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Cyprus – A year after the bail-in

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In March 2013 Cyprus experienced the shock of a depositor bail-in for its two systemic banks. Large capital inflows, bad banking practices, excessive construction activity and a general culture of over-consumption had created huge imbalances during the boom years of 2004-2008 (as described in "The Time of Truth for Cyprus", Opinion Article No 5, March 2013). The global financial crisis burst the bubble and a painful adjustment was inevitable. The pain was made much greater by catastrophic policy failure that culminated in the bail-in, causing a tremendous loss of wealth, the destruction of the banking sector, a loss of trust and credibility, and significant economic hardship. The economic outlook in March 2013 was extremely bleak.

One year later, things are not as bad as many feared. The contraction in 2013 was 5.4%, a full 3.3% better than the Troika forecasts, which most people considered optimistic at the time. Unemployment has risen but seems to have leveled off and currently stands at 16.8%, just two percentage points higher than the 14.8% it had hit in March 2013. Fiscal targets are being met, with some room to spare. The banking sector is moving in the right direction, although the process will be long; the sector's return to normalcy remains the biggest single challenge Cyprus faces as it strives to emerge from the recession.

There are several reasons why Cyprus is doing better than expected. Strict implementation of the Memorandum of Understanding (MoU) is foremost among them. Fiscal measures had already been put in place in December 2012, three months prior to the bail-in. After the initial shock and early mistakes, the government fully committed itself to the implementation of the MoU and passed the first three Troika reviews with minimal problems. This success has done much to restore the country's international credibility. A second reason is the remarkable resilience of the international business sector. Everyone's biggest fear was that the loss of trust in the system would cause foreign firms to abandon the island in a hurry. The fact that this did not happen pays tribute to the quality of services provided by Cyprus' accountants, lawyers and financial advisors. It shows that the hope we expressed in last year's article was not baseless; Cyprus can maintain and build on its status as a business center, albeit without an accompanying large banking sector and the associated risks.

Some other factors also played an important role. The political climate was civil even in the face of disagreement and there was no social unrest to scare tourists away. The timing was also much better for Cyprus than it was for Greece as the European economies are now emerging from the recession, making for a much more helpful external environment. Tourism held up very well in 2013 – thanks partly to the difficulties

faced by regional competitors – and is looking to do better in 2014, barring any deterioration of the situation in Ukraine.

With the fiscal situation in check and the banking sector's reorganization nearly complete, the focus must now shift to structural reform. Cyprus' track record in this respect is miserable. The political system has an extremely difficult time designing, agreeing to and implementing important reforms. It is not an exaggeration to say that the only major reforms implemented in Cyprus over the last twenty years were those associated with EU accession. It is difficult to think of a single major reform that came from within the system.

The MoU requires Cyprus to implement a number of major reforms. Many of those are much-needed, by Cyprus' own admission; they have been considered and debated by the Cypriot political system, but never carried through to fruition. Examples include the national health system, social security, tax collection, local government, property titles, semi-governmental organizations, and public administration. The MoU provides an opportunity and the seemingly necessary outside pressure to push ahead with reforms that will modernize the economy, increase efficiency and improve competitiveness. Public sector reform is particularly important. In the World Bank's 2014 Doing Business report, Cyprus ranks 39th in the world overall but scores much lower in several aspects of public service provision: 86th in dealing with construction permits, 108th in getting electricity, 103rd in registering property, and 110th in enforcing contracts. These are unacceptable outcomes for a country that markets itself as a business center.

Beyond the MoU, Cyprus needs to refocus its economy and correct the distortive policies that contributed to the boom and bust of the 2000s. Reliance on construction and real estate as engines of economic growth is not wise. They can provide ephemeral revenues but cannot deliver steady and sustainable growth. In the past, Cyprus had focused on attracting investment in those areas rather than productive investments that increase productivity and create jobs. It needs to change its strategy and aim to attract not cash but brains: entrepreneurs, scientists and researchers who will come to Cyprus to innovate and bring along knowledge and expertise. Attracting foreign direct investment will be crucial as the local financial system will go through a long phase of deleveraging and credit will be scarce.

Tight credit conditions will make it difficult for new areas of economic activity to emerge quickly. For the near future, Cyprus will be heavily dependent on its traditional strengths, tourism and international business. The latter is perhaps the only sector in a position to deliver a significant economic boost. In order to do so, it must do three things:

First, it should focus on the provision of business services and play down the financial dimension (which was probably exaggerated anyway). As a business center Cyprus can continue to provide good quality and cost-effective legal, accounting and other services without requiring a large domestic banking sector and the associated risks.

Second, it should play down its low tax regime and focus on the quality of its services and the other benefits that are truly unique to it. Cyprus has well-trained and highly experienced professionals and a good legal framework (and its location is still great). It would also do well to specialize in particular niches – the success of shipping provides a good model.

Third, it needs to become a model in implementing regulations on financial transparency, money laundering and tax evasion. The laxity of the 1990s still haunts Cyprus; a clean image can attract reputable

businesses and bring many benefits to the country.

It is often said that every crisis is an opportunity. It is a cliché, but it is a good one. The first year after the bail-in went better than expected, but this is no time to relax. The banking sector will take a long time to return to normalcy; tight credit and the need for deleveraging will be hampering the return to growth. But the road ahead is clear: Cyprus must use this opportunity to push through reforms that will correct the mistakes and excesses of the past, attract foreign investment and put the economy on a path of steady and sustainable growth.

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