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Overcoming the crisis in Cyprus

Following the March 2013 bail-in of large bank depositors and the subsequent crisis, Cyprus faces major challenges and risks during 2014 and 2015. The first challenge is to ensure financial stability and lift all capital control restrictions. Another challenge is to move fast with structural reforms, gain credibility in fiscal policy and ensure the recession ends by 2015. The early end of the recession is a prerequisite for no additional strict fiscal measures in 2015, which would derail any hopes of recovery and risk turning the Cypriot recession into a Greek style depression. In parallel, Cypriot policy makers have to redesign their growth model with a renewed emphasis on the island's comparative advantages, less dependence on the banking sector, a balanced current account and government budget, and with investment taking the front seat in policy decisions. Time cannot be wasted and the suggested policy recipe is: (1) Do not waver on the fundamental geostrategic choice of being a member of the Euro Area. (2) Follow the agreed MoU requirements and do not delay the implementation of reforms. (3) Build and follow a tailor-made growth model. (4) Build social consensus on the required policies by ensuring those in need are not left behind.

1. Introduction

Following Greece, Ireland and Portugal, in 2013 Cyprus became the fourth country of the Euro Area to enter into an official borrowing arrangement with the rest of the Euro Area. Yet the Cypriot rescue was extraordinary, the most dramatic among the four. Not only did negotiations last for nine full months, much longer than in any other country, but in the end it appeared the country was short-changed, as it was offered substantially less money than was needed. Europeans insisted that Cypriot bank stakeholders be bailed-in in order to clean up the bank balance sheets with own resources, thus saving future Cypriot tax payers a debt burden of €9.4bn, or approximately 50% of annual Cypriot GDP, and ensuring the Cypriot public debt would be sustainable. The rescue money of €10bn was intended to finance the rest of the economy, including the small and local cooperative banks.

The bail-in decision was novel and quite abrupt compared to the slow pace of European politics. As a result, it did not sail through in a straightforward manner. The first version that came out of the Eurogroup meeting of March 15-16, 2013 was iconoclastic and raised eyebrows across the world, causing panic and turmoil in Cyprus. It was supposed to bail-in even insured depositors, those with deposits of less than €100 thousand and indiscriminately depositors of all banks, healthy or unhealthy ones. The decision represented a major earthquake into the foundations of the deep rooted principle of deposit insurance. Luckily, a week later a second Eurogroup decision was more sensible and spared the small depositors and the depositors of banks that did not require a rescue. In addition, right after the first Eurogroup meeting, in order to avoid a bank run, Cyprus imposed capital controls, declared a temporary bank holiday and deleveraged its banking system abruptly within a week. Within days of the first Eurogroup meeting, it carved out and sold its Greek bank operations to a Greek bank, thus reducing its bank asset size by approximately €23.9bn or 147% of GDP.

At that point, there was an immediate disruption in trading activity with the outside world and in all financial transactions, which added to the negative effects on the economy by the wage and pension cuts that had earlier been instituted together with the 2014 budget. The reshuffling of the large banking sector, the loss of wealth and the capital restrictions generated huge uncertainty. Many feared the recession could take epic proportions. Yet, despite the original fears of March 2013, the subsequent recession turned out less onerous than originally expected, at -5.5% yoy in the first three quarters of 2013, compared to an initial programme forecast of -8.7%. Put differently, given the seriousness of the financial disruption, the Cypriot economy surprised everyone positively in 2013. Uncertainty, of course, remains and is very high and in early 2014 capital controls are still present.

The questions about the future of the economy are many: When will capital controls be lifted and when will stability come back to the financial sector? Will the recession be over in 2015? Will politicians tackle the vested interests and proceed with structural reforms? Would fiscal policy become even more restrictive in the future like it happened in Greece? What will be the sources of growth in the island in the years to come?

The rest of the article is organized as follows: Section 2 takes a look at the evolution of the Cypriot economy since 1999, the date when the Economic and Monetary Union (EMU) was formed in Europe. While growth was high until the international crisis of 2007, a number of imbalances and risks were building up, most notably in the current account, in the size of the banking sector and in the real estate sector. Those imbalances continued and multiplied after 2008, when fiscal laxity became the new norm and investment, private and public collapsed. Section 3 describes the events that led to the crisis of 2013 from the middle of 2012 on. The Cypriot rescue was unique in both its prescription and in the length of its negotiations. The section provides a chronology of the main events which shed light on the process that led to the crisis. Section 4 describes the main risks to the Cypriot economy over the 2014-2015-period. The biggest risk is the stability of the financial sector. Other risks include the length of the recession and the potential damage a restrictive fiscal policy may impose on Cyprus after 2015. Section 5 explores the sources of long-term growth and the steps required to design a new growth model. The same section assesses the probability of Cyprus succeeding to escape the crisis and moving to a new equilibrium growth path. Section 6 concludes, summarizing the main points of the paper and providing a policy recipe for escaping the crisis.

2. Evolution of the Economy up to 2012

To be able to understand today's risks and challenges that Cyprus faces, it is important to acquaint ourselves with the economic environment of the last fifteen years, which set the stage for the calamity of early 2013. A natural point to begin such an investigation is 1999, the year when the Euro Area was created, originally with 11 members. The period 1999-2012 was characterized by two important events for Cyprus. The first was the 2004 Cypriot entrance into the European Union and the second was the 2008 entrance into EMU. Both events provided geostrategic security to Cyprus and forced policy makers to abide by a set of minimum economic principles.[2]

For ease of exposition, it is essential to separate the period 2008-2012, which was dominated first by the international and subsequently by the Euro Area crisis, from the earlier and quieter period 1999-2007, characterized by high growth and low inflation globally.

2.a The period of rising living standards up to the international crisis

Table 1 shows that Cyprus enjoyed a very rapid rate of growth in economic activity from 1999 until 2007, the year the international financial crisis began. Cyprus had an average real growth rate of 3.9% and average unemployment of 4.3%, the third lowest in EU-27. During those years, a good dose of fiscal discipline characterized its public finances. The average general government balance was -2.7% of GDP, below the Maastricht limit of 3%, and the corresponding average debt at 64.3% and declining over time.

2.b Early vulnerabilities

The high growth of the early years did not occur without underlying vulnerabilities. Those vulnerabilities continue to be present today and represent important risk factors. The first and most important one was a lack of competitiveness, which was manifesting itself in the large current account deficit, which jumped upward in 2004 and even more so in 2007, reaching a peak in 2008 at 12.2% of GDP (Figure 1). The country was not able to export as much as it imported in goods and services. Evidently, the population was consuming beyond its means, i.e., beyond the ability of the domestic economy to support the citizen's ambitious living standards. Apparently, the country's high growth was also based on on-going and unsustainable external borrowing. This discrepancy between means and wants continued over the next five years from 2008 to 2012. The 2013 crisis has put a stop to the large size of external deficits because imports collapsed. Yet, as we see later, competitiveness remains a challenge the country needs to address.

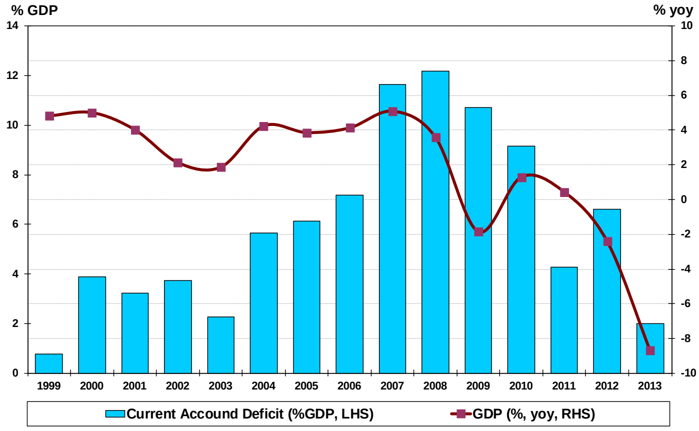
[2] *The expected future economic impact of those two events on the Cypriot economy is described in an early working paper of Kyriacou and Syrichas (1999).*

Table 1
The Cypriot Economy Compared to the EMU Periphery

Average 1999-2012	CY	Euro Area	GR	PT	IR	SP	IT
GDP, %yoy	2,6	1,4	1,0	0,7	3,5	2,1	0,5
Unemployment, %	5,3	9,1	11,7	8,6	7,3	13,7	8,4
Budget Balance, % GDP	-3,4	-2,8	-7,4	-5,1	-4,2	-3,1	-3,2
Public Debt, % GDP	64,7	74,2	117,7	72,9	50,6	54,0	110,6
Current Account, % GDP	-6,2	0,4	-12,0	-9,1	-1,0	-5,4	-1,1
Average 1999-2007	**CY**	**Euro Area**	**GR**	**PT**	**IR**	**SP**	**IT**
GDP, %yoy	3,9	2,3	4,0	1,8	6,3	3,7	1,5
Unemployment, %	4,3	8,7	10,2	6,7	4,5	10,6	8,4
Budget Balance, % GDP	-2,7	-1,9	-5,3	-4,1	1,6	0,2	-2,9
Public Debt, % GDP	64,3	69,1	103,3	59,9	31,9	49,4	106,5
Current Account, % GDP	-4,9	0,4	-11,8	-9,4	-1,4	-5,7	-0,4
Average 2008-2012	**CY**	**Euro Area**	**GR**	**PT**	**IR**	**SP**	**IT**
GDP, %yoy	0,2	-0,2	-4,4	-1,1	-1,5	-0,9	-1,4
Unemployment, %	7,0	9,8	14,4	12,0	12,3	19,2	8,4
Budget Balance, % GDP	-4,6	-4,5	-11,0	-6,9	-14,6	-9,1	-3,8
Public Debt, % GDP	65,4	83,3	143,6	96,3	84,2	62,4	117,9
Current Account, % GDP	-8,6	0,4	-12,4	-8,6	-0,2	-4,8	-2,4

Source: *Eurostat, IMF World Economic Outlook, Eurobank Research.*
Note: *CY=Cyprus, GR=Greece, PT= Portugal, IR=Ireland, SP=Spain, IT= Italy. GDP reflects real GDP and the growth is annual.*

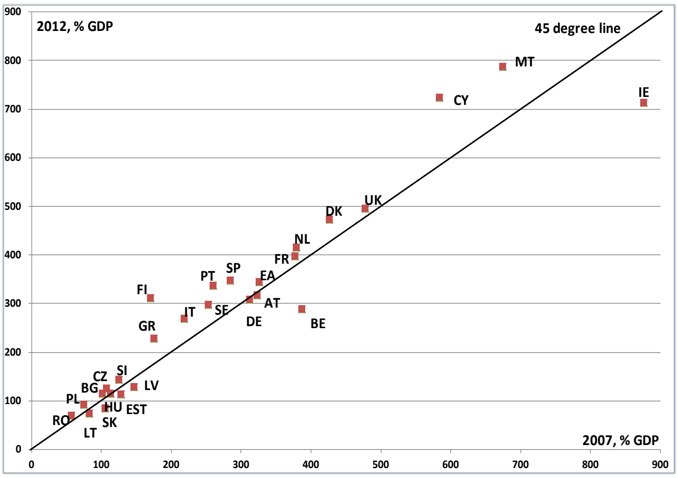
Figure 1
Economic Growth & the External Deficit



Source: *Eurostat, Eurobank Research*
Note: *Annual real GDP growth is depicted on the right axis. The current account deficit as a % of nominal GDP is drawn in columns and depicted on the left axis.*

A second vulnerability was the large size of the financial sector (Figure 2a). At the end of 2007, banks' assets operating in Cyprus were close to six times the size of Cypriot GDP. Only Malta and Ireland had a bit larger banking sectors, while Luxemburg, a much smaller state, had a whopping multiple of 31.1 and is outside the perimeter of the Figure. While a large banking sector does not automatically imply instability, it does become a potential vulnerability. This is because any mistake in bank management, which results in losses to stockholders beyond their ability to absorb them, gets multiplied effectively by a factor of six when it reaches the pocket of the average Cypriot tax payer. This is because there are relatively few taxpayers for the huge balance sheets the Cypriot banks manage. As shown in Figure 2a, the size of the banking sector continued to grow in the later years and at the end of 2012 it represented 7.2% of GDP. The expansion included overseas banking in Eastern Europe, in Russia, Romania and Serbia. Then in 2013, the vulnerability morphed into today's crisis. Currently, the financial sector risk is the most dramatic risk that the economy faces.

Figure 2a
Size of the Banking Sector across the EU-27
(Assets, % of GDP)

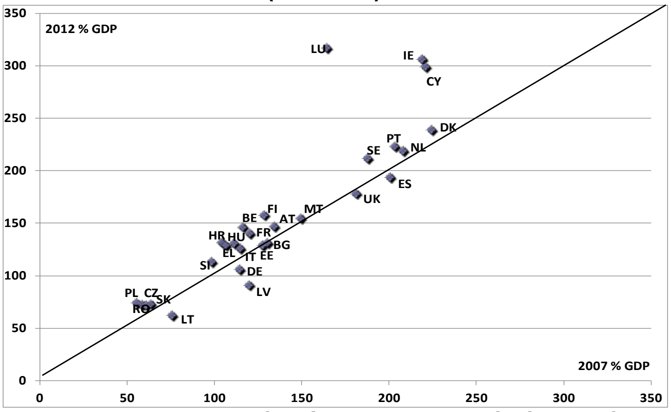


Source: *ECB, Eurostat, Eurobank Research.*
Note: *The recorded assets include the assets of the domestically regulated banking system plus those of the domestic branches of foreign banks. Luxemburg is not shown in the graph. Its assets stood at 31.1 times GDP in 2007 and 22.4 times in 2012.*

Another aspect of the large size of the domestic banking sector is a corresponding high leverage of the domestic private sector (Figure 2b). Banking activity in Cyprus was not focused exclusively on foreigners. It also facilitated domestic enterprises and households. The size of borrowing by the private sector in Cyprus was overwhelming. At the end of 2007**,** corporate debt stood at 96.9% of GDP and household debt at 101.4% of GDP. This leverage is another hidden vulnerability, which grew bigger over the following years, reaching 139.2% and 134.8% of GDP respectively at the end of 2012.[3] This vulnerability easily morphs into an overwhelming financial risk once a negative financial shock occurs, like it did in early 2013.

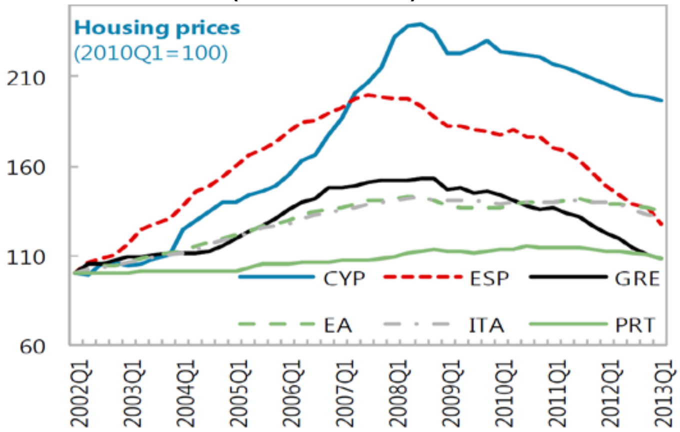
[3] *The private sector leverage data in Figure 2b come from the Eurostat MIP Scoreboards 2007, 2012, and include securities issued by the private sector as well.*

Figure 2b
Private sector leverage across EU-27
(% of GDP)



Source: Eurostat MIP Scoreboards 2007 & 2012, Eurobank Research
Note: The leverage data include bank loans to companies and households plus securities issued by the private sector

Figure 3
Index of Housing Prices
(Year 2000 = 100)



Source: IMF Country Report No. 13/293, page 30

A third vulnerability arose from the rapid rise of real estate prices. From year 2000 to year 2008, prices more than doubled (Figure 3). Since then, they declined somewhat but not by as much as the corresponding prices in Spain or in other countries fell. Hence, there is a fear today that unless something gets done by the house developers or the Cypriot State to increase demand for housing, a similar fate may fall upon housing prices in Aphrodite's island. A future fall in house prices would affect the collateral values of many bank loans, further deteriorating the health of domestic banks and prolonging the recession. On the positive side, housing transactions continue to take place, albeit their activity is at approximately 40% the activity levels of 2010.[4] Cypriot businessmen are quite active, travelling abroad to find new potential buyers. And the government adopted a new law in 2012, giving residence to foreigners if they brought cash to buy real estate worth €300 thousand.[5]

2.c Additional risks emerge after 2007, as economy slows down

After 2007, an abrupt regime shift occurred both in the rate of economic growth and in economic policy. The international financial crisis and the subsequent Euro Area crisis had a profound negative impact on Cyprus. Naturally, as the international environment worsened, the earlier vulnerabilities and risks grew bigger. Yet more risks emerged. Those new additional risks of the post 2007 period carried the potency to permanently derail the earlier Cypriot economic miracle.

The first additional risk relates to what appears to be reckless public finances. Figure 4a presents the fiscal story concisely in two statistics. It traces the primary fiscal balance (defined as general government revenues minus general government expenditure, excluding interest payments) as a percent of GDP as well as the general government debt as a percent of GDP over the period from year 1999 to future year 2020. The statistics for the period 1999 to 2012 are realizations, for year 2013 are estimates, and for 2014-2020 are the agreed targets between the Cypriot Government and the Troika (IMF/EU Commission/ECB).

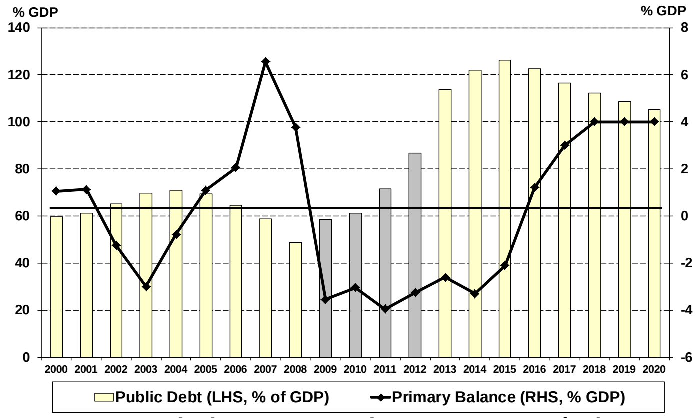
The fiscal statistics in Figure 4a are consistent with the average fiscal data included in earlier Table 1. The figure shows that from 2005 to 2008, Cyprus was running primary surpluses and the ratio of Debt to GDP was declining. Then, during the international crisis, an abrupt change took place in the primary fiscal balance: From a primary surplus of 6.5% GDP in 2007, we witness a decline to a primary surplus of 3.8 % in 2008 and then an overwhelming reduction to a primary deficit of -3.6% of GDP in 2009.[6] The primary deficits remain in the neighborhood of -3% to -4% of GDP for a number of years afterwards, including the years 2013 and 2014. The estimate for 2014 is a target and is set at -3.1% in the November 2013 programme forecast (revised down from -4.3% in July 2013 forecast). Apparently, the Troika is aware of the large negative fiscal multiplier of crisis periods and wants to give some breathing space to the economy, before insisting on the reduction of deficits and the subsequent generation of surpluses.

[4] *See the October 2013 Power Point presentation of the Cypriot Ministry of the National Economy, entitled: "Cyprus: Macroeconomic Outlook."*

[5] *There is an analogous stricter decree by the Council of Ministers for granting citizenship. The most popular of the various steps somebody can take for a citizenship is a fixed deposit of €5mn in a bank for three years coupled with an investment in a property of at least €500K.*

[6] *The data source is AMECO online: http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm*

Figure 4a
General Government Primary Balance and Debt

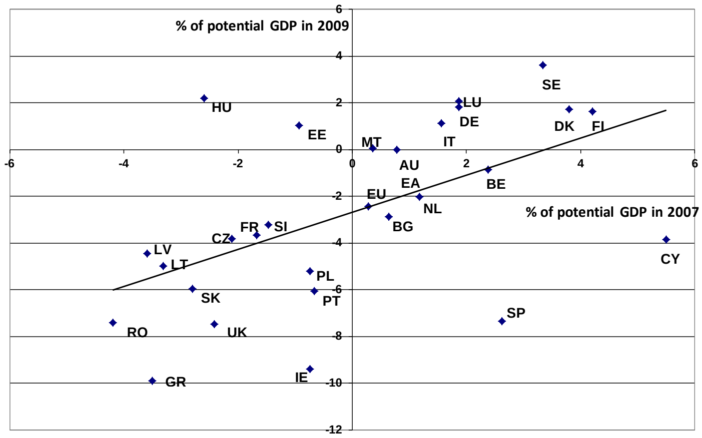


Source: *AMECO database, Economic Adjustment Programme for the forecasts, Eurobank Research*

Year 2009 was unusual in many countries, as they struggled to contain the negative effects of the international financial crisis, using expansionary fiscal policy as one of their tools. It was, in fact, the year world real GDP declined for the first time in recorded history. One should not, therefore, point the blame on the Cypriot fiscal authorities for the rapid fiscal deterioration, without first comparing it to the corresponding deterioration in other European countries. We proceed with such a comparison, utilizing the cyclically adjusted primary balance, so as to neutralize the effects of the size of the economic contraction on the fiscal balances of the time.

Figure 4b lines up the 27 European Union countries on the horizontal axis by the size of the cyclically adjusted primary fiscal balance of year 2007, as a percent of potential GDP. About half the countries in 2007 had cyclically adjusted primary deficits and half had cyclically adjusted primary surpluses. Cyprus had a cyclically adjusted primary surplus of 5.5% of potential GDP, the largest among all 27 countries. Then the vertical axis shows the same balance in 2009. Cyprus now has a cyclically adjusted primary deficit of -3.9%, the 11th worst or the 17th best among the EU-27. Put differently, the ranking dropped from first best to seventeenth best, a drop of 16 places. This drop in ranking actually understates the true relative deterioration. Observe that in Figure 4b the regression line has a positive slope, indicating that countries with 2007 surpluses are likely to have 2009 surpluses, i.e., fiscally conservative countries tend to continue being fiscally conservative. Cyprus was such a country in 2007. Based on its pre-crisis fiscal policy it was predicted (by the regression line) to have a cyclically adjusted primary surplus of +1.7%. Instead of the prediction of a surplus, Cyprus delivered a huge deficit. The Cypriot distance from the regression line is -5.5% of potential GDP, the 3rd worst among the 27 EU countries, which is the equivalent to a fall of 23 places in rankings. The conclusion is, therefore, unambiguous: Fiscal laxity characterized year 2009 and beyond.

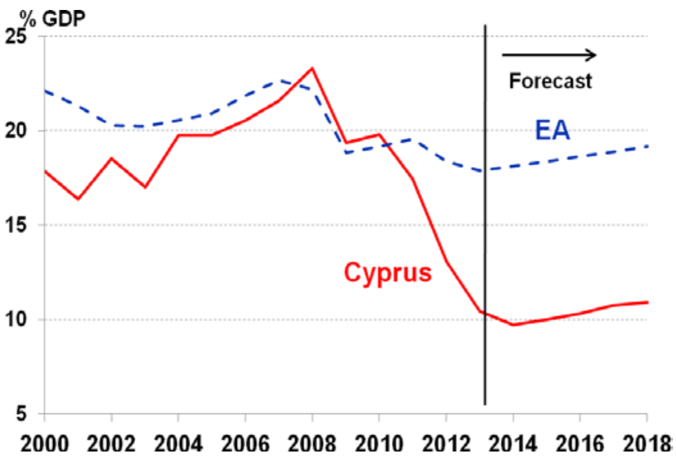
Figure 4b
Cyclically-Adjusted Primary Fiscal Balance
(% Potential GDP)



Source: *European Commission, AMECO data base, Eurobank Research.*
Note: *The cyclical adjustment plus the size of potential GDP is calculated by the European Commission.*

The second additional post-2007 risk relates to investment. Figure 5 shows that after 2008, the share of investment in GDP collapsed. This is not a good omen for the future ability of the economy to produce goods and services, which are necessary for the future generations' incomes and living standards. The collapse is actually present in all components of investment, both private and public, both investment in structures and investment in machinery & equipment. Hence, the real estate sector alone cannot be blamed for the collapse. The collapse in investment represents a clear policy failure, revealing that post-2008, resources were diverted towards consumption of the current generation at the expense of the consumption of future generations, who do not necessarily vote and do not have a voice in Parliament.

Figure 5
Total Investment in Cyprus and in Euro Area
(%GDP)



Source: *Eurobank Research, IMF World Economic Outlook September 2013*

Table 2
Sovereign Spreads over Bunds

	Jun-07 (average) Before Int/nal crisis	Aug-08 (average) Before Lehman collapse	Sep-09 (average) Before Greek crisis)	Jun-11 (average) Before Cyprus Mari accident	May-12 (average) Before Greek elections	15/3/13 Before 1st Eurogroup Cyprus decision	22/3/13 Before 2nd Eurogroup Cyprus decision	28/3/13 The day after Banking Holiday	31/12/13 End 2013
GR	0.24	0.67	1.30	13.81	25.56	9.36	10.59	11.15	6.49
IT	0.21	0.61	0.83	1.93	4.44	3.14	3.17	3.47	2.20
SP	0.06	0.36	0.55	2.59	4.79	3.46	3.49	3.77	2.22
PT	0.19	0.49	0.68	7.98	10.25	4.50	4.66	5.08	4.20
IE	0.06	0.39	1.65	8.54	5.78	2.54	2.79	2.93	1.58
CY		0.44	0.99	5.77	12.52	7.21	12.00	14.02	6.85

Source: Eurobank Research, Bloomberg
Note: Spreads were calculated from the yields of 10-year government bonds of each country vs. those of Germany. For Cyprus, a single bond issue is used with maturity date at 03.02.2020. The spreads reflect either the market close before a specific event or the monthly average before a specific event. See notes of Table 1 for the country initials.

Surprisingly, the share of investment in GDP is not expected to increase much after 2013 (see Figure 5). According to the programme forecasts, total investment as a percentage of GDP is forecasted to rise to 12.3% of GDP in 2020 vs. 11.5% in 2013. These forecasts can only be justified if the Troika does not take into consideration the large investments the country has to make in order to extract from the sea basin and then process the newly discovered natural gas.[7]

2.d Markets deny access to Cyprus following GREXIT fears

Early on during the international crisis, investors were comfortable in holding Cypriot government bonds (CGBs). For a long period during the international crisis and up to the Mari accident in July 2011, the CGB spreads over Bunds were smaller than the equivalent Irish spreads. Unlike Greece, Cyprus was perceived to be an economically stable country, with prudent public finances, low government debt, low corporate tax rates and an efficient state bureaucracy. The relative fiscal laxity, which began in 2008, was not recognized by the markets at the time.

It was the Mari accident in July 2011 and the simultaneous Greek and Euro Area crisis that alerted markets to Cyprus. The discussions of a Private Sector Initiative (PSI) for Greek bonds, which began in the summer of 2011, brought Cyprus under increased scrutiny, as market participants became increasingly aware of the large Greek Government Bond holdings of Cypriot banks, the large portfolio of Cypriot bank loans to Greek customers, and the large exposure of Cyprus to Greece via trade links in many other sectors of the economy. After all, 20% of total Cypriot trade in goods is with Greece. That summer, discussions of Greece leaving the Euro Area (GREXIT) were frequent in the media and spreads of all countries in the European Periphery had widened. A GREXIT created the threat of an eventual Euro Area break up. The market was asking the question which country would be next in line to exit, etc.

In October 2011, conditions in the Cypriot private banking sector were becoming stressful as well. One Cypriot bank (Cyprus Popular Bank or Laiki-Marfin) began using the Extraordinary Liquidity Assistance (ELA) mechanism in a massive way, as it apparently ran out of good quality collateral. As a result, official statistics show that total ELA borrowing by all banks jumped from €0.1bn in August to €2.7bn in October. Total bank borrowing from the Eurosystem, including ELA, had jumped from €5.8bn in August to €8.0bn in October, a size close to half the country's GDP (Figure 8). It was the first red alert on a specific bank.

The rising spreads and the difficulty of accessing the international capital markets led the Cypriot government to seek alternative sources of financing. Soon, in December 2011, Cyprus succeeded in securing a €2.5bn loan from the Russian Federation, with a maturity of 4.5 years and a coupon rate of 4.5%, which was disbursed in early 2012.[8]

The first rating agency to downgrade Cyprus to a below investment grade status was Standard & Poor's. It brought its rating to BB+ on January 13, 2012. Moody's followed on March

[7] *AMECO Autumn forecasts cover the period only until 2015. The forecasts in Figure 5 originate from the IMF World Economic Outlook of September 2013.*

[8] *Apparently, Europeans did worry about the Cypriot financing problem at the time. In his letter to President Nicos Anastasiades of April 15, 2013, EU Commission President Jose-Manuel Barroso writes "… As far back as November 2011 we spoke to your predecessor about the need of Cyprus to enter into a macro economic assistance program…"*

13, 2012, with a below-investment grade rating of Ba1. Fitch was the last one. It downgraded Cyprus on June 25, 2012 with a below investment grade rating of BB+.

The terms of the Greek PSI were finalized in February 2012. Holders of GGBs lost 78% of the face value. Greek banks were amongst the major losers. For this reason, Greece received an extra €50bn by the Troika in order to liquidate the non-viable banks and recapitalize the viable ones. The Cypriot banks in Greece were branches, not subsidiaries, and were thus under the auspices of the Central Bank of Cyprus. They could not participate in the same rescue. Despite the large Cypriot bank exposure to GGBs, which was close to € 5.7bn, no separate rescue was apparently contemplated for them.[9]

By the time of the first Greek elections in May 2012, when GREXIT fears reached their maximum, Cypriot spreads had risen to 12.5%, being smaller only to Greek spreads. Cyprus was considered to be a country with the highest probability of exiting the Euro Area following Greece.

After the second Greek elections in June 2012, a stable pro-EMU government coalition was formed in Greece and GREXIT fears subsided. Mario Draghi delivered his famous July London speech that he would do "*whatever it takes*" to save the Euro Area. Markets were persuaded that the Euro Area will survive and spreads in the European Periphery declined, including the Cypriot ones.

During the Cypriot Presidency of the European Union from July to December 2012, the spreads, although lower than in May 2012, continued to be prohibitive for government borrowing from the international markets. The fundamental economic disequilibria we discussed earlier, i.e., lack of competitiveness, fiscal laxity, a real estate bubble, a low investment rate plus a huge banking sector that suffered losses and in obvious need for liquidity and capital, had become apparent to everyone and markets were demanding drastic action. Yet, the government could not deliver a swift and persuasive response to those disequilibria, some of which were partly the result of its own policies. It appeared to be dragging its feet, prolonging the negotiations of the Memorandum of Understanding, a procrastination task made easier through its holding of the Presidency of the European Union.

In the pre-election atmosphere of the autumn of 2012, the procrastination was convenient for the Cypriot government. From the lenders' perspective, it was tolerable, as a new government with a longer political horizon would be able to execute the agreement more credibly after the Cypriot Presidential elections of February 2013. Yet, with the benefit of hindsight, it is now clear that the procrastination was a mistake on the part of the Cypriots, as it allowed the European hardliners to come up with a plan for a very drastic rescue solution, while Cypriots were preoccupied with their domestic elections. President Christofias himself, apparently unable to offer solutions to the difficult situation Cyprus was in, decided to escape the political heat by abstaining from being a candidate.

3. The slippery path to the Cypriot crisis

3.1 Lengthy negotiations up to the February 2013 elections

Perhaps the first sign of trouble in Cyprus came in May 2012, when the term of office of the Governor of the Central Bank, Mr. Orphanides, expired but was not renewed by President Christofias. The Orphanides dismissal was due to major differences between the two men regarding the handling of the banks and the economy, yet it dealt a major blow to the negotiating power of Cyprus as Mr. Orphanides was well respected at the ECB and his opinion carried important weight.[10]

A month later, trouble became more concrete. Recall that Cyprus had a big exposure to Greece; hence discussions of requesting official assistance were very frequent after the Greek PSI and, particularly, in May/June 2012 when GREXIT fears rose, leading the Cypriot spreads to 14%. Thus, when on June 25, 2012, the third in a row rating agency, Fitch, also downgraded Cyprus into non-investment grade, danger was at the door step: The downgrading would immediately imply a loss of cheap ECB financing for the Cypriot banking sector. Facing the threat, the Cypriot government responded quickly and officially announced to the European Authorities its decision to finally request financial assistance from the EFSF/ESM.[11]

In July 2012, the first month of the Cypriot Presidency of the European Union, the Troika (EC/ECB/IMF) visited Cyprus twice in order to review the domestic economy and assess the country's

[9] *This issue has become a political hot potato in Cyprus today, first as to whether or not there was an effort to secure a loan similar to the Greek one at the time of the Greek PSI, and second, about who is primarily responsible for the involvement of Marfin bank in Cyprus Popular Bank (or Laiki). Later in the same winter of 2012, Laiki bank did try to tap into the Greek fund of €50bn, but the European banking rules on bank branches did not allow its participation.*

[10] *From their subsequent public statements, we know that President Christofias held Mr. Orphanides responsible for not containing the excesses of the Cypriot banking system, which in his view led to the crisis, while Mr. Orphanides has argued Mr. Christofias never acted on his early warnings about the banking problems, neither did he try to protect the Cypriot banks from the consequences of the Greek PSI, and that it was the inadequacies of his government and, in particular, the fiscal laxity that brought the crisis.*

[11] *At the end of June 2012, total Eurosystem borrowing of Cypriot banks jumped to €13.2bn from €11.8 in May, an increase of €1.4bn. Interestingly, this change consists of a decline in regular and cheap ECB borrowing by €0.9bn and an increase in the more expensive ELA borrowing of €2.3bn. See Figure 10. See also* http://www.reuters.com/article/2012/06/26/us-cyprus-ecb-idUSBRE85P13G20120626

financial needs. Reportedly, the troika found more than the suspected banking problem: The country's fiscal prospects and growth outlook were a lot worse than was earlier expected.[12]

The Troika mission submitted the terms of the bail-out program on July 25, 2012. The Cypriot government expressed disagreement over those terms and continued negotiations with Troika representatives throughout the following months. During the same period, on September 27, the Central Bank of Cyprus commissioned PIMCO and Deloitte to proceed with an independent due diligence exercise of the local banking system, which included an asset quality review and a bottom-up stress test to determine the capital needs of each banking institution**.**

On November 22, the Christofias administration announced that the Cypriot Government converged with the Troika on the MoU terms with only the amount of funds required for the recapitalization of the banking sector remaining to be agreed upon. On a less positive tone, the IMF simply cited "*good progress towards an agreement*".[13] No document was officially presented at that time. Instead, on November 30, a "preliminary MoU agreement" was leaked to the press. The leaked preliminary fiscal consolidation package included cuts in civil service salaries and headcount via hiring freeze, cuts in social benefits, in allowances and pensions, and increases in VAT on tobacco, alcohol and fuel taxes, taxes on lottery winnings and on property, and higher public health care charges. Out of the total fiscal adjustment of 7.25ppts of GDP envisaged for the period 2012-2016, the unofficial preliminary MoU specified in detail some 5.25ppts.

At this stage, Cypriots acted in a united way. They were not split between those for and those against the MoU, like it had happened earlier in Greece. The Cypriot parliament approved the bulk of the measures as part of the budget adoption of 2013 and the medium term fiscal plan. Outside observers were thus reassured that the Cypriots would be able to handle the prospective measures that accompanied the rescue package a lot more efficiently than Greeks ever did their own.

Meanwhile in November and December 2012, the German press was inundated with caustic articles about Cypriot banks and alleged money laundering. Most newspapers would quote the German foreign intelligence agency, BND, which presumably had circulated a damaging report on Cyprus and its money laundering activities, claiming that Russian oligarchs have deposited $26 billion (€20.25 billion) in Cypriot banks, an amount greater than the island's annual gross domestic product. These deposits, according to the press reports, would be guaranteed if European bailout money were paid to shore up the island's banks.[14] Cypriots answered the accusations, citing the European inspections and relevant official reports on the issue, yet they seemed to have lost the game of public relations / image with the European public and European policy makers.[15] With the benefit of hindsight, it seems the German and European public and elite were been prepared for the bail-in that was to come, something to which Cypriots were oblivious at the time, as they were focused on the domestic pre-election campaign.[16]

On December 13, 2012, the Euro-Group statement took notice of the progress made at the staff level in the drafting of a MoU, which foresaw significant financial, fiscal and structural adjustment. No hint of a bail-in in the official announcement.[17] The next Euro-Group statement of January 21, 2013 did not even mention Cyprus.

In mid-December, the interim results of the PIMCO/Deloitte due diligence exercise on the capital needs of the Cypriot banking sector were submitted to the authorities. The final results were expected in mid-January 2013.[18]

Examining the behavior of bank depositors at the end of 2012, it seems that non-residents were more worried about the safety of their deposits in Cypriot banks than residents were. Perhaps this was because more of the non-residents held large uninsured deposit accounts than residents did. In January 2013, bank deposits posted the largest monthly decline of the recent history up to that point. From €70.2bn at the end of December, total deposits dropped to €68.4bn at the end of January, a drop of €1.8bn or -2.5%. The drop was due to a drop of €0.53bn (or -

[12] *For a more detailed analysis of the events of that period, please see:* http://www.eurobank.gr/Uploads/Reports/Cyprus%20June%202012.pdf

[13] http://www.imf.org/external/np/sec/pr/2012/pr12457.htm

[14] *A first critique came from the weekly magazine Der Spiegel in early November. See* http://www.spiegel.de/international/europe/german-spy-agency-says-cyprus-bailout-would-help-russian-oligarchs-a-865291.html

[15] *An external audit of the banking system was subsequently performed as a result of the unofficial accusations. Deloitte Italy and Moneyval did a thorough review in March-April 2013 and concluded the accusations were not even near reality. Yet, the damage on the Cypriot image was done.*

[16] *Apparently, the topic was being discussed at the Euro-Group level, as the electronic form of the Wall Street Journal of March 4, 2013 reported: "At a euro-zone finance ministers' gathering in Brussels on Dec. 3, Maria Fekter, a blunt Austrian with little time for collegial niceties, captured the mood in the currency union over the prospect of bailing out Cyprus. "What about the Russians and their fake companies laundering their cash through your banks?" she asked her Cypriot counterpart at the time, according to two people present at the closed-door meeting. "Are we giving them our taxpayers' money too?"" See* http://online.wsj.com/article/SB10001424127887323452204578292541738312974.html#printMode

[17] http://eurozone.europa.eu/newsroom/news/2012/12/eurogroup-statement/

[18] *The final results were officially announced on April 19th, see* http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12750

1.2%) by domestic residents, €0.57bn by other euro area residents (or -10.8%) and €0.64bn (or -3.0%) by non-euro area foreigners.

An awakening call came on Monday morning, February 11, 2013, the day when the February Euro-Group meeting began in the afternoon. The *Financial Times* published a shocking lead article, entitled: "Radical rescue proposed for Cyprus."[19] The article cited a "*strictly confidential*" memorandum, which was allegedly distributed to Euro Area officials the earlier week. The memorandum contained three options for shrinking the Cypriot banking sector, one of which was a radical "*bail-in*" option that would reduce Cyprus' outstanding debt to just 77% of GDP instead of the 140% in a full bail-out plan.[20] According to the FT, the memo warned that the risks of the bail-in option are significant, including a renewed danger of contagion in Euro Area financial markets and premature collapse of the Cypriot banking sector. Yet, despite this blow-whistling article, the Euro-Group statement of that day revealed that Ministers of Finance had simply postponed the decision on the rescue details, stating that they would like to see an independent assessment of the implementation of rules for financial institutions in order to reach a decision for the new program in March, after the completion of the Presidential elections on the island. Euro-Group was obviously buying time, waiting for the election results and the new government.

The bail-in issue was sidetracked in Cyprus due to the pre-election campaigns. The hot issue at the time seemed to be the topic of privatizations. Politics pushed almost everyone to adopt an anti-privatizations stance with different shades of strength. The first round of Presidential elections on February 17 did not decide the winner, as no candidate collected an absolute majority of votes. After the second round on February 24, current President Anastasiades earned 55% and his administration was sworn in on February 28.[21]

3.2 A new government, a proposed bail-in and capital controls

During February, the bail-in issue continued to be more worrisome to Euro Area residents who were not Cypriots rather than Cypriots themselves. Their deposits declined by -18.1%, following the already large January decline of -10.8%. Cypriots only withdrew -0.4% of their deposits and non-Euro Area foreigners actually increased their deposits slightly by 0.5%. Yet, the risk of a bank run must have worried policy-makers right after the government was sworn in. In his first speech in Parliament on March 1, President Anastasiades claimed he "*… would not accept any reference to a deposit haircut.*"[22] Newly appointed Finance Minister Michael Sarris, addressing the domestic media a few day later, on March 7, expanded on the issue and claimed that *"… a deposit haircut is not an option because it would be disastrous not only for Cyprus but for the Euro Area as well."*[23]

The much awaited March Euro-Group meeting took place on a Friday night – Saturday morning of the 15-16, less than three weeks following the formation of the new government. Given the crucial decisions to be taken on the Cypriot MoU, the Minister of Finance was accompanied by the President. The discussions seem to have taken the newly formed government by surprise but the details of what exactly went on during the meeting have not fully emerged yet. Europeans were unwilling to bail-out the banking system (and the large Russian depositors, as many newspapers wrote later) with tax-payer money and essentially offered only a €10bn rescue loan to the Cypriot government for supporting the rest of the economy and the small cooperative banks. This way, in their view, the public debt burden would not increase out of control.

Most of the deliberations that night were apparently consumed on the topic of who will bear the burden of financing the banking system, i.e. the details of the bail-in. The final agreement "bailed in" all bank depositors, both insured and uninsured in all Cypriot banks, in an apparent attempt to collect €5.8bn for liquidating some of the banks and recapitalizing the rest. The agreement foresaw the imposition of a 9.9% levy on bank deposits above the €100k deposit-guarantee threshold, and a 6.75% tax on guaranteed deposits. The package was sweetened later with an exemption for banking accounts below €20k. Meanwhile, over weekend, the Central Bank of Cyprus imposed temporary capital controls on the banking system and declared a bank holiday without announcing the date of bank re-opening. Citizens had the right to withdraw cash only from ATMs, with a maximum of €300 per day.

The decision to bail-in insured depositors sent shock waves across the world, not just within the Euro Area but way beyond its boundaries. This was not a decision by some kind of a dictatorship that confiscated part of the guaranteed deposits. This was supposed to be a collection of democratic governments of advanced nations, which presumably respect

[19] *The authors are Peter Spiegel in Brussels and Quentin Peel in Berlin. See the February 10 electronic version:* *www.ft.com/intl/cms/s/0/1d17a320-736f-11e2-9e92-00144feabdc0.html#axzz2mhvfR0ko*

[20] *The bail-in would shrink the banking sector by a third by 2015 and would involve uninsured depositors, especially from Russia, some of whom have used the island as a tax haven in recent year, writes the newspaper.*

[21] *Mr. Mallas, a candidate supported by the leftist AKEL party, earned 45% of the votes.*

[22] *News media coverage of the speech in the parliament March 1st (in Greek) http://www.tovima.gr/finance/article/?aid=500838*

[23] *See the report in Greek:* http://www.sigmalive.com/simerini/business/news/555581

the rights of citizens and the contracts they sign with them. Policy makers across Asia and Latin America began worrying that their own citizens would not take seriously their own deposit guarantee schemes. Inside Cyprus, the decision unleashed a wave of protests and the plan failed to receive any parliamentary support when it was put to vote on the bank holiday of Tuesday, March 19. Meanwhile Cypriot bond yield spreads increased from 6.82% on March 15, prior to the Euro-Group meeting, to 8.07% on March 18 and 10.22% on March 19.

After the parliamentary rejection of the plan, the Cypriot government moved to hammer out a plan B in order to collect the designated funds for the recapitalization of the banking sector.[24] The plan B attempted to satisfy the official lenders' demands for the participation of depositors in the bail-in scheme and at the same time receive enough parliamentary backing. The plan B was approved by the parliament in the form of nine bills. The most important clauses foresaw the creation of a resolution framework for the banking sector, the establishment of a National Solidarity & Development Fund, the imposition of capital controls and laws amending banking services, special tax on credit institutions and financial crisis management. In addition, the Cypriot government sought unsuccessfully from the Russian government a €5bn new loan and the restructuring of the former one.

The government also began talks of carving out the Greek branches of all Cypriot banks. Indeed, Piraeus Bank was quick to buy all Cypriot operations in Greece, adding to its network 289 new branches, some 5,100 new employees, €23.9bn of loans (before provisions), and €12.5bn of deposits. The sale reduced the asset size of the Cypriot banking system by approximately 147% of GDP, as the Euro group had demanded over the previous weekend. On Tuesday, March 26, all Cypriot branches in Greece opened for business under the new ownership. The possibility of contagion into Greece had been avoided.

3.3 A follow-up Euro-Group in March 2013 reshapes the banking system

In the second Euro-Group meeting of March 25-26, the negotiations about the fate of the banking system were tough and stressful. President Anastasiades was again present. A last minute agreement was reached, just before an ECB ultimatum to discontinue liquidity through the Emergency Liquidity Assistance (ELA) mechanism was about to expire.

With the new Euro-Group agreement, a relative calm returned to the island and the central bank re-opened the banks to the public on Thursday, March 28, almost two weeks after they were last open for business, on Friday, March 15. Of course, bond spreads over bunds were very high, at 14.6% (Table 2**).** Trading on the Cyprus Stock Exchange (CSE) had also been suspended to safeguard the interest of investors while banks were closed. The last trading took place on Friday, March 15. CSE reopened on Tuesday, April 2, and by mid-day, the Hellenic Bank, historically the nation's 3rd largest bank, had sunk 20%. The other two banks, Bank of Cyprus and Cyprus Popular Bank (Laiki), were suspended from trading.

The new agreement called for a comprehensive resolution and restructuring of Cyprus Popular Bank (CPB) and Bank of Cyprus (BoC), the two biggest domestic banks, via a bail-in scheme from uninsured depositors, bondholders and shareholders. The total bailed-in amount turned out to be approximately €9.4bn (Table 3a) and represents future tax payers' savings. No insured depositors (amounts below €100k) would participate in the bail-in, hence the earlier error of almost destroying the concept and reality of deposit insurance was corrected. All insured deposits in all banks were protected in accordance with the relevant EU regulatory framework.

Table 3a
Bail-in Amounts (€ bn)

	BoC	Laiki	Total
Uninsured deposits	3.9	4.0	7.8
Senior debt	0.0	0.1	0.2
Subordinated debt	0.6	0.8	1.3
Total	4.5	4.9	9.4

Source: *IMF Country Report No. 13/293 page 13, Central Bank of Cyprus, Eurobank Research.*

Resolution of CPB was a pre-condition for the program money to flow. CPB was split by the Central Bank into a legacy unit and a second, healthier, unit. The legacy unit took all uninsured deposits and all non-performing loans and remains under special administration.[25] The second unit assumed (i) specific CPB assets at fair value, (ii) all insured CPB deposits and (iii) the bank's Emergency Liquidity Assistance (ELA) exposure of approximately €9bn at nominal value. Given its large ELA debt,

[24] *For a more detailed analysis of the events between the two critical Euro groups of March 16th-March 31th and the impact of the Euro group decisions on the local economy please visit* http://www.eurobank.gr/Uploads/Reports/New%20Europe%20Cyprus%20March%2026.pdf http://www.eurobank.gr/Uploads/Reports/Cyprus%20Trip%20notes%2030%20April%202013.pdf

[25] *Large depositors of the legacy unit were given 18% of the shares of the newly created bank of Cyprus plus the proceeds from the asset liquidation of the legacy unit, including the overseas operations.*

this second unit was deemed not viable and was folded into the Bank of Cyprus.[26]

The new Bank of Cyprus was recapitalized through a deposit/equity conversion of its original large depositors. For about four months, there was uncertainty as to how many of the deposits would be bailed-in. Eventually in July 2013, the full picture emerged and is described in Table 3b. The bailed-in depositors of BoC received bank stocks. 81% of BoC stockholders today are previous large BoC depositors, 18% are previous large depositors of CPB and the remaining 1% belongs to other stakeholders. This fresh capital was of sufficient magnitude to generate a core Tier I capital ratio of 11.8%, which would gradually decline to 9% by the end of the program period in 2016 primarily due to the expected rise of loan write-offs. The 9% ratio satisfies the Basel III criteria.

Table 3b
Transformation of Uninsured Deposits
Bank of Cyprus

End-March 2013	End-July 2013
37,5% converted into equity	47% converted into equity
22,5% blocked as buffer for final bail-in	12,5% converted into 12month time deposits
30% blocked	12,5% converted into 9month time deposits
	12,5% converted into 6months time deposits
10% released	15% released

Source: *IMF Country Report No. 13/293, page 13, Central Bank of Cyprus, Eurobank Research*

Bank of Cyprus exited the resolution status at the end of July after being successfully recapitalized, thus it regained ECB counter-party status.[27] [28] The General Meeting of the new shareholders took place on September 10 in order to elect a new Board of Directors. The new Board of Directors reflects the ownership shift to the non-resident uninsured depositors. Six out of sixteen members of the new Board represent Russian interests.

Following the recapitalization of BoC, in early November the Hellenic Bank also managed to raise €358 million in fresh capital, overshooting its needs. Subsequently, the restructuring of the co-operative sector proceeded smoothly.[29] The sector was deemed viable and was recapitalized with €1.5bn from the second tranche of loan disbursement. The more than 90 cooperative credit institutions are expected to be merged into 18 entities by March 2014.

In the aftermath of the dramatic March events, both President Anastasiades and the Central Bank of Cyprus commissioned independent investigation committees to investigate the causes of the crisis. Given the on-going friction between the President of the Republic and the Governor of the Central Bank, differences in the conclusions between the two reports are not surprising. The first Commission, appointed by the government, puts the blame on the former Christofias government and on the current governor of the Central Bank, Mr. Panicos Demetriades for the accumulation of ELA liabilities.[30] The second Commission, appointed by the Central Bank, puts the blame more generally on the weak corporate governance, the poor bank supervision practices on behalf of authorities at all levels, imprudent business practices and the insufficient attention to overseas expansion.[31]

4. Risks in the Short-Run

A few months after the infamous Euro-Group meetings of March 2013, Troika's official projections for the cumulative drop in real output over 2013 and 2014 is around 12.6%. This cumulative forecast was originally made in April 2013 and remains unaltered, even though the economy has surprised everyone positively since then. Troika remains wary of the underlying risks, which continue to threaten the economy, now expecting to see a much larger drop in economic output during 2014.

Many risks are hanging over the economy with the most important one the stability of the financial sector. Yet it is not the only one. Other risks include the income contraction and unemployment expansion and their multiple negative effects on the economy, the negative economic sentiment or the loss of complementary business services to banking. These risks

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[26] *The transfer of CPB ELA liabilities to the Bank of Cyprus was, naturally, unwelcomed in Cyprus. Many commentators argued the Eurosystem ought to have ceased the collateral of the ELA loans to CPB and stopped there, with the Eurosystem itself (specifically, the Central Bank of Cyprus) writing down its possible losses. Others complained that part of the CPB ELA liabilities were incurred in order to support the Greek operations, yet those ELA liabilities were not transferred to the Bank of Piraeus when the Greek operations were sold. Of course, were some of the ELA liabilities transferred to the Bank of Piraeus, the sale price of the Cypriot branch operations would have been lower.*

[27] *http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12896&lang=en*

[28] *http://www.bankofcyprus.com/Documents/Investor%20Relations/Press%20Releases/GR/20130731_RecapGR.pdf*

[29] *For a more detailed and updated analysis on the restructuring of the domestic financial sector please see http://www.eurobank.gr/Uploads/Reports/Focus%20Cyprus%20Oct10_2013.pdf*

[30] *The Report is in Greek and can be found in: www.sigmalive.com/inbusiness/news/financials/68323*

[31] *See http://www.centralbank.gov.cy/media//pdf/LSE_ICFCBS_Final_Report_10_13.pdf*

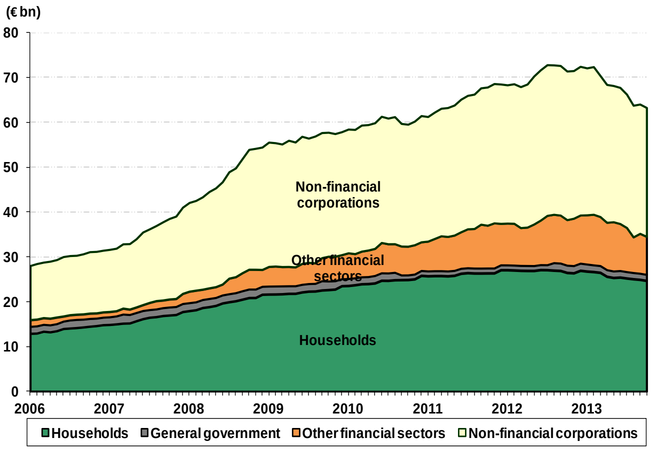
may prolong the recession and they feed on each other. Another separate risk is the potential negative effect on output of the anticipated further fiscal contraction of the later years.

4.1 Financial sector risk: A Damoclean sword

In all countries the health of the banking system and the health of the economy are intimately related. Problematic banks do not provide an adequate amount of loans and can cause an economic contraction. Conversely, an economic recession that causes problems and bankruptcies on businesses and households reduces bank profitability as bank-customers default on their loans, or delay their payments. This bidirectional feedback was preeminent during the international financial crisis and the subsequent Euro Area crisis. It is present in Cyprus today as well, especially following the large scale restructuring of the domestic banks and the imposition of capital controls. And given the large size of the banking sector in Cyprus, the bidirectional effects are particularly strong. The stability of the financial sector in Cyprus is, therefore, a huge risk that has to be addressed for the economy to be able to stabilize.

Figure 6a presents the evolution of credit since January 2006. Credit growth was high until 2009 and then it tapered off to single digit rates. In 2013, both corporate and household credit growth turned negative, particularly after the March events.

Figure 6a
The evolution of credit
Total Credit, Outstanding Amounts by Institutional Sector

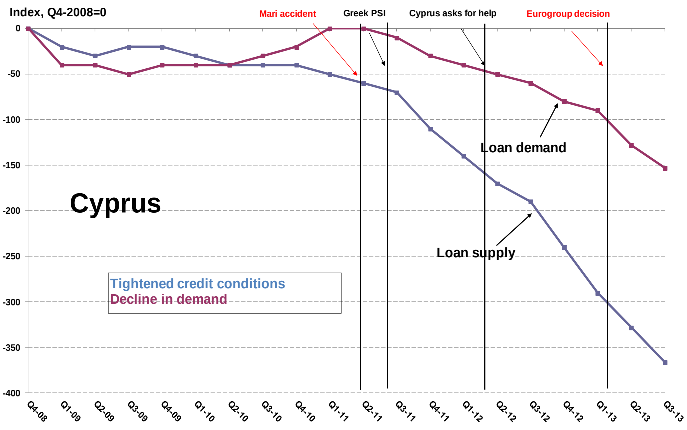


Source: Central Bank of Cyprus, Eurobank Research

A deeper look into the causes of credit contraction reveals that both demand and supply of credit are behind the contraction. Figure 6b uses quarterly survey data of the Eurosystem in order to create "demand-type" and "supply-type" curves for loans. The survey asks bankers whether the demand for loans has gone up or down in the current quarter relative to the previous quarter. The survey also asks whether or not the bankers themselves have become more or less stringent in giving out loans relative to the previous quarter, hence asking for their supply behavior. The optimistic and pessimistic answers are netted out. We cumulate the reported net percentages over the quarters to construct the graphs of the figure.

In most economies, the demand for loans is usually a function of the underlying economy. Cyprus is no exception. The demand began deteriorating after the middle of 2011, well before the peak of the March 2013 crisis. Around the same time, the supply of loans also deteriorated. It is striking that the supply side is declining faster than the demand side. This implies that the Cypriot banking system does not only face an external demand-for-loans problem, but even more so, internal structural banking issues that it has to solve first.

Figure 6b
Index of Demand and Supply of Credit



Source: ECB, Bank Lending Survey, Eurobank Research calculations
Note In each quarter, the net balance of banks reporting tightening of credit standards is added to the value of the previous quarter to form the Supply Curve. The same process is repeated for customer demands to form the Demand Curve.

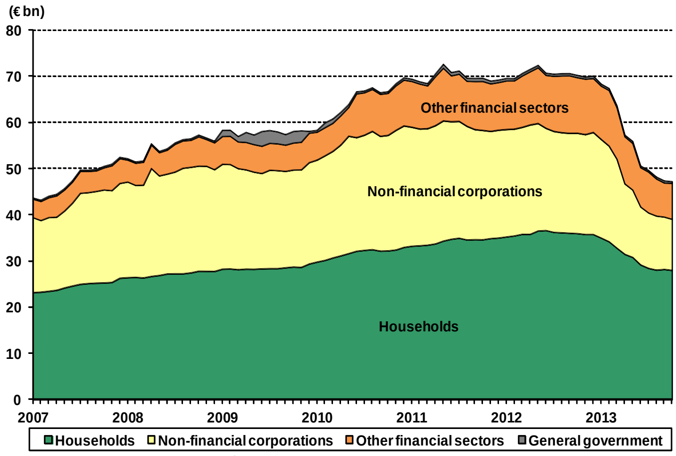
In managing the banking sector, one thorny issue is the growing size of non-performing loans (NPLs). In every country NPLs become problematic during recessions when credit expansion stops or switches to contraction. This is because the NPL ratio is affected negatively both by the expansion of its numerator and the contraction of its denominator. In Cyprus, NPLs are rising quickly. From 11.7% of total loans in the fourth quarter of 2010, they rose to 20.9% in the fourth quarter of 2012 and are rapidly going up. [32] The rise in NPLs necessitates increased provisioning. Hence, even if the Cypriot banking system eventually returns to profitability, there will be little cash left to distribute as dividends to shareholders, as the profitability will be used for additional provisions and write-offs.[33]

[32] *Cyprus operations only, i.e., excluding the overseas operations.*

[33] *Before the recent crisis, the Central Bank of Cyprus never reported NPLs using the international 90-days plus definition. Moreover, it subtracted the existing collateral values from the non-performing loans. It was thus extremely difficult to get a good sense of what was happening to NPLs from the reported statistics. One of the first changes that occurred recently is a more sensible definition of NPLs,*

Another thorny internal banking issue is the financing side of bank operations. Deposits to the Cypriot banking system declined sharply during 2013, from €70.2bn in December 2012 to €47.3bn in October 2013 (Figure 7). Part of the decline, €7.8bn (out of the €9.3bn of bailed-in amounts) is due to the transformation of uninsured deposits into equity, as part of the bail-in exercise. Nevertheless, the decline is enormous and is on-going, although at a slower pace. If the outflow stops, it would provide the first signal that credibility is coming back to the banking system.

Figure 7
Bank Deposits
Total Deposits, Outstanding Amounts by Institutional Sector (€bn)



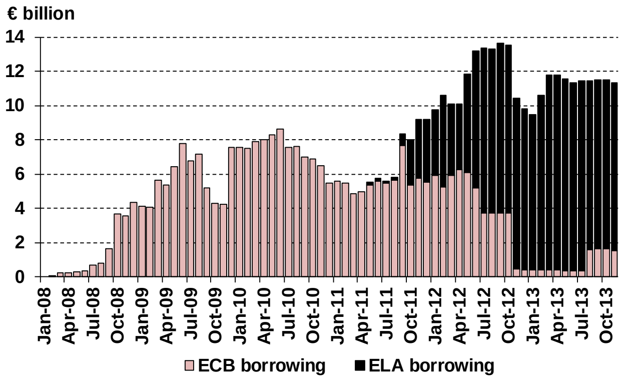
Source: Central Bank of Cyprus, Eurobank Research

The stress on the financial system is also visible from the banks' dependence on the Eurosystem (Figure 8). This dependence began growing after the Lehman episode in October 2008. The use of the Extraordinary Liquidity Assistance (ELA) began in large volumes three years later, in October 2011, as banks were running out of good-quality collateral due to the declining value of assets, and the ECB refused direct financing to banks. Today most of the Eurosystem lending to Cypriot banks is via ELA. In October 2013, regular ECB lending amounted to € 1.6bn and ELA lending to another €9.9bn.

Financial system risk will go away only if capital restrictions are lifted and depositors choose to keep their savings within the domestic Cypriot banking sector and do not shift them to banks abroad. But for this to happen, the Cypriot banking system and the country itself have to re-establish credibility. Depositors have to feel safe in keeping their savings with the domestic banks.

In August 2013, the government published a roadmap for the relaxation of administrative measures and capital controls. This roadmap is subsequently being followed and restrictions are gradually lifted. For example, by the end of 2013, commercial transactions do not have any restrictions inside the country. No limits exist for payments related to goods and services. For cross border flows, which are justified by supporting documents, the original ceiling of €200 thousand was raised to €1 million on November 21st, 2013. By the end of 2013, it is also allowed to open fixed term deposit accounts and current accounts in other credit institutions if they are related to new credit facilities. However, the maximum cash withdrawal of €300 for individuals and €500 for legal entities per day has not changed. Also, at the end of 2013, the most difficult task of allowing free cross border capital mobility has still to come.

Figure 8
Bank borrowing from the Euro system (€bn)



Source: ECB, Bloomberg, Eurobank Research

4.2 A second risk: Will the recession be over in 2015?

The real economy is affected not only by the financial sector, but by a multitude of other interconnected critical third factors as well. Those include the disposable incomes of families, economic sentiment, new investment activity, the private sector's ability to find creative solutions to the collapsing demand, the politicians' ability to reach consensus in key policies, the credibility of policies pursued, the restrictiveness of fiscal policy, and many others. I aggregate all those risks under the umbrella question: Will the recession be over by 2015?

At the end of 2013, there is no clear consensus that the economy will stabilize in 2015. Some economists predict the recession continuing all the way to 2016 with stability coming only in 2017 (Spanos and Papadopoulou (2013)). On the other hand, the troika is more optimistic and asserts positive growth of 1.1% in 2015 and 1.9% in 2016, but is silent about the factors which would lead to such an economic expansion. In fact, the Troika forecasts are even more optimistic than the forecasts of the Cypriot Ministry of Finance itself, which expects 0.5% and 1.0% in 2015 and 2016 respectively (October 2013 Presentation).

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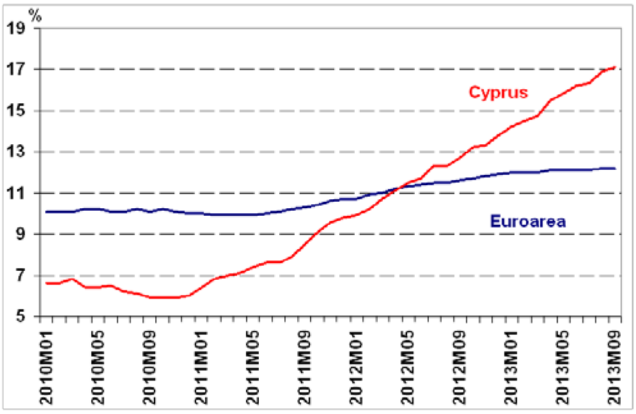
similar to the one used internationally. Yet, Cypriot bankers complain the Troika is unusually restrictive in the definition of 90-days plus NPLs. If a loan is restructured a second time within 18 months after the first restructuring, it automatically counts as non-performing.

The IMF has also released forecasts for the years 2017-2020, with annual growth rates in the neighborhood of 2%. It does not expect growth to return to the 4% rates of the golden years before the international financial crisis.[34]

The recession is affecting disposable incomes and the rate of unemployment is rising fast (Figure 9). The change in unemployment within a single year, 2013, is the highest among the EU-27. Unemployment generates further stress not only on the families involved but also on aggregate consumption and output, which feeds back to even higher unemployment. The full negative multiplier effects will be carried on to year 2014. Many forecasters expect to see a worse economy in 2014 than originally estimated.

Figure 9
Unemployment Rate

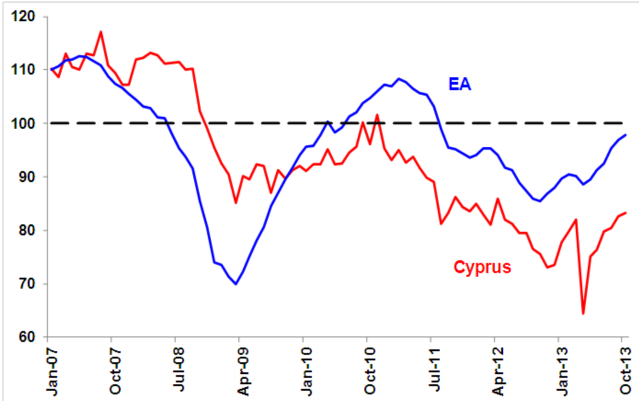


Source: Eurostat

One area in which Cyprus is doing well is the business activities that are complementary to banking, i.e. in registering new internatioanl companies, in accounting services, etc. The original fears for their loss did not materialize as Cypriots were quick to react to the crisis and safeguard their international comparative advantages. International firms also realized that it would be too dangerous to relocate or choose another EMU country like Malta or Luxembourg for their international activities as they are likely to face similar European hurdles or more.

International company activity may be kept in Cyprus and even grow larger, but it will not save the day. In an environment of shrinking banking and shrinking lending activity, it takes a lot more for the economy to stabilize. First, as explained earlier, the deleveraging process has to stabilize and capital controls have to be lifted. Second, sentiment has to improve. It is very negative today and has improved only slightly relative to March 2013, following the overall European trend, but has a long way to go, simply to catch up to the average of 2007-2012 (Figure 10). Third, investment has to rebound. Hopefully, the natural gas project will deliver the promised results and so investment can rebound. But this prospect is still uncertain.

Figure 10
Indicator of Economic Sentiment



Source: European Commission, Eurobank Research
Note: long-term average= 100, SA

A necessary condition for the banking system to stabilize, sentiment to improve, investment activity to pick up, foreign direct investment to come to Cyprus, etc. is the building of trust and credibility. Cyprus needs to work very hard to regain the country's credibility. This is translated into receiving positive reviews from investors, from European partners, from international think tanks, from rating agencies, etc. The country cannot afford to be casted as a heretic in any single issue. Thus far, throughout 2013, it is doing well, as it has earned good marks from the first two quarterly Troika evaluations. Also, on November 29, 2013, Standard & Poor's upgraded Cyprus to B- from CCC+.

Naturally, the domestic political debate tends to expose some extreme positions. This is part of the democratic process and is not dangerous to credibility. What is dangerous, however, is for those politicians, who do not want to push the necessary reforms, to adopt a "trade-off view" of reforms, i.e., to think that if Cyprus does better on, say, the fiscal targets, then this better performance can be used to "buy" some relaxation on other agreed reform targets, which politically cost more. This type of trade-off does not work and destroys credibility. It can only alienate the lender side. It would sound suspicious to neutral third parties as well. If Cyprus puts its signature on agreements which specify that it will proceed with certain actions or reforms, then it has to abide by its signature without stonewalling the process. Whatever bargaining or trade off exists, it occurs

[34] *The IMF claims its aggregate forecasts are based on forecasts of five sectors, which comprise of 85% of domestic value added, tourism, business services, construction, financial services, public services & education (see IMF(2013)). Eurobank Research comes up with approximately similar forecasts based on the components of aggregate demand, consumption, investment, exports and imports. See Anastassatos, Gkionis & Monokrousos (2013).*

before the signature of an agreement, not afterwards, during the delivery process. Greek politicians made this mistake repeatedly in Greece and lost credibility, thus adding an important causal factor to the country's lengthy recession.

Let us take the example of privatizations, which was an issue of contention during the recent national elections in Cyprus. According to the leaked MoU of November 6, 2013, the country is supposed to privatize its energy company, its telephone company and its ports and earn 1.4 billion Euros up to 2018. Naturally, a bargaining point is the timing of prospective sales. It is always better to sell assets after the economy has stopped declining because this way their selling price is maximized. Yet, following a signature after the bargaining process, the country cannot back off, no matter how acrimonious the subsequent debates may be in Parliament. After all, the sale of "strategic" assets can always be done in a way that does not compromise national security plus the assets always remain in the judicial territory of Cyprus. In early December 2013, the Cypriot government announced a road map of specific privatizations.[35]

More generally, Cypriot politicians cannot afford to look back at their past way of conducting politics, even as recently as the 2013national elections, and behave as if no crisis has occurred. At times of crisis, citizens become realistic about the limited choices at their disposal, their perceptions of the economic environment change dramatically and demand concrete solutions from their representatives without fanfares and populist bravados. Cypriot politicians need to show the way forward with constructive solutions and with no ideological blinkers.

4.3 Risk of a future fiscal crunch

Another important source of risk is the environment in which the future fiscal contraction will be implemented. The fiscal measures for years 2013-14 are approximately 6.7% of GDP and are equally split between expenditure reduction (3.2%) and revenue expansion (3.5%). Observe that despite the measures, the size of the targeted primary fiscal balance does not change much relative to 2012 (earlier Figure 4a). It remains in the neighborhood of -4% of GDP. The measures are obviously counteracting the negative effect of the current recession on the budget. Thus far the budget arithmetic is according to target. No immediate fiscal risk is in sight.

[35] *The approval of a privatization plan was a precondition for the disbursement of the €187 million third trance at the end of December 2013. The detailed program provides for the privatization of Cyprus Telecommunications Agency (Cyta, with participation of employees) and the Cyprus Port Authority by the end of 2015 and the selling of Electricity Authority of Cyprus by the September 2017, as well as divestment in four other organizations. The plan also includes the privatization of the Cyprus Stock Exchange, the selling of Cyprus State Fair Authority`s immovable property, selling the state`s 51% stake in Forest Industries and the 11.9% stake in the Pancyprian Bakers Company, the selling of real estate owned by the state, or a licensing round for State Lottery and video lottery.*

The risk of fiscal crunch comes after 2014. Table 4 shows the fiscal targets up to year 2018. The primary balance is expected to reach +4% of GDP in 2018 and stay at that level thereafter. In the Troika projections of the second review of the programme in November 2013, output is expected to grow by only 0.9% in 2015 (revised down from 1.1%) and 1.9% (forecast unchanged) in 2016.

Table 4
Targets of Primary Fiscal Balance

% of GDP	2014	2015	2016	2017	2018
Primary balance	-3.1*	-2.1	+1.2	+3.0	+4.0
ANNUAL CHANGE		+2.2	+3.3	+1.8	+1.0
CHANGE		5.5		2.8	

* *The target for the primary balance in 2014 was revised to -3.1% in the second review of the Programme in November 2013, from -4.3% in the first review of July 2013*

Source: *Memorandum of Understanding, Economic Adjustment Programme for Cyprus, Second Review, Autumn 2013*

No extra measures are mentioned for that period, apparently under the assumption that the improvement in the budget numbers of 5.5% of GDP during 2015-16 will be generated automatically through the economy's expansion. The same holds for the period 2017-18. This is where the major risk lies. In other words, what if the economy does not manage to escape the recession by 2015-2016? Would the Troika insist on the attainment of the fiscal targets then regardless of the state of the economy? Unless European politics do change on this matter, the Greek experience suggests that, most likely, it will insist on new contractionary fiscal measures. The recession would then become worse. Thus, if the economy were not to pick up by 2015, Cyprus risks becoming another Greece in disguise, namely suffering a second blow to the economy, this time coming from the imposed restrictive state sector finances.

Cyprus may have entered this recession due to the Greek government bond holdings of its banks. But the Greek experience seems to have benefited Cyprus when it comes to the fiscal targets. Europeans matured from the Greek, Portuguese and Irish experience and have come to appreciate the existence of a negative fiscal multiplier. They did not seem to act in a punishing way when it comes to the required fiscal tightening. Cypriots should not, however, think that in 2015 the European side will be as flexible. Troika gave the Cypriots two years to fix their economy and Cypriots have to run with it. They have to fix the financial sector and carry the structural reforms quickly. Time is "money" and intentional or unintentional delays work against the possibility of recovery.

5. Will long-term growth come back?

Assuming the recession stops in 2015, the next critical question is whether the Cypriot economy will manage to ride on a strong equilibrium growth path. To achieve this, Cyprus needs to develop its own internal growth model. The actions and reforms included in the Memorandum of Understanding are only necessary conditions for growth. They tackle issues of fiscal sustainability, financial sector stability, labor and product market reforms, or reforms of the government apparatus. They are not sufficient conditions for growth. Cyprus has to come up with its own economic growth strategy in a precise and quantitative manner on top of the MoU agenda. It has to decide how much to invest and in which sectors, the types of fiscal tools it wants to use, the marginal tax rates it will impose, etc. The model ought to be transparent and become the backbone of Cypriot economic policies over the long-run, shared with all stakeholders, namely households and enterprises.

Table 5
World Bank's Ease of Doing Business: Rankings

	RANK DB2014	Δ(2013-2012)
OECD	29	-1
Cyprus	39	-1
Greece	72	17
Italy	65	2
Spain	52	-6
Portugal	31	-2
Ireland	15	0
Germany	5	0
USA	4	0

Source: World Bank Doing Business Reports 2013, 2014, Eurobank Research
Note Rankings among 189 countries.

A number of observations make me optimistic that Cyprus is up to the task of forming and adhering to a long-term growth model. First, Cyprus has a relatively flexible economy when one compares it to the economies of other European counties in crisis. Table 5 presents such clues from the World Bank's "Ease of Doing Business." It ranks 39th among 178 countries across the globe in offering an attractive environment for running a business, a ranking better than that of Spain, Italy or Greece.

Second, Cyprus is being forced to plan for the future thanks to the discovery of natural gas in its sea basin. The extraction and processing of natural gas, forces the Cypriot politicians and elite to make decisions today about future outcomes. The usefulness of the intellectual exercise of choosing among alternative future scenarios that involve trade-offs, is well understood in Cyprus. Hence, the intellectual jump into a broader framework than natural gas, which involves the full economy, is easy to make.

Third, Cyprus does have a well-functioning State sector, as revealed by indices that measure the quality of institutions (Table 6). Therefore, Cyprus has the infrastructure to enable it to carry reforms necessary for growth.

Table 6
Quality of Institutions

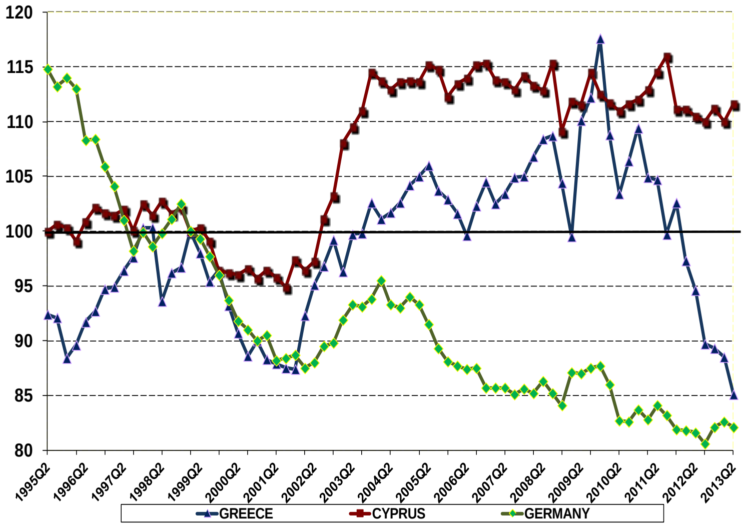
	Cyprus	EA-12
1. Corruption Perceptions Index 2012 (0-100)	66.0	68.6
2. Rule of Law 2011 (score -2,5 to 2,5)	1.06	1.41
3. Government Effectiveness 2011 (score -2,5 to 2,5)	1.53	1.36

Source: EUROSTAT, Transparency International, World Bank.
Note: The higher the index, the higher the quality. The corruption perceptions index can take a maximum value of 100 and its source is Transparency International. The other two indices take a maximum value of 2.5 and come from the World Bank.

Academics typically compare countries over 5- or 10-year intervals and try to correlate their rates of growth with underlying economic, social, political or structural factors. From those analyses, they come up with lists of variables that inhibit or contribute to growth (Kosma & Malliaropulos (2013). The main positive factors are: a well-educated labor force, high rates of investment, a small size of government, low inflation, competitiveness, high quality of institutions or a high degree of openness of the economy. Cyprus is doing well in a number of those factors. It does need to tackle others.

Three factors ought to be at the top of the agenda in Cyprus. First, the investment share in economic activity has to increase. In 2012, the share of total investment was 12.8% of GDP, whereas the same share in the Euro Area was 18.4%. Yet economic history has taught us that countries that wish to grow fast and converge to the living standards of the rich countries, they need to have larger investment shares, not smaller than the existing shares of those rich countries. Investment will probably be increased automatically in the next few years, thanks to the discovery of natural gas, whose extraction and distribution involves large investments.

Figure 11
Competitiveness Index
(REER based on ULC, 1995-2013, Cyprus, Greece, Germany)



Source: Eurobank Research, ECB
Note: The ECB Real effective exchange rate is deflated by the Unit Labor Costs for the total economy and is constructed using each country's trading partners and the respective trading shares with them. The data represent quarterly averages. The index is set in 1999 Q1 equal to 100. An increase in the index implies loss of cost competitiveness.

Second, Cyprus needs to regain its lost cost competitiveness through labor market and product market reforms (Figure 11). Economists have found an important positive correlation between cost competitiveness and rates of economic growth. Third, Cyprus needs to shrink the size of public consumption, which increased over time, from an average share of 17.9% of GDP in 2000-2008, to 19.4% in 2012.

6. Conclusion

The paper reviewed the evolution of the Cypriot economy from 1999 to 2012 and provided a detailed account of the recent slippery path towards the March 2013 bail-in decision. It also analyzed the main risks over the period 2014-2015 as well as the potential for a subsequent strong long-term equilibrium growth path.

From 1999 to 2007, at the beginning of the international crisis, Cypriot growth was strong but vulnerabilities did exist. A large current account deficit revealed the existence of an uncompetitive economy, while a large and expanding banking sector was exposing the economy to huge multipliers from a possible negative financial shock. The expansion of the real estate sector also moved real estate prices way high up, like in many other countries, risking a major future collapse. After 2008, two more risks were added to the previous menu: Fiscal laxity, which was more than was justifiable by the international crisis, plus an abrupt decline in the share of investment to GDP, revealing a policy that favored the consumption of the present generation against the interests and welfare of future generations.

The Cypriot crisis originated from its exposure to Greek government bonds and the Greek economy, yet markets seemed to tolerate that exposure for a long time. Cypriot government bonds yields were lower than the corresponding Irish government bond yields until mid-2011. It was the Mari accident in July 2011, which marks the market awareness of Cyprus and its underlying imbalances and risks. A number of policy missteps after that event plus the lack of willingness to come to terms with the underlying economic imbalances and correct them, led gradually to the March 2013 bail-in decision.

Will Cyprus manage to turn the 2013 crisis into an opportunity of establishing a new equilibrium growth path? The long-term challenges include the creation of a new growth model in which public consumption will have a slightly smaller share of GDP, and, particularly, investment will be boosted drastically. Competitiveness also ought to improve. Yet, before one can seriously entertain the idea of returning to the glory days of high growth, which were prevalent prior the international financial crisis, there are serious short-term risks that have to be overcome.

The first and major risk is the stability of the banking system. Capital controls are still in place and before they are completely lifted, no one can safely predict the return to normality. A second risk is whether the recession will stop and the real economy will manage to return to stability in 2015, as predicted in the MoU. For this to happen, Cypriots do not have the luxury to wait, as time is running against them. They need to quickly work on all the structural reforms and re-establish credibility in the country and in its banking system. And they need to look for growth opportunities. A third risk will appear in 2015, when the primary government deficit is expected to start shrinking towards zero and then turn into a surplus. European lenders have learned from the experience of other Program countries not to over-do it in fiscal discipline right away but to allow the country to stabilize first. Thus they have given the Cypriots a two-year window without a target of shrinking the primary general government deficit. But their behavior in 2015 is unpredictable if the economy were not to rebound and the fiscal deficit were not to decline automatically on its own.

In order to minimize risks and improve the chances of return to high equilibrium growth rates, the analysis of the paper suggests the following prescription: First and foremost, the geostrategic choice of Cyprus to belong to EMU has to be clarified once and for all. This was never a question while the communist party, AKEL, was in power from 2008 on. Yet after the February 2013 Presidential elections, the AKEL party candidate lost and following the March crisis, many AKEL members as well as others have opened up the discussion of taking Cyprus out of the Euro Area as part of a necessary Plan B.

Yet Cyprus cannot afford to waver on such fundamental choices. While the treatment of Cyprus in March 2013 was harsh when compared to previous treatment of other Program countries, no domestic economic policy can be built on flimsy foundations, i.e. with the participation in EMU always in question.

Second, it is imperative that Cypriots have ownership of the MoU they signed and thus they do deliver on the reforms they agreed with the lenders. Some reforms may hit vested interests and will be resisted, but Cypriot politicians, once they signed them into the MoU, they have to implement them. These include the opening of closed professions, privatizations, sustainability of the pension system or labor market liberalization. Procrastinating on those reforms is not smart policy, as it reduces the credibility of policy makers and risks sidetracking the recovery.

Third, Cyprus needs to design its own growth model. The MoU contains some necessary policies for growth, yet those are not sufficient, i.e., they do not represent a complete growth policy guide. For example, Cyprus ought to be assertive when it comes to its comparative advantages, such as its low corporate tax rate. Cyprus ought to maintain the attractiveness it enjoys for foreign companies to set up their headquarters in the island. Also, it has to readjust its dependence on the banking sector and emphasize other sectors like energy, quality tourism, etc. Cyprus has to expand public and private investments, something that is likely to happen due to the discovery of gas in its sea bed. A complete policy guide will also help in future negotiations with the Troika.

Finally, the growth prescription requires consensus, which can only happen in a society that does not abandon its weakest members. As the rate of unemployment goes up and families face difficulties, it is important to allocate part of the annual budget in ensuring a minimum welfare state. At times of crisis, when domestic aggregate demand declines, welfare policy is also good economic policy as the marginal propensity to consume is a lot higher for low income individuals.

Overall, throughout 2013 the Cypriot economy has responded a lot better than expected. The banking system was recapitalized, foreigners did not leave the island and Cypriot policy makers have avoided any major blunders. Thus far the program of stabilizing the economy is on track but it is way too early to claim we clearly see green-shoots in the horizon. Yet we are optimistic that Cypriots are flexible in their response and will expedite the necessary reforms.

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