THE CYPRUS ECONOMY: A LEAP FORWARD?

Yiannis Tirkides
Associate of the Center for European and International Affairs, University of Nicosia

The Cyprus economy is at a dire strait. The banking sector has been severely affected by the crisis in Greece and more broadly by the European debt crisis. Domestically the economy is contracting and the property market remains at a state of flux. Public finances are unsustainable not just because of the state of the banking sector, but because of the inherent dynamics that are now built in the budgetary position. The economy exhibits a number of serious imbalances that need to be addressed.

In a context of lingering uncertainties and following a series of downgrades by the main rating agencies, the Cyprus government has lost access to financial markets for over a year now. Russia has provided Cyprus with a €2,5 billion loan at the end of last year which allowed the country to meet its debt payments this year until now. Fiscal consolidation measures taken at the end of last year, which were thought to be potent enough so as to reduce the budget deficit to 3% of GDP this year, are now shown to be inadequate either through poor or delayed implementation, or simply through revenue losses as a result of a deeper recession than initially anticipated.

Coupled with the considerable capitalisation needs by the country's biggest banks, the government had no option but to apply to the European Union and the IMF for assistance, which the government did at the end of June 2012. There are on-going consultations and negotiations thence, between the government of the Republic of Cyprus and the Troika of lenders - the European Commission, the European Central Bank and the International Monetary Fund – for a conclusive multi-year bailout programme.

After three years of stagnation and unemployment now at 11 percent, the economy faces the risk of being dragged further down. The discovery of offshore gas reserves are expected to provide some consolation but their commercialisation are years away.

The Cyprus economy remains exposed to considerable uncertainty and risks going forward including mainly a further deterioration of condition s in Greece, an intensification of the debt crisis in Europe further down the road, and fiscal adjustment. A continuing recession in Greece and a possible exit from the Eurozone, though we don't anticipate it, pose considerable risk for the Cyprus economy. Total loans of Cypriot banks to the private sector in Greece are almost one and a half times the country's GDP. The impact from a worsening outlook in Greece on Cypriot banks and the economy more generally would be large and would lead to further tightening of financial conditions at home.

In this context Cyprus will need to adjust and reform itself in three areas: banking and finance; public finance; and productivity and competitiveness.

The Cyprus banking sector has been severely affected by the crisis in Greece and remains vulnerable due to its large size relative to the economy, under provisioning and exposure to the domestic property market. In this context the domestic banking sector suffers from a severe capital shortage and liquidity constraints. Thus capital must be restored, the liquidity problem must be addressed and the framework of regulation and supervision should be strengthened.

At the same time, and in order to stabilise the economy and restore confidence in its long term viability, it is necessary to put public finances on a sustainable path in order to create the conditions that would allow an active fiscal policy to take shape in the future. This requires both fiscal consolidation and fiscal structural reform. The budget should balance within a defined period of time, say two to three years, primarily through measures that rein in the expenditure side. Such fiscal measures should have a permanent nature so as to ensure the long term viability of public finances. On the revenue side measures should aim on broadening the tax base and effectively controlling tax evasion. The future potency of fiscal policy would depend on fiscal structural reform that enhances the efficiency of public spending and improves the viability of the public pension system. The role of the public sector will need to be re-examined and the nature of semi-public organisations will likewise need to be revisited.

In order to improve competitiveness a number of practices will have to be reconsidered. The Cost of Living Adjustment mechanism needs to be reformed for flexibility and fairness. Wage setting in general should be linked more clearly to productivity and unions should seek to play a catalytic role in the economy overcoming problems created by exogenous shocks or domestic imbalances.

Minimising the impact to the most vulnerable remains a fundamental condition for the success of any restructuring programme. You can’t expect to sustain your social cohesion by hitting those in the greatest need. Hence, the adjustment effort should have a sense of fairness.

Building your economic viability has a policy induced side, which although not always pleasant, it is the only available option. Collective action will be needed as well as the foresight to understand that the future cannot be won by clinging to the past.