Financial Crisis:
Challenges for Cyprus & Greece

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Financial Crisis: Challenges for Cyprus and Greece

1. The international financial crisis of 2007-2009 led to
   - Stricter Basel III capital adequacy regulation, with regulators conducting AQRs and Stress tests (annually in USA, biennially in Europe)
   - Efforts for a banking union in Europe with the SSM supervising the large banks since November 2014
   - Quantitative easing and very low nominal interest rates, even negative
2. It also exposed Euro Area to its deficiencies, and especially Greece and then Cyprus to the previous excesses of their economies.
   - We will perform a comparison between Cyprus & Greece
     - Greek excesses were a lot worse, except in the financial sector
     - Cyprus handled its crisis better than Greece did
     - Cyprus is out of the recession, while Greece still struggles in Crisis-Phase II
     - Today they both face some similar challenges, the major one being NPLs

Differences in State of Economy before Crisis Outbreak

Initial Conditions	**Greece** (April-May2010) or 2009)	**Cyprus** (March 2013) or 2012)
Primary Balance (% GDP)	-10.3%	-2.9%
General Gov. Balance (% GDP)	-15.2%	-5.8%
Gross Public Debt (% GDP)	127%	79%
Current Account Balance (% GDP)	-12.3%	-6.0%
Doing Business Distance to Frontier (best = 100)	62.4 *(2010)*	69.1
REER (ULC total economy deflated, 1999Q1 = 100)	123 *(2010Q1)*	110 *(2013Q1)*
Private Sector Debt (% GDP)	117%	328%
Banks Assets (% of GDP)	213%	750%

More Differences before Crisis Outbreak

4) **Crisis arrived in Cyprus 2 to 3 years after it arrived in Greece**
   a) Later crisis-outbreak made Cyprus worse-off because
      - European economy was growing in 2012-13
      - in 2012-13 Europe had developed defense mechanisms (ESM, Banking Union, etc) and was not worried about contagion
   b) Later crisis-outbreak made Cyprus better off because
      - Cyprus had the benefit of hindsight, observing earlier crisis-hit countries: Greece, Ireland, Portugal, and even Spain

5) **Speed in concluding the negotiations**
   - Greece concluded the details of the MOU and signed in a month
   - Cyprus applied in June 2012 and signed in March 2013

6) **Different government relations with the central bank**

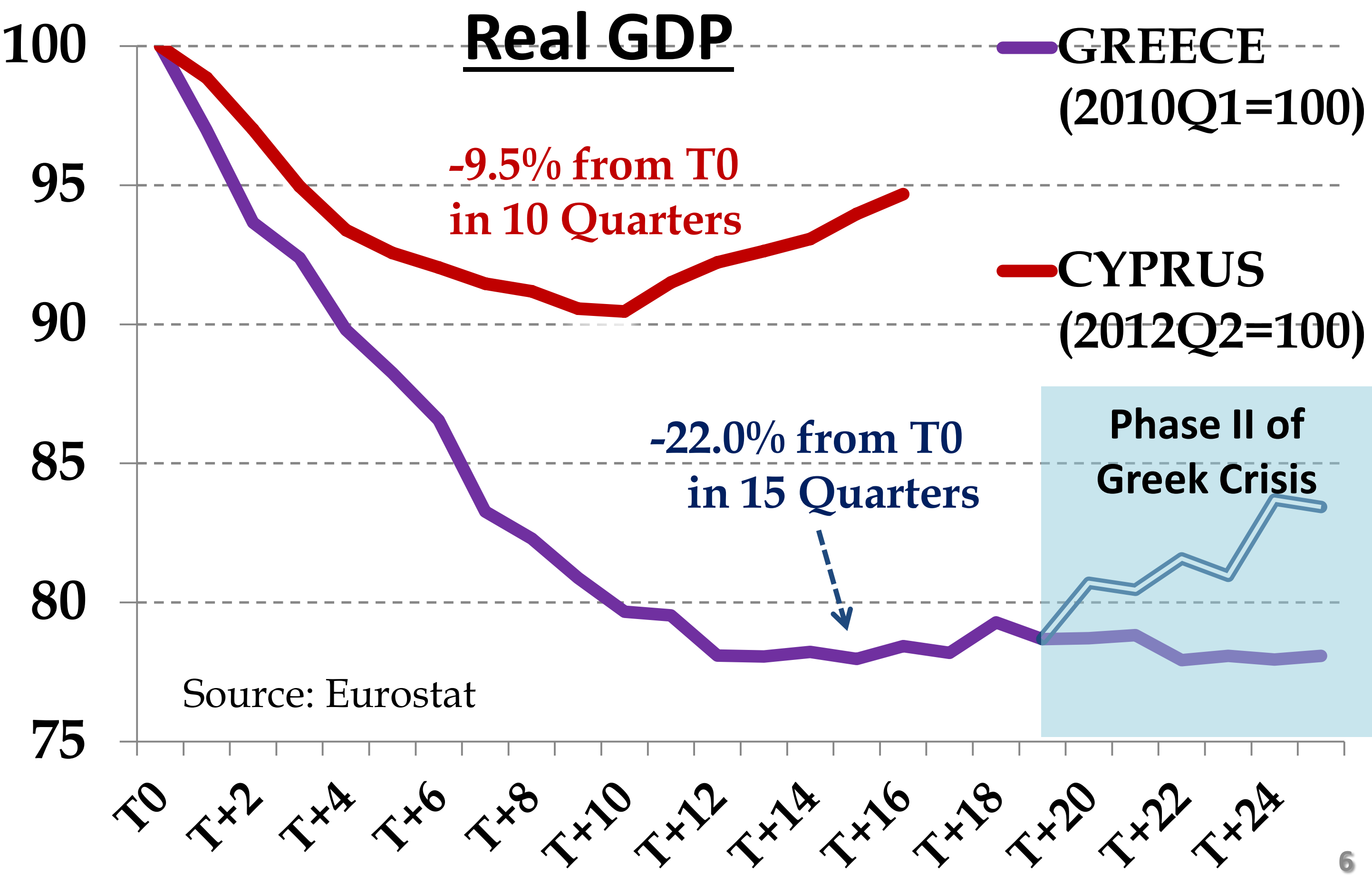
7) **Different types of political parties in power**

Cypriot Policy Response was more Efficient

- Lenders' policy response: Harsh on Cyprus, lenient on Greece
  - In Cyprus, a Bail-in with immediate capital controls
    - loss of wealth, yet primarily by foreigners
    - lower public debt due to the bail-in
  - In Greece, a Bail-out with the PSI delayed by 1.5 years
    - Greek debt unsustainable after Crisis-Phase II
- Domestic policy response: Very different
  - Program ownership in Cyprus, absent in Greece
  - Capacity to implement reforms in Cyprus, not so in Greece
  - Timely implementation of reforms in Cyprus
  - Package of fiscal measures were front-loaded in Cyprus
  - Cyprus exited the program in three years, Greece had a Phase II version of the crisis in 2015 just after its economy had picked up momentum and was ready to exit its MoU

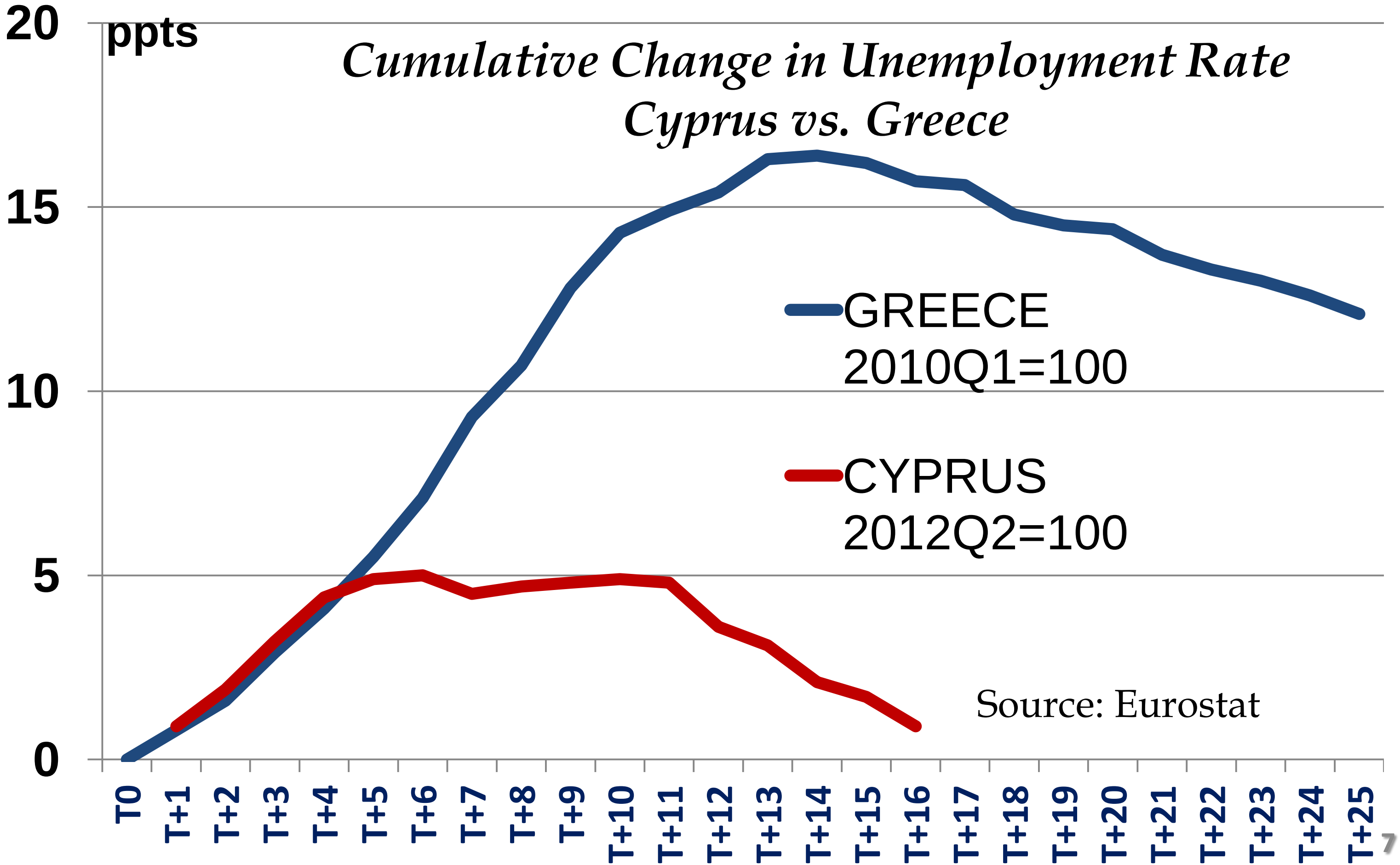
Cypriot Economy recovered quickly

- Given current forecasts, Cyprus will recover lost output by mid-2018
- Greece is still struggling with recession
- The different trajectory will also affect the financial sector



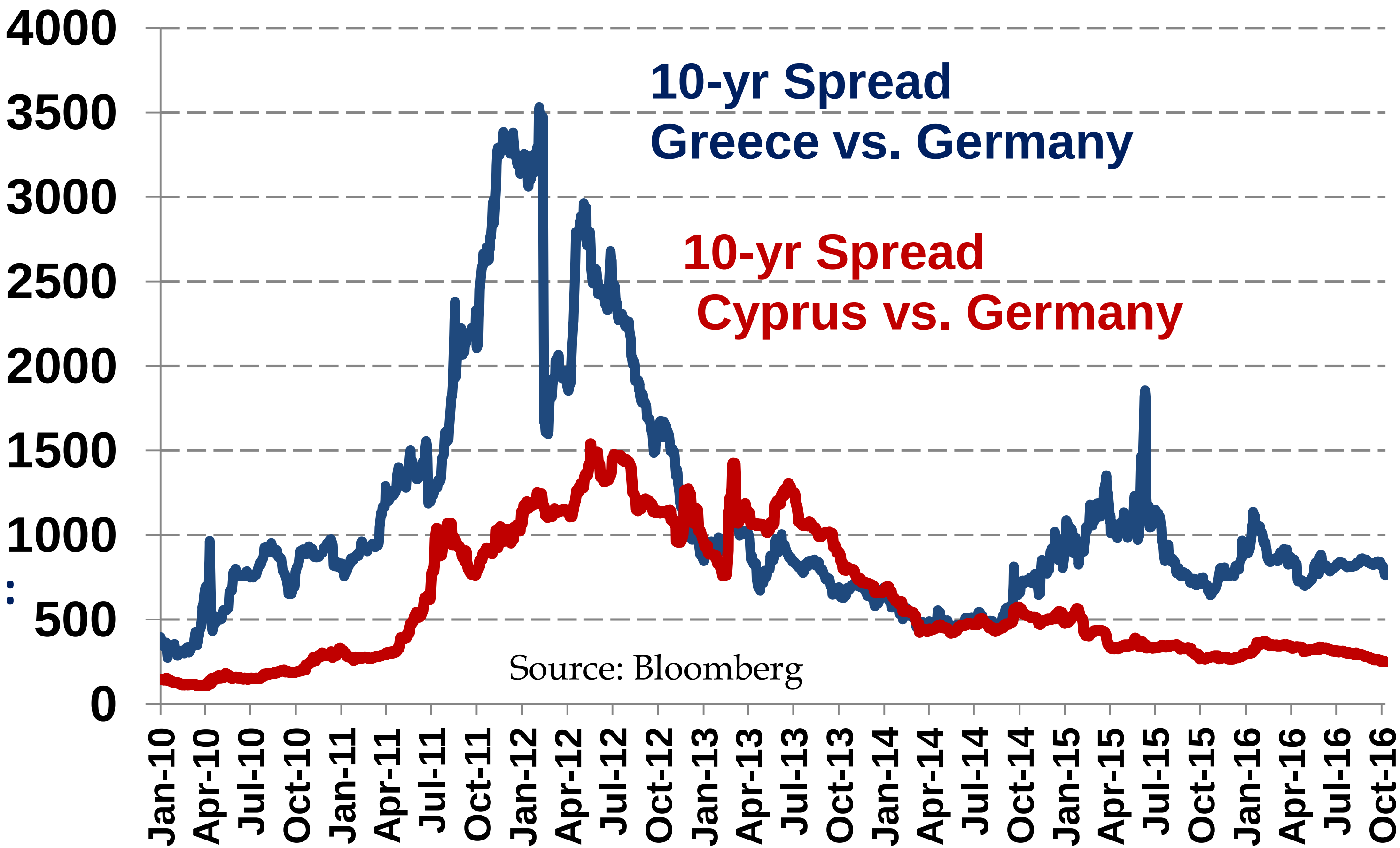
Cypriot Unemployment back to where it started

- Unemploy-ment is almost back to pre-crisis levels in Cyprus
- Problems remain in Greece



Country Credit Risk declines steadily in Cyprus

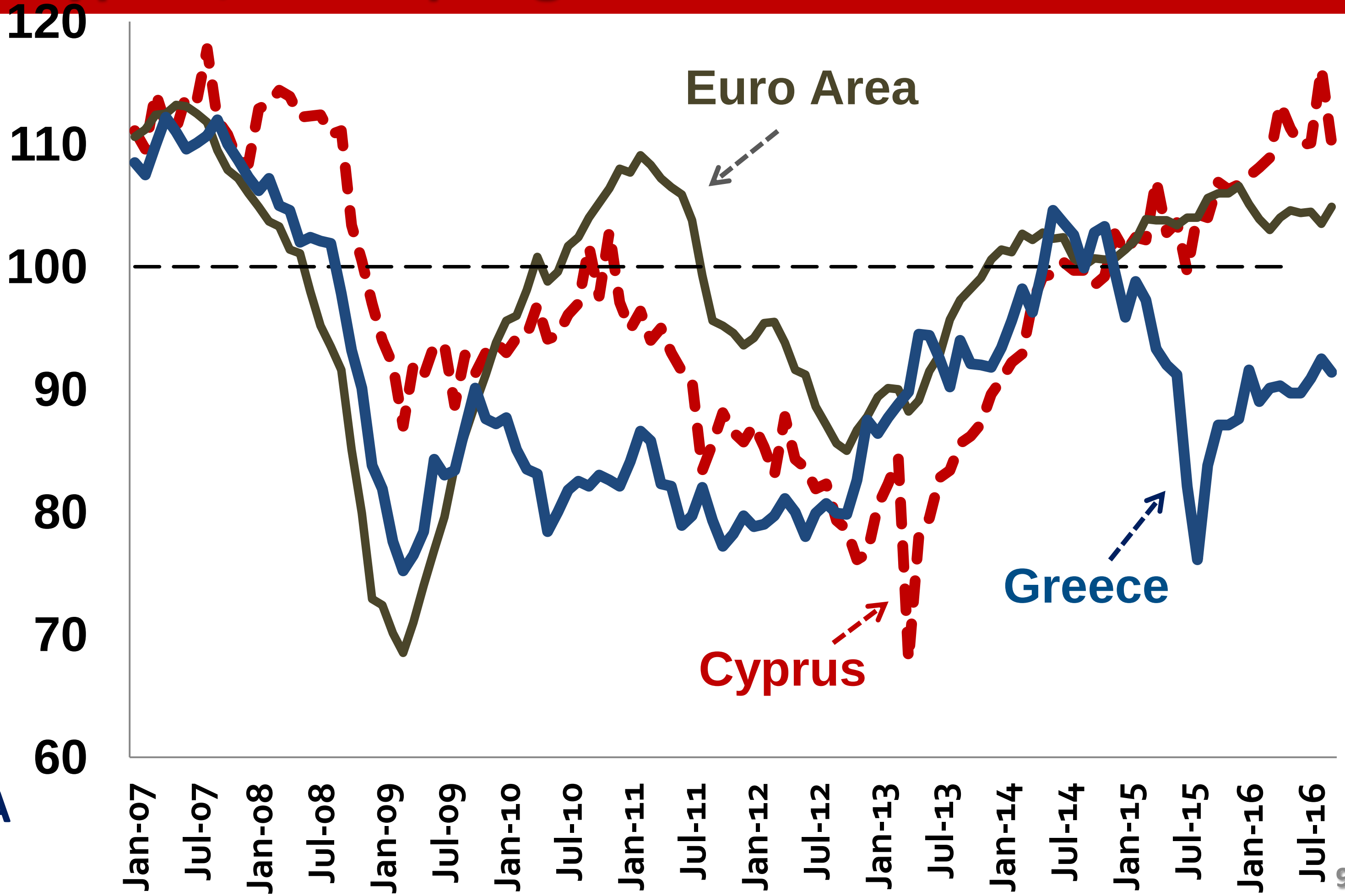
- ❑ Markets perceive Cyprus to be credible: its spread on a declining trend
- ❑ Not so in Greece since Crisis-Phase II: Spreads took off



Optimism in Cyprus, decoupling of Sentiment in Greece

Index of Economic Sentiment

- Cypriot senti-ment moves up and down together with EA sentiment
- However, in Greece, senti-ment has de-coupled from EA



Where are the countries now, at the end of 2016?

Greece

- is struggling with Phase-II of the crisis and hopes for a cyclical recovery
- Is in a third rescue program which ends in 2018
- Cannot access markets, capital controls are still in place, and ECB dependence is high
- Lacks credibility
- Its investment – to- GDP ratio is very low, below 12%
- NPLs are high and keep rising
- Is burdened by unsustainable debt, high unemployment and an over-taxed population
- For long-term growth to come back, at a minimum, a complete reversal of the current taxation policy is required

Cyprus

- Managed to keep its international tax advantages, did not lose its foreign investors
- Is expected to grow at least 2.5% per annum for the next two years
- Has the luxury to focus on its long-term growth strategy
- Has low investment – to – GDP ratio, below 14%
- NPLs are high but began declining

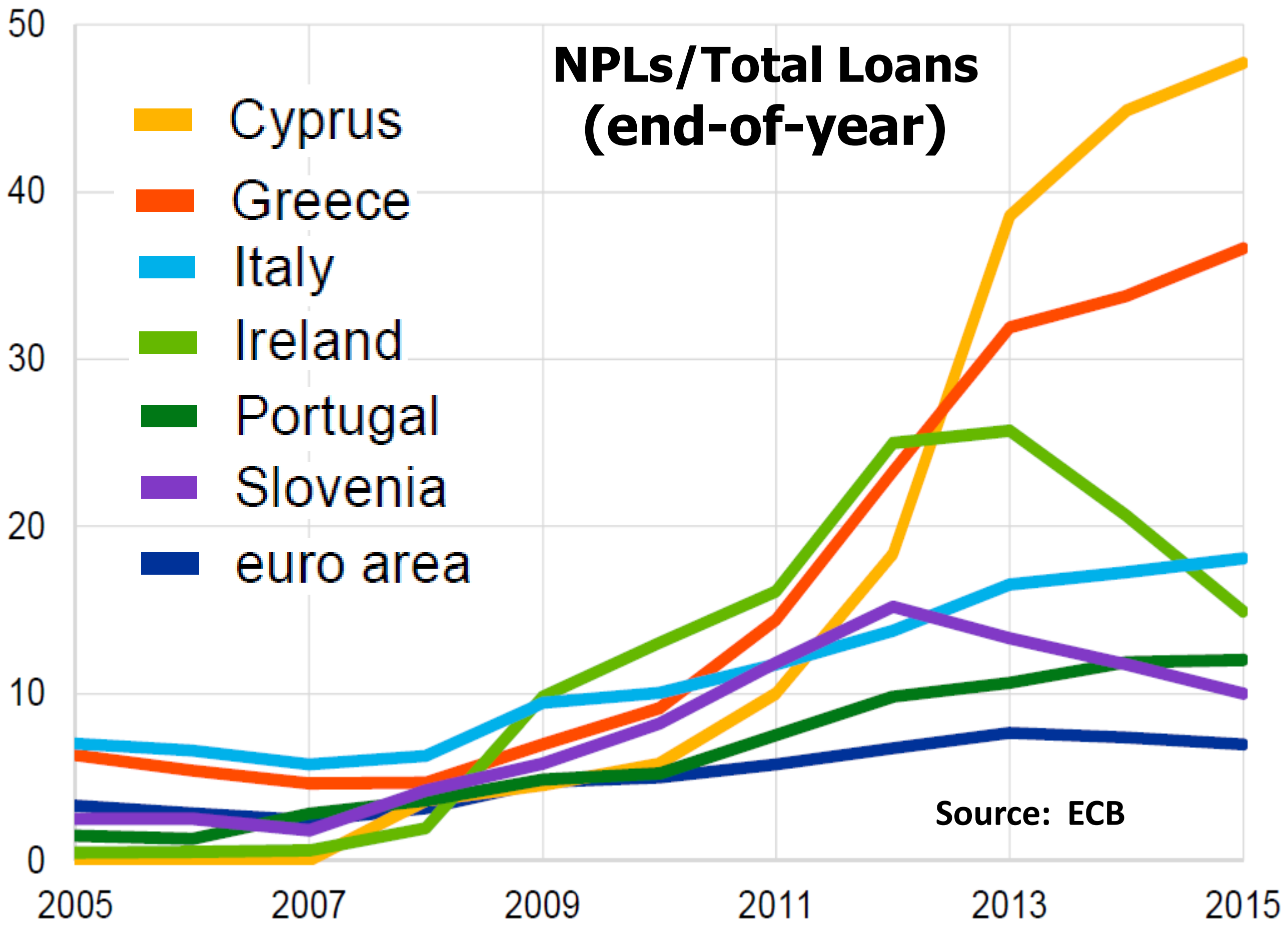
Cyprus can now focus on long-term growth

Cypriot Long-Term Growth Recipe:

1. Safeguard macroeconomic stability and market credibility. Keep the fiscal budget balanced and ensure the pension system remains stable in the new era of low fertility rates. Macro stability may not be a sufficient condition for growth, yet it is necessary
2. Keep the political consensus on the geostrategic choice of EMU
3. Improve cost competitiveness, continue to reform and push the competitive advantages of the country. Besides low tax rates and specialized legal and accounting services, the country need to invest more in IT services
4. Improve the share of Investment in GDP. View discovery of natural gas as bonus
5. NPLs are 1.5 times the size of GDP. Their resolution requires a delicate policy path, which will not disturb society, avoid a further collapse of asset prices and allow for their smooth recovery

NPLs: The current six worst Performers in Euro Area

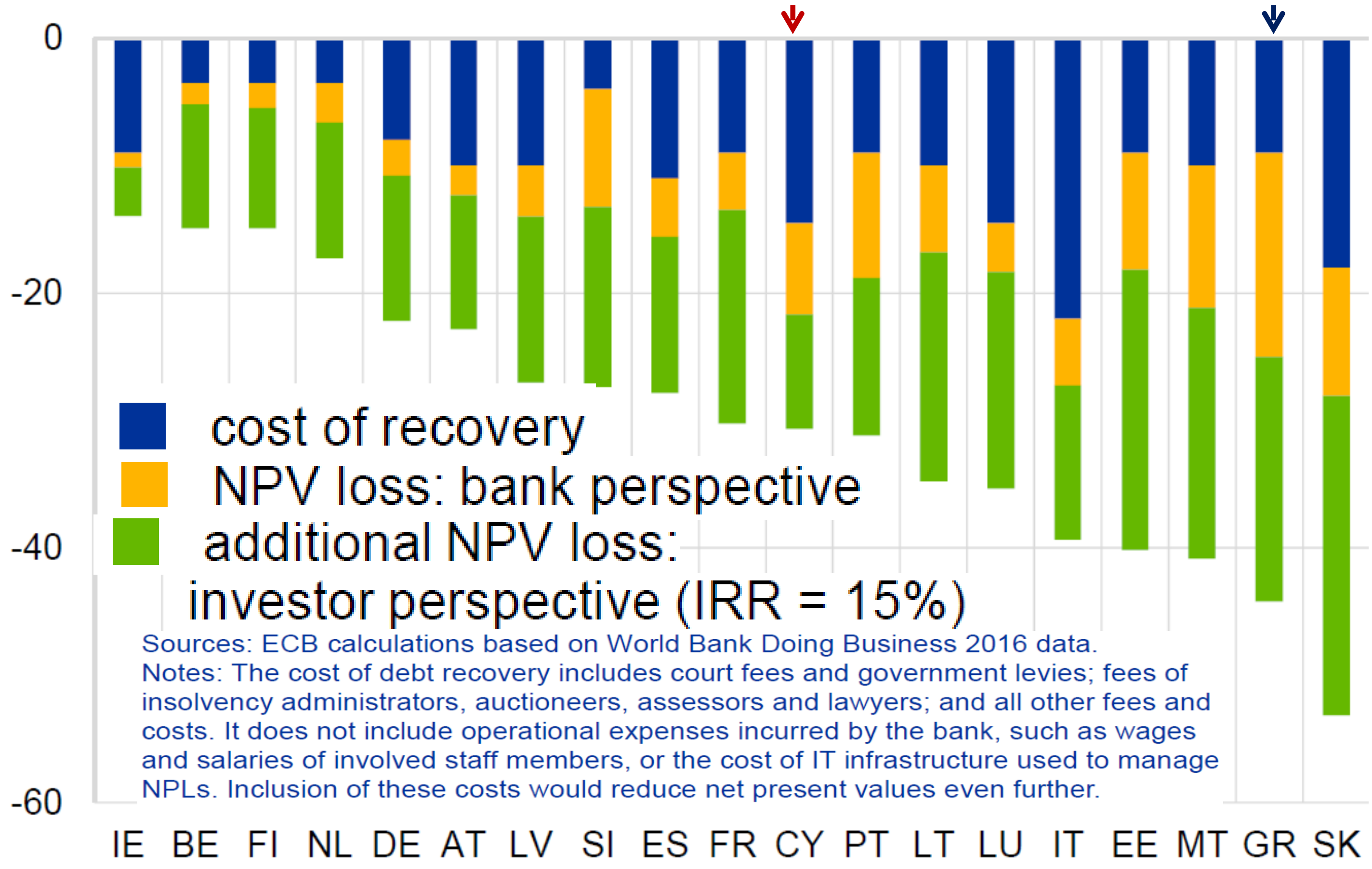
- Both Cyprus and Greece face the same major financial risk: NPLs
- The economy's improvement suggests NPLs will keep declining in Cyprus



NPLs: Market Value of Collateral less than Book Value

ECB estimates:

- Italy, Slovakia and Cyprus have the highest costs of recovery
- Yet it takes longer in Greece to liquidate the collateral



Thank you for your attention

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