

January 29, 1982 - 82/7

Statement by Mr. Polak on Cyprus
Executive Board Meeting 82/11
February 1, 1982

On behalf of the Cypriot authorities I thank the staff for constructive consultation discussions reflected in clear and incisive reports. The Cypriot authorities agree with the thrust of the staff analysis and appraisal.

The Cypriot economy is confronted with some interrelated problems: the external deficit and the overall budget deficit are both excessive, the stabilization program of 1980 has brought about an undesirable shift in the composition of domestic demand, and the rise in real wages far outstrips the increase in productivity.

After a successful and dynamic adaptation to the new circumstances in which the country found itself in 1974, the situation facing the Cypriot authorities changed character in 1979 when the refugees had been integrated into the economy, labor became scarce, and demand, in particular consumption, had to be restrained. The authorities adopted a stabilization program in the first half of 1980 supported by a stand-by arrangement with the Fund in the first credit tranche. While this program achieved its broad objectives of reducing the external current account deficit and the rate of inflation, this result was achieved to an unintended degree by a reduction in private productive investment. As the staff points out, there occurred an undesirable shift in the composition of domestic demand from the private to the public sector and from investment to consumption.

Moreover, the problems of 1979 have not been fully overcome and the Cypriot economy remains faced with excessive external current account and overall budget deficits. In 1981, the current account deficit was some 8.5 per cent of GDP and the overall budget deficit 7.8 per cent of GDP. These figures take account of the latest data indicating a current account deficit of Cypriot £70 million compared with earlier estimates of £75 million. It may be noted that the government deficit and the current account deficit are of the same order of magnitude; these figures convey the correct impression that a reduction of the government deficit to more manageable levels would also bring about a more manageable external account.

The overall budget deficit has been financed almost totally by monetary expansion. As the statutory limit of government borrowing from the Central Bank was approached, the Government resorted to financing its deficit by foreign borrowing. Legal interest rate ceilings made possible only minor sales of government securities on the domestic market. The resulting inflow of foreign exchange was more than sufficient to finance the external current account deficit, but it also produced excess domestic liquidity: the existing ceilings on credit to the private sector were not reached.

Wage increases have outstripped productivity gains but statistical deficiencies may somewhat exaggerate the extent to which this phenomenon took place. Nevertheless, there is no doubt that a moderation in the rise of wages and salaries as well as the introduction of some flexibility in the wage indexation system will be necessary to achieve a sustainable situation. With this in mind the Minister of Finance has recently taken an active interest in wage negotiations with the trade unions in the semi-public enterprises which set the pace for both government wages and wages in the private industrial sector.

In the budgetary field the Cypriot authorities are attempting to achieve a substantial reduction in the overall deficit, and they are concentrating their efforts on constraining the rise in public expenditure. A reduction in the overall budget deficit and the concomitant reduction in foreign borrowing would increase the effectiveness of monetary policy. It would then become vital to change the interest rate structure so as to achieve positive real interest rates. In fact, a bill that would abolish the present ceiling on nominal interest rates is before Parliament. (The inflation rate has been reduced to 10.8 per cent).

Monetary policy for 1982 has become more selective. Overall credit ceilings have been abandoned. Strict limitations continue on import trade and domestic trade as well as on personal loans; credit to other sectors has been freed from credit ceilings. To contain an excessive expansion in total credit, the required liquidity ratio has been increased by 2 percentage points on January 1 of this year, with a further 1 percentage point increase announced to become effective on March 1. One half of the amounts that have become available from the first increase will flow to the special fund for the financing of priority projects; the list of projects eligible for such financing has been extended.

In a general approach to economic policy the Government has now introduced a proposal for a broad package of measures dealing with indexation, incomes as well as the government deficit. The aim of this package would be to bring about a growth rate of GDP of 3 per cent, a reduction of inflation to single digits and a further improvement of the balance of payments. These efforts have to be seen against the background of the presidential elections to be held about a year from now. But the Cypriot authorities have shown in the past that they are well able to manage their economy under difficult circumstances, and they will no doubt be able to do so again.