

The Economic Outlook for Cyprus

The tragic events of last March have created many problems for the Cyprus economy, as we are all painfully experiencing. The austerity measures imposed by the MoU and the prolonged loss of confidence that the banking sector is suffering led to a huge deterioration of the macroeconomic and other economic indicators. Unemployment has skyrocketed, surpassing 17% in October 2013 and exhibiting the highest increase from a year ago (together with Greece and the Netherlands). Compare that with a rate of 3.7% in 2008, and someone can understand the magnitude of the problem! The real GDP growth rate is projected to be negative and significant for another recession year contracting by almost 8%! Recent estimates showed that the contraction reached 5.7% during the third quarter of 2013 over the corresponding quarter of 2012. Public debt has reached 98.3% of GDP by the third quarter of 2013 continuing its rising trend since 2008 (at 48.9% of GDP during 2008), while budget deficit is projected to be close to 6%.

All of these portray unfortunately a very pessimistic outlook for the economy in 2014 as well. But I really don't see an easier route towards recovery. Our economy needs to go through this harsh, but necessary adjustment before we see better days. Thus, we need to continue implementing all the necessary reform measures that are outlined in the MoU, i.e. to restructure the banking sector, to correct the fiscal imbalances, as well as the long-standing structural measures. And we certainly need to keep our public debt under control and within levels that make it sustainable. If we don't achieve that, then this can be extremely dangerous for the future prospects of our economy with a number of negative consequences. At the same time, we need to put in place measures to compensate the negative effects of the memorandum and promote growth following specific intermediate plans. What could be some of those measures? For a start, more emphasis on innovation and entrepreneurship (we can learn a lot in this area from our neighboring country, Israel). We should also cut bureaucracy that deters the inflow of foreign investment. We should diversify into other areas of employment, perhaps in technology (can we finally have a technological park?!). Obviously we are also relying a lot on the prospects of energy sources, such as natural gas and oil. And we should move fast with the establishment of casinos that could provide substantial revenues to our economy in times that are much needed.

The services sector and especially banking needs to regain back its lost confidence and credibility from investors/depositors – surely, the latest upgrade of Cyprus government from S&P's by one notch to B- from CCC+ is a step in the right direction. Commercial banks and even the Central Bank of Cyprus (CBC) need to improve their corporate governance practices, and there needs to be a better supervision by the CBC. Improved confidence in the system would solve (improve) the liquidity problem and would also attract foreign investment. Latest figures show that deposits withdrawal has slowed down and have fallen to €47.31 billion in October (compared to €47.47 billion in September). The second major problem that the banks face is how to handle properly and in the best possible manner their non-performing

loans (NPLs) as this has serious negative effects on their liquidity and capital adequacy (recent results showed that the ratio of NPLs for Bank of Cyprus, Hellenic Bank, and Cooperative Central Bank are 48%, 43.6%, and 40%, respectively!). One way that this issue is being tackled is by creating a special unit within the bank that would have the necessary expertise in project financing and would be able to distinguish the viable with the non-viable projects. Projects that are deemed to be viable should be restructured, either through extension of loan repayment or even a gradual reduction of the loan rates. For the non-viable ones, the banks should take all the available measures to get back what they are entitled, protecting though the first residency.

Certainly, the biggest obstacle towards our recovery is how to obtain the necessary funding. The banks will have to deleverage and will not be able to fund the market in the near future. According to latest statistics the loan portfolio of our banking sector has shrunk to €63.3 billion, a drop of 12.1% in relation to last year. Therefore, we need to develop alternative forms of funding, such as specialized funds (UCITS, Venture Capital Funds, etc.) where we can offer administration of these funds and even management. We should also make better use of EU structural funds, especially for support of SMEs (recent loan agreement between our government and the European Investment Bank (EIB) is a step in the right direction, but we need more of that). On the fiscal side, it seems that we are meeting the targets but our lenders are putting more pressure on us to complete the agreed reforms on the structural issues of the economy (health care, pension, tax compliance and collection, labour market reforms, and privatisation of SOEs and semi-public enterprises).

As I pointed out at the beginning, I expect 2014 to be another difficult year with unemployment to continue rising to almost 20% and the real GDP growth rate to remain negative to just below 5%. However, if in the meantime we implement all of the above measures and suggestions, receive further upgrades from the credit rating agencies and attract foreign investments, then by 2015 we may be able to return to low, but positive growth rate, and unemployment to gradually fall.