CYPRUS IN THE CHALLENGING EUROZONE ENVIRONMENT*

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Introduction

- As was widely predicted, worldwide recovery is taking a slow and hesitant path with unemployment the most stubborn and painful indicator: brief discussion of the uneven experience of the emerging economies, the United States, Europe and Cyprus.

- In parallel with strong and unprecedented Central Bank action, most countries have responded to the crisis with expansionary fiscal policies and banking sector support leading to larger budget deficits and ballooning government debt levels. While projected budget deficits in many countries are beginning to decline, debt levels continue to rise and funding needs for both the public and private sectors loom large in the coming years. .

The Crisis in the Eurozone

- The crisis (i) brought to the surface preexisting and homegrown structural problems in many eurozone member countries, including persistent differences in the behavior of unit labor costs (competitiveness) (ii) highlighted the damage done by past relaxations (2004) and violations of the Stability and Growth Pact and (iii) underscored shortcomings in the functioning of the Economic and Monetary Union.

- With entry into monetary union, under the umbrella of a common stable currency and lower interest rates, fiscal policy, still a national responsibility, was not adjusted in many countries leading to unsustainable overheating of the economy, characterized by asset prices (construction) booms.

- The crisis also revealed the weaknesses of the surveillance and enforcement process at the European Union and eurozone levels: besides the fiscal and debt criteria of the Stability and Growth Pact, there was near total neglect of other macroeconomic imbalances and of macro-financial sector risks.

- Despite sharp economic performance differences, and differences in economic fundamentals, government debt yields across member states of the eurozone moved together and differed little from each other until 2010, when we witnessed unprecedented and remarkable diverging spreads on long-term government debt.

- As the sovereign debt crisis developed, it became clear that persistent errors in national economic policies not only damaged a country´s own economic welfare but caused serious problems for the eurozone as a whole.

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Managing the Crisis

- Largely for this reason, the European Central Bank took exceptional and unconventional measures to help manage tensions in the sovereign debt markets (unfolding not only in Greece but also in Ireland and potentially in Spain and Portugal) while the Eurogroup political leadership struggled with the dilemma between, on the one hand, the moral hazard of under-mining the no-bail-out principle, thereby providing governments and markets with the wrong incentives, and, on the other hand, averting the threat to the stability of the common currency.

- As the thinking of how to improve the governance of the eurozone evolved, on the one side there was (i) the real concern that a quasi-automatic bail-out system would effectively validate bad policies and send the national policy making in the wrong direction of unsound policies, while on the other side (ii) there was a clear recognition that the doubts implicitly expressed by the behavior of markets could only be eased by correcting the perception of a failure in European solidarity (which was evident in the process of reaching agreements on the handling of the sovereign crisis in the euro area over the past several months) and reaffirming stronger mutual support among eurozone member states.

Building on What went Wrong

- In several instances not only did the preventive part of the Stability and Growth Pact not succeed in preventing excessive deficits, but also the corrective arm failed in inducing prompt excessive deficit reversal, all this amidst failures in budgetary reporting and surveillance and the resulting inevitable reputational cost for the European institutions.

- Not only were the rules not enforceable and sanctions were not available, while peer pressure was not enough for the avoidance of persistent excessive deficits, but market forces failed to signal the urgent need for budgetary discipline in that, until the onset of the crisis, markets did not differentiate among the debt of different member countries of the eurozone. Indeed, we now know that markets take too long to provide signals of underlying trouble and then, when the crisis erupts, they overreact compounding severe disruption, and they are not easily convinced that effective corrective measures are taken and adequate external support is being provided.

- Furthermore it now seems that being a member of the eurozone, which does not allow the exchange rate flexibility that would contribute to macroeconomic adjustment, while normally it brings significant benefits, during times of crisis in the common currency area can be a distinct liability, certainly for countries which do not follow sound and sustainable policies but also for other countries as can be seen by the behavior of markets, even as the recession appears to be drawing to an end.

The Way Forward

- As we go forward there seem to be three areas of needed action (i) first, how to deal with the fallout and the consequences of the ongoing sovereign debt crisis (ii) second, how to ensure that in the future economic policies of member countries are consistent with membership in a sound monetary union and (iii) how can the economic governance of the eurozone be improved so as to restore confidence in its financial stability.

- In the first area, strong and painful measures are being taken by the countries most seriously affected by the sovereign debt crisis, and by others which do not wish to suffer the same fate, while at the same time a massive coordinated package of financial support by the European Union and the International Monetary Fund has been put in place. While it is perhaps not appropriate to speculate here on the outcome of these efforts, for the time being the behavior of financial markets suggest significant betting on some sort of restructuring of the Greek debt (discounting) and similar odds for a number of other eurozone member countries.

- Critical to needed action in the second area is strengthening the code of conduct for national governments in the eurozone, notably the Stability and Growth Pact, supported by improved economic governance, including the possibility of sanctions, as well as incorporating in the surveillance process an assessment of the overall macroeconomic situation (not only fiscal). Effective improvements are essential to reap the benefits of the European Stability Mechanism, a form of mutual insurance facility which is currently under design, while at the same time avoiding moral hazard perverse incentives discussed earlier.

Medium-term Fiscal Consolidation

- While immediate reduction in fiscal deficits is important, much more critical in the adoption of a multi-year fiscal planning horizon in budget discussions and design with a transparent and consistent framework with clear and binding rules – such discussions should include contingent liabilities such as long-term expenditures in which the state or state enterprises are committed and unfunded social security and other future retirement liabilities; binding rules could include setting limits on the growth of the overall and specific expenditure categories to facilitate budget consolidation in case of excessive deficit or debt ratios.

- Also needed at a European level is a rigorous and credible budgetary data reporting and analysis as well as surveillance, framework. For some countries an independent budget evaluation agency could be useful to provide a cross-check to the national budget authority and facilitate the analysis at the European level.

- To be effective a compliance framework needs to be complemented by strong incentives and effective sanctions. In this context, clear and quasi-automatic sanctions are being discussed including well publicized country missions, fines, reduced access to European Union funds and other financial consequences, with the severity of the breach determining the severity of the sanction. Shorter deadlines under excessive deficit procedures and more ambitious targets for the reduction of public debt towards the 60% of GDP ceiling (and beyond if necessary) seem appropriate.

The Role of Competitiveness

- Beyond the clear message to bond markets, and other economic agents who invest and create jobs, that the era of fiscal misconduct is over, macroeconomic stability and the prospects for economic growth need to be anchored firmly on competitiveness in the eurozone. The primary symptoms of a widening competitive gap which has hit the eurozone, are to be seen in unit labor costs and inflation differentials and mounting current account imbalances. The real damage to the economy takes the form of persistent differentials in output and employment growth and welfare.

- In some countries, exemplified by Germany where relative labor costs have improved and labor market barriers have been lowered, employment has risen. Going forward, countries which take advantage of the crisis to implement structural reform will reap the benefits. And Europe for its part needs to establish a rigorous and credible framework for monitoring the implementation of these measures and the subsequent behavior of national cost and price developments sending the message that if they are persistently and significantly higher than the eurozone average competitiveness and growth will suffer.

Rebuilding Confidence in the Eurozone

- The third area of action which is designed to correct the perception of failures in European solidarity in facing the sovereign debt crisis in the eurozone, is the establishment of a mutual support framework known as the European Stability Mechanism. The objective of this mechanism is to address situations where a eurozone member state has lost, or is in serious risk of losing, the ability to finance itself at sustainable interest rates on the capital markets. While the need for such a mechanism is clear to help restore confidence and has been demonstrated by the ongoing sovereign debt crisis, a number of key issues need to be resolved.

- The avoidance of moral hazard through the strengthening of the fiscal and competitiveness code of conduct is clearly crucial for the success of the mechanism. Related to this is the governance of the macroeconomic adjustment program to restore the eurozone member state to a situation where it can finance itself on the markets. Other areas which need to be worked out in detail are the appropriate size and lending capacity of the mechanism, its capital structure including an equitable burden sharing among member countries, what instruments it will use and at what price and how will the private sector be involved. Good work is being done on all these issues.

Cyprus: Urgent Action Needed

- Much of what has been said about the eurozone member countries needed course of action going forward applies to Cyprus as well. What needs to be done has been repeatedly analyzed and discussed and this is not the place to go into detail. The deterioration in Cyprus´ public finances since 2008 has been severe and it cannot be simply explained by the world economic crisis. Our ambition to continue to grow as a regional financial center and not to undermine the key role of our internationally – oriented banking sector as a source of growth, demands urgent fiscal consolidation.

- The messages from the rating agencies are clear as are the areas of concern and the urgency for meaningful action. The adverse environment for the sovereign debt of several eurozone member countries make it even more important to set and achieve ambitious fiscal consolidation targets. Modest revenue increases resulting in marginal improvements in the fiscal situation must not divert attention from the need for structural containment of public sector expenditures.

- The required action program for Cyprus includes addressing a structural fiscal deficit though a multi-year program of expenditure control, focusing on the civil service wage bill, much better targeting of social spending with explicit ceilings, a reversal of the rapid growth of the state and structural reforms to improve the productivity and the competitiveness of the economy. The experience of several eurozone countries demonstrates the high cost of inaction and of the pretence that all is well until much more painful action becomes inevitable.