

Rolf Strauch in interview with Politis (Cyprus)

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Interview with Rolf Strauch, ESM Chief Economist

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Politis: The Cypriot economy is performing better than the euro area average. What does Cyprus need to do from now on to maintain this growth momentum?

Rolf Strauch: The Cypriot economy is indeed performing strongly and is proving particularly resilient. It is expected to continue to grow more than the euro area

average, according to market participants and official institutions. At the same time, inflation is falling, and is below the euro area inflation rate.

This strong performance is recognised by all major rating agencies, which now rate the country investment grade, and is the result of the reform efforts over the last decade.

But there is always more to be done. Especially because we are living in a world of great uncertainty, with wars erupting in neighbouring regions. Cyprus should continue its proven path of prudent fiscal policy to keep investor confidence and maintain the necessary buffers.

Overall, implementing the Recovery and Resilience Plan, with its growth-enhancing reforms, should be a priority going forward.

Which is the most important reform to implement in the next few years?

Two very important areas are diversifying and modernising the economy, and being prepared for the effects of climate change.

One example is fostering digitalisation, including in the public sector. This will increase productivity and the attractiveness of 'doing business' in Cyprus. Attracting foreign investment in this area has already helped increase digital know-how in the country.

Further diversification of the economy would help to increase the economy's resilience to external shocks.

Regarding climate change, Cyprus should take actions to increase its capacity to cope with these shocks to preserve future economic growth.

The country's national Recovery and Resilience Plan (RRP) includes important reforms and investments in both areas. This is why the efficient implementation of the plan is key.

Cyprus has come under pressure from an international journalistic investigation, Cyprus Confidential. The investigation paints a picture of Cyprus as an offshore centre to help Russian oligarchs. Is this a problem for diversifying the economy? Should Cyprus also invest in its image to solve reputational problems?

I understand that the Cypriot authorities are evaluating the report and immediately responded, underlining their commitment to address possible issues and starting an investigation. Ensuring transparency is very important for the country's reputation and credibility.

A stable legal and regulatory environment, including respect for the rule of law is important for any economy, including that of Cyprus.

Demonstrating the commitment to strengthen and enforce a sound legal and regulatory approach to business and investment, will contribute to a stable and healthy business environment.

This will help both to further diversify the economy and to mitigate potential reputational risks. But, the diversification of the Cypriot economy requires much broader policy initiatives, beyond this media investigation.

A new moratorium on foreclosures is still in place. There is also an ongoing discussion in Cyprus about how to protect borrowers and how to protect the primary residents. Are you concerned about the ongoing discussion? Do you see any risks?

Banks have significantly reduced the level of non-performing loans on their balance sheets. This is a very good development. At the same time, it is still higher than the euro area average.

Even more concerning is that non-performing loans in the non-bank financial sector remain very high. That tells us that non-performing loans have not been resolved and are still a drag on the economy.

The recurring suspensions and discussions on amending the foreclosure framework affect the willingness and the ability to work out these non-performing loans.

A clear, effective, and stable legal framework would bring certainty to all parties and support the use of constructive voluntary solutions, like restructurings. Legal and policy certainty is also important for foreign investors interested in Cyprus' financial system.

Of course, you still may want to protect the most vulnerable borrowers, and that can be done with specific government programmes. But having a strong foreclosure framework is a necessary condition to deal effectively with non-performing loans,

safeguarding future growth and financial stability.

What will happen if Parliament passes legislation that freezes the foreclosure process?

It's not for me to speculate, and the ESM fully respects parliamentary procedures and decisions. I can only repeat that it is very important to have an effective foreclosure framework to deal with existing non-performing loans.

Unresolved non-performing loans, and uncertainty about how to manage potential future ones, weigh on new lending opportunities and banks' profitability. Borrowers are not able to return to banks as viable clients, which ultimately inhibits future economic growth.

Will less debt help the economy grow more in the long run?

If you have many individuals or companies still carrying a lot of debt, that will hamper their ability to borrow in the future. And if you have a lot of households and firms in that situation, it can reduce the overall ability of banks to lend, and therefore support investment. In the case of non-performing loans, this is where a stable foreclosure framework could help.

In the next two years, Cyprus will have to start repaying the loan from the ESM. Is the country able to easily repay this loan?

We do not see problems for Cyprus to repay its ESM loans. As I said before, growth is relatively robust and above the euro area average.

Public debt as a share of GDP is expected to come down to 80% this year and then continue to decline. And Cyprus has an adequate liquidity position. Also, the improving sovereign ratings contribute to Cyprus's repayment capacity.

Having said that, it's important for small and infrequent bond issuers, like Cyprus, to maintain an adequate liquidity buffer for the foreseeable future.

So, it is important for the country to produce a high level of surpluses in the coming years?

The country's draft budgetary plan which envisages significant primary surpluses is considered by the European Commission in line with its fiscal guidance.

In our view, Cyprus should have sufficient liquidity to cover future payments. This places Cyprus in a good position and has been the strategy followed so far. Other countries, which we have worked with, and supported, have also followed this strategy successfully over time.

Do you think government spending could be at risk? Does the size of the state payroll worry you, along with the possibility of increased healthcare expenses?

Cyprus has maintained a rather prudent fiscal position over the years. Like other countries, Cyprus needs to address fiscal risks, including expenditure overruns.

There is a general agreement that euro area governments, not only Cyprus, should maintain a prudent fiscal stance this year and next, to align monetary and fiscal policies.

That includes the phasing out of the energy support measures. This will also give more space to the government in the future to keep supporting the most vulnerable citizens and to finance the most critical areas.

These are times of uncertainty. Europe must deal with two wars, one in Ukraine and now one in Israel. At the same time, there is a lot of uncertainty around energy prices. Is the European economy able to cope with these two wars?

The European economy proved to be very resilient in the face of the pandemic and the cost-of-living shock, after the Russian aggression against Ukraine.

That resilience was due not only to national measures, but also, to a significant extent, because of European initiatives, such as Next Generation EU. This resilience shows up very strongly across Europe, especially in labour markets.

But there is still uncertainty, as you say, especially surrounding military conflicts. Growth is weak and some investors are predicting a technical recession this year. Even though the underlying fundamentals are sound, and some of the vulnerabilities and imbalances that we have seen in the past have overall been avoided.

So, EU Member States must remain vigilant and maintain a prudent policy stance. I am hopeful that they will be able to cope with this situation.

Energy prices are also affected by these conflicts, in the Middle East and Ukraine. And interest rates are expected to stay higher for longer. This puts pressure on governments to implement more measures to lower people's energy costs.

Energy prices have indeed moved, but only moderately. The conflict in the Middle East has been a factor that drives oil prices up. At the same time, slower growth reduces demand and helps to stabilise energy prices.

We need to wait and see how the conflicts evolve. It goes without saying that the most severe impact of any conflict is on the people.

In any case, this affects the yields of European bonds, Italian bonds. Even German bonds. Are you afraid that Europe will enter another debt crisis in the next few months?

I do not expect Europe to face another debt crisis in the next months. Monetary policy responded strongly to inflationary pressures. And for that reason, interest rates have increased sharply to 4 percent. This is a very significant move and is driving government bond yields up. We have seen some spread widening, but it has been quite contained so far.

Any interest rate increase affects public debt as governments roll over debt. The increase is not immediate, it is phased in over time. That also gives governments time to adjust.

According to our calculations, the interest rate increase as such over the next decade will lead to an increase in the effective cost of financing of one percentage point, on average, for the euro area. This is manageable, but it can be significantly higher for highly indebted countries.

Governments' fiscal space has clearly become smaller because financing is more expensive. Governments need to make clearer decisions about spending and financing priorities and be prudent.

Some member states, including Italy, are choosing to run deficits in coming years. This contrasts with what you are saying. What is your recommendation to those member states?

The main guideline is the one agreed in the Eurogroup, by the 20 euro area finance ministers. Governments should pursue a restrictive fiscal policy, and phase out

temporary energy measures, so that monetary and fiscal policies are not pulling in different directions. This is the priority.

One last question on the Stability and Growth Pact. Member states are trying to review the Pact by the end of this year. If member states cannot find common ground, what will that mean for European debt markets?

We fully support this important discussion. Member states are very engaged in this review and there are active negotiations going on.

From a market perspective, if governments come to an agreement, investors will have a clearer sense of what EU fiscal policy will look like going forward. The lack of a decision could lead to more market volatility and wider interest rate movements in the future.

But I would say, not only the markets, but also the people have a right to know where governments' spending is going.

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