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The Financial Landscape of the Euro Area After the Storm

Klaus Regling, 11th Cyprus Summit, 3 November 2015

Dear President Anastasiades, Dear Minister Georgiades, Ladies and Gentlemen,

It is always a pleasure to be in Cyprus. And it is an even greater pleasure to see so many of you with whom the ESM has worked intensively in the past few years. And with some very good results, I might add. I also spoke at this conference in 2014. And what a difference a year makes! Cyprus has become an example of the progress that is possible in the euro area.

What does the world look like now that the worst of the euro area storm is behind us? Commodity prices are depressed, global indebtedness continues to creep up, investment and productivity are slowing. Greece is just starting its third economic adjustment programme. Many European banks are still burdened with large portfolios of non-performing loans. More broadly, there is the refugee crisis, and an ageing population. So it’s still a choppy sea, and it is essential for Europe to keep the pace of reforms going.

But the good news is that we are much better placed to face such challenges today than a few years ago. The focus of risks is shifting away from Europe, towards emerging markets. Forced by the crisis, the euro area has made a number of important institutional changes, and has deepened economic integration. Let me give you some examples. Firstly, there is far more budget discipline, and structural reforms have been implemented vigorously. This has restored competitiveness, and has made economies less vulnerable to shocks. As one of the few regions in the world, the euro area did not have its growth projections lowered by the IMF. The ECB is also helping, with an active monetary policy. We have much better economic coordination, for instance through the European semester and the new macro-economic imbalances procedure. Importantly, we have also advanced a lot with the Banking Union, creating a single supervisor and a single resolution authority.

Last but not least, we erected a firewall against future crisis with the EFSF and the ESM. These two institutions played a crucial role in saving the euro. In 2010, many people thought that would not be possible. But we did it. And this is a prime example of what euro area countries can achieve: to provide substantial financial solidarity in exchange for implementing significant reforms. Of the five countries that have received assistance, four are clear success stories by now. Greece remains a special case, though the newly elected government has an opportunity to make a clean break with the past. Former programme countries Spain, Portugal and Ireland are among the top reformers in the world, according to the OECD and the World Bank. In Spain, growth should reach 3 percent this year. Ireland is even looking at 6 percent.

Cyprus looks set to become our fourth success story, assuming it will continue its path of responsible policies. The country is getting its economy back in shape, and the government has used its time wisely to implement reforms. It benefits from the favourable conditions of the ESM loans. We currently charge an interest of less than 1 percent, far below market rates. This provides savings to the Cypriot budget of €260 million each year, or 1.5 percent of GDP. Not every citizen will already feel the effects of the turnaround. The benefits of many years of painful reforms will take some time to trickle through. But the country is growing again: GDP expanded in the first two quarters of this year, at the strongest pace since 2009. That expansion is set to continue. The labour market is improving, and job creation has resumed. In all likelihood, Cyprus can stand on its own feet next year.

That does not mean there is no work left. Future reforms in Cyprus should target an increase in competition in the non-tradable sectors, cut bureaucracy, reform the public administration and the legal system. All this is important for the competitiveness of the Cyprus economy. An even bigger issue looms in the banking sector – that of non-performing loans. This is a problem burdening many European banks, but it is particularly acute for Cyprus. The stock of impaired loans at banks across the euro area rose above 900 billion euros during the crisis. In Cyprus, it stands at €27 billion, or about 1.5 times GDP. This ties up capital that banks cannot use to grant new lending for consumption and investment. Solving this issue would be a substantial complement to the Juncker plan, the ambitious EU investment plan. Solving the issue of non-performing loans won't be easy – not in Cyprus, and not in Europe as a whole. It requires modernizing foreclosure and insolvency frameworks, and opening the market for professional service providers to preserve the value of problem loans and maximize recoveries. Impediments on the sale of loans must be removed, and securitization enabled. So it's an impressive to-do list. But the potential benefits are enormous.

Has Cyprus completed its metamorphosis? This is one of the questions the conference is raising today. My answer is a qualified yes. I am confident that Cyprus will continue to work to solidify the achievements of its economic transformation.

Let me finish by looking somewhat further ahead. There are many ideas on how to further integrate the European economy, and make it more resilient. The so-called five presidents' report includes proposals for a limited fiscal capacity for the euro area, and stronger commitment to structural reforms. Creating the role of a euro area finance minister is another option. Particularly important is completion of the banking union and building a capital markets union, which would further enhance risk-sharing between national economies. Several of these proposals can be implemented without a burdensome change of the EU Treaty.

Europe has made great strides in improving cooperation, and it's showing result. Today, the euro area is in much better shape to face challenges than before the crisis. Cyprus too has turned a corner. Without the solidarity offered in the euro area, the impact of the crisis would have been far worse. Let's not wait until the next crisis before deepening Economic and Monetary Union further.

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