FOR AGENDA

SM/82/12
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

January 28, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Cyprus - Recent Economic Developments

The following corrections have been made in SM/82/12 (1/20/82):

Page 1, footnote 1, line 5: for "population of the cultivated area" read "population and nearly half of the cultivated area"

Page 5, 1st full para., last line: for ("Table 3)" read "(Table 4)"

Page 6, footnote 2, line 1: for "of the sector" read "of the mineral sector"

footnote 3, line 2: for "and 10 per cent" read "and nearly 70 per cent"

Page 7, para. 1, line 4: for "increased 6 per cent" read "increased by nearly 26 per cent"

line 5: for "32.1 per cent " read "23.2 per cent"

Page 11, 3rd full para., line 2: for "Table 8" read "Table 9"

Page 12, line 5: for "(Table 8)" read "(Table 9)"

1st full para., line 10: for "(Table 8)" read "(Table 9)"

Page 17, footnote 3, line 3: for "Chapter ," read "Chapter II,"

Page 25, para. 1, line 8: for "(Table 11 and Chart 2)." read "(Table 11 and Chart 3)."

Page 29, footnote 4, line 1: for "(cont'd from p. 5)" read "(cont'd from p. 28)"

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Page 30, 1st full para., penultimate line: for "in the import duty from" read "in this import levy from"

2nd full para., line 2: for "to GDP. It increased" read "to GDP, it increased"

Page 31, line 7: for "(Table 21 and Chart)" read "(Table 21 and Chart 3)"

Page 33, lines 19 and 20: for "increase in import duties" read "increase in revenue from import duties"

1st full para., line 10: for "(Tables 13 and 19); reflecting" read "(Tables 13 and 19). Reflecting"

Page 47, 2nd full para., line 6: for "(Tables 20 and 21 and Charts 4 and 5)" read "(Tables 22 and 23 and Charts 4 and 5)"

Page 49, 2nd full para., last line: for "(Chart 5 and Table 21)" read "(Chart 5 and Table 23)"

Page 50, para. 1, last line: for "(Table 22)" read "(Table 24)"

para 2, line 25: for "Chart ," read "Chart 7,"

Page 51, 1st full para., line 4: for "(Table 23)" read "(Table 25)"

2nd full para., line 5: for "(Table 24)" read "(Table 26)"

Page 52, 2nd full para., line 3: for "(Table 25)" read "(Table 27)"

Page 53, 2nd full para., line 2: for "(Table 27)" read "(Table 29)"

Corrected pages are attached.

Att: (18)

Other Distribution:
Department Heads

I. Domestic Economy

1. Introduction

The economic rehabilitation of Cyprus after the hostilities of mid-1974 1/ has been remarkably rapid. Unemployment, which approached 25 per cent of the labor force in late 1974, has been reduced to around 2-3 per cent; real per capita output has risen by well over 40 per cent above the 1973 level; exports of manufactures have become the most dynamic components of foreign trade; and the island has resumed its role as a favorite tourist center. This impressive performance was facilitated by an ample supply of labor, wage moderation, especially in the initial phase of the reconstruction effort, expansionary financial policies and buoyant foreign demand.

In the course of 1979, however, the economy of Cyprus moved beyond the problems of recovery and rehabilitation to problems of inflation and external imbalance. The economy operated at full capacity, shortages of skilled labor became widespread and wage increases became excessive. The external current deficit widened to the equivalent of 11 1/2 per cent of GDP and inflation approached double digit figures. These developments can be ascribed in part to the increase in oil prices, but to a large extent they reflected factors of domestic origin. Financial policies, which were instrumental in reactivating the economy after the events of mid-1974, remained expansionary for too long and in fact encouraged speculative investment.

In early 1980 economic policy began to be tightened with the main objective of eliminating excessive domestic demand. Subsequently, the authorities drew up a short-term stabilization program--which formed the basis for a stand-by arrangement with the IMF in the first credit tranche. The objectives of the program were to reduce the external deficit on current account to a level which could be sustained over time and to lay the foundations for a deceleration in the rate of inflation. For the year from July 1980 to June 1981, the goal was to reduce the current external deficit to the equivalent of less than 10 per cent of GDP from 15 per cent in the preceeding year.

The Cypriot authorities sought to achieve their objectives mainly by demand management; their effort coincided with stable oil import prices and improved agricultural output, which helped to dampen inflationary pressures and to reduce the balance of payments deficit. The objectives

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1/ The events of 1974 left the territory of Cyprus divided into two administrative zones. The area to the north of the demarcation line--accounting for 36 per cent of the island's land mass--passed out of the Government's control. This area contained in mid-1974, inter alia, two fifths of the total population and nearly half of the cultivated area. At present there continues to be little movement of people or goods between the two zones. This report concerns only the area remaining under the Government's control.

as set in the stand-by arrangement were fully met; the current external deficit was contained to just under 8 per cent of GDP, to a large extent due to a fall in stock accumulation which has a large import component. The year-on-year rate of inflation as measured by the CPI in the program period was contained to the preceding year's level, though it fell from a peak of 16 per cent in July 1980 to around 10 per cent in the second quarter of 1981.

Progress toward internal and external adjustment during the program period was accompanied by a respectable rate of real GDP growth (3 1/4 per cent) and a further improvement in living standards without any significant increase in unemployment. Growth throughout the program period was export-led; domestic demand was reduced substantially, the burden initially falling on private consumption and stockbuilding, and subsequently extending to gross fixed investment. Public consumption bore only a slight part of the adjustment burden.

Wages and salaries for a substantial part of the labor force remained indexed to cost-of-living changes and rose by well over 20 per cent during the 12 months to June 1981. In addition, wage earners were the main beneficiaries of a reduction in income tax rates introduced in March 1981 with effect from the beginning of the year (see Chapter II). Even so, private disposable income increased by some 17 per cent in nominal terms and 4 per cent in real terms at about the same rates as in the preceding 12-month period. However, the weakening of consumption expenditure in the program period led to an increase in the savings ratio, thus allowing a rise in the domestic component of gross investment financing.

Growth in the second half of 1981 continued to be export-led, though domestic demand began to recover from the very depressed levels of the corresponding period of 1980. The unemployment rate inched up but remained low by international standards. Though the social partners did not reach agreement on an incomes policy, wage claims began to moderate in the second half of 1981; partly as a result, there was no significant acceleration in the rate of price inflation up until September 1981.

2. Developments in 1980 and 1981 1/

Real GDP growth, which had fallen from an average rate of over 20 per cent in 1976-77 to one of about 9 per cent in 1978-79, eased to just under 4 per cent in 1980-81 (Table 1). Economic developments during 1980-81 were influenced by the demand management policies, mentioned above. Between 1979 and 1981 the rate of growth of private consumption was reduced from 6.4 per cent to around zero, that of public consumption was about halved, and the volume of gross fixed investment fell by some 3 percentage points (Table 2). Stockbuilding, which had continued to add strongly to growth in the first half of 1980, fueled in part by speculation about

1/ The data for 1981 are provisional estimates of the Cypriot authorities.

other export-related activities, such as hotel construction. These sectors were generally not affected by the ceilings on bank credit (see Chapter III), and enjoyed tax benefits in the form of accelerated depreciation allowances for plant and equipment and the doubling to 6 per cent of the tax deduction on income from exports. The demand for housing remained depressed; housebuilding was also affected by the slowdown in the public scheme for refugee housing. Furthermore, public infrastructural projects added little, if anything, to real fixed capital formation.

Stockbuilding played a leading role in the evolution of domestic demand during 1980; destocking in the second half of the year was sufficiently large to cause a fall of 2.4 per cent in the volume of gross investment for the year as a whole, as against an increase of 8.2 per cent in 1979. For 1981 as a whole, stockbuilding did not add to growth, as destocking in the first half was made good subsequently. The fall in the volume of investment in 1980-81 however, was accompanied by an improvement in its financing. Between 1979 and 1981, the share of domestic savings in total financing increased by about 9 percentage points to over 58 per cent, while that of factor income and transfers from abroad declined by about 4 percentage points; the share of net foreign finance fell by some 5 percentage points to slightly below 26 per cent (Table 4).

b. Output

(1) Primary sectors

Real output in the primary sectors, which had increased fairly strongly in both 1979 and 1980, declined in 1981 as a result of a sharp fall in activity in the mining and quarrying sector and less favorable conditions in agriculture. Real value added in agriculture rose by 5 per cent in 1980, slightly less than a year earlier and its share in real GDP at 11.4 per cent was unchanged from the previous year. The long-term downtrend in agricultural employment continued, and the share of farmhands in the total workforce declined to 24.6 per cent in 1980 from 25.1 per cent in 1979.

The volume of crop production increased by 3.7 per cent. Among the major crops only cereals, potatoes, and olives showed gains over 1979. Output of barley in 1980 was equal to 95 per cent of that preceding the hostilities of mid-1974, while output of wheat was equivalent to less than one fifth. 1/ Production of potatoes, which continued to be the main agricultural crop, increased by 10.6 per cent, facilitating an increase of 9 per cent in the volume of its exports. The volume of output of a wide range of fresh fruits and vegetables showed declines ranging from 3 per cent to over 10 per cent; the impact of this decline was reflected most vividly in the rise of the cost of living index (see section below) and also in exports (Chapter IV). Among livestock products only poultry, meat and egg production exhibited modest increases.

1/ The low wheat production is due to the loss of the prime wheat growing fields of the Messoria plain in the wake of the hostilities of 1974.

Agricultural output grew by only 0.7 per cent in 1981, as a result of reduction in the production of potatoes, olives and cereals. The output of fruit and vegetables increased sufficiently to exert a moderating influence on price developments in the first eight months of 1981. Except for output of sheep and goat meat, which fell sharply, all other meat production increased moderately in real terms in 1981.

In addition to the financing of a number of important irrigation projects underway or planned 1/ for the development of the agricultural sector, the Government offers various advisory services to farmers, including programs for improving quality and reducing costs, as well as low interest loans and subsidies for the promotion of certain crops with good demand prospects in the domestic and export markets and the stabilization of farmer incomes.

Real value added in mining and quarrying declined by 1.0 per cent in 1980, compared with an increase of 3.2 per cent in 1979. As a result, the share of this sector to real GDP declined to 1.6 per cent, from 1.8 per cent in 1979; employment also declined in 1980 when it accounted for only 1 per cent of the total labor force. Production of the traditional cupriferous ores was discontinued during 1980. Iron pyrites increased by 16 per cent to 53,600 tons, but were equivalent to only 11.6 per cent of the prehostilities level. Production of other exportable minerals (chrome ore and asbestos) 2/ remained depressed, mainly because of world demand conditions. Output of quarrying materials, which have become the main growth factor of the sector, maintained its strong upward momentum despite the slowdown in construction activity. In 1981, however, activity in this sector declined by 12.6 per cent, and the output of quarrying materials fell as a result.

(2) Industry

The rate of growth of real value added in industry decelerated from 11 per cent in 1979 to 4.6 per cent in 1980 and 2.2 per cent in 1981 primarily on account of the reduction in the rate of growth of the construction sector. Manufacturing output, accounting for nearly 55 per cent of real value added in industry, 3/ grew by 7.1 per cent in 1980, and 6.8 per cent in 1981, somewhat less than in 1979, displacing construction as the leading growth sector (Table 5).

1/ In advanced state of constuction are the Paphos Irrigation Project, which is expected to double dam reservoir capacity by 1982, and the Pitsillia Rural Development Project; feasibility studies have been completed or will be shortly completed for the Vassilikos-Pendasvirnos Projects, the Polis Watershed Project, the Kouris Delta Dam and, the largest of them all, the Southern Conveyor Scheme.

2/ The share of the mineral sector in total domestic exports declined to 5.4 per cent from 6.6 per cent in 1979.

3/ In 1980 manufacturing accounted for 18.1 per cent of total GDP, 21.4 per cent of total employment, and nearly 70 per cent of domestic exports.

As in previous years, manufacturing production in 1980 was directed more toward exports than the domestic market; the value of exports of manufactures, despite the adverse international economic environment, increased by nearly 26 per cent, while the gross value of output in manufacturing rose by 22.6 per cent. The figures for 1979 were 23.2 per cent for exports and 20.9 per cent for gross output (Table 6). Excluding petroleum products, the output of which increased by 80 per cent primarily due to price inflation, the main growth leaders were paper products, chemicals, and nonmetallic minerals. Textiles, clothing, and footwear, on which the recent industrial success in Cyprus largely rests, exhibited a more modest rate of growth, a reflection perhaps of the declining competitiveness of Cypriot goods vis-à-vis a number of newly industrializing countries in Asia and Africa. Transport equipment and food processing were the worst performers, the latter on account of the relatively poor harvests.

In 1981 foreign demand continued to be the driving force behind manufacturing activity. Production of wine products, footwear and cigarettes increased at a fairly rapid pace, while production in the canning industry, and of cement, bricks, and petroleum products showed substantial declines.

Manufacturing is dominated by family-based and relatively small-scale units; average employment per establishment has been increasing but was still below seven employees in 1980. Establishments with five or more employees predominate in the fields of food processing, tobacco, plastics, petroleum refining, and cement. The main constraints on the size of establishments are the small size of the domestic market, the scarcity of local sources of raw materials, technological and financial factors, and the family-based management style of most businesses.

The authorities recognize that a sustained rate of growth in manufacturing requires a reorientation of investment. For the medium term, they envisage the need for a major shift in investment priorities toward more capital-intensive and larger scale production. Construction of new industrial buildings in government-financed industrial estates and the provision and extension of infrastructures are important elements in the authorities' industrial strategy. Some fiscal measures have already been taken in order to facilitate the consolidation of small productive units into larger combines. Rules governing foreign investment are being reviewed to attract know-how and technology, and a free industrial zone has been completed. The authorities have been reviewing the tax regime to be offered to the industries which will operate in the zone. 1/

1/ Cyprus also hosts some 900 offshore companies--60 of which are physically located in Cyprus--providing a variety of services to neighboring countries in the Middle East and Africa. Partnerships are completely tax-exempt as are branches of overseas companies managed and controlled from abroad. Companies incorporated in Cyprus, whether or not managed or controlled from Cyprus, are liable to pay tax on assessable income at one tenth of the standard rate of 42.5 per cent.

Real value added in construction increased by 1.7 per cent in 1980 and declined by over 4 per cent in 1981, following increases of 15.4 per cent, 20.5 per cent, and 48.4 per cent in 1979, 1978, and 1977, respectively. The slowdown, in both the private and public sector was the combined result of a cyclical drop in activity, the dampening of speculative investment in the sector, and the credit squeeze especially since the second half of 1980, which affected primarily commercial buildings and private dwellings.

The activities of the newly instituted Land Development Organization (LDO) and the Housing Finance Organization (HFO) did not have yet any impact on building activity. In the years ahead, however, the industry may be significantly influenced by them. The main objectives of LDO is to acquire land suitable for residential development, provide all necessary services, and divide the land into building plots for sale to middle- and low-income groups at cost plus a set rate of return of about 15 per cent; in addition, it can erect low cost houses for the same groups. The HFO is to provide 15-year housing finance for low- and middle-income groups. Such loans, if secured by mortgages, would cover up to 75 per cent of the value of the house or if secured against savings deposits with HFO up to 90 per cent of such deposits. 1/

(3) Services

In the face of the general decline in the rate of growth of economic activity, the growth of output in the services sector slowed significantly since the second half of 1980. As a result, real value added in the services sector, which had increased by 8.8 per cent in 1979, rose by 4.9 per cent in 1980, accounting for just under 54 per cent of total GDP at factor cost. The slowdown was quite marked in wholesale and retail trade but was particularly significant in banking, insurance, and real estate. The rate of growth in real value added in services decelerated to 4.5 per cent in 1981; while there was some recovery in wholesale and retail trade as well as in banking and insurance, activity in all other service sectors declined perceptibly.

The tourist industry continued to make a strong contribution to economic activity; after increasing by 22 per cent in 1978 and 37 per cent in 1979, the number of long-stay visitors 2/ rose by 19 per cent to over 353,000 in 1980. The average length of stay was 10.4 days, slightly less than in 1979. This relatively good performance was accompanied by a further increase in employment (by 9.1 per cent to 10,364 persons) and in hotel capacity. During 1980 five new hotels and ten new hotel-apartments were put into operation, raising the total number of beds available by

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1/ The Government intends to encourage deposits with the HFO by small depositor/savers as well as large ones (insurance companies, provident funds, etc.) through the extension of tax incentives.

2/ The number of one-day visitors declined by 18 per cent to just over 50,000 in 1980.

cent in 1980--was the first since 1975; it was concentrated in the second half of the year, when the number of registered unemployed averaged 2.7 per cent of the labor force. Nearly all sectors of the economy were affected; however the number of unemployed construction workers more than doubled prompting the authorities to relax their previous policy regarding the temporary employment of skilled workers abroad. Particularly acute became also the problem of unemployed university graduates, for which plans to train them for middle and top positions in the tourist industry are being evaluated.

The easing of the labor market continued during 1981; the number of registered unemployed averaged 5,795 in the first eight months of the year, or just above 3 per cent of the labor force, compared with 2.1 per cent in the corresponding period of 1980 (Chart 1). The progressive easing of the labor market since mid-1980 is also brought out by two other indicators: the ratio of vacancies filled to vacancies notified, which increased from 23.8 per cent at end-1979 to 38.6 per cent at end-1980 and 46.7 per cent at end-August 1981; and the ratio of vacancies notified to registered unemployed, which declined from 29.5 per cent at end-1979 to 14.0 per cent at end-1980, and 9.1 per cent at end-August 1981.

The Government finances a number of programs for vocational and industrial training and encourages other programs, such as schemes for employing pupils during school vacation and for increasing mobility which has tended to diminish in response to narrowing wage differentials. Higher participation of women 1/ in the labor force is encouraged through flexible working conditions, the provision of more child care centers and other services.

b. Productivity

Only limited data on productivity are available, but a rough calculation of developments in recent years is given in Table 9. This measure of change in output per employee does not allow for changes in hours worked per employee, for which data are not available. Thus, while the measure overstates the growth in "true" productivity (i.e., output per man-hour) up to 1979, as average hours worked until then increased, it may understate the growth of productivity in 1980-81, when hours worked probably declined. The increase in output per employee--which had averaged 10.9 per cent in 1976-77 and 5.3 per cent in 1978-79--slowed to 3.4 per cent in 1980 and is likely to slow further in 1981 on the basis of preliminary estimates. In 1980, productivity increased in manufacturing and agriculture and declined in construction.

5. Wages and income determination

Despite the incipient easing in the labor market, the rate of growth of average wage rates increased from 25.4 per cent in 1979 to 28.2 per

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1/ The share of female workers increased from 37 per cent of the employed in 1979 to 37.6 per cent in 1980.

cent in 1980, more than half of which was on account of automatic wage indexation. Wages in the government and semigovernment sectors rose slightly less than those in the private sector, where manufacturing posted an increase of 30.4 per cent following one of 29.1 per cent in 1979 (Table 9). In 1980, the increase in real average wage rates was 12.6 per cent, or nearly four times as large as the gain in productivity; this came in the wake of very substantial real wage rises in each of the preceding three years and at a time when the second oil price shock required an additional transfer of resources abroad. In the four years to 1980, the cumulative rise in average real wage rates exceeded 60 per cent, implying a significant improvement in the relative position of wage earners vis-à-vis other income recipients. However, given the high progressivity of income taxes and an increase in social security contributions larger than the rise in benefits, the growth of disposable income has been considerably lower than suggested by the unadjusted wage data (Table 3).

Income tax concessions were introduced in March 1981 (see Chapter II), retroactive to the beginning of the year, to reduce the tax burden of wage earners, which, in the view of the authorities "... during the last years has risen beyond desirable levels...." It would seem that these tax concessions are being to some extent taken into consideration by the trade unions in submitting their pay claims for 1981-82. Settlements of many of the two-year collective agreements that were up for renegotiation in 1981, including about ten pace setters in the semipublic sector, appear to have been somewhat more moderate. On balance, however, increases in average real wage rates still exceed productivity gains by a large margin (Table 9). On the other hand, the number of man-days lost in strikes was much lower than in 1980 (101,000 man-days) and 1979 (22,000 man-days), despite a strike wave that hit the economy early in the year.

All collective agreements, including those for civil servants, provide for a cost of living allowance tied to the price index, in addition to annual increments for seniority and negotiated overall wage increases. It is estimated that between 60 per cent and 70 per cent of the working population receive a cost of living adjustment. Wages are adjusted semiannually--in January and July--for movements in the six-month moving average of the retail price index. The reference base, i.e., total pay at end-1977, is adjusted to take into account increases in real wages which have taken place in the meantime so that the indexation mechanism now in effect allows full compensation for inflation.

6. Prices

Retail prices rose by 13.5 per cent, on average, in 1980 compared with increases of 9.5 per cent and 7.4 per cent in 1979 and 1978, respectively (Table 10). Some 27 per cent of the increase in the retail price index was accounted for by the direct effect of the oil price rise. 1/

1/ In 1979-80 the cumulative increase in the unit import value of oil and oil products exceeded 120 per cent in terms of Cyprus pounds.

Table 4. Cyprus: Savings and Investment, 1976-81

(At current prices)

	1976	1977	1978	1979	1980 1/	1981 1/ Estimates
	(In millions of Cyprus pounds)					
Domestic savings 2/	36.7	57.5	83.8	117.2	137.9	169.9
Factor income and transfers from abroad (net)	38.8	48.5	45.7	47.7	51.1	46.6
National savings	75.5	106.0	129.5	164.9	189.0	216.5
Public sector 3/	-0.3	15.3	14.5	9.6	10.3	1.2
Private sector	75.8	90.7	115.0	155.3	178.7	215.3
Plus net foreign financing (= current account deficit)	4.2	35.9	58.6	72.6	81.0	75.0
Gross domestic investment	79.7	141.9	188.1	237.5	270.0	291.5
	(In per cent of GNP)					
Domestic savings	10.6	13.0	15.8	18.0	17.8	19.3
Factor income and transfers from abroad (net)	11.2	11.0	8.6	7.3	6.6	5.3
National savings	21.8	24.0	24.4	25.3	24.4	24.6
Public sector	-0.1	3.5	2.7	1.5	1.3	0.1
Private sector	21.9	20.5	21.6	23.9	23.0	24.5
Plus net foreign financing	1.2	8.1	11.0	11.2	10.4	8.5
Gross domestic investment 4/	23.1	32.1	35.4	36.5	34.8	33.2

Source: Data provided by the Economic Studies and Research Section of the Ministry of Finance.

1/ Preliminary.
2/ Domestic savings defined as GDP less domestic consumption.
3/ Defined as current domestic revenue plus foreign grants less total current expenditure of the consolidated Central Government. These data do not agree with the public sector's savings data in Chapter II, mainly because of the exclusion of unallocable expenditures.
4/ The figures may not add up due to rounding.

	Cyprus pounds; at constant prices	In per cent of total	Annual percentage changes at constant factor cost				
Primary sectors	78.5	13.0	1.5	-2.2	4.9	4.2	-1.0
Agriculture 2/	69.0	11.4	0.9	-3.1	5.1	5.0	0.7
Mining and quarrying	9.5	1.6	6.0	4.5	3.2	-1.0	-12.6
Industry	200.1	33.2	26.8	14.1	11.0	4.6	2.2
Manufacturing	109.2	18.1	16.6	10.3	8.0	7.1	6.8
Construction	82.9	13.7	48.4	20.5	15.4	1.7	-4.2
Power and water	8 0	1.4	9.7	7.4	6.8	2.6	7.5
Services	324.7	53.8	13.9	7.9	8.8	4.9	4.5
Transport and communications	48.6	8.1	18.2	6.1	10.0	10.5	3.1
Wholesale and retail trade	92.7	15.4	22.5	8.5	10.0	1.2	3.5
Banking, insurance, and real estate	34.9	5.8	24.3	21.4	7.9	-1.7	0.6
Ownership of dwellings	29.6	4.9	4.7	5.7	6.6	7.2	3.4
Public administration	43.0	7.1	-2.1	-1.3	3.7	10.5	7.9
Other services	75.9	12.5	12.5	8.7	11.0	5.7	7.0
GDP at factor cost	603.3	100.0	15.4	8.3	9.0	4.7	3.0

Source: Data provided by the Economic Studies and Research Section of the Ministry of Finance.

1/ Provisional.
2/ Includes forestry, fishing, and hunting.

The rapid expansion in government expenditure after 1973 was not matched by a similar increase in revenue (Chart 2). With the exception of the period 1974-76, 1/ domestic revenue as a ratio to GDP remained rather stable around 19.2 per cent. The increasing revenue trend in 1980 and 1981 reflected the higher social insurance contributions required under the new earnings-related social insurance scheme introduced in October 1980; as a result, the share of direct tax revenue in total tax revenue increased substantially in the last two years (Table 11 and Chart 3). In addition to the dislocation of the economy, the revenue base became severely eroded by fiscal incentives geared toward stimulating the economy; furthermore, tax evasion remained a serious problem. On the other hand, total expenditure as a ratio to GDP increased by almost 10 percentage points, from 21.9 per cent in 1973 to an estimated 31.6 per cent in 1981. Current expenditure constitutes the bulk of total expenditure while its share is on an increasing trend; from 74.6 per cent in 1979, current expenditure reached an estimated 80.0 per cent of total expenditure in 1981, on account mainly of the increasing payments on wages and salaries and on subsidies and transfers (Chart 3). Consequently, the share of capital expenditure is falling, while at the same time, more than 50 per cent of them represent housing expenditure by the Special Relief Fund for Displaced Persons.

Since mid-1977, when the economy was rapidly approaching full capacity output, efforts have been made to gradually reduce the expansionary impact of fiscal policy and to restore public savings. Hence, the stimulus provided by the difference between domestic revenue and total expenditure (budget deficit excluding grants) as a ratio to GDP was sharply reduced from 12.6 per cent in 1976 to an average of 8.4 per cent for the period 1977-79. In 1980 fiscal policy turned out to be more expansionary than intended, due entirely to current expenditure overruns increasing the budget deficit (excluding grants) by 1 percentage point to 9.3 per cent of GDP. In 1981 the budget deficit is estimated to have been contained at the same percentage to GDP as in 1980. Reflecting the declining importance of foreign grants, the overall budget deficit, after a substantial improvement in 1977, followed an increasing trend (Chart 2 and Table 11) rising from 2.8 per cent of GDP in 1977 to an estimated 7.8 per cent in 1981. The current account balance (government domestic savings) 2/ remained negative throughout the period since 1973, and since 1979 it has been following a deteriorating trend.

1/ Because of the decline in nominal GDP in 1974 and 1975 (in 1976 nominal GDP was still lower than its 1973 level) the ratios to GDP of all variables in Chart 2 for the period 1974-76 are atypical.

2/ The current balance is given by the difference between current revenue (capital revenue is almost nil) and current expenditure. The latter is the sum of the ordinary budget expenditures, the unallocable expenditures, the expenditures of the Social Insurance Funds and the current expenditures of the development budget, and the Special Relief Fund.

The inflow of foreign grants alleviated somewhat the financing of the deficit, but still, because of the limited potential for domestic non-bank financing, the Government had to resort to considerable domestic bank and foreign borrowing to finance its overall budget deficit (Table 11). In the last two years, central bank financing approached its legal limit of 55 per cent of the estimated ordinary budget revenue, resulting in an acceleration of foreign borrowing. This increased the Central Government's foreign debt to an estimated 16 per cent of GDP in 1981 while total debt (both foreign and domestic) is estimated to have risen to a peak of 32.4 per cent of GDP. As a result, debt service payments on the Central Government's total debt, as a ratio to GDP, more than doubled in the last four years, reaching an estimated 3.1 per cent of GDP in 1981 (Chart 3).

In July 1980, the Cypriot authorities embarked upon a one-year stabilization program supported by use of Fund resources in the first credit tranche, aimed at reducing the current external deficit to a sustainable level over time, laying in the process the foundations for a reduction in the inflation rate. In terms of the stabilization program, the overall budgetary policy was formulated to support both the desired reduction in consumption and the need to limit the domestic credit expansion. In particular, the stabilization program entailed a substantial reduction in the ratio of the overall budget deficit to GDP from 6.3 per cent in 1979/80 to about 2.9 per cent 1/ in 1980/81; the program also envisaged a 2 percentage point increase in the tax ratio to GDP to 18.7 per cent and a substantial improvement in public sector savings. In addition, a hiring freeze was imposed on the civil service and the Government undertook to assess the feasibility of a 10 per cent reduction across the board in total expenditure. In the event, the objectives of fiscal policy turned out to be too ambitious; current expenditure and subsidies in particular exceeded by far their program levels. As a result, the overall deficit, instead of being substantially reduced, increased slightly to 7.0 per cent of GDP, while the current balance of the budget deteriorated even further; the tax ratio to GDP, however, increased modestly to 17.8 per cent.

2. Fiscal developments in 1980-81

Among the major objectives of the Third Economic Emergency Plan for 1979-81 was to reduce the budget deficit so as to moderate the expansionary impact of the public sector on the economy. The distribution between current and capital expenditure was to be altered to increase public savings. In view of the inelasticity of a large part of the expenditure, especially in the ordinary budget, and the need to complete sizable development and social programs already embarked upon, the implementation of these objectives was to be gradual. The fiscal outturn for 1979, the first year of the program, exerted a stronger expansionary impact than intended. The growth of domestic revenue and total expenditure, including net lending, accelerated slightly relative to 1978 but their ratios

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1/ Due to a new presentation of the budget, the 2.9 per cent of GDP deficit is equivalent to the 1.2 per cent of GDP deficit envisaged under the program.

The substantial acceleration of domestic revenue in 1980, which increased by 30.5 per cent relative to an average of 22.3 per cent in the previous two years, was due to the acceleration of direct tax revenue and nontax revenue. Owing to the improvement in the revenue situation of both the Social Insurance Funds and the Special Relief Fund, direct taxes increased by 45.5 per cent, compared to an average growth of 27.7 per cent in the previous two years. Nontax revenue, because of the expansion of the nontax revenue of the ordinary budget, increased by 43.7 per cent relative to 4.4 per cent in 1979. Indirect taxes decelerated substantially, their growth rate falling from 28.0 per cent in 1979 to 15.9 per cent in 1980. As a result, the share of direct taxes in total tax revenue increased by 5 1/2 percentage points to 46.1 per cent, raising the tax ratio to GDP to 17.3 per cent (Tables 11, 12 and 14).

The relatively slow growth of the ordinary budget revenue of 22.5 per cent reduced its share in total domestic revenue to 77.8 per cent, down from 82.9 per cent in 1979. The slowdown in ordinary revenue was due to the substantial deceleration in the growth of both direct and indirect taxes (Table 16). Direct tax revenue increased by 25.7 per cent, compared with 36.6 per cent in 1979. Legislation for an immovable property tax and a capital gains tax was introduced in 1980, but it is expected that substantial revenues from these taxes will be realized only from 1981 onward. 1/ Direct taxes on income and profits increased by 31.2 per cent, relative to 41.4 per cent in 1979. Direct taxes on companies increased only modestly by 9.0 per cent after having been more than doubled in 1979, following the introduction of a system of collection on a current year basis; however, direct taxes paid by individuals nearly doubled their growth rate to 42.0 per cent, constituting 72.9 per cent of total taxes on income and profits. On the other hand, the indirect tax revenue of the ordinary budget increased by 12.0 per cent, down from the 27.6 per cent increase in 1979 mainly because of the very modest growth of excise taxes. Despite the increase in excise tax rates for petroleum products and motor vehicles, receipts from excise taxes decelerated from their 51.6 per cent growth rate in 1979 to 4.2 per cent in 1980. Receipts from the excise tax on motor vehicles declined by 9.3 per cent, reflecting a small decline in motor vehicle registrations and some movement toward

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4/ (cont'd from p. 28) Development Organization and a Housing Finance Organization. The main objective of the former is to develop residential building plots and to provide low-cost housing to middle- and low-income groups. The Housing Finance Organization is to provide long-term housing financing to the same income groups. Both institutions will become operational in 1982 and are to be self-financed with no budgetary implications, apart from an £C 1 million budgetary grant (though not yet transfered). In the future they could affect budget revenues indirectly in the form of tax incentives for deposits with the Housing Finance Organization or possible interest subsidization of loans.

1/ Thus, while £C 6 million of immovable property tax revenue is budgeted for 1981, only £C 0.6 million was received from this tax in 1980.

the registration of smaller capacity vehicles, in line with the legislated increase in the component of excise tax paid according to engine size. Revenue from customs duties rose by 19.8 per cent, in line with the growth of imports. The nontax revenue increased by 55.7 per cent, mainly due to the more than doubling of the central bank profits transferred to the ordinary budget (Table 16).

The acceleration in the rate of growth of total direct taxes stemmed exclusively from the improvements in the revenue situation of both the Social Insurance Funds and the Special Relief Fund. Following the introduction of the new earnings-related social insurance scheme in October 1980, social insurance contributions for 1980 increased by 45.6 per cent, more than twice their growth rate in 1979; the higher contributions required under the new legislation should result in a surplus of revenue in the first years of operation of the scheme. 1/ The receipts of the Special Relief Fund (excluding government contributions), on the other hand, more than doubled, increasing from £C 7.1 million in 1979 to £C 16.3 million in 1980. The receipts of this fund consist almost exclusively of the mandatory contributions by employers and self-employed and the temporary import levy. Following the Supreme Court decision in November 1979 about the constituionality of the relevant law, mandatory contributions more than trebled, increasing by £C 6.6 million to £C 9.5 million, as many of those liable started paying their full contributions in 1980 (Table 19). Revenue from the temporary import levy (part of indirect tax revenue) increased by 77.8 per cent to £C 6.4 million, as a result of the increase in this import levy from 2.0 per cent to 3.5 per cent.

The overall budget deficit at £C 57.1 million was by 47.2 per cent higher than in 1979, and as a ratio to GDP, it increased by almost 1 1/2 percentage points to 7.6 per cent (Tables 11 and 20). Net domestic borrowing declined, covering 45.7 per cent of the overall deficit compared to 88.9 per cent in 1979. The sale of government securities at £C 4.5 million, was at the same level as in 1979, whereas the sale of Treasury bills increased from £C 4.6 million in 1979 to £C 31.5 million in 1980. While nonbank financing declined substantially, bank financing increased by 22.9 per cent relative to 1979, covering 38.5 per cent of the deficit and accounting for the substantial increase of domestic credit to the public sector. Central bank financing of the budget deficit approached its statutory limit. 2/ As a result, net foreign borrowing nearly trebled relative to 1979, financing 54.5 per cent of the overall deficit, its ratio to GDP increasing from 1.7 per cent in 1979 to 4.1 per cent. Net IMF transactions were slightly negative in spite of the drawing of the

1/ It is estimated that by 1990, the cumulative surplus of the Social Insurance Funds will reach about £C 568.7 million, including government contributions.

2/ The Government can borrow from the Central Bank 55 per cent of its estimated ordinary revenue, 25 per cent of it in advances and 30 per cent of it in Treasury bills.

first credit tranche because of existing repurchase obligations. The net domestic and foreign borrowing allowed a quadrupling of advances to the Cooperative Central Bank, from £C 3.2 million in 1979 to £C 12.5 million in 1980, to improve its liquidity position. The substantial increase of both domestic and foreign debt let to a sudden jump of the ratio of the central government debt to GDP from 21.7 per cent in 1979 to 27.3 per cent in 1980 (Table 21 and Chart 3).

b. Fiscal developments during 1981

The overall budgetary policy for 1981 reflected the quantitative targets of the one-year stabilization program embarked upon in July 1981. The budget for 1981, as amended by the tax-relief measures of April 1981 (but effective from January 1981), 1/ provided for a 2 percentage point increase in the ratio of domestic revenue to GDP to 23.4 per cent; total expenditure was budgeted to increase by only 2.0 per cent in nominal terms, implying a substantial reduction in real terms, so that the ratio of total expenditure to GDP would fall by more than 3 1/4 percentage points to 27.4 per cent. As a result, the budget deficit, excluding grants, was expected to decline by 5 1/2 percentage points to 3.9 per cent. Similarly, the overall deficit was to decline to 2.4 per cent of GDP, whereas public savings were to become positive, equivalent to 2.5 per cent of GDP. In 1981 the budget also provided for a levelling off of current expenditure (subsidies and transfers were budgeted to decline slightly) and a modest acceleration of capital expenditure, altering the composition of total expenditure in favor of capital expenditure (Tables 11, 12 and 14).

The official estimates for the 1981 fiscal outturn indicate that the overall budget objectives, as in 1980, were rather ambitious. The existing constraints in reducing current expenditure, the full wage indexation mechanism for wages and salaries, and the prevailing system of grain subsidies in particular, limited considerably the government efforts to reduce current expenditure; in consequence, capital expenditure had to be curtailed by more. In particular, whereas both domestic revenue and total expenditure fell short of their budgeted targets, domestic revenue increased by 19.6 per cent, raising the ratio of domestic revenue to GDP by 1 percentage point to 22.4 per cent. In contrast, total expenditure increased by an estimated 17.7 per cent, much less than in 1980, but

1/ These tax-relief measures, aimed at reducing the tax burden, which, in the authorities' view, during the last few years had risen beyond desirable levels, entailed a loss of public revenue estimated at £C 8.5 million on the basis of 1980 incomes. The tax measures, apart from increasing substantially the family and dependent allowances, increased also the tax exemptions on interest income from government securities and bank deposits (i.e., indirect interest rate subsidy). In addition, fiscal incentives were provided for increased capital expenditures by public companies, as well as additional tax exemptions for acquisitions of shares of newly established public companies.

still exceeding by far the 2.0 per cent growth allowed in the budget; as a result, the ratio of total expenditure to GDP increased by almost 1 percentage point, to 31.6 per cent. In consequence, the budget deficit ratio to GDP (excluding grants) is expected to remain at almost the same level as in 1980, at 9.2 per cent; because of a modest reduction in grants, the ratio of the overall budget deficit to GDP is projected to increase marginally to 7.8 per cent. Public savings continued to be negative, reaching 2.9 per cent of GDP during 1981.

Despite the overrun of total expenditure relative to the budgeted target, the growth of total expenditure decelerated substantially, increasing by only 17.7 per cent, compared to 31.6 per cent in 1980 and the 25.1 per cent average growth rate in the previous two years. Current expenditure, which accounts exclusively for the expenditure overrun increased by an estimated 22.5 per cent, down from the 35.6 per cent growth in 1980, raising the share of current expenditure in total expenditure to 80 per cent from 76.9 per cent in 1980. Both wages and salaries and transfers and subsidies, the main reasons for the expansion of current expenditure, decelerated relative to 1980, increasing by 19.6 per cent and 34.0 per cent, respectively; expenditure on goods and services grew moderately at 12.6 per cent, whereas unallocable expenditure remained at the same level as in 1980. The share of wages and salaries in total current expenditure declined by 10 percentage points to an estimated 40 per cent, while the share of subsidies and transfers rose by 3 1/2 percentage points to 40.9 per cent. The expansion of subsidies and transfers reflects the 35.3 per cent increase in grain and vine subsidies, the 48.6 per cent increase in interest payments on the expanding foreign and domestic public debt (Table 15), and the 41.9 per cent increase in social insurance benefits on account of the higher benefits provided by the new earnings-related social insurance scheme (Table 18). The ordinary budget expenditure increased by an estimated 22.9 per cent, providing the main impetus for the expansion of total current expenditure; apart from subsidies and interest payments, the increase of ordinary budget expenditure involved higher expenditure on education and defense (Table 15).

Development budget expenditure increased by only 10.0 per cent, continuing its decelerating trend, down from 13.2 per cent in 1980 and 45.6 per cent in 1979; the increase reflected mainly the 40.3 per cent expansion of the expenditure on transport and communication (Table 15). Expenditure by the Special Relief Fund followed a similar trend; capital expenditure on the refugee housing scheme increased by 6.7 per cent, compared to 14.4 per cent in 1980, accounting still for more than half of total capital expenditure (Table 19). As a result, capital expenditure fell short of its modest budget target, decelerating to 6.3 per cent relative to 11.8 per cent in 1980 and 38.8 per cent in 1979 (Tables 11, 12 and 14).

Domestic revenue did not reach its budget target, increasing by 19.6 per cent relative to 30.5 per cent in 1980. The rate of increase of tax revenue decelerated to 22.2 per cent from 27.9 per cent in the previous year; however, as a ratio to GDP, tax revenue increased by more than 1 percentage point to 18.5 per cent. The improvement in the tax ratio is due entirely to the expansion of direct taxes, which, mainly because of the required higher social insurance contributions, increased by 39.1 per cent. Because of the sluggish growth of the indirect tax revenue of the ordinary budget, total indirect taxes slowed down to 7.7 per cent, less than half their growth rate in 1980 (Tables 12, 14, and 16). The ordinary budget revenue continued its decelerating trend, increasing by only 7.9 per cent as against 22.5 per cent in 1980, reflecting the slowdown of both its tax and nontax components (Table 16). As a result of the tax-relief measures of early 1981, the growth of the direct ordinary budget revenue decelerated to 14.8 per cent, from 25.7 per cent in 1980. While income taxes paid by companies increased by 46.7 per cent, more than five times higher than their growth rate in 1980, income taxes paid by individuals declined by 4.1 per cent, in contrast to their 42.0 per cent increase in the previous year. Indirect ordinary revenue slowed down as well, increasing by only 5.8 per cent, relative to 12.0 per cent in 1980 and 27.6 per cent in 1979. This deceleration is due to the reduction in the imports of motor vehicles, which resulted in the leveling off of the revenue from selective excises, and to the general decline in real imports (see Chapter IV), which allowed only a modest increase in revenue from import duties of 9.4 per cent.

Because 1981 is the first full year of operation of the new earnings-related social insurance scheme, the revenue of the Social Insurance Funds more than doubled relative to their high 1980 level, giving rise to an estimated £C 11.3 million surplus, in contrast to the traditional modest deficit; as expected, higher benefit payments were more than offset by the required higher contributions (Tables 13 and 18). Following the more than doubling of the revenues of the Special Relief Fund in 1980, because of the final payment of the delayed mandatory contributions by employers and the self-employed, in 1981 the revenue of the Special Relief Fund declined modestly by 5.5 per cent, returning to normal (Tables 13 and 19). Reflecting the depressed demand for imports, the receipts of the temporary import levy slowed down to 25.0 per cent relative to 77.8 per cent in 1980.

The overall budget deficit in 1980 increased by 17.0 per cent to £C 66.8 million, raising marginally its ratio to GDP to 7.8 per cent (Table 20). Since the Central bank financing of the budget deficit was close to its legal limit, net domestic borrowing covered roughly the same proportion of the overall deficit as in 1980 (46.3 per cent). Central bank advances declined from £C 12.0 million in 1980 to £C 1.4 million in 1981, while the net issue of Treasury bills fell from £C 31.5 million in 1980 to £C 26.0 million in 1981; the issue of governmnent securities to the nonbank public remained at £C 4.5 million, the same level as in the previous two years. As a consequence, net foreign borrowing increased both in absolute and relative terms. Net foreign borrowing expanded by 36.7 per cent to £C 42.5 million, covering 63.6 per cent of the deficit compared to 54.5 per cent in 1980, increasing the ratio of net foreign borrowing to GDP from 4.1 per cent in 1980 to 4.9 per cent in 1981. Net transactions with the IMF are negative, as a result of outstanding repurchase obligations. The expansion of domestic and foreign borrowing increased the outstanding central government debt, as a ratio to GDP, by more than 5 percentage points to 32.4 per cent; similarly, debt service payments continued their upward trend increasing from 2.3 per cent of GDP in 1980 to 3.1 per cent in 1981 (Table 21 and Chart 3).

10 per cent by mid-1980. The authorities are aware, however, that if inflation is to remain in the single-digit range over the medium term, monetary growth has to be reduced from the current level.

In June 1981 banks were informed that prevailing economic conditions necessitated the continuation of a restrictive monetary policy for the whole of 1981. Accordingly, credit ceilings were extended from end-June 1981 to end-December 1981 and the overall ceiling in credit expansion to the private sector was put at £C 26 million. Ceilings were made more restrictive and, at the same time, more selective. Loans to the trading sector--except for exports--were to remain at their end-June level for the rest of the year; banks were asked to reclassify their trade loans to show export loans separately. Similarly, personal and professional loans were to remain at their end-June level. Local bills discounted, falling within these categories of loans, must equally remain at end-June levels. On the other hand, loans for priority projects were exempted from the ceilings. Unused allocations under the credit ceilings for the program year, net of any excesses over those ceilings, were allowed to be carried over to the remainder of 1981. This was done to avoid a situation where banks would have made strenuous attempts--on announcement of the extension of restrictive credit policy in June--to make loans.

2. <u>Developments in monetary aggregates</u>

In the period from 1979 to the end of the third quarter of 1981, total liquidity grew rapidly at year-on-year rates of 18 1/2 per cent by the end of 1979, some 16 per cent a year later and around 20 per cent by the end of September 1981. As for the components of total liquidity, the divergent developments in narrow money and quasi-money, already in evidence since 1978 (Tables 22 and 23 and Charts 4 and 5), generally continued: narrow money grew more rapidly than quasi-money. The size of the divergence, however, which had increased to almost 15 percentage points by the end of the first quarter of 1980, when narrow money and quasi-money increased at respective year-on-year rates of 29.5 per cent and 14.7 per cent, subsequently declined to between 1-3 percentage points in the first two quarters of 1981. Finally, in the third quarter, quasi-money grew faster than narrow money. Looked at individually, narrow money shows a decline in growth of 7 percentage points over the period attributable largely to reduced expansion in demand deposits while cash holdings were relatively less affected. In contrast, quasi-money registered a rise of 5 percentage points in its rate of expansion as a result, in particular, of an accelerating build-up of time deposits in the second and third quarters of 1981. Accordingly, with the weight of quasi-money in total liquidity being larger than that of narrow money, rapid growth in total liquidity persisted.

Among the factors accounting for these divergences and the changes in them are movements in the real interest rates on time deposits and the relative effect of changes in net foreign assets on the two money aggregates. Real interest rates, which had become negative once more in 1977, continued to fall until the first half of 1980--encouraging a switch out of money and into both higher interest-bearing deposits with cooperative banks which are not counted in the monetary survey and real assets. Since then, real interest rates recovered somewhat as a result of decelerating inflation. Over the five years from 1976 to 1980 velocity increased but, except for 1980, at a declining rate (Chart 6). In 1981 velocity is expected to fall. These movements in velocity have affected developments in inflation. The upward drift in velocity has contributed to the acceleration of inflation up to mid-1980, while the decline in velocity will have contributed to the subsequent deceleration of inflation. This stresses the need for further efforts to reduce growth in money over the medium term when velocity cannot be assumed to continue its decline, thereby helping to keep inflation down. It appears further that unless interest rates are adjusted, or more generally, are allowed to respond to economic factors, negative real interest rates may give rise to an upward drift in velocity and a consequent inflationary bias.

Domestic credit to the private sector, which in 1978 had temporarily grown more slowly than the year earlier on account of the selective measures of credit restraint adopted in mid-year, grew again at increasing rates in 1979 and the first quarter of 1980, on a year-on-year basis. From the 18 per cent mark in 1978 its growth accelerated to 21.8 per cent in 1979 and 23.1 per cent in the first quarter of 1980. From the second quarter of 1980 on, however, the reverse applies. Domestic credit to the private sector exhibits a virtually continuously declining rate of expansion to mid-1981. Decelerating by about 1 1/2 percentage points, credit expanded by 21.5 per cent in the second quarter of 1980. In the subsequent two quarters the deceleration gathered momentum involving a 4 percentage point reduction both in the third and fourth quarters to rates of expansion of 17.6 per cent and 13.5 per cent, respectively. During the following two quarters of 1981 corresponding rates of 12.8 per cent were recorded in each instance, although in the third quarter credit expansion did turn up somewhat. Under the influence of both a cyclical weakening of demand for credit and the restrictive measures adopted in March, the decline in domestic credit expansion is thus seen to have begun ahead of the implementation of the stabilization program with the Fund, to have responded most strongly to it during its first half and to have shown its full response by the end of the second half.

The banking system's claims on the public sector followed a different pattern. In terms of year-on-year increases in absolute values, these claims stood at £C 16.2 million at the end of 1979, £C 33.5 million in the first quarter of 1980, £C 45.7 million in the second quarter, and £C 46.2 million in the third quarter. This tendency of increasing public sector domestic borrowing was reversed in the fourth quarter of 1980 when the year-on-year increase declined to £C 30 million; in the first quarter of 1981 the increase was on the same order, amounting to £C 31 million. A further easing of claims on the public sector was registered in the second quarter of 1981, with the increase down to £C 23.8 million, followed by a sharp fall to £C 8.3 million in the third quarter. However, developments in domestic credit to the public sector must be seen in the context of concomitant developments in net foreign assets (Chart 4). As government borrowing from the Central Bank in particular reached its statutory limits, equivalent to 55 per cent of ordinary government revenues, the Government increased its foreign borrowing. On adjustment of the net claims on the public sector for the Government's foreign borrowing, the total contribution of the Government to liquidity growth during the program year may be put at 50 per cent.

The budget deficit of the Government rose from about £C 39 million in 1979 to £C 57 million by the end of 1980 and to £C 67 million by the end of the third quarter of 1981, requiring large increases in domestic and foreign borrowing. The nonmonetary proportion involved appears to have been small, a factor that may be said to have been partly responsible for the failure to observe the credit ceiling decreed for the public sector over the program year.

Total net domestic credit expansion accelerated between 1977 and mid-1980 from 20 per cent to some 34 per cent per annum. It declined to 29 per cent in the third quarter of 1980 as the large decline in credit expansion to the private sector more than compensated for the continued increase in credit expansion to the public sector. The largest reduction during the year of the stabilization program occurred in the fourth quarter of 1980, when net domestic credit expanded by 20 per cent, down 9 percentage points from the preceding quarter, as a result of the large deceleration in credit expansion to private and public sector alike. In the remaining two quarters of the program year to mid-1981 credit expansion slowed further by 1 1/2 percentage points and 2 percentage points, respectively. In the third quarter of 1981 a further drop of 3 percentage points was recorded. These developments are reflected in the contribution of net domestic credit expansion to growth in total liquidity, which rose from 19 per cent to 29 per cent between the end of 1978 and mid-1980. The subsequent decline to mid-1981 was most pronounced in the fourth quarter of 1980, and relatively modest thereafter (Chart 5 and Table 23).

Net foreign assets of the banking system were subject to a worsening drain between 1978 and mid-1980 as net capital inflows did not rise in step with the sharply widening deficit in the current account of the balance of payments. The largest losses occurred in the first half of 1980 when the current account deficit rose by an annual rate of 60 per cent over the level of 1979, while net capital inflows remained unchanged. The situation was reversed in the second half of the year as the current account improved by 56 per cent and capital inflows more than doubled, so that at end-1980 total net foreign assets were £C 2 million above their end-1979 values. At the end of the program year, official net foreign assets, exclusive of net claims under payments agreements, stood at £C 142.5 million, some 40 per cent above their mid-1980 value; by the end of September they had risen to £C 191.5 million, a level 63 per cent above that of a year earlier. However, total net foreign assets recovered less rapidly, owing in particular to the continuing rise in foreign liabilities of the Deposit Money Banks.

Reserve money growth, which had accelerated by an average of some 3 percentage points in 1978 and 1979, rose sharply by 8 percentage points during 1980, to a rate of 27.6 per cent. During the first half of 1981, growth slowed to 14.6 per cent at an annual rate, mainly because of the contraction that occurred during the first quarter; but by the end of September it had turned up again to a corresponding rate of 24.2 per cent. The dominant influence on recent reserve money developments has been credit creation to the public sector. From a proportion of about 7 per cent in 1978 net domestic credit to the public sector increased to 40 per cent by mid-1981, while the proportion of net foreign assets fell from 95 per cent to 68 per cent over the same time. The partial reversal of this tendency that became clearly apparent by the end of the third quarter of 1981--with net domestic credit to the public sector down to 27 per cent and with net foreign assets up to 83 per cent--but that had already begun during 1980, and is to be explained by the Government's increase in foreign borrowing. Through the increase in its net foreign borrowing, the Government has contributed to reserve money creation to a substantially greater extent than appears from the balance sheet of the Central Bank (Table 24).

3. The money multiplier

It is apparent from Chart 7 that in 1976/77 the sharp fall in the reserve ratio in the wake of the rapid recovery led to the largest rise in the money multiplier since 1975, notwithstanding the fact that the currency ratio declined. This had the effect of raising monetary expansion despite a more moderate growth in reserve money. During the remainder of 1977 and early in 1978 the multiplier fell, rose, and fell again, as the reserve and currency ratios--by moving in opposite directions in each instance--reinforced each other in their effects on the multiplier. For the remainder of 1978 and until the first quarter of 1980 inclusive the multiplier remained broadly stable and has therefore had no effect on the growth of money during that period. The multiplier then declined over the remaining three quarters of 1980 because of the large rise in the reserve ratio which more than compensated for the concomitant rise in the currency ratio. The rise in the reserve ratio may be attributed to the sharp decline in credit expansion to the private sector, and hence in its deposit growth, during the quarter preceding the stabilization program and during its early phase. Together with the reduction in the expansion of credit to the private sector, the decline in the multiplier helped to restrain the expansion of total liquidity in the face of continuing high growth in reserve money. During 1981 the multiplier rose in the first quarter but fell in the second quarter to a level slightly below that of end-1980. This particular decline is again associated with both a rise in the reserve ratio and a fall in the currency ratio, reinforcing each other in their combined effect on the multiplier. Over the period under review in Chart 7, the reserve ratio does not exhibit any trend influence, while the currency ratio has fluctuated first around a declining trend between 1975-77 and around a rising trend since then. These trend influences appear to be related to developments in the real interest rate (Chart 6). The opportunity costs of holding narrow money are relatively high when the real interest rate on time deposits is positive, which it generally was during 1975-77, and relatively low when the real interest rate is negative, which it has increasingly become since then, at least up to 1980.

The authorities have not made any effort since 1978/79 to affect the multiplier by altering the reserve ratio. Both the "minimum liquidity requirement ratio" and the "minimum reserve requirement ratio" have remained unchanged at 23 per cent and 12 per cent, respectively (Table 25). The "excess liquidity ratio," the difference between the total liquidity ratio and the "required liquidity ratio," after being negative between 1979 and mid-1980 as a result of the rapid credit expansion, was positive during the early part of the stabilization program when credit expansion declined sharply. After having become temporarily negative early in 1981, it has risen rapidly since then. Excess liquidity, while serving as an indicator of bank lending, has not been per se an incentive or disincentive to credit expansion, because the amounts involved have been small, on the order of £C 2-3 1/2 million.

4. Interest rates

Data on nominal interest rates reflect the apparently broadly based preference in the society for low and stable rates which are fixed by law. The official discount rate and the Treasury bill rate have been unchanged since 1971, amounting to 6 per cent and 5.5 per cent, respectively (Table 26). The seven-day and one-month central bank deposit rates have equally remained constant at respective rates of 4.5 per cent and 5 per cent. The authorities raised the minimum reserve rate by half a percentage point to 5.5 per cent after the 1974 hostilities in an effort to increase bank liquidity and compensate the banks for abolishing commissions they had previously charged on their lending. Accordingly, even though the maximum interest payable on advances and loans remained unchanged at 9 per cent, effective lending rates were reduced to boost demand for credit. The interest rates on deposits were changed to encourage longer-term fixed deposits of large amounts, to help the banks improve the maturity structure of their deposit liabilities and promote longer-term bank lending. Thus, the maximum interest rate on time deposits for balances over £C 50,000 to be held for at least 12 months was raised by 2 percentage points to a level of 7 per cent. At the same time, the rates on shorter-term, lower amount, deposits were either reduced or abolished. The rate on demand deposits in excess of £C 15,000 was reduced from 2.5-3.0 per cent to 2 per cent, while the minimum interest-bearing amount on demand deposits was set at £C 1,000, thus abolishing interest payments on deposits of smaller amounts. Since that time interest rates on time deposits have been changed. With the intent, again, to improve the maturity structure of deposit liabilities, a 4.5 per cent rate was allowed to be paid on time deposits of up to £C 5,000, and a 4 3/4 per cent rate on balances in excess of this amount, that require seven days' notice for withdrawal. Treasury paper has recently been made more attractive. Issued at 8 per cent it has found subscribers among banks but, in particular and to a substantial extent, among individuals, insurance companies, and provident funds, improving thereby the prospects for nonmonetary financing of the government deficit. Further, in contrast to earlier practices, the price of outstanding paper has recently been allowed to decline as the interest rates on new paper is increased.

The problem of negative real interest rates is not new. As apparent from Chart 6, rates had become even more substantially negative by the time immediately preceding the 1974 events than they were in 1980. From a positive real interest rate of some 2 per cent in 1970, given the nominal interest rate of 4 per cent and the 2 per cent rise in consumer prices, the real interest rate fell progressively on account of the fixed nominal interest rate and the accelerating price increases. By 1974 the real interest rate had fallen to a level of -13 per cent. Had it not been for the events of mid-1974 which temporarily reduced wages and arrested inflation so that the real interest rate improved sharply becoming positive in 1975/76, pressure to reform the way in which interest rates are determined would have built up much before 1979 when the real interest rate was again significantly negative. In 1981, for the first time since before the hostilities of 1974, the real interest rate and velocity moved in "normal" directions. With the substantial deceleration of inflation the real interest rate improved, while velocity fell as the flight out of money lost momentum. The argument made by the public that an increase in nominal interest rates raises inflation is not necessarily valid over the medium term. On the contrary, such an increase is likely to reduce inflation for the following reasons: (i) it will raise productivity by improving the allocation of financial resources, (ii) it will reduce the currency to deposit ratio and hence the money multiplier, (iii) it will reduce velocity, (iv) it will reduce the erosion of real savings and hence may moderate wage and salary claims, and (v) it will make it possible to increase the nonmonetary share in the financing of the Government's budget deficit and build-up of cash balances. In addition, it would promote a better composition of absorption and hence a more "sustainable" current account position of the balance of payments by attracting funds from abroad, reducing the incentive for capital outflows provided at present by the differential between foreign and domestic interest rates, and by improving prospects for a decline in foreign debt over the longer run. Finally, it would help to find an appropriate level for the exchange rate.

5. Operations of lending institutions

The pace at which Deposit Money Banks expanded their total assets in both 1980 and 1981 remained at about 20 per cent virtually the same as in 1979, but the composition changed (Table 27). Advances and loans, whose share in total assets fell from 71 per cent in 1979 to 67 per cent in 1980, and to 63 per cent by end-September 1981, rose in 1980 by 13.5 per cent, or 8 percentage points less than the year before, to a level of £C 403 million; in the year to end-September 1981 they rose by 14.2 per cent to £C 430 million. Holdings of Treasury bills, on the other hand, which had declined by £C 2 million during 1978-79, rose during 1980 by £C 13.5 million or 75 per cent to a level of £C 31.6 million, and during the first nine months of 1981 to a level of £C 37.1 million, illustrating the disparate developments in credit to the private and public sectors. The earlier decline in the rate of expansion in foreign assets continued in 1980 and 1981 amounting to some 11 per cent and some 14 per cent, respectively, compared with 28.5 per cent in 1979. By contrast, cash and balances with the Central Bank continued to rise at an increasing rate, from 13.3 per cent in 1979 and 41.5 per cent in 1980 to 85.7 per cent in the year ending in September 1981, reaching at that time £C 123.7 million and leaving the banks very liquid.

Data on the sectoral distribution of Deposit Money Banks' advances and loans show that loan expansion declined most markedly to the sector of foreign and domestic trade, and in "personal loans." Loans to foreign and domestic trade which had risen at a rate of some 21 per cent during 1979 rose by 12 per cent in 1980 and by 7.7 per cent during the year ending in September 1981, reflecting the speculative build-up of inventories before mid-1980 and the subsequent destocking during the year of the stabilization program. By contrast, decline in loan expansion to the building and construction sector and to mining and manufacturing were less pronounced, reflecting in the former case the continuing need to settle refugees.

Total assets of "other financial institutions" 1/ rose by 16.1 per cent in the year to December 1980 (Table 29), about the same amount as in 1979, but down substantially from the rates of 24 per cent in 1977 and 20 per cent in 1978. In the year to September 1981, expansion amounted to no more than 8 per cent. While during 1977 lending by these institutions outpaced lending by the Deposit Money Banks, the reverse applies to the years of 1978 to 1981. In part this reversal is due to the relatively more rapid expansion of credit to the tourist sector in particular, which accounts for a rising share in total lending of the Deposit Money Banks, while total loans of the financial institutions consist, to about 50 per cent, in loans to the building and construction sector whose rate of expansion slowed considerably in 1980. The reversal is further attributable to the fact that the surge in bank lending during the year and a half to mid-1980, in connection with the build-up of inventories and the rise in consumption expenditures, has been mainly accounted for by the Deposit Money Banks. The new Five-Year Plan for 1982-86 envisages incentives to innovation in which the Cyprus Development Bank in particular might play an important role, perhaps sharing the risk involved in potentially highly productive investment projects.

In the calculation of monetary aggregates only deposits with Deposit Money Banks (DMBs) are currently included. Deposits with the Co-operative Central Bank--which is a DMB--are included while those of other cooperative financial institutions such as credit societies (CSs) and savings banks (SBs)--for which no balance sheets are available--and those of "other financial institutions" (OFIs) are not included. At the end of 1980

1/ The Mortgage Bank of Cyprus, Ltd., Lombard Banking, Ltd., and the Cyprus Development Bank, Ltd.

total deposits with DMBs reached £C 463.5 million while deposits with OFIs, CSs and SBs were £C 175.8 million. Thus, total deposits--including an unidentified amount of double counting between the Co-operative Central Bank and CSs and SBs--at the end of 1980 were £C 639.3 million with the share of deposits not included in monetary aggregates to total deposits being 27.5 per cent. To establish an historical record of the respective growth in these two groups it is noted that in 1978, 1973, 1968 and 1962 this ratio was respectively, 29.5 per cent, 31.1 per cent, 25.6 per cent, and 14.4 per cent. Thus, there was an increase in the share of these deposits vis-à-vis deposits with DMBs throughout the 1960s and the early 1970s followed by a decline throughout the middle and late 1970s which appears to continue to date.

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