The impact of the economic crisis upon Cyprus

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The paper tackles the economic context in which Cyprus finds itself for the time being. Cyprus represented one of the dreams come true for businessman and investors all over the world. Investors were attracted by the low corporate tax rate in amount of 10% in comparison to the other European member states. Among other attraction were the well-educated labour force, the highly developed infrastructure and high quality financial, business and other services.

Keywords: GDP, corporate tax, bonds, win-win situation, curb tax evasion

Overview upon Cyprus Economy

The area of the Republic of Cyprus under government control has a market economy dominated by the service sector, which accounts for four-fifths of GDP.

In Cyprus tourism, financial services and real estate are the most important sectors. Erratic growth rates over the past decade reflect the economy's reliance on tourism, the profitability of which can fluctuate with political instability in the region and economic conditions in Western Europe.

Economic Crisis in Cyprus

Nevertheless, the economy in the area under government control has grown at a rate well above the EU average since 2000. Cyprus joined the European Exchange Rate Mechanism (ERM2) in May 2005 and adopted the euro as its national currency on 1 January 2008. An aggressive austerity program in the preceding years, aimed at paving the way for the euro, helped turn a soaring fiscal deficit (6.3% in 2003) into a surplus of 1.2% in 2008, and reduced inflation to 4.7%. This prosperity came under pressure in 2009, as construction and tourism slowed in the face of reduced foreign demand triggered by the ongoing global financial crisis. Although Cyprus lagged behind its EU peers in showing signs of stress from the global crisis, the economy tipped into recession in 2009, contracting by 1.7%, and has been slow to bounce back since, posting anemic growth between 2010 and 2011 before contracting again by 2.3% in 2012. Serious problems surfaced in the Cypriot financial sector in early 2011 as the Greek fiscal crisis and euro zone debt crisis deepened. Cyprus's borrowing costs have risen steadily because of its exposure to Greek debt.

Two of Cyprus's biggest banks are among the largest holders of Greek bonds in Europe and have a substantial presence in Greece through bank branches and subsidiaries. Cyprus experienced numerous downgrades of its credit rating in 2012 and has been cut off from international money markets. The Cypriot economy contracted in 2012 following the write-down of Greek bonds. A liquidity squeeze is choking the financial sector and the real economy as many global investors are uncertain the Cypriot economy can weather the EU crisis. The budget deficit rose to 7.4% of GDP in 2011, a violation of the EU's budget deficit criteria - no more than 3% of GDP.

In response to the country's deteriorating finances and serious risk of contagion from the Greek debt crisis, Nicosia implemented measures to cut the cost of the
The impact of the economic crisis upon Cyprus

In July, Nicosia became the fifth eurozone government to request an economic bailout program from the European Commission, the European Central Bank, and the International Monetary Fund - known collectively as the "Troika". Negotiations over the final details of the plan are ongoing.

The following table shows Cyprus's GDP in the last 3 years.

<table>
<thead>
<tr>
<th>Table 1: GDP in Cyprus in 2010, 2011, 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP (purchasing power parity)</strong></td>
</tr>
<tr>
<td>------------------------------------------</td>
</tr>
<tr>
<td>$23.99 billion</td>
</tr>
</tbody>
</table>

Data processed by author

The year of 2011 registered the highest peak in what concerns the purchasing power parity.

<table>
<thead>
<tr>
<th>Table 2: Real GDP growth rates in 2010, 2011 and 2012</th>
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</thead>
<tbody>
<tr>
<td><strong>GDP - real growth rate</strong></td>
</tr>
<tr>
<td>------------------------------------------------------</td>
</tr>
<tr>
<td>1.1%</td>
</tr>
</tbody>
</table>

Data processed by author

The GDP of Cyprus recorded a decrease, in 2011 the indicator decreased by 50%, in comparison to the previous year, following in 2012 to record negative values. The negative outlook on the long-term foreign currency reflects the following risk factors that may, individually or collectively, result in further pressure on the ratings:

- implementation risk for the programme is high. The deep recession and sharply rising unemployment will make it more difficult to implement fiscal consolidation plans. Significant slippage from future programme targets, in particular fiscal deficits, would undermine the rating.
- the recession could be materially deeper and last longer than assumed under the EU/IMF programme as has been the experience of other programme countries in the Eurozone. This would have direct and indirect consequences for the Cypriot debt dynamics.
- intensification of the banking crisis in Cyprus. There is a still high risk of capital flight from banks if capital controls are lifted prematurely, exacerbating the domestic credit contraction even assuming liquidity support from the ECB.

<table>
<thead>
<tr>
<th>Table 3: Capital per GDP in 2010, 2011, 2012</th>
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</thead>
<tbody>
<tr>
<td><strong>GDP - per capital</strong></td>
</tr>
<tr>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>$28,600</td>
</tr>
</tbody>
</table>

Data processed by author

The GDP per capital has registered no major fluctuations. The decrease tendency is present here also, due to the fact that the GDP per capital takes into account the market value.

*Note: all data are in 2012 US dollars*
The impact of the economic crisis upon Cyprus

Table 4: GDP and labor force by sector

<table>
<thead>
<tr>
<th>GDP - composition by sector</th>
<th>Agriculture</th>
<th>Industry</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.4%</td>
<td>16.7%</td>
<td>80.9%</td>
</tr>
<tr>
<td>Labor force by occupation</td>
<td>8.5%</td>
<td>20.5%</td>
<td>71%</td>
</tr>
</tbody>
</table>

Data processed by author

Figure 1

The labor force was estimated at 416,900 in 2012.

The estimated unemployment rate increased at 8% in 2012, from 7.9% that was registered in 2011.

The major concern of the government is to do everything possible, with everyone's cooperation, to try to avoid any problem with the payment of salaries and pensions, during the context of the crisis.
Excluded from international markets, Cyprus applied in June 2012 for financial assistance, after its two largest banks sought state aid, following massive write downs of their Greek bond holdings amounting to €4.5 billion or 25% of the island’s GDP, as a result of the Greek sovereign debt haircut.

The government concluded a deal with the Troika of international lenders, which needs to be ratified by national parliaments and the Euro group. The Euro group reached an agreement with the Cypriot authorities on the key elements necessary for the macroeconomic adjustment programme.

The island’s second largest bank, Cyprus Popular Bank (Laiki), splits into a "good" and a "bad" bank. The bank’s "good" assets are being transferred to the Bank of Cyprus, where a massive haircut is being imposed on uninsured deposits of more than €100,000.

On their side of the island, Greek Cypriots are facing a future of economic hardship under new austerity measures demanded by international creditors who bailed the Mediterranean island out of a paralyzing banking crisis earlier this year.

However, the financial troubles may have a silver lining: hope that Cyprus’s scramble for economic lifelines will encourage a new effort to unite North and South for their common benefit.

Members of the international community have been making that case in recent times. The reunification of the island would give a major boost to the economic and social development of Cyprus.

The new realities — good and bad — offer an opportunity to move forward on the long-term solution for Cyprus. This is seen from an optimistic point of view. Others warn that bickering over who owns undersea natural gas deposits could propel the two sides back to the brink of war.

Turkey first sent troops to Cyprus in July 1974 after Greece’s military rulers botched an attempt to mastermind a coup by Greek Cypriots and fold the island into Greece.

The plotters and their Greek backers withdrew after they found themselves overwhelmed by the Turkish forces, leaving behind a divided island.

On-again-off-again peace talks, a referendum on reunification and easing border restrictions have failed to reconcile both sides.

The 40 percent of the island that constitutes Northern Cyprus remains recognized only by Turkey. Some 210,000 people are displaced on both sides of the border.

While Northern Cyprus languished in international isolation in the years following the split, Greek Cypriots aggressively promoted tourism and offshore banking. That fueled a decades-long economic boom that crashed after the banks racked up unmanageable debt.

Now Cyprus is scrambling to develop a plan to manage a bleak future as the growth forecast tumbles and unemployment soars. The EU and International Monetary Fund have pledged $13 billion to stave off bankruptcy, but Cyprus must come up with $17 billion itself.

Winding down its two biggest banks is expected to raise nearly $14 billion, and the central bank is considering selling some of its gold reserves.

Northern Cyprus has remained off the official agenda so far. This kind of deal would create not only a larger market and a boom in tourism, but also the potential for exploiting the recent gas finds.

An estimated 7 trillion cubic feet lies in the Aphrodite field off the island’s south coast, neighboring Israeli waters where similar finds are expected to provide Israel with billions. Although many Greek Cypriots are pinning hopes for future prosperity on gas, Northern Cyprus also claims rights to the waters.

In March, when it was announced that Cyprus would put the reserves on the table as part of its bailout negotiations, Turkey warned the move was a dangerous manifestation of the illusion of being the sole owner of the island, which may lead to a new crisis in the region. But there are indications that Ankara may be putting forward a solution. A way of solving the Cyprus problem could be represented by the together cooperates on the gas. The largest problem for developing the Aphrodite field is getting its gas to market. One practical option, a pipeline to Turkey, is perceived as
inconceivable, without solving the Cyprus problem.

The problem could be solved in a win-win situation for everyone — if it’s done smart.

There are many different options on the table ranging from complete unification to friendly cohabitation. However, any solution would require serious political will to overcome deep wounds.

References