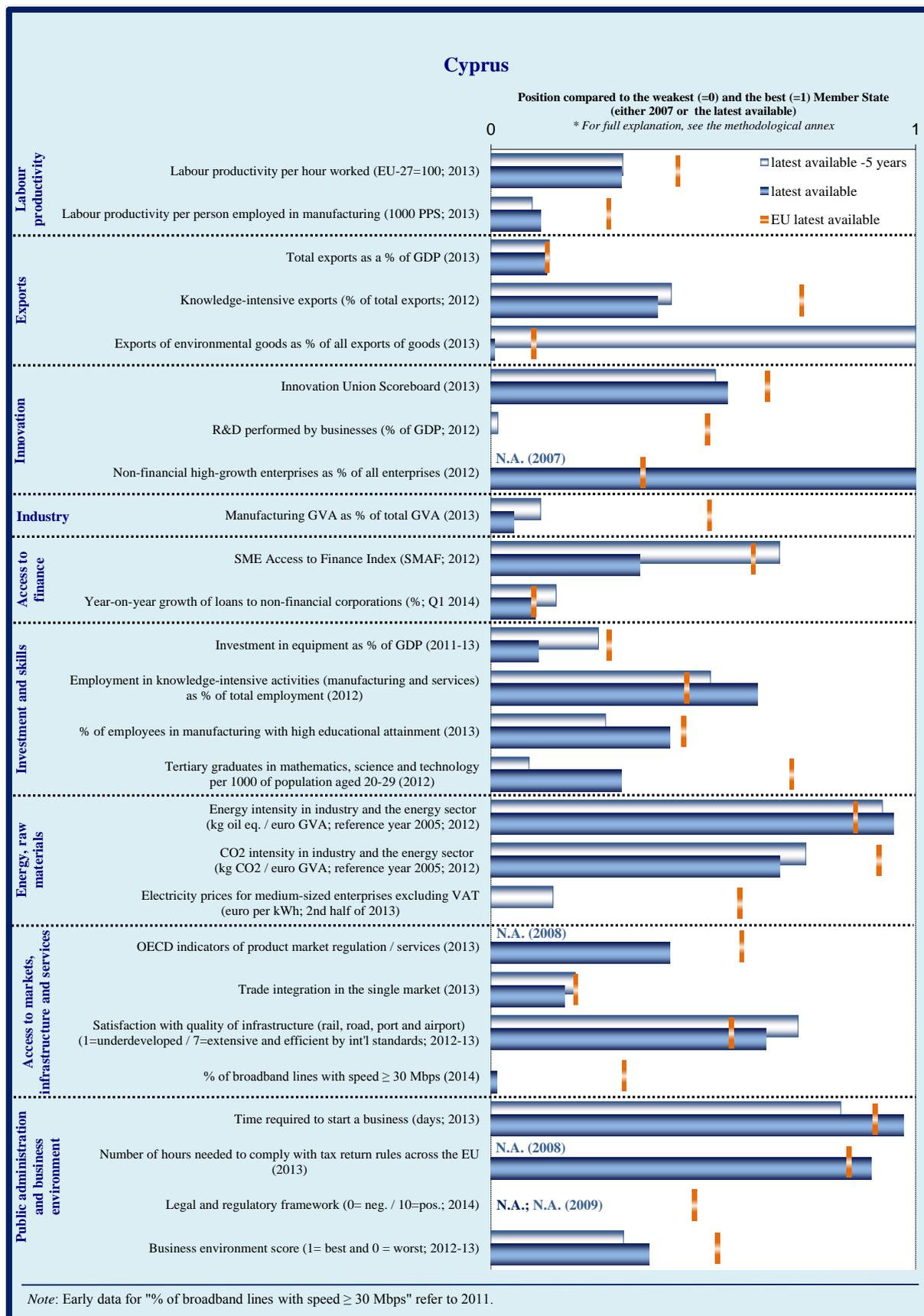
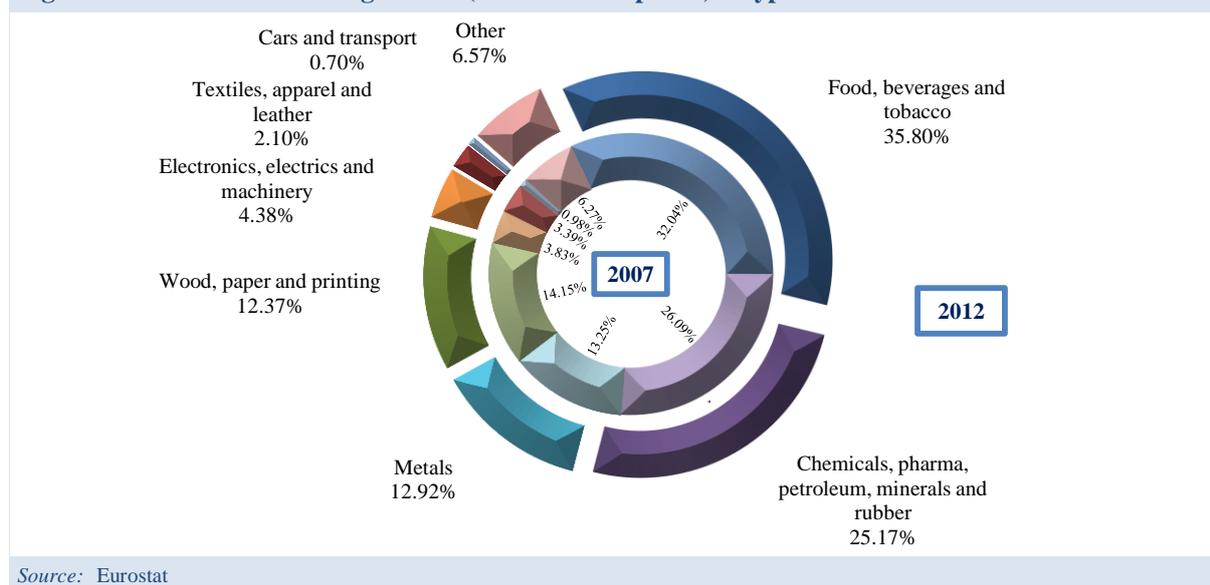


### 3.13 Cyprus



**Figure 3.13.1: Manufacturing sectors (GVA at basic prices) - Cyprus**

### 3.13.1 Introduction and performance

Economic performance and policy developments in Cyprus evolved in the context of the adjustment economic programme agreed in April 2013 <sup>(1)</sup> with the European Commission, the European Central Bank and the International Monetary Fund. While the recession is bottoming out real GDP has contracted by an estimated 5 % in 2013, though this result was better than expected. In the first five months of 2014, the index of industrial production averaged 68.3 (base 2010=100), with a further decrease of 3 % in comparison with the corresponding period of 2013. In manufacturing, the index for May 2014 reached 75,4 units, recording a decrease of 2,1% compared to May 2013.

However, corporate profits in manufacturing and in the more tourist-oriented industries have been holding up quite well. In particular, in manufacturing, this reflects a sharp decline in labour costs, to which the suspension of the application of a cost of living allowance contributed. According to Eurostat, Cyprus saw a decline in its nominal hourly labour costs of 6.5 per cent in Q4 2013 (industry -4.6 %), the sharpest adjustment in the Eurozone. Even business sentiment and consumer confidence indicators are on the rise.

Nevertheless, tight credit conditions, fiscal consolidation measures and weakening private

demand are among the factors that weigh on the economy.

### 3.13.2 Access to finance and investment

While the stabilisation of the banking sector is following its course, access to finance remains limited. This is mainly because of the high rate of non-performing loans (at 41.7 % and 47.5 % for banks and the cooperative sector respectively).

In the meantime, Cyprus managed to re-open current accounts, removing completely internal capital controls. In fact before this action, a newly opened account with cash could only be used as term deposit. Transfers to and from these accounts were not permitted, while the capacity to put money on them was also constrained by the banks' policy to impose cash withdrawal restrictions. Thus, payments within Cyprus are again totally free and only the cross-border capital controls remain in place.

However, credit to the private sector has continued to contract. Loans to non-financial corporations fell by about 10 % in the year to January 2014, with corporate credit falling by 12½ % (5 % for residents). The Bank Lending Survey indicates that this is the result of both tight supply conditions and weak demand. Although, lending rates have been declining from the peaks of 2013, they remain at around 6 %, which is over 3 percentage points higher than the Euro area average.

<sup>(1)</sup> European Economy. Occasional Papers. 149. May 2013. Brussels. Paper and internet.

In this context, the government managed to put in place two financial instruments with the EIB in support of SMEs in Cyprus. A Cyprus Entrepreneurship Fund (CYPEF) (EUR 200 million made up of a EUR 100 million loan by the government and EUR 100 million by the participating local banks) establishes a fund mechanism on a risk-sharing basis with banks to support SMEs' investment and working capital needs. To support foreign trade activities, a EUR 150 million facility from the EIB is expected to re-activate credit lines with international banks and support the capacity of the Cypriot banking sector to provide short-term trade-related instruments such as letters of credit, despite the deterioration of its credit rating. By mitigating the risks involved in trade financing, the scheme will support export and import flows estimated at EUR 300-450 million per year, mainly by SMEs, which are suffering most from the credit squeeze. Finally, the Bank of Cyprus has signed an agreement with the EIF to continue the implementation of the financial instruments established under 2007-2013 programming period of the structural funds for the remaining EUR 8 million. Consequently, EUR 16 million in total will be made available to SMEs and each can benefit from a loan of up to € 100 000.

Two further initiatives are being developed to alleviate the acute lack of liquidity for businesses. The European Bank for Reconstruction and Development granted Cyprus the status of recipient country in May 2014 and is planning to provide financial assistance until 2020. This will strengthen the financial sector, support the government's privatisation programme and provide financing for SMEs. Finally, the government is focusing on establishing a development finance institution in a bid to channel financial assistance from foreign national and international financing organisations to SMEs.

### 3.13.3 Innovation and skills

Economic trends will undoubtedly affect the research and innovation sector that relies mainly on public expenditure.

Even though research and development intensity has almost doubled since 2000, (from 0.25 % in 2000 to 0.47 % in 2012), persistent stagnation has been observed since 2009, with intensity stabilising at 0.5 % of GDP in 2010 and 2011. This matched the

government's national target. However, this indicator started to decrease 2012, when severe fiscal cuts on public spending kicked in.

Nevertheless, the Innovation Union Scoreboard 2014 confirms that Cyprus is among innovation followers, i.e. countries in which innovation performance is around the EU average.

Indeed, while R&D expenditure in the business sector remain very low (weight on GDP is 5 % of EU average), Cyprus scores well above the EU average for non-R&D innovation expenditure, thanks to SMEs innovating in-house and cooperating with other enterprises or institutions. As a consequence, the performance is average in all but one of the indicators that try to capture economic effects of innovation (employment in knowledge-intensive activities, exports of high-tech products, sales of innovation).

The results of the entrepreneurial innovation scheme (EUR 4 million) launched by the Ministry of Energy, Commerce, Industry and Tourism indicated that Cyprus's SMEs were strongly committed to innovation activities. The resources of the scheme were completely absorbed, with 83 applications received and 41 projects funded, worth over EUR 6 million. The ICT sector (42 applications, 16 funded) can be identified as a major innovation driver throughout the economy.

On the policy side, there is now awareness that the participation of business in R&D activities might also have been hampered by institutional factors, complex and lengthy procedures in the system of incentives, as well as policies that favour academia rather than the need of enterprises to improve their competitiveness. As a result, a National Committee on Research, Innovation and Technological Development was set up in September 2013. This aims to review the national research and innovation system and to give relevant recommendations on its governance directly to the President. The work of the committee has been completed and its outcome was submitted to the President on 26 March 2014. While competences have been allocated to different ministries, the overarching goal of the review was to create a new single governance structure that would for the first time bring together research and innovation and entrepreneurship. This report, along with the smart specialisation strategy drafted for the programming period of European Structural and Investment Funds, is expected to feed into the national 2014-2020

research and innovation strategy. This should be finalised by the end of 2014.

### 3.13.4 Energy, raw materials and sustainability

High electricity prices drag down the competitiveness of industry. Latest data of electric prices for industrial consumers show that they are the highest in EU. Moreover, in Cyprus they are around 95% of the prices for domestic consumers, while EU average is around 65%.

The full liberalisation of the electricity market was formally achieved in January 2014, but has not yet been implemented in practice. The Electricity Authority of Cyprus, a semi-public body, is still the sole supplier.

In the meantime, the repeal of the extra charge imposed after the explosion that damaged Vasiliko electricity plant, as well as the downward trend of oil prices led to a fall in electricity prices, by 17% compared to end-2012. The Cyprus Energy Regulatory Authority is working on revising the tariff setting methodology to ensure that electricity tariffs reflect costs and are incentive-based and non-discriminatory.

Natural gas discovered off the southern coast is not expected to reach the island before 2019. An interim solution has been planned to supply electricity generation with natural gas until domestic natural gas reserves become available. A first invitation for expressions of interest for the supply of natural gas to Cyprus did not attract offers that would have reduced the price of electricity. A new tendering procedure on a 10-year supply contract for imported natural gas appears to be on track. According to the tender timeline, a contract can be signed in the second half of 2014, and gas supply should start in 2016.

Thus, in the medium-term, the energy mix will continue to be dominated by oil and petroleum products, though the currently modest share of renewable energy is expected to rise rapidly. Oil products represented 94.9% of gross energy consumption in 2012, with only 3.6% of electricity generated by renewables, despite remarkable potential in solar and wind. But renewables are

increasing their contribution to electricity generation. In 2012, electricity generation from renewables more than tripled compared to 2010 levels, mainly due to a rise in wind power generation. The percentage rose to 6.5% in 2013.

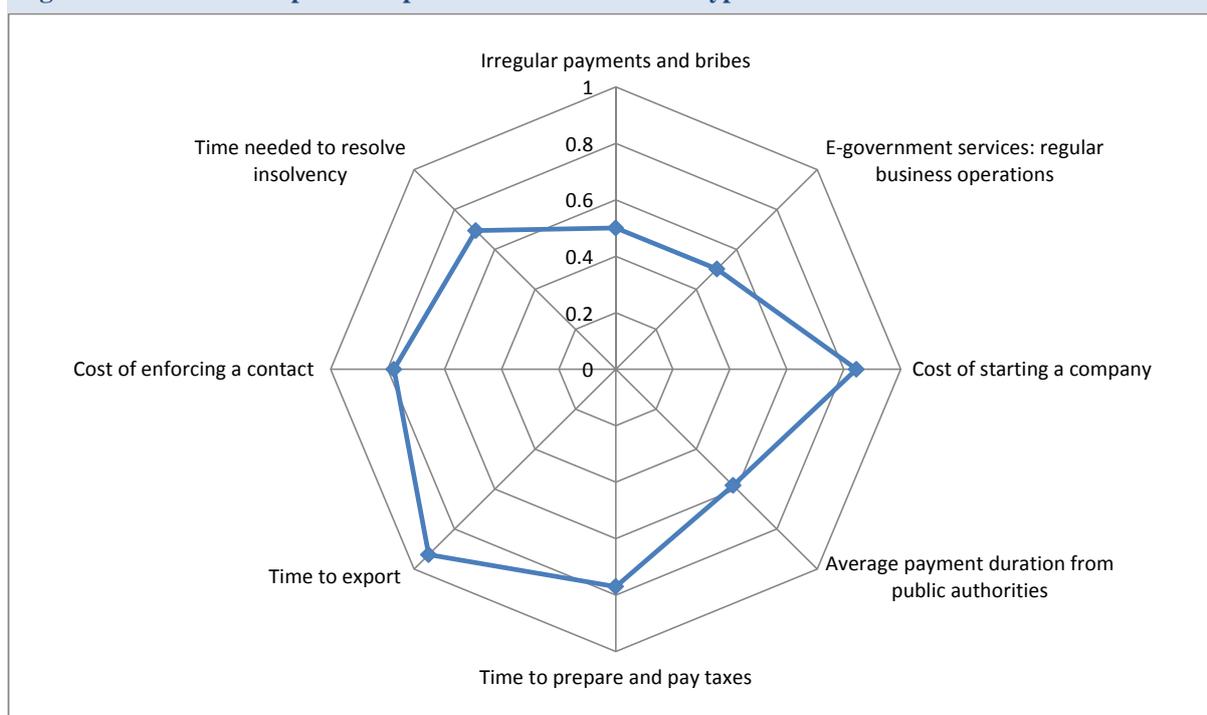
### 3.13.5 Access to markets, infrastructure and services

Because of current (nearly) complete dependence on imported oil products, Cyprus has a large deficit on its energy trade balance. However, the current account adjustment continued in 2013. This was largely due to a significant decline in imports (-16.2%), combined with better export performance, reflecting higher tourism receipts. However, this was partly offset by a further decline in exports of financial and other business services. As a result, the current account recorded a deficit of 1.9% of GDP in 2013, compared to a deficit of 6.9% in 2012.

Exports of goods to non-EU countries have slowed, while EU exports are showing some signs of stabilisation.

The Cyprus privatisation plan, adopted by parliament in March, may boost the country's role in international trade. Severe restrictions in key transport sectors in terms of working hours (e.g. ports, warehouses) have been one of the major sources of complaints among stakeholders. Just two weeks after the parliament gave its green light, the Council of Ministers launched privatisation procedures for the port of Limassol by liberalising the port's commercial arm.

In addition, Cyprus is also committed to removing the entry and exercise of regulated professional services where there are fixed or minimum tariffs (including lawyers and architects). Improving the quality and reducing the cost of professional services could have a multiplier effect on the economy in the medium term, as these play an important role in a variety of contractual and legal obligations for businesses and citizens.

**Figure 3.13.2: Overall profile of public administration — Cyprus**

*Note:* Values have been scaled so that the best observation (Member State) gets 1 and the worst gets 0.

*Source:* World Bank Doing Business; Intrum Justitia; OECD; World Economic Forum; European Commission;

### 3.13.6 Public administration and business environment

Under the Economic Adjustment Programme, Cyprus is also pursuing the modernisation of public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services.

One of the axes of the action plan for reforming the civil service is to improve the regulatory framework and to introduce e-government. The strategy will build on the national plan for better regulation adopted in 2007 based on three pillars: 1) legislative simplification; 2) reduction of administrative burden; 3) impact assessment of legislation. It will also include also smart regulation. In the meantime, a package of measures to cut the administrative burden by an estimated 20 % has almost been completed, but there has been no evaluation, so it is difficult to assess whether the EUR 150 million of savings claimed were really achieved.

To speed up the deployment of e-government, Cyprus is considering the establishment of a task force, bringing together all the relevant services, to promote

the digital strategy as laid down in the national digital agenda of 2012.

Civil justice is also receiving some attention. The establishment of an administrative court is being evaluated and the Supreme Court is revising procedural rules to reduce the length of proceedings.

### 3.13.7 Conclusions

The financial crisis that hit Cyprus marked the collapse of an economic model heavily dependent on financial services. Although the economic adjustment programme is on track and the recession is milder than expected in real terms, a number of sectors that played a leading role in the high growth rates of previous years have been affected. Tight credit conditions, fiscal consolidation measures and a worsening labour market are among the factors that are slowing down economic recovery.

Cyprus could now take advantage of the European structural and investment funds for the new programming period 2014-2020 to provide partial funding to reorient the economy towards a more sustainable economic model along the lines of the Europe 2020 strategy.