

Introductory Remarks to First Annual Symposium on the Cypriot Economy

Alexander Michaelides*

School of Economics and Management, University of Cyprus

The First Annual Symposium on the Cypriot Economy was held on November 5, 2011, at the University of Cyprus, at a difficult juncture for the Cypriot economy. The School undertook this initiative feeling the need to respond to two challenges. The first challenge concerns the need to raise the standard of discussion about economic policy issues in Cyprus, and perhaps also to contribute to the discussion about European and world issues in economics and finance. The second challenge involves offering independent, evidence-based and theoretically coherent responses to the problems facing the economy of Cyprus. The Cyprus economy is facing important challenges as it attempts to come out of the crisis, which is still affecting its financial system, and importantly, its fiscal position. The strong financial-sector links with Greece, and lack of progress in pursuing structural, mainly fiscal, reforms have rendered the economy vulnerable and have led to a series of downgrades by credit ratings agencies, which in turn have severely dented the ability of the country to raise debt in international capital markets.

Professor Pashardes enumerated various structural problems in the Cypriot economy such as the tax system, the social protection system, the public sector, and institutional factors limiting competition. Pashardes proposed that the basic principle in tax reform should be the equity-efficiency tradeoff, rather than an accounting approach or one arising from any other motive (for example, political interests).

Specific recommendations were as follows. Taxing property is probably both equitable and efficient, yet property taxes are not really used effectively in Cyprus. An emphasis on targeted social transfers is another

* Corresponding address: Department of Public and Business Administration, School of Economics and Management, University of Cyprus, P.O.BOX 20537, 1678 Nicosia, Cyprus. E-mail: michaelides.alexandros@ucy.ac.cy.

policy approach that needs to take centre stage in policy discussions and is consistent with the equity, and sometimes also with the efficiency, principle. With regards to public sector wages Pashardes noted that the higher salaries in the public (relative to the private) sector are explained in large part by low-human-capital-intensive occupations or teachers. The stereotype that “public sector wages are high” is wrong because doctors and skilled public sector workers are actually not overpaid relative to their counterparts in the private sector. Finally, institutions protecting competition should be bolstered and not be seen as a drag on the economy.

Symeon Matsis started his discussion of this presentation with a dramatic graph illustrating that real wages have outpaced productivity every year since 1980. Starting from a scale of 100 in 1980, productivity increased to 180 in 2010 while real wages soared to 280. This has damaged external competitiveness, as reflected in unit labour costs, and increased the current account deficit, and hence Cyprus’s external debt, to very high levels. Matsis noted that one reason behind the poor external competitiveness is the low productivity of the public sector.

The main explanation offered by Matsis for the sharp rise of the public sector wage bill is the complex public sector salary structure maintained and bred over the years to meet partisan demands and serve special interests. A large number of salary scales would not have been a problem had it not been the case that every year, rain or shine, civil servants enjoy an unconditional and sizeable (3.4% - 4.4%) increase in their real wages as they move from one grade to another. The concept of a “combination salary scale” also means that public sector employees can enjoy a real increase in salary for decades even without promotion (and without reference to theirs, or the economy’s, productivity increases).

Louis Christofides noted five issues that policy makers in Cyprus should deal with urgently: remuneration and regulation in the banking sector, freezing pay in the broader public sector, modernising the public sector, pension reform and reforming the property tax system to tax property and not sales. Christofides focused on the commonly used assertion that “the labour market in Cyprus can be considered to be relatively flexible and well functioning”. Even though there are some elements of flexibility in the system (extent of self employment, amount of incoming foreign labour), there are elements that create substantial inflexibility like the automatic cost of living adjustment, and reduced competitiveness, primarily through the increases in the public sector wage bill that are most acute (relative to the private sector) for lower wage employees. A third problem is the minimum wage that, at 909 euros per month, is very high when compared to Cyprus’s main trading partners (both in absolute terms and relative to mean wages). A fourth problem involves the educational system that does

not provide the support and strategic decision-making necessary to foster high value added services. As an example, he noted the setting up of three public sector universities in Cyprus in one year and the subsequent cut in their budget by 20-35 percent the following year, as an example of a lack of strategic thinking.

Andreas Pavlikas discussed this and raised three main points. The first is an interesting puzzle that needs to be addressed in future work by the economists present in the symposium. The question was why the share of wages in GDP is so low (48%) in Cyprus, both over time and compared to across countries. How does this square up with the large increase in the wage bill noted by the previous presenters? His next two points were with regards to the COLA. The wage bill is only around 25% of the total cost in a factory; therefore the loss in competitiveness cannot be attributed just to the automatic cost of living adjustment. His view is that low productivity is the problem and that is what policy makers and the private sector should try to address, focusing on productivity and management of enterprises and small businesses. He noted that an automatic indexation system prevents unnecessary friction in industrial relations and in some cases prevents work stoppages and strikes.

Constantinos Stephanou talked about regulation in the banking sector and the management of crises. Stephanou noted the large size of the Cypriot banking system, which partly reflects the success and contribution to the economy of this sector. On the other hand, banks are special because they might pose systemic risks to the rest of the economy, as the recent global financial crisis and the experience of the US, UK, Ireland and Iceland have shown. There are two lessons from these crises. First, governments in countries with large banking sector exposures need to be very strict in prudential regulation and supervision. Second, these countries need to allow for considerable “fiscal space” to support the economy in the event that a crisis arises.

Marios Clerides raised a host of issues and relevant questions that policy makers and regulators should address. One in particular was whether accountants and lawyers, who also benefit from banking sector activity and from a large and healthy financial system, should also contribute to “bank stabilisation funds”.

In the discussion that followed, Stavros Zenios noted the need for a more environmentally-driven growth strategy and noted World Bank statistics showing environmental degradation that are not flattering for the Mediterranean in general, and Cyprus in particular. Governor Athanasios Orphanides noted the urgent need to take measures to manage the public debt and deficit. Michalis Sarris talked in a similar vein, as participants in

the audience were reminded that Moody's had downgraded the sovereign debt of Cyprus to the grade just above the non-investment one. Orphanides noted that public sector credibility is key to convincing the markets that the Cypriot economy can rise to the challenge of creating the much-needed "fiscal space". At stake is perhaps the status of Cyprus as a respectable financial centre and it is with this in mind that policy makers should be making their decisions.