Cyprus: a bailout success story

Seven years ago, the Cyprus economy was shut out of financial markets. Today, the country is considered a good example of an economy that managed to recover from a deep economic crisis and recession with the help of a bailout economic adjustment programme and structural reforms. While the economy still faces challenges, it overall represents a good example of crisis management and a path to recovery.

During the 2000s, Cyprus registered strong economic growth driven, mainly, by strong domestic demand.

The country enjoyed full employment, low inflation and rising real disposable income. This led to real economic convergence with the richer European Union economies.

Despite these positive developments, economic vulnerabilities and imbalances were building up due to the deterioration of the public finances as well as the reluctance or significant delay to implement structural reforms needed in certain sectors of the economy. More specifically, Cyprus ran current account deficits averaging 6.9% of GDP for approximately one decade during the period of EU accession and entry to the euro. In order to finance its current account deficit, Cyprus relied on foreign capital inflows, which led to a rapid expansion of the banking sector while adding little productivity to the economy. At its peak the banking sector attained a size of eight times GDP. Furthermore, the banking sector was vulnerable because of inadequate risk management.

In addition, the public sector had grown extensively and total government expenditure as a share of GDP increased. When the financial crisis and subsequent euro crisis hit, the Cypriot banking sector was unprepared and severely impacted. At the same time, Cyprus reached a 6.3% budget deficit and gross debt rose sharply to 85.8%

of GDP, subsequently going over 100%. Cyprus was shut out of financial markets in mid-2011.

In order to adjust its economy, Cyprus agreed in 2013 a bailout programme and undertook wide-ranging structural reforms.

The bailout programme targeted both the public sectors and the banks and involved a severe austerity programme (cuts to public spending, structural reforms etc).

The adjustments to the banking sector, which saw Cyprus' second-largest bank entering resolution, had a lasting negative impact on depositor confidence as they involved losses to all stakeholders in the banking sector, and a bail in of depositors. However, authorities in Cyprus were determined to implement the reforms.

The country finally exited the bailout programme on track in 2016 due to ambitious and consistent implementation of many of the necessary reforms.

Results prove the progress the country has achieved. Actual results have been consistently exceeding projections. Specifically, real GDP in Cyprus recorded an annual increase of 3.9% in 2017 compared with 3.4% in 2016. It is broad based and, other things being equal, it is expected to be sustained at least until 2020. The upward trend in domestic demand, both investment and private consumption, as well as the acceleration observed in exports of services, mainly tourism, were the main drivers of growth. Growth is recorded in almost all sectors of the economy, excluding financial and insurance activities as a consequence of deleveraging.

The aforementioned positive developments in GDP growth, with some time lag, have had a gradual positive impact on the labour market, with employment registering an increase in almost all areas of economic activity. Unemployment, whereas still high, has been steadily declining since the highest rate of 17.6% recorded in the first quarter of 2015. The unemployment rate fell to 10.1% in the fourth quarter of 2017.

It is important to note that the growth recorded is not based on unsustainable fiscal expansion or unsustainable lending. Public finances have improved significantly, and private consumption growth is mainly driven by employment growth and rising household disposable income, while investment is mainly financed from private domestic and foreign capital. The future course of the economy will also be affected by the degree of implementation of structural reforms that have either begun or are pending in several areas of public and private economic activity.

The larger than expected progress achieved by the country’s economy was also recognized by international credit rating agencies. Standard & Poor’s as well as Fitch have upgraded Cyprus’ rating to BB+ (one notch away from investment grade, while DBRS and Moody’s are two and three notches away from investment grade respectively. The current ratings of Cyprus - still below investment grade- are also affected by the biggest existing problem of the economy, i.e the falling but still very high level of non-performing loans in the banking sector. Risks related to the high level of both private and public debt are additional constraints. Nevertheless, Cyprus regained access to financial markets in October 2015 with the successful issuance of ten-year government bonds at a yield of 4,08%. The latest sovereign bond issue was in June 17(Seven-years maturity) at a yield of 2,75%.

Overall, the performance of Cyprus has been good whereas challenges remain and further reforms are needed. The country should not rest on its successes even if it has registered significant economic progress.

Therefore, further work is required on restructuring non-performing loans and improving public finances is required in order for the remaining legacies of the past crisis to be dispelled.