Rolf Strauch in interview with Politis (Cyprus)

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Interview with Rolf Strauch, ESM Chief Economist
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Politis: Five years after the crisis, two years after the programme ended, what is your feeling about the Cyprus economy today?

Cyprus's economy has turned around. Overall, we can say that Cyprus is a success case, when looking at the performance after the ESM programme. You have 4% growth after a very severe crisis. This is a very strong performance, and the country is growing above potential growth, estimated at about 3%. That is also very good when compared to other euro area countries. Nonetheless, if you grow for a time above your potential, you can expect the economy to slow down. That is also what we expect to happen in other European countries. At the same time, the government has used the opportunity to build up some strengths. You have a primary surplus of more than 5% and that is certainly very valuable. Having said that, some vulnerabilities remain, related to banking sector and the high level of private debt. Being a small open economy, there are also risks attached to the external environment. Brexit, Turkey and the volatility of the Turkish lira could all affect the country. It's good that an effort is being made to create buffers and pursue further reforms.

Talking about reforms. What exactly does the country need to do?

There are two important reform areas. One is the reform of the judicial system that has already started. And the second area is the creation of a sovereign wealth fund. With the right governance, such a fund could potentially function as a kind of buffer, like a rainy day fund, that can help in the future to prevent crises.

After 2019, the growth is going to be slower than today, below 3%. Does that have to do with the business model of the country or is it something normal, expected? Our economy still depends on real estate, tourism, professional services.

Cyprus is now growing above its potential, a rather high growth rate of 4%. You now see some slowdown. I don’t find this worrying. This is normal and what is expected to happen in most European countries. I would not conclude from that there is a need to structurally change, as you called it, “the business model of Cyprus”.

The other big problem of the country is the high level of non-performing loans. How urgent is it to address this problem?

I agree it is indeed a problem that needs to be addressed. The level of NPLs is still high, very high compared with other countries, and something needs to be done. The good sign is that the level has started to decline. The Bank of Cyprus announced a possible deal with a US investment fund for the sale of a large NPL portfolio. This is important because it can be a first catalytic step toward creating a market and more transactions may follow. Also, the government has announced a strategy for dealing with NPLs, including the sale of Coop to Hellenic Bank, the Estia scheme and the further improvement of the solvency and foreclosure laws. These are important steps going forward to address the problem.

The Cypriot banking system is still a big banking system, when compared with the country’s economy. Is more consolidation in the banking system something that is needed? Would that be helpful for the economy?

In fact, the size of the banking sector has reduced drastically and is now in line with the EU average. The question is not whether there is an optimal size for a banking system compared to the size of the national balance sheet. One of the important steps of the Banking Union is the attempt to move away from that and create a European banking market that can work across borders. Having said that, there is still too much competition, which undermines profitability, in the European banking sector, and certain national banking sectors. It depends very much on the business model whether banks can operate profitably. In Cyprus, due to the NPL problem among other issues, more steps need to be taken to improve profitability.

You mentioned the Banking Union that remains incomplete. How crucial is it, for the stability of the Eurozone, that EU leaders make the proper decisions by the end of the year on the common backstop for the single resolution fund and the European Deposit Insurance Scheme?

This is important because a better working Banking Union will make the euro area more resilient. The main initiatives of the Banking Union, shifting the supervisory authority and the resolution authority to the European level, have already happened. Now it’s about completing the third pillar, which is the financial backbone. We need an integrated and well-functioning euro area banking sector. Two main steps are being discussed. The first is a common backstop to the single resolution fund. This will come into place at the latest in 2024, and the ESM will have that role. The second is a common deposit insurance scheme. The progress here is more difficult but keeping that objective is very important because when we do have it, it will make the overall structure safer. The ESM programmes could have been smaller if there had been a common deposit insurance scheme in place during the crisis,.

What about the ESM, how do you see the role of ESM going forward? Will it be the “shadow budget” of the Eurozone?

We will not be the budget of the Eurozone. That is not being discussed. The ESM is a crisis resolution mechanism and it will remain a crisis resolution mechanism.

A European IMF?

You can call it the European monetary fund, but the name is secondary. We remain a crisis resolution mechanism that is there to support the euro area when countries run into economic problems. The discussion that we are having now is how strengthen the ESM to fulfill that role even better. One of the points is having an enhanced role during the programmes and, together with the European Commission, do more in designing and managing them. Over the past years we have shown, for example, that we have great expertise when it comes to debt sustainability analysis and issues related to market access, which can be useful in future crises. We also need to think about the instruments at ESM's disposal. So far, only two of the six instruments available have been used. Policymakers are discussing, for example, how the credit line instruments can be streamlined to better prevent a deeper crisis in the future. Finally, there is talk on whether the euro area needs some central fiscal capacity, but this is a much longer discussion, and I don't think that it will be resolved in the near term. There are many ideas for this, including the possibility of the ESM providing short-term loans that would help stabilize economies. At this stage, the main point is to strengthen the role of the ESM as a crisis resolution mechanism and to get it more involved in the future, when problems emerge.

A lot of the elements of Banking Union are still missing and the Eurozone does not have a fiscal capacity. Could those gaps in the policy tools be a trigger for a new crisis?

We are working very hard on the agenda of the Banking Union right now in preparation of the euro summit in December. As for a fiscal union, I don't think we need a full fiscal union. If you look at the instruments that are actually available, you have the EU budget, that provides funds, and in some cases is very sizeable, and you have the EIB that supports investments. You then have the ESM as a crisis resolution mechanism when countries face a severe crisis. What is missing in the end is a stabilization facility that would support a country hit by an asymmetric shock and provide some financial assistance to avoid a bigger crisis. Such a facility would not lead to permanent additional transfers or debt mutualization.

Is Italy a real problem for Europe?

The key point is that we need assurance that the Italian debt and the Italian fiscal situation is sustainable in the long run. Because that is what eventually helps the economy, protects taxpayers and also protects all those that have invested in Italy and Italian bonds, including Italian pensioners and families. This is exactly what the European fiscal rules are about, preserving sustainability, and why the guidelines were set up. It is right that the European Commission applies the rules. This is also eventually what financial markets will be looking at to ensure that Italian public finances are sustainable in the long term. That is the path the Italian government should follow in order to achieve long-term growth. We see that spreads have widened, but at the same time volatility has been limited recently. So markets are in an observing state and it’s the responsibility of the Italian government to gain their trust.

The main goal of the ESM programmes is that countries regain access to financial markets. Until now Greece has failed to build a robust access to the markets.

I am confident that Greece can gain access to markets, provided the country continues to implement the agreed reforms. We have set the best possible conditions for that, with reforms that will help improve the country’s economy, and also through debt relief measures. As a result, Greece saves a lot of money. With the cash buffer, the Greek government does not have to rush to the markets. I am very confident that the Greek debt management office is doing its best and it is running a proper strategy to regain market access. The cash buffer provides comfort to investors and gives the government the possibility of only accessing the markets when it is appropriate.

Can the cash buffer be used to support the Greek banking system?

The cash buffer was set up to cover sovereign debt payments. Other purposes have to be agreed by all ESM member states.

So it is possible for the cash buffer to be used for other purposes?

As I said, it wasn’t designed for more than servicing the country’s debt obligations. It’s a backstop in case there is not enough money for the sovereign. To use it for other purposes would require a decision by the ESM governing bodies.

Is the reversal of the pension cuts a signal that Greece is back tracking on reforms or are these cuts no longer needed because the country has achieved its fiscal goals?

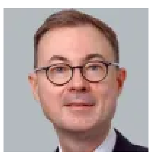
The situation is being assessed by the European Institutions and, as you know, there will be a Eurogroup meeting on 19 November where this topic could be discussed. We are following the situation closely. Also, importantly, the commitment to achieve a primary surplus of 3.5% is not being questioned by anybody in the Greek government – so that’s also positive. But there is the understanding that previous commitments under the ESM programme should be respected or discussed with the institutions. We are currently going through that process.

Author

Rolf Strauch

Chief Economist and Management Board Member

Contacts

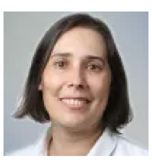


Cédric Crelo

Head of Communications and Chief Spokesperson

+352 260 962 205

c.crelo@esm.europa.eu

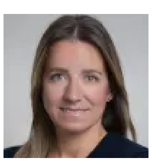


Anabela Reis

Deputy Head of Communications and Deputy Chief Spokesperson

+352 260 962 551

a.reis@esm.europa.eu



Juliana Dahl

Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu