

There is No Room for Complacency

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1. *Although the Cypriot economy has exited the Memorandum in March 2016, the last recommendations of the International Monetary Fund do not leave space for complacency. What key measures are still pending?*

Let me say upfront that the economic recovery has strengthened further since Cyprus exited the IMF-supported program 15 months ago. Growth has exceeded our expectations and latest indications point to continued, strong momentum this year. Unemployment has fallen. The fiscal position now shows a small surplus and returning confidence in the banks has encouraged deposit inflows.

However, it would not be a fair assessment, if we did not acknowledge the challenges still lying ahead and if we did not stress the need for equally great efforts going forward. The just-released IMF Staff Report of the First Post-Program Monitoring discussions identify three policy priorities: i) accelerating the reduction in non-performing loans (NPLs); ii) creating precautionary fiscal space; and iii) advancing macro-critical structural reforms. In a nutshell, one could indeed say that there is no room for complacency.

2. *Why do you think these measures are essential for the Cypriot economy?*

High NPLs put long-run growth prospects at risk. Perversely, as sizeable private debt goes unserviced, disposable income and profits get inflated, with tangible benefits for short-term growth. However, the continued erosion of payment culture, coupled with postponement of critical reforms, could set the current positive cycle in reversal and undermine the sustainability of the recovery in the long term. Conversely, faster reduction in NPLs may dampen growth in the short term, but it would fully restore banks' ability to extend new credit to families and firms on more attractive terms.

Strong economic growth and a sizeable fiscal primary surplus have set the public debt ratio on a downward trajectory. However, at over 107 percent of GDP in 2016, gross public debt is still a significant source of vulnerability. Restarting the privatization process, saving any windfall revenue and reversing some of the recent loosening measures, including reinstating the immovable property tax, would create precautionary fiscal space to deal with unanticipated shocks.

Finally, structural reforms could play a critical role in supporting long-term growth. For instance, weak legal enforcement discourage investment and undermine the attractiveness of Cyprus as a business center. Introducing streamlined enforcement for small claims and moving from paper to electronic record-keeping could enhance legal certainty and ultimately benefit growth prospects. Similarly, privatizations could increase competition and help modernize key sectors.

3. *Why do you think these measures have not yet been applied to the Cypriot economy? Because of the fear of political cost or the trade union reactions? And do you consider the stagnation in the reform agenda to be sustainable in the long run for the economy of Cyprus?*

Broad-based political support for structural reforms has clearly faded and trade unions have resisted changes. One can only reiterate the importance of some of these measures. For instance, the recent agreement with the unions to cap the growth in public sector wages replicates the provisions of the civil service reform bills is an encouraging step forward. However, adopting this long-delayed reform would provide greater assurances that wage growth will be permanently contained, further anchoring expectations of sustainable recovery.

4. *From the recommendations of the IMF seems that some of the most crucial legislations that the MPs enacted during the implementation of the Memorandum were ineffective. Do you agree with this position?*

No, I would not agree with that. Parliament has passed important bills, which have played a critical role in turning the economy around. For instance, MPs adopted the Fiscal Responsibility and Budget System Law (FRBSL) which has significantly strengthened budget formulation and execution processes; they endorsed the integration of the inland revenue and the VAT offices into a single Department of Taxation, thus harmonizing procedures and increasing the efficiency of the revenue administration; they have adopted a welfare law which has unified previously fragmented benefits under a single Guaranteed Minimum Income and brought Cyprus's welfare system in line with best international practices; and they have enacted laws supporting a major overhaul of the insolvency and foreclosure framework. Of course, as mentioned earlier, more can - and should - be done to advance the reform agenda further, as well as ensuring smooth implementation of the existing legislation. However, the results obtained so far are tangible achievements of a concrete reform effort.

5. *The Cypriot government has announced recently that it will repay in advance a part of its loan to the IMF. Have you started negotiations about it and what is the position of the IMF? Could you be more precise on that?*

This is a positive development and a sign of the stable presence in capital markets that the country has succeeded in regaining. The government should be commended for the strengthening economic recovery and the prudent macroeconomic policies, that have enabled Cyprus to take this step. And it should be noted that early repayment to the Fund is not subject to any negotiations, conditions or charges.

6. *In terms of the situation of the banking sector in the north what progress has been made so far? Can you announce something new?*

This is an area where limited progress has been made. It would be very important, in case of a settlement of the Cyprus Problem, for all banks in the island to be assessed in line with international best practices. For banks currently licensed by the Central Bank of Cyprus,

assessments in line with the standards and practices of the ECB's Single Supervisory Mechanism were recently performed and can adequately inform the settlement process. It is of critical importance that a comprehensive assessment conducted according to similar standards takes place as soon as feasible for the Turkish-Cypriot banking system. To ensure its credibility, such an assessment must be in line with international best practices and performed under a bi-communal governance structure.

7. *More in general, what progress have you made in your work in support of the reunification?*

First, let me say that the two leaders and their teams should be commended for working to find sustainable solutions to the economic aspects of post-settlement Cyprus. IMF staff has responded to their request for technical assistance under the auspices of the UN Special Adviser to the Secretary General and supported the process across the spectrum of its core competencies. In addition to assessing the health and viability of the banking sector, activities included: i) designing a new effective federal fiscal structure that interacts smoothly with subnational structures; ii) creating an efficient tax policy that avoids unfair competition; iii) preparing changeover to the euro by the Turkish-Cypriot community; iv) integrating macroeconomic statistics; and v) developing consistent macroeconomic and fiscal frameworks for a united Cyprus.

8. *What progress still needs to be made?*

A reunification of the island offers significant opportunities that would ultimately benefit Cyprus's potential growth. Critical preparatory work should be initiated as soon as feasible to seize these opportunities. If a political agreement is reached, this technical preparatory work will be of utmost importance to ensure key public institutions are ready to hit the ground running, and can formulate and implement sound macroeconomic and financial policies from day 1. Therefore, going forward the focus should be on: i) building efficient federal institutions and policy frameworks; and ii) integrating structures at the constituent states level with these new federal institutions. IMF staff remains ready to support this effort.