

Rolf Strauch in interview with Cyprus News Agency

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Interviews

ESM

Interview with Rolf Strauch, ESM Chief Economist Published by *Cyprus News Agency*

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CNA: How would you describe the course of the Cypriot economy, since the country's exit from the economic adjustment programme back in 2016?

Rolf Strauch: Cyprus is one of the success stories of the ESM. The country is experiencing high growth rates. Last year the economy grew by 3.9% and now it is projected to slow down somewhat to about 3%, closer to the country's long-term potential growth. This is not a reflection of economic weakness. We see this moderation in growth as part of the normalisation phase after years of "above-potential growth", leading to a cooling down also for other euro area countries and for the euro area as a whole. It is not a Cyprus-specific phenomenon.

Over the recent years, the country has done a good job in attracting investment and employment, which are important drivers of growth. Obviously, there are still vulnerabilities, namely the high public and private debt, and the non-performing loans.

Cyprus is a small, open economy and therefore exposed to external risks, such as trade wars, Brexit, and fluctuations in currencies like the Russian ruble and the

Turkish lira. These external risks may affect the development of the country. From that perspective, there is good reason to be prudent in terms of policies and to keep fiscal buffers.

What are the challenges that need to be tackled in Cyprus going forward?

The economic performance of Cyprus has been good but some vulnerabilities remain. Public debt is high, but has already been declining and is expected to continue this downward trend going forward. That is a good achievement. There have been some initiatives to diversify the economy and to grow more in sectors that so far have been underdeveloped. For example, in education and the energy sector. Countries that are able to diversify their economic structure, reduce vulnerabilities and can stay on a good growth path. Cyprus needs to tackle its non-performing loans, as they are a vulnerability to the economy. Despite the significant drop in 2018, a large stock of non-performing loans still weighs on the Cypriot economy. To put it into context, non-performing loans on bank balance sheets have been reduced drastically over the last years: they were reduced by 60%. But at the same time, their size is still about 50% of GDP. And this is clearly too high.

Recently we had sales of non-performing loan portfolios and also the orderly resolution of the Cyprus Cooperative Bank. We see that non-performing loans are offloaded from the banking sector to asset management companies, which means that non-performing loans decline but private debt remains elevated. What in your view should be the authorities' approach on this issue?

The government took several initiatives to reduce non-performing loans. I am thinking in particular of three: the Cyprus Cooperative Bank, the ESTIA scheme and the legal framework.

In view of the NPL subsidy scheme ESTIA, we now need to see if it ensures a sound payment culture. We will continue to assess the situation and will be seeking the feedback of the government and the Central Bank of Cyprus.

Banks report first positive signs of the improved law on insolvency, foreclosure and sale of loans. The main reduction of the non-performing loan portfolio last year was through the transfer or the resolution of the Cooperative Bank as well as the loan

sale by the Bank of Cyprus. We hope that actually the loan sale can be the incipient moment for developing the market for non-performing loans. There are policy measures taken to develop a market for non-performing loans, but ultimately the responsibility lies with the banks.

How would you respond to people that say that offloading non-performing loans from the banks to asset management companies may lead to mass foreclosures and auctions?

Banks need to comply with the regulatory requirements that are given to them. This requires an efficient management of non-performing loans. But the government has put ESTIA in place foremost to protect home owners.

If you had to single out one main challenge what would that be?

I have mentioned the main challenges that need to be addressed. Maybe the most imminent is indeed the level of non-performing loans that deserves attention.

On Greece, is the country heading towards fiscal derailment following the social measures adopted by the government?

Klaus Regling in the Eurogroup press conference on 16 May made our concern very clear and let me just refer to that. We see that risk-aversion in the financial markets increased globally. This affects countries where the financial markets are not entirely clear about the economic situation and the economic policy course. It also applies to Greece. And that is why we have seen Greek credit spreads increasing by 50 basis points over the last weeks.

The Greek government announced a new set of budgetary measures. Some of these measures have been implemented and already adopted by the parliament. We do not have a complete assessment but our preliminary assessment indicates that with these measures, the primary surplus target of 3.5% this year might not be reached by a significant margin. In 2020, there will be a new budget, so this is harder to predict but if the announced measures are implemented then that could become even more of an issue.

Another point is that the measures that were taken are not really growth-friendly in

the medium- to long-term perspective. They may help short-term growth, but this differs from a medium- to long-term perspective. And this is a concern for us, as the largest long-term lender to Greece by far.

With respect to the euro area economy, many analysts express fears for a slowdown or even a recession, driven mainly by trade tensions between the US and China which could affect the EU the most. What is the outlook of the euro area economy?

For the euro area economy as a whole, I see a normalisation of growth. This means, we are not heading into a recession. In 2017 euro area growth was clearly above its potential. What we are observing now is a maturing of the cycle. Although the main downside risks come from the external side, there is some robustness in the domestic economy driven by employment, wages and consumption. But we have to be mindful of risks such as trade wars. Trade wars affect an economy not only directly through sanctions but also indirectly through increased uncertainty, which can undermine investments.

Immediate fears of a recession are clearly overdone, but at the same time we need to be cautious and prudent.

Is Europe prepared or is ready to face a possible downturn?

One of the key differences compared to ten years ago is that Europe now has the ESM, which significantly strengthens its institutional infrastructure. Another quantum leap after the euro crisis was the creation of banking union. All institutional improvements that were introduced with banking union, made the financial structure and the banking sector safer. The Euro Summit decided last December on a set of measures in order to finalise much of the process of institutional strengthening. Next to strengthening the ESM, there is also the task of completing banking union with a European deposit scheme, and the discussion over a euro area budget. The euro area budget will primarily be directed towards convergence and competitiveness. The budget would give another layer of robustness to architecture of the euro area.

What remains for the completion of the ESM reform?

We are now working towards the implementation of a broader mandate for the ESM.

That means a draft ESM Treaty should be submitted for endorsement in June, first to the euro finance ministers and then to the Euro Summit. The treaty also needs to be ratified by the 19 ESM Member states and their national parliaments. This will take a year or more. The first elements of this broader mandate would be for the ESM to provide the backstop to the Single Resolution Fund. In case the Fund ran out of money, the ESM would provide a credit line. Second, the ESM will – jointly with the European Commission – negotiate, design and monitor financial support programmes. Third, we are looking at our financial instrument toolbox. We aim at making the precautionary credit lines more efficient. This should help countries that are affected by contagion, the so-called “innocent by-standers”. The final point is that member states want more clarity on how we can deal with sovereign debt sustainability in the future.

On the banking union, wouldn't you agree that there is a paradox here, supervision and resolution, the two pillars of the Banking Union, are in place whereas the most important part, the European Deposit Insurance Scheme is still absent?

Banking union was clearly meant to have three pillars: the first two pillars have been created with supervision and resolution tasks. And now there is the very important task to also build the third pillar, which is the common deposit insurance scheme. Having a common deposit insurance after an appropriate further reduction of risks is overall beneficial. It helps to avoid bank runs and it gives a layer of security for depositors. The ESM programmes would have been smaller if such an insurance were in place during the crisis. Because a significant amount of the money was spent on bank recapitalisation. That is why we think the common insurance scheme adds to the stability of the euro area.

What we now need to clarify is what are the conditions for putting this insurance in place. And that is precisely what we are currently discussing. There must be agreement on risk reduction before countries can jointly enter such a scheme. But the long-term objective is to have such a common deposit insurance scheme in place.

Do you believe that ten years after the financial crisis, risks in the banking sector have been sufficiently reduced to warrant the establishment of the common deposit insurance scheme?

A common deposit insurance is an important piece to complete banking union. I agree that a lot has been done in risk reduction over that period. Non-performing loans have been reduced, although they are still too high in some countries, including Cyprus. The banking sector has also become safer through more capital and by building up bail-inable liabilities. It is a matter of how far you want to go. Eventually, we have to agree on the conditions for everyone to sign up for a common deposit insurance scheme.

There have been voices that the fiscal rules in the euro area are creating austerity in member-states, which in turn fosters political extremism in the EU. How do you comment on such views, should the EU fiscal rules change?

In a currency union with a single monetary policy but national economic and fiscal policies, common fiscal rules are a requirement for the good functioning of the currency union. However, there are valid reasons to look into the European fiscal rules. Over the crisis, the European fiscal rules have become more complex, probably even too complex. This complexity makes them very hard to communicate and therefore less effective. There is reason to see whether the fiscal rules can be simplified to be more effective. What does it mean to make the EU fiscal rules more effective? It means that countries create the necessary fiscal room in good times in order to have the ability to spend in bad times.

If the fiscal rules were more effective, it would generate more trust among member states. And they would provide flexibility to actually smooth economic shocks and support growth when it is needed most. A key component of the current fiscal rules is the medium-term fiscal targets that should lead countries to build up buffers when growth is strong, and allow a country to react to downturns. Part of the fiscal rules is also that there can be exceptions when there is a severe downturn.

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