The Economic Adjustment programme for Cyprus

Conclusion of the 1st review – Summer 2013

Brussels, September 18th, 2013

http://ec.europa.eu/dgs/economy_finance/index_en.htm

The compliance report (1 of 2)

- It is a technical report by the Commission Services, *in liaison* with the ECB

- It provides input (the Commission Services assessment of compliance) for the Eurogroup to decide on the disbursement of each tranche of the financial assistance

- The IMF (Board of Directors) decides based on its own 'staff report'

The compliance report (2 of 2)

The report includes,

- Our assessment of progress made by Cyprus: macroeconomic, fiscal, financial developments, structural reforms, debt sustainability etc
- The compliance table, which is a detailed assessment of compliance with policy conditionality
- The detailed economic projections through 2016, shared between the programme partners
- The updated Memorandum of Economic and Financial Policies/Memorandum of Understanding (MoU)

The programme

1. Introduction – 1st review conclusion
2. Economic developments - outlook
3. Programme implementation
4. Programme financing
5. What next?

Introduction – 1st review conclusion

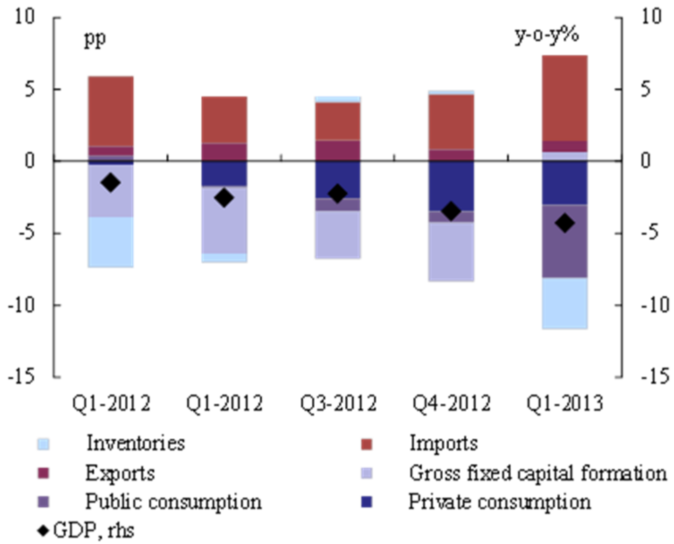
1. EC/ECB/IMF staff concluded the first review mission on July 31st - the economic adjustment programme is on track
2. Cyprus has made determined start with the implementation of the programme
3. Financial sector stabilisation and confidence building under way. Gradual relaxation of deposit restrictions and capital controls.
4. 2013 budget execution remains on track, but extraordinary compensation of pension funds in Laiki will cost 1.8% of GDP this year. Subsequent annual fiscal targets are within reach
5. Implementation of programme commitments have started in all key areas. Fiscal-structural and structural reforms have been taken forward, although delays have been more prominent in these areas.
6. On September 13th, the Eurogroup decided to unlock the disbursement of EUR 1.5bn by the ESM; the IMF BoD similarly decided for an amount of EUR 86mn

Economic developments – outlook (1 of 4)

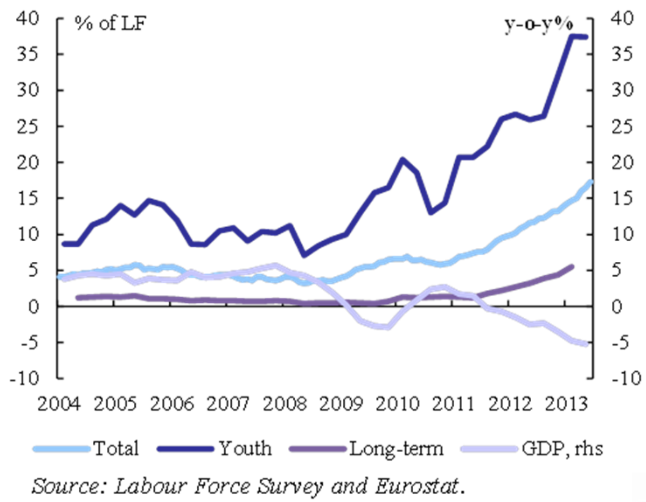
The recession is intensifying within expectations,

- Real GDP declined 4.9% y-o-y in the first quarter, accelerating from -3.5% y-o-y in the fourth quarter of 2012 –second quarter preliminary data imply a further acceleration, to 5.7% y-o-y
- Employment continued to adjust and declined in all major sectors, i.e. manufacturing, construction, services and public administration - unemployment exceeded 15% of the labour force

1. Real GDP change - contributions



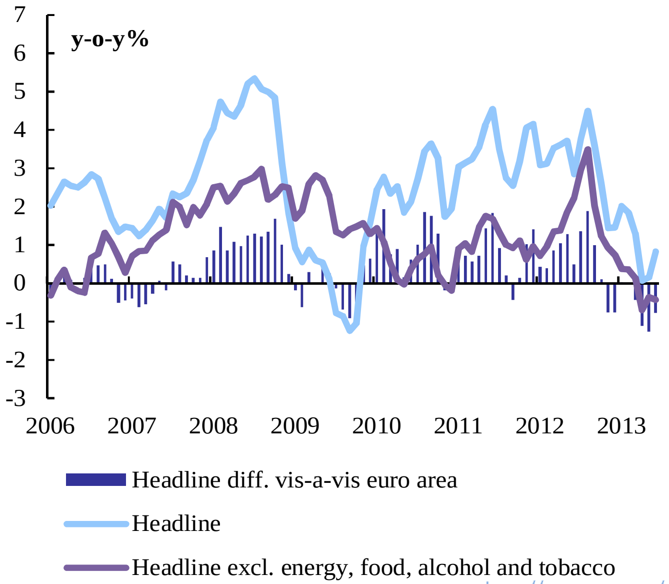
2. Unemployment/GDP change



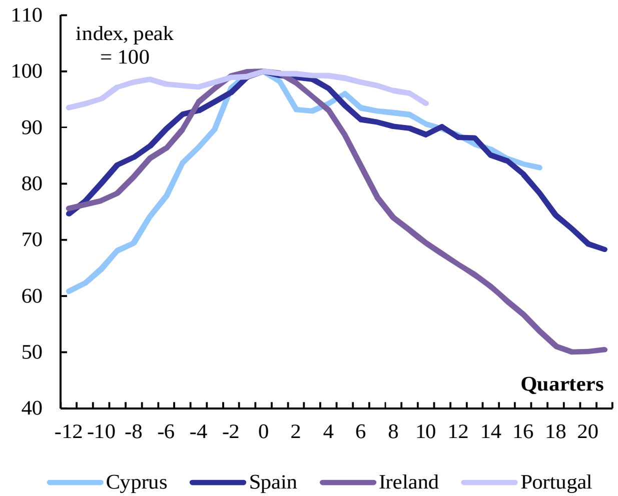
Economic developments – outlook (2 of 4)

- Low domestic cost pressures and sizable spare capacity have contained inflation and HICP has continued declining - reductions in the prices of the housing component and of clothing/footwear offset the VAT hikes and the higher taxes on alcoholic beverages and tobacco
- The gradual narrowing of the positive HICP inflation differential vis-à-vis the euro area turned negative in last part of 2012, partly explained by the weak underlying inflation

3. HICP inflation



4. Nominal house prices



Economic developments – outlook (3 of 4)

- Real GDP is expected to decline **by 8.7% in 2013**, unchanged compared to the April 2013 programme forecast: **(i)** immediate restructuring of the banking sector, **(ii)** longer-lasting deleveraging of balance sheets, **(iii)** fiscal consolidation, **(iv)** economic uncertainty, **(v)** temporary imposition of capital controls, **(vi)** bail-in of uninsured depositors causing a loss of wealth.
- Economic activity will shrink further in 2014, although to a milder extent than in 2013 - the economy is expected to contract **by around 15%** cumulatively in 2012-2014

						Annual percentage change			
						Updated forecast		April forecast	
	2012		2010	2011	2012	2013	2014	2013	2014
	Curr. prices (EUR m)	% of GDP							
GDP	17,887	100	1.3	0.5	-2.4	-8.7	-3.9	-8.7	-3.9
Private consumption	11,948	66.8	1.5	0.5	-3.0	-12.4	-5.7	-12.3	-5.5
Public consumption	3,588	20.1	1.0	-0.2	-1.7	-8.9	-3.7	-8.9	-3.6
Gross fixed capital formation	2,295	12.8	-4.9	-13.1	-23.0	-29.5	-12.0	-29.5	-12.0
Exports (goods and services)	8,137	45.5	3.8	4.4	2.3	-5.5	-2.5	-5.0	-2.5
Imports (goods and services)	8,127	45.4	4.8	-0.7	-7.2	-16.5	-6.8	-16.0	-6.5
GNI (GDP deflator)	17,185	96.1	2.4	4.3	-6.6	-5.5	-4.4	-5.5	-4.4
Contribution to growth:	Domestic demand		0.2	-2.2	-6.1	-13.8	-5.5	-13.7	-5.5
	Inventories		1.8	0.5	-0.9	0.0	0.0	0.0	0.0
	Net exports		-0.7	2.2	4.4	5.0	1.6	5.0	1.6
Employment			-0.2	0.5	-4.1	-7.8	-3.7	-6.6	-3.1
Unemployment (1)			6.3	7.9	11.9	17.0	19.5	15.5	16.9

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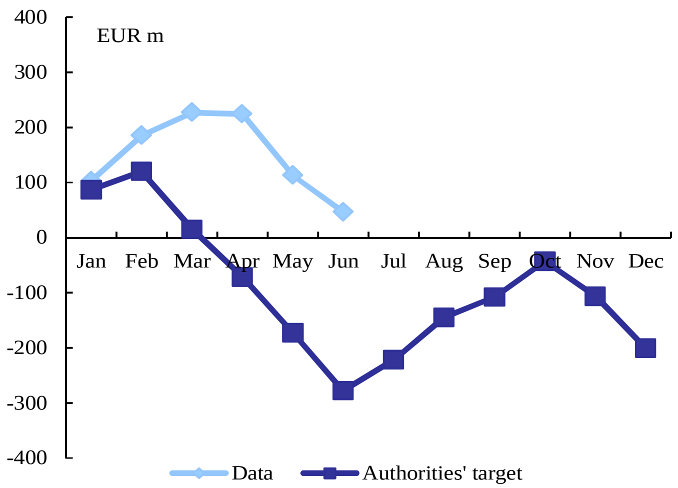
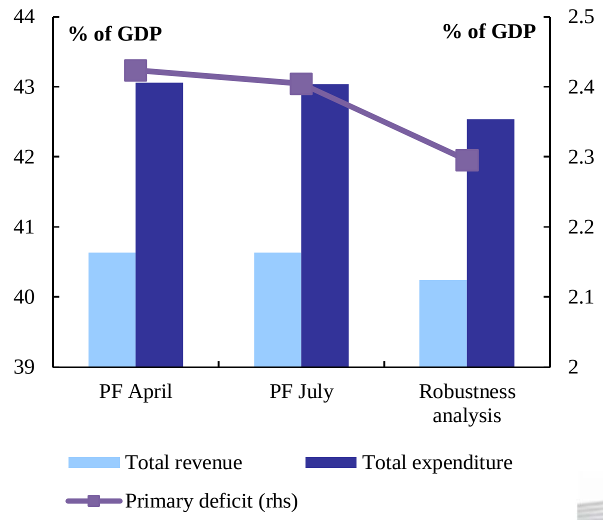
Economic developments – outlook (4 of 4)

- The Jan-Jun 2013 budget execution data suggests that budgetary execution remains on track - primary balance for the central government maintained a surplus in cash terms, compared to a sizeable deficit expected
- General government H1 data confirms these trends - primary balance and headline budget balances over-performed, by 1.6% of GDP and 2.3% of GDP, respectively; however, weak macroeconomic outlook and downward trends in both direct and indirect tax collection are expected to advesely affect budgetary outcome

5. Budget primary balance



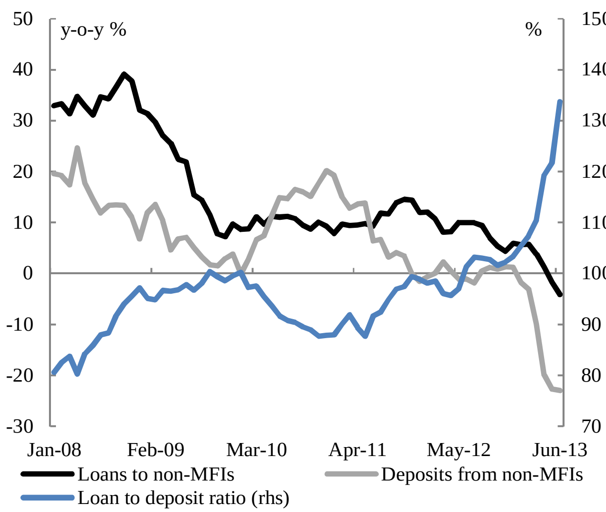
6. Robustness analysis, 2013



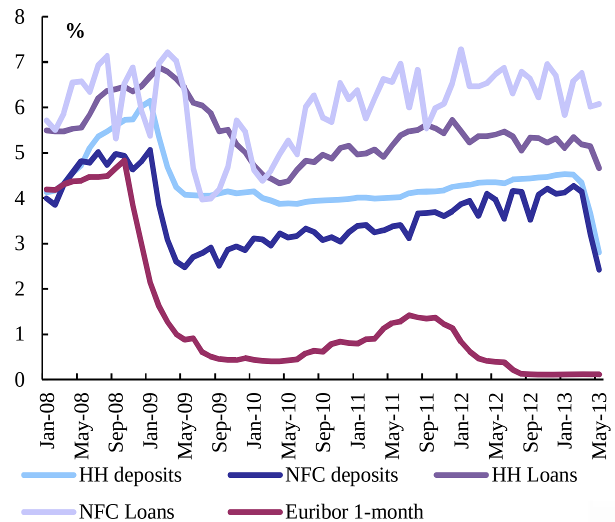
Financial developments – outlook (1 of 2)

- Since mid-March, financial sector developments have been driven by liquidity constraints and deteriorating asset quality - deposit outflows have slowed down recently
- Squeezed liquidity, together with the erosion of the capital position due to NPLs, has constrained loan growth and contributed to quicker-than-expected deleveraging
- In an effort to contain cost of credit, a capital surcharge was imposed on too high deposit interest rates, which dropped drastically, hoping this would be passed on to lending rates

7. Loans and deposits



8. Interest rates on loans/deposits



Financial developments – outlook (2 of 2)

- Bank of Cyprus and Cyprus Popular Bank (CPB) have been restructured and the former has been taken out of resolution on 31 July, while the "bad bank" of the later remains under special administration
- Upon exiting resolution, Bank of Cyprus regained ECB counterparty status
- The "*good bank*" of CPB was merged into Bank of Cyprus with sufficient assets at fair value to ensure an end-of-programme core tier I ratio of 9%
- To ensure a sufficiently robust core tier I ratio of about 12% now and 9% at the end of the programme, eventually 47.5% of the uninsured deposits of Bank of Cyprus were converted into equity (vis-à-vis the initial estimate of 37.5%)
- Upon exiting resolution, 5% of the uninsured deposits were released but subject to the capital controls and the remaining uninsured deposits (37,5%) was frozen in time deposits in equal tranches for 6, 9 and 12 months with a possibility to roll-over once
- A General Meeting took place on 10 September to appoint a new Board of Directors for Bank of Cyprus, to prepare the restructuring plan defining the bank's business objectives by mid-October

Programme implementation (1 of 5)

1. Financial sector reforms (compliant with delay)

- Restructuring the financial sector, in spite of some delays, has considerably progressed:

(i) a strategy to restructure the cooperative credit institutions has been designed and agreed; a capital need of EUR 1.5 bn was confirmed to be provided by the programme (no deposit bail-in); the more than 90 cooperative credit institutions will be merged into 18 entities by March 2014

(ii) Hellenic bank has launched a capital raising plan aiming at finalisation by end-December without state aid

- Administrative restrictions and capital controls,

(i) have gradually been relaxed (card payments, increasing the ceiling for free money transfers, reducing documentation for international trade payments), and

(ii) a milestones approach for the further progress in four steps has been adopted linking gradual capital liberalisation to successful implementation of policy measures; first restrictions inside Cyprus will be eliminated and then outside

Programme implementation (2 of 5)

- On supervision and regulation, the majority of envisaged reforms have been observed on time:

(i) a new classification on non-performing loans is in effect,

(ii) a unified data reporting system for both commercial and cooperative banks has been implemented,

(iii) the integration of the supervision of the cooperative credit institutions is ongoing.

  - Preparatory work for promptly meeting future deadlines is ongoing, related to the establishment of a single credit register, mandatory supervisory action, the regulatory framework on loan origination, asset impairment and provisioning practices, and the revision of the internal governance directive

- Monitoring of private sector indebtedness is stepped up and legislation regarding troubled borrowers is in place; regulation for better managing arrears is now adopted and setting up a mediation service is in preparation

- An Anti-Money Laundering action plan addressing the remaining legal framework shortcomings is agreed and the Cypriot authorities have committed to ensure its implementation – relevant legislation is prepared

Programme implementation (3 of 5)

2. Fiscal policy (compliant)

- Cyprus has implemented 2013 Budget Law and fiscal consolidation measures with determination - part of the fiscal adjustment measures were enacted in end-2012, while further measures were enacted via the 2013 Budget Law
- Additional fiscal consolidation measures of more than 2% of GDP were enacted in April 2013, raising the total amount of fiscal measures for 2013 to around 4.5% of GDP, balanced between expenditure and revenue side
- Although some measures on the revenue side may underperform compared to targeted yields, Cyprus implements more-than-agreed expenditure cuts
- Exceptional (one-off) compensation of pension funds who suffered losses in Laiki is likely to lead to a 1.8% of GDP higher-than-budgeted 2013 deficit, already foreseen in the MoU

	2011	2012	2013	2014	2015	2016
Real GDP (1)	0.5	-2.4	-8.7	-3.9	1.1	1.9
Output gap (2)	1.1	0.1	-5.8	-6.6	-3.0	0.8
General government balance (3)	-6.3	-6.3	-6.5	-8.3	-6.3	-2.9
Primary balance (3)	-3.9	-3.1	-2.4	-4.3	-2.1	1.2
Cyclical-adjusted balance (4)	-6.9	-6.3	-5.8	-5.4	-4.9	-3.3
Structural balance (4)	-6.7	-6.7	-5.6	-5.4	-4.9	-3.3

Programme implementation (4 of 5)

3. Fiscal structural reforms (partially compliant)

- Important fiscal-structural reform steps have been launched, although with some delay
- Public administration reforms are a priority for Cyprus and as agreed in April, an independent external review has been commissioned and already initiated, led in a first phase by the World Bank and the UK public administration
- Cyprus announced on 26 July 2013 a major reform for its welfare system, to be prepared in stages and enter into force on 1 July 2014 – it aims to better protect the most vulnerable households while ensuring a more efficient use of public funds
- The main cornerstones of the revenue administration reform, also by improving the governance structure, in spite of some delay, are now agreed
- The authorities will need follow-up on: (i) the actuarial study for the GSIS; (ii) the approval of an umbrella law to improve budgetary processes; (iii) up-do-date valuation of the inventory of SOEs and subsequent steps in the privatisation process; (iv) further specification of the reform plans for the revenue administration and the welfare system

Programme implementation (5 of 5)

4. Structural reforms (labour, product and services markets)

- Cyprus has successfully transposed the Third Energy Package and has made some progress in formulating a comprehensive strategy for rearranging the energy sector
- Labour market-related reform steps have been initiated; however, the assessment of current activation policies needs to be followed by detailed proposals
- Most amendments aligning the legislation with the principles of the Services Directive have been adopted
- The reform of the housing market and immovable property regulation, although advancing, is taking longer than foreseen
- A study on a new tourism sector business model and an update of the Tourism Strategy 2011–2015 were prepared, to constitute the basis for a concrete action plan to be presented later in 2013
- Follow-up is needed regarding: (i) a more comprehensive outline on the regulatory regime and market organisation for the energy sector and gas exports; (ii) some regulated professions still need full elimination of bans on advertising.

Programme financing and debt (1 of 2)

- The first disbursement of EUR 3.1bn, provided the Cypriot authorities with sufficient funds to cover debt servicing and deficit financing needs, until the next cash disbursement foreseen by end-2013
- The successful exchange of domestic-law bonds held by residents and the improvement of the terms of the loan granted by the Russian Federation, increased Cyprus' outstanding marketable public debt average maturity and normalised its repayment schedule/profile
- Following the first cash disbursement (EUR 3bn) and the cash-less second tranche for the recapitalisation of the financial sector (EUR 1.5bn), the ESM will have disbursed half of its commitment of EUR 9bn
- The IMF, which does not participate in the recapitalisation of the financial sector, will have disbursed a total of EUR 0.17bn.

Programme financing and debt (2 of 2)

- There are no critical changes to the debt sustainability assessment (DSA)
- Key parameters of the macro- and fiscal forecasts which would impact on the debt trajectory have not been revised
- Estimated financing needs over the programme horizon still seem appropriate and have not been revised
- General government (gross) debt is expected to peak at around 127% of GDP in 2015 and start declining from 2016 on

	2012	2013	2014	2015	2016
Gross debt stock (% of GDP)	85.8	115.0	123.2	126.9	122.5
Δ debt stock	14.7	29.2	8.2	3.6	-4.4
Primary balance (neg = PB in surplus) (1)	3.1	4.2	4.3	2.1	-1.2
Interest payments	3.2	4.1	4.3	4.1	4.2
Deficit/debt adjustment	8.1	13.3	-3.6	0.6	-2.7
Growth impact	1.8	8.2	4.6	-1.3	-2.4
Inflation effect	-1.4	-0.6	-1.3	-1.8	-2.2

Risks to the programme

1. potentially stronger contraction of the economy, further worsening of the labour market outlook and steeper drop in real estate prices;
2. protracted period of low confidence in the banking sector; relatively large amount of NPLs could further tighten credit supply conditions;
3. worsening of the economic situation in trade-partner economies;
4. insufficient implementation of fiscal-structural measures; inability to reach the agreed primary surplus targets established in the programme;
5. lower-than-expected privatisation proceeds;
6. insufficient implementation of structural reforms, constrained by adverse macro and financial developments, but also by vested interests

What next…

1. In coordination with the CY authorities, the Commission and the fellow programme partners, keep monitoring the programme conditionality implementation, as agreed in the revised MoU

2. There is a number of Q3-2013 deadlines, related to important policies and reforms, that the CY authorities are well placed to respect

3. The next review mission, is expected to take place in late October - early November and will certainly focus on the financial sector reforms, the 2014 budget preparation and the on-going structural reforms, e.g. privatisation process and energy sector development plan.

Your questions, comments please… Thank you!

"The Economic Adjustment Programme for Cyprus – first review"

http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op161_en.htm

(European Economy. Occasional Papers. 161. September 2013. Brussels. Paper and internet.)