Distress signals from the services sector

By Elias A. Neocleous
Vice Chairman and Head of Commercial/Corporate Department
of Andreas Neocleous & Co LLC

The financial upheavals undergone by the Cyprus economy in the first half of 2011 and the tragic explosion at Mari which destroyed half the island's electricity generating capacity and left the government in disarray have added to the risk of a new recession, and have led to a downgrading of Cyprus's credit rating and an increase in bond yields, putting the public finances under severe strain.

More worryingly for the longer term, the government's apparent inability to guarantee political and financial stability puts Cyprus's hard-won reputation as a leading financial centre at risk. In order for investors to have confidence in a financial centre a stable environment is a sine qua non.

In the years after joining the EU in 2004 the Republic of Cyprus made great progress in improving service quality, transparency and the coordination of public finances, while maintaining its comparative advantage over its competitors within the EU and worldwide. As a result Cyprus became the portal of choice for investment between the EU and the dynamic economies of Central and Eastern Europe, India, China and beyond. Adoption of the euro in 2008 further consolidated the island's position as a bridge for investments and capital flows within and outside the European market. The services sector grew to be the backbone of the modern Cyprus economy, providing many thousands of people with employment, generating substantial revenues and attracting foreign deposits and investments, so strengthening the domestic banking system and providing liquidity.

The presence of some fifty thousand Russian permanent residents in Cyprus reflects not only the close cultural links between the two nations, but also the beneficial business, investment and taxation regime which Cyprus offers, particularly with the double taxation agreement between the two countries. The Russian community is a significant economic force, strengthening the domestic market for goods and services.

However, the progress made in the first decade of the twenty-first century risks being lost unless rapid and effective action is taken to reassure investors and potential investors. Cyprus needs to reform and improve its government infrastructure, particularly its civil service, and build alliances with neighbouring countries and other financial centres within the EU to promote common interests more effectively. Cyprus needs to get itself off the danger list of candidates for the European support mechanism so that it can regain its influence in the debate on reform of the internal market and effectively promote its national interests.

It is particularly important that Cyprus should do this as soon as possible in the light of the threat posed by European proposals for tax harmonization and the adoption of a common consolidated tax base. If a common consolidated tax base were allowed to develop into a Europe-wide minimum tax rate, which has been suggested in some quarters, this would seriously damage the economies of smaller countries such as Cyprus, Malta and Ireland that base their competitiveness on their comparative tax advantages.

Since tax harmonisation is largely a Franco-German initiative, and since the influence of France and Germany is strong due to their current position as Europe's paymasters, Cyprus will need every means at its disposal in order to effectively resist the proposals. The impending Cyprus EU Presidency and the long-running reunification negotiations with Turkey add a further dimension to the issue.

The need for action is urgent, as the lack of investor confidence is starting to be reflected in the financial statistics, with deposits at banks in Cyprus falling by 1%

(€1.8 billion) during the month of June, and the relocation of shipping offices away from Cyprus.

With increased mobility within the single European market there is a prospect that financial institutions such as banks and finance companies will also abandon Cyprus. Further, financial instability is pushing yields on public debt to unprecedentedly high levels, which add to the erosion of investor confidence. Bank of Cyprus, the country's largest commercial bank, has publicly expressed its concerns over the prospects for the economy, receiving widespread coverage in the international media.

The government needs to take rapid, radical measures to return the economy to sustainable growth and restore Cyprus's international image.

Within the framework of the services sector, there are already significant initiatives in the right direction, such as the bill to update the International Trusts Law of 1992 and remove certain obstacles to investment, which is under consideration by the Parliament. Businesses, banks and trade associations have made a concerted appeal to expedite passage of the law so as to encourage existing investors, some of whom have holdings of billions of euro, to keep faith with Cyprus, and hopefully to attract new investors.

Reform of the public finances will involve substantial changes, which are likely to be fiercely resisted by certain sectoral interests, but it is essential if Cyprus is to retain its position as a reliable, reputable financial centre, regain its influence in Europe and re-establish control over its economic destiny. ■