Economic Policies on the Road to Recovery

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Thank you for inviting me to this engaging event. It is a real pleasure to be here today and I appreciate the opportunity to say a few words about the economy of Cyprus and the role of economic policies going forward.

I will start with some introductory remarks about the world economy. Global growth in 2014 was 3.4 percent. According to the last IMF World Economic Outlook, it is projected to reach 3.5 percent in 2015 and 3.8 percent in 2016. High income economies are expected to do a bit better in 2015 compared to 2014, whereas the prospects for some large emerging market economies and oil exporters are a little more subdued. All in all, this is a rather mediocre perspective. Moreover, risks are still tilted to the downside. Greater demand stemming from lower oil prices is an important upside risk. However, geopolitical tensions, disruptive shifts in financial markets and stagnation in high income economies continue to be material downside risks. In this context, efforts aimed at boosting growth and creating jobs continue to be a general policy priority.

Accommodative monetary policy is certainly important to support economic activity and lift inflation expectations. However, implementing structural reforms is at least equally important to tackle the legacies of the crisis and raise productivity, which is the essence of long-run growth. As you can imagine, the same policy priorities can easily be applied to Europe and to Cyprus.

So, let me move on to Cyprus then and I will do that by striking upfront a positive note. Cyprus's economic reform program is producing concrete results. After going through an unprecedented downturn, the economy is now stabilizing and we are starting to see encouraging signs, with the number of jobs rising again. Economic activity has entered a path of gradual recovery, moving from an annual GDP growth rate of -5.4 percent in 2013 to -2.3 percent last year. In the first quarter of 2015, Cyprus returned to positive growth for the first time in 4 years. Notably, these outcomes have exceeded our earlier expectations and those of other forecasters. In the World Economic Outlook, we forecast marginally positive growth in 2015, a rate of 0.2 percent, followed by a further gradual expansion in the following years. Banks are now adequately capitalized. Their liquidity conditions have stabilized. Payment restrictions introduced to protect financial stability during the crisis have been lifted. Sovereign market access has been regained. The fiscal deficit has turned into a small surplus.

The people of Cyprus should be given full credit for all these results. It is only their determination in addressing economic and financial difficulties and for taking full ownership of far-reaching reforms that has allowed this progress.

It would not be a fair assessment, however, if we did not acknowledge the challenges still lying ahead and if we did not stress the need for equally great efforts going forward. On the road to recovery three key priorities stand out: i) banks should be in a position to extend new credit to the economy, which, in turn, would let firms invest and create more jobs; ii) the corporate sector should manage to attract more capital through foreign direct investment, which again would boost economic growth and employment (as I see it, both privatizations as well as several other reforms that would make the country a better place to do business concur with this policy priority. I will elaborate on that); and iii) the government should continue protecting vulnerable groups affected by the crisis, while steering the public debt ratios down.

Targeted economic policies can support these priorities.

First and foremost, Cyprus must deal with its NPL problem. Why is this so important? A lot has been said about the impact of NPLs on banks' balance sheet and capital, but not enough on the broader implications for the economy. NPLs approaching 60 percent of all loans for the domestic banks are preventing "banks from being banks", which means being able to extend new credit to the economy. This is understandable. If financial institutions are not in a position to get paid back, how could they offer new lending? Only by lowering NPLs, we will allow banks to extend new credit to families and corporations, and to do that on better terms. In turn, this will support growth and jobs.

So, why has the NPL problem not been tackled appropriately so far? Several factors prevented that from happening. Incentives for borrowers and lenders to restructure loans have been low. Foreclosing on a property took years, to the point that no foreclosure took place at all. Corporate restructuring and personal bankruptcy procedures were obsolete. Banks lacked capacity and expertise to deal with large number of delinquencies. The result was no restructuring at all or few restructurings with high risk of re-defaulting.

The new debt restructuring framework is a major step forward. The foreclosure law should provide creditors with a credible threat against strategic defaulters and help restore a solid payment culture in the country. The personal and corporate insolvency framework should allow debtors to restructure their loans, for those who can, or, for those who really cannot pay, to have a "fresh start". The combination of the two sets of measures should encourage banks and borrowers to move towards quicker solutions, which, in turn, should free up capital for new lending and support growth.

Let me be clear. This is far from a "perfect law". Some of the last minute provisions introduced during the discussions in Parliament deviate from international best practices and risk undermining the effectiveness of the framework by delaying the process and keeping debt restructurings from happening. But it is a good starting point. It is now time to move on, implement the framework, monitor it closely, and review it, as needed, as evidence of its performance builds up over the coming months. Additional steps aimed at facilitating the sale of loans to other investors could also speed up the reduction of NPLs. We hope to see concrete progress in this direction soon.

Another key policy priority is privatization. Progress on this front is also underway, after some delays. The privatization of state-owned enterprises is often portrayed as a way to raise short-term revenue for the state budget, while the long-run benefits to the economy are not given sufficient emphasis. On the contrary, the main aim of privatization is not to realize revenue, but rather to realize these benefits. These are critical and include i) allowing for better and less expensive services for the population and ii) attracting foreign direct investment, which again can bring jobs and increase liquidity in the economy. Therefore, going forward, it is important that further decisive steps are taken in this reform area too.

Next, Cyprus should double its efforts to make the country a good place to do business. The government's plan to put in place a growth strategy is a welcome initiative. Efforts should be addressed towards those areas where the gap relative to international best practices is the widest and the impact of reforms on long-run potential growth the highest. These include strengthening the legal system, opening up closed professions, removing barriers to competition, reducing red tape, and fostering innovation. These are all steps that could support growth, competitiveness, and innovation, and act as catalyst for further investment, thus helping to ensure a job-rich recovery. Many of these areas are well known and don't require further study, so is very much a question of getting it done.

Finally, Cyprus should continue in its effort to implement a modern welfare system able to ensure benefits for all those in need. The reform adopted last year has unified fragmented benefits under a single guaranteed minimum income, the GMI. It has brought the welfare system of Cyprus in line with best practices in Europe. Going forward, the system will have to be monitored carefully to ensure appropriate coverage, prevent abuses and ensure that further changes don't fragment the system again. Over time, this will help improve adequacy of public assistance and reduce poverty.

Let me conclude by saying that there is no quick fix to the economic crisis the country went through over the past few years. Only steady and resolute implementation of structural reforms along the path already started can ensure a sustained return to economic prosperity and jobs. On the contrary, no reforms would mean a stalling scenario for the economy: low growth, high unemployment, a future that is going to offer much fewer opportunities to the new generations of young Cypriots. The cost of getting stuck in a no-reform scenario would be very high. Most likely Cyprus will not go back to pre-crisis growth rates anyway, and maybe it shouldn't! That growth was rooted in major imbalances and proved unsustainable. But targeted reforms can ensure a return to jobs, stability and prosperity.

Thank you all for your attention. I am now available for questions.