THE POST-PANDEMIC STIMULUS TO RESTART THE CYPRIOT ECONOMY
A wage-led growth strategy

Elias Ioakimoglou
Nicos Trimikliniotis

FRIEDRICH EBERT STIFTUNG

The global effect of the pandemic is expected to be severe for the Cypriot economy. Under current circumstances, the question is what kind of stimulus is necessary to produce growth so as to counter the vicious cycle of depression and to redress the dangerous rise in inequality and poverty. We propose a wage-led growth strategy to achieve sustained GDP growth, at this particular historical moment of dramatic recession, where pressure on demand is excessive and most firms suffer losses. The proposal has the advantage over other policies in that it recommends to directly support demand by boosting wages, i.e. to support income of those in work, who under the current situation would be vulnerable to pressures of reduced wages.

THE COVID-19 PANDEMIC AND THE CYPRIOT ECONOMY

This note is concerned with the ability of the Cypriot economy to recover from the deep recession caused by the first wave of the Covid-19 pandemic. The global effect of the pandemic is expected to be severe and to exceed the initial estimation (made before the second wave of the epidemic) of -6,2% annual rate of GDP change. According to the IMF, this crisis, in terms of reduction of the world GDP, is estimated to be the worst economic crisis in 200 years, and the IMF are pinning their hopes on a speedy recovery based on different kinds of government stimulus interventions (Euronews, 2020).

The recession is expected to increase until the end of 2020 (a) net lending of the general government above 6% of GDP, (b) the public debt to more than 110% of GDP, and (c) the unemployment rate by 2,5 percentage points, from 7% in 2019 to 9,5% in 2020. Beyond the fall in GDP, there are strong indications that, unless drastic measures are taken, Cyprus may be facing the greatest poverty crisis of modern times (*Cyprus Times*, 2020). The economic consequences of the lockdown and the bleak economic forecasts are likely to have a serious impact on those working in precarious jobs. Cyprus is characterised by relatively high shares of non-standard employment and labour fragmentation (Ioannou, 2015) and is marked by one of the highest adjusted wage gaps in the EU between permanent and temporary employees (Da Silva and Turrini, 2015). Many workers in precarious jobs work in the informal sector, a large portion of whom are migrant workers and irregular workers. The informal sector is estimated to be over 25% of the Cypriot economy, which is the sixth largest percentage in the EU; only eastern European countries have larger informal economies (OECD, 2015). Cyprus and Latvia are the only countries where informal wage employment is more prevalent than self-employment across all EU Member States covered by a comparative study (Hazans, 2011). Whilst non-standard employment is more likely to be held by women and young persons, following the financial crisis in Cyprus after 2012, non-standard employment increased considerably among men and persons with tertiary qualifications. Studies have shown how the crisis has adversely affected these precarious workers in terms of their rights (Demetriou, 2015) and their income and benefits (Ioannou, 2014). Inequalities in the labour market are translated into higher risk of in-work poverty and disparities in social provisions, mostly in regard to the adequacy of earnings-related benefits, including pensions (Koutsampelas, 2018).

The three-month winte lockdown period and the rest of the COVID-19 restrictions led to a deterioration of the income of employees (Trimikliniotis and Demetriou, 2020a, 2020b). Studies (Cyprus Labour Institute PEO, 2019) based on the Eurostat figures (Eurostat, 2020) show that, since 2013, at the height of the last economic crisis in Cyprus, employees' share in the gross domestic product was 7.5% lower compared to the pre-2013 period. About one in 12 employees was faced with poverty and social exclusion. Cyprus has a special category of the working poor, who are in relative poverty and at risk of social exclusion, in spite of being in employment, because their wages are low: Eurostat figures show that, from 2008 to 2011, the percentage of the population at risk of poverty or social exclusion, based on the 2008 poverty line, was 16% of the population, and the corresponding rate in 2018 was 26%. In other words, the Eurostat figures show that, based on the 2008 poverty line, one in four Cypriots in 2018 were at risk of poverty or social exclusion compared to one in six in 2008 (Cyprus Labour Institute PEO, 2019).

The public health policy response, on both sides of the barbed wire, was essentially a rapid move to close down movement and activity, reflecting the fact that the public health system was already in a poor state and is not equipped to deal with a large number of cases (Mullen and Faustmann, 2020). The economic and political choices to deal with the pandemic is already impacting negatively on democratic life, human rights and the reconciliation between Greek-Cypriots and Turkish-Cypriots (Trimikliniotis and Demetriou, 2020B). The abrupt and without consultation and coordination closure of crossing points is undermining further efforts for reunification of the country, endangering to cement the division of the island (Mullen and Faustmann, 2020; Trimikliniotis and Demetriou, 2020a).

A WAGE-LED GROWTH STRATEGY

Under current circumstances, the private sector of the economy, left to its own devices, is unable to trigger a spontaneous turn of the economy from recession to recovery, nor can it ensure that the economy will come to rest at full utilisation of productive capacity. Therefore, government intervention to regulate the economy is prerequisite to achieving sustained GDP growth for increased utilisation of productive capacity. We argue that to achieve sustained GDP growth at this particular historical moment of dramatic recession, where pressure on demand is excessive, recession is deep and all firms suffer losses, the government should implement *a medium-term wage-led strategy, increasing the purchasing power of workers and thus private consumption, GDP and* employment.**[1]**

Increasing private investment under current economic conditions seems rather improbable (Arestis and Sawyer 2005), since, for firms to have an incentive to increase their production capacity by investing in fixed capital, at least two conditions should be met: firstly, actual rates of capacity utilisation should be near full capacity; and secondly, expected profitability of new investment should be relatively high. Still, both conditions are not met at the actual conjuncture. Increasing public investment in making use of European funds would be beneficial but not enough. Increasing net exports (heavily dependent on tourism) and their contribution to GDP growth seems like an impossible task. Exports should not be expected to recover soon in the environment of radical uncertainty induced by the Covid-19 epidemic. Therefore, implementing a wage-led recovery boosting private consumption, and then GDP and employment is the most rational and feasible policy to apply at present. Furthermore, a wage-led recovery would contribute to restore fairness, at least partly, in the distribution of income.

Central to the wage-led policy we propose is the condition that increasing private consumption can be effective in boosting GDP and reactivating idle resources only if it is sustained over several years. Therefore, an initial impulse on demand should activate a virtuous cycle producing repeated increases in demand until the productive capacity utilisation rate is increased to its maximum under the balance-of-payments constraint (Nah and Lavoie, 2019).

In this note we present, **firstly**, certain critical characteristics of the current situation concerning distribution of income and fairness, **secondly**, a short description of a virtuous cycle (producing repeated increases in demand until the capacity utilisation rate rises to its maximum under the balance-of-payments constraint) that could be activated in Cyprus if the necessary political will existed, and **thirdly**, conditions and constraints under which the wage-led growth strategy is feasible.

THE STRUCTURAL SHIFT IN THE DISTRIBUTION OF INCOME AND FAIRNESS

The relation between the average real wage and unemployment shifted during the period of 2012: Q3-2015: Q3 (figure 1, shift from line AA’ to line BB’) indicating a devaluation of labour. In other words, since the third quarter of 2012, for any given value of the unemployment rate, the average real wage is now lower than before. This structural shift created a gap between the average real wage and labour productivity (figure 2), leading to a dramatic redistribution of income: the income share of labour has been reduced, and the profit share has been increased by 4 percent points of GDP (figure 3), leaving nevertheless fixed capital accumulation rate at low levels (Cyprus Labour Institute PEO, 2019, p.70). It is thus a matter of fairness to design and pursue a redistribution of income in favour of labour. This cannot be obtained by decreasing unemployment rates; it is only reform of labour market institutions (Howell, 2019) that could reverse the structural shift and boost thus the effectiveness of wage-led growth (King 2019). *We do not see the redistribution of income in favour of labour and corresponding structural reform of the labour market simply as a matter of fairness, but also as active constituent parts of a wage-led growth process* (Stockhammer, Onaran and Ederer, 2009)*, which can end the recession and drive the economy to maximum utilisation of its idle resources under the balance-of-payments constraint*.

1 Bhaduri and Marglin, 1990; Blecker, 2002, 2011; Blecker and Setterfield, 2019; De Jesús and López 2019; Hein and Tarassow, 2010; Hein and Vogel, 2008; Lavoie and Stockhammer, 2011; Nishi and Stockhammer, 2019; Onaran and Galanis, 2013; Palley (2011), Stockhammer, 2011.

Figure 1.
Average Gross Real Wage vs Unemployment Rate

Figure 3.
Income Shares (% of GDP at market prices, MA-4*)

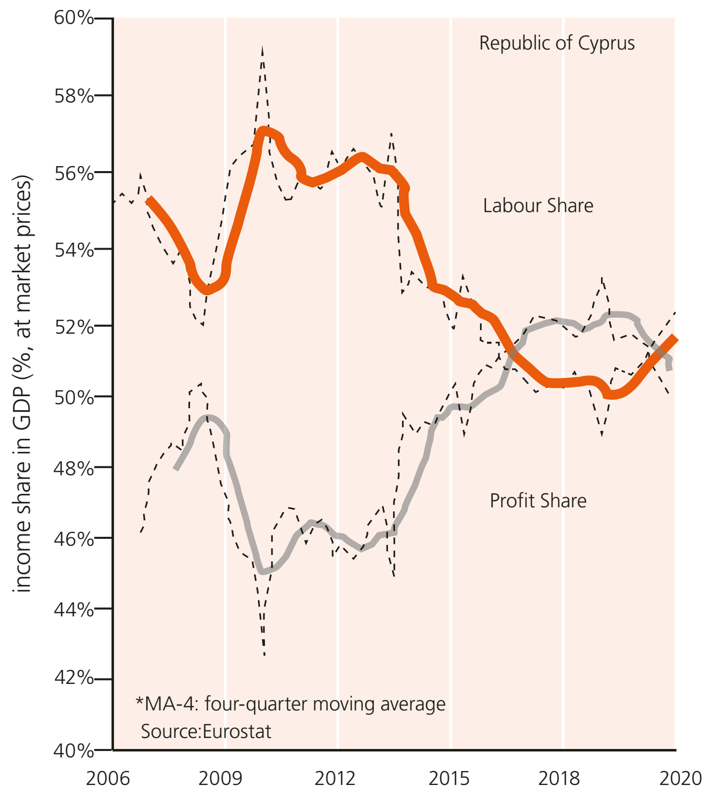


Figure 2.
Average Wage vs Labour Productivity: The Structural Shift

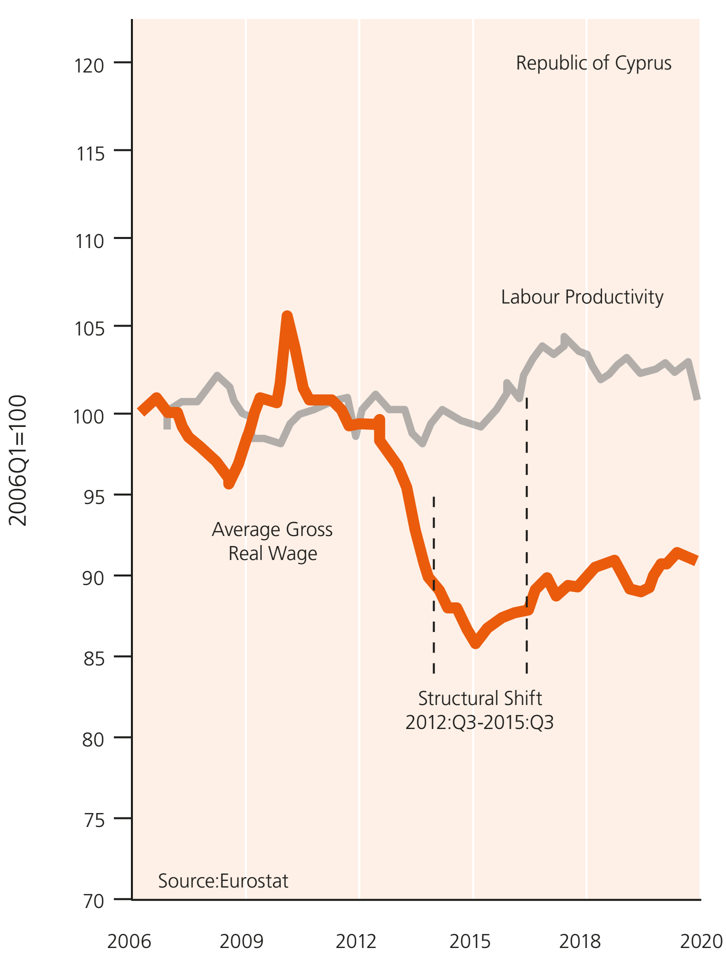
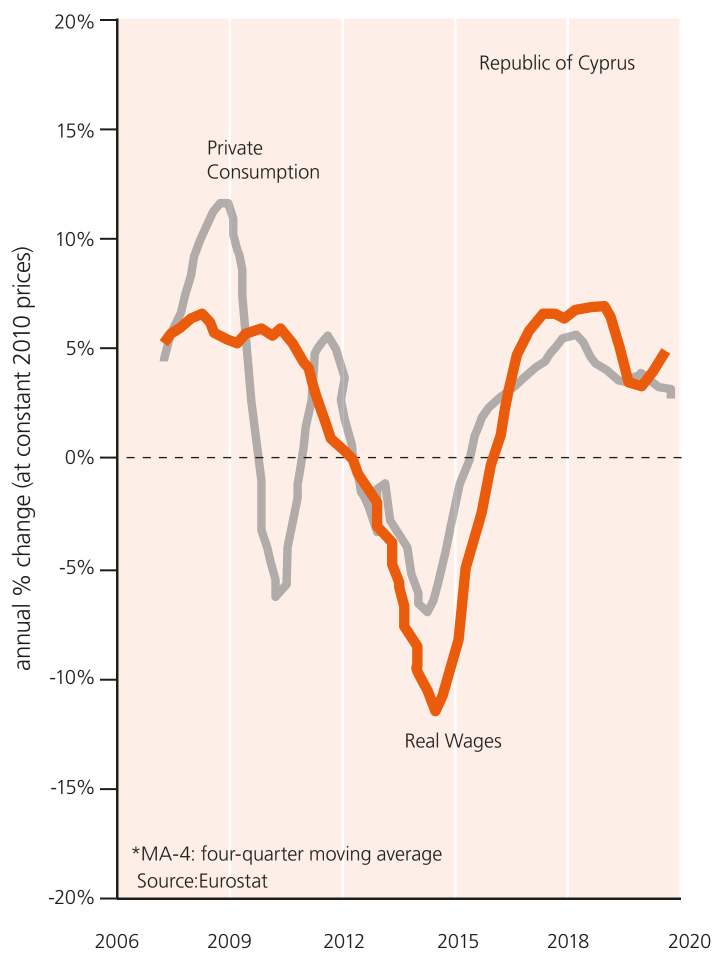


Figure 4.
Real Wages and Private Consumption (MA-4*)



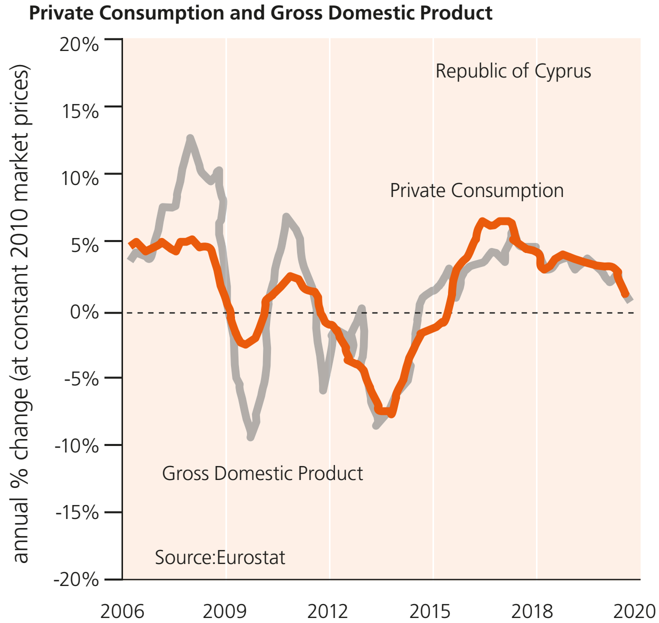
THE VIRTUOUS CYCLE OF WAGE-LED GROWTH

We argue that under present economic conditions, it is feasible to implement a virtuous cycle of wage-led growth producing sustained increases in demand in the medium term until capacity utilisation reaches its maximum level (under the balance-of-payments constraint). The argument runs as follows:

1. Private consumption changes depend heavily on changes in the sum of real wages (that is the average real wage multiplied by the number of employees) (figure 4)[2].
2. The GDP rate of change is correlated with private consumption changes (figure 5).
3. Labour productivity depends on GDP growth (figure 6) (McCombie, 2002) and on fair wages (Bowles et al., 1984; Akerlof and Yellen, 1990).
4. The average real wage depends on the unemployment rate and labour productivity. Real wages depend on the average real wage and employment.

Considering all other factors (fiscal policy, propensity to consume etc.) are unchanged, these correlations taken together constitute ***a virtuous cycle of wage-led growth.*** Shown in figure 7, the path of the cycle (in red colour) is formed by the sequence of nodes 1-2-3-4-5-1: A higher average real wage (node 1) increases the sum of real wages (node 2), which leads to a rise in private consumption (node 3), then in GDP (node 4) and in labour productivity (node 5), which positively affects the average real wage (node 1), triggering thus a new cycle following the same path until the system meets its balance-of-payments constraint. ***Three secondary virtuous cycles*** operate simultaneously in interaction with the main cycle of wage-led growth:

Figure 5.
Private Consumption and Gross Domestic Product



1. The GDP-employment cycle, where growth consecutively increases employment, thus the sum of real wages, private consumption and GDP.
2. The GDP-unemployment cycle, where growth decreases unemployment, enhances the bargaining power of employees and increases, thus, the average real wage.
3. The productivity-wage cycle, where higher real wages enhance motivation and effort of employees, thus boosting labour productivity.

Figure 6.
Gross Domestic Product and Labour Productivity

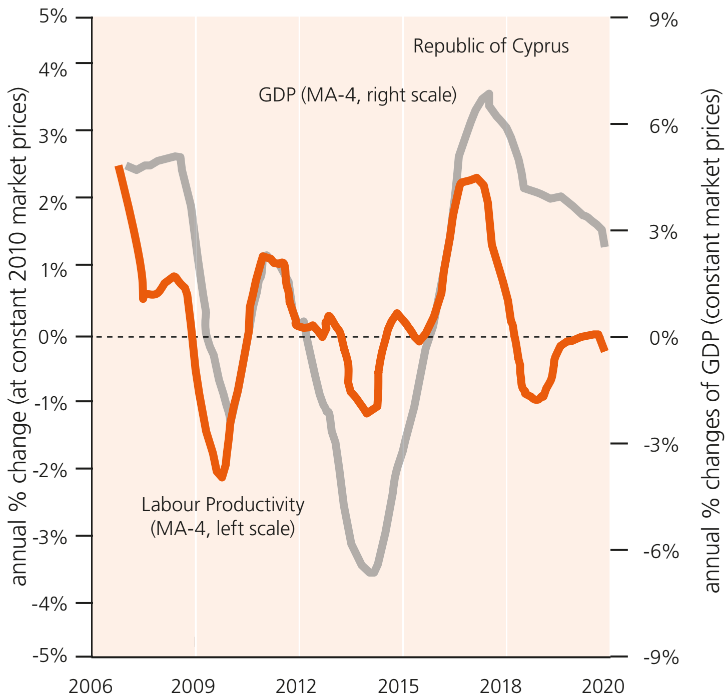
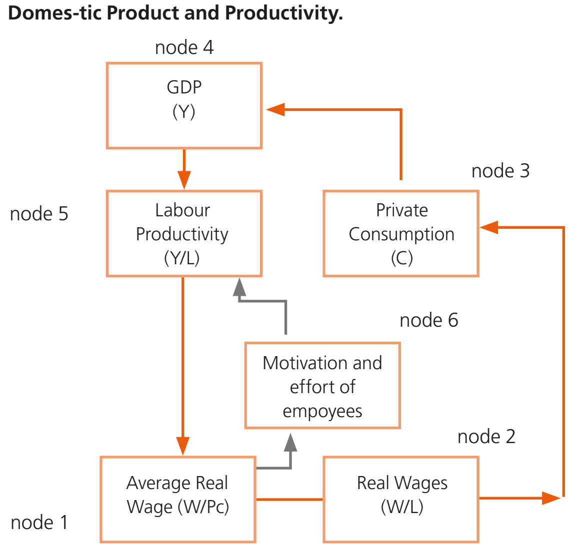


Figure 7.
The Virtuous Cycle of Real Wages, Private Consumption, Gross Domes-tic Product and Productivity.



2 All figures are from the annual report on the economy and on employment by the Cyprus Labour Institute PEO (2019).

As the main and the three secondary cycles operate, higher aggregate demand emanating from higher wages reactivates idle resources up to the point of maximum capacity utilisation under the balance-of-payments constraint.

Still, the above dynamics of the wage-led virtuous cycle has no internal driver; it has to be triggered from an external impulse. There are at least two ways to trigger and accelerate the wage-led growth process:

1. The *introduction of the national minimum wage in the institutional framework of the labour market* can act as the driving force of the process (provided the initial level of the minimum wage is set at the appropriate level), as higher wages of the minimum wage beneficiaries should be expected to have a spill-over effect on the wages of other workers and therefore on the average wage in the private sector.
2. Structural reform of the labour market enhancing the bargaining power of workers in the private sector can trigger the process and increase the dynamism and the persistence of the wage-led process (King, 2019).

THE FEASIBILITY OF THE PROPOSAL

1. The objection can be made concerning the feasibility of our proposal, that higher wages resulting from the wage-led recovery could, presumably, reduce profitability and therefore investment. Profitability, though, (i.e. the rate of return on capital) is not determined solely by the average real wage but also by labour productivity, capacity utilisation rate and the product/capital ratio. Certainly, profitability declines as a result of higher real wages, but this is simply the direct impact, which should be examined in conjunction with the effects of higher wages on the other determinants of the rate of return (which are the capacity utilisation rate, productivity of labour and the product/capital ratio).
   There are at least three beneficial effects that wage-led growth can produce:
   Firstly, it increases labour productivity, with workers' motivation and better quality of work emanating from higher wages, on the one hand, and with the decrease of the ratio of overheads to prime costs, on the other.
   Secondly, it increases the capacity utilisation rate, with private consumption and aggregate demand rising as a result of higher wages.
   Thirdly, it increases the product/capital ratio as *economies in the use of capital* (Marx, 1975[1867]) are obtained with enhanced workers' motivation and effort.
   Summing up, in the specific context of deep recession, when the negative effect of rising wages on profitability is jointly taken into account with their beneficial effects, it is ambiguous whether profitability increases or decreases in the process of wage-led growth (Storm and Naastepad, 2011). We consider the reversal of the undervaluation of labour not only as a matter of fairness but also as an effective policy for restarting the economy.
   It is only when full capacity utilisation is exceeded that the process of wage-led growth could generate negative effects on profitability.
2. Concerning investment, when income is at very low levels, as it is at present, investment becomes insensitive to profitability changes because
   (a) there is a huge amount of excess capacity, and
   (b) conditions are where "the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations" (Keynes, 1936).
3. Under certain circumstances, a large influx of imports fuelled by rising demand could emanate from the wage-led recovery, leading to a balance of payments deficit, hindering the economy from moving to full utilisation of its potential (McCombie and Thirwall, 1994). The expansionary policy would have then to be reversed. Consequently, the rise in demand should proceed at a gentle pace (Kaldor, 1986) otherwise the increase in demand, after a run-down of stocks, would give rise to undesirable trade balance deficits or to increases in the price of some domestically produced services, and unless capital inflows are attracted by growth prospects, structural policies should be implemented to prevent the formation of excessive trade deficits. Therefore Cyprus's exporters, mainly tourism producers, should be encouraged by competitiveness policies, possibly financed by EU funds, to succeed in creating conditions enhancing both their price competitiveness and structural (non-price) competitiveness, increasing the income elasticity of exports.[3] Reducing import propensities would also be an important task of the government. In any case, whether under a wage-led or another economic strategy, the constraint of the balance of payments will be an important problem to solve as soon as possible.
4. The successful implementation of wage-led policies requires social consensus between firms, the government and labour organisations (Gouzoulis and Collin, 2019, Kalecki, 1943).

3 Higher real wages can also be an important element in improving structural (non-price) competitiveness.

REFERENCES

Akerlof, G. and Yellen, J.L. (1990), 'The Fair-Wage Hypothesis and Unemployment', *Quarterly Journal of Economics*, Vol. 105, No. 2, pp. 255-284.

Arestis, P. and Sawyer, M. (2005), 'Aggregate Demand, Conflict and Capacity in the Inflationary Process', *Cambridge Journal of Economics*, Vol. 29, No. 6, pp. 223-227.

Bhaduri, A. and Marglin, S. (1990), 'Unemployment and the real wage: the economic basis for contesting political ideologies', *Cambridge Journal of Economics*, Vol. 14, pp. 375-393.

Blecker R. (2002), 'Distribution, demand and growth in neo-Kaleckian macro-models', in M. Setterfield (ed.), *The Economics of Demand-led Growth: Challenging the Supply-side Vision of the Long Run,* Cheltenham: Edward El gar, pp. 129–152.

Blecker, R. (2011), 'Open economy models of distribution and growth, in E. Hein and E. Stockhammer (eds), *A Modern Guide to Keynesian Macroeconomics and Economic Policies*, Cheltenham: Edward Elgar, pp. 215–239.

Blecker, R.A. and Setterfield, M. (2019), *Heterodox Macroeconomics. Models of Demand, Distribution and Growth*. Cheltenham: Edward Elgar Publishing.

Bowles, S., Gordon, D.M. and Weisskopf, T.E. (1984), *Beyond the Waste Land: A democratic alternative to Economic decline*, London: Verso.

Cyprus Labour Institute PEO (2019), *Έκθεση για την Οικονομία και την Απασχόληση*, Nicosia.

Cyprus Times (2020) '*Σειρά εισηγήσεων από το Κυπριακό Δίκτυο Ενάντια στη Φτώχεια*', *Cyprus Times*, 27 April 2020.

Da Silva, A. and Turrini, C. (2015), 'Precarious and less well-paid? Wage differences between permanent and fixed-term contracts across the EU countries', *European Economy*, Economic Papers No. 544.

De Jesús, V. and López, J. (2019), On wage- and profit-led demand regimes: learning from the evidence, *Journal of Post Keynesian Economics*, Vol. 42, No. 4, pp. 620-637.

Demetriou, C. (2015), *The impact of the crisis on fundamental rights across Member States of the EU: Country Report on Cyprus*, Directorate General for Internal Policies, European Parliament.

Euronews (2020), 'COVID-19: World economy in 2020 to suffer worst year since 1930s Great Depression, says IMF', 14/4/2020, https://www.euronews.com/2020/04/14/watch-live-international-monetary-fund-gives-world-economic-outlook-briefing-on-covid-19.

Eurostat (2020), At-risk-of-poverty rate anchored at a fixed moment in time (2008) by age and sex - EU-SILC survey, Last update 17 June 2020.

Gouzoulis, G. and Collin, C. (2019), 'Class Conflict, Fiscal Policy and Wage-Led Demand: A Model of Kalecki's Political Business Cycle, *Journal of Sociology and Social Policy*, Vol. 10, No. 2, pp. 51-69.

Hazans, M. (2011), 'Informal Workers across Europe: Evidence from 30 Countries', IZA Discussion Paper No. 5871, Institute for the Study of Labor, Bonn; OECD (2015) in Policy Brief on Informal Entrepreneurship Entrepreneurial Activities in Europe, European Union/OECD, 2015

Hein, E. and Tarassow, A. (2010), 'Distribution, aggregate demand and productivity growth: theory and empirical results for six OECD countries based on a post-Kaleckian model', *Cambridge Journal of Economics*, Vol. 34, No. 4, pp. 727–754

Hein, E. and Vogel, L. (2008), 'Distribution and growth reconsidered — empirical results for Austria, France, Germany, the Netherlands, the UK and the USA', *Cambridge Journal of Economics*, Vol. 32, No. 3, pp. 479–511.

Howell, Ch. (2019), 'Neoliberalism, capitalist growth models, and the state: An agenda for industrial relations theory', *Journal of Industrial Relations,* Vol. 61, No. 3, pp. 457-474.

Ioakimoglou, E., Kosmas, P., and Tombazos, S. (2020), *Cyprus facing the Great Recession*, Cyprus Labour Institute PEO (forthcoming).

Ioannou, G. (2014), 'Employment in crisis: Cyprus 2010-2013'. *The Cyprus Review*, Vol 26, No. 1, pp. 107-126.

Ioannou, G. (2015), 'Labor force fragmentation in contemporary Cyprus', *Working USA: the Journal of Labor and Society*, Vol. 18, No. 4, pp. 595-612.

Kaldor, N. (1986), *Economics without Equilibrium*, New York: M.E. Sharpe.

Kalecki, M. (1943), Political Aspects of Full Employment, Political Quarterly, October-December

Keynes, J.M. (1964 [1936]), *The General Theory of Employment, Interest, and Money*, New York: Harvest Books.

King, J.E. (2019), 'Some obstacles to wage-led growth', *Review of Keynesian Economics*, Vol. 7, No. 3, pp. 308–320.

Koutsampelas, C. (2018), 'Non-standard employment in Cyprus: Trends and policy responses', *Cyprus Economic Policy Review*, Vol. 12, No. 1, pp. 41-58.

Lavoie, M. and Stockhammer, E. (eds.) (2011), *Wage-Led Growth, An Equitable Strategy for Economic Recovery*, London: Palgrave Macmillan

Marx, K. [1975(1867)], Capital Vol. III, London: Penguin.

McCombie, J. (2002), Increasing returns and the Verdoorn law from a Kaldorian perspective, in J. McCombie, M. Pugno and B. Soro (eds), *Productivity Growth and Economic Performance: Essays on Verdoorn's Law*, Basingstoke: Palgrave Macmillan, pp. 64–114.

McCombie, J. and Thirwall, A.P. (1994), *Economic Growth and the Balance-of-Payments Constraint*, London: Macmillan.

Mullen, F. and Faustmann, H. (2020), The Impact of Covid-19 crisis on divided Cyprus, 20 April 2020, Report for Friedrich-Ebert-Stiftung.

Nah, W.J. and Lavoie, M. (2019), 'The role of autonomous demand growth in a neo-Kaleckian conflicting-claims framework'. Structural Change and Economic Dynamics, Vol. 51, pp. 427-444.

Nishi, H. and Stockhammer, E. (2019), 'Demand and distribution regimes, output hysteresis, and cyclical dynamics in a Kaleckian model', Working Paper 1902, Post-Keynesian Economics Society.

OECD (2015), **'**Policy Brief on Informal Entrepreneurship Entrepreneurial Activities in Europe', European Union/OECD, 2015.

Onaran, Ö**. and Galanis, G.** (2013), 'Is aggregate demand wage-led or profit-led? A global model', in M. Lavoie and E. Stockhammer (eds), *Wage-led Growth: An Equitable Strategy for Economic Recovery*, Basingstoke and Geneva: Palgrave Macmillan and ILO, pp. 71-99.

Palley, Th. (2011), 'The economics of wage-led recovery: Analysis and policy recommendations', *International Journal of Labour Research*, Vol. 3, No. 2, pp. 219-244.

Stockhammer, E. (2011), 'Wage-led growth: An introduction', I*nternational Journal of Labour Research*, Vol. 3, No. 2, pp. 167-188.

Stockhammer, E., Onaran, O. and Ederer, S. (2009), 'Functional income distribution and aggregate demand in the euro area', *Cambridge Journal of Economics*, Vol. 33, No. 1, pp. 139-159.

Storm, S. and Naastepad, C.W.M. (2011), 'The productivity and investment effects of wage-led growth', *International Journal of Labour Research*, Vol. 3, No. 2, pp. 197-218.

Trimikliniotis, N. and Demetriou, C. (2020a), *Coronavirus COVID-19 outbreak in the EU, Fundamental Rights Implications, Country: Cyprus*, University of Nicosia and Symfiliosi, covers the period 1 February – 20 March

Trimikliniotis, N. and Demetriou, C. (2020b) *Coronavirus pandemic in the EU – Fundamental Rights Implications, Country: Cyprus*, Report for the Fundamental Rights Agency, University of Nicosia, Covers the period 1 May – 30 June 2020, July 2020.

Elias Ioakimoglou is an independent researcher and invited senior researcher and principal author to the Annual Economic and Employment Outlook, published by the Cyprus Labour Institute INEK PEO. As an advisor of the Institute of Labour (INE) of the Greek General Workers' Confederation (GSEE) (1992-2019) and trade union federations in Greece, he has published numerous studies and books on economic policies and labour market issues. Selection of Publications: Economic and Employment Outlook, Cyprus Labour Institute, 2019; What Economic Growth Model in the Context of Reunification? Cyprus Labour Institute, 2014 and A political economy of division, development, and crisis: Envisioning reunification beyond the Cyprus economic miracle, 2012, Trimikliniotis, N and Bozkurt, U. (eds.) Beyond a Divided Cyprus: A State and Society in Transformation, Palgrave (with Trimikliniotis and Pantelides). See Academia Edu https://independent.academia.edu/EliasIoakimoglou and ORCID https://orcid.org/0000-0002-8046-9591.

Nicos Trimikliniotis is Professor of Sociology at the School of Social Sciences, University of Nicosia. He heads the team of experts of Cyprus' team for the Fundamental Rights Agency of the EU. He is also a trained Barrister and legal expert who has researched on state theory, conflict and reconciliation, fundamental rights, digitalities, work, precarity, citizenship, migration and asylum, racism, free movement of workers, discrimination, nationality, asylum and immigration law and Labour Law. Publications selection: Migration and the Refugee Dissensus in Europe: Borders, Security and Austerity (2020, Routledge); Mobile Commons, Migrant Digitalities and the Right to the City, Palgrave, 2015) and Beyond a Divided Cyprus: A State and Society in Transformation, (Palgrave MacMillan, 2012).

CONTACT

Friedrich-Ebert-Stiftung | Cyprus Office
20 Stasandrou, Apt. 401 | 1060 Nicosia | Cyprus
Responsible: Hubert Faustmann | Director
Tel. +357 22377336
Email: office@fescyprus.org
www.fescyprus.org