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One year of the Cypriot programme: a review

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This panel discussion featured Harris Georgiades (Minister of Finance, Cyprus), Matina Stevis (European Economics Reporter at The Wall Street Journal), Maarten Verwey (Deputy Director-General for Economic and Financial Affairs, European Commission), and Starvros. A. Zenios (University of Cyprus). They discussed about how successful the Cypriot programme has been and what Cyprus should do more in order to be recover from the crisis as soon as possible. The panel discussion was followed by a Q&A session. Guntram Wolff (Director of Bruegel) chaired the event.

The main points made by each speaker were:

HARRIS GEORGIADES

- Before the crisis, Cyprus was on an unsustainable fiscal path, with public spending growing faster than the economy, in a not well-targeted nor well-thought manner.
- Banks were inadequately supervised and corporate governance failures led to a credit boom
- By 2011, Cyprus had lost market access. However, the beginning of the programme, which should have taken place when the haircut for Greece was implemented, was unduly procrastinated.
- As part of the programme, these trends are now largely reversed, and government spending has been cut significantly
- Structural reforms in Cyprus are being implemented as well in order to set the economy back on a sustainable path. This is something the Cypriot government should have done a long time ago for the benefit of its citizens and should thus not be seen as an unduly imposition from the Troika.
- Cyprus is no longer in the news – which is *per se* good news. Credit rating agencies have already started upgrading the country's outlook.
- The economy has proved more resilient than previously expected, in key sectors as tourism, business services, and merchandise shipping. The priority now is to restore credit, which is the main factor weighing on economic activity.

MAARTEN VERWEY

- Mr Verwey, Commission chief for the Cyprus mission, framed his message in three key points: (i) causes of the crisis, (ii) progress made under the programme, and (iii) ongoing challenges.
- Conversely to the minister, attention was focused on the financial sector as the main determinant of the current crisis, rather than fiscal profligacy.
- At the time Cyprus adopted the euro (2008), banks gained access to easy funding, and expanded credit. Even though the short term effects were positive for households and unemployment, domestic imbalances were building up and the net investment position of Cyprus deteriorated. Sound macroprudential policy would have called for fiscal tightening, which is not what happened, as described by Mr Georgiades.
- The early stages of crisis management by the Cypriot authorities can be considered a failure (e.g. turning to Russia for a loan while the budgetary situation continued to deteriorate and only bad options were left by March 2013).

- Without EU/IMF assistances, the crisis would have resulted in a full-blown meltdown of the banking sector (with the government defaulting even on its public sector wage bill).
- Objectives of the Cypriot programme are:1) Restoring trust in banking sector 2) fostering growth of Cypriot economy
- The Cypriot economic performance has surprised to the upside, even though the consumption has contracted sharply. The business service sector did better than originally expected.
- Banking restructuration is fully under way.
- Fiscal performance has been very strong, probably the strongest point of the programme. The budget has outperformed the projections, and this seems likely to continue in 2014.
- Structural reforms: progress has been made, particularly under the pension reform heading. Work is progressing in other sectors as well. There have been delays in other areas like privatization, but with the recent adoption of the privatization law, a good milestone has been reached.
  However, it is important to remember that Cyprus is still going through a hard time– the unemployment rate is at about 17%.
- Challenges ahead: (i) restoration of confidence in the banking sector, (ii) dealing with troubled borrowers and over-indebtedness: the high number of non-performing loans held by Cypriot banks constrains their ability to provide credit. This might require a revision of the insolvency laws.
- The key to restore confidence is to have a plan and to implement it meticulously.

MATINA STEVIS

- Potential of the peace talks and reunification of islands cannot be ignored. Unleashing economic growth through an agreement would be massively beneficial.
- Is the EU ready to accept investors from unconventional locations? So far, Cyprus only attracted investments that were "unwanted" by other EU members. Is it acceptable that (at least in words) a discrimination was made in the bail-in, based on the geographical origin of investors?
- Non-Performing Loans are a serious cause of concern which needs be to tackled, if not, like in Greece, no investor will buy the assets of the bad bank.
- There should be more discussions about what happened during the 10 days of the bailout negotiations. We saw a complete breakdown of the European crisis management framework, four bailouts after and years into the crisis. Lessons should be learned.
- What happened in Cyprus would not have happened in any other EU member country. Cyprus was a perfect place to have "an experiment".

STAVROS ZENIOS

- Cyprus waited too long to ask for assistance.
- Besides the problems that have been stated with banking sector, Cyprus was also suffering from a debt overhang from households and corporations, which was covered by foreign money.
- Bail-in: broadly in favour as it disciplines bankers, who should pay for their poor management of funds (in the specific case, borrow from the ECB to invest in high-yielding euro area peripheral bonds)
- How did Laiki bank became a shareholder in Bank of Cyprus?

- Economy proved much more resilient than expected by economic models. However, there is the risk now to enter an L-shaped recovery, rather than the classic V-shape, as the economy may settle at very low levels.
- In favour of bail-in, which should be progressive (>100k) and possibly also take into account the speed of money (difference between money parked into an account for years and money received the day before by a company in exchange for goods and services). All this will be to the benefit of the economy as well, as consumption would take a lighter hit from a properly fine-tuned bail-in.
- "Cypriot problem" [of reunification] and economic problem should be kept separate.

Q&A

- Energy as a prospect for Cyprus – **hydrocarbons** + renewables (solar) may play a major role. However, the adjustment programme should not rely on these very uncertain financial sources. A restructuring of the economy and perhaps painful but needed structural reforms are to the benefit of the Cypriot people.
- With respect to the "Cypriot problem" [of reunification], the minister clarified that yes – it would lead to a boost in economic activity but this should not be the main driver of re-unification. Already having Turkey open its ports to Cypriot ships, admittedly a small step, would largely benefit a country where merchandise shipping takes a lion share in the economy.
- The issue with "unwanted money" also happens in other EU capitals, so a bit of honesty would be needed. Cyprus has been forthcoming in closing loopholes in its money laundering legislation..
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- The privatization program will be implemented in the next 2 years, but there will not be privatizations this year. Privatizations of the key sectors will take place in order to improve the competitiveness of these industries.

- Capital controls have already been relaxed extensively and do not regard new money flowing or leaving the country. However, a way must be found to reduce the potential harm to the economy in lifting them completely.

Notes by Daehyon Kim