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An Uncertain Future Lies Ahead For Cyprus' Economy

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RÉSUMÉ

L'histoire économique moderne de Chypre remonte à 1960. Durant cette courte période l'économie est détruite à deux reprises (1974: 19% de contraction et 2013: diminution de 10% -20%). Chypre doit maintenant repenser son économie à partir de la base zéro étant donné que le secteur des services hautement profitable a été détruit. Pour sortir de la depression économique Chypre doit: a) Appliquer une solide et saine planification à long terme, b) encourager davantage l'implication de tous dans le processus de prise de décision, c) liberaliser le marché du travail, d) réduire son vaste secteur public, e) devenir plus compétitive et f) permettre l'épanouissement de l'ingéniosité.

ABSTRACT

Cyprus' modern economic history dates back to 1960. This short period saw the economy destroyed twice (1974: 19% contraction and 2013: shrinkage of 10%-20%.) Cyprus now needs to redesign its economy from zero base considering that its highly profitable services sector has been destroyed. To come out of economic despondency Cyprus needs to: a.) apply sound long-term planning, b.) encourage more inclusiveness in the decision-making process, c.) introduce labor freedoms, d.) shrink its vast state sector, and e.) become more competitive and f.) allow the ingenuity of its people to thrive.

Introduction

Apple's market value stood at US$624 billion in the last Forbes review.[1] Cyprus' GDP at that time stood at US$22bil (28 times smaller than Apple's market value.) This contrast puts into sharp relief the smallness of Cyprus' economy which the Eurogroup failed to save. Instead, Cyprus' economy was catapulted by the Eurogroup into an uncertain and gloomy future after it took

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the decision to destroy Cyprus' two largest banks (with roughly 50% of total banking sector assets.) In the process the Eurogroup destroyed the lives of thousands of people who either lost their deposits to a disastrous bail-in, which is unprecedented in the history of the Eurozone, or lost their businesses or jobs.

Approximately 37% of Cyprus' territory (and nearly 70% of its productive resources) have been under Turkish occupation since the summer of 1974 when the Turkish army invaded the island. Within a period of 30 years after the catastrophic events of 1974, Cyprus' economy not only recovered fully but also earned the accolades of the European Commission (EC) in 2004. *"The economy of Cyprus flourishes and today it is considered as one of the strongest economies in Europe,"* said the EC.[2] In building up its economy Cyprus exploited smartly its geographic location which the EC described as "unique" and as a "cross roads." The "cross roads" tag comes from the fact that Cyprus is located at the north eastern corner of the Mediterranean, linking the east with the west, Europe with Africa and the Middle East.

The economy of Cyprus received praises ten years back but now lies in tatters. To many in Cyprus this came as an astonishing turn of events. To the more astute observers, however, this was a natural development considering the many problems behind the ostensibly optimistic performance figures. Successive Cyprus governments failed to cure the many problems (e.g. high interest rates, oversized public sector, crippling energy prices, a real estate market gone berserk) or chose to ignore these for political expediency.

In its November 2011 world economic outlook report the IMF[3] continued to describe the economic situation of Cyprus as stable; even though it noted the contagion effect from a continued slide in the economy of Greece. At that time the Cyprus' budget deficit stood at 7% of GDP and debt at 68% of GDP, inflation was below 4% and unemployment stood at 8.5%; though high, this unemployment figure compared well with other peripheral economies in the Eurozone. This report warned, however, that Cyprus continued to have high public spending.

Cyprus' Modern Economy Started from the Ashes of War

Cyprus' modern economic history started in 1960 when it gained its independence from Britain and established its own sovereign government.

The year 1960 ushered in the first stage of economic development which lasted up until 1974 when Cyprus was invaded by the Turkish army. In this period (1960-1974), Cyprus managed to create a thriving export trade that included products such as: copper, asbestos, wines, citrus, vegetables, potatoes, etc. which helped improve people's living standards. During this period the economy of Cyprus operated within its own possibilities whilst a wise management of government finances ensured a healthy fiscal position.

The second period starts after the Turkish invasion (1974) that saw the virtual destruction of Cyprus' economy including its nascent tourist industry. This stage of the economy was characterized by more emphasis on tourism and export of manufactured goods. Many small factories were set up and a thriving manufacturing sector developed quickly with exports of footwear, clothing, etc., going mostly to countries in the Middle East. Dependency on agricultural revenu lessened as the bulk of Cyprus' agriculture was destroyed by the Turkish occupation. This period lasted for about 10 years and demonstrated how flexible and versatile Cyprus' economy could be and how enterprising its people are. It also demonstrated the strong will of Greek Cypriots to survive under threat and uncertainty.

The third stage (with two phases) started in the mid 80s when the nature of the economy changed. The country started moving with haste towards the services business. Cyprus set up an offshore regime and vigorously exploited its new-found offshore status by offering international businesses favourable tax conditions. The services sector grew and grew in size to the point that it ultimately accounted for some 75% of Cyprus' economy (just before the Eurogroup-induced crash). During this third stage of Cyprus' economic history household names such as Coca-Cola and Pepsi International set up their regional offices in Cyprus. Tetra pack started a production facility and a great number of other respected international companies used Cyprus as base from which to serve Middle East markets. The Anglo administrative system that Cyprus inherited from the British served Cyprus well. The abundance of well-qualified and trained professionals in the financial /accounting and legal professions gave Cyprus a strong competitive edge and an impetus for further growth of the sector.

One advantage that Cyprus economic model had in relation to its neighbors was its classification as a free (or relatively free) economy by Heritage. Up until a year ago (2012) Cyprus held the 20th place on Heritage's economic freedom table.[4] This relative economic freedom provided confidence to companies that wished to set up their offices in Cyprus. Regrettably for Cyprus all this changed as economic freedom was hit hard by the imposition of capital controls and the restrictions imposed on banks.

Cyprus has a strong infrastructure which was the result of many years of development. This strength made Cyprus a good place for foreign investment. In 2010 the road network of Cyprus was a very respectable 12,380 km. Cyprus' two international airports were up to recently connected with 115 airports in Europe, the Middle East, Asia and Africa.[5] Telecommunications also improved over the years and served the economy well.

Cyprus' membership in the EU and the Eurozone continued to provide some type of external certification for the economy of Cyprus and served as a driver for liberalization. The Heritage Foundation[6] reported in 2012 that Cyprus' membership in the EU "….enhanced economic liberalization…." In the same report Heritage noted as a strong negative the fact that Cyprus had not made progress in liberalizing the telecommunications and utilities sectors.

Shipping is a success story for Cyprus. In 2013 Cyprus' shipping register had more than 1,000 ocean-going vessels (more than 21 million gross tonnage.) The shipping industry continues to employ some 4,500 onshore staff and 55,000 seafarers. Importantly, most of the ship-owning and ship-management companies in Cyprus are controlled by EU countries.[7]

The strength of the family unit continued to be Cyprus' main social strength. In 2011 Cyprus registered the highest number of weddings per 1,000 in the EU. Equally, it registered one of the lowest divorce rates; at least as regards the indigenous population.[8] Cyprus along with Poland continued to have the highest density in the EU of people practicing their religion.

Cracks in the Economy

Cracks in the economy of Cyprus began to appear some time back. In the same year that the economy of Cyprus held the 20th position on freedom to do business (2012) it descended to a poor 36th position (out of 183 countries) on the "ease to make business" (table of the World Bank).[9] Bureaucracy, nepotism, selfishness, individualism and opaqueness started to take their toll gradually and threatened to destroy the economy. As Cyprus' rating on the "ease to make business" was falling, other business centers were making great strides forward. In the same year (2012) Singapore ranked 1st and Honk Kong 2nd with the UAE ranking higher than Cyprus, in 26th position. Cyprus took comfort in the fact that Greece ranked 40 places behind, in 78th place on the same index. On the "registering property index" Cyprus ranked a dismal 98th spot and on "enforcing contracts" a disastrous 108. These were the tell-tell signs of a looming catastrophe that was about to unfold.

Some six years back construction and real estate started to unravel and the real estate bubble began to burst in the process becoming the biggest (probably) single cause of non-performing loans (NPL) that contributed to the crashing of the two banks. The Anglo administrative tradition that had served Cyprus so well for decades slowly began to deteriorate as bad habits from the Greek market began to infiltrate Cyprus and erode its system of doing business.

The Land Registry that was once the pride of Cyprus' administration began to unravel into a horror story. The issuing of title deeds took years and the process of dividing land between two or more owners took decades in some cases. To this day there are outstanding applications for land division that date 40+ years back. The high unionisation figures that for some employees were a sign of good consultative management, gradually ended up becoming a deadly weapon in the hands of the political elite and the colluding unions that benefited from exchanging their votes with political support.

Cyprus hoped to build its economy partly on the strength of its many university graduates. The College graduation rates of Cyprus compared well with any country in the EU. Cyprus ranked 2nd on the graduation rates table whilst Ireland ranked 1st with 32%. Finland and the United Kingdom ranked joint 3rd with 32.5%. Belgium ranked 5th with 31%.[10] Cyprus had a mighty weapon in its arsenal which it failed to use in the end.

Regrettably, Cyprus failed to capitalize on the great advantage that educated talent provided. Young graduates opted for the security of state employment rather than entrepreneurship or employment in the private sector. Even those that earned their degrees from highly ranked competitive universities ended up in the civil service or the semi-government sector and in the process deprived the private sector from talent. The accounting profession was an exception to this rule considering the blossoming of the services sector. Today, the Accountants Association counts over 3,000 members who work mostly in private enterprise. Interestingly only 21 qualified accountants were registered in 1961.[11] Regrettably, many of these professionals will now be left without a job.

In 2011 some 254,227 foreign enterprises were registered in Cyprus.[12] These companies employed some 5% of the total work force.[13] The registration of foreign companies peaked in 2007 with a total of 29,016 new companies. As uncertainty about the economy grew the registrations figure dropped (2011: 19,538 new companies.) Table 1.

Table 1

Year	New company registration in Cyprus
2006	20,280
2007	29,016
2008	24,453
2009	16,101
2010	19,278
2011	19,538

Source:

(1): Registrar of Companies and Official Receiver, Republic of Cyprus

(2): Cyprus Investment Promotion Agency, 09/04/2012

In summary, not long ago the economy of Cyprus looked to have a bright future. But, on closer examination not all was well. In fact, a storm was gradually brewing. The major indicators (some of these were outlined above others will follow) of this impending storm were: a.) the relatively weak productivity levels that continued to threaten Cyprus' competitiveness, b.) the ever-growing public sector that kept gobbling up taxes and taking resources away from development, c.) the unreasonably large banking sector that in size was 7 times that of Cyprus' GDP and which was a disaster waiting to happen, d.) the high interest rates that pushed the cost of money to unsustainable levels, e.) the country's overreliance on the services sector including real estate and e.) the ever-stifling bureaucracy and lack of accountability in the public sector that gradually made Cyprus an unwelcoming place for business. Most importantly, Cyprus' democratic rating dropped to that of a "faulty democracy"[14] largely on account of diminishing accountability, e.g. high promises and low delivery by politicians and low accountability.

Markers Pointing to an Impending Failure:

Public Sector:

The strong interdependency between unions and politicians and the need of the latter to control voter patterns let to a relentless expansion of the broader public sector that ultimately throttled the development of the country as more and more funds were needed to meet the ever-bulging public payroll. Repeated government promises of future head count reductions let to nowhere. In fact, even after the economic crisis started hitting Cyprus hard the public sector head count showed no signs of reduction (Table 2). Figures in the table include only state employees but not another, roughly, 20,000 employees that work in state-controlled organisations. The total number of those in full-time employment in Cyprus is now just about 390,000 employees. Thus, the broader public sector (that includes employees of the state-controlled organisations) now employs nearly 1 in 5 employees in Cyprus (18.5% of the gainfully employed). In other words every 4 tax payers sustain one highly paid state sector employee.

Table 2

Employee category	**January 2009**	**January 2013**
Monthly paid	17,890	17,988
Hourly paid	8,740	7,875
Staff in education	12,918	13,160
Staff in state security	10,064	10,073
TOTAL	49,612	49,096

Source: Ministry of Finance of Cyprus

Employment in the broader public sector continued to climb (Table 3) even as two momentous events threatened the economy of Cyprus: a.) the stock exchange bubble of 1999 and b.) the economic crisis that started to deepen from 2009 onwards.

Table 3

	Number of State employees by year				
	1995	2000	2005	2010	2011 3rd quarter
Central Government	38.297	42.611	49.068	55.445	56.024
Government	36.946	40.972	46.480	51.015	51.960
Non-profit organisations*	1.351	1.639	2.588	4.430	4.064
Local Government	3.364	3.649	3.976	4.677	4.905
Organisations that are controlled by the Government (β)**	9.462	9.742	10.281	10.307	9.712
l	51.123	56.002	63.325	70.429	70.641

Source: Cyprus department of statistics (http://www.mof.gov.cy/mof/cystat/). The table was compiled by Simon Matsis, former head of Cyprus' Planning Bureau.

*: includes staff serving in the state universities, Cyprus Sports organisation, School boards, Institute for culture, state symphony orchestra, etc.

**: includes, semi-government organisations, Cyprus Airways, Cyprus Central Bank, etc.

In terms of government expenditure public sector employment contributed as much as any other factor in the deterioration of the economy of Cyprus as seen below (Table 4)

Table 4

Year	Total public expen-diture (mil)	State salaries and pensions (€mil)		State salaries and pensions as a % of:			
		Department of Statistics*	Ministry of Finance**	Total public expen-diture*	GDP*	Total public expen-diture**	GDP**
2002	4357,3	1500,3	2178,6	34,4	13,7	50,0	19,8
2003	5182,4	1809,7	2520,3	34,9	15,4	48,6	21,4
2004	5311,3	1884,5	2474,1	35,5	14,9	46,6	19,6
2005	5779,1	1997,2	2658,4	34,6	14,8	46,0	19,7
2006	6144,6	2155,0	2933,4	35,1	14,9	47,7	20,3
2007	6548,4	2279,1	3058,6	34,8	14,4	46,7	19,3
2008	7206,8	2450,7	3336,6	34,0	14,2	46,3	19,3
2009	7754,0	2669,4	3588,3	34,4	15,8	46,3	21,2
2010	8139,1	2686,7	3715,1	33,0	15,4	45,6	21,3
2011	8860,6	2744,6		30,9			
2012	8770,2	2748,5		31.3			

*: the Cyprus department of statistics figures do not include entities that have "independent" budgets which allow them to make payments autonomously, e.g. the public universities. Of course the funds in these budgets come from the public purse.

**: the Ministry of Finance includes all the spending in the public sector.

Sources: (a) Fiscal Magnitudes, 11.April, 2011, Department of Statistics.

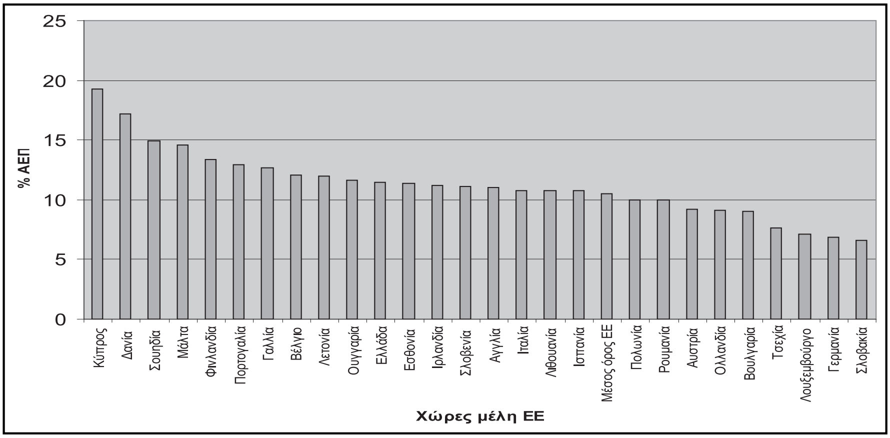
www.mof.gov.cy/mof/cystat/. (β) Page 5 Tables on Economic Indicators 2002-2013 April 2010, Ministry of Finance www.mof.gov.cy/

Table compiled by Simon Matsis former head of Cyprus' Planning Bureau.

Public expenditure on salaries and pensions in the broader public sector showed an increase of 9.8% in 2011 (vs 2010.) It also registered an increase of 0.1% in 2012) (vs 2011) even if both these years were crisis years that saw tens of businesses going bankrupt and private sector employees becoming unemployment in their thousands.

In 2008, just as the economic crisis was beginning to rear its head, Cyprus ranked first amongst all countries in the EU in terms of cost of running the public sectors as percent of GDP. The reader will notice that Cyprus' public sector costs (first bar from L to R in table 5 below) is roughly three times that of Germany's (second bar from R to L). Germany is Cyprus' main lender through the Troika.)

Table 5: Broader public sector cost of employment as % of GDP: 2008



Source: Eurostat

Productivity:

Historically the EU lagged behind Japan and the USA on productivity. O' Mahony and van Ark note: "Comparing the EU with Japan and the US... .during the 1980s, real GDP growth was fastest at 4.0 per cent per year on average in Japan, followed by 3.2 per cent in the US. Growth was slowest in the EU at only 2.4 per cent. During the early 1990s GDP growth slowed in all three regions, but both the US and the EU saw a substantial recovery during the second half of the 1990s."[15] Cyprus failed to even meet average EU productivity levels. Feeble attempts were made by successive governments to redress the situation but these were doomed to fail. In an attempt to improve the situation The Cyprus Productivity Council set as national labor productivity strategy for years 2007-2013 the improvement of Cyprus' productivity to EU average levels by 2013.[16] Current Cyprus productivity levels fall short of the average of the 27 EU countries.[17] (Table 6)

Table 6: Cyprus productivity levels: 2000-2010

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010
Cyprus	84.2	81.9	82.3	82.9	84.0	85.5	91.0	91.5	90.3

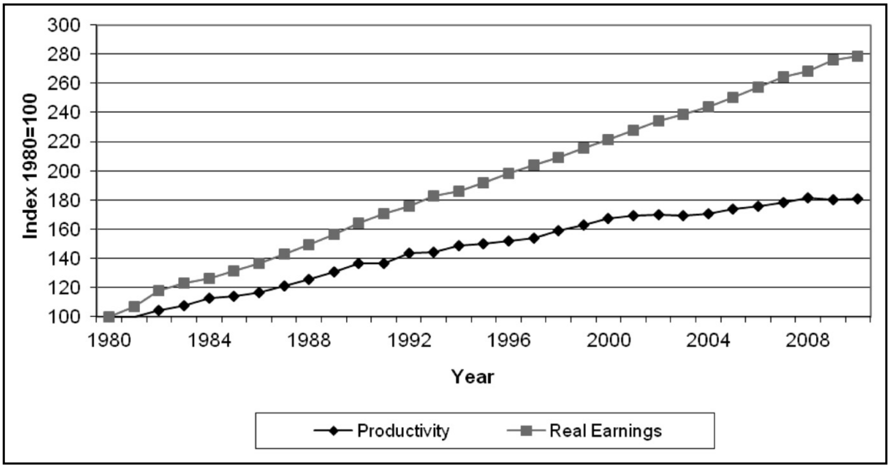
Source: Eurostat. EU average = 100

Unbridled Unionisation:

It is estimated that up to 70 % of employees in Cyprus are unionized (18) and are thus covered by collective agreements. The vast majority of these are sector collective agreements that constrain employer freedom to deal directly with their staff, to apply incentives and generally to operate in a manner that is conducive to proper management. The bulk of the unionized staff is in highly protected (and in many ways monopolistic) sectors that provide essential services such as government, banks, petroleum distribution, etc and where the need for union protection is least necessary. For decades unions and politicians worked hand in glove to help enact laws that were favourable to unions but bad for the economy. For example, laws that force non-unionized companies to apply the terms and conditions of sector collective agreements even if they played no part in the formulation of the agreement, laws that provide over-generous redundancy benefits to the point of encouraging employees of certain ages to seek redundancy arrangements with their employers. Politicians repeatedly took the side of unions in strike action situations and in the process caused great damage to the economy. This relationship was instrumental in encouraging unions to make outlandish demands around the negotiating table. As a result, and for a period of over 30 years, real salaries rose much faster than productivity and in the process created a time-bomb for the economy.

Diagram 1 below shows the catastrophic course that Cyprus followed and which led to an ever-widening disparity between real salaries and real productivity for a period of 30 years. The Employers Association and the Chamber of Commerce played their own particular role in this decline considering the feeble positions they often took over the years. Conventional wisdom at the time allowed employers to accept high salary increases on the fallacious premise that they could easily pass these unreasonable costs to their customers. As we will see later, the above spiral let to Cyprus losing ground in the export market particularly after Cyprus' accession to the EU that saw the abolition of any remaining trade barriers.

Diagram 1: Indices of real earnings and productivity 1980-2009 (1980=100)



Source: Labour Statistics 2009 and National Accounts, Department of Statistics and department's website www.mof.gov.cy/mof/cystat/

Arduous Legal Process

The long and arduous legal process of the last 30 years made it hard for business grievances to be settled within a reasonable time frame. The length of time a case in court took before it could be resolved did much harm to the economy and created a milieu of "nothing moves fast in Cyprus." The collection of unpaid bills, for example, took years to resolve in court. This loophole was often used by debtors to delay paying their obligations to businesses in the process creating all sorts of cash liquidity problems. This abnormality let to many businesses losing faith in the court system as a timely adjudicator; many businesses simply refrained from taking their cases to court and chose instead to bear the loss. Indicatively, the Nicosia District Court reported that the average number of civil cases lodged in court in the years 2001-2004 was 13,353 whilst for the period of 2005-2009 this number fell to 9,073.[19] Many believe that this drop in numbers can be attributed to loss of faith by businesses in the process.

Taxing and Diverting

Turkey currently maintains some 40,000 occupation troops in the occupied part of Cyprus according to the United Nations Secretary General[20] plus an immense number of armaments. This terrifying situation let to people focusing their attention on the political problems of Cyprus and taking their eye off critical economy issues and decisions. For example, the government slammed a crippling "defense levy" that takes away form businesses every year some €400 million ostensibly for defense purposes. The reality is that these funds help the government meet the over-blown public sector payroll and have nothing to do with defense.

During the period of the real estate bubble, some ten years back, the government did little to discourage the destructive course that the bubble was taking because it profited in a big way from the taxes it collected through inflated land prices. The 20% capital gains tax filled government coffers and encouraged outrageous union demands whilst in the process killing agriculture. With land prices rising fast, land owners pressed the government to change building zones and in effect to convert nearly all of Cyprus' private land into a huge building plot. The vast majority of private land now has some form of building rights. Agricultural land that was under vine cultivation for centuries was turned into high-priced building land thus removing it from agriculture. In fact, it was not uncommon to hear of traditional farmers selling their land to live off the proceeds. Grape production fell from a high of 250mil kilos in the late 70s to some 13mil in 2012.[21]

The state-controlled monopoly/oligopoly organisations such as the electricity and telephony providers that were supposed to operate as not-for-profit entities were ultimately turned into tax generators and tax collectors for the government. Using a cost-plus approach they upped their prices as necessary and generated what they euphemistically called "profit" which in turn went to the government in the form of dividends. These untowardly practices added to the cost of doing business and in some cases even drove businesses out of the market, e.g. the high electricity costs.

The banking fraternity that was basically controlled by 2 or 3 banks used its dominant position, and the sector's relationships with politicians, to charge exorbitant interest rates plus a long list of other "charges" that pushed the cost of money for business out of bounds. As if this was not enough several politicians and political parties had their loans forgiven by the banks and in the process infuriating a suspicious public. As the economic situation kept worsening the government of the day decided to secure a Russian loan of 2.5bil to pay public sector bills instead of first cutting down on its expenses. Once the cash flow situation was temporarily solved through this loan the government and the political elite continued in their high spending ways whilst making no serious effort to solve the economy's structural problems.

Banking

The banking crisis was a systemic catastrophe that brought the economy to the brink of total disaster. The banking situation was an accident waiting to happen. Over the years the balance sheet of Cyprus' banks kept growing in an uncontrolled manner and by 2011 banking loans accounted for 385% of GDP, many of these loans turned out to be non-performing. The banking system found "ingenious" ways of attracting deposits. They simply offered depositors interest rates of 4+% whilst most of the EU's interest rates on deposits were less than half this number. Having attracted expensive money the banks had to find borrowers that were willing to borrow at 9% in most cases. Alternatively they had to invest their money in risky high-yield Greek bonds, etc. The high cost of borrowed money in turn rendered business uncompetitive and unable to export. The high cost of borrowed money cost businesses and individual borrowers some 1.5bil per year if one were to assume that an interest surcharge of 3% was charged by the banks. All these plus autocratic and ineffectual leadership proved to be the undoing of Cyprus' banking system. Despite the high interest rates banks maintained a huge portfolio of assets. Banks' loans alone equalled 385% of GDP. (Table 7)

Table 7

Banking loans by category	**Banking loans as % of GDP as at Dec., 2011**
Loans to households	152%
Loans to businesses	175%
Total loans to households and businesses	327%
Total loans to economy	385%

Source: Cyprus Central Bank

Even the economic crisis failed to put a break on the banks' half-crazy behaviour **Table 8**

Table 8

Loans	**Dec. 09**	**Dec. 10**	**Dec. 11**	**% change**	
				Dec. 10/ Dec.09	Dec. 11/ Dec.10
Businesses	27.441	28.179	31.079	2,7	10,3
Households	23.515	25.818	27.070	9,8	4,8
Housing	12.616	14.474	15.139	14,7	4,6
Consumer	4.857	3.479	3.483	-28,4	0,1
Other	6.043	7.864	8.448	30,1	7,4
Other loans	6.918	7.478	9.921	8,1	32,7
Total	**57.874**	**61.475**	**68.573**	**6,2**	**11,5**

Source: Central Bank of Cyprus http://www.centralbank.gov.cy/

To the above list of bad practices the independent observer needs to add the Central Bank of Cyprus' poor controls that basically allowed banks to trade riskily and with few checks. Uppity behaviour was also at the centre of failure.

Cyprus' Missed Chances

Tourism:

Cyprus missed the chance to make good use of its priced tourism asset because of lack of farsightedness. In terms of Tourism Infrastructure Cyprus ranked 1st in the world.[22] Yet Cyprus failed to capitalise on this because it offered a poor value for money package. The 2011Travel and Tourism Competitiveness Index ranked Cyprus in 24th place in the world.[23] Whilst tourism started out with optimism, the overall product value worsened with time and now attracts mostly medium-spending tourists of a 70 a day budget.[24] Cyprus' hoteliers are asked to pay a host of taxes on their revenues that make the product difficult to sell. Taxes include amongst others: corporate tax, immovable property tax, sewage tax, value added tax, municipal tax and levies on: overnight stay (1-2% of room rate,) municipal immovable property tax, beach tax, cleanliness tax. In addition hotels have to pay numerous levies and permit costs such as: a Cyprus Tourism Organisation levy, permit to sell Alcohol and Tobacco, permit to allow the exercise of Professional services, permit to practice the Occupation of hotelier, swimming pool permit, petrol and gas permit, "wireless" levy, etc. The hotelier is then asked to pay crippling electricity bills which in themselves include a host of other taxes.[25]

For years Cyprus' labor costs to revenue stood at a crippling 50% the moment the American Hotel Motel Association recommended 34%. The labor cost situation has now improved slightly; but not enough to make a difference.

Cyprus failed in its effort to extend its tourist season outside the traditional tourism months of April-October which in 2011 contributed 86% of the tourist revenue.[26] In the same year the remaining 5 months contributed only 14% of revenues. By all accounts Cyprus is ideal for winter tourism partly due to its temperate climate.

Merging Small Businesses:

Cyprus' market is dominated by small family-owned businesses many of which disappointingly are too small to enjoy economies of scale; thus making survival difficult. An incredible 94% of companies in Cyprus employ less than 10 employees.[27] These organisations have little or no critical mass. Small businesses were the first to fail as the crisis began to take hold of the economy. Even though small businesses have their own characteristic merits (e.g. commitment by family members) these often lack competitiveness, invest little on expansion, have little or no research and development and corporate governance is often non-existent. Cyprus failed to see the possibility of mergers as a way of alleviating the problem. In the few activities where mergers took place service to the client improved vastly and chances of survival were enhanced.

Energy Alternatives:

Cyprus failed to promote sustainable renewable energy sources. Cyprus failed to abide by the relevant European directive that asked member countries to reduce their dependence on imported oil. European directive EU 77/2001 includes a list of renewable energy sources that include: wind, solar, geothermal, biomass, etc. In the case of Cyprus the debate was naturally concentrated around solar energy where Cyprus has a vast advantage. Cyprus failed to exploit solar energy and continues to have an isolated system of energy management which is totally dependent on imported oil.[28] According to the Cyprus Meteorological Service all areas of Cyprus have long periods of sunlight and certainly much more than most European countries. In the flatter areas of Cyprus the average number of hours of sunlight for a whole year is 75% of the number of hours that the sun stays in the horizon. During the summer period Cyprus enjoys 11.5 hours of sunlight and 5.5 hours in the months of December and January. Instead of pursuing with vigor solar energy projects, successive governments chose to stay with imported fossils for electricity generation.[29]

Innovation

Cyprus failed to use the skills of its many graduates; many from world class international universities. Successive governments created a culture that encouraged young talented people to join the public sector or the quasi oligopolistic banking sector where waterproof job security and unreasonably high salaries were the rule of the day. All one needed to do to gain a promotion in these sectors was to wait one's turn. In this way, instead of creating a vibrant community of innovators and entrepreneurs Cyprus created a privileged class of bureaucrats who for over many years worked until mid-day and then took the afternoon off courtesy of the "privileges" bestowed on them by the unions in complicity with the political elite. Cyprus saw far too many young people gradually becoming victims of the very system they served. As unemployment now looms many of the banking sector's 11,000 employees will for sure face many a hardship before securing another job which would probably pay half of what their current job pays.

Cyprus has a poor record of investment in innovation and has little to show in this area. The EU set as target that of 3% of GDP for investment in research and development. In 2010, Cyprus invested only 0.50% of GDP in research positioning itself second-but-last (Romania was last) in the "investment in research" table.[30] Finland took first place with 3.96% of GDP and Sweden 3.62% of GDP.[31] Worst, Cyprus did little to improve the situation considering that in 2009 it invested only 0.49%, in 2008 a mere 0.42% and in 2007 just 0.44%. Of this meager investment in research: tertiary education institutions invested 46%, Government invested 20.4%, private businesses 19.8% and private non-profit organisations 13.8%.[32] Cyprus counts only 900 researches out of a total of 1.56 million in the EU.[33]

Privatization and Elimination:

Cyprus failed to take bold steps towards privatization and elimination of government departments that have no role to play because of fear of antagonizing the unions and the many voters that state-controlled organisations command. These types of organisations are friendly to politicians and allow them to make appointments of party supporters. The political elite had an opportunity to make change and to move the economy of Cyprus forward; but squandered it. To this day we see state-dependent organisations, whose role has become either fully or partly defunct, continue to employ staff that have little or no work. For example: the Grain Board and Land consolidation department. The two major ports of Cyprus are under the control of the state (and the unions!) A great opportunity was missed to privatize these two ports. Exploitative practices by the employees and their unions have been in existence for decades inside the ports. Overtime pay often doubled take home pay the moment a less-costly shift system could have sufficed. It took a decade of negotiations before an under-utilised crane could be moved from one port to the other as the unions demanded that the crane remain immobile and unused to justify their "employment."

With the advent of the Troika the three main state-controlled organisations that are now targeted (mentioned in the MoU) for privatization are: telephony, electricity and the ports. There is much resistance to change by the public partly because of propaganda over the years in favour of state control and out of the hands of greedy capitalists (!). Cyprus Airways, the state-owned airline and for all practical purposes bankrupt company, is also on Troika's target list.

Path-dependency

In their compelling book titled "Why Nations Fail" Daron Acemoglu and James A. Robinson talk about "Path-dependency."[34] They describe path-dependency as doing the same thing but at a different level. In other words, maintaining the same mind set over time and failing to learn from past experiences.

Many of the wealthier Lebanese that tried to escape the long civil war (1975-1990) in their country found refuge in Cyprus where they enjoyed a hospitable environment a few tens of kilometers away from their mother land that was in strife. The continued influx of Lebanese into Cyprus obviously created opportunities for real estate companies and pushed rents up; particularly in the quality residence market. Equally, many Lebanese set up their business offices in Cyprus and continued operations out of Cyprus. As a result, a new set of well-paid activities cropped up. The author considers the period between 1974 and 1990 as the first phase of stage 3 in Cyprus' modern economic history and the period after 1990 as phase two.

Once the Lebanese war ended the Russians started arriving into Cyprus in numbers. Though no specific date can be put on the demise of the Soviet Union one can say that 1990 was a pivotal year. It so happens that this year also marks the end of the Lebanese civil war. As the Soviet Union began to unravel and the system opened up, thousands of Russians began to flock to the historically friendly (towards Russians) Cyprus. This development created a lucrative business opportunity for Cyprus as Russians started bringing in billions of Euros, buying expensive properties, setting up businesses, etc.

The two events above are characteristic of how opportunities come out of historic events and how these can shift the economy into a lucrative but dangerous course as often such events are chancy and unsustainable. Worse still, new economic activity is often built around such precarious situations as old but time-tested activity is abandoned. The above two events had a seminal effect on the services sector that Cyprus built and which ultimately ended in disaster with the crushing of Cyprus' two largest banks that saw thousands of Russians losing their money to depositor bail-ins.

The crux of the matter is that Cyprus never stopped to ask whether this course was sustainable and whether it was really working around a firm business model. To this day Cyprus failed to learn from its bad experiences with the "business services" model and continues to emulate a failed model. Cyprus is now granting easy visas to third country citizens that wish to buy property in Cyprus for 300,000. One now sees land developers and land agents scurrying the Middle East and China in search of visa takers and in the process angering many EU countries that see visas as something different to a tradable package of "residence visa + property for 300,000."

Failure to Create a Real Economy

Over the last 20 years Cyprus failed to create a real and well-balanced economy. Instead of exercising patience and taking a long-term view of its economy Cyprus elected the short-term unsustainable route of making quick money out of all types of services some of which were of a questionable nature. Balanced economies need long term planning and sound leadership. Central to the success of many time-tested and successful economies is their dependence on a broad range of activities (eg. Switzerland: 1^{st} on the WEF's competitiveness table.) For centuries Switzerland relies on a broad-based economy that includes banking, insurance, etc but also agriculture (dairy business), manufacturing, pharma, technology-based industries, etc.

Cyprus' viticulture goes back to ancient Greek times having survived, through the resilience of its vine stock, many a pestilence including the phylloxera epidemic of the 19^{th} century that devastated the majority of the vineyards in Europe and North America. Cypriot viticulture that stood firm for millennia was destroyed overnight some 35 years ago through a thoughtless government decision to offer farmers incentives to uproot the indigenous and resilient varieties and to replace these with French varieties or to abandon viticulture altogether in favour of the emerging services sector. It took thousands of years to create a tradition and a few years of "modernity" to destroy this. Some twenty years later, and after viticulture was basically destroyed and farmers were turned into hotel employees, a decision was taken to go back to the indigenous variety.

Public-Private Partnership (PPP)

The concept of public-private partnership was fought tooth and nail by unions and most political parties. It took over 10 years of debate before Cyprus' two international airports could be built through private money. The debate raged as the tax-payer kept subsidizing the two loss-making airports and as the public kept receiving shoddy and impolite service. With PPP the government is now spared the subsidization, whilst earning an annual fee plus a share of the airports revenues; not to mention the huge upgrade in quality of service.

What next for Cyprus' Economy

The loan agreement (Agreement) between Cyprus and the European Stability Mechanism (ESM) is now a reality. Thus any debate on a "for" or "against" platform is fruitless; at least for the moment. Some see the approval of the Agreement as a disaster that has put Cyprus in an unwinnable game. These same people see the signing of the Agreement as a hopeless move that aims to help the government get the first tranche of money: a.) to escape bankruptcy and b.) to pay the public servants' next salary and to stop them from turning ugly. The Agreement is viewed by most as a short-term cure for Cyprus' deep-rooted economic problems. The Agreement stresses frugality and cuts, introduces higher taxes but fails to tackle the burning issue of short-term development to help kick-start the economy. The Agreement has no answer to the expected fall in internal demand by 12.2% in 2013 and probably 5.6% in 2014.(35) Admonitions in the direction of improving revenues from tourism that are expressed in the MoU, touch themes that have been discussed repeatedly in the past. The Agreement's terms on restructuring sound good and hold great promise; but only apply to the medium and long term.

The agreement sounds optimistic (as if deliberately) on GDP forecasts. To many observers these forecasts appear to be the product of political wishful thinking and justifiably come into conflict with other more well-thought-out forecasts.[36] The Economist forecasts that in the worst case scenario the fall in GDP in 2013 *could be* as high as 20% and unemployment as high as 17% of Cyprus' labor force. Significantly, the year after the Turkish invasion of Cyprus (1975) the economy shrank by 19%. The Economist goes on to say that any forecasts on what is likely to happen are impossible to make at this stage. The same article also talks about "….looming impoverishment…." of Cypriots. The more sinister members of the community see these unrealistic figures of the Troika as a "catch" that was designed to encourage an easy run through parliament; parliament voted yes, albeit with a flimsy majority. Others say that the optimistic figures that appear in the MoU are meant to appease the IMF whose contribution was necessary if Germany were to be part of the plan. The Agreement fails to take account of the uncertainty around the banking sector and the fact that the two major banks (formerly holding nearly 50% of deposits) have blocked depositors' money and that when these monies are ultimately freed they are likely to migrate out of the two banks (and most likely out of Cyprus.)

Cyprus will find it hard to repay its loans to the ESM and in all likelihood will ask for extensions, etc. Cyprus' debt will certainly exceed its GDP as the latter begins to shrink; just as it happened in Greece. In 2010 Greece's debt to the ESM stood at 49.5% of GDP. Two years later (2012) and on account of falling GDP this debt stood at 67.1%.[37] Cyprus debt to the ESM now stands at 57.1% of GDP but even under the most optimistic forecasts this percentage is likely to rise as GDP falls. The analysis of the University of Cyprus Economic Research Centre[38] as regards the impact of the bail-in says, "…. *a reduction of 20%-30% in total deposits will have the following effects on the Cypriot economy: (a) A reduction by 5%-8% in real GDP; as a result the contraction in real economic activity in 2013 is estimated, at least, at 9%-12%.*" Unemployment is likely to rise to 20% considering the closure of at least one bank and the downsizing of the banking sector and likely redundancies in the public sector. The same report says that business and consumer confidence is going to drop as the Economic Sentiment Indicator (of the Center) is likely to drop by 20 units thus worsening an already bad scene. The report estimates reduction"…..*in imports of goods (in nominal terms) by up to 22%; a smaller decrease in exports of goods (2%-6%) and a slight increase in tourist arrivals (2%-4%)….*" The magnitude of the drop in GDP is the big question that no-one dares answer with confidence. Even if in 2013 GDP drops by a modest 10% this is likely to result in a debt that will exceed 100% of GDP. Carmen Reinhart and Kenneth Rogoff believe (even if Thomas Herndon, Michael Ash and Robert Pollin disagree) that when government debt exceeds 90% of GDP, growth slows to almost a standstill.[39] Few in Cyprus would disagree with Reinhart and Rogoff seeing what happened to their brethren in Greece under Troika.

Marios Zachariadis, economist at the University of Cyprus in a recent article[40] lambasts the Eurogroup for its unfair treatment of Cyprus and for the fact that the Eurogroup sacrificed Cyprus to save the Greek banking system. Zachariadis forecasts that, "The overall likely outcome (of the bail-in of depositors) is a double-digit dip in GDP growth for 2013 with positive growth rates out of reach for several years thereafter."

Referring to the Troika's conditions Lawrence Knight, business reporter of the BBC forecasts that Cyprus' short-term future is likely to be bleak and that the long-term future of Cyprus looks uncertain *and out of its control***.** Thus, Cyprus is about to experience something very distasteful; regrettably it is the product of the banking sector's systemic and devastating effects, the ruthless (and unfair) treatment of Cyprus by the Eurogroup and the careless and self-serving bad practices of successive governments.

For 2013 the Agreement forecasts a fiscal deficit for the general government of not more than 395mil or 2.4% of GDP the moment the economy is crumpling and no-one dares forecast what will happen after the banks start operating normally. No-one knows what would be the reaction of foreign companies that operate out of Cyprus and whose deposits were marauded by the decision of the Eurogroup.

This insidious economic decline could have been avoided had the Eurogroup adopted a more helpful and less punishing approach to Cyprus' economic problems. In a letter to the deputy editor of the Financial Times on the 13th of February and as the bail-in of depositors was mooted Aris Petasis (author of this report) suggested the following as a way to solving Cyprus' economic woes and avoiding a meltdown, *"A workable plan for Cyprus would entail the following: a.) comprehensive examination of the money laundering question to provide added confidence in the system, b.) involvement of the European Stability Mechanism in the recapitalization of banks, c.) major restructuring of the Cyprus* *economy; starting with a significant shrinkage of the bloated public sector and the selling off of state organisations which is long over-due. This will help Cyprus become more competitive (currently ranked 58th on the World Economic Forum index) and d.) unrelenting, but methodical, shrinkage of Cyprus' Over-grown banking sector starting with their oversees operations. Cyprus' banking sector at this moment is 8 times the size of its GDP and this worries the Eurozone."* Regrettably once the Eurogroup had taken its decision there was no going back, irrespective of the validity of counter arguments.

Though most of the measures suggested by Troika look helpful, some of these appear superficial and cannot in any meaningful way contribute to solving the problem. The MoU calls for a trivial reduction in the rewards of pensioners and employees of the public sector: 0-2000:0.8%, 2001-3000:1%, 3001-4,000:1.5%, over 4001:2.0%. Even the uninitiated knows that these kinds of measures simply scratch the surface but do not solve the problem. Simply: these make life easy for politicians and help them avoid making hard but necessary decision. The MoU calls for the non-replacement of 3,000 public sector employees for every 4,000 that retire. This could have been an option two years back but not now that the government's financial resources have dwindled and the economy is crumpling. A more radical approach is needed soon to reduce the burden on the economy that the thousands of super-numerari public sector employees are creating. The Agreement fails to address the calamity that has befallen on the thousands of people that are now out of a job or have lost their businesses.

The Agreement includes some potentially dangerous clauses particularly as regards the sovereignty of the country. More specifically the ESM is free to revise the terms of the agreement before giving Cyprus more money. Specifically, the agreement gives the right to the ESM to change terms and refuse outflow of funds if: a.) it notices that the Memorandum is not applied as given and b.) it feels that the fiscal and economic situation of Cyprus has deteriorated.[41] Equally dangerous to the economy of Cyprus is the option of some of the money to be loaned to Cyprus going towards the recapitalisation of the remaining banks (e.g. the Co-op banks, Hellenic bank, etc.,) the moment no one knows what the potential needs of these institutions would be.[42] In such an event the line of credit will for certain not be enough to cover the cash-flow shortfall of the government, making more loans mandatory.

The Agreement allows controls from outside Cyprus (controllers from abroad), a development that most Cypriots find unpalatable considering the long continued interferences of outsiders in the affairs of Cyprus. Thus, much of the economic decision-making will now be in the hands of the Troika and the democratic institutions of Cyprus will suffer. In addition, the Troika could create incalculable risks as regards Cyprus' energy reserves. More frightening is the possibility that this Agreement may impact negatively on the way Cyprus' political problem is solved.

It seems that the sooner Cyprus applies all the reorganization provisions of the MoU, the sooner Cyprus can free itself from the risks of financial and political fallout from the Agreement. Already articles in the foreign press mooted the possibility of Cyprus' potential gas supplies going through Turkey, seen as a cheaper route that would give Cyprus more cash to pay back the Troika. Those supporting these views take no cognizance of the fact that nearly half of Cyprus is occupied by Turkey and that Cyprus cannot possibly partner with its occupier.

As regards the energy reserves that could potentially liberate Cyprus from the Troika, Aris Petasis wrote in an article that appeared in the Energy Tribune, Houston (posted on 27 December, 2013,)[43] that the energy reserves will always be under threat from Turkey and thus any future revenues will need to be seen through this prism. He suggests that unless the security of these reserves is guaranteed any talk of future revenues is fruitless. Petasis wrote, "*Any discussion on the management of Cyprus' and Greece's energy reserves has to take cognizance of the geopolitics of the volatile Eastern-Mediterranean and the shifting political sands of the Middle East….Whilst recognizing the importance of economics….we also need to focus on diplomacy and geostrategy*." The article goes on to explain that: "*At its core lies diplomacy and geo-strategy as much as economics. We need to view Russia and Israel as pivotal players that need to be on board with us. Importantly, we need to work closely and amicably with the US, France, China, the UK (guarantor power of our constitution) and our friend Egypt making doubly sure that the interests of these important countries are served.*"

Cyprus needs to act quickly now that the Agreement is a fact. For a start, Cyprus would need to start looking at restructuring its economy speedily (as explained earlier.)

Cyprus would need to start rebuilding its economy from zero base considering the destruction of some of its sectors as a result of the Eurogroup's decision to crash Cyprus' two largest banks. Prior to the banking disaster Cyprus had the following sector activities (Table 8)

Table 8

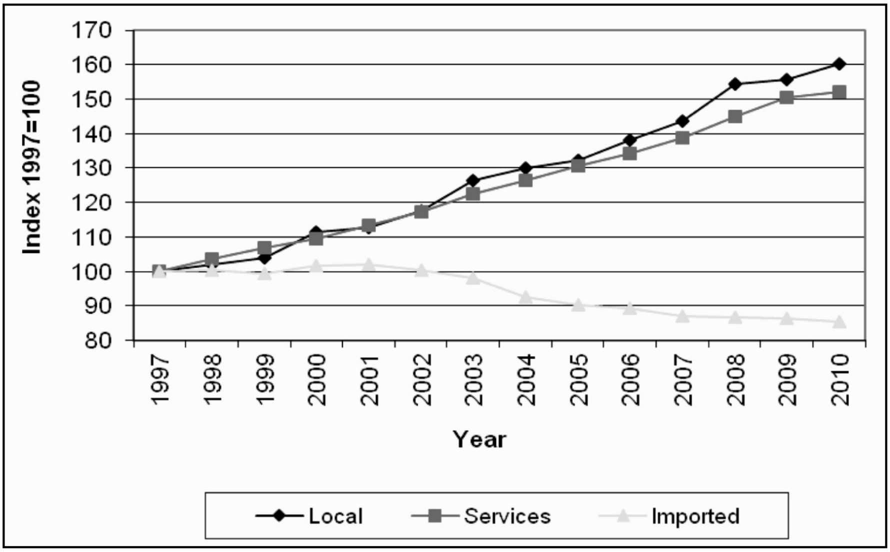
Sector	**Cyprus**
Agriculture, etc.	2.3%
Industry	6.6%
Construction	7.2 %
Other industries	2.6 %
Tourism, wholesale/retail	25.5%
Financial & real estate	30.0%
Public services	25.9%

Source: Eurostat 2010

The above sector mix has now changed considering that the financial sector that used to contribute 13% of total has for all practical purposes been destroyed at least for the near future. Construction that accounted for 7.2% to the economy has also been destroyed for now. So, Cyprus would need to look into the other sectors to recover its economic vibrancy. Regrettably, an irresponsible euphoria has been built around the belief that tourism is going to save Cyprus. The reality is that the tourist industry has its own limitations and cannot possibly rebuild the economy on its own. For a start tourism's contribution to the economy is hardly 10%. This percentage is likely to improve but only on account of the expected shrinkage in GDP. Tourism used to contribute roughly 20% of GDP in 2000. Now this has fallen to about 10%. More importantly, occupancy rates that used to be 70% in 2000 are now (2012) down to 60% because the Cyprus tourist product is not competitive and is highly taxed. So, for tourism to have its full impact a lot of work would need to be done first.

Cyprus would need to improve its competitiveness quickly. This will not be easy considering that in the last WEF rating Cyprus held the pitiful 58th position and probably now this position has deteriorated even further. For a start, Cyprus would need to improve its productivity (labor and total productivity). A 2012 ILO report puts Cyprus' average salary in PPP terms at 16th place, just \$11 lower than Singapore's, who is ranked 2nd on the WEF's competitiveness table out of more than 140 countries. Either employees will have to become significantly more productive (a fit that sound less than plausible) or their salaries would need to be reduced significantly to create what is known as internal devaluation. Some of the measures that Troika suggests, if applied timely and rightly, will probably go a long way in achieving this objective. This would need to be done soon if Cyprus is to reverse the disastrous position of its current account deficit which in 2010 was in the region of 10% of GDP.[44] The graphs in diagram 2 below show that Cyprus has a long way to go before reversing its current account balance considering that the prices of local goods and services have been growing since 1997 whilst the prices of imported goods have been falling for most of this period. With 1997 indexed at 100 the cost of local goods stands at roughly 160 units and that of services at just above 150. The cost of imported goods stands at a commanding 85.

Diagram 2



Source: Cyprus Ministry of Finance. Table constructed by Simon Matsis former head of Cyprus' planning bureau.

Cyprus would have to look into improving its performance all-round: with or without Troika. In the WEF competitiveness index 2011/12 Cyprus has a pitiful performance on many counts aside of general competitiveness; particularly on critical indices such as: tertiary education (39^{th} place), technological readiness (41st), innovation (45^{th}), market sophistication (48^{th}) and labor market efficiency (60^{th}). As far as the labor market efficiency is concerned the author of this paper would go as far as to suggest that for the next 10 years, and as an emergency measure, union activity in the public and banking sectors and in all essential service sectors would need to be curtailed to a minimum if not frozen. This would go a long way in stopping the catastrophic relationship between unions and politicians that has wreaked havoc on the economy for so many years and helped create the situation that Cyprus finds itself in now. During this period salary and benefits reviews would have to depend on the data of salary and benefits surveys. Independent committees of experts could also be set up to review salaries, benefits and conditions of service.

The MoU stipulates that the public sector headcount would need a review by outsiders to determine structure and numbers. This is a step in the right direction provided that politicians accept the findings and enforce the recommendations. If this is done in the right manner, public sector staff numbers could probably reduce by about 30%. Regrettably this would mean more unemployment but in the end it would bring benefits to the economy and redress a long standing imbalance. In such a case the economy stands to save about 5bil in 10 years considering that the average cost to the government of employing a public servant is roughly 50,000 per year. If public servant salaries and benefits are reduced to market levels the economy would gain in competitiveness.

The three Troika targets for privatization would need to be sold off immediately if possible; with necessary care. The Troika expects the government to make about 1bil from this exercise. This amount would of course need to go towards helping reduce Cyprus' debt and not to cover public servant salaries.

Probably the most intractable problem that would need to be addressed is that of attitudes. Attitudes would need to change radically and a new spirit would need to reign otherwise any temporary gains would quickly erode; bad habits die hard! People would need to accept that reward must be tied to performance and that good performers would be earning more than low performers. Meritocracy would need to be established in public life and politicians would need to make an extra effort to stay away from areas that are not in their domain and in this way allowing the market to work unhindered. In this regard the following attitudes would need to be ingrained: more rational behaviour and less emotionalism, more strategy and holistic approaches and less shortermism, more team work and modesty and less individualism, more concern for others (the unfortunate in particular) and less concern for oneself and lastly more belief in our ability to survive this catastrophe and to turn things around. Attitude change starts in the home and in the school at an early age.

Cyprus can come back from the dead just as it did 40 years ago when it survived a military invasion that killed 2% of its male population and in 2004 when it managed to fend off against all odds the onslaught of a deadly plan that ostensibly was supposed to solve its political problem but which in reality would have destroyed its people. Cyprus would need determined actions, however, before its people can regain their smile.

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