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## The Cyprus Adjustment Programme – Necessity or Wrong Medicine

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# The Cyprus Adjustment Programme – Necessity or Wrong Medicine

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### *Abstract*

This paper attempts to evaluate whether the Cyprus adjustment program signed with the Troika was a necessary precondition to correct the imbalances in the economy in 2013. Although the factors leading to these imbalances appeared to be of exogenous nature, it is argued that the underlying problems were homegrown. In 2008, the Cyprus economy presented a satisfactory picture. However a careful assessment would have brought to the surface the hidden structural imbalances, which led in the subsequent years, to an unsustainable bubble. These home grown imbalances were not addressed, in contrast adjustment was delayed and the negotiations with Troika took an unduly long time to conclude, with severe consequences. Against this background, the implementation of the adjustment programme of Cyprus is considered as successful. However, given the rather low growth prospects further reforms are required. In the current debate, there is some support for utilizing the perceived fiscal room to stimulate the economy. However, it is argued that the case for adopting an expansionary fiscal stance is not strong given the still high level of public debt. Some elements of MOU are highly controversial. The most prominent one was the bail-in of uninsured depositors. This paper argues that, instead of imposing upfront losses to the uninsured depositors, a long-term adjustment path in the banking sector would have been preferable, because it would have allowed the economy to adjust in a smoother manner without damaging the confidence in the banking sector. At the end of the paper the issue of political ownership of the reform program is raised.

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**ΠΕΡΙΛΗΨΗ**

Το παρόν άρθρο επιχειρεί να αξιολογήσει κατά πόσο το πρόγραμμα οικονομικής προσαρμογής της Κύπρου που υπογράφηκε με την Τρόικα ήταν απαραίτητη προϋπόθεση για τη διόρθωση των ανισορροπιών στην οικονομία το 2013. Αν και οι παράγοντες που οδήγησαν σε αυτές τις ανισορροπίες φαίνεται να είναι εξωγενούς χαρακτήρα, υποστηρίζεται ότι τα βασικά προβλήματα ήταν γηγενή. Το 2008, η κυπριακή οικονομία παρουσίαζε μια ικανοποιητική εικόνα. Ωστόσο, μια προσεκτική αξιολόγηση θα είχε φέρει στην επιφάνεια τις κρυμμένες διαρθρωτικές ανισορροπίες, οι οποίες οδήγησαν κατά τα επόμενα χρόνια, σε μια μη βιώσιμη φούσκα. Αυτές οι γηγενείς ανισορροπίες δεν αντιμετωπίστηκαν, ενώ αντίθετα η αναπροσαρμογή καθυστέρησε και οι διαπραγματεύσεις με την Τρόικα πήραν ένα υπερβολικά μεγάλο χρονικό διάστημα για να ολοκληρωθούν, με σοβαρές συνέπειες. Εν αντιθέσει με τα ανωτέρω, η εφαρμογή του προγράμματος προσαρμογής της Κύπρου θεωρείται ως επιτυχής. Ωστόσο, δεδομένων των μάλλον χαμηλών προοπτικών ανάπτυξης, χρειάζονται περισσότερες μεταρρυθμίσεις. Στη συζήτηση που διεξάγεται σήμερα, υποστηρίζεται η αξιοποίηση των αντιληπτών δημοσιονομικών περιθωρίων για την τόνωση της οικονομίας. Ωστόσο, υποστηρίζεται ότι το ενδεχόμενο υιοθέτησης μιας επεκτατικής δημοσιονομικής πολιτικής δεν είναι ισχυρό λόγω του ακόμη υψηλού επιπέδου του δημόσιου χρέους. Ορισμένα στοιχεία του Μνημονίου Συναντίληψης είναι εξαιρετικά αμφιλεγόμενα. Το πιο σημαντικό ήταν η διάσωση με ίδια μέσα των ανασφάλιστων καταθετών. Το παρόν άρθρο υποστηρίζει ότι, αντί της εκ των προτέρων επιβολής ζημιών στους ανασφάλιστους καταθέτες, μια μακροχρόνια πορεία προσαρμογής του τραπεζικού τομέα θα ήταν προτιμότερη, επειδή θα επέτρεπε στην οικονομία να προσαρμοστεί ομαλότερα χωρίς να καταστραφεί η εμπιστοσύνη στον τραπεζικό τομέα. Στο τέλος του άρθρου εξετάζεται επίσης το θέμα της πολιτικής ιδιοκτησίας του μεταρρυθμιστικού προγράμματος.

## 1. INTRODUCTION

This paper attempts to critically evaluate the major strategic objectives and policies, and outcomes of the Memorandum of Understanding (MOU) and the Memorandum of Economic and Financial Policies (MEFP), signed on April 2013, between the Authorities of the Republic of Cyprus and the European Commission and the International Monetary Fund (IMF) respectively. The views in this paper are the author's and are not necessarily shared by the Ministry of Finance.

The signing of the MOU/MEFP was considered necessary, in order to address the major fiscal and structural imbalances as well as the major imbalances in the banking sector, which started emerging after the world financial crisis in 2008, and became more pronounced after the explosion of the electricity plant in Mari in mid-2011, which caused disruptions in the electricity supply and had a huge impact on the economy, mainly by eroding confidence.

Although the factors leading to the emergence of the macroeconomic imbalances appeared, at a first glance, to be of exogenous nature - that is outside the control of the Authorities of the Republic of Cyprus - this paper presents the view that the underlying problems were homegrown and reflected the lack of a coherent strategic approach, ill designed macroeconomic policies, the lax supervisory and regulatory frameworks and, decisively, very long delays in taking corrective action.

The paper attempts to address two main questions, which are still at the forefront of the political and technical debate, both in Cyprus as well as in the European Union (EU) context.

(1) Was the MOU a necessary precondition for correcting the observed imbalances and achieving sustainable growth, or was the MOU the wrong medicine, imposing excessive austerity, without paying due attention to the growth and social dimensions?

(2) What were the broad policy options, on the background of economic developments in Cyprus beginning 2013?

The Troika (European Commission, European Central Bank (ECB) and the IMF) represent the view, that the adjustment program agreed with (or imposed onto) the Authorities of the Republic of Cyprus entailed substantial costs in the short and medium term, but was the only realistic option to restore sustainable growth. The same view, with some differentiations, was expressed by the Government of the Republic of Cyprus, under President Anastasiades, which was elected in February 2013. The Minister of Finance, Mr. Georgiades, on many occasions, refers to the MOU as “our” program, demonstrating political ownership of the adjustment program. The opposition, but also many economists referred to the MOU as the wrong medicine, imposing too much austerity, affecting growth prospects and social cohesion.

This paper provides the framework for the discussion by presenting policy options against the background of the economic conditions prevailing in 2013. It then briefly analyses the macroeconomic developments during 2008-2013. Based on this analysis, it then presents the main objectives and policies of the MOU, followed by a critical assessment of outcomes and a presentation of a number of additional reform options necessary to enhance the growth potential in the medium term, and ends with concluding remarks.

## 2. POLICY OPTIONS

Strategies and policies should be designed to address the identified challenges in a particular situation.

In the concrete case of Cyprus, the legitimate questions to pose were (i) what is the appropriate policy approach in situations, in which an output gap (meaning the level of growth being below potential) and a high leverage of both the public and the private sector co-exist? The existence of an output gap normally suggests that the adoption of expansionary macroeconomic policies is appropriate to push growth back to its potential. However, the existence of excessive leverage in both the public and the private sector, manifested in persistently high fiscal deficits as well as a high public debt and high indebtedness of the private sector would suggest exactly the opposite that is the adoption of demand consolidating, restraining measures, aiming to curb private and public consumption.

In the same context, a second legitimate question is, whether it is appropriate to pursue at the same time adjustment of both the public as well as the private sector, in particular in periods of a benign external environment, which acts as an additional drag to economic growth. In such situations the impact of demand restraining policies is severe. This issue is of particular relevance to Cyprus, given the small size and the open character of its economy, which makes it dependent and vulnerable to exogenous factors.

These are, in my view, legitimate questions and the answers are not straight forward, they depend on the particular conditions prevailing in a concrete country and period. In the next chapter, I will try to set the context for responding to these questions, by briefly analyzing the macroeconomic conditions prevailing in Cyprus during 2008-2013.

**Macroeconomic Developments during 2008-2013**

The Cyprus economy presented relatively high economic growth, which reached a peak of around 5% in 2007, leading to near full employment conditions. As a result, public revenues were buoyant, leading to surpluses in public finances, notwithstanding the excessive increase in public expenditures. Growth was mainly based on construction and financial services. Initially the effect of the world financial crisis in 2008 was rather moderate but, in the subsequent years, growth decelerated, following the burst of the bubble in the construction sector.

A careful assessment of the situation in 2008 would have brought to the surface the hidden major structural imbalances, which led in the subsequent years, to an unsustainable bubble. The main drivers to growth were showing clear signs of overheating. The most evident indicators of imbalances in the property sector were exorbitant real growth in construction and financial services of (6% and 10% per annum on average respectively during 2005-2008). These developments were fuelled by excessive lending (average nominal growth of around 21% during 2007-2008), which was made possible due to the ample liquidity conditions prevailing in the banking system at that period, reinforced by the reduction of the liquidity ratio from 70% to 20% on Euro deposits of non – residents. The increased liquidity emanating from the reduction of the liquidity ratio on non- Euro resident deposits was channelled to non-productive investments. As a consequence the current account deficit reached a peak of

15.5% of GDP in 2008, reflecting the extremely high indebtedness of corporations and, to a lesser extent, households.

Furthermore, the apparent strong surplus position of public finances was based on the abnormally high increase of public revenues of 11.5% on average per annum during 2005-2008. If one would normalize revenues, then the emerging picture of public finances of that period would be different. In more concrete terms, the underlying fiscal position in 2008, after correcting for the abnormally high public revenues by applying the long run elasticity to GDP of 1, would be of a deficit of 1.5% of GDP in 2008 instead of nominal surplus of 0.9% recorded in that year.

In addition the structural deficiencies of the economy were manifested in a deterioration of competitiveness, reflected in high increases in nominal unit labour costs, low productivity growth and diminishing investment in machinery equipment.

In the banking sector, prudential indicators were showing, at the surface, a picture of a sound position, but masked enormous problems in the asset quality of the balance sheet of banks, reflected in huge exposures in Greek Government bonds, and to a lesser extent on Cyprus sovereign bonds, highly problematic loans in the Greek market and highly problematic loans in the domestic construction sector, which was characterized as already mentioned by an unsustainable bubble. Problematic governance structures geared towards short term profit, as well as the excessive liquidity in the banking system, driven by increase of resident as well as non-resident deposits were the main factors driving developments, as they stimulated excessive risk taking, in an attempt to achieve high yield. As a consequence of this excessive risk taking, the banking sector was characterized by huge hidden capital shortfalls, which became apparent in the coming years and made the necessary economic adjustment process extremely challenging and painful.

The hidden imbalances in the years of apparent economic prosperity, analyzed above, were brought to the surface, following the deterioration of the external environment after 2008 but more visibly following the burst of the bubble of the hugely overheated economy. As a consequence, the economy unavoidably followed a downward spiral reflected in diminishing growth, rapidly rising unemployment, high public deficits of structural nature and a steep increase in public debt, which was further burdened by the capital injection to recapitalize the Laiki Bank in June 2012. In specific terms, real growth was negative in 2009 and subdued in 2010-2011 and turned again negative in 2012, unemployment rose to 12% of the labour force in 2012, public deficit rose to 6.3% of GDP, notwithstanding some partial corrective actions taken in 2010 and public debt increased to 86% of GDP. In 2013 the public debt was further burdened through a capital injection of 1.5 bln Euros, to recapitalize the Central Co-operative Bank equivalent to almost 10% of GDP.

These home grown imbalances were not addressed, in contrast adjustment was delayed and the negotiations with Troika to develop a coherent adjustment program and provide financing for the public sector but also for the recapitalization of the banking sector took an unduly long time to conclude, with severe consequences. This made the necessary adjustment effort even more sizeable. It is revealing that the first draft adjustment program presented by Troika to Cyprus in end July 2012 foresaw a total fiscal adjustment of 5.75 percentage points of GDP. By the time a program was agreed in March 2013 the required adjustment increased to 12 percentage points of GDP, despite the fact that a major part of the recapitalization needs of the banking sector was not covered by public funds, but by bailing in shareholders, bondholders and the uninsured depositors of Laiki Bank and Bank of Cyprus.

Many observers point out that the lack of co-operation at the highest level between the CBC and the Ministry of Finance proved to be highly detrimental and exacerbated the problems.

## 3. MAJOR OBJECTIVES AND POLICY DIRECTIONS OF THE MOU/MEFP

Against this background of subdued economic activity, rising unemployment, high fiscal and public debt and, in more general terms, excessive leverage in the economy, an adjustment program was agreed in April 2013 between the Authorities of Cyprus and Troika, aiming at addressing the identified challenges and providing for a financing envelop of 10 billion euro.

The major objectives of the adjustment program were to (i) restore the sustainability of public finances (ii) enhance growth potential by addressing structural deficiencies issues (iii) improve the soundness and resilience of the banking sector.

The program identified that the challenges in the economy were broad based and covered all important segments of the economy, with emphasis on the banking sector, where the magnitude of imbalances were thought to be of an unprecedented nature.

Against this assessment, the main policies were the following:

**(A) Banking Sector**

- Disposal of the banking operations of the three biggest Cypriot banks in Greece, with a view to ring fence the Greek banking sector from the developments in Cyprus but, at the same time, reduce the exposure of the Cypriot banking sector to the volatile and vulnerable Greek banking market;

- Address the problem of an oversized banking sector, by imposing the disposal of the operations of Cypriot banks in Greece and the adoption of prudent lending policies;

- Recapitalize Laiki Bank via a bailed in of shareholders, bondholders and uninsured depositors. Laiki was considered insolvent and was forced into a liquidation, resulting in the creation of a good bank and a bad bank, with the good bank being absorbed by Bank of Cyprus;

- Recapitalize Bank of Cyprus, which was considered illiquid but solvent, via a bailed in of shareholders, bondholders and uninsured depositors;

- Recapitalize the Co-ops banking sector via an injection of public money of 1,5bln Euros

- Address the problem of non-performing loans, mainly by facilitating debt restructuring and removing impediments to the seizure of collateral ;

- Maintain sufficient liquidity into the banking system, by imposing restrictions in deposit outflows and providing, in addition, Government guarantees as backstop for liquidity enhancing actions, until confidence into the banking system was restored;

- Restructure the banking sector by adapting its business model, through focusing on domestic and traditional banking operations, thus de-risking the balance sheet of banks.

**(B) Public Finances**

- Frontloading adjustment through approximately equality distributed revenue enhancing measures and expenditure spending cuts, equivalent to 7¾ percentage points of GDP. This was a rather ambitious adjustment, leading to a severe contraction of demand, in an environment which was additionally constraint through the deleveraging in the banking sector, wage cuts in the private sector and a benign external environment;

- Expenditure cuts affected inter alia (i) wages and wage related benefits, (also in an attempt to influence wage settlements in the private sector and improve cost competitiveness) (ii) pensions, in an attempt to ensure long term viability of the pension system through the automatic link of the retirement age to life expectancy developments, adjusting contribution and benefits and introducing actuarial penalties for early retirement (iii) employment in the public and broader public sector and (iv) social expenditures via better targeting of benefits, in favour of the vulnerable groups and adopting the means tested concept of the minimum guarantee income per household;

- Revenue enhancing measures affected, inter alia, indirect taxation through increases in excise duties and VAT rates and direct taxation, through increases in corporate and immovable property tax rates.

**(C) The Structural Agenda - growth enhancing measures**

The fiscal-structural reforms were deemed necessary to provide the appropriate support for sustainable and balanced growth, ensure the long-term sustainability of public finances, and provide fiscal space necessary to support the diversification of the economy.

In this context, the objectives were:

- to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF);
- to implement further reforms of the pension system to address the high projected increase in pension spending;
- to take further steps to control the growth of health expenditure, through, inter alia, the introduction of contributions, co-payments and a National Health Scheme;
- to enhance tax revenues by improving tax compliance and collection;
- to undertake reforms of the public administration, with the aim to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organization of public services;
- to undertake labour market reforms notably by reforming the system of wage indexation, commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments;
- to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, and target income support to the most vulnerable ;
- to elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatization programme.

Further elements of the structural agenda included a market oriented reform of the energy sector and the removal of hindrances to access certain professions;

At a later stage of the implementation of the MOU/MEFP, the modernization of the foreclosure law as well as the insolvency framework came to the forefront of the attention, with an aim to help banks addressing the problem of non-performing loans (NPLs) and restoring lending into the economy. Additional elements, in the same context, were the promotion of a legal framework, facilitating the sale of loans and the securitization of loans.

Furthermore, the court reform was brought into the reform agenda, aiming at facilitating the effective functioning of the foreclosure and insolvency laws.

**Assessment of the Accomplishment of MOU/ MEFP objectives**

The implementation of the adjustment programme of Cyprus is generally considered as successful, judged by the evolution of the key performance indicators, as well as the degree of the implementation of the financial, fiscal and structural reform agenda.

**(A) Banking**

In the banking sector, the capital position of the banks has been strengthened, primarily via turning uninsured deposits into share capital, recapitalizing the Co-operative banks via public money and, at a later stage, via the access of the Bank of Cyprus and the Hellenic Bank to private investors as well as the enhancement of profitability and cost cutting measures. Currently, the core tier 1 ratio stands at 15.1%, which is much above the prescribed regulatory benchmark.

This is a remarkable achievement, however, banks are still burdened by the high level of NPLs at 47.4% , furthermore, many observers judge that provisioning levels for NPLs, need further strengthening, given the risk profile of the banking sector in Cyprus

Liquidity levels have also improved substantially and deposits have stabilized and, in recent months, have started to grow, despite the abolition of all capital controls, in April 2015.This is all evidence of confidence into the banking system being gradually restored.

However, the improved liquidity did not lead to a restoration of sufficient lending into the economy. Lending continues to decline, reflecting, mainly demand side factors, such as the lack of a sufficient number of bankable projects and an overcautious approach adopted by banks but, more importantly, the high level of indebtedness of the corporate sector, which makes further lending problematic.

Interest rates have been brought down but are still above the average rates prevailing in the EU, including for corporates, which brings the Cyprus business sector in a disadvantaged position.

In more general terms, banks are now in a much better shape than expected at the beginning of the programme, however important challenges remain, in particular concerning the asset quality of the balance sheet of the banks and the provision of financing at affordable terms.

**(B) Public Finances**

Public finances improved substantially, primarily via a combination of structural spending cuts affecting the wage bill, pensions and social transfers, as well as discretionary spending cuts. The structural fiscal position, that is the cyclical adjusted balance excluding measures of temporary nature, is estimated to have turned positive, reaching a surplus of 3% of GDP in 2014. This reveals that simply by maintaining the current fiscal stance, without taking additional revenue enhancing or expenditure reducing measures, public finances will further improve and the public debt, which is the most important indicator, will be on a sustained downward path, falling to about 90% by the end of 2020, compared to about 110% assumed in the first adjustment programme.

It should be stressed that while the path of fiscal adjustment is a positive development, the level of debt remains at historically high levels, which makes the economy still vulnerable to shocks and cyclical slow-down of economic growth.

**(C) Growth**

Economic growth was remarkable and exceeded expectations by a wide margin. While the programme originally foresaw a cumulative downward adjustment of 15 percent of GDP over the period 2012-14, before the economy would return to moderate growth, adjustment was significantly smaller, at around 7¾ percent and already in 2015 growth is expected to return to positive, albeit moderate by historical standards growth. The factors behind this welcome development, include the restoration of confidence through the implementation of the reform agenda, agreed with the Troika (despite some delays), favourable external developments supporting the tourism sector and the resilience of the business services sector, notwithstanding the shock via the bail in experienced in 2013.

In addition, the fact that the programme adjustment affected to a significant extent wealth and only to a lesser extent income meant that the negative impact on spending was smaller than originally thought. In other words, people in Cyprus attempted to maintain a relatively high living standard, notwithstanding severe wealth losses, via the write off of share capital, bondholding and uninsured deposits and reductions in real estate wealth, by reducing their saving holdings. The implications of this behavior for the future is an open question, but in general terms one would expect, absent any positive shocks emanating from further natural gas recoveries and a solution to the Cyprus problem, a rather moderate growth in a medium to long term perspective, as Cypriots are expected to gradually rebuild their savings. Future growth is also expected to be constrained, given the fact that both households and in particular corporations remain highly indebted and need to restore a more healthy balance sheet.

**The Unfinished Reform Agenda**

This rather remarkable macroeconomic performance was achieved against the background of the implementation of a sound reform agenda, in particular as regards public finances and banking regulation and supervision.

However, given the rather low growth prospects, primarily due to the high level of leverage in the economy, further reforms are required with a view to reduce both public and private debt, utilize the comparative advantages of Cyprus and enhance the growth potential.

This growth oriented agenda could include

- Continuation of stability oriented fiscal policies and supervisory policies for the financial sector, with a view to further enhance confidence in the

Cyprus economy and improve the framework conditions for sustained economic growth;

- Implementation of an objective based, medium term oriented budgetary framework, with clear spending ceilings, of binding nature, for the broad public sector;

- Implementation of a framework for public investment appraisal as well as for Private – Public Partnerships which would enable prioritization of infrastructure projects, in line with the growth and social cohesion objectives;

- Establishment of a framework which would be supportive to the commercial exploitation of public assets, including real estate;

- Encouragement of the restructuring of debt of households and enterprises via closely monitoring the achievement of ambitious restructuring targets for banks, via utilization of the reformed restructuring framework;

- Link wage developments with overall economic developments and productivity, by reforming the wage framework in the public sector, thus providing guidance for similar developments in the private sector

- Promote the involvement of strategic investors in public utilities (telecommunications, ports, energy), with a view to improve competitiveness, as well as the quality of the services offered to citizens and businesses;

- Encouragement of the engagement of the fund industry in the field of equity financing, with a view to reducing dependence of corporations on debt finance;

- Utilization of the activities of the European Investment Banks, as well as the European Bank for Reconstruction and Development as sources for additional finance for the productive sectors of the economy; and

- Encouragement of foreign investment, by simplifying approval procedures and promotional activities.

### Can we achieve growth via expansionary policies?

In the current debate, there is some support for utilizing the perceived fiscal room, following the improvement of public finances to stimulate the economy, via increasing public spending and / or granting tax incentives. There is certainly room to further enhance the contribution of the broad public sector to growth through redirecting public spending to growth supporting activities and improving the effectiveness of the tax system. However, the case for adopting an expansionary fiscal stance and increasing deficits is not evident given the still high level of public debt, which reflects the vulnerable character of recovery. Moreover, empirically in Cyprus, a positive correlation between economic growth and fiscal expansion has not been substantiated. A good example is the recent experience, where fiscal adjustment was accompanied by unexpectedly rapid economic recovery. Apparently factors of political economy, which affect the effectiveness of public intervention into the economy, are in place.

## 4. CONCLUDING ASSESSMENT REMARKS

Returning to our original question, it appears that the strategy of frontloaded fiscal consolidation, through structural measures was the right response to addressing the imbalances facing the economy, given the excessive level of leverage.

The allegations that a different growth oriented and socially more balanced agenda would have been preferable and feasible cannot be justified, in particular because they are based on a presumption that an activist fiscal policy would have supported economic growth.

The view that a more balanced social agenda would have been preferable lies outside of the scope of this study. Its assessment would require an in-depth study of the social implications of the MOU/MEFP, which I would very much welcome. Tentatively, I would argue that a number of policy measures included in the MOU/MEFP, such as the progressivity of wage cuts, or the targeting of social benefits lead to a fair distribution of the adjustment burden. Moreover, the imposed wealth losses on shareholders, bondholders and not insured depositors as well as the wealth losses via the adjustment of real estate prices affected more the wealthier segments of the society. However, lower income segments of our population are likely to have been more affected via unemployment and wage cuts in the private sector. Thus the overall impact is not clear and requires further investigation.

Some elements of MOU/MEFP are, however, highly controversial. The most prominent one was the bail-in of bondholders, including retailers and even more the bail-in of uninsured depositors. Once again there are pros and cons. The ideas of the IMF and those countries supporting the bail-in in Cyprus were, that a front loaded adjustment of the banking sector was preferable given the unprecedented nature of the banking crisis and the magnitude of the required adjustment effort. Furthermore, it was argued, that it was fairer to impose the burden on bondholders and shareholders rather than on current and future tax payers. I, strongly, disagree on several grounds. First, in my view a long-term adjustment path in the banking sector would have been preferable, because it would have allowed the economy to adjust in a smoother manner, without damaging the confidence in the banking sector. While in the short term, we witness some restoration of confidence, in the medium to long term the banking sector remains vulnerable, given the bail in experience. In this context, one should bear in mind that Cyprus was required to implement an ambitious fiscal adjustment program, in an environment of severe bank deleverage and a negative external environment, all factors acting as a drag on economic growth. In such an environment, there is certainly a case for advocating a more gradual adjustment in the banking sector. Secondly, bail-in was implemented without a pre-existing framework. Neither in the EU nor in Cyprus economic agents were aware that by investing in bonds or commercial banks or depositing their savings in bank accounts, they would be treated as investors and that a bail-in was, theoretically, on the agenda. Therefore, the imposed bail-in occurred in a non-transparent way and imposed losses in an accidental and unfair manner. There are many known cases of people and business depositing long-life earnings in bank accounts, which were lost overnight, companies being unable to function because they lost their working capital and/or finding themselves with huge liabilities after losing their savings. Functioning market economies should be based on transparent frameworks and not on policies that catch agents by surprise, as the bail-in framework imposed on Cypriots.

The concrete evidence following the implementation of the programme does not provide support for the unprecedented imposition of a bail-in. The Cyprus economy proved to be much more resilient than expected and already, as analyzed above, the economy is showing modest signs of recovery. In my view, this recovery path would have been much smoother had the bail-in not severely affected confidence in the economy and disrupted the functioning of the banking sector and markets.

Another controversial measure was the requirement to sell the Cypriot branches operating in Greece. I would not dispute that de-risking the balance sheet of Cypriot banks was absolutely warranted, given the risk profile of banking business in Cyprus. However, imposing such a transaction in an emergency situation, led to justified complaints, including that over the price, at which the disposal of the branches took place.

One should mention that the adoption of the controversial measures, criticized above, could have been avoided had a timely conclusion of the negotiations for a MOU/ MEFP programme taken place.

**What is next?**

Cyprus is on the right track but on a long journey - further structural reforms are required to consolidate achievements and complete the unfinished reform agenda.

This reform agenda has to be implemented without the support (pressure) of the Troika, which brings me to the last point I would like to raise in this paper. Reforms require political ownership and consensus to succeed – they cannot indefinitely rely on external pressure. The EU and the Eurozone need to have a serious debate on how to improve the political ownership of reform programs - because experience, not only in Cyprus, demonstrate that benefits from externally imposed structural reforms are of limited effectiveness over a long term horizon.

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