Investment and Investment Finance: The Cypriot Case

Conference Report

Introduction

The conference "Investment and Investment Finance: The Cypriot Case" held in Nicosia, Cyprus, on 31 May 2018 was organized jointly by the Nicosia Chamber of Commerce and Industry and the European Investment Bank. This report summarizes the content of the presentations and discussions.

Main interventions

Stelios Anastasiades, President of the Nicosia Chamber of Commerce and Industry, opened the event by welcoming the audience. The EIB role in promoting investment and economic prosperity was acknowledged. Particular reference was made to EIB's long-standing engagement in Cyprus with 350 projects financed in the private sector and 50 projects in the public sector over the last 25 years of EIB activities in the country. Also, the role of the EIB Investment survey as the single source of information on investment conditions in Cyprus was recognized.

Jonathan Taylor, Vice President, European Investment Bank, emphasized EIB's activities in Cyprus with €2.7bn invested in the country over the last decade bringing EIB's total exposure in Cyprus to 14% of GDP, the highest exposure within the EU. EIB's activity has been focused on energy efficiency, funding for investments by SMEs and public sector with a total of €260mn in projects in the pipeline. The signature between the EIB and the Republic of Cyprus, on the margins of the event, of the first infrastructure EFSI project in Cyprus of €35mn, namely the KODAP Emergency Oil Reserves facility

that aims at building the strategic oil reserve capacity of the country, further illustrates EIB's commitment in Cyprus.

Harris Georgiades, Minister for Finance of the Republic of Cyprus, identified investment as the only way for the country to exit the crisis. In that regard, stabilizing the banking system by capitalizing banks, managing non-performing loans and enhancing banks' governance was critical. Stable fiscal finances and a stable tax system further enhanced the country's attractiveness to investors. The government is cooperating with the private sector. For example, building the casino and the marinas in Limassol. Already, the new investment law has been submitted to the Parliament as well as laws on reforming municipalities. The Minister cited that reforming the judicial system, municipalities and phasing in e-governance in public services are top priorities in the government's reform agenda. The MoF thanked the EIB for its involvement in Cyprus citing the €1bn EIB scheme in support of SMEs and EIB's funding for the Clinic of Neurology in Limassol and the University of Cyprus. Higher economic growth, improved employment and lower interest rates in Cyprus, according to the MoF, is the result of EIB's activities since 2014.

Debora Revoltella, Director, Economics Department, European Investment Bank, presented the results for Cyprus from the 2017 wave of the EIB Investment Survey. The improvement of the more productive part of the economy is showing that other more dynamic investment sectors have recovered faster than the real estate market that had been hit the most from the 2012 banking crisis. According to the survey results, Cypriot firms adopt and do not produce innovation revealing the need to focus investment in intangibles and innovation. Also, 20% of the survey participants replied that they do not have investment plans in the future, while 50% of those firms without investment plans had not invested in the past masking weak profitability and legacy issues that need to be addressed. Uncertainty about the future and high energy costs are the most important barriers to investment according to the survey participants, while there is a clear message from corporates that hospitals should be the top priority of the public policy at percentages well above the EU average. Cypriot firms rely mostly on internal finance, while bank loans are preferred the most among the various sources of external finance. It is mostly SMEs and the services' sector that is the most financially constrained with existing collateral not helping to access credit due to legacy issues, underlining

the need for the transformation of the banking system and the financial sector at large. The survey confirms the priorities of the Cypriot government.

Panel I moderated by **Andreas Charalambous**, Economic Director, Directorate of Investment and Finance, Ministry of Finance focused on Investment and Investment Finance in Cyprus.

George Kyriacou, Director of Economic Analysis and Research, Central Bank of Cyprus, argued that investment has always played an important role in the catching up process of Cyprus since its independence. Investment stood at 26.6% of GDP, on average, in the period 1960-1985 versus 22.6% in 1985-2011. Residential investment, however, is 48% below the 2008 level and other investment is 16% below, revealing that more dynamic investments have recovered more relative to real estate. Cyprus is a less diversified economy today than before the crisis. For example, services contributed 85.7% to production in 2017 versus 78.4% in 2008, while construction contributed 5.3% to production in 2017 versus 10.4% in 2008, revealing the urgent need to diversify the economy. This could materialize by supporting off-season tourism and building casinos in order to attract high quality tourists. The dynamics are good for the economy account taken of the low interest rates environment and the 15% drop in unit labour costs over 2013-2017 that brought Cyprus' unit labour cost below the EU average and helped small Cypriot firms to survive. Yet, structural reforms are still needed in order to make Cyprus an attractive investment destination, especially in the judicial system as the country ranks 138 out of 190 in the enforcement of contracts. Finally, G. Kyriacou emphasized the role of Special Purpose Entities (SPE) in biasing negatively internal indebtedness and investment position statistics. SPEs are legal entities in the financial and non-financial sectors, like shipping, with no or a very small number of employees.

Vincenzo Guzzo, IMF Resident Representative, focused on the economic outlook with particular reference to services and internal and external financing. Outlook is more positive with a significant turnaround of the economy. IMF is calling for a GDP growth rate of 3.6% in 2018 and Cyprus is expected to recover in 2018 the 10% of economic activity lost over the three-year recession after the banking crisis. Economic momentum is strong and the business confidence is improving, supporting investment. The services' sector is the most optimistic as confirmed by the relevant confidence indices. Activity in the real estate sector is supporting economic activity after the boost the real estate sector received from measures like the new zoning, tax reform and the offering of Cypriot citizenship to foreign investors buying a property in Cyprus. Uncertainty, though, remains and is broad based. Risks relate to the large stock of NPLs (42% of total loans in 2017), lack of diversification and high indebtedness that exposes Cyprus to exogenous shocks. Structural weaknesses include the high energy cost, also revealed by EIB's investment survey, the lack of digital

economy and e-governance of the public sector, high structural unemployment due to skills' mismatch and the judicial system. Vincenzo Guzzo argued for a proper governance of NPLs in order to avoid the warehousing of NPLs from banks to special purpose vehicles, highlighted the need to support contract enforcement by reforming the judicial system, reconsider the citizenship by investment and strengthen the anti-money laundering framework in order to improve governance perceptions about Cyprus.

Stavros Zenios, Professor of Finance and Management Science at the University of Cyprus, argued for good institutions and a coherent investment strategy that will identify the strategic and sustainable investment sectors. Institutions are as important, if not more important, as macroeconomic policy. The legal framework to protect financiers from expropriations relating to NPLs should be reinforced. No securitization framework is in place despite the fact that it was discussed in 2014 at the Central Bank of Cyprus and could have benefited the banking crisis' management. Professor S. Zenios underlined the need for a sustainable tourist industry, focusing on high value added activities and the need to reconsider the citizenship-by-investment policy that supported the real estate sector in Cyprus as the recovery is based on foreign funds the same as it had been the case before the crisis. Deal with fragilities, do not procrastinate, build consensus, focus on IT and digitalization and use professionals to analyze data were Professor S. Zenios' recommendations.

In the discussion that followed, **Professor S. Zenios** argued that indeed poor digital skills are a constraint to economic growth but it is rather an education issue. **V. Guzzo** argued that the use of technology is necessary as well as removing regulatory barriers in order to accelerate the rate at which new firms are created. **G. Kyriacou** cited that one in five households owns a business dictating an improvement in the current growth model that is battered by legacy issues. Also, **Professor S. Zenios** argued that the government should go for a real strategy for the future development of the economy, leveraging on its competencies and developing new ones. This is particularly relevant in the context of the current digitalization transformation. However, a strategy is not enough. Strategies need to be implementable and implemented. So the Government should not only push for developing a strategy, but pursue its delivery.

Michalis P. Michael, President, Cyprus Investment Promotion Agency, recognized EIB's contribution since 1981 in facilitating investment in Cyprus and improving the overall economic activity, while realizing synergies with Cypriot banks. M. Michael stressed the need for fast realization of investment projects, supported by a strong and sound institutional setting. High quality standards in Cyprus are conducive to a friendlier investment destination.

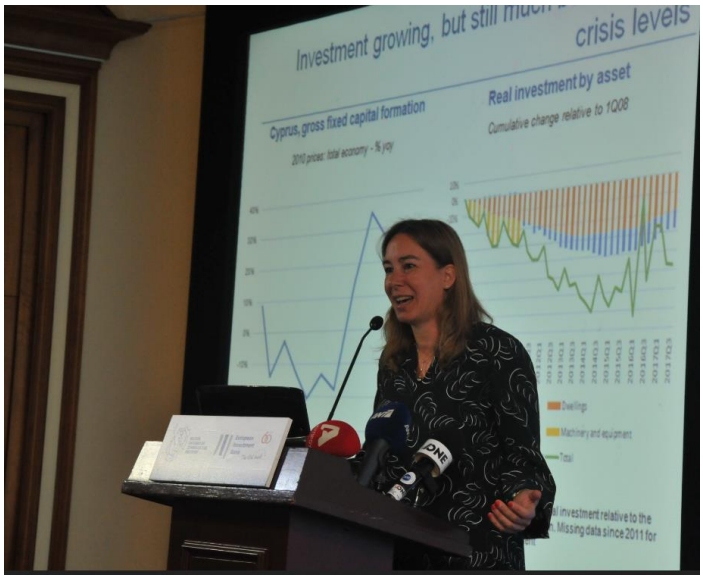
Panel II, moderated by **George Campanellas**, Director General, Cyprus Investment Promotion Agency, focused on Investment in Cyprus – corporate perspective.

Anita Fürstenberg, Director, Operations Directorate, European Investment Bank, emphasized that the EIB is a long-term partner of the Cypriot private and public sector with EIB lending operations during 2013-2017 in excess of €1bn or 1.8% of GDP. There are several other EIB-funded projects like the Institute of Neurology in Limassol, the University of Cyprus and projects supporting SMEs. EIB has put in place a program in order to support SMEs at low interest rates now totaling €1bn supported by the Ministry of Finance's guarantees and in collaboration with twelve banks. About 25% of the growth in EIB's lending operations in Cyprus is attributed to the lending activities relating to that program. SMEs in the tourist industry are the biggest beneficiaries of this EIB-funded SME program, while more than 70% of the recipient of EIB-funding SMEs responded that they would not have realized their investment plans without EIB's support. The majority of the SMEs firms asked for a continuation of the program. A. Fürstenberg underlined that the EIB will continue to support the transformation of the Cypriot economy into a smart economy where renewable energy, energy efficiency and digitalization will be predominant. EIB will continue to foster economic sustainability and improve employment conditions in high value-added sectors because that is where more growth will originate.

Andreas Poullikkas, Chairman, Cyprus Energy Regulatory Authority (CERA) and Cyprus Energy Strategy Council, attempted to explain the high energy cost in Cyprus revealed by the EIB investment survey. Penetration of renewables in Cyprus stands at 9% versus a target of 16% by 2020. Natural gas will be available from 2020 onwards but only for power generation. Electricity prices in Cyprus are the third highest in the EU. Options to address high electricity prices include energy audits; reducing further

network fees; using net metering/net billing and introducing the EU electricity target model and new basic tariffs resulting into a 6% tariff reduction. Other options include natural gas-electricity interconnection that will be realized in 2020 and could reduce the cost of electricity production, which is now oil fuel based, as well as change the electricity supplier.

Yiorgos Mavroudis, Vice-Chairman, Cyprus Chamber of Commerce and Industry, argued for the need to improve the quality of the collateral and overall credit conditions that related to addressing the high stock of NPLs. Y. Mavroudis reiterated that reducing the red tape is necessary in order to attract more foreign direct investment. Also, the product offering by banks should expand and include other types of financing to firms like factoring and equipment financing. Fund financing, although not currently offered, could also diversify firms' external financing options.



In her closing remarks, **D. Revoltella** argued that the economic and investment outlook is more favourable now relative to the past. There is a need for a diversification strategy and improvement in the institutional setting. A reform in the judicial framework would enhance the attractiveness of Cyprus for foreign direct investment as well as the simplification in regulation. A strategy on digitalization is necessary given the needs and the human resources available to the Cypriot economy. Energy can benefit from the application of a digitalization strategy bringing more valueadded and contributing to the transformation process of the economy. Legacy issues in the form of high NPLs were acknowledged, while the government was praised for understanding the need for improvement on e-governance, energy efficiency, regulation, education and technology.