# The Crises of Others: Greece and the Eurozone Periphery –The Case of Cyprus

Foundation of Economic and Industrial Research

**Cotsen Hall, Athens**

**Thursday, 21 April 2016**

## Presentation by Mikis Hadjimichael, PhD, CFA

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**and former senior official of the *Institute of International Finance* and the *International Monetary Fund***

Disclaimer: Personal views and not necessarily those of the Bank of Cyprus Board and Management

# Some Common Truth

***"People only accept change when they are faced with a necessity and only recognize necessity when crisis is upon them"***

*Jean Monet*

# Prologue

**Quote from the *Financial Times* Lex Column, April 1, 2016**

***"In the hierarchy of banking sins, loosing shareholders' money is unfortunate and losing creditors' money is unforgivable. Losing depositors' money is unspeakable – except at the Bank of Cyprus, which has announced plans to switch its primary listing to London three years after becoming the first eurozone bank to bail in depositors as part of a recapitalization."***

**This is an indication of the progress made by Cyprus.**

# Outline: Six Key Questions

1. What were the causes of the crisis in Cyprus?
2. What has been achieved?
3. What made the success possible?
4. What is the unfinished reform agenda?
5. How do Cyprus and Greece compare?
6. What are the shared lessons for success?

# 1. What were the causes of the crisis in Cyprus?

- **Cyprus faced consumption- and investment -led overheating, a fiscal crisis , a property boom-bust crisis and a banking crisis**

- **Bursting of housing price bubble in 2008 in the context of the global financial crisis**

- **Continued excessive bank credit expansion until 2008, particularly in the housing and real estate development sectors**

- **Poor bank risk management and corporate governance**

- **Poor bank supervision**

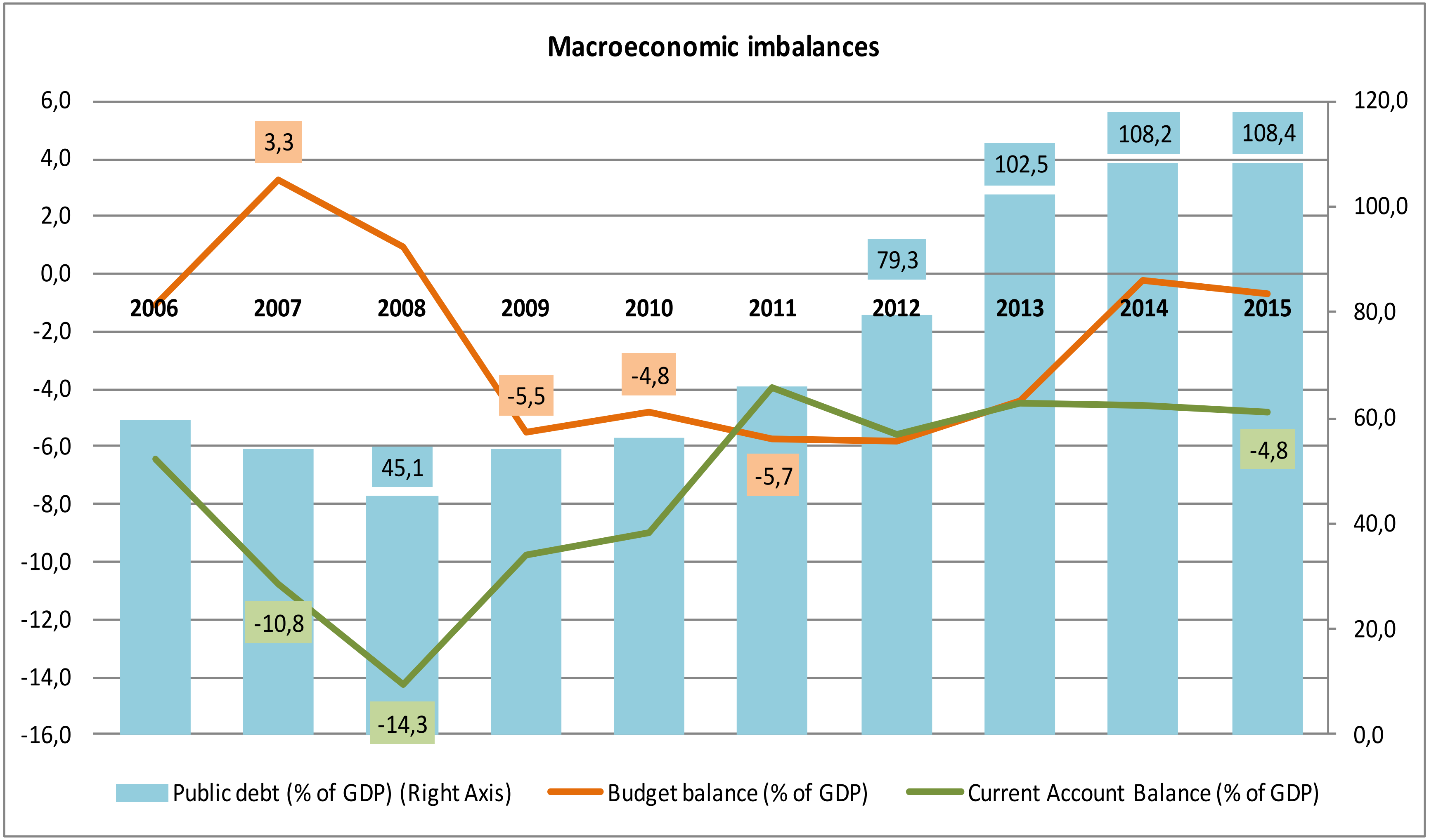
# 1. What were the causes of the crisis in Cyprus? (Cont.)

- **Unsustainable and imprudent expansion of banking system to 8 times GDP, including to subsidiaries/branches in Greece, Russia and East European countries, with unfunded contingent government liabilities in the form of deposit guarantees of around 130% of GDP**
  - **Made possible by:**
    - **Large deposit inflows from Russia**
    - **British and other EU capital inflows for house purchases**
    - **Interest rate liberalization prior to EU entry in 2004**
    - **Excessively loose ECB monetary policy after Eurozone entry in 2008**
    - **Limited policy options to curb credit expansion other than macro prudential policy and L/V ratios**
    - **Search for high yields by bank managers, diverting foreign deposits into domestic consumer and housing loans, as well as investments abroad and in Greek Government Bonds**

# 1. What were the causes of the crisis in Cyprus? (Cont.)

- **Poor fiscal policy and public debt management**
- **Expansionary fiscal policies during 2008-2011 through permanent civil service wage increases and increases in social benefits**
- **Loss of access to capital markets in May 2011**
- **High cost structures and worsening competitiveness**
- **Denial and unforgivable delays by the government in taking corrective policy action**
  - **Motivated by a desire to avoid political cost**
  - **Despite emerging gaps in bank recapitalization and request for ESM/IMF assistance in June 2012**
  - **Despite pleadings by Eurozone officials to accept financial assistance during June-October 2012**

# Structural imbalances were manifested in large and deteriorating current account deficits, large fiscal deficits and rising public debt



# 1. What were the causes of the crisis in Cyprus? (Cont.)

- **The end-result was for Cyprus to "miss the boat"**

- **Forced to accept radical and unprecedented solutions for bank recapitalization in March 2013 after a new government came to office:**

  - **Merging of selected assets and liabilities of Laiki bank (including ELA and guaranteed bank deposits) with BOC, wiping out of BOC shareholders and bond holders and bailing in at 47.5% of unsecured BOC depositors**

  - **Closure of remaining Laiki bank, wiping out shareholders, bond-holders and bailing in 100% of unsecured depositors**

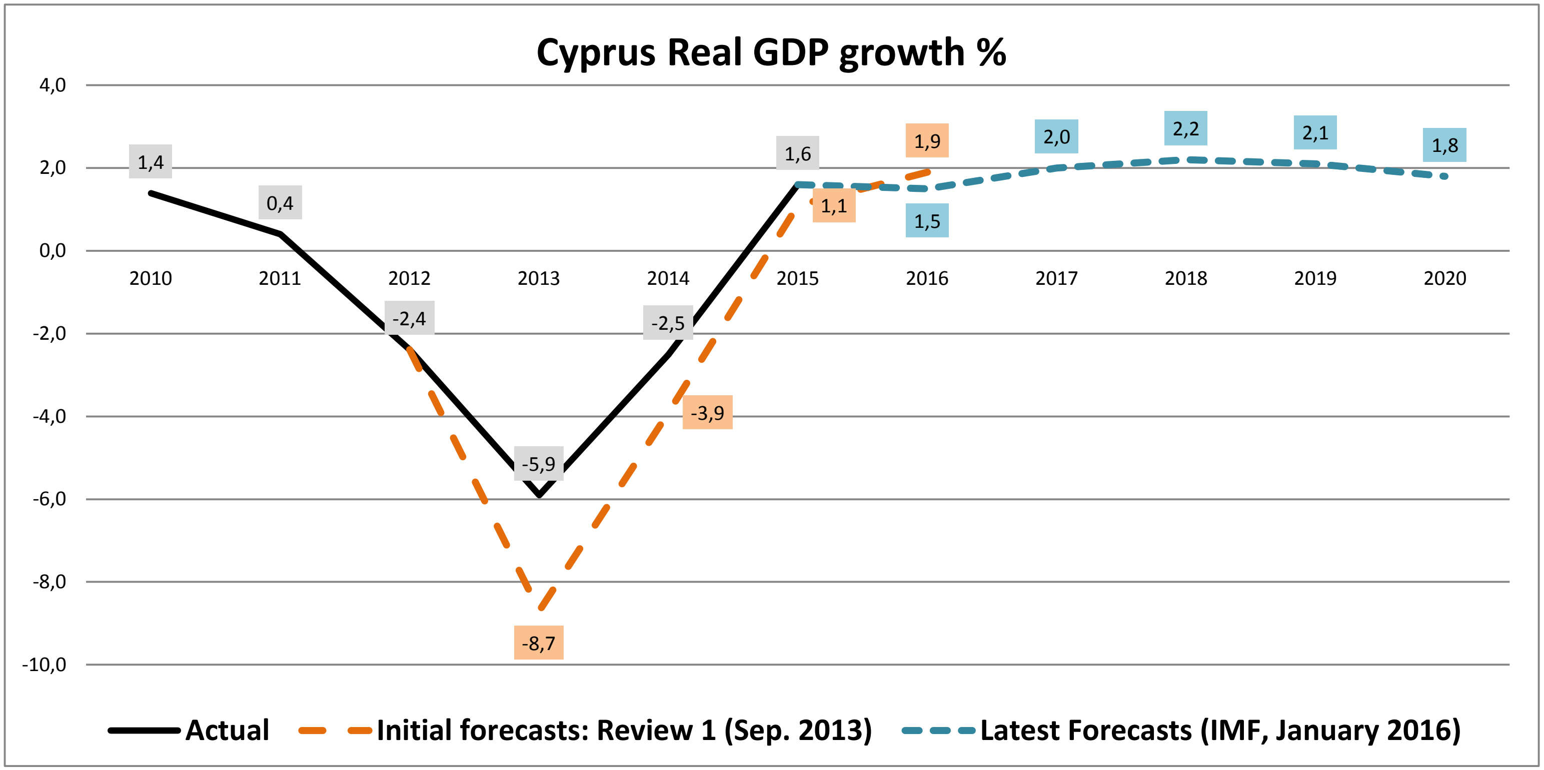
  - **Sale of Cypriot bank branches in Greece to Piraeus Bank**

  - **Imposition of capital controls and restrictions on bank transactions**

# 2. What has been achieved?

- **Lower contraction in output and stronger GDP recovery in 2015 than initially projected**
- **Less shallow recession (10% cumulative decline during 2012-14) due to resilience of private consumption and activity in the tourism and professional services sectors**
- **Stronger improvement in public finances than initially projected**
- **Levelling off of public debt at 108% of GDP and regaining of capital market access at less than 4% yields**
- **Restoration on financial stability and enhanced confidence in banks, culminating in the complete lifting of capital controls and bank restrictions by April 2015 and a recovery in bank deposits since end-2014 (especially for BOC)**

# 2. What has been achieved? (Cont.)



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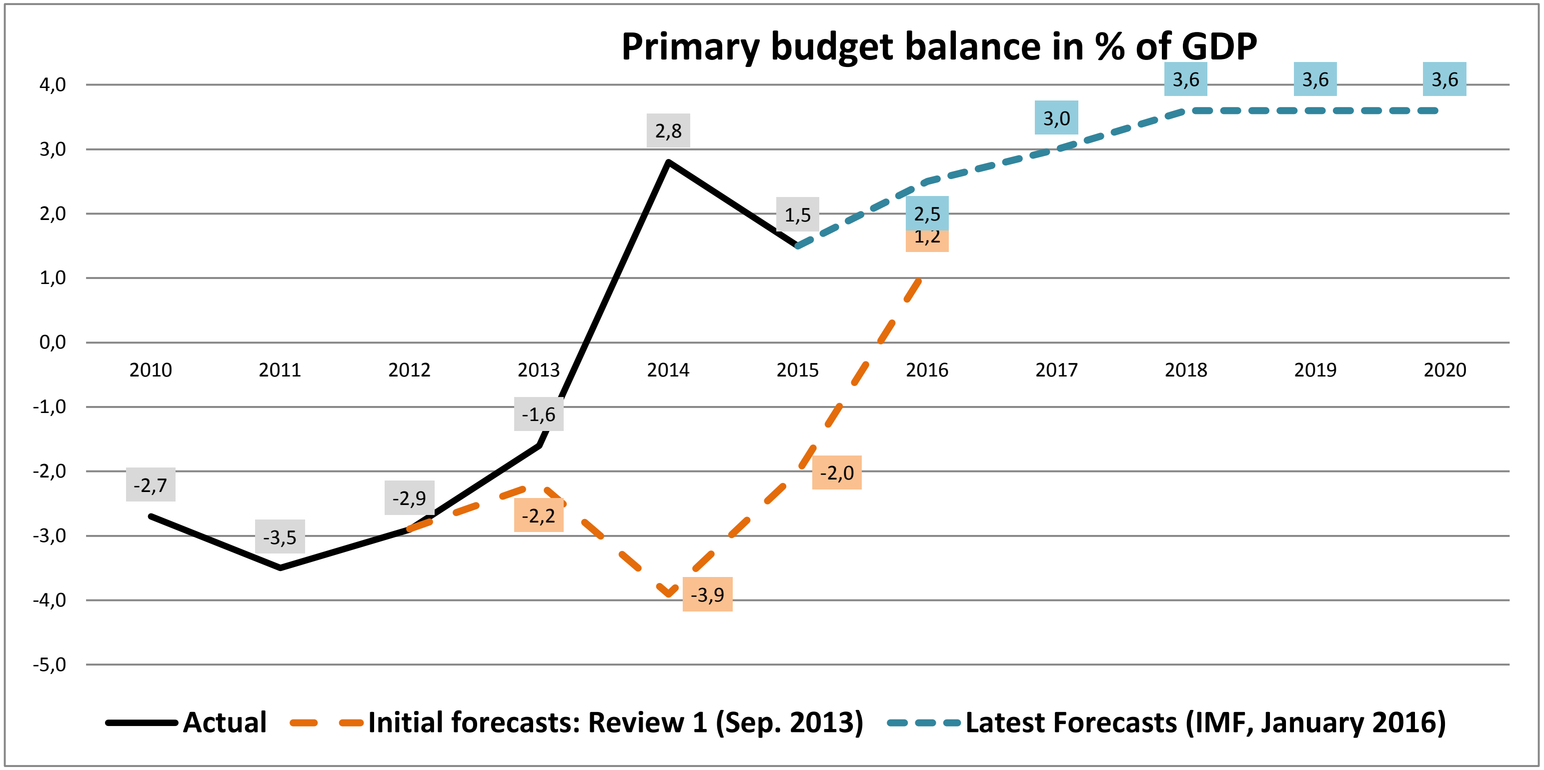
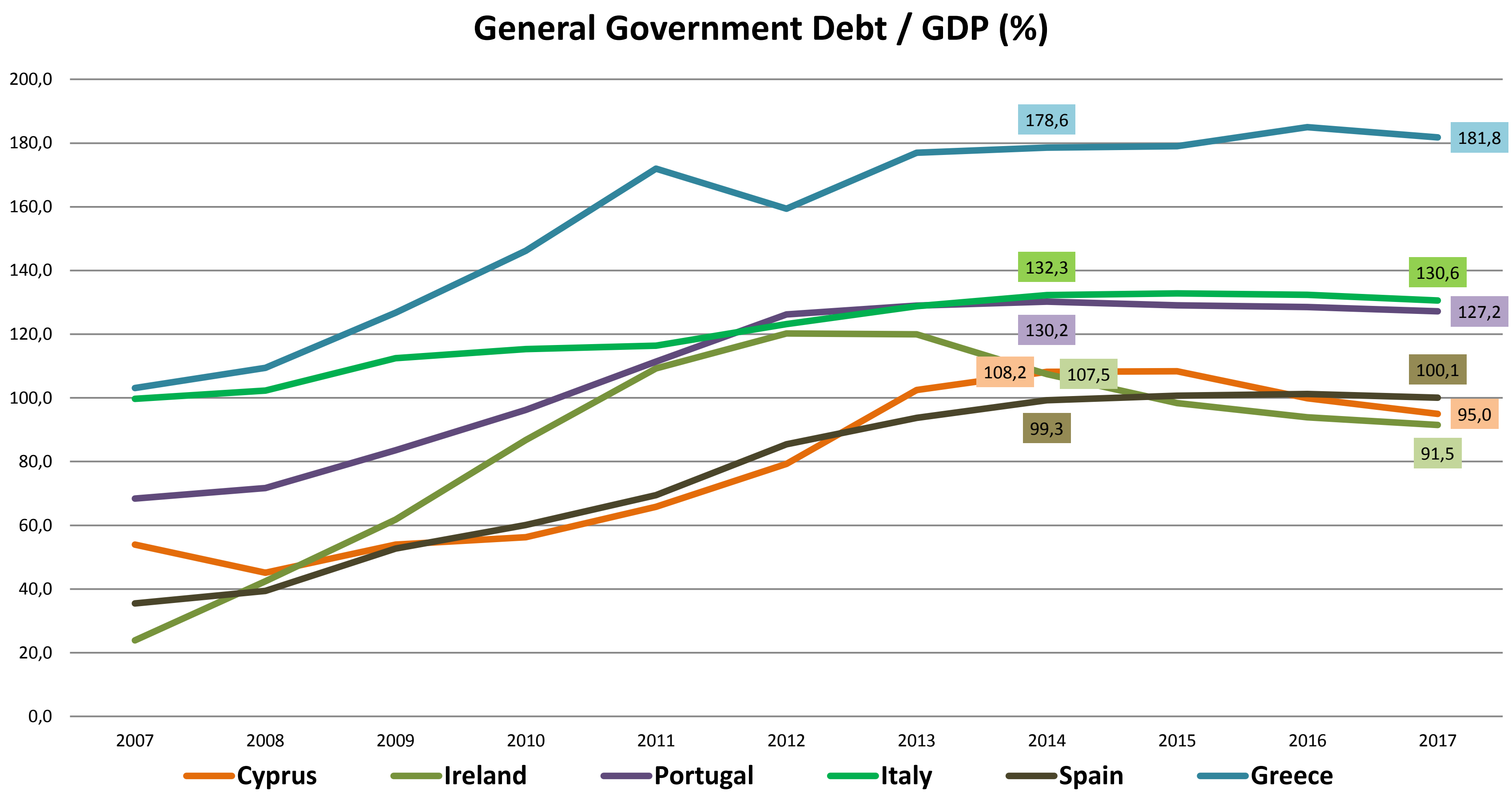


# 2. What has been achieved? (Cont.)



# 2. What has been achieved? (Cont.)

- **Yet, the unemployment rate remains high at over 15%, particularly among the young (32%)**
- **Non-performing bank loans remain exceptionally large (around 60% of gross loans for the three systemic banks), but restructuring activity and bank provisions have escalated since Q4 2015**
- **Households and corporate sectors over-indebted with continued deleveraging needs**
- **New bank lending is very modest due to very low creditworthy demand; credit-less growth**
- **Weakening political support in parliament since mid-2014 led to delays, a watering down or even postponement/cancellation of key structural reforms and to a premature exit from the Troika-supported program in March 2016 without completion of all reviews and the disbursement of all available financial support**
- **Growth projected at 2% during 2016-2020, with unemployment rate remaining at 10% by 2020**

# 3. What made the success possible?

- **Mature response to the crisis and the bail-in of depositors by the Cypriot population**
- **Sharing of the bail-in burden with foreign depositors**
- **Strong commitment to the program (ownership) by the government and the ruling party**
- **Upfront fiscal adjustment with no additional fiscal measures during the course of the program**
- **The buoyancy of economic activity that facilitated better-than-expected fiscal outcomes**
- **Timely completion of program reviews contributed to enhancing confidence and the early regaining of market access**

# 4. What is the unfinished reform agenda?

- **Structural reforms to promote faster growth**
- **Need to promote domestic and foreign investment**
- **Stronger growth is needed to reverse the increase in unemployment and facilitate NPL reduction**
- **Risk of complacence and of losing the reform momentum**
- **Constraints to growth:**
  - **Rigidities in legal system, labour market, unexploited comparative advantage in tourism**
  - **High NPLs, strategic defaults, non-payment culture**
  - **High household and corporate indebtedness, prolonged deleveraging, credit-less growth**

# 4. Unfinished reform agenda: What needs to be done?

- Improve further the business environment, cut government bureaucracy
- Enhance urgently the effectiveness of the legal system—slow speed of dispute resolution and inadequate protection of investor and creditor property rights
- Improve the functioning of the labour market – need to modernize the industrial relations framework, reduce rigidities, and introduce more flexibility; insider-outsider problem
- Carry out privatizations of CYTA, EAC and CPA
- Implement urgently key sectoral reforms - National Tourism Strategy

# 5. How do Cyprus and Greece compare?

- Different underlying causes and severity of the economic crisis
  - Greece: fiscal crisis with spillovers to the banking system
  - Cyprus: housing and bank crises aggravated by fiscal imbalances
- Differences in timing: Greece first, Cyprus last EA crisis

# 5. How do Cyprus and Greece compare? (cont.)

- **Differences in Eurozone crisis management mechanisms and Troika adjustment strategy**
  - **2010-No EU mechanism, gradually moving to EFSF, ESM, SSM, SRM, BRRD**
  - **Greece: Program design mistakes, adjustment fatigue, administrative weaknesses, lack of ownership and political support, excessive reliance on tax rate increases in an environment of poor tax collection and tax evasion, unequal sharing of the burden of adjustment, excessive adjustment costs for private enterprises, undermining confidence and recovery prospects in an environment of still major structural rigidities**
  - **Greece: record fiscal adjustment and output and employment losses, yet no gain despite the pain**
  - **Cyprus: Eurozone/IMF lending fatigue, no risk to the Euro after mid-November 2012, tougher approach by Troika, partly due to policy mistakes by Cyprus**
  - **Cyprus: Shallower fiscal adjustment and output loses partly due to bail-in, better government bureaucracy and program implementation, and stronger political support and leadership by the Ministry of Finance**
  - **Differences in the handling of the banking crisis: Troika relatively lenient for Greece, harsh for Cyprus**

# 6. What are the shared lessons for success?

- **Program ownership is fundamental to success**
- **Avoidance of overloading the implementation capacity with too many structural reforms**
- **Broad based political support essential for parliamentary approval of reforms and their effective implementation**
- **Prolonged negotiations, followed by partial implementation and lack of ownership of agreed reforms is a recipe for disaster: All pain and no gain**
- **Negative feedback loop between fiscal imbalances and the banking system**
- **Negative feedback loop between political support for the program and confidence by both the public, and financial markets and investors**

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