immediate change of the economic philosophy and the creation of a new government by President Anastasiades with broader support and a clear mandate based on a commonly accepted new program. Alternatively, the new course of developments would be a sad outcome after the country is led to collapse.

It would be better if the temporary exit of Cyprus from the euro area was undertaken with the cooperation and support of the European partners. This would allow for better planning and coordination for the revival of the economy. Within this framework it is also possible to determine the rate of currency depreciation.

If the government persists to stay under the current philosophy, the developments would be such that Cyprus would probably be forced to formally exit the euro area at a later stage and severely impoverished. Then, the situation will be much more difficult.

It is vital that the economy embarks on a path of recovery. Such a development would mark a new economic era and restore the feeling of dignity and self-confidence. In short, the pillars of the new policy would be as follows:

1. Temporary adoption of the pound / Cypriot euro at the rate 1:1. At the same time there would be a comprehensive design of monetary and exchange rate policies.

2. Deposits in euro would be maintained while the current restrictions to capital flows will continue. These restrictions will be gradually lifted.

3. Foreign and private business, if they wish, may pay their employees and conduct their transactions in euro.

4. The context of banking operations would be redefined, and the financial supervision would be enhanced.

5. The households and businesses loans would be converted in pounds / Cypriot euros. The Central Bank would gradually pay banks and cooperatives the corresponding amounts which would be lost by the expected depreciation.

6. Wage cuts would be avoided. For example, a professional with a monthly salary €3,000 would be paid 3,000 Cyprus pounds / Cypriot euros. At the same time it would be important to introduce income policies.

7. Renegotiation between households and banks / cooperatives for their debt obligations. Prevent the divestment of the primary residence.

8. Comprehensive planning of fiscal, developmental and social policy. Initially, after the adoption of a national currency, there would be deficits which would gradually decrease. The following pillars would need to be implemented:

    i. A new tax reform which will take into account all relevant developments. It will have a social dimension while encouraging deposits and investments utilizing various incentives;

    ii. Reduction of Value added tax (VAT) from 18% to 13%;

    iii. Reduction of Cooperate Tax from 10% to 9% instead the suggested increase by the Troika to 12.5%;

10. As already noted it is also essential that there is full rationalization of the public and the financial sectors.
11. Cyprus, among other things, could advance itself as a medical and academic centre as well as an energy hub.

iv. Fiscal rationalization and balanced budgets would be promoted over a longer period (Swedish philosophy)[12].

v. There would be no tax increases for income from interest rates. The tax would remain at 0.095%.

9. More efficient tax system with low tax rates and high non-compliance penalties.

   i. Rationalization of expenditures;

   ii. Provisions for increase in property taxation (this would be implemented after Cyprus exits the depression);

   iii. Reduction of public expenditures below 40% of GDP in the long run[13].

10. The domestic and foreign public debt should be reassessed as well as ways for its effective management.

11. Extension, broadening and deepening of the tourist product.

12. Encourage new sectors of economic activity and new engines of growth. In this context, it is essential to encourage the prospect of establishing Cyprus as an academic and medical centre and to promote research and innovation.

13. Special emphasis would be given to the exploitation of energy resources (hydrocarbons). Furthermore, renewable energy sources should cover at least 20% of Cyprus energy needs, as per EU targets.

14. Comprehensive strategy for upgrading the efficiency of public and private organizations.

15. The solution of problems should take place within the framework of a new social contract.

16. The implementation of administrative reforms and promotion of meritocracy as a means of social justice and highest efficiency.

17. Reduction of the public and wider public sector payroll as a result of various measures (e.g. philosophy of interchangeability). Promote consolidation of municipalities and other services.

18. Convergence of the employment conditions between public and the private sector.

19. Approve legislation to establish casinos and taxation of online and other forms of gambling.

20. Restructuring pension plans in a way that restores equity among citizens and economic rationalization. The pension scheme for the public and broader public sector is unsustainable. Furthermore, there should be a range with an upper and a lower limit for pensions.

21. Re-evaluation of state grants and allowances.

22. Increase the efficiency while reducing the bureaucracy of the state (e.g. faster delivery of building permits and property deeds). Greater cooperation between the public and private sector.

Taking into account all relevant developments, the Cypriot crisis can be handled with a policy mixture similar to that of the USA President Roosevelt in the 1930s and that of President Reagan in the 1980s. This would

12. The approach of balanced state budget over a longer period (e.g. five years) was used by Sweden during the 50s.
13. This can be the outcome of fiscal rationalization including the long run downsizing of the broader public sector but moreover of economic growth.

include an expansionary fiscal policy as well as multidimensional incentives and reductions in tax rates to boost supply.

The adoption of a national currency would have immediate positive effects in financing some of the requirements of the state. Specifically, the state would not pay salaries and pensions in euros but in Cypriot euros / pounds. Initially the financial requirements of the country for imports would not exceed € 3.5 billion annually. This amount would be more than covered by revenues from tourism and from developments in other areas such as the property market. The dynamic would be such that more income in hard currency will be generated. This would allow the country to gradually repay its foreign public debt obligations. Within the proposed new economic architecture the transition to the national currency would give better and faster results.

This study opens the door to new approaches and simultaneously indicates the need for further investigation of several issues. For example, the conversion of domestic public debt in pounds / Cypriot euros helps the state but on the other hand it creates complications for the creditors such as insurance funds. It is however also possible to introduce plans to support or provide some compensation which may also be extended to individuals and businesses that had lost their deposits.

3.2. The alternative approach and economic implications

3.2.1. Fiscal deficit

The adoption of the national currency and the exercise of expansionary discretionary economic policy would initially entail high fiscal deficits. Using the assumption that initially the deficits would be between 6-9% of GDP, the government would partly monetize it for a short period, boosting aggregate demand. Eventually with economic recovery and growth it would be reduced and, indeed, be balanced. With the new state of affairs economic recovery would take place faster given the ability of the government to exercise discretionary fiscal and monetary policy. A further boost to the economy would come from the expansion and deepening of tourism and of the construction sector as the currency depreciation will render Cyprus a more attractive destination. At the same time, as already noted, it is understood that substantial restructuring would be undertaken.

3.2.2. Inflation, purchasing power of wages and interest rates

It is possible that the currency devaluation would not exceed 20%. In such a situation the impact on prices may be well below 20% and in long-term even below 10%. At the same time given that the proposed measures include tax reductions there would be a countervailing influence on prices. Furthermore, taking into consideration the whole architecture of the economic package the purchasing power of wages would be higher while more people would have jobs. On the other hand, given the inflationary pressures, nominal interest rates would be higher. That does not mean that real interest rates would be higher[14].

3.2.3. Gross domestic product and repercussions on the public and private debt

With the new economic architecture including the ability of the state to exercise discretionary economic policy there would be recovery and growth. Furthermore, there would be a substantive increase of domestic and foreign investment as investors will seize emerging economic opportunities. With the new economic policy, domestic as well as foreign investors would be able to do business in any currency they wish. So given that there would be no currency risk for investors, uncertainty will decrease. After a stabilization period with economic recovery the business climate would improve even more.

In the case of the public debt the coordination of fiscal and monetary policy would be beneficial since the state will have the necessary tools to be able to reduce the public debt through faster GDP growth. Simultaneously

14. If Cyprus stays in the Troika philosophy and is forced to adopt a national currency at a later stage the results will be worse. For example, depreciation and inflation will be much higher.

with the currency change the government would be able to roll over the public domestic debt by providing state guarantees while it renegotiates the foreign debt. In addition, the private debt would be reduced with the devaluation of the pound/Cypriot euro. The implication is that the economy would be reflated and a greater proportion of loans will be served.

Furthermore, considering the expected depreciation, the difference in the actual value of the private debt would be paid by the Central Bank. This would be done in a controlled way, over time and not as immediate compensation, in order to minimize inflationary pressures. For example, assuming that the private debt is about €56 billion and that the pound would be depreciated by 20% and that the average debt period is about 15 years: this means that the Central Bank would pay 11.2 billion pounds/Cypriot euros for the whole period of 15 years, in other words 0.747 billion pounds annually. By the same token, similar arrangements could be made for the domestic public debt which amounted to €7.3 billion (48.4% of the GDP) at the end of 2012.

3.2.4. Unemployment and immigration

The new economic architecture would lead to faster recovery. Thus, there would be more job opportunities. Furthermore, it is noted that the adoption of the national currency would allow the employment of more Cypriots, as the trend of EU citizens coming to Cyprus to work would be reduced.

3.2.5. The trade balance, the current account balance and the balance of payments

The devaluation of the pound/Cypriot euro and the expected inflationary pressures are expected to encourage domestic production of goods and services. This would result in the reduction of the trade deficit. Neglected economic sectors such as agriculture and industry would experience growth.

At the same time, the redirection of economic activity and the growth potential would lead to greater domestic and foreign investment. The net effect would be positive leading to improvements in the current account and the balance of payments.

In addition, the exit from the euro area would create new prospects for the Cypriot products and services. Thus, the competitiveness of Cypriot products and services would rise through the currency devaluation and not by deflation which leads to depression.

3.2.6. The foreign and domestic public debt and its implications

After exiting the euro area and adopting the pound, the government would renegotiate and restructure the foreign debt. However, at this stage there cannot be a precise calculation of the final size of the foreign debt. The reality is that the earliest Cyprus exits the euro area the better it would be for the prospects of creating the preconditions for putting an end to the depression. In the same line, the smaller would be the amount of foreign debt to be renegotiated. Within this framework the ELA obligations could be questioned and legally challenged.

Additional risk for both Cyprus and its creditors is the exchange rate risk associated with debt denominated in euros. The domestic public debt would be converted into the new currency. Simultaneously with the adoption of national currency the Central Bank of Cyprus would gain the control monetary policy. The controlled inflation would have a beneficial effect in reducing the public debt[15].

15. The timing of adopting a national currency is also important.

4. The political dimension of the options

4.1. The political economy of the options

The assessment of the options for the Cypriot economy is taking place within a broader political, economic and social framework. It has repeatedly been indicated that the decisions of the Troika were very harsh and destructive. They constituted a lethal strike for the financial sector and pushed the country from recession into a very deep depression from which it will be impossible to exit within the framework of the current philosophy and architecture. Hence, the temporary exit from the euro area must be seriously assessed as the alternative option. If the European partners insist on the continued participation of Cyprus in the euro area, and this would be the preferred option, then they must act accordingly: the EU should move towards new policy perspectives, as already noted, that will make possible the exit from the depression within the euro area feasible.

If the EU cannot accept such a change, the adoption of a national currency is imperative. The opponents of this approach argue that the withdrawal from the euro area will leave Cyprus geopolitically isolated in a very difficult environment. While this position is acknowledged, it cannot be ignored that it is the philosophy of the Troika and the decisions of the Eurogroup that unnecessarily dragged Cyprus into a very deep depression and have already weakened it at a decisive period. In any case, currently Cyprus is *de facto* outside the euro area.

Another question raised is what developments can be expected after the German elections in September 2013. Is it possible that following Angela Merkel's electoral victory, Germany will relax the policy of fiscal austerity? And if yes, to what extent? Will it push for a fiscal union with greater emphasis on balanced budgets while ignoring other dimensions of fiscal policy such as growth and social cohesion? Furthermore, can Cyprus follow if Germany seeks more convergence of tax systems? In such a situation, Cyprus will also lose one of the few comparative advantages which have been left. In short, Cyprus needs to consider its options.

By definition the economy plays a significant role because it influences the standard of living and the relative power of every country. The recovery of the Cypriot economy after 1974 was of crucial importance for the survival and the continuity for the Republic of Cyprus. It was the economic robustness and the "economic miracle" that followed which contributed to sustainability, demographic stability and which eventually enabled the Republic of Cyprus to negotiate successfully its accession to the EU and subsequently to the euro area.

Cyprus is experiencing difficult times and it is tested once more. One of the most difficult challenges is to prevent the migration of young Cypriots and even of families who are forced to seek opportunities abroad.

Last but not least, the case of Cyprus might constitute the beginning of a broader thinking on the euro area and EU integration. Cyprus, despite its bitterness, should explain what took place and submit comprehensive proposals for its own exit from the crisis. This will enrich the debate on the broader challenges.

4.2. Political considerations and implications

On January 11, 2013 the then Presidential Candidate Nicos Anastasiades hosted leaders of the European Peoples Party, including Chancellor Merkel, who offered their support. Ironically only a few days after his electoral victory on February 24 and the assumption of his duties on March 1 the newly elected President was presented with an extraordinary situation which effectively humiliated him and undermined his credibility. Sadly, it has become obvious that Cyprus was used as an experiment and an example for other euro area members without consideration that the situation could have been made more difficult.

One of the issues that are raised is whether there are plans outside Cyprus to push for a package deal involving the economic crisis, energy issues and the Cyprus problem. In other words, Nicosia suspects that its current weakness may be exploited.

Given these elements in conjunction with the new economic approach it becomes imperative for Cyprus to pursue a multidimensional foreign policy. While Cyprus remains a member of the EU it must strive to cultivate bilateral relationships at all levels with various countries. This should also be done with key EU countries - including Britain and all the Mediterranean countries - and third countries such as USA, Russia, China and India. Particular attention should be given to Israel as well as a balanced Middle East policy which will create benefits for all involved parties.

"THE EUROGROUP DISREGARDED THE ENERGY POTENTIAL OF CYPRUS, ITS GEOPOLITICAL POSITION AND THE ASSOCIATED IMPLICATIONS."

The Eastern Mediterranean has always been a particularly significant geostrategic region. At this historical moment there is an upheaval in the broader area as well as new opportunities following the discovery of huge amounts of hydrocarbons. Cyprus should have been in a position to play a substantive and multidimensional role in the broader region for the benefit of the EU. Indeed, the former Minister of foreign affairs of Spain M. Moratinos criticized the stance of the EU accusing them with political and geostrategic myopia. He also indicated that the Eurogroup completely disregarded the energy potential of Cyprus, its geopolitical position and the associated implications.

Cyprus must come out of the crisis as soon as possible. The perpetuation of the crisis will not allow Cyprus to implement those policies that will maximize its potential and prospects. Furthermore, Cyprus will not be in a position to serve the broader objectives and interests of the EU in the region.

The question raised is whether Cyprus outside the euro area and distanced from the EU would be weaker. This is an issue that cannot be ignored, but on the other hand it is lethal for Cyprus to stagnate without any prospect of exit from the depression. Under such circumstances Cyprus will not even be able to sustain its population.

The issue which is extremely important however and cannot be overlooked is the political dimension of the exit from the euro area. Cyprus should proceed in the desired direction with the consent of its partners. Thus, it should be explained why the adoption of a national currency is the only solution for exiting from the crisis.

Cyprus would have to explain to its European partners that the decision to temporarily exit from the euro area is due to the fact that the situation cannot be managed under the existing developments. That is, with a discredited banking sector, with serious internal and external capital controls, as well as a huge fiscal cliff, Cyprus cannot hope for recovery.

The Republic of Cyprus should have a strategy to get out of the economic crisis and, moreover, create a new economic paradigm. Furthermore, while a priori Cyprus cannot reject the idea to simultaneously address the Cyprus problem, the energy issues and the economic crisis, its weakness should not be used as a pressure tool.

Last but not least, Cyprus must have a comprehensive narrative. This should aim to explain its economic circumstances, the harshness of the Troika decisions and point out to the alternative option. The narrative should also highlight the role of Cyprus in the region and the broader benefits that may be generated. It should finally explain the Cyprus problem and suggest a road map of its solution along integrationalist lines.

5. Concluding remarks

Even before the climax of the crisis, Cyprus seemed to be a resigned country and society. The Cypriot economy was facing very serious structural problems. Nevertheless, these could have been managed and addressed with a gradualist approach. The Troika philosophy and the Eurogroup's decisions in March 2013 in essence gave a lethal blow to Cyprus and the country has fallen from a sustained recession to a very deep depression. The damage in economic terms is huge – comparable to the 1974 fallout. Not surprisingly, today, there is in Cyprus growing Euroscepticism and bitterness.

The lack of a narrative contributed to serious misperceptions about Cyprus. Furthermore, this island-state was seen as disposable and consequently was used as an experiment. In addition, the small economic size of Cyprus (about 0.2% of the euro area), and the eagerness of the Eurogroup to try new ways to deal with addressing debt issues and bank rescues ("bail in"), contributed to the disastrous March 2013 decisions.

But it is now emerging that the Eurogroup's thoughtless vindictiveness against Cyprus is beginning to backfire. This has not only been an attack on Cyprus; it undermines the entire concept of the euro, and worse, of all modern banking systems which are based on fractional reserves for banks, backed by one or another form of governmental guarantee. It remains to be seen how this will end.

The Cyprus crisis can be addressed within the architecture of the euro area if the EU changes fundamentally its philosophy and direction. This would involve a very generous Marshall plan, allowing the country to have discretionary fiscal policy (including higher deficits) until it exits the crisis, unconditional access to ELA and absolute relaxing of the internal financial controls. In the absence of such an approach inevitably Cyprus has to exit from the euro area temporarily and introduce a national currency.

The policy plan could combine elements of Roosevelt's policy in the 1930s in the USA to address the depression and Reagan's philosophy in the 1980s to stimulate the economy. Such a strategic policy mix will include an expansionary fiscal policy allowing for deficits in the immediate short run as well as tax decreases – VAT from 18% to 13% and Corporate Tax from 10% to 9% instead of the proposed tax increases by the Troika.

The suggestions also entail keeping the current deposits in euros while the debts will be paid in the new national currency, the pound or the Cypriot euro. The amount that will be lost for the banks due to the devaluation will be compensated by the Central Bank. This will not lead to high inflationary pressures as the monetization will be spread over an extended period of time.

It should be noted that in any economy there is an optimum level of money supply/stock. In the case of Cyprus the amounts involved are such that the monetization process will not cause any serious problem. The fact that current deposits will initially stay in euros will be an additional factor which will contain inflationary pressures. Cyprus can work in ways that inflationary pressures are kept to the minimum.

Exiting the euro area and adopting a new national currency is a necessary but not sufficient condition for recovery and for embarking on a new path of growth and development. Indeed, it is essential that Cyprus moves gradually toward fiscal rationalization, financial streamlining while looking into new engines of growth and for a new economic paradigm.

Given that the philosophy of the Troika and the architecture of the euro area are leading Cyprus to collapse, the study gives a bold and comprehensive road map for exiting the crisis while paving the way for a broader debate within Europe. At the same time, the study points out that the EU should revisit its overall approach to the problems of the European South. If there is no change of philosophy and economic directions in the euro area, other countries may end up following Cyprus. It is not an exaggeration to note that if the current economic policy pursued by Germany persists, the future of the euro itself will be at stake.

> "THE EU SHOULD REVISIT ITS OVERALL APPROACH TO THE PROBLEMS OF THE EUROPEAN SOUTH"

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