

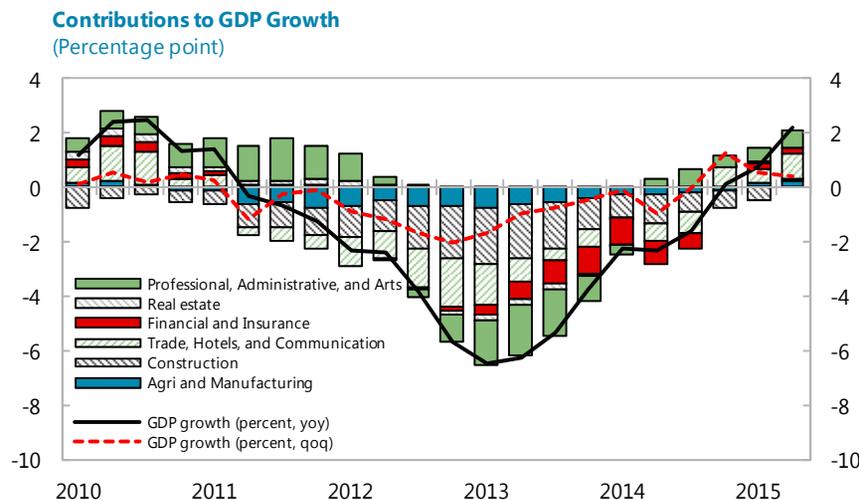
European Department

Opportunities and Challenges on the Road to Long-Lasting Growth



Vincenzo Guzzo
Resident Representative in Cyprus

Cyprus continues to recover from the crisis



Sources: Cystat; and IMF staff estimates.

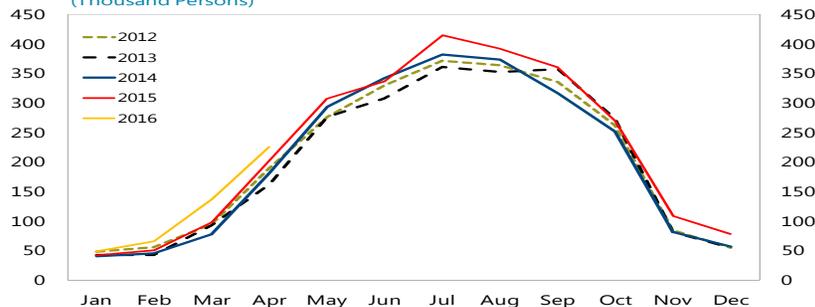
□ In 2015, GDP grew by 1.6 percent, after a cumulative contraction of 10.9 percentage points over the previous three years

□ In Q1/16, growth accelerated to 2.7 percent yoy

□ The recovery in economic activity is broad-based, with tourism and professional services still being the main contributors to growth

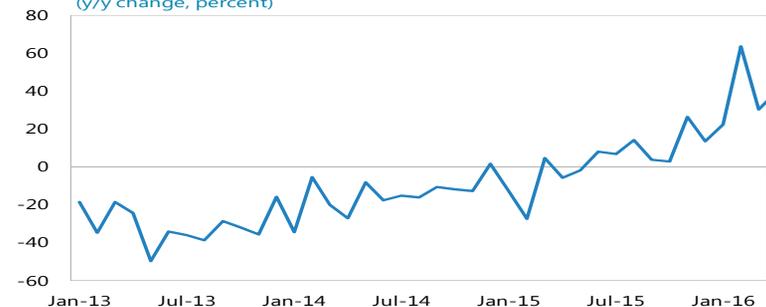
The recovery is broad-based

Tourist arrivals
(Thousand Persons)



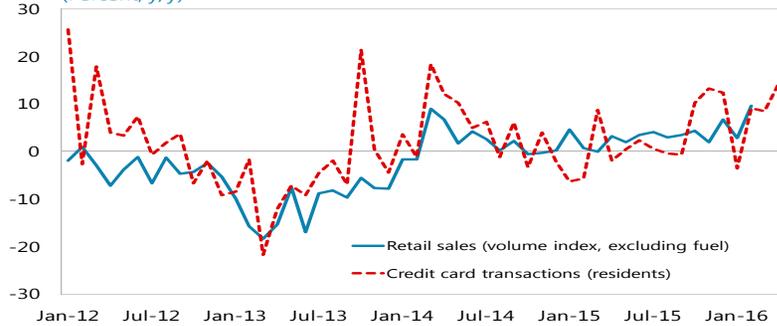
Source: Cystat.

Local sales of cement
(y/y change, percent)



Sources: Cystat; and IMF staff estimates.

Retail sales and credit card transactions
(Percent, y/y)



Sources: Cystat; JCC payments; and IMF staff estimates.

Registration of motor vehicles
(Percent, y/y)

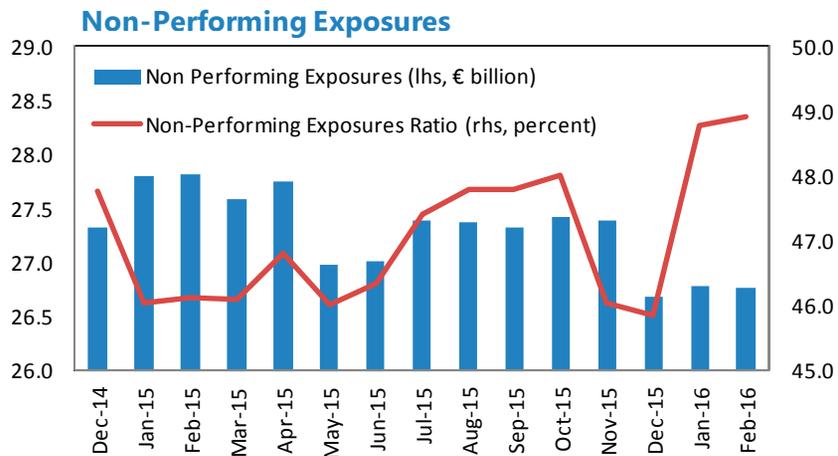


Source: Cystat.

But further acceleration may be hard to achieve

- ❑ According to current IMF staff projections, growth is expected to remain at around 2 percent during 2017-2020
- ❑ This would be far better than the nearly -2 percent recorded in the crisis years 2009-2014, but well below the average growth rate of 5 percent seen during 1988-2008
- ❑ Why is that? What challenges does the Cypriot economy face? What opportunities should be seized to allow a return to stronger and, most importantly, long-lasting growth?

Challenge #1: NPLs are very high



Source: Central Bank of Cyprus

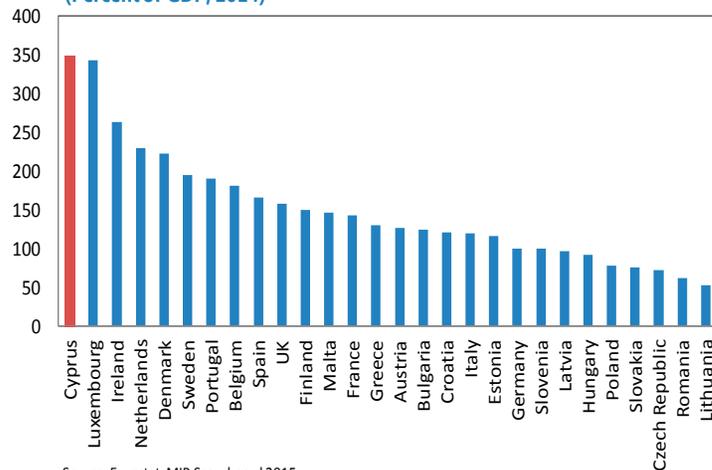
❑ At nearly €27 billion, non-performing exposures are over 150 percent of GDP

❑ The NPE ratio for the total banking system is 49 percent and for the core domestic banks is close to 60 percent, broadly unchanged from a year earlier

❑ On a more positive note, over €14 billion of loans have been restructured, €6.8 billion of which from early 2015

Challenge #1: NPLs are very high (cont.)

Private Sector Debt, Consolidated
(Percent of GDP, 2014)



Source: Eurostat, MIP Scoreboard 2015

- ❑ Private sector overleverage is the mirror image of banks' NPLs
- ❑ Overleveraged firms have little incentive to invest, because any return has to be allocated to service their debt
- ❑ This implies that demand for credit is weak, which further weighs on banks' profits and makes it difficult for them to dispose of impaired assets
- ❑ IMF analysis shows that high leverage contributed to a quarter of the decline in investment in Cyprus during 2008-13

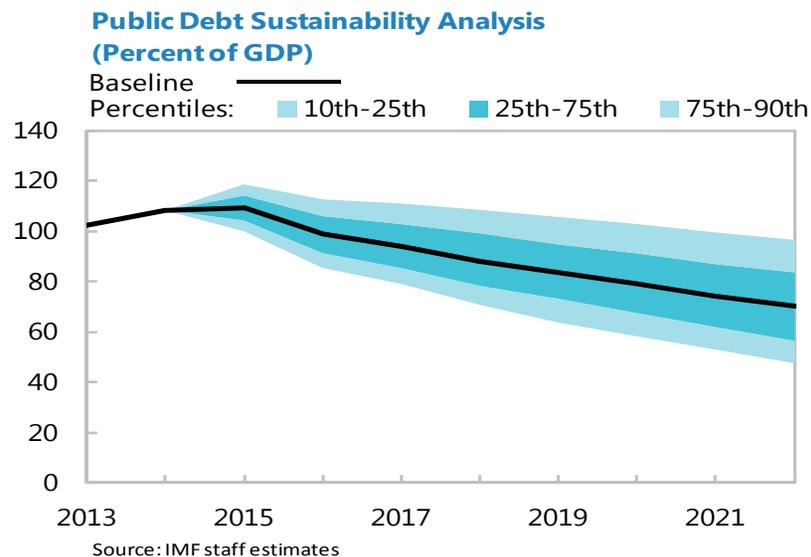
Opportunity #1: lower NPLs, stronger growth

- ❑ Concerted efforts on both NPLs and private sector overleverage would likely support a sustainable economic recovery
- ❑ Dealing with the NPL problem effectively not only would have an impact on the balance sheet and the capital of the banks, but it would also have broader implications for the economy
- ❑ By lowering NPLs, banks could increasingly extend new (targeted) credit to families and corporations, and do that on better terms, thus supporting investment and jobs
- ❑ In turn, stronger growth would increase borrowers' ability to repay, thus reinforcing the case for further reduction in NPLs
- ❑ Banks' improved lending capacity would affect especially SMEs that are more dependent on bank financing. This is very important for Cyprus, where SMEs play a critical role in the economy

Opportunity #1: lower NPLs, stronger growth (cont.)

- ❑ Encouraging the securitization of loans, within an appropriate legal and regulatory framework, would help banks deal with the NPL problem and, eventually, unlock additional sources of funding for the economy
- ❑ Accelerating the implementation of the new insolvency and foreclosure frameworks would also have a strong impact on NPLs
- ❑ Reviewing the civil procedure and other related laws would ensure that courts are in a position to implement effectively the new legal framework
- ❑ Facilitating the transfer of title deeds not covered by existing legislation (non-legacy cases) would improve the functioning of the property market and the debt restructuring framework

Challenge #2: public sector debt is still high



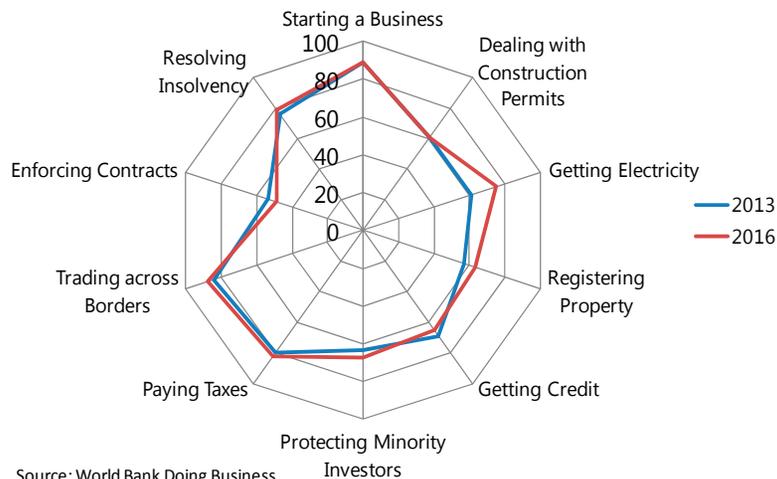
- Fiscal performance consistently exceeded targets during the program period
- However, at nearly 109 percent of GDP in 2015, public sector debt is still high
- Primary surplus will have to be kept at over 3 percent of GDP to maintain public debt on a sustained downward path

Opportunity #2: sustainable public debt, more fiscal space

- ❑ Ensuring sustainable public debt would allow adequate fiscal space for productive public investment spending, which in turn would support long-lasting growth
- ❑ Controlling the growth of the public sector wage bill and increasing the efficiency of the public sector through promotions and mobility across the civil service would be a critical step in this direction
- ❑ Completing the reform of the revenue administration through the integration of the tax departments would support revenue collection over time and contribute to creating adequate fiscal space
- ❑ Overcoming vested interests and strengthening the functioning, oversight and governance of state-owned enterprises would further improve fiscal sustainability and contribute to ensuring a more dynamic and just society

Challenge #3: Cyprus is not an easy place to do business

Distance to Frontier



❑ Despite some recent progress, Cyprus ranks 25th out of 28 EU countries in the 2016 World Bank Doing Business Index

❑ It takes an average 617 days to deal with the construction permits to build a warehouse

❑ It takes an average 1,100 days to enforce a contract

Opportunity #3: business-friendlier environment, more investment

- ❑ Continuing to privatize state-owned enterprises would i) allow better and less expensive services for the population and ii) attract foreign direct investment, which again can bring jobs and increase liquidity in the economy
- ❑ Favoring deeper capital markets and encouraging the development of an investment fund industry, within an appropriate regulatory framework, would help channel capital towards productive investment and reduce over-reliance on bank credit
- ❑ i) Reducing labor market redundancy costs; ii) opening up closed professions by streamlining licensing restrictions; iii) removing barriers to competition, including protection of firms and price controls; iv) reducing red tape; v) strengthening the legal system and vi) fostering innovation would all have a significant impact on medium-term growth

Opportunities and challenges on the road to long-lasting growth

“We must plan for freedom, and not only for security, if for no other reason than only freedom can make security more secure”

Karl Raymund Popper
The Open Society and Its Enemies