Interview with Klaus Regling, Managing Director, ESM

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Phileleftheros: Cyprus is concluding its cash-for-reform programme with the European Stability Mechanism (ESM). How will you track the progress from now on to ensure the loans are repaid?

Klaus Regling: There is a standard monitoring framework that will apply to Cyprus as to all former programme countries. The ESM will need to protect its claim as creditor – that is an obligation under the ESM Treaty. It is called the Early Warning System, in shorthand EWS. Under this system, the ESM monitors a country's financial situation to be sure our loans are repaid on time. Additionally, Cyprus will be subject to the European Commission's so-called post-programme surveillance. Furthermore, like all EU countries, Cyprus is fully integrated in the macroeconomic surveillance and coordination framework under the European semester and the standard surveillance by the IMF, which is also a creditor.

But as the ESM programme ends, I want to acknowledge the country's major achievements, given the enormous difficulties it faced when the programme started in 2013. Cyprus completed nearly all policy conditions attached to its programme. That allowed it to start regaining market access and to successfully complete the programme. Cyprus is yet another example of an ESM programme where sound fiscal and economic policies coupled with determined reform implementation allow for its progressive return to a sustainable economic model and stable growth.

However, this does not mean all is good now. There are big challenges ahead and the government must continue to implement reforms and conduct a responsible fiscal policy.

Do you have any concerns given that not all programme reforms were completed?

At the end of a three-year programme it's important to look back and check on the progress made. Consider where Cyprus was three years ago and where it is now. The difference is remarkable. It turned a dreadful outlook into a prosperous one: it converted an economic contraction of 5.9% in 2013 into 1.4% growth in 2015. The public deficit went from 5.8% in 2012 to 1% in 2015. It stabilised the banking sector after adopting some of the most challenging features of crisis resolution to date in Europe, such as bail-in and capital controls. The experience in Cyprus confirms what we have seen in other programme countries such as Spain, Ireland, and Portugal: the strategy of providing loans to a country in a deep crisis in exchange for economic policy reforms works.

It is true that one prior action of the last review was not completed. That is regrettable. But it is important to keep implementing reforms after the programme and not to become complacent. The President of Cyprus and the Finance Minister have stated repeatedly that this will be the case in Cyprus. In my experience, modernising the governance of state-owned companies and ensuring an efficient public administration are part of good housekeeping in any country. Only then can a country stay competitive, bolster investor confidence, and weather unexpected challenges that may be outside the country's control. Just think of the recent volatility in financial markets. Or the refugee crisis that Europe is currently coping with.

What kind of prospects and opportunities do you see for Cyprus after the programme?

Cyprus has gone a very long way when you look back to 2012 when it first requested an ESM programme. These years have been very demanding for the Cypriot people, the government, and its administration. Cyprus really does deserve credit for what has been achieved. Fiscal imbalances have been corrected, the country's debt profile is now good and the cash position comfortable. Also, legal frameworks have been upgraded. Banks have been restructured and recapitalised, bank supervision markedly strengthened, and the public sector significantly reformed. In other words: the basis for sound economic development has been laid.

Looking ahead, Cyprus is expected to grow about 1.5% in 2016. The EU and euro area memberships give Cyprus clear advantages in the region. Of course, to leverage these advantages and opportunities Cyprus should continue to implement sound policies. It must have sound banks that are in full compliance with all regulations. It must maintain a flexible labour market and keep up its attractiveness as a regional investment destination.

From your experience with other countries, what are the potential risks?

Complacency is a clear risk after an adjustment programme. There is often a temptation to yield to the political pressure to delay or stop the reforms. Reforms are almost always politically difficult to do and to sustain. Often people are asked to give up benefits that the country can no longer afford. Embracing reforms is the only way a country in a crisis can restore its competitiveness, maintain it, and increase the living standard of its citizens. As it leaves the programme and its tight surveillance, Cyprus will now have to mobilise the political will and the consensus to continue reforms. If Cyprus stays on the reform course this will further enhance investor trust in the country's long-term economic perspective.

If Cyprus reunifies, do you believe that our commitments towards the EU to repay the loans will derail? If so, how could this threat be avoided?

I have no doubt that Cyprus will honour its obligations towards the ESM and its other creditors and that reunification would have no impact. Quite the opposite, if the reunification goes ahead – as I hope – it will be a great opportunity for growth. We all know from Germany's reunification that such a fundamental event comes with a cost. But as for Germany, I am convinced that the benefits for Cyprus would clearly outweigh these costs. It would send a strong signal of stability in the region. And the economy could benefit greatly, for instance the tourism and the hydrocarbon sectors.

What would you recommend to address the serious problem of non-performing loans?

Non-performing loans – also called NPLs – are indeed the biggest remaining problem to solve. The level of NPLs is, at 47%, the highest in Europe. It is encouraging that the level has peaked and the NPLs are now adequately provisioned and even show some signs of decline. But they continue to tie up a significant part of banks' capital in Cyprus that could otherwise be used to finance new businesses. There are new tools to be used. Banks should make use of the new foreclosure and insolvency frameworks to pursue sustainable restructurings. In this regard, it is equally important that the judicial system works efficiently, and has the necessary resources to handle these cases.

What about reducing unemployment?

The best cure for unemployment is growth. We have seen how sound policies have created a virtuous cycle in Cyprus leading to growth. Unemployment is traditionally a lagging indicator, it is one of the last to pick up in a recovery. But although the level is still high we are starting to see a decline. Furthermore, reforming the Cypriot labour market and making it more flexible will make the country more attractive for investors. New investments will also create new jobs. Reunification is also an opportunity for investment and hence growth and jobs.

A possible Brexit, how would that affect the rest of the European Union?

That is clearly a scenario we neither want nor need. Politically, it would weaken the European Union as a whole. Don't forget that the UK is a large country, a net contributor to the EU budget and a relevant power in foreign and security policy. But economically, it would mainly be a problem for the UK. The country would be separated from the EU, its largest trading partner. There would be a lot of uncertainty about the future relationship with the EU. A separation from the EU would have an effect on foreign investors who now see the UK as the gateway to the single market. If that is no longer guaranteed, some of this foreign direct investment is likely to go directly to the continent.

Some fear that Grexit is unavoidable. What is your view?

When you look at what has changed since the crisis began, you have to give Greece credit for what it has already been achieved. There have been many hiccups and setbacks in the political process but Greece has made progress in addressing some key economic problems. All of this would not have been possible without the sacrifices that the Greeks made.

Greece was always the most difficult case in the euro area crisis. This is the reason why we are now in a third adjustment programme, which is an ESM programme, and why we are already in the seventh year of crisis. By contrast, Ireland, Portugal, and Cyprus were able to deal with their problems in a three-year programme.

But Greece had the biggest macroeconomic imbalances. It had problems on the fiscal side. It was uncompetitive. Current account deficits were very large and there was a general lack of structural reforms. Things have improved on all fronts. International institutions like the OECD, World Bank, and the World Economic Forum measure progress in structural reforms. Today they all agree that Greece has implemented more reforms than other countries. By 2014, imbalances in the Greek budget deficit or current account deficit had been greatly reduced, growth had returned, and market access had again become a reality.

This was encouraging. I am now confident that this new cycle of sound policies that the government began adopting last summer, when the ESM programme started, can bring Greece back to sustainable growth. We are only at the beginning of this programme, Greece now has another 2.5 years to complete its reform agenda. And given the extent of the problems in Greece at the start, much more remains to be done.

Together with the other institutions, the ESM is now back in Athens to conclude the first review of our programme. Greece's ambitious reform package is under review. Furthermore, the euro area finance ministers are committed to looking at further debt relief measures, if Greece continues to reform. These measures should increase the sustainability of Greece's debt.

Based on my experience with other adjustment programmes I have no reason to share the pessimism of some observers with regard to Greece. Since the elections last summer the Greek government has a mandate for reform. As long as Greece continues to implement reforms, the creditors and the partners in the euro area will continue to help Greece.