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BUFF/ED/13/62

May 10, 2013

Statement by Mr. Snel and Mr. Kanaris on Cyprus
Executive Board Meeting
May 15, 2013

Background

On March 25 2013, after exactly nine months of protracted discussions since its request for assistance, Cyprus reached a political agreement with its international partners on the key elements of a macroeconomic adjustment programme. Cyprus's request for assistance on June 25, 2012 was triggered by increasing pressure in financial markets, against the background of rising concerns about the sustainability of its public finances and the increasingly fragile position of the two largest banks.

In the months and years leading to this point, several events and circumstances contributed to the deterioration of the Cypriot economy. Although Cyprus had weathered the beginnings of the European crisis relatively well, reluctance to correct long standing imbalances, the lax fiscal policies and the banking sector's large exposure to Greece had started taking the toll on the country's ability to refinance its debt at rates compatible with long term fiscal sustainability. These imbalances became increasingly more evident in 2011 as rating agencies launched a series of downgrades and investors increasingly focused on the large exposure of the country's banks to Greece. By mid-2011, Cyprus lost access to long-term sovereign debt markets.

While these imbalances were reasonably manageable at the time, the events that followed accelerated and magnified the island's problems. On July 11, 2011 a catastrophic explosion of a huge cache of confiscated munitions stored at a military base caused significant loss of life and destroyed the next-door Vassilikos power plant, which supplied half the island's power. The fallout included rolling blackouts in the summer months, with adverse effects on output and government revenues, deepening the sense of economic uncertainty. After the explosion, the economy was thrown into recession.

Three months later, on October 26, 2011 at the EU council in Brussels, the decisions taken on the Greek PSI resulted in an effective loss of about 80% of the value of the debt that the private sector held. Cyprus's two largest banks had significant exposures, costing them overnight more than €4.5 billion (around 25% of GDP) and a substantial amount of capital.

Failing to request assistance at that point, when the island's lending partners may have been more sympathetic, Cyprus's fate had taken a path of inevitability. Following these events, a

new wave of consecutive downgradings rendered the sovereign debt non-investment grade and made government securities ineligible as collateral for borrowing from the euro system. In parallel, the banking sector was increasingly cut off from international market funding and major financial institutions recorded substantial capital shortfalls. The situation in the banking sector worsened dramatically in early-2013. The delays in concluding an assistance package, unfavorable statements and rumors in the press regarding deposit haircuts and the consequent fall in confidence led to accelerated and substantial deposit outflows.

Against the background of these severe economic and financial disturbances, on March 16 and 25, 2013, an agreement was forged on the key elements of a programme, which included the restructuring and substantial downsizing of the banking sector, the reinforcement of efforts on fiscal consolidation, and initiation of structural reforms. Arguably, the most important and extraordinary element of the programme was that the recapitalisation of banks would be almost exclusively generated from the banks' retail deposits. Deposits up to €100,000 were to remain unaffected. Amidst financial turmoil and public outcry, a bank holiday of 10 days was imposed, followed by an introduction of capital controls and restrictions on deposit withdrawals – a course of action considered necessary to prevent what was probably an imminent collapse of the banking system. At the same time, the separation of the Greek operations of Cypriot banks was a required feature that immediately downsized the banking sector by a significant amount. It was also pursued in an effort to eliminate any potential spillovers operating in either direction. In that context, Greek deposits in Cypriot banks were unaffected.

On April 2, 2013, an agreement at the technical level was reached in respect of a comprehensive policy package to be implemented in a 3-year macroeconomic adjustment programme whose key objectives, measures and outcomes are specified in the MEFP between the IMF and the Republic of Cyprus.

The programme

The authorities' concern, even dissatisfaction, regarding the chosen type of the unconventional financing method of "bailing-in" depositors and particularly the extent to which this took place, is no secret. However, a variety of reasons, some of which are explained in the staff paper, necessitated the use of this alternative. Furthermore, the delays in concluding an agreement between all parties involved, worsened the situation and magnified the size of the financing need that is now seeked out from the uninsured depositors, which the authorities accept some responsibility for. Even so, they would have hoped that the negotiations were dealt with a more sensitive and fair manner for the benefit of Cyprus, the euro area, the EU and for the programme in general.

Nevertheless, despite so harsh realities, the lingering problems and the demoralizing uncertainty overshadowing the island for the past year have finally been addressed. A macroeconomic adjustment programme has now been agreed that aims at restoring financial market confidence, re-establishing sound macroeconomic balances and enabling the economy to return to sustainable growth. To achieve these goals, the programme builds on three pillars:

(i) A financial sector policy that aims to restore financial stability and resume credit to

support economic activity. Building on the restructuring and downsizing of its financial institutions, the recapitalization of the whole system will be completed, supervision will be further improved and private sector debt will be restructured. Furthermore, despite several independent positive evaluations with respect to the AML practices (FATF-MoneyVAL, Basel Institute of Governance AML index etc.), the authorities will further strengthen the AML framework to satisfy any remaining concerns for good. Similarly, the independent evaluation in banks by an external auditor and MoneyVal that was requested of Cyprus, has recently been completed. The results serve to further evidence that some perceptions abroad were highly exaggerated. At the same time it is acknowledged that there is room to improve and the recommendations made will be taken on board.

(ii) An ambitious fiscal consolidation strategy, building on the consolidation efforts initiated in 2012, in particular through measures to reduce current primary expenditure, enhance government revenues, improve the functioning of the public sector and maintain fiscal consolidation in the medium-term. The aim is to correct the government deficit while balancing short-run cyclical concerns and long-run sustainability objectives.

(iii) A broad structural reform agenda, with a view to improving competitiveness and sustainable and balanced growth, in line with country-specific recommendations addressed to Cyprus in 2012, and allowing for the unwinding of macroeconomic imbalances.

Policy developments

Fiscal sector

The Government is committed to working with its international partners in implementing a determined deficit reduction strategy. The strategy tries to balance the need for fiscal correction without hindering economic recovery. Accordingly, the authorities re-confirm their commitment to the fiscal adjustment targets set forth.

A key objective of the fiscal strategy is to achieve a continuous strengthening of the primary budget balance over the programme period, resulting in a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018. This constitutes an ambitious but feasible improvement in the primary balance of close to 4 p.p. of GDP over 2013-16 and close to 3 p.p. of GDP over 2017-18. The consolidation schedule is also considered appropriate in addressing the need to balance cyclical considerations and sustainability concerns.

Building on past peer experiences, the authorities are fully cognizant that programme ownership and implementation are key. Confirming their commitment, the majority of the fiscal adjustment measures for the programme had already been enacted by the parliament in December 2012 almost unanimously. These were identified as potential prior actions following the November 23, 2012 staff-level agreement and legislated well before signing the MEFP, without having any assurances at the time for imminent financing. The measures represented around 5% of GDP and included the bulk of fiscal measures for 2012-16 (outlined in the paper), as well as important steps in relation to fiscal-structural reforms. The range of fiscal-structural and structural reforms agreed and detailed in the staff paper include establishing a medium-term budgetary framework, undertaking pension system, health care

and welfare system reform measures, enhancing revenue collection and tax administration and ensuring improvement to the public finance management and the functioning of the public sector.

Subsequent to the March 25, 2013 Eurogroup political agreement, new additional fiscal consolidation measures of around 2.2% of GDP for 2013 have been legislated and implemented, namely (i) an increase in the statutory corporate income tax to 12.5%, (ii) an increase in the interest income withholding tax to 30%, (iii) an increase in the bank levy to 0.15% and (iv) a revision of the property tax and of the social housing schemes.

With these, all the remaining prior actions pending at the time the staff paper was issued have now been completed.

Financial sector

The authorities are moving rapidly with the plans for a complete overhaul of the financial sector. Most importantly, on March 22, 2013, the Parliament adopted legislation establishing a comprehensive framework for the recovery and resolution of credit institutions. The new framework allowed the carve-out of the Greek operations of the largest Cypriot banks, the resolution of Cyprus Popular Bank and the transfer of selected assets, insured deposits, interbank liabilities and ELA to the Bank of Cyprus. The upfront actions have addressed immediate concerns while reducing the domestic banking sector from 550 to 350 percent of GDP. Furthermore, the recapitalization of the Bank of Cyprus was done mainly through the conversion of uninsured deposits into equity. The structure implies a minimum of a 37.5% conversion ratio with a maximum of 60% pending the completion of a new independent evaluation of the bank's assets and liabilities. Once the recapitalisation is completed, Bank of Cyprus could then resume normal activity and will also regain its eligible counterparty status for the purpose of participation in regular Eurosystem monetary policy operations.

To preserve the liquidity of the Cypriot banking sector administrative measures on capital flows have also been imposed. However, as restrictions remain in place and depositor uncertainty remains, there is still way to go to rebuild confidence in the viability of the banking system and lay down the conditions for growth.

It must be reiterated that the capital restrictions are an undesirable but necessary constraint. However, as unwelcome as they are – particularly given that they are disrupting economic activity – premature lifting could undermine financial stability. The authorities intend to fully pursue their complete removal at the earliest opportunity. Early lifting would be facilitated by external support in terms of liquidity as well as supporting communication regarding the strength of the restructured banking system. Notwithstanding, after a series of gradual relaxations, the latest decree[1] entails significant relaxations of the measures, further to those pointed out in Box 3.

Recapitalization of the Banking System

In consultation with program partners, PIMCO was commissioned to undertake an independent due diligence of Cypriot financial institutions. The due diligence which was completed in January 2013 covered 22 institutions representing approximately ¾ of the

1 http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12776

Cypriot banking system's assets. These capital needs are the result of a comprehensive and conservative analysis following a bottom up evaluation of credit portfolios and foreclosed assets, and of the earnings capacity of the banks to absorb losses over the next three years under a base and an adverse scenario.

The final report identified an overall capital shortfall of €5,980 million in the Base Scenario (to reach a Core Tier 1 of 9% by the end of the programme) and €8,867 million in the Adverse Scenario (to reach a Core Tier 1 of 6% by the end of the programme). As regards to the solvency problems of the two largest banks pointed out in the paper, it should be clarified that these translate to a negative capital of €2,060 million under the baseline scenario. It must also be noted that for the restructured institutions, the recapitalization now taking place is completed under a stricter target, aiming to reach 9% under the adverse scenario by the end of the programme. In that context, preliminary estimates point towards a Core Tier 1 ratio of around 18% for the recapitalized structures.

Furthermore, unlike previous exercises in peer countries, PIMCO has used a more conservative methodology in arriving to the final numbers, providing an implicit buffer for a worse than expected macroeconomic environment. Namely, in contrast to comparable stress test exercises where expected loan losses were calculated on an undiscounted basis, the calculation of expected loan losses under this exercise projected recoveries discounted at the original effective rate of the loan. Also very conservative assumptions were used for estimating the recovery amounts on defaulted borrowers including, particularly, the application of a forced sale discount of 25% on the projected declining market value of property collateral.

Outlook

Under the staff-level agreement of November 23, 2012, projections of the economic outlook for 2013 and 2014 were pointing to a prolonged recession with a cumulative loss in output of around 5%, due to declines in domestic demand and investment activity resulting from fiscal consolidation and subdued credit growth. The external sector was set to provide a positive contribution to growth in both years as prospects for the export of goods and services were seen to remain favorable, particularly for tourism and business services.

Following political agreements in the Eurogroup on March 16 and 25, 2013, real GDP is now projected to contract by 12½% cumulatively in 2013-14. This arises largely from the frontloaded banking sector restructuring of the island's two largest banks combined with the extensive bail-in of uninsured depositors. As these two banks constitute more than 70% of the domestic deposit market, the choice of this financing instrument will have severe implications on GDP via numerous channels. First, the loss of working capital by Cypriot businesses held at the two main banks is estimated to be around 50% or close to 100% of their deposits over €100,000, depending on the bank. Similarly, a number of households saw much of their wealth in the form of savings disappear overnight. Second, a liquidity shock is unraveling due to the remaining deposits in these banks being frozen for months; 90%-100% of deposits over €100,000 have either been converted or frozen. Third, the fallout from an irreversibly damaged sector that constituted a significant part of GDP i.e. banking, finance and related services. Fourth, the impact of fiscal consolidation already undertaken and new

measures agreed will further hamper domestic demand. Finally, all of the above are amplified by the unprecedented internal and external capital controls required to safeguard financial stability. In turn, these will hinder international capital flows and reduce business volumes in both domestic and internationally oriented companies. Overall, the above channels will sharply reduce private consumption and business investment. Little relief can be expected from exports amid uncertain external conditions and a damaged financial service sector.

Given that the key problems are addressed upfront, a large drag on growth is expected to be lifted. As such, growth is projected to rebound in 2015. The fiscal consolidation is expected to help restoring consumers and investors' confidence in the medium-term. The ongoing deleveraging of both household and corporate balance sheets will over time remove the impediment to a more balanced growth. At the same time, the restoration of a sound and well-capitalized banking system is expected to gradually loosen the tight credit conditions in the economy. However, the medium-term recovery of economic activity depends very heavily on the restoration of confidence, and measures and reforms to directly boost medium-term economic growth are rather sparse in the programme. In this respect, additional policy measures could entail investment projects financed from FDI and European institutions.

There is no fallacy; the authorities are well aware of the risks that lie ahead. In these circumstances, any preliminary forecasts come with a high degree of uncertainty. Staff correctly point towards the difficulty in estimating the impact on real GDP and the deflator with sufficient accuracy, the potential creation of a vicious cycle of bankruptcies and unemployment given the systemic nature of these banks as well as the remaining banking sector risks such as litigation risks or risks of longer lasting lack of confidence in the banking sector. These, of course, are inherent with the choice of financing and must, or should, have been expected when that choice was being made.

Nevertheless, it is worth noting that some reprieve may be had from a programme design which builds on past experiences. Furthermore, as explained above, the bank recapitalization exercise was completed under a more conservative methodology relative to those applied in similar exercises in the euro zone. In addition, given the uncertainty surrounding the macroeconomic outlook, a buffer of about 10 percent of GDP has been included in the baseline analysis, leaving space for a larger than expected recession. Finally, it must be noted that no impact has been assumed in staff projections from investments projects related to the energy sector and the prospects of exploitation of natural gas, which should contribute significantly and increasingly to economic growth in the coming years. As such, the authorities expect a higher long-run growth than that envisaged by staff.

Conclusion

Although the agreement with the international partners has been accepted reluctantly by the authorities, given the constraints posed conditioning support, they are fully committed to ensure its resolute implementation. While difficult for the people of Cyprus, the degree of social cohesion in the face of the adjustment so far has been impressive and commendable. This constitutes a powerful assurance of engagement and ownership of the programme. Looking forward, Cyprus is faced with an extremely difficult and challenging path ahead

through an extended period of consolidation and repair. However, after a long and tiring period of uncertainty, there is at last a paved path. With the financial support and expertise of Cyprus's international partners, including commitments by the Russian Government on softer terms for the loan repayment for which the authorities are grateful for, the joined efforts now in place will see Cyprus through this difficult time.

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GRAY/13/1373

May 13, 2013

Statement by Mr. Nogueira Batista and Mr. Torres on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We thank the staff for their well-structured paper and Messrs. Snell and Kanaris for their candid buff statement. Directors are confronted with a difficult decision. Either the Board approves a program that has little ownership and even less chances of success, or it runs the risk of exacerbating the crisis in Cyprus which could engulf bystanders as Slovenia or Malta and aggravate the problems in Greece. The Executive Board is at that route-fork right now. In our view, before deciding the road to take, the Board needs to receive further information and assessments from staff.

We start by acknowledging that this program is better than the first purported "sustainable solution" with "appropriate allocation of burden-sharing" that was fortunately shot-down by the Congress of Cyprus on March 19th. However, that is not a difficult mark to meet. The first package was unacceptable as it imposed losses on small insured depositors and did not differentiate between solvent and insolvent banks. It should have never been endorsed by Management, especially before consulting with the Board. In contrast, this program preserves insured depositors and does not impose losses on depositors of solvent banks. Also, by "bailing-in" uninsured depositors, it reduces the burden on tax-payers. However, direct recapitalization of insolvent banks by the European Stability Mechanism (ESM) would have been a far better option, with much higher chances of success. It would have not deprived Cypriot businesses from their working capital and medium-income households from their life-savings. Alas, this option was, as staff puts it, "not available" (i.e. not acceptable for Cyprus' euro-area partners). Having said this, we turn now to our misgivings and doubts about the program.

How much and who? First and foremost we need to understand how much financial support Cyprus will need and where it would come from. According to the oral brief the Board received from the Director of the European Department on March 18, the total financial needs of Cyprus were around €17 billion. Cyprus requests to borrow from the Fund €1 billion; the ESM is expected to contribute with €9 billion. This adds up to €10 billion which is, according to staff, the overall financing package required to cover Cyprus' external

financing needs between 2013 Q2 and 2016 Q1 (para. 39 and Table 5). However, on April 12 a spokesman from the government of Cyprus was quoted as stating that financing costs through 2016 had risen from the initial estimate of €17.5 bn. to €23 bn. He did not provide details nor expand on how Cyprus was planning to raise the difference of €5.5 bn. but there was speculation that the gap (or at least part of it) would be covered by selling gold reserves from the Central Bank. Finally, the overall numbers put forward by staff in Table 5 are even more puzzling. According to the aforementioned table, on top of the €10 billion coming from the Europeans and from the IMF, Cyprus will need to borrow, presumably from private sources, over €85 billion between 2013 and 2016 (see "Sources of Financing"). *This raises two questions: a) what is the actual number the IMF staff is working with: the original €17 billion, the figure of €23 billion put forward by the government spokesman or the €95 billion indicated in Table 5?; b) if the figures in Table 5 are correct, and Cyprus will need to complement the €10 billion coming from the IMF and the ESM by borrowing €85 billion between 2013-2016, who does staff believe would be willing to lend this amount to Cyprus?*

An over-dose of optimism? Staff is projecting a cumulative drop in output of 13 percent for 2013 and 2014. Staff is also projecting that the primary fiscal balance will move from a deficit of 5.6 percent of GDP in 2012 to the surplus target of 4 percent of GDP in 2018. This huge fiscal effort would be quite difficult to materialize in any country, but even more in Cyprus that needs to find a new business model in the midst of the deepest crisis it has ever had, in an unfavorable international environment and while its euro-zone partners are themselves striving for more fiscal adjustment. Every program needs a pinch of optimism but in this one the required dose of good-will – or suspension of disbelief, if you will –goes way beyond the average. The two pillars of the economy in Cyprus are banks and tourism. The two biggest banks are insolvent. One will be liquidated and the survival of the other cannot be taken for granted. The government is now determined to do what previous governments could and should have done in better times; namely strengthen the anti-money laundering framework (hence presumably reducing flows of "dirty" money). Regarding tourism staff argues that, at least for this year, we may be reassured as capacity had been sold before the crisis. We wonder if the country's touristic industry would not need to offer price-discounts to retain tourism in the coming years. *We would appreciate staff's comments on the following: a) what industries could replace the share of banking in Cyprus' GDP and in what period of time could this happen?; b) are there any fiscal support measures for start-ups contemplated in the program; c) what happened to tourism in Greece after the crisis? does Greece's experience provide any indication of what to expect in the case of Cyprus?*

Capital restrictions: devaluation without benefits? Due to restrictions in capital outflows, one euro in Cyprus can buy less goods or services than one euro in any other partner of the monetary union. How long can this go on before creating a parallel market where a euro in Cyprus is traded for less than 100 cents in Germany? Wouldn't this be tantamount to devaluation without recovering the independence of monetary policy? How could this affect the program? *We would appreciate staff's views.* Assuming the Board approves this program, capital restrictions will need to be phased out with extreme care and adequate support from the ECB. The IMF may need to request Cyprus to impose restrictions on capital transfers in order to avoid the misuse of Fund resources (Article VI, Section 1 (a) of the Articles of Agreement).

A new business model with no new bank accounts? Staff notes that the aforementioned restrictions to capital outflows need to be applied together with the prohibition to open new bank accounts. The objective is to reduce the risk of deposit migration that could (further) undermine

banks' liquidity. We understand the objective but have doubts on whether banning the opening of new bank accounts would not increase the difficulties of initiating new businesses and ultimately undermine Cyprus' tax-revenue base, preventing start-ups or pushing them into the informal economy. *We would appreciate staff's views*.

What is "external" debt in Cyprus? Staff estimates Cyprus' "external" debt at 450 percent of 2012 GDP. Considering that some of this debt may end up swelling the public balance sheet, we would like to receive clarification on the following: *What is "external" regarding Cyprus' liabilities?* We understand that obtaining a residence in Cyprus was not particularly difficult; consequently *we wonder if some of the "internal" debt could also be in the hands of actual non-residents?*

Could privileged depositors create contingent liabilities for the sovereign? Staff notes that some uninsured depositors will be exempted from converting their claims into equity, and warned the authorities about the legal consequences of giving unequal treatment to uninsured depositors. In their statement, Messrs. Snell and Kanaris note that "Greek deposits in (the two insolvent) Cypriot banks were unaffected" (regardless of their amount) . *We would appreciate further clarification on this point. For instance, couldn't UK residents claim the same treatment? Moreover, if Cyprus gives preferential treatment to residents in Greece, would this be consistent with Cyprus' "most favored nation" obligation at the relevant WTO agreement (i.e. the GATS)?* We also note that some banks and cooperatives, deemed to be solvent, will need public capital injections to survive. Uninsured depositors in these "solvent but under-capitalized" institutions will also be exempted from converting their claims (deposits) into equity (but will benefit from the injection of public funds). Given the context and the implications for depositors, we wonder if these rather subtle distinctions (between insolvent institutions and institutions that are solvent but need to be capitalized through public funds) would not also raise legal questions. *Staff's views will be appreciated.*

Cooperatives: solvent overall? Staff notes that the cooperative sector, "assessed as a whole and given its mutual-guarantee structure" has been found to be solvent (para. 20). However, the sector's NPLs averaged 38 percent of total loans at the end of 2012 (para. 23) and this figure may have risen further (NPLs in some cooperatives are as high as 80 percent!). *Will the government need to capitalize cooperatives? Is this contemplated in the program?*

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GRAY/13/1374

May 13, 2013

Statement by Mr. Shaalan and Ms. Choueiri on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

1. We thank staff for their assessment of the policies and financing needed to address the difficult challenges facing Cyprus. We also thank Messrs. Snel and Kanaris for their helpful Buff statement.

2. Cyprus is facing a severe banking crisis. The crisis was mainly the result of an oversized and weak banking sector that was heavily exposed to Greece. It followed the accumulation of large current account deficits and private indebtedness in the run-up to the global financial crisis, as well as expansionary fiscal policies after Cyprus joined the eurozone in 2008. The country lost market access in mid-2011 and we are considering Cyprus' request for an Extended Fund Facility (EFF)-supported program about two years later. Messrs. Snel and Kanaris indicate that it is after nine months of protracted discussions since its request for assistance in June 2012 that Cyprus reached a political agreement with its international partners on the key elements of a macroeconomic adjustment program. *We would appreciate staff's clarification on the reasons for the delay in approaching the Fund and European partners*.

3. The authorities are to be commended for taking major steps to address the challenges facing the economy. These include intervening in two insolvent banks with assets of around four times GDP and adopting substantial consolidation measures for the 2013−16 period. The authorities are also proposing a comprehensive adjustment program—aimed at restoring financial sector stability and achieving sustainable public finances—for which they are seeking support under an EFF with the Fund. We note the significant risks to the outlook and debt sustainability as highlighted by staff. Accordingly, timely and comprehensive implementation of the proposed measures even beyond the Fund's program duration is critical.

4. Staff indicates that compliance with the program is expected to allow a gradual rebuilding of market access at reasonable terms over the long run. Accordingly, it can be expected that Cyprus remains reliant on official financing beyond the projected duration of the program. The report indicates that the EFF-supported program is designed to cover

sizeable financing needs associated with debt amortization, the fiscal deficit, and the recapitalization of banks other than the two institutions being restructured. *Can staff provide more details on what the European Stability Mechanism is expected to cover?*

5. We welcome the elaboration in paragraph 11 on the alternative program strategies that were either unavailable or undesirable or both. *Was recapitalization of the two insolvent banks with contribution from uninsured deposits without exempting any institution from the haircut envisaged as an alternative? What could have been the implications for the uninsured depositors of the two insolvent banks? Why was this approach followed for Cyprus and not for other countries with banking crises, and what could be the implications for bailouts in future banking crises?* Relatedly, we wonder if exemptions from conversions into equity—which could lead to unequal treatment among uninsured depositors as noted by staff—could hamper efforts to restore confidence in the banking system. *Staff's comments would be appreciated.*

6. We support the authorities' focus on completing the restructuring and recapitalization of the banking sector so as to rebuild confidence in the viability of the sector and normalize financial flows. Putting public finances on a sustainable path is the other key pillar of the authorities' program. Building on the fiscal consolidation measures introduced last year, the program envisages a comprehensive fiscal consolidation plan supported by structural reforms. In this connection, we found staff's analysis on the impact of the crisis on economic activity (Box 4) interesting. We agree that fiscal adjustment will reduce domestic demand, as recent literature and the experience from other program countries suggest that fiscal multipliers are higher in recessions. *Accordingly, we would be grateful for further elaboration by staff on the assumptions underlying their medium-term growth projections, particularly the resumption of growth in 2015 despite fiscal adjustment efforts that extend well into 2017.* Theses assumptions appear to us to be rather optimistic and could have adverse implications for debt sustainability.

7. The staff report makes a reference to the need for a new business model. *How important is this for the success of the authorities' program and for setting the conditions for sustained growth? Can staff also elaborate on the extent to which growth depended on the banking sector attracting foreign deposits in the years preceding the crisis?*

With these remarks, we wish the authorities success in addressing the formidable challenges ahead.

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GRAY/13/1375

May 13, 2013

Statement by Mr. Zhang and Mr. Xia on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

It appears difficult at this stage to assess the *de facto* loss and future financing needs of the Cypriot banks. Growth outlook is veiled by enormous uncertainties if further combined with a drag from significant fiscal consolidation. Notwithstanding the unusual resolves in addressing the bank crisis, market reaction is unclear due to the temporary exercise of administrative controls. Recession is set to continue as some output loss would become permanent. Against this backdrop, the authorities are less likely to restore financial stability and ensure fiscal sustainability, absent proper financial assistance. **We, therefore, can support the proposed decisions**, and would like to provide the following for emphasis.

Financial sector policies

We urge the authorities to take decisive steps to complete the restructuring and recapitalization process for the Bank of Cyprus (BoC) and Cyprus Popular Bank (CPB), in an effort to rebuild confidence and resume their roles in financial intermediation. We share staff's caution over the equal treatment among BoC uninsured depositors. *Could staff please advise under what circumstances the uninsured deposits are exempt from conversion into equity?*

Special vigilance is warranted when lifting the temporary administrative controls. At this time, we can support the authorities' request for approval of the exchange restrictions under Article VIII. Eurosystem liquidity is critical on this front for the Cypriot banking sector to withstand a potential reinforced capital flight. While recognizing the drawbacks by imposing payment limitations in the economy, we invite staff to take caution that failure to lift controls by a target date could exacerbate market fears. *Staff comments are welcome.*

Implement asset valuation in Credit Cooperative Institutions (CCIs), and develop a comprehensive strategy to restructure and recapitalize troubled CCIs. We welcome the

authorities' initiatives to intensify the supervision of and regulations on CCIs. Given the rise in troubled assets, the sector's NPLs averaged at 38 percent. *We welcome staff's comments on the measures, if any, to facilitate private debt restructuring. Is there a developed resolution framework to provide a legal basis to address individual insolvencies?*

The Cypriot bank crisis is not a segregated issue. Domestically, a downsized banking sector—associated with liquidity stress—is undermining the roots of the economy. A few other economies are subject to some common features although it will not necessarily translate into deeper concerns. In this respect, immediate priority should be given to contain risk contagion by putting in place a unified resolution mechanism and banking supervision at an early stage.

Fiscal policies

The Cypriot banking sector is outsized against its fiscal capacity when risks materialize. We welcome the broad string of measures the authorities have undertaken to meet the short- and medium-term fiscal objectives. Challenges, however, are mounting.

- Fiscal policy, in the first place, needs to be designed in tandem with other policy instruments to limit contingent liabilities from banks.
- We see merit in staff's appraisal that fiscal structural reforms should underpin the consolidation effort. Further room exists to improve the medium-term budget framework and revenue collection.
- Streamlining public expenditure—particularly in terms of the public wage bill, pension, and social transfers—could contribute to the austerity effort.
- We consider it necessary to balance the short-run cyclical concerns and long-run sustainability objectives. The authorities may need to carefully calibrate the fiscal adjustment pace before new growth driver is identified.

Program modalities

Could staff please clarify the additional buffers under the financing envelope? According to baseline projections, the Cypriot fiscal position and other economic indicators at the end of the program (2016) are yet to be stabilized. *How could staff assure these buffers are sufficient to withstand an adverse scenario, inter alia, combined with growth shock and additional costs for bank restructuring and recapitalization?*

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GRAY/13/1377

May 13, 2013

Statement by Mr. Garcia-Silva, Mr. Carrière-Swallow, and Mr. Vogel on Cyprus (Preliminary)
Executive Board Meeting
May 15, 2013

Crisis prevention has failed in Cyprus. For many years, Europe and its institutions, the IMF, and the world in general knew the delicate situation and perspectives faced by the country: namely that Cyprus has had an oversized and weak banking sector; that Cyprus' banks were heavily exposed to Greece's public debt; that Greek debt restructuring was unavoidable; that Cyprus was accumulating unsustainable imbalances, etc. In the last Article IV Consultation on Cyprus (November 16, 2011) our Chair underscored that "developments are moving too fast, especially in Europe, and the need for preemptive actions if not rapidly taken, could swiftly transform into the necessity of crisis-resolution strategies, which are, of course, more costly from an economic, political and social point of view". It is of significant concern that bilateral surveillance appears to have failed to gain enough traction with the authorities, both national and regional, to undertake the necessary preventive policy measures.

We strongly believe that a proper assessment of the shortcomings in our surveillance will be necessary at some point in the future. Now, however, is the time for crisis resolution and we hope that its design and implementation properly address the challenges. One of the key aspects is related with the critical need of having realistic assumption and projections. Policies, reforms and targets should not be based on wishes, but on their economic, political and social feasibility and their likely results.

With regard to the GDP, the staff underlines in Box 4 of the staff report that "compared to recent crisis episodes, Cyprus' output loss is expected to be larger than most, except Greece, over the long run". According to the staff's assumptions, differences with regard to Greece's output path would be considerable. What has been the weight of the financial sector in the country's economic activity over the last decade? We would like to know the staff's view on the sources of growth for Cyprus over the medium-term, which although modest, still depends on a considerable 4 percent from "confidence effect unwinding" by 2015. A pick-up of growth only a couple of years after such a massive financial disruption, and without the boost from a significant nominal exchange depreciation, is too optimistic in our view. *May the staff provide some more arguments to figure out the logic of these assumptions?*

We think that the authorities appropriately focus on restoring financial sector stability and achieving sustainable public finances. On the first issue, we consider that the envisaged measures and reforms maybe show a proper alternative to deal with a delicate situation. Meanwhile, underscoring that “alternative strategies were either unavailable or undesirable (or both)”, the staff notes that “a proposal to impose a large one-off levy on both insured and uninsured deposits in all banks operating in Cyprus did not differentiate between solvent and insolvent institutions and conflicted with the aims of deposit insurance”. However, this strategy was endorsed by the Fund in its March 16 press release. We believe that this kind of statement has the potential of damaging the Fund’s credibility and thus should be avoided.

Beyond what we underscored in the previous paragraph, we observe that Cyprus’ access to the Fund’s resources is around 188 percent of its quota annually and 563 percent cumulative, so that it does not reach for a very small margin the limits established for exceptional access. We believe that the logic for this lower engagement compared with, for instance, the Greek program, should be clearly spelled out. Is it related to the doubts that the fulfillment of the criteria for exceptional access in Cyprus’ case would have generated? These doubts did not seem to exist with Greece’s case. Does the lower exposure imply a gradual disengagement by the Fund from the Eurozone crisis? If so, we wonder what implications might be derived into the negotiation power within the Troika at the time of discussing the terms and objectives of the program.

Will Cyprus be able to raise the privatization's nvisaged amount? How will the authorities’ and the society's ownership be when the perception of urgency is left behind? Mr. Snel and Mr. Kamari's helpful Buff statement leaves some doubts in this regard, when noting, for instance, that "the authorities' concern, even dissatisfaction, regarding the chosen type of the unconventional financing method of 'bailing in' depositors and particularly the extent to which this took place, is not a secret" and that "although the agreement with the international parties has been accepted reluctantly by th authorities, given the constraints posed conditioning support, they are fully committed to ensure its resolute implementation". Although we welcome the candor in these statements, we are concerned about the actual prospects of success in the program.

The use of administrative controls on outflows is warranted in the case of Cyprus. When discussing the institutional view on capital flow measures, we supported the idea that institutional view would be informed by the practice and experience in specific cases. The Cypriot case should be quite informative in this respect. Although the staff provides in Box 3 a factual description of the administrative measures, it would be illustrative to have an appropriate assessment on how these fit within the institutional view in practice. Also, a more precise assessment, even if tentative, on the specific economic impact of these measures would be welcome. *Comments from the staff would be appreciated.*

Notwithstanding these comments, we support the proposed decision and wish Cyprus and its people the best in these difficult circumstances.

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GRAY/13/1378

May 13, 2013

Statement by Mr. Alshathri and Mr. Rouai on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

1. **The Cypriot crisis will always be associated with the unsuccessful attempt to involve in bank resolution and for the first time holders of insured deposits, even in solvent banks.** If such scheme had gone through, after the agreement reached on March 16, 2013 by the Troika, the Fund could have been subject to serious reputational risks. We should keep in mind that the insurance of bank deposits has been the cornerstone of financial stability and trust in banking since the Great Depression. For the Fund, setting up sustainable deposit insurance institutions has been one of the recurrent recommendations of financial sector surveillance and FSAPs, including the 2009 FSAP for Cyprus. While we are relieved by the rejection of the initial strategy to involve holders of insured deposits in bank resolution, the Fund needs to assess how to preserve its independence and the credibility of its policy advice, particularly during heated times of crisis management and resolution.

2. **Among all recent crises that affected the euro area, the Cypriot crisis is perhaps the least unexpected.** Cyprus lost market access almost two years ago and the fragility of its oversized banking sector was clearly put at risk as a result of the Greek PSI. The Cypriot and euro area authorities could have avoided the exacerbation of the crisis if decisive and sustainable actions were taken at an early stage of the crisis.

3. **It is against this background that we welcome the authorities' program to be supported by a three-year EFF.** While the key objectives of restoring financial sector stability and achieving sustainable fiscal position are sensible, the program is also subject to significant risks detailed by staff in ¶43 and we therefore urge the authorities to remain committed to the reform agenda and to its timely implementation. We offer the following comments on some aspects of the program.

4. **We are not convinced about the realism of staff growth projections for Cyprus and their impact on debt sustainability**. After a cumulative loss of output of about 13

percentage points between 2012 and 2014, staff projects growth to resume in 2015. At this early stage of the program, staff should build on the experience of Greece where successive and consistently optimistic growth projections since the 2010 SBA have greatly affected the realism of the debt sustainability exercise. Cyprus' growth model characterized by a preferential tax regime and the importance of financial services differs from that of other euro area countries. This growth model would probably be disrupted by the crisis and its aftermath and it is not clear to us what other sources of growth Cyprus could rely on, apart from the potential offshore gas exploitation. *Staff elaborations would be welcome.*

5. **The sustainability of the Cypriot debt is also of concern**. Even without the involvement of the public sector in bank resolution, public debt is expected to increase significantly under the program's baseline scenario, reaching 126 percent of GDP in 2015 before falling gradually to 105 percent of GDP by 2020. This scenario assumes a number of ambitious developments, including a resumption of growth by 2015 and a primary balance of 4 percent of GDP by 2018. Other measures to reduce the level of debt are also planned, including privatization, asset swap, and sale of gold. In this regard, we are intrigued by the planned swap of €1 billion loan by the Central Bank of Cyprus (CBC) for real estate and other fixed assets. We *would appreciate Staff clarifications on the impact of this transaction and also of the planned sale of gold reserves on the CBC balance sheet. Is the asset swap* consistent *with the CBC mandate and with EU regulations?*

6. **We take note of staff analysis in Box 5 and of the conclusion that spillovers have been limited in magnitude.** The limited spillover could be explained, in our view, by the administrative measures involving restrictions on cross-border transactions. *Does staff see any risk of migration of uninsured deposits out of Cyprus and toward other tax havens?* This would be unfortunate and we take this opportunity to reiterate the recent call by the IMFC on member countries to fight tax evasion and promote transparency in the tax, anti-money laundering and counter-financing of terrorism areas. In this regard, we welcome Cyprus' agreement to further strengthen the AML framework and strengthen its implementation. We look forward to the independent audit of the implementation of the AML framework by credit institutions. As indicated by staff, the authorities' ability to reform the AML framework will be a test on the capacity to reform the country's business model.

7. **With regard to the recapitalization strategy, we welcome the distinction between solvent and insolvent institutions. We are however concerned by the introduction of wide ranging exemptions.** We are disappointed that the staff report is silent on this issue beyond the short sentence in ¶20.On the basis of the clarifications published by the CBC on March 30, 2013 the following deposits are exempt from the contribution of uninsured depositors to the recapitalization of Bank of Cyprus and are treated as insured deposits in totality. These include deposits belonging to financial institutions, the government, municipalities, municipal councils and other public entities, insurance companies, charities,

schools, educational institutions. *We would appreciate staff clarifications on the discriminatory aspect of these exemptions and on their share in total deposits*. Since any exemption will lead to an increase in the haircut to be applied to the rest of the uninsured depositors, there is a risk that the additional buffer of 22.5 percent of uninsured deposits would be indeed used. *Staff clarifications are also welcome.*

8. **We note that the recapitalization strategy of the Cypriot banking sector has been designed on the basis of the due diligence work and stress tests conducted by PIMCO**. However, additional forensic investigation conducted by Alverez & Marsal commissioned later by the government raises a number of troubling issues related to data deletion in the books of Bank of Cyprus which lead the government to extend this investigation to the Laiki Bank. We would appreciate staff elaborations on these developments and their potential impact and on the bank recapitalization strategy.

With these comments, we thank staff for their work and Mr. Snel and Mr. Kanaris for their informative statement. We wish the authorities all the success.

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GRAY/13/1379

May 13, 2013

Statement by Mr. Mozhin and Mr. Lushin on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

The Cypriot economy suffered a major blow from the collapse of its two largest banks. It is often said now that the whole business model of Cyprus relying on an over-extended financial sector was unsustainable and doomed to fail. We believe this conclusion is not fully supported by the facts, at least at this stage. There is a number of other small economies, including in Europe, which have a relative size of the banking sector comparable to that in Cyprus, and which still remain undamaged. The origin of the crisis in Cyprus was a large exposure of the Cypriot banking sector to Greece, which has not been reversed even after almost three years of an acute crisis in that country. Questions about the effectiveness of Fund surveillance in this case could be raised. Also, we wonder to what extent the obvious complacency of the Cypriot bankers stemmed from the fact that in 2010-2011 the Fund had been actively supporting an illusion that Greek public debt was sustainable.

Now Cyprus has to go through a period of long and painful adjustment to new realities. A joint IMF/ESM program is necessary to help the country regain financial and fiscal sustainability, and we support it. This said, we recognize that at this moment the program is subject to an extremely high degree of uncertainty originating from a highly uncertain impact of the banking crisis on the economy. For this reason the program's quantitative framework will most likely not hold even for 2013, not to mention a longer period. The currently anticipated debt trajectory under these circumstances is nothing more than a guess. We should stand ready that every 3 to 6 months the program will need to be considerably revised. Below we suggest a few comments on the specific modalities of the proposed EFF.

Financial sector policy. We observe that uninsured depositors will be treated differently in restructuring of the BoC and other commercial banks/credit cooperative institutions (CCIs). While 22.5 percent of uninsured deposits in the BoC will remain subject to conversion into equity after the completion of the valuation process, other financial institutions will be recapitalized with public funds if they fail to raise capital in the market. This places an additional burden on the public sector balance sheet (of about 7 percent of GDP) and also raises a question about the uniformity of treatment of depositors in different financial institutions.

The authorities and staff should seek to find a right balance between preserving financial stability and lifting payment restrictions. These restrictions will limit near-term outflows but at the same time could create considerable risks to the financial sector in the medium to long term.

Fiscal policy. The path of fiscal consolidation envisaged under the program looks challenging, as well as the 4 percent-of-GDP primary balance target to be reached and maintained in the medium term. While staff admits that this is ambitious relative to past performance in Cyprus, they encourage the authorities with previous precedents in other countries (p.42). The situation in Cyprus may be somewhat different, however, since it will have to comply with fiscal austerity in a low-growth environment, which is much more difficult.

Looking at the DSA for the public sector, we are very much concerned by a high sensitivity of the debt trajectory to growth risk. Also noteworthy is the vulnerability to contingent liabilities risk, which may materialize in a low-growth scenario through additional losses in the financial system. Other than that, we would not read too much into the presented scenarios of debt dynamics as well as fiscal accounts, since these are impossible to predict at this point (remember the first Greek program).

We welcome ***structural fiscal reforms*** envisaged under the program, in particular introducing a medium-term budget framework, strengthening revenue administration, and more effective targeting of welfare programs. Privatization of SOEs will also be an important source of improving a fiscal position and reducing debt.

Program modalities. The Russian authorities have indicated their preparedness to consider the rescheduling of Russia's loan to Cyprus. However, the details of this rescheduling provided in para 40 and also in bullet 4, p.42 of Annex 1 (public sector DSA) are nothing more than preliminary assumptions at this stage. The bilateral negotiations on this issue are yet to commence.

Finally, we observe that in the context of the EFF the Fund will cover only 10 percent of Cyprus overall financing needs in 2013-2016, with the rest being provided by the ESM. This is different from the ratios between the IMF and EFSF financing in previous programs with the euro area members. In this regard, we would like to know if the Fund has reached an *ex ante* understanding with the EC/ECB on burden sharing in financing euro area countries, or the Fund's contribution is still determined on a case-by-case and *ad hoc* basis. If the latter is true, we wonder if the Fund's staff and management see merit in more structured approach to cooperation/co-financing with the ESM.

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GRAY/13/1384

May 13, 2013

Statement by Mr. Davidoff and Mr. Fisher on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We thank Staff for their report and Mr Snel and Mr Kanaris for their useful statement.

We consent to the EFF for Cyprus, as a failure to approve the program would likely lead to a further loss of confidence in Cyprus and be destabilizing for the euro area as a whole. We do, however, have doubts that this program will unfold without the need for modifications down the track, given the ambitious implementation requirements and the highly uncertain macroeconomic environment. The manner in which the program was conceived, including the initial proposal to bail-in insured depositors, also raises concerns about the policy making process and highlights some broader issues for both the euro area and the IMF.

We broadly support the main elements of the program, which focus on restoring financial stability in the near term, restructuring the financial system, and a commitment to fiscal reform. In the circumstances, the imposition of capital controls was necessary to prevent a destabilizing flight of capital from Cyprus. The authorities will need to strike a balance between removing these controls in a timely manner and the risk of capital outflows if they are removed too soon. *Can staff provide further information on the effectiveness of these measures, and what is likely to be the appropriate time to remove them – that is, what are the criteria by which to judge when the timing is right?*

While we acknowledge that Staff has taken account of the unusually high macroeconomic risks facing Cyprus, we still find the central growth scenario on which the program is premised to be overly optimistic. In particular, it is not clear what factors will drive the pick-up in growth from 2015 onwards. The Cypriot economy faces a difficult period of structural adjustment, with the financial services and real estate-related sectors – on which the economy has been so heavily dependent – likely to remain weak for a number of years. Meanwhile, the sharp drop in tourist arrivals since the recent tensions emerged does not bode well for this important sector. *The staff report refers to the economy 'adapting its business model'; yet it is unclear what the new model will be. We therefore request a further elaboration of this point along with an indication of what policy measures are necessary to unlock this new business model. Could Staff also please provide further details of why they envisage the recovery in Cyprus to be significantly quicker than that in Greece?*

Debt dynamics in Cyprus are highly sensitive to macroeconomic and other assumptions,

and we concur that there is no room for implementation slippages. The Cypriot authorities will need to be vigilant in implementing the required fiscal reforms, and we welcome the consolidation measures that have been put in place so far. However, the experience of other programs suggests that, despite best intentions, it is unrealistic to expect that all elements of the reform package will proceed as smoothly as hoped. By way of example, we note the difficulties that Greece experienced with its privatization program and raise the possibility that privatization receipts in Cyprus could fall short of expectations. More so than usual, program implementation will need to be fastidiously managed by staff and the authorities as the program unfolds.

The way in which the crisis in Cyprus has been handled holds broader implications for both European policy makers and the Fund that demand attention. We briefly highlight the following points:

- The fact that decisive action on Cyprus was not taken until the situation had reached crisis point – even though Cyprus' financial sector exposures were well known for some time – led observers to again question the capacity of euro area authorities to formulate timely and effective solutions in a difficult political environment. A particular concern was, and remains, the initial proposal to impose haircuts on insured depositors. This initial decision continues to raise questions about the veracity of deposit insurance arrangements more widely.

- On a related point, the crisis in Cyprus underscores the importance of the euro area delivering on the necessary financial sector reforms, especially common oversight, resolution and deposit insurance arrangements. These reforms will help break sovereign-bank linkages, prevent the build-up of bank risks, and provide market participants with greater certainty about their exposures to future bank resolutions.

- While the Fund's financial contribution is relatively small (and the report mentions safeguards that are in place), the program for Cyprus nonetheless increases the IMF's financial exposure to Europe. Although our view is that the financial risks in this case are outweighed by the avoidance of a further loss of confidence in Cyprus, the growing concentration of lending to Europe is an issue that remains a risk for the Fund which requires careful management.

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GRAY/13/1386

May 13, 2013

Statement by Mr. Hockin and Mr. Lessard on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

Significant steps have been taken by Cyprus and its European partners in order to make this program possible and because of this we can go along with the proposed decision. Nonetheless, even under the base scenario, the outlook remains extremely difficult and risks are heavily tilted to the downside. Program success will require unwavering implementation on the part of the Cypriot authorities and continued support from their European partners to meet challenges as they materialize. We welcome the authorities' resolute commitment to implementation expressed by Messrs. Snel and Kanaris. These difficult program negotiations, marked by protracted discussions and a failed original proposal that presented a financial system threatening haircut on insured depositors, highlights the need for Europe to move swiftly on the implementation of a banking union, a framework for bank resolution, and deeper fiscal integration.

It remains unclear how Cyprus will adapt to a new sustainable business model in the long term and what sectors will lead the recovery and growth. We note the sizeable improvement in private consumption and real GDP growth in 2015, which is hard to reconcile with Messrs. Snel and Kanaris' comment of "how measures and reforms to directly boost medium-term economic growth are rather sparse in the programme." Similarly, Messrs. Snel and Kanaris are forthright in their assessment that little can be expected from net exports given uncertain external conditions and a damaged financial sector. *We would welcome staff's further elaboration on the relatively optimistic, compared to private sector estimates, medium-term growth forecast.* Consequently, although we welcome the sizeable fiscal and capital buffers that are built into the program at inception, we are concerned they will prove insufficient if the economic contraction is longer, and deeper, as a result of the drastic financial sector restructuring, imposition of capital controls, and wealth shock to depositors. We welcome the extraordinary amount of financial support that is to be delivered by European partners and hope that, similar to Greece, they stand ready to provide additional assistance if program implementation is successful but forecasts proved optimistic.

The dramatic resolution and reduction of Cyprus' outsized banking sector is the epicenter of the country's economic troubles and a cornerstone of the Fund-supported

program. Initial hesitation and protracted negotiations unfortunately have increased the costs of reforming the financial sector, but the authorities are to be commended for recent steps to move quickly to resolve, restructure, and recapitalize their two largest banks. *On the resolution and restructuring plans of these two banks, we would welcome staff's view on the likelihood and magnitude of litigation risk.* Going forward, the authorities will need to ensure that other banks, and especially the Cooperatives, are strengthened, with a strong preference for private funding to be used to bolster these institutions.

We note from Messrs. Snel and Kanaris' Buff that the decision taken on Greek PSI wiped out overnight €4.5 billion (approx. 25% of GDP) from the two largest Cypriot banks. **Given the intensified attention to spillovers since the onset of the European crisis, we wonder if the effect of Greek PSI on the stability of the Cypriot financial system was anticipated.** If it was not anticipated, there would seem to be a gap in our surveillance and program frameworks that needs to be addressed; if it was anticipated, a more explicit elaboration of these risks in program documents would be beneficial.

Staff's candid acknowledgement of downside risks is welcome, but we would have appreciated staff to exercise further discretion in modeling deeper shocks in the DSA in light of the high degree of uncertainty facing Cyprus. The shock scenarios run for the Cypriot DSA are relatively benign considering the difficulty in forecasting and the astonishing shrinkage of the financial sector that is expected to take place. It is difficult to ignore how gentle the shocks are in the Cypriot DSA when they are compared to DSAs in other programs, particularly large precautionary FCL programs.

The success of the program hinges on substantial fiscal consolidation measures to be identified and implemented late in the program (or afterwards), which runs the risk of fiscal slippage and austerity fatigue. *While accepting the need to pace adjustment, we would appreciate greater clarity on the timeline for identifying additional fiscal measures and when they can be included in the program as structural benchmarks.* With respect to austerity fatigue, the recent split vote in the Cypriot Parliament on approving the program is a cause for concern. We are willing to give the benefit of the doubt to the authorities, given the tremendous measures they have already had to undertake to bring this program to the Board for approval, but securing and maintaining broad-based support throughout the program period will be challenging.

Finally, we understand the necessity for Cyprus to put in place a number of capital and exchange restrictions in order to allow time for the financial sector to adjust. As such, we agree to the proposed exchange restrictions under Article VIII and welcome the authorities' commitment to remove the restrictions as soon as it is practicable to do so. *We would also welcome comment from staff on whether a strategy has been developed for the gradual removal of these restrictions as progress is made under the EFF.*

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GRAY/13/1387

May 13, 2013

Statement by Mr. Shimoda and Mr. Kitamura on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We welcome the Cypriot authorities' efforts to address the troubled banking sector upfront, and also welcome their commitment to implementing measures to restore both internal and external imbalances. Although the size of the Cypriot economy is relatively small, potential spillovers resulting from shocks to market confidence should be contained and their debt ratio should be put into a sustainable trajectory. In this light, we will support the authorities' request for the Extended Fund Facility arrangement and other proposed decisions.

Cyprus is facing formidable challenges arising from an oversized banking sector, high-levels of debt and weak competiveness. The risks to its program are high; however, to this date, the authorities have made some progress in terms of financial stability and fiscal adjustments. We hope that they will continue their efforts to build a good track record of implementation. Having said that, considering that the Cypriot parliament endorsed the EU-IMF program by a narrow margin, 29 votes to 27, strong ownership by the authorities will be critically important for the program's success; thus, we urge the staff to closely engage with key stakeholders so as to build broad consensus among them.

The objective of this new program is to enable Cyprus to address, not only its underlying financial and fiscal problem, but also macroeconomic adjustments as a whole. Indeed, after Cyprus' entry in the euro area in 2008, the unemployment rate increased and the real effective exchange rate modestly appreciated. In order to achieve sustainable growth, we encourage the authorities to steadfastly implement the labor and product market reforms identified in the MOU.

Debt Sustainability and Market Access

According to the Debt Sustainability Analysis, despite the highly uncertain economic environment, there is no margin for implementation slippages to absorb any adverse shocks. Indeed, the implementation of some agreed measures, such as the rollover of maturing domestic debt entails uncertainty. Their debt sustainability remains at risks to reach 105 percent of GDP by 2020. In the event of a program slippage, stemming from either an

implementation slippage by the authorities or unintended external shocks, this could cause additional financing needs. Naturally, the authorities should consider additional measures to cover this financing gap first. However, if the risks to the program materialize beyond the authorities' capacity to address, *what kind of contingent measures does the staff envisage?*

As regard to market access, in para. 12, on page 10, the staff assumes that regaining market access will be reasonably gradual over the long run. In this regard, *does the staff assume that market access will be gradually restored within the current program envelope, or would this occur beyond the program period?* In case of the latter, as we discussed earlier, *are there any financing assurances beyond the program period until the country regains market access?*

Bank Resolutions

We welcome the upfront measures taken by the Cypriot authorities to resolve, without fiscal cost, the two largest banks through the participation of their creditors including uninsured depositors. We note that this action has already significantly helped downsize the domestic banking sector. Although this restructuring process is still ongoing, *we would like to ask the staff's view on this case, especially regarding the implications of the resolution mechanism at the EU level based on the proposal published last year, which is still under consideration. Also, we would like the staff to include an explanation on the differences between this restructuring process and the possible resolution mechanism in the EU.*

Fiscal Policy

We welcome the progress made by the authorities in identifying half of the fiscal consolidation measures to be implemented by 2018. We agree with the staff's view that, since, so far, Cyprus has been largely reliant on revenue adjustments, incremental fiscal measures should focus on its expenditure side. Particular, attention should focus on the public sector wage bill and social transfers, which are large in relation to regional averages. In terms of not only longer-term fiscal sustainability but also the country's competitiveness, even though the 2013 budget includes cuts to public sector wages, the authorities will need to further streamline public spending, in a gradual manner. Although we recognize that the proposed performance criteria will apply the General Government Primary Expenditure, given the importance of the wage and social transfer reforms, *we would like to hear the staff's view on setting up structural benchmarks so as to monitor developments in the progress of these reforms.*

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GRAY/13/1388

May 13, 2013

Statement by Ms. Lundsager and Mr. E. Meyer on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

Cyprus has taken significant steps to address its deteriorating economic, fiscal, and financial sector challenges. The strong measures already implemented, as enumerated by Messrs. Snel and Kanaris in their buff, reinforce the authorities' commitment to future reforms and we support the proposed decisions. Nonetheless, the outlook remains difficult and a successful turnaround will require perseverance and consistent implementation of its IMF and EU supported program. Importantly, the continued financial and economic support of Cyprus' European partners, including the ECB, needs to be matched by further progress on implementing the euro area's banking union and deeper fiscal integration so as to provide a fuller safety net and the economic space for Cyprus to implement the tough reforms needed.

The painful resolution path of Cyprus' outsized banking sector lies at the core of the island's economic troubles. Despite hesitation in tackling an unsustainable business model and the protracted negotiations and initial missteps in restructuring the two largest banks, the authorities are now moving in a concerted manner to resolve, restructure and recapitalize the financial sector. At the same time, the authorities will need to ensure that Hellenic Bank and the Cooperatives are strengthened, including through a possible capital injection if private funding cannot be raised. We also acknowledge and welcome the steps being taken to strengthen the AML/CFT frameworks. *We would appreciate staff comments on the results and recommendations of the most recent independent AML/CFT evaluations.*

While these efforts will shrink the size of the banking sector, it will remain very large relative to the Cypriot economy. This argues for urgent follow-through in strengthening the regulatory and supervisory frameworks. It also serves as a reminder of the need for accelerating the development of a banking union in Europe. We would have liked to see more in the staff report on how Cyprus' banking sector will fit in the broader European banking union currently under discussion, including with respect to a single supervisory mechanism and common deposit insurance or guarantees. *Thinking beyond Cyprus, it would*

be useful for the staff to consider the consequences of the restructuring and resolution process for other economies. For example, it is not clear to us that the precedents set in Cyprus would have the limited market impact suggested in Box 2 in the event of renewed stress elsewhere in the region. *We also would welcome staff reflections on a broader discussion of the drivers of and lessons to be learned from the Cypriot experience.*

Cyprus also faces difficult fiscal scenarios and we recognize the strong effort and up-front commitment to consolidation – 7.2 percent of GDP in measures already agreed or legislated. We welcome the authorities' efforts to strengthen public financial management and to put public finances onto a more sustainable path, including increases in a range of tax rates, reform of the cost of living adjustment public wage indexation system, and pension system reforms. We note, however, that the frontloaded consolidation may prove challenging if output declines faster than anticipated. We therefore welcome the inclusion of a buffer in the staff's debt analysis to provide financial flexibility in the event the recession is deeper than anticipated. The delay in anticipated privatization receipts to beyond 2015 also adds a dose of realism. Nonetheless, it is clear that achieving debt sustainability faces risks and will require continued, strong European financial and economic support.

Even with consistent program implementation, Cyprus faces a difficult economic path. In particular, the drivers of growth on the island will need to shift dramatically. The banking sector is unlikely to play a leading role and related services are likely to continue to contract. In addition, property development and the real estate market will face a difficult transition further jeopardizing economic recovery. *Staff comments on the implications of a possible decline in the property market and the resulting potential for larger banking sector losses than currently forecast, as well as the impacts on the program overall, would be welcome. More generally, we would appreciate some discussion of what would be Cyprus' future growth model.*

Finally, we recognize that Cyprus imposed a number of exchange and capital restrictions while initiating financial sector restructuring. While most uncommon in a currency union, we agree to the exchange restrictions requiring approval under Article VIII. We urge the authorities to seek to reverse these as the situation stabilizes. *Staff comments on the implications of the controls and the strategy for gradually removing them would also be of interest.*

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GRAY/13/1393

May 13, 2013

Statement by Mr. Mojarrad and Mr. Jbili on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We thank staff for the concise report and Mr. Snel and Mr. Kanaris for their insightful statement. It is regrettable that we are presented with Cyprus's request for assistance after imbalances have been allowed to deteriorate significantly, market access had dried out, the banking and payment system had almost collapsed, and recession and high unemployment loom large over the medium term. Mr. Snel and Mr. Kanaris provide an accurate account of the delays in concluding the assistance package, as well as the factors that contributed to the worsening of the economic and financial situation, including the spillover of the Greek PSI. Lessons from similar banking crises, including their detrimental effect on growth, seem to have been ignored at significant costs to Cyprus and loss of credibility of the regional and global crisis management framework.

Be that as it may, the proposed program to be supported by a three-year EFF arrangement offers a chance—a slim one in our view—for Cyprus to overcome its severe economic and financial imbalances over the medium term. We note the unusually high degree of uncertainty surrounding the program assumptions and projections, the considerable downside risks, and the high economic and social costs of adjustment, which may quickly become unsustainable. Against this background and in light of the experience of the Greek program, we are skeptical that the growth and debt sustainability objectives will be attained.

We have the following comments:

1. We agree with the overall strategy of restoring financial stability by restructuring and downsizing financial institutions, reducing the fiscal deficits to put the public debt ratio on a declining trend, and improving competitiveness through wide-ranging structural reforms. However, given the magnitude of the bank downsizing and the shift toward a new business model, which is yet to be specified, staff growth projections and the underlying fiscal targets seem to be highly optimistic. In particular, we are concerned that the front-loaded fiscal adjustment will severely weigh down on growth at a time when temporary restrictions on access to bank deposits and working capital of businesses will not have been fully lifted and normal credit flows restored. *Could staff explain the reasons behind the front-loaded fiscal*

adjustment given the high fiscal multipliers and the expected fall in private sector demand? We also ask staff to elaborate on the sources of future growth, including from recently discovered gas resources.

2. We commend the authorities for taking decisive steps to address the daunting challenges in the financial sector, as outlined in Box 1 and the MEFP. Intervening the two largest banks, which were insolvent, and recapitalizing the Bank of Cyprus by bailing in creditors and non-insured depositors has the merit of protecting taxpayers and preserving the integrity of the insurance deposit system. Nonetheless the process of restoring financial stability is at an early stage, and we encourage the authorities to fully implement their reform agenda in this area, including completing the restructuring and recapitalization of banks, addressing the problems of credit cooperatives, dealing with the rise in NPLs, and strengthening bank supervision. Lifting the temporary administrative measures will help restore normalcy to financial flows and the payment system and enhance confidence, but caution is needed to avoid destabilizing deposit outflows. We agree with Mr. Snel and Mr. Kanaris that external liquidity support would facilitate early lifting of capital restrictions.

3. We welcome the amendments of the AML legal framework to incorporate tax and other fiscal–related elements, and are encouraged by the authorities' agreement to introduce further revisions in line with international standards (structural benchmark for end-September 2013) and strengthen implementation and supervision in this area. While these efforts are laudable and would move the economy away from its tax-haven status and reliance on dubious deposits, we wonder how the transition might be managed to preserve financial sector stability. *Staff may wish to comment.*

4. We support the structural reform agenda, including in the areas of public financial management, privatization of SOEs, pension funds, and the social welfare system. Given the likelihood that the economy will undergo a prolonged period of weak growth and high unemployment, we encourage the authorities to preserve a core social safety net.

5. Overall, when considering the proposed program for Cyprus, it is difficult to avoid a feeling of déjà vu with the Greek experience still vivid in mind. The key question going forward is what options would be available if growth and debt scenarios follow the pattern of the initial Greek program. Something to ponder while hoping for the best.

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GRAY/13/1400

May 13, 2013

Statement by Mr. Yambaye on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

The economy of Cyrus faces significant challenges that originated from a build-up of financial sector excesses in the period leading up to the global crisis. Loose fiscal policies added to fiscal and macroeconomic vulnerabilities. These have been exacerbated by inward spillovers from Greece due to tight financial links. The combination of these factors has led to a loss of market access, recessionary pressures, housing market corrections and deterioration of banks' balance sheets. These adverse effects have been reinforced by negative feedback loops. Against this backdrop, the authorities of Cyprus have taken actions—both on the fiscal and financial sector front—to put an halt to these loops and this contributed to somewhat stabilizing the markets.

Going forward, Cyprus continues to face daunting financial challenges. We share the view that the depth and nature of actual and projected balance-of-payment financing needs warrant Fund support under the Extended Fund Facility (EFF). We welcome the additional financial support that is being provided by the European Stability Mechanism (ESM) which provides the bulk of the needed assistance to Cyprus over the medium term. We support the proposed decisions.

The path to recovery and renewed sustained growth in Cyprus could prove bumpy in light of the global uncertainties and the significant risks to the outlook (impact of the banking crisis and fiscal consolidation on growth) as well as to the program itself (debt trajectory, implementation capacity, reform fatigue). It is therefore of paramount importance that the authorities fully implement their broad strategy laid out in their Letter of Intent and MEFP, and reinforced in Mr. Snel and Mr. Kanaris in their comprehensive and insightful Buff statement. We are encouraged by the authorities' commitment to the reform strategy, and we share the view that time is of the essence to allow the economy to correct its fiscal, debt, financial and external imbalances, and to adjust to a new, sustainable economic model.

Regarding **financial sector policy**, we welcome the broad agreement between the authorities and staff on the needed further steps to complete the restructuring and recapitalization process, with the view to rebuild confidence in the sector, normalize financial flows and put in place the basis for sustained growth. We note however that the recapitalization strategy carries significant potential costs for public resources, especially if private capital does not come forward. *In this regard, we are eager to know whether sufficient official funds will be disbursed in a special account at the time of the first review to cover recapitalization and restructuring costs not only for credit cooperative sector but also for other banks that would be found solvent but not successful in raising adequate private capital. Staff's elaboration will be appreciated.*

We support the strategy laid out by the authorities to improve their preparedness to cope with troubled borrowers, strengthen regulation and supervision and enhance the AML framework as required.

On **fiscal policy**, the approved consolidation measures included in the 2013 budget and the agreed measures to supplement these in 2013-15 contain significant tightening. The fiscal program for 2015-18 as discussed in the staff report is based on the projected deterioration of the public debt throughout 2016 and its subsequent slow improvement thereafter. This program considers an additional 4.7 percent of GDP measures over that period to attain the target primary surplus. Not only does such primary surplus of 4 percent of GDP seem ambitious by historical and international standards, it may also entail considerable growth loss and risks to the program, notably "austerity" fatigue. *Against this backdrop, we would like staff to elaborate on an alternative approach of back-loading the fiscal adjustment measures in the period 2015-18 towards greater efforts down the road as growth resumes and improves.*

As regards structural fiscal reforms, we emphasize that due consideration be given to protecting the vulnerable groups while considering streamlining public spending as stressed(by staff para.32 of the report), particularly in the area of social transfers. We endorse the reforms to strengthen PFM practices, enhance revenue administration to secure the fiscal targets, adequately target welfare programs to vulnerable groups, and reduce debt and fiscal risks while raising economic efficiency. On the pension system, we look forward to the outcome of the envisaged actuarial study to assess the effect of the recent pension reforms and the budgetary cost of the public pension system.

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GRAY/13/1401

May 13, 2013

Statement by Mr. Saho on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

1. **We support the Cypriot authorities' request for an Extended Fund Facility arrangement given the country's substantial balance of payments needs and to allow for effective implementation of their comprehensive reform package aimed at addressing excessive macroeconomic imbalances which had triggered a banking crisis with the propensity of a spillover to other Eurozone countries.** The actions by the authorities to address insolvent banks, implement an ambitious fiscal consolidation in 2012, and institute critical fiscal reforms, underscore their commitment to implementing prudent macroeconomic and structural policies within the context of a Fund-supported program.

2. **Exceptional actions by the authorities have prevented the collapse of the banking sector.** We welcome the efforts at resolving, recapitalizing, and restructuring the weak banks, notably the two largest and insolvent banks. However, the persistence of vulnerabilities in the banking sector requires prompt and decisive action to strengthen capitalization of the sector and preserve its stability. Furthermore, it is evident that the banking problems were exacerbated by poor risk management practices and inadequate oversight, resulting in the buildup of excessive risk exposures. To this end, we welcome the authorities' plan to strengthen the supervisory and regulatory framework, including through reinforcing credit-risk management practices and ensuring implementation of accounting standards on loan provisioning. We also take note of the authorities' determination to reinforce their anti-money laundering framework in line with the FATF standard, including an independent audit of its implementation as it is a major concern for the country's development partners.

3. **From a zonal perspective, faster progress toward realizing the proposed banking union is needed, in view of the adverse feedback loop between the weak banks and governments.** This will not only protect taxpayers, but will also provide a single oversight framework that ensures effective supervision of all EU banks and help minimize the risks of crises spillovers to the rest of the banking system. The banking union could be complemented by a common crisis resolution mechanism.

4. **We note staff's projection of a total output decline of about 13 percent over the next two years and the commencement of a gradual recovery in 2015.** With the likelihood of the Eurozone reverting into recession and the significant overvaluation of the euro for Cyprus, an export-led recovery does not seem realistic. Thus, given the limited alternative drivers of growth for Cyprus, a growth resurgence is unlikely in the near to medium term. *We would therefore welcome staff comments on the assumptions underlying the overly optimistic growth outlook.*

5. **A realistic fiscal consolidation path is crucial to ensuring long-run fiscal sustainability.** We welcome the comprehensive package of fiscal measures adopted in December 2012 which is an important initial step towards achieving the medium-term fiscal targets. While we consider the rationalization of social benefits and pensions and streamlining public sector wages a central part of the consolidation process, we are concerned that further expenditure restraints could stifle growth, undermine attainment of the ambitious fiscal targets, and throw the economy into a deeper recession. We thus see merit in limiting additional fiscal measures and extending the horizon for attaining the authorities' long-term primary balance target. In addition, further streamlining of public spending could heighten social tensions and result in a political backlash. Well designed and targeted programs to protect the poor and vulnerable segments of the populace should thus form an essential element of the adjustment program.

6. **The judicious implementation of far-reaching structural reform measures is critical to returning public finances to a sustainable path.** Of paramount importance, in this regard, is the strengthening of public financial management systems. To this end, the progress accomplished by the Cypriot authorities in implementing a medium-term budget framework (MTBF) is commendable. However, there is need for expediting the development of the legislative and regulatory framework needed to operationalize the MTBF. Also, the timely enactment of a fiscal responsibility and budget systems law as stipulated under the program would help ensure effective implementation of the budget framework. Finally, we underscore the need for deeper reforms of the pension system to ensure its long-term sustainability and financial viability, and the privatization of inefficiently-run state-owned enterprises to help minimize fiscal risk.

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GRAY/13/1402

May 13, 2013

Statement by Mr. Santoso, Mrs. Zainal Abidin, and Ms. Soontornpoch on Cyprus (Preliminary)
Executive Board Meeting
May 15, 2013

We thank Messrs. Snel and Kanaris for their insightful Buff and staff for their comprehensive report on Cyprus' request for an arrangement under the Extended Fund Facility (EFF). The root causes of the unprecedented economic crisis in Cyprus are significant structural imbalances in the economy and the oversized banking sector. It is evident that the insolvency of the two largest banks is beyond the capacity of the Cypriot government to meet their recapitalization needs. We acknowledge that the substantial adjustment is inevitable and entails a lot of painful burden on the people of Cyprus. The authorities' strong commitment to implement the adjustment program aimed at restoring financial stability, achieving sustainable public finances, as well as improving competitiveness through structural reforms are crucial to secure medium-term recovery. **With this strong commitment, a comprehensive reform package, significant ESM support, and a view toprovide some support to meet the country's balance of payments need, we can supportthe request for a 3-year EFF program under the proposed terms and the retention ofexchange rate restrictions.**

Restoring financial stability is key priority

1. **We can empathize with the authorities' need to administer controls to forestall substantial deposit outflows from the banking system.** As highlighted by Messrs. Snel and Kanaris, the restrictions are undesirable but necessary under these circumstances; we view that the measures provide a breathing space for the authorities to address substantial risks to financial stability. On this note, we welcome the recent move to gradually relax some restrictions to enable the execution of essential business transactions. We encourage the authorities to put in place a comprehensive and clear roadmap including the necessary pre-conditions and communication strategy for further unwinding of the capital controls and administrative restrictions to enable the private sector to devise their business adjustment plans. *Staff comments are welcome*. We also agree with staff that the ability to access the Eurosystem liquidity support is critical to facilitate an early lifting of

payment restrictions. *Does staff see a possibility of unwinding all administrative measures before the indicative date in November 2013? What are the material risks to removing the measures? What are the strategic plans if the risks crystallize?*

2. **Successful resolution and restructuring of the two largest banks is a key imperative to stabilize the banking sector, normalize financial flows, and restore orderly functioning of banking system.** We are aware that the size of BoC and CPB's capital shortfalls is too large for the government to bailout and depositors will suffer severe hardship from the partial conversion of their uninsured deposits into banks' equity. To continue on the resolution process, we view that key success factors also involve credible resolution plan and effective communication to the public to restore confidence in the banking sector. This is to ensure the viability of the intervened banks, sever bank-sovereign link and prevent eventual recourse to public funds.

3. **The substantial need for recapitalization of the remaining banks and credit cooperative institutions pose challenges to fiscal position.** We support the plan to expeditiously recapitalize other viable banks in the coming months preferably with private capital. Nevertheless, given the worrying liquidity conditions, limited access to international credit markets, loss of deposits and reduced profitability, the prospect of recapitalization of banks and CCIs is highly challenging. More importantly, considering the likelihood of higher NPL ratio and more provisioning requirements, the situation may worsen and the government may need to bear the full burden of recapitalization costs. As initial estimation by PIMCO suggests that the capital needs of €9 billion would account for only three quarter of the total banking system assets, *we are interested in staff views on the adequacy of public funds for the recapitalization of banks. Given the different capital structure of the credit cooperatives relative to that of banks, we are interested in staff elaboration on the plan to recapitalize the credit cooperative institutions. What is the contingency plan to close down nonviable financial institutions?*

4. **We support the measures to facilitate private sector debt restructuring to revive financial services activity, facilitate new lending, and diminish credit constraints.** Weakening economic activity and loss of capital buffers may render many businesses to downsize or face bankruptcies. In this regard, the temporary suspension of loan installment to alleviate businesses' needs for working capital is welcome. *We welcome staff comments on corporate debt restructuring initiatives that would expedite successful negotiation process.*

5. **A comprehensive reform of the financial system is necessary to put medium-term financial stability on a firm footing.** We agree with the plan to significantly downsize domestic banking sector to EU average by end-2018. Equally important is the need to revamp banking business model, to have in place better risk management framework and to create strong disincentives towards imprudent activity. We welcome the authorities' intention to strengthen the supervisory and regulatory framework by improving credit quality monitoring in accordance with international standards, empowering the CBC with sufficient supervisory tools, and transferring supervisory and regulatory powers of the

CCIs to the CBC. We would also encourage the supervisory authorities to further strengthen the monitoring of banks liquidity risk management framework. *In this connection, staff comments are welcome on CBC's institutional capacity to supervise theCCIs and the plan to reform the credit cooperatives industry given the peculiarity of thebusiness model of cooperative banking relative to commercial banking.*

Well-balanced fiscal consolidation and reform to achieving sustainable public finances

6. **We commend the steadfast efforts by the authorities to implement fiscal consolidation measures taking effect during 2013-2016 and the completion of prior actions as underscored in the buff statement.** Ambitious strategy for further deficit reduction is based on delicate balancing act of expenditure cuts and revenue increases. We note from staff report that specific measures include scaled public sector wage cuts of 10-15 percent, rationalization of social benefits and pensions, and increases in the VAT, excise taxes, and pension contributions. Nevertheless, staff projections of fiscal account still show relatively high level of wages and salaries as well as social transfers that would only trend down after 2015. *Staff clarification on this matter is welcome. We would also benefit from deeper impact analysis of the austerity measures on the ongoing government investment projects and PPPs.* While we agree with most of the prescribed measures to increase revenue, we are concerned that the increased VAT rates may further dampen domestic demand and also pose burden on the low-income population. *Staff comments on the capacity of the population particularly the vulnerable segment of the population to absorb the fiscal adjustment measures is welcome.*

7. **Additional measures toward structural fiscal reforms are necessary steps to strengthen fiscal institutions and reduce fiscal risks.** We support the rollover of maturing domestic debt and congratulate the authorities for obtaining the Russian government's financing assurances to extend the loan repayment and lower the interest rate as confirmed in Messrs. Snel and Kanaris' statement. We are encouraged by the set of reform measures to ensuring sustainability of pension system, improving public finance management and introducing a more targeted social welfare system to protect the most vulnerable group.

8. **The risks under the proposed program remain significant.** Staff report projects that debt-to-GDP ratio will peak at 126 percent in 2015 and fall to 105 percent by 2020 and suggests that a medium-term debt level of around 100 percent of GDP could be consistent with debt sustainability. However, the analysis in Box A1 highlighted the risks to the projection of debt sustainability: Cyprus had lost market access at a lower debt level, growth prospect undermined by the banking crisis; conversion of uninsured deposit to equity had likely lowered the debt tolerance threshold; and the weak track record of maintaining high primary surpluses. All these characteristics pointed towards higher vulnerability to shocks and risk of losing investor confidence. *Against this background, staff elaboration on the conclusion reached for the sustainable level of debt for Cyprus is welcome.*

Broader structural reform measures are warranted to ensure sustainable recovery.

9. **We welcome the difficult decisions on corrective measures taken by the Cypriot authorities thus far, and their commitment to the full implementation of the reforms.** Apart from the two main pillars of adjustment program, a comprehensive set of structural reforms to restore international competitiveness and address unemployment problem is appropriate to enhance economic productivity and build the foundation for sustainable growth. The possibility of new investment projects financed by FDIs and exploitation of natural gas resources as mentioned in the buff statement would further support growth prospects. *We look forward to staff analysis of these developments once clearer investment prospects become available.*

To remain steadfast during this difficult time and ensure the success of adjustment program, we encourage the authorities to embark on a clear communication strategy to garner broad support from the public. With these remarks, we wish the authorities and the people of Cyprus every success in their future endeavors.

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GRAY/13/1403

May 13, 2013

Joint Statement by Mr. de Villeroche, Mr. Montanino, Mr. Prader, Mr. Temmeyer, and Ms. Meyersson on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We thank staff for the comprehensive report and for their efforts, together with the European Commission and the European Central Bank, to help the Cypriot government to develop an appropriate program. We agree with the thrust of staff report and support the requested Extended Arrangement.

We commend the authorities for their resolve in implementing unprecedented measures to restore the soundness of the Cypriot banking sector, the structure of which reflected unique challenges. We appreciate the efforts made by Cypriot citizens and acknowledge the hardship that they are enduring. We welcome the reaffirmation of the authorities' commitment towards the resolute implementation of the program presented in Mr. Snel and Mr. Kanaris's very informative Buff. The success of the program will critically hinge on political ownership, implementation capacity and the rebuilding of a sustainable economic model.

Program design

The process that led to the agreed program design was protracted and difficult. However, the agreement eventually reached has been crucial to promote the stabilization of the financial sector. We are confident that the firm implementation of the program will enable the Cypriot economy to return to a sustainable growth path.

The program addresses the relevant policy challenges, in particular the need to urgently restore the viability of the Cypriot financial sector without affecting public debt sustainability, ensure sound public finances over the medium term, and promote structural reforms, which are necessary to re-direct the economy towards a balanced growth model.

We are aware that this is a very challenging program, with non-negligible risks, such as the uncertain impact of the depositor bail-in on the growth model. The largest share of these risks is borne by the Cypriot citizens and by their European partners, who are supporting their efforts providing loans of up to €9 billion via the European Stability Mechanism (ESM). On

the basis of the agreed program, the Board of Directors of the ESM has already approved the Financial Assistance Facility Agreement and the disbursement of the first tranche of financial assistance of €3 billion, €2 billion of which was disbursed today. The Fund's financial support is more limited compared with previous arrangements, which reflects the fact that the ESM is now fully operational. Nevertheless, the Fund's engagement is essential for the success of the program. We encourage the authorities in their efforts to demonstrate strong ownership and successful implementation. Good coordination among decision makers and additional targeted technical assistance will be necessary to achieve the program objectives.

Finance Ministers of euro area Member States also look forward to the finalization of the negotiations between the Cypriot and Russian authorities on the restructuring of the loan granted to Cyprus by the Russian Federation in 2011.

Financial sector

The fragile and unique situation of Cyprus' financial sector called for an unprecedented package of resolution, restructuring and recapitalization measures. The adoption in March of national legislation establishing a comprehensive framework for the recovery and resolution of credit institutions proved to be an indispensable step in this respect.

We are pleased to read in Mr. Snel and Mr. Kanaris's Buff that the authorities are moving rapidly with plans to complete the necessary overhaul of the financial sector and that they will further strengthen the anti-money laundering (AML) framework. The resolution of the Cyprus Popular Bank and the restructuring of the Bank of Cyprus need to be finalized urgently with normal activities resuming as soon as possible. While temporary restrictions imposed on financial flows are justified in the given circumstances, they are a very serious limitation to the free movement of capital. They should be gradually lifted, while balancing financial stability risks. Together with the recapitalization of other banks, if needed, a resolution and restructuring, including of the cooperative credit sector, and an improvement in financial supervision would help restore depositor confidence, which is a key element for the further relaxation of capital controls.

We agree with staff that market reaction to events in Cyprus has been limited up to now. Progress in strengthening institutional frameworks both at the euro area and national levels has helped reduce the negative spillovers to the rest of euro area countries. Risks of longer-term spillovers should not be underestimated. Continued Eurosystem liquidity support is important to mitigate risks of widespread bank funding stress; this support is already very significant.

Fiscal policy and management

We welcome the additional fiscal consolidation measures adopted following the Eurogroup political agreement of March 25 2013 and the authorities' commitment to working with their international partners in implementing a determined deficit reduction strategy.

Overall, we agree with staff's fiscal projections, provided that all measures are implemented,

and their debt sustainability analysis, recognizing the large degree of uncertainty as stated by staff. While we agree that the fiscal multiplier can be expected to be high due to the financial sector constraints, we invite staff to consider that a relatively larger part of the fall in output could be the result of the generalized uncertainty about developments in the economy and in the banking sector.

We concur with staff on the need for an expenditure-based adjustment, to be achieved over the full program period, and on the importance of implementing additional measures after the program period to achieve the necessary further improvement in the structural balance. It is clear that ambitious and front loaded consolidation efforts are indispensable to achieve the desired debt trajectory.

We support the structural fiscal reforms established by the program, which will help securing the fiscal targets, ensure the long-term sustainability of the pension system and increase the efficiency of the public administration. Structural fiscal reforms, such as enhancing revenue collection and improving targeting of social welfare programs, will also help in embedding equity considerations in the fiscal adjustment plans.

Structural reforms

While we welcome the wage indexation reform, we note that it still foresees a partial indexation scheme. In a currency union, wage indexation schemes, whether automatic or not, impair the proper working of price setting mechanisms and the alignment of wage increases to productivity gains. We encourage the authorities to explore different avenues to reduce wage-indexation further.

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GRAY/13/1404

May 13, 2013

Statement by Mr. Varela and Ms. Navarro on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We thank the staff for a well written and comprehensive report and Mr. Snel and Mr. Kanaris for their helpful Buff statement. We broadly agree with staff's appraisal and support the requested 3-year Extended Arrangement.

Cyprus is confronted with daunting macroeconomic challenges that are to be addressed by a well designed program aimed at restoring the financial sector stability and achieving sustainable public finances. In addition to helping the country address the severe crisis it faces and the challenges ahead, the program will contribute to the financial stability in the euro area as well as the global economy. Financing support will be the largest to be provided to a euro area country relative to the size of its economy, with the bulk of the contributions coming from the euro area partners. Also, the Fund's participation will be key, especially given its outstanding expertise.

Circumstances in Cyprus have been unique and have required also unique, unprecedented solutions to deal with insolvent banks that will be difficult to be repeated, as measures have been tailored-made to a very exceptional situation. The authorities have already taken significant steps to address the problems of the banking system. The necessary downsizing and thorough restructuring of the banking sector is now underway. The establishment of a comprehensive framework for the recovery and resolution of credit institutions has been an important measure in this regard. Like staff, we encourage the authorities to step up their efforts to complete the bank recapitalization process as soon as possible as this is critical to the restoration of confidence in the banking system and to withdraw capital controls.

In this regard, we support the approval of the three exchange restrictions described in the proposed decision as they appear to be warranted to avoid a collapse of the banking system and to safeguard financial stability in Cyprus. While necessary and unavoidable in the current circumstances, these restrictions are also disrupting economic activity and creating risk to the financial system. For this reason, the authorities' intentions to fully remove them as soon as conditions allow and the significant relaxation of controls already taken are welcome.

Other program measures are also critical to put the financial sector on a sustainable footing and allow lending flowing again to support economic activity. These include the strengthening of the supervisory and regulatory frameworks, and plans to establish a framework for targeted private sector debt workouts. We also welcome the authorities' intention to continue reinforcing financial transparency by further strengthening the anti-money laundering legal and implementation framework.

On the fiscal front, the aim to balance short-run cyclical concerns and long-run sustainability objectives is adequate and should be preserved. We also concur with staff that future fiscal adjustment should rely largely on expenditure-side measures, and note that for the moment they represent 40 percent of the agreed consolidation package. We acknowledge that the adjustment required to reach a primary fiscal surplus of 4 percent of GDP is ambitious, although staff's assurances that other countries have been able to sustain large primary surplus give us confidence. We also note that while the remaining effort is sizeable, substantial consolidation measures have already been adopted and the authorities have declared a strong commitment with the consolidation path. In any case, careful note should be taken of staff's warnings on the existing risks to the outlook and debt sustainability and the need for rigorous implementation by the authorities.

The consolidation strategy needs to be complemented by deeper reforms on the fiscal framework. We welcome the recent steps taken by the authorities regarding the public wage indexation system and the introduction of a parametric pension reform. We also welcome their commitment to further reinforcing public finances through more powerful fiscal management practices, strengthening the revenue administration and adjusting welfare programs to make them better focused on protecting the most vulnerable and better adapted to the new revenues structure. Another important step will be the reform of the pension system. We look forward to the assessment that will be made on the current system and the specific actions to be proposed in future reviews. Finally, we encourage the authorities to develop a credible privatization plan with strong ownership, which will facilitate attaining the fiscal targets and will increase overall efficiency.

The staff paper indicates competitiveness has not been substantially affected so far. However, the adjustment process will have a significant impact on the productive fabric of the country and hence new growth sources should be found and expanded. As a consequence, the authorities should consider the option of designing a set of structural measures aimed at fostering new activities and promoting further gains in competitiveness and smooth transfer of resources among different economic sectors. Going forward, completing the wage indexation reform will be crucial both for inflation alignment with international peers and retaining an adequate level of competitiveness.

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GRAY/13/1405

May 13, 2013

Statement by Mr. Yeates and Mr. Meads on Cyprus
(Preliminary)
Executive Board Meeting
May 15, 2013

We thank staff for a comprehensive report, which sets out in a candid way the unusually high risks to the programme. We agree with the thrust of the staff report and can support Cyprus' request for a three-year Extended Fund Facility. We also broadly associate ourselves with the comments made by Mr. de. Villeroche et al., but wished to add the following points for emphasis.

We recognise and agree with the main objectives of the programme to restore financial stability and ensure the sustainability of public finances. But, as staff note, the risks around the programme are unusually high given uncertainties around the impact of the banking crisis, of the planned change in growth model, and of fiscal consolidation on economic activity. We welcomed the discussion of these channels on economic activity provided in box 4. Nonetheless, we would have appreciated more detail on the calibration of the impact of financial sector restructuring on demand. For example, more information on the distribution of expected losses between types of households and companies would have assisted in understanding the size of wealth effects assumed. The basis for estimating a 2.5 percent reduction in GDP growth as a result of a 100 percent decline in bank assets is also unclear. Information on the impact of downsizing the banking sector on future fiscal revenues would also have been welcomed.

In the medium-run, growth is projected to stabilize at 1¾ percent. We note that this is already well below the pre-crisis average, but *would welcome elaboration by staff as to which sectors, following the required change in growth model, will drive this projection?*

Overall, while the growth projections are consistent with those for other banking-crisis episodes, the unique set of circumstances and weak external environment could render such comparisons misleading. As such, we agree with staff that there would appear to be substantial downside risks to the growth outlook. In light of those risks, we view the cautious approach towards overall programme financing within the debt sustainability analysis (DSA) to be appropriate. But, even with a buffer of 10 percent of GDP included in the baseline DSA, the report states (paragraph 17) that additional financing measures may be needed to

preserve debt sustainability should downside risks materialise. *Staff comment on whether contingency measures have already been indentified would be welcome.*

Financial sector risks also remain high. A central facet of the analysis is the identification of recapitalisation needs. These are keyed off PIMCO's adverse scenario analysis, but it is not clear what the precise macroeconomic conditions are assumed to be under that adverse scenario. As noted under the contingent liabilities risk in the DSA, a further deterioration in the macroeconomic outlook would likely feed back into asset positions, raising the financing needs for other viable commercial banks and credit cooperative institutions (CCIs) within the programme.

A key challenge is to normalise financial flows. We share staff's view that the imposition of liquidity restrictions, while necessary to stabilise the financial sector, should be temporary in nature so as not to choke off real activity. As such, we support calls for the authorities to monitor the effects carefully and relax these restrictions as soon as conditions allow. To allow that to occur promptly, the continued provision of euro-system liquidity is crucial.

It is imperative that the authorities fully commit to consolidation efforts in order to place public finances on a sustainable path. We welcome efforts already taken and agree with staff that the focus for further measures should be on the expenditure side and embedded in a multi-year budget framework so as to enhance credibility. The projected fiscal adjustment is ambitious, however, and highlights the need for structural reforms to underpin the consolidation effort in the medium term. Nonetheless, given the uncertainty surrounding the programme, we note the possibility that headline fiscal targets might prove difficult to achieve for reasons beyond the control of the authorities.

The programme also assumes several supplementary measures to reduce financing and/or public sector debt – helping to share the burden. One such measure is to identify SOEs and other assets to be privatized. At present the authorities are drawing up an inventory of assets, but – as highlighted by other programmes - it may be challenging to realise the required revenues either in scale or the desired timeframe. *Staff comment on the likelihood of meeting this challenge would be welcome.*