Summary for non-specialists
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The Economic Adjustment Programme for Cyprus First Review – Summer 2013

Staff teams from the European Commission (EC), European Central Bank (ECB) and the International Monetary Fund (IMF) visited Nicosia on 17-31 July for the first quarterly review of Cyprus' economic adjustment programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The programme's objectives are to restore financial sector stability, strengthen public finance sustainability and implement structural reforms so as to support sustainable and balanced long-run growth.

Staff concluded that Cyprus' economic adjustment programme is on track. The authorities have taken decisive steps to stabilise the financial sector and have been gradually relaxing deposit restrictions and capital controls. The fiscal targets have been met as a result of significant fiscal consolidation measures underway and prudent budget execution. Structural reforms have been taken forward in important areas, although delays and partial compliance were observed in a number of cases. While the programme has been implemented with determination so far, downside risks remain substantial. Continued full and timely policy implementation is essential for the success of the programme.

The short-run economic outlook remains difficult and subject to considerable uncertainty. Recent indicators support the programme's projections of a contraction in output of about 13% cumulatively during 2013-2014. Encouragingly, business and, to a lesser extent, consumer confidence indicators, have improved somewhat from the troughs in April. However, the labour market has weakened, and unemployment is rising faster than anticipated in the spring. Growth is expected to recover modestly starting in 2015, driven by revamped and more competitive non-financial service sectors.

Financial sector policies have been geared toward restoring confidence in the banking system, aiming at supporting economic activity. Confidence in the banking sector deteriorated in the first part of the year, and deposits have gradually left the banking sector. Therefore, the authorities have taken difficult but necessary steps to fully recapitalise Bank of Cyprus, thus allowing it to exit resolution and return to normal operations. The authorities have also set out a clear agenda to restructure and recapitalise the cooperative credit sector, before the end of 2013, using programme resources where necessary, and without involving depositors. A milestone-based roadmap for the gradual removal of capital controls and administrative restrictions was agreed to ensure an orderly and predictable exit. Banking sector regulation and supervision are also being strengthened. The authorities have developed an action plan to strengthen the implementation of the Anti-Money Laundering framework.

On fiscal policy, the ambitious package of measures already implemented and a prudent execution of spending are yielding results, with the primary fiscal deficit in the first half of the year better than the programme target for the same period. Overall, the Cypriot authorities have implemented its budgetary policy in compliance with the requirements of the MoU. Over the longer run, the government's fiscal policy remains anchored in achieving a primary fiscal surplus of 4% of GDP by 2018, needed to place public debt on a firmly downward path.

Major fiscal-structural and structural reforms are being designed to modernise Cyprus' institutional framework and to provide a sound basis for economic growth. Revenue administration will be overhauled, including by establishing an integrated function-based tax administration and taking measures to fight tax evasion. Reforms in the areas of pensions, health, public administration and social welfare are also being undertaken, the latter aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and the elimination of duplicate benefits. The authorities have initiated work on a privatisation strategy, but timely and concrete steps are still needed. In product and services markets, first important steps have been taken on energy, housing, tourism, regulatory authorities and regulated professions, but concrete follow-up will be required.

A successful completion of the first review should pave the way for the disbursement of EUR 1.5bn by the ESM, and about EUR 86m by the IMF. This will bring the total amount authorised for disbursement under the programme to 47% of the overall international assistance of EUR 10bn.