The End of the Memorandum Does not Mean the End of the Effort

Vincenzo Guzzo, IMF Resident Representative for Cyprus

June 28, 2015

1. IMF notes - in a policy paper - that monetary policy and structural reforms are equally important to tackle the legacies of the crisis and raise productivity. What does that mean for Cyprus which has already implemented a very tough program?

>> The priority for Cyprus is a sustained return to jobs, stability, and prosperity. With that in mind, accommodative monetary policy, including through the asset purchase program of the European Central Bank, is certainly an important channel to support economic activity in the short run and lift inflation expectations. However, looking further ahead, implementing structural reforms will be crucial to strengthen public finance and lay the ground for raising productivity, which is the essence of long-run growth. To that end, reforms such as revenue administration, public financial management, and public administration will be critical to lay the basis for sound public finances. To raise Cyprus's growth prospects, further efforts are also needed to improve the country's business environment by streamlining regulations and red tape, modernizing contract enforcement and judicial procedures, and reducing obstacles to growth in sectors such as tourism. Advancing on the privatization program will also be important to boosting investment, increasing efficiency, and improving the delivery of public services.

2. In less than a year Cyprus hopefully will exit the bail-out program. How do you assess the effort that has been made the last two years?

>> Cyprus' financial assistance program has been a success. After going through an unprecedented downturn, the economy has started stabilizing and we are now seeing encouraging signs, with growth turning positive and the number of jobs rising again. In the first quarter of 2015, Cyprus returned to positive growth for the first time in four years. Banks are now adequately capitalized, and their liquidity conditions have stabilized. Payment restrictions introduced to protect financial stability during the crisis have been lifted. Sovereign market access has been regained. The fiscal deficit has turned into a small surplus. Many challenges remain, but it is a welcome sign that the discussion is turning away from managing the crisis to how we can boost Cyprus's growth prospects.

3. Is the conclusion of the MoU also the end for the reform effort?

>> Not at all. It would not be a fair assessment if we did not acknowledge the challenges still lying ahead and if we did not stress the need for equally great efforts beyond the program horizon. On the road to recovery three key priorities stand out: i) banks should be in a position to extend new credit to the economy, which, in turn, would let firms invest and create more jobs; ii) the corporate sector should manage to attract more capital through foreign direct investment, which again would boost economic growth and employment; and iii) the government should steer the debt down, while continue protecting vulnerable groups affected by the crisis and targeting public investment to support the economic recovery.

4. Which are the main challenges still laying ahead?

>> Cyprus must deal with its NPLs: this is by far the most immediate challenge. Banks are

unable to lend, which means it is difficult for individuals and businesses to get credit. As a result, growth in the economy and jobs is less. So far, several factors have prevented all those involved from tackling the problem appropriately. Incentives for borrowers and lenders to restructure loans were low. Foreclosing on a property took years, to the point that no foreclosure took place at all. Corporate restructuring and personal bankruptcy procedures were obsolete. Banks lacked capacity and expertise to deal with large number of delinquencies. The solutions offered to borrowers were often window-dressing exercises. The result was no restructuring at all or few restructurings with high risk of re-defaulting, and little new lending.

The new debt restructuring framework is a major step forward. The foreclosure law should provide creditors with a credible threat against strategic defaulters and help restore a solid payment culture in the country. The personal and corporate insolvency framework should allow debtors to restructure their loans, for those who can, or, for those who really cannot pay, to have a "fresh start". The combination of the two sets of measures should encourage banks and borrowers to move towards quicker solutions, which, in turn, should free up capital for new lending and support growth.

Let me be clear. This is far from a "perfect law". Some of the last minute provisions introduced during the discussions in Parliament deviate from international best practices and risk undermining the effectiveness of the framework by delaying the process and keeping debt restructurings from happening. But it is a good starting point. It is now time to move on, implement the framework, monitor it closely, and review it, as needed, as evidence of its performance builds up over the coming months.

5. **We hear several forecasts for the economic activity during 2015. Which is the main trend for this year?**

>> We forecast marginally positive growth in 2015, a rate of 0.2 percent, followed by a further gradual expansion in the following years. Risks to this forecast are broadly balanced. Weaker external demand from Russia and Greece could weigh on private consumption and investment. Conversely, the effect of lower energy prices on households' purchasing power may support private consumption beyond current expectations. All in all, what matters is that economic activity has entered a path of gradual recovery, moving from an annual GDP growth rate of -5.4 percent in 2013 to -2.3 percent last year and, as we said, we expect to see a small positive number this year.

6. **The main critic to the program is that it creates too much pain and undermines the prospective of the real economy, through the high level of NPLs and the high level of unemployment. Do you consider this critic as well founded?**

>> The high level of NPLs and the high level of unemployment are legacies of the crisis. In the boom years, significant foreign inflows and loose supervisory practices had led to a rapid expansion of the banking sector and fuelled a property bubble. When the global crisis hit, the cycle went in reversal. Foreign inflows slowed down and bank credit shrunk. The property boom turned to bust. Borrowers started defaulting on their loans, eventually leading to a collapse of the banking system. Unemployment rose to an unusually high level for the country.

These are precisely the problems the program is trying to tackle. A lot has been said about the impact of NPLs on banks' balance sheet and capital, but not enough on the broader implications for the economy. NPLs approaching 60 percent of all loans for the domestic banks are preventing "banks from being banks", which means being able to extend new credit to the economy. Only by lowering NPLs, banks will be able to extend new credit to families and corporations, and to do that on better terms. In turn, this will support growth and jobs.

As for the high level of unemployment, as the recovery takes hold, job creation should continue to increase. The structural reforms mentioned earlier should support growth and likewise boost employment. In addition, Cyprus should continue in its effort to implement a modern welfare system able to ensure benefits for all those in need. A reform adopted last year has unified fragmented benefits under a single Guaranteed Minimum Income, the GMI. It has brought the welfare system of Cyprus in line with best practices in Europe. Going forward, the system will have to be monitored carefully to ensure appropriate coverage, prevent abuses and ensure that further changes do not fragment the system again. Over time, this will help improve adequacy of public assistance and reduce poverty.

7. In the same context, there is a lot of fear for the sale of loans to investors and especially to foreigners. Should the average household be afraid?

>> In the effort to deal with the NPL problem, all possible options should be considered and possibly used, including that of selling loans to non-bank third parties. Borrowers should not be afraid to the extent that they will be able to retain the same level protection offered to them under the Code of Conduct. The aim is precisely that of striking the right balance between attracting potential investors and ensuring adequate consumer protection.

8. The law-making of foreclosure legislation was not an easy process for Cyprus. Are you afraid of a repetition of the same scenario with the country's privatisation program?

>> The delay in the adoption of the foreclosure legislation reflected in part concerns that the law would benefit creditors without adequate safeguards in place for vulnerable borrowers, given the absence of an updated insolvency framework. In turn, the package of insolvency laws was delayed due to technical complexity and lengthy political deliberations. Eventually, Parliament ensured a broad-based support to the reform and allowed a fundamental step forward.

That same broad-based support would help the country making progress in other reform areas for the country, including towards the privatization of state-owned enterprises. Here an important point is worth noting. Privatization is often portrayed as a way to raise short-term revenue for the state budget, while the long-run benefits to the economy are not given sufficient emphasis. On the contrary, the main aim of privatization is not to realize revenue, but rather to realize these benefits. These are critical and include i) allowing for better and less expensive services for the population and ii) attracting foreign direct investment, which again can bring jobs and increase liquidity in the economy.

9. Why the scenario of a "bad bank" is not on the table? Could the "bad bank" be part of a comprehensive solution for the NPLs problem?

>> If by "bad bank" we mean a vehicle funded (fully or partly) with taxpayers' money to deal with the large amount of NPLs in the banking system, it is really hard to see any room for it in Cyprus. After all the efforts made to strengthen public finances, and as shown by the

experience in other countries, it would be ill-advised to use the public sector balance sheet to clean up the balance sheets of the banks.

A different question is whether capital can be attracted to set up a privately funded asset management company. This may well be a useful option that contribute to the restructuring of NPLs discussed earlier, even though we should mindful of the challenges in transferring assets at an attractive price for an investor, in the absence of state funding or government guarantees.

10. Key priority for the government is to attract FDI. What are the things that must change, in order for the country to reach this target?

>> Cyprus should double its efforts to make the country a good place to do business. The government's plan to put in place a growth strategy is a welcome initiative. Efforts should be addressed towards those areas where the gap relative to international best practices is the widest and the impact of reforms on long-run potential growth the highest. These include strengthening the legal system, opening up closed professions, removing barriers to competition, reducing red tape, and fostering innovation. These are all steps that could support growth, competitiveness, and innovation, and act as catalyst for further investment, thus helping to ensure a job-rich recovery. Many of these areas are well known and do not require further study, so is very much a question of getting it done.

11. Looking back, could the bail-in have been avoided for Cyprus? I am asking that because the program assumed worst conditions in the real economy. On the contrary, the recession was much less than expected and Cypriot banks attract foreign investors. In this perspective, do you believe that troika was unfair to Cyprus?

>> It is always difficult to assess the counterfactual and there were no easy options. Had upfront steps to deal with the banking system not been taken, then taxpayers would have been asked to foot the bill. This would have entailed onerous measures to correct imbalances and Cyprus might still be confronting questions about the sustainability of public finances. This might have weighed adversely on the economy and perhaps discouraged foreign capital. Thus, we consider that the path chosen was the least bad option.

Unfortunately, there is no quick fix to the economic crisis the country went through over the past few years. Only steady and resolute implementation of structural reforms along the path already started can ensure a sustained return to jobs and prosperity. The people of Cyprus have shown the way: it is only their determination in addressing economic and financial difficulties and for taking full ownership of far-reaching reforms that has allowed this progress. They should be given full credit for all the results the country has achieved. It is now a matter of continuing along the same path.