



ΚΕΝΤΡΟ ΜΕΛΕΤΩΝ
ΤΑΣΣΟΣ ΠΑΠΑΔΟΠΟΥΛΟΣ



Eurobank

Cyprus *in the middle of a storm*

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Panel discussion on: "Lessons, Challenges and Opportunities," in the 2nd Scientific Conference of May 17-18, 2013 on "Cyprus: Five Years in the Eurozone"

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I. WHY STILL AN EMU CRISIS? BECAUSE ...

THE EMPHASIS FOCUSED ON THE EMU ARCHITECTURE

- ❖ In late 2009, the Greek fiscal problems brought to the surface two needs, not necessarily complementary:
 - 1) Need for actions to contain the Greek crisis
 - 2) Need for a better EMU framework, consistent with an Optimum Currency Area (OCA), which would ensure the long-term stability of the euro
- ❖ Moral hazard concerns prevented EMU from achieving both goals simultaneously: If it were to take actions that would solve the Greek crisis once and for all, it would minimize the chances of creating a new stricter EMU framework
- ❖ Academics of all political persuasions agree: Solve the crisis first and then worry about long-run architecture and adverse incentive problems
- ❖ Hardliners in Europe, the ones with the money, chose to ignore the Greek crisis and concentrated on the EMU architecture.
- ❖ This policy preference is the driver of EMU events ever since

I. PIECEMEAL SOLUTIONS PROLONGED THE CRISIS

- ❖ When the crisis hit Greece, the country seemed too small to impact the rest of EMU. Moral hazard reasons and austerity prescriptions naturally dominated the discussions
- ❖ EMU leaders helped Greece, but also catered to their domestic constituencies and the domestic populist press, and were continuously “behind the curve” in their responses to the evolving crisis
- ❖ **Markets were particularly irked after the Deauville German-French meeting in October 2010 and its message that the private sector would pay, hence interest rate spreads shot up.** This message came 15 years too late, at the wrong moment and institutionalized sovereign credit risk
- ❖ From October 2010 to October 2011, Greeks had gradually lost all their credibility as they could not carry on with the needed reforms at the desired speed, the recession deepened and the sustainability of debt came into question, leading the IMF to change its original softer position
- ❖ The Greek PSI was decided in late October 2011 and wiped out 80% of the value in the hands of bondholders, giving birth to the Cypriot crisis
- ❖ The Greek PSI was being discussed for 3 months before materializing. It was not handed down abruptly on the Greeks, as appears to be the case in the Cypriot bail-in

I. A HARSH BAIL-IN FOR CYPRUS: WHY?

- ❖ The Cypriot **Bail-in** decision (plus ELA treatment) destroyed a comparative advantage that Cyprus enjoys in financial services, plus created unwanted capital restrictions within the Euro Area that may cause damage to other foreign-related businesses. WHY?
 - ✓ Did Cyprus suffer from European **rescue fatigue**, being fourth in line to receive European support after Greece, Ireland and Portugal?
 - ✓ Was Cyprus perceived too small to propagate **contagion**?
 - ✓ Was Cyprus, prior to the German elections, a convenient **signaling** vehicle to the larger EMU Southerners, Spain and Italy, to forget about a banking bail out?
 - ✓ Was the needed rescue way too big -- as a %GDP -- for future tax-payers to shoulder it, hence forcing a bail-in decision?
 - ✓ Was there too-much **procrastination** by the Cypriot side? Perhaps in
 - First, in pursuing the needed fiscal & structural reforms early on in the International crisis, i.e. disequilibria were building up
 - Second, in begrudgingly engaging the Troika too late, as evidenced by the ECB essentially forcing the Cypriot government to ask for assistance in July 2012
 - Third, in not quickly completing the agreement (with the financial package) immediately after July 2012, thus allowing the European side to devise its Bail-in plans at leisure while the Cypriot side relaxed, drawn sideways by the natural politics of its upcoming elections?

I. WHAT ABOUT THE DAY AFTER?

- ❖ Many theories can float around to explain this surprising harsh treatment, anger is cheap, populism is cheap in the short-run as well,
 - but it seems Europeans did not have a concrete full plan in place besides their bail-in dogma, as revealed by the quick reversal of the first Eurogroup decision
- ❖ Ex-post, the Bail-in decision did not create a Lehman Moment in Europe, thus solidifying the hard-liner position as they seem to be proven correct in their strict decision
 - This is evident in the way financial markets reacted
 - In my view, EMU countries turned out to be lucky, a luck that may not last
- ❖ Cyprus should not be caught in a game of recrimination, trying to allocate the blame to various participants.
 - Cyprus needs to look ahead into its future, to clarify once and for all where its geostrategic interests lie and act in unison. Will it remain in the Euro-Area?
 - Cyprus needs to stop the recession from developing into a Depression
 - Cyprus needs to come up with a new growth strategy, which would replace the lost comparative advantage in financial services After all, the financial industry is a declining industry worldwide over the next decade, so perhaps the long-run damage is not a huge as it is perceived at the present

I. MARKET VIEW OF THE CRISIS: SPREADS OVER 10-YR BUNDS (%)

	Jun-07 (Before Int/nal crisis)	Aug-08 (Before Lehman collapse)	Sep-09 (Before Greek crisis)	Jun-11 (Before Cyprus Mari accident)	May-12 (Before Greek ele- ctions)	15/3/13 (Before 1st Eurogroup Cyprus decision)	22/3/13 (Before 2nd Eurogroup Cyprus decision)	27/3/13 The day after	16/5/13
GR	0.24	0.67	1.30	13.81	25.56	9.36	10.59	11.57	7.37
IT	0.21	0.61	0.83	1.93	4.44	3.14	3.17	3.51	2.58
SP	0.06	0.36	0.55	2.59	4.79	3.46	3.49	3.81	2.92
PT	0.19	0.49	0.68	7.98	10.25	4.50	4.66	5.10	3.99
IE	0.06	0.39	1.65	8.54	5.78	2.54	2.79	2.99	2.12
CY		0.44	0.99	5.77	12.52	7.21	12.00	14.59	10.82

Source: Eurostat, Bloomberg. Monthly averages from Eurostat, unless a date is indicated, where Bloomberg is used. For Cyprus, individual long term bond is close to 10-yr. For all other countries, benchmark average 10-year bond.

Note: Cypriot spreads started rising steadily more than a year before the Cypriot government asked for official assistance, 2-3 months before the Mari accident.

II.

- I. CYPRUS: EMU BREAKS NEW GROUND IN ITS INTERNAL CRISIS MANAGEMENT
- II. **HOW DEEP AND LONG WILL THE RECESSION BE IN CYPRUS?**
- III. A SUBSEQUENT STRONG RECOVERY OR A MUDDLE THROUGH?

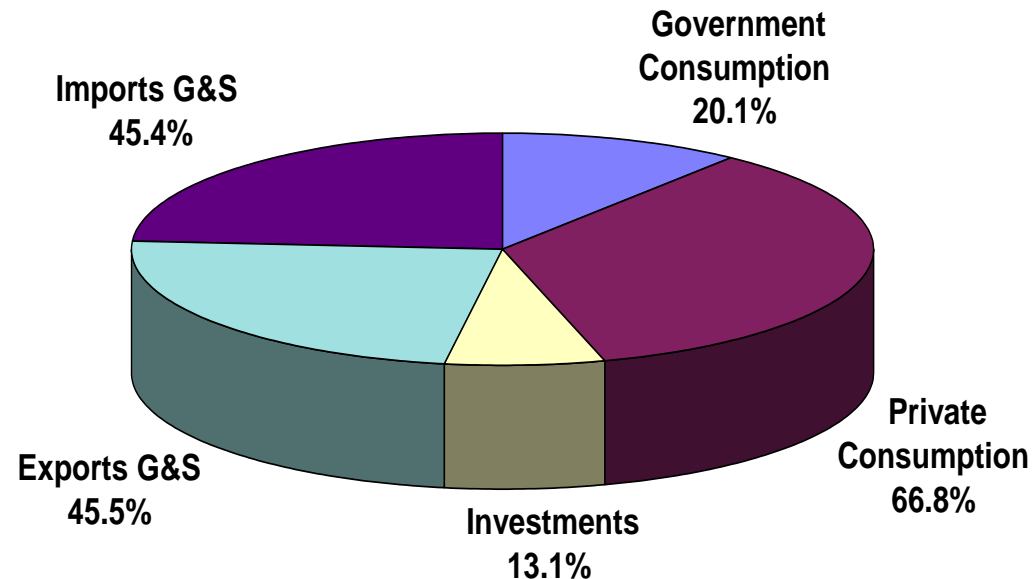
II. NEGATIVE FISCAL, CREDIT CRUNCH, BUSINESS ACTIVITY & SENTIMENT MULTIPLIERS OPERATE SIMULTANEOUSLY

MANY NEGATIVE FACTORS:

- Fiscal measures of 2.3% of GDP in 2013 and 1.9% in 2014 & much more to come
- A dramatic shrinkage in bank assets from 550% to 350% of GDP
- Possible loss of other complementary business services
- Unemployment rising and incomes declining
- Sentiment declining fast
- External environment in Europe in recessionary mode

FORECASTS BASED ON THE GDP DECOMPOSITION

- ❖ Exports & Imports of Goods & Services are balanced
- ❖ Share of Investment is very low, similar to Greece
- ❖ Share of Private Consumption is closer to EMU average than Greece



Total GDP in 2012: €17.88bn

II. CYPRUS: VERY UNCERTAIN FORECASTS BASED ON GDP DEMAND DECOMPOSITION IN 2012

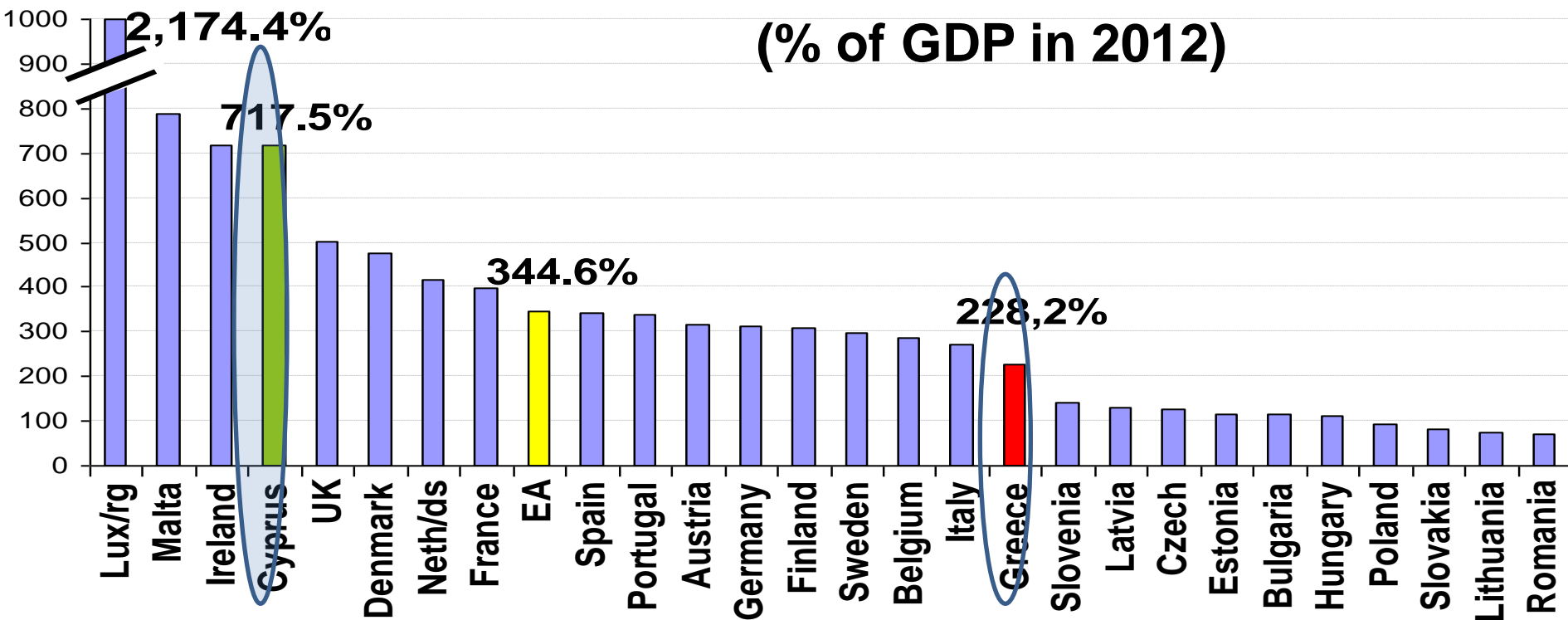
BASELINE SCENARIO	2012 €bn, Nominal	Share in 2012 GDP	2012 %yoy Real	2013f %yoy Real	2014f %yoy Real
Private Consumption	11.948	66.8%	-3.0%	-15.9%	-9.6%
Government Consumption	3.588	20.1%	-1.7%	-9.0%	-3.7%
Total Consumption	15.536	86.9%	-2.7%	-14.3%	-8.2%
GFCF	2.295	12.8%	-23.0%	-29.5%	-12.0%
Domestic Demand	17.877	99.9%	-6.8%	-16.3%	-8.6%
Exports	8.137	45.5%	2.3%	-7.2%	-3.2%
Imports	8.127	45.4%	-7.2%	-19.1%	-11.5%
Real GDP	17.887		-2.4%	-10.9%	-4.8%
GDP deflator			2.0%	1.5%	0.0%
Unemployment			11.9%	18.0%	20.0%

II. MOSTLY DOWNSIDE RISKS TO SHORT-TERM OUTLOOK

- **Risk #1: Difficulty in removing temporary capital controls, which creates uncertainty**
 - Haircuts should be clarified soon as uncertainty hurts domestic activity & international capital flows, causing further reduction in business volumes in both domestic and internationally oriented companies
- **Risk #2: How much will the turmoil spill over to other sectors?**
 - Can Cypriots manage to keep the international businesses that need a strong financial sector?
 - Will Cypriots adjust prices for tourists fast enough not to lose their international market share?
- **Risk #3: Worse domestic credit supply conditions**, arising from sources like:
 - Collateral values declining as housing & other asset prices crash and a need arises for extra provisioning
 - Actual defaults causing a rise in NPLs and a fear of extending fresh credit
 - Eurocrats assessing higher NPL values than traditionally thought to exist
 - Financial sector may shrink more, to below 350% GDP if Euro exit
- **Risk #4: Worse aggregate demand conditions** ⇒ **negative downward spiral**
 - of rising unemployment, disposable incomes falling faster than predicted, further defaults and larger asset price losses, propagating further banking sector losses, and a prolonged loss of business and consumer confidence.
- **Risk #5: Will the existence of large stocks of gas supply be confirmed soon?**
- **Risk #6: Litigation risks from Bail-in exercise**

II. RISKS ARE HIGH BECAUSE THE BANKING SECTOR IS LARGE AND

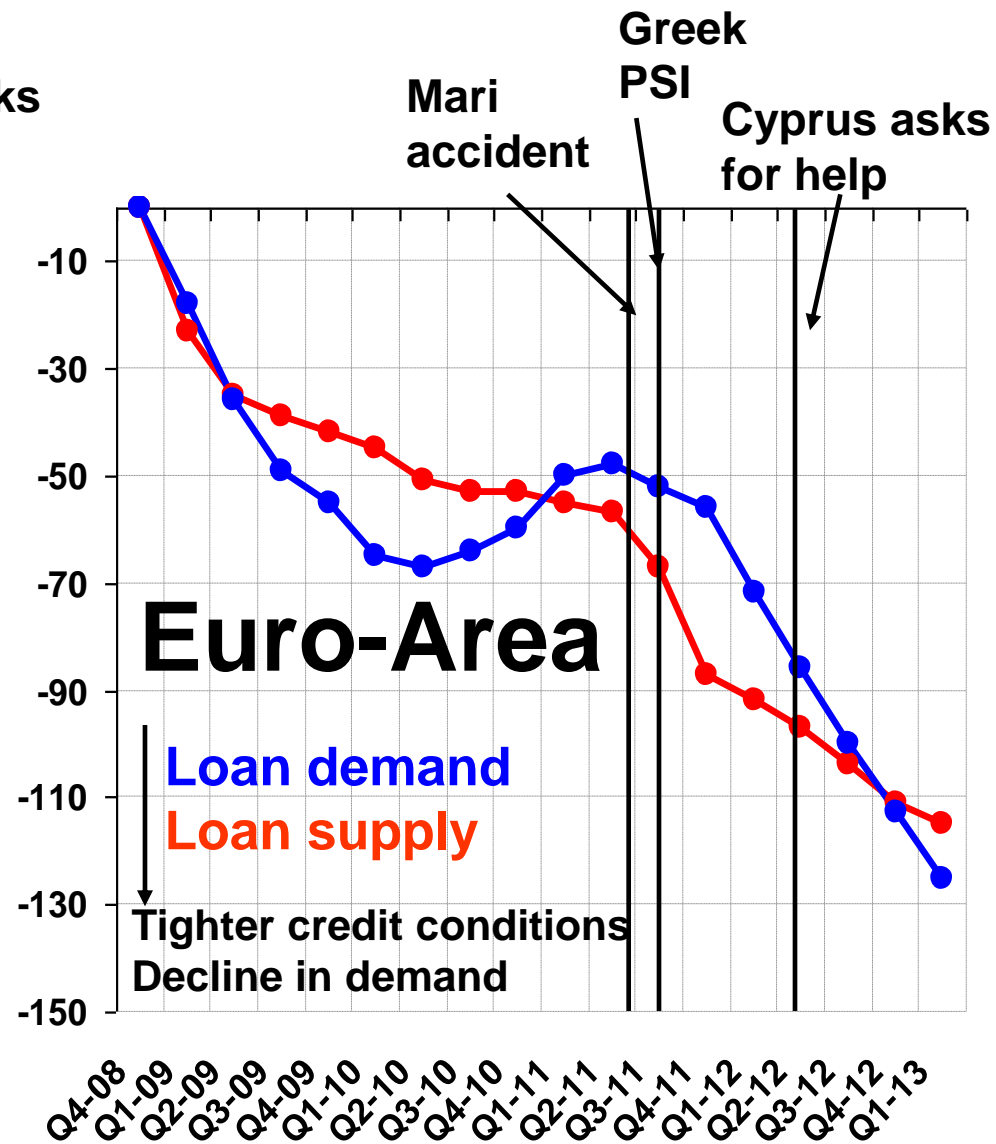
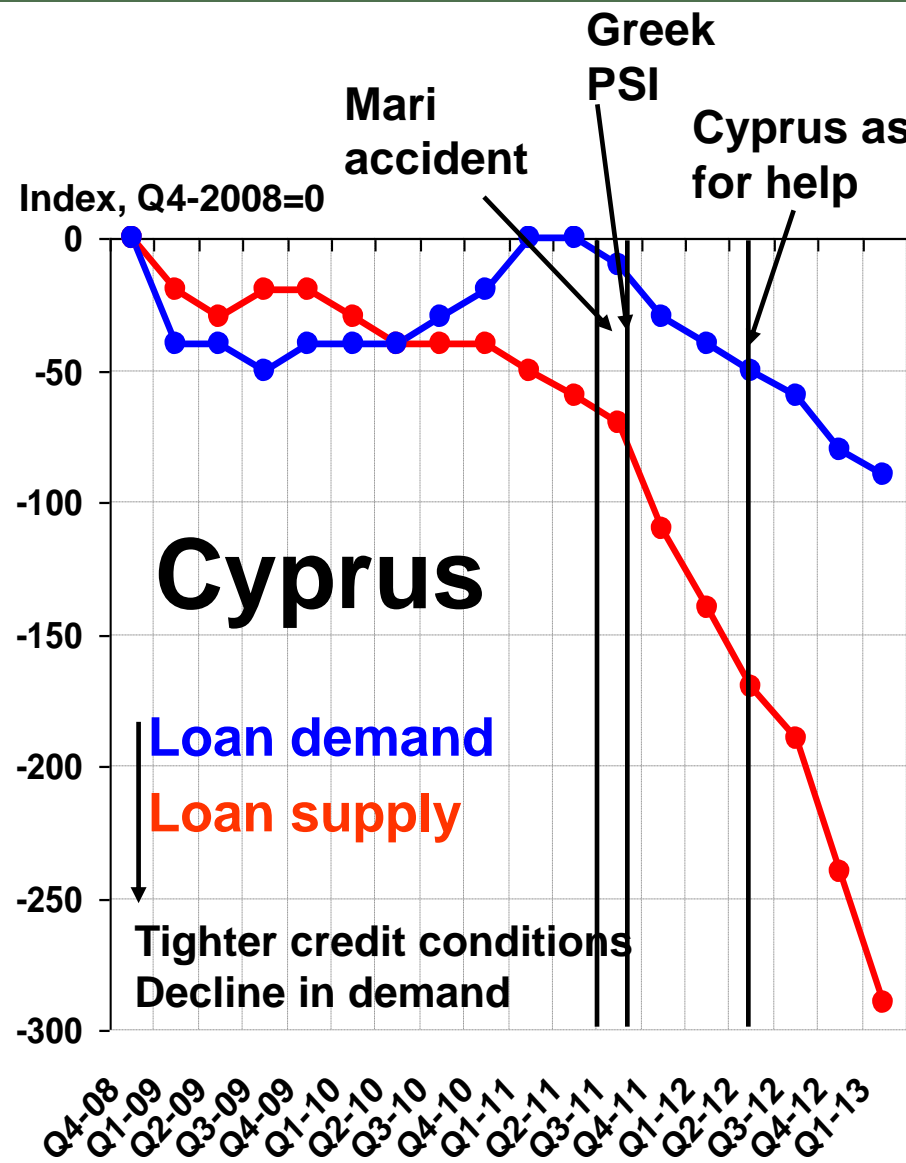
Total MFI Assets in EU-27 (% of GDP in 2012)



Source: ECB, EU

Note: The MoU claims the Domestic banking sector was only 5.5 times GDP and after the recent restructuring it is down to 3.5, the EA average

II. ... AND ... A CREDIT CRUNCH HAD ALREADY STARTED BEFORE THE MARCH DECISIONS



Source: ECB, Bank Lending Survey

II. HOW MUCH OF A BUSINESS RISK IS THERE?

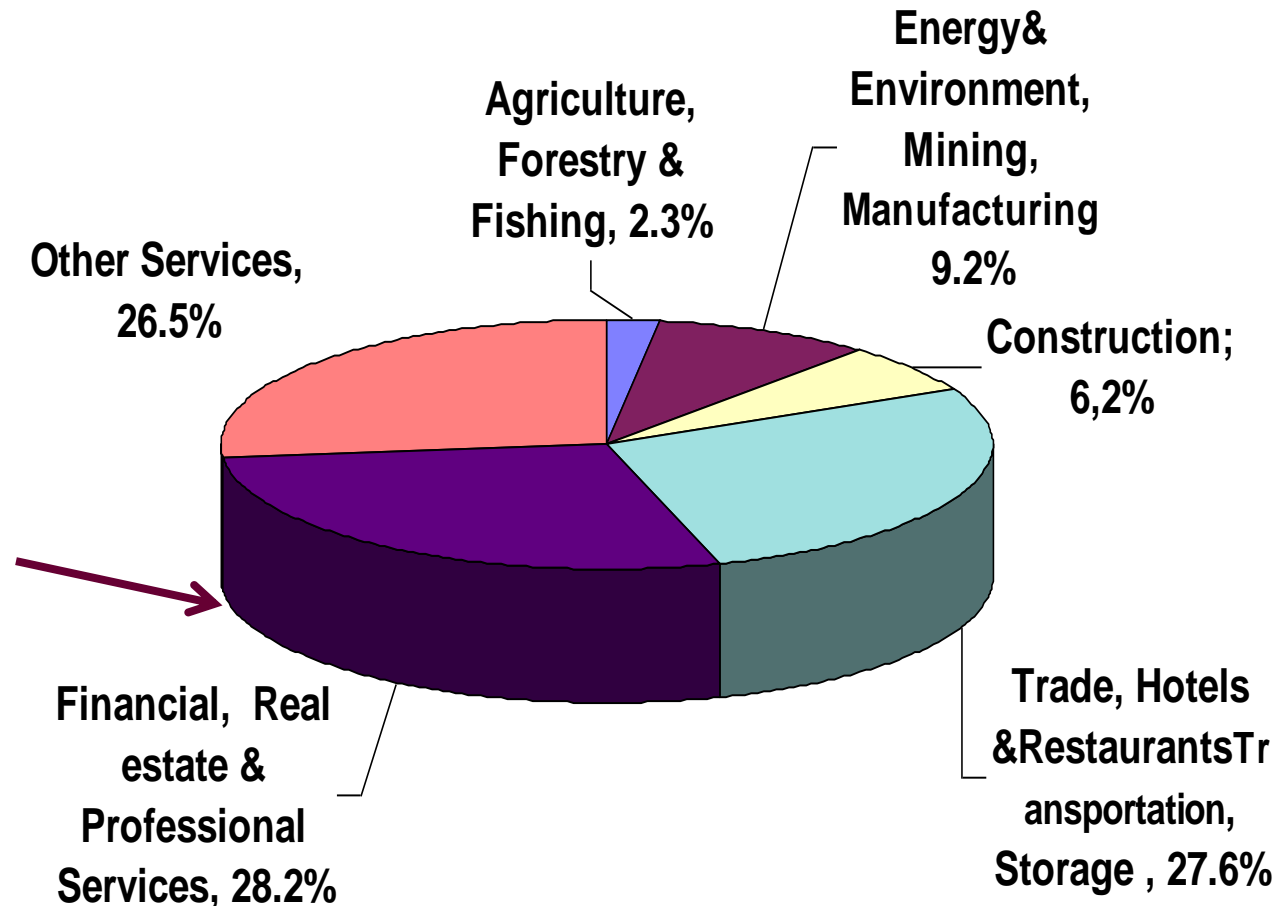
- ❖ All sectors will be affected
- ❖ The most vulnerable business sector is Financial, Real Estate & Professional services at 28.2% of GDP

Financial & Insurance
9.2%

Real Estate
11.6%

**Professional, Scientific
& technical activities**
6.1%

**Administrative &
support service
activities**
1.3%



Total GDP in 2012: €17.88bn

II. THE SUPPLY SIDE: NEED FOR ADJUSTMENT IN UNIT LABOR COSTS

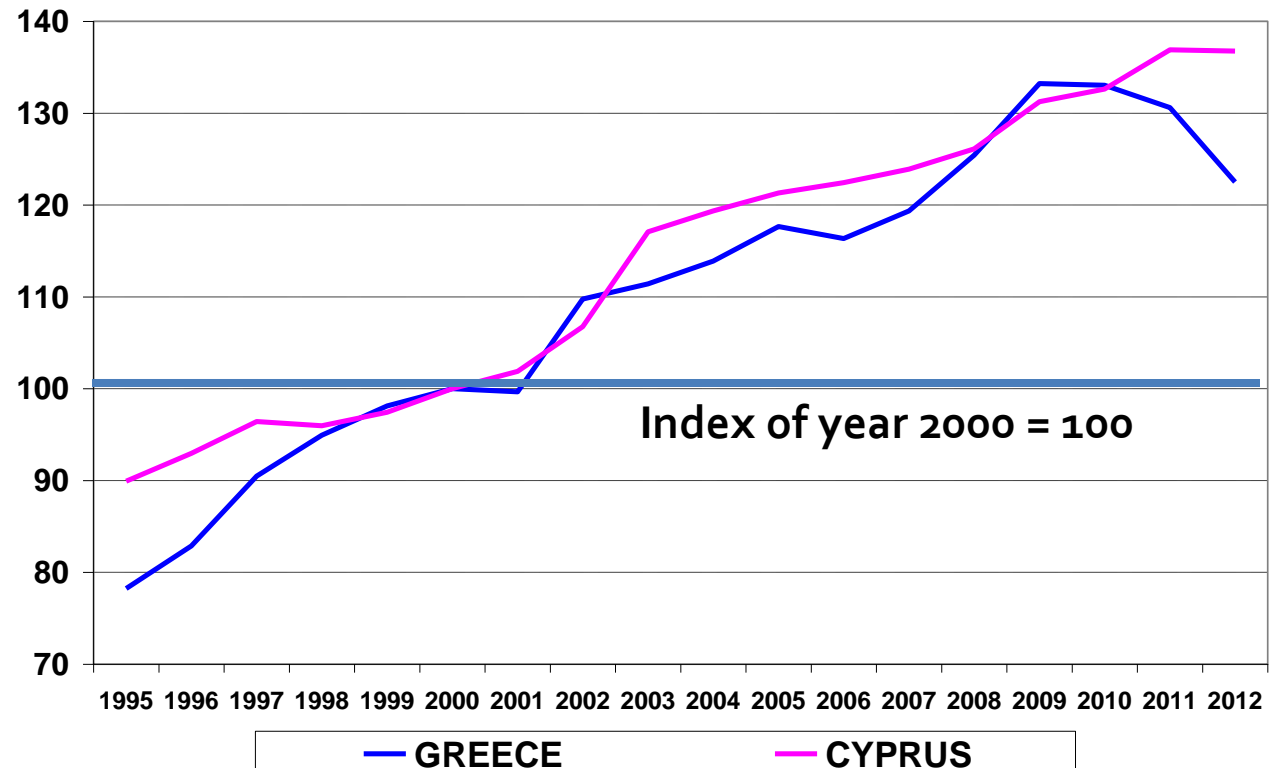
Source: European Commission

NOMINAL UNIT LABOR COSTS

% Δ	GR	CY	DE	FR	IT	ES	IE	PT	US	EA17	EU27
2000 -											
2009	31.6	28.5	5.6	22.4	31.4	33.8	34.6	26.8	-21.7	21.1	15.0
2009 -											
2012	-10.0	4.4	3.1	4.2	2.4	-6.4	-10.4	-5.5	11.5	1.5	4.4

❖ Unit labor costs in Cyprus have adjusted the least (actually worsened) among program countries over the last 3 years

❖ Troika is likely to push hard on this point like it did in Greece



III.

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III. DETERMINANTS OF LONG-TERM ECONOMIC GROWTH

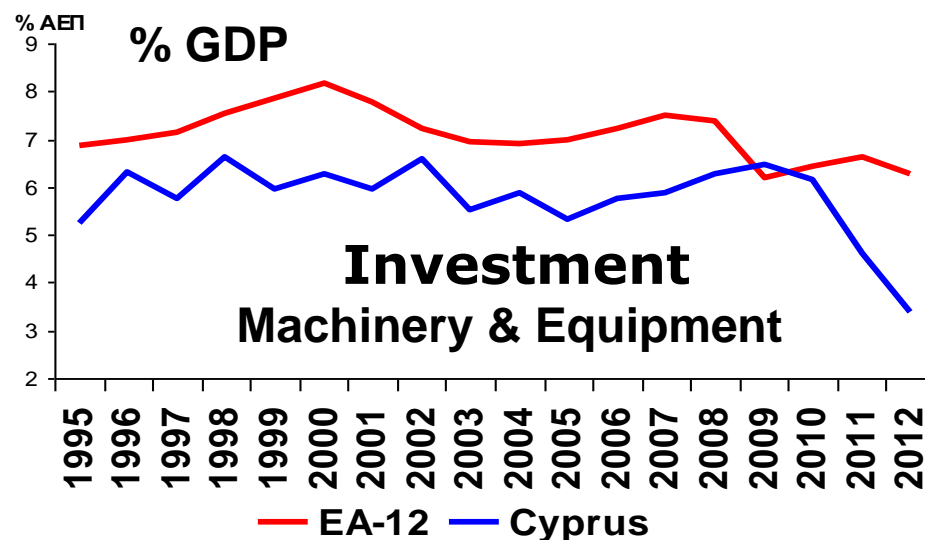
- ❖ In the baseline scenario, Cyprus will begin its new growth path from a much lower point, at 70.7% of EU-15 at best in the beginning of 2015
- ❖ Size of new average growth rate be from 2015-on?
- ❖ What are the driving factors of growth?
The empirical literature makes cross-country comparisons over decade-long time intervals. Variables found important:
 - I. (+) Investment as a % of GDP (affecting size of physical capital)
 - II. (+) Rate of human capital increase, ~ by % population in sec. education
 - III. (-) Initial income, capturing convergence
 - IV. (-) Government consumption, thought not to be productive (e.g. military exp.)
 - V. (-) Inflation, which destroys the price mechanism
 - VI. (-) Real effective exchange rate, showing the competitiveness effect
 - VII. (+) Openness
 - VIII. (+) Quality of institutions
 - IX. (-) FX risk premium in countries that have flexible FX

<u>Cypriot Relative Living Standards</u>	
EU-15=100 in PPS	
1991	67.2
1995	75.4
2000	76.0
2005	82.3
2009	90.6
2012	82.6
2014	70.7

III. CYPRUS NEEDS TO ADDRESS MANY FACTORS THAT AFFECT LONG-TERM ECONOMIC GROWTH

1. Investment ought to be a top priority, now emphasizing the energy sector
2. Cost competitiveness needs a major boost, as shown by the rising ULCs
3. The trend in the share of government consumption needs to be reversed. It **increased**, from 17.9% in 2000-2008 to 20.1% in 2012.
4. Staying in the Euro is a major plus for export-oriented business and for shielding the gas project's potential, but to stay in the Euro, Cyprus has to adhere to the Programme

	<u>Cyprus</u>	<u>EA-12</u>
1. <u>Investment</u> (% GDP)		
2001-2009	19.5	20.7
2012	12.8	18.4



Source: European Commission

III. CYPRUS DOES HAVE RELATIVELY STRONG INSTITUTIONS & OTHER ADVANTAGES

- ❖ Strong institutions when compared to Greece, particularly an effective public sector relative to what exists in EU-12
- ❖ A more unified population than in Greece: Cypriots have gone through dramatic changes in the past and have shown composure & adaptivity
- ❖ The potential to develop the energy sector, which is not counted in the MoU and could push investment activity and employment in the intermediate run before the cash starts flowing in

	<u>Cyprus</u>	<u>EA-12</u>
1. <u>Corruption Perceptions Index</u> 2012 (0-100)	66.0	68.6
2. <u>Rule of Law</u> 2011 (score -2,5 to 2,5)	1.06	1.41
3. <u>Government Effectiveness</u> 2011 (score -2,5 to 2,5)	1.53	1.36

Source: EUROSTAT, Transparency International, World Bank

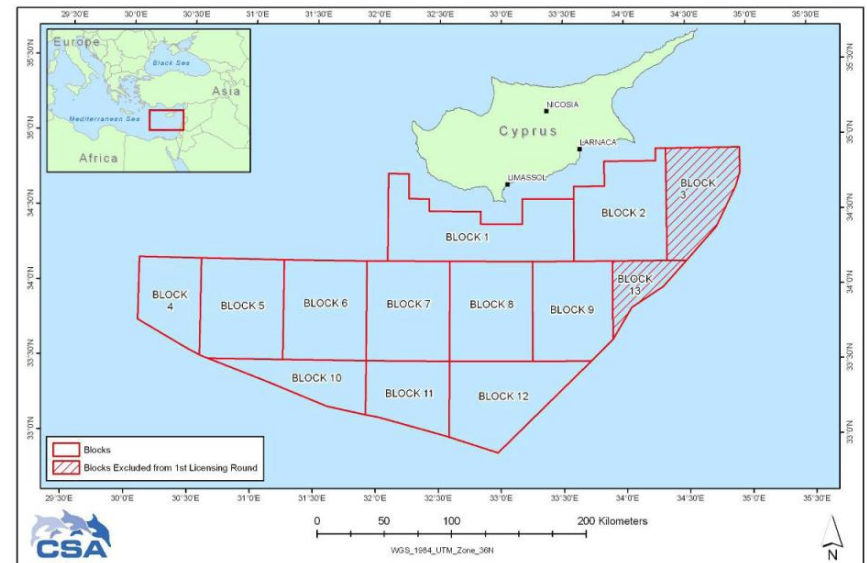
III. FROM AN INTERNATIONAL BUSINESS HUB TO A HYDROCARBONS EXPLORATION CENTER?

- **Block 12:** Noble Energy reported significant natural gas findings 5-8 trillion cubic feet (tcf) with a gross mean of 7tcf in Dec 2011. Confirmatory drilling is still pending
- **Blocks 2, 3 and 9:** Signed contracts with the ENI/KOGAS consortium in Jan2013. The first indications point to a bigger reserve than Block 12.
- **Blocks 10 and 11:** Signed contracts with French TOTAL in Feb2013.
- Based on geological data, KRETYK estimates that gas reserves within the six auctioned blocks of the Cypriot EEZ could amount up to 40 tcf and may translate into €4bn per year in direct government revenue
- **Significant infrastructure investments required:** The construction of a gas pipeline to the coast and a liquefied natural gas (LNG) plant plus other gas facilities in the Vasilikos area on the southern coast would cost approximately €10-12 bn

A novel opportunity for the island:

Benefits from gas exploitation are not limited to licensing fees, direct sales revenue and related investments but can also span the whole economy due to positive spillover effects. Making Cyprus an important offshore energy hub will help the island accumulate more geopolitical power within the broader region.

Downside risks: 1) Uncertainties over volumes and future price of gas 2) Geopolitical risks



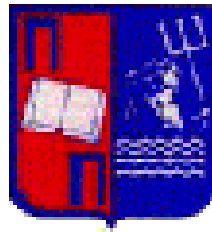
Source: Cyprus Shipping Association, Ministry of Energy & Industry of Cyprus Republic, KRETYK

SUMMARY: A MINIMUM RECIPE

- ❖ Try to reach the widest possible agreement or even unanimity on basic geostrategic choices, like being a member of the Euro Area, and once you make this choice, do not look back
- ❖ Be aggressive in keeping the Cypriot international comparative advantages, e.g. low corporate taxes (12.5%)
- ❖ Ensure foreign interests operating in Cyprus continue to use the island for its superb services; be quality and price sensitive and competitive
- ❖ Clarify soon the financial landscape, who owes how much and to whom, what is the eventual loss in each account, etc. and then gradually phase out capital controls in consultation with European partners
- ❖ Agree on an action plan of minimizing the negative impact on those most in need, trying to extract available European funds for it
- ❖ Bite the bullet and implement the MoU structural reforms quickly without procrastination, as the benefits accrue well after their implementation and the probability of V-shaped recovery improves
- ❖ Be aggressive in finding a substitute for the lost financial services, e.g. support a sector like the energy sector that can bring fresh investment and employment opportunities in the intermediate run

**Thank you
for your attention**

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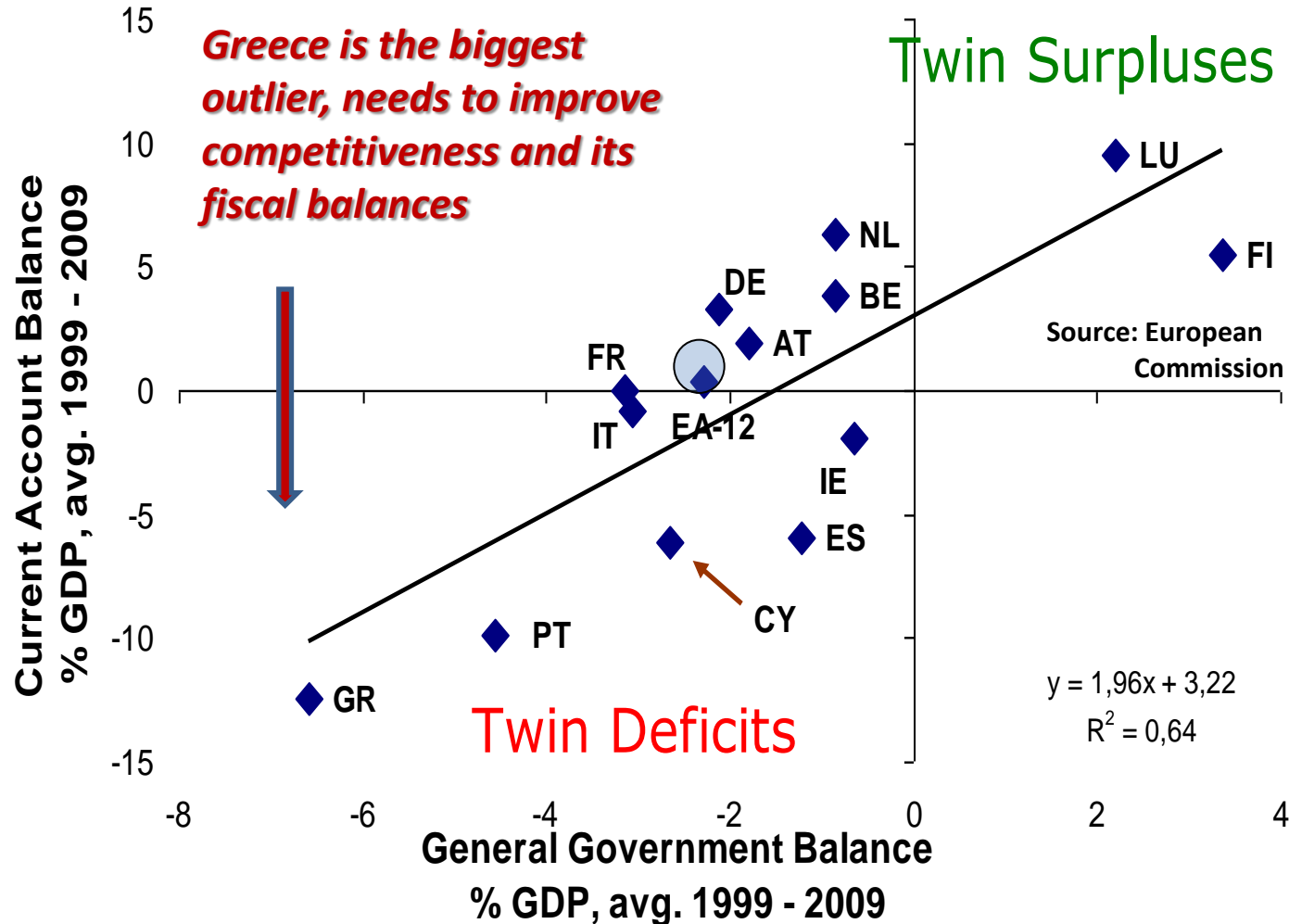
APPENDIX: A BIRD'S EYE VIEW ON CYPRUS

	2012	Cyprus	Greece	EA17
Population (mil.)		0.87	11.3	333.5
Geographical Area (thousand km²)		9,2	132.0	2,624.0
GDP per capita (€)		19,676	17,146	28,460
Human Development Index (2012 UN ranking among 186 countries)		31	29	
Life expectancy (years)		81.2	80.0	79.8
Motor vehicles per 1000 inhabitants (2010)		579	624	593
Suicides / 100 thousand inhabitants (2010)		3.1	2.9	9.1
Primary Sector (% GDP)		2.3	3.4	1.8
Secondary Sector (% GDP)		15.4	16.4	25.2
Tertiary Sector (% GDP)		82.3	80.2	73.1
Tourism (Total contribution, % GDP)		19.4	16.4	8.3
Construction (% GDP)		6.2	2.1	5.9
Public Sector (Prim. Gen. Gov. Exp. % GDP)		46.9	45.4	46.7
Exports (% GDP)		45.5	27.2	45.8
Imports (% GDP)		45.4	32.1	43.1
Private Consumption (% GDP)		66.8	74.6	57.5
Gen. Gov. Debt (% GDP)		86.5	161.6	93.1

APPENDIX: CYPRUS SUFFERED FROM DISEQUILIBRIA, YET NOT AS BAD AS IN GREECE

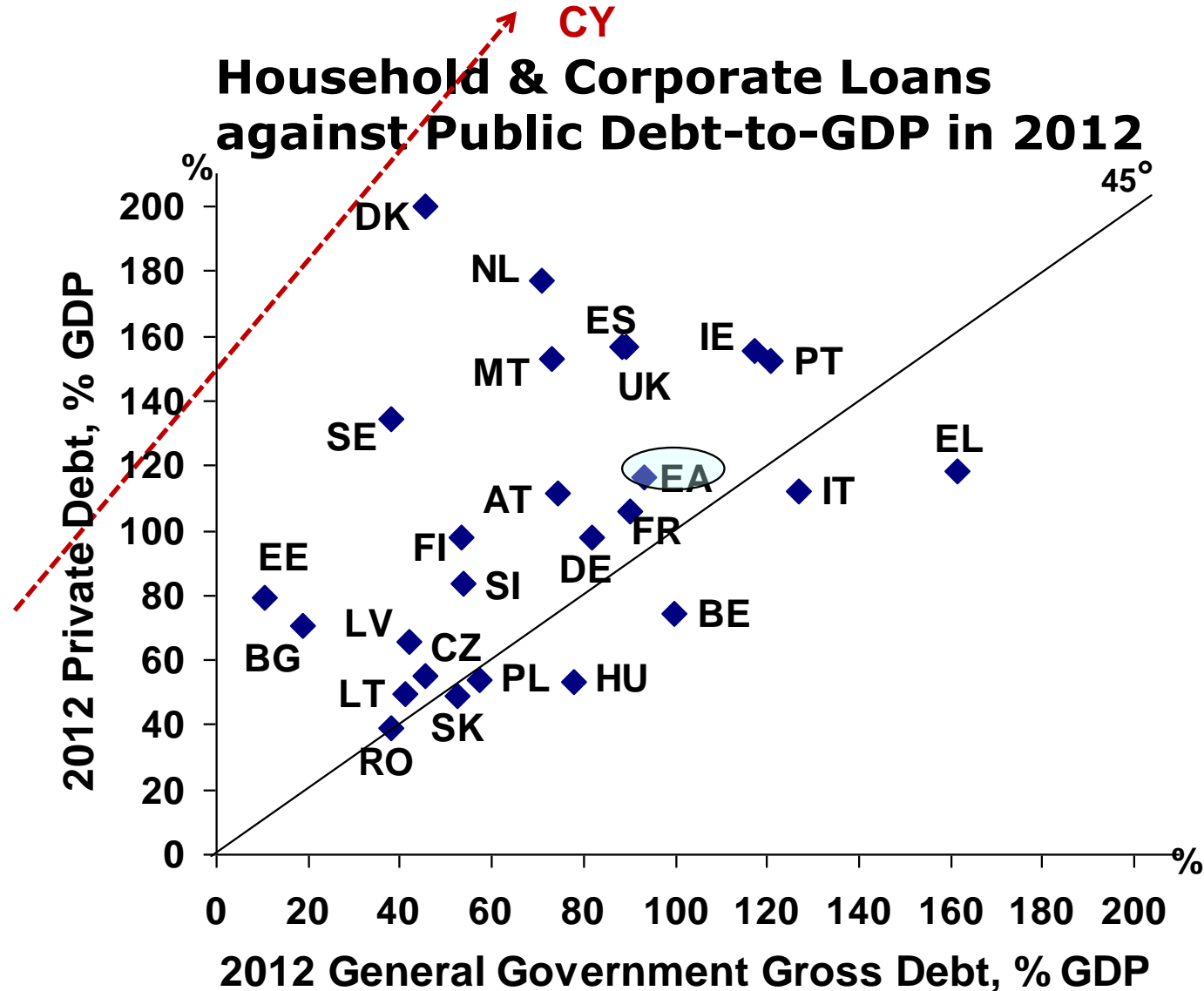
- ❖ Greece suffers from lack of fiscal discipline and competitiveness as shown in the Figure
- ❖ The third leg, the banking crisis in Greece was caused by the state's PSI and the continuing recession that drives up NPLs
- ❖ Post-EMU, a competitive North and an uncompetitive South emerged

Average annual external and fiscal balance in EA-12 before the Greek/EMU crisis hit in early 2010



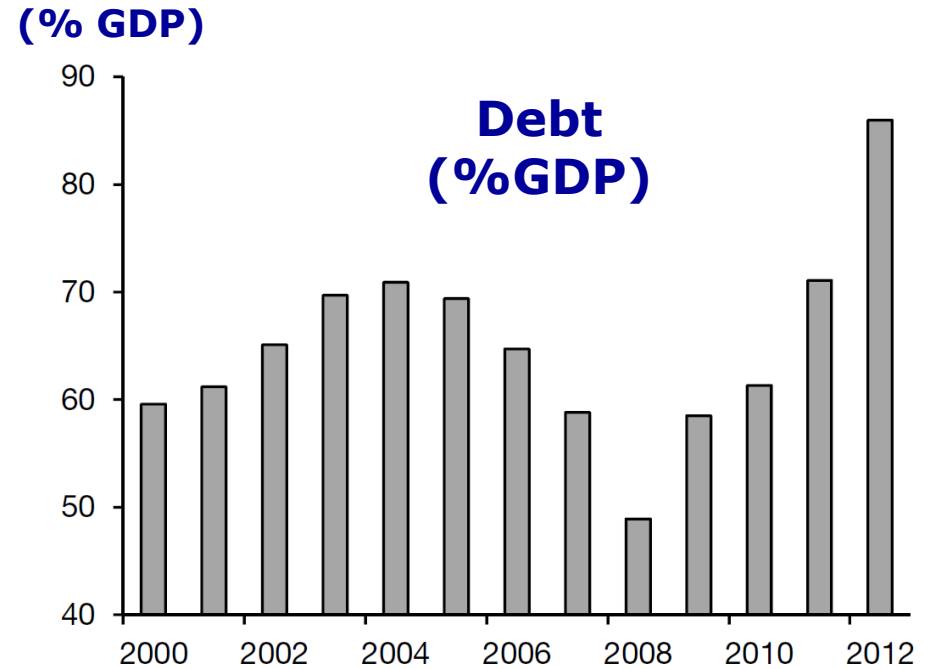
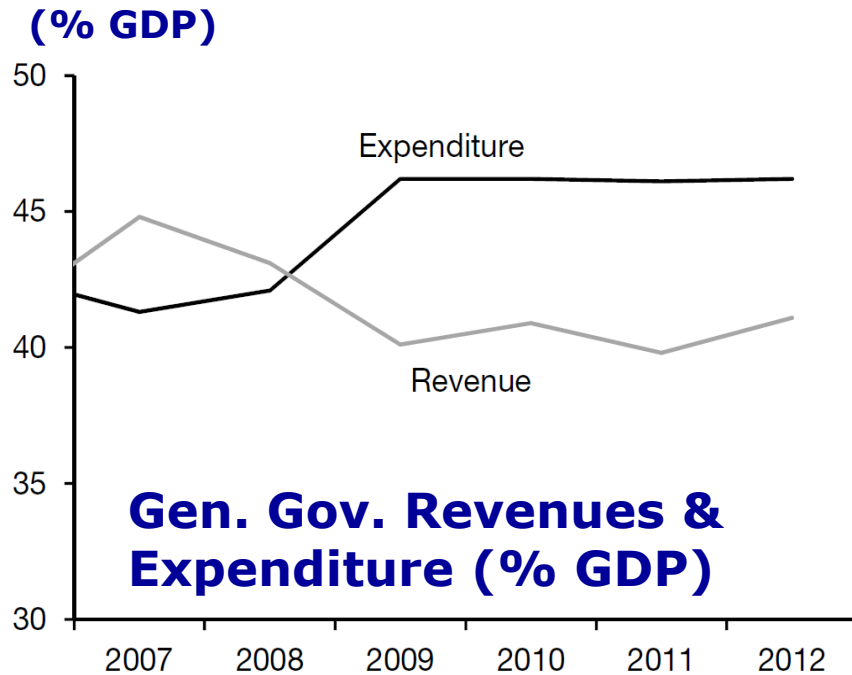
APPENDIX: PRIVATE DEBT WAS NOT A GREEK PROBLEM BUT A CYPRIOT PROBLEM

- ❖ EA Private debt higher than Public debt in 2012
- ❖ Most countries above the 45-degree line: Higher private than public debt
- ❖ In Luxembourg, private debt at 292.6% and public at 20.5%
- ❖ For Cyprus, private debt at 323.6% and public debt at 86.6%
- ❖ Exceptions in the EA are Belgium, Italy & Greece, where Private debt is smaller than Public Debt



Source: EU, ECB

APPENDIX: FISCAL STATISTICS IN CYPRUS



Source: IIF

- ❖ The fiscal picture in Cyprus deteriorated after 2008, going from fiscal surpluses to deficits
- ❖ The DEBT/GDP was very low in 2008 and still remained relatively low in 2011, but in 2012 it begins an upward rise
- ❖ The crisis was not caused by the public sector's deteriorating finances, although its deficits did contribute to the problem

APPENDIX: BANKING STATISTICS IN CYPRUS

❖ Non-residents contribute more to deposits than they absorbed in terms of loans

❖ The distribution of deposits is:

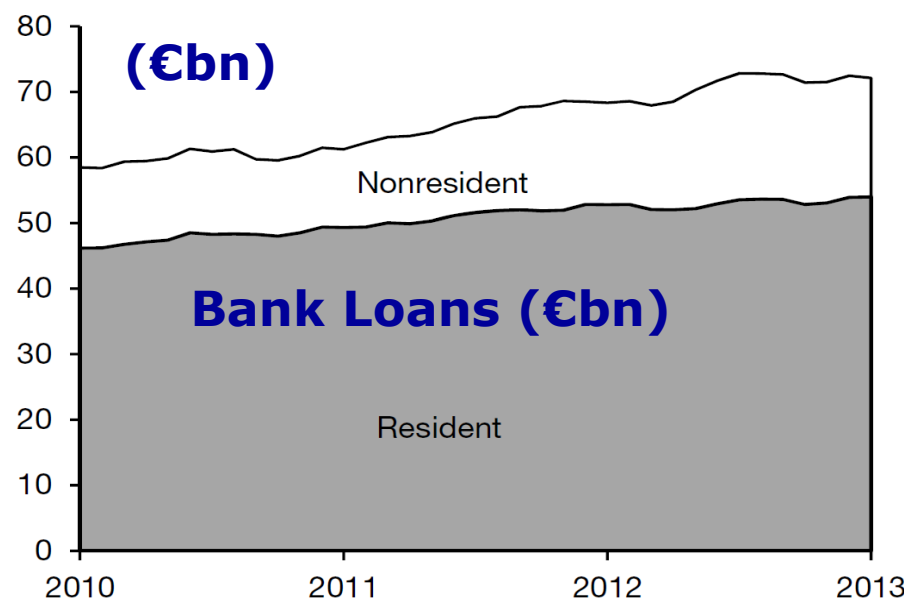
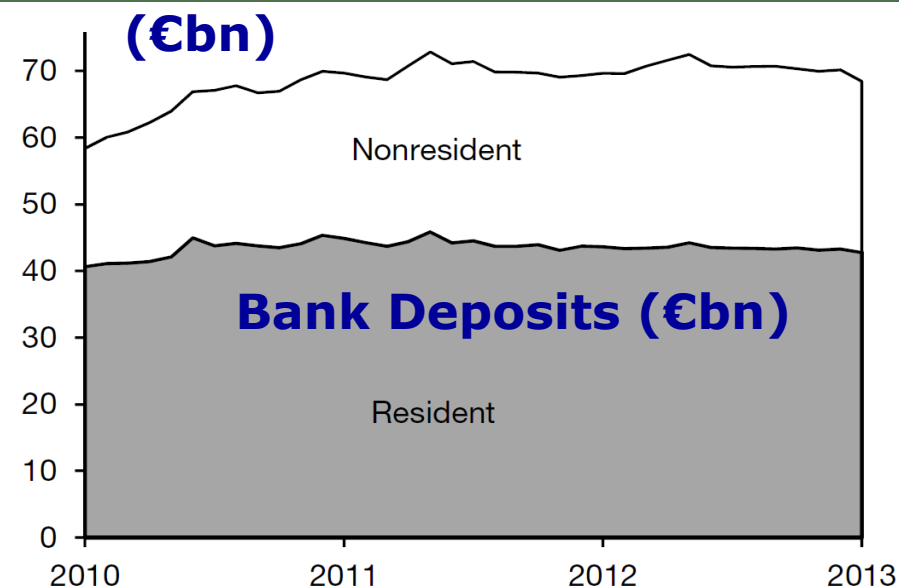
26.7% Bank of Cyprus (€18.71bn),
14.4% Cyprus Popular (€ 10.09bn) &
58.9% the Rest (€41.03bn)

100% is €70.1bn

❖ The distribution of loans is:

22.6% Bank of Cyprus (€15.34bn),
16.1% Cyprus Popular (€ 10.93bn) &
61.3% the Rest (€41.63bn)

100% is €67.9bn



Source: IIF