

Klaus Regling in interview with Phileleftheros (Cyprus)

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Interviews

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Interview with Klaus Regling, ESM Managing Director

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How do you evaluate the Cyprus economy? How can our country differentiate its economic model from the current dependence on services, real estate and tourism?

Cyprus staged a solid economic recovery in 2015, supported by three years of ESM assistance. Cyprus's growth is expected to remain robust, with moderate risks in the medium term. Although challenges remain, I believe the Cyprus economy is doing well even with the current specialization. Of course, it's always good to try to diversify because if one country is too dependent on certain sectors, the economy is vulnerable. A disorderly Brexit would be one example. Cyprus could also suffer from the consequences. Beyond tourism, there are some other areas where Cyprus can have a competitive advantage and the government is trying to diversify its economic model in that direction. That could be: higher education health and energy sectors. I believe those are areas where Cyprus might have a competitive advantage. Some proposals have been submitted by the government to the House of Representatives. That's certainly positive.

Cyprus has high growth rates and surpluses. What should the government's priorities be?

It's good to achieve a sound fiscal situation. I can only applaud that. And that will be important for a while in order to bring those high debt ratios down. It will also be important to strengthen the banking system in order to reduce further non-performing loans (NPLs). A lot has happened -NPLs are already down by three quarters from their peak level- but it would be good- and the government is planning to do so- to eliminate NPLs or bring them closer to a very low normal European level. Moreover, the profitability of the banking sector is low. After NPLs are reduced further, the profitability of the banks will increase and the banking sector can play its important role in any economy: to provide credit to the economy.

Although it's been 6 years since the haircut, the banking sector still faces challenges. Did the banks fail to implement the appropriate measures to deal with NPLs?

No I don't think it would be fair to say that the banks failed because the adjustment in Cyprus was very large: a bigger adjustment than in any other European country. And what we are seeing now and what remains to be dealt with are legacy problems from that period. We also see that the profitability of many European banks is low. This is not only a problem for Cyprus but also in northern European countries like Germany for instance - probably for different reasons. But the fact remains. Profitability is low. When I look at European banks compared to U.S. banks, there is a big difference in profitability. So that's something that many countries need to work on.

The NPLs level in Cyprus is still high.

Well, there's no further growth and NPLs have come down by three quarters. The progress has been significant and there are plans now under discussion to bring the NPLs down to a normal European level.

So, are you satisfied?

Yes. However, the work is never finished.

The government has not succeeded in the privatization field. Do you agree?

I think that's probably an area where more could be done. As Minister Harris Georgiades said at the Economist Conference, the Government has introduced proposals but there is not a clear majority in Parliament for them. We would support those additional efforts for more privatization if it improves the overall efficiency and benefits the Cypriot economy.

Finance Minister Harris Georgiades said that the proposal for partial privatization of Cyta will be revisited. Are you in favor of that proposal?

It is up to the government to come up with proposals and I would not wish to comment further than that. I would only repeat that we support the government's additional efforts for more privatizations if it will benefit the Cypriot economy.

Cyprus has been criticized over the investment for citizenship scheme. Do you agree with all that criticism?

From the ESM perspective, we were not involved. It's an issue between the government and the European Commission. The European Commission checks carefully whether the schemes are okay or misused and they do that not only with Cyprus but also with other countries that offer similar schemes, like Portugal and Malta. And as a European, I can only say that it's important to avoid any misuse. If somebody enters a border of any EU member state, the citizenship gives him the right to move freely throughout the European Union. So it's very important to really avoid the misuse and offer citizenship after proper due diligence. And I know that the Cypriot government is looking into improving the system because it seems there were a few cases of misuse in the past. That must be avoided.

The memorandum required reforms in the public service. Do you think Cyprus has delivered?

The government is in the process of the administrative reform which I think is an important step to improve the efficiency of the public sector. There's also another important issue: the reform of the judicial system where Cyprus is lagging a bit behind other European countries. We don't look at political issues, but we look at

issues that affect economic performance and the reform of the judicial system could also be beneficial for the economic performance.

Cyprus has implemented a national health system, since June. Do you fear this will have a negative impact on public finances?

The reform of the National Health System was a positive step and very important for citizens. But governments in all countries around the world have to be very careful and monitor the expenditure side because health care expenditures typically rise faster than economic growth. This is linked to the technological progress and to the high demand for medical services as society gets older and richer. That also applies for Cyprus. It's very important to keep an eye on the cost.

The Ministry of Finance is waiting for the Supreme Court to rule on whether money should be returned to public servants. There have been concerns that this issue could spark a new crisis. What is your opinion?

This is something that has happened in other countries that borrowed money from the ESM. We have seen on several occasions that a Supreme Court declares certain measures as unconstitutional and then the government has to decide what to do and to take steps to compensate for that.

For instance, in Portugal. The government took certain measures to reform the pension system which basically meant to reduce pension expenditure. It was declared as unconstitutional. So the old provisions had to be reinstated which left a gap in the budget. In that case it was more serious because it happened while the programme was still ongoing. But the Portuguese government adopted compensatory measures.

In my view, Cyprus now is in a better place. The programme has been implemented and economic growth is back. In that sense, it will be easier to deal with any problem that comes up. I know that the Cyprus government is preparing for that. Given that the economic and also fiscal developments have been positive the past years, I certainly do not foresee a crisis as a result of any court ruling.

What are the future challenges?

As I have argued, Cyprus has solid growth, but it is, like any other economy, subject to overall and country-specific vulnerabilities. Looking ahead, external risks such as Brexit, protectionism and high exposure to financial market volatility may affect the country's growth. I don't see another crisis coming either for Europe or for Cyprus in the foreseeable future. However, we know that there will be crises from time to time. That is why we must do everything to try to prevent them.

Are you confident that Cyprus will pay back the €6.3bn owed to the ESM?

Yes. Our lending terms are generous in respect to maturity and in terms of low interest rates. So that's our way to help the Cypriot adjustment.

A recent report by the Commission comments that the 10 B. euro bailout package for Cyprus should not have been approved so easily. Instead, the international lenders should have put more pressure before disbursing the money. What is your opinion?

We all look back to try to understand whether we made mistakes in the different adjustment programmes, what could have been done better. I believe in the case of Cyprus the main lesson is that the program should have been introduced earlier. It would have been less costly and the adjustment would have been easier. So the question and the quote you use out of a long report seem to indicate that the programme should have happened later. I think it should be the opposite: it should have been introduced earlier.

Is Europe close to a new recession?

The slowdown in euro area growth since last year has been sharper than expected, and there are downside risks ahead. But this does not necessarily mean that we are heading into a new recession. Overall, we have strong economic fundamentals sustained by favourable financial conditions. And growth in the euro area is still close to its potential. We have to remember that not every cyclical slowdown leads to a recession, and not every recession leads to another crisis.

What measures are taken by the E.U. in order to protect countries from another economic slowdown?

We are working on further steps to deepen the monetary union. The ESM will play a stronger role in the future economic adjustment programs. Moreover, we are discussing steps to complete the banking union and have a new budgetary instrument for the euro area. As I have argued many times, the euro area today is better equipped to deal with a future crisis than ten years ago, but there is still work to be done.

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