ECONOMIC COMMENT **18/10/2011**

The IMF mission's to Cyprus: main findings

The conclusion of the IMF's visit to Cyprus yielded some interesting insights about the local economic situation. In general, the IMF team's findings were critical of the situation but they also contained useful prescriptions for policymakers. The team's preliminary findings dealt with four broad themes: the economic outlook, fiscal policy, the financial sector and structural reform.

With respect to the economic outlook, the IMF team sighted "substantial downside risks". Key challenges for the local economy emanate mainly outside Cyprus; the debt crisis in Greece (where the banking system has exposure) and the Eurozone as a whole as well as a global economic slowdown. Slower growth in Cyprus's main trading partners could affect the island's dynamic services export sector. Domestically, consumption and investment are likely to be hit by "a climate of tight credit and uncertainty". Construction is also expected to continue to correct its previous excesses. Fiscal consolidation is also expected to have a negative impact on domestic demand in the short-term. Therefore, the IMF is predicting little or no growth for 2011 and a small contraction for 2012.

The other theme that the report is dealing with is the deterioration in public finances and the fact that the country has lost its access to international capital markets. The Fund mentions a deficit of 7% of GDP for 2011. The reversal of this deterioration is an "urgent priority" according to the team's findings. In order to achieve this, a credible medium-term program should be implemented, with emphasis on expenditure cuts, which will put the debt-to-GDP on a declining path and balance the budget in a 3-year horizon. The Fund welcomed the passage of fiscal consolidation measures in August while supporting the additional measures the government is considering. The key target should be to quickly restore investor confidence in public finances.

Concerning the financial sector, the IMF team stressed the importance of the sector for the local economy, providing a high share of jobs and income, but also its size (eight times GDP). The Fund praised local banks for their limited exposure to securitized assets and reliance on deposits rather than wholesale funding but cautioned with respect to their exposure to Greece and the financial turbulence in the Eurozone. These problems could negatively impact "asset performance, profitability and capital and liquidity buffers". The Fund calls for "utmost vigilance and careful contingency planning" with respect to the sector. It calls for stress tests, bank liquidity monitoring, close cooperation with other countries and the EU and enhancement of the legal and regulatory powers to enable prompt action to recapitalize or resolve banks. Finally, the IMF calls for similar measures with respect to cooperative credit institutions and harmonization of their regulatory regime with that of banks in order to ensure consistency in treatment.

Moving on to structural reforms, the key structural advice from the IMF is for government to strengthen the "well-qualified private sector labor force" so as to boost prospects for growth and employment. This can be done by containing the wages and benefits of the public sector, increase wage flexibility and facilitate the flow of highly qualified workers to the private sector. The IMF also draws attention to the long-term challenges faced by the national pension system and the need for reform to ensure it is in equilibrium in the long-term. With respect to fiscal institutions, the Fund calls for "more accurate revenue and expenditure estimates" as well as combining tax collection departments in order to improve efficiency and enhance the collection of information. The need for improving the framework for Public-Private Partnerships is also mentioned.

The report was also interesting not only because of the recommendations and comments it contained, but also because of what it left out. Specifically, while the local media and politicians are constantly mentioning the prospects for natural gas exploration and production, the IMF kept such talk out of its preliminary findings. In addition, there was also no mention of the medium-term loan from the Russian Federation. When the IMF team was asked about the Russian loan during the press conference, it replied it did not comment on inter-state agreements. Perhaps one reason neither the Russian loan nor the prospects for natural gas exploration and production were explicitly mentioned, is the uncertainty surrounding these two factors and the fact that in the long-term they are not a panacea for Cyprus's economic situation. These two factors may also (falsely) be weakening the resolve for more intense fiscal consolidation and deeper structural reforms.

To sum up, in the conclusion of its preliminary findings of its mission, the IMF stresses the large risks the economy faces and the need for a strong policy response. This puts the onus on fiscal and financial authorities to implement measures that are necessary in order to improve public finances and to safeguard the financial system.

The Eurozone debt crisis: who will pay?

The Eurozone debt crisis is almost two years old but unfortunately a solution has not yet been found that adequately addresses concerns. The crisis has reached a point that it is threatening the entire global economy and it has become a focal point for investors from Tokyo to Toronto. It has been characterized as the key challenge facing the global economy. The most important clue to understanding the crisis is to ask a series of questions: Why has it proved so intractable? Why has a solution not be found? Why has the current approach to deal with the crisis failed to convince investors? The questions are unfortunately more than the answers.

At the heart of the Eurozone debt crisis are the large fiscal imbalances which have been built up in peripheral Eurozone countries either through banking crises (Ireland) or through low competitiveness and low economic growth (Greece, Portugal). Doubts about the sustainability of public finances, have caused the prices of government bonds of mostly Southern peripheral Eurozone countries to decline and hence their interest costs to rise. In the case of Greece, Portugal and Ireland, their debt financing costs rose so much so as to force these countries to seek an EU/IMF bailout.

Cyprus has also lost its access to international capital markets for the moment, but has managed to find alternative sources of financing. The worry is that the weakness of peripheral government bonds will infect Eurozone banks, which are massive investors in such bonds as they were previously thought to be risk-free. The deterioration in the health of banks (this is after all a credit or financial crisis) in turn will require Eurozone states to bail out their banks, causing further deterioration in public finances and creating a vicious cycle. Then, there is the additional concern that countries such as Italy or Greece, with public debt ratios in excess of 100% of GDP, will be unable to generate enough growth to repay their debts. Without adequate economic growth, their debt burden will continue to grow and it will eventually choke them.

Therefore, the necessary ingredients to a solution are fiscal consolidation and structural reforms in heavily indebted countries (politically unpopular in indebted countries), in combination with aid or a rescue or backstop facility by the remaining 'healthy' countries in cases where investors refuse to finance an indebted country (politically unpopular in the fiscally healthy countries). Forcing investors such as banks to take losses or 'haircuts' on their holdings of government bonds and reducing the debt burden that way, risks weakening the fragile banking system too much and creating a severe credit crunch. However, as these were in essence bad investments by banks and investors, forcing taxpayers to pay up is also not at all popular in the current lean times.

Finally, printing money by the European Central Bank to buy the debt of heavily indebted countries is a no-no according to EU treaties as it basically means financing debt by seigniorage. This is anathema to monetary orthodox countries such as Germany that have suffered from such practices in the 1930s and which led to hyperinflation, severe economic crises and nationalism. In not-so-monetary-orthodox countries such as the United States or the United Kingdom, printing money in moderation (so-called quantitative easing or quantitative measures) is considered a useful tool to help the economy recover but the effectiveness of such measures is questioned even in those countries.

The key problem with Europe's sovereign debt crisis then is that getting the right formula and striking a balance between fiscal consolidation and reforms in indebted countries, aid and support from the rich countries, losses to bond holders and money printing, has so far proved elusive as each of the parties concerned- taxpayers, investors and central banks- want to do the minimum sacrifices required of them so as to make the crisis go away. So far this has not proved an effective strategy and has given rise to accusations that Europe is always a day behind and doing 'too little too late' in fighting this crisis. Whether this will change in the near future and the necessary will for a comprehensive solution is found, remains to be seen. The stakes are very high.