

## “Restoring confidence in Cyprus - Thinking beyond the crisis”

Nicosia, 4 November 2014 – Klaus Regling, Managing Director, ESM

- Good morning!
- I’m delighted to be here today to discuss ways to restore confidence in Cyprus and look beyond the crisis. In particular, I look forward to hearing the views of both the Minister of Finance Harris Georgiades, and the Governor of the Central Bank of Cyprus, Chrystalla Georghadji.
- Before turning to what will bring about a prosperous future, I would like to recall what brought this country to the brink of economic collapse.
- In the run-up to the 2008 global crisis, Cyprus had accumulated large imbalances and vulnerabilities that were masked by an average 4 percent annual growth rate:
  - Consumption climbed to almost 90 percent of GDP in 2008, which was not sustainable. This led to a 5 percent annual growth in domestic demand
  - As a result, the current-account deficit widened to about 16 percent of GDP at the end of 2008. This reflected surging imports and an erosion of external competitiveness as wage growth exceeded productivity
  - Banks assets increased to more than 8 times GDP. Total private indebtedness exceeded 3 times GDP
  - Non-performing loans rose to €29 billion by the end of August 2014.
- The sheer scale of these imbalances led Cyprus to request financial assistance from the ESM and IMF. It has been one of most demanding programmes but, to date, Cyprus has delivered a lot.
- The long maturity and low interest ESM loans have helped ease some of the painful burden of adjustment. Until the most recent review, all were completed on time – a remarkable achievement and a sign of ownership.

- Many problems are beginning to turn right for Cyprus. Why? It's due to the rigorous programme implementation, the resilience and flexibility of the economy, and the dedicated work of people in both the private and public sectors.
- Importantly, the Cypriot banks passed the ECB stress-test with only one bank requiring a small and manageable capital shortfall – this was a good result and sends a strong message to bank customers and markets.
- A year and a half ago large scale bank restructuring started – a time no doubt that few here will ever forget.
- And yet this year, macro-fiscal performance has been well ahead of targets, a primary surplus may already be within reach. This performance is getting noticed – with positive attention from both the markets and the rating agencies.
- This Cypriot recovery is beginning to resonate very well with performances of the other four EFSF and ESM programme countries. They are already showing more signs of recovery, but then, their programmes began much earlier.
- According to the OECD and other research, our five programme countries, Ireland, Portugal, Spain, Greece and Cyprus are amongst the top reformers in the EU and in the OECD area. We disbursed total loans of €232 billion over the last three and a half years to these 5 countries.
- I have already spoken about some of the adjustments in Cyprus, but all the 5 programme countries are well positioned for future growth, if they continue their reforms – that's why they are increasingly being called the “reform champions” of Europe.
- What are these reform measures? They involve removing barriers to competition by opening closed professions and reducing bureaucracy, reforming labour markets, cutting public expenditure, reforming tax systems, and other important structural measures (strengthening public administrations).

- The policies chosen were in the best interest of each individual country and of all euro area as a whole. Any alternative that would have included the risk of a disorderly exit, or a disintegration of the currency union, would have proved much more costly than the path we chose.
- And the outcome is becoming very clear: Competitiveness is restored, unit labour costs and current account deficits have decreased and fiscal deficits are cut. In Ireland, growth this year may reach 4.5%. Ireland, Spain and Greece are also seeing unemployment rates starting to fall. With a continued reform drive, Cyprus will follow a similar path.
- The ESM programme has supported Cyprus with a total disbursement of €5.35 billion until now, with €1.5 billion for bank recapitalisation. As a proportion of total GDP, the Cypriot programme was the second highest of our five programme countries.
- Since our interest rates are so much lower than what markets have been offering Cyprus, our loans have resulted not only in more time to reform, but also in a significant financial benefit.
- The total budgetary saving for Cyprus in 2013 was 1.5% of GDP, or €240 million. Or to put another way, it corresponds to over one fifth of fiscal spending on education or over 41% of health expenditure. Cyprus also benefits from a lengthy repayment schedule, with the first principal loan repayment due to the ESM in 2026 – 12 years from now. Because of this, the debt profile for Cyprus is very sound as long as reforms continue.
- Looking to the future for Cyprus, it is now important to reignite the momentum and quickly complete the 5th programme review. This would send yet another positive signal to boost investor confidence. Needless to say, reforms don't end with the programme, for the sake of Cyprus and future generations of Cypriots, they need to continue.
- In the short term, effective management of non-performing loans are amongst the most - if not the most - important area where further progress is needed. So, putting in place an effective foreclosure and insolvency framework will be in the best interest of the Cypriot economy.
- The experience from previous crises demonstrates that an active and swift solution to problem loans is key to restoring the ability of a bank to finance new business.

- To conclude: I would like to stress that Cyprus has several fundamental strengths like its skilled professional services sector and the country is an important example of political stability in the region, underpinned by EU and euro area membership. Of course, with sunshine all year around, Cyprus is also an attractive destination for people, like me, from the north of Europe and elsewhere.
- We do not know yet what the exact potential from hydro-carbon reserves might be, so let's leave this as potential upside, but not count on it.
- Taken together, these advantages should enable Cyprus to reposition itself so that during the coming decade it can build a more diversified, balanced and prosperous economy with sustainable growth and high employment.