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Cyprus: A Case Study on how to Get an Economy into Recession and Keep it in the Muddle

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RÉSUMÉ

Les économies efficaces et bien gérées bénéficient autant de la confiance et du respect des citoyens, que des milieux d'affaires locaux et internationaux, des investisseurs et de tous les autres. Les économies mal gérées souffrent du manque de confiance qui les maintient dans un bourbier et dans la confusion pendant de longues périodes avant de connaître la relance. Il n'est pas facile de retrouver la confiance une fois perdue. Il faut des années pour bâtir la confiance et seulement quelques jours pour la perdre. Un événement majeur, comme l'effondrement du système bancaire, peut littéralement détruire la confiance. Mais les événements catastrophiques ne se produisent pas tous seuls. Il y a d'innombrables mauvaises décisions et des années de mauvaise gestion économique avant qu'une catastrophe ne se produise. Les planificateurs économiques efficaces considèrent l'économie comme un système unifié plutôt qu'un ensemble de fonctions et d'industries individuelles et indépendantes. Une gestion de qualité n'est pas intéressée par des décisions ad hoc, mais plutôt par des décisions qui font partie d'un plan bien pensé. Les économies saines produisent des biens et des services de qualité et parviennent à les exporter parce qu'ils sont compétitifs. Les économies non compétitives ont peu de valeurs à exporter et se contentent, entre autres, de voir des terrains changer de mains à plusieurs reprises, avec l'illusion que "tout le monde gagne de l'argent." Comment tout le monde peut- il faire de l'argent? Les économies saines sont basées sur des faits concrets et authentiques tandis que les économies non sérieuses s'appuient sur des discours farfelus et une vision à court-terme. En examinant l'économie chypriote, l'auteur conclut qu'il a fallu 30 ans de mauvaises décisions (qui ont bénéficié aux intérêts étroits et particuliers de certains groupes et individus) pour mettre l'économie à genoux et en même temps ruiner la confiance globale. Il faudra un miracle pour inverser cette situation parce que la confiance est un concept multifactoriel, qu'il n'est pas facile de reconstruire une fois perdue. Les relations publiques, les paroles en l'air, les visions à court-terme ne peuvent pas restaurer la confiance perdue. La reprise de confiance fait appel à l'autocritique, dans le cas de prises de mauvaises décisions, aux remords sincère, au changement de mentalité et à l'abandon des comportements catastrophiques. La confiance peut être restaurée avec l'adoption d'un comportement honnête, sérieux et authentique et une action efficace et crédible.

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ABSTRACT

Efficient and properly-run economies also enjoy the trust and respect of citizens, the international and local business communities, investors and others. Badly-run economies suffer from luck of trust that keeps them in morass and economic muddle for long periods before experiencing any revival. Trust is not easy to regain once lost. It takes years to build trust and days to lose it. A major event, such as the collapse of the banking system, can literally shred trust to pieces. But catastrophic events do not just happen. It takes countless bad decisions and years of bad economic management before all these can build up to a catastrophic strike. Effective economic planners view the economy as a unified system rather than as individual and independent functions and industries. Quality management is not interested in ad hoc decisions but rather in decisions that form part of a well-thought-out plan. Healthy economies produce quality goods and services and manage to export these because they are competitive. Uncompetitive economies have little of value to export and enjoy, amongst others, seeing land change hands repeatedly under the illusion that "everyone is making money." How can everyone make money? Sound economies work on hard facts and authenticity whilst less than serious economies rely on airy-fairy talk and short-termism. In reviewing the Cyprus economy the author concludes that it took 30 years of bad decisions (that benefited the narrow self-interests of some groups and individuals) to bring the economy to its knees and at the same time ruin trust comprehensively. It will take a miracle to reverse this situation because trust is a multi-factor construct that is not easy to rebuild once lost. Public relations, glib talk, short-termism and grasping at straws do not restore lost trust. Trust calls for seriousness, acknowledgment of bad decision-making, sincere remorse, change of mind-set and abandonment of catastrophic behaviours. Trust can be restored with honest, sound and authentic behaviour and effective and creditable action.

1. Long-term Costs of Recession

Under the title *"Counting the long term costs of the financial crisis"* the *Economist*[1] talks of wasted economic potential. The paper makes reference to the work of Laurence Ball of John's Hopkins, Robert Hall of Stanford and to the findings of the OECD. The article supports that based on OECD Economic Outlook (December 2007 and May 2014) Greece lost about 30% of its *potential* economic output in the period 2007-2013. Spain lost 18%, the USA nearly 5% and Sweden lost about 8%. The article then forecasts, perhaps hastily, *"This year may be the first since 2007 in which all big advanced economies manage to grow."* The essence of the article is that in these 6 or so years of economic crisis rich economies performed below pre-crisis expectations and below what seemed possible to achieve by these countries. The use of potential economic output throws into sharp relief not only what economies actually lose when in a recession or when experiencing slow GDP growth but also what they lose in terms of what was once thought possible for them to achieve (their economic potential). *"Potential economic output"* is defined as the, *"highest level of production each economy could feasibly sustain without igniting inflation."* The *Economist* notes that, *"By 2015 the weighted average loss among rich countries as a whole is projected to reach 8.4%—as if the entire German economy had evaporated."* This is a depressing conclusion particularly as no one knows with certainty when this long recession will finally come to an end.

1.1. Economic Crisis through the Cyprus Paradigm

Through the Cyprus paradigm this paper attempts to explain how a recession can creep into an economy, causing damage to the short-term potential of the country and rendering quick recovery difficult. The author tries to highlight the importance of individual and group attitudes to creating and solving an economic crisis. Trust and confidence are central to economic recovery. When confidence in an economy is lost, its ability to bounce back is all but lost as well. Lose faith in the banking system and you cripple the economy. Bailing-in depositors through legislation is probably the fastest way to destroy confidence in an economy; particularly in the eyes of international investors. Cyprus is the only country in the EU (and in the West) to have done the unthinkable; to bail-in depositors. As a result investors and potential customers shun away from Cyprus' banks and in the process destroy any prospects for quick and sustainable recovery. This paper takes the line that intractable recessions do not strike out of the blue; it takes a series of bad decisions over many years for the recession to gather pace and to mature.

Cyprus and Greece are classical examples of bad decisions, incompetence, failed judgment and most critically inability and/or unwillingness to reverse bad decisions once these proved to be detrimental to the economy. Policy makers and the political establishment in both countries had ample signs of an impending economic catastrophe but ignored these for the sake of short-term and transient economic and party political gains; winning the next election was often more important than saving the economy. Three examples help highlight short-termism in both countries: a) for decades both countries experienced low productivity; yet both succumbed to the temptation of rewarding public sector employees above productivity, b) both countries registered prolonged dismal current account deficits; both imported much and exported little; yet they failed to address this most serious issue and c) both countries had a bloated public sector that in the case of Cyprus cost nearly 20% of GDP. Low productivity led to low competitiveness which in the end marginalized the economies of both countries. Decision-makers and policy-makers failed to understand the seriousness of not having a vibrant export economy. The political establishment: a) failed to understand that the public sector's mission ought to be service to the public and the business community at reasonable cost to the taxpayer and b) allowed public sector costs to balloon out of control for the sake of party political gains. And, when tragedy struck the political elite failed to appreciate the magnitude of the impending economic calamity. Equally, they failed to assess the (long) duration of the recession and as such took few measures before the arrival of the Troika. Ad hoc decision-making replaced integrated planning and selling land to each other at ever-increasing prices became respectable business.

Now that the realization is beginning to dawn unless the root causes of failure are tackled first, any recovery is bound to be short-lived and unsustainable with the country's economy remaining in a muddle. True recovery requires: a) root causes to be identified honestly and precisely and with self-interest playing no part in the process, b) those that played a major part in bringing the economy to its knees to show genuine remorse which will help them change their attitudes for the better, and c) major players in the economy to now put together a fresh and realistic reconstruction plan that would rest on sound foundations, and most importantly d) commitment not to revert back to old ways.

As things stand now the immediate economic future does not augur well. Some of the major contributors to the catastrophe are more concerned about exonerating themselves, and throwing the blame on others, rather than on finding sound solutions to major problems. Not owning up to one's past errors continues to bedevil the recovery process of the economies of Greece and Cyprus. Only the other day the author and a group of mostly university students attended a lecture by one of the central protagonists of the banking catastrophe who had showed criminal dereliction of duty and unfathomable incompetence in the events leading up to the financial crisis and soon after. For more than one hour the speaker pummeled his audience with the names of those that in his view were to blame: the former government, the European

Central Bank, the IMF, the bank boards and a host of others save himself; not a word about his own sins and striking incompetence. Not a shred of remorse.

Economies that lose the trust of local and international investors need to prepare for a long recovery process because trust takes years to build and days to lose. For example, under pressure from the Troika the government of Cyprus broke a major trust link when it asked parliament to enact laws that allowed banks to convert depositors' money into equity without their consent. This act (cunningly known as "bail-in" of depositors) was ostensibly done, in the government's words, *"....to save the banks once and for all."* Since then billions of additional money was poured into the banks as the bail-in failed to save them; the depositor money that was converted into capital is now worthless. Bail-ins have serious ramifications on trust, irrespective of whether these are justified or not. When a depositor puts his money in a bank "in trust" s/he does so on the assumption that honesty will always prevail and that the money will be there for withdrawal as per contract. Not even in their worse nightmares do depositors think of the possibility of an outside third party, government and Troika in this case, forcing the bank to take their money to *"....save the bank."* Insult adds to injury when the bank management and the government proudly and in many ways deceptively announce to current and prospective customers that, *"our banks are now fully capitalized and as strong as ever."* The moral equivalent would be for a hotelier to boast /advertise to clients that his hotel is always in a spic and span condition because he never runs out of refurbishment money. He fails, however, to tell them that refurbishments are funded from the proceeds of sales of customer jewelry which the hotelier grabs from them by marauding their suitcases.

Every bank customer knows *a priori* that he risks losing his money in the event of the bank going bankrupt. But, in Cyprus' case no customer was ever told that he risked having his money taken to be converted into valueless capital whether he agreed or not with that. And in this lies the crux of the ruined trust that will haunt the Cyprus economy perhaps for decades. *Peter Drucker* once said something to this effect: it takes 21 years before the trust between a depositor and his cheating/thieving bank can be restored. International investors do not care about the reasons of failed trust. All they register is that here is a country that legislates in favour of taking people's deposits. In 1956 Egypt went through massive expropriation of properties (all "legal!") and regrets it to this day because investors never forgot this even if 6 decades have gone by.

Trust extends to all fields of economic endeavor including the tax system (it's axiomatic that taxpayers are more willing to pay their taxes if they know that these go to good cause and are managed wisely). Outside investors are never happy to pay more taxes than agreed on account of changing tax laws (see Cyprus' new tax on registered companies and new property taxes). Broken promises have the nasty habit of coming back to bite the guilty party. Cyprus suffers from weak trust in more than one ways. The latest Global Competitive Index (GCI) puts Cyprus in 58th position (out of 144) on the factor of *"public trust in politicians"* and in 45th place on *"judicial independence."* The dismal 63rd place is reserved for Cyprus on the factor of *"favoritism in decisions of government officials"*.[2]

Greece and Cyprus agreed with the Troika on austerity measures which basically call for three things: a) higher taxes, b) lower total public expenditures and c) re-organization, such as privatization of state organisations, down-sizing of the public sector, opening up of protected professions, etc. The first two steps are unlikely to bring the two countries out of the recession because in many ways these are counter productive. The third step is more long-term and its success will depend on whether the exercise is done properly and with the intention of making changes difficult to reverse.

The Government Revenues Side

In the last two years, and as the effects of the recession started to bite, Cyprus imposed a variety of new/additional *taxes* in an effort to ensure that the fiscus had enough money to meet its current expenses and particularly public sector employee salaries. This fact seems to be worrying businesses as the factor of *"tax rates"* was mentioned as the sixth worrisome problem for doing business in Cyprus; *"access to financing"* and *"inefficient government bureaucracy"* earned 1st and 2nd place respectively on list of barriers.

The problem for the government is that taxes and unemployment went up simultaneously necessitating more tax money for the unemployed and needy and leaving little money to spare. Indicatively, the tax position of Cyprus for the period 2010 - 2014 appears below, Table 1.

Table 1: Tax increases in the period 2010-2014

Tax on	2010 rates	Intervening period	2014 rates
Corporate tax	10%	12.5% starting 2013	12.5%
VAT	15%	17% -01.03.2012 18% -14.01.2013	19%
VAT on food (hitting mostly the poor)	0%	No change	5%
Interest received (euphemistically called "defense tax")	10%	2012 – 15%	30%
Tax on dividends (euphemistically called "defense tax")	15%	2012 – 17% 2013 – 20%	17%
Immovable property tax	0.025% rising to 0.04%	2012: 0.04% rising to 0.08% 2013: 0.06% rising to 0.109%	0.06% rising to 0.109%
Special levy on the salary of those holding a job	0%	2012: monthly salary of € 2500-3500= 2.5% € 3500-4500 = 3% € 4501+ = 3.5%	Monthly salary of € 1500-2500=2.5%, € 2501-3500 = 3%, > € 3501+ = 3.5%
Income tax scales	€ 19500 -28000: 20% € 28000 -36300: 25% >36300: 30%	Same as 2010 with the additional step of > € 60,000 = 35%	Same as 2012

The hotel industry, hailed as the flagship industry of Cyprus' recovery, is asked to pay a host of additional industry-specific taxes making it difficult for the tourist product to sell and for businesses to make adequate profit. These dedicated taxes include amongst others: sewage tax, municipal tax, levies on overnight stay (1-2% of room rate,) municipal immovable property tax, beach tax and cleanliness tax. In addition hotels are asked to pay numerous other levies and to bear permit costs such as: Cyprus Tourism Organisation levy, permit to sell alcohol and tobacco, permit to exercise professional services, permit to practice the occupation of hotelier, swimming pool permit, petrol and gas permit, "wireless" levy, etc. Most importantly, and just like everyone else, hoteliers are asked to pay crippling electricity bills (remembering that hotels are to a large extend energy-guzzlers in summer) which in themselves include a host of other taxes.[3]

The high cost of electricity (partly on account of imbedded taxes) is a major problem for businesses; particularly those in manufacturing. In a recent interview the chairman of Cyprus Electricity Board admitted that taxes make up 20% of the final electricity bill to the customer. Thus, the higher the electricity bill the more tax to be collected by government. Cyprus generates over 4.5 billion kilowatt hours of electricity relying primarily on imported petroleum as energy source. It is reported that, "*....consumers in Cyprus pay some of the highest electricity prices in the European Union*".[4] At 0.17 per kWh Cyprus leads the list of the most expensive suppliers of electricity amongst EU member countries; ahead of Ireland, Malta, Spain and Belgium (in 5th position) in terms of expensive electricity. The countries with the least expensive electricity are: Lithuania, France, Greece, Latvia and Estonia (at 0.07 per kWh).[5]

Even though at the time of writing the government boasted a "primary surplus" in its finances, meaning that revenues exceeded expenses not including interest payments on loans, the situation looks volatile. Largely on account of reduced business activity, reduced spending and high unemployment. The main two tax sources: a) VAT and b) income and wealth tax for the period April – June, 2014 brought to the taxman these amounts: a) VAT: 335.4 million (18.5% reduction over the same period of 2013,) b) Income and wealth tax: 302.9 (17.4% reduction over the same period of 2013).[6] For most governments taxes look like an attractive proposition because they are generally easy to impose. Such practices, however, when not applied in measure fail to yield much fruit in recessionary times; paying taxes has never made the taxpayer any wealthier and have never given him more money to spend to enhance the economy. This is particularly true when excessive taxes are collected just to cover operating expenses rather than to invest in infrastructure projects.

2. The Government Expenditure Side

Government and Troika agreed on plans to reduce excess expenses which basically include reduction in: a) government operating expenses and b) targeted reduction of social benefits. Both these measures were long overdue considering that no government in the past dared touch these two expenses for fear of voter backlash in a political system that twice elected its State President on a swing of less than a 1,000 votes. The difficulty with the first category lies with the political strength of the unions (product of party politics) and other vested interests and their ability to create havoc when decisions don't go their way. The political establishment knows that their supporters can easily turn on them once they start taking away their benefits and *"acquired rights;"* morality plays little if any role in such cases. For example, retiring public sector employees are entitled to lump-sum payments from their employer plus monthly pension. This lump-sum is a defined end-of-service benefit (calculated on an agreed formula) that often exceeds 100,000 even for retiring middle-level staff. In addition, upon retirement public sector employees are entitled to a monthly pension equal to roughly 50% of last salary index-linked. Lump-sum and pension come from contributions of the employer save for a meager minute contribution by the employees.

The above exaggerated practice is hard to find in any other country and basically amounts to having two sets of old-age schemes for the same person: a) a defined benefit scheme (lump-sum) and b) monthly pension scheme. The Cyprus taxpayer is naturally annoyed with this outlandish practice particularly when the average pension for private sector employees is only a fraction of that of the public sector. Ludicrous and annoying as the lump-sum scheme may sound, one cannot be sure that public sector employees will give up this benefit without a destructive fight. If at the end they lose this benefit (only on account of Troika and perhaps only temporarily), they will for sure bring the issue back once the Troika leaves Cyprus in the knowledge that they will probably get it back on account of their voting power and party politics.

Expenses have already been reduced in the sensitive areas of health and education. Social benefits have been slashed and the bureaucratic barriers raised to discourage from applying, even those that are genuinely entitled to the revised benefits. The biggest hurdle that the government has to negotiate is that of reducing significantly the public sector payroll that has been a consistent sore on the economy for the last 3 or more decades; too large and too expensive public sector and too inefficient. In the past, and when the real-estate bubble was at its peak, the government had few problems funding an expensive and extravagant public sector considering that large amounts of capital gains, taxes and other transfer fees from real-estate deals were filling government coffers. Now the property sector is all but dead.

For years the Cyprus taxman was elated with the real estate bubble as this provided a hefty 20% tax on capital gains plus huge transfer fees, bringing the total bill in the region of 30%. Much of the land sold was former agricultural land with little value prior to the bubble. With the bubble these values increased a hundredfold of the original in exceptional cases. As a result revenues for the government were sizeable and very tempting. These revenues financed the high salaries and benefits of public servants and catered for the limousines and first-class travel and executive suits of the higher-ups. The elite of the elite were beneficiaries of several and varied pension payments from the government /taxpayer on account of having served in several posts after leaving the civil service and earning full pension, e.g.: a) full pension on account of having completed the number of required years of service in the public sector, say 36 years, b) second pension for being appointed to the Civil Service Board after retirement and c) third pension for holding a cabinet post after five-years of service in the last post. Thus, the individual in our example earned two additional pensions from his original employer (government) the moment his employer had paid him full pension on account of his first appointment.

Flashed with capital gains and other taxes at the height of the real-estate bubble successive governments saw fit to employ thousands of supernumerary public sector employees that would also prove to be good supporters of the political party that helped them secure the appointment. Thus, a vicious circle was started that ended up with a crippling over-sized and expensive public sector that the current government is unable to pay unless it taxes heavily. The public sector payroll plus other sundry employment costs are still at a record of 21% of GDP whilst that of Germany's is a meager 7%.[7] The falling GDP of Cyprus has kept the public salary bill more or less at the same percentage of

GDP as in the past, despite recent marginal reductions in salary and marginal shrinkage of public sector head count. As things stand the government has a lot of leeway to reduce public sector salaries and benefits and also head count. The government's ability to keep its books balanced will depend much on whether or not the public sector payroll is reasonable and in line with what responsible countries in the EU are doing.

The public sector was expanding dramatically up to very recently as did the power of the unions. Union heads were much-sought-after partners of political parties and of the political establishment. This let to the public sector salaries topping Cyprus' salary table; in contrast to what was happening in other EU countries. Whilst the annual median salary in Cyprus (including in the calculation public sector salaries) was in the region of 25,000, the annual cost to the tax payer of each public service employee stood at a whapping 55,000.[8] Civil servants, and banking employees, became (and still are) the privileged class in the island with real average salary increases in the last 30 years of 4.1% and 4.8% respectively. Other unionised employee classes also did well from their close relationship to political parties but not as well as the former two classes (average real salary growth for all unionised employees in the last 30 years was 3.5%). The average productivity for Cyprus over the same period stood at a paltry 2%.[9] The figures in Table 2 are self-explanatory.[10]

Table 2: Average real salary growth in the period: 1980-2009

Sector	**Average annual % salary increase**
Banks	4.8
Government	4.1
Local authorities and broader public sector	3.8
Trade and tourism	3.8
Construction	3.2

Public sector employees, and more so civil servants, are still a law unto themselves in that they work with little accountability towards the tax payer that funds their beyond-all-reason salaries and privileges. Public sector bureaucracy is seen as the second most serious barrier to business.[11] The public sector is still invincible, often arbitrary in its decisions (too much discretionary decision making) and profligate. The standard of service of the civil service is the subject of continuous negative comment amongst the public. Literally not a single public sector employee has ever been dismissed for reasons of poor performance. In an effort to meet the Troika requirement of reducing civil service numbers by 4,500 by the end of 2016 the Ministry of Finance is trying to square the circle. Up to now the government was happy to reduce head count through voluntary and normal retirements as this entailed no political cost considering that voluntary retirement was accompanied by a generous bonus from the employer (courtesy of the taxpayer!). Interest in early retirement amongst public sector employees ebbs and wanes according to the tax regime applicable to severance bonus and end of service lump-sum. Up to Q1 2014 the number of employees leaving the civil service reached 2,732.[12] The Civil Service Commission now expects only about 100 employees to leave the service in the remainder of 2014. The current number of public sector employees appears below (one in five employees is currently working in the public sector) Table 3.

Table 3: Number of public sector employees 2013-2014

	Q1 2014	**Q4 2013**
Civil Service	53,475	55,188
Local Authorities	4,371	4,600
Semi-government	7,703	7,829
Total (public sector)	65,549	67,617

The relatively privileged position of public sector employees (and bank employees) persists to this day and not withstanding the fact that the recession is throwing into poverty thousands of unemployed. An advertisement appearing on the site of a private, not unserious finance company, in August 2014 is indicative of the perceived privileged position of these two classes as regards security of tenure. This particular financing company encourages potential borrowers to apply for loans up to 10,000 provided, “a *civil servant* or a *bank employee acts as guarantor*"! Incidentally, the interest rate for this type of loan stood at 6.75% flat rate (APR 12.50%).

The whole government expense-reduction exercise hinges on: a) how far the government is willing to go to reduce public sector head count and how fast it can do it, b) the government's ability to reduce public sector salaries and benefits to bring them in line with other countries as percent of GDP, c) how well the present and future governments manage to keep any changes in the right direction. It's interesting to remember that as part of his programme for smaller government Roland Regan reduced head count massively when he started his term. By the time he left he saw the final head count exceeding the original one, and d) how well the social benefits are streamlined so as to be fair. People do not mind seeing such benefits reduced or redistributed as long as this is done with fairness. This is bound to be a tall order considering that *"public trust in politicians"* puts Cyprus in 58th position on the GCI.

2.1. Need to Restructure

The restructuring that is required by Troika touches a wide area of activity but is fundamentally concentrated on privatizing organisations that are owned by the government (3 in particular) and shutting down those that have no function to perform. These organisations come in two forms: a) semi-government entities that are owned fully by government and b) public organisations with majority holding by the government. The way things had been handled in the period leading up to the economic recession and the way things are being dealt with since the coming of the Troika have made most Cypriots very suspicious of everyone and not just politicians. On the factor of *"efficacy of corporate boards"* Cyprus earns a troubling 90th place on the GCI. Nor is the situation any better on the factor of *"ethical behaviour of firms"* where Cyprus earns 51st position on the GCI. People in Cyprus do not trust foreign ownership either and this may partly explain why Cyprus earns 84th position on *"prevalence of foreign ownership"* on the GCI. This high level of suspicion and mistrust (which in many ways can be explained) does not auger well for the privatization process. On the one hand people mistrust government and on the other hand they are uncomfortable with private enterprise and its management approaches. So, back to the problem of trust once more!

Privatisation may at the end mean some of Cyprus' "iconic!" semi-government organisations ending up in non-Cypriot hands; which is unlikely to go down well with many voters (and politicians are aware of this). Equally, these target organisations are now employing nearly 8 thousand staff (many of whom are party stalwarts) that have made it known that they will resist changes to the status quo and their high salaries and benefits. They are afraid that their current cozy working conditions will be eroded and the work-ethic that is modeled on the civil service changed. Admittedly some of these organisations are in many ways doing a reasonably good job even if bureaucratically; but they are over-manned with over-paid staff and politically party-dependent. Undoubtedly many that are now employed with these organisations stand to lose their jobs as more competent boards and professional executive teams take over and start streamlining and down sizing to enhance productivity and competiveness.

As owner the government has been making a hefty "profit" from at least 2 of these monopolistic organisations that are supposed not to make a profit from their monopolistic practices but which operate on a cost-plus basis. "Profit" for these organisation comes from the pockets of the taxpayer-consumer who is also the guarantor of their loans via the government. Some of these organisations have open corruption cases against some of their former officials. Selling off some of the other smaller (and defunct) organisations will not be easy as many of these have no net worth to talk about; others are in a state of hibernation whilst their staff continue to draw high salaries. Still, others are kept from bankruptcy by all sorts of funding vehicles that has earned the ire of Brussels. Maybe only 2 or 3 of the larger organisations will turn out to be attractive to local or foreign investors. Namely: the public telecoms company, the ports and maybe (big maybe) the public electricity company. The government stands to improve its cash flow through the sale of the above three organisations and will save money from the closure of the rest. The Troika will press hard in the direction of privatization, staff and unions will oppose and politicians will be sitting on the fence. The government cash flow is in dire straights and its officials will be delighted to get some cash for the purser. The government is well aware of the resistance coming from those that benefit from the current system. People are scared that even if the government sells off these organisations its cash flow will not improve because it may be need to put the proceeds into the black hole of a banking system with never-ending non performing loans.

Foreign investors will be loathed to put their money in a country with a broken banking system and which scores 51st position on the GCI on the factor of *"efficacy of legal framework in settling disputes."* Selling off a publicly-owned going concern may not prove as easy as it looks because of the decay in the softer areas of the economy and which the foreign investor is aware of. Neither the potential investors nor the Troika have much sway and influence in the intangible area of attitudes, accountability, confidence, trust in others and institutions, etc. There is little the Troika can do in these areas despite its power to wield the lenders whip. Perhaps the biggest and most important restructuring that needs to take place if the economy lies in the area of attitude and behavior change that will bring the trust level back to the economy. The Troika has no say in these areas and here lies the crux of the effort to restructure the economy.

2.2. The Banking Morass Refuses to go Away

The economy will probably continue in its current depressed path for a long time to come and as long as the banking crisis continues to have a negative impact on economic developments. The obsession with saving Cyprus' largest bank at any cost is a major contributing factor to the economy's inability to move ahead. For a start, the current banking affairs of the country are detrimental to the name of Cyprus and its economy. Many in the peripheral financial sector are keen to keep the bank alive so that eventually it can revert to its old "glory." The brutal fact, of course, is that Cyprus' banking sector of old is now history. Cyprus will have to look for a new banking paradigm that will conform to its capabilities and limitations (?deposits equal to GDP). Cyprus' largest bank is threatening to take the economy down considering its all-but-bankrupt balance sheet. Purists content that had the market been left alone to do its work the bank would have already gone through the liquidation process in an organized manner. What is keeping the bank afloat, purists content, are not the bank's fundamentals but its huge debt to the European Central Bank (ECB) that is guaranteed by the Cyprus government via the Central Bank of Cyprus (CBC). In the event of the bank folding up (as it should have in the opinion of the purists of the free enterprise system) the government will be held responsible for the huge outstanding emergency liquidity assistance (ELA) and other debts to the ECB. Equally, the government is the guarantor of deposits up to 100,000; and the government has no money. The major causes of Cyprus banking failure appear below:

The banking sector was dangerously over-sized and with a balance sheet 7-8 times Cyprus' GDP. Thus, Cyprus had an accident in waiting. The problems that were created as a result of the over-sized banking sector have been debated extensively by many and there is no reason to go into this debate again. The issues appearing below (and some others) have not been debated adequately: 1) the incompetence of the CBC has been monumental largely because it allowed the building up of a massive banking sector and as such created some of the preconditions for the catastrophe that ensued. It's as if the CBC planted an incendiary devise in the foundations of the Cyprus economy, 2) successive governments knew that the cumulative sum of the secured bank deposits (up to 100,000 per depositor per bank) was beyond the ability of Cyprus to handle in the event of a major bank collapse or bank run. Yet no steps were taken to reduce the banking sector and 3) the incompetence of some at bank board and top management level is humongous. Board members exercised little control on management and allowed management with a parochial background and with little understanding of the big picture to deal with complex matters. Boards allowed management cadre with illusions of grandeur to take decisions far beyond their limited competencies. This illusion of grandeur let them to trade in high-risk foreign government bonds the moment the more prudent and knowledgeable international bankers were rushing to offload such toxic instruments.

Bank managers imprudently (if not foolishly) extend risky loans to off load the massive high-interest-bearing deposits that needed to be loaned out to generate income and profits. This practice let to a calamitous level of non-performing loans (NPL). At the time of this writing the non-performing loans of *commercial banks* stood at nearly 42% of bank loans (or 20bil which account for roughly 135% of Cyprus' current GDP.[13] If 50% of this amount is finally lost the banks will be in dire trouble yet again. Add to the above amounts another 6bil which are the NPLs of the *coop bank* (50% NPLS) and the total NPLs for Cyprus rise to 26bil or some 160% of Cyprus' current GDP. Indicatively and at the time of this writing the *commercial banks'* NPLs stood at the levels appearing in Table 4.[14]

Table 4

Loans by *commercial banks*:	**% of loans that were non performing as @ June, 2014**
Business loans	46
Construction and real estate	68
Individuals	44
Housing loans	40
Consumer loans	62

The cost of money remains sky-high as the discredited banking sector tries to squeeze as much as possible out of every transaction by charging unsuspecting customers ludicrous interest rates and a host of charges totalling to a crippling 8-10%. The discredited banking system is not working as intended and in the process has hit the recovery process hard. As Timothy Geithner notes, *"When the financial system stops working, credit freezes, savings evaporate and demand for goods and services disappears, which leads to lay-offs and poverty and pain"*.[15] Whilst the Cyprus economy is beset by crippling interest rates and banking fees the EU is moving in the opposite direction to help revitalize the economy. Indicatively the deputy governor of the Bank of England was predicting that the official UK interest rate could reach an average of 3% in 2017-19. The reader is reminded that the UK rates were at a historic low of 0.5% starting 2009 and as recession began to bite.[16]

The impending foreclosures (covering private and commercial borrowers) that the banks are pressing for are bound to create an overall feeling of panic and great despondency which in the short-term is likely to hurt the economy. As loan security was pecked to inflated prices (bubble prices) in many/most cases the liquidation of the asset will only cover a portion of the loan; thus opening up the possibility for borrower (and guarantor) bankruptcies. This new reality plus the newly imposed property taxes has thrown into disarray home and property ownership. The introduction of property taxes (at inflated, bubble-level values) has added to the feeling of state arbitrariness which has further depressed the market and further reduced trust in government. Bankruptcies are not exactly the best short-term strategy to bringing an economy back to health. Nor does the fact that Cyprus holds these positions on the GCI help recovery: a) 143rd position on the factor of *"soundness of banks,"* b) 109th on *"ease of access to loans"* and c) 113th on *"financing through equity market."*

The Cyprus banking crisis continues unabated and there is no respite in sight. This is touching people's lives. Thousands of people and businesses are worried that they will lose their homes and businesses and in the end continue to owe to the banks. They are worried that any residual debt after the forced sale of their properties will soon grow to the original debt levels considering the 17% bank charge on delayed loan payments. They are concerned that a few years after they lose their properties they will still be in debt for the same amount as before foreclosure. The banking crisis has been the major culprit of the recession and continues to keep the Cyprus economy critically ill and with huge public debt. This is putting a dampening effect on prospects and is causing much pessimism. Repeated declarations to the effect that the banking system is heading for recovery have, as expected, been empty words if not shameless public relations exercises with a view to creating a feeling of unjustified euphoria.

People and businesses are racing to deleverage so as to be spared themselves from the effects of the debilitating interest rates and fees banks charge without mercy. As people and businesses rush to pay their debts and as banks sell debtor assets at depressed values in an effort to collect portions of the NPLs, consumption unavoidably reduces and in turn diminishes the prospect for recovery. Cyprus is now experiencing what is known as the Minsky effect as insolvent debt pushes the economy to recession.[17]

The unchecked land/property values of the past have caused, and continue to cause, great harm to the economy of Cyprus. Speculation in land created what are commonly known as Ponzi schemes. Basically people borrowed on over-priced land but were unable to service such debts (not even interest payments.) They survived by refinancing these loans on the strength of ever-rising land values. This is how many of Cyprus real estate developers and property dealers stayed afloat for a long time. The banks were ever ready to advance loans so as to reduce their ever-growing deposits. Speculative borrowing was on the rise as people borrowed now to pay later. Banks even promoted schemes that required the borrower to cover interest payments only for a period of say 3-5 years, thus trapping him in an illusionary process. These schemes let many borrowers to see the repayment of principal as a far-distant event. Other borrowers were under the illusion that if the banks pressed for repayment of the loan all they had to do is sell their asset at an appreciated value and in the process even make a profit.[18]

In the author's view probably the single most important cause of Cyprus' economic calamity was the eagerness of successive Cyprus governments to profit from land through the collection of soaring capital gain taxes and exploitative transfer fees. Governments, under voter pressure, granted building coefficients to practically every piece of land on the Island thus turning the whole country into a large building plot of varying building coefficients. This fiasco gave land owners the illusion of being wealthy. In the vast majority of cases these bloated values meant nothing in reality. Under the illusion of being wealthy land-owners began to borrow and spend. A piece of agricultural land with an intrinsic value of 50,000 overnight was worth 20 times that value on account of improved building coefficients; but, just on paper. Under the illusion of being a millionaire the owner hurried to the bank to get a loan beyond his cash flow capabilities and ability to repay. The banks obliged (after all banks needed to advance loans to deal their huge deposits) and accepted the price-inflated land as collateral. Once the crisis hit, the bubble burst leaving both sides exposed. Irresponsibility finally took its toll.

3. Corruption

Corruption of all sorts, major and minor, also took its toll. Here is what Paul Krugman had to say about corruption and its workings.[19] *"There's plenty of raw corruption….But in many, perhaps most cases, the corruption is softer and less identifiable….At a still more amorphous level, wealth brings access, and access brings personal influence*. And, *"If you leave office held in high esteem by the Davos set, there are any number of European Commissions or IMF or whatnot gigs that you might be eligible for even if you're absolutely despised by your fellow countrymen"*. Cyprus is in a good position to appreciate what Paul Krugman is talking about considering that hundreds of corruption cases have been reported many which are now sitting on the Attorney General's desk pending investigation. At the time of writing, Cyprus received with mirth, and anger, the appointment to high office of unemployed (unemployable!) politicians whose only qualification was the fact that they crossed the floor to support the government. Self interest, corruption and petty politics helped sink Cyprus to the position it finds itself in today on the Global Corruption Barometer (2013 report) that repors that, 53% of respondents felt that 'corruption in Cyprus increased a lot in the past 2 years' vs only 1% that felt that it decreased a lot. Table 5.[20]

Table 5: Cyprus on the Global Corruption Barometer (2013)

Institution in Cyprus	**% of respondents from Cyprus who felt that the institution was amongst the most corrupt/extremely corrupt**
Political parties	91%*
Parliament /legislative	76%
Business	37%
Education systems	27%
Judiciary	38%
Medical /health services	54%**
Police	76%
Public officials and civil servants	59%*

* note: 51 of 107 countries felt that political parties were amongst the institutions most affected by corruption.

** note: 14% of respondents reported paying a bribe to the medical services in the past 12 months.

***note: only 7 countries out of 107 felt that public service and civil service were amongst the most corrupt.

4. Reducing Investment

Due primarily to low confidence in the economy gross fixed capital formation (GFCF) has been hit hard. GFCF in Cyprus fell by 4.9% in 2010 in relation to 2009 and continued to drop ever since by these percentages: 8.7% (2011), 19.6% (2012), 24.0% (2013) and 18.1% (projected for 2014).[21] GFCF measures the net increase in fixed capital (minus disposals) that could include: a) improvements in land (e.g. farmers improving their irrigation systems and fencing), b) improvements in machinery and plant, c) purchases of new equipment and d) construction of roads and buildings such as schools, offices, commercial and industrial buildings and private homes all of which increase the value of physical assets.

The economic crisis reduced investment for upkeep and construction of new public roads and other infrastructure works that are so necessary for the advancement of the economy that is now in recession. Reversing this trend will not be easy because it requires money which the Cyprus government does not have and is unlikely to have in the short term, at least. The depressed mood of a recession sometimes even affects sectors that appear to be healthy, such as the hotel industry in the case of Cyprus. A depressing environment is often contagious. Management is tempted to put off to a later date refurbishment work and other investments for fear of what the future might bring. Even if the economy starts to show signs of recovery the business community will be loathed to believe that the signs are real and will probably hold back on investment.

5. Effects of a Depressing Environment

In the case of Cyprus the recovery process has been held back partly on account of the surrounding depressing economic environment in other euro zone countries as well. The most recent figures coming out of the euro zone disappointed all those that viewed with optimism its immediate economic future. Just as economists (economists are part of the problem says Paul Grugman) in the euro zone were expecting recovery, its industrial production fell unexpectedly, proving the fickle nature of economic recovery and economic predictions. In June, 2014 factory output in the euro zone fell by 0.3%, contrary to predictions of growth in factory output of 0.3% (thus a shortfall of 0.6% from target). This piece of negative news resulted in the fall in value of the Euro against the US dollar.[22] Whilst the fall of the Euro was good news for exporters the reasons as to why it fell make depressing reading.

6. Public Relations and False Positive Messages

Most politicians and policy makers around the world like to give positive messages even when surrounded by negative facts. They tend to put a gloss on bad news with the hope that this will create optimism, show them in good light and win votes for them. This explains the barrage of news announcing massive impending investments from abroad (that at the end never materialized!) and half-truths and vague messages from politicians and officials of the discredited banking system; even some academics fell in the trap of exuberance. Any seasoned PR professional will tell us that false notes of optimism are typically followed by a drop in trust once reality is known which in turn hurts the recovery process even more than before the falsehoods. This partly explains why repeated opinion polls tend to show that the trust level of the people of Cyprus in institutions, elected representatives and those holding positions of authority is all but lost. In years past, Cyprus was characterized by: a) high electoral turnout and b) high politicization of the citizenry. Yet in the last euro parliament elections abstention from voting reached a high of 56% with a much higher abstention rate amongst the youth. Admittedly other European countries did not fare any better but this is no consolation to Cyprus' political system that has known halcyon days in times past. The first party in the last Cyprus elections managed to secure a meager 16.1% (formerly 35%) of eligible votes and the second secured a paltry 11.5% (formerly 32%).

7. Employment

Recession hit employees hard. Cyprus unemployment rate now stands at about 16.9% of the active population (or roughly 78,000 unemployed). The official figure of *registered unemployed* is now 73,000.[23] The young have been worse hit considering that roughly one in four in this age group is now out of a job. Officially 39.4% of Cyprus employable youth (15-24 years old) were unemployed in Q1 of 2014. The growth of unemployment in Cyprus followed this path: unemployment rate of 6.3% (2010), 7.9% (2011), 11.9% (2012) 16.0% (2013), and 19.2% (projected for 2014).[24] In Q1 of 2014, 48,000 were unemployed for more than 6 months and are thus now not earning unemployment benefits.[25] This relatively high unemployment figure caused the government to go back to an old bad habit; that of borrowing from the Social Insurance Pension Fund to cover needs not related to pensions. The government already borrowed 170 million from the pension fund to pay the unemployed. If past practice is any guide these moneys will probably not be repaid by the government.

In the past, successive Cypriot governments borrowed heavily from Social Insurance over 7bil which they never returned. Incidentally, the Troika encouraged government to default on its loan obligation as this particular loan was considered domestic as it was owed to locals (.... owed to natives of colonial times!) This added to the dent in confidence as the government was seen to order by edict the slashing of bank deposits and reneging on loan obligations to the common man. This led to a short-fall in the social insurance fund that necessitated an increase in social insurance premiums /contributions which brought the rates to a neck-breaking 19.3%. It is unlikely that the economy will be able to shoulder such a vast burden that is the result of an ill-thought-out decision. Employers will probably look for ways to reduce and even avoid this crashing weight. If we now add to the above burden (19.3% of payroll) another 4.7% to cover the proposed universal medical plan of the government, the total jumps to roughly 24%.

The economic crisis has also created a major labour utilisation problem. Many of the unemployed fail to register after receiving unemployment for the maximum allowed 6 months. An unspecified number, in the thousands, of young men and women with potential and with a high competiveness index have already left the Island and are now working in Europe, the Gulf and other countries. Most of these young men and women are gifted and their skills levels probably fall at the top 5-10% of their international peers. Indicatively by last count some 44 Cypriot pilots (an impressive number for a small population) are now working in the Gulf region and Saudi Arabia; a number of these are now holding senior positions. All these young, competent professionals had to take competitive examinations and earn demanding certifications before being allowed to compete, let alone be selected. They also had to compete in a strong international field of other gifted candidates.

It is a fact that the first to emigrate are those that maintain an international focus, are highly numerate and/or verbal and know foreign languages. Another group of young men and women started working abroad on completion of their education without first returning to Cyprus. Others have simply given up and just stopped looking for a job and are now in a quandary. Another group of employees work in Cyprus part-time even if they wish to work full-time. Others are working on an hourly basis without any job security or career future. Many work beneath their skills level just to secure a living (no matter how low the standard). These are people penumbra. A notable drop in wages for some has reduced their living standards and the quality of their life; though they consider themselves lucky to still have a job. The median monthly salary of Cyprus dropped in Q2/14 vs Q2 2013 and now stands at 1,807.[26] Many young unemployed and destitute are now staying with their parents for longer than warranted.

8. Consumption and Economic Sentiment

Unemployment and low labor utilisation takes away from consumption. Those that migrated took their purchasing power to the country they migrate to. On the positive side people that left Cyprus reduced Cyprus' labor surplus and unemployment benefits; many also make transfers from abroad to their families in Cyprus. In the final analysis the weak domestic demand is further weakened by those emigrating from Cyprus. Fiscal austerity has added to the consumption problem. Private consumption in Cyprus though up by 1.5% in 2010 and 1.3% in 2011, took a plunge in 2012 (-2.5%), 2013 (-7.5%) and 2014 (projected -6.3%).[27] The latest (August, 2014) economic sentiment indicators make bleak reading, particularly as regards consumption. Below is a sample of current sentiment. Table 6.[28]

Table 6 : Economic sentiment

Sector/factor	Score August 2014*
Major purchases at present (feedback by consumers)	-48
Major purchases intentions in next 12 months (feedback by consumers)	-56
Current overall order books (feedback from Construction)	-85
Expected business activity: sales next 3 months (feedback from the retail trade)	-24

* difference between % positive responses and % negative responses

9. Current Account

The current account balance does not look well either; in fact it never did! Cyprus' current account balance (trade balance plus the net amount received from Cypriot factors of production used abroad in the period) stood at -6.8 % of

GDP (2012), -1.7% (2013) and 0.0% (2014) and -275.7 million for June/2014.[29] The improvement of the 2014 picture is largely on account of reduced imports rather than improved exports. Exports require competitiveness and Cyprus is weak in this area. On the GCI Cyprus holds the unenviable 58th position out of 144 countries on "*competitiveness*." On imports as percent of GDP Cyprus ranks in 78th position and on exports as percent of GDP Cyprus holds 59th position. Suffice to say that in June, 2014 total imports into Cyprus stood at 422,1mil (315,7 mil of which from EU countries) and total exports stood at a meager 146,4mil (88,2 mil to EU countries).[30] The country needs desperately to export as domestic demand is low and no business will produce what it cannot sell.

10. Productivity

For many years Cyprus has been bedeviled by low productivity. There are many reasons for this including: a) "*country's capacity to attract talent*" 66th position on the GCI, b) "*production process sophistication*" 45th position, c) "*capacity for innovation*" 63 and d) "*Flexibility of wage determination,*" 108th position. For the last 30 or so years the average annual productivity in Cyprus was roughly 2% with net average annual salary increases in this period of roughly 3.6%.[31] These and other factors kept Cyprus uncompetitive. The current recession has worsened productivity because of reduced investment in machines and technology and poor innovation. Firms are reluctant to take borrowing risks to invest in plant, equipment and intellectual property for two major reasons: a) Cypriot banks make lending difficult and charge prohibitive interest rates and difficult-to-bear charges. Banks have been known to act arbitrarily (almost pirating) in an effort to cover their bad decisions and inefficiency that ate up their capital and discredited them internationally and, b) businesses have little confidence in the economy as things stand and are thus loathed to take medium- or long-term risks that would entail payback periods of, say, 5-12 years. Unsavoury practices such as the hair-cut on deposits made businessmen adopt short-termism in their investment strategy thus avoiding payback periods of more than a few years. The investment shortfall in technology and machinery hurts the already low productivity of Cyprus. Poor investment in technology is hurting private and public enterprise. On the GCI factor of "*government procurement of advanced technology*" Cyprus holds 55th position.

11. Promising areas not Delivering

At the start of the recession tourism looked as Cyprus' great hope for recovery. In the end this did not happen and the industry failed to deliver the much vaunted results and in the process depressed the mood further. The high educated workforce of Cyprus held the other great promise but this did not delivered either. At the start it was believed that the educated unemployed would find ways to lift themselves out of unemployment (e.g. starting their own business, working remotely out of Cyprus, etc). This did not happen in any notable way. In its *"International Assessment of Adult Competitiveness"* (PIAAC) the "OECD Skills Outlook 2013" puts Cyprus in a bad light considering that: a) on the factor of "*numeracy*" (*"comparison of average proficiency scores 16-24 year olds"*) Cyprus scores fell into the *"significantly below average"* band (Cyprus scored 265 against 288 of leader Japan and 282 point for runner-up Finland). In *literacy* Cyprus (score 267) found itself in the same band as that of numeracy. Japan (299) and Finland (297) earned first and second place respectively on literacy. Encouragingly the GCI placed Cyprus in 10th position on the factor of *"quality of math and science education."*

Naïve attempts to resurrect the financial services sector also failed just as attempts to bring into Cyprus new international investors failed; at least for the moment. All these disappointments point to the reality of long-drawn-out recession that will not go away. Typical of the way many governments, with little experience in handling major economic crises, deal with recession, the Cyprus government attacked the problem through "feel-good" PR exercise and promises of a bright future that apparently was just around the corner. Instead of looking at the seriousness of the problem with great care and thoughtfulness the Cyprus government started putting out outlandish pronouncements of foreign investors that were queuing to kick-start the economy, of impromptu presidential visits to the Gulf followed by pronouncements that investment agreements were just about to be signed with X or Y country from the Gulf and other places. One of the most amusing of these attempts was the first-page report in a pro-government paper with the title, *"first the airline connection and then investments will follow."* Apparently one of the Gulf airlines decided to establish an experimental route to Cyprus which was in the airline's plan for some time. This simple business activity was "sold" as the precursor to large Gulf investments in Cyprus; as if prospective investors need a direct airline route before investing in a country. Needless to say that at the end nothing materialized! When the government was supposed to repay an internal loan that was falling due it managed to rollover the loan through high-interest bonds. Bloomberg had this to say, *"Cyprus sold the June 2019 bonds to yield 4.85 percent, down from initial price talk at about 5 percent, according to the finance ministry. The sale exceeded expectations and the cash raised will be used to help finance internal borrowing).*[32] Instead of the government coming out with facts and reality it came out with triumphant propaganda that lasted for weeks. *"We are now back in the money markets",* read the headings. This created false exuberance. After the bond issue Cyprus' credit rating continued to hold 97th position on the GCI. The government of Greece employs similar practices whilst its high public debt continues to throttle the economy. Exuberance was partly created from outside the country as the European Commission predicted in November 2010 that Greece's economy in 2012 would grow by 1.1%. The same body predicted growth for Greece in 2013 and also 2014. A former prime minister of Greece (who has much to explain as regards the mismanagement of the economy) announced triumphantly in December 2010 that Greece would be out of the woods in 2012. Greece is still in recession.

12. Quick Fixes do not Work

The Cyprus government's first-aid packages did not work either as these were bereft of sound planning and failed to take into account that business activity requires sound infrastructure and long-term planning and above all trust. For example, the government promised to grant government land to young unemployed wishing to employ themselves in farming. The scheme failed to provide the expected results as the land holdings were too small to sustain meaningful farming, the reliability of the water supply was in doubt and the skills set of the new farmers was below par despite going through a hurriedly-prepared training program.

Through one of its departments the government announced schemes that were meant to subsidize the cost of employment in an effort to encourage employers to employ more staff. This scheme was designed to pay for ten months 50% of the cost of employment with a maximum government outlay of 5,000 per employee. The scheme naively assumed that employers would create new jobs out of nowhere simply because they would temporarily enjoy access to cheap labor. The reality is that such schemes rarely have long-term prospects because in the long-term what determines the employment levels of a business is its ability to sell and offer real value to the customer. Businesses will not produce unless they have a customer.

The failure of such schemes discredits the overall government effort. The daily political pressures on government to do something appear to have pushed policy makers towards hurried actions that usually fail to take into account market and economic realities; worse, they fail to take account of the social system within which a particular economy operates. Cyprus now finds itself in the trap of thinking that major structural problems can be addressed through quick-fixes. Of the many Cypriot quick-fixes the one that offers visas and passports to foreign third country investors stands out (even if this practice is not unique to Cyprus). Under pressure from land developers, realtors and politicians Cyprus initiated a scheme to grant third-country citizens migration permits, permits of long-term stay or even passports; ostensibly to entice them to "invest" in Cyprus. To many in Cyprus this scheme looks like an effort designed to hurriedly bring the land development industry back from the dead. Even the uninitiated know that serious investors are welcome everywhere in the world and do not need preferential visa arrangements to entice them to invest. Those with sustainable projects chose to set up business in places that they believe will provide them with value and not in places that will trade a visa for an investment project. All countries welcome good investors and in fact bend over backwards to accommodate them. Rarely do people choose a country to invest in based on visa facilitation.

Current efforts to revitalize the real estate market, that to a large extend has been one of the major culprits of the current calamity, is not the answer. One piece of evidence to this effect are the attempts of the Cyprus Investment Promotion Agency-CIPA.[33] The CIPA was set up by law in 2007 for the purpose of promoting outside investments. A cursory look into the internet site of this body gives the impression that its main focus is the real estate market and not much else. Rather than generating new ideas the CIPA seems to have reverted to the beaten track of the past.

The visa offer/attraction gave real estate salesmen the platform on which to plough their wares to third-countries (targeting primarily countries with political instability and people wishing to secure residence and ultimately citizenship of an EU country). The author witnessed in person the efforts of real estate salesmen in his travels to Cairo. He had occasion to talk to salespeople and also read their brochures many of which carried titles to this effect, *"If you wish to obtain a Cyprus visa then start thinking about buying property in Cyprus."* The brochures outlined in detail how to go about securing a visa in an EU member state. In June 2014 a senior migration officer of Cyprus addressed the Cyprus International Business Association (CIBA) saying that starting 2012 Cyprus granted a total of 1,124 migration permits to third country citizens which required the holders to buy a house in Cyprus for at least 300.000. In the same period another 813 regular migration permits (not related to the above scheme) and 257 long-term stay permits were granted to third country residents. Recently the Ministerial Council of Cyprus approved the scheme for naturalising by exception non-Cypriot investors. The scheme set out the criteria under which non-Cypriots businessmen /investors may secure Cyprus citizenship. Specifically, citizenship will be granted to foreigner business people with 5 million investment in: real estate, government or private assets, Cypriot companies or Cypriot banks (deposits count as investment!) Additionally, citizenship will be granted to depositors that suffered at least 3mil haircut during the depositor bail-in of 2013. In every case the investor is required to buy a house of at least 500,000. Long-term stay requires a minimum of 5 years residence before applying. Many economic purists look askance at such practices and consider these suspect as governments use their right to issue visas and to grant citizenships to aid business. In some ways such practices remind one of agricultural (or other) subsidies. The EU is not happy with visa/citizenship practices as these impact on other countries as well. Some other EU countries are employing similar practices and only recently Malta came under fire from the EU for doing exactly this. *BBC* lately reported that, *"The tiny nation of Malta recently came under fire when it announced plans to allow wealthy foreigners to obtain a passport for a 650,000 euro investment with no residency requirement, which would have made it the cheapest European Union (EU) nation in which to purchase citizenship. Prime Minister Joseph Muscat estimated about 45 people would apply in the first year, resulting in 30m euros (£24m; $41m) in revenues."* Interestingly Malta expects a mere 45 people to apply whilst Cyprus expects thousands!. After pressure from EU officials, Malta changed the rule and now requires potential passport holders to reside in Malta for a year and raised the investment to 1.15m.

Instead of Cyprus relying on its own potentialities and good planning to reinvent itself, it started looking for easy solutions through "giveaways" that are reminiscent of the failed practices of the past (e.g. attracting huge bank deposits by offering interest rates of 4-5% and then placing these funds in high risk ventures). Cyprus is failing to take an honest look into the real reasons that put her in 58th place on the GCI. Equally Cyprus does not inquire seriously why it gets bad ratings on other investment-related parameters such as: a) *"business impact of rules on FDI"* (foreign direct investment): 51st position, b) *"FDI and technology transfer"*: 78th position and c) *"number of procedures to start a business"*: 57th position. Sound investors first look for promising business opportunities, transparency, well-functioning civil service bureaucracy, property rights (54th position on the GCI index for Cyprus) and a sound and incorruptible banking system. At the time of this writing the *Time magazine* reported that only 11% of respondents trust the banking system of Cyprus. This flies into the face of declarations by the Association of Cyprus Banks (June, 2014) that, *"trust in Cyprus banks is gradually being restored."*

13. Innovation

People that believed in innovation as a tool for economic recovery were disappointed from the Cyprus paradigm. Cyprus now lies in 63rd position on the GCI's *"capacity for innovation."* Cyprus' low ratings on innovation defy logic because Cyprus is rich in talent and claims a large pool of academically qualified people. One would have expected that this calibre of people would have easily promoted innovation. Cyprus' notorious bureaucracy is of course a barrier to innovation. So, is the low connectivity between Cyprus' many universities and institutes with industry and the market place in general. The need of some academics to study and research issues of an international, rather than of local, nature helps them further their research potentialities abroad but does not necessarily help Cyprus; this may partly explain why not much innovation is taking place in Cyprus. Furthermore, Cyprus may also have a problem with accepting and disseminating innovation fast enough. Rogers[34] supports that ideas spread assuming an innovation exists in the first place. Many other issues need to be dealt with after the innovation is announced. Many of these issues are not in the control of the innovator. These issues include communication channels to get the innovation known and accepted, time to allow the innovation to be adopted by people speedily and a social system that is willing to work towards the common objective of accepting, adopting and applying the innovation. Cyprus seems to have failed to produce innovative products, processes and ideas in the first place. Low rate of innovation coupled with a low adoption and implementation rate by society of the few innovative practices and products that Cyprus may have created, puts Cyprus in 63rd position on the GCI.

Despite the creation of several research institutes and the work of many well-qualified individuals Cyprus still remains dishearteningly low on innovation. The rate of adoption of innovative practices in the civil service of Cyprus is not something to be proud of. Departments and ministries tend to create fiefdoms that isolate staff and thus harming cooperation, communication and joint effort. The obvious need in the civil service to transfer staff from one department to another (hardly an innovation!) has not yet been adopted despite two decades of discussion. For reasons of self-interest unions, department officials and employees refuse to accept this most obvious practice that one finds even in the most primitive organisational systems. In June, 2014 a Cyprus cabinet member said (in translation), "recovery of the Cypriot economy undoubtedly will come through the entrepreneurship, innovation of the productive sector.... The role of the public sector....is to work supportively in this direction." Interestingly, this particular message does not recognise the need for the public sector innovativeness.

14. Unemployment: the Problem that will not go Away Easily

To be considered unemployed a person must: a) declare that he/she is not working, b) wish to work, c) have actively sought employment in the last 4 weeks and d) be willing to work or is waiting to start work in the next 4 weeks. Anyone out of work who fails to meet the above criteria is "economically inactive" rather than unemployed. The International Labour Organisation (ILO) defines unemployment more or less as above and covers those 16 years or older. The rate of unemployment is defined by the ILO as the ratio of economically active people who are unemployed (as per above definition of the term "unemployment.") People that are retired or are pursuing education or that have stopped looking for a job because they have come to the conclusion that there are no job prospects, and therefore are discouraged from pursuing the task of finding a job, are excluded from the labor force.

15. The Causes of Unemployment are Varied and Include amongst Others:

Employers often refuse to hire new staff because they consider that the going wages are too high *(known as "classical or "real wage" unemployment).* At one point unions in Cyprus pushed wages to prohibitive levels in certain sectors and in the process drove some companies to the ground; particularly in the agricultural sector. Here is an example from the author's work experience: whilst the free market was paying 850 per month for the services of an unskilled potatoes packing worker the unions forced some companies (through threat of strike which when it materializes can ruin perishable products in a matter of days) to pay employees two or three times the going wage; ostensibly to compensate for the fact that the employees were long-serving. In other words an employee with 10 years of service had to be paid twice as much as one with two years of service even if the latter performed twice as well as the former. This happened with the tacit support of the ministry of labor's mediation service; they obstinately failed to see any link between performance and reward.[35]

Even in the most vibrant economies some people are unemployed because it takes time for those that lose their job before they can locate a promising vacancy, applying and ultimately starting to work *(known as "frictional" or "search" unemployment).* With the recession in full swing not many vacancies exist in Cyprus today, leading some job seekers to even stop searching. In a small place like Cyprus vacancies become known rather speedily either through word of mouth or through the unions; this helps cut down the in-between-jobs time.

In times of great change in the economy (including recessions) employees that lose their jobs need to adapt to the new realities quickly. This often entails upgrading, or even acquiring, new skills that can help their employment prospects. A prolonged skills' mismatch unavoidably increases one's period of unemployment *(known as "structural" unemployment).* In the case of Cyprus many of those that lost their jobs are in industries such as construction where the immediate outlook looks grim. Many are trained artisans and will thus find it difficult to look for alternative employment in the tourist sector for example. Worse still, they run the risk of losing their skills-set through prolonged unemployment. Many of the unemployed from the banking sector may find it difficult to locate a job at their old salary. Coming from highly unionised and protected environment former bank employees may even have to face adjustment problems in transiting to a more competitive environment.

Those that are now unemployed, but before held unionised jobs, may need to change their attitude to work. The problem transcends skills and goes into behaviour. The banking work environment of the last 30 years was closed and had created a comfortable symbiosis between management and unions that was disastrous for the customer. Indicatively, members of the employers negotiating team were often union members as well and thus benefited equally with other employees from the outcome of the negotiations. During the negotiating process they had no reason to go against their own interests by standing up to the unions. With this and other astonishing practices the banking sector became the coveted place of work for those that wished to have absolute security coupled with a high salary. Unemployed staff that come from such "happy family" environments certainly need to have a change of perceptions as what work ethic entails.

Globalisation that is often blamed for developing structural unemployment is not very prevalent in Cyprus; except maybe in the low-skills food and catering sector now that international food chains started operating in Cyprus. Seasonal unemployment on the other hand has always been a major problem for Cyprus considering the seasonality of the tourist industry and the fact that many coastal hotels and restaurants remain closed throughout winter.

Cyprus has been hit badly by recessional unemployment *(known as "cyclical" unemployment)* as a result of: a) the shrinking economy that forced many employers to shut their operations or retrench and b) falling aggregate demand *(demand deficient Keynesian unemployment).* Putting the unemployed back will require more that "normal" growth rates in the economy *(see* Okun's law *below for the empirical relationship between GDP growth and unemployment levels).*

There is little data on Cyprus' *"voluntary" unemployment* but one would suspect that there is no major problem to deal with. The right to unemployment pay is limited to 6 months only and this discourages people from willingly staying out of a job for long. The proposed guaranteed benefit for the needy is unlikely to encourage voluntary unemployment as the proposed guidelines are quite strict. Also, income tax kicks in on incomes of more than 19,500; this removes taxation as an incentive not to work. A potential problem could be the equilibrium wage rate that is now falling and in all likelihood will continue to fall. If this happens some may be discouraged from working on account of low salaries. The after-tax salary of all employees has already fallen due to the special levy on salaries.[36]

Unemployment is a major and intractable problem because: a) under recessionary conditions the unemployed will not produce even if they wish to; thus restraining economic growth, b) the government is forced to provide relief funding. As we have already seen the government has already transferred nearly 200mil from the pension reserves to cover shortfalls in the hard-pressed unemployment fund. Additionally, the government is forced to reduce spending in health, education, etc., as the need to provide relief to the unemployed and the destitute increases c) the high unemployment of the young and the educated means that the costs parents and society incurred to educate the youth is not providing the needed return to justify the expenditure; aside of course of the psychological trauma the unemployed experience, d) the inflow of direct and indirect taxes to the government purser reduces because the unemployed pay minimum indirect tax as they spend so little; not to mention the fact that the unemployed typically burden society with many physical and mental health problems, e) Cyprus is already experiencing the surreptitious negatives of a potential diminished skills pool despite the feeble attempts at retraining the unemployed. A young graduate that stays unemployed for, say, two years can hardly stay competitive in the job market.

The unemployment problem is likely to stay with Cyprus for a long time considering the current and expected progress of the economy and the debilitating effects of a broken banking system. If *Okun's* theory of a direct relationship between output and unemployment is to be trusted then it will take a miracle to put the unemployed back to work. To make a dent on unemployment the economy needs to grow by more than the "natural" rate because the labour force has a natural rate of increase which holds the unemployment rate in a steady position. Equally, unemployment in the short-term could grow because of increased productivity on account of the use of more technology (i.e. robotics reduce the need for manpower). Therefore, to reduce unemployment the economy has to grow above its potential (say 2% in the case of Cyprus and between 2.3% and 2.6% in the case of the USA). On the basis of *Okun's* useful predicting technique (and assuming no imponderables in the Cyprus economy) to achieve a drop of 1% in unemployment the economy must grow by 2% above its potential/natural growth rate. This means that it would take a 4% growth in GDP to reduce Cyprus' unemployment by 1%. Not an easy task considering the unstable and discredited banking system and the absence of a real economy besides tourism and shipping.[37] In discussing the future unemployment rate for Cyprus one must be weary of the direction inflation might take and how this may impact on the economy. Friedman differentiates between rising and high rates of inflation and warns, "*A rising rate of inflation may reduce unemployment, a high rate will not*".[38]

Some may feel optimistic about the future of unemployment considering that salaries and benefits in Cyprus are likely to drop and will thus make employers more likely to hire new employees. But, will employers hire more staff if they know that there is little demand for their products due to falling consumption? The labour market in Cyprus could easily fall victim to "*hysteresis*" as the unemployed lose their skills and also their will to work. Under conditions of "*hysteresis*" unemployment remains higher than expected as a result of the damage caused by prolonged economic recession and the shocks that this creates. Those that stay in employment during the recession do not take kindly to having their wages drop; this explains why wages in Cyprus have not reduced as much as one would have reasonably expected. If those that remain unemployed succeed to keep salaries at a relatively high level during the crisis then this will not allow the labour market forces to take effect and create a new equilibrium (i.e. though the market will experience high supply of labour wages it will not fall to make employment more attractive for businesses).[39]

In summary: the recession and the accompanying unemployment have brought with them, amongst others, reduced revenues for the tax man, lower-self respect for the semi-employed and the unemployed, employment in menial low-paying jobs, loss of skills and reduced competitiveness in the labor market, physical and mental problems and higher expenses on social benefits from a cash-strapped government.

15.1. Reducing GDP and Increasing Public Debt

Cyprus' GDP growth versus that of the other EU countries in the last 7 years appears below. Table 6.[40]

Table 6: GDP growth: 2008–2013

GDP growth for 27 EU countries						
2008	2009	2010	2011	2012	2013	2014
+0.4%	-4.5%	+2.0%	+1.7%	-0.4%	-0.1%	
GDP growth for Cypurs						
3.6%	-1.9%	1.3%	0.4%	-2.4%	-5.4%	-4.1 (Q12014– *(Cyprus Ministry of Finance)*

Cyprus is now beset by a falling GDP and a rising debt (on the factor of *"general government debt"* Cyprus ranks 136th on the GCI) that makes the economic situation look very bad. All the markers show that not all is well with the Cyprus economy. In the last 2 years Cyprus produced relatively less goods and services (adjusted for inflation) than the average of the EU; which also includes countries in crisis such as Greece, Spain, Portugal and Ireland. When GDP drops everyone in the country suffers, *"since income comes from selling stuff, it's also the total amount of income earned, determining the size of the pie that gets sliced between wages, profits and taxes"* to use Paul Krugman's language.[41]

So, is Cyprus in recession or depression? In the early 70s, and in response to a question, President Nixon jokingly described economic recession as, "*.... when your neighbor loses his job*" and depression as, "*....when you lose your job.*" Much earlier, in the 30s, Keynes[42] took a more comprehensive (and comprehensive) view of depression by defining it as *"a chronic condition of subnormal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse."* In summary, Keynes viewed economic depression as: a) a below normal activity that, b) tends to last and which c) suffers relapses and vacillations (a little bit up and a little bit down but without meaningful progress towards health or regression towards collapse). For Cyprus semantics do not matter. The fact is that Cyprus (the only country in the EU to experience depositor bail-in) has a broken banking system, its GDP is reducing, its unemployment and government debt are rising. None of the above are likely to go away soon. Cyprus' national debt in relation to some of its neighbors does not look good either when one compares what the relative situation was 10 years ago and what it is now (2003-2014.) Cyprus debt as % of GDP took a swing for the worse (42.6%) over this 10-year period whilst that of Malta, a fellow EU member, registered a minor swing for the worse of only 10.3%. All three of Cyprus geographically close countries had a positive swing in that the ratio of debt to GDP dropped significantly over these 10 years. Table 3.[43]

Table 3: Public Debt in 2003 vs 2014 of Cyprus and its Neighbours

Country	Public debt per person 2003 $	Public debt per person 2014 $	2014/2003	Debt as % of GDP 2003	Debt as % of GDP 2014	2014 -2003
Cyprus	12,716	22,105	1.73836112	68.40%	111%	42.6%
Malta	8,562	14,666	1.712917543	64.80%	75%	10.3
Egypt	1,307	2,839	2.172149962	132.60%	78%	-54.4
Israel	18,033	23,533	1.304996395	100.20%	77%	-23.4%
Lebanon	8,268	14,291	1.728471214	166.70%	115%	-52.1%

Of the 4 comparator countries Cyprus comes out worse on national debt as percent of GDP. Cyprus' national debt grew from a manageable 68.4% of GDP in 2013 to a difficult-to-manage 111% in 2014.

16. Where Does one go from Here?

In all probability the Cyprus economy will remain in a muddle for a long time to come as there is no integrated plan to help the economy come out of the morass and the problems are far too many and serious; particularly those of the banking sector and its lack of credibility which in turn affect and pull down the economy. For a start the economy will first have to overcome nepotism, sleaze, dishonesty, corruption, half-truths, propaganda, cunningness, intrigue, short-termism, self-interest and all those behaviours that helped bring Cyprus down to its present dismal condition. The population is leery of anything said and of anyone in public or private domain. Trust levels are at an all time low and this must be redressed as soon as possible. It will not be easy, however, considering that mistrust goes very deep. It took decades of bad practices, bad ideas and bad behaviours to ruin the Cyprus economy. Recovery will need time. In the author's view the single most serious issue that the economy suffers from is that of low trust: trust in banks, in government, in institutions, in mass media, in the school system, in the legal and accounting sectors, in consultants, in academics, in economists, in hoteliers and the list is endless.

On the plus side the Troika is now helping bring about some long over-due structural changes though its role is beginning to erode as people are beginning to mistrust the Troika and its motives. Troika's high handedness and its role in degrading the democratic processes of Cyprus have been instrumental in creating a negative and sometimes hostile environment. The Troika has forced the passage of laws through parliament without the required democratic due process of extensive debate, it made agreements with government for fundamental changes in the law on the premise that parliament will endorse these willy-nilly because it would be given no choice. Troika uses threats (withholding tranches of money) to force through often unpalatable changes, etc. By side stepping parliament the Troika in its own way is eating away at the fundamental pillar of democracy: that of checks and balances. Worse still, the Troika is sometimes exhibiting a blatant disregard for the common man's feelings. The author is one of the original supporters of the Troika but above all is a committed devotee of democracy.

Even if restructuring takes place with the help/pressure of Troika concern will linger on as to what happens after the Troika leaves Cyprus. Will the changes to be brought in be sustainable or will Cyprus revert back to its old habits. It is uncertain how committed the political establishment, the unions and the many vested interests are to real and lasting change when this goes against their narrow self-interests. As these lines are being written the government back-tracked hurriedly from imposing a long-overdue and absolutely reasonable tax on the government-funded (at 100%) lump-sum payable to retiring public sector employees because of the threat of strikes. Many worry that the same actors that created the economic morass will soon regroup and revert to their old bad habits of promoting self-interest.

On the minus side the Troika seems to have a fixation with austerity and austerity alone which in the short-term diminishes any meagre chance of economic recovery. In fact every feeble attempt to re-start the economy in the last 2 years or so has failed; public declarations of impending investments now draw laughter. One gets the impression that the Troika is in tunnel vision mode and only looks at a balanced budget (and repayment of money owed to it by Cyprus) rather than growth and reduction of unemployment. No wonder many in Cyprus and Greece see the Troika as an agent of austerity and harbinger of ills to come. It is now common belief in both countries that the Troika failed miserably to take short-term growth into account. This unavoidably creates a negative environment towards Troika which ultimately hurts the recovery process.

Growth needs a plan and to date no such plan is in place. The random and isolated voices that express impromptu views on what needs to happen do not constitute a plan. None of the following bodies have come up with a coherent and integrated plan on how to bring about economic growth: Cyprus Government, Chamber of Commerce, Employers Association, Bankers Association, universities, unions and the Cyprus Investments Promotion Board (that looks increasingly more like a land development agency than an investments board!). Cyprus now needs urgently a short-term integrated growth plan. The long-term can wait for a while, though not for long, because as Keynes reminds us, *"This long-run is a misleading guide to current affairs. In the long run we are all dead."!*

Cyprus now *lacks a sound economic plan* that can propel the economy to growth and in turn create the conditions for improved standards of living for its people. Lee Kuan Yew, the "father" of new Singapore, sets the following preconditions for an improved economy and consequently improved standards of living, *"A people's standard of living depends on a number of basic factors: first, the resources it has in relation to its population…..; second its level of technological competence and standards of industrial development; third, its educational and training standards; and fourth, the culture, the discipline, and drive in the workforce"*.[44] Cyprus appears to fall short on at least some of the above requirements: a) limited natural resources; except for plenty of sunshine (the issue of potential energy finds is not covered in this paper), b) low technological absorption (see GCI), c) low industrial development and production process sophistication (see GCI), d) an educated cadre (strong but not necessarily well trained (43rd position on the GCI's "extent of staff training") and e) low discipline and poor organisational culture (see GCI on productivity and competitiveness). The author singles out work culture in the public sector and the political establishment as being probably the most worrisome factors both for Cyprus and Greece: poor and shoddy customer service, low productivity and slow speed of doing things. It took decades of public debate about transiting to the cheaper option of gas for the generation of electricity; yet nothing has happened and Cyprus's economy is now languishing under the weight of the most expensive electricity supply in the EU. In the meantime the cost of electricity is literally ruining some sectors of the economy.

And now back to trust once again. In the author's view *loss of trust* is probably the biggest impediment to growth. As mentioned earlier Peter Drucker says that it takes 21 years before a cheated bank customer can forget and forgive. Trust in banks, in the political system, in institutions, in people would need to be reestablished. But, trust is a fickle thing and does not obey dictates. To regain trust banks would need to change their ways, the political elite would need to act decently and fairly, the business leadership would need to become less self-centered, the school system would need to deliver value for money by focusing more on the student and so on and so forth.

It is said that bankers hate two things: a) low interest rates and b) high inflation. The current high interest rates and fees are not sustainable, create a catch22 situation and need to be urgently revised. The Cyprus economy cannot bear this kind of bank rates and charges. Those players in the Cyprus economy that benefited from the old banking paradigm would need to look elsewhere for income as the banking industry will probably never be the same. The new banking system would need to be smaller and within the capabilities and potentialities of Cyprus. Gigantism should be a thing of the past. Not many rational investors would be willing to risk their money in a troubled economy that does not have a semblance of banking decency and respect for depositor and borrower. Cyprus needs to build a down-sized banking system literally from the drawing board if hope is to return to the banks, the peripheral financial industry and the market. The current modus operandi as regards banks is not sustainable just as the high interest rates are not sustainable. Breathing life into the banking system will not be easy as the mammoth (8-9bil) ELA (emergency liquidity assistance) burden is holding hostage both banks and government (as guarantor of the ELA debt). The high NPLs do not help the ELA situation either. New banks are unlikely to be set up but some of the more decent banks now in operation could play a more helpful role right away. In fact some are already doing so.

Banks are unlikely to accept the recommendation of a *debt hair-cut,* for some borrowers at least, which to the author looks like a rational option. Banks could support depositor hair-cuts, if necessary, but hate debt hair-cuts no matter how rational this option may be in the end. It all goes back to psychology and the sin of fear. Banks know that they will simply not get back fully what is owed to them because of the issues surrounding NPLs; even if they bankrupt their customers (and in some cases their guarantors). Better for the banks to consider a debt hair-cut than selling people's properties at forced-sale prices and then spending time and money in court trying to bankrupt borrowers and guarantors and in the end collecting only a fraction of what is owed to them. Both options lead to the same result: in the end banks lose money; except that the debt hair-cut option is more rational, less expensive, less harmful to the economy and less detrimental to the already bad name of some banks. Granted, a debt hair-cut would be a violation of banking principles but the banks already violated their own rules and customs by bailing-in depositors that once trusted them with their money. In my view the debt hair-cut violation will be less repugnant than the depositor hair-cut and will give the banks and their customers a chance to redeem themselves. Though rational, this option is unlikely to be accepted by the banks largely because of fears that this will encourage future borrowers to default. This fear is probably unfounded because under normal conditions the vast majority of people would settle their accounts promptly.

Real-estate prices are expected to continue to fall as more and more properties that now serve as debt collateral for NPLs, will start being auctioned off. Fewer properties will be auctioned off with a debt hair-cut. Mass auctions are likely to cause this spiral: a) property prices will fall just as customer net worth will automatically fall, b) many property owners will not only become poorer but they will also go into bankruptcy, c) disposable cash will reduce and this will hurt consumption further, d) government will be hard-pressed for revenues and as such will attempt to impose more taxes on less people to pay its bills (the public sector payroll is unlikely to reduce significantly because of voter politics) and e) government will be hard-pressed to increase its spending on social welfare but it will not have the money to do so (?more taxes). The above cycle is likely to spare the civil servants (and probably the banking employees) that are the sacred cows of the political establishment on account of their strong voting power.

The *public sector's general inefficiency* should be on the top of the list of priorities of improvements that need to be made in the direction of growth. The current verdict of the GCI as regards the Cyprus civil service is not at all flattering. The Cyprus civil service (just as that of Greece) has become a complex web of unnecessary bureaucratic hubbub that literally throttles progress; both at businesses as well as at individual level. Bifurcation of interests between competing, rather than cooperating, departments makes delays in performing a task the rule of the day. Managers build absurd empires that are impregnable and of little use to the tax-paying citizen and businessman. The delay in the introduction and proper use of IT is creating frustration and hampers the work of business and the public. Some suspect that the e-government project is boycotted by those in the civil service that wish to exercise arbitrary power on the citizen through civil servant discretionary powers. Tiers of management were created over the years with a view to accommodating the interests of party apparatchiks and in the process efficiency was stalled and decision-making came to a near standstill. An untold number of committees and "coordinating" bodies, that often yield few if any results, bedevil the proper functioning of the civil service. The higher one goes in the hierarchy the more meaningless meetings one is asked to attend.

Lack of accountability and punishment is probably the single most important barrier to the proper functioning of the civil service. Thousands of telephone calls from the public remain unanswered and letters are rarely answered on time; if at all. The author reports the following anecdotal evidence from a recent interview he had with a taxpayer: on a visit to a government department this particular taxpayer was told that the computers were down and was asked to return later. He gave his mobile phone number to the attending clerk asking her to kindly call him once the computers were up and running so that he could return. Her response was, "you call me as many times as necessary to find out about the status of the computers." This attitude would never be tolerated in any proper functioning organisation. Worse, Peter had no recourse knowing his complaint would go unanswered and that there would be no disciplinary action; of the 72,000 public service employees in Cyprus hardly anyone ever got punished in the last 20 years. The civil service efficiency and its cost will be central to the true recovery of the economy. And the question arises: are people hopeful that improvement will come soon? Probably not! The difficulty is that no country in recession can truly recover without an efficient bureaucracy.

The government is unlikely to take the tough decision of *laying off supernumerary public sector* employees because it will be terrified of the political cost this will entail and of the long-term effects of a reduced captive voter pool. Nor will the political establishment put pressure in the right direction. Reducing the public sector headcount by 4,000 by the end of 2016 through normal and voluntary retirement, as is the current plan, is not likely to solve the problem; their numbers are far too high. The way head count is reducing now also runs the risk of creating performance problems in an already low-performing sector; the current scheme does not provide for staff renewal. In a letter to a high ranking European Commission (EC) representative, and later member of the Troika, the author suggested an annual net reduction in head of 3,000 per year on the basis that for every 4,000 leaving, 1,000 would need to be recruited. This letter was acknowledged and forwarded internally to the ECB and the IMF. In this letter the author recommended that the program of annual staff reductions and renewal would need to continue until the public sector head count is reduced to about 70% of its pre-Troika size (e.g. the 52,000 civil servants to be reduced to about 36,000). But, applying the above suggestion to the full will take time and Cyprus is now short of time considering the way things turned out.

Now the author puts forward another alternative that would help government achieve results quickly, help reduce the tax burden on the economy and improve the economy's disposable income. The author recommends mandatory early retirement (starting with those with poor performance and poor attitudes) amongst employees aged, say, 50 or above. This is the group of employees that profited most from past bad practices, earned high salaries (much above EU norm) and contributed little if anything towards their pension. To reduce the possibility of creating social problems for this class and to reduce a possible negative impact on consumer demand the author recommends that these employees start earning pension immediately after they leave public service. The monthly pension to come out of the amounts earmarked for their natural retirement; thus, no extra cost to the taxpayer. These steps would need to be applied: a) calculate the cumulative expected pension at normal retirement (at 63 now) using actuarial data, b) divide the cumulative pension figure in "a" above with the years the employee is expected to earn pension from the day he leaves the service under the above recommended scheme, c) consider the figure from "b" above as the redundant employee's pension starting on the day he leaves the service. With current data a male civil servant is expected to live actuarially for, say, 15 years after normal retirement (at 63) earning total pension of 400,000 (15 years X 26,666: assumed figure). If the employee now retires at, say, 58 an additional 5 years of pension time would need to be added thus bringing the total period of retirement to 20 years. If we now divide 400,000 by 20 years the annual pension will drop to 20,000 (from 26,666) paid over 20 years instead of 15.

Investment in *asset maintenance and renewal and capital investment* is likely to improve slightly as businesses see their assets decaying and becoming obsolete. At some point lorries will need to be renewed and buildings will need to be painted and refurbished. But, such measures are not expected to save the day and will not impact strongly on the economy which is in great need of new investment. One traditional way of kick-starting the economy is for the government (or government plus private enterprise) to invest in real infrastructure projects that will provide employment and generate business activity. The problem with Cyprus is that the government does not have any money to invest in infrastructure as it is heavily indebted and soon will need to start repaying interest. Additionally, few if any promising projects exist in which to invest. Cyprus has done a terrific job on highway construction; for its size and economy Cyprus can claim some of the best roads in the world. Thus, most if not all major and necessary road-development programs have all but been completed. Cyprus gets another first for its damps that help the country collect winter rain for use during the dry summer months. This project has also been completed. The same applies to the desalinization program. The two major airports have been completed as well. There is, however, work to be done on Cyprus' two ports. A promising project could be the building of a technological park; which has been long over due. Also, new marinas for the tourist industry could be another option. Surely one can think of other opportunities that can give the economy a gentle push.

Cyprus needs to improve the quality and distinctiveness of its goods and service if it is to improve its *export* position. Cyprus has a tiny domestic market and below EU average productivity. Both factors reduce the country's export capabilities. A large domestic market often acts as magnet for foreign investment in areas such as manufacturing, for example, which in turn acts as platform for exports to other countries. Egypt, with its low cost of labour, comparatively good universities and qualified professionals does that well in, for example, the manufacture of beverages and pharmaceuticals and software development. Cyprus is also hampered by low productivity which does not seem to improve despite the setting up of a productivity council that was supposed to spearhead the advancement of productivity. Productivity largely depends on the efficiency of labour, innovation and investment in technology. Cyprus sometimes finds it difficult to invest in technology on account of its tiny domestic market, minimal raw materials and tiny consumer market. For example, the packing of Cypriot fruit for export relies to a great extent on expensive labor rather than on machinery. The quantities of local fruit for packing and export are so small that they render uneconomic investment in high-capacity technology. This in the end pushes export prices up and makes the export of fruit not competitive.

Many of the international manufacturing companies that Cyprus played host to in the past have left: processing and packaging, e.g. Tetra pack, soft drinks, e.g. Pepsi Cola has stopped its bottling operations and is now thinking of restarting but employing just a mere 20 or so new employees, e.g. BAT left because it does not make sense for the company to be in Cyprus which has: a small market, little export potential, high labour cost and unions, inefficient civil service, restricted flights (Cyprus holds 64th position on "available airline seat km/week" on the GCI). In terms of manufactures Cyprus now exports generic drags, cheese products, etc but in relatively small quantities. The pharma business is hampered by high energy costs, union constraints and a stifling bureaucracy. Garment and shoe manufacturing, that once stood as the bulwarks of Cyprus' export economy are now a fading dream and a closed chapter. Low quality and high production costs drove the industry on its knees.

Cyprus can improve its export position if it manages to produce items that can offer *relative advantage* (based on quality and uniqueness rather than on price and competitive advantage). In other words, those products that are more advantageous to the customer than competing products. This is not an easy task, however, because the country needs first to build a name as producer of quality and distinctive products. History and past practice is not on Cyprus' side. But, it can be done through transfiguration and radical change in business culture, innovation and work ethic that would support quality.

Countries that enjoy relative advantage are innovators and have a long history of producing high-quality products, e.g. Germany and Switzerland. Cyprus missed opportunities to develop relative competitiveness in products in which the country traditionally had a historic advantage. Cyprus' viticulture goes back 4,000 year. The same applies to cheese products. These areas should be revisited and put on relative advantage mode. Cyprus has great promise in the IT area provided it organizes itself well and its people adopt high work standards. With sound planning and a proper road mapping much can be done. Who would have ever imagined years back that Lebanon would now be export high quality sweets, even chocolates and, of all things, designer cloths? *Internal devaluation* (decreased wages) should not be encouraged except perhaps in select cases. Nor is leaving the euro zone and bringing in a debased currency an option.

The *services sector* has the potential to contribute to exports but needs to be re-designed, some sectors cleansed and others upgraded. The shipping sector has great promise considering that Cyprus is an ancient shipping nation and with some of the world's largest shipping companies already in Cyprus. Tourism has not reached its potential despite optimistic predictions and needs urgently to upgrade standards (including cleanliness beyond the space of the hotel premises) so that its product can earn a higher quality rating. At the moment Cyprus tourism lies in 29th place.[45] Tourism and shipping continue to provide some comfort to an economy in distress. As for the legal and accounting services that thrived in pre-crisis times these would need to re-invent themselves as the Cyprus financial sector has lost trust both domestically and internationally and trust is difficult to regain. The after-effects of the break-down of the financial sector and all that followed (blocking of accounts, initiating exchange controls, depositors losses and so on) will stay with Cyprus for a long, long time. The fact that exchange controls in various forms where instituted in March 2013 have all but shattered Cyprus' image as an open "financial center." Worth remembering that Lebanon went through a devastating 20-year civil war but never put in place exchange controls ostensibly to protect its banking system. The Lebanese were well aware of the long-term damage that this would cause to the inflow of foreign exchange from its expatriates and investors from the region.

Quick fixes such as granting residence visas to promote property sales are not going to help growth and send the wrong message. The granting of permanent stay status leading ultimately to citizenship rarely attracts the investors that the country needs. Investors that see a true business opportunity will come to Cyprus anyway and will secure a visa speedily. All countries like to see a good investor come to their country. The long Canadian experience with visas and citizenship (Canada has a scheme similar in philosophy to that of Cyprus) has let them consider scrapping the scheme all together. Recently Chris Alexander, Canadian Minister of Citizenship and Immigration told CBS[46] that the Canadian government will be scrapping the immigrant-investor program because, *"This was not a program that was generating jobs, growth, opportunity in Canada and it was certainly not a program that was getting the immigrant investors we wanted,"* Selling land and bringing back the Ponzi schemes of the past is not the proper way to kick-start the economy though on the surface this may look an attractive proposition that can bring some financial respite to the hard-pressed property sector and real estate developers most of whom are all but bankrupt.

Cyprus needs to revisit its education system to help the long-term development of the country. Cyprus needs to revisit its educational standards at all levels and, from the economy's point of view, improve the connectivity between education, skills and market needs. Maybe its time for Cyprus to study in some depth the features of the German system that qualifies graduates to work in the market place. For a small, and in the case of some sectors unsophisticated, economy Cyprus has far too many in academic streams and too few in technical /service streams even though latest figures show a slight shift towards technical subjects. Of a total student population of 42,205 in the academic stream there were 4,800 in the technical stream (250 students more than last year).[47] Counselling and career planning would need to improve as well. Indicatively the figures coming from the ministry of health show that the market is flooded with hundreds of unemployed nursing graduates that rushed off to prepare themselves to fill a need which by the time they completed their studies had already been filled.

As far as tertiary education is concerned more emphasis should be placed on value for money and outputs rather than costs and inputs. Competing on cost to attract foreign students is not the answer. The State should provide more support, e.g. guaranteed loans to local meritorious students wishing to attend private institutions to help upgrade the intake of students in these institutions. With the current modus operandi private institutions are unlikely to move to the next stage of their development as issues of economic survival will weigh them down. Private tertiary education institutions charge their students only a fraction of what a student attending a public institution costs. By upgrading their finances private institutions will then be able to upgrade their academic standards. This in turn will help them earn improved academic ratings which in turn will help them attract quality foreign students as well.

The voices that were clamouring for Cyprus to *leave the euro zone* have to a large extent fallen silent once it became clear that leaving the euro zone was not a viable option. Leaving the euro means that Cyprus will need to adopt a new and "unrecognised" currency that would likely create inflation which in turn will destroy Cyprus' import-reliant economy. A run on the already discredited banks would certainly follow as savers rush to find more stable places to put their money. Cyprus will open itself to currency volatilities once it leaves the common currency of the euro. Potential investors will shun Cyprus on account of a weak currency and exchange controls that will almost certainly follow. Rolling over of government debt would be difficult, if not impossible, as investors will not be willing to buy the new government bonds denominated in a new and unknown currency which will probably lead Cyprus to default. Stagflation could follow as inflation and unemployment will both rise; for a while at least.

Now Cyprus has the Troika managing its major economic affairs and the Troika wants its money back in euro. To ensure that this happens the Troika is demanding changes from Cyprus even if these cause unemployment and business failures. Troika knows that its policies are certain to cause unemployment and business failures in the short-term. It seems that the Troika is concerned mostly about the long-term and as such does not show the level of sensitivity one would have expected from them to the suffering or those losing their job, their businesses and even their houses. True to Schumpeter's edict the Troika wishes to see the recession take its course as a long-term cathartic process (in their view). Troika also assumes that after they leave Cyprus their changes will hold. And here lies the crux of success and failure.

In the absence of an integrated program on how to come out of the recession one hears piecemeal *impromptu (and often not-well-thought-out) recommendations* from various sectors including: a) *"the government should get involved in the capitalisation of the banks either as direct shareholder or as guarantor"* forgetting that Cyprus' debt is already 111% of GDP and will soon rise to 120%, b) *"extend shopping hours to weekends"* forgetting that though good this measure may be it will not really make any difference considering the fact that consumers are cash strapped and on top of that they are forced to pay a host of taxes and repay loans, c) *"turn Cyprus into a services centre"* forgetting that this is a rehashed idea and that the last time Cyprus acted as a *"financial centre"* it ended up with a collapsed banking sector and d) *"allow the setting up of casinos"* forgetting the social fallout of such a project and the fact that casinos just provide another dangerous entertainment option which never saved a single economy. If one casino is going to save the economy why not build nine?

For the foreseeable future Cyprus' economy is unlikely to go anywhere largely because of the following: a) low trust in Cyprus' discredited banking system and nearly all other institutions, b) austerity measures with little concern for investment, c) explosive public debt including government guarantees for banks, municipalities, etc, and d) below par public debate that hinders integrated planning. Even if one sees from time to time spurts of improvement the muddle is likely to continue for years. Impromptu and superficial action is not going to help. A holistic, rather than a piece-meal, approach is needed. To use Porter's language Cyprus would need to *"combine activities"* and create a *"strategic fit."* Taxing to make ends meet and boasting about temporary primary surpluses does not help. Cyprus will probably have to first reach bottom with all that this entails as regards hardship and loss of potential GDP. Japan (with a debt to GDP of about 200%) is still struggling to recover from a recession that was started in the 1990s. But, Japan has its own currency that can shelter her against its vast debt. And most importantly Japan's economy is in the top five economies of the world and does not suffer from a trust problem. Japan is serious about its economy. Most of the old economic paradigms of Cyprus have proven to be wrong and any attempt to revive these will perpetuate the recession if not worsen it. Nothing can replace sound and honest planning.

The Cyprus economic case study as analyzed above can teach us a lot regarding how a country can get into recession and stay there longer than expected. Here are some of the major lessons learned. We learned that:

1) When *trust* in an economy (and a country) is lost it takes a very long time before it can be regained. (Foreign investment is nowhere to be seen in Cyprus). Remorse, personal responsibility for errors committed and a genuine desire for a fresh and decent start are just a few of the essential parameters in this regard.

2) *Quick fixes*, piecemeal approaches and public relations fireworks that are designed to create an atmosphere of euphoria do not work. These kind of approaches are not serious and do harm in the long-term. (see Cyprus' migrant investor scheme and its link to the real estate business and talk about casinos!)

3) *Unrestrained austerity* that is designed to balance the government's books but which in the meantime ruins people's lives and creates mistrust in the lender is unwise; more sensitivity to people's needs and feelings is needed. Better to take a softer approach even if this tends to delay change. (see Cyprus' austerity measures that have put out of work 17% of the Island's working population and forced many to migrate).

4) Under conditions of severe financial strain *democratic processes can be sidestepped* on account of lender pressures; this kind of phenomenon creates a cascade effect and tends to justify further violations (if you have done it once why not do it again?) Democratic processes are indivisible and sacrosanct and are not meant to be trampled upon for economic reasons and on account of lender pressures/bulling. The lenders will one day leave the country but the effects of the violations of democracy will linger on and may even act as precedent for future violations. (see Troika pressure on Cyprus parliament to rush through bills of great importance to the country and its economy).

5) *Weak countries* with a small economy but with a major political problem on their hands (occupation by the Turkish army of nearly 40% of Cyprus' territory) have little negotiating power when they come up against big-time international players of the Eurogroup. When the negotiators of small and weak countries are inexperienced, with only rudimentary understanding of history and ill-prepared, they are likely to be over-awed by the presence of powerful interlocutors, succumb to fear and not to have the stomach to put up a fight for their country. (See period just before the depositors bail-in)

6) *Panic and naïveté* often force governments to take measures that in retrospect look ludicrous and even derisory. Feeling the breath of the Troika the Cyprus government sent urgently an emissary to Russia to secure alternative and additional funding to cover its cash flow shortfalls and to roll over loans falling due (including one to Russia itself!) The trip was ill-fated from the start, ill-prepared, hurried and most importantly Cyprus had no business

plan to offer the Russians. The Cyprus emissary just asked for money; period. As expected the Cyprus hapless representative was sent back empty-handed. To the Russians Cyprus' naïveté seemed to have no bounds considering that the Cyprus government was making commitment after commitment to work speedily towards Cyprus' membership of NATO; which in the Russian government's view is trying to encircle the Russian Federation. See other naive measures such as compensating with a citizenship those depositors that suffered a hair-cut of 3mil or more and thinking that this exchange would placate the hapless investors that trusted Cyprus' banking system with their money.

7) Lenders (the Troika in this case) can turn a minister of finance into a *rudimentary project officer* by taking away from him the right to formulate economic policy and to employ his discretionary powers. Lenders to government are no different to other lenders that have the right to take over the management of a corporation with an insolvent debt. Banks do it all the time. Debate over economic matters all but vanishes if the issues to be debated are covered by agreement. *"This is what the Troika wants us to do,"* is the mantra of the ministry of finance whenever there is legitimate concern on any issue that has been agreed with the Troika. This practice naturally raises many serious matters including that of the emasculation of the legislative branch considering that parliament has to follow willy-nilly whatever the executive branch agrees with a third party.

8) When the economic crisis started to assert itself the government quickly set up all sorts of committees staffed mainly with tertiary level educators and blatantly excluding well-educated and well-rounded professionals from business and industry and the professions. The government had fallen into the trap of thinking that people with solid business experience, in-depth knowledge of the market and who have set up their own businesses successfully and in the process generating wealth for the country are just "practitioners" who have no business advising government on policy formulation. At its peril the government under-estimated the value of business people with a successful track record and as such hardly got a complete picture of the realities of business. If anything, the government should have at least encouraged debate between educators and managers with real-life experiences before making policy decisions. The author

understands that some of these committees rarely meet and are more decorative than real.

9) Banks also crush just as any other business. *Not all banks can be trusted with depositors' money* particularly as banks can ally themselves with government to turn (legally!) unsuspecting depositors into shareholders whether they like it or not. Incompetent bank managers can think of all sorts of devises (including the charging of exorbitant interest rates) to make money in the short-term whist endangering the bank's long-term viability. Cyprus has seen bankers gamble with depositors money. When banks start offering inflated interest rates to depositors they mathematically start getting into risky investments. Regrettably, some depositors are willing to risk their money for the temporary enjoyment of high interest rates. (see Cyprus' 4.5% interest on deposits versus Germany's 1-2%).

10) *Public sector head count* will not reduce easily as governments in general are loathed to take on the public sector unions for no other reason other than their voting power. No well-run company will tolerate for long having supernumerary staff paying them above-median salaries; yet the Cyprus government is willing to wait and wait until numbers are reduced through attrition or through attractive severance packages and until the Troika leaves the island. (see the government's hasty retreat on its decision to tax government funded lump-sum payments to retiring public sector employees).

11) The *collapse of the banking sector* of any country coupled with a *high public debt* is a lethal cocktail that guarantees the economy to stay in a quagmire for a very long, long time. Under such conditions any fickle signs of optimism are typically followed by pessimistic news. Unemployment figures are a surefire sign as regards the direction of the economy. These are unlikely to drop. Unemployment rates are obstinate and difficult to tame. (see government's unsuccessful efforts to reduce unemployment through all sorts of ill-planned schemes).

12) *Salaries are by and large resilient to recession*. Employees would rather experience all sorts of unpalatable measures than see their salaries reduce. Policy-makers should not rely much on falling salaries to encourage employers to hire more people (it does not work like that) or to generate what is commonly known as "internal devaluation" that in turn makes a

country's exports more attractive (it does not work like that either). Better to concentrate on raising productivity (rather than lowering wages) to gain competitiveness. (see marginal drop only in median salaries in Cyprus despite the recession and the discouraging prospects of the economy).

13) *Employers are not likely to employ new staff* even if salaries fall significantly. Companies are unwilling to employ new staff to produce what they cannot sell domestically or in the export market (see the substantive failure of the government's subsidization of salaries scheme to tempt employers to give jobs to the unemployed).

14) Despite pronouncements to the contrary people do not seam to learn from bad experiences. For many people the tendency to revert back to the old ways is almost second nature. Most people understand that bad decisions have the nasty habit of coming back to haunt them. Yet, they would agree to such decisions if their negative impact is expected to manifest itself in the distant future. (See ongoing attempts to repeat the real estate mistakes by concentrating efforts to revive the economy on the selling of land and property that originally created the property bubble). (Interesting to read "The Wealth and Poverty of Nations").[48]

15) *Real estate bubbles* are a recurring phenomenon in economic history; America's recent recession all started from the property bubble. Yet people fall into the same trap time and time again knowing full well what will happen at the end. People know that something must be wrong when they see the value of a piece of land shoot up five-fold literally overnight whilst the fundamentals of the economy remaining unchanged. People fall victim to the illusion that everyone can make money at the same time by selling property to each other ad infinitum. In fact the Cyprus banking crisis and the distrust in banks may have already sawn the seeds of the new property bubble as people start looking for the "safer" haven of the property market for their money. The expected mass auctioning of properties (see the many people that are now trapped with properties of little value and loans that are beyond their capacity to repay) and property taxes will only help slow the inevitable process towards the new property bubble.

16) The economic crisis has once more highlighted the strength of the *family unit* and how important strong family ties are in supporting those that are

in need. The Cypriot family rallied around its unemployed members, gave them succour and emotional support. Welcomed unemployed children (even married and with their own children) back to the family home because parents saw fit to support their children until the last days of their lives. Another institution that comes out of this crisis with flying colours is the Orthodox Church that got going from day one opening up hundreds of its churches to provide free food and offer provisions to the needy with no questions asked. Pious people donated to the church generously and hundreds thronged to the churches to provide their services free of charge; preparing breakfast for needy school children, cooking meals for the destitute. No wonder the people of Cyprus consistently rank church and family as the most respected and cherished institutions. Cyprus is rated among the top 2 countries in the EU in terms of church going; this goes to explain much of what is described above.

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