Staff Statement Following the Fifth Post-Programme Surveillance Mission to Cyprus

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28/09/2018
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European Commission staff, in liaison with staff from the European Central Bank (ECB), visited Cyprus from 24 to 28 September to conduct the fifth post-programme surveillance (PPS) mission and undertake specific monitoring of macroeconomic imbalances under the Macroeconomic Imbalance Procedure (MIP). The mission was coordinated with an International Monetary Fund (IMF) Article IV mission. Staff from the European Stability Mechanism (ESM) also participated in the mission on aspects related to the ESM's Early Warning System.

The Cypriot economy continues its strong cyclical upswing, creating favourable conditions for tackling the key vulnerabilities of the country, thus ensuring sustainable growth. After recording an impressive GDP growth rate of 4.2% in 2017, the economic expansion has continued at a robust pace in the first half of 2018, while inflation has remained subdued. Further increased tourism and construction activity have had positive spill-overs to the other sectors of the economy. The labour market situation has also continued to improve, with employment increasing across most sectors and unemployment falling rapidly, while youth unemployment remains high. Looking forward, growth should remain solid but decelerate somewhat over the medium term. Risks to the outlook stem predominantly from the reduced, but still very high, non-performing loans (NPLs), high private and public debt, and higher levels of uncertainty in the external environment.

The sale of Cyprus Cooperative Bank (CCB) to Hellenic Bank (HB) has

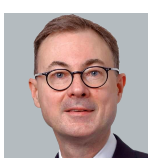
reduced uncertainty in the financial sector, improved depositor confidence and helped consolidate the banking system; but significant challenges remain, including the reduced but still very high NPL ratio. The CCB sale has put the banking sector on a sounder footing and was an important driver for the return of the Cypriot sovereign to investment grade for the first time since 2012. Around one third of total NPLs (or EUR 5.7 bn) were shifted from the CCB to the publicly-owned wind-down entity. The envisaged large NPL sale by Bank of Cyprus (BoC) is expected to further significantly reduce the NPL ratio in the banking sector, which nevertheless remains the second highest in the euro area. The mission welcomed the adoption of the legislative package to accelerate NPL resolution, which included amendments to the insolvency and foreclosure frameworks, legislation on the sale of loans and the adoption of the securitisation law. Improving the payment culture needs to remain the government's overarching priority. In this context, the mission stressed that the final design of the ESTIA scheme should mitigate moral hazard risks and fairness issues. It will therefore be important that eligibility criteria are tightened and that, should there be re-default, foreclosure will be promptly initiated. Moreover, it will be essential to ensure that the CCB residual entity is independent from the government and its sole objective is to divest its assets with a view to maximise the returns to the state in a swift manner. This and other commitments undertaken in the context of the state aid decision will be closely monitored by the Commission. Other challenges also include the full integration of CCB into HB, which should be carefully managed. Overall, the banking sector continues to be under pressure, given low interest income, the potential need for additional provisions in the context of high NPLs, and high operating costs.

Buoyant tax revenues, combined with prudent expenditure management, resulted yet again in an impressive fiscal performance, but the CCB sale comes with very high costs for the government. Headline and primary surpluses further increased in the first seven months of 2018 compared to the same period in 2017. However, the fiscal implications related to the sale and orderly winding down of CCB have resulted in a large increase in public debt and may also weigh on the budget balance in 2018, depending on the still to be determined statistical treatment. This sale has also resulted in contingent liabilities in relation to the Asset Protection Schemes (APSs). The final costs to the government will depend on the actual proceeds from the NPL workout by the residual entity and the potential losses under the APSs. Although the public debt-to-GDP ratio is expected to resume its declining path as of next year, it remains one of the highest in the euro area. This calls for safeguarding fiscal sustainability in line with the requirements of the preventive arm of the Stability and Growth Pact. In this context, increasing pressure for fiscal relaxation should be resisted, particularly in view of contingent financial sector liabilities, potential cost overruns from the implementation of the healthcare reform, and the cyclical nature of tax revenues.

Renewing the structural reform momentum is necessary to sustain strong economic growth. The strengthened legal framework for NPL resolution needs to be complemented with the comprehensive reform of the judicial system, including more efficient court procedures, stronger legal enforcement of commercial claims, and resolution of the high backlog of court cases. Moreover, efforts need to be stepped up considerably in order to accelerate the issuance and transfer of title deeds, especially with regards to the resolution of the legacy cases. It is also important to enhance the business environment and attract productivity-enhancing investment by, inter alia, swiftly adopting the strategic investment law, opening up the electricity market, and proceeding with foreseen privatisations. Other pending reforms that should be given priority include the local government reform and the integration of pension and insurance supervision.

The mission would like to thank the Cypriot authorities for their constructive and open discussions and IMF and ESM staff for their cooperation. The next PPS mission will take place in spring 2019.

Contacts



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