CHANGE OF PARADIGM OR FALSE ALARMISM?: THE CASE OF CYPRUS

Marat Yuldashev
Expert with experience in the financial services sector in Cyprus and CIS as well as private consulting in East Europe, CIS and the Middle East

"To be prepared is half the victory"
Miguel de Cervantes Saavedra

Last month Ministry of Economics of Cyprus announced that it expected the country's GDP to exceed 2% growth mark in 2016. The optimistic news was boosted by the Minister of Commerce, Tourism and Industry who declared that tourist sector must be credited for pulling the local economy out of the crisis. These are obviously positive developments for the island, and indeed tourist arrivals are expected to be on the rise this year, mainly because Egypt and Turkey became almost a no-go zone for many Russian and other holidaymakers.

In the meantime, while Cyprus was looking forward to a good year ahead, Eurostat's Consumer Price Index continued falling with Eurozone jobless rate remaining at over 10%[1], economic adviser to the Russian president announced that as a result of the crisis the number of the "new poor" in Russia exceeded 5 million people[2] and recovery of the national economy would probably take substantial period of time, and finally, on the other side of the planet Japanese Prime Minister Shinzo Abe warned his Group of Seven counterparts on May 27 that the world may be on the brink of a global financial crisis on the scale of Lehman Brothers[3].

Such a stream of conflicting news could possibly create a cognitive dissonance in the minds of some Cyprus residents.

To overcome the confusion, it is vital to take a look at fundamental pillars of the island's economy through the prism of the global historical context.

Cyprus service economy stands, primarily, upon its financial/corporate services and tourist sectors, supported by other segments such as shipping and to a lesser degree tertiary education.

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[1] Euronews (2016) *Eurozone: inflation is still negative and jobless rate unchanged* Retrieved from http://www.euronews.com/2016/05/31/eurozone-inflation-still-negative-and-jobless-rate-unchanged/

[2] Lenta.ru (2016) *Crossed the threshold* Retrieved from https://lenta.ru/articles/2016/05/27/newpoverty/

[3] Zerohedge (2016) *Global financial crisis coming – Japan warns of "Lehman-scale" crisis at G7* Retrieved from http://www.zerohedge.com/news/2016-05-30/global-financial-crisis-coming-%E2%80%93-japan-warns-%E2%80%9Clehman-scale%E2%80%9D-crisis-g7

The roots of what was sometimes called "Cyprus economic miracle" lie in two global historical processes: de-colonization of 1960-70s followed by the launch of financial globalisation in the 1980s.

Disintegration of colonial empires provoked flight of capitals out of the newly independent states and created urgent need for financial harbours where those capitals could be conveniently parked. "Convenience" was the main criteria which meant low taxation, flexible regulation, preferably rule of English Law, Anglo-Saxon administrative and banking system, and availability of English-speaking lawyers, accountants and tax advisors. No wonder such international network swiftly emerged, mainly, in small island-nations scattered around the globe, most of which happened to be former British dependent territories.

Emergence of such convenient centres became quickly popular with many other international investors, who did not feel particularly comfortable keeping capitals in their respective countries of origin.

Deep economic crisis of 1970s in the West required new mechanisms to re-start the economy. Reagonomics inaugurated the era of financial deregulation and globalisation. In the USA, the centre of global economy, deregulation meant financialization, i.e. unprecedented growth in size and scope of finance and financial activity in the economy, rise of debt-fuelled speculation over productive lending[4]. Economic growth was achieved through stimulation of domestic consumption based on debt refinancing mechanism (for the mechanism to work, the lending rate should continuously keep falling).

On the international front globalisation meant lifting of barriers on the way of goods and financial capital flows. The era of global consumerism and financialization of world economy began.

Financial globalisation required availability of relevant international banking infrastructure and jurisdictions, which could assist and facilitate the flow and distribution of international capitals with minimum costs and maximum flexibility. The existing network of island-nations and other tax-heaven statelets contributed enormously to the process, which brought some of these nations (Cyprus among others) unprecedented prosperity within quite short period of time. If there were no such centres, the very logic, scale and speed of financial globalisation should have created them anyway.

Collapse of the former socialist block and opening of new markets accompanied by the emergence of China and other developing economies have taken globalisation to the new era.

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[4] Foroohar R. (2016) *Saving Capitalism* Time, p. 25.

Impressive economic growth in many parts of the world and lifting of barriers created new middle class and the new rich, who were eager to travel, spend and consume without limits. Tourism has become a truly global multibillion industry. Educational sector internationalized and expanded as never before. Consumer goods and services sectors flourished, commodity prices reached all-time highs.

However, as it turned out, in the shadow of global economic expansion, severe disbalances of similar magnitude were building-up for decades: first, prosperity and rise in living standards was achieved at the price of accumulation of unprecedented debts of all types, and second, global economy has become the *economy of exporters*.

Almost all countries (including Germany-led Europe, Japan, China, Russia, Brazil) became dependant on sales of their products and services abroad. The only major nation where growth is driven by domestic consumption by two-thirds is the United States. As it paradoxically turns out, directly or indirectly, all countries are selling to the USA, and at the end of this long and complex global consumption chain an average American Joe is standing.

The only problem though is that for decades the average Joe could increase his consumption only through accumulation of debts which became possible thanks to debt refinancing mechanism in place, which in turn, depended on gradual reduction of interest rates. Thus, the Federal Funds Rate gradually went down from 20% in March 1980 to 0.00%-0.25% in December 2009[5] when the mechanism came to an end. The QE program which followed, without doubt, saved the global economy from collapse and brought temporary relief but the fundamental problems of revival of *sustainable demand* and *reduction of debts* were not solved. From 2007 to 2014 global cumulative debt (household, corporate, government, financial) increased by USD 57 trl. and reached USD 199 trl[6].

Programs similar to Fed's QE pursued in other major economic powers produced no fundamental change. The so-called Abenomics in Japan ended up in recession, deflationary pressure and falling consumer demand persist in Europe despite ECB's desperate efforts.

Lord Mervyn King, former Chairman of the Bank of England, described the current situation in global economy as "radical uncertainty" with major crisis still ahead.

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[5] About Money (2016) *Fed Funds Rate History: Highs, Lows and Chart With Major Events* Retrieved from http://useconomy.about.com/od/monetarypolicy/p/Past_Fed_Funds.htm

[6] Zerohedge (2016) *Global financial crisis coming – Japan warns of "Lehman-scale" crisis at G7* Retrieved from http://www.zerohedge.com/news/2016-05-30/global-financial-crisis-coming-%E2%80%93-japan-warns-%E2%80%9Clehman-scale%E2%80%9D-crisis-g7

Looming debt problems force governments to restructure the system and chase those engaged in financial optimization. According to Tax Justice Network, by the end of 2014 USD 1.3 trl. from Russia and USD 1.2 trl. from China were sitting offshore[7]. Boston Consulting Group estimates that over USD 11 trl. are stocked in offshore centres around the world. In her recent interview to BBC's Hardtalk, Christine Lagarde called to bring those funds to transparency. And there is a growing international consensus that The Panama Papers case was just the beginning.

Crisis of exporters, growing debts, falling global demand and shrinking middle class risk to create a domino effect when customers can no longer buy and spend as they used to over previous decades of prosperity.

These problems will be aggravated in coming years by noticeable aging demographic shift in the West, Russia and China.

It is impossible to make accurate predictions but what *is* possible to identify the emerging trends and prepare for the new changing world. It is evident that industries which were drivers of prosperity in Cyprus, like most of the world, facing radical uncertainty with uncertain outcome at the end. Positive developments so far this year, although welcomed but should not create false sense of safety and immunity, and distract the focus from the global context.

The purpose of this article is not to spread panic and false alarmism but to raise awareness in the business community and among policy makers, and provoke constructive debate and scenario planning. No one should have illusions and underestimate the swift and unexpected *power of change*. Construction of Interstate Highway System in the US in 1950s led to gradual disappearance of hundreds of small towns across the country, automation of manufacturing and gasoline crisis of 1970s have turned Detroit from the automobile capital into a ghost city, and the list of examples goes on.

At the same time, every crisis opens new opportunities and creates new unexpected winners. Examples? The candy industry in the US flourished during the Great Depression and war time, Japanese car manufactures went global during the oil crisis of 1970s.

Ignorance and inaction are dangerous but to be prepared is already half the victory.

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[7] The Guardian (2016) *Offshore finance: more than $12tn siphoned out of emerging countries* Retrieved from https://www.theguardian.com/business/2016/may/08/offshore-finance-emerging-countries-russia-david-cameron-summit