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Press Release: IMF Executive Board Approves €1 Billion Arrangement Under Extended Fund Facility for Cyprus

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The Executive Board of the International Monetary Fund (IMF) today approved a three-year SDR 891 million (about €1 billion, or US$1.33 billion; 563 percent of the country's quota) arrangement under the Extended Fund Facility (EFF) for Cyprus in support of the authorities' economic adjustment program. The approval allows for the immediate disbursement of SDR 74.25 million (about €86 million, or US$110.7 million).

The EFF arrangement is part of a combined financing package with the European Stability Mechanism (ESM) amounting to €10 billion. It is intended to stabilize the country's financial system, achieve fiscal sustainability, and support the recovery of economic activity to preserve the welfare of the population.

Following the Executive Board's action, Ms. Christine Lagarde, Managing Director and Chair of the Board, said:

"The Cypriot economy has suffered a confidence crisis, linked to weaknesses in the oversized banking sector and large external and internal imbalances. The authorities took bold steps to address the crisis, including the upfront resolution and restructuring of the two largest and insolvent banks at no fiscal cost, while protecting insured depositors. They also implemented ambitious fiscal consolidation measures. Nevertheless, challenges ahead are significant, including restoring credibility in the banking sector and reducing fiscal deficits and debt to sustainable levels.

"The three-year ESM/IMF-supported program will help Cyprus address these challenges. The program aims to achieve financial sector stability and debt sustainability to restore growth. The authorities' commitment to use internal financing resources, together with support from European partners, helps to ensure that the program is fully financed.

"The immediate priority is to stabilize the banking sector. The authorities need to complete the bank recapitalization process, including by using public funds for solvent institutions where necessary. In parallel, decisive steps will be taken to restructure weak banks. Temporary payment restrictions should be relaxed at a pace consistent with maintaining financial stability, while minimizing distortions to economic activity. It is important to strengthen supervision and regulation of banks and credit cooperatives, and to enhance the framework for anti-money laundering.

"Another priority is to achieve sustainable public finances. The fiscal consolidation package balances cyclical and sustainability considerations. It needs to be complemented by structural reforms to strengthen budget processes and revenue administration, while better targeting welfare programs to protect vulnerable groups. Additional fiscal measures of close to 5 percent of GDP will be needed in outer years to put debt on a sustained downward path.

"The macroeconomic outlook is subject to high uncertainty and risks to the program are substantial. There is no room for implementation slippages. Full and timely implementation of the program is critical to maintain credibility and achieve the program's objectives," Ms. Lagarde stated.

ANNEX

Recent Economic Developments

Cyprus accumulated large imbalances in the run-up to the global financial crisis. Sizeable non-resident inflows attracted by the low corporate tax regime led to a rapid increase in the size of the banking sector to over eight times GDP. These inflows helped to finance large current account deficits. It also facilitated fast domestic credit growth, fueling a housing boom and an increase in gross household and corporate sector indebtedness to one of the largest levels in the euro area. Loose fiscal policies, following Cyprus' entry in the euro zone in 2008, contributed to a rapid rise in fiscal deficits and public debt.

Tight sovereign-bank links exacerbated these imbalances as the crisis intensified. Given deep financial links to Greece, as the Greek crisis unfolded, Cyprus' sovereign debt spreads soared, and it lost market access by mid-2011. The economy fell into recession in late 2011, exacerbating the correction of the housing market that had started in 2009. This, together with the Greek private sector involvement, impacted banks' balance sheets. Negative feedback loops further weakened public finances, and public debt climbed to 86 percent of GDP in 2012.

Program Summary

The authorities' economic program aims to restore the health of the banking sector and place public finances on a sustainable footing. The program builds on resolute policy steps taken recently and aims to lay the foundations for a recovery of Cyprus' economy.

Restoring financial sector stability: The authorities' policy actions aim to place the banking system on a sustainable footing to restore financial intermediation and support economic activity. The program builds on the recent actions to deal with the two largest and troubled banks to complete their recapitalization process. It also develops a strategy to recapitalize and restructure remaining viable banks and the cooperative sector, using public funds, as needed. The program supports the gradual removal of temporary restrictions while preserving financial stability. Finally, measures will be put in place to deal with private sector debt restructuring, reform financial sector supervision, and strengthen the Anti-Money Laundering (AML) framework.

Achieving sustainable public finances: The program entails an ambitious and well-paced fiscal adjustment that balances short-run cyclical concerns and long-run sustainability objectives, while protecting vulnerable groups. The consolidation will be anchored in a primary fiscal surplus target of 4 percent of GDP by 2018 needed to achieve a debt level of close to 100 percent of GDP by 2020. This includes an adjustment of 2¼ percent of GDP during 2013-2015, which has been recently implemented by the Cypriot authorities, in addition to 5 percent of GDP already underway for the same period of time. To attain the long-term debt and deficit targets while keeping a gradual approach to fiscal consolidation, a further effort of 4¾ percent of GDP will be implemented during 2015-18. Given the significant revenue measures already taken, the future consolidation is expected to rely largely on reducing spending. In addition, structural fiscal reforms will support these efforts, with privatization and reforms to the public wage indexation mechanism also helping to strengthen the economy's efficiency and competitiveness.

Growth Expectations

Output contracted by 2½ percent in 2012, with the decline accelerating toward the end of the year, as economic uncertainty intensified. Private demand led the decline: investment plunged by 25 percent, and consumption fell by around 3 percent. Activity is expected to contract by 9 and 4 percent, respectively, in 2013 and 14, consistent with other banking-crisis episodes.

As problems have been addressed upfront, removing a drag on economic growth, a gradual recovery is expected to start in 2015, driven by a normalization of private consumption and a rebound of investment from a low base. Growth is, however, expected to remain modest as the economy adapts its business model, stabilizing at just under 2 percent by 2020.

Additional Background

Cyprus, which became of member of the IMF on December 21, 1961, has an IMF quota of SDR 158.20 million.

For additional background on the IMF and Cyprus, see: http://www.imf.org/external/country/cyp/ (/external/country/cyp/)

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