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Cyprus – The economy calls for immediate action!



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As expected, the Cyprus sovereign rating has been downgraded by Standard & Poor's to "A" with a negative outlook...

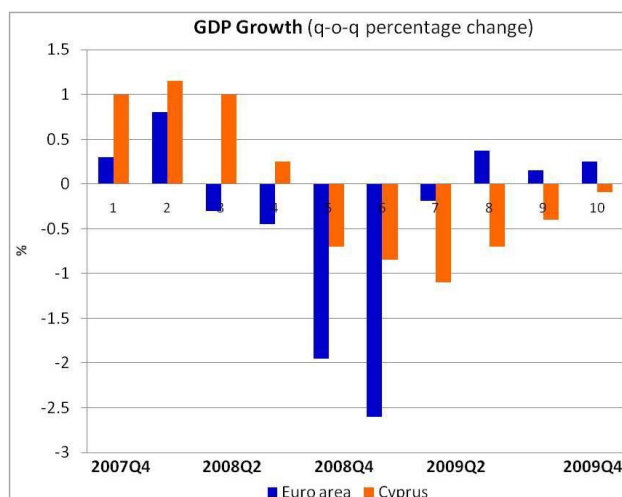
Cyprus is a reputable regional and rather unique financial hub, due to its strong and applicable legislation and sound regulatory system, Eurozone membership (since 2008), the lowest corporate tax within the European Union (10%) and double-tax-treaty agreements with 46 countries, sound historical fiscal performance, relatively low public debt, higher GDP per Capita (>98% of the EU average), relatively low unemployment level under the global market circumstances (expected to be around 7% by the end of the year) and a well positioned quality tourist destination.

Investment activity in Cyprus, however, will continue to be weighed down by the island's political problems and economic imbalances (namely twin fiscal and current account deficits) caused by the illegal occupation of almost 40% of the island by Turkey.

In addition, **the important tourism sector is facing increased regional competition and requires immediate and constant uplifting. The traditionally healthy banking sector, although it has weathered the recent global financial crisis – Cyprus has been somewhat shielded from the crisis, largely because of its low reliance on exports, prudent fiscal policies, resilient financial sector, and limited exposure to subprime mortgages and complex securitized products – is now under relative strain mostly because of its large exposure to neighboring Greece (now under recession) and the indecisiveness of the government to take fiscal measures.**

It is important to note that Cyprus was affected by the global crisis with a lag, as it entered into a shallow recession in early-2009, about a year after the euro area as a whole.

Prior to the crisis, rapid credit growth drove private sector indebtedness up and led to overheating. Above Euro area average real wage and price dynamics exacerbated external imbalances and the related loss in competitiveness and immediately required necessary adjustment in saving patterns will moderate growth going forward. Meanwhile, tax revenue buoyancy during the upturn, especially related to asset prices, proved cyclical and the fiscal position took a sharp turn for the worse since 2009.



Source: Eurostat

After experiencing average growth of 4.25% over 2004-2008, the economy contracted to negative growth, weighed down by a partial correction in the real estate market and a sharp decline in the tourism sector.

Private consumption growth, the main driver of the expansion in the recent past, evaporated, reflecting leveraged balance sheets, rising unemployment and slowing household credit growth. In the backdrop of weakening demand prospects and deteriorating financing conditions, fixed investment contracted sharply. The inventory cycle was particularly pronounced, as firms reacted with delay to the slowdown in trade partners' economies.

Nonetheless, the domestic correction was partially cushioned by a substantial fiscal relaxation and the reversal in the net export contribution; **the current account deficit moderated, although it remained high, at above 8 percent of GDP – indicating that the domestic savings are insufficient to finance domestic investments exposing the Country to shifts in the availability and conditions of capital inflows and thus creating vulnerability. Most importantly a current account deficit at this level signals losses**



in the international competitiveness of the Cyprus economy, related in particular to excessive increases of costs including unit labor costs triggering low growth and low employment.

Real wage growth, which had exhibited significant buoyancy since 2004, moderated insignificantly but remained above the Euro area levels as wage contracts did not incorporate the entire drop in inflation due to the backward looking inflation-indexed wage adjustment mechanism (Cost of Living Allowance or COLA).

COLA is strongly supported by the trade unions, and although falsely considered to having contributed to long-term contracts and labor market peace, it resulted in large increases in real wages and deterioration in competitiveness of domestic companies due to second round inflationary effects undermining flexibility and competitiveness as it impedes relative wage adjustments across companies and sectors in line with productivity differentials. **The COLA also imparts inertia to the public sector wage bill, making it more difficult to reverse the excessive growth of public sector wages and salaries. If you add this to a policy (embraced by the governmental and semi-governmental sectors and most financial institutions) that is not based on merit and performance, where people get jobs for life despite their performance, and where trade unions (that are influential and pampered by each and every government in power because of political cost and own benefits) influence management decisions... then you have a formula of self-destruction!**

By linking wages to the Consumer Price Index (CPI) rather than productivity, COLA undermines competitiveness and labor flexibility, in addition to exacerbating the level and persistence of price shocks. Moreover, downward wages stickiness resulting from the COLA may become an impediment to the economy's ability to respond to the current low-growth environment. In particular, in the presence of long-duration wage contracts the COLA constrains the markets' ability to correct an overshooting of wages that may result from too optimistic an outlook at the time of the contract's inception.

Although access to domestic funding sources could become more difficult if risks to the financial sector from exposure to Greek assets and to the local real estate market materialize, the risk of imminent financing pressures appears contained for the banking industry. Despite recent decline in profitability, return on equity remains high compared to other Euro area banking sectors and liquidity ratios appear comfortable. Defensively, to their credit, banks lowered dividend payout ratios, cut operational costs, strengthened non-interest margins, and bolstered fee-based activities to support net income; increased loan loss provisions and tightened underwriting standards; and have been able to attract deposits from Greece owing amongst other to perceived safety of the banking system. Additionally, the Cyprus government has facilitated the securing of cheap funding of about €4.0 billion worth of bonds during 2010 (equivalent to about 22% of GDP).

The social security system surplus is currently about 4% of GDP as contributions by employers, workers and the government, exceed outlays. **Over the next three to four decades pension outlays are projected to rise by some 10 percentage points as the system matures and demographic changes play out. Unless other area of government spending is curtailed, this would raise total government spending to more than 50% of GDP – a very high level that could be sustained only with a heavy increase in the tax burden.** A lasting solution requires bringing outlays more in line with contributions, through lower replacement rates and higher retirement age.

Recent studies imply that the size of the black economy in Cyprus cannot be more than 8.5%, one of the lowest in the EU. Given the high tax free income in Cyprus (and the skewness of income distribution) the majority of workers are below the income tax threshold. A high tax free income can help not only to reduce tax evasion directly but to also limit the potential tax evaders amongst higher earners. Adoption of such policy will even make tax compliance measures less costly to implement. **There has been plenty debate lately about tax evasion instead one of finding ways of how tax revenues should be best managed and best directed towards the ever much needed public services improvements.**



Opinion: Every day that goes by without the Cypriot government taking action is disastrous, tarnishing the reputation that Cyprus enjoyed for more than two decades (and worked for so hard) as a solid, reputable business hub and financial center!

The way forward is relatively easy, relatively painless and simple. The benefits are huge, benefits that with some sacrifices will be enjoyed by current and future generations, if only a spirit of collectiveness, pride and transparency is adopted. Cyprus is given now the opportunity and probably a last chance to eliminate "cancerous" practices that have accumulated over the years.

The main policy priorities should be to stabilize public debt at a more prudent level and boost competitiveness, while safeguarding the stability of the financial sector.

The banking, tourism and real estate industries have to be reinforced in each and every possible way! Corporate and personal income taxes have to remain intact. Incentives, especially for foreign investors but also for private local ones have to multiply. Prudential controls towards cooperative credit societies should become stricter. Procedures within the governmental machine at every level have to be streamlined and become more responsive. Income tax evasion should be handled but should not become a "psychosis" by establishing complex legislation and inspection – if procedures do not remain as simple as possible they will scare off investment and eliminate the entrepreneurial spirit that resurrected this country after the Turkish invasion of 1974. Double tax treaties with more countries are a priority and should be dealt as such. Trade unions should adopt an open-minded policy. The pension fund has to be restructured. More decisive steps need to be taken to eliminate delays related to the issuance of title deeds. Building coefficients in selected areas have to increase. Hospitality and tourism have to be upgraded. International hotel chains should be targeted and "invited". Architectural monstrosity should be eliminated. Architectural uniformity in all areas has to become a way of life. Tradition and heritage has to be protected and better projected. Creation and ingenious vision has to be cultivated. But above all and as a first step, populist like and bigoted demagogic methods embraced by most political parties and trade unions alike, making use of popular prejudices and promises in order to gain power (remain in power), preying people's fears have to stop!

Rumors and proposals for a temporary or permanent hike in the corporate income tax rate, even by a fraction, are disastrous! Rumors and proposals for higher property taxes are disastrous! Rumors and proposals for burdening the banking sector with any form of taxation is disastrous! The current high interest rate regime is disastrous! Rumors and proposals for lifting bank confidentiality to spot tax evaders is disastrous! The temporary reduction in tourism sector VAT rates if not extended is disastrous!

The relatively large size of the public sector, the gradual increase of pension outlays as the system matures and the population ages, and the need to maintain a favorable tax regime to attract investment all argue for a focus on expenditure measures – given the dominant share of government wages and salaries and social transfers in the budget, these sectors will need to absorb the bulk of adjustment. Options that should be pursued include adjustments to the incremental salary step increase schedule and to the COLA for public workers; the introduction of contributions by government employees toward their unfunded pension benefits; reducing lower priority capital expenditure and restraint on other goods and services. Specifically,

1. Freeze COLA for at least 2011, 2012 and 2013.
2. Freeze salary increments for 2011 and 2012.
3. Increase government employees contribution to pension fund to 4% in 2011 and 5% in 2012.
4. Increase VAT from 15% (the lowest in the EU) to 19% (will still remain one of the lowest in the EU).
5. Impose a marginal excise tax on petroleum imports for 2011 and 2012.
6. Impose additional taxes on tobacco imports.

Above measures and considerations if incorporated will transform Cyprus into a dominant financial center and business hub that will provide along with the discovery of oil and gas in the island's seabed a tremendous boost to the economy – more jobs, more FDIs, better standard of living, prosperity for generations to come...



See also:

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The Cyprus real property market contracted...
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Sources

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INBNEWS
Financial Times
Economist Intelligence Unit

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