



# Spring Report

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2018 Cyprus Fiscal Council



# Content

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- Synopsis – Risks & challenges / Reforms
- Summary findings– compliance with fiscal framework regulations
  - Medium term objective
  - Upper limits
  - Macroeconomic and fiscal projections
  - Public debt evolution
- Necessary reforms
- Conclusions



# Synopsis: Risks and challenges

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- Lack of competitiveness and diversification- Dependency on a small number of sectors.
- High level of public and private debt. Slow progress in reducing high level of Non-performing loans.
- The economy is vulnerable to external and unexpected shocks. Limited ability to react in the case of shocks because of the high debt level.
- Reversal of the favorable external/ internal environment. Tourism boost due to challenges faced by neighboring destinations, the accommodative monetary policy by the ECB and the schemes “investment for citizenship” boosted economic activity, but can and should be expected be limited to the minimum or even stopped/ reversed.
- Continued reliance on the above, especially on the scheme “investment for citizenship” will undoubtedly cause some of the effects of the Dutch Disease, i.e. the transfer of resources away from productive sectors of the economy, thus increasing their operating/ investment costs and negatively affecting their competitiveness.



# Synopsis: Addressing risks and challenges

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## Immediate / substantial reforms

- The better than expected macroeconomic environment and in particular the strong economic growth over the past years, and the overachievement of fiscal targets, either set during the Economic Adjustment Program or later, as set in the Strategic Framework for Fiscal Policy, should not be seen as arguments in favor of reversing measures taken during the crisis period or for termination of reforms. On the contrary the favorable macroeconomic environment is conducive to reforms.
- Reforms during periods with strong economic growth can be implemented in an orderly manner without the pressure and negative effects of reforms implemented during crisis periods. Furthermore governments are in a better position to intervene in case needed to mitigate the negative effects.



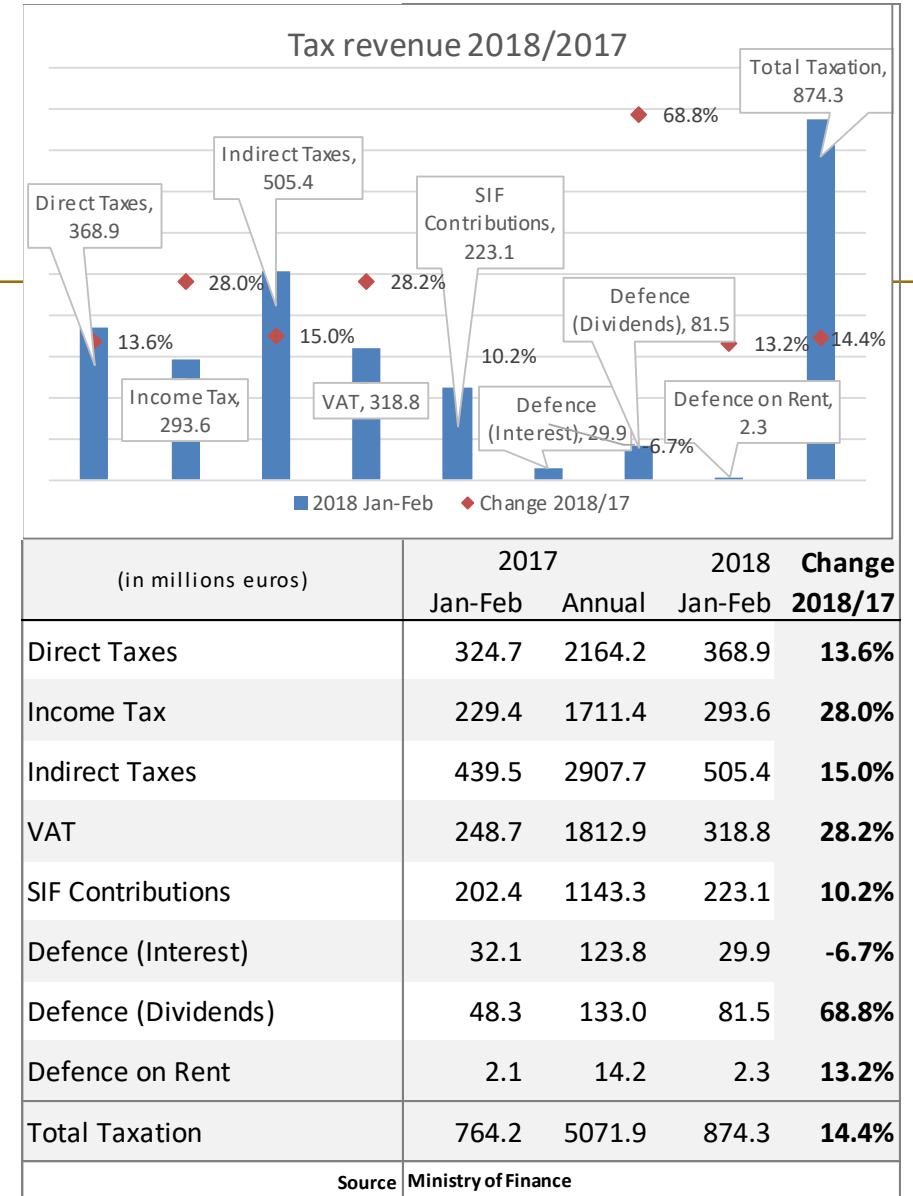
# Summary of findings(1)

- No deviation from the 2017 Medium term Objective. i.e. 0% cyclically adjusted structural balance.
- No deviation from the MTO of 2018-2019 is expected, subject to no significant policy changes / no unexpected external shocks.

Primary balance			
Year	Source	Millions €	% of GDP
2015	Actual	299	1.7
2016	Actual	529	3.0
2017	SFFP 2018-20	493	2.6
	Actual	845	4.4
2018	SFFP 2018-20	568	2.9
	SFFP 2019-21	907	4.5
2019	SFFP 2018-20	607	3.0
	SFFP 2019-21	991	4.7
2020	SFFP 2018-20	641	3.0
	SFFP 2019-21	1016	4.6
2021	SFFP 2019-21	1026	4.6

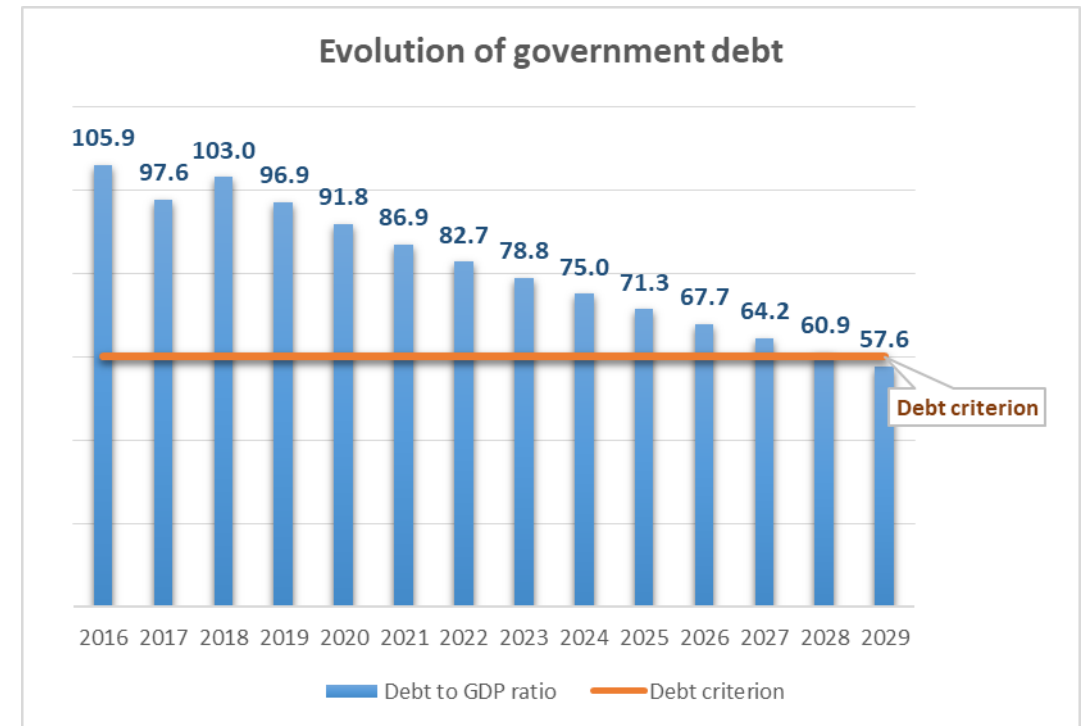
## Summary of findings(2)

- The fiscal targets and the macroeconomic projections set for 2017 included in the Strategic Framework for Fiscal Policy (SFFP) 2017-2019 and then revised in the SFFP 2018-2020 have been met.
- The corresponding targets and projections for 2018 and 2019 included in the SFFP 2019-2021 are considered to be attainable subject to no material deviation from the current fiscal policy and no major external shocks.



## Summary of findings(3)

- Public debt increased by 2.35 billion euros or 12.2% of GDP after the issue of government bonds in order to inject liquidity to the Cyprus Cooperative Bank.
- The improved macroeconomic environment which boosted government revenue and lead to higher than planned primary balance. This will allow for the reduction of public debt. No deviation is expected from the debt rule subject to no material deviation from current fiscal policy and the assumption than the primary balance will be mainly used to repay the public debt.
- If all projected primary balance is used to repay debt then the latter can fall below the 60% of GDP target before 2030.



# Challenges / risks (1)

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## Low competitiveness

- **World Bank** – Doing Business report (DBR) (54th – 4th from the bottom of the table). Special reference in the legal system and in particular in resolving civil cases. Not only the score is low but a deterioration has been observed. In the 2010 DBR (first time Cyprus was included in the DBR) Cyprus was at the 40<sup>th</sup> position, while in the 2010 DBR it dropped to 53<sup>rd</sup>.
- Competitiveness Index of the **World Economic Forum** (64th – second from last in the EU).
- Index by **IMD** World Competitiveness Centre (Dropped from 37<sup>th</sup> in 2017 to 41<sup>st</sup> in 2018 out of 62 countries)

## Macroeconomic Imbalances Procedure

- **European Commission report.** Several imbalances noted, mainly pointing to lack of competitiveness. High debt level.

## Weak enforcement of Property and contractual rights

- Chairwoman of the Supervisory Board at the European Central Bank **Daniele Nouy**: *«the very high level of non performing loans still is the major vulnerability of the Cyprus economy and of the banking system. It affects the ability of the banks to fulfill their intermediary function»*.
- **Report by the Auditor General**: *“According to the Memorandum of Understanding during the period January –June 2017 3000 title deeds should have been issued every month, instead, during the whole period only 4215 title deeds were issued (of which only 3082 related to the memorandum)... it is also noted that despite the several amendments to the legislation that were passed between 2011-2016, the process of issuing title deeds still appears not to move fast enough, nor the transfer of title deeds to trapped buyers”*.

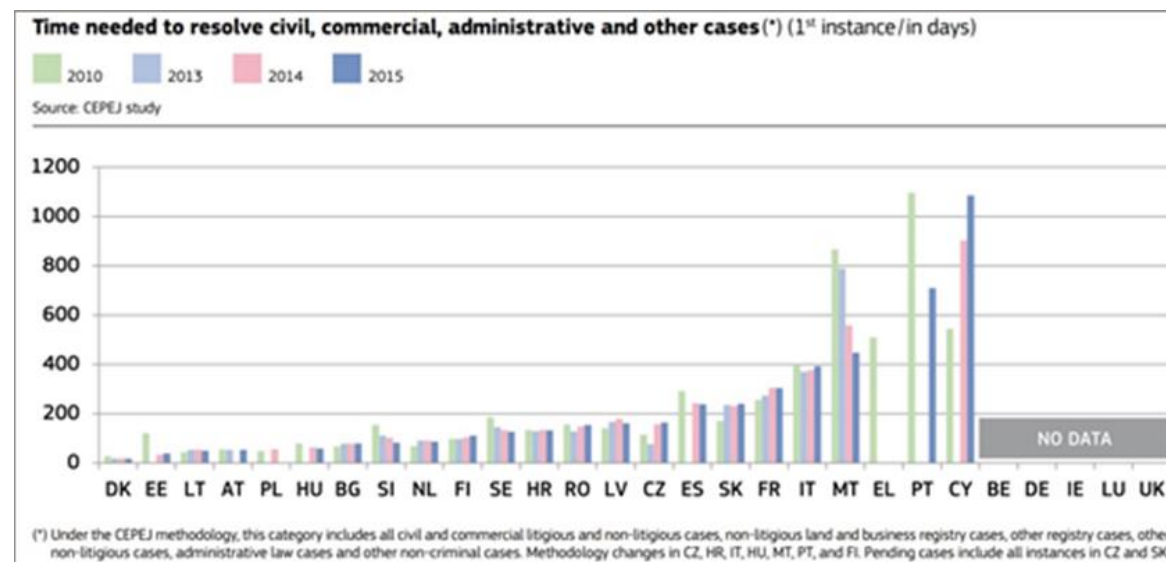


## Challenges / risks (2)

- In the European Commission report on the effectiveness of EU justice systems (“The 2017 EU Justice scoreboard” ) Cyprus is at the bottom of the table «Time needed to resolve civil. Commercial and other cases”.
- Member states that faced similar challenges, through reforms managed to improve the effectiveness of their justice systems over the period 2010-2018. During the same period in the case of Cyprus a deterioration was observed.

### Recommendations by the European Commission (COM(2018) 412 final):

*«Inefficiencies in the justice system continue to affect contract enforcement and the swift resolution of civil and commercial cases. Cumbersome civil procedures and weak enforcement of court decisions weigh on banks’ incentives to use the insolvency and foreclosure frameworks to reduce their stock of non-performing loans.»*



# Negative effects

## Weak property and contractual rights

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Lower property prices = Bigger gap between loan and mortgaged asset value = Bigger capital requirements for banks and outstanding amounts than will be shared between borrowers and lenders.

Increased cost of finance and limited capacity to finance = Economy cannot function at its full potential.  
Lower growth and increased difficulty in acquiring prime residence

Continuous change in the legal framework creates unnecessary level of uncertainty and additional costs to participants. This discourages institutional investors and often attracts investors than can function in non transparent and uncertain environments.

Providing full – universal protection of mortgaged properties (prime residence and main business property) = More difficult for new couples / entrepreneurs with no or limited wealth to buy property (either prime residence or for starting new business)

Social policy should be carried out by the government not assigned to private individuals or corporations.

# Negative effects - Studies

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- *“In the credit market, when agency or enforcement costs are important, lenders may not be willing to lend an efficient amount or, in some cases, lend at all. Property rights improve the ability of borrowers to pledge their assets as collateral, and thereby relax credit constraints”. He also points out that “Effective states in the current context are those that support institutions that allow households and firms to enjoy secure property rights”*(Richard E. Messick, (Παγκόσμια Τράπεζα).
- *“Property titles issued in Peru starting in the mid-nineties led to a significant increase in labor supply by urban slum dwellers”. (Economics Professor Erica Field).*
- *“Insecure property rights impede efficiency by undermining investment incentives, and creating barriers to trade” and they point out that “effective states in the current context are those that support institutions that allow households and firms to enjoy secure property rights”. Professors Timothy Besley και Maitreesh Ghatak in their book «Development Economics»).*

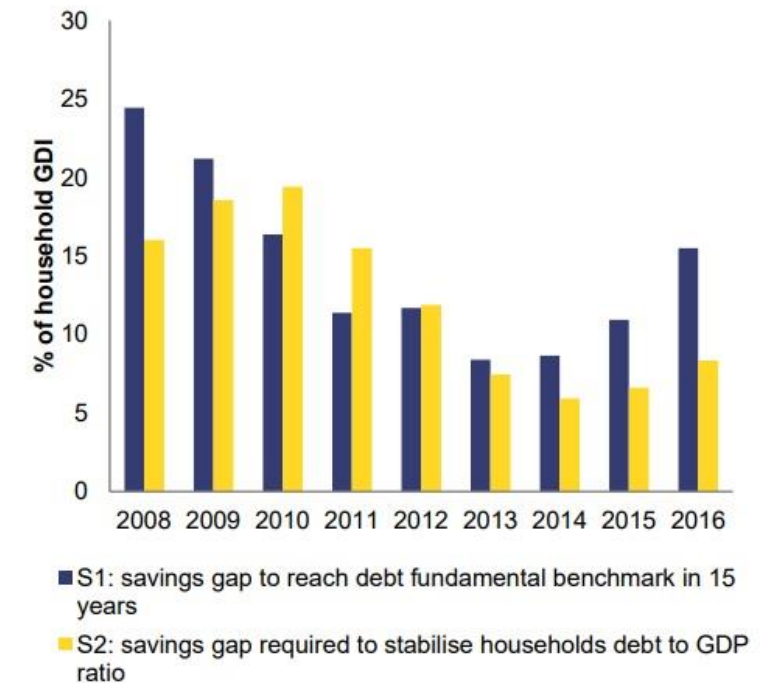
# Reforms

## Pension adequacy/ Savings

- The need to encourage savings through a comprehensive reform of the pension system in Cyprus is considered imperative, given the very low saving rate, the ineffective institutional framework and the high private debt.
- The reform of the pension system should be based on the principle of adequacy of pensions for all citizens and should promote savings.
- European Commission report on the need for households to increase savings in order to stabilize/ reduce debt.



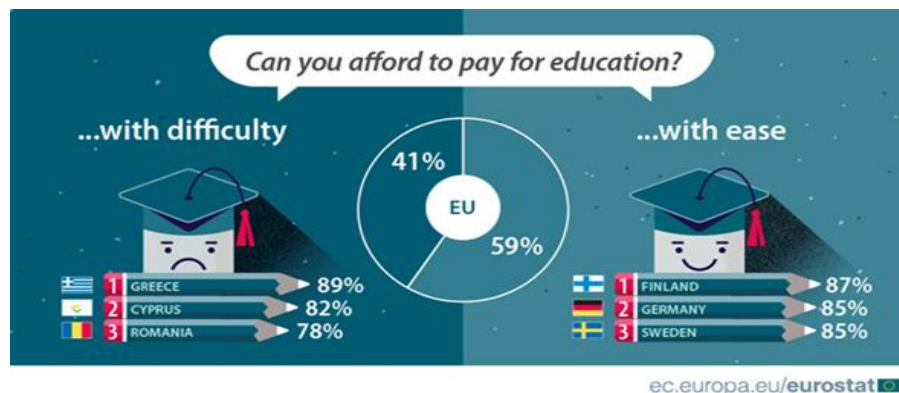
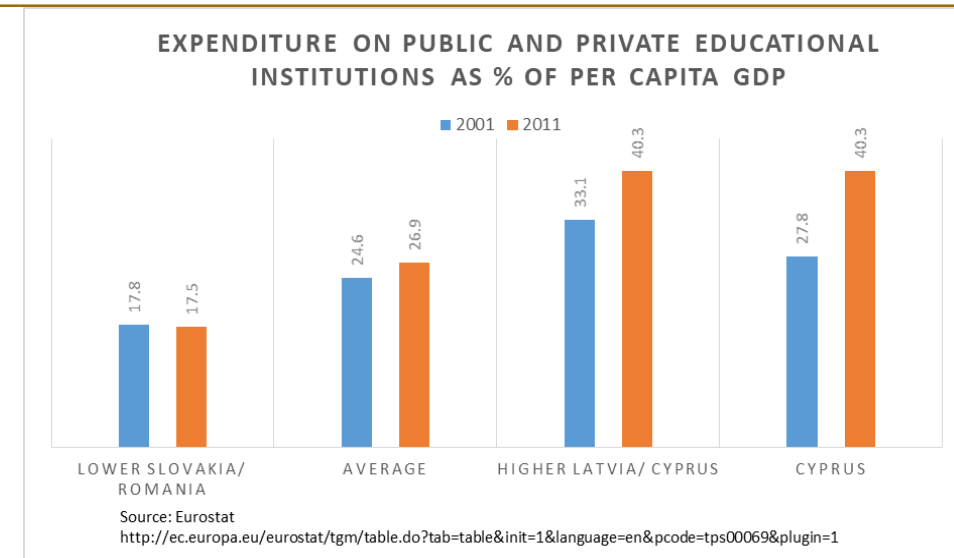
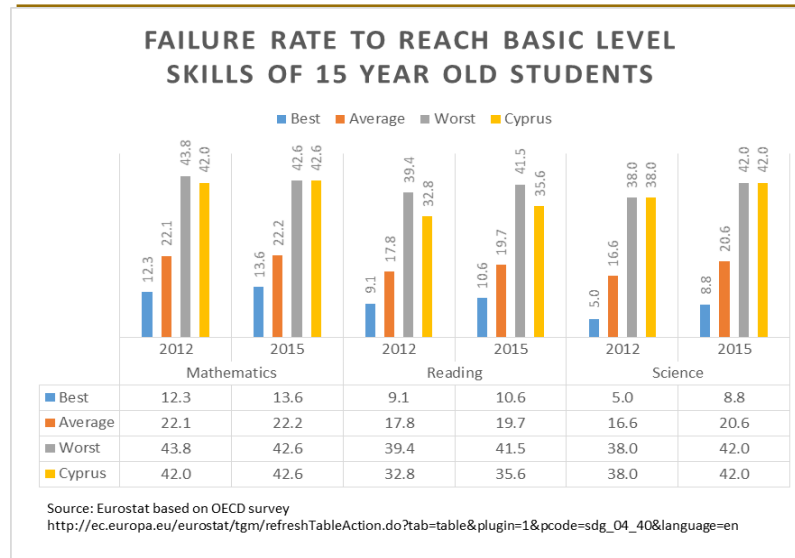
Graph 4.2.5: Cypriot households savings gap



Source: European Commission



# Reforms : Education



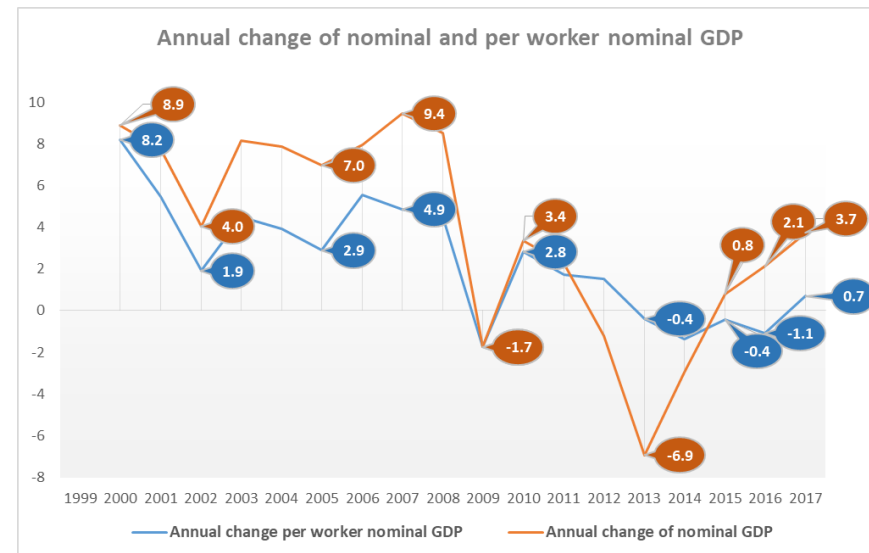
Paper on “Education and economic growth” by Robert j. Barro on education : “Scores on science tests have a particularly strong positive relation with economic growth. Given the quality of education, as represented by the test scores, the quantity of schooling — measured by average years of attainment of adult males at the secondary and higher levels — is still positively related to subsequent growth. However, the effect of school quality is quantitatively much more important”».



# Reforms

## Remuneration mechanism in the public sector

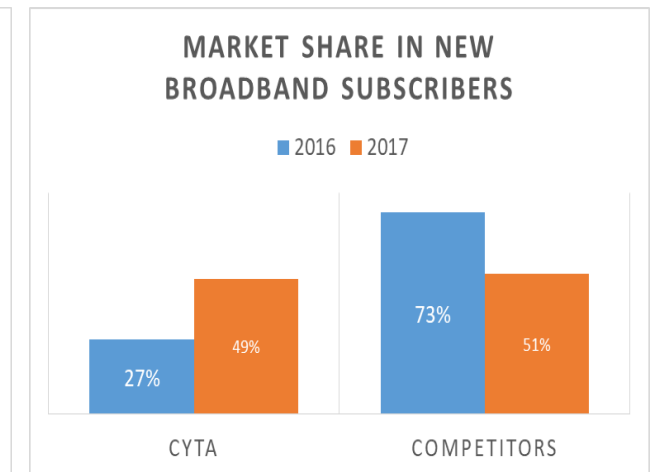
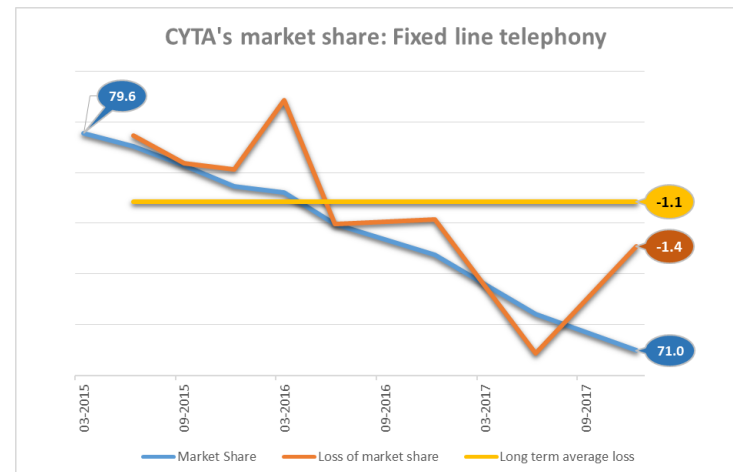
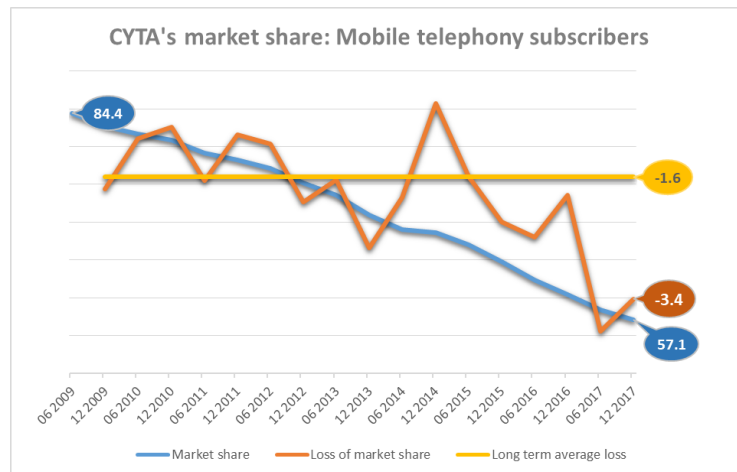
The agreed limit to the government payroll of up to the nominal GDP growth rate should only be used as a safety net in the context of a medium-term plan to contain government spending. It should not be used as a benchmark or part of a mechanism for setting increases, as it may lead to wrong concessions that will affect public finances and the competitiveness of the economy.



*The Council stresses that the creation of a transparent and scientifically designed mechanism for determining the remuneration and future development in the public and broader public sector, besides restraining public spending, will improve the procedures for promoting meritocracy, will enhance transparency by reducing corruption, will help develop good management practices, will limit political pressure for unreasonable concessions and will allow the governments to justify the granting of any increases when circumstances permit so.*

# Reforms: CYTA

It is reiterated that the inability to reverse the trend of loss of market share and revenue by CYTA, while meeting demands for remuneration increases will affect negatively its profitability. The abandonment of the privatization effort / finding of a strategic investor may worsen its position and reduce its value.



# Conclusions

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The Council assessed the macroeconomic and fiscal forecasts of the Ministry of Finance as well as the budgetary outcomes included in the Strategic Framework of Fiscal Policy of 2018-2020 and 2019-2021. At the same time, the Council examined compliance with Regulations regarding its fiscal position (MTO), the spending ceilings and the debt level.

The Council concluded that:

- (a) there was full compliance with the Regulations as described in the institutional framework,
- (b) the macroeconomic projections upon which the government's fiscal planning is based are within acceptable limits and
- (c) that no deviation from these regulations is expected within the two years 2018-2019 provided that there will be no significant differentiation in fiscal policy and the economic environment.

The Council reiterates the urgent need of promoting reforms aiming at improving the competitiveness of the Cyprus economy and strengthening its position in the face of unforeseen adverse developments while ensuring a stable and sustainable rate of economic growth.

# Thanks You

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ΕΑΡΙΝΗ ΕΚΘΕΣΗ

Μάιος 2018

