

Cyprus Falling Savings Rate

Treasury & Correspondent Banking

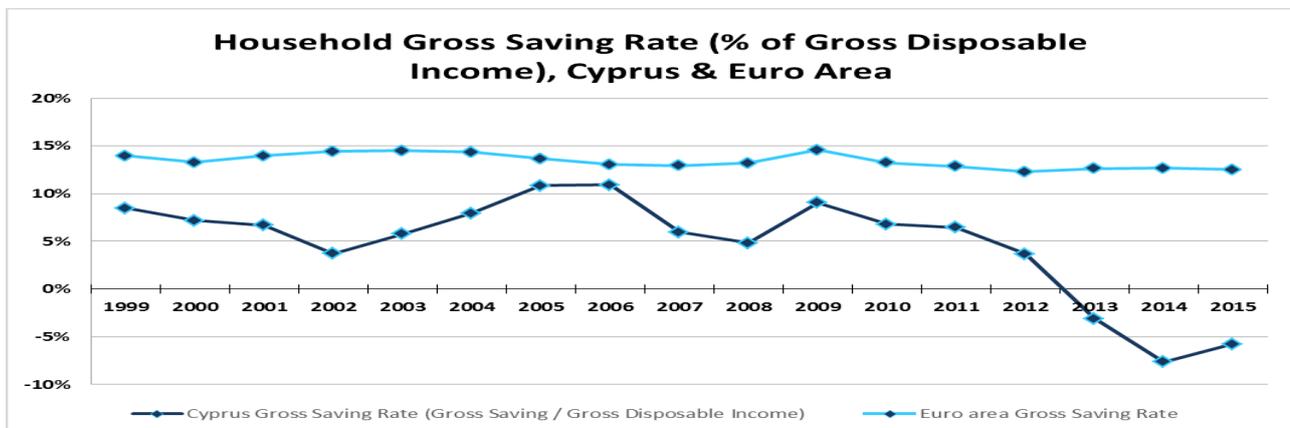
- Cyprus' saving rate has experienced deep declines over the last few years since 2009. The decrease was so deep, that the savings rate turned negative following the bail in events of 2013. Negative saving implies that spending is financed by already accumulated savings.
- The decrease is Cyprus-specific: the Euro area savings rate has moved broadly sideways over the same period. Countries facing similar economic conditions had their savings rates decreasing by a much lower proportionally rate, and nevertheless not turning negative.
- Cyprus' consumption is growing quite robustly pointing towards a more consumer oriented society. However, a decreasing, and even negative, savings rate is nonetheless problematic from a widening trade and current account deficit perspective. It could also lead to a higher poverty rate for the young generation in their old age.
- Despite the decline observed, there exists evidence that no structural change in the Cyprus household consumption habits has taken place following the 2013 bail in events.

The savings rate is decreasing in Cyprus, but not in the rest of the Euro area

Over the past 15 to 20 years, Cyprus experienced large fluctuations in its household savings rate. During 1999–2002, the savings rate declined steadily from a peak of 9.5% in 1999 to 4.6% in 2002, while growth averaged 3.5% per year, given a period of easy credit and a housing market boom. During 2002 to 2006, as the credit and housing market boom picked up further, and growth averaged to 3.8% per year, Cyprus's household savings rate rebounded above its 1999 levels at 11.4%. Since 2007, the saving rate fell rapidly, as the credit and housing market bubbles burst in 2009 following the global economic crisis. Growth declined, and was followed by a deep domestic recession during the years 2012 to 2014. This pattern is similar to that observed in other European countries (Ireland, Spain, Portugal) that suffered a similar credit-housing boom-bust cycle, although *the decline in the Cypriot saving rate seems to have been the deepest* (partly explaining the less than predicted decrease in retail volume sales) *moving to a negative territory at a level of -6.7% in 2014 and -5.8% in 2015*.

On the other hand, the Euro area savings rate has moved broadly sideways over the same period and was at the level of 12.5% in 2015.

Figure 1

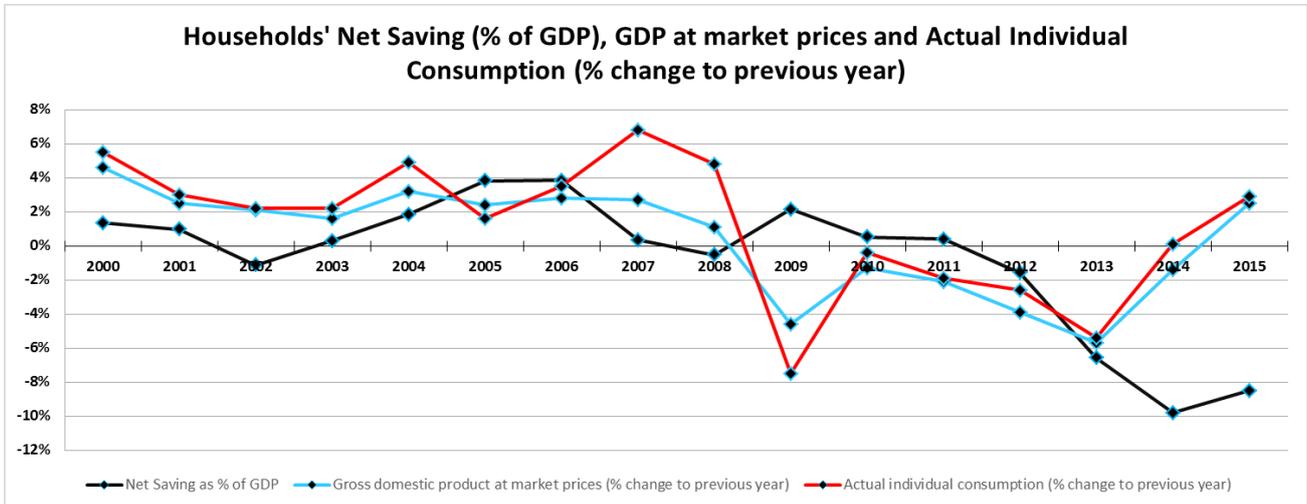


Rising income pushes savings up while decreasing income pushes savings down

The household savings rate is likely to respond to changes in household income growth. As income growth accelerates, households tend to increase their consumption less than proportionally, implying higher savings.

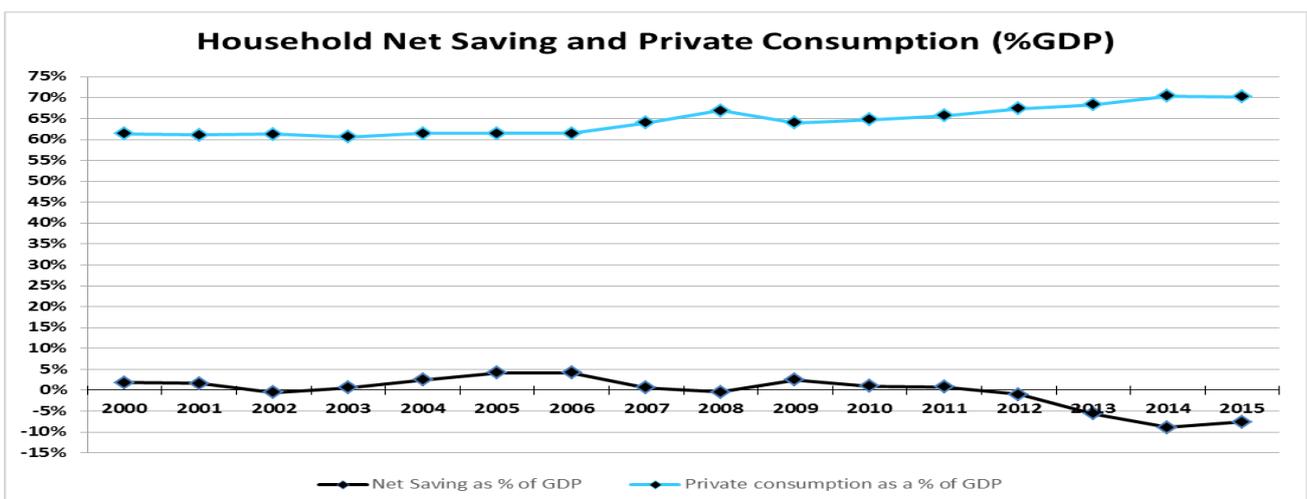
However, as indicated in Figure 2, as income in Cyprus was growing, households increased their consumption more than proportionally (with the exception of the year 2005), implying lower savings. Likewise, as income growth became negative or decreased, households decreased their consumption less than proportionally (with the exception of the year 2009), implying lower savings.

Figure 2



In fact, as it can be observed from Figure 3, private consumption (as a % of GDP) steadily increased from 2009 onwards from 64% of GDP in 2009 to 70.4% in 2015, while the savings ratio had decreased. In absolute figures, private consumption has increased from €11.8 billion in 2009 to €12.2 billion in 2015. Rising consumption has been partially supported by the dissolution of approximately 1,200 provident funds (out of a total of 1,800) during the years of 2013, 2014 and 2015 (following the 2013 bail in events) and growing tourism revenues. The dissolution amount is estimated at around €1.8 billion. It should be mentioned that the legislation in Cyprus allows the dissolution of provident funds without any penalties (unlike the legislation in EU countries in which penalties are imposed).

Figure 3

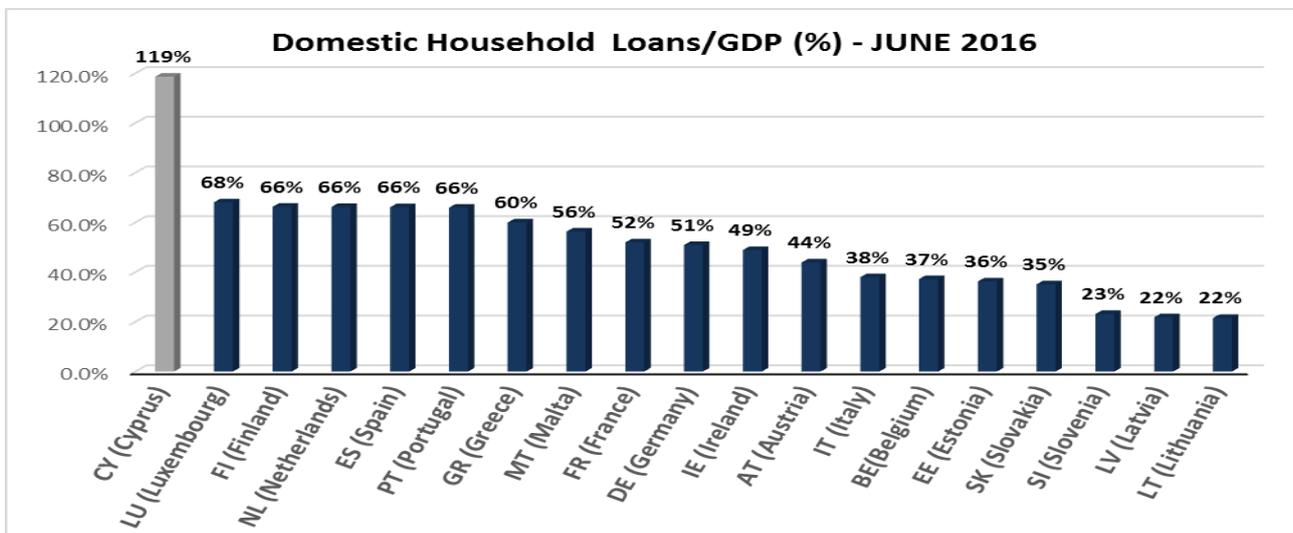


Household balance sheets look weak

The relative weakness of household’s balance sheets is a possible determinant of savings behaviour. A high debt level, for example, may force households to reduce their leverage (by cutting borrowing and building up wealth). Cyprus’ household indebtedness is the highest among the Euro area (Figure 4). Although it exhibited a decrease of around 13% during 2012 to June 2016,

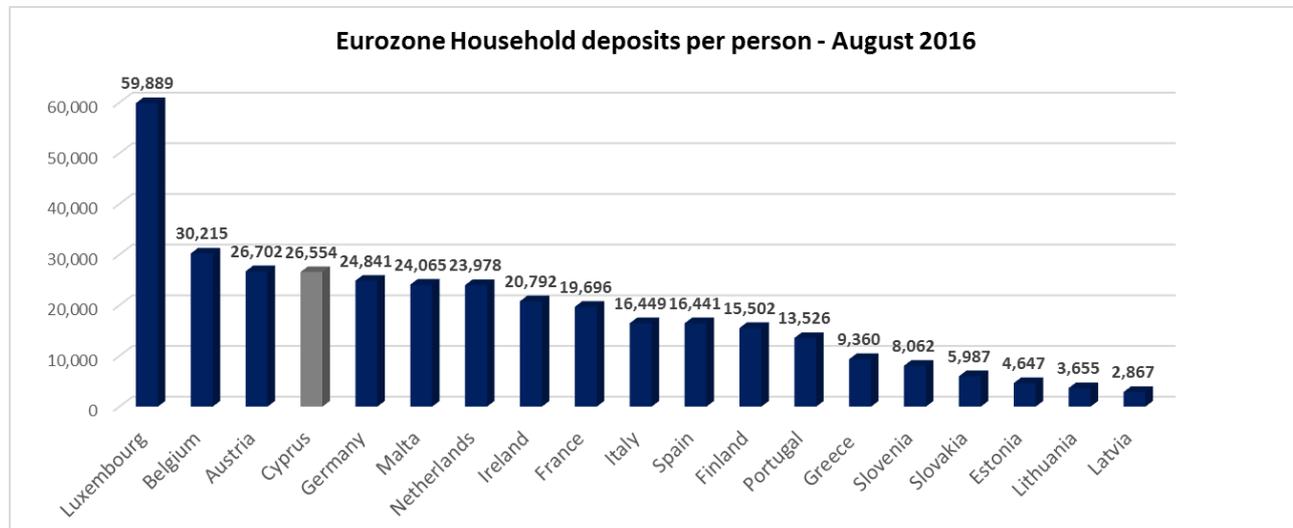
household indebtedness as a % to GDP, remained fairly stable, and dropped from 123% to 119%, due to an equivalent decrease of 10% in GDP during the corresponding period.

Figure 4



On the other hand, as it can be observed from Figure 5, Cyprus' household deposits per person compare favourably with the rest of the Eurozone's deposits. This could be partially explained by the dissolution of a large number of provident funds (taking place during 2013 to 2015) as already discussed above.

Figure 5

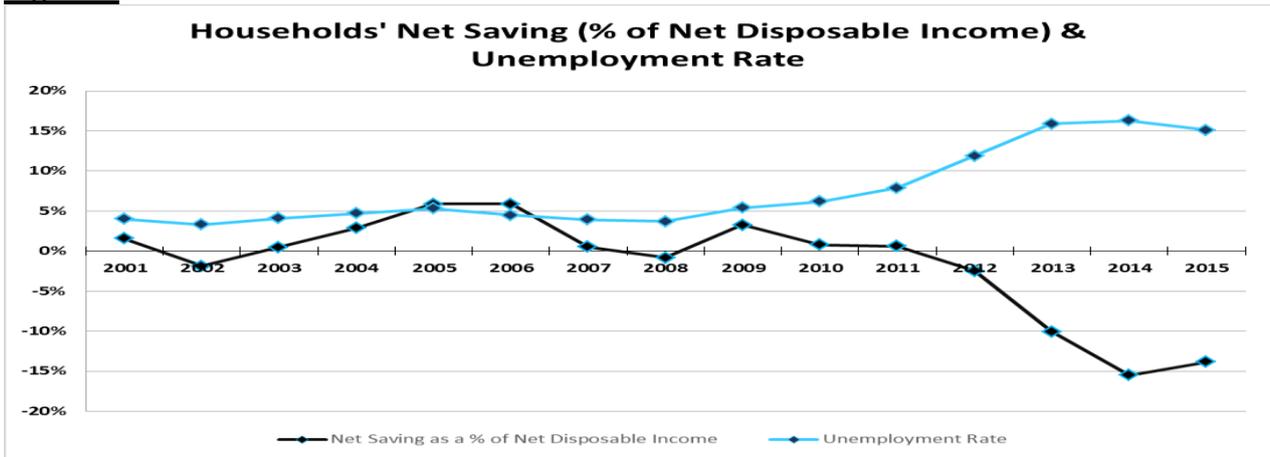


The savings rate vs the unemployment rate

The savings of private households are likely to change over the course of the business cycle. On account of the precautionary motive for saving, private households may adjust their savings according to the (actual or perceived) uncertainty of the economic outlook. And the unemployment rate can be seen as a proxy for the cyclical uncertainty households face. On the other hand, as unemployment increases, the unemployed people tend to use part of their past savings in order to pay their obligations (e.g. rent, loan payments, grocery expenses etc).

In Cyprus, there is little correlation (or at times negative correlation) between the Cyprus unemployment rate and the savings rate as shown in Figure 6. In particular, the continuing increase in the unemployment rate since the year 2009 resulted in a decrease of the savings rate during the corresponding period.

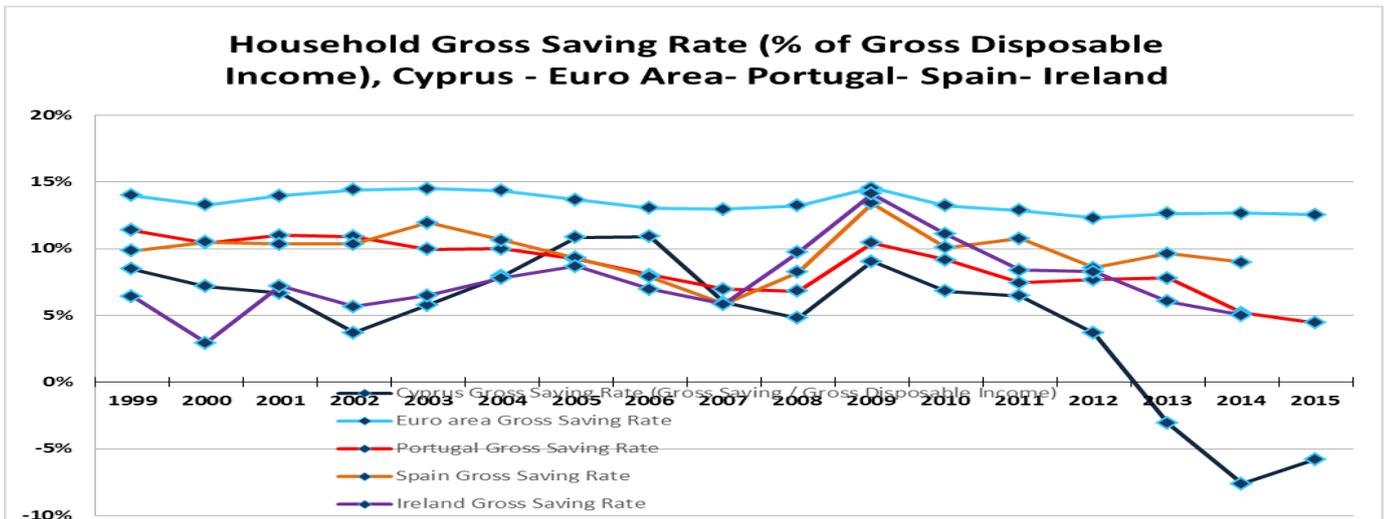
Figure 6



Cyprus savings rate drop, far deeper than other bailout countries

The pattern of a decreasing savings rate, was also observed in other Euro area countries that went through a similar credit-housing boom-bust cycle (Figure 7). However, the decline in the Cypriot savings rate seems to have been the deepest amongst all the countries that had also agreed a financial assistance program with Troika. Ireland, Portugal and Spain have all signed a financial assistance program in November 2010, May 2011 and June 2012 respectively. Ireland’s savings rate decreased from 14% in 2009 to 5% in 2014, Portugal’s from 10% in 2009 to 4% in 2015 whilst Spain’s (a country with the second highest unemployment rate, standing at 20%, in the Euro area after Greece) rate decreased from 13% in 2009 to 8% in 2015. No data exist for Greece that had signed a financial assistance program with Troika in April 2010.

Figure 7

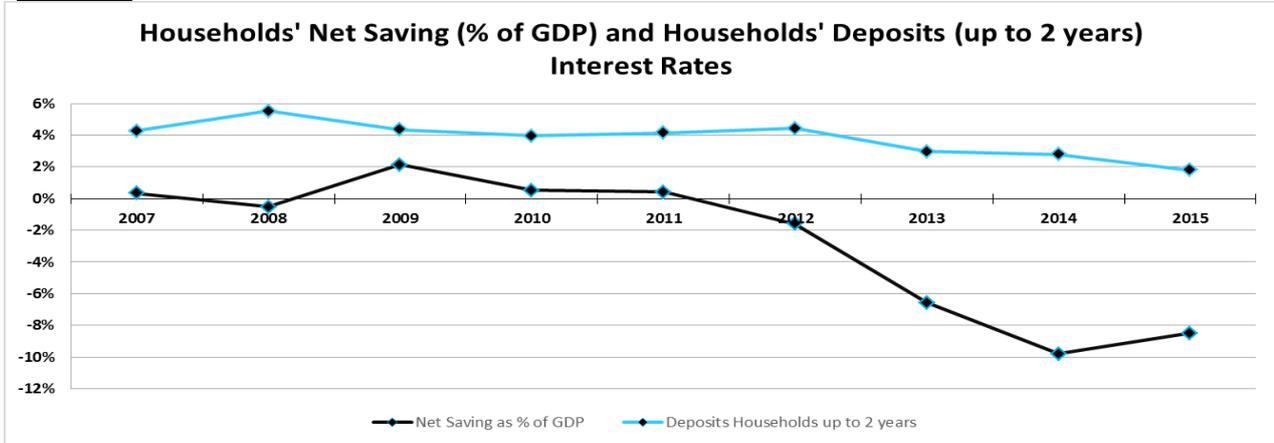


Low returns may boost savings (if the ‘income effect’ dominates the ‘substitution effect’)

At least during ‘normal’ times, the correlation between interest rates and savings should be positive. Lower interest rates imply it is relatively more favourable to spend today as compared with saving today and consuming tomorrow. This should lead to lower savings. But in addition to this ‘substitution effect, a so-called ‘income effect’ is also at play. Low interest rates reduce returns and thus intertemporal income. At least in principle, households may be forced to save more in order to compensate for this decline in total income.

The relative importance of these two effects is likely to depend on the overall level of interest rates. In Cyprus as the deposit interest rates fell from the area of 4% prior to the bail in events of 2013 to levels below 2% in 2015, the savings rate has also decreased (Figure 8).

Figure 8

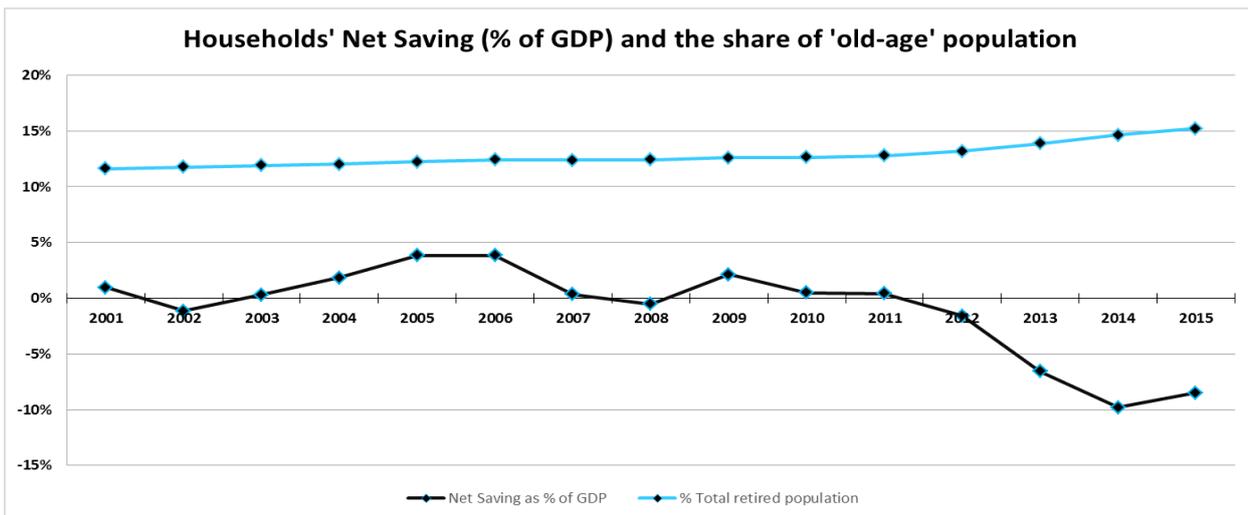


Higher percentage of pensioners pointing to lower savings

Savings change over an individual’s lifetime, displaying a hump-shaped development. When young (and still in education or with relatively low income), people tend to save less of their income. Working age people save more, while pensioners tend to dis-save again. This implies that, all else equal, an increase in the proportion of the population that has retired should push the savings rate down.

There is indeed a positive correlation between the change in the ‘old-age population’ (defined as the number of people aged 65 or over) and the savings rate. The ‘old-age population’ share in Cyprus has increased from 12.4% in 2008 to 15.2% in 2015 mainly due to migration of the young generation seeking employment abroad (Figure 9).

Figure 9



The Demographics: Implications of Low Saving (and dissaving) on the younger generation

Cyprus savings rate has always been lower than the Euro area’s savings rate and has recently turned negative. The majority of this wealth is owned by people who are 50 or older, who appear to be spending a good deal of it on themselves, and helping their children. However, this may change in the future, and in fact the young generation’s standard of living may drop once the currently young Cypriots reach their old age.

Compared with their parents, the younger generation can expect to retire earlier, live longer, rely less on inheritances, receive less help from their children, experience slower real wage growth, face higher taxes, and replace a smaller fraction of their preretirement earnings with Social Security retirement benefits. *Unless the young generation change their saving habits substantially and relatively quickly, they may experience much higher rates of poverty in their old age than those currently observed.*

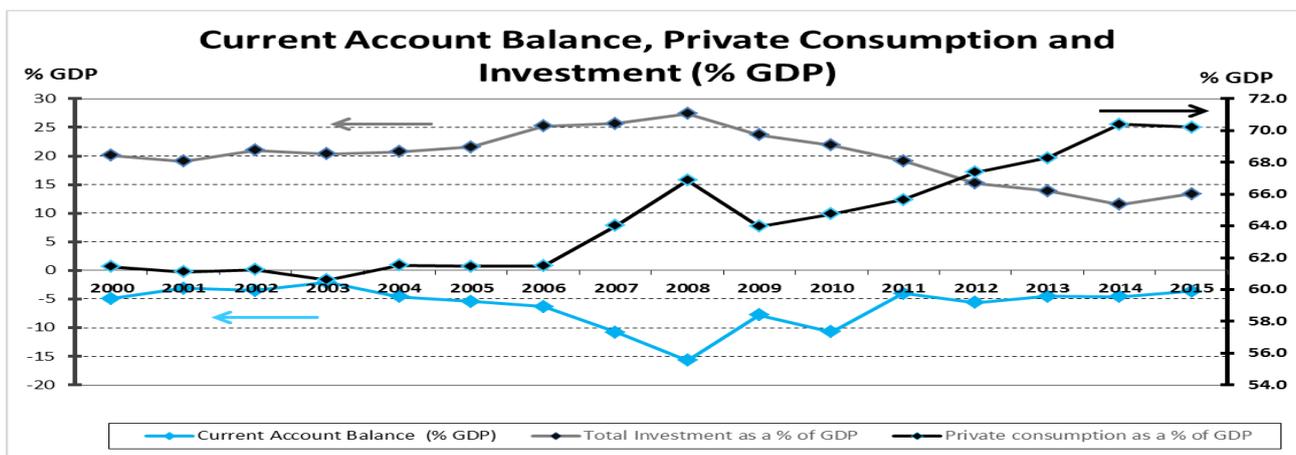
The Implications of Low Saving (and dissaving) on the Current Account

The current account can be expressed as the difference between the value of exports of goods and services and the value of imports of goods and services. A deficit then means that the country is importing more goods and services than it is exporting, although the current account also includes net income (such as interest and dividends) and transfers from abroad (such as foreign aid). The current account can also be expressed as the difference between national (both public and private) savings and investment.

In Cyprus, the deficit reflects an excess of imports over exports which is indicative of competitiveness problems. Furthermore, as the current account deficit also implies an excess of investment over savings, it could equally be pointing to a highly productive, growing economy. However, as the deficit reflects low savings rather than high investment (investment as a % of GDP decreased from 25.7% in 2008 to 13.4% in 2015, as shown in Figure 10), it may be caused by a consumption spree (which could possibly be explained by a psychological shock following the bail in events of 2013), or it could reflect sensible intertemporal trade, because of shifting demographics as analysed above.

Deficits are financed from foreigners that are willing to lend these economies huge sums. *But as the easy credit will come to an end at some point, or the current account deficit becomes unsustainable, Cyprus' ability to repay, and therefore its solvency, might come into question.*

Figure 10



Empirical Evidence (Econometric Analysis)

Despite the decline observed, there exists strong evidence that no structural change in the Cyprus household consumption habits appears to have taken place following the 2013 bail in events.

Overall the results suggest that the major driving forces behind the decrease in the saving ratio during the recent years were:

- The negative shocks to income and total net wealth (both being adversely affected by the Cyprus bail in events of 2013 by approximately 9% to 10%), and not a change in the underlying saving behaviour (specifically, the response of real consumption to income and total net wealth) of the Cypriot household.

That is, there has not been a structural change in the Cyprus household consumption habits because of the Cyprus 2013 bail in events.

Sources: Eurostat, Cystat, CBC, ECB, Department of Registrar of Companies (Cyprus)



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