Some less pleasant national accounts arithmetic

Description

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We use summary indicators to conveniently measure the performance and health of the economy. But while these can be useful in some respects, they have their drawbacks and their interpretation and meaning may not be so straightforward. The usual way to measure an economy's performance, and to compare it over time and with its peers, is to look at gross domestic product, also in per capita terms and in real inflation-adjusted terms. But a sheer number like the 3.7 per cent growth in Cyprus' GDP at constant prices in the second quarter of this year may sound impressive, but it says little about how that growth is distributed across the community or about the overall health of the economy. In this article, we focus on this issue, how we can better understand the health of the economy and what specific measures can help us to do so. We argue that for Cyprus, gross national product is a better measure of economic performance than gross domestic product, and that the picture it paints is less favourable. Combining it with the balance of payments reveals the nature of foreign investment in the country, the problems and constraints it poses, and what needs to be done to avoid the risky accumulation of external imbalances over time. Cyprus needs to take a close look at the productivity of its FDI, its competitiveness and the regulatory framework governing foreign investment.

Gross Domestic Product and Gross National Product

Both gross domestic product and gross national product measure a country's performance, but they are not exactly equivalent. Gross domestic product measures the value of all final goods and services produced in a year by all factors of production employed domestically, including those owned by foreigners. It is location that counts, not ownership. Gross national product, on the other hand, takes into account the ownership of the factors of production and includes what is known as net factor income from abroad.

This measures the inflows and outflows associated with domestic factors such as labour and capital employed abroad, and foreign factors employed in the domestic economy. Put more simply, net factor income from abroad is the sum of the returns to domestic investment abroad minus the returns to foreign investment in the domestic economy. This can be wages, profits, interest and dividends, and rents.

Obviously, net factor income can be positive or negative. It is negative if the returns on foreign investments in the domestic economy are higher than the returns on investments by nationals abroad.

Relation to the balance of payments

The balance of payments is a comprehensive record of a country's economic transactions with the rest of the world. It consists of the current, capital and financial accounts. The current account consists of the trade in goods and services account and the primary and secondary income accounts. In particular, the primary income account measures the income flows generated by both foreign direct investment and foreign portfolio investment. Most of these income flows are profits and interest, dividends and rents. The primary income account shows whether a country is a net recipient or payer of income from the rest of the world, while the financial account of the balance of payments tracks the cross-border investments that give rise to the income flows recorded in the primary income account.

The primary income account in the balance of payments corresponds to the net factor income from abroad in the national accounts.

Back to domestic and national

Typically, for most countries, the differences between the domestic and national concepts in national accounts are small and stable, and gross domestic product is often preferred because it is easier to measure. However, in some cases, where the level of foreign investment is high, the difference between the two can be substantial. In the European Union, this is mainly the case for countries such as Ireland, Luxembourg or Malta, and increasingly for Cyprus. In all these cases, gross national product is much smaller than gross domestic product but is the more appropriate measure of economic performance.

The metrics

Gross national product data are not readily available from Eurostat for cross-country comparisons, but we can make estimates from the gross domestic product data that are available and from balance of payments statistics, including the primary income account. We can also adjust for inflation by using the deflator of gross domestic product to obtain the inflation-adjusted gross national product. We calculate per capita figures from population figures.

Looking at these statistics historically, Cyprus’ gross domestic product was slightly higher than its gross national product in 2011, before the economic crisis. But from 2012 onwards, gross national product started to lag gross domestic product. By 2023, Cyprus’ gross national product was about 10% lower than its gross domestic product. At the same time, the primary income account of the current account of the balance of payments, deteriorates in parallel, reaching a deficit of 10% of GDP in 2023. This is the same as the gap between gross domestic product and gross national product.

By comparison, Malta’s gross domestic product in 2023 was 13% lower than its gross domestic product. It was 23% lower in Ireland and 27% lower in Luxembourg. Like Cyprus, these countries had large deficits in their respective primary income accounts equal to the difference between gross national product and gross domestic product.

Their significance

If gross national product is smaller than gross domestic product, and the difference is increasing on average, then it follows that average growth rates will be lower. In 2023, real gross domestic product in Cyprus increased by 2.5%, while real gross national product decrease slightly by 0.4%. The average annual growth over the period 2009-2023 was 2% for gross domestic product and 1.4% for gross national product, all in real terms. Over the same period, the average annual growth in real gross domestic product per capita was 0.9% and 0.3% for real gross national product per capita.

Malta, Ireland and Luxembourg, our peer group for gross national product, performed much better. In Malta, for example, annual average growth in real gross domestic product was 5.6% over the period 2009-2023, compared with 4.9% for gross national product. In real per capita terms, the growth rates were 3.5% and 2.8% respectively.

The difference between Cyprus and its peer group is reflected in the current account. A deficit in the primary income account, in itself, is not necessarily a cause for concern. However, if the overall current account also shows an even larger deficit, this points to deeper structural imbalances.

Unlike Malta, Luxembourg and Ireland, which have surpluses in their overall current account balances, despite large deficits in their primary income account, Cyprus has a current account deficit that is even larger than the deficit in the primary income account. This may indicate that foreign direct investments in Cyprus may be less productive or less beneficial to the domestic economy than in Cyprus' peers. As such, it may not contribute significantly to the long-term growth, employment or productivity of the domestic economy.

Solutions

To address this situation, Cyprus may need to focus on encouraging more productive foreign direct investments, in higher value-added sectors of the real economy, including manufacturing, technology and renewable energy.

Cyprus could also seek to improve its competitiveness and strengthen its regulatory environment. This will require increased public and private investment in infrastructure, education and innovation to develop sectors better suited to long-term growth and reduce the need for external borrowing to finance current account deficits. It will also require a tightening of regulations on financial flows and real estate investment to ensure that foreign direct investment makes a more meaningful contribution to the local economy, other than just rent seeking.

Conclusion

The large and persistent deficits in the primary income account of the balance of payments suggest substantial foreign ownership of the domestic economy. This makes gross national product rather than gross domestic product the more meaningful measure of Cyprus's economic performance, and the results are less favourable in comparison. The combination of large primary income account deficits and even larger current account deficits may indeed indicate that much of the foreign direct investment in Cyprus is less productive than in peer countries and has so far not contributed significantly to the long-term growth or competitiveness of the domestic economy. To ensure the long-term health of the economy, Cyprus may need to rethink its growth model and incentive structures.

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