STUDY

Cyprus

»Bleak recovery« and signs of hope

MICHALIS PERSIANIS

October 2015

- Cyprus has »survived the fall«, showing stronger-than-expected performance since the crisis erupted in 2013.
- However, imbalances remain strong as indebtedness in the private sector has not been tackled. The main concern now is that the country will continue to suffer flat GDP growth, with restrictive credit and low employment becoming a »new normal«. The banking system has reacted impressively but still has quite some way to go.
- Structural reform, including measures to reduce red tape, will be critical for the country's future prospects. Other external factors, such as the discovery of natural gas and possible resolution of the Cyprus problem are very promising, if handled carefully.

Content

Introduction

After protracted discussions, Cyprus agreed to a rescue package in March 2013. The plan (»Memorandum of Understanding«, MoU) foresaw a €9-plus-1 billion rescue package on the fiscal side, and a bail-in for ailing Cypriot banks.

The bail-in rescued the Bank of Cyprus – for the time being – as its former shareholder base and bondholders lost their failed investments and 47.5 percent of uninsured deposits (over €100,000) were transformed into bank equity. The second-largest bank, Laiki Popular Bank, was resolved and legacy assets (including ELA liabilities) were merged into Bank of Cyprus.

The economy moved into a zombie-like state for several months. Uncertainty, a long bank holiday, widespread fear – and rife rumors – of further deposit haircuts and capital controls brought the economy to a standstill. The Troika had expected an 8.7 percent recession for 2013, followed by a further 3.9 percent decline in 2014, before returning to marginal growth in 2015.

The final outcome bemused most observers: Although unemployment continued to grow at the same rate as before the bail-in, the fall in GDP remained below 6 percent, with some measures putting it as little as 5.4 percent.

The economy appears to have bottomed out around the third quarter of 2014, with unemployment recording a decline consistent with GDP data for the first time since 2008. GDP growth appears to be recovering, as do prices, both of assets and on a HICP (Harmonized Index of Consumer Prices) basis. At the same time, confidence in the banking system appears to be returning, with the deposit base consolidating and foreign non-financial corporations (both Eurozone and rest-of-the-world) doing business with Cypriot banks once again. Indeed, fixed deposits in the largest bank of the country, the bailed-in Bank of Cyprus, have recovered and have been on the increase since mid-summer 2014. Foreign deposits are also showing steady recovery, having increased by 34 percent in the first quarter of 2015 since reaching their lowest value in March–April 2013.

Most impressively, fiscal results outperformed all expectations. Primary balances and debt servicing overshot targets, with the government announcing a marginal increase in spending for 2015 after an 11 percent cut in 2014. Although most of the new increase in spending planned for 2015 reflects EU co-financed projects, this is still a turnabout on expectations and on Troika projections.

The story of Cyprus's economy in the midst of the crisis is one of rapid adjustment, shallower recession and milder social impact than expected, but at the same time of emerging imbalances and mismatches that threaten the country with a protracted secular stagnation: The existing elements of growth have matured and the economy appears to be testing a new long-term equilibrium, with underemployment and »Japanese« levels of growth.

What is clear is that growth needs to be driven by reforms, new »technologies« and elements of population growth.[1]

1. A Silver-Lining Crisis

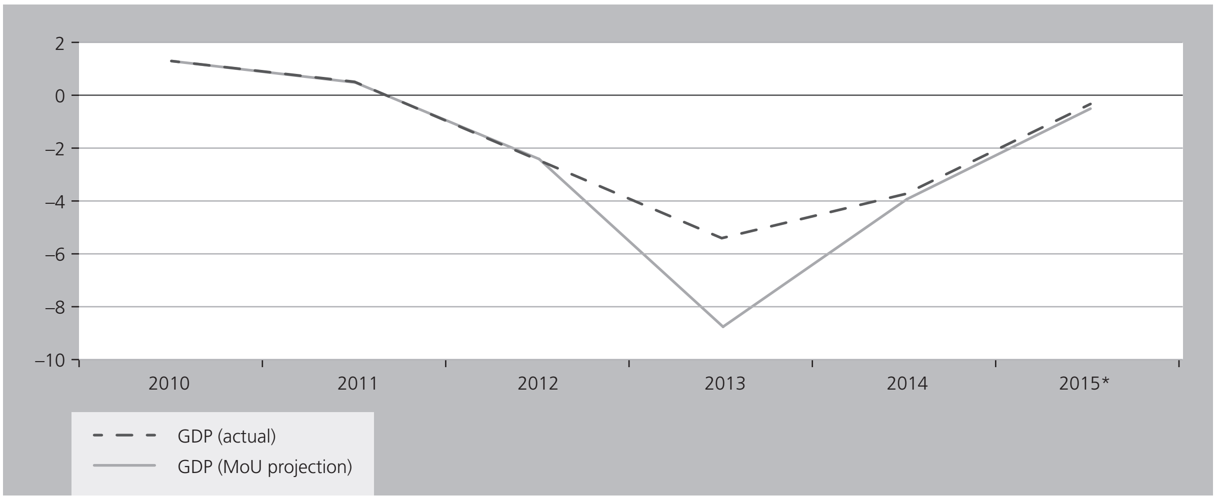
The second year of the crisis could therefore be called the year of stabilization, on almost all fronts of the economy: banking, fiscal, employment, GDP growth, even price levels. This stability shows that the economy is poised to return to positive levels of GDP growth and technically exit the depression, while the country is also ready to exit the MoU, perhaps earlier than anticipated, in Q2 of 2016.

None of these successful outcomes can be felt on the ground, however. While analysts may be justified in saying that Cyprus is poised to »exit the crisis«, and while »the process of recovery is almost complete«, the prospects for the next few years remain rather dull.

By most expectations, the greatest threat is a »bleak recovery«, with the economy showing hysteresis in employment, lower asset prices with wealth effects aggravating indebtedness, and a »new normal« of low investment levels. In such a scenario, GDP will grow, but barely. Wages will recover, but not to pre-crisis levels. Businesses will do better, but not much, while household assets will recover, but only partly compared

1. For example, by increasing the »transit population« by boosting tourist flows through better air travel and improved products.

Figure 1 Real GDP growth: Projected in MoU and actual (%)
(2014: revised projections)



to the inflated price levels of real estate and equity (mainly bank shares) that were used to collateralize their debt obligations. The threat, in short, is that Cyprus will not see the rebound growth typical in many currency, banking and fiscal crises since the 1990s.

The question »*What does recovery mean?*« has no easy answer when the real economy is experiencing secular stagnation even as all economic metrics appear to be recovering. Indeed, the long-term threat of barren growth, with flat GDP and stagnant unemployment rates, is the dark side of what is, in the short term, a recovery that hardly falls short of a miracle.

2. Surviving the Fall

One of the most impressive aspects of the Cypriot crisis has been that the economy adjusted much faster than had been assumed by the Troika and the Debt Sustainability Assessment (DSA) of the country's fiscal prospects. GDP dropped by a much smaller level, even though unemployment increased slightly faster than had been projected. However, in the face of what appeared to be a complete bank collapse and an inescapable debt crisis, the economy is, by all measures, »up and running« again. In fact, there are indications that the long-overdue restocking will take place towards the end of 2015, thus putting a floor on GDP levels. (See chart 1)

The rapid adjustment caught many analysts off guard, especially when the collapse of the banking system and the capital controls are taken into account. Despite the extraordinary conditions that existed in Cyprus, a series of idiosyncratic characteristics of the small, open island economy that is Cyprus made the adjustment much faster than had been originally assumed.

2.1 Fiscal Correction

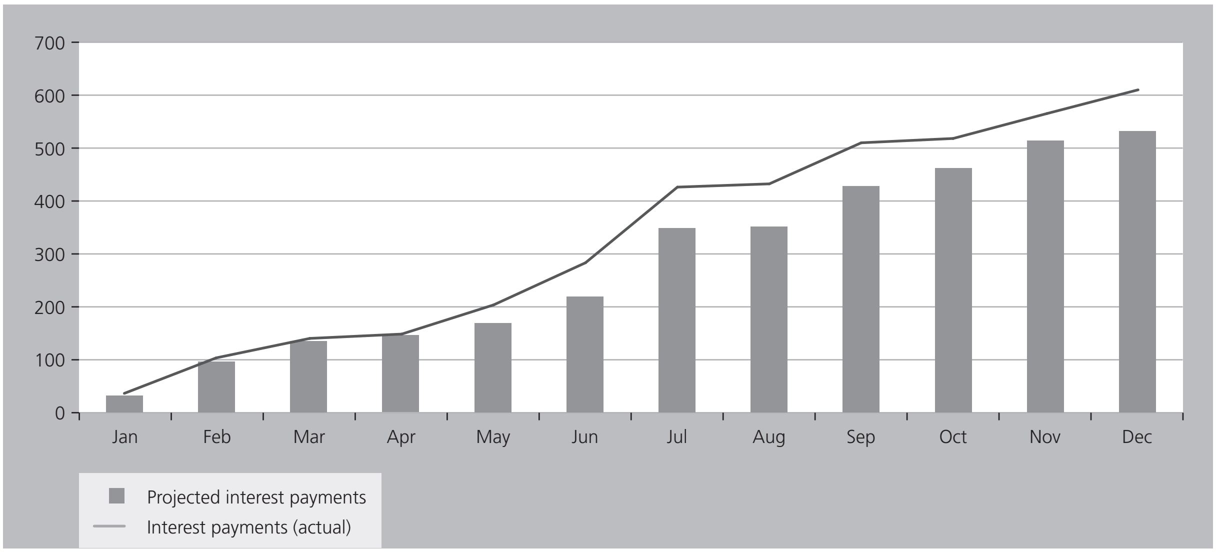
The fiscal correction, while steep, does not appear to have affected the real economy as much as had been feared. Although the 2014 budget included a brave 11 percent spending cut, the effects of such cuts proved to be virtually imperceptible on a macroeconomic level. With the largest spending cuts concentrated in the Ministry of Finance (30 percent) and the Foreign Ministry (13 percent), the spending cuts led to smaller multiplier effects than had been feared. Additionally, spending cuts in the Ministries of Transport (13 percent) and Health (12 percent) represented cost rationalization rather than the shedding of programs.[2]

As the government engaged in fat-cutting, important services (such as tax collection) were not significantly

2. This is an important element in cases where austerity policy proves successful: When a) crowding out effects are very strong and b) cost cutting represents cost rationalization rather than the shedding of programs, then the macro-effects of austerity can be offset by easing the pressures of interest rates, liquidity and eventually investment levels.

Figure 2 Primary Balance: Projected and actual

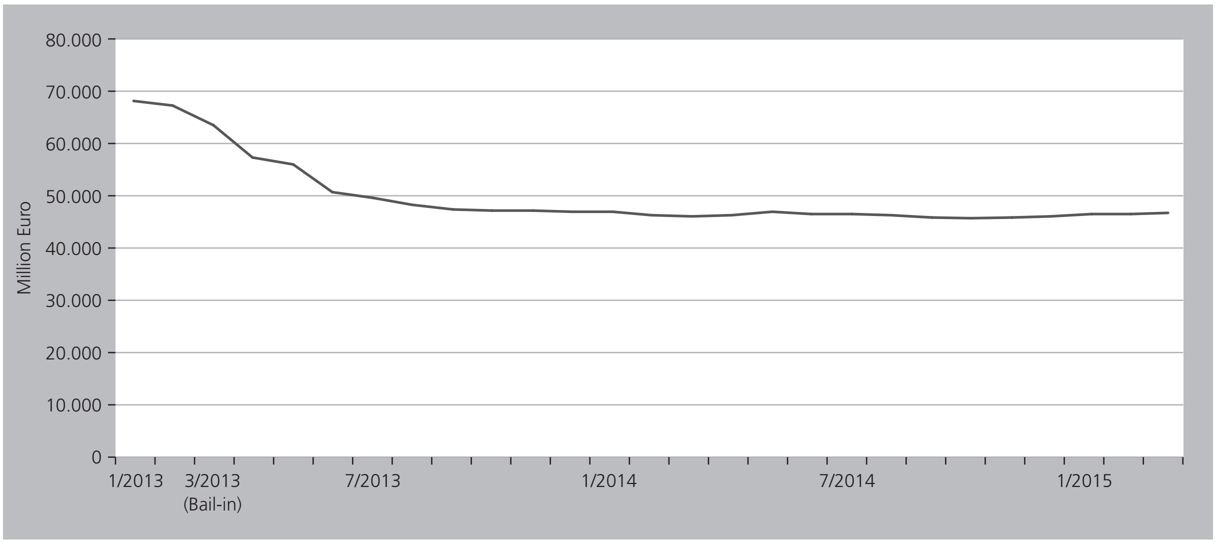
Figure 3 Cumulative interest payments (projected and final, 2014)



affected. Indeed, reforms like the merging of the Internal Revenue Service and the VAT Service are leading to improvements in performance. The fact that the state had been shut off from international debt markets encouraged the government to borrow short-term from the domestic market in the months running up to the bail-in. Here, fiscal austerity reduced crowding-out effects since the reduction in spending also meant ceteris paribus less pressure on liquidity and interest rates. Pressure on interest rates and private lending was lowered, creating a silver lining of sorts at a time of severe liquidity pressure on the banks.

Given the country's small, open island economy, mild salary cuts for senior civil servants and bank managers (whose marginal spending tends to be mainly on imported goods) led to declines in imports. This, in turn had a relatively small effect on GDP, as corroborated by the retail turnover data. Cyprus's peculiarity, where most retail consumption concerns imported goods, translates to low labour intensity of consumption and thence to smaller-than-assumed multiplier effects on wage spending. (See charts 2 and 3)

Figure 4 Total deposits in Cyprus banks



On top of cost rationalization and efficiency-enhancing moves, the government also enjoys reduced debt servicing costs. The Troika loans, at 3 percent, mark a decline in the cost of borrowing for the government, while the renegotiated loan from Russia (another €2.5 billion) also reduced debt service costs. The declining yields on Cypriot sovereign debt are a boon to the government's projected debt sustainability, especially as GDP was revised upwards and absolute debt stock downwards in 2015.[3] This was due to planned Eurostat revisions which had a significant denominator effect on debt sustainability with no further improvement on fundamentals. For these reasons, the fiscal austerity was mild and had very small macro-effects on the economy.

2.2 Smaller Credit Crunch

Even before the bail-in, it was clear to most observers that the banks would need to heavily deleverage their positions in order to cope with increasing non-performing loans (NPLs) and other troubled assets. The credit crunch materialized as expected in the aftermath of the bail-in, with banks shedding deposits quickly (including some €3.4 billion that were bailed-in and transformed into equity in Bank of Cyprus) as well fast reductions in assets, including outstanding loans. (See chart 4)

However, the large offshore exposures of Cypriot banks – a large part of the very problem they were faced with – proved beneficial to the real economy. While the overall reduction in credit and the disintermediation in Cypriot banks were both heavy, the reduction in *domestic* loans was rather mild, remaining near 6 percent overall through 2014.

Banks shed assets abroad, including the forced sell-off of Greek operations, which still remains questionable as to the valuations used. However, the fast shedding of these overseas assets (including loans) allowed the banking system to hold off dramatic reductions in credit inside Cyprus. The local economy came under much less pressure than had been anticipated – or at least the total credit crunch impact has been spread out, becoming more gradual and allowing more time for adjustments in businesses. (See chart 5)

Bank confidence started to return to the system, especially after both Hellenic and Bank of Cyprus attracted large foreign investors, including EBRD. Indeed, the capital increase of €1 billion in Bank of Cyprus was the single largest FDI inflow in the history of the country. US dollar deposits, naturally erratic as they reflect hot money »in transit« from Cyprus to regional destinations,

3. This is part of periodic Eurostat reviews; although GDP growth rates are not expected to be revised, the absolute size of GDP is expected to be revised upwards. The author's estimates put this increase at 4 percent, thus creating important denominator effects on debt sustainability. Debt stock assumptions for 2015 include €1 billion to be used to recapitalize cooperatives; as long as the stress tests reveal a smaller requirement, 2015 debt stock will be lower than projected. The ECB's ABS purchasing program will help Cyprus in this respect, too.

Figure 5 Annualized credit growth rates, domestic and total (January 2013 to March 2015)

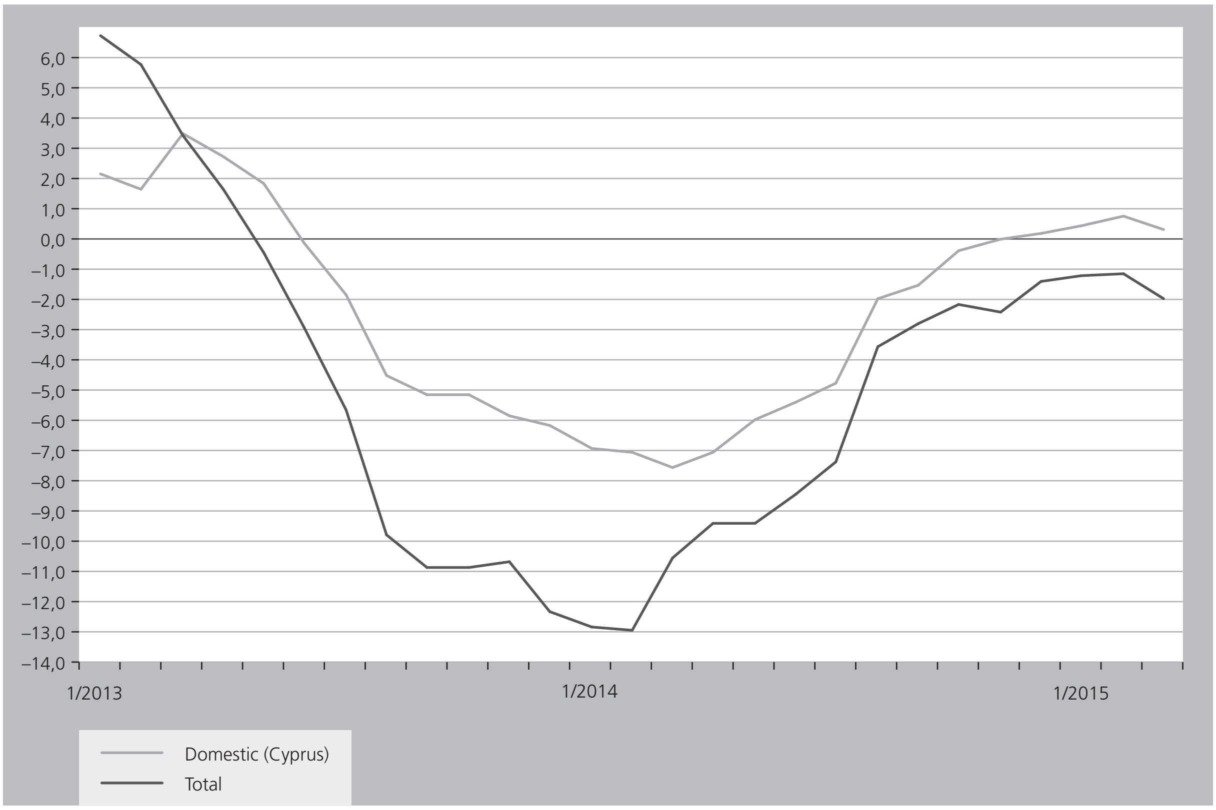
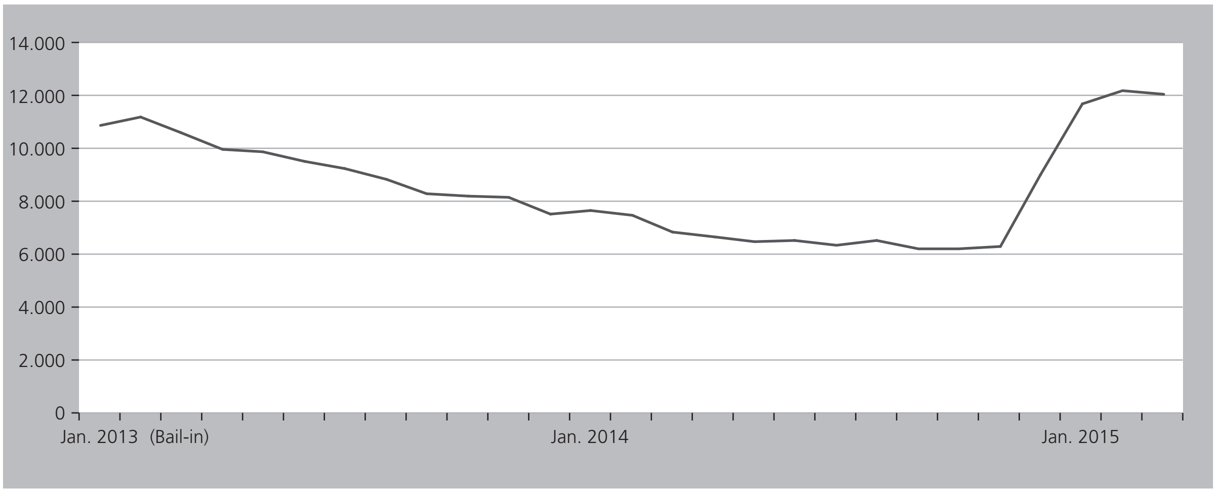
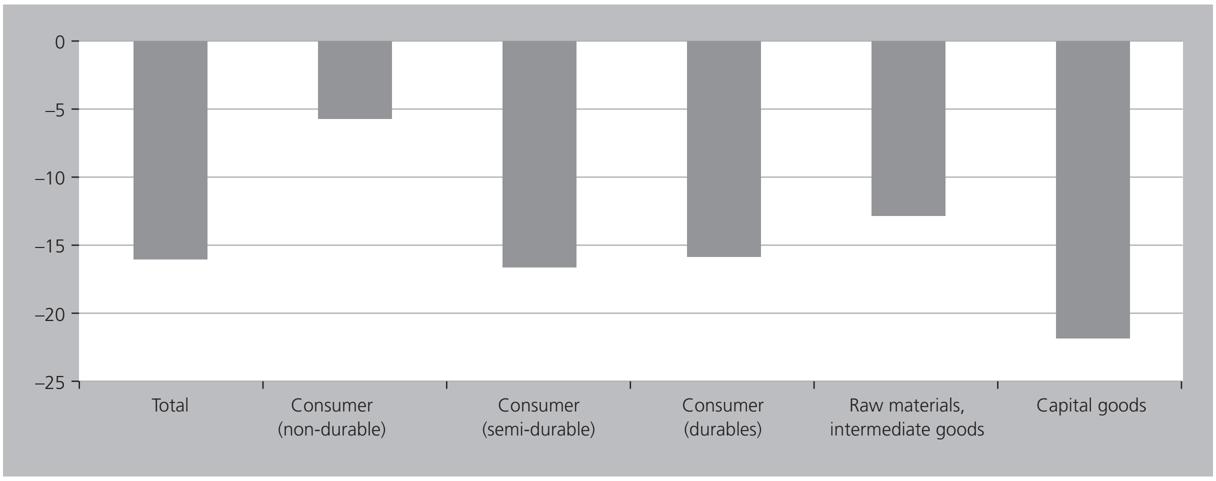


Figure 6 USD deposits in Cyprus banks million euro outstanding (per month)



soon started to return to the system; this reflects foreign businesses again using Cyprus as a »station« for their international financing needs. It is therefore a good proxy for confidence in the banking system. (See chart 6)

Figure 7 Imports per category (2013, Δ% y-o-y)[4]



2.3 Maintaining Consumption and Household Savings

Households have adjusted to the crisis by running down their savings. Private consumption has not declined as much as had been expected. Although households have been hit in both revenue (higher unemployment and lower wages), and assets (stock and real estate prices), data shows that consumption patterns were not as heavily affected as had been anticipated. Indeed, non-fuel, non-food spending remains robust, given the circumstances.

One extraordinary feature of the months after the crisis has been that consumption remained rather flat, with consumption of durable and semi-durable goods declining faster than non-durables. Hence, durable goods (larger-ticket items, appliances, white goods etc) essentially slowed down in tandem with the pause in the real estate boom; non-durables, or »current consumption« on such items as imported foods and entertainment, continued at »non-crisis« levels. (See chart 7)

Households still maintain more deposits than loan obligations, while there are strong indications that substitution effects have helped households maintain their spending patterns (for example switching to domestic goods).

4. As Cyprus is a small, open island economy, with a small manufacturing base, imports reflect consumption more than in most other economies. In the absence of category break-downs in official retail data, imports are the best available proxy.

One additional element that warrants some attention is the dissolution of Provident Funds in the aftermath of the bail-in. AON Hewitt finds that some eight hundred funds, one-third of the total, have been liquidated, with some €1.5 billion returning to policyholders. This represents 50 percent of all pension and provident fund savings, and approaches 10 percent of GDP.

This vast dissaving has, by all indications, financed current consumption; it was, effectively, an intertemporal transfer of future spending to the present, amounting effectively to an additional »hidden« future household debt and a hidden future GDP decline. (See chart 8)

2.4 Business Adjustment

Certain sectors (shipping, professional services) have been insulated from the crisis, generating important Gross Value Added (GVA) through the most difficult periods of the crisis. Maritime services (6 percent of GDP) face no direct pressures from the Cypriot crisis, and indeed grew some 15 percent during the darkest months of 2013, while professional services have adjusted relatively well. The latter sector appears to have taken precautionary measures in the run-up to March 2013, as employment reductions, wage cuts and adjustments to services provided were noted near the end of 2012.

Tourism, although in overall long-term decline due to excessive bureaucratic pressures and an ageing product, has performed well in the last 36 months, attracting

Figure 8 Cyprus domestic households: Loans and deposits (January 2014 – March 2015)

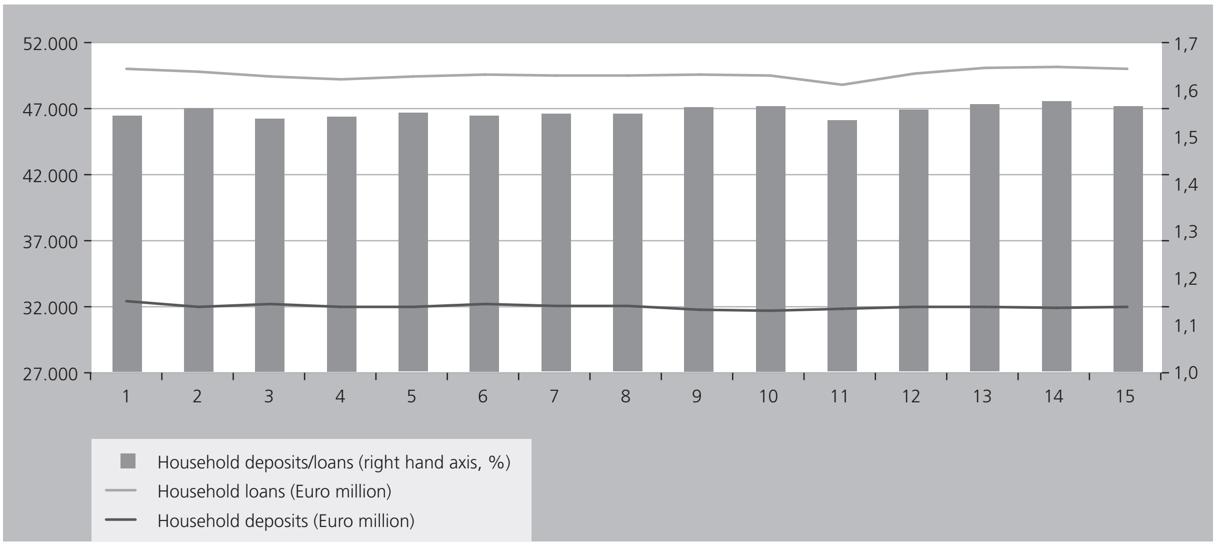
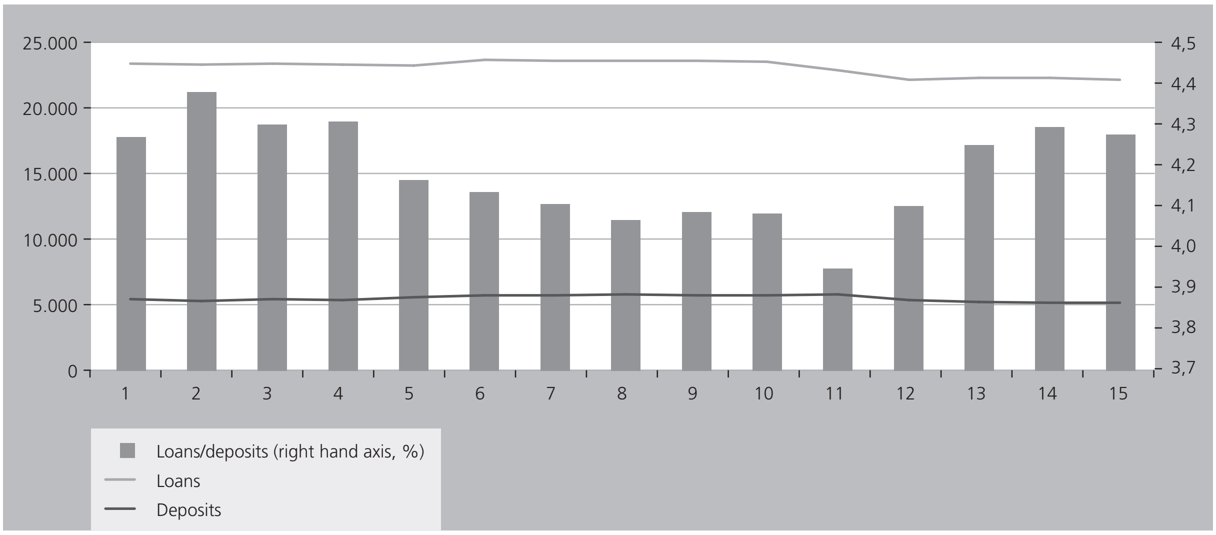


Figure 9 Domestic non-MFI loans and deposits (January 2014 – March 2015)



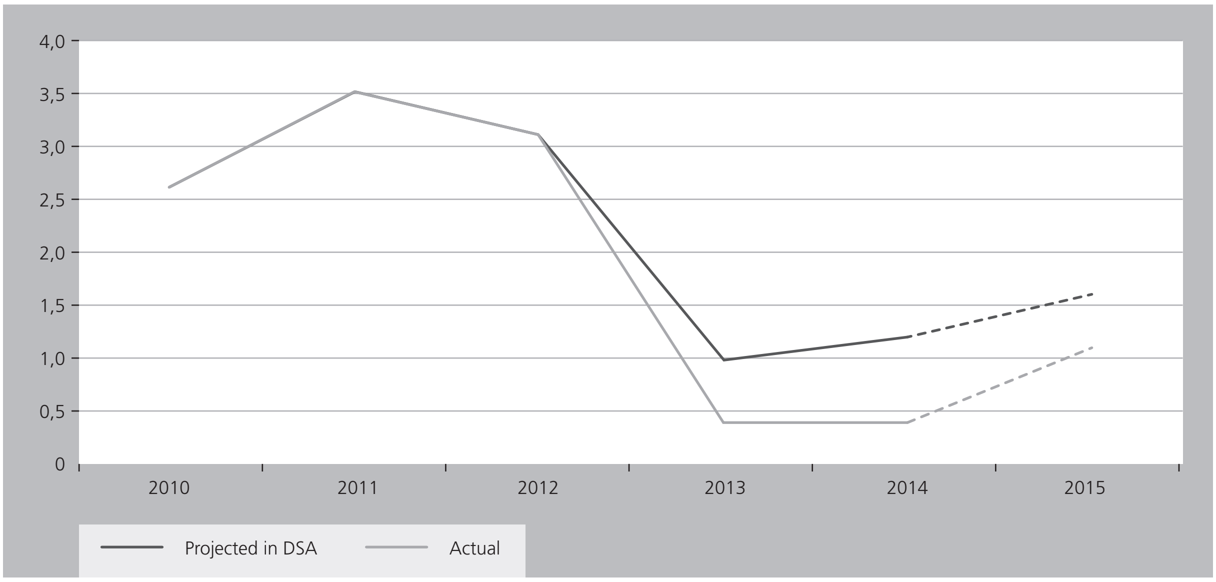
more higher-spending customers, largely from Russia. Per-capita and total revenues remain elevated, on a year-on-year basis, compared to 2011 and 2012.

Overall, unemployment adjusted rather quickly, rising since 2008 and hence boosting productivity. Wage cuts have also adjusted business spending since 2009; this allowed businesses to implement relatively fewer changes than expected as the crisis progressed. (See chart 9)

However, businesses remain heavily leveraged; with loans accounting for more than 400 percent of their deposits, the extent to which they can continue to finance their obligations remains a major unknown. Although leverage is an expected »fact of life« for businesses, the main question is how they can cope if the credit squeeze proves to be more protracted than anticipated, moving into the latter parts of 2015 and into 2016.

The overall economy reports heavy destocking (including inputs like spare parts, stocks, and lubricants, which are necessary for continued operations). Investments appear to have declined strongly, although this largely reflects the complete pause on real estate development.

Figure 10 Annual HICP inflation



»Productive« imports (capital goods, intermediate goods and raw materials) have declined dramatically as businesses focused on these categories in order to cut costs rapidly. This phenomenon has two effects. First, it lowers maximum potential production and potentially lowers both quality and competitiveness in the medium term. Second, it raises the interesting question – after the weakest have been weeded out – of restocking. The longer the stock rundown, the more inevitable will become a wave of new orders for imports, at least for the surviving businesses that still have access to finance.

2.5 Internal Devaluation?

One of the main questions posed in the DSA (Debt Sustainability Assessment) and MoU (Memorandum of Understanding, or »the Program«) process has been whether the economy could adjust to crisis conditions through internal devaluation; the failure of this »theorem« in Greece created a great deal of suspicion. In the case of Cyprus, there was little indication of an outright »internal devaluation«. However, the per-category data tell a different story: The economy entered a deep disinflation, recording declines in inflation rates in almost every category, including, conspicuously, health, telecoms, electricity and transport. Indeed, health and education moved into deflationary rates.

These were categories with consistently high rates of inflation before the crisis, remaining close to 4 percent on an annual basis. At the same time, inflation rates (in HICP terms) remained far below the overall rates recorded in the Eurozone, creating a »disinflation differential« with the rest of the Eurozone. This amounts to improved competitiveness.

Throughout the crisis annual inflation rates remained positive, reflecting the fact that the disinflation recorded in almost all categories of GDP did not always move into deflationary levels. However, price slowdowns in transport and telecoms were coupled with deflation in edibles, education, housing and electricity; categories where household demand remains relatively inelastic as they are staples of »current« consumption. (See charts 10 and 11)

Although annual inflation rates for 2014 were marginally positive the economy remained in deflation for most of the year. For 11 months (September 2013 to July 2014), year-on-year monthly inflation rates remained negative, bottoming out in December 2013 with –1.6 percent. Although it is still too early for comprehensive official data, initial 2015 figures show that disinflationary pressures remain strong across the economy.

Asset prices also declined. Both stocks and equity and real estate prices showed significant declines, although

Figure 11 Monthly HICP inflation, y-o-y

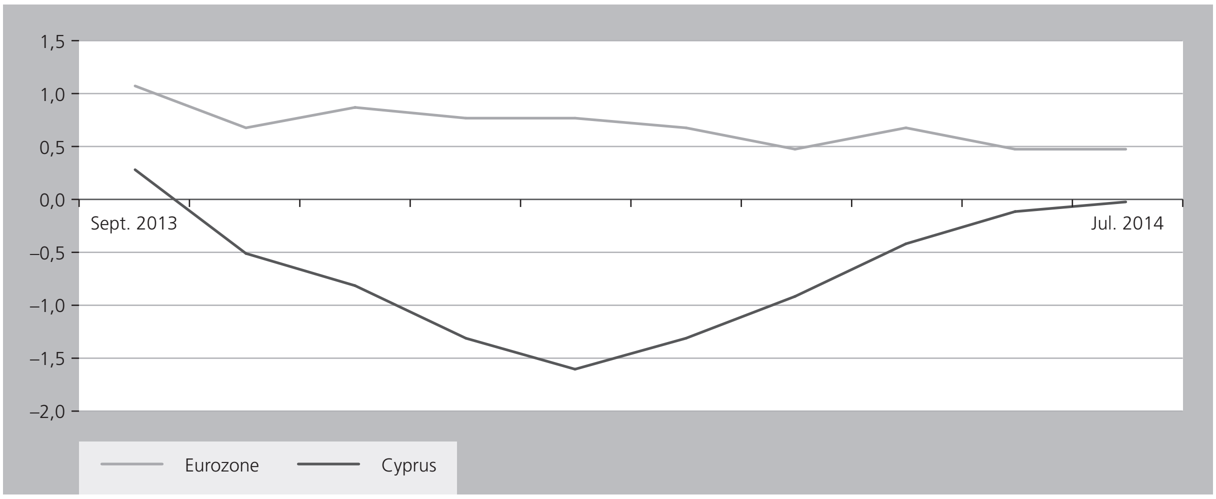
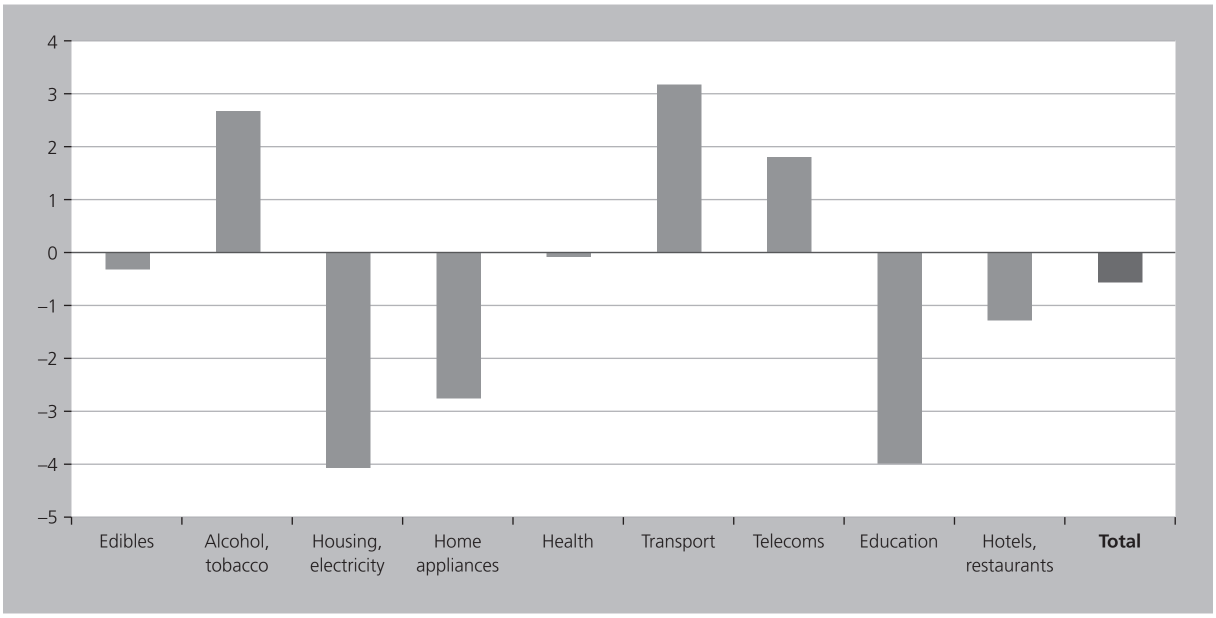


Figure 12 Inflation rate (national definition), first half of year 2014

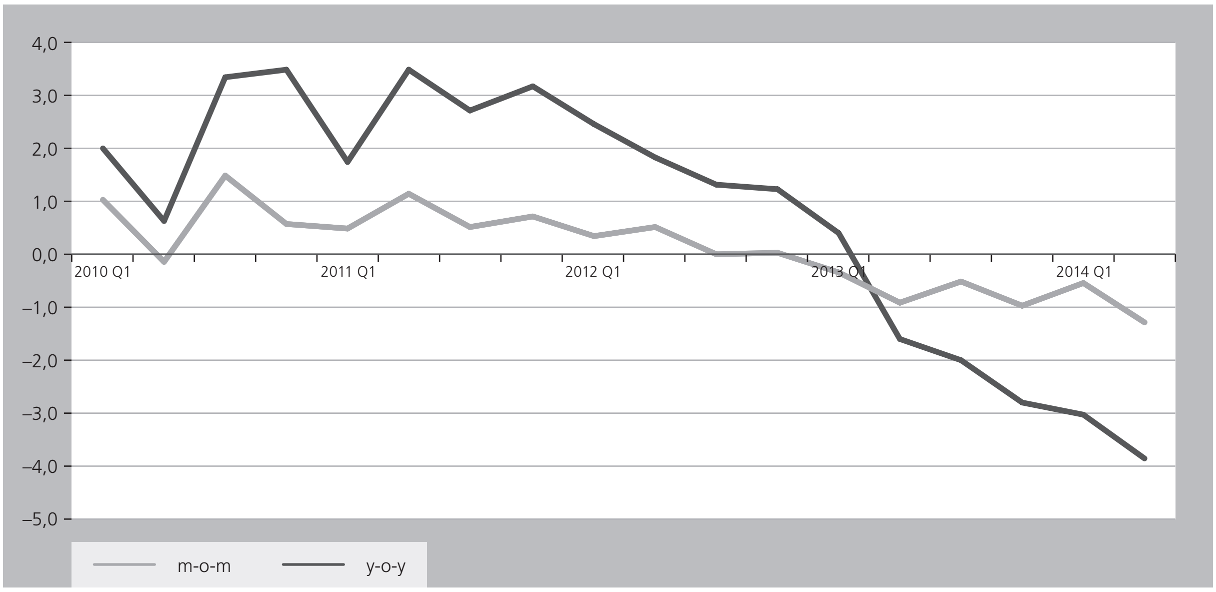


official data is unreliable.[5] Interestingly, transport as well as »alcohol and tobacco«, two categories recording positive price growth (and in the case of alcohol and tobacco, recording price tax increases), are affected by policy-driven price increases (such as imposition of new taxes). (See chart 12)

5. Data using estate agents' surveys are notoriously problematic as they possess incentives to keep prices inflated. Nonetheless, surveys show a decline of up to 15 percent, which is probably understating the change in prices.

The per-category data reveals that, although it may be an exaggeration to speak of outright deflation and »internal devaluation«, the economy showed rapid *price adjustments* that also reflect wage cuts. Prices being less sticky than had been originally assumed, the economy moved into a »price correction« path. The differential created between Cypriot and rest-of-the-Eurozone inflation rates could be deemed an internal devaluation of sorts, since it boosted relative competitiveness with respect to the rest of the Eurozone.

Figure 13 Mean Monthly earnings (Δ% per month and year-on-year)



Given bank disintermediation and the broken transmission mechanisms of monetary policy, Cyprus appears (so far) not to be affected by monetary decisions of the European Central Bank (ECB); therefore the differential between Cyprus and the rest of the Eurozone could open anew if Eurozone price levels rise as per ECB policy, and Cypriot HICP levels remain stable.

This notwithstanding, price correction appears to have contributed significantly to the economy's immediate adjustment to the realities of the economic crisis and is part of the explanation as to why the depression was so much milder than originally expected. (See chart 13)

2.6 The Import Idiosyncrasy

It is worth noting that in the case of Cyprus, as a small, open island economy with a small manufacturing base, increasing imports reflect booming GDP growth. Both the bulk of consumption in all categories, and virtually all inputs in the economy, are imported.

It is therefore crucial for the country to move into a price correction even without a currency devaluation, which is impossible for countries which, like Cyprus, have no monetary policy options because they are members of the Eurozone. In contrast to »traditional« assumptions, as inputs (intermediate goods, capital goods, raw materials, fuel etc) are imported in their entirety, a currency devaluation would increase rather than reduce production costs. This is especially true as Cyprus does not have exports priced in foreign currency.[6]

Therefore, the declining trade balance reflects reduced imports due to declining GDP, not price competitiveness. A declining trade deficit is in fact an indication of lingering crisis. The flip side of trade deficit, the reduced balance-of-payments figures, reflect deposit flight and disinvestment in many segments of the economy. Improved productivity and competitiveness mainly concerns financial and professional services, as well as tourism.

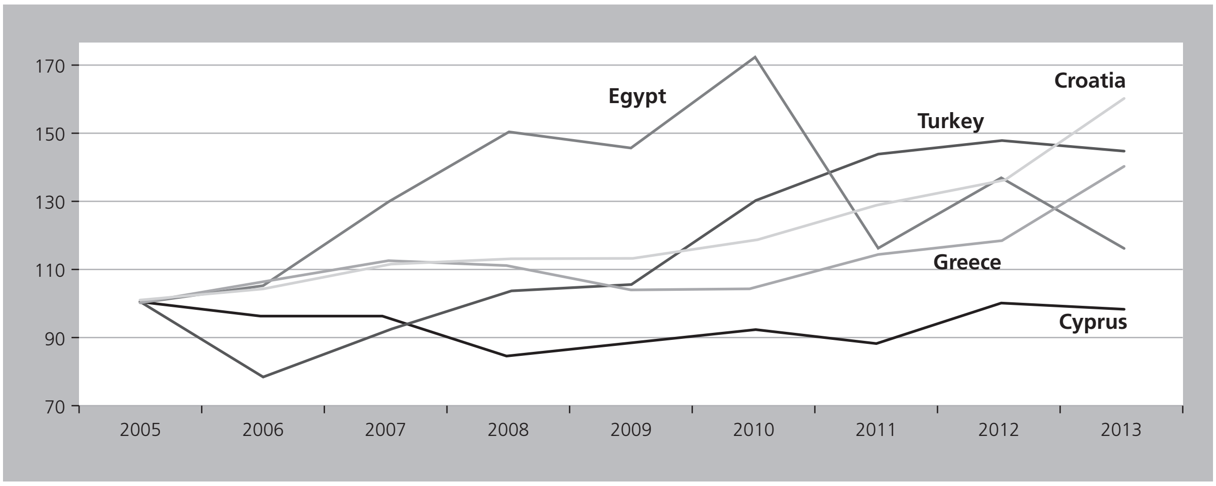
3. Long-Term Pressure

Bank recapitalization, which brought in large foreign investors,[7] is likely to change the credit conditions in 2015, provided that political conditions do not become an obstacle to their decision-making processes. Although political risk concerning the MoU is still present, with

6. Apart from political concerns, this was the main argument against leaving the Eurozone after the bail-in. Unlike Iceland, whose main exports are denominated in US dollars and fuel dependency is low, and unlike major exporting economies like Argentina and Brazil, Cyprus would not benefit from currency devaluation, which would increase input costs and put pressure on export prices.

7. The capital increase at Bank of Cyprus, amounting to €1 billion, marks the largest single inward FDI movement in the country's history (excluding sovereign debt).

Figure 14 Tourist arrivals per year (2005=100)



the parliament willing to vote down some of the critical issues scheduled for the next few months (including privatizations, national health system), Cyprus's track record still shows that the country is willing to implement all its obligations.

The fact that fiscal performance has been better than anticipated in the DSA, with primary deficits and the overall balance outperforming DSA targets, promises that Cyprus will move ahead and meet the MoU targets on time. Big questions remain, particularly on privatizations, civil service reform and the national health system – issues that have proved difficult in most crises. However, beyond the political risk regarding implementation of the MoU, the most important question looking forward is: »*What will the recovery look like after the crisis?*«

3.1 Temporary Growth

Even as the crisis turns out shallower than anticipated, with GDP declining much less than projected, it has produced »areas of potential growth«. Under conditions of easy and cheap credit – including up to 40 percent of GDP in real estate lending which is marred with allegations of cronyism – the pattern of growth in the years since 2004 depended on a booming real estate sector, boosted by extremely liquid and ever-expanding financial institutions that, at the beginning of the crisis, maintained total deposits of €73 billion, compared to a GDP of €17 billion.

Much of this expansion was fuelled by Professional and Back-office services provided to foreign investors who used Cyprus as a hub for their operations. Ostensibly presumed to be exclusively Russian these also included US- and EU-based non-MFIs (i.e. businesses outside of the financial industry) outside the so-called »round-tripping« process by which foreign (mainly Russian) businesses used Cyprus to channel investment back into their own country.

Easy credit also boosted retail turnover, leading to a »silent bubble« that is now reflected in astronomical levels of NPLs, amounting to 54 percent of all consumer loans. This model of growth increased employment and profits in »auxiliary« services, as well: legal, accounting and business consulting grew rapidly in the years preceding the crisis.

At the same time, in the years prior to the crisis, tourism seemed to have fallen into a Dutch Disease state. As yields increased in other areas of the economy, investment and wages in tourism stagnated. Although official data is hard to obtain, the ageing of the tourism product has led to both absolute and relative declines in arrivals and revenues. (See chart 14)

The banking crisis put an end to these processes. However, it is creating some islands of potential immediate growth, already recorded in macroeconomic data, including VAT and land registry revenues.

3.2 Asset Sales and the »Slack«

In the wake of the crisis, assets belonging to distressed borrowers began to be sold off; the initial deals accounted for assets exchanged for deposits »corralled« in Bank of Cyprus deposits, to which depositors could not get access.

With approximately thirty-one groups of companies holding an estimated €6 billion in troubled loans, asset sales started to materialize. With banks' pressure on major distressed borrowers increasing alongside NPL levels in their books, asset sales are creating some room for growth. This is especially true with regard to projects that were stalled in the run-up to the crisis. Indeed, Land Registry data shows a dramatic decline in final building permits. These fewer permits, however, represent projects that are larger than the pre-2012 average, both in size and in cost.

The change in ownership is, however, creating room for improvements in productivity and yields on many of the assets taken over by foreign investors. Improved productivity is already noted, with slimmer employment and »fat-cutting« measures by new managements. Effectively, these distressed asset sales amount to debt-equity swaps from the point of view of the distressed businesses.

Foreign investors are also boosting new areas hitherto untouched by the rapid growth of real estate. These include casino and gaming projects, luxury beachfront developments and marinas, as well as health tourism, all of which now have official applications submitted by foreign interests.

The privatization processes, concerning the Ports Authority, the Electricity Authority and telecoms, are also expected to significantly tighten the slack observed in production and running costs in areas of the economy deemed critical for their pass-through effects in other industries. These developments, while boosting both employment and GDP growth in the next twelve to twenty-four months, cannot however provide an adequate long-term boost to the economy and production. Significant misalignments remain.

4. Investment and Employment

As the crisis progressed, deepening misalignments in investment and employment started to manifest themselves. Unemployment, already in the process of adjusting to economic pressures since 2008, appears to have peaked in early 2015, and is now in a shallow decline. (See chart 15)

However, per-category data raise the question whether a sort of hysteresis should be expected in the Cypriot job market. Some 25 percent of all unemployed come from commerce – both retail and wholesale – which is not expected to recover to the pre-crisis levels that depended on easy credit. Domestic displacements favouring larger trade establishments such as shopping malls and known, international brands have driven smaller establishments to bankruptcy. Dependable official data is not forthcoming; however, while »traditional« shopping districts in the larger cities are now recording high vacancy rates,[8] shopping malls and other larger establishments are at full capacity. Retail and wholesale employment peaked in 2008, after three years of rapid growth in which total employment in commerce increased by 17 percent to reach 68,000 (including self-employed workers). It has shed some 5,000 positions since, coinciding with the credit crunch. These job cuts appear to be continuing. (See chart 16)

At the same time, household finances appear to be putting pressure on retail; with non-performing loans accounting for a staggering 54 percent of all consumer loans and reaching some €5 billion in arrears, it is doubtful that households will be able to maintain pre-2008 consumption patterns. The coincidence between retail growth and credit growth also corroborates the assumption that retail was buoyed by the credit bubble.

The 38 percent growth in value added in the retail trade in the period 2005–2008 was not sustainable, and the collapse coincides with the end of rapid credit growth. A return to such dramatic figures can hardly be expected.

Similarly, construction accounts for 20 percent of total unemployment and a return to full employment appears impossible, given the oversupply that exists in the real

8. The author's estimates put vacancy rates in Nicosia's Makarios Avenue at 48 percent. The Avenue, once the most important shopping street in Cyprus, is now virtually derelict.

Figure 15 Unemployment per economic category (% of total)

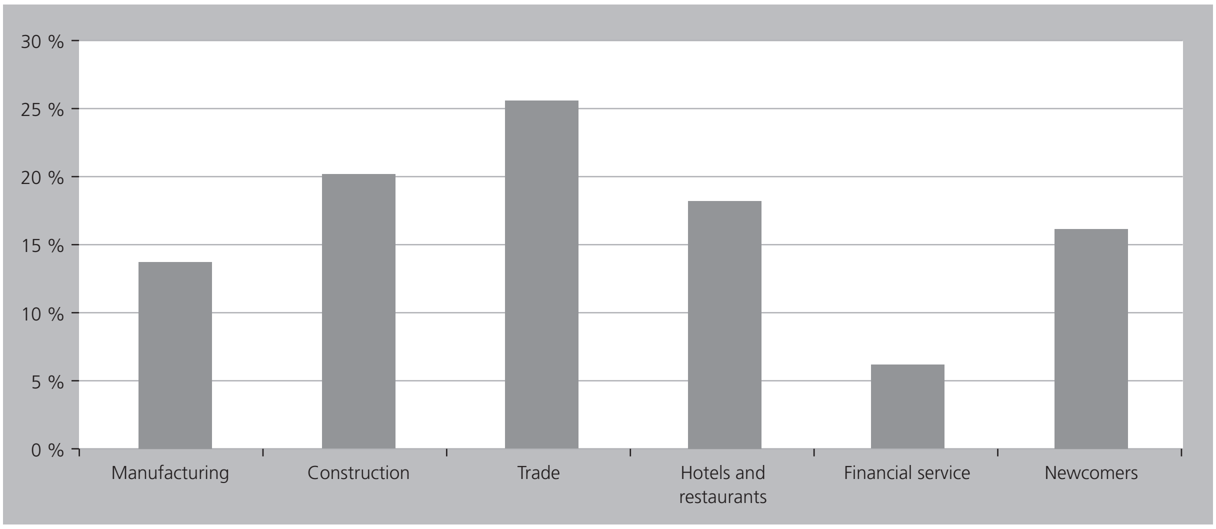
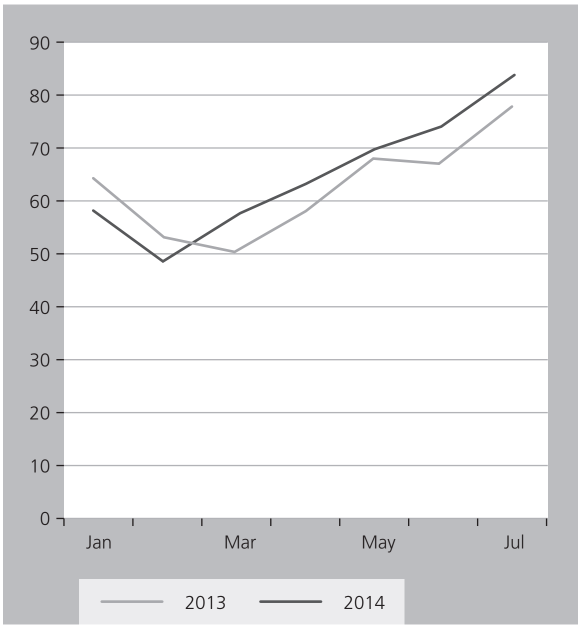


Figure 16 Retail turnover per month (non-food, non-fuel 2010=100)



estate industry. Employment in construction peaked in 2008, with some 41,000 workers; in 2014 official data show barely half that number, 21,500. With the bubble now burst, as reflected in the 30 percent decline in turnover, a return to previous employment levels appears all but impossible. There are some indications, however, that many workers in the construction industry are dropping out of the job market: while some 20,000 jobs were shed, the number of registered unemployed only reached 6,700. The difference may represent migrant workers, many from EU countries, who are now seeking employment elsewhere. This is particularly true for workers from Romania and Bulgaria, where there is strong anecdotal evidence that the expiry of travel restrictions on 1 January 2014 is encouraging them to seek employment in other EU countries. At the same time, many Turkish Cypriot workers who previously worked in construction are no longer seeking employment in the Republic of Cyprus.

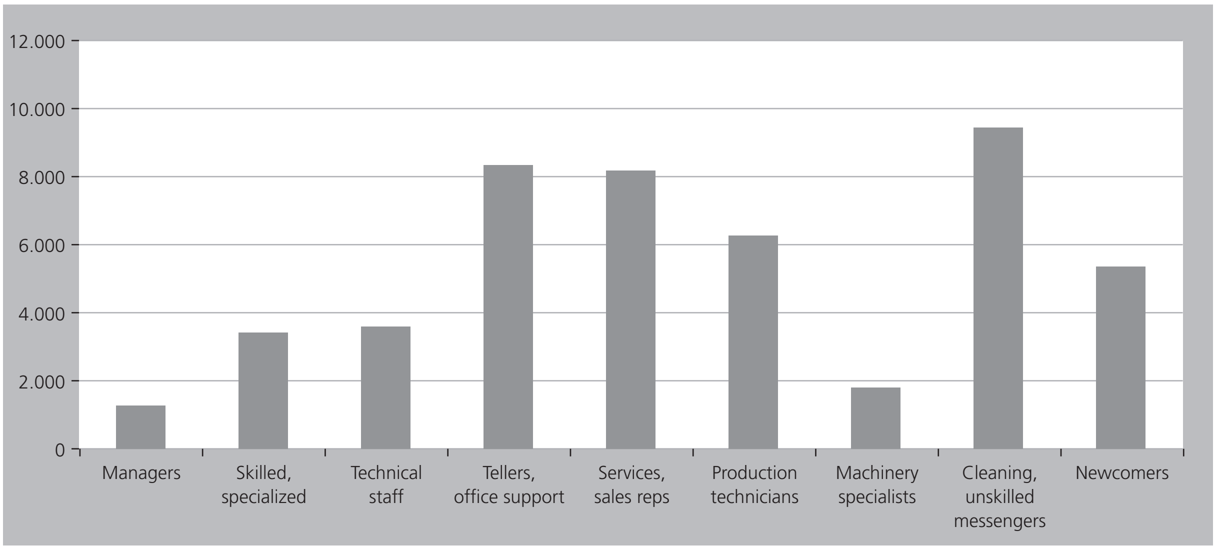
Other sectors, including the long-declining manufacturing and tourism, are »telling a similar story«. On the higher-skilled side, the decline of financial and professional services is reflected in the two thousand or so individuals who now appear on the registered unemployed lists. Skill mismatches for such workers are a bigger concern.

5. The Emerging Mismatch

Although the economy adjusted rather quickly with wage declines, a small increase in part-time and contractual work, and even unemployment, the emerging skills mismatch is the biggest concern for the »post-crisis« period. Rising long-term unemployment figures indicate that these concerns should trouble policymakers as »recovery« takes shape.

Unskilled labour is the largest category of unemployed. With agriculture, retail and construction on the wane,

Figure 17 Reg. unemployed by professional skill (mean, year-to-August)



an important question for the recovery is whether the economy can absorb these unemployed in 2015 and beyond. Some 54 percent of the registered unemployed fall into three skill categories: a) tellers and office administration staff; b) service employees; and c) cleaning staff, messengers and unskilled labour. Another 11 percent are »newcomers« in the job market. This particular category, although large, is probably under-reported as newcomers receive no benefits and possess no incentives to register as unemployed. (See chart 17)

These data raise the question whether the economy will be able to absorb the unemployment caused by the crisis. Construction will continue to decline at least until the oversupply is eased, while strong displacements in retail point towards slimmer employment per value added. Services, including banking and tourism, are also recording important spikes in productivity, which, although desirable in itself, may be pointing towards lower employment relative to turnover in the coming quarters.

The data also raises the question of a severe skills mismatch. As higher-end services (including, potentially, natural gas) are growing, it is unlikely that many of the workers leaving construction, retail and even banking can move easily into other businesses.

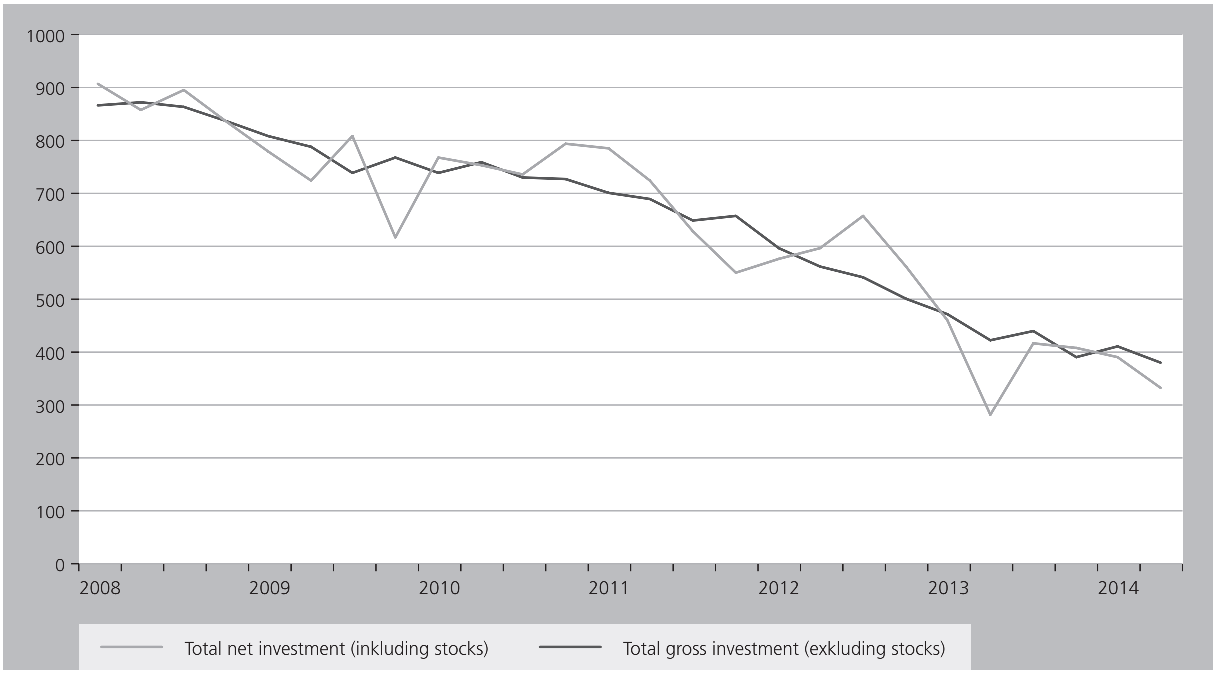
Although part-time and contractual work are showing some increases, other work conditions – like work hours and fringe benefits – appear to remain rather constant. Working hours are also showing a small increase that may reflect natural seasonal fluctuations. Strong labour unions appear, for the time being, able to protect working conditions (wage cuts notwithstanding). The largest concern, therefore, is unemployment, rather than protection of those already employed.

A relative increase in self-employment may reflect externalization and ad-hoc outsourcing of some services, while unrecorded work remains a constant concern. Again, official data is lacking, while even the best efforts to measure underground economic activity remain questionable. Pre-crisis Ministry of Labour inspections, however, put unrecorded work at 30 percent in key industries: agriculture, tourism and construction. The incidence of unrecorded work should be assumed to have increased, also leading to increased concerns for workers' safety and working conditions.

5.1 Jobless Growth: Fear of a »New Normal« in Unemployment

The facts outlined above raise the concern that Cyprus may be entering a period of »anaemic« GDP growth, where »the good times are over«. This is partly because of displacements taking place towards business sectors with lower labour intensity, while at the same time skill mismatches can be discerned.

Figure 18 Total investments per quarter (seasonally adjusted, mil. euro)



A nominal decline in recorded unemployment levels may be expected as some of the jobs lost (salespersons, tellers, office workers etc.) are often not the main household breadwinner; this is compounded by social norms which encourage secondary earners (mainly women) to stay at home rather than seek employment, especially at lower wage levels.

However, such a virtual decline in employment notwithstanding, long-term unemployment appears difficult to tackle, despite the rather high-sounding hopes expressed by investors and politicians that projects like casinos and marinas, together with natural gas, can bring the economy back to full employment. It also follows that employment levels will likely decline, reflecting workers dropping out of the workforce.

5.2 Investment Atrophy

While the economy managed to react swiftly to the new reality created by the crisis, the longer-term issues that arise become more acutely visible in the investment figures. Although natural under crisis conditions – and particularly a severe credit squeeze – the fall in investment remains acute.

Loan demand remains subdued. While this is expected, given the leverage of businesses and the uncertainty stemming from developments (such as delays in parliament and the lingering Greek crisis), de facto creditless growth is becoming the dominant scenario. At best, such growth will be very shallow.

This is largely to be expected: As the housing bubble collapsed, investments in this category »dragged« overall investment rates into negative territory. However, continued pressure on other categories remains visible as well. Transport investment flows remain some 50 percent lower than in 2008, although there has been some recovery since Q1 2014. For machinery and tools, investment flows show a continuing decline since the crisis started, and in Q2 2014 it was 35 percent off its peak in Q2 2009. Accounting for depreciation, it is likely that the economy is moving into disinvestment in these categories.

Even more pressure remains on stocks. As businesses found themselves without credit (or with Cypriot bank credit that is not accepted by exporters), they drew down on stocks, including items such as spare parts and machinery. (See chart 18)

The decline in investment appears to hold labour-to-capital ratios down, despite an increase in unemployment, and it appears that maximum productive capacity is declining as the economy enters recovery. This is a particular concern as it minimizes the ability of the economy to achieve »recovery« rates of growth.

One important element that remains unresolved is the extent to which credit will finance investment once the crunch is over. With demand for credit low in all metrics employed by the Central Bank, commercial banks remain unwilling to lend as they perceive the risks to be very high.

6. Future Prospects

The economy remains mired in long-standing imbalances. Private debt is still too high, investment continues to decline after the housing bubble collapse, businesses are faced with strong credit and liquidity pressures, and labour market mismatches are creating profound concerns for the medium-term prospects for reducing unemployment.

The banking sector has handled the dangers impressively. Emergency liquidity from the ECB is now under €7 billion, compared to nearly €11 billion eighteen months ago. Capitalization remains strong and the deleveraging process is almost complete. Planning for the next moves, with liability rationalization, access to markets and perhaps even new listings in stock exchanges abroad, is also progressing as planned. However, the pressure from NPLs remains intense and the banks will be unable to »finance growth« until they are able to put more pressure on the larger NPLs holders and to securitize assets for sale. Additionally, unless equity finance is attracted to the country (which also requires legal and institutional improvements) and unless productive infrastructure (including privatizations) provide opportunity, Cyprus may be forced to make do with creditless growth. Because of the structural characteristics of economies like Cyprus, a creditless growth also translates to a recovery that is both jobless and shallow.

While the economy managed to handle the immediate aftermath of the crisis, including the bank bail-in, longer-term prospects remain dull. Indeed, »Japanese« growth patterns remain a profound concern for the next few years. In search of »game-changing« developments, Cyprus is looking to events that might reshape the economy, creating »room for growth«, especially as investments are declining and longer-term prospects in the job market remain uninspiring.

6.1 Cyprus Problem

As the economic situations on both sides of the Cypriot divide almost mirror each other,[9] the idea that a solution might generate more sustainable economic growth is gaining wide currency.

Cyprus's shipping sector is hampered by the Turkish embargo that puts a cap on growth. Even more importantly, the prospect of opening trade routes to and from Turkey's comparatively large markets at a time when exporters are desperately seeking new markets, would be a boon to the economy.

The prospect of opening Famagusta – which has been fenced off since 1974 – would bring the island's prime beachfront locations back onto the market, while also boosting construction and auxiliary services; first through the demolition process, and later with infrastructure and rebuilding projects.

Most importantly, a solution to the Cyprus Problem would lift a great deal of the uncertainty that exists today, while probably boosting household assets and opening up new opportunities for regional synergies. A peace dividend remains one of the most important prospects for lasting growth.

However, such developments remain far from certain despite recent developments; a variety of political sticking points have hampered a solution to the Cyprus Problem since the early 1960's; ever within reach, a comprehensive solution has evaded Cypriots since the country became independent. Recent developments appear to represent the »last best chance«. Indeed the road to a deal, driven by proposed confidence-building measures may be the best hope for a speedy resolution for the economy.[10]

9. The Northern Part of Cyprus agreed to a bailout agreement with the Republic of Turkey (known as the »Protocol«). In many respects, the bailout of the North is similar to the MoU that the Republic of Cyprus signed with the Troika.

10. Although modalities remain complex and uncertain, the confidence-building agenda will include the opening of the closed city of Varosha, the opening of Tymbou-Ercan airport and Famagusta port to international traffic, and the partial lifting of the Turkish maritime embargo on vessels from Cyprus.

6.2 Natural Gas

The prospects created by natural gas discoveries in Cyprus's Exclusive Economic Zone (EEZ) have been a game-changer on many fronts. Geopolitically, they cement a closer relationship between Cyprus and Israel, as well as significantly improved relations with Egypt and even Lebanon. The prospects for both employment growth and significant fiscal revenues are significant, while the introduction of natural gas in domestic consumption (both for households and for electricity generation) would lower economic costs across the board.

However, pitfalls do exist. Size, marketability and the extent to which natural gas production can be »monetized« remain uncertain, while the »messianic« fervour with which political leaders describe natural gas as a panacea for all the island's economic (and geopolitical) problems raises concerns over political risks.

As long as solid data on the quantity and quality of potential gas production remain lacking, further discussion is moot and indeed dangerous. The host of new university programs in »Natural Gas Management« point towards a potential influx of newly trained – but probably unemployable – Cypriots seeking employment that in fact requires years of experience. Additionally, Natural Gas exploitation remains dependent on fluid and unpredictable developments in regional geopolitics.

6.3 Reforms

The most immediately »useful« prospect for boosting growth in Cyprus remains fiscal, political and economic reforms. Such efforts are already under way, with senior government officials pinning many hopes on the growth-boosting effects of reform efforts. The Presidential Palace has now taken charge of the reform effort – a significant move because the President's inner circle will be left politically exposed if reforms fail. This is an important political signal of the government's willingness to push forward with reform.

Given the antiquated systems of the Cypriot civil service, reform efforts may have an important impact on growth prospects. Complex procedures, lack of digital services for businesses, and procedural opacity are among the main issues faced by the economy. Above all, uncertain outcomes in dealing with public authorities (for example in licensing processes) and opacity of rules act as a severe handicap to both investment and business growth.

The Presidential Palace's own estimates, for example, show that for an investment in renewable energy, an investor has to complete »37 different procedures, involving 4 different licenses in 6 different ministries and 4 different public authorities«, creating a prohibitive regulatory setup. This story, the same government report notes, »is found virtually everywhere« in the economy. »Boutique hotels cannot move forth because nowhere in the relevant rules and regulations are boutique hotels foreseen«, according to the same report, because such projects were not envisaged at the time when rules were put together, »in the 1980's«.

The same Presidential Palace report, quoting a Finance Ministry study, comments that »excessive bureaucratic obstacles« and other red tape costs amount to an estimated €1 billion per year, or 6.5 percent of GDP. Such estimates put the costs of Cypriot opacity very high and show that there is ample room for creation of added value by reducing obstacles. It is estimated that some 250,000 to 300,000 property deeds are still pending in the Land Registry Department, as are »thousands« (with no more detailed numbers available) of so-called »final permits«. The World Bank's *Doing Business Report* for 2014 estimates that the settlement of disputed contracts takes a staggering 735 days to be settled, while legal proceedings take 477 days and forty-three procedures. A request for connection to the electricity grid takes 277 days, according to the same sources. (See table 1)

There is thus vast room for improvements in the conditions for doing business in Cyprus. Indeed, in the case of health tourism, deals have failed because of the continuing lack of a proper legal framework, including state guarantees of emergency blood supply, to name another example.

The dedication of the presidency – and the political risk it has taken – implies that progress will be made in the next twenty-four to thirty-six months. This is perhaps the most promising of the immediate options available for Cyprus: by addressing obstacles to innovative projects caused by the absence of rules (for example for boutique hotels) the political leadership can release a great deal of potential currently stifled by excessive rulemaking and opaque red tape.

Table 1 WB Doing Business Report Rankings (out of 149)

103	Registering property	Costs 10.3 percent of property value. Five permits requiring one month to complete
110	Implementation of contracts	43 procedures also requiring 680 days to complete
108	Acquiring a building permit	Nine permits requiring 677 days to complete
44	Registering a company	

Some Examples:
- Electricity connection: 247 days and six different procedures
- Renewable energy investment: 37 stages of licensing: four permits from six ministries and two public authorities
- Registrar of Companies estimates that 70 percent of companies are not registered.
- Unknown number of deeds and titles pending at Land Registry Department. Official comments place the number at 250,000

Access to equity finance through government initiatives (including tapping into the Juncker Plan), are another political promise that could boost both GDP growth and employment levels. Its success, however, depends both on actual implementation and on the channelling of financing into carefully selected projects; experience shows that too often, political concerns lead to decisions that are not driven by market-based criteria and are therefore inefficient.

7. Conclusions

Rapid adjustment to the immediate challenge of economic »survival«, including important structural changes, took place in the wake of the bank bail-in and the introduction of the MoU. The fiscal side of the crisis has been very successful and austerity – in as much as this entails spending cuts – has been relatively mild. The immediate effects of the crisis have been of the kind expected in all banking and sovereign crises: spiking unemployment, negative GDP growth, a lingering threat of asset-price deflation despite ECB monetary easing, worsening income inequality (Gini coefficient), and falling wages. These aspects, however, are still somewhat better than had been anticipated. Tellingly, unemployment appears to have peaked at levels just under 20 percent, despite increased youth unemployment.

The immediate reaction to the crisis, including widespread »spring cleaning« in government spending as well as dramatic changes in bank ownership structures, has been successful and the economy appears to have »survived the fall«. However, mismatches and imbalances that had been hiding behind the rapid credit growth that ended with the crisis, as well as displacements provoked by the crisis itself, have squeezed maximum growth levels to »Japan-like« levels.

Cyprus is therefore threatened with a recovery that will entail shallow growth and persistent unemployment – as a by-product of the successful reaction to the immediate threats. Although a solution to the Cyprus problem and the exploitation of natural gas discoveries offer auspicious prospects, the most promising immediate policy to bring about a »secular recovery« entails far-reaching reforms in the civil service as well as in regulation and supervision of markets. These include a national health system and key privatizations, both of which are highly unpopular but envisaged in the MoU.

»Game changers« do exist: the Cyprus problem and natural gas developments will be important if progress materializes. Reforms will also attract equity finance and open hitherto untapped areas of growth. These could change not simply the speed and gradient of growth, but also its long-term sustainability.

Abbreviations

CBM	confidence building measure
DSA	Debt Sustainability Assessment
ECB	European Central Bank
EEZ	exclusive economic zone
GVA	gross value added
HICP	Harmonized Index of Consumer Prices
MoU	memorandum of understanding
NPLs	non performing loans

About the author

Michalis Persianis is Corporate Affairs Director of the Bank of Cyprus. Born in 1978, Persianis worked from 2009 to 2014 for Kathimerini newspaper as chief editor for economy and finance. He was co-founder of Intelanco Ltd, a company providing bespoke economic analysis, and Cyprus correspondent for the Wall Street Journal. After a spell working at the European Parliament, he returned to Cyprus in 2008. Michalis Persianis joined the Bank of Cyprus at the beginning of 2015. In his current capacity as Corporate Affairs Director, he is responsible for communication strategy and corporate affairs, including press relations, relations with external partners, CSR actions and the Cultural Foundation. Persianis holds an M.A. in International Relations and International Economics from the Johns Hopkins University, School of Advanced International Studies (SAIS), at Washington, DC.

Imprint

Friedrich-Ebert-Stiftung | Western Europe/North America
Hiroshimastraße 28 | 10785 Berlin | Germany

Responsible:
Michèle Auga, Head, Western Europe/North America

Tel.: ++49-30-269-35-7736 | Fax: ++49-30-269-35-9249
http://www.fes.de/international/wil
www.facebook.com/FESWesteuropa.Nordamerika

To order publications:
FES-WENA@fes.de

FES Cyprus office

FES has been active on the Mediterranean island since 1986 and is promoting a cooperative dialogue between political decision makers and civil society. Between 1986 and 2011, the Cyprus branch was administered by the Athens office, however, since 2011 the FES Cyprus has had its own small office in Nicosia, Cyprus. The Nicosia office is part of a global network comprising 107 local branches. Ending the division of Cyprus and the reconciliation of all parties involved in the conflict; promoting bi-communal dialogue; regional stability and constructive conflict management; changes in the social, democratic and constitutional frameworks with an emphasis on good governance and social justice; minimizing the negative social and political repercussions of the economic and financial crisis as well as the austerity policy; regional cooperation and conflict prevention in the context of the hydrocarbon findings off the coast of Cyprus and in the Eastern Mediterranean are some of the thematic fields the work of FES is focusing on.

In collaboration with local, regional and international partners, e.g. trade unions, professional organizations, the political elite or universities and research centers, FES Cyprus organizes workshops, seminars, presentations and conferences in order to promote as well as to strengthen the dialog between the decision makers, multipliers and citizens.

More information at www.fes-cyprus.org

EFQM
Committed to excellence

ISBN 978-3-95861-279-2