Financial risk and unemployment in Cyprus enriched

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Abstract

The upswing of the unemployment rate in Cyprus in 2011-2015 seems to be associated with increasing financial risk[1]. During the last financial turmoil, the financial risk measured by the level of domestic corporate[2] interest rate and the interest rate spread with a relevant German bond, is found to be associated with the movement of the unemployment rate.

The unemployment rate is adversely affected by the rate of economic growth. In most times, the higher the economic growth, the lower the unemployment rate and vice-versa except for cases when the economy is at full employment where the higher growth might be reflected into higher prices. In Cyprus, the domestic economy was adversely affected by the higher unemployment during 2011-2014, mainly due to negative economic growth triggered by the financial turbulence.

Recent research has indicated that there exist a correlation between corporate interest rate and risk of default with the unemployment rate. Moreover, it seems that that the volume of non-performing loans in Cyprus has also been associated with higher unemployment rate and corporate interest rates. The driving force behind this seems to be that higher interest rates in terms of higher financial risk reduces vacancy creation and increases vacancy costs for firms, which in turn increases unemployment. In turn, unemployment has both, economic and social impacts and any therapy is time consuming to achieve since the unemployment rate is a lagging indicator and slow reducing.

Keywords: financial risk, unemployment rate, corporate interest rate, non-performing loans, financial stability.

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[1]The views expressed herein are those of the author and do not necessarily reflect the views of the Ministry of Finance or the Government of the Republic of Cyprus.

[2] Based on the Central Bank of Cyprus΄ data the corporate interest rate reflects loans for up to 1 year to non-financial institutions over €1 million with fluctuating interest rate.

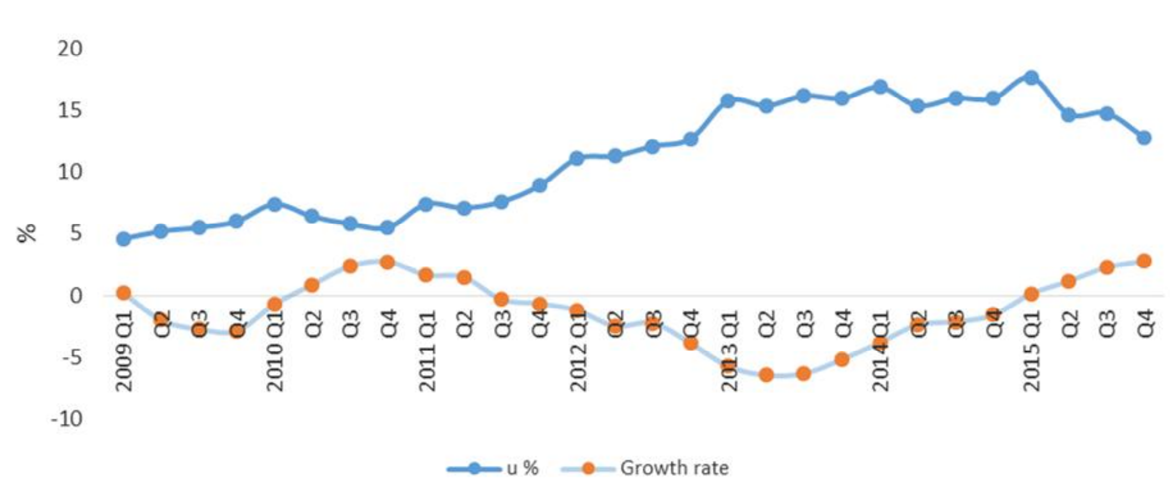
I. THEORETICAL BACKGROUND

In economic theory, interest rate fluctuations (shocks) affect unemployment through the traditional Keynesian transmission mechanism. A shock that leads to an increase in the interest rate reduces planned investment spending of business firms and consumers purchase less number of durable goods leading to a reduction of consumption spending. Moreover, due to the interest rate upswing it is possible asset prices to be affected influencing wealth and real money balances validating the Pigou effect[3] (A. Stevenson et. al, 1988).

At the same time, interest rates affect firms' profits by influencing capital costs and wages (Z. Eckstein et.al, 2015). All the above mentioned adjustments would ultimately impact output and employment, once firms have higher incentive to produce fewer goods and consumers to demand less and thus, firms decide to employ fewer workers.

In parallel, Cyprus during 2011-2014 experienced higher unemployment as a result of economic recession caused by the global crisis that hit the economy commencing in mid-2009. This is graphically depicted below in Figure 1 pinpointing that negative growth is linked with higher and time lagged unemployment validating Okun's law, which brings together real GDP with the unemployment rate affirming the inverse relationship between them (Okun. A.M, 1962). Furthermore, the graph exhibits that during the peak of the financial crisis (2012-2014) the distance between the GDP growth line with the unemployment rate line is enlarged.

Figure 1: Real GDP and unempoloyment rate, 2009-2015

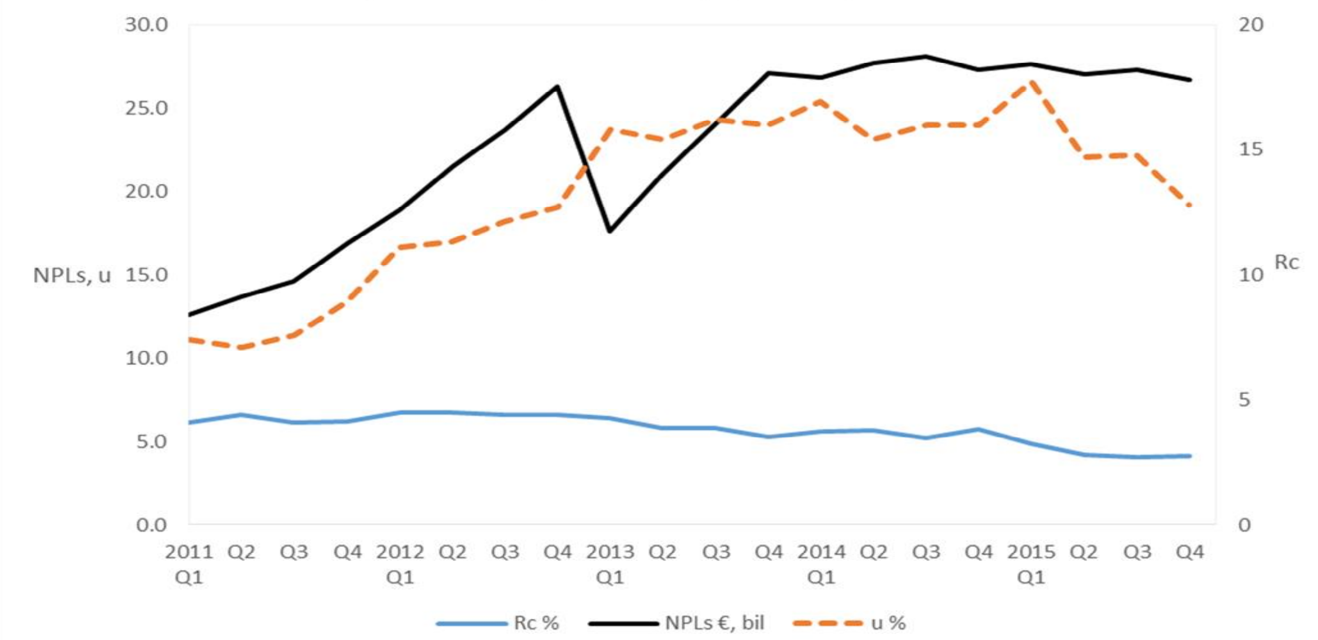


[3] The Pigou or real-balance effect is a mechanism by which an increase in the real money supply resulting from a fall in the price level can influence aggregate demand through increasing autonomous expenditure.

There are also signs that the generation of unemployment was somehow associated with increasing financial risk related to financial intermediation and bad loans causing corporate interest rate levels to be above norm. Financial risk was reflected with past excessive lending (including loose lending practices) that subsequently led to non-performing loans. The above remarks exhibit that higher unemployment in Cyprus during 2011 onwards was adversely hit initially by increasing financial risk and thereafter triggered by lower economic activity.

Another significant implication arising from investigating empirical data is the large association of non-performing loans with quarterly unemployment rate. During the crisis years, the number of NPLs[4] denoted a huge upswing which was associated with the rise of unemployment rate as depicted in Figure 2. The large increase of NPLs was one of the financial crisis drivers highly associated with the high unemployment rates, which always reflect the impact on the real economy.

Figure 2: Quarterly NPLs & unempoyment rate, 2011-2015



[4] Non-Performing Loans, as per the definition in force before 1 July 2013, which excluded loans fully covered by tangible collateral. As per above, adjusted to include those loans fully covered by tangible collateral but which fulfil all remaining criteria to be classified as NPLs (primarily, being those having arrears exceeding 3 months).

II. FINANCIAL RISK IMPACT ON UNEMPLOYMENT

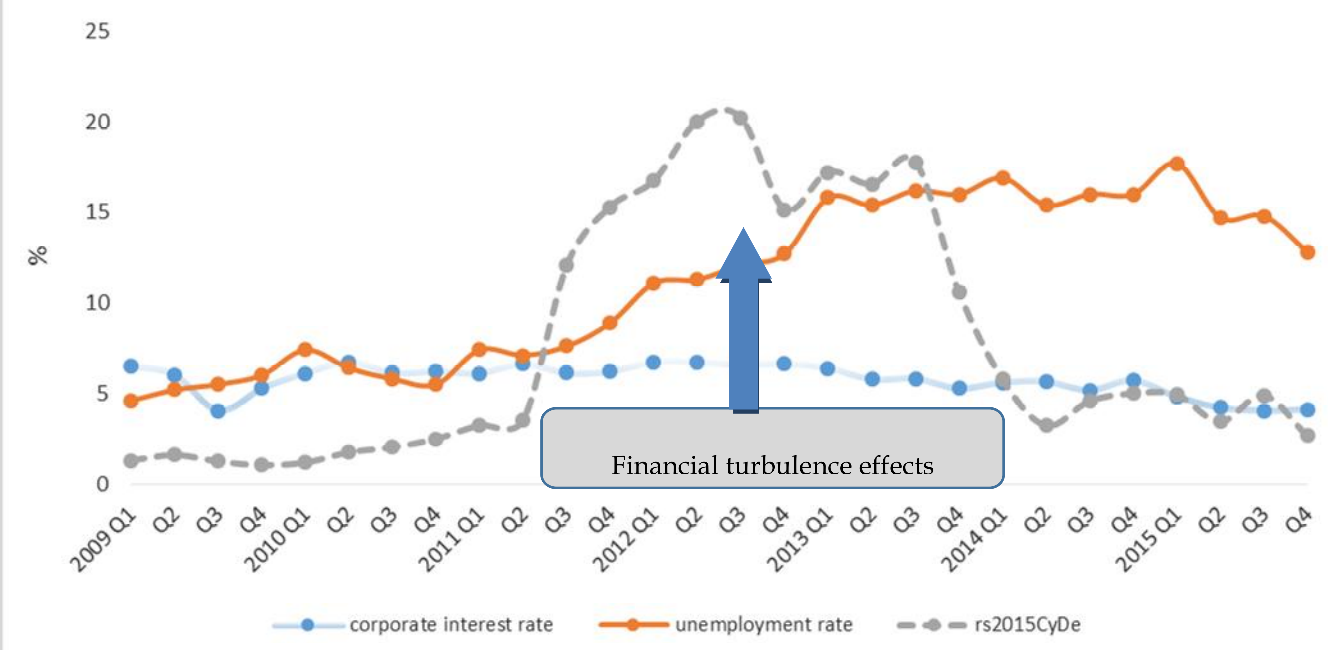
As described above the recent financial crisis has led to some significant outcomes as regards the movement of the unemployment rate in relation to the corporate interest rate and the default risk. The above implication is described through the interest rate channel and its correlation with the unemployment rate. In other words, high corporate interest rate could cause unemployment through business firms' balance sheets. Furthermore, the investigation of the US economy on the same area has shown that the default risk can indirectly trigger unemployment through higher interest rates for firms, which can be exacerbated by the increasing vacancy cost(Z.Ecksteinet.al,2015).

Figure 3: Financial risk & unemployment, 2009-2015

As depicted in Figure 3 above, the corporate interest rate in Cyprus during 2009-2015, was retained relatively high and without any significant variation due to the absence of both monetary policy tools and strong competition in the banking sector. The graph reveals that the level of the interest rate throughout 2009 to 2015 was between 3 and 6 percent. Before the crisis, the corporate interest rate was retained high mainly due to the absence of risk management tools on behalf of banks and the large number of non-performing corporate and housing loans provided to borrowers. Spending is decreased due to the decrease in actual wealth. People's wealth diminishes so they spend less and consumption is lower, mitigating turnover and employment thus, raising unemployment. Also people save more, so, Sousa (ECB, 2009) showed that a 10% increase in currency and deposits (and in general financial wealth) increases consumption by 0.6% to 1.5% (short and long run impact).

The increased financial risk is indicated to have begun in mid-2011 onwards as measured by the interest rate spread between the Cyprus government bond due 2019 with a relevant and comparable German government bond (Bund) due 2019. The interest rate spread is depicted for that period in Figure 4 where the rectangle exhibits the onset and easing of the financial turbulence. The spread (CyDe) of the Cyprus international government bond due in 2019 with a similar German sovereign bond due 2015 experienced significant upswing during 2011-2013 when it increased dramatically as a result of the financial crisis. The above spread increase was of magnitude of 17.0 p.p. within 6 successive quarters. During the same period unemployment rose significantly by 8.4 p.p. Signs of easing of financial risk seem to have initiated by the end of 2015 leading unemployment to start exhibiting some signs of stabilization and reduction especially, after the second quarter of 2015.

Figure 4: Financial risk in Cyprus 2009-2015



III CONCLUDING REMARKS

Within the last 4 years, Cyprus has experienced the repercussions of the global and internal financial turmoil that has unavoidably led to an increase of the unemployment rate and to a substantial income redistribution. As it is well known, the time for an economy to return to normal economic activity is longer, in case of financial crisis and that was the case for Cyprus. Data investigated reveal that financial risks experienced in Cyprus during 2011-2014 were strongly interrelated with downward rigidity and relatively high corporate interest rates and a high volume of non-performing loans that ultimately led to high unemployment rate as well with a large number of non-performing loans during the reference period.

As a result, the importance of confidence and trustworthiness exhibited by domestic and foreign investors towards the Cyprus economy become crucial and necessary to enhance the robustness of economic activity.

In terms of economic policy making, what matters is to safeguard and foster financial stability, which is necessary for retaining macroeconomic stability. The effective supervision exercised by the Central Bank, in conjunction with efficient policy measures the Ministry of Finance should pursue, can maintain and safeguard financial stability, which is both, necessary and sufficient conditions to achieve sustainable growth in the longer run.

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RELEVANT WEB SITES

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Ministry of Finance, www.mof.gov.cy