***IMF: Its History, Its Role, Its Work Today in Cyprus and a View on the Future***

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Thank you for inviting me to this engaging event. It is a real pleasure to be here today and I appreciate the opportunity to say a few words about the IMF, the economy of Cyprus, and the role of economic policies going forward.

The History of the IMF

In brief, the IMF was conceived at a conference in Bretton Woods, New Hampshire, in the United States, in July 1944. The 44 countries at that conference tried to build a framework for economic cooperation to avoid a repetition of the policy mistakes that had contributed to the Great Depression of the 1930s.

The Role of the IMF

The IMF is a Fund where quota subscriptions are a central component of its financial resources. Each of its 188 member countries is assigned a quota, based broadly on its relative position in the world economy.

The primary role of the IMF is to ensure the stability of the international monetary system, that is to say the system of exchange rates and international payments that enables countries and their citizens to transact with each other. Over time, the mandate of the Fund has evolved to include all macroeconomic and financial sector issues that have implications on global stability.

This mission is pursued in three ways: i) keeping track of developments in the global economy and the economies of member countries; ii) lending to countries with economic and financial difficulties; and iii) giving practical help to members. Let us take a closer look at these three functions:

i) Keeping track of economic developments

The IMF oversees the international monetary system and monitors the economic and financial policies of its 188 member countries. As part of this process, which takes place both at the global level and in individual countries, the IMF highlights possible risks to stability and advises on necessary policy adjustments.

ii) Lending

A core responsibility of the IMF is to provide loans to member countries experiencing actual or potential economic and financial problems. This financial assistance enables countries to restore financial stability, put public finance on a sustainable trajectory and achieve conditions for a return to strong economic growth. In this capacity, the Fund has been engaged in Cyprus in the last two years. Unlike development banks, the IMF does not lend for specific projects.

iii) Giving practical help

The IMF helps its member countries design economic policies and manage their financial affairs more effectively by strengthening their human and institutional capacity through technical assistance and training. The IMF aims to exploit synergies between technical assistance and training, which it calls capacity development, to maximize their effectiveness. Although less visible than the work done in the context of the financial assistance program, extensive technical assistance and training has been provided to Cyprus lately.

The Work of the IMF in Cyprus

Let me now move to the economy of Cyprus and the work done by the IMF. I will go back to the run-up to the 2008 global crisis. In those years, Cyprus accumulated large imbalances. Following the entry into the EU and the removal of capital account restrictions in 2004, significant foreign inflows led to a rapid expansion of the banking sector to over seven times GDP. Easy credit fuelled a housing boom and an increase in private-sector debt to over 300 percent of GDP by 2008, one of the highest levels in the euro area. The financial sector became deeply interlinked with that of Greece, through significant lending by the branches of the Cypriot banks in Greece as well as large holdings of Greek sovereign debt. Imports surged. Exports were dampened by loss of competitiveness as wage grew faster than productivity. As a result, the current account deficit widened to about 16 percent of GDP.

As the global crisis hit in 2008, the cycle went in reversal. Foreign inflows slowed down and bank credit shrunk. The housing boom turned to bust. In 2009, output fell for the first time. In response, fiscal policy was loosened, which led to a rapid deterioration in the budget balance and public debt. Domestic weaknesses were compounded by tight linkages between the sovereign and the banks and the intensification of the Greek crisis, eventually resulting in the loss of market access in May 2011. In July of the same year, the explosion of the power station in Mari added to the economic distress. The decision to restructure Greek sovereign debt in late 2011 dealt a severe blow to Bank of Cyprus and Laiki, which lost a combined 25 percent of GDP. The banking sector collapsed. Laiki was recapitalized through state support of 10 percent of GDP in 2012. Deposit outflows intensified, and reliance on Emergency Liquidity Assistance rose to 60 percent of GDP by end-2012.

In mid-2012, over a year after losing market access, Cyprus requested official assistance from the EC, the ECB, and the IMF. However, negotiations were protracted, due to the difficulties in addressing the large capital needs of the banking sector without endangering debt sustainability, as well as to the impending presidential election in early 2013. In March 2013, following the elections, the new government took unprecedented measures to stem the crisis. The authorities moved aggressively, resolving the two systemic and by-then insolvent banks, recapitalizing the resulting institution at no fiscal cost through bail-in of bank creditors (including uninsured depositors) and selling the banks' Greek operations. Domestic and external payment restrictions were imposed to prevent a bank run.

This paved the way for an agreement on an adjustment program supported by official financing. The three-year program—underpinned by financial support of €10 billion from European partners and the IMF—aimed at stabilizing the financial sector and ensuring sustainable public finances. The financial sector strategy focused on: (i) completing the recapitalization and restructuring of the banking sector, including the cooperative credit sector; (ii) implementing a debt-restructuring framework to address rising non-performing loans and private indebtedness; (iii) developing a roadmap for the gradual relaxation of payment restrictions; and (iv) strengthening bank regulation and supervision. Fiscal policy aimed to achieve well-paced consolidation, balancing short-term cyclical concerns and longer-term sustainability. The program was complemented by comprehensive structural reforms aimed at restoring economic growth job creation.

A View on the Future

Let me strike a positive note. Cyprus's economic reform program is producing real results. Capital and liquidity conditions in the banking system have stabilized. Domestic and external payment restrictions have been lifted and market access has been regained. The fiscal deficit has turned into a small surplus. After going through an unprecedented downturn, the economy is stabilizing and we are starting to see encouraging signs, with the number of jobs now rising again. Economic activity has entered a path of gradual recovery, moving from an annual GDP growth rate of -5.4 percent in 2013 to -2.3 percent last year. Notably, these outcomes have exceeded our earlier expectations and those of other forecasters. In our recent World Economic Outlook, we forecast marginally positive growth for Cyprus in 2015, a rate of 0.2 percent, followed by a further gradual expansion in the following years.

The people of Cyprus should be given full credit for these results. It is only their determination in addressing economic and financial difficulties and for taking full ownership of far-reaching reforms that has allowed this progress.

It would not be a fair assessment, however, if we did not acknowledge the challenges still lying ahead and if we did not stress the need for even greater efforts going forward. In the search for growth two key priorities stand out: i) banks should be in a position to extend new credit to the economy, which, in turn, would let firms invest and create jobs more vigorously; and ii) the economy should manage to attract more capital through foreign direct investment. This again would boost economic growth and employment.

Targeted economic policies can support these priorities.

First and foremost, Cyprus must deal with its NPL problem. Why is this so important? NPLs approaching 60 percent of all loans are preventing banks from extending new credit to the economy. Understandably, financial institutions are not in a position to offer new lending if they are unlikely to get paid back. Only by lowering NPLs, we will allow banks to extend new credit and on better terms. This, as said, will support growth and jobs. The recently adopted legislation on foreclosure should provide creditors with a credible threat against strategic defaulters – borrowers, who can pay, but decide not to – and help restore a solid payment culture in the country. The foreclosure law has been complemented by a reform of the personal and corporate insolvency framework, which should allow debtors to either restructure their loans or, for those who truly cannot pay, to have a "fresh start". The combination of these two sets of measures should encourage banks and borrowers to move towards speedier solutions, which, in turn, should free up capital for new lending and support growth.

Another key policy priority is privatization. Progress on this front is also underway, after some delays, mainly of procedural nature, relative to the initial program. The privatization of state-owned enterprises is often portrayed as a way to raise short-term revenue for the state budget, while the long-run benefits to the economy are not given sufficient emphasis. On the contrary, these benefits are critical and include i) allowing for better and more cost-effective services for the population and (ii) attracting foreign direct investment, which again can bring jobs and increase liquidity in the economy. Therefore, going forward, it is important that further decisive steps are taken in this reform area too.

Finally, Cyprus should double its efforts to make the country a good place to do business. The government's plan to put in place a growth strategy is a welcome initiative. Efforts should be addressed towards those areas where the gap relative to international best practices is the widest and the impact of reforms on long-run potential growth the highest. These include strengthening the legal system, opening up closed professions, removing barriers to competition, reducing red tape, and fostering innovation. These are all steps that could support growth, competitiveness, and innovation, and act as catalyst for further investment, thus helping to ensure a job-rich recovery.

Let me conclude by saying that there is no quick fix to the economic crisis the country went through over the past few years. Only steady and resolute implementation of structural reforms along the path already started can ensure a sustained return to economic prosperity and jobs. Most likely Cyprus will not go back to pre-crisis growth rates, and maybe it shouldn't! That growth was rooted in major imbalances and proved unsustainable. But targeted reforms can ensure a return to jobs, stability and prosperity.