

Research on Money and Finance

Occasional Policy Papers

The Cypriot Economy: Living on Savings?

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1. The prospects for Cyprus in 2014: An unbalanced economy and households in deep trouble

A characteristic feature of the Cypriot economy in recent years has been the slow but steady squeeze on households since 2008, the year of euro adoption as well as the year that the global economic crisis began to buffet the island. Since 2008 a series of events have led the Cypriot economy to become steadily more unbalanced and indeed very fragile. The advent of the Troika in 2013 was the culmination of great instability. The programme of the Troika, however, has been severely criticised and there are grave doubts regarding the future of Cyprus, if it continues along Troika lines. Fortunately, in 2013 the economy shrank slightly less catastrophically than the IMF had predicted, but it is hard to see where support will come from in 2014.

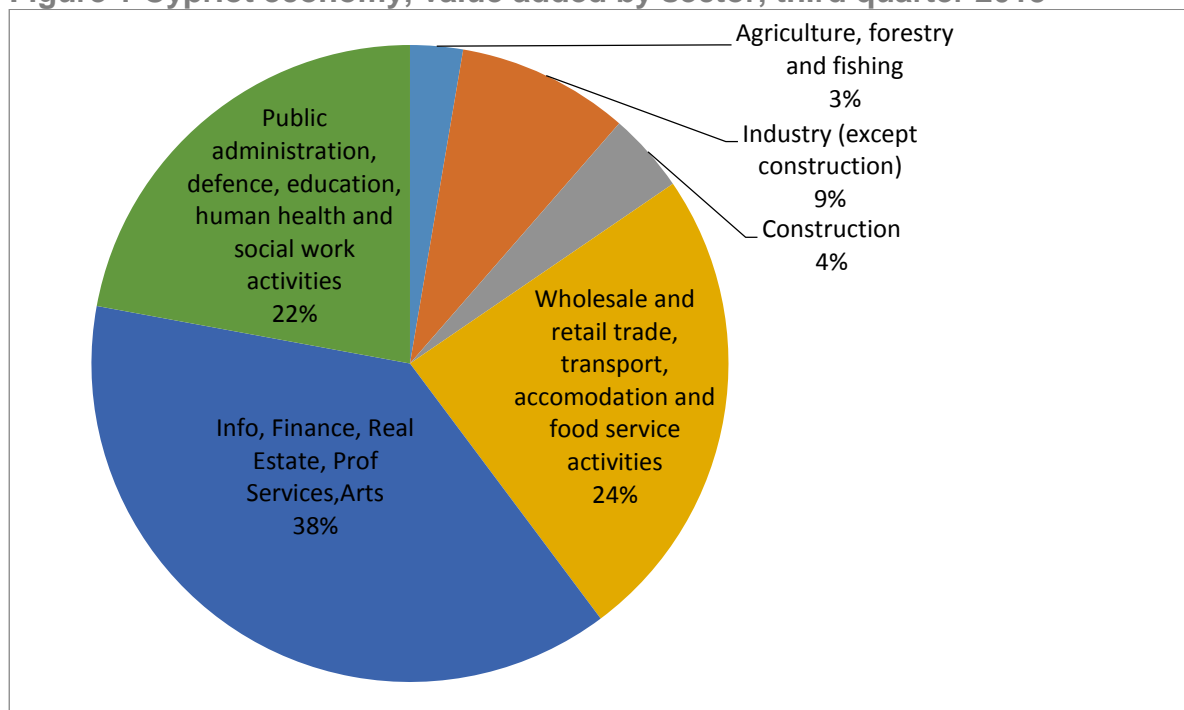
This OPP examines the economy from different perspectives to reveal increasing fragility since 2008 and, above all, the steady squeeze on Cypriot households.

- i. Looking, first, at value added by sector reveals a construction boom in the 2000s which turned to bust in 2008. Further investigation reveals that this was largely driven by overseas property sales which were badly affected by the global crisis of 2008. Property prices have been falling since 2008, even as bank mortgage lending rose.
- ii. Turning to employment, employee compensation and consumption it can be seen that the construction bust affected employment but was somewhat counterbalanced by increasing jobs in services. This came to an end in 2011, however, at which point employee compensation started to fall, even as profits manage to rise for a while longer. Shortly afterwards households consumption also began to fall.
- iii. Examination of the current account shows that the construction bust and the fall in domestic consumption acted to reduce the imports of goods, and hence lowered the current account deficit since 2008. Service exports as a whole have remained relatively stable in the 2000s but have undergone dramatic changes in composition. Exports of all services are now falling with the exception of “travel” which will soon be the largest service export of Cyprus.

iv. Finally considering in more detail the performance of the economy in 2013, it transpires that the financial position of households, non-financial firms and the government has been deteriorating since the outbreak of the global crisis in 2008. Household consumption has suffered and the negative impact has been exacerbated by the adoption of the Troika programme. During the first half of 2013 the drop in household consumption was ameliorated by households drawing down their savings. However, this pattern changed in the second half of the year as households withdrew less from their savings. The effect on consumption has been noticeable and the fall accelerated as the year went on. Finally while the financial position of financial firms appears at first sight to have improved, given the economic backdrop and their continued lending to a weakening economy, it is reasonable to surmise that their balance sheets are increasingly fragile.

These developments have exacerbated the squeeze on households in the context of an extremely unbalanced economy, shown in figure 1. The country is now extremely dependent on services (financial, real estate professional/scientific/technical) as well as tourism; while the primary and secondary sectors (agriculture, forestry, fishing, manufacturing and construction) make up only 16% of GDP.

Figure 1 Cypriot economy, value added by sector, third quarter 2013



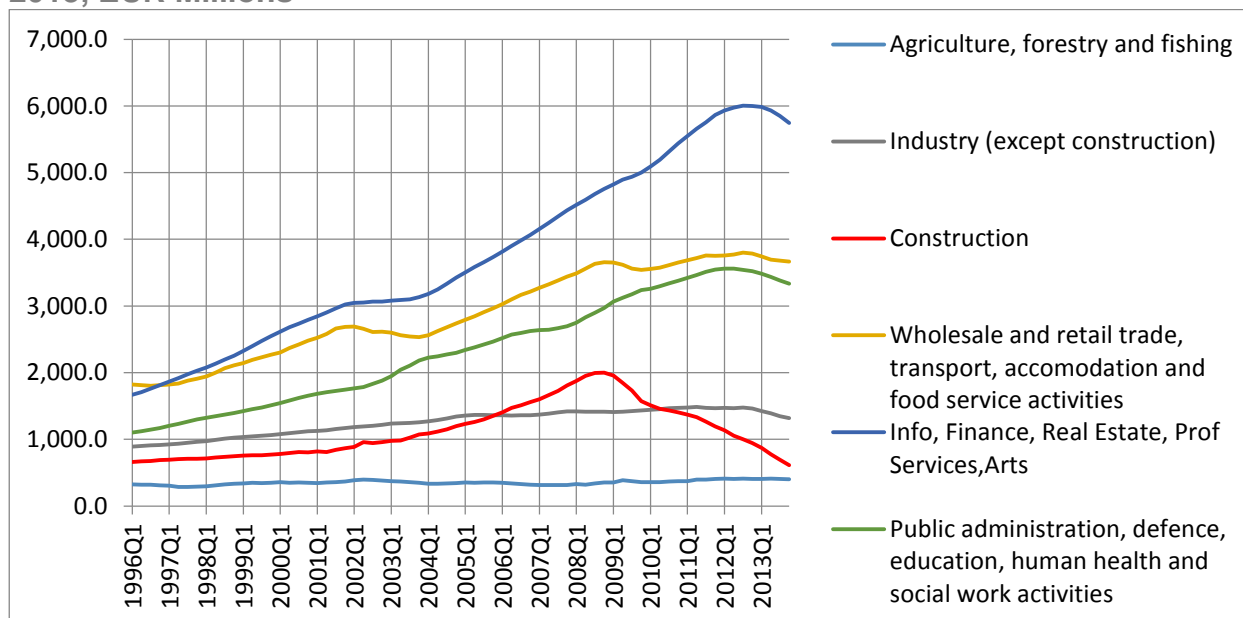
Source: Eurostat

A profoundly unbalanced economy with households in deep difficulties offers little encouragement for the future. If household savings are no longer capable of supporting consumption - and thus the economy as a whole - where can Cyprus turn to boost demand? Rising investment is an unlikely avenue, particularly as non-financial firms are also reducing their savings and bank lending remains deeply problematic as banks deleverage and face up to weak balance sheets. To cap it all, austerity imposed by the Troika continues to cut public spending, thus undermining that element of aggregate of demand. In short it is hard to be optimistic for 2014. It is likely that the Cypriot economy will remain in deep and persistent recession under Troika policies. To avoid this fate the country urgently needs a different set of policies.

2.The boom of the 2000s and its bust in 2008.

Examining different sectors of the Cypriot economy figure 2 shows that the most important feature of the behaviour of the Cypriot economy in the 2000s was a boom and bust in construction. Construction grew rapidly in the 2000s until 2008, when an even faster decline began, one that continues.

Figure 2 – Cyprus economy; value added by 6 sectors (sum of 4 last quarters), 1996-2013, EUR Millions

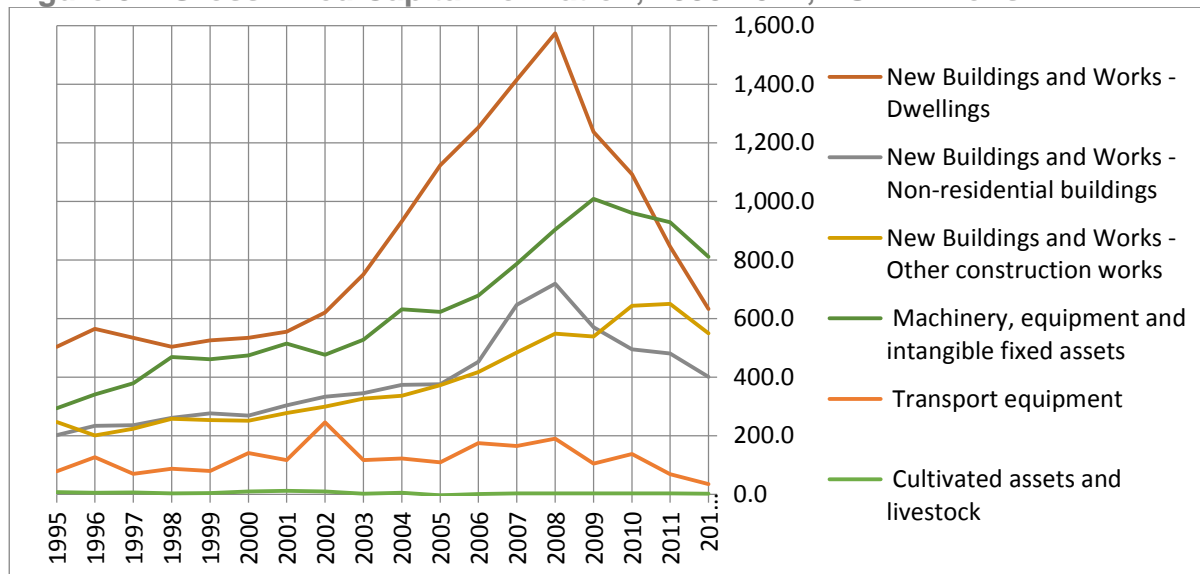


Source: Eurostat

Further insight into the construction bubble and the behaviour of the real sector can be gained by examining the components of gross fixed capital formation. Figure 3 shows that

building investment (New Buildings and Works – Dwellings) underwent a sharp boom prior to 2008 followed by an equally sharp bust thereafter.

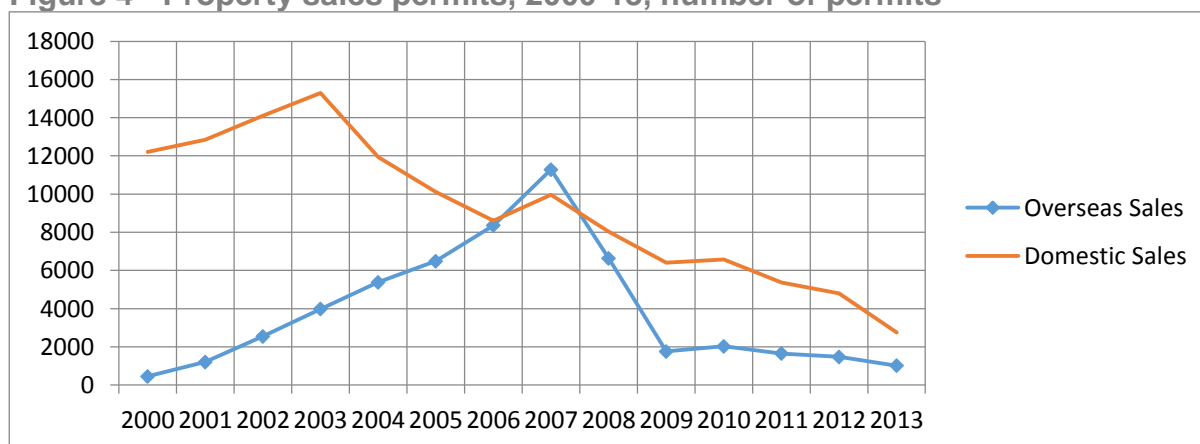
Figure 3 – Gross Fixed Capital Formation, 1995-2012, EUR millions



Source: Eurostat.

The collapse in building investment was probably linked to a sharp fall in property sales to foreigners, as is shown in Figure 4 – itself most likely associated with the global financial crisis. Collapse of real estate sales to foreigners was eventually followed by a significant decline of sales to domestic buyers. The overall decline in real estate sales set the terrain for the emergence of crisis conditions in the financial sector, which have eventually led to a deep recession in the economy generally.

Figure 4 - Property sales permits, 2000-13, number of permits



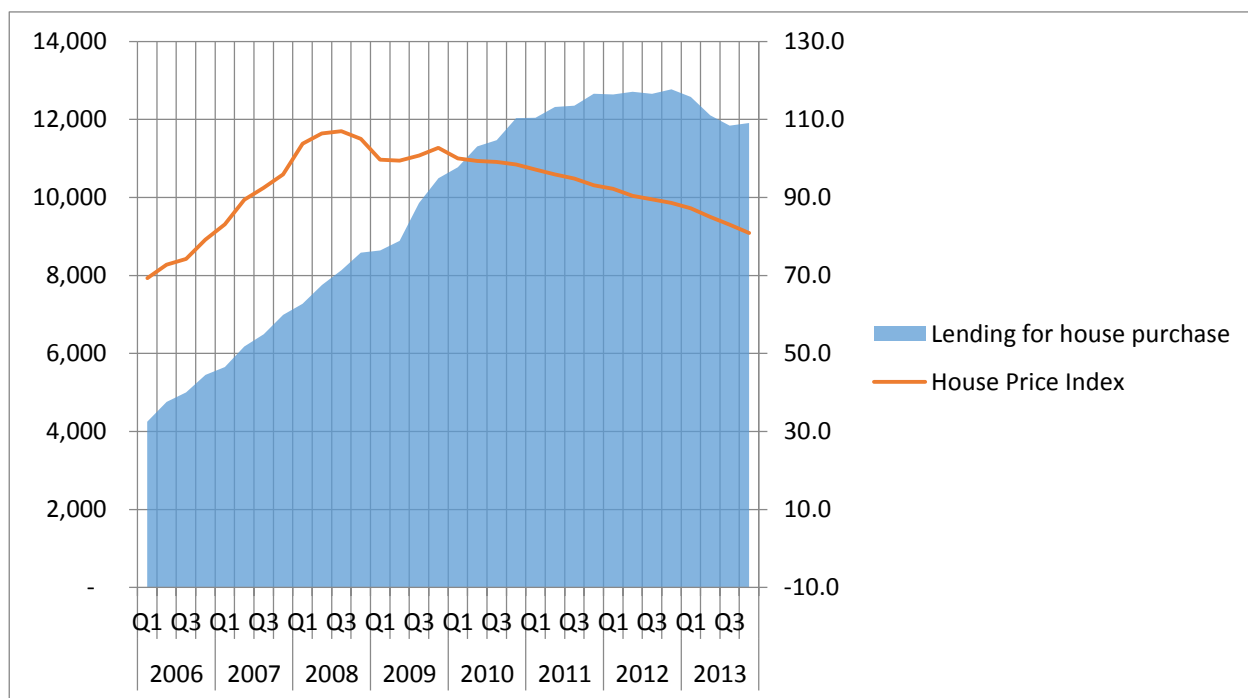
Source: www.new.cyprus-property-buyers.com¹

¹ [Available here: <http://www.news.cyprus-property-buyers.com/2014/01/09/cyprus-property-sales-record-low/id=0016577>]

The succession of boom and bust in the construction and real estate sectors can also be seen in terms of residential house prices. Figure 5 shows the rapid rise in the Central Bank of Cyprus house price index; a high point was reached in 2008 followed by small falls and effective stagnation until the end of 2009. House prices declined steadily after that. The rise and fall of house prices has been an important element in inducing the emergence of financial crisis as well as contributing to the current parlous condition of financial institutions.

Figure 5 also shows that Cypriot banks' balance of "lending for house purchase" continued to rise even after house prices started to fall; the increase in lending simply slowed down in 2010-11 and balances only began to decline in late 2012. In yet another instance of poor judgement, Cypriot banks appear to have expanded their mortgage lending even as falling house prices were actually worsening the quality of housing loans on their balance sheets. Worsening asset quality for banks is the backdrop for the liquidity problems of late 2012 and early 2013.

Figure 5 – Residential house price index and Cypriot bank 'lending for house purchase' (EUR millions), 2006-2013

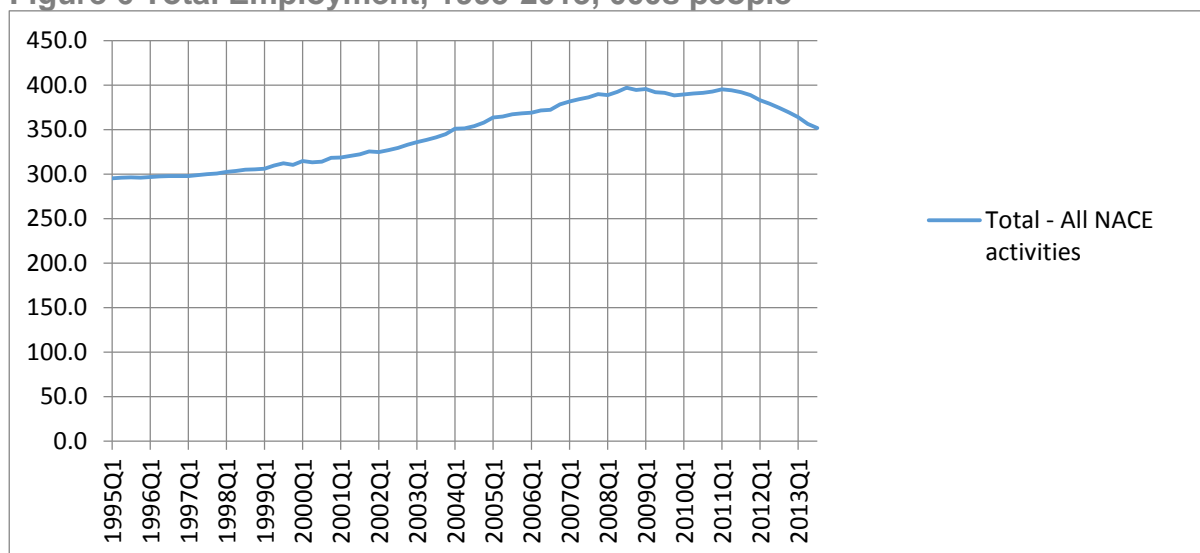


Source: Central Bank of Cyprus and ECB

3. A closer look at employee compensation and employment

The boom of the 2000s and the bust that followed after 2008 – based on construction and real estate – is fully apparent in employment and employee compensation data. Figure 6 shows that total employment rose through the 2000s until 2008; total employment initially dipped after 2008, it then recovered but began to fall steadily after mid-2011.

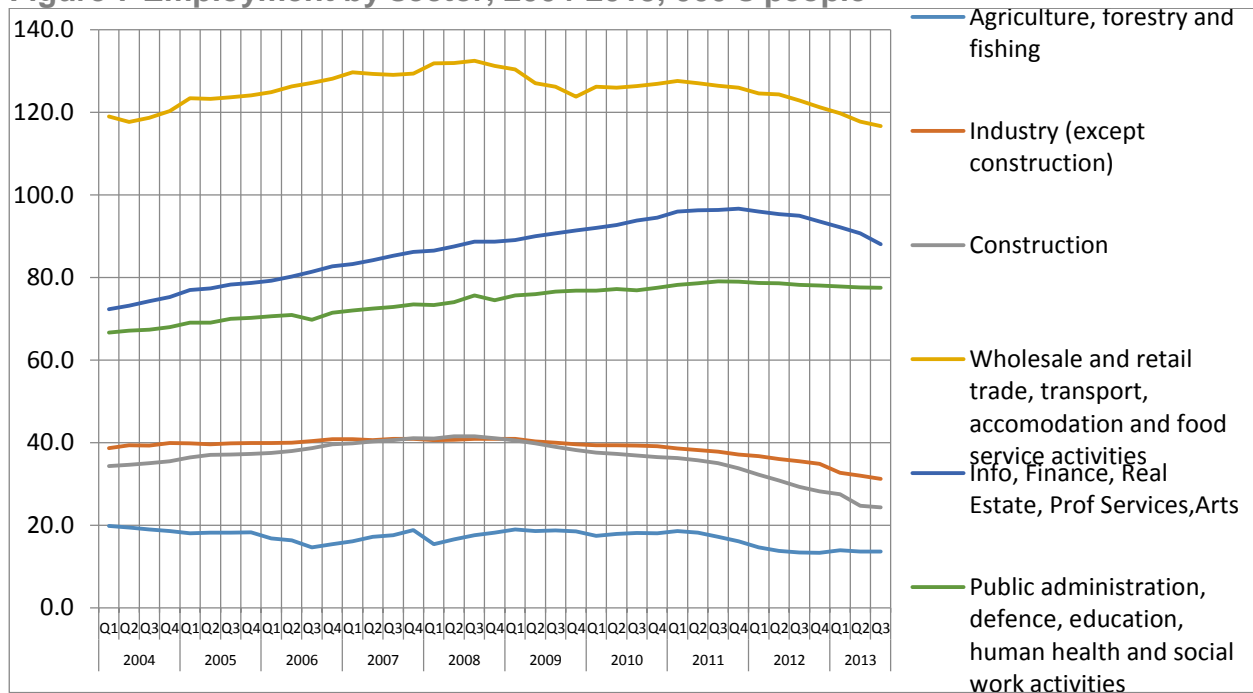
Figure 6 Total Employment, 1995-2013, 000s people



Source: Eurostat

Figure 7 splits employment into the 6 sectors that were used in Figures 1 and 2. It can thus be seen that employment began to fall from 2008 onwards primarily in three sectors: construction, industry and ‘Wholesale and retail trade, transport, accommodation and food service activities’ – which includes the bulk of the tourism. To some extent this decline was offset by rising employment in public administration and in finance, real estate, information, communication and other services between 2008 and 2011. In 2011, however, employment in public administration and the service sectors also began to fall. Agriculture, forestry and fishing which otherwise remained reasonably steady throughout the period - and which contributes fewer than 20,000 jobs - also fell noticeably in late 2011.

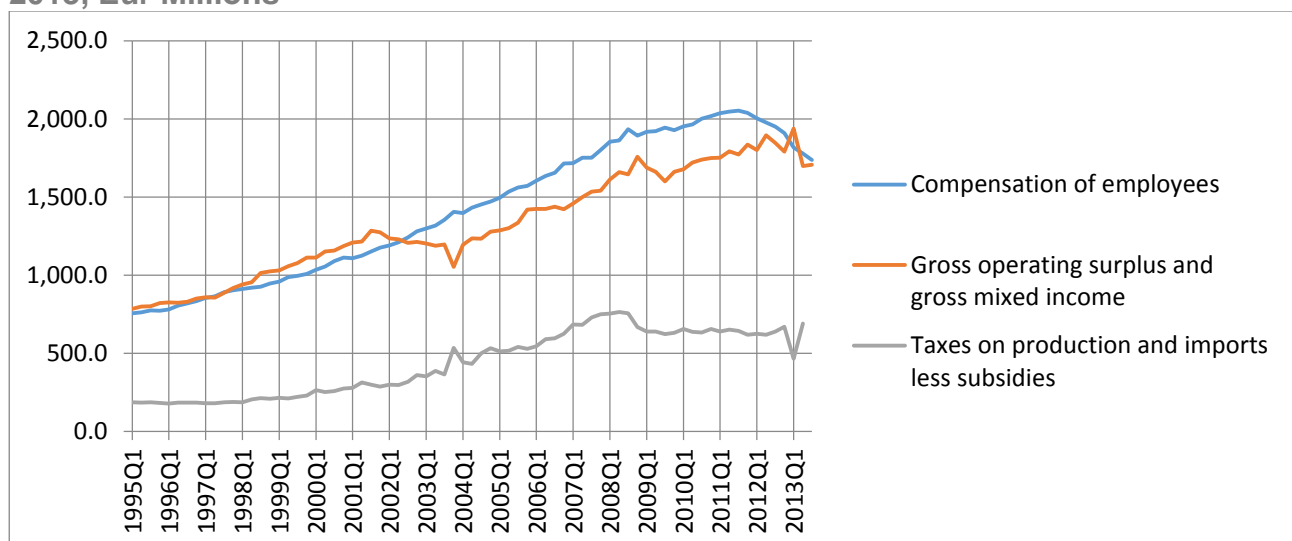
Figure 7 Employment by sector, 2004-2013, 000's people



Source: Eurostat

The fall in employment in 2011 is associated with a dramatic reversal in employee compensation. Figure 8 splits GDP into: i) compensation of employees, ii) operating surplus and iii) taxes and subsidies. It is clear the compensation of employees rose steadily until the third quarter of 2011, at which point it underwent a sharp turnaround and has continued to fall since then. However, gross operating surplus continued to rise, as profitability was maintained, until it fell at the end of 2012 – when the Cypriot financial crisis entered its most acute phase.

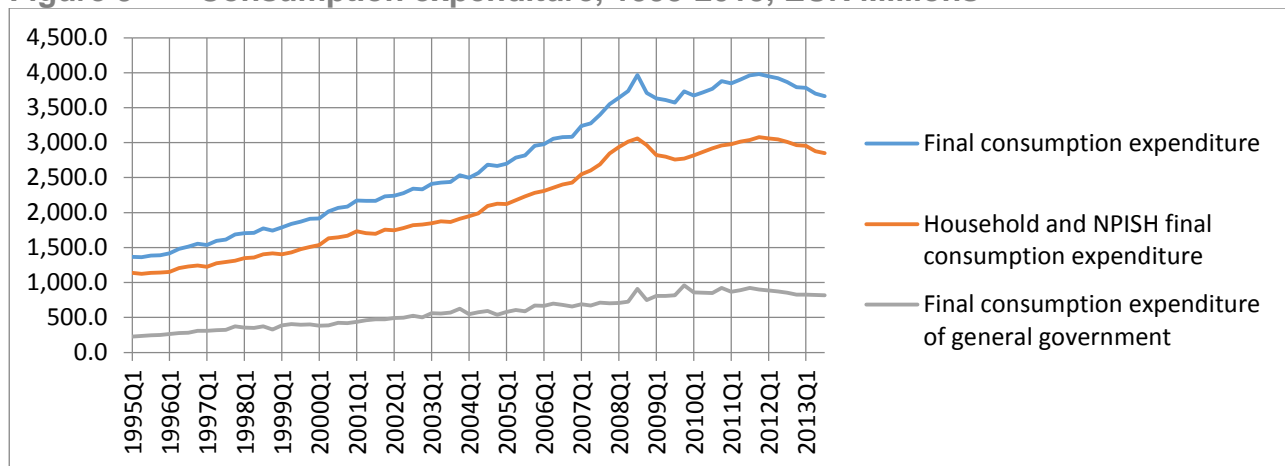
Figure 8 Employee compensation, operating surplus and taxes/subsidies, 1995-2013, Eur Millions



Source: Eurostat

The fall in employee compensation from around mid-2011 is - unsurprisingly - associated with a fall in household expenditure towards the end of 2011. As will be seen below, the financial position of households deteriorated in 2011, presumably as they held off cutting consumption through a variety of measures including borrowing and drawing down savings.

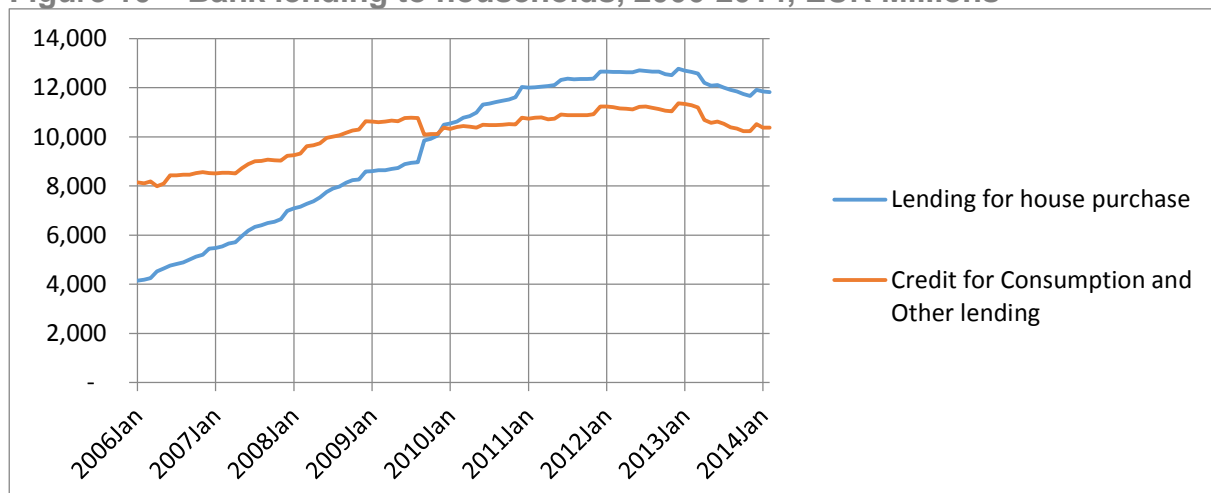
Figure 9 Consumption expenditure, 1995-2013, EUR Millions



Source: Eurostat

Once again it is worth noting the poor judgement of Cypriot banks, which continued to lend heavily to households, especially for housing, against the backdrop of falling employment and declining employee compensation. Figure 10 shows that even consumption and other credit, not to mention ‘lending for house purchase’ (as was also shown in Figure 5 above) continued to rise until January 2013. The profound solvency problems of Cypriot banks can partly be understood in the context of a continued expansion of credit to households even as the economy weakened.

Figure 10 – Bank lending to households, 2006-2014, EUR Millions

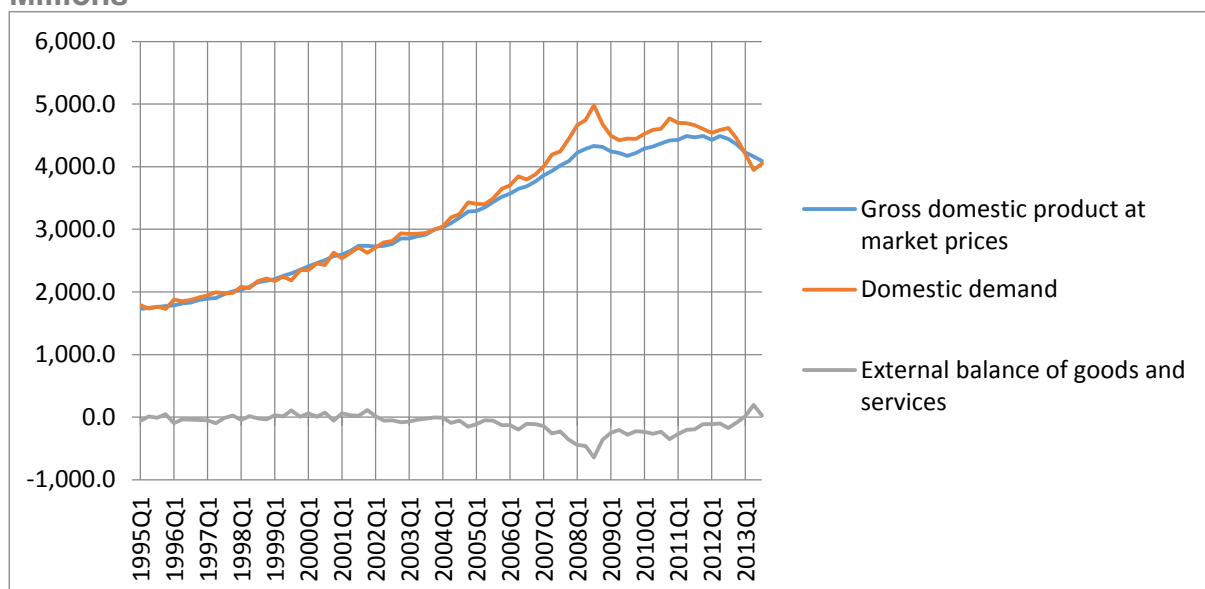


Source: ECB

4. The external balance of the Cypriot economy

Boom and bust in the construction and real estate sectors in the 2000s as well as the falls in employment and employee compensation from 2011 onwards are also reflected in the national accounts, particularly if GDP is split into domestic demand and external balance of goods and services, as in Figure 11. Domestic demand peaked in 2008, at which point Cyprus had a large external deficit. The boom led to heavy imports of goods, partly for the construction sector and partly as consumption rose. The bust, in contrast, has improved the external balance substantially as investment has collapsed and, from 2011, consumption has also suffered.

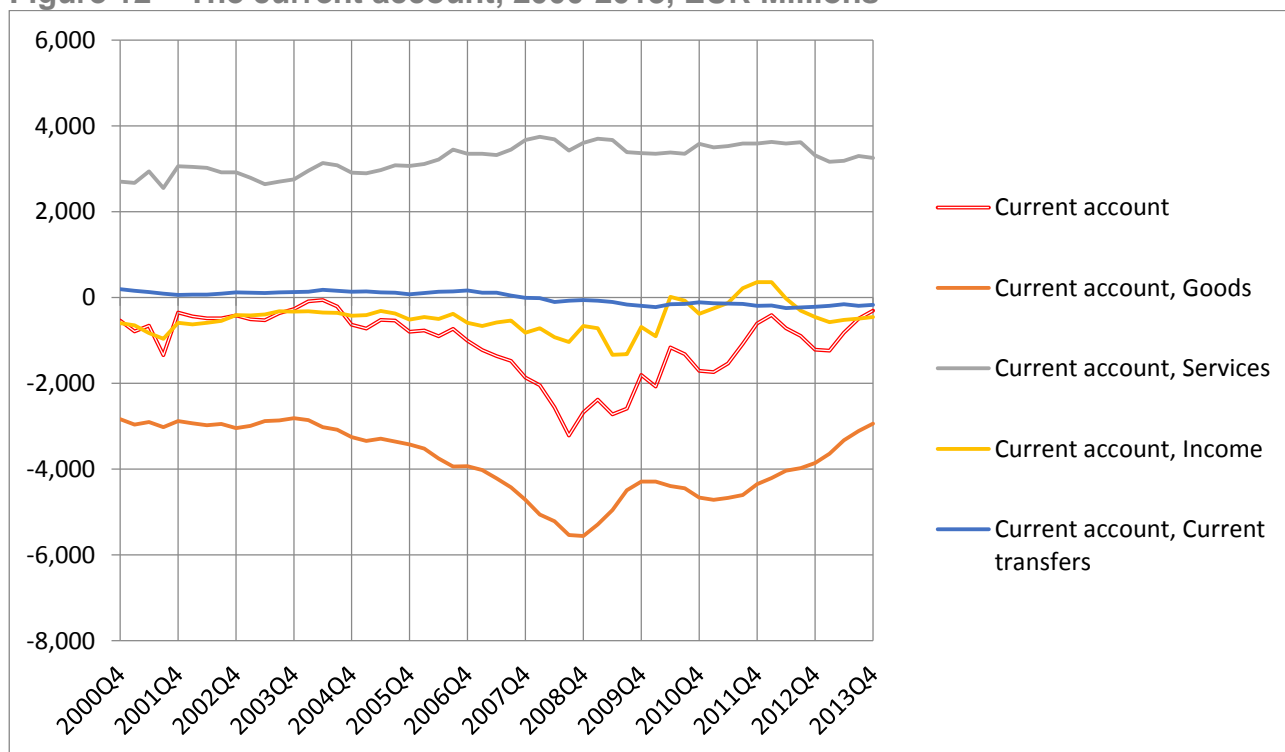
Figure 11 GDP split into domestic demand and external balance, 1995-2013, EUR Millions



Source: Eurostat

By breaking down the current account in Figure 12 it can be seen that Cyprus has a current account goods deficit, paid for in part by the export of services. The current account goods deficit peaked in 2008 when construction demand and domestic demand were at their highest; the goods deficit declined rapidly as the construction boom turned to bust, and contracted steadily after 2011, when domestic employment, employee compensation and consumption began to fall.

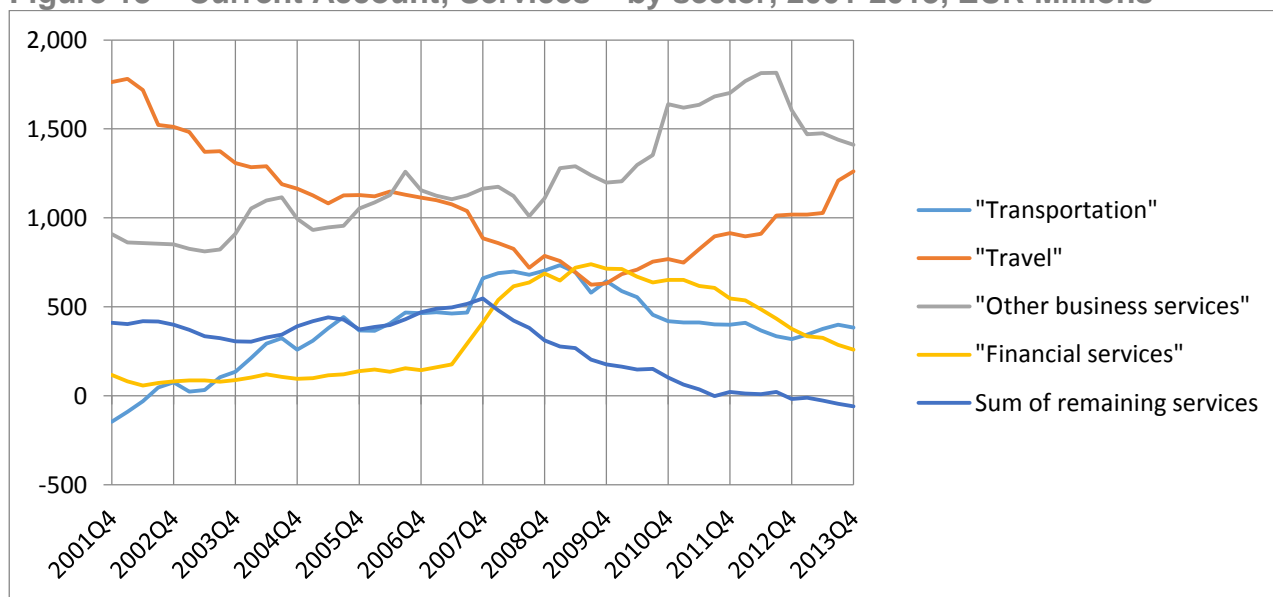
Figure 12 – The current account, 2000-2013, EUR Millions



Source: Eurostat

Note that, throughout this period, the export of services has been reasonably stable. However, a closer look reveals that the apparently steady trajectory in the 2000s masked changes in composition. A range of minor export services (‘sum of remaining services’ shown in Figure 13 below) began to fall in 2007, joined by financial services and transportation in 2009. These falls were compensated by rises in the export of “travel” and “other business services”. Yet, even “other business services” started to fall dramatically in late 2012 as the Cypriot crisis entered its most acute period. Service exports by Cyprus have, consequently, become ever more reliant on “travel” exports – which look set to become the largest export service sector.

Figure 13 – Current Account; Services – by sector, 2001-2013, EUR Millions



Source: Eurostat

5. Economic performance in 2013 – the end of savings?

Where do these changes leave the Cypriot economy today? Several clues can be gleaned by looking more closely at consumption in 2013 and at the country’s financial position, and in particular that of households.

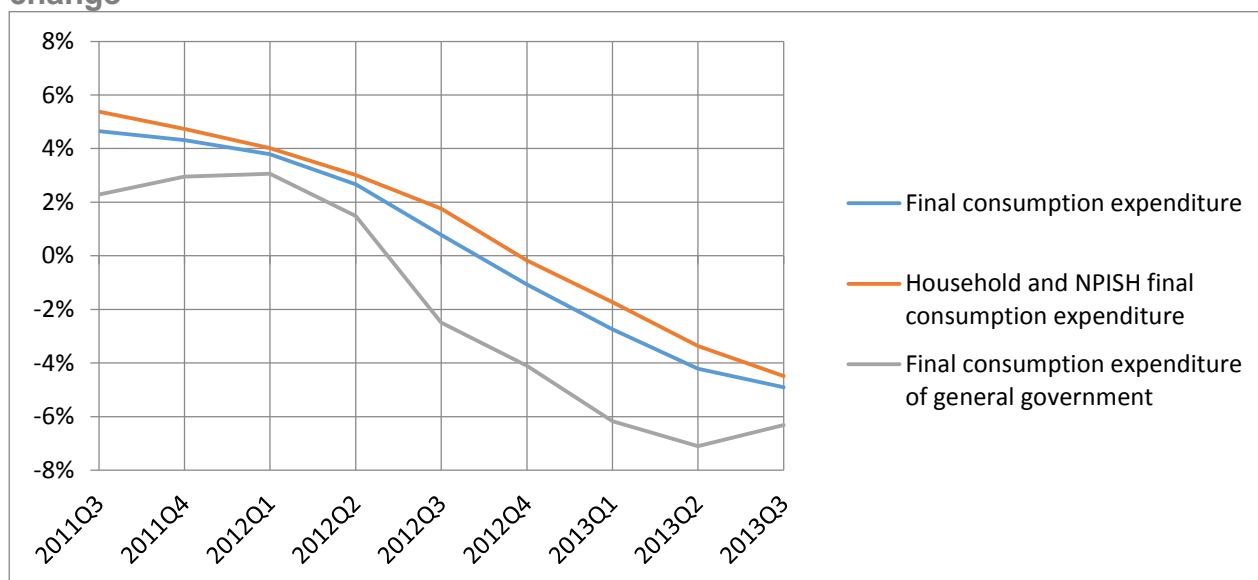
When the Troika programme was adopted, the IMF forecast a fall in annual GDP of -7.7% for in 2013. However, according to their latest estimations, it would appear that the economy will “only” shrink by 6% on this measure.² One reason for this development is that tourism has remained relatively robust, as was shown in Figure 2. The steadiness of tourism’s contribution to GDP cannot be taken for granted, of course. More important than tourism in explaining the performance of GDP in 2013, however, has been the behaviour of household consumption.

Figure 14 shows aggregate consumption growth since the third quarter of 2011 and indicates that government consumption fell by at least 6% in each of the first three quarters of

² IMF, *Cyprus: Third review under the extended arrangement under the extended facility and request for modification of performance criteria*, page 4-5. Available here: <http://www.imf.org/external/pubs/ft/scr/2014/cr1492.pdf>

2013. However, household consumption, which is by far the largest element of aggregate consumption, fell by only 1.7%, 3.4% and 4.5% in the first three quarters of 2013, respectively.³ It is reasonable to surmise, therefore, that the main reason why the fall in GDP was a little less disastrous than the IMF had anticipated was that household consumption held up rather well, particularly during the first two quarters of 2013.

Figure 14 Consumption growth for households and government, 2011Q3-2013Q3, % change³



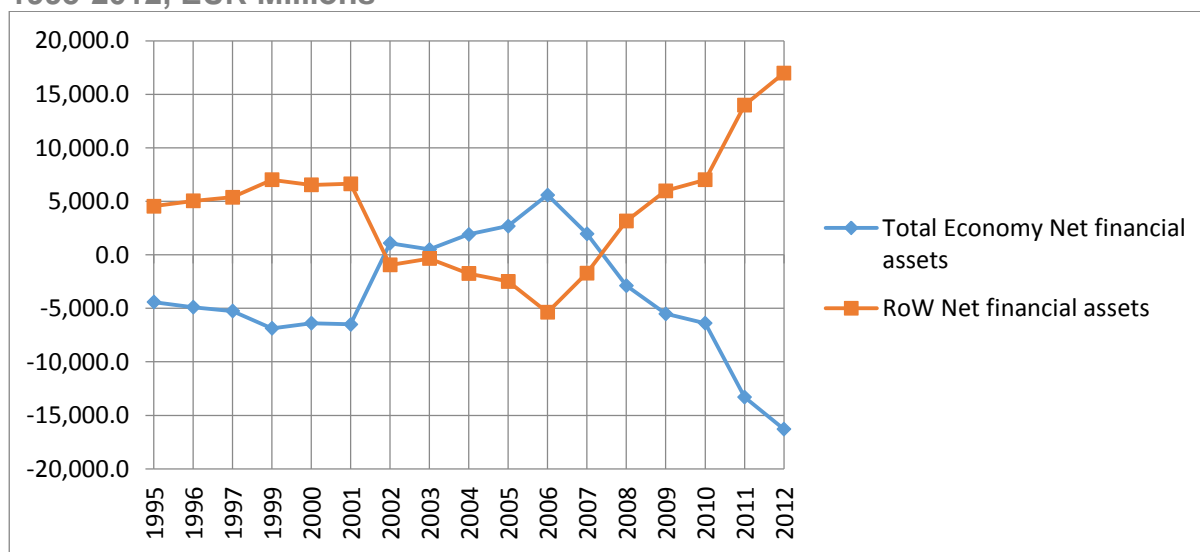
Source: Eurostat

How were households able to maintain consumption in the first half of the year, particularly in view of declining employee compensation? It appears that Cypriot households have continued to eat into their financial savings as they have been doing since, at least, 2011. However, this process perhaps came to an end in the second half of 2013.

To establish this point, consider first the financial balance sheet of Cyprus as a whole. Figure 15 shows the net financial position of Cyprus and indicates that the country has become increasingly indebted to the rest of the world (ROW) since 2008 and indeed the external indebtedness accelerated in 2011.

³ The calculation is based on the sum of trailing 4 quarters compared to the same 4 quarters a year earlier.

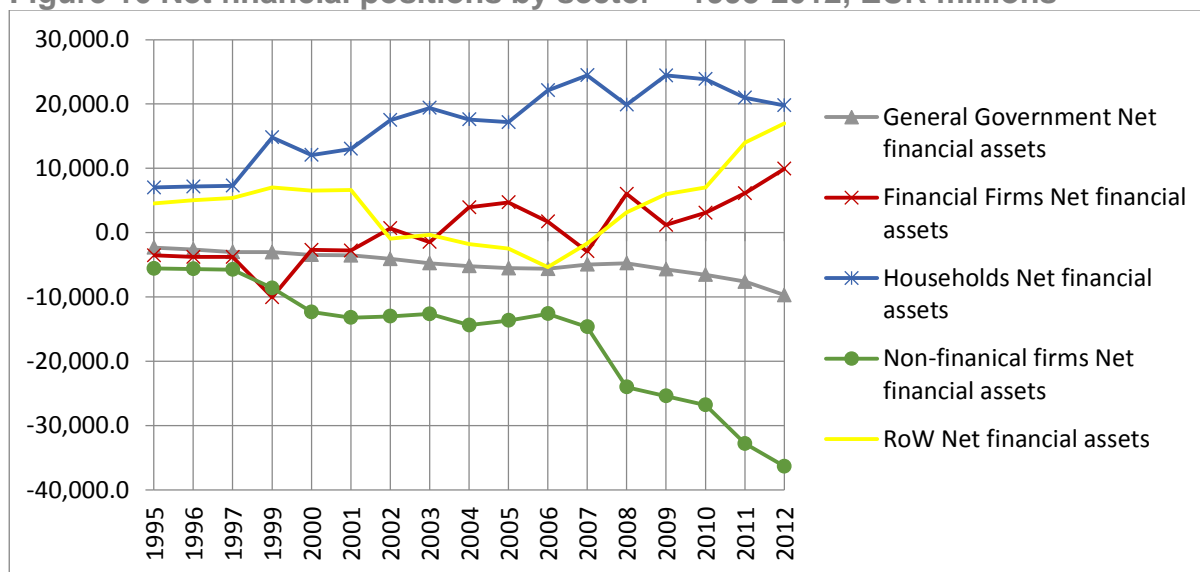
Figure 15 The net financial position of Cyprus – domestic vs Rest of World (RoW) – 1995-2012, EUR Millions



Source: Eurostat

Looking more closely at the domestic economy there is a notable divergence between the worsening financial situation of households, government and non-financial firms and the improving financial situation of financial firms in this period, shown in Figure 16. The net indebtedness of non-financial firms has increased considerably; meanwhile, households have had their financial surplus reduced since 2009; finally, the government has become steadily more indebted since 2008. By contrast financial firms have generated a position of net financial surplus since 2009.

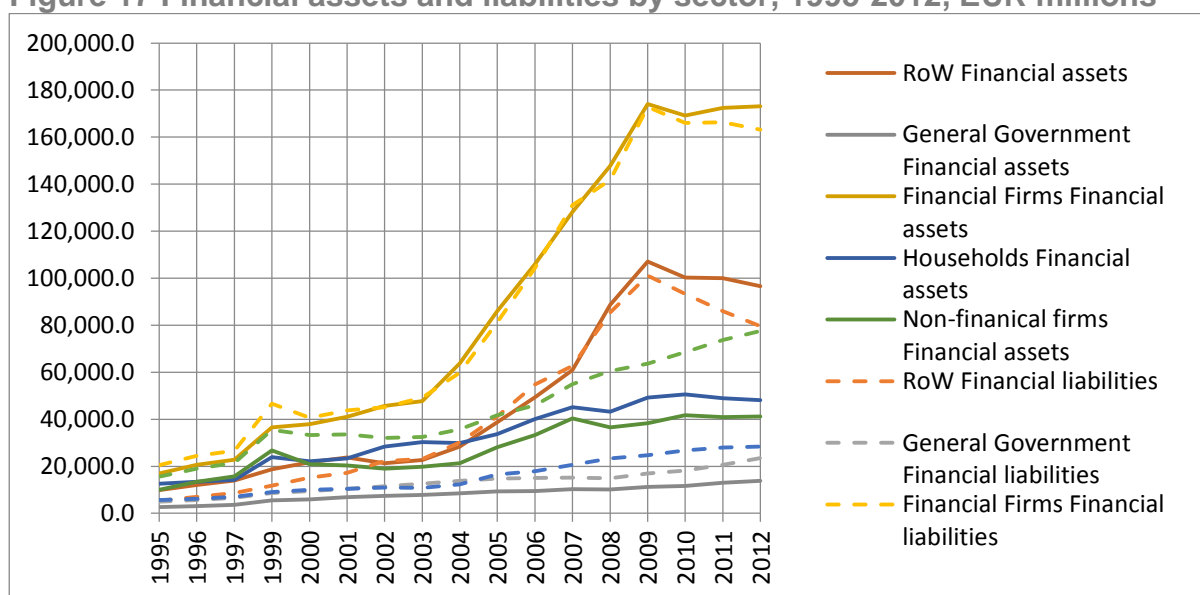
Figure 16 Net financial positions by sector – 1995-2012, EUR millions



Source: Eurostat

Looking in more detail at the financial assets and liabilities of these different sectors, Figure 17 reveals significant differences among them. RoW and financial firms (whose overall position has improved) have had their liabilities fall fast since 2009, while assets have been steady. Conversely non-financial firms and, less dramatically, government have had financial liabilities increase, while assets have been steady. Finally, for households, financial assets have fallen steadily, while financial liabilities have risen equally steadily.

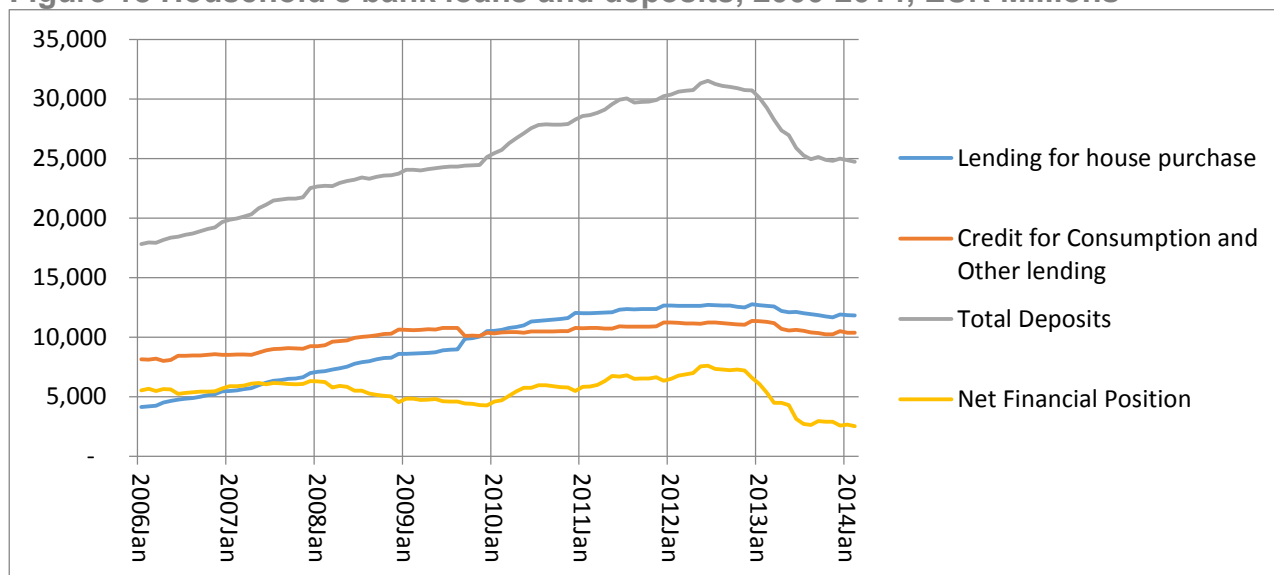
Figure 17 Financial assets and liabilities by sector, 1995-2012, EUR millions



Source: Eurostat

Unfortunately data is not available for 2013. To some extent, however, a picture can be gleaned by looking at bank loans and deposits of households and non-financial firms. Figure 18 shows clearly that household deposits have been falling faster than loans since the second half of 2012; but it also shows that the drop in deposits appears to stabilise in the second half of 2013.

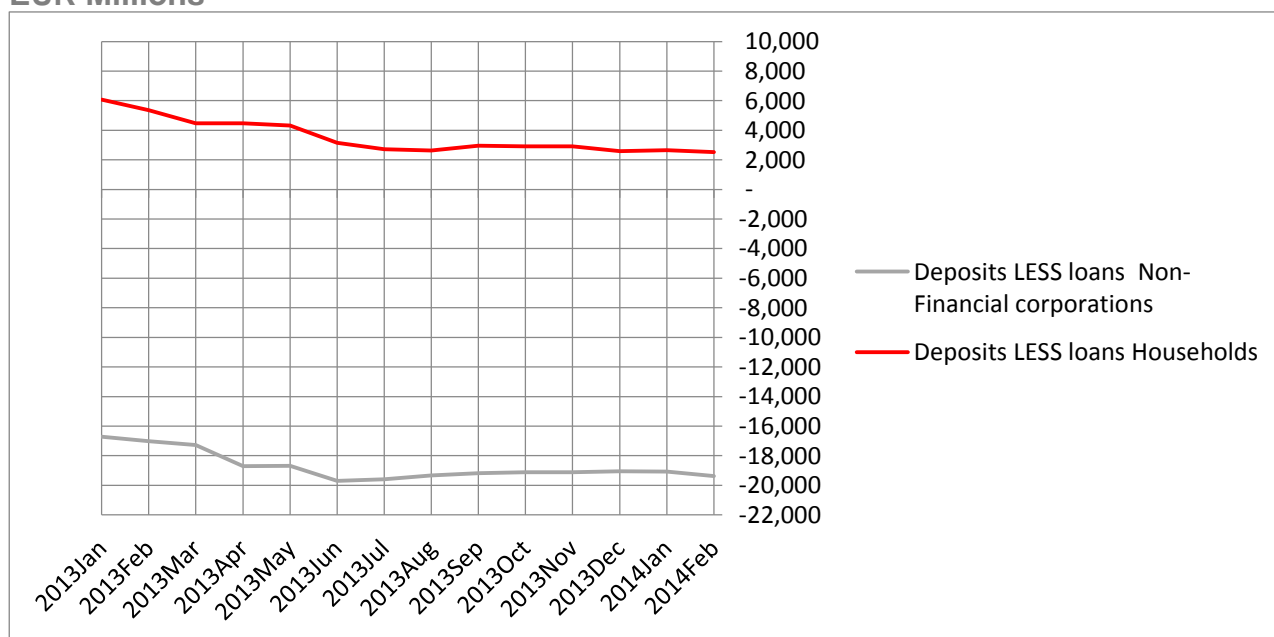
Figure 18 Household’s bank loans and deposits, 2006-2014, EUR Millions



Source: ECB

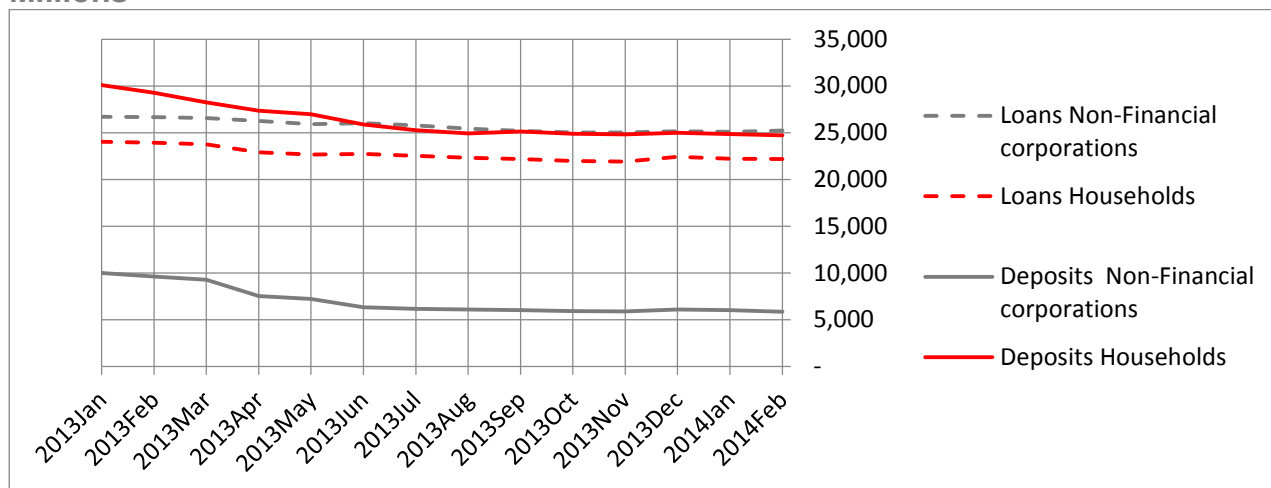
Examining 2013 a little more closely in Figures 19 and 20 shows that the financial situation of households and non-financial firms has clearly deteriorated. Figure 19 shows that ‘deposits less loans’ for households has fallen by 3.5billion EUR in 2013, while that of non-financial firms has fallen by 2.3billion.

Figure 19 – Households and non-financial firms – deposits less loans, 2013-2014, EUR Millions



Source: ECB

Figure 20 – Households and non-financial firms – loans, deposits, 2013-2014, EUR Millions



Source: ECB

Figure 20 shows that households and non-financial firms have used some deposits to pay back loans, but their overall deposits have tended to fall considerably faster than loans until July 2013; after that point the situation has stabilised. Some of the fall in deposits has been associated with bank restructuring and the transformation of deposits over 100000EUR into equity. However, since deposits fell in each month over the first half of the year, and given the depth of recession, the rise of unemployment and the fall in wages, it is reasonable to conclude that a large part of the 5.8bn net fall in financial assets has occurred because firms and households have spent their savings.

In sum, it appears that for a considerable time Cypriot households - rocked by falling employment and employee compensation - have been drawing down savings faster than they have been paying back loans. The behaviour of households is a direct result of the unbalanced Cypriot economy experiencing the effects of a construction boom and bust as the global crisis burst out. Cypriot households have, thus, prevented consumption from collapsing in 2013, particularly in the first half of the year. While the economy in 2013 has shrunk slightly less catastrophically than the IMF had predicted (by around 300m euro worth of GDP) this appears to be a result of households and non-financial firms drawing down 5.8bn euro of savings.

In the second half of 2013 things appeared to have reached the end of this particular road, at least for Cypriot households. If deposits cease to be drawn down, the implication is that

consumption will decline significantly, further weakening the economy. The impact on the already fragile banks is also likely to be severe, further worsening the quality of their balance sheets. In short, it is unlikely that in 2014 Cypriot households will be able to repeat the trick of 2013, thus rescuing the economy. Caught in Troika policies and with a profoundly unbalanced economy, Cyprus is likely to continue experiencing deep recession in 2014, with all the attendant negative implications for employment, living standards and the welfare system.