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The Economic Adjustment Programme for Cyprus

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OUTLINE OF THE REPORT

LIST OF BOXES

LIST OF TABLES

LIST OF GRAPHS

1. EXECUTIVE SUMMARY

Following a request by Cyprus on 25 June 2012, the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) finally agreed an Economic Adjustment Programme with the Cypriot authorities on 2 April 2013. The Programme aims to address the financial, fiscal and structural challenges facing the economy in a decisive manner and should allow Cyprus to return to a sustainable growth path. The Programme was agreed by the euro-area Member States on 24 April 2013 and by the IMF Board on 15 May 2013. It covers the period 2013-2016. The financial package will cover up to EUR 10 billion, including EUR 1 billion from the IMF.

In the last decade, Cyprus was increasingly faced with serious challenges in terms of unsustainable external and internal macroeconomic imbalances. While some imbalances have only emerged following the sharp recession and the collapse of the domestic credit boom, others have been building up over the past decade.

Cyprus enjoyed strong growth in the first decade of the millennium, twice that of the euro area. Growth took place in conditions of almost full employment, low inflation and rising real disposable income. The latter largely benefited from wage increases significantly higher than in the rest of the euro area. Economic performance during this period was driven mainly by buoyant domestic demand, which was supported by a surge in credit growth. The fall in risk premia, financial integration, capital liberalisation and excess liquidity in the banking sector, which was linked to large inflows of foreign deposits, contributed to the credit expansion. Furthermore, the dynamic activity in the real estate sector and asset re-pricing, particularly of land, coupled with the positive confidence effect of EU accession and subsequent euro adoption, augmented the build-up of the asset boom. In parallel, persistently high current account deficits were recorded. Lagging exports went hand in hand with significant losses of price/cost and non-price/cost competitiveness. Private sector indebtedness, in both the corporate and the household sectors, increased rapidly, resulting from more favourable financing conditions and the steady increases in housing prices. A strong inflow of foreign capital (mainly deposits) allowed the current account deficit to keep growing, while further fuelling credit growth in the domestic economy.

Financial soundness indicators for Cypriot banks started to deteriorate in 2010, revealing vulnerabilities with respect to their capital buffers and liquidity positions. The banking sector was increasingly cut off from international market funding and major financial institutions recorded substantial capital shortfalls against the backdrop of the exposure to the Greek economy and deteriorating loan quality in Cyprus. Bank credit policy, poor risk management practices and insufficient supervision were recognised as partly responsible for the prevailing imbalances. On the fiscal front, the policy stance was found to have been insufficiently prudent during the economic boom years, while the subsequent counter-cyclical policy action to mitigate the effects of the global economic crisis produced a back-loaded fiscal consolidation strategy that was ineffective in correcting the excessive budget deficit. Amidst consecutive downgradings of Cypriot sovereign bonds by credit rating agencies, the country became unable in mid-2011 to refinance itself at rates compatible with long-term fiscal sustainability.

Against this background of increasing pressure in financial markets, due to concerns about the sustainability of its public finances and a weakened financial sector, the Cypriot authorities requested financial assistance from euro-area Member States and the IMF on 25 June 2012. The situation in the banking sector worsened further in early 2013, due to a drop in confidence leading to continuous and substantial deposit outflows. In March 2013, the Eurogroup reached a political agreement on the key elements of an Economic Adjustment Programme for Cyprus with a financial envelope of up to EUR 10 billion, including the restructuring and substantial downsizing of the banking sector and the reinforcement of efforts on fiscal consolidation, structural reforms and privatisation. An important element of the agreement was the contribution of uninsured bank depositors towards the recapitalisation needs of the two largest banks. Following financial turmoil, a bank holiday of 10 days was imposed, during which the sector was downsized substantially through the resolution and restructuring of banks and the separation of the Greek operations of Cypriot banks. On 2 April 2013, an agreement at technical level was reached in respect of a comprehensive policy package to be implemented in a three-year Economic Adjustment Programme; the key objectives, measures and outcomes were laid down in a draft Memorandum of Understanding (MoU) between the Commission and the Republic of Cyprus.

The Programme 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:

(1) **Ambitious measures to address the deep banking crisis, with efforts to address capital and liquidity shortfalls.** The authorities have already taken decisive action to cope with the capital needs of two of the major banks without recourse to taxpayer money. Restructuring and downsizing of banking is underway and the Programme aims to complete this process, to return speedily to free financial transactions and to preserve the soundness of financial institutions. Regulatory provisions and governance of the financial sector will be strengthened.

(2) **Determined action to continue the on-going process of fiscal consolidation**. This will be an ambitious fiscal consolidation strategy, building on the consolidation efforts intiated 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 excessive general government deficit as soon as possible and to put the gross public debt-to-GDP ratio on a firm downward path in the medium term.

(3) **Ambitious structural reforms to support competitiveness and sustainable and balanced growth**, allowing for the unwinding of macroeconomic imbalances. The aim is to overcome the macroeconomic imbalances that accumulated before and during the crisis and to re-establish solid foundations for a sustabinable growth path.

An important feature of the Programme is the mitigation of any adverse social effects, while addressing fiscal, banking and structural imbalances. In particular, the reforms of the wage indexation mechanism cost-of-living allowance (COLA) and the pension system, and the targeting of social benefits are designed so as to minimise the impact on the lowest income groups.

This report provides a background to the Programme and builds on the documents agreed with the Cypriot authorities.

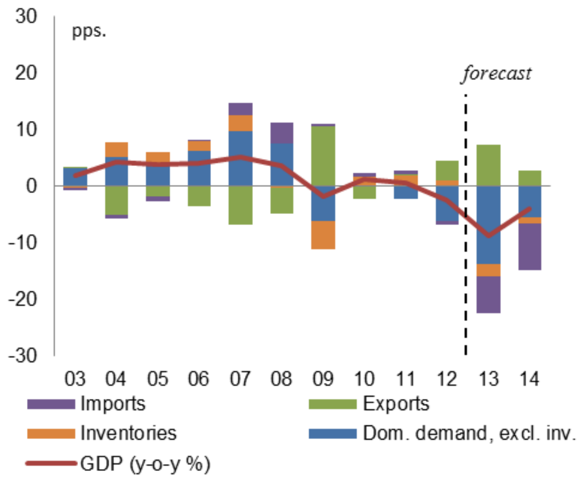
2. BEFORE THE CRISIS: EMERGING IMBALANCES AMID HIGH GROWTH

2.1. ECONOMIC TRENDS

1. **Economic activity in Cyprus enjoyed strong growth in the first decade of the millennium, with an average annual GDP growth rate of 3.0% in real terms, twice that of the euro area.** Growth took place in conditions of almost full employment, with remarkably high job creation (3% per year on average), low inflation and rising real disposable income**.** The latter largely benefited from wage increases significantly higher than in the rest of the euro area and faster than productivity developments in the country and from a broad tax reform that shifted taxation from direct to indirect taxes, the aim of which was mainly to harmonise the Cypriot tax system to the EU *Acquis*. This period of economic expansion was supported by a succession of credit-led impulses, demographic changes (due to inflow of foreign workers), and adjustment processes, such as the convergence of nominal interest rates towards the levels of euro area in the run-up to EU accession in 2004 and the macroeconomic-stability policy framework put in place by Cyprus to ensure euro adoption in 2008.

2. **Economic performance during this period was driven mainly by buoyant domestic demand.** Dynamic private consumption was supplemented by strong private investment, especially in construction, and, to a lesser extent, by public consumption, whereas net exports contributed negatively to GDP growth. Strong domestic demand benefited from a surge in credit growth, encouraged by a fall in risk premia, financial integration, capital liberalisation and excess liquidity in the banking sector, which was linked, inter alia, to very large inflows of foreign deposits. Furthermore, for the small open economy of Cyprus, the confidence effect of EU accession and subsequent euro adoption was non-negligible for both consumers and investors. The highly optimistic level of confidence along with the credit growth, and coupled with dynamic activity in the real estate sector and asset re-pricing, particularly of land, were all symptoms of an underlying asset boom.

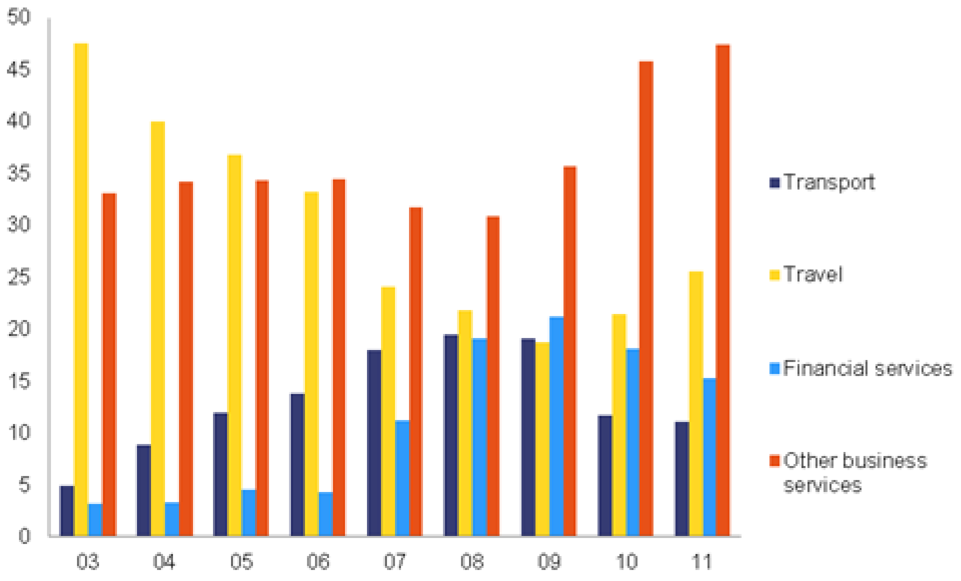
Graph 1. Contributions to GDP growth



Source: Commission services

3. **Cyprus' services sector has grown and has become quite diversified.** Over time, trade in services (in particular, travel services, transport, financial services, as well as other business services[1]) has acquired a pivotal role in the economy. The trade surplus in services was consistently high over the period 2003-2010, at levels of around 20% of GDP, but only partially offset the increasing trade deficit in goods. In addition, the construction and property sectors have made an important contribution to the country's economic activity. More generally, the development of business services[2], which increased from 5.5% of GDP in 1995 to 7.8% of GDP in 2011, was related to a number of factors including, inter alia: the accession of Cyprus to both the EU and the euro area, considering that it reinforced Cyprus' role as a bridge between third countries and the EU/euro area; the existence of an accommodating low-tax regime and the availability of highly-skilled labour, both of which contributed to a favourable environment for business services. It is worth noting that the share of financial services in the total services trade balance increased significantly in the years 2007-2010, reaching 21.2% in 2009 and decreasing gradually in the subsequent years.

Graph 2. Trade in services: Contribution (%) to the overall services balance, by broad economic category



Source: Commission services

4. **However, Cyprus has faced increasingly serious challenges in terms of external and internal macroeconomic imbalances.** While some imbalances have only emerged following the sharp recession and the collapse of the domestic credit boom, others have been building up over the past decade. Over the past decade, persistently high current account deficits were recorded. Lagging exports went hand in hand with significant losses of price/cost and non-price/cost competitiveness, mainly due to wage indexation, delays in the introduction of productivity-and-competition-enhancing structural reforms and the longer-term impact on competitiveness and entrepreneurship of an oversized public sector. Strong net inflows of foreign capital (mainly deposits) allowed to the current account deficit to grow, while stoking a credit boom in the domestic economy. Banks' credit policy has also been responsible for the prevailing imbalances. With the introduction of the euro and high economic growth led by domestic demand, private

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[1] Trade in other business services includes trade in merchanting and other trade-related services, operational leasing services, professional and technical services (e.g. legal, accounting, management and public relations services, advertising, research and development services, architectural, engineering and other technical consultancy).

[2] Business services include, inter alia: Legal and accounting activities; activities of head offices, management consultancy activities; Architectural and engineering activities; Advertising and market research; Other professional, scientific and technical activities; Rental and leasing activities; Travel agency, tour operator reservation service and related activities; and Other personal service activities .

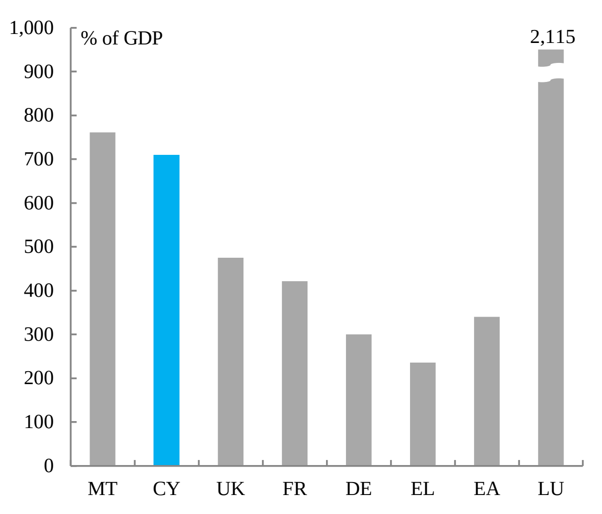
sector indebtedness increased rapidly, resulting from more favourable lending rates, improved income expectations and steady increases in housing prices. On the fiscal front, the policy stance was insufficiently prudent during the economic boom years, while the subsequent counter-cyclical policy action to mitigate the effects of the global economic crisis produced a fiscal consolidation strategy that was back-loaded and ineffective.

2.2. FINANCIAL SECTOR

5. **The rapid expansion of the banking sector since 2005 has led to the build-up of significant vulnerabilities.** Low corporate interest rate coupled with comfortable deposit rates led to the build-up of a specific business model for the banking sector in Cyprus in the second half of the previous decade. Banks were gaining funding capacity from the non-resident segment of depositors. This encouraged strong growth rates of bank credit to the private sector, especially for house purchases, and fuelled a real estate bubble, while contributing to a very high level of private indebtedness, which reached 310% of GDP in 2011, up from 213% in 2007. Cypriot banks, and in particular Cyprus Popular (Laiki) Bank and the Bank of Cyprus, engaged in substantial expansion in Greece, which left them exposed to the adverse macro-economic developments there. The very rapid expansion of the Greek sovereign and loan book and the deteriorated macroeconomic conditions in Greece and also in Cyprus led to rapidly rising levels of non-performing loans within both the Greek and the domestic portfolio of the Cypriot banks. Losses due to rising non-performing loans were mounting up, with negative effects on bank capital. Finally, regulatory requirements for investing excess liquidity in government debt resulted in a high exposure to the Greek sovereign and subsequent losses.

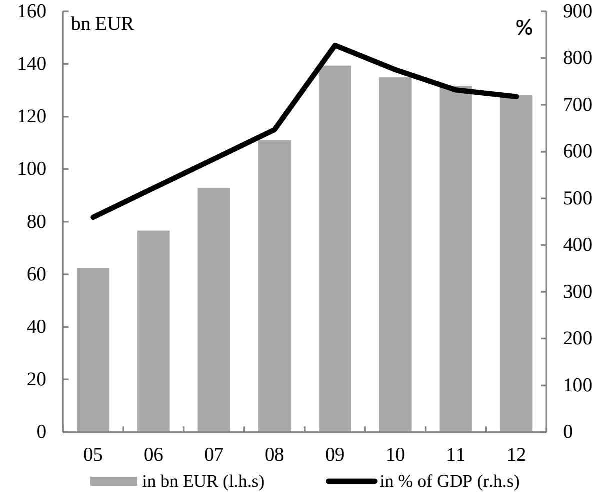
6. **The financial sector in Cyprus doubled in size during the pre-euro-accession phase and was very large until recently.** The Cypriot financial sector, which is dominated by the Monetary Financial Institutions (MFIs), was growing rapidly from 2005 onwards and reached a peak in 2009. Assets held by MFIs jumped from EUR 62.5 billion at the end of 2005 to a peak of EUR 141.5 billion in 2009. At the end of December 2012, total assets amounted to 718% of GDP, twice the euro-area average. A moderate and gradual deleveraging has been taking place since mid-2009 (Graphs 3a and 3b). The earlier expansion was mainly financed by attracting deposits, especially from non-residents, who found in Cyprus a favourable tax and business environment. Some of the attracted resources were working balances for international companies established in Cyprus, some were re-routed as foreign direct investment and some fuelled the property boom in Cyprus or were used for lending in Greece. Poor risk management practices, insufficient capacity to exercise prudential oversight compared to the size of the financial sector, and excessive concentration of investments led to the unprecedented challenges for the system.

Graph 3a: Relative size of the banking sector, end-2012



Source: ECB

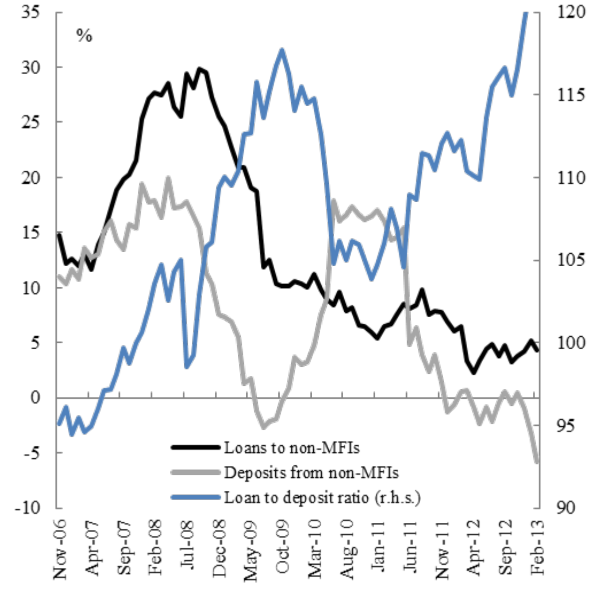
Graph 3b: Evolution of banking sector assets



Source: ECB, Commission services.

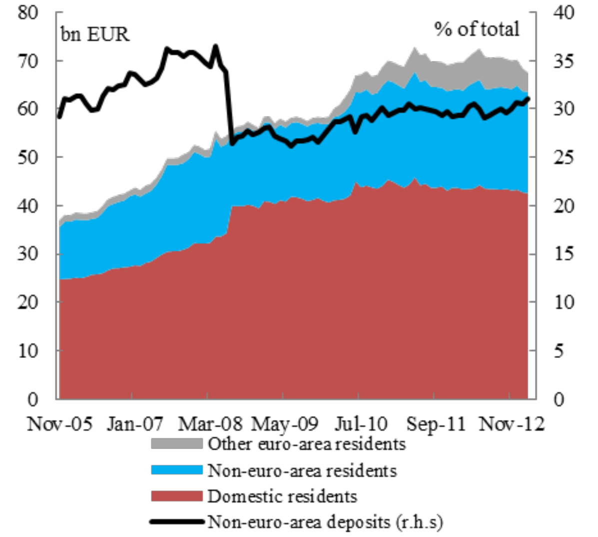
7. **The banking sector was involved in strong credit expansion in the past decade, leading to an increase in the loan-to-deposit ratio.** After the adoption of the euro, the y-o-y growth rate of loans to non-MFIs peaked at 35% in October 2008, but deposits grew at a slightly more moderate rate (Graph 4a). A salient feature of the deposit structure was the high share of deposits from non-residents, in particular from outside the euro area, which accounted for about 30% of all deposits at the end of 2012 (Graph 4b). Since the onset of the financial crisis in Greece in May 2010, the share of non-resident deposits from the euro area has been increasing steadily, reaching a peak in July 2012 of 9.1% of the total, while it fell during the recent crisis to 5.8% in February 2013. The loan-to-deposit ratio for the consolidated banking sector increased somewhat in 2011, to 112.7%, mainly due to deposit outflows from the Greek branches and from foreign-owned companies in Cyprus. Accordingly, domestic deposits accounted for 63% only of total deposits at the end of 2012, i.e. excluding operations in Greece. During the period of credit expansion, the share of loans to non-residents peaked at 26% in October 2012 (with only 5% granted to non-Cypriot euro-area residents, mostly from Greece, Graph 4c), and then fell to 25% in February 2013. While loans to households also grew, the increase in credits was mainly driven by loans extended to financial and non-financial corporations (Graph 4d).

Graph 4a: Evolution of deposits, loans, (annual growth rates) and loan-to-deposit ratio



Source: ECB

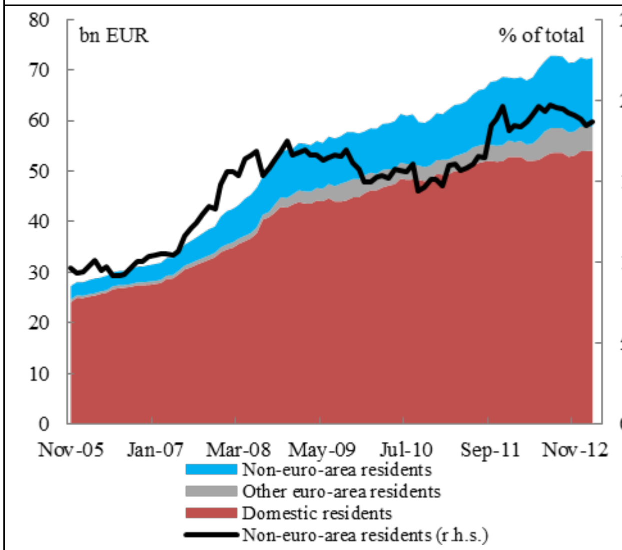
Graph 4b: Structure of deposits



Notes: The large decline in rest-of-the-world deposits in July 2008 is due to a reclassification of some brass-plate company deposits into resident deposits.

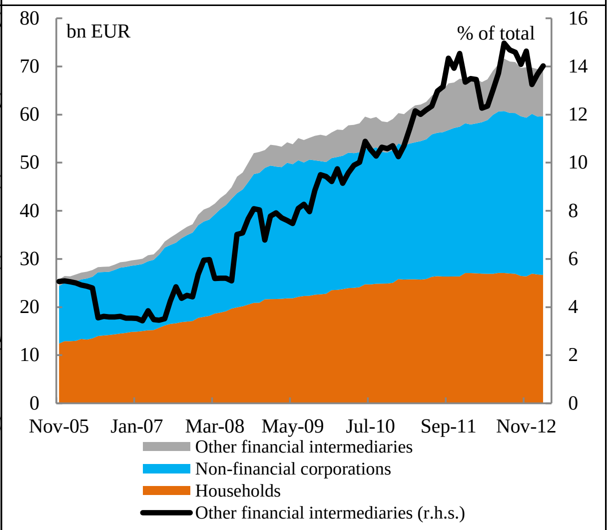
Source: Central Bank of Cyprus

Graph 4c: Structure of loans, based on origin of residents



Source: Central Bank of Cyprus

Graph 4d: Structure of loans in the private sector



Source: *Central Bank of Cyprus*

8. **Regulatory requirements to maintain a foreign currency liquidity ratio of at least 70% and a euro liquidity ratio of at least 20% led to the concentrated exposure of Cypriot banks to the Greek sovereign debt.** This gave Cypriot banks an incentive to invest in Greek euro-denominated sovereign bonds, which evenutally led to severe losses for the Cypriot banks.

9. **Solvency coefficients for the local Cypriot banks fell below local regulatory levels as a result of increasing non-performing loans.** Following substantial impairments in the nominal values of the Greek Government bonds, Cypriot banks' capitalisation levels were significantly reduced. Their Core Tier 1 ratio fell to 4.3% by the end of 2011 from 8.6% in June and their capital adequacy ratios (CAR) dropped to 8.3% from 12.4% (Table 1). Given the 9% Core Tier 1 EBA requirement, this implied a substantial capital shortfall for the domestically-supervised institutions. To this end, domestic banks started to raise capital on the market. Bank of Cyprus managed to still raise some capital from the market in the first half of 2012, mainly by converting CoCos, by a rights issue and also by selling its subsidiaries. In contrast, Cyprus Popular Bank was less successful and state aid was unavoidable.

10. **Assets have been rapidly deteriorating since 2009.** Non-performing loans (NPLs) rapidly increased in the second half of 2010 and in 2011, reaching 16.2% for domestic institutions and 15.9% for all banks operating in Cyprus. In nominal terms, they amounted to EUR 13.9 billion for all banks, with EUR 7.3 billion being held by locally active banks. For loans not covered by tangible assets, total provisions reached 50% of total non-performing loans in end-2011, well below the 75% recorded at the end of 2008. Given the large exposure of the Cypriot banks to Greece and the weakening economic environment in both Greece and Cyprus, asset quality deteriorated further in 2012

Table 1: Key banking-sector indicators

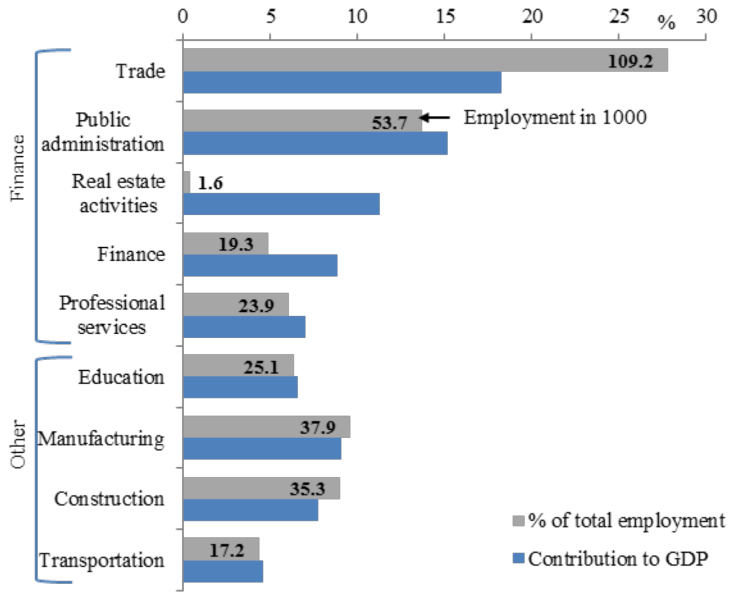
in %	Overall solvency ratio - CAR		Core Tier 1 ratio		Return on assets (RoA)		Non-performing Loans (NPLs)		Coverage ratio (Loss provisions/NPLs)		Loan/Deposit ratio***
	all banks	domestic	all banks	domestic	all banks*	domestic**	all banks	domestic	all banks	domestic	all banks
2008	10.6	10.5	7.5	7.3	0.9	1.0	n.a.	n.a.	70.7	76.3	109.4
2009	11.8	11.7	7.8	7.3	0.6	0.6	9.0	9.8	61.0	65.8	114.0
2010	12.2	11.9	8.6	8.1	0.6	0.4	11.5	12.1	56.6	61.2	103.9
2011	9.5	8.2	5.8	4.3	-3.7	1.1	15.9	16.2	53.1	50.0	112.7

* Source: ECB, June 2010
** Local banks including subsidiaries.
***For non-financial sector. ECB database, June 2011

11. **Profitability turned negative in 2011 due to increasing provisioning of non-performing loans.** Since the outbreak of the financial crisis, banking profitability has deteriorated due to an unfavourable domestic and foreign macroeconomic environment. The locally active banks reached the peak of their profitability in 2007 with a net after-tax profit of EUR 1.2 billion. Since then, profit has been gradually declining and turned negative by the end of December 2011 with EUR 4.4 billion in losses after tax. Due to a substantial increase in provisioning and non-performing loans, banks' RoA stood at -3.7% at the end of 2011.

12. **The financial services sector has been a major contributor to GDP and employment until recently.** Financial and insurance activities contributed 9.2% to GDP in 2012 and provided employment to 19,300 people or 5% of total employment (Graph 5), above the EU averages of 5.7% and 2.7%, respectively. In addition, other businesses, including trading, real estate activities and professional services (lawyers, accountants) were closely intertwined with the financial sector and accounted for about 50% of the economy and employment throughout 2012.

Graph 5: Contribution to GVA and total employment by sector



Source: Commission services

Structure of the Cypriot banking system

13. **The banking sector itself comprises four distinct segments**: domestic commercial banks, cooperative credit institutions, subsidiaries of Greek banks, and other foreign branches and subsidiaries, which remain in place after the restructuring. The segment of domestic commercial banks has been dominated by Bank of Cyprus, Cyprus Popular Bank and Hellenic Bank (Table 2). The first two institutions had a combined market share of 78% in terms of deposits and 86% in terms of loans in 2012. Altogether, domestic banks held 48% of deposits in Cyprus and were granting 45% of total loans extended by banks in Cyprus in 2012.

14. **A specific characteristic of the domestic commercial banks has been their significant exposure to foreign economies.** Both Bank of Cyprus and Cyprus Popular Bank expanded their activities abroad, particularly in Greece. In September 2012, domestic banks' direct loans to the Greek economy amounted to EUR 19 billion, which was the equivalent of about 111% of Cypriot GDP. The full exposure to Greece also included holdings of Greek government bonds and Greek bank bonds, which were valued at EUR 1 billion and EUR 0.3 billion, respectively, in September 2012. Prior to the PSI in Greece, the holdings of Greek government debt had reached EUR 4.7 billion in June 2011. The carve-out of the Greek operations in March 2013 and the intention to sell the other international operations means that the foreign business of the domestic banks has almost completely disappeared.

Table 2: Structure of the banking system, by deposits and loans (EUR million)

end-Feb 2013	Deposits	Market share as % in total deposits	Deposits as % GDP*	Loans	Market share as % in total loans	Loans as % GDP*
DOMESTIC BANKS						
Bank of Cyprus	17 106	25.4	95.6	16 470	22.8	92.0
Cyprus Popular (Laiki) Bank	8 462	12.5	47.3	11 278	15.6	63.0
Hellenic Bank	7 014	10.4	39.2	4 510	6.3	25.2
COOPERATIVE AND HOUSING INSTITUTIONS						
Cooperative Central Bank LTD & Credit Cooperation	15 053	22.3	84.1	13 798	19.1	77.1
Cyprus Development Bank Public Company	548	0.8	3.1	447	0.6	2.5
Housing Finance Corporation	933	1.4	5.2	1 392	1.9	7.8
GREEK SUBSIDIARIES						
Alpha Bank Cyprus	2 465	3.7	13.8	4 182	5.8	23.4
National Bank of Greece (Cyprus) LTD	812	1.2	4.5	1 475	2.0	8.2
Piraeus Bank (Cyprus) LTD	1 087	1.6	6.1	853	1.2	4.8
Emporiki Bank - Cyprus LTD	203	0.3	1.1	618	0.9	3.5
Eurobank EFG Cyprus LTD	3 126	4.6	17.5	2 275	3.2	12.7
Sub-total of Greek institutions	***7 694***	***11.4***	***43.0***	***9 403***	***13.0***	***52.5***
OTHER FOREIGN BANKS						
Societe Generale Cyprus LTD	425	0.6	2.4	306	0.4	1.7
USB Bank PLC	608	0.9	3.4	507	0.7	2.8
OTHER	9 614	14.3	53.7	14 003	19.4	78.2
SUM	**67 456**	**100.0**	**376.8**	**72 114**	**100.0**	**402.9**

Source: Central Bank of Cyprus. The data refer to the Cypriot operations only and are not affected by the Greek carve-out.

15. **There have been significant weaknesses in the regulation of cooperative credit institutions, even though this segment is systemically important**. The segment is composed of the Central Cooperative Body, which includes the Cooperative Central Bank and 95 affiliated institutions, as well as the unaffiliated cooperative savings society of Limassol. The latter is by far the largest institution, with a loan portfolio of EUR 1.5 billion and total deposits of EUR 1.7 billion in 2013. All cooperatives together provide an important source of funding for residents, as their current market share in loans reaches 19%, which is equivalent to more than 72% of GDP. Cooperatives hold Cypriot sovereign debt to the tune of some EUR 1.4 billion or 10% of total public debt. The cooperative institutions have very limited dealings with non-residents and rely entirely on domestic deposits for their funding. Their deposit holdings of EUR 15 billion account for more than 20% of total deposits or 40% of deposits from residents. While the cooperative credit sector is subject to the same prudential regulations as commercial banks, institutions affiliated to the Cooperative Central Bank are under no obligation to comply with the regulations (such as liquidity and capital requirements) on an individual basis.

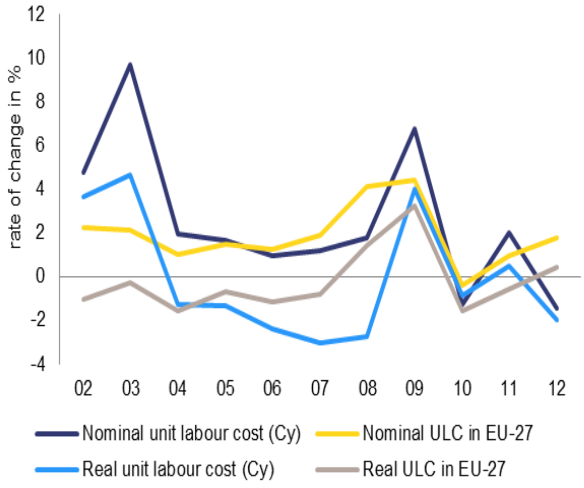
16. **The third and fourth segments of the banking sector, subsidiaries and branches of Greek and other foreign institutions, have played a limited role in the funding of the domestic economy.** Their loans to the Cypriot economy amounted to only EUR 8.8 billion in September 2012, of which almost half was to non-residents and brass plates. The Greek institutions held additional assets worth EUR 5.6 billion and represented an exposure to non-residents, mainly in the form of securities investments (EUR 2.4 billion) and claims on their parent institutions (EUR 1.9 billion). It is worthwhile noting that most of the risk related to these securities rests with the parent institutions.

2.3. INTERNAL AND EXTERNAL IMBALANCES

17. **Unit labour costs (ULC) grew particularly fast in the run-up to EU accession in 2004 and after joining the euro area in 2008.** Between 2001 and EU accession in 2004, real ULC grew faster than the EU-27 average, driven mainly by rapid growth of labour costs. Between 2004 and 2008, real ULC in Cyprus were on a decreasing path, contrary to the developments in the EU27 during the same period

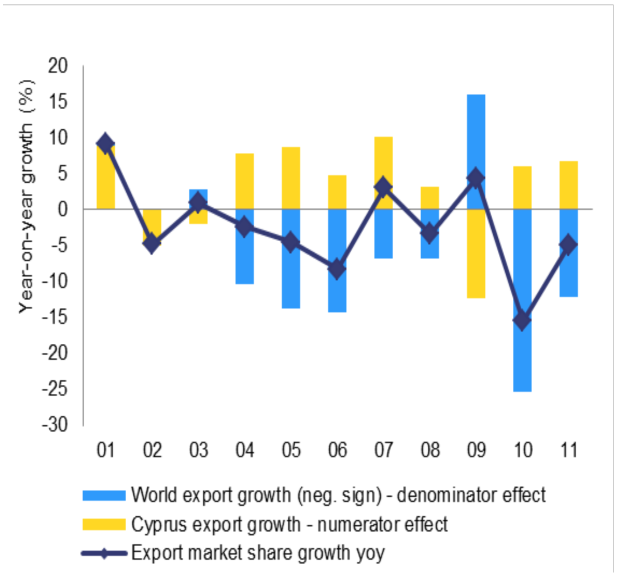
(Graph 6a). A significant increase took place in 2009 as a result of the lagged effect of the global economic downturn and the significant wage increases recorded in 2009, which were underpinned primarily by wage indexation (COLA[3]). Since then and up to 2011, the evolution of real ULC closely mirrored the trend of the EU-27 average, although the rates of growth were consistently higher. In 2012, the rate of growth of real ULC fell below the average EU-27.

Graph 6a: Development of unit labour costs



Source: Commission services

Graph 6b: Export performance - development of export market shares (EMS)



Source: Commission services

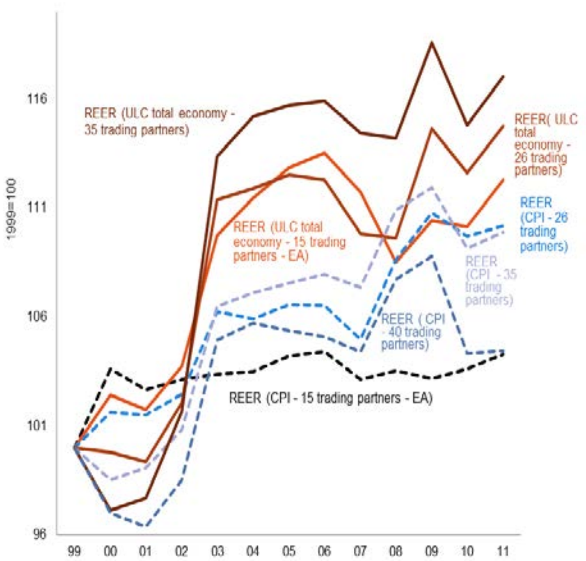
18. **A comparative analysis using both relative PPIs and labour costs suggests a persistent competitive disadvantage of Cyprus with respect to trading partner countries in the euro area.** Buoyant growth under conditions of full employment and low inflation in a business-friendly tax environment led to strong productivity advances and were conducive to Cyprus' real convergence with the EU. Cyprus' real GDP grew at an annual average rate of 2.75% between 2000 and 2010 (3.8% between 2000 and 2008), compared with an average of 1.4% for the euro area (1.9% between 2000 and 2010), while employment grew by 2.2%, sustained by inflows of foreign workers and an historically low unemployment rate. However, the rates of change of the consumer price index (CPI), the producer price index (PPI) and, labour costs were also persistently higher in most years than the corresponding averages for the euro area. This deterioration in price and cost competitiveness contributed to a rapidly growing trade deficit in goods and to the erosion of the trade surplus in services.

19. **Between 2000 and 2009, Cyprus experienced a substantial appreciation in the real effective exchange rate (REER), which was particularly pronounced in the run-up to EU accession in 2004.** While this appreciation mirrors wage growth in excess of productivity gains to a certain extent, part of the apparent loss in competitiveness is also attributable to the appreciation of the nominal effective exchange rate. The latter partially reflected the appreciation of the euro, to which the Cypriot pound was pegged before the country's accession to the euro area. In early 2007, the exchange rate establishing the irrevocable fixing of the Cyprus pound to the euro was considered to be broadly in line with equilibrium at that time. In 2010,

[3] At that time, the twice-a-year automatic cost-of-living allowance (COLA) adjustment was linked directly to the average percentage change in the consumer price index (CPI) over the six months just elapsed compared with the preceding six-month period. Thus, the total wage automatically increased in line with the CPI excluding excise taxes. The uniform application of the COLA introduced an element of real wage rigidity, which may have hampered the adjustment to supply and terms of trade shocks and limited the ability of wages to reflect productivity growth differences across economic sectors.

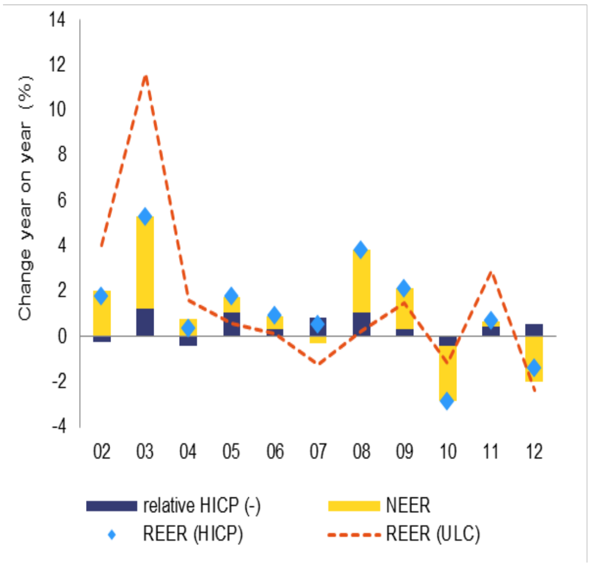
the rate of appreciation of the REER decelerated, as a result of subdued economic activity and moderating inflation. The degree of appreciation of the REER depends on the indicator – ranging from 16.75% (GDP deflator) to 10.5% (export price deflator) – as well as on the reference group used (Graph 7a). The ULC-based REER appreciated by between 4.5% (vis-à-vis the rest of the euro area) and 17.7% (vis-à-vis the IC35). Unlike the experience of other euro-area countries, there was hardly any real depreciation in the ULC-based REER in response to the downturn in 2010. This lack of downward adjustment is likely to have been caused by wage rigidities imposed by the COLA, which indexes wages to past inflation. The change in HICP-based REER ranged from a slight depreciation of 0.4% (vis-à-vis the rest of the euro area) to an appreciation of 12.7% (vis-à-vis IC35). This development was influenced by an increase in indirect taxes, as part of the VAT harmonisation process of Cyprus' compliance with the EU *Acquis*, as well as by temporary factors, such as rising energy and commodity prices in 2008.

Graph 7a: REER (ULC) and REER (CPI) - Cyprus vs. different groups of trading partners



Source: Commission services

Graph 7b: Change in the nominal and real effective exchange rates vis-à-vis the IC35



Source: Commission services

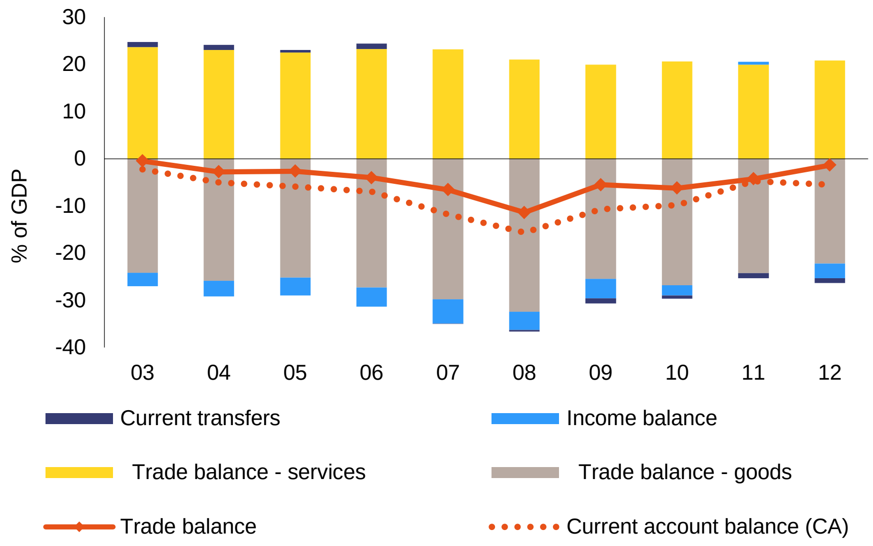
20. **The Cypriot economy was characterised by persistent current account deficits for more than a decade**. From a close-to-balance position in the second half of the 1990s, the current account balance weakened progressively over the following decade, with the deficit reaching a record high of 15.6% of GDP in 2008, a year marked by booming economic activity, strong domestic demand, and the adoption of the euro. By 2010, the external deficit had moderated to 9.9% of GDP. In the period 2000-2010, the average deficit was 6.9% of GDP, i.e. higher compared to previous decades due to the effects of Cyprus' EU accession, entry into the euro area, the boom in construction activity, an increase in prices of raw materials (oil, iron, etc.), and a significant increase in imports of goods. The three-year average of the current account deficit increased from 6.0% of GDP in 2004-2006 to 10.5% for the period 2009-2011, well above the indicative MIP scoreboard threshold of -4% of GDP.

21. **A progressively worsening trade balance was the main driver behind the deterioration of the current account**. The small size of the Cypriot domestic market and the economy's openness and integration in the world economy mean that foreign trade plays a pivotal role in the country's economic development and performance. This heavy reliance on foreign trade is reflected by the sum of imports and exports of goods and services, which reached about 100% of GDP for the period 2000-2010, compared to less than 40% on

average for other euro-area Member States. As evidenced in Graph 8, the trade balance moved in parallel to the current account balance, from a still close-to-balanced position in 2003 to a deficit of 11.4% of GDP in 2008. Another contributor to the current account deficit was the negative income balance, which stood at -3.7% of GDP on average over the period 2003-2010, with a slight downward trend. The importance of the income balance has been growing, due to an increasing number of Cypriot-based firms with foreign shareholding choosing to channel their operations via Cyprus, attracted by the country's favourable tax regime.[4]

22. **The worsening trade balance was due to an increasingly large deficit in trade in goods and, to a lesser extent, to a decline in the traditionally high trade surpluses in services.** The trade deficit in goods rose from 24.1% in 2003 to a peak of 32.4% in 2008, while the trade surplus in services declined from 23.6% in 2003 to a low of 19.9% in 2009. A number of factors contributed to these developments. The progressive loss of competitiveness of domestically-produced goods, which became evident with the liberalisation of trade and the accession of Cyprus to the EU, together with the shift of productive resources to the tertiary sector (tourism, financial and other business services), led to a decrease in exports of goods. At the same time, imports of goods, primarily for domestic consumption, expanded swiftly, reflecting the acceleration and changing composition of GDP growth. Exogenous factors such as rising prices for oil, food and other commodities, on which Cyprus is highly dependent, as well as the level of imports of defence equipment, also played an important role. Cyprus' energy needs are almost exclusively (above 95%) met by imported oil. Imports of oil products accounted for over 5.0% of GDP in 2007-2010; the energy trade deficit deteriorated in this period to 7.5% GDP in 2011. The annual value of the oil imports in GDP terms varies strongly from year to year, with clear spikes in years of oil-price hikes. The overheating of the domestic economy ahead of the financial crisis, particularly the construction boom, also led to higher imports of goods for construction purposes. In the services sector, there was a progressive decline in exports of services, driven mainly by reduced revenues from the tourism sector. The latter was attributed to rising costs, a deteriorating infrastructure and increased competition from other Mediterranean countries emerging as low cost destinations.

Graph 8: Current account balance: evolution and composition

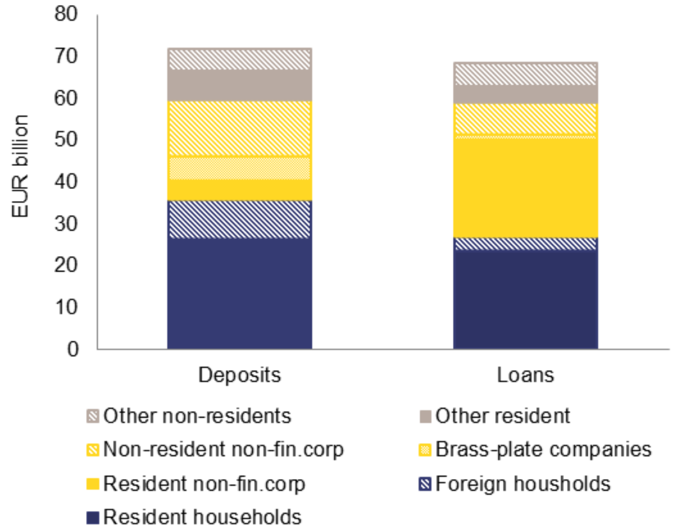


Source: Commission services

[4] Cyprus had the lowest corporate tax regime in the EU, at 10% until March 2013, while dividend income, profits from overseas permanent establishments and profits from the sale of securities were tax exempted, with no withholding tax on dividends, interest and royalties paid from Cyprus. The favourable tax framework was combined with a range of double tax treaties with over 43 countries worldwide, while, as an EU member, Cyprus' tax legislation is in line with EU law.

23. **For the financing of the current account deficit, Cyprus relied in the past on high capital inflows from foreign deposits and foreign direct investment (FDI), including a large share of re-invested profits of foreign companies in Cyprus**. Inward FDI averaged 3.8% of GDP over the years 2004-2006 and 7.4% of GDP over the years 2009-2011[5]. It constituted a significant source of financing of the current account deficit, covering on average close to 60% of the total balance for the period 2000-2007, although this was volatile due to year-by-year variation in FDI green-field projects and share participations. However, the positive net FDI inflow was composed mostly of retained profits of firms with foreign shareholdings based in Cyprus, thus financing the current account position on 'retained profits', rather than the trade deficit. The retained profits of these firms reached 3.5% of GDP in 2009-2011, up from 1.9% in 2004-2006. In 2008, reinvested earnings amounted to 53.5% of inward FDI, the highest share since 2000. Overall, FDI constituted ca. 13% of Cyprus' external liabilities by 2012. However, sectoral statistics suggest that much of FDI was directed in the past to deposits held by brass-plate companies and to the housing sector (FDI stocks in services and manufacturing seem rather low in view of existing scarce data).

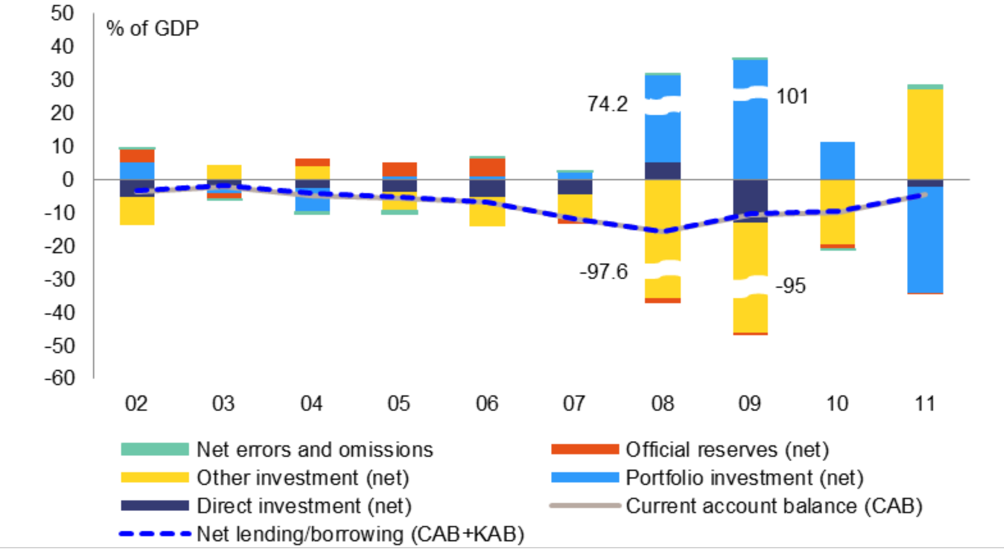
Graph 9: Deposits and loans



Source: Commission services' calculations, based on data from the Central Bank of Cyprus

5 Statistical data from the Central Bank of Cyprus.

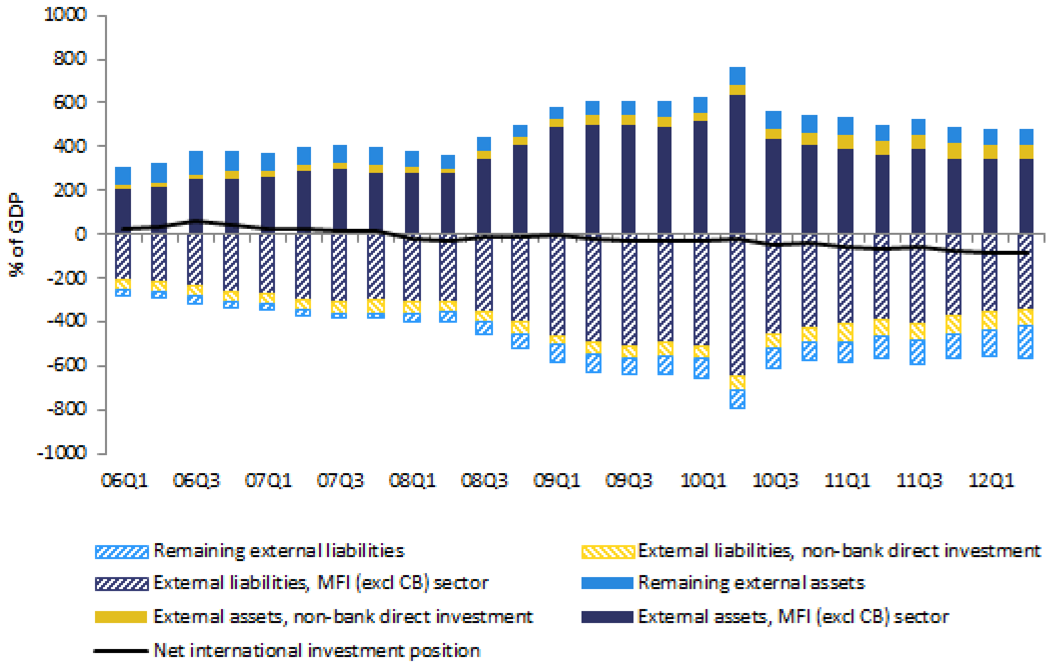
Graph 10: Components of the net borrowing/lending position



Source: Commission services

24. **The most striking feature of external financing until 2009 has, however, been massive deposit inflows to Cypriot banks (totalling more than 100% of GDP in 2008 and 2009) that were only partially matched by the banks' acquisitions of external assets.** The remaining part of capital inflows allowed banks to extend credit to domestic households and companies, which was related in particular to the booming housing sector. The difference between the build-up of foreign liabilities and the acquisition of foreign assets provided for easy financing for the current account deficit in the run-up to the financial crisis in Cyprus. Moreover, such bank-related flows led to the rapid expansion of gross assets and liabilities in the international investment position (IIP) up to 2010. As a consequence, the IIP continued to be characterised by bank liabilities (mostly deposits) and bank assets (mostly portfolio holdings of foreign securities and assets in Greece). The rapid expansion of assets and liabilities stopped in 2010, but their stocks remain at elevated levels.

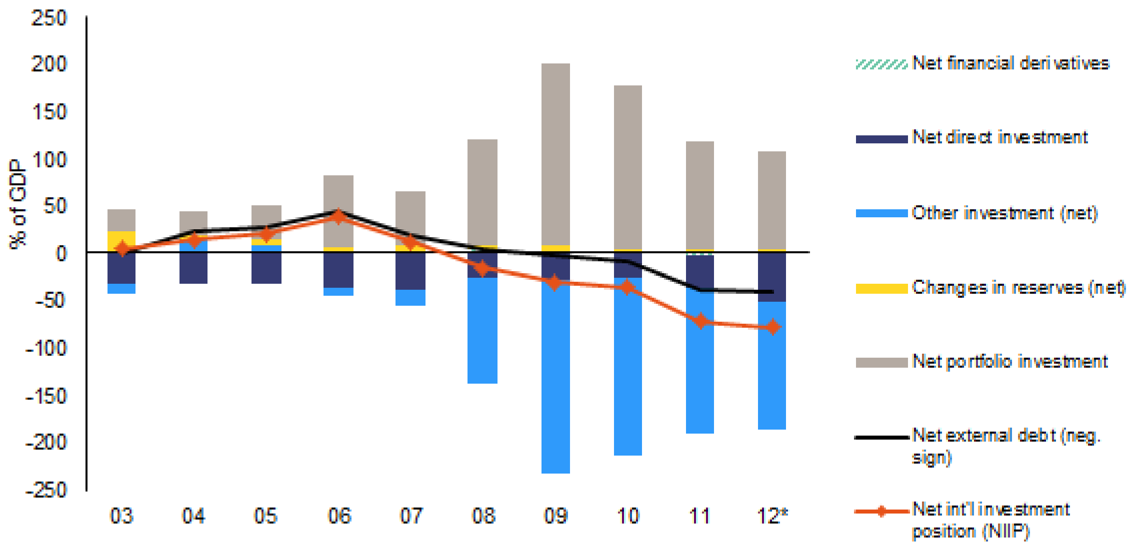
Graph 11: International investment position by sector



Source: Commission services

25. **Along with the increased debt financing of the persistent current account deficit, there has been an increase in external liabilities, clearly reflected by the deterioration in the net international investment position (NIIP).** The NIIP has been on a declining trend since 2006, turning negative for the first time in 2008, reaching a level of -71% of GDP in 2011, and ranking amongst the most negative in the EU. The deterioration of the NIIP by more than 100 pps of GDP from 2006 to 2011 partly reflects changes in portfolio investments relating to intra-group transfers of foreign debt securities between domestic monetary financial institutions (MFIs) and their parent MFIs in Greece. Such transfers were incentivised by the low Cypriot tax on income earned from securities and do not reflect a true reshuffling of foreign financing. In addition, in 2010, there was a merger of a Cypriot MFI with the parent MFI in Austria, which resulted in the reduction of a considerable amount of stock value in the international investment position, in terms of both assets and liabilities. However, more than half of the NIIP decline cannot be explained by such balance-of-payments transactions. Statistics indicate that most of the decline was due to valuation losses on portfolio securities and banking loans. The net (stock of) direct investment (originating mainly from Greece, Russia and the UK) is negative (Graph 11). This means that FDI inflows constituted mainly a source of financing for the current account deficit, while its composition seems to provide very low added value to the domestic economy.

Graph 12: Components of the net international investment position - NIIP



Source: Commission services, 12* *represents data for 2012Q3*

26. **Total private sector indebtedness (as a share of GDP) was the highest among the euro-area Member States, with the debt of non-financial corporations being particularly outstanding by 2012.** Between 2003 and 2010, the debt-to-GDP ratio for non-financial corporations increased from 88% to 146%.[6] However, over the same period debt-to-equity and debt-to-assets ratios were rather stable. The main vulnerabilities of the Cypriot corporate sector stemmed from weak profits, high leverage, and a notable dependence on bank finance. In addition, the indebtedness of the domestic corporate sector was characterized by large outstanding loans related to real estate (ca. 20% of GDP), matched by relatively few deposits (more than a quarter of resident corporate deposits seems to stem from reclassified offshore entities). Following a rapid increase in housing loans, the ratio of household indebtedness to GDP reached one of the highest levels in the euro area in 2011. While loans to resident households were matched by substantial deposits of this sector in the aggregate (the net financial position of households is positive), the servicing costs of mortgages included high spreads on variable interest rates, implying an important vulnerability in terms of potential interest rate rises. Mirroring the rapid expansion of credit, gross value-added in construction and house prices were both on a rising trend up to 2008 (see also Box 3).

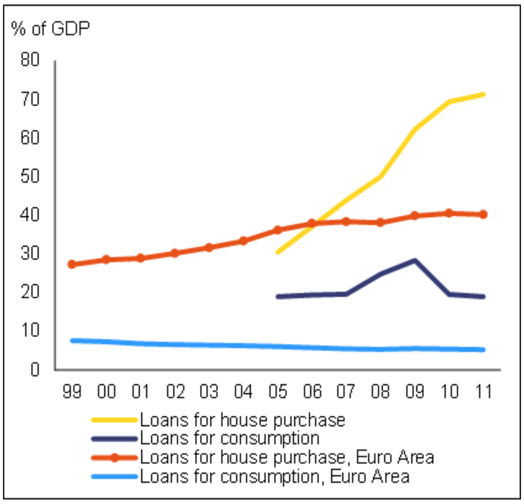
Box 1: Housing sector

The housing market in Cyprus is of particular importance for both financial stability and fiscal sustainability, as it poses a serious risk to bank balance sheets. The housing boom was accompanied by a rapid increase in loans to households (Graph 13a) and non-financial corporations up to 2008, leaving the Cypriot private sector the most indebted (in relation to the country's GDP) among the euro-area Member States (on a par with Ireland). Indeed, loans amounting to 150% of GDP in 2011 were directly related to the domestic housing sector, with even more consumer and business loans collateralized with real estate. The due diligence of the Cypriot banks has established that, in many cases, banks put a greater weight on collateral than on cash flows of the borrowers. Loans to residential developers and the construction sector exceed 50% of GDP in 2011, with more than half of them already having been rescheduled (estimate). Thus, an important part of bank balance sheets hinged on assets related to local house prices, which were experiencing protracted

[6] Source: Commission services. Note that this is based on consolidated indebtedness figures, which net out liabilities within the household and non-financial corporate sector . Using non-consolidated figures, the indebtedness of non-financial corporations rose from 88% of GDP in 2003 to 153% in 2011.

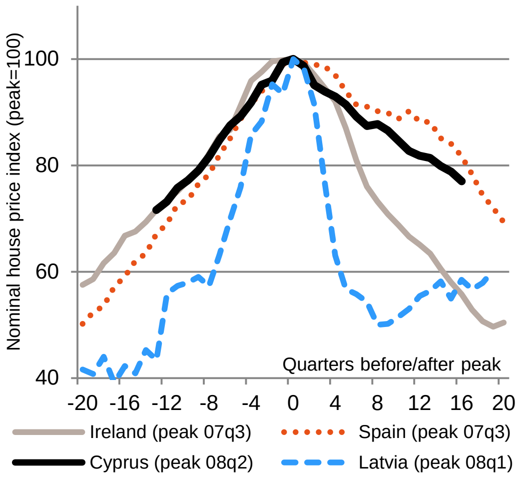
adjustment after a long boom. In real terms, real house prices saw a downward correction by ca. 28% (in Q1 2012) from their peak values in Q1 2008 (Graph 13b).[7]

Graph 13a: MFI loans to households



Source: ECB

Graph 13b: Nominal house price indexes



Source: Commission services

Regulatory factors influence the scale and pace of house price adjustments

Moreover, supply and demand factors indicate that prices are set to undergo a further substantial decline, in particular prices for holiday homes. The pace of the house price decline will crucially depend on the amount of loan rescheduling and the efficiency of collateral seizure. Repossession procedures are in turn affected by both the backlog of the land registry system (title deeds) and considerable delays in asset liquidation administration and judicial procedures. Furthermore, the housing market will be affected by fiscal consolidation efforts via the rationalization of the existent myriad of housing assistance schemes and the implementation of a recurrent property tax system based on updated valuations of the tax base.

Collateral seizure is in turn influenced by both the backlog of the land registry system (title deeds) and considerable delays in asset liquidation administration and judicial procedures. Improving these settings would result in a more rapid supply increase and a swifter decline in house prices, and accordingly in earlier price stabilization. The potential advantages of a swift decline in house prices would be: front-loading of mortgage book valuation losses, earlier restoration of confidence in the housing market and thus a pick-up in (external) demand, with a positive feedback to GDP growth. The risks lie mainly in front-loading effects on the economy and the risk of undershooting house prices and thus collateral values.

Registration and transfer of immovable property

In 2011, up to 120 000-130 000 properties lacked title deeds, i.e. the land registry does not reflect their building and ownership situation. Scattered evidence on the progress since 2011 indicates that only a rather small portion of pending cases have been resolved so far. This regulatory issue creates a bottleneck for the housing market in two respects: *First*, it acts as an impediment to demand, particularly from foreigners, as they are not able to fully enjoy the benefits of ownership (for instance, deeds are generally required as proof of mortgage collateral). *Second*, there is a risk element for the bank mortgage books, as it is not clear how many (developer) mortgages are secured with title deeds that are actually outdated and should be replaced with new title deeds to be transferred to dwelling purchasers. This is compounded by the fact that a sales contract on immovable property represents a senior claim on the property for the amount that has already been paid, thus giving the buyer a secured creditor position.

[7] Note that this figure is based on the harmonized Eurostat house price index. Data from the Central Bank of Cyprus indicate that decline was less steep, and closer to 15% between Q3 2008 and Q2 2012.

Against this backdrop, the Parliament approved substantial reforms in 2011 (N81(I)/2011). The new framework introduced vested contracts, enabling the sale of a property without a deed, and provided purchasers and authorities with the rights to request, and enforce, the issuance of title deeds. The approval of planning and building permits as a necessary prerequisite for the issuance of title deeds was identified as a major driver of the title deeds backlog, and has been tackled by the introduction of simplified approval procedures and a town planning infringement amnesty in 2011. However, the effectiveness of these reforms hinges on their implementation in expediting the issuance of the more than 100,000 still-outstanding title deeds. Preliminary figures suggest this measure resulted in a substantial, but by far non-exhaustive, decrease in the title deeds backlog. Note, however, that any new title deeds issued still have to be transferred to the purchasers, which poses further risks for sales contracts concluded before 2011. Improving judicial incentives in order to ensure speedy title deed transfers is therefore a crucial aspect in resolving regulatory risks to house prices, banks, and the economy.

2.4. STRUCTURAL FRAMEWORK

27. **The services sector plays a more prominent role in Cyprus compared to the EU as a whole.** Around 82% (2012) of employment in Cyprus comes from services, compared to 75% in the EU, and this share has been growing over time. The picture is similar, but more pronounced, for the contribution of services to GDP. By comparison with the EU, the contributions of tourism (especially), financial intermediation, local services (e.g., wholesale and retail trade), construction and public administration to both employment and GDP are high. In terms of employment, construction, local services and business services all grew in importance up to 2010; in terms of contribution to GDP, financial intermediation and business services were notable growth drivers. By contrast, tourism's importance as an employer (hotels and restaurants) has been declining (from 10.2% of total employment in 2000 to 9.4% in 2011), while its contribution to GDP had shrunk from 9.7% in 2000 to around 6.4% in 2011.

28. As Cyprus' energy consumption depends almost fully on imported oil products (with a share of 96% in 2011), Cyprus **ranks as one of the most vulnerable countries in the EU in terms of security of energy supply.** This is compounded by a lack of interconnections with other countries.[8] This dependency on imported oil weakens Cyprus' external position as reflected in its large energy trade deficit, which is the second largest in the EU (7.5% of GDP in 2011) and which amounts to almost three quarters of its current account deficit. This share is so substantial that it arguably constitutes a macroeconomic imbalance on its own accord. Moreover, the energy trade deficit deteriorated sharply over the period 2007–2011 (by 2 percentage points of GDP). The variations in this deficit over the period illustrate the influence of changes in the oil price. The very strong reliance of electricity on oil inputs, in combination with the cost-based price regulation of the state-owned electricity company, has led to high and volatile electricity prices.

29. **Collectively-agreed wages have in general been indexed to inflation, thus inhibiting real wage flexibility and weakening the link to productivity.** In Cyprus, automatic wage indexation is not prescribed by law but is the result of voluntary collective bargaining. Hence, it is important to distinguish between the public and private sectors, as the government can directly affect cost-of-living allowance (COLA) provisions only in the former. The share of employees in the whole economy receiving COLA is about 60-65% (those covered by collective agreements). Coverage is 100% in the wider public sector and in the banking sector, while, in the remainder of the private sector (excluding banking), coverage is much lower, at around 30-35%. As a result of this uneven coverage across sectors, those benefiting most from wage indexation are high-income earners employed in the public sector and banking industry, while the majority of the lowest paid workers – employed in less unionised sectors with no collective agreements - are not covered. Until the temporary suspension imposed for 2011 and 2012 in the public sector as a response to the crisis and the subsequent broader reform introduced at the end of 2012 in the context of the programme, adjustment of wages by the COLA took place every six months in accordance with changes in the consumer price index (CPI), net of excise taxes.

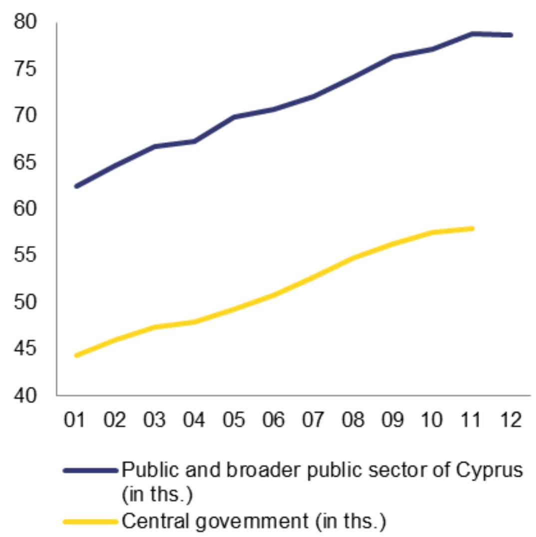
[8] European Commission (2013), Member States' Energy Dependence: An Indicator-Based Assessment, European Economy, Occasional Papers 145/2013.

30. **The minimum wage is close to 40% of the average wage and is applicable to those professions that are considered vulnerable.** There is no comprehensive national minimum wage in Cyprus. The minimum wage is applicable only to specific professions, which are deemed vulnerable and which are not covered by collective agreements. The largest professions covered by the minimum wage include clerks, auxiliary healthcare staff, sales persons and cleaners, representing about 13-14% of the employed population. The current level of the monthly minimum wage, payable 12 times per year, is EUR 870 for new hires and EUR 924 after six months on the job. In terms of international comparison, the minimum wage appears relatively high, close to 40% of the average wage after 6 months on the job. The tourism sector (hotels, restaurants), crucial for the Cypriot economy, is not subject to the minimum wage, as it is covered by collective agreements.

31. **The rise in unemployment has underlined the importance of activation of the unemployed, as well as increasing the recourse to public assistance.** Unemployment rose from around 4% in 2008 to 11.9% in 2012. This has been putting a considerable burden on the public employment service, as more unemployed persons need to be activated. It also requires good cooperation between departments, since activation of the unemployed and payment of benefits are split across several departments of the Ministry of Labour. With the increase in unemployment, and in particular long-term unemployment, more unemployed persons become eligible for means-tested public assistance, which is payable after expiry of unemployment insurance benefits.

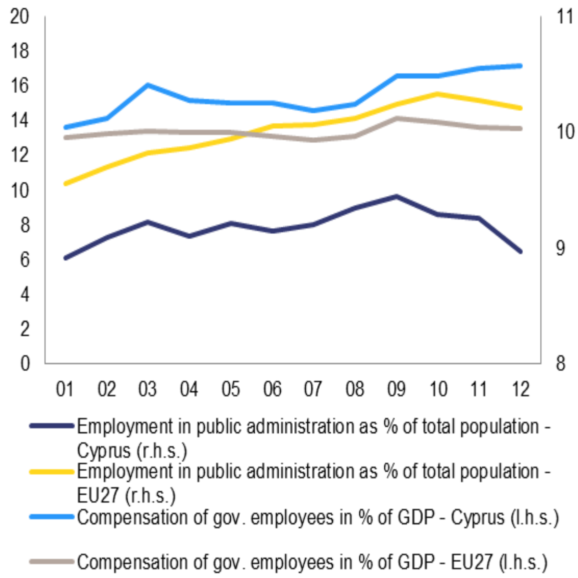
32. **The public sector in Cyprus has grown considerably over the last few years, in parallel with an increasing trend in public expenditure**. Total employment in the public and broader public sector stood at more than 70,000 in 2011, representing about 19% of total employment. Between 2003 and 2010, employment in the sector grew on average by 2.2% per year. Furthermore, in 2011, compensation of government employees as a share of GDP was the second highest in Europe (only Denmark was higher) and exceeded the EU-27 average by about 2.5 pps in 2011. The difference to the EU-27 average has become more pronounced over the past years. Between 2003 and 2011, compensation of government employees as a % of GDP grew on average by 2% per year in Cyprus, while for the EU-27 the corresponding average change was only 0.37% (Graph 14a). Over the same period, employment in the public administration as a share of total population has been similar to the corresponding average in EU-27. Cyprus has recently implemented a number of measures to reduce both the size of the public sector and its wage bill. These measures include freezing emoluments of all existing employees and reducing the entire wage scale by 10% for new hires. Moreover, a one-recruitment-for-every-four-retirees policy was also introduced.

Graph 14a: Employment in the public sector



Source: Commission services

Graph 14b: Relative size of the public sector (% of total population and % of GDP)

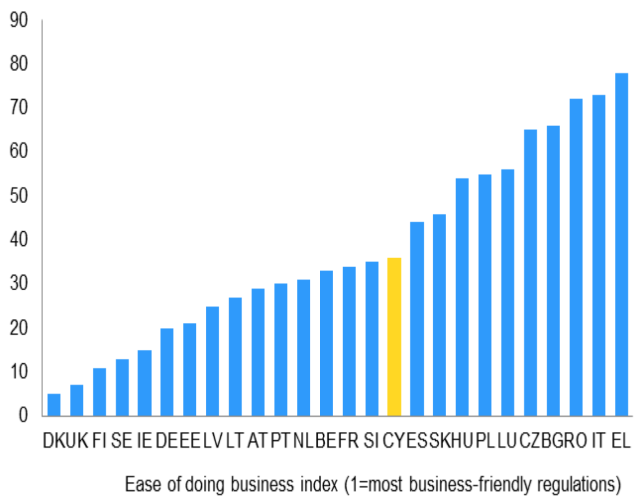


Source: Commission services

33. **In terms of its business environment, Cyprus ranked 36th out of 185 economies in 2012, according to the World Bank's "ease of doing business" index**, which captures how a country's regulations affect its business environment. Among 26 EU countries, Cyprus ranked 16, according to the same index. At the same time, the World Bank reports that Cyprus performed poorly in a number of sub-areas such as dealing with construction permits and registering property. Cyprus has until now been the fourth most expensive place to start a business among 26 countries of the EU. Start-up costs in Cyprus amounted to 12.4% of income per capita compared to an average cost of only 5% for the 26 countries covered by the report. In addition, a main drawback for business activity has been related to the very serious judicial backlog. According to CEPEJ indicators[9] Cyprus was actually among the Member States having witnessed an increase in the backlog, with 19% more incoming cases than resolved ones. It was also among the Member States not reaching a 100% clearance rate for civil litigious cases, meaning that the backlog of unresolved cases has been growing and their already high treatment time (second worse in the EU) has further deteriorated.

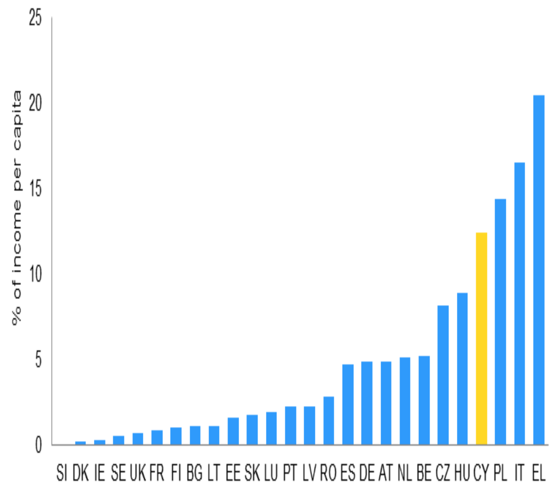
[9] CEPEJ (European Commission for Efficiency of Justice), Report on European judicial systems, 2012 Edition (data 2010).

Graph 15a: Ease of doing business, 2013



Source: World Bank

Graph 15b: Starting a business – cost (% of income per capita), 2013



Source: World Bank

34. **A number of Public-Private Partnerships (PPPs) have been implemented in Cyprus**. These include airports, marinas and desalination plants. PPPs refer to contractual arrangements in which the private sector supplies infrastructure assets and services that are traditionally provided by the government. Since the majority of PPPs involve some sharing of responsibilities and risks between the public and private sectors, they can also result in significant contingent liabilities. The main argument for PPPs relates to potential efficiency gains from the greater management skills of the private sector. However, because of the lack of a regulatory framework for PPPs and insufficient ex-ante evaluation of the projects in Cyprus, i.e. little use of economic analysis tools such as value for money (VfM) and cost-benefit analysis (CBA), there is a risk that the selected projects do not bring sufficient added value for the economy. There is also no regular ex-post evaluation or auditing of investment projects.

35. **Cyprus has a total of about 60 institutions known as Semi-Government Organisations (SGOs)**. Some of these entities may be a source of recurrent losses for government finances and the quality of the service provided leaves room for improvement. About 20 are non-profit organisations and 40 are publicly-owned companies and enterprises (hereafter, State-Owned Enterprises – SOEs). All 60 SGOs are established by law and their board members are appointed based on political considerations and are therefore subject to control and supervision by the Executive branch of the Government and the House of Representatives. There are three categories of SGOs: (1) those operating in a market environment (e.g., Cyprus Telecommunication Authority, CyTA; Electricity Authority of Cyprus, EAC; Cyprus Port Authority, CPA; etc.); (2) those established to fulfil a specific purpose (e.g., Cyprus Land Development Corporation, Cyprus Potato Marketing Board, etc.); and (3) those providing non-commercial activities but promoting concrete activities (e.g., Cyprus Theatre Organisation, Cyprus Tourism Organisation, etc.).

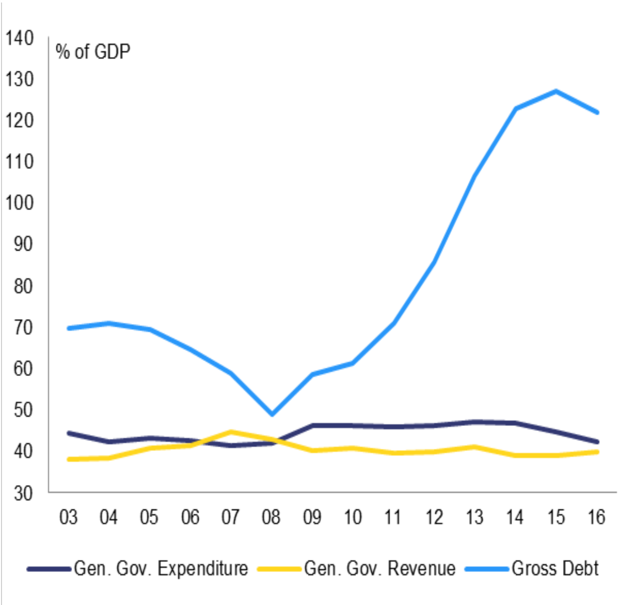
2.5. FISCAL DEVELOPMENTS

36. **Just prior to the EU accession in 2004 and in the run-up to the euro adoption in 2008, Cyprus experienced an improvement in the budgetary position from a deficit of almost 7% of GDP in 2003**

to a surplus of above 3% in 2007 for the first time in a decade. However, public finances deteriorated substantially right after, as a result of the global economic crisis, discretionary fiscal stimulus measures, as well as composition effects due to a less tax-rich GDP growth pattern. As a result, the government balance turned from a surplus of 0.9% of GDP in 2008 into a deficit of 6.1% of GDP in 2009. In parallel, the general government gross debt, which stood at 58% of GDP in 2009, increased sharply.

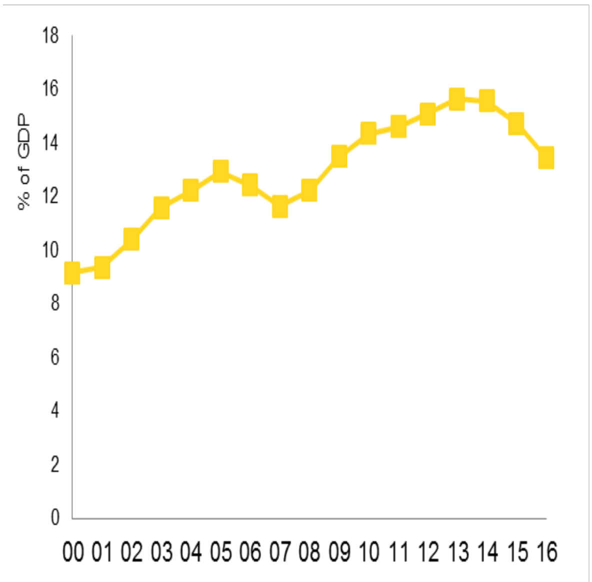
37. **The improvement in the budgetary position between 2000 and 2008 was predominantly driven by a steady increase of government revenues.** Between 2000 and 2008, total tax receipts increased by more than 130% in nominal terms. The downward trend of total government revenues as a share of GDP started already during 2008 (Graph 16a). In terms of composition, taxes on production and imports contributed slightly more to GDP than taxes on income, while the contribution of the immovable property taxes, which rose by just 50%, was small. Social contributions followed the overall trend, increasing by close to 110%. Receipts from corporate income taxes collected from international business companies (i.e. companies that are foreign-owned) rose by 530% between 2000 and 2008. This steep increase is particularly remarkable against the background of a major tax reform in the run-up to the EU accession in 2003. The government's strategy was to conform to EU and OECD requirements, while ensuring budget neutrality and maintaining the country's attractiveness for international businesses. As a consequence, the reform involved a major shift from direct to indirect taxes and transposition of EU law in a way that was as favourable as possible for companies. The new corporate income tax rate was set at 10% for all companies, which meant a decrease for domestic companies from the previous 20%-25%, but an increase for international businesses from the existing 4.25%.

Graph 16a: Government expenditure, revenue and debt



Source: Commission services

Graph 16b: Social transfers



Source: Commission services

38. **The tax administration has not succeeded in developing a comprehensive compliance management.** The outstanding feature of the revenue administration is the separation of the Inland Revenue Department, responsible for direct taxes, and the Customs and Excise Department, which administers VAT. Cyprus is the only EU Member State with this type of division, which is considered to impede taxpayer compliance. It not only leads to an unnecessarily high administrative burden on taxpayers due to different processes in place for filing, payment, dispute resolution, etc. but also makes it difficult to have a complete view on

individual taxpayers, in particular in light of the lack of systematic exchange of information between the two departments. More generally, there is no comprehensive compliance strategy, which is problematic as the share of the shadow economy is estimated to be among the largest in the EU.[10] E-filing and self-assessment are not widely used and returns of direct taxes can take up to six years to be issued, resulting in high numbers of taxpayer objections. Due to a lack of administrative enforcement powers, the enforcement of collection relies largely on court procedures, resulting in significant amounts of outstanding taxes. In addition, there is limited or no prosecution activity. In particular, criminal prosecutions for tax evasion have not been pursued.

39. **Since 2000, total government expenditure has generally been increasing as a share of GDP**, starting from around 37.1% in 2000 and reaching 46.3% of GDP in 2012. Total revenues rose from 34.7% of GDP in 2000 to 40.1% of GDP in 2012. Among the most significant increases in total government expenditure has been the category of social benefits, which increased by 6 pps of GDP to 15.1% of GDP in the period 2000-2012 due to increased coverage and generosity of benefits. Most social transfer schemes are not targeted on needs. Often, there is duplication of purpose and transfers, making the system rather complex and inefficient. In addition, high growth rates in expenditure appear to be linked to phases of the electoral cycle. The increase in public salaries and pensions, the main driving force being the application of the COLA, has also been significant.

40. **Budgetary framework provisions were found broadly insufficient and conducive to short-sighted fiscal strategies.** The 2011 EPC peer review on budgetary frameworks highlighted that Cyprus was one of the few EU Member States with neither national fiscal rules nor a functioning Medium-Term Budgetary framework. This meant that fiscal planning was being conducted without firm multi-annual numerical anchors consistent with the EU SGP-based framework. While the Ministry of Finance relied on timely expenditure reporting checks and controls at budget execution stage, it lacked the instruments to deliver prudent fiscal plans and had frequent recourse to successive supplementary budgets within the fiscal year to adjust to unforeseen events given the inflexibility of the budget structure. Budgetary outturns had also been affected by the less-tax rich growth composition, due to lower-than-projected final domestic demand and lower imports, and by the stronger deterioration in the labour market, which led to major revenue shortfalls, notably in indirect taxes. The establishment of an independent fiscal council would strengthen the credibility of the Cypriot framework by providing an alternate source of expertise in budgetary affairs, in particular by delivering regular assessments on the implementation of national fiscal rules and providing its input in the forecasting process.

41. **Cyprus' ageing population is aggravating the significant challenge faced with regards to ensuring the long-term sustainability of public finances.** While the level of pension expenditure in 2010 (7.6% of GDP) was still considerably below the EU average of 11.3%, the projected increase of 8.7 pps of GDP for the period 2010-2060 is significantly higher than the EU average of 1.5 pps of GDP. Even though pension contributions were lower than expenditures, the pension system showed a surplus, due to government subsidies and revenues generated by the Social Security Fund. The Fund has placed nearly all of its assets, in deposits with the general government which yield very low interest rates. As the earnings-related insurance feature of the compulsory pension system (General Social Insurance Scheme – GSIS) was introduced only in 1980, the Cypriot pension system is still maturing, and many pensioners continue to face the risk of poverty today. However, the coverage of earnings-related pensions will increase significantly as the pension system matures, thus reducing adequacy concerns but the sustainability concerns will intensify due to ageing-related factors .

42. **From 2003 to 2012, public health expenditure per capita increased by roughly 1/3, albeit from a low level.** In 2012, with 3.3% of GDP, Cyprus had the lowest public expenditure on health in the EU (EU: 7.9%), but this was complemented by high private expenditure (in 2010: Cyprus: 3.9%[11]; EU: 2.3% of GDP). While public and private expenditure increased rapidly, there was very limited progress in the

[10] European Commission (2012), Tax Reforms in EU Member States 2012, European Economy 6/2012.
[11] According to the "Health and Hospital Statistics 2010", available at: http://www.mof.gov.cy/mof/cystat/statistics.nsf/All/39FF8C6C587B26A6C22579EC002D5471/$file/HEALTH_HOSPITAL_STATS_2010-150213.pdf?OpenElement

implementation of the necessary reforms to address the inefficiencies of healthcare provision and inequalities in access to care. Key issues include: (i) no framework integrating public and private financing and provision of health care services; (ii) little managerial autonomy and financial accountability of public hospitals; (iii) inadequate monitoring and quality assurance system; (iv) limited incentives for using the most cost-effective levels of care; and (v) lack of a structure for pricing and reimbursement of goods and services based on the actual level of costs. To address these imbalances, legislation was enacted already in 2001 to create a National Health Insurance Scheme (NHIS), but this was not implemented.

3. CRISIS: THE RUN-UP TO THE PROGRAMME

3.1. FINANCIAL TRENDS

The financial sector increasingly worsened...

43. **The exposure to the Greek economy, the deteriorating loan quality in Cyprus and eroding depositor confidence culminated in an unprecedented banking crisis against the background of weak prudential supervision**. Concerning their Greek exposure, Cypriot banks were vulnerable on two fronts (Box 2). First, they considerably expanded their loan operations in Greece from 2005 onwards. The second channel of exposure consisted of investments in Greek government bonds. With respect to loan quality in Cyprus, impaired credits for real estate projects in particular were behind the deterioration linked to the high indebtedness of the private sector and the worsening macroeconomic environment. As a consequence, confidence in the banking sector waned and liquidity pressures mounted.

BOX 2: THE EXPOSURE TO GREECE

Given the strong expansion of their balance sheets in Greece, it was unavoidable that Cypriot banks would be severely hit by Greece's economic and financial crisis. However, the impact of the Greek crisis was neither immediate nor unambiguous. The first stage of the Greek crisis (2009 and 2010) had positive repercussions on Cypriot banks, in particular for their liquidity. In their flight away from Greek banks, some depositors patronised institutions in Cyprus, thereby improving the latter's liquidity. Thus, non-resident euro-area deposits steadily increased from less than EUR 2 billion at the beginning of 2010 to EUR 6.6 billion in June 2012. In a sense, the Cypriot banking system benefitted from its position as an international financial services centre. Later, during the second stage in the unfolding of the Greek crisis (2011), Cypriot banks established in Greece suffered substantial liquidity outflows from their operations in Greece. Cyprus Popular Bank was particularly hit by this development, to the extent that it required significant amounts of emergency liquidity assistance from the Central Bank of Cyprus. This reverse, adverse, impact on Cypriot banks' liquidity accelerated in the context of the increasing political uncertainty.

Following the voluntary participation in the Greek PSI, the three domestic banks applied a haircut of about 74% to the nominal value of their Greek government bond holdings by the end of March 2012, and some additional haircuts had to be recognised by end June 2012 after an audit. Subsequently, the sovereign exposure to Greece of domestic banks was reduced from EUR 5 billion to about EUR 1 billion by end-September 2012 and virtually disappeared in the Greek buy-back exercise of December 2012. The heavy losses incurred on the sovereign exposure highlight the importance of including concentration limits on security investments in prudential regulation. The large and deteriorating loan portfolio in Greece, amounting to EUR 19 billion (111% of GDP) by end-September 2012, was an additional weakness. The ratio of non-performing loans in their Greek operations worsened to 42% of total loans.

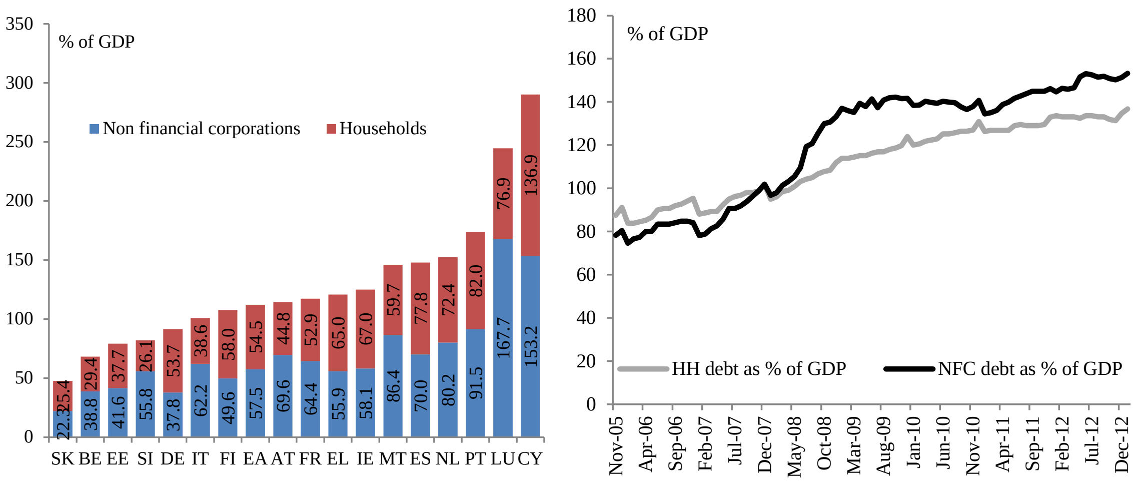
44. **The Cypriot private sector is considerably leveraged.** At about 290% of GDP, total indebtedness in Cyprus is an issue of concern (Box 3). In particular, the indebtedness of the corporate sector is large in Cyprus. Although Cypriot lending rates were higher than the euro-area average, firms and households have

been borrowing at lower interest rates than in the past, which has led to a rapid accumulation of private sector debt.

BOX 3: PRIVATE SECTOR INDEBTEDNESS

Households' indebtedness has been rapidly increasing, but their net financial position remained positive. Total household debt increased considerably in the past five years with the ratio of resident bank loans to GDP moving from below 90% of GDP in before 2005 to above 130% in 2010, and remaining at 137% of GDP in January 2013. The tripling of housing loans (in absolute value) between 2005 and 2010 fuelled this rise, increasing their share in resident financial liabilities towards banks from 33% in 2005 to 53% in 2012. Stagnating GDP and debt rescheduling contributed to the continued increase of the loan-to-GDP ratio throughout the financial crisis. Along with expanding loans, resident household deposits increased up to 2009 and stabilised thereafter. With loan growth outstripping the increase in domestic deposits, residents' net financial assets declined, but remained positive, with resident deposits exceeding domestic loans by about 15% of GDP in mid-2012. Consequently, the ratio of domestic financial liabilities to financial assets has been increasing rapidly both before and during the financial crisis. Falling incomes in view of a deteriorating labour market have adversely affected debt repayments with loans to households in arrears over three months increasing substantially from EUR 2 billion in 2010 to EUR 3.4 billion in 2012.

Cypriot private sector debt in international perspective (left) and evolution of gross debt of households and non-financial corporations (right), January 2013.



Note that figures represent sectoral debt towards monetary financial insititutions, which account for most of private debt. Total sectoral data are only available up to 2011.

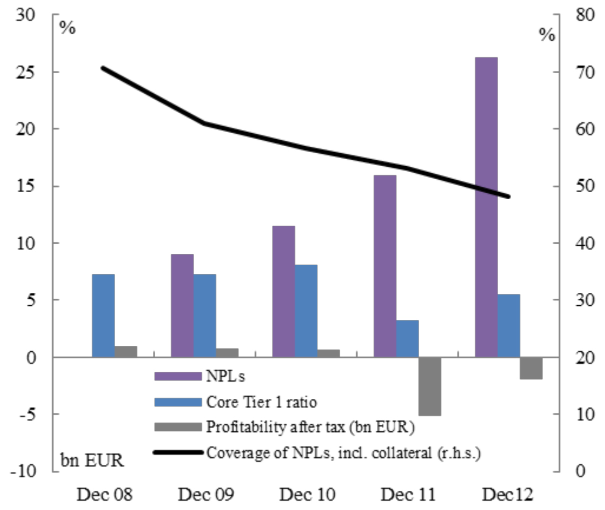
Source: ECB

Corporate indebtedness in Cyprus is one of the highest in Europe. Cypriot corporations are highly indebted with a ratio of corporate resident bank loans and securities to GDP of 153% in January 2013, while their borrowing from banks in 2006 was still around 100% of GDP. Unlike the household sector, their net financial position is negative. The largest share of the corporate assets is currency and deposits, representing around 35% of total assets, while shares and other equity constitute the biggest component on the liability side. Loans account for around 40% of total corporate liabilities and amounted to 150% of GDP at the end of 2012. The main vulnerabilities for the Cypriot corporate sector are weak profits and high leverage, as well as a notable dependence on bank finance. Corporate loans with arrears over 3 months increased from 12% of the total in 2010 to 22% in 2012.

45. **Financial soundness indicators for Cypriot banks started to deteriorate in 2010, revealing vulnerabilities with respect to their capital buffers and liquidity positions.** Bank solvency suffered from the still on-going decline in asset quality. The share of non-performing loans (NPLs), i.e. loans with

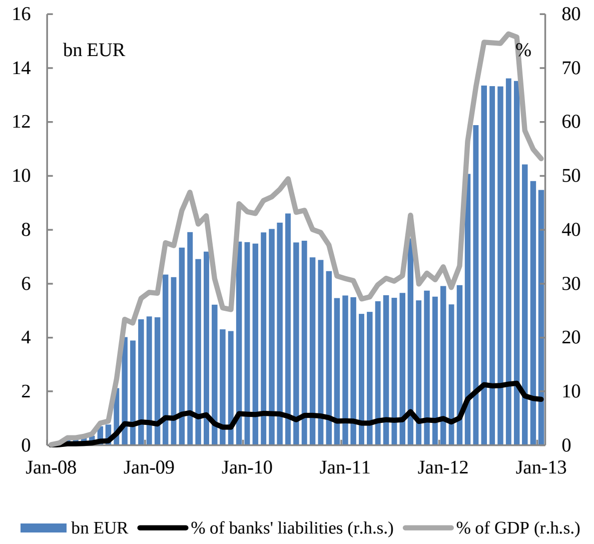
over-due payments above 90 days, reached 26% in December 2012, up from around 8% in December of 2009 (Graph 17a). The NPL ratio has been particularly high for the cooperative credit institutions (above 30%), while the frequency of delinquencies has been highest among development and construction loans. As a result of the Greek PSI and a rise in NPLs with subsequent provisioning, bank profitability turned negative with a big loss of EUR 5.2 billion in 2011, and capital was consequently eroded, with the core Tier 1 ratio bottoming at 3.2% in December 2011. The evolution of loan-to-value ratios suggests that banks were relatively conventional during the boom years, respecting ratios of no more than 70% (80% in the case of a first residence). As a consequence, only slightly more than one third of the impaired loans were covered by provisions, counting on high recovery values of the collateral. This might be unrealistic in the context of a systemic crisis. The decline in the coverage ratio of impaired loans, including collateral, from 73% in 2008 to 48% in December 2012, is further evidence of insufficient provisioning by the banks in Cyprus.

Graph 17a: Financial stability indicators



Source: Central bank of Cyprus

Graph 17b: Eurosystem lending (monetary policy operations and ELA) to banks in Cyprus



Source: IMF, FSI

46. **The liquidity position of banks started to deteriorate already in September 2008, even before solvency indicators had given rise to worries about the financial soundness of the banks.** Borrowings from the Eurosystem (regular monetary policy operations and ELA) increased steadily from negligible levels to a peak of EUR 13.6 billion in September 2012, before slightly decreasing to EUR 9.5 billion in January 2013 Graph 17b). The reliance on central bank funding has been very large, given the small size of the economy. In relative terms, it represented almost 53% of GDP, or 8.5% of banks' total liabilities. This adverse development was a clear sign of a loss of confidence in the Cypriot banks.

...but some remedial measures have been taken...

47. **The Cypriot authorities took supervisory action to strengthen the banks' capital base after the Greek PSI and the EBA stress tests.** When the first PSI in Greece was discussed in March 2011, it was clear that the Cypriot banks would have to raise their capital to address market concerns over their sovereign exposure to Greece. Also, the EBA stress tests conducted on the two largest domestic Cypriot banks in July 2011 indicated that further strengthening of capital buffers would be required to reach a core capital ratio of 9% by end-June 2012. Consequently, the Central Bank of Cyprus tightened capital

requirements in July 2011. The minimum Core Tier 1 ratio was set at 8% and included a GDP factor to reflect size[12]: Core Tier 1 equals [8 + α*(assets/GDP)] percent. In December 2011, the EBA Capital Exercise revealed that Bank of Cyprus and Cyprus Popular Bank needed additional capital of EUR 1.56 billion and EUR 1.97 billion, respectively.

48. **Because private investors were reluctant to further invest in Cypriot banks, the Cypriot Government stepped in.** At the end of March 2012, the Bank of Cyprus increased its capital base by EUR 594 million through a voluntary exchange of convertible capital securities into shares and through a rights issue. Cyprus Popular Bank bought back Tier 2 hybrids at a discount and, since private investors showed no interest in the rights issue, the government provided the missing EUR 1.8 billion. A crisis management legislative act was adopted. The Council of Ministers approved two bills in mid-December 2011, which brought significant changes to the financial system in Cyprus by giving the possibility to the State to cover 100% of the issuance of capital titles. The legislation in question, prepared by the Ministry of Finance in close co-operation with the Central Bank, relates to government intervention in times of crisis and to the establishment of an independent Financial Stability Fund.

…followed by more drastic action to contain the banking crisis.

49. **A due diligence review of the Cypriot banking revealed that more capital was needed.** In the context of the programme negotiations for external assistance, which had started in June 2012, an asset valuation was commissioned to an independent external consultant (PIMCO). With a Core Tier 1 capital ratio of 5.5% for domestic banks at the end of September 2012, the Cypriot banks remained undercapitalised according to the new supervisory regulation (Box 4).

Box 4: Capital shortfalls determined in a due diligence review

An international consultant firm (PIMCO) has conducted an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a sample representing about 63% of the cooperative credit institutions' assets, as well as Alpha Bank Cyprus and Eurobank Cyprus. The assessment, which was overseen by a Steering Committee including representatives of the Cypriot authorities, the EC, the ECB, the EBA and the ESM (as members) and the IMF (as observer), started formally on 4 October 2012, with the selection of the external consultant (PIMCO). This due diligence review included both an accounting review and an assessment of the economic value of bank assets, which formed the basis for the bank-by-bank stress tests.

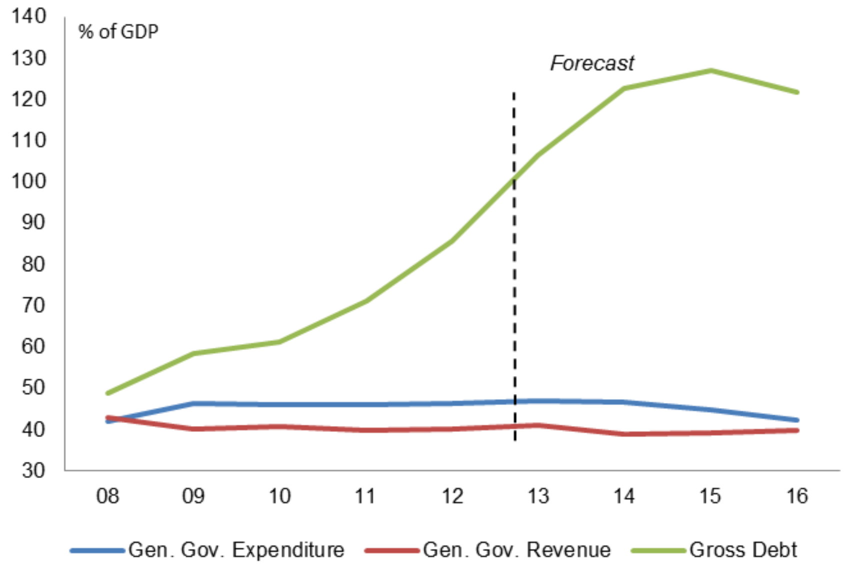
The bank-by-bank stress tests resulted in an overall capital shortfall of EUR 6 billion under a baseline scenario with a Core Tier 1 target ratio of 9% and of EUR 8.9 billion under the adverse macroeconomic scenario with a Core Tier 1 target ratio of 6%. These numbers include one foreign bank, but do not include the EUR 1.8 billion of capital already injected by the Cypriot State in Cyprus Popular Bank in June 2012. Also some cooperative institutions were not covered by the due diligence exercise. The specific capital needs were communicated to each participating bank on 18 March 2013.

3.2. FISCAL DEVELOPMENTS AND GOVERNMENT FINANCING

50. **In 2012, the budget deficit remained at 6.3% of GDP and thus Cyprus failed to comply with the 2012 Council deadline for correcting the excessive fiscal deficit.** Even though the government adopted a fiscal consolidation effort with an estimated annual consolidation impact of about 4% GDP in 2012, the deficit in 2012 did not improve mainly due to the lower-than-expected revenues. Revenues stagnated due to less tax-rich growth, lower corporate profitability and deteriorating labour market conditions. Also, some related expenditure items were higher than targeted by the Cypriot authorities, due to the rapidly growing unemployment and due to the increased number of early retirements and growing unemployment.

[12] The coefficient α smoothens the transition; α=1/3 from 31 December 2012 to 30 December 2013 and α=2/3 from 31 December 2013 to 30 December 2014. From January 2015, the full impact of the GDP factor will be felt.

Graph 18: Evolution of general government balance and gross debt



Source: Commission services

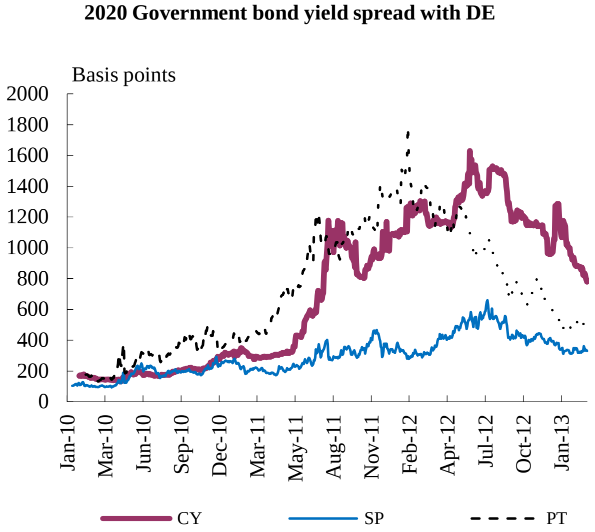
51. **The general government gross debt has been increasing sharply.** Gross debt, which still stood below 60% of GDP in 2008, increased sharply during the subsequent years and reached 85.8% of GDP in 2012. The banking sector's large exposure to Greece also had an adverse impact on overall public debt. Notably, after the voluntary Greek PSI, the government recapitalised Cyprus Popular Bank (Laiki Bank), following the bank's failure in raising funds in capital markets, by EUR 1.8 bn. Cyprus' government debt ratio has also been affected by the sizeable and persistently large budget deficits, increasing interest payments on government debt and the fall in nominal GDP in some crisis years (denominator effect)..

52. **De facto, Cyprus has been shut out of financial markets for long-term financing since mid-2011,** when yield spreads with the German bund on 10-year government bonds reached prohibitive levels.[13] Market uncertainty surrounding the situation in Greece and the government's ability to raise the required funds for the bank recapitalisation, as well as sovereign financing needs, outweighed the positive confidence effect arising from the government's consolidation efforts undertaken in March 2011, and this was reflected in rising yields (e.g. the yield on a three-year sovereign bond rose to 6.75% in December 2011 up from 5% in April 2011). Authorities thus shifted from medium-term to short-term borrowing to cover financing needs even though yields on short-term issuances were also rising throughout 2012. Following Fitch's downgrade of Cypriot sovereign debt to junk status at the end of June 2012, the government's short-term debt roll-over became extremely difficult.

53. **In 2011, the Cypriot government secured a bilateral loan from Russia**. The bilateral loan of EUR 2.5bn with 4.5% interest *per annum* was disbursed in three tranches of EUR 0.6 bn, 1.3 bn and 0.6 bn, respectively, between December 2011 and March 2012, and helped to meet most of the financing needs for 2012. Repayment of the loan was foreseen for 2016. The terms of the contract foresaw the possibility of renegotiating the repayment schedule and Cyprus has been negotiating revised terms of the loan with the Russian Federation, aiming at reimbursement as of 2018 and a reduction of the interest rate from 4.5% to 2.5%.

[13] It has to be borne in mind, however, that the market for Cypriot sovereign debt has always been very thin.

Graph 19: Sovereign bond yield spreads vis-à-vis the German bund



Source: Bloomberg (based on bonds with a maturity in 2020)

Spreads for Cyprus are calculated on the basis of a single 9-year bond as the market for Cypriot bonds is too thin for data providers (Bloomberg, Ecowin) to calculate yields for a generic sovereign benchmark bond.

3.3. STRUCTURAL ASPECTS

54. **Reforms of the pension system were undertaken in recent years to improve the long-term financial viability of the system.** The pension schemes in Cyprus include: the General Social Insurance Scheme (GSIS) and the occupational pension plans. The GSIS is a compulsory earnings-related scheme that covers all those gainfully employed in the private and public sector, including self-employed individuals. The occupational pension plans provide supplementary pensionable benefits to their members and include the Government Employees Pension Scheme (GEPS) for central government employees and the Semi-governmental Sector Employee Pension Schemes.[14] Until the end of 2012, the pensionable age under the GSIS was 65 years for both men and women. Nonetheless, early retirement at the age of 63 was common, given that under certain conditions, there were no penalties for early exit. [15] Public spending on the pension system was projected to increase by more than 8½ pps of GDP by 2060, bringing Cyprus into second place after Luxemburg in terms of increases in public pension expenditure in the EU. Initial reforms had already been introduced in order to improve the financial viability of the insurance-based schemes. For instance, in the case of the GSIS, in 2009, the contribution period was extended and contribution rates were set to gradually increase by a total of 9.1 pps (1.3 pps every five years between 2009 and 2039). Furthermore, the GEPS was closed to new entrants in October 2011, with new public sector employees joining the GSIS on the same terms as in the private sector. Pension contributions of existing members were increased from approximately 1% to 5% of pensionable income.

[14] There are also Voluntary Provident Funds and other similar collective arrangements in the private sector, which primarily provide defined-contribution lump-sum benefits. They are financed by contributions from employers and employees and their up-take is encouraged through tax incentives.

[15] Under the GEPS, the compulsory retirement age was 63 for most public servants, but early retirement was possible without any actuarial reduction of benefits.

55. **Significant additional reform measures to address the long-term financial viability of the pension system were introduced at the beginning of 2013.** The measures for the GSIS included: an automatic adjustment of the statutory retirement age every five years in line with changes in life-expectancy at the statutory retirement age (to be applied for the first time in 2018); an increase to the minimum age for entitlement to an unreduced pension by six months per year to bring it into line with the statutory retirement age; a gradual increase to the minimum contributory period from 10 to 15 years, the introduction of actuarially fair penalties for early retirement; and separating in accounting terms of the minimum (non-contributory) pension from the insurance-based (contributory) pension scheme (as of the 30the June 2013). In the case of the GEPS and similar schemes for the broader public sector employees, the reforms enacted focus on limiting future accrual of rights of existing members, *inter alia,* increasing the statutory retirement age, and accordingly the minimum retirement age, by 2 years - with automatic adjustment for changes in life-expectancy (to be applied for the first time in 2018); the introduction of an early retirement penalty to make early retirement actuarially neutral, while preserving acquired rights; the calculation of pension benefits on a pro-rata basis taking into account life-time service; changing the indexation of benefits from wages to prices; and the taxation of pension entitlements, including lump-sum payments, accruing after 1 January 2013, as personal income, with the option of converting all or part of the lump sum into an actuarially neutral annuity.

56. **To control expenditure and ensure efficiency gains in the mid-term,** the Cypriot Council of Ministers, recently renewed the decision to implement the NHIS in the second semester of 2015. The main challenges for NHIS are to integrate public and private provision of healthcare services within a sustainable financing structure and to reorganise public hospitals to face competition from private healthcare providers. Under the current economic environment, there is a potential fiscal risk, as projected expenditure from NHIS may exceed projected income under currently proposed healthcare contribution rates and allocation from the state budget. In the short-term, authorities have executed a set of measures, effectively reducing the growth in expenditure on pharmaceuticals and decreasing expenditure for treatments abroad. Further measures, recently legislated, redefined fees for medical visits, pharmaceuticals and laboratory test in order to align prices with actual costs and to decrease medically unnecessary consumption of services and goods. A Ministerial decision has now paved the way for a much needed restructuring plan for public hospitals, the aim of which is to improve quality and optimise costs. However, major reform steps are still needed to improve the financial sustainability, quality and efficiency of public healthcare provision.

3.4. PROGRAMME APPLICATION AND AGREEMENT

57. **The Cypriot authorities requested financial assistance from the EU and the IMF on 25 June 2012.** A joint EC/IMF/ECB mission team negotiated the conditions of the Programme and staff-level agreement was reached on 2 April 2013 on a comprehensive policy package for the period 2012-16, supported by financing for a total amount of up to EUR 10 billion. On 25 March, the Eurogroup issued a statement supporting the policy Programme and the loan package associated with it. On 12 April, the Eurogroup considered that the necessary elements of the Economic Adjustment Programme were in place to launch the relevant national procedures for the formal approval of the ESM financial assistance facility. On 24 April, the ESM Board of Governors took the decision in principle to grant financial assistance to Cyprus on the basis of the agreed MoU. On 25 April, the Council adopted a decision under Article 136 TFEU containing the main elements of the macroeconomic adjustment programme to be implemented by Cyprus. On 26 April, a Memorandum of Understanding, consistent with the said-decision, was signed by the Cypriot authorities and the Commission, acting on behalf of the ESM. The Cypriot House of Representatives endorsed the Programme on 30 April 2013.

BOX 5: TIMELINE OF EVENTS LEADING TO THE ECONOMIC AND FINANCIAL CRISIS IN CYPRUS

- **31 May 2011:** Cyprus suffers a sovereign triple-notch downgrade by Fitch and a one-notch downgrade by S&P's on the grounds of the large exposure of Cypriot banks to Greece, given increasing rumours about an upcoming voluntary private sector involvement (PSI), and the large fiscal deficits. This is the start of a rally of rising two-year spreads over the German bund, prior to reaching a record high in September 2011 of 2548 bps, and de-facto blocking Cyprus from the access to international capital markets.

- **11 July 2011:** a lethal explosion destroys the Vasiliko electricity producing plant, which accounts for half of the total generating capacity of Cyprus. The destruction takes a toll on economic activity and lowers confidence levels in all sectors.

- **21 July 2011:** euro-area Member States announce the commitment of voluntary PSI as a contribution to covering the Greek financing gap.

- **16 December 2011:** the Budget Law 2012 is adopted incorporating a significant number of consolidation measures with the aim of reducing the government deficit from 6.3% of GDP in 2011 to 2.5% of GDP in 2012.

- **23 December 2011:** a bilateral loan of EUR 2.5 billion is agreed with Russia, the aim of which is to cover 2012 sovereign financing needs. The first tranche of the loan is disbursed on 31 December 2011.

- **21 February 2012:** 53.5% (in nominal terms) voluntary private sector involvement (PSI) in the Greek sovereign debt is announced by the euro-area Member States, significantly affecting the capital adequacy of the largest Cypriot banks.

- **21 May 2012:** legislation is adopted and enacted allowing for state aid to Cyprus Popular Bank (Laiki), through a EUR 1.8 bn rights issue. This is considered necessary because Laiki's strategy was not successful in meeting its financing needs indicated by the EBA requirements and within the EBA deadline.

- **30 May 2012:** published EC proposals for the Council Recommendations to Cyprus and the conclusions of the In-Depth Review of the macroeconomic imbalances in Cyprus identify very serious imbalances that need to be addressed urgently.

- **25 June 2012:** Fitch downgrades the Cyprus sovereign to non-investment grade. As a result of this, all of the three major credit rating agencies have ranked the Cyprus sovereign as non-investment grade.

- **25 June 2012:** Cyprus formally presents euro-area Member States with a request for external financial assistance from the EFSF/ESM to contain the risks arising in the banking sector in the presence of economic imbalances.

- **23 November 2012:** Cyprus and EC/ECB/IMF reach an agreement on the policy side of a draft Memorandum of Understanding (MoU). The text is detailed and ambitious, covering all elements of a fully-fledged programme: i) a comprehensive plan for financial sector restructuring; ii) a frontloaded and expenditure-based fiscal adjustment; and iii) structural reforms to enhance Cyprus' competitiveness and fiscal sustainability.

- **Early-December 2012:** the Cypriot House of Representatives passes almost unanimously a number of bills that cover the vast majority of fiscal measures for 2012-14 as outlined in the draft MoU, as well as important first steps in relation to fiscal-structural reforms (e.g. pension system, health sector, budgetary framework, welfare benefits, COLA, etc.).

- **Mid-December 2012:** EC/ECB/IMF are presented with the preliminary results of the financial sector due diligence exercise -carried out by PIMCO and Deloitte- broadly confirming the EC/ECB/IMF assessment of the banking sector recapitalisation needs of approx. EUR 10 bn.

- **21 January 2013:** the Eurogroup welcomes progress made with the adoption of the policy measures by the Cypriot House of Representatives in December 2012, which was marked by the support of almost all political parties, indicating a broad political consensus behind the key fiscal objectives of a macro-financial programme for Cyprus, as outlined in the draft MoU.

- **2 February 2013:** the results of the due diligence exercise are submitted to the Central Bank of Cyprus and circulated to the members of the Steering Committee (EC, ECB, IMF, ESM, EBA, CBC and CY MoF).

- **4 March 2013:** the Eurogroup welcomes the commitment of newly-elected President Anastasiades to closely cooperate with Cyprus's European partners towards the earliest possible completion of the loan agreement.

- **16 March 2013:** a political agreement is reached between the Eurogroup and the Cypriot authorities. The Cypriot authorities commit to introducing an upfront one-off stability levy applicable to resident and non-resident depositors, both insured and uninsured. Additional measures include the increase of the withholding tax on capital income, a restructuring and recapitalisation of banks, an increase of the statutory corporate income tax rate, a bail-in of junior bondholders, and a privatisation plan.

- **18 March 2013**: the Central Bank of Cyprus declares bank holidays, extended until 28 March 2013, due to bank-run fears following the decision of the Cypriot House of Representatives not to adopt the government's proposal for the one-off stability levy agreed at the Eurogroup of 16 March 2013.

- **25 March 2013**: the Eurogroup and Cypriot authorities reach an agreement, supported by all euro-area Member States and the three institutions (EC/ECB/IMF), on the key elements necessary for a future Economic Adjustment Programme.

- **30 April 2013**: the Cypriot House of Representatives endorse the Programme.

- **8 May 2013:** the Board of Directors of the ESM approve the disbursement of the first tranche in two instalments, the first one of EUR 2 billion on 13 May and the second one of EUR 1 billion at the end of June.

- **15 May 2013:** The Executive Board of the International Monetary Fund (IMF) approved a three-year SDR 891 million (about EUR 1 billion) arrangement under the Extended Fund Facility (EFF) for Cyprus in support of the authorities’ economic adjustment programme.

- **16 May 2013:** the Council adopted a revised Recommendation to Cyprus under the Article 126(7) with an extension of the deadline for correction of excessive deficit by four years until 2016.

4. PROGRAMME DESIGN AND OBJECTIVES

58. **The economic adjustment programme will address short- and medium-term financial, fiscal and structural challenges facing Cyprus.** The key programme objectives are:

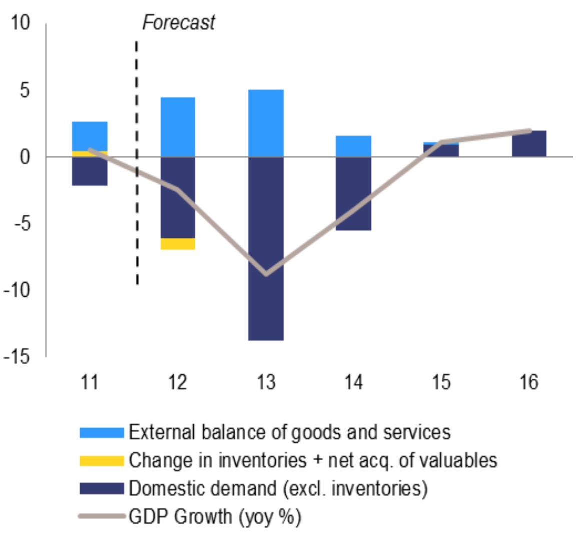
- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls, in line with the political agreement of the Eurogroup of 25 March 2013;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

4.1. ECONOMIC PROSPECTS

59. **Looking ahead, the Cypriot economy is expected to face heavy headwinds in the coming years, with a projected return to growth only in 2015.** The contraction of economic activity in 2013 is expected to intensify. Domestic demand will continue to contract up to and including 2014, in particular due to a strong drag on economic activity from private consumption and investment. The immediate restructuring of the banking sector (which will impact on net credit growth), the fiscal consolidation efforts pursued, the rapid deterioration in labour market conditions, and the high degree of economic uncertainty are together expected to continue to weigh heavily on domestic demand. In addition, the temporary restrictions required to safeguard financial stability are likely to hamper international capital flows and reduce business volumes in both domestic- and internationally-oriented companies. The bail-in of uninsured depositors is projected to cause a loss of wealth, reducing private consumption and business investment. This, compounded by the impact of the fiscal consolidation already undertaken and the new measures agreed, is forecast to result in a sharp fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial services sector.

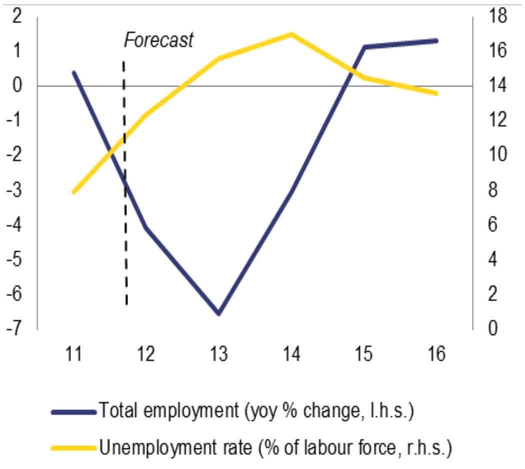
60. **A rebound of the economy is projected for 2015 and 2016, reaching close to 2% over the long run.** The on-going deleveraging of both household and corporate balance sheets will remove the impediment to a more balanced growth over time. At the same time, the restoration of a sound and well-capitalised banking system is expected to gradually loosen the tight credit conditions in the economy. In the outer years, investment projects related to the energy sector and the prospects of exploitation of natural gas could contribute increasingly to economic growth. The recent reform of Cyprus' wage-indexation mechanism should contribute to aligning public wages with developments in economic activity, improving competitiveness, and supporting economic recovery. This is expected to have a positive impact on the external balance, with the current account deficit contracting over the programme period and external debt, in particular that related to external liabilities of financial institutions, expected to decline.

Graph 20a: Projected real GDP growth and contributions



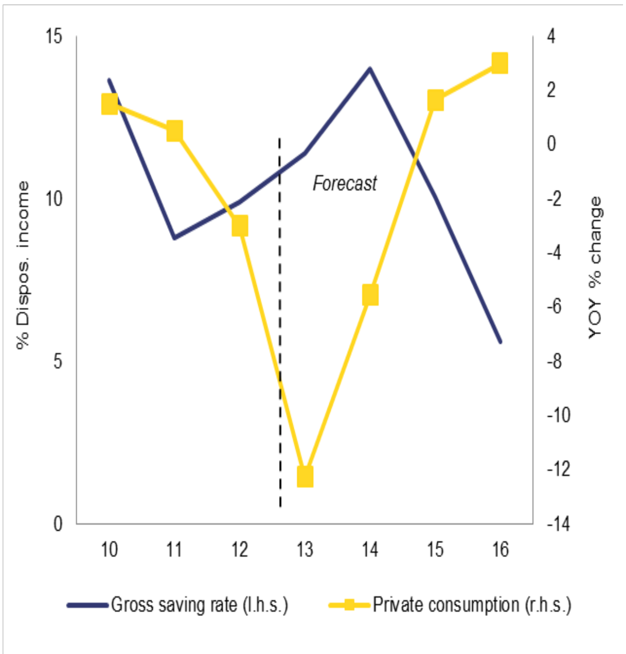
Source: Commission services

Graph 20b: Projected employment growth and unemployment rate



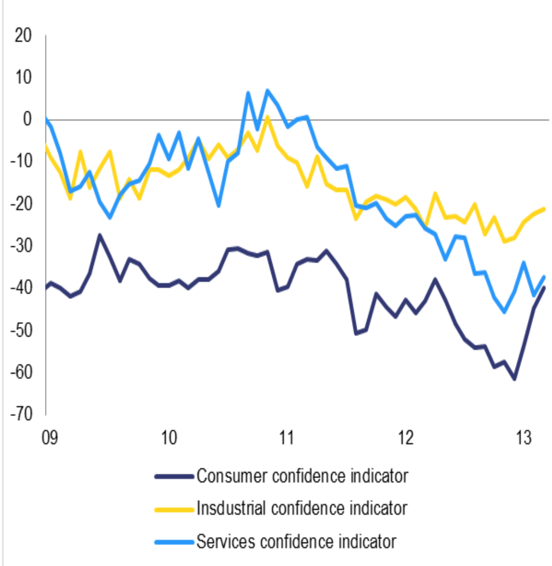
Source: Commission services

Graph 21: Household saving rate and consumption growth



Source: Commission services

Graph 22: Confidence indicators



Source: Commission services

61. **The implementation of the Programme should ensure that the deleveraging process is not abrupt, thereby underpinning a return to economic growth and macro-financial stability, while restoring financial market confidence** and confidence among consumers and businesses, which are currently at record lows (Graph 22). However, structural reforms in the labour market and the public sector, including reforms of the wage indexation and pension systems, should improve fiscal sustainability, competitiveness and raise potential growth, especially in the medium- to long-term. With the implementation of the Programme, economic growth is foreseen to be -8.7% in 2013, improving to -3.9% in 2014, to 1.1% in 2015 and 1.9% in 2016.

Table 3: Macroeconomic framework

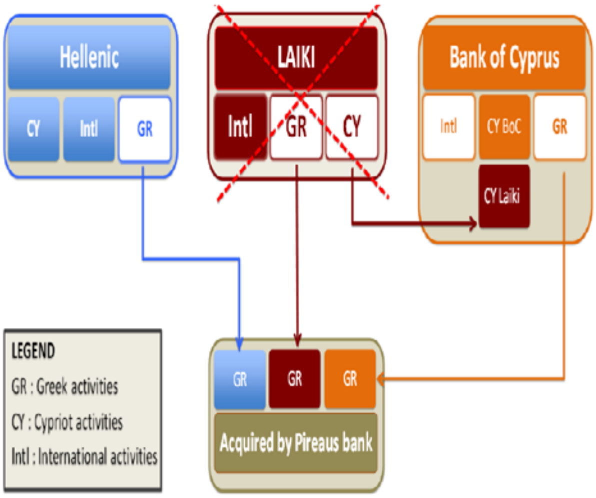
	2011	**2012**	**2013**	**2014**	**2015**	**2016**
			% change on previous year			
Real GDP growth	**0.5**	**-2.4**	**-8.7**	**-3.9**	**1.1**	**1.9**
Domestic demand contribution (excl. inventories)	**-2.2**	**-6.1**	**-13.8**	**-5.5**	**0.9**	**2.0**
Net trade contribution	**2.2**	**4.4**	**5.0**	**1.6**	**0.2**	**0.0**
Unemployment rate (level)	**7.8**	**12.2**	**15.5**	**16.9**	**14.4**	**13.5**
HICP	**3.5**	**3.1**	**1.0**	**1.2**	**1.6**	**1.7**

Source: Commission Services

4.2. RESTORING FINANCIAL STABILITY

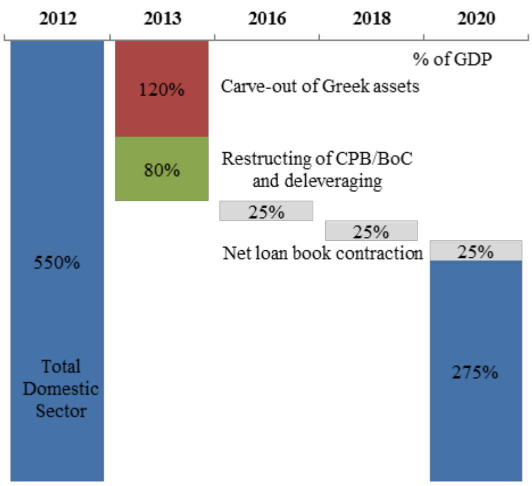
62. **A quick and upfront deleveraging was considered as a necessary first step in the adjustment process in light of the accumulated imbalances.** Using the newly-adopted resolution framework Cyprus Popular Bank and Bank of Cyprus were intervened (Box 6). The Greek operations of the two main banks were sold out to the Greek bank Piraeus (Graph 23a). Thanks to the carve-out, the system achieved an immediate upfront deleveraging by some 120 percentage points of GDP (Graph 23b). At the same time, Cypriot banks' risk-weighted assets declined substantially, thereby resulting in a lower capital requirement.

Graph 23a: The Greek carve-out



Source: Commission services

Graph 23b: Downsizing the Cypriot banking system



Source: Commission services

63. **Subsequently, the two main banks were subject to a thorough restructuring by means of resolution**. This involved the immediate bail-in of some EUR 1.4 billion of subordinated debt. All insured deposits at Cyprus Popular Bank, together with Cypriot and UK assets were moved to Bank of Cyprus. Uninsured deposits, together with the remaining assets and the foreign subsidiaries remained in the legacy part of Cyprus Popular Bank, which is to be liquidated over time. Simultaneously, uninsured deposits at the Bank of Cyprus were subject to an immediate bail-in of 37.5%, implying a deposit-to-share swap. Another 22.5% of the uninsured deposits were frozen with the view to ensuring that all capital needs of the institution will be entirely covered by the own contributions of large depositors. Should the bank turn out to be over-capitalised, i.e. have its Core Tier 1 over 9%, due to this measure, the excess will be unfrozen and returned to the depositors. The resolution of Cyprus Popular Bank and the consolidation of Bank of Cyprus as the leading Cypriot bank resulted in a further immediate deleveraging of the sector by some 80% of GDP (Graph 23b). The capital needs of Cyprus Popular Bank and of Bank of Cyprus, which together totalled about EUR 10 billion (over 50% of Cypriot GDP), have been covered, exclusively through the contributions of uninsured depositors with full contribution of equity shareholders and bond holders.

Box 6: Main laws in the financial domain

In the context of restructuring and downsizing of the financial sector, the Cypriot authorities passed a number of laws to implement an effective legal resolution framework. The main pillar of this framework is the **Resolution of Credit and**

Other Institutions Law of 2013, which endows the Central Bank with new powers, as a Resolution Authority, to implement restructuring measures on banks that are either no longer viable or are likely to no longer be viable. These measures include a forced capital increase, transfer of assets and liabilities to a bridge bank or asset management company and, as subsequently utilised in relation to Bank of Cyprus and Cyprus Popular Bank, the sale of operations and bail-in.

Furthermore, five other accompanying laws were passed to strengthen the resolution framework and one regulation was also approved by the House of Representatives:

- **Law Amending the Restructuring of Financial Institutions Law of 2011 to 2013**, which allows for the possibility of nationalisation of credit institutions.

- **Banking Laws (Amending) Law of 2013** and the **Cooperative Societies (Amending) Law of 2013**, which increases the early intervention measures available to the supervisor and requires the introduction of resolution plans for each institution.

- **Law on the Establishment and Operation of the Deposit Protection and Resolution of Credit and Other Institutions Scheme**, which combines the previously separate deposit protection schemes for banks and co-operatives into one scheme that may also be used for funding resolution actions.

- **Special Tax on Credit Institutions (Amending) Law of 2013,** which amends the existing law to allow for the funding of the Deposit Protection and Resolution Scheme through taxation of credit institutions and co-operatives.

- **Operation of the Deposit Protection and Resolution of Credit and Other Institutions Scheme Regulations of 2013**, which outlines the protection given to depositors by the newly-created Deposit Protection and Resolution Scheme.

In addition and separate from the resolution framework, the Parliament approved the **Enforcement of Restrictive Measures on Transactions in case of Emergency Law of 2013** that gave the Minister of Finance the ability to implement temporary administrative restrictions on financial transactions to stem excessive deposit withdrawals and capital outflows. The measures were necessary to preserve the stability of the economy and society as a whole.

64. **In order to prevent massive liquidity outflows and a collapse of the banking system, Cypriot authorities had no option but to impose administrate measures**. After the announcement of the resolution and restructuring of the two largest banks on Saturday 16 March, a bank holiday was declared for Tuesday 19 March, Monday 18 March being a regular bank holiday, and this was extended several times until the banks reopened on Thursday 28 March. During the bank holiday, as during weekends, all payments and transfers within a banking group as well as inter-bank transactions were prohibited, with few exemptions related to essential payments. In addition, limits on cash withdrawals for the two stressed banks were imposed. The exceptions concerned payments of systemic relevance, meaning with a risk of default for the credit institution or of further harming financial stability, and included payments of salaries, and payments for food, oil and tuition fees, as well as payments by government services for humanitarian reasons. Also cash withdrawals at ATMs remained free, subject to the normal individual limits agreed with the bank, except for Cyprus Popular Bank (Laiki Bank), where there was a cap of EUR 260 per day which was the bank's own decision. There were no restrictions on credit cards, which remained generally accepted with a few exceptions, mainly at gasoline stations.

65. **After the bank holiday, capital controls had to be implemented.** Once the banks reopened, a strict regime was put in place in order to avoid excessive liquidity outflows. The overall objective was to allow current transactions for goods and services inside and outside the country, but to limit capital transactions. The regime was applied to all banks including foreign banks and was initially implemented for 7 days, but has already been prolonged and eased on some points. Some entities have been exempted from the restrictive measures including the Central Bank, the state and the local authorities. There was a general ban on cashless payments or transfers of deposits/funds to accounts held abroad or to other credit institutions, but an authorisation regime applied for transactions falling within "normal business practices" (e.g. buying goods). Initially, payments of up to EUR 5,000 per day per account were free, but then increased to EUR 25,000, while from EUR 25,001 to EUR 200,000, they were subject to approval, and beyond EUR 200,001 prior authorisation was necessary, taking into account the liquidity buffer of the credit institution. Furthermore, payments for salaries were free and living expenses up to EUR 5,000 per quarter. A Cypriot resident with an immediate family relative who was a student abroad also had free tuition fees. Individuals

were affected in particular by the following measures: (i) Payments and/or transfers outside Cyprus, via debit and/or credit and prepaid cards, were not allowed to exceed EUR 5,000 per month per person in each credit institution; (ii) the termination of fixed term deposits prior to their maturity was regulated; and (iii) cash withdrawals were limited to EUR 300 per day and per bank account. Finally, exports of euro notes up to EUR 1,000 or the equivalent in another currency were prohibited. This comprehensive framework for administratively managing liquidity was further tightened by the freezing of the uninsured deposits in the context of their bail-in to cover losses and address the recapitalisation of Laiki Bank and Bank of Cyprus.

66. **One of the aims of the Programme is to ensure the stability of the financial sector in order to restore its capacity to contribute to economic growth.** Cypriot financial institutions suffered serious losses due to their exposure to Greece as well as to poor management of the risks related to both their international exposure and the domestic overexpansion of credit, in particular to the real estate sector. In addition to the international and domestic shocks, the sensitivity of collateral valuations to property prices and certain gaps in the regulatory framework led to delays in the accounting recognition of economic losses, and therefore to significant under-provisioning. The proposed reform comprises a number of policy elements, organized across three broad strategies. The first strategy aims at improving regulation and strengthening supervision. This will be achieved by concrete steps in four areas: bank liquidity, supervision of credit institutions, addressing private indebtedness, and increasing financial transparency. The second strategy aims at ensuring that banks are viable and possess sufficient capital buffers. This will be achieved through restoring adequate capital buffers, the restructuring of the two main domestic banks, the restructuring and recapitalization of the other commercial banks, and lastly the restructuring and recapitalization of the cooperative credit institutions. Finally, efforts will be made to limit the duration of the imposition of capital controls. Each of these policy actions is briefly discussed below.

67. **Maintaining the liquidity of banks is crucial for preserving their role in the financing of the economy.** In the context of the Programme, the authorities will continue to closely monitor the liquidity situation of banks, which will aim at reinforcing their collateral buffers. Institutions borrowing from the Central Bank will establish and submit quarterly medium-term funding plans, taking into consideration the expected path of deleveraging that would avoid asset fire sales or a credit crunch. Also with a view to improving the institutions' medium-term liquidity position, the Central Bank of Cyprus will review its prudential regulations on liquidity by end-2014.

68. **The supervision and regulation of both commercial banks and cooperative credit institutions will be reviewed in depth.** The Central Bank of Cyprus will be given new tools for monitoring developments in banks and for intervening if necessary. The definition of non-performing assets will be modified to include all loans above 90 days in arrears. A central credit register, which will permit the identification of borrowers in arrears, as well as final beneficiaries, will become operational by end-September 2014. A supervisory mandatory structured intervention based on capitalisation levels will be introduced by March 2014. A unified data reporting system for both commercial banks and cooperative credit institutions will be implemented by end-June 2013. Stress tests will become a regular element of off-site bank supervision and will serve as an input into Pillar 2 assessments. Furthermore, after analysing of the results from the due diligence exercise, the Central Bank of Cyprus will review its current regulatory framework with respect to loan origination process, asset impairment and provisioning, and the treatment of collateral in provisioning. Finally, the Central Bank will also become the supervisor of the cooperative credit institutions by July 2013, which will ensure a level playing field in regulation and supervision of all credit institutions.

69. **In order to prevent the build-up of macro-financial imbalances in the future, the monitoring of private sector indebtedness will be stepped up.** The authorities will prepare quarterly reports, including information on the distribution of assets and liabilities across households and an assessment of debt-servicing capacity and refinancing activities. The Financial Stability Report, to be published on a yearly basis as of December 2013 will include an extended analysis of corporate and household indebtedness. In addition to this enhanced monitoring and in order to mitigate the possible negative impact of quickly increasing non-performing loans, measures will be taken to deal with troubled borrowers. These measures will include the imposition, by the end of April 2013, of a grace period of 60 days to allow borrowers and banks to restructure loans. Further steps concern a review of possible legal and other impediments to private-sector out-of-court settlement of debt in arrears.

70. **Financial transparency will be enhanced by further strengthening the anti-money laundering framework.** An independent audit was finalised by end of April 2013, the recommendations of which will be implemented without further delay as part of a comprehensive action plan, which should deal, *inter alia*, with improvements to the identification of the ultimate beneficial owners of Cypriot legal persons and arrangements, the reporting of suspicious transactions, the functioning of the Registrar of companies and other aspects of customer due diligence. The Cypriot authorities intend to establish trust registers with the

supervisory authorities and launch a third-party assessment of the functioning of the Registrar of companies. Cooperation with foreign intelligence units will be strengthened, in particular in the area of timely identification of the ultimate beneficial owners of Cypriot legal persons and arrangements. Finally, by the end of 2013, the supervision department of the CBC will review its off-site and on-site supervisory procedures in order to further implement a risk-based approach to anti-money laundering supervision.

71. **The restoration of adequate capital buffers in the system is a complex goal that mobilises a number of policy tools**. First, the Central Bank of Cyprus will increase the minimum Core Tier 1 capital ratio from the present 8% to 9%, and banking groups will be required to comply with the new requirement by end-December 2013. Second, undercapitalised institutions in comparison with a 9% core tier 1 capital target under stress conditions will be required to submit funding plans and to increase their capital to the extent possible by recourse to private investors. Should such efforts fail, state-funded recapitalisations can take place only after approval of the banks' restructuring plans.

72. **Following the restructuring and resolution steps undertaken, in accordance with the Cypriot resolution framework, assets at the two largest banks are subject to a more detailed independent valuation to be completed by June 2013**. If this independent valuation were to find that additional capital would be required, such capital would be funded with a swap of uninsured deposits for class A shares.

73. **The Programme also emphasises the importance of ensuring a proper capitalisation of the other commercial banks.** Viable commercial banks with a capital shortfall, which could not find private funding, could ask for state-funded recapitalisations only after approval of restructuring plans, to be submitted by November 2013. Should state-aid be granted, its terms and remuneration must comply with the EU state-aid rules, which aim at avoiding the subsidisation of existing shareholders, with due consideration for financial stability.

74. **Finally, the Programme also provides for a proper restructuring and recapitalization of the cooperative credit institutions.** Based on an assessment of the institutions' capital needs and viability, to be completed by June 2013, the authorities will submit by July 2013 a strategy for reforming the sector. In the context of that strategy, which could involve mergers and restructuring, coops will seek a private solution to their capital needs by July 2013. State aid will be made available to viable institutions that have secured approval of their restructuring plans by September 2013.

75. **The administrative measures will be closely monitored.** While freedom of capital movement is the one of the key principles on which the Internal Market and the European Union are based according to article 63 of the Treaty, restrictions are possible in exceptional circumstances. They must be justified on the grounds of public order and security that could be threatened if uncertainty in the financial sector risked destabilising public life. A monitoring committee oversees that the measures taken are proportional to the problems to be tackled, cause the least damage to economic activity and looks for ways to end them as soon as possible.

4.3. FISCAL POLICY

76. **Based on the macroeconomic projection underpinning the programme, the budget deficit is forecasted to widen in 2013-2014 and to start improving only in 2015.** After a significant consolidation effort of about 4% of GDP in 2012, further consolidation measures of about 5% of GDP were adopted in December 2012. Furthermore, following the decisions of the Eurogroup of 25 March 2013, further permanent revenue consolidation measures of about 1½% GDP were adopted. Despite the fiscal consolidation effort undertaken, the impact of developments in the financial sector on the macroeconomic outlook and the effect of the one-off effect of some revenue measures in 2013 will lead to a large drop in the government primary balance in 2014. Drivers of the worsened government balance up to 2014 include considerably lower economic activity, lower corporate profitability and a deteriorating labour market. In outer years, the improvement in the macroeconomic situation will lead to higher revenues from both direct and indirect taxes. In 2016, a primary surplus is expected to be reached.

Table 4: Public finance targets

% of GDP	2012	2013	2014	2015	2016
GDP (% real growth)	-2.4	-8.7	-3.9	1.1	1.9
Fiscal targets (primary balance[1])	-	-2.4	-4.25	-2.1	1.2
Headline balance	-6.3	-6.5	-8.4	-6.3	-2.9
Structural balance	-6.7	-5.4	-5.1	-4.4	-2.5
Consolidation measures by year	0.3	4.8	1.7	tbd*	
- Expenditure measures	0.1	2.2	0.7		
- Revenue measures	0.2	2.6	1.0		
Debt	85.8	109.5	124.0	127.9	123.9

*tbd: to be decided, based on what is required for the achievement of the primary balance targets.

Source: Commission Services

77. **In the MoU, the authorities committed to implementing permanent measures that aim to achieve a primary balance of 4% of GDP by 2018 and to maintain it thereafter.** For the years 2013-2014, the amount of fiscal consolidation measures is about 6½% of GDP, which have been already legislated. Over the medium term, fiscal-structural measures will help to underpin a lasting adjustment. In 2015-2016, based on Commission services' spring forecast 2013 additional permanent measures of around 2½% of GDP will be needed to achieve the MoU targets of a primary deficit of 2.1% of GDP in 2015 and a primary surplus of 1.2% of GDP in 2016. The adjustment should be focused mainly on the expenditure side, in particular on cuts of the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on disadvantaged people and preserving the good implementation of Structural and other EU Funds. Further measures will be required after the Programme period, in order to achieve and sustain the 4% of GDP primary surplus objective.

78. **The consolidation effort for the Programme period** covers mainly: (i) compensation of public sector employees; (ii) social benefits and discretionary spending; (iii) reform of pension schemes; and (iv) tax increases, both indirect (VAT) and direct (withholding tax, corporate income tax, bank levy) taxes. The main elements in each of these categories are:

- **Compensation of public sector employees**: progressive scale of wage cuts in 2012 and streamlining of allowances in 2013 with a full year effect of 1.2% of GDP. An additional 3% horizontal wage cut will take place as of 1 January 2014 (reduction of 0.4% of GDP). Also, an income contribution of 1.5% will be applied to public servants from 2014 onwards, as a means of facilitating their access to public healthcare;

- **Social benefits** and discretionary spending: better targeting of various social transfers, while protecting disadvantaged people by, inter alia, abolishing/streamlining certain (redundant) schemes and introducing or tightening of means testing criteria. The first round of reforms in social transfers is expected to save an amount equivalent to 0.6% of GDP in 2013, and an additional round in 2014 is expected to yield ¼% of GDP;

- **Reform of pension schemes**: important reform steps for both the GEPS (public servants) and the GSIS (general pension system) are expected to have a significant fiscal benefit over the long term. For the GEPS, the systemic changes including linking the statutory retirement age to life expectancy, the introduction of an early retirement age penalty and the calculation of the pension benefit on a pro-rata basis taking into account life-term service (instead of end-career salary) should yield significant long-

[1] Excluding extraordinary revenues related to the energy sector.

term benefits. The reform of the GSIS will, in addition, contribute to the fiscal consolidation effort during the Programme period (0.5% of GDP in 2016), by linking the statutory retirement age to life expectancy and introducing a penalty for early retirement; and

- **Taxation measures**: increases in property taxation are estimated to yield 0.4% of GDP in 2013, while increases of excise duties (alcohol, tobacco, and petrol) are expected to yield 0.7% of GDP over 2012-2014. Two increases in VAT rates, 1 pp on the standard rate in 2013 and 1 pp on both the standard and the reduced rates in 2014 are assessed to yield 0.2% and 0.25% of GDP, respectively. Other measures on the revenue side include an increase in government fees and an extension of a temporary contribution on all wages until the end of the programme period. Also, following the decisions of the Eurogroup of 15 March 2013, increases in the corporate tax, the withholding tax on interest and the bank levy were implemented.

79. **In order to achieve a durable correction of the excessive deficit by 2016, the full and timely adoption and implementation of fiscal-structural measures are crucial**. This will also foster the achievement of a balanced position in structural terms at the earliest possible time after the Programme ends, as well as compliance with the expenditure benchmark and sufficient progress towards the debt reduction benchmark.

80. **On 16 May 2013, the Council granted an extension of the EDP deadline and adopted a revised Recommendation under Article 126.7 of the TFEU recommending Cyprus to put an end to the present excessive budget deficit situation by 2016.** Cyprus was considered to have taken effective action in 2011-2012, based on an average fiscal effort of 2.4% of GDP, after taking into account the effects of the revised macroeocnomci projections, which is above the fiscal effort of at least 1½% of GDP over 2011-2012 recommended by the Council. In view of the projected distance at end-2012 to the 3% of GDP reference value for the deficit, after taking into account the current adverse macro-economic circumstances and the perspective of a longer-lasting deleveraging of the economy, four additional years are considered necessary for a correction of the excessive deficit. This would correspond to an average annual structural fiscal effort by more than 4% of GDP over 2013-2016 in order to bring the headline government deficit below the 3% of GDP by 2016.

4.4. FISCAL-STRUCTURAL MEASURES

81. **Fiscal-structural reform steps are needed to allow for the long-term sustainability of public finances**. In addition, the reforms will provide the fiscal space necessary to support the diversification of the economy and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. The fiscal-structural reforms of the programme comprise the following key elements: (1) further reforms of the pension system to address the high projected increase in pension spending; (2) rapid implementation of measures to contain the growth of health expenditure; (3a) a comprehensive reform of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (3b) additional measures to strengthen the effectiveness of the revenue administration, with the particular aim of improving tax collection; (4) adoption of a Medium-Term Budgetary Framework; (5) targeted reform of the overall social benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (6) establishment of a legal framework for PPPs and initiation of a programme for improving the efficiency of state-owned and semi-public enterprises.

82. To assess whether further measures are necessary to ensure the long-term viability of the pension system, the authorities will conduct an actuarial study for the GSIS by end July 2013. The study should analyse the impact of additional reform options such as benefit reductions (while considering adequacy), an increase in the statutory retirement age and increases in contribution rates or combinations thereof taking into account the impact on labour costs. The Government contribution of 4.3% of insurable earnings and the return on the accumulated notional reserves of the SSF will not be taken into account in this actuarial study.

83. **To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures were adopted in late April 2013**:

a) abolition of the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. The measure will be reviewed by Q2-2014 with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;

b) increase of fees for medical services for non-beneficiaries by 30% to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;

c) introduction of effective financial disincentives for using emergency care services in non-urgent situations;

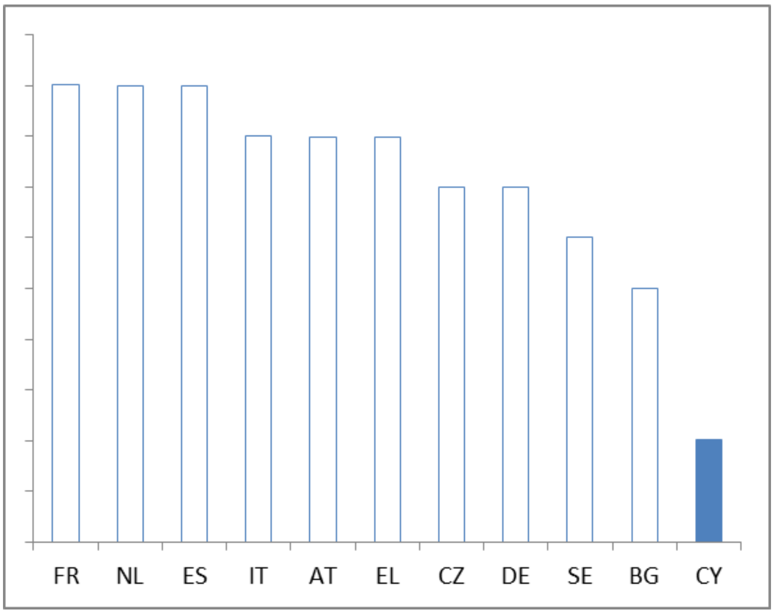
d) introduction of financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and

e) adoption of a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

84. **To enhance the functioning and cost-effectiveness of the public administration, the authorities commit to undertaking a comprehensive reform**. The reform will centre around the removal of impediments to staff mobility in the broader public sector and enhancement of working time flexibility, especially for public sector services with extended operating hours. An external review will be commissioned to examine further reforms options, including a review of the system of remuneration and working conditions and the introduction of a performance-based appraisal. A comprehensive reform of the revenue administration will also be implemented with a focus on strengthening collection capacity. The authorities have also committed to removing remaining barriers to timely and effective international tax cooperation.

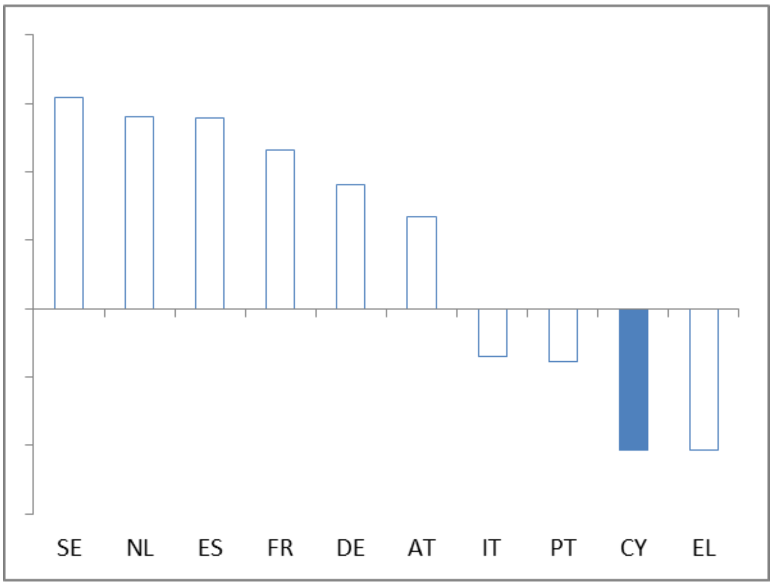
85. **Cyprus needs urgent legislative action to upgrade its budgetary framework**. Until recently, the essential building blocks of a fiscal framework were missing, making Cyprus one of the few Member States with neither functioning fiscal rules nor a medium-term budgetary framework, as evidenced by the low values in relative terms of the Cyprus fiscal rules and MTBF indexes (see Graph 24a and 24b). These two indexes are computed from the DG ECFIN database on fiscal governance and gauge the breadth and effectiveness of national numerical fiscal rules and the capacity of existing national Medium-Term Budgetary Frameworks to promote a genuine multi-annual approach in fiscal planning. The higher standards contained in the recently-adopted EU legislation (notably Council Directive 2011/85/EU) and in the Treaty on Stability, Coordination and Governance (TSCG) provide a timely opportunity to upgrade the budgetary framework on a broad front. To provide a firm legal footing to the recently-adopted developments in fiscal legislation at the EU level, a Law on the Medium-Term Budgetary Framework and Fiscal Rules' was adopted with the 2013 budget law. Consistent with these legislative steps, the authorities should anchor the principles of multi-annual fiscal planning in their annual budget cycle by establishing a rolling three-year Medium-Term Budgetary Framework document that would present the main orientations of fiscal policy over the medium-term.

Graph 24a: Medium-term budgetary frameworks



Source: Commission services

Graph 24b: Numerical fiscal rules index



Source: Commission services

BOX 7: EU BUDGETARY FRAMEWORKS AND THEIR BENEFIT FOR THE MANAGEMENT OF PUBLIC FINANCES IN CYPRUS

EU action in the field of budgetary frameworks, while recent, has proceeded at a rapid pace. The aggregation of several self-supporting documents ('six-pack', 'two-pack', Treaty on Stability, Coordination and Governance) forms a legislative block with a clear operational purpose. From the six-pack, Council Directive 2011/85 sets out requirements for Member States' fiscal frameworks with a view to ensuring consistency between national fiscal governance and Treaty provisions on budgetary discipline. The choice of essential minimum requirements seeks to apply the lessons learnt from features that are conducive to good policy-making, while allowing Member States the discretion of applying them in an appropriate way. As it sets uniform standards for all Member States, the Directive requires more significant efforts in Member States like Cyprus, where institutional features have been perceived as being in need of urgent improvement.

Directive 2011/85/EU on Budgetary Frameworks, part of the 'six-pack', stipulates that the reporting of cash-based fiscal data should be conducted each month for the central government and other general government sub-sectors. While the informational content of monthly data taken in isolation may be affected by considerable volatility and noise, the time series can reveal patterns warranting closer surveillance, which the more refined corresponding ESA95 figures would confirm only at a later stage. In Cyprus, monthly data are available for the central government in cash-terms.

Lessons learned highlight the need to complement the EU-wide fiscal rules enshrined in the EU Treaty with national fiscal rules. Such rules provide numerical milestones for national policy-making, increase domestic ownership of shared fiscal goals, and foster transparency and accountability. Failure to set up fiscal rules, as in Cyprus, is conducive to pro-cyclical policies amplifying the effect of the cycle. Boom and bust episodes are particularly harmful in the case of small, open, economies that are heavily dependent on the dynamism of a few critical sectors. Following the signature of the Treaty on Stability, Coordination and Governance (TSCG), the Cypriot authorities adopted a Law on the Medium-Term Budgetary Framework and Fiscal Rules together with the 2013 Budget Law, which stated as a matter of principle that the nominal fiscal position of the general government should be balanced or in surplus. However, setting up fiscal rules is not a panacea: timely monitoring and enforcement is paramount to ensure their effectiveness. Since Cyprus does not currently have a fiscal institution that acts as independent referee and provider of economic and fiscal expertise, the Ministry of Finance is expected to submit a proposal to the Council of Ministers for the establishment of such a fiscal institution.

Although the approval of the annual budget law remains the key instrument for adopting fiscal policy decisions, most fiscal measures have budgetary implications that go well beyond the yearly budgetary cycle. The use of a multi-annual perspective should also allow stakeholders to better understand the inter-temporal trade-offs of national fiscal strategies, while deterring electoral-cycle strategies in the process. The MTBF law provides for the establishment of a Medium-Term Budgetary Framework. The full implementation of the MTBF law should effectively anchor the principles of multi-annual fiscal planning in the Cypriot fiscal planning.

In March 2013, the European Parliament and the Council agreed on the details of the so-called 'Two-Pack' regulations applicable to euro-area Member States. The Two-Pack comprises two Regulations designed to further enhance economic integration and convergence amongst euro-area Member States. In the fiscal area, a major innovation of the Two-Pack is that the Commission will examine and give an opinion on each draft budget by 30 November at the latest. If the Commission detects severe non-compliance with the obligations under Stability and Growth Pact, it will ask the Member State concerned to submit a revised plan. For the euro area as a whole, the Commission will publish a comprehensive assessment of the budgetary outlook for the coming year. The Commission's opinions on national budgets and on the euro area will facilitate discussions in the Eurogroup. Importantly, the Two-Pack will also enhance the soundness of national budgetary processes by obliging Member States to base their draft budgets on independent macroeconomic forecasts and ensure independent bodies are in place to monitor compliance with national fiscal rules. Such provisions are especially relevant for Cyprus and provide further support to the policy initiatives included in the Directive on Budgetary Frameworks and the TSCG.

86. **A reform of the welfare system will streamline the broad range of individual benefits provided, while protecting disadvantaged people.** While lowering or abolishing a number of benefits and tightening means-testing criteria, the reform will ensure a proper balance between welfare benefits and incentives to take up work. To improve the consistency of the welfare system, common definitions for means-testing will be introduced.

87. **The Cypriot authorities will initiate a privatisation plan to help improve economic efficiency through enhanced competition and encouragement of capital inflows, and to help restore debt sustainability.** The privatisation plan will yield EUR 1 bn by end of the programme and an additional EUR 0.4 bn by 2018. This plan should consider the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC

(electricity), CPA (ports), as well as real estate/land assets. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and appropriate secondary legislation rules. Successful privatisations as part of a wider structural reform programme can improve economic efficiency and overall productivity. The proceeds from privatisation may not only contribute directly to a reduction in government debt, but can also increase the prospects for sustainably lower funding conditions for the government, with positive effects on the debt-to-GDP ratio.

88. **As a first step towards greater efficiency and effectiveness of SOEs, Cyprus will establish an inventory of assets**, indicating possibilities for divestments, restructuring and liquidation. The authorities will prepare a plan to strengthen the governance of SOEs in accordance with international best practices and submit a law to regulate the creation and functioning of SOEs at the central and local levels and to enhance their monitoring. This will be done in conjunction with the agreed privatisation plan.

89. **Other flanking reforms should provide added value**. The establishment of an independent Fiscal Council should strengthen the credibility of the Cypriot framework by providing an alternative source of expertise in budgetary affairs. It should in particular deliver regular assessments on the functioning of national fiscal rules and provide its input to the forecasting process. Independent monitoring and assessment are warranted given the inevitable challenges the revamped framework will face in its first years of existence. Besides, against the background of stringent fiscal consolidation needs, expenditure control is likely to remain high on the agenda. As a priority, Cypriot authorities should make sure that top-down budgeting procedures are firmly in place.

90. **Income streams from the future exploitation of the offshore gas will be deposited in a resource fund backed up by sound revenue rules**. In the past, such revenues have proved to be a mixed blessing in many countries, since they amplified boom and bust cycles, encouraged poor investment and spending choices, and led to a deterioration in fiscal governance. The establishment of a resource fund to ring-fence the proceeds from gas exploitation would ensure better transparency, accountability and effectiveness in their use. In this context, the authorities have committed to establishing a solid legal base, preparing the set-up of a best-practice resource fund for revenues from offshore gas exploitation.

91. **A comprehensive property tax reform will be implemented in 2014.** The new property tax will make use of an area-based index that establishes the average market values of 2013. At the same time, existing exemptions and derogations from property taxation will be reviewed.

4.5. STRUCTURAL REFORMS

92. **The structural reforms laid down in the MoU are designed to support a recovery of competitiveness and the return to a sustainable and balanced growth path.** Reforms of the labour market are designed to mitigate the impact of the crisis on employment and to support a strengthening of competitiveness. Well-targeted reforms will improve business conditions in high added-value sectors, namely tourism and financial services. Removing unjustified obstacles in services markets is another key factor, in particular for the services-intensive economy of Cyprus. For the proper functioning of the housing market, it is essential to improve the regulation of administration related to the real estate sector. Finally, the authorities commit to setting the right conditions now for reforming Cyprus' energy market. This is paramount to ensuring that Cyprus will enjoy all benefits from the exploitation of the domestic offshore natural gas potential, which in the medium- to long term offers the prospect for reducing Cyprus' energy import dependency and improving the security and sustainability of energy supply. This would also help to address Cyprus' sustained current account deficit and high public debt.

93. **To improve real wage adjustment, reflecting developments in labour productivity and competitiveness, the authorities have agreed to reform the wage-setting framework for the public**

and private sector. The application of the Cost of living adjustment (COLA) in the public sector has been suspended for the full programme period (end-2016). In the meantime, a reform of the COLA will reduce the frequency of adjustment (once instead of twice per year), will introduce a mechanism for automatic suspension during adverse economic conditions and move from full to partial indexation of 50%. A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector. Further labour market reforms will focus on policies aiming at activating benefit recipients and improving incentives to work. In particular, measures will aim at facilitating the reinsertion of unemployed in the labour market, reducing disincentives to work and imposing job-search requirements for continued benefit receipt. Any change in the minimum wage covering specific professions and categories will take place only upon consultation and agreement with the programme partners.

94. **Issues concerning the functional organisation of the public sector need to be urgently addressed**. These include: (1) obstacles to staff mobility between public departments/entities; (2) the large share of overtime and shift payments in the wage bill, which indicates a suboptimal working-time organisation; (3) the large range of allowances, which add the wage bill; and (4) the weak link between the staff appraisal system and wages and promotions. Further areas also warranting review include the appropriate remuneration and working conditions in relation to the private sector, the potential for development of part-time work, the potential for streamlining staff categories, and the appropriateness of the pay and working conditions for semi-governmental organisations.

95. **Restrictions in services sectors will be lifted to the greatest extent possible**. Entry barriers and operation restrictions generate inefficiencies and excess profits in protected sectors. Ensuring the complete transposition of the EU Services Directive will address this, notably by lifting restrictions on cross-border providers and removing limits to competition, including in the tourist sector, and professional services such as architects, engineers and lawyers. Amendments will be presented to the House of Representatives and minimum tariff requirements without justification should be abolished by June 2013.

96. **As a first essential step towards a properly functioning housing market, the authorities commit to substantially reducing the backlog in the issuance and transfer of title deeds.** Cooperation with the financial sector in that regard will be enhanced. Furthermore, the authorities will ensure electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the financial sector and government services. To enhance efficiency in the seizure of property collateral, the forced sale of mortgaged property procedure should be amended and allow for private auctions within the shortest feasible timespans. The pace of court case handling should improve and court backlogs should be eliminated. Guaranteed timeframes for the issuance of building certificates and title deeds will be implemented.

97. **Tourism is a crucial export sector and is of great importance to domestic value added and employment**. Since 2011, tourism has experienced a significant increase in tourism arrivals and incomes, while the prospects for the continuation of that upward trend in 2013 are excellent. In particular, in 2011, there was an increase of 10.1% in tourism arrivals and 12.9% in revenue growth compared to 2010, while in 2012 (latest data August) there was a further increase of 5% and 8.5% respectively compared to 2011. To strengthen the competitiveness of the tourism sector, the Cypriot authorities will carry out a study on how to improve the tourism sector business model. The Tourism Strategy for 2011-2015 will be reviewed and, if necessary, revised based on the study's findings. The authorities will also facilitate condo hotel projects with the aim of enhancing access to financing investment in hotel development, including the removal of any legal impediments and in order to enhance attractiveness of the country as a destination, the authorities will engage in a thorough analysis of the best means of achieving sufficient air connectivity for Cyprus, including by negotiating new or amending existing air services agreements.

98. **With a view to ultimately ensuring diversification of the energy mix, which will reduce dependency on imported oil (and hence the energy trade deficit), the authorities commit to implementing a number of important preparatory steps.** They will, without delay, complete the transposition and full implementation of the Third Energy Package and notify this to the Commission. They will also indicate the date of delivery of the first commercial supply of natural gas under a long-term supply contract. In addition, a study will be carried out to examine the financial aspects of the transition towards gas exploitation, use and exports. Lastly, Cyprus will provide an outline of the regulatory regime and market organisation, which would be conducive to the introduction and proper functioning of open, transparent,

competitive energy markets. In order to be able to take advantage of the full potential benefits, the energy sector needs to be transformed, as regards infrastructure, market organisation and functioning, and energy connections with other countries. Furthermore, the gas revenues need to be managed well in order to avoid the "resource curse", i.e. the well-known phenomenon that a large influx of resource revenues can lead to inflation and a loss of competitiveness in the rest of the economy, eventually taking its toll on growth and employment. In order to counter these challenges, there is a need for a comprehensive development plan for the transformation of the energy sector as well as the right institutional and budget arrangements for managing the revenues.

99. **The EU co-financed funds will continue to form a strong basis for economic growth**. Preserving the good implementation of Structural and other Union Funds is a priority and appropriate measures are being taken by the banks to ensure the availability of liquidity for enterprises/SMEs, including for the implementation of the EU co-financed projects. The necessary national contribution, including non-eligible expenditure, under the Structural and Cohesion Funds will remain available for the EU co-financed operational programmes in the context of the 2007-2013 and 2014-2020 programming periods. In the course of reforms such as those under the auspices of the public administration review, the Cypriot authorities will try to safeguard the human resources involved in the management and control of the EU co-financed operational programmes, as long as these are strictly necessary. At the same time, the authorities' planned privatisation plan will consider the requirement relating to the durability of EU co-financed operations, pursuant to Article 57 of Council Regulation (EC) N° 1083/2006, whereby EU co-financed projects cannot be privatised before they have been operational for at least five years.

5. PROGRAMME FINANCING

100. **In line with the Eurogroup statements of 16 and 25 March, a total net financing gap of EUR 10 billion will be covered by official lenders until the end of the first quarter of 2016.** [16] Over the three-year period 2Q2013-1Q2016 the Cypriot government faces medium-term as well as long-term net refinancing requirements of EUR 4.1 billion, including loan amortisations of EUR 0.4 bn. Fiscal needs are expected to amount to around EUR 3.4 billion under the programme's macroeconomic scenario. Moreover, it is estimated that bank recapitalisation needs will reach up to EUR 2.5 billion.

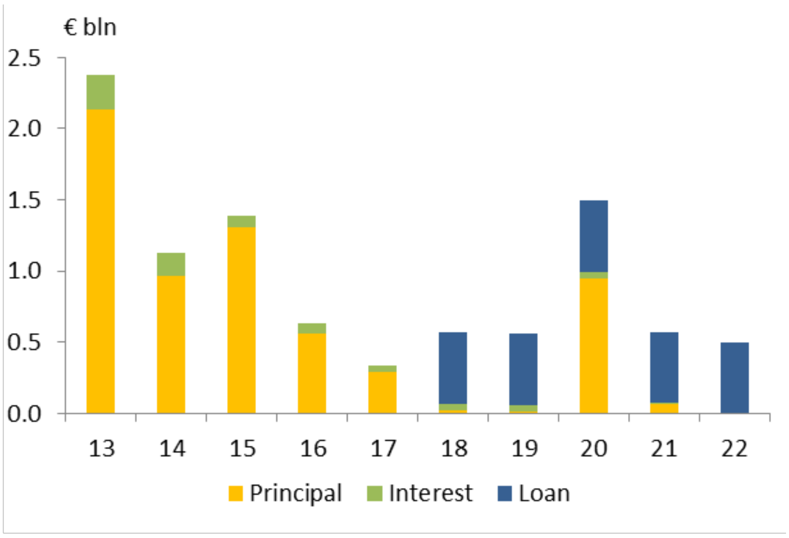
101. **Following the Eurogroup decision of 25 March, the Cypriot authorities have committed to taking significant burden-sharing measures.** In particular the additional bail in of creditors in Laiki bank and Bank of Cyprus will provide an estimated contribution to bank recapitalization needs of EUR 8.3 bn. Moreover, it is envisaged to use the allocation of future central bank profits of approximately EUR 0.4 bn – subject to the principle of central bank independence and provided such profit allocation is in line with CBC rules and does not undermine the CBC duties under the Treaties and the Statute. The Cypriot authorities will also encourage domestic investors (banks, insurance companies and state-owned enterprises) to roll over up to EUR 1 bn of domestic-law bonds (GRDS) that arrive at maturity over the programme horizon, thus reducing external financial assistance for debt redemption by the same amount. Finally, Cyprus will launch a privatisation programme estimated to yield proceeds of EUR 0.5 bn by end-2015, another EUR 0.5 bn in the course of 2016 and an additional EUR 0.4 bn thereafter.

102. **The average maturity of Cyprus's outstanding public debt at the end of 2012 was relatively short.** The weighted average maturity of total outstanding debt (EUR 15.5 billion, of which around 36% in loans), is slightly below 6 years. All outstanding marketable medium-term and long-term debt will be reimbursed by 2021, but repayment is concentrated during the period Q2 2013 – Q1 2016, with about EUR 2 billion in 2013, EUR 1 billion in 2014, EUR 1.3 billion in 2015, and EUR 0.4 billion in Q1 2016. In addition, the envisaged use of the allocation of future central bank profits – subject to the principle of central bank independence and provided such profit allocation is in line with CBC rules and does not undermine the CBC duties under the Treaties and the Statute – and privatisations are expected to amount

[16] Further details regarding estimates of programme financing needs can be found in the annex.

to around EUR 1 billion. Finally, the authorities will encourage domestic bond holders to roll over at the same terms up to EUR 1 billion in domestic-law bonds that arrive at maturity over the Programme horizon.

Graph 25: Debt amortisations and sovereign maturing debt



Note: IMF and EU support needs to be repaid. Graph includes RU loan repayment as of 2018.

103. **The Programme will be financed through contributions from the ESM (EUR 9 billion) and the IMF (EUR 1 billion)**. The ESM loan will cover financial sector needs (EUR 2.5 billion provided in a cash-less transaction) and EUR 6.5 billion of fiscal and debt redemption needs. The IMF will provide its share for fiscal needs as a loan under the Extended Fund Facility.

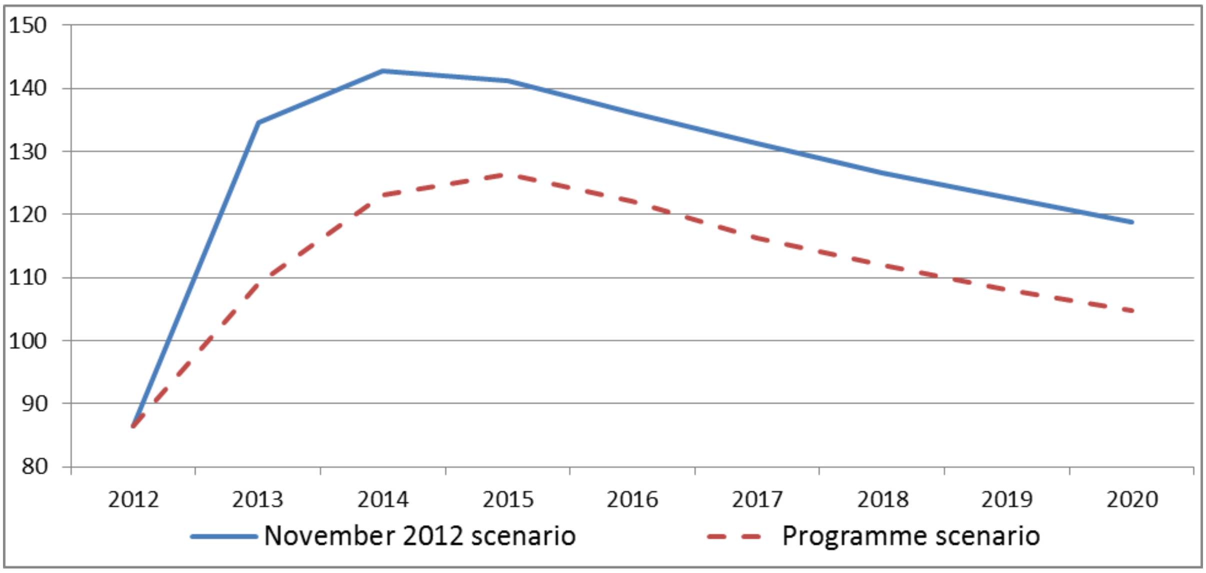
Box 8: Debt sustainability assessment for Cyprus

This box assesses the sustainability of the Cypriot sovereign debt in light of the latest macroeconomic developments and the measures agreed by the Eurogroup on 25 March 2013. The forecast of the evolution of the Cypriot government debt-to-GDP ratio up to 2020 is based on assumptions on economic growth, fiscal performance, other financial flows and debt reducing measures, such as privatisation receipts, recapitalisation of the banking sector, as well as on official and market financing interest rates. The analysis suggests that the debt outlook is challenging, but that a sustainable debt trajectory can be reached, provided that there is strong implementation of the Adjustment Programme. The debt-to-GDP ratio is expected to peak in 2015 at around 126% of GDP and then to steadily decrease to around 105% of GDP in 2020.

In Graph 26, the Nov. 2012 scenario is based on the Commission services' winter 2013 forecast including EUR 10 bn re-capitalisation of the Cypriot banking system, while the "programme" scenario is based on the agreed draft MoU (April 2013).

Under the November 2012 scenario, the debt would have peaked at around 143% in 2014 and would then decline to just below 120% of GDP by 2020. Taking into account the programme's macroeconomic projection and under the assumption that fiscal targets are met, the debt ratio under the "programme scenario" is expected to peak at around 126% of GDP in 2015. Compared to the Nov. 2012 scenario debt trajectory, the peak in the debt ratio is around 15 pps lower. In the "programme" scenario, the front-loaded fiscal consolidation measures will not be able to offset the impact on debt of the significant decline in GDP and the recapitalisation of the banking sector. From 2015 onwards, a growing primary surplus and the return to positive GDP growth will bring the debt ratio on to a declining path, reaching around 122% of GDP at the end of 2016 and around 105% of GDP in 2020.

Graph 26: Debt trajectories under the "programme" scenario and the "November 2012 scenario"



Note: The Nov. 2012 scenario is based on the Commission services' winter 2013 forecast including EUR 10 bn re-capitalisation of the Cypriot banking system, while the "programme" scenario is based on the agreed draft MoU (April 2013).

Source: Commission services

The "programme" scenario takes into account a number of policy measures to strengthen debt sustainability, including, inter alia, the proceeds generated by privatisation of state-owned assets. As far as the total re-capitalisation needs for banking sector institutions are concerned, the programme scenario incorporates the effect of (i) the resolution of Laiki bank and the bail-in of the uninsured depositors; (ii) the deposit-to-equity swap of the uninsured depositors in Bank of Cyprus; and (iii) the carve-out of the Greek assets of Laiki Bank, Bank of Cyprus and Hellenic Bank.

Debt projections are sensitive to macroeconomic developments, in particular deviations in the projected nominal GDP path and the fiscal balance. Graph 27 shows a sensitivity analysis of the programme scenario. The panel depicts, respectively, the impact of a 1 pp change in annual GDP growth each year during 2013-16, the impact of a 1 pp change in primary fiscal balance each year during 2013-16 and the impact of a 2 pp change in market interest rate on new and rolled-over debt during 2013-2020, as well as the impact on the projected debt ratio of a combined shock.

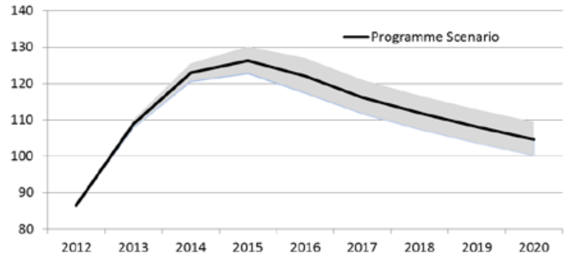
In spite of the sound foundations of the programme, **there are downside risks to the projected debt developments during and after the Programme period**, which are linked in particular to: (i) a possible stronger contraction of the economy, steeper drop in real estate prices, and further worsening of the labour market outlook, especially if the banking-sector downsizing and administrative restrictions will result in a more protracted period of low confidence and credit contraction (Graph 27a); (ii) non-attainment of the agreed primary surplus targets established in the programme (Graph 27b); (iii) insufficient implementation of fiscal-structural measures to underpin the attainment of continued high primary surpluses; (iv) lower-than-expected privatisation proceeds; (v) a less tax-rich composition of growth and possibly stronger sensitivity of revenues to the structural adjustment of the Cypriot economy; (vi) a worsening of the economic situation in trade-partner economies; and (vii) lack of success in regaining market access at a reasonable borrowing cost after the programme period (Graph 27c).

There are also **upside risks to be taken into account**, albeit difficult to quantify, including: i) the macroeconomic scenario underpinning the programme assumes a pronounced short-term impact of fiscal consolidation on economic activity. However, the Cypriot economy is a small open economy, implying that the impact on growth from consolidation could be comparatively small, while the benefits of confidence-enhancing fiscal and structural reform measures may be comparatively large; ii) the future exploitation of Cyprus' offshore gas fields is expected to increase government revenues both directly and via increased economic activity. These effects are excluded from the current debt projections as the size of these natural resource revenues remains uncertain. Overall, although both the timing and size of the revenues remain uncertain, exploitation of Cyprus' natural resources constitute a significant upside risk to debt sustainability; and iii) the agreed and planned structural reforms will lead to a fall in long-term expenditures especially in the area of pensions. The agreed increases in retirement ages and other parametric changes to the pension system and the health care system will contribute to containing the growth in public expenditure..

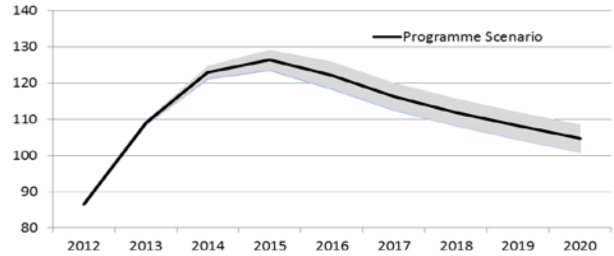
The projections carried out by the Commission services, in liaison with the ECB, on the basis of the financial, fiscal and macroeconomic parameters of the draft MoU, suggest that Cyprus' debt outlook is challenging, but will allow Cyprus' public debt to remain on a sustainable path, provided that there is strong implementation of the Adjustment Programme.

Graph 27: Programme scenario sensitivity analyses

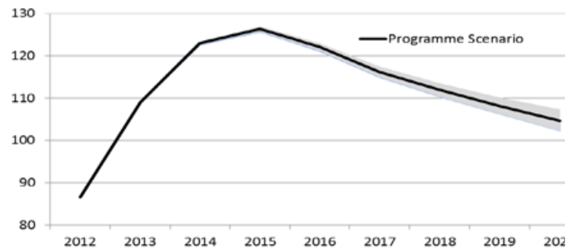
a. Real GDP growth (+/- 1p.p.)



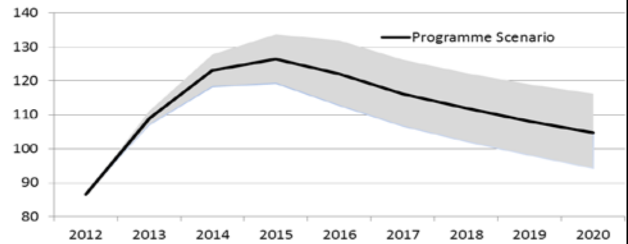
b. Primary Balance (+/- 1p.p.)



c. Interest rate (+/- 2 p.p.)



d. Combined effect (a+b+c)



Source: Commission services

6. THE RISKS AHEAD

The achievement of Programme targets is subject to the following risks:

- a possible stronger contraction of the economy, a steeper drop in real estate prices, and further worsening of the labour market outlook, especially if the banking sector downsizing and administrative restrictions results in a more protracted period of low confidence and credit contraction;
- non-attainment of the agreed primary surplus targets established in the Programme;
- insufficient implementation of fiscal-structural measures to underpin the attainment of continued high primary surpluses;
- lower-than-expected privatisation proceeds;
- a less tax-rich composition of growth and possibly stronger sensitivity of revenues to the structural adjustment of the Cypriot economy;
- a worsening of the economic situation in trade-partner economies; and
- lack of success in regaining market access at a reasonable borrowing cost after the programme period.

7. PROGRAMME MONITORING AND IMPLEMENTATION

104. **Progress in Programme implementation will be monitored by the EC, ECB and IMF teams through quarterly programme reviews**. Fiscal performance will be assessed through updated forecasts and quantitative performance criteria (related to fiscal consolidation in particular). Compliance with measures regarding the financial sector and other macroeconomic and structural policies will be assessed against the conditionality and timetable in the Memorandum of Understanding as also laid down in the Council Decision of 23 April 2013 on granting Union financial assistance to Cyprus. If the deficit deadline is extended, the Commission will furthermore monitor compliance with the relevant Council Recommendation 8609/2013 addressed to Cyprus on specific measures to restore financial stability and sustainable growth in accordance with Articles 126(7) TFEU under the EDP.

8. ANNEX – PROGRAMME DOCUMENTS

Commission services' macroeconomic projections

Programme documents:

Memorandum of Understanding on Specific Economic Policy Conditionality (MoU)

Assessment of the actual or potential financing needs of Cyprus

Assessment of the public debt sustainability of Cyprus (DSA)

Assessment of the risks to the financial stability of the Euro Area

Letter of Intent

Memorandum of Economic and Financial Policies (MEFP)

Technical Memorandum of Understanding (TMU)

Annex 1: Macroeconomic projections

Overview table

	2009	2010	2011	2012	2013	2014	2015	2016
					% change on previous year			
Real GDP growth	-1.9	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9
Private consumption	-7.5	1.5	0.5	-3.0	-12.3	-5.5	1.7	3.0
Public consumption	6.8	1.0	-0.2	-1.7	-8.9	-3.6	-1.7	-1.5
Fixed investment	-9.7	-4.9	-13.1	-23.0	-29.5	-12.0	2.3	3.4
Domestic demand (contribution)	-6.3	0.2	-2.2	-6.1	-13.7	-5.5	0.9	2.0
Inventories (contribution)	-1.6	1.8	0.5	-0.9	0.0	0.0	0.0	0.0
Exports	-10.7	3.8	4.4	2.3	-5.0	-2.5	1.7	2.7
Imports	-18.6	4.8	-0.7	-7.2	-16.0	-6.5	1.6	3.3
Net trade (contribution)	5.7	-0.7	2.2	4.4	5.0	1.6	0.2	-0.1
Employment	-0.4	-0.2	0.5	-4.1	-6.5	-3.1	1.1	1.3
Unemployment rate	5.4	6.3	7.9	11.9	15.5	16.9	14.6	13.7
GDP deflator	0.1	1.9	2.7	2.0	0.6	1.1	1.5	1.8
HICP inflation	0.2	2.6	3.5	3.1	1.0	1.2	1.6	1.7
Current account (% of GDP)	-10.7	-9.2	-4.8	-4.8	-1.9	-0.6	-0.9	-1.0
Nominal GDP (EUR billion)	16.9	17.4	18.0	17.9	16.4	16.0	16.4	17.0
						level as % of GDP		
General government								
Government balance	-6.1	-5.3	-6.3	-6.3	-6.5	-8.4	-6.3	-2.9
Government balance (EUR billion)	-1.0	-0.9	-1.1	-1.1	-1.1	-1.3	-1.0	-0.5
Primary balance	-3.6	-3.0	-3.9	-3.1	-2.4	-4.3	-2.2	1.2
Interest expenditure	2.6	2.2	2.4	3.2	4.1	4.1	4.2	4.2
Gross debt	58.5	61.3	71.1	85.8	109.5	124.0	127.9	123.9
Gross debt (EUR billion)	9.9	10.7	12.8	15.3	18.0	19.8	20.9	21.0

Source: Commission services

Table 1: Use and supply of goods and services (volume)

Annual % change	2009	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	-7.5	1.5	0.5	-3.0	-12.3	-5.5	1.7	3.0
2. Government consumption expenditure	6.8	1.0	-0.2	-1.7	-8.9	-3.6	-1.7	-1.5
3. Gross fixed capital formation	-9.7	-4.9	-13.1	-23.0	-29.5	-12.0	2.3	3.4
4. Final domestic demand	-5.7	0.2	-2.1	-5.9	-13.8	-5.8	1.0	2.1
5. Change in inventories	-0.2	0.1	0.2	0.0	0.0	0.0	0.0	0.0
6. Domestic demand	-7.0	1.9	-1.6	-6.7	-13.8	-5.8	1.0	2.1
7. Exports of goods and services	-10.7	3.8	4.4	2.3	-5.0	-2.5	1.7	2.7
7a. - of which goods	-16.2	12.2	22.6	1.0	-1.9	-0.4	1.9	2.8
7b. - of which services	-9.7	2.4	1.2	2.6	-5.6	-3.0	1.7	2.7
8. Final demand	-8.1	2.4	0.1	-4.0	-11.0	-4.7	1.3	2.3
9. Imports of goods and services	-18.6	4.8	-0.7	-7.2	-16.0	-6.5	1.6	3.3
9a. - of which goods	-19.7	7.3	-4.0	-10.0	-19.2	-8.3	1.6	3.3
9b. - of which services	-16.1	-0.4	6.8	-1.4	-10.0	-3.5	1.7	3.3
10. Gross domestic product at market prices	-1.9	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9
Contribution to change in GDP								
11. Final domestic demand	-12.7	3.6	0.1	-5.9	-15.9	-6.7	1.8	3.3
12. Change in inventories + net acq. of valuables	-1.6	1.8	0.5	-0.9	0.0	0.0	0.0	0.0
13. External balance of goods and services	5.7	-0.7	2.2	4.4	5.0	1.6	0.2	-0.1

Table 2: Use and supply of goods and services (value)

Annual % change	2009	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	-6.9	3.7	3.9	-0.5	-11.5	-4.2	3.2	4.8
2. Government consumption expenditure	9.9	2.6	3.5	-0.5	-8.1	-2.3	-0.1	0.2
3. Gross fixed capital formation	-12.1	-3.7	-11.8	-21.9	-28.7	-10.9	4.0	5.3
4. Final domestic demand	-5.2	2.0	1.0	-3.9	-13.1	-4.5	2.6	3.9
5. Change in inventories	-0.2	0.1	0.2	0.0	0.0	0.0	0.1	0.1
6. Domestic demand	-6.6	3.8	1.4	-4.7	-13.0	-4.5	2.7	4.0
7. Exports of goods and services	-12.5	6.1	6.6	4.5	-3.5	-1.2	3.1	4.3
8. Final demand	-8.3	4.5	2.9	-2.0	-10.0	-3.4	2.9	4.1
9. Imports of goods and services	-19.8	7.0	2.1	-5.1	-14.0	-4.5	3.5	5.0
10. Gross national income at market prices	-4.8	4.4	7.2	-4.8	-5.0	-3.4	1.5	3.0
11. Gross value added at basic prices	-0.1	3.8	3.9	-0.3	-11.2	-2.6	2.4	3.2
12. Gross domestic product at market prices	-1.8	3.3	3.3	-0.5	-8.2	-2.9	2.6	3.7

Table 3: Implicit price deflators

% change in implicit price deflator	2009	2010	2011	2012	2013	2014	2015	2016
1. Private consumption expenditure	0.7	2.1	3.4	2.5	0.9	1.4	1.5	1.8
2. Government consumption expenditure	2.9	1.6	3.8	1.2	0.9	1.3	1.5	1.6
3. Gross fixed capital formation	-2.6	1.2	1.4	1.4	1.1	1.3	1.7	1.8
4. Domestic demand	0.5	1.9	3.1	2.1	0.9	1.4	1.7	1.8
5. Exports of goods and services	-2.0	2.2	2.1	2.2	1.5	1.3	1.3	1.6
6. Final demand	-0.2	2.0	2.8	2.1	1.1	1.4	1.6	1.7
7. Imports of goods and services	-1.5	2.1	2.8	2.3	2.4	2.1	1.8	1.6
8. Gross domestic product at market prices	0.1	1.9	2.7	2.0	0.6	1.1	1.5	1.8
HICP	0.2	2.6	3.5	3.1	1.0	1.2	1.6	1.7

Table 4: Labour market and cost

Annual % change	2009	2010	2011	2012	2013	2014	2015	2016
1. Labour productivity	-0.8	0.8	0.0	1.0	-1.2	-0.5	0.0	0.4
2. Compensation of employees per head	2.5	2.6	3.3	1.6	-7.5	-5.0	-1.8	1.3
3. Unit labour costs	4.1	1.1	3.2	-0.1	-5.4	-4.2	-1.8	0.6
4. Total population	2.7	2.6	2.6	2.7	1.0	1.0	1.0	0.8
5. Population of working age (15-64 years)	2.0	2.9	2.9	1.7	1.0	1.0	0.2	0.3
6. Total employment	-0.4	-0.2	0.5	-4.1	-6.5	-3.1	1.1	1.3
7. Calculated unemployment rate - Eurostat definition (%)	5.4	6.3	7.9	11.9	15.5	16.9	14.6	13.7

Table 5: External balance

levels	2009	2010	2011	2012	2013	2014	2015	2016
1. Exports of goods	1.0	1.1	1.4	1.4	1.4	1.4	1.5	1.5
2. Imports of goods	5.3	5.8	5.8	5.3	4.4	4.1	4.3	4.5
3. Trade balance (goods) (1-2)	-4.3	-4.7	-4.3	-3.9	-3.0	-2.7	-2.8	-2.9
3a. p.m. (3) as % of GDP	-25.5	-26.8	-24.2	-21.6	-18.1	-16.8	-16.9	-17.2
4. Exports of services	5.9	6.2	6.4	6.7	6.4	6.3	6.5	6.8
5. Imports of services	2.5	2.6	2.8	2.8	2.6	2.6	2.7	2.8
6. Services balance (4-5)	3.3	3.6	3.6	3.9	3.8	3.8	3.9	4.0
6a. p.m. 6 as % of GDP	19.8	20.6	19.9	21.6	23.3	23.6	23.6	23.6
7. External balance of goods & services (3+6)	-1.0	-1.1	-0.8	0.0	0.9	1.1	1.1	1.1
7a. p.m. 7 as % of GDP	-5.7	-6.2	-4.3	0.1	5.2	6.8	6.6	6.4
8. Balance of primary incomes and current transfers	-0.9	-0.5	-0.1	-0.9	-1.2	-1.2	-1.2	-1.3
8a. - of which, balance of primary income	-0.7	-0.6	0.1	-0.7	-1.3	-1.3	-1.5	-1.7
8b. - of which, net current transfers	-0.1	0.0	-0.2	-0.2	0.1	0.2	0.3	0.4
9. Current external balance (7+8)	-1.8	-1.6	-0.9	-0.9	-0.3	-0.1	-0.1	-0.2
9a. p.m. 9 as % of GDP	-10.7	-9.2	-4.8	-4.8	-1.9	-0.6	-0.9	-1.0
10. Net capital transactions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11. Net lending (+)/ net borrowing (-) (9+10)	-1.8	-1.6	-0.8	-0.9	-0.3	-0.1	-0.2	-0.2
11a. p.m. 11 as % of GDP	-10.6	-9.0	-4.6	-4.8	-2.1	-0.7	-0.9	-1.0

Table 6: Fiscal accounts

	2009	2010	2011	2012	2013	2014	2015	2016
				% of GDP				
Indirect taxes	15.2	15.4	14.5	14.8	14.1	13.8	14.0	14.4
Direct taxes	11.2	11.1	11.7	11.1	10.9	10.8	10.8	10.9
Social contributions	8.7	8.9	8.7	9.1	8.5	8.0	7.7	7.7
Sales	4.9	5.4	4.7	4.9	7.1	6.4	6.9	7.8
Other current revenue	2.5	2.8	2.3	2.2	4.0	3.5	4.0	5.0
Total current revenue	40.0	40.8	39.6	39.9	40.6	39.0	39.3	40.7
Capital transfers received	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total revenue	40.1	40.9	39.7	40.0	40.6	39.1	39.4	40.8
Compensation of employees	16.2	15.8	16.0	15.8	15.8	15.4	14.9	14.3
Intermediate consumption	5.4	5.6	5.3	5.1	5.3	5.7	5.6	5.5
Social transfers in kind via market producers	0.2	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Social transfers other than in kind	13.3	14.2	14.6	15.0	15.7	16.3	15.8	15.0
Interest paid	2.6	2.2	2.4	3.2	4.1	4.1	4.2	4.2
Subsidies	0.2	0.4	0.5	0.5	0.6	0.6	0.6	0.5
Other current expenditure	2.9	2.5	2.8	2.7	2.2	2.0	1.5	1.2
Total current expenditure	40.7	40.9	41.5	42.3	43.7	44.2	42.6	40.7
Gross fixed capital formation	4.2	3.8	3.5	2.7	2.0	1.8	1.8	1.8
Other capital expenditure	1.3	1.5	1.0	1.3	1.4	1.4	1.3	1.2
Total expenditure	46.2	46.2	46.0	46.3	47.1	47.5	45.7	43.7
General Government balance	-6.1	-5.3	-6.3	-6.3	-6.5	-8.4	-6.3	-2.9
Underlying Government balance (EDP)	-6.1	-5.3	-6.3	-6.3	-6.5	-8.4	-6.3	-2.9
				EUR billion				
Indirect taxes	2.6	2.7	2.6	2.6	2.3	2.2	2.3	2.4
Direct taxes	1.9	1.9	2.1	2.0	1.8	1.7	1.8	1.8
Social contributions	1.5	1.6	1.6	1.6	1.4	1.3	1.3	1.3
Sales	0.8	0.9	0.9	0.9	1.2	1.0	1.1	1.3
Other current revenue	0.4	0.5	0.4	0.4	0.7	0.6	0.7	0.8
Total current revenue	6.7	7.1	7.1	7.1	6.7	6.2	6.4	6.9
Capital transfers received	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total revenue	6.8	7.1	7.1	7.2	6.7	6.2	6.4	6.9
Compensation of employees	2.7	2.8	2.9	2.8	2.6	2.5	2.4	2.4
Intermediate consumption	0.9	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Social transfers in kind via market producers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social transfers other than in kind	2.2	2.5	2.6	2.7	2.6	2.6	2.6	2.5
Interest paid	0.4	0.4	0.4	0.6	0.7	0.7	0.7	0.7
Subsidies	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other current expenditure	0.5	0.4	0.5	0.5	0.4	0.3	0.2	0.2
Total current expenditure	6.9	7.1	7.5	7.6	7.2	7.1	7.0	6.9
Gross fixed capital formation	0.7	0.7	0.6	0.5	0.3	0.3	0.3	0.3

Other capital expenditure	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditure	7.8	8.0	8.3	8.3	7.7	7.6	7.5	7.4
General Government balance	-1.0	-0.9	-1.1	-1.1	-1.1	-1.3	-1.0	-0.5
Underlying Government balance (EDP)	-1.0	-0.9	-1.1	-1.1	-1.1	-1.3	-1.0	-0.5

Table 7: Debt developments

	2009	2010	2011	2012	2013	2014	2015	2016
Government deficit (% of GDP)	-6.1	-5.3	-6.3	-6.3	-6.5	-8.4	-6.3	-2.9
Government gross debt (% of GDP)	58.5	61.3	71.1	85.8	109.5	124.0	127.9	123.9
				levels, EUR billion				
Government balance	-1.0	-0.9	-1.1	-1.1	-1.1	-1.3	-1.0	-0.5
Gross debt	9.9	10.7	12.8	15.3	18.0	19.8	20.9	21.0
Change in gross debt	1.5	0.8	2.1	2.6	2.6	1.8	1.1	0.1
Nominal GDP	16.9	17.4	18.0	17.9	16.4	16.0	16.4	17.0
Real GDP	14.9	15.1	15.2	14.8	13.5	13.0	13.1	13.4
Real GDP growth (% change)	-1.9	1.3	0.5	-2.4	-8.7	-3.9	1.1	1.9
Change in growth rate (pps. of GDP)	-5.4	3.2	-0.8	-2.9	-6.3	4.8	5.0	0.8
Stock-flow adjustments (% of GDP)	2.6	-0.6	5.4	8.1	9.6	2.9	0.6	-2.4
				% of GDP				
Gross debt ratio	**58.5**	**61.3**	**71.1**	**85.8**	**109.5**	**124.0**	**127.9**	**123.9**
Change in gross debt ratio	-	2.8	9.7	14.7	23.7	14.5	3.8	-4.0
				Contribution to change in gross debt				
Primary balance	3.6	3.0	3.9	3.1	2.4	4.3	2.1	-1.2
"Snow-ball" effect	3.4	0.4	0.4	3.5	11.7	7.4	1.1	-0.4
of which								
Interest expenditure	*2.6*	*2.3*	*2.4*	*3.2*	*4.1*	*4.2*	*4.2*	*4.2*
Real growth effect	*0.9*	*-0.8*	*-0.3*	*1.8*	*8.1*	*4.5*	*-1.3*	*-2.4*
Inflation effect	*0.0*	*-1.1*	*-1.7*	*-1.4*	*-0.5*	*-1.2*	*-1.8*	*-2.2*
Stock-flow adjustments	**2.6**	**-0.6**	**5.4**	**8.1**	**9.6**	**2.9**	**0.6**	**-2.4**
Implicit interest rate	*5.1*	*4.0*	*4.0*	*4.4*	*4.3*	*3.7*	*3.4*	*3.4*

Memorandum of Understanding on Specific Economic Policy Conditionality

The economic adjustment programme will address short- and medium-term financial, fiscal and structural challenges facing Cyprus. The key programme objectives are:

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls, in line with the political agreement of the Eurogroup of 25 March 2013;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit as soon as possible, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector reform

Key Objectives

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece. However, many of the sector's problems are home-grown and relate to overexpansion in the property market as a consequence of the poor risk management practices of banks. Furthermore, the financial sector is vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector would benefit from a considerable downsizing and restructuring in order to restore its solvency and viability, reinforce its resilience and regain public confidence.

Progress to date

The domestic banking sector, including the cooperative credit institutions, represented until recently 550% of GDP. The necessary downsizing and restructuring of the banking sector is already under way. The House of Representatives adopted legislation on 22 March 2013 establishing a comprehensive framework for the recovery and resolution of credit institutions, drawing, inter alia, on the relevant proposal of the European Commission[17] (EC). Under the terms of that legislation, the Central Bank of Cyprus (CBC) is the single resolution authority for banks and cooperative credit institutions alike. Using this new framework, the Cypriot authorities have proceeded with (i) the carve-out of the Greek operations of the largest Cypriot banks, (ii) the resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus and (iii) the recapitalisation of the Bank of Cyprus through a debt to equity conversion, without the use of public money. As a result of these actions, the Cypriot banking sector was downsized immediately and significantly to 350% of GDP and the Bank of Cyprus has been fully recapitalised in order to regain its eligible counterparty status for the purpose of its participation in regular Eurosystem monetary policy operations. Further downsizing will be achieved through the restructuring of the cooperative credit institutions. To preserve the liquidity of the Cypriot banking sector, administrative measures have also been imposed.

A. Regulation and supervision

Maintaining liquidity in the banking sector

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[17] http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#framework2012

1.1. As bank liquidity was under pressure, exceptional measures were necessary with a view to preventing large deposit outflows and preserving the solvency and liquidity of the credit institutions. Cash withdrawals, electronic payments and transfers abroad were temporarily restricted. The implementation of these measures was designed to minimise disruptions in the payment systems, and to ensure the execution of transactions essential for the functioning of the economy. The Government committed to managing the introduction and implementation of restrictions in line with the rules on the free movement of capital set out in the Treaty on the Functioning of the European Union. The impact of the restrictions will be monitored on a daily basis with full information sharing with the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). The restrictions on capital movements will be gradually relaxed, after consultation with the EC, the ECB and the IMF and will remain in place no longer than is strictly necessary to mitigate serious risks for the stability of the domestic financial system. A Monitoring Board comprising the EC, the EBA and the Cypriot authorities is being established to ensure the monitoring and assessment of the implementation of the temporary capital controls.

1.2. Furthermore, the Cypriot authorities will encourage banks to strengthen their collateral and liquidity buffers. The CBC, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector and will stand ready to take appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules.

1.3. The authorities will request domestic banks relying on central bank funding or receiving state aid to establish and submit, quarterly, medium-term funding and capital plans, to be communicated at the end of each quarter, **starting from June 2013**, to the CBC, which will be transmitted to the ECB, the EC, the European Stability Mechanism (ESM) and the IMF. The plans should realistically reflect the anticipated deleveraging in the banking sector and reduce dependency on borrowing from the central banks, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the CBC, in coordination with the ECB.

1.4. The lack of concentration limits in the liquidity framework for euro-denominated assets allowed a concentrated exposure of Cypriot banks to Greek sovereign debt. To avoid similar outcomes in the future, the CBC will update the liquidity regulations **by December 2014**, after consultation with the ECB, the EC and the IMF.

<u>Regulation and supervision for banks and cooperative credit institutions</u>

1.5. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. Based on a report commissioned to an independent expert, the necessary legislative changes will be submitted to the House of Representatives **by mid-2014** and implemented **by end-2014**, macroeconomic conditions permitting.

1.6. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. The CBC's guidance on the classification of loans as non-performing will be amended to include all loans past due by more than 90 days. This amendment will be introduced **by 30 May 2013**. The time series for non-performing loans will be published including historical observations reaching as far back as possible.

1.7. The CBC will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears and will help monitor credit risk and large exposures. The legal framework for the credit register will be set up **by 30 September 2013** and the central credit register will be operational **by 30 September 2014**.

1.8. After analysis of the results from the due diligence exercise and taking into account best practices in the implementation of the International Financial Reporting Standards, the CBC will review, **by end-September 2013**, its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this review and to the existing regulatory and accounting framework in the EU, regulatory amendments will be introduced, drawing on technical assistance, with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force **by end-March 2014**.

1.9. Legislation will be passed **by end-September 2013** to strengthen banks' governance by prohibiting commercial banks and cooperative credit institutions from lending to independent board members, including their connected parties, and removing any board members in arrears on existing debts to their banks, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the CBC. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.

1.10. The CBC will introduce mandatory supervisory action based on capitalisation levels, drawing upon technical assistance and international best practices **by end-March 2014**.

1.11. The CBC will implement a unified data reporting system for the banks and the cooperative credit institutions **by end-June 2013**. The publication of the statistical data will be extended to the cooperative credit institutions, for which the CBC will disclose aggregate data covering the same elements as for banks, including balance sheet items, income statements and prudential indicators.

1.12. Stress-testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments. Supervisory stress-tests will be carried out at an annual frequency, with the first exercise completed **before end-June 2014**.

1.13. Cooperative credit institutions play a significant role in the domestic economy and an important objective of the programme is to strengthen the cooperative credit sector. Due to its economic relevance and legal specificities, as well as deficiencies in risk assessment, this segment of the financial sector requires stronger regulation and supervision. The Cypriot authorities will align the regulation and supervision of cooperative credit institutions to that of commercial banks. Since December 2012, the supervision of cooperative credit institutions is being conducted independently of considerations for the development of this sector. The supervision of cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and integrated into the CBC **by end-July 2013**, for which legislation will be passed **by end-June 2013**. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, a time-bound, actionable plan to achieve this **by end-June 2013**. **By end-May 2013** legislation will be introduced to authorise the CBC to instruct the current cooperative credit sector supervisor to intervene also at the level of individual cooperative credit institutions.

1.14. The accounts of cooperative credit institutions, above a size to be decided by the CBC after consultation with the EC, the ECB and the IMF, will be subject to an independent annual audit by an external, recognised and independent auditing firm. The CBC will have the right to overturn the selection of an auditor by any cooperative credit institution.

Monitoring of corporate and household indebtedness

1.15. The Cypriot authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including information on the distribution of assets and liabilities across households, and an assessment of debt-servicing capacity and refinancing activities. Data from surveys will be used until the credit register becomes fully operational. The Financial Stability Report, to be published on a yearly basis **as of December 2013**, will include an extended analysis on corporate and household indebtedness. These enhanced monitoring actions will be put in place by **end-June 2013**.

1.16. Measures will be taken to deal with troubled borrowers following the implementation of the resolution and recapitalisation of weak banks. A framework for targeted private-sector-debt restructuring will be established to facilitate new lending, and diminish credit constraints. Ways will be explored to improve the funding constraints of SMEs. First, **by end-April 2013** a directive will be circulated by the CBC to recommend banks to provide a grace period of 60 days without penalties to pay interest only on loans coming due. This legislation aims to prevent disruptive effects in related payments throughout the whole economy. Second, legislation will be passed, if needed, to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers. Third, **by end-June 2013** the Cypriot authorities will develop a framework and issue legislation as needed to address legal, administrative or other impediments affecting the restructuring of viable borrowers, while preserving credit discipline. The approach will be based on market-based voluntary workouts, underpinned by measures to strengthen the legal framework to support debt restructuring. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented. Moreover, amendments will be introduced to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring. Finally, a mediation service between banks and their clients to achieve fair debt restructuring will be established **by end-June 2013**.

Increasing financial transparency

1.17. The anti-money laundering (AML) framework will be further strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the Cypriot authorities are committed to further enhancing their standing by taking a number of measures, in line with recommendations made by IMF staff.

- The legal framework will be further revised[18] to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit.
- Following the completion of the April 2013 audit, the findings and recommendations contained in the final reports of MONEYVAL and the auditor will be taken into account in the action plan envisaged in the programme, and the customer due-diligence and suspicious-transaction reporting procedures will be enhanced following the audit report recommendations **by Q2-2013**.
- Furthermore, to address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have committed to an action plan on entity transparency to revise the legal framework and ensure its dutiful implementation, so that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters. To this end, the action plan will envisage that the Cypriot authorities will promptly revise relevant pieces of legislation, including, inter alia, the Trust and Company Services Provider law and the Anti-Money Laundering law **by Q2-2013**. In addition, directives and circulars issued by supervisory authorities (CBC, Cyprus Bar Association, and Institute of Certified Public Accountants of Cyprus) will be revised to lay down clear implementing procedures that are in line with relevant legislation and international standards **by Q2-2013**.
- As part of the action plan, the Cypriot authorities intend to establish trust registers with the supervisory authorities and launch a third-party assessment of the functioning of the Registrar of companies. The trust registers will be for all trusts established under Cyprus law, will be kept by the relevant supervisory authorities in order to enable them to carry out their duties, and will contain the name of the trust and the name and address of the trustee.
- Finally, the supervision department of the CBC will review its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision **by Q4-2013**. In particular, the off-site supervisory tool will include monthly reporting by credit institutions on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

B. Recapitalisation, due diligence, resolution and restructuring

[18] The legal framework was substantially revised in December 2012.

1.18. A Coordination Committee with representatives from the CBC and the Ministry of Finance will be set up to oversee the implementation of the financial sector reform programme and to monitor developments in the banking sector.

Due diligence and restoring adequate capital buffers

1.19. The CBC will increase the minimum Core Tier 1 capital ratio from the present level of 8% to 9% **by 31 December 2013**.

1.20. An international consultant has conducted an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a sample representing about 63% of the cooperative credit institutions' assets, as well as Alpha Bank Cyprus and Eurobank Cyprus. The assessment, which was overseen by a Steering Committee including representatives of the Cypriot authorities, the EC, the ECB, the EBA and the ESM (as members) and the IMF (as observer), started formally on 4 October 2012, with the selection of the external consultant. This due diligence review included both an accounting review and an assessment of the economic value of banks' assets. Its results formed the basis for the bank-by-bank stress tests.

1.21. The bank-by-bank stress tests conducted by the CBC resulted in an overall capital shortfall of EUR 6 billion under a baseline scenario with a Core Tier 1 target ratio of 9% and a shortfall of EUR 8.9 billion under the adverse macroeconomic scenario with a Core Tier 1 target ratio of 6%. These numbers include one foreign bank, but do not include the EUR 1.8 billion of capital already injected by the Cypriot State in Cyprus Popular Bank in June 2012, which will be rolled over, nor do they include the capital needs of those credit cooperative institutions that were not covered by the due diligence exercise. The specific capital needs were communicated to each participating bank on 18 March 2013.

1.22. In response to the results of the due diligence exercise, Bank of Cyprus and Cyprus Popular Bank have been intervened and restructured using the recently-adopted resolution law. The other commercial banks will be instructed by the CBC to take the necessary steps to ensure that they meet regulatory requirements in a stress scenario by end-September 2013. Cooperative credit institutions will be instructed to meet capital regulatory requirements by July 2013. If necessary, public programme funds will be used to recapitalize these institutions in accordance with EU state-aid rules.

Restructuring and resolution of Cyprus Popular Bank and Bank of Cyprus

1.23. The accounting and economic value assessment already mentioned revealed that the two largest banks of Cyprus were insolvent. To address this situation the government has implemented a far-reaching resolution and restructuring plan. In order to prevent the build-up of future imbalances and to restore the viability of the sector, while preserving competition, a fourfold strategy was adopted, which does not involve the use of taxpayer money. The Cypriot authorities will closely monitor the implementation of this strategy.

1.24. First, all Greek-related assets (including shipping loans) and liabilities were carved-out, estimated in the adverse scenario at EUR 16.4 billion and EUR 15.0 billion, respectively. The Greek assets and liabilities were acquired by Piraeus Bank, the restructuring of which will be dealt with by the Greek authorities. The carve-out was based on an agreement signed on 26 March 2013. With the book value of the assets at EUR 19.2 billion, the carve-out has substantially reduced the cross exposures between Greece and Cyprus.

1.25. With respect to the UK branch of Cyprus Popular Bank, all the deposits were transferred to the UK subsidiary of the Bank of Cyprus. The associated assets were folded into the Bank of Cyprus.

1.26. Second, Bank of Cyprus is taking over -via a purchase and assumption procedure- almost the entire Cypriot assets of Cyprus Popular Bank at fair value, as well as the latter's insured deposits and Emergency Liquidity Assistance exposure at nominal value. The uninsured deposits of Cyprus Popular Bank will remain in the legacy entity. The aim is for the value of the transferred assets to be higher than the transferred liabilities with the difference corresponding to the recapitalisation of Bank of Cyprus by Cyprus Popular Bank amounting to 9% of the risk-weighted assets transferred. Bank of Cyprus is being recapitalised to reach a core tier one ratio of 9% under the adverse scenario of the stress test by the end of the programme, which should help to restore confidence and normalise funding conditions. The conversion of 37.5% of the uninsured deposits in Bank of Cyprus into class A shares with full voting and dividend rights provides the largest part of the capital needs with additional equity contributions from the legacy entity of Cyprus Popular Bank. Part of the remaining uninsured deposits of Bank of Cyprus will be frozen temporarily until the completion of the independent valuation referred to in the paragraph below.

1.27. Third, to ensure that the capitalisation targets are met, a more detailed and updated independent valuation of the assets of Bank of Cyprus and Cyprus Popular Bank will be completed, as required by the bank resolution framework, **by end June 2013**. To this end, **no later than mid-April 2013**, the terms of reference of the independent valuation exercise will be agreed in consultation with the EC, the ECB, and the IMF. Following that valuation, and if required, an additional conversion of uninsured deposits into class A shares will be undertaken to ensure that the core tier one capital target of 9 % under stress by end-programme can be met. Should Bank of Cyprus be found to be overcapitalised relative to the target, a share-reversal process will be undertaken to refund depositors by the amount of over-capitalisation.

1.28. Finally given the systemic importance of Bank of Cyprus, it is important that the operations of Cyprus Popular Bank are quickly integrated, operational efficiency is improved, the recovery of non-performing loans is optimised with the work-out implemented by the going concern entity and the funding conditions are progressively normalised. In order to achieve these goals and to ensure that Bank of Cyprus can operate with maximum safeguards to preserve stability and continued viability during a transition period, the CBC, following consultation with the Ministry of Finance, will appoint a new Board of Directors and an acting Chief Executive Officer until Bank of Cyprus' new shareholders are organised in a general meeting. The CBC will require the Board of Directors to prepare a restructuring plan defining the bank's business objectives and credit policies **by end- September 2013**. To ensure that normal business activities are not affected, institutional arrangements will be designed **by end-June 2013** in accordance with Cypriot law to insulate Bank of Cyprus from reputational and governance risks.

Restructuring and recapitalisation of other commercial banks

1.29. Commercial banks with a capital shortfall, which are deemed viable, can, if other measures do not suffice, ask for recapitalisation aid from the State. In order to ensure timely recapitalisation, the Cypriot authorities should submit **by 30 November 2013** restructuring plans for these banks to the EC, which are drawn up in compliance with EU state-aid rules, while also informing the ECB and the IMF.

1.30. Capital should, to the largest extent possible, be raised from private sources including internal measures, asset disposals and liability management exercises. Banks in need of aid from the State will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, including on pay levels of executive and supervisory board members, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. If the recapitalisation takes the form of state aid, funds for the recapitalisation of these banks will be made available in the context of the programme.

Restructuring and recapitalisation of cooperative credit institutions

1.31. With a view to minimising state aid, cooperative credit institutions requiring recapitalisation should seek private sector participation **no later than 31 July 2013**.

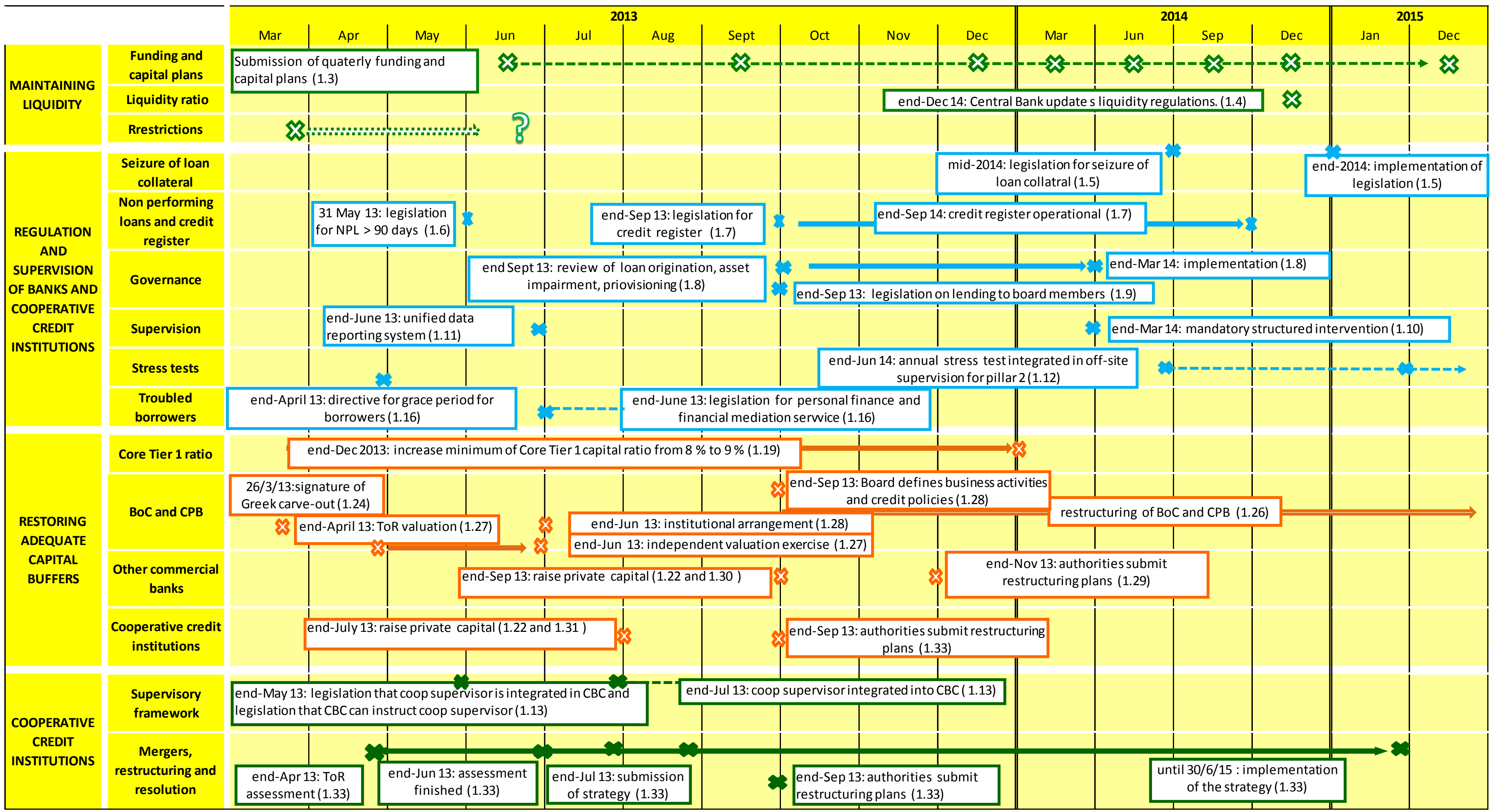
1.32. As regards the cooperative credit institutions, the CBC, assisted by the current supervisor and in consultation with the EC, the ECB and the IMF, will ascertain the viability of individual cooperative credit institutions and design a strategy for restructuring and recapitalising the sector.

1.33. This strategy, including the possibility of the application of mergers and restructuring, will be submitted to the EC, also informing the ECB and the IMF **by end-July 2013** based on an assessment of capital needs and viability to be finalised **by June 2013**. The terms of reference for this assessment will be finalised in consultation with the EC, the ECB and the IMF **by April 2013**. The restructuring plans for the cooperatives will be submitted to the EC **by September 2013**. Cooperative credit institutions in need of aid from the State will not be recapitalised before their restructuring plans have been formally approved under state-aid rules. The terms and remuneration of the state aid will comply with the EU state-aid rules, with due consideration for financial stability. The cooperative credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. Implementation of the strategy should be completed **by 30 June 2015**. Until the overall strategy has been agreed, there will be no change in the structure of the sector, without prior consultation with the EC, the ECB and the IMF.

1.34. Sufficient funds for the recapitalisation of the cooperative credit institutions will be made available from the programme following the first programme review and will be deposited in a dedicated account with the Central Bank to boost confidence in the system. The amounts will be injected following the identification of the capital needs and in accordance with the agreed strategy, after approval of the restructuring plans. A new governance structure will be established, which allocates clear levels of continued accountability and provides for proper incentives to avoid moral hazard, having regard to a two-tier supervisory system applied in other EU Member States.

1.35. Information pertaining to articles 1.4, 1.13, 1.14, 1.32 and 1.33, will also be shared with the ESM.

Time span for conditionality in the financial sector



2. Fiscal policy

Key objectives

Putting public finances on a sustainable path is of overriding importance in order to stabilise the economy and to restore the confidence of companies, citizens and foreign investors in the longer-term economic prospects of Cyprus.

In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation in order to achieve a 3% of GDP primary surplus in 2017, 4% of GDP in 2018 and maintain at least such a level thereafter; (2) to correct the excessive general government deficit as soon as possible; (3) to this end, to fully implement the fiscal consolidation measures listed in Annex 1 and the fiscal consolidation measures for 2013 listed in paragraphs 2.2 – 2.11 below; (4) to achieve the annual budgetary targets as set out in this Memorandum of Understanding (MoU) through high-quality permanent measures, and additional measures in the outer years, in particular to reduce the growth in expenditure on the public sector wage bill, social benefits and discretionary spending, while minimising the impact of consolidation on vulnerable groups; and (5) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 as well as initial steps in relation to fiscal-structural reforms.[19] The authorities commit to the full implementation of these measures (see Annex I) and to monitoring the budgetary effect of the measures taken on a monthly basis. Any deviation from the projected budgetary effect of the measures will be evaluated and addressed accordingly in the quarterly programme reviews, taking into account macroeconomic developments. The fiscal measures taking effect in 2012 were included in the amended 2012 Budget Law, which was submitted to the House of Representatives after consultation with the programme partners (i.e. EC/ECB/IMF). Likewise, the budgetary measures with effect in 2013 were embedded in the 2013 Budget Law after consultation with the programme partners. The impact of the additional permanent measures for 2014 has been embedded in the multi-annual expenditure targets accompanying the 2013 Budget Law.

In the event of underperformance of revenues or higher social spending needs, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse

[19] The adopted bills amounted to consolidation measures of about 5.0% of GDP for 2012-2016, in particular 0.3% of GDP in 2012, 2.3% of GDP in 2013, and 1.9% of GDP in 2014, and ½% of GDP in 2015-2016 based on the macro-economic projections of 23 November 2012.

macroeconomic effects. Over the programme period, cash revenues above programme projections, including any windfall gains,[20] will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

Fiscal policy in 2013

2.1. The Cypriot authorities will achieve a general government primary deficit of no more than EUR 395 million (2.4% of GDP) in 2013. The 2013 deficit target may be revised to incorporate compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing for such compensation.

Over 2013, the Cypriot authorities will rigorously implement the 2013 Budget Law with additional permanent measures of at least EUR 351 million (2.1% of GDP).

After consultation with the programme partners, the 2013 Budget Law was adopted in December 2012. The budgetary target for 2013 was also adopted, accompanied by elements for a medium-term budgetary framework, in particular expenditure ceilings for the budget years 2013-2015 for each government entity.

Additional permanent measures for 2013 will be adopted after review by and consultation with the programme partners and prior to the granting of the first disbursement of financial assistance (applicable to the measures outlined in 2.2, 2.3, 2.4, 2.5, 2.7, 2.8, 2.9, 2.10 and 2.11).

To this end, the Cypriot authorities will amend the 2013 Budget Law, which will contain the additional consolidation measures, and, accordingly, the revised general government primary deficit. In addition, the authorities will update the expenditure ceilings for the budget years of 2013-2015.

The additional consolidation measures will include the following and will, where legally possible, be applicable retroactively from 1 January 2013:

Revenue measures

[20] Windfall gains associated with hydrocarbons shall mean only the blocks' licencing fees or related signature bonuses for exploration thereof. It is noted that any streams of revenues associated with hydrocarbon exploitation are dealt with under section 5.6, second bullet-point, indent 3.

2.2. Ensure additional revenues from property taxation of at least EUR 75 million by: (i) updating the 1980 prices through application of the CPI index for the period 1980 to 2012; and/or (ii) amending tax rates and/or (iii) amending value bands.

2.3. Increase the statutory corporate income tax rate to 12.5%.

2.4. Increase the tax rate on interest income to 30%.

2.5. Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.11% to 0.15% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

2.6. Undertake by June 2013 a reform of the tax system for motor vehicles, based on environmentally-friendly principles, with a view to raising additional revenues, through the annual road tax, the registration fee and excise duties, including motor fuel duties. The reform will take into account the related study of the University of Cyprus.

2.7. Complete the increase in fees for public services by at least 17% of the current values.

Expenditure measures

2.8. Introduce measures to control healthcare expenditure (see 3.2, measures a), b), c), d) and e).

2.9. Reduce the expenditure on various housing schemes by at least EUR 36 million by consolidating and streamlining the schemes for the displaced and the Comprehensive Housing Scheme, discontinuing the special grant for acquiring a first residence and ceasing the provision of loans and loan guarantees related to house construction and acquisition under all government-administered housing schemes.

2.10. Further streamline the Easter allowance to pensioners by limiting the benefit to pensioners with a monthly per household income of at most EUR 500.

2.11. Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-2.000: 0.8%; EUR 2.001-3.000: 1%; EUR 3.001-4.000: 1.5%; above EUR 4001: 2.0 %.

2.12. Introduce as of the budget year 2014 structural reform measures in the educational system, notably, a reduction of the number of teachers seconded to the Ministry of Education and Culture, the removal of 1:1.5 teaching time ratio from evening schools of general and technical and vocational education, the elimination of teaching time concession to teachers for being placed in two or more educational districts, the elimination of mentoring components for pre-service and in-service training for newly appointed teachers and the reduction of the cost of afternoon and evening programmes.

Fiscal policy in 2014

The Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 678 million (4¼% of GDP) in 2014.

The budgetary target and the permanent measures for 2014 already adopted by the Cypriot authorities (see Annex I) were considered in the adopted Medium-Term Budgetary Framework, accompanying the 2013 Budget Law. After review by and consultation with the programme partners **by mid-September 2013**, the 2014 Budget Law will be adopted **by mid-December 2013**. The 2013-2015 expenditure ceilings will be updated for the period 2014-2016 and will accompany the 2014 Budget Law document. The presentation of these ceilings will evolve into a full-fledged Fiscal Strategy Statement in line with the MTBF requirements contained in Directive 2011/85/EU. Any deviation from the budgetary objectives contained in the 2013-2015 framework will be properly documented and reasons for such deviations will be provided.

<u>Fiscal policy in 2015-16</u>

The Cypriot authorities will achieve a deficit in the 2015 general government primary balance of no more than EUR 344 million (2.1% of GDP) and a surplus in the 2016 general government primary balance of at least EUR 204 million (1.2% of GDP).

After review by and consultation with the programme partners the 2015 and 2016 Budget Laws will be adopted, respectively, **by mid-December 2014** and **mid-December 2015**.

The 2014-2016 expenditure ceilings will be updated for the period 2015-2017 and will accompany the 2015 Budget Law document. Any deviation from the budgetary objectives contained in the 2014-2016 framework will be properly documented and reasons for such deviations will be provided. In Q2-2016, the Cypriot authorities will present the programme partners with a provisional list of measures to attain a primary surplus of 3% of GDP in 2017 and 4% of GDP in 2018. The measures required will be included in the draft 2017 Budget Law.

3. Fiscal-structural measures

<u>Key objectives</u>

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus' exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While taking note that the Cypriot authorities have recently introduced significant reforms (as noted below), the implementation of further reforms of the pension system to address the high projected increase in pension spending may be necessary in order to put the pension system on a sustainable path. The overarching objectives of the reforms are: i) to reduce the increase in pension spending, ii) to ensure the long-term financial viability of the pension system through 2060, and iii) to limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pension.

In view of this, the Cypriot authorities have implemented/agreed to implement the following measures:

- separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme **by 30 June 2013**. The non-contributory part will be tax financed;
- for the General Social Insurance System (GSIS): (i) increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age; (ii) introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iii) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; and (iv) gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17 (in place since December 2012) ;
- for the Government Employee Pension Scheme (GEPS): (i) increase the statutory retirement age by 2 years for the various categories of employees; (ii) increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; (iii) while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iv) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; (v) introduce a change of indexation of all benefits from wages to prices; and (vi) pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013 (in place since January 2013);
- ensure that total annual public pension benefits for public sector employees and state officials do not exceed 50% of the annual pensionable salary earned at the

time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector (in place since January 2013);

- ensure that pension entitlements that will accrue after 1 January 2013 are considered as personal income, thus becoming fully taxable also in the case in which they are received as a lump-sum payment. At the same time, employees will be granted the option of converting all or part of the lump-sum into an actuarially neutral annuity (in place since January 2013); and
- ensure that all of the above measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

An actuarial study for the GSIS will be carried out and submitted for peer review in the Ageing Working Group of the Economic Policy Committee **by end-July 2013**. The objective of the actuarial study is to provide additional reform options to ensure the long-run viability of the national pension system.

The actuarial study should project the scheme’s finances on a cash basis. Given the financial sustainability focus, on the revenues side, the study should not take into account any government subsidy (i.e. contribution that is currently at 4.3% of the payroll and the return on the accumulated notional reserves as at the start of the projection period) with the exception of credited contributions and the contributions made by the government as an employer on behalf of its employees. On the expenditures side, the study should only take into account benefits related to contributions paid and credited contributions, i.e. excluding the costs related to the top-up for the minimum pension (which is considered to be tax financed). The study should analyse the impact of additional reform options such as benefit reductions (while considering adequacy), an increase in the statutory retirement age and increases in contribution rates or combinations thereof taking into account the impact on labour costs.

After review by and consultation with the programme partners, if needed, a comprehensive reform with the aim of establishing the long-run viability of the system, will be carried out; and, this reform will be adopted **by end-December 2013** and enter into force **in Q1-2014**.

<u>Health care expenditure</u>

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted prior to the granting of the first disbursement of financial assistance:

f) abolish the category of beneficiaries class "B" and all exemptions for access to free public health care based on all non-income related categories except for persons suffering from certain chronic diseases depending on illness severity. Introduce as a first step towards a system of universal coverage a compulsory health care contribution for public servants and public servant pensioners of 1.5% of gross salaries and pensions. The measure will be reviewed **by Q2-2014** with the programme partners. For families with three or more dependent children, the participation in this health care scheme will be voluntary;

g) increase fees for medical services for non-beneficiaries by 30% to reflect the associated costs of medical services and create a co-payment formula with zero or low admission fees for visiting general practitioners, and increase fees for using higher levels of care for all patients irrespective of age;

h) introduce effective financial disincentives for using emergency care services in non-urgent situations;

i) introduce financial disincentives (co-payment) to minimise the provision of medically unnecessary laboratory test and pharmaceuticals; and

j) adopt a new decision by the Council of Ministers concerning a restructuring plan for public hospitals, improving quality and optimising costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap".

In addition, the programme partners will review and be consulted on the following measures before their implementation:

k) assess and publish, before parliamentary discussion, the potential risks and benefits of the planned introduction of the National Health System (NHS) in an updated actuarial study, taking into account possible proposals for implementing NHS in stages **by Q2-2013**;

l) make the award of the tender for the IT-infrastructure conditional upon the results of the study and the decision for implementing the NHS;

m) review income thresholds for free public health care in comparison to the eligibility criteria for social assistance while ensuring that co-payments to public health care are set so as to protect individuals/households effectively from catastrophic health expenditures **by Q4-2013**;

n) create protocols for laboratory tests and the prescription of pharmaceuticals based on thorough scientific evidence;

o) introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred in accordance with Article 7 of Directive 2011/24/EU of the European Parliament and of the Council of 9 March 2011. An interim report will be ready **by Q3-2013**;

p) conduct an assessment of the basket of the top 4 publicly reimbursable healthcare products in terms of annual spending and prepare a report to establish an integrated system for health-technology assessment to increase the cost-effectiveness of the basket of publicly reimbursed products; and prepare the implementation of 10 new clinical guidelines focusing on high annual volume and high cost diseases **by Q2-2013**;

q) start coding inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs **by Q3-2013**;

r) in a first step, establish working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.11) **by Q1-2014**; and

s) define a basket of publicly-reimbursable medical services based on objective, verifiable, criteria, including cost-effectiveness criteria **by Q2-2013**.

Furthermore, the Cypriot authorities will consider establishing a system of family doctors acting as gate-keepers for access to further levels of care.

Budgetary framework

3.3. The Cypriot authorities will:

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures for its governing body and funding arrangements grounded in law **by Q2-2013**;
- complete the adoption of the law transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and provisions pertaining to the fiscal compact of the Treaty on Stability, Coordination and Governance (TSCG) on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342, with implementing texts ensuring that adopted measures are fully effective **by Q2-2013**. In particular, integrate the presentation of the existing multi-annual budgetary objectives (MoU fiscal targets and the rolling three-year expenditure ceilings) into a comprehensive Fiscal Strategy Statement in compliance with MTBF requirements in the sense of Directive 2011/85/EU to guide the preparation of the 2014 budget **by Q2-2013**; and
- submit to the House of Representatives a draft high-level Fiscal Responsibility and Budget System Law applicable to the entire general government sector. The draft law will encompass, inter alia, macro-fiscal policy-making, and budget formulation and approval. It will address remaining gaps and inconsistencies and codify existing good budget practices **by Q4-2013**.

Public private partnerships (PPPs)

3.4. The Cypriot authorities will:

- create an inventory of PPPs including information on the objectives of current and planned PPPs and more detailed information on signed contracts, including their nature, the private partner, capital value, future service payments, size and nature of contingent liabilities, amount and terms of financing. In addition, an inventory of contingent liabilities including information on the nature, intended purpose, beneficiaries, expected duration, payments made, reimbursements, recoveries, financial claims established against beneficiaries, waivers of such claims, guarantee fees or other revenues received, indication of amount and form of allowance made in the budget for expected calls, and forecast and explanation of new contingent liabilities entered into in the budget year will be compiled. The inventories will be shared **by Q3-2013** with the programme partners. As of 2014, the inventories will be updated annually and included as “Statement of PPPs” and “Statement of Contingent Liabilities” in appendices to the annual budget law and to the annual financial report;

- put in place an adequate legal and institutional framework for PPPs designed according to best practices, including ex-ante assessment and monitoring of the fiscal risks of engaging in PPPs and concessions as compared to other public investments. A proposal for such a strengthened legal and institutional framework for PPPs should be drafted **by Q3-2013** and implemented **by Q4-2013**; and
- commit not to enter into any new tendering process and not to sign any new PPP contract before the implementation of the legal and institutional PPP framework, excluding any project having reached commercial close by end-October 2012.

State-owned enterprises and privatisation

3.5. As regards extra-budgetary funds and entities, in particular the State-Owned Enterprises (SOEs) and other state-owned assets, the Cypriot authorities will:

- establish an inventory of assets, owned by central government, municipalities and regional administrations, including real estate and land. As a first step, priority will be given to assets with the highest commercial value, including at least one third of SOEs **by Q2-2013** and the remaining SOEs **by Q3-2013**. This inventory will indicate which SOEs could be subject to divestment or restructuring or liquidation. The inventory of the largest and most valuable real estate and land assets will be ready **by Q3-2013**. The full inventory of all assets (SOEs, real estate and land) will be completed **by Q4-2013**. The inventory will be gradually submitted to the programme partners;
- prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs (see 3.11) **by Q3-2013**. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The Cypriot authorities will adopt the necessary legal changes to fulfil this requirement **by Q4-2013**. No additional SOEs will be created throughout the duration of the Programme; and
- submit to the House of Representatives a draft law to regulate the creation and the functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOEs in the context of the annual budgetary procedure **by Q4-2013**.

3.6. The Cypriot authorities will initiate a privatisation plan to help improving economic efficiency through enhanced competition and encouragement of capital inflows, and to help restoring debt sustainability:

- This plan should consider the privatisation prospects of state-owned enterprises (SOEs) and semi-governmental organisations (SGOs), including, inter alia, CyTA (telecom), EAC (electricity), CPA (ports), as well as real estate/land assets. For the privatisation of natural monopolies, an appropriate regulatory framework is a prerequisite. The provision of basic public goods and services by privatised industries will be fully safeguarded, in line with the national policy goals and in compliance with the EU Treaty and appropriate secondary legislation rules;

- The privatisation plan will be based on the report reviewing the operations and finances of SOEs, as well as the inventory of assets. The privatisation plan will be created after consultation with the programme partners, including asset-specific timelines and intermediate steps **by Q3-2013**;
- In parallel, the specific legal and institutional framework for the privatisation process will be drafted **by Q3-2013** and implemented **by Q4-2013**, after consultation with the programme partners; and
- The privatisation plan identified by the Government after consultation with the programme partners will raise at least EUR 1 billion by the end of the programme period and an additional EUR 400 million by 2018 at the latest.

<u>Revenue administration, tax compliance, and international tax cooperation</u>

3.7. The Cypriot authorities will propose a comprehensive reform plan to improve the effectiveness and efficiency of tax collection and administration **by Q4-2013**, for implementation as of the budget year 2014. The reform shall encompass the following elements:

- attribute personal responsibility for payment of company taxes to those, who -in the case of non-listed companies- truly and effectively control a company;
- attribute personal responsibility to the responsible manager for fraudulent filing of company taxes;
- strengthen powers by the tax authorities to ensure payment of outstanding tax obligations, e.g. by having authority to seize corporate assets, prohibiting alienation or use of assets, including property and bank accounts, by the taxpayer;
- harmonise the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and that there is an administrative appeals process for all of these taxes before going to the courts;
- increase staff mobility between different tax administration entities in order to ensure appropriate staffing of entities with high revenue collection capacities;
- where not in place, establish clear performance objectives, including on revenue collection results, for each revenue administration entity, and improved transparency regarding the performance of revenue administration entities, e.g. via publication of the tax gap for main revenue categories (the difference between the tax owed and the amount actually collected);
- optimise use of IT systems in the tax administration based on: (i) facilitating information exchange between tax administration entities; (ii) enhancing the use of e-filling of tax returns and e-payment (e.g. by allowing payment through bank transfers); (iii) improving the exchange of information, including data on natural and legal persons, between relevant authorities for tax collection purposes, taking into account legal provisions for data protection; (iv) enhancing reporting capabilities in relation to obligations under Council Directive 2003/48;
- enhance the efforts to reduce administrative burden on businesses, with a view to reducing informal activities and achieving voluntary compliance to the widest possible extent. In this respect, systematically measure the time and cost for taxpayers to complete revenue administration procedures such as registration or filing;

- step up administrative tax fraud investigations and enhance cooperation between the tax and judicial systems, while addressing potential bottlenecks in the tax appeal system;
- improve capacity of the Inland Revenue Department to follow-up on tax information received from other countries, e.g. by permitting the department to access databases of other public entities in order to facilitate and expedite the identification of the taxpayer; and
- remove from the income tax law the Director's prerogative to act as deemed necessary in relation to the application of the Law's provisions, including the decision on the withdrawal of lawsuit for unpaid taxes.

3.8. The Cypriot authorities will implement reforms, which build on the main recommendations derived from the diagnostic technical assistance mission conducted in February 2013. To this end, the authorities will elaborate a comprehensive reform agenda and consult with the programme partners on this agenda **by Q2-2013**.

3.9. The Cypriot authorities will safeguard the timely and effective exchange of information in regard to tax matters, fully ensuring the applicability of laws and standards governing international exchange of tax information. In this respect, the Cypriot authorities will enhance the practice of timely delivery of relevant and accessible tax information to other EU Member States. The authorities will:

- fully transpose and implement Council Directive 2011/16/EU on administrative cooperation in the field of taxation[21] and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/2010 on administrative cooperation and combating fraud in the field of value-added tax, which prescribe specific timeframes within which Member States shall provide information to each other;
- ensure timely access to information on beneficial ownership of trusts and to an audit trail of financial transactions of trustees. To this end, the programme partners take note of the Cypriot authorities' intention to establish registers of trusts held by the respective competent supervisory authority and of the recently-introduced obligation to have, at any given time, for trusts under Cyprus law at least one trustee who is a resident in Cyprus. Professional trustees should be authorised or otherwise regulated (i.e. as lawyers, accountants or Trust and Company Service Providers) and all trustees, whether regulated or not, should be registered (see paragraph 1.17). Trustees should report information to their respective supervisors on their relation to a trust. In addition, the Cypriot authorities will require trustees of trusts under Cyprus law to declare their status to credit institutions[22] when using the financial system in Cyprus, and require credit institutions established in Cyprus to obtain a corresponding declaration of status from trustees of trusts created under and governed by foreign law as a mandatory condition for using the financial system in Cyprus **by Q3-2013**;
- ensure that they have timely access to information on who truly and effectively controls a company established in Cyprus. To this end, they will either a) require

[21] The Cypriot authorities have submitted Law N. 205(I)/2012 (enacted on 28 December 2012), transposing the Directive, to the European Commission.
[22] As defined bin Art. 2.1(1) of the Third Anti-Money Laundering Directive, 2005/60/EC

nominee directors[23] and nominee shareholders to disclose the identity of their nominator to the company and to the company register; or b) require that all nominee directors and nominee shareholders be authorised or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs). In the case of the trustee service being provided by a TCSP, the information that the TCSP is a professional service provider will be accessible through the registers under the TCSP Law **by Q3-2013**;

- ensure the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and
- implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

In the context of an effective implementation of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the EUSD), the Cypriot authorities will continue to provide to the EC all necessary and available information/statistics extracted from the data exchanged under the FISC153. In addition, on an annual basis and starting from the tax year ending on 31 December 2013, the Cypriot authorities will provide to the EC a breakdown of the information provided under the EUSD by sector of activity of the paying agents, including possible sanctions actually claimed of paying agents for their application of the EUSD. **In 2015**, the Cypriot authorities will provide to the European Commission a report on the results of audits conducted in 2014. The Cypriot authorities (CBC) will provide on an annual basis detailed sectoral deposit statistics with a breakdown of non-resident deposits by country.

Immovable Property Tax Reform

The following measures will be taken to increase revenue and to improve the fairness of the tax burden by levying the recurrent property tax on current market values. An additional objective is to reduce overhead cost in tax base administration.

3.10. In view of this, the Cypriot authorities have agreed to implement the following measures:

- implement a property price index that establishes the average property market valuation in 2013 by square meter of habitable surface and land plot. This index shall be operational to provide imputed market valuations for each non-agricultural cadastral plot **by Q2-2014**, in time for its application in the calculation of the

[23] Under Cyprus law, there is no legal concept of 'nominee director', but it is used with reference to professionals who provide director services.

immovable property tax in 2014. The index shall vary according to location and zoning as well as other building- and plot-related characteristics. Moreover, propose and implement a methodology for annual updates of such imputed market valuations;

- implement the recurrent immovable property tax based on imputed market valuations of land plots according to a unit tax base established by this property index **by Q3-2014**. The tax rates shall reflect the progressivity and revenue of the preceding property tax. For co-owned land plots, individual owners shall be taxed according to ownership proportions as provided in the cadastre;
- establish the legal basis for a mandatory annual adjustment of the property unit tax base by a competent executive authority **by Q3-2014**; and
- in order to retain a stimulus to property demand and reduce distortions in property prices, provide for an extension of the reduction in property transaction fees until 2016 **by Q2-2013**.

In addition, the following studies should be initiated **by mid-2013**, and their recommendations implemented at the latest **from 1 January 2015 onwards**:

- a study on refining the parameters of the imputed property market value index within the bounds of administrative and legal simplicity. In particular, the study shall assess the feasibility of a unit tax base for individual dwellings. Moreover, the study shall report on a mechanism to dampen cyclical variations in the index; and
- a further study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenue from transaction fees and taxes to recurrent taxation **by early 2015**.

<u>Public administration reform</u>

3.11. The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the Cypriot authorities will undertake the following reform measures:

- reduce impediments to staff mobility within the public and broader public sector, inter alia, by removing restrictions arising from the Public/Broader Public Service Laws as to the duration and placement of secondments, as well as the need for employee consent **by Q2-2013**; and
- in a first step, as of 1.9.2013, establish working time in the Public Service, in conjunction with moving the starting time by half an hour (from 7:30 to 8:00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following part 1 of the below review, in a second step, further reduce overtime and related costs to the public sector wage bill by making working time more flexible so as to cover - as a minimum - service hours from 7:00 until 17:00 in the entire public sector and service hours from 7:00 to 19:00 for public sector services with extended operating hours (including, but

not limited to, healthcare and security), under regular working time. Working hours outside regular working time shall be limited by enforcing strict controls, including requiring pre-approval of any non-emergency work outside regular working time (see 3.2) **by Q1-2014**.

In addition, the Cypriot authorities will commission an independent external review of possible further reforms of the public administration based on the terms of reference already agreed with the programme partners.

The review will comprise two parts, covering the following areas:

Part 1:

- examination of the role, the competences, the organisational structure and the size/ staffing of relevant ministries, services and independent authorities;
- examination of the possibility of abolishing or merging/consolidating Non-profit Organisations/Companies and publicly owned enterprises; and
- re-organisation/re-structuring of local government.

Part 2:

- appropriate system of remuneration and working conditions/conditions of employment in the public sector (e.g. annual vacation leave, sick leave, maternity leave, working time), in relation to the private sector and to other EU countries and based on best practices; and
- introduction of a new performance based appraisal system in the public sector, for development and promotion purposes, linking performance with the remuneration system/ increments.

The first part of the review will be published **by Q1-2014**. The second part of the review will be published **by Q3-2014**. Based on the findings of the review, the Cypriot authorities will agree upon a reform after consultation with the programme partners, submit it to the House of Representatives for approval and implement a reform of the public administration (part 1 **by Q2-2014** and part 2 **by Q4-2014**).

<u>Welfare system</u>

3.12. The welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministries and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work (as further specified in section 4.3 below), the Cypriot authorities will carry out a reform of the welfare system to be implemented and applied as of 1 January 2014 after review by and consultation with the programme partners (draft reform plan to be submitted **by Q2-2013**). The reform will cover the following elements:

- streamlining the number of benefits available through merging and phasing out;

- better targeting of various social transfers, so as to reduce the total number of beneficiaries while protecting the most vulnerable by:

    - the introduction of a common definition of income sources, financial assets and movable and immovable property to be taken into account for means-testing, so as to ensure consistency across different benefit schemes;

    - the introduction or tightening of means-testing criteria, on the basis of the above definition, for benefit provision and continued access to benefits by lowering income thresholds, accounting for wealth such as financial assets, movable and immovable property, and broadening the sources of income to be taken into consideration. With respect to the latter, as a general principle benefits provided should be fully accounted for in the computation of personal income;

- a review of the appropriate levels of individual benefits and the index for adjustment of benefit levels; and

- transferring of all the relevant competences and responsibilities related to the administration and provision of all social benefits to the Ministry of Labour and Social Security, which should be appropriately equipped in terms of financial and human resources, reassigned from other departments of the public administration **by Q1-2014** (see 3.11).

The reforms must be consistent with the fiscal targets defined in this MoU.

4. Labour market

<u>Key objectives</u>

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

Cost of living adjustment (COLA) of wages and salaries

4.1. To ensure that wage growth better reflects developments in labour productivity and competitiveness, in both expansions and recessions, the Cypriot authorities will reform the wage-setting framework for the public and private sector in such a way as to improve real wage adjustment. To this end, the effective application of the reform of the wage indexation system (COLA) applicable to the broader public sector, as determined in the budget of 2013 and embedded in the Medium-Term Budget, must be ensured. This reform acts on relevant elements of the indexation system, as follows:

- a lower frequency of adjustment, with the base period for calculating the indexation (COLA) being lengthened from the current period of six months to twelve months. Indexation would take place on 1st January each year;
- a mechanism for automatic suspension of application and derogation procedures during adverse economic conditions, such that if in the second and third quarters of a given year negative rates of growth of seasonally adjusted real GDP are registered, no indexation would be effected for the following year; and
- a move from full to partial indexation, with the rate of wage indexation being set at 50% of the rate of increase of the underlying price index over the previous year.

As foreseen in section I.2 of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme.

A tripartite agreement will be pursued with social partners for the application of the reformed system in the private sector **by end-2013**. Furthermore, based on the current economic outlook, wage and salary indexation is foreseen not to be applied in the private sector until 2014.

Minimum wage

4.2. With a view to preventing possible adverse competitiveness and employment effects, the Cypriot authorities commit that, over the programme period, any change in the minimum wage covering specific professions and categories of workers should be in line with economic and labour market developments and will take place only after consultation with the programme partners.

Public assistance and activation of the unemployed

4.3. The increase in unemployment underlines the need for an overall assessment of activation policies and available instruments for income support after the expiration of unemployment insurance benefits. The planned reform of public assistance should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support a basic standard of living, while safeguarding incentives to take up work, ensuring consistency with the reform of the welfare system as described in section 3.12. Therefore, the Cypriot authorities will:

- ensure that the planned reform of public assistance includes measures aimed at activating benefit recipients by facilitating their reinsertion in the labour market, reducing disincentives to work and imposing job-search requirements for continued benefit receipt. To this end, the draft reform plan on public assistance will be submitted to the programme partners **by Q2-2013** for review and consultation;

- provide an assessment of current activation policies **by Q2-2013**; and
- review and enhance the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

5. Goods and services markets

Key objectives

Addressing issues of a structural nature is critical for rebalancing the Cypriot economy, restoring its growth potential and improving competitiveness. Removing unjustified obstacles in services markets can have a significant impact on growth, in particular for the services-intensive Cypriot economy. In addition, improving the quality and reducing the cost of regulated professional services can play an important role for the business environment and for Cyprus' competitive position. Since tourism is one of Cyprus' largest sectors and an important potential driver of future growth, a reinvigoration of the competitiveness of this sector is warranted. Improving the regulation of administration related to the real estate sector will contribute to the overall functioning of the housing market and help to foster foreign demand at a time when the prospects of this sector are affected by downside risks. Finally, the exploitation of the domestic offshore natural gas potential offers the medium- to long term prospect for reducing Cyprus' energy import dependency and the security and sustainability of energy supply. This would help to address Cyprus' sustained current account deficit and high public debt. However, these positive effects will accrue only after overcoming the challenges of financing and planning the infrastructure investments, designing effective energy markets and an adequate regulatory regime.

Services Directive: Sector-specific legislation

5.1. The Cypriot authorities will adopt the remaining necessary amendments to the sector-specific legislation in order to fully implement the Services Directive, easing the requirements related to entry and establishment. In addition, requirements concerning minimum tariffs should be eliminated unless they are justified according to article 15(3) of the Services Directive. Amendments will be presented to the House of Representatives **by Q2-2013** and minimum tariff requirements without justification will be abolished **by Q2-2013**.

Reform of regulated professions

5.2. The Cypriot authorities will:

- eliminate any existing total bans on the use of a form of commercial communication (advertising) in regulated professions, as required by the Services Directive **by Q2-2013**; and
- further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the exercise of activity **by Q3-2013** and eliminating those that are not justified or proportional **by Q1-2014**; and
- requirements affecting the access to the activity shall be assessed in order to repeal those which are not justified or proportionate after the adoption of the Directive amending Directive 2005/36/EC on the recognition of professional qualifications and Regulation on administrative cooperation through the Internal Market Information System, and in accordance with the evaluation, methodology and timeframe to be defined in the said amending Directive.

Competition and sectoral regulatory authorities

5.3. The Cypriot authorities will:

- ensure the independence and enhance the effective functioning of the Commission for the Protection of Competition and its ability to enforce effectively the competition rules **by Q4-2013**; and
- ensure the necessary independence and power of the national regulatory authorities (NRA) and enhance their ability to exercise their responsibilities and to carry out effectively their tasks, including monitoring the competitive situation in their respective sector **by Q4-2013**.

Housing market and immovable property regulation

5.4. The Cypriot authorities will take the following measures to ensure market clearing of the property market, allow for efficient seizure of property collateral, and for market-based assessment of property prices, as well as alleviating the factors deterring both domestic and foreign demand. A particular risk arises from legal disputes, which may be due to incomplete documentation of ownership and property rights and the slow pace of judicial procedures.

The Cypriot authorities will:

- provide for mandatory registration of sales contracts for immovable property **by Q2-2013**. **By Q4-2014**, eliminate the title deed issuance backlog to less than 2,000 cases of immovable property sales contracts with title deed issuance pending for more than one year. The Cypriot authorities will enhance cooperation with the financial sector to ensure the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property, and implement guaranteed timeframes for the issuance of building certificates and title deeds;
- publish quarterly progress reviews of the issuance of building and planning permits, certificates, and title deeds, as well as title deed transfers and related mortgage operations throughout the duration of the programme;
- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the financial sector and government services **by Q4-2014**. Personal data privacy legislation shall be reviewed and amended to alleviate legal impediments to such electronic access, in particular concerning the procedures for proof of legal interest **by Q2-2013**;
- introduce legislation on amending the procedure on the forced sale of mortgaged property to allow for private auctions as under the rules for immovable property recovery under bankruptcy regulations. The Cypriot authorities shall enact regulations to provide for the conclusion of such private auctions within shortest feasible timespans (see 1.5) **by end-2013**; and
- better target the rules of court to improve the pace of court case handling. The Cypriot authorities shall assess the need for additional measures – including if necessary legislative reforms - to eliminate court backlogs by end of the programme. Moreover the authorities shall provide for specialized judges akin to the rules for criminal case handling in order to expedite the handling of cases under commercial and immovable property laws **by Q4-2013**.

Tourism

5.5. Tourism is an important export sector and is of great importance to domestic value added and employment. Since 2011, tourism has experienced a significant increase in tourism arrivals and incomes, while the prospects for the continuation of that upward trend in 2013 are excellent. In particular, in 2011, there was an increase of 10.1% in tourism arrivals and 12.9% in revenue growth compared to 2010, while in 2012 (latest data August) there was a further increase of 5% and 8.5% respectively compared to 2011. To strengthen the competitiveness of the tourism sector, the Cypriot authorities will:

- carry out a study on how to improve the tourism sector business model, in particular, with a view to lengthening the tourist season, increasing occupancy rates of hotels and promoting resident tourism during winter time, developing a multi-dimensional and high quality tourism, *inter alia*, by defining thematic niches such as sport, cultural and medical tourism, developing individual tourism, promoting professionalism of tourist service providers and ensuring the dissemination of best-practices on upgrading the quality of the services provided, improving the role of tourism-related infrastructure investment. The Tourism Strategy for 2011-2015 will be reviewed and, if necessary, revised based on the study's findings **by Q2-2013**;

- facilitate condo hotel projects with the aim of enhancing access to financing investment in hotel development, including the removal of any legal impediments **by Q2-2013**; and
- in order to enhance attractiveness of the country as a destination, engage in a thorough analysis of the best means of achieving sufficient air connectivity for Cyprus, including by negotiating new or amending existing air services agreements.

Energy

5.6. The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package has been completely transposed and fully implemented and notify the European Commission that the necessary legislation has been transposed; indicate the date of delivery of the first commercial supply of natural gas under a long-term supply contract, thereby ending Cyprus' derogation of an isolated energy network and initiating the application of the emergent market derogation; and indicate the intended duration of the latter derogation;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy, to be developed under the full authority of the Cypriot Government, should include at least the following three key elements, which should be presented to the programme partners for consultation according to the timeline specified below:
    1. a *roll-out plan* for the infrastructure required for the exploitation of natural gas, taking into account possible commercial uncertainties and risks. The plan should cover: the required investments, associated costs, financing sources and methods, related major planning risks and bottlenecks; and a projection of the revenue streams over time; first version **by Q3-2013**;
    2. *an outline of the regulatory regime (CERA) and market organisation* for the energy sector and gas exports, which would be conducive to the introduction and proper functioning of open, transparent, competitive energy markets, taking into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emissions. Specifically, the outline should include the following elements: the potential for setting-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; full unbundling of gas suppliers and customers, in particular electricity companies; and an appropriate sales framework for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues **by Q2 2013**; and

3. a plan to establish the institutional framework for the management of hydrocarbon resources, including a *resource fund*, which should receive and manage the public revenues from offshore gas exploitation. The preparatory phase should include the required legal steps and their adoption. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. In particular, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, giving due respect to the need to develop the hydrocarbon industry, including the necessary infrastructure, the importance of bringing Cyprus' public debt on a steady downward path and the need to invest and generate value for all strata of society, including future generations **by Q3-2013**.

Since these three key elements are strongly interdependent, they need to be developed in parallel over time. In addition, the plan should take account of the current uncertainty over the actual size of domestic, offshore, commercially-viable, natural gas fields and possible changes in international gas prices and demand, and appropriate data should be firmly based on *alternative world energy scenarios* from an internationally-reputed organisation. The plan will be based on an appropriate level of technical assistance on technical aspects in this context.

Annex I

Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

I.1 Implement a scaled reduction in emoluments of public and broader public sector pensioners and employees as follows: EUR 0-1000: 0%; EUR 1001-1500: 6.5%; EUR 1501-2000: 8.5%; EUR 2001-3000: 9.5%; EUR 3001-4000: 11.5%; above EUR 4001: 12.5%.

I.2 Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (Q1-2016) (see section 4.1).

I.3 Extend the freeze of increments and general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions by three additional years until 31 December 2016.

I.4 Reduce the number of public sector employees by at least four thousand five hundred over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.11); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see I.16).

I.5 Freeze the hiring of new hourly paid employees and enforce immediate application of mobility within and across ministries and other government entities. In the case of health and security posts, recruitment of one person for every five retirees will be possible to meet urgent needs.

Revenue measures

I.6 Appropriate a one-off additional dividend income collected from semi-governmental organisations.

I.7 Increase the bank levy on deposits raised by banks and credit institutions in Cyprus from 0.095% to 0.11% with 25/60 of the revenue earmarked for a special account for a Financial Stability Fund.

I.8 Introduce a mechanism for a regular review of excise taxes to secure the real value of excise tax revenue. Such a mechanism should be non-recurring and should, by no means lead to an automatic indexation mechanism of excise taxes to price developments.

Fiscal measures with effect in 2013

Expenditure measures

I.9 Ensure a reduction in total outlays for social transfers by at least EUR 113 million through: (a) the abolition of a number of redundant and overlapping schemes such as the mothers allowance, other family allowances and educational allowances; and (b) the abolition of supplementary allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners.

I.10 Ensure a reduction of at least EUR 29 million in the total outlays of allowances for employees in the public and broader public sector by:

i. taxing pensionable allowances provided to senior government officials and employees (secretarial services, representation, and hospitality allowances) in the public and broader public sector;

ii. reducing the allowances provided to broader public sector employees and reducing all other allowances of broader public sector employees, government officials and hourly paid employees by 15%; and

iii. reducing the daily overseas subsistence allowance for business trips by 15%. Ensure a further reduction the subsistence allowance of the current allowance when lunch/dinner is offered by 50% (20% - 45% of overseas subsistence allowance instead of 40% - 90% currently paid).

I.11 Reduce certain benefits and privileges for state officials and senior government officials, in particular by:

i. suspending the right to travel first/business class by state officials, senior government officials and employees with the exception of transatlantic travel. The right to business class travel shall be maintained for the President of the Republic of Cyprus and the President of the House of Representatives;

ii) abolishing the right to duty free vehicles for employed and retired senior public sector officials; and

iii) extending the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals) for 2013-2016, including members of the House of Representatives. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8% on the pensionable earnings of these individuals.

I.12 Implement the following measures regarding the Government Pension Scheme (GEPS):

i. freeze public sector pensions;

ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;

iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;

iv. introduce a permanent contribution of 3% on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8% on pensionable earnings by officials, who are entitled to a pension and gratuity but are not covered by the government's pension scheme or any other similar plan;

v. amend Article 37 of the Pensions Law to abolish the provision according to which, in the case of death of an employee, if the deceased had a wife/husband at the time of his/her retirement and thereafter he/she remarried, his/her last wife/husband is considered a widow/widower. With the abolition of this provision, the second wife/husband will not be considered a widow/widower and thus she/he will not be entitled to pension;

vi. increase the contribution rate on the pensionable earnings of the members of the Tax Tribunal Council and the Tender Review Authority from 3.4% to 6.8%; and

vii. the contributions to the Widows and Orphans Fund will no longer be reimbursable.

I.13 Implement further reform steps under the General Social Insurance Scheme by:

i. actuarially reducing pension entitlements from the General Social Insurance Scheme by 0.5% per month for retirements earlier than the statutory retirement age at the latest from January 2013, in line with the planned increase in the minimum age for entitlement to an unreduced pension to reach 65 (by 6 months per year), between 2013 and 2016;

ii. freezing pensions under the Social Security Fund for the period 2013-2016;

iii. abolishing the increase of pensions for a working dependent spouse under the General Social Insurance Scheme at the latest from January 2013 onwards.

I.14 Reduce transfers by EUR 25 million from central government to state-owned enterprises and semi-public institutions.

I.15 Ensure a targeted reduction of budgetary appropriations for a series of semi-governmental organisations in the 2013 Budget Law, supported by well-defined activity-reducing measures.

I.16 Implement a four-year plan as prepared by the Public Administration and Personnel Department aimed at the abolition of at least 1880 permanent posts over the period 2013-2016.

Revenue measures

I.17 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excise duties on cigarettes by EUR 0.20/per packet of 20 cigarettes.

I.18 Increase excise duties on beer by 25% from EUR 4.78 per hl to EUR 6.00 per hl per degree of pure alcohol of final product. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 956.82 per hl of pure alcohol.

I.19 Increase excise duties on energy, i.e., on oil products, by increasing tax rate on motor fuels (petrol and gasoil) by EUR 0.07.

I.20 Increase the standard VAT rate from 17% to 18%.

I.21 Introduce a tax of 20% on gains distributed to winners of betting by the Greek Organisation of Football Prognostics S.A. (OPAP) and the National Lottery for winnings of EUR 5,000 or more.

I.22 Abolish all exceptions currently in place for paying the annual company levy of EUR 350.

Fiscal measures with effect in 2014

Expenditure measures

I.23 Ensure a reduction in total outlays for social transfers by a at least EUR 28.5 million to be achieved through streamlining and better targeting of child benefits and educational grants, and abolition of social cohesion benefits provided by the welfare services.

I.24 Implement a further reduction in emoluments of public and broader public sector employees and pensioners by a flat rate reduction of 3% on all wages.

I.25 Introduce a fee on monthly transportation cards for the use of public transportation services by students and pensioners.

Revenue measures

I.26 Extend the application of the temporary contribution on gross earnings and pensions of public and private sector employees up to 31 December 2016 as follows: EUR 0 – 1,500: 0%; EUR 1,501 – 2,500: 2.5%; EUR 2,501 – 3,500: 3.0%; and > EUR 3,501 - : 3.5%.

I.27 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.

I.28 Increase the reduced VAT rate from 8% to 9%.

I.29 Increase excise duties on energy, i.e., on oil products, by increasing the tax rate on motor fuels (petrol and gasoil) by EUR 0.05.

I.30 Increase the contributions, as of 1.1.2014, of salaried employees and employers to the GSIS by an additional 1 percentage point on pensionable earnings, i.e. 0.5 of a percentage point from employees and 0.5 of a percentage point from employers and 1 percentage point in the case of self-employed persons.

Assessment of the actual or potential financing needs of Cyprus

In compliance with Article 13.1 of the ESM Treaty, this note has been prepared by the European Commission in liaison with the ECB.

1. Total financing needs

At its meeting of 16 March 2013, the Eurogroup agreed to provide financial assistance to Cyprus – in principle – for a total amount of up to EUR 10bn, i.e. the remaining financing needs over the three-year programme period stretching from 2Q2013 until 1Q2016 after inclusion of proceeds from burden-sharing measures adopted by the Cypriot government. This programme envelope has been reconfirmed in the Eurogroup meeting of 25 March 2013.

An overview of estimated quarterly financing needs to be covered by official lenders during the programme period is provided in Annex 1, an annual overview up to 2020 in Annex 2.

a. Financial sector

The annex to the Eurogroup statement of 25 March 2013 emphasises that external financial assistance shall not be granted for the resolution and restructuring of Cyprus Popular Bank and Bank of Cyprus using the recently adopted resolution law in Cyprus. **Hence, the European Commission, in liaison with the ECB, estimates that total needs for the recapitalisation of the remainder of the restructured banking sector amount to around EUR 2.5bn.**

This amount also includes a buffer to cover for worse macro-economic developments, in particular an increase in non-performing loans (NPLs), and recapitalisation needs of Hellenic Bank in case this cannot be achieved fully via private sources. The buffer also reflects the as yet unknown results of the requested due diligence on the cooperative banks which were not covered by the PIMCO exercise.

The EUR 1.9bn bond issued by the government to recapitalise Cyprus Popular Bank in June 2012 is not foreseen to be replaced by an ESM bond and thus does not figure in the financing envelope.

b. Medium- and long-term debt redemption

Over the programme period, around EUR 4.1bn are required for the redemption of medium- and long-term debt maturing over the programme period and the amortisation of government loans, taking into account the roll-over of marketable debt held by domestic investors.

Regarding the redemption of bonds a distinction needs to be made between foreign-law bonds (so-called Euro Medium Term Notes, EMTNs) and domestic-law bonds (so-called Government Registered Development Stocks, GRDS).

Over the programme period EMTNs worth about EUR 3bn mature. Almost half of this amount needs to be provided in June 2013 as an EMTN worth EUR 1.4bn will have to be redeemed. Two EMTNs worth a total of EUR 0.6bn will mature in June and July 2014, EUR 0.9bn in November 2015 and EUR 0.2bn during the first quarter of 2016.

Regarding GRDS, the redemption profile is more evenly spread over the programme period, with a total of EUR 0.7bn maturing in July 2013, EUR 0.4bn in 2014 (of which around 80% during the first quarter), EUR 0.4bn in 2015, and about EUR 0.2bn during the first quarter of 2016. It is foreseen that out of total GRDS redemptions of EUR 1.7bn only EUR 0.7bn are covered by official lenders. The Cypriot authorities intend to roll-over the remainder with the domestic investors holding these bonds.

Loan amortisations amount to a total of around EUR 0.4bn, with on average EUR 0.1bn per year in 2013, 2014 and 2015 and only very small payments during the first quarter of 2016.

c. *Fiscal needs*

Over the programme period up to EUR 3.4bn are required to cover fiscal needs.

Based on the underlying macro-fiscal assumptions deficit financing needs over the programme horizon are estimated at around EUR 3.5bn. This amount also includes a one-off payment of EUR 0.4bn in 2013 to compensate all pension funds for part of their losses on deposits in Cyprus Popular Bank and put them at par with pension funds that held deposits in Bank of Cyprus.

Cumulative below-the-line transactions reduce financing needs by around EUR 0.1bn as privatisation proceeds of about (EUR 0.6bn) and the envisaged use of the allocation of future central bank profits (EUR 0.4bn) – subject to the principle of central bank independence and provided such profit allocation is in line with CBC rules and does not undermine the CBC duties under the Treaties and the Statute – offset a buffer included to cover currently unforeseen expenditures, e.g. state guarantees for local-government and state-owned enterprises' loans (up to EUR 0.5bn), capitalised interest on the CPB bond (around EUR 0.3bn)[24] and capital contributions to the ESM and EIB (around EUR 0.1bn).

2. Financing sources

a. *ESM*

The ESM is expected to provide EUR 9bn of external financial assistance, subject to IMF's contribution. This amount should allow to fully cover needs identified for the recapitalisation of the banking sector (EUR 2.5bn) in a cashless transaction and EUR 6.5bn for debt redemption and fiscal purposes. An indicative break down of total quarterly financing needs which will have to be covered by official funds is provided in Annex 1.

b. *IMF*

The Eurogroup statement invites the IMF to contribute to the financing of the programme. The IMF has signalled its willingness to participate in the programme

[24] The statistical treatment of the CPB recapitalisation bond is currently subject to assessment by Eurostat in context of Cyprus' April 2013 fiscal notification.

financing (except for financial sector recapitalisations) under the "normal access" procedure. This would imply an IMF contribution of up to EUR 1bn.

The IMF contribution is expected to take the form of a 3-year extended fund facility (EFF).

3. Burden sharing

a. Following the Eurogroup decision of 25 March, the Cypriot authorities have committed to take the following additional steps: *Additional bail in of creditors in Laiki bank and Bank of Cyprus*

The bail in of uninsured depositors of Laiki and Bank of Cyprus will provide an estimated contribution to recapitalization of EUR 8.3bn. [25].

b. *Gold sales*

It is envisaged to use the allocation of future central bank profits of approximately EUR 0.4bn, subject to the principle of central bank independence and provided such profit allocation is in line with CBC rules and does not undermine the CBC duties under the Treaties and the Statute.

c. *Roll-over of marketable debt held by domestic investors*

Cypriot authorities will encourage domestic investors (banks, insurance companies and state-owned enterprises) to roll over up to EUR 1.0bn of GRDS that arrive at maturity over the programme horizon, thus reducing external financial assistance for debt redemption by the same amount.

d. *Privatisations*

Cypriot authorities will launch a privatisation programme, estimated to yield proceeds of EUR 0.5bn until end-2015, another EUR 0.5bn in the course of 2016 and an additional EUR 0.4bn thereafter.

e. *Change of terms on the outstanding loan from the Russian Federation*[26]

Cypriot authorities will endeavour to change the terms on the outstanding EUR 2.5bn loan from the Russian Federation, i.e. repayment in five instalments of EUR 0.5bn between 2018 and 2022 and possibly a reduction of the current interest rate of 4.5% . A reduction of the interest rate could yield up to EUR 0.1bn.

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[25] This is a maximum estimate. The final amount will depend inter alia on the conversion under the debt for equity swap in Bank of Cyprus and the recoveries of Laiki Bank.

[26] Under the current loan agreement between Cyprus and the Russian Federation, repayment of the loan falls outside the programme period. Hence, the change of the repayment period of the loan does not have an impact on the financing needs under the adjustment programme, but rather improves the maturity profile of Cyprus's public debt shortly after the end of the programme.

Moreover, it is foreseen that Cyprus will roll-over the outstanding stock of Treasury Bills (around EUR 1bn) on the market, i.e. without ESM / IMF support. This is in line with the working assumption of other euro area macroeconomic adjustment programmes.

4. Conclusion

The European Commission, in liaison with the ECB, estimates that Cyprus's net financing needs amount to EUR 10bn over the three-year programme horizon, i.e. 2Q2013-1Q2016. This includes needs for the recapitalisation of the banking sector, the redemption of maturing medium- and long-term debt including loans, and fiscal needs after taking into account the extensive burden sharing measures adopted by the Cypriot authorities.

This programme envelope, which rests on plausible growth and fiscal assumptions, includes buffers in case of worse than expected macroeconomic and financial sector outcomes.

Annex 1: Overview of estimated financing needs to be covered by ESM/IMF over the programme period

	programme period																			
	2013					2014					2015					2016				
mln EUR, negative = surplus / revenue	Q1	Q2	Q3	Q4	year	Q1	Q2	Q3	Q4	year	Q1	Q2	Q3	Q4	year	Q1	Q2	Q3	Q4	year
Amortisation of existing market debt excl. short-term	**7.7**	**1438.2**	**346.3**	**38.6**	**1830.8**	**26.7**	**111.7**	**560.1**	**93.7**	**792.2**	**17.6**	**49.7**	**146.4**	**927.6**	**1141.3**	**363.1**	**64.2**	**161.9**	**99.6**	**688.8**
medium & long-term bonds	0.0	1416.9	714.6	1.0	2132.4	319.0	90.0	500.0	55.3	964.3	209.9	127.7	85.4	888.6	1311.7	358.0	42.6	102.5	58.2	561.4
loans	0.0	13.7	24.1	30.0	67.8	0.0	14.0	52.5	30.7	97.3	0.0	14.3	53.3	31.3	98.9	0.0	16.6	54.4	36.4	107.4
foreign loans - excluding Russia	0.0	13.7	0.9	30.0	44.6	0.0	14.0	0.9	30.7	45.7	0.0	14.3	0.9	31.3	46.5	0.0	16.6	1.1	36.4	54.2
foreign loans - Russia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
domestic loans	0.0	0.0	23.2	0.0	23.2	0.0	0.0	51.5	0.0	51.5	0.0	0.0	52.4	0.0	52.4	0.0	0.0	53.3	0.0	53.3
local government loans	5.0	5.0	5.0	5.0	20.0	5.0	5.0	5.0	5.0	20.0	5.0	5.0	5.0	5.0	20.0	5.0	5.0	5.0	5.0	20.0
saving certificates	2.7	2.7	2.7	2.7	10.7	2.7	2.7	2.7	2.7	10.7	2.7	2.7	2.7	2.7	10.7	0.0	0.0	0.0	0.0	0.0
bond roll-over by domestic investors	0.0	0.0	-400.0	0.0	-400.0	-300.0	0.0	0.0	0.0	-300.0	-200.0	-100.0	0.0	0.0	-300.0	0.0	0.0	0.0	0.0	0.0
Amortisation new market debt	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Amortisation of offical lenders	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
ESM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial sector recapitalisation	**0.0**	**0.0**	**1400.0**	**200.0**	**1600.0**	**125.0**	**125.0**	**125.0**	**125.0**	**500.0**	**100.0**	**100.0**	**100.0**	**100.0**	**400.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
of which:																				
total recapitalisation estimate	0.0	0.0	11500.0	0.0	11500.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
debt-equity swap for unisured BoC deposits and CPV resolution	0.0	0.0	-10300.0	0.0	-10300.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
contingency buffer	0.0	0.0	200.0	200.0	400.0	125.0	125.0	125.0	125.0	500.0	100.0	100.0	100.0	100.0	400.0	0.0	0.0	0.0	0.0	0.0
Fiscal financing needs	**251.2**	**343.2**	**810.2**	**366.3**	**1770.9**	**-1.7**	**447.9**	**384.3**	**366.1**	**1196.5**	**168.5**	**195.6**	**134.6**	**140.1**	**638.7**	**17.3**	**56.6**	**-12.6**	**-40.8**	**20.5**
headline deficit (including one-offs)	245.6	219.1	700.2	224.9	1389.8	340.5	264.0	329.3	311.1	1244.9	265.7	193.1	234.6	240.1	933.4	142.3	73.8	112.4	84.2	412.8
of which one-off measures /1	0.0	0.0	400.0	0.0	400.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
of which:																				
primary balance	98.5	98.5	98.5	98.5	394.1	169.6	169.6	169.6	169.6	678.3	86.0	86.0	86.0	86.0	343.9	-50.9	-50.9	-50.9	-50.9	-203.8
interest	147.1	120.6	201.7	126.3	595.8	170.9	94.4	159.8	141.5	566.6	179.7	107.1	148.6	154.1	589.5	193.2	124.8	163.3	135.2	616.5
additional financing needs / below the line																				
privatisations of SOEs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-125.0	-125.0	-125.0	-125.0	-500.0	-125.0	-125.0	-125.0	-125.0	-500.0
ESM & EIB capital contributions	5.6	31.4	0.0	31.4	68.4	2.8	31.4	0.0	0.0	34.2	2.8	0.0	0.0	0.0	2.8	0.0	0.0	0.0	0.0	0.0
called guarantees	0.0	0.0	110.0	110.0	220.0	55.0	55.0	55.0	55.0	220.0	25.0	25.0	25.0	25.0	100.0	0.0	0.0	0.0	0.0	0.0
future central bank profits	0.0	0.0	0.0	0.0	0.0	-400.0	0.0	0.0	0.0	-400.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
capitalised interest on CPB bond /2	0.0	92.7	0.0	0.0	92.7	0.0	97.5	0.0	0.0	97.5	0.0	102.5	0.0	0.0	102.5	0.0	107.8	0.0	0.0	107.8
net financing needs	**258.9**	**1781.5**	**2556.5**	**604.9**	**5201.8**	**150.0**	**684.5**	**1069.5**	**584.8**	**2488.8**	**286.1**	**345.2**	**381.0**	**1167.7**	**2180.0**	**380.4**	**120.8**	**149.3**	**58.9**	**709.3**

/1: One-off measures include compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing.

/2: The statistical treatment of the CPB recapitalisation bond is currently subject to assessment by Eurostat in context of Cyprus' April 2013 fiscal notification.

Annex 2: Annual overview of estimated financing needs for the period 2013-2020

mln EUR, negative = surplus / revenue	2013	2014	2015	2016	2017	2018	2019	2020
Amortisation of existing market debt excl. short-term	**1 830.8**	**792.2**	**1 141.3**	**688.8**	**417.9**	**656.9**	**655.0**	**1 586.8**
medium & long-term bonds	2 132.4	964.3	1 311.7	561.4	287.4	19.6	10.9	949.8
loans	67.8	97.3	98.9	107.4	110.5	617.2	624.1	617.0
foreign loans - excluding Russia	44.6	45.7	46.5	54.2	56.4	62.1	68.0	60.0
foreign loans - Russia	0.0	0.0	0.0	0.0	0.0	500.0	500.0	500.0
domestic loans	23.2	51.5	52.4	53.3	54.2	55.1	56.1	57.1
local government loans	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
saving certificates	10.7	10.7	10.7	0.0	0.0	0.0	0.0	0.0
bond roll-over by domestic investors	-400.0	-300.0	-300.0	0.0	0.0	0.0	0.0	0.0
Amortisation new market debt	**0.0**	**0.0**	**0.0**	**0.0**	**164.5**	**0.0**	**0.0**	**0.0**
Amortisation of offical lenders	**0.0**	**0.0**	**0.0**	**0.0**	**3.6**	**50.0**	**114.3**	**167.8**
ESM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF	0.0	0.0	0.0	0.0	3.6	50.0	114.3	167.8
Financial sector recapitalisation	**1 600.0**	**500.0**	**400.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
of which:								
total recapitalisation estimate	11 500.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
debt-equity swap for unisured BoC deposits and CPV resolution	-10 300.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
contingency buffer	400.0	500.0	400.0	0.0	0.0	0.0	0.0	0.0
Fiscal financing needs	**1 770.9**	**1 196.5**	**638.7**	**20.5**	**-185.4**	**30.7**	**37.9**	**85.1**
headline deficit (including one-offs)	1 389.8	1 244.9	933.4	412.8	101.3	-88.5	-87.4	-46.6
of which one-off measures /1	400.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
of which:								
primary balance	394.1	678.3	343.9	-203.8	-530.8	-736.8	-764.8	-793.8
interest	595.8	566.6	589.5	616.5	632.1	648.3	677.4	747.2
additional financing needs / below the line	288.4	-145.8	-397.2	-500.0	-400.0	0.0	0.0	0.0
privatisations of SOEs	0.0	0.0	-500.0	-500.0	-400.0	0.0	0.0	0.0
ESM & EIB capital contributions	68.4	34.2	2.8	0.0	0.0	0.0	0.0	0.0
called guarantees	220.0	220.0	100.0	0.0	0.0	0.0	0.0	0.0
future central bank profits	0.0	-400.0	0.0	0.0	0.0	0.0	0.0	0.0
capitalised interest on CPB bond /2	92.7	97.5	102.5	107.8	113.3	119.2	125.3	131.7
net financing needs	5 201.8	2 488.8	2 180.0	709.3	400.6	737.5	807.1	1 839.8

/1: One-off measures include compensation for provident and retirement funds in Cyprus Popular Bank to ensure equal treatment with such funds in Bank of Cyprus following the conversion of deposits into equity. Given the social welfare nature of provident and retirement funds, the Cypriot authorities will use the necessary amount out of programme financing.

/2: The statistical treatment of the CPB recapitalisation bond is currently subject to assessment by Eurostat in context of Cyprus' April 2013 fiscal notification.

Assessment of the public debt sustainability of Cyprus

In compliance with Article 13.1 (b) of the ESM Treaty, this note has been prepared by the European Commission in liaison with the ECB.

The economic and financial adjustment programme for Cyprus: Debt sustainability assessment

Introduction: the programme objectives support the sustainability of public debt

1. A positive assessment of the long-term sustainability of public debt is a sine qua non for granting financial assistance from the ESM and the IMF. In view of Cyprus' weak budgetary starting position, an already high government debt ratio, adverse macroeconomic circumstances and downside risks in the banking sector, the debt outlook is challenging for Cyprus. The financing needs of the government will be substantial, in a situation where the sovereign does not have access to international markets. The weak economic outlook may potentially also lead to additional financing requirements for re-capitalising banking institutions[27].

2. Pursuant to Article 13.1(b) of the ESM Treaty, the Chairperson of the Board of Governors of the ESM shall entrust the European Commission, in liaison with the ECB, with assessing whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF. This note by the Commission services, in liaison with the ECB, assesses whether public debt is sustainable under the macroeconomic adjustment programme agreed with the Cypriot authorities at staff level on 2 April 2013. The assessment has been conducted with IMF Staff[28].

3. An ambitious fiscal adjustment path over the medium-term is essential to contribute to the sustainability of Cyprus' public debt. With exception of short-term placements of treasury bills, the Cypriot government is unable to fund itself on the regular bond market. The loss of market access is a clear indication of investors' concerns about the sustainability of public debt. Assistance from the ESM, subject to strict conditionality laid down in the macroeconomic adjustment programme to continuous respect of pre-established eligibility conditions, will help to mitigate the impact of the adjustment process, undertake necessary reforms and contribute to rebuilding confidence, thereby paving the way for regaining market access.

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[27] The Eurogroup statement of 25 March reconfirmed, as stated already on 16 March, that – in principle - financial assistance to Cyprus is warranted to safeguard financial stability in Cyprus and the euro area as a whole by providing financial assistance for an amount of up to EUR 10bn. The Eurogroup would welcome a contribution by the IMF to the financing of the programme. Together with the decisions taken by Cyprus, this results in a fully financed programme which will allow Cyprus' public debt to remain on a sustainable path. The Eurogroup also agreed that programme money will not be used to recapitalise Laiki and Bank of Cyprus.

[28] The sensitivity analysis in this assessment has been conducted by the Commission independently.

4. A quick and sustainable solution to the banking crisis is of major importance to ensure debt sustainability. The programme measures aimed at restoring the soundness of the Cypriot banking sector, which in the longer term will support the aim of a sustainable debt trajectory. Thoroughly restructuring, resolving and downsizing financial institutions, strengthening of supervision, addressing expected capital shortfall and improving liquidity management are key steps in this regard. The gradual phasing-out of exceptional capital controls and other administrative measures will be conducive to better macroeconomic outcomes and thus contribute to improving the debt outlook.

5. A fundamental requirement for debt sustainability is that Cyprus can generate lasting growth. While the necessary medium-term deleveraging process of Cyprus' unsustainable internal and external imbalances will take a toll on medium-term growth performance, the programme will support a return to balanced growth. Addressing issues of a structural nature will also contribute to restore its growth potential over the long term thereby rebalancing the Cypriot economy, restoring its growth potential and strengthening competitiveness. These includes improving the functioning of labour, service and product markets, reinvigorating the performance of sectors where Cyprus has comparative advantages, reforming the public administration and carefully preparing for the exploitation of the Cyprus' offshore natural gas.

6. Programme ownership is a prerequisite for a successful adjustment programme. On 25 June 2012 Cyprus requested external financial assistance from euro area Member States as well as from the IMF with a view of the challenges that Cyprus is facing, in particular due to distress in the banking sector and the presence of macroeconomic imbalances. After unprecedentedly protracted programme discussions, Cyprus and the programme partners reached a provisional staff-level agreement on November 23 on the policy side of a draft Memorandum of Understanding (MoU), but did not conclude the financing side of the economic and financial adjustment programme. In December 2012, the Cypriot Parliament voted the large majority of fiscal measures for 2012-14 outlined in the draft MoU, as well as first important steps in relation to fiscal-structural reforms (e.g. pension system, health sector, budgetary framework, welfare benefits, COLA etc).

Macroeconomic developments and outlook

7. More than a decade of sustained and strong economic expansion in Cyprus came to an end in 2009. Economic activity in Cyprus fell by close to 2%, with weak domestic demand and an adverse external environment weighing strongly on growth. Economic activity recovered in 2010 with real GDP growth of around 1%. In 2011 the Cypriot economy grew by a modest 0.5%, with economic activity seriously affected by the accident in July 2011 that destroyed the Vasilico power station.

8. Since 2011, financial sector headwinds and growing uncertainty regarding the public finances position, including the impact of financial sector related contingent liabilities have had a negative impact on confidence and economic activity. These adverse developments related to the unwinding of very serious private and public sector imbalances in the Cypriot economy as well as to the negative spill-overs from financial and economic turmoil in neighbouring economies and weak external demand. Financial sector deleveraging and fiscal consolidation weighed negatively on domestic demand, consumer and corporate sector confidence weakened, and unemployment rose.

9. The Commission services' Winter 2013 Forecast (published on 22 February 2013) incorporated the provisional staff-level agreement of 23 November 2012. Economic activity in Cyprus was expected to significantly weaken with real GDP contracting by close to 2½% in 2012. The deterioration was seen to be driven by a marked contraction of domestic consumption and private investment, as a result of the prolonged high economic uncertainty and the tightening credit conditions due to on-going deleveraging process, the significant deterioration in the labour market and the pass-through of fiscal consolidation measures implemented at the end of 2011. Projections of the economic outlook for 2013 and 2014 were pointing to a prolonged recession with a further cumulative loss in output of around 5%, due to further 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 favourable, particularly for tourism and business services.

10. Following political agreements in the Eurogroup on 16 and 25 March, the agreed economic and financial adjustment programme entails a frontloaded banking sector restructuring. In accordance with the Cypriot authorities' policy plans, major financial institution will be downsized combined with extensive bail-in of uninsured depositors, and a set of wide-ranging temporary capital controls and administrative measures. The programme is envisaged to build the foundation for sustainable growth over the long run. Nevertheless, in the short run, the economic outlook remains challenging. Real GDP is projected to contract by 12½% cumulatively in 2013-14. Short-run economic activity will be negatively affected by the immediate restructuring of the banking sector, which will impact on net credit growth and by additional fiscal consolidation measures. Temporary restrictions required to safeguard financial stability will hamper international capital flows and reduce business volumes in both domestic and internationally oriented companies. The bail-in of uninsured depositors will cause a loss of wealth, which will reduce private consumption and business investment. This, compounded by the impact of fiscal consolidation already undertaken and new measures agreed, will result in a sharp fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial service sector.

11. Having addressed the banking sector problems upfront, growth is projected to rebound in 2015-16 and attain close to 2% over the long run. 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-capitalised banking system is expected to gradually loosen the tight credit conditions in the economy. Also, in the outer years, investments projects related to the energy sector and the prospects of exploitation of natural gas could contribute increasingly to economic growth. The recent reform of Cyprus' wage-indexation mechanism will contribute to align public wages with developments in economic activity, improve competitiveness, and support the economic recovery. This is expected to have a positive impact on the external balance, with the current account deficit contracting over the programme period and external debt, in particular related to external liabilities of financial institutions, expected to decline.

12. Macroeconomic risks remain important and tilted to the downside. On the domestic front, downside risks are associated with domestic credit conditions and further deterioration of confidence in the banking system. Moreover, there is a non-negligible risk of a cycle of household and corporate defaults propagating through the economy, leading to further banking sector losses, worsening of labour market conditions, stronger than expected fall in house price and a prolonged loss of business and consumer confidence. Also, the deep restructuring of the Cypriot banking sector could have strong spill-overs on related professional business services and financial services exports. More generally, the transition to a more varied growth model will be challenging for the economy in the coming years and will imply a re-allocation of economic resources across sectors, which may take time and will require flexible factor and product markets. Upside risks for the Cypriot economy are limited, relating mainly to higher investment activity in the energy sector and possible improvements in the external outlook, should the euro area economic activity strengthen beyond expected.

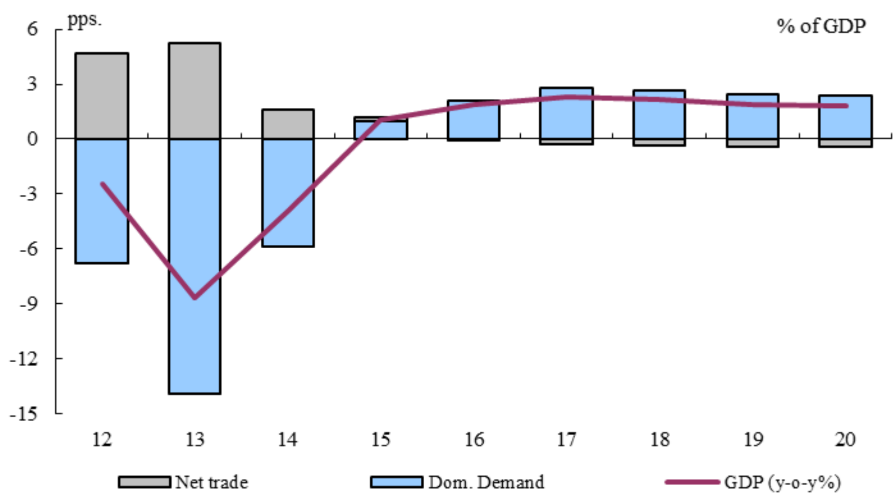
Table 1: Macroeconomic projections, 2012-16

	2012	2013	2014	2015	2016
		Proj.			
Real Economy					
Real GDP	-2,4	-8,7	-3,9	1,1	1,9
Domestic demand	-6,8	-13,9	-5,9	1,0	2,1
Consumption	-2,7	-11,5	-5,1	0,8	1,9
Private consumption	-3,0	-12,2	-5,6	1,6	3,0
Public consumption	-1,7	-9,0	-3,7	-1,7	-1,5
Fixed investment	-23,0	-29,5	-12,0	2,3	3,5
Inventory accumulation 1/	-0,9	0,0	0,0	0,0	0,0
Foreign balance 1/	4,7	5,2	1,6	0,2	-0,1

Exports of goods and services	2,3	-5,0	-2,5	1,7	2,7
Imports of goods and services	-7,2	-16,0	-6,5	1,7	3,3

1/ Contribution to growth.

Graph 1: Cyprus – GDP growth and contributions



Source: Commission services' calculation

<u>The programme's fiscal consolidation strategy aims at achieving a sizeable primary surplus</u>

13. An ambitious but achievable fiscal adjustment path over the medium-term is essential to contribute to the sustainability of Cyprus' public debt. For this reason, a key objective of the fiscal strategy and the agreed consolidation measures in the draft Memorandum of Understanding with Cyprus (MoU) 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, maintaining at least such a level thereafter. This constitutes an 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.

14. The adoption and implementation of fiscal-structural measures are critical to achieve a permanent consolidation and maintain a primary surplus at high level over the longer-term. The range of fiscal-structural and structural reforms agreed in the MoU 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.

15. Debt sustainability depends critically on determined programme implementation. The Cypriot authorities have legislated and implemented an important number of fiscal measures for 2012-2014, amounting to around 4½% of GDP of measures[29].

16. Following, the 25 March 2013 Eurogroup political agreement, additional fiscal consolidation measures of around 1.5% of GDP for 2013 will be legislated and implemented before disbursement of the first tranche of financial assistance, namely (i) increase in the statutory corporate income tax to 12.5%, (ii) increase in the interest income withholding tax to 30% and (iii) increase in the bank levy to 0.15%. The majority of the fiscal adjustment measures for 2013-14 agreed in November 2012, as well as the immediate consolidation measures for 2012, were already enacted in 2012. The remaining measures agreed in November 2012 but not yet implemented, notably the revision of the property tax and of the social housing schemes, will be legislated as prior actions. The total additional fiscal measures in 2013 therefore amount to slightly above 2% of GDP.

17. The fiscal consolidation implies that the improvement in the primary balance over 2013-14 will contribute to reducing the debt ratio substantially within the programme period, in spite of the rather strong debt-increasing effects from interest expenditure and the projected recession (table 2). To safeguard the return to a sustainable debt trajectory, the measures prescribed in the MoU for the period 2015-2017 will be fully specified during the programme period and laid down in the adopted Medium-Term Budgetary Framework, accompanying the annual Budget Law. The 2015 and 2016 Budget Laws will be presented for review by the programme partners before submission to the House of Representatives. The Cypriot authorities will present programme partners in early-2016 with a provisional list of permanent measures to attain a primary surplus of 3% of GDP in 2017. The measures required will be included in the draft 2017 Budget Law.

18. In the event of underperformance of revenues or higher social spending needs, the Cypriot government has committed to stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending, taking into account adverse macroeconomic effects. Over the programme period, cash revenues above

[29] The adopted measures amounted to consolidation measures of about 5.0% of GDP for 2012-2016, in particular 0.3% of GDP in 2012, 2.3% of GDP in 2013, and 1.9% of GDP in 2014, and ½% of GDP in 2015-2016 based on the macro-economic projection underpinning the 23 November 2012 staff-level agreement.

programme projections, including any windfall gains, will be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

Table 2: Public debt trajectory projections, 2012-2016

	2012	2013	2014	2015	2016
Gross debt ratio	**86.5**	**109.0**	**123.0**	**126.3**	**121.9**
Changes in the ratio	*15.4*	*22.4*	*14.0*	*3.3*	*-4.4*
(1) Primary balance	**1.9**	**2.4**	**4.3**	**2.1**	**-1.2**
(2) Snowball effect	**3.3**	**11.4**	**6.8**	**0.5**	**-0.9**
Interest expenditure	*2.9*	*3.6*	*3.6*	*3.6*	*3.7*
Growth effect	*1.8*	*8.3*	*4.4*	*-1.3*	*-2.4*
Inflation effect	*-1.4*	*-0.6*	*-1.2*	*-1.8*	*-2.2*
(3) Stock flow adjustment	**10.2**	**8.6**	**2.9**	**0.6**	**-2.4**

Source: Commission services

Table 3: Fiscal projections, 2012-2016

		2012	2013	2014	2015	2016
			Proj.			
General government balance	Nov. 2012 Draft MoU	-5.8	-4.3	-3.2	-1.9	-0.2
(% of GDP)	WF13	-5.5	-4.5	-3.8	n.a	n.a
	Apr. 2013 Draft MoU	-5.5*	-6.0	-7.9	-5.7	-2.5
Primary balance	Nov. 2012 Draft MoU	-2.2	-0.7	1.0	2.7	4.0
(% of GDP)	WF13	-1.9	0.2	1.2	n.a	n.a
	Apr. 2013 Draft MoU		-2.4	-4.3	-2.1	1.2
Interest payments 1/	Nov. 2012 Draft MoU	-3.6	-3.6	-4.2	-4.6	-4.2
(% of GDP)	WF13	-3.7	-4.6	-5.0	n.a	n.a
	Apr. 2013 Draft MoU		-3.6	-3.6	-3.6	-3.7

Government gross debt	Nov. 2012 Draft MoU	86.5	134.6	142.7	141.1	136.1
(% of GDP)	WF13	86.5	93.1	97.0	n.a	n.a
	Apr. 2013 Draft MoU		109.0	123.0	126.3	121.9

**: Pending validation of April 2013 EDP notification by ESTAT*
1/ final estimates of interest payments will depend on the agreed financing conditions under the ESM and IMF facilities.
Source: Commission services. Nov. 2012 Draft MoU: Based on the draft MoU, as of end-November 2012. WF13: Data from the Commission services' Winter 2013 Forecast. April 2013 Draft MoU: Data from the draft MoU, as of beginning of April 2013.

The programme's banking sector restructuring reduces the needs for public support

19. The Cyprus-domestic banking sector, including the cooperative credit institutions, was oversized and represented until recently 550% of GDP. The two main banks of Cyprus, Bank of Cyprus (BoC) and Cyprus Popular Bank (Laiki), were insolvent. The necessary downsizing and restructuring of the banking sector is already under way. The Parliament has adopted on 22 March 2013, legislation establishing a comprehensive framework for the recovery and resolution of credit institutions. Under the terms of that legislation, the Central Bank of Cyprus (CBC) is the single resolution authority for banks and cooperative credit institutions alike. Using this new framework the authorities have proceeded with:

(i) the carve-out of the Greek operations of the largest Cypriot banks: The Greek assets and liabilities of the largest Cypriot banks were disposed of to a Greek core bank[30] at the end-of March 2013 and thus reduced the size of the Cypriot banking sector by 120 per cent of GDP. It also reduced any potential spill overs between the Greek and the Cypriot banking system going forward.

(ii) the resolution of Cyprus Popular Bank and the absorption of selected assets and liabilities by the Bank of Cyprus: Laiki entered resolution on the 25 March 2013 and its performing assets along with the insured deposits and the ELA were transferred to the BoC.

(iii) the recapitalisation of the Bank of Cyprus through a debt to equity conversion, without use of public money: The Bank of Cyprus has been fully recapitalised in order to regain its eligible counterparty status for the purpose of participation in regular Eurosystem monetary policy operations and it was transformed into a conventional lender, active mainly

[30] On 26/03/2013, Piraeus Bank of Greece signed an agreement to acquire all of the Greek deposits, loans and branches of Bank of Cyprus, Cyprus Popular Bank (CPB) and Hellenic Bank, including loans and deposits of their Greek subsidiaries (leasing, factoring and the Investment Bank of Greece (IBG)).

in Cyprus. By granting only limited new lending, this bank would be dramatically downsized overtime.

20. As a result of these actions the Cypriot banking sector has been downsized immediately and significantly to 350% of GDP. Hellenic Bank, which has a limited capital need, may find this from private sources. Further downsizing will be achieved through the restructuring of the cooperative credit institutions. To preserve the liquidity of the Cypriot banking sector administrative measures have also been imposed.

21. The Cooperative banking sector, which needs a significant amount of recapitalisation aid, would be rationalised through mergers of its member institutions, and would also have to downsize significantly.

22. Recapitalisation needs arise from expected losses estimated by PIMCO in an adverse scenario and to ensure that the banks remain sufficiently capitalised at 9% core tier one. In response to the results of the due diligence exercise, Bank of Cyprus and Cyprus Popular Bank have been intervened and restructured and thus programme money will not be used to recapitalise Laiki and BoC. Against this background, programme money will be used for the recapitalisation of the remainder of the restructured banking sector (including the co-operative), taking also into account that further recapitalisation needs may arise in the case of higher-than-projected loan loss provisions. The recapitalisation bond injected in Laiki in June 2012 is not replaced by ESM financing.

Financing needs and sources

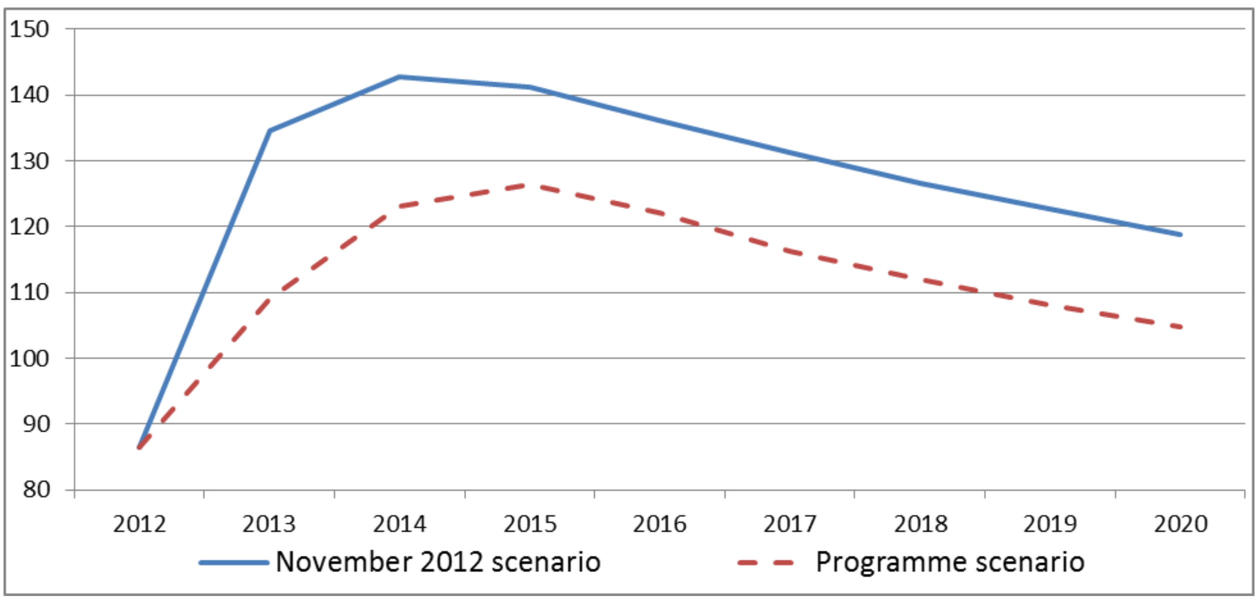
23. The Eurogroup meeting of 16 March 2013 approved financial assistance to Cyprus – in principle – for a total amount of up to EUR 10bn, i.e. the remaining financing needs over the programme period 2013-2016 after inclusion of proceeds from burden-sharing measures adopted by the Cypriot government. This programme envelope has been reconfirmed in the Eurogroup meeting of 25 March 2013. This amount will cover financing needs arising from the recapitalisation of the remainder of the restructured banking sector, redemption of maturing medium- and long-term debt including loans, and net fiscal needs after measures taken over a three-year programme horizon, i.e. 2013-2016.

24. The ESM is expected to provide EUR 9.0 bn of external financial assistance. The IMF has signalled its willingness to participate in the programme financing (except for financial sector recapitalisations) under the "normal access" procedure. This would imply an IMF contribution of up to EUR 1.0 bn. For a detailed analysis please see the note on the assessment of financing needs put forward by the Commission services under Art. 13.1 of the ESM Treaty.

Assessment of the sustainability of public debt

25. The total programme envelope is estimated at EUR 10 bn (56% of 2012 GDP). Taking into account the programme's macroeconomic projection and under the assumption that fiscal targets are met, the debt ratio under the "programme scenario" is expected to peak at around 126% of GDP in 2015. Compared to the debt trajectory implied by the November 2012 provisional staff-level agreement ("Nov. 2012 scenario"), the peak in the debt ratio is around 15 p.p. lower. In the "programme" scenario, the front-loaded fiscal consolidation measures will not be able to offset the impact on debt of the significant decline in GDP and the recapitalisation of the banking sector. From 2015 onwards, a growing primary surplus and the return to positive GDP growth will bring the debt ratio on a declining path, reaching around 122% of GDP at the end of 2016 and around 105% of GDP in 2020 (Graph 2).

Graph 2: Debt trajectories under the "programme" scenario and the "November 2012 scenario"



Source: Commission services

Note: The Nov. 2012 scenario is based on the Commission services' winter 2013 forecast including EUR 10 bn re-capitalisation of the Cypriot banking system, while the "programme" scenario is based on the agreed draft MoU (April 2013).

26. The programme partners have identified total re-capitalisation needs for banking sector institutions in the order of EUR 2.5 bn, incorporating the effect of (i) the resolution of Laiki bank and the bail-in of the uninsured depositors; (ii) the deposit-to-equity swap of the uninsured depositors in Bank of Cyprus; (iii) the carve-out of the Greek assets of Laiki Bank, Bank of Cyprus and Hellenic Bank. A possible unforeseen deterioration in non-performing loans, stemming from worse-than-expected adverse macroeconomic developments, would lead to additional banking sector needs over the programme period.

27. The "programme" scenario takes into account a number of policy measures to strengthen debt sustainability, in particular (i) proceeds generated by privatisation of state-owned assets; (ii) the proceeds from the sale of excess gold reserves owned by the Republic of Cyprus; and (iii) an asset swap in order to repay in kind part of the loan that the Central Bank of Cyprus extended to the Republic prior to the euro accession.

28. Privatisation receipts: The Cypriot authorities have committed to initiating a privatisation programme, which improves the debt outlook. Privatisation proceeds of at least EUR 1.0 bn within the programme period and additional EUR 0.4 bn in the outer years from the sale of state-owned companies and other state assets appears feasible. The establishment of a complete inventory of assets owned by central government, the municipalities and the regional administration should provide a basis for the sale of additional public real estate and land assets.

29. Sale of excess gold reserves: It is envisaged to use the allocation of future central bank profits of approx. EUR 0.4 bn, subject to the principle of central bank independence and provided such profit allocation is in line with CBC rules and does not undermine the CBC duties under the Treaties and the Statute. This is estimated to generate one-off revenues to the state.

30. Asset swap of part of the outstanding loan by the Central Bank of Cyprus: Prior to the accession to the Eurozone, CBC had provided a loan to the Republic. The current outstanding amount is approx. EUR 1.4 bn. It is estimated that real estate or other fixed assets valued at EUR 1.0 bn will be swapped for an equal value loan portion.

31. A number of other policy steps will alleviate financing needs over the programme period, but with limited or no impact on the public debt trajectory: i) the Cypriot authorities will endeavour the roll-over of up to EUR 1.0 bn domestic law long-term debt maturing during the programme period. In order to implement this, the Cypriot authorities intend to undertake a voluntary sovereign bond exchange covering bonds maturing in 2013-15. The maturing bonds will be exchanged for new longer dated sovereign bonds with maturities between 5 and 10 years; ii) reschedule the Russian loan falling due in 2016 to be repaid in 5

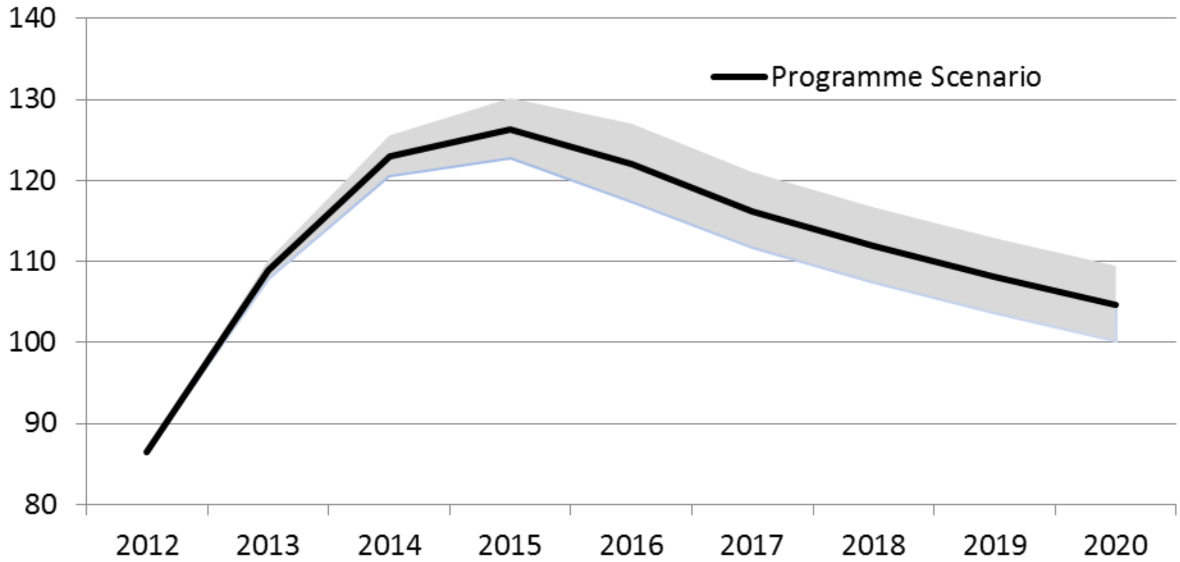
equal instalments starting in 2018 and lower the interest rate; iii) rolling over the EUR 1.9 bn CPB recapitalization bond[31].

32. Debt projections are sensitive to macroeconomic developments, in particular deviations in the projected nominal GDP path and the fiscal balance. Graphs 3-6 (Commission services' estimates) show a sensitivity analysis of the programme scenario. The charts depict, respectively, the impact of a 1 p.p. lower annual GDP growth each year during 2013-16, the impact of a 1 p.p. worse primary fiscal balance each year during 2013-16, the impact of a 2 p.p. higher market interest rate on new and rolled-over debt during 2013-2020 and the impact of a combined shock on the projected debt ratio.

33. In spite of the sound foundations of the programme, more pronounced downside risks to the projected debt developments than shown in graphs 3-6 exist and are linked in particular to: (i) a possible stronger contraction of the economy, steeper drop in real estate prices, and further worsening of the labour market outlook, especially if the banking sector downsizing and administrative restrictions will result in a more protracted period of low confidence and credit contraction; (ii) non-attainment of the agreed primary surplus targets established in the programme; (iii) insufficient implementation of fiscal-structural measures to underpin the attainment of continued high primary surpluses; (iv) lower-than-expected privatisation proceeds; (v) a less tax-rich composition of growth and possibly stronger sensitivity of revenues to the structural adjustment of the Cypriot economy; (vi) a worsening of the economic situation in trade-partner economies and (vii) lack of success in regaining market access at a reasonable borrowing cost after the programme period.

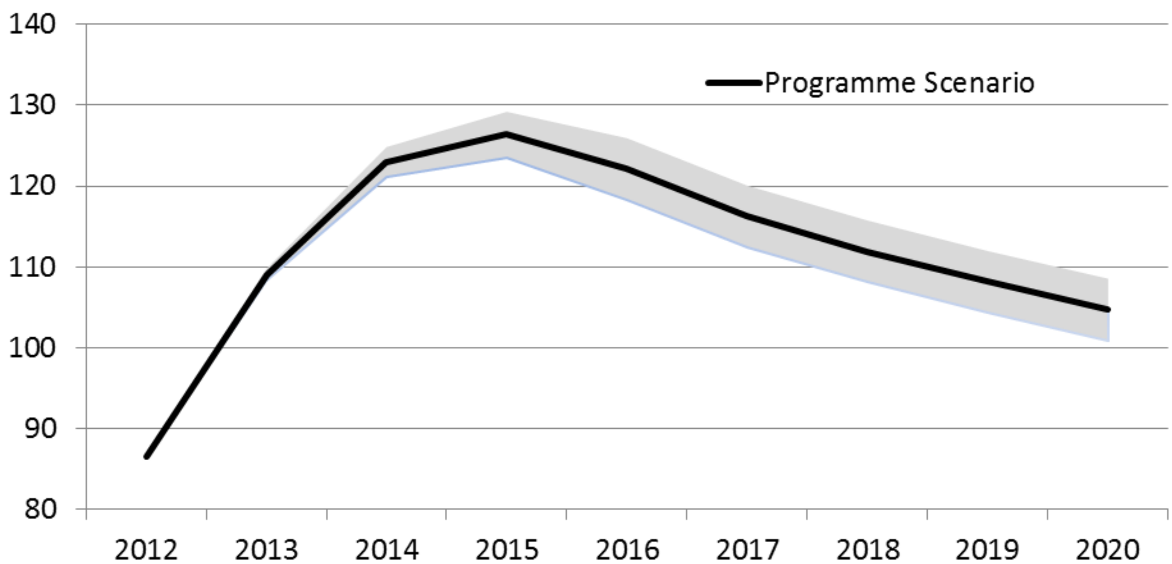
Graph 3: Programme scenario: sensitivity to lower/higher growth

[31] The statistical treatment of the CPB recapitalisation bond is currently subject to assessment by Eurostat in context of Cyprus' April 2013 fiscal notification.



Source: Commission services' sensitivity analysis

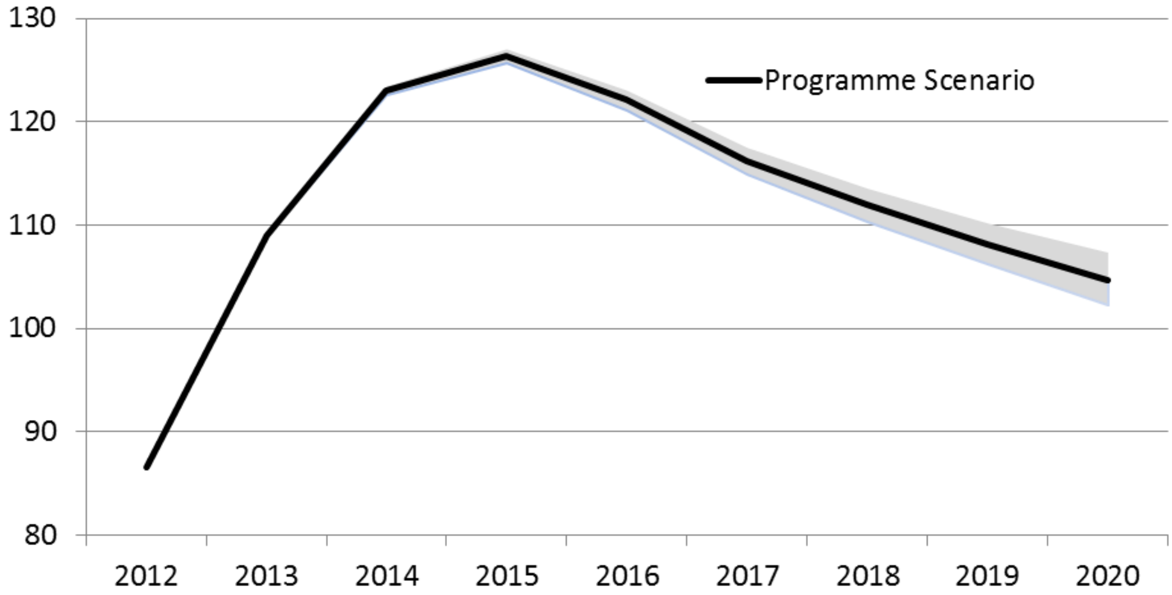
Graph 4: Programme scenario: sensitivity to 1 p.p. worse/better primary balance



Source: Commission services' sensitivity analysis

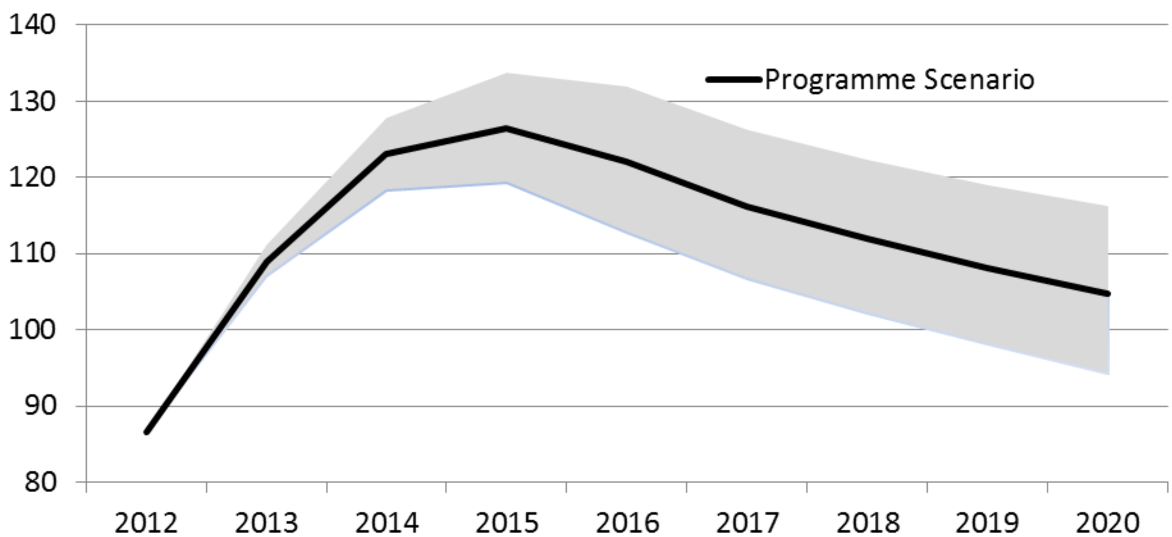
34. The low financing needs and the fact that a majority of the debt will be to the ESM after the end of the programme period imply that debt dynamics are less sensitive to market interest rate changes until 2020. This is confirmed by assuming higher market interest rates of 2 p.p. on new and rolled-over debt, which has a limited impact on debt dynamics up to 2020 (graph 5).

Graph 5: Programme scenario: sensitivity to higher/lower interest rate



Source: Commission services' sensitivity analysis

Graph 6: Programme scenario: combined sensitivity to growth, primary balance and interest rate



Source: Commission services' sensitivity analysis

Note: Combines the effect of a lower/higher growth, worse/better primary balance and higher/lower interest rates, respectively.

35. There are, however, also upside risks to be taken into account, albeit difficult to quantify, including: i) the macroeconomic scenario underpinning the programme assumes a pronounced short-term impact of fiscal consolidation on economic activity. However, the Cypriot economy is a small open economy, implying that the impact on growth from consolidation could be comparatively small, while the benefits of confidence-enhancing fiscal and structural reform measures may be comparatively large; ii) the future exploitation of Cyprus' offshore gas fields is expected to increase government revenues both directly and via increased economic activity. These effects are excluded from the current debt projections as the size of these natural resource revenues remains uncertain. Overall, although both the timing and size of the revenues remain uncertain, exploitation of Cyprus' natural resources constitute a significant upside risk to debt sustainability; iii) the agreed and planned structural reforms will lead to a fall in long-term expenditures especially in the area of pensions. The agreed increases in retirement ages and other parametric changes to the pension system and health care system will yield significant savings in public finances.

Conclusions

36. The projections carried out by the Commission services, in liaison with the ECB, on the basis of the financial, fiscal and macroeconomic parameters of the draft MoU, suggest that Cyprus' debt outlook is challenging, but will allow Cyprus’ public debt to remain on a sustainable path, provided that there is strong implementation of the adjustment programme. The assessment has been conducted with IMF Staff.

37. A number of downside and upside risks to the debt projections may impact on the actual debt trajectory. Although difficult to quantify, downside risks appear dominant.

Annex 1: Main technical assumptions underpinning the debt projections

Description of scenarios in the DSA

- The **November 2012 scenario** is based on the Commission's services 2013 Winter Forecast which builds on no-policy-change, apart from the fiscal measures already adopted and implemented in December 2012 in line with the draft Memorandum of Understanding agreed in November 2012, and includes the costs for the recapitalisation of the banking system amounting to EUR 10.0 bn.
- The **Programme Scenario** is based on the commonly agreed macroeconomic forecast and the fiscal consolidation measures incorporated in the MoU agreed between the Cypriot authorities and the Troika on 2 April 2013, including, inter alia, privatisation receipts for state-owned and semi-public companies of EUR 1.4 bn over 2013-2018, roll-over of domestic-law long-term debt of EUR 1.0 bn, CBC loan asset swap of EUR 1.0 bn and sale of excess gold reserves of EUR 0.4 bn.

Macroeconomic and fiscal assumptions

- The projections under the November 2012 scenario are based on the Commission services' 2013 Winter Forecast, which incorporated the provisional MoU agreed at staff level. Projection of the programme scenario is based on the commonly agreed programme partners' macro-fiscal forecast for 2013-2016.
- The scenarios assume a rescheduling of the redemption of the loan by the Russian Federation of EUR 2.5 bn so that repayment takes place as from 2018 in 5 equal instalments and an interest rate reduction. For technical purposes and pending finalisation of the agreement between the Russian Federation and the Republic of Cyprus, an interest rate of 2½% was used.
- The GDP deflator is assumed to be 1.9% between 2017-2019, reaching 2.0% by 2020 and remain stable thereafter.

Interest rate assumptions

- The ESM interest rate reflects the expected path of 10-year Bunds, plus a margin, ranging from 2.27% in 2013 to 3.80% in 2025.
- The IMF interest rate increases from 2% in 2013 to 3.4% in 2017. It declines gradually to 3.2% until 2020 and remains stable at that level thereafter.
- The nominal long-term interest rate on new/rolled over debt is assumed to be at 5%. The nominal short-term interest rate on new/rolled over debt is assumed to decline linearly from 5% in 2013 to 3% by 2015.

Debt profile and loan assumptions

- The ESM loan of EUR 9bn has a maximum average maturity of 15 years with a maximum maturity of 20 years - in practice this implies that half of the outstanding ESM loan has been paid back by 2028 and the ESM loan will be repaid by 2033;
- The IMF loan of EUR 1bn is granted under the Extended Fund Facility. Repayment starts after 4.5 years.
- Cyprus continues to roll-over outstanding T-Bills at programme start on the market, i.e. programme funds are not used for the redemption of T-Bills.

Cyprus: assessment of the risks to the financial stability of the Euro Area

(Art 13 of ESM Treaty)

In compliance with Article 13 (a) of the ESM Treaty, this note has been prepared by the European Commission in liaison with the ECB

Cyprus: assessment of the risks to the financial stability of the Euro Area

(Art 13 of ESM Treaty)

Background

On 25 June 2012, the Government of Cyprus requested external financial assistance from the ESM Member States, in the context of a full-fledged economic stabilisation programme implying strict conditionality in the areas of financial sector, budgetary and structural policies. Article 13 of the ESM Treaty entrusts the European Commission, in liaison with the ECB, with the task to '*assess the existence of a risk to the financial stability of the euro area as a whole or of its Member States'*. Pursuant to article 13 of the ESM Treaty this note assesses the existence of a risk to the financial stability of Cyprus, its direct neighbours (notably Greece) and the euro area as a whole.

Financial stability risk to Cyprus

The financial situation in Cyprus is fragile. The Cypriot economy is characterized by a large financial sector. The consolidated balance sheet of the Cypriot banking sector is about 750% per cent of GDP (including foreign banks operating in Cyprus), with a high exposure to Greece and domestic real estate.

The Cypriot banks have been badly hit by the Greek crisis. The Cypriot banks suffered about 4 billion in losses from the Greek PSI, i.e. more than 22 per cent of GDP. The steep contraction of the Greek economy has caused a significant deterioration in the quality of the Greek loan book. In Cyprus the property market has gone from boom to bust, which has impacted negatively on the domestic loan book. Based on stress-tests, including by PIMCO, the capital shortfall of the Cypriot banks is estimated at around 10 billion, after bailing in junior debt holders, or almost 60 per cent of GDP.

The liquidity situation in the banks is tight. The only available liquidity backstop for Cypriot banks is ELA from the Central Bank of Cyprus (CBC). Due to the capital shortage and the erosion of collateral value large Cypriot banks have lost access to the regular financing operations of the ECB.

Since the start of the crisis the fiscal situation has sharply deteriorated. The ratio of debt to GDP has increased from 58.8 % of GDP in 2008 to 89.7% of GDP in 2012. Rating agencies have progressively downgraded the sovereign signature until it reached junk status in early 2013. The Cypriot government has lost market access in autumn 2011.

In the absence of an assistance programme the capital shortfall in the banks would not be addressed. As a consequence the Euro system could also not any longer grant a liquidity backstop to Cypriot banks. In the event of a bank default the Cypriot government would not be able to fulfil its obligations and would have to default on its current payments and debt service.

In this scenario the Cypriot government would be forced to instantly balance its books, resulting in a very sharp contraction of the economy and the collapse of the banking system. Cypriot citizens would suffer significant reductions in wealth and income and a large part of the companies would not survive the shock. The Cypriot government would also have to put in place a bank holiday, deposit withdrawal restrictions, and capital controls for extended period of time to avoid a flight of capital and liquidity.

Financial stability risks to Greece

The country that would be most directly affected is Greece. The economic and financial situation in Greece is still very fragile. This means that Greece is relatively vulnerable to shocks. A collapse of Cyprus would have direct and indirect impacts on Greece.

The direct impact on Greece will be primarily through the banking sector. The two largest Cypriot banks have systemically important operations in Greece via branches. The two banks account for 8 per cent of the Greek deposits. The collapse of the Cypriot banks would lead to a deposit freeze and the imposition of any other restrictions put in force in Cyprus also on the Greek branches of these Cypriot banks. There would be a direct confidence impact on Greek banks, at a time when the 4 major banks are consolidating and have two more months to raise missing capital from the market. Failing this, most of the Greek banking system will be nationalised (or publicly owned), with potential adverse impact of perceptions of sovereign debt sustainability.

There could be significant and negative signalling effect related to deposit runs, defaulting banks, sovereign default and the risk of imposition of administrative controls also elsewhere. Moreover, it could lead to renewed doubts about the integrity of the euro zone. Greece being the weakest link would likely be the first in line.

Financial risks to the euro

Cyprus, with its GDP of less than EUR 18 billion, is by all standards a small economy relative to the size of the euro area. For this reason one would under normal circumstances expect the direct impact of an outright default on the broader Eurozone to be limited. The situation in bank funding and sovereign markets however is still very fragile. The indirect consequences of a Cypriot default should be assessed against this backdrop. A number of risks can be identified.

- The example of very steep deposit losses in Cyprus, may negatively impact on deposit stability elsewhere.

- Apart from any possible instability in deposit base, Eurozone banks may see their ability to raise unsecured funding deteriorate.

- There is a risk of a negative impact on the funding outlook for vulnerable sovereigns. A number of countries are approaching the end of their programme and are working towards establishing full market access (for example Ireland and Portugal). Others have been working hard to keep market access. There is a risk that a new round of instability may reverse this.

- The imposition of capital controls in one part of the euro area may have an impact in and by itself on the private capital flows to other vulnerable countries.

- An uncontrolled collapse of Cyprus may create renewed doubts on the integrity of the euro zone. This could be very damaging for financial stability and economic growth in the Eurozone.

Conclusion

Despite the small size of the Cypriot economy, disorderly developments in Cyprus could undermine important progress made in 2012 in stabilizing the Eurozone. A default of Cyprus and banks would have direct stability implications for Greece and indirect consequences for the wider euro area, with possibly doubts about the integrity of the euro zone resurfacing again. This could lead to renewed financial instability requiring further mitigating policies and to a further loss of growth and jobs in the Eurozone.

I. Cyprus: Letter Of Intent

Nicosia, April 29, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington D.C.

Ms. Lagarde:

Cyprus is facing an unprecedented crisis originating from our oversized banks, some of which faced solvency problems, compounded by lax fiscal policies. The crisis will have severe implications for economic growth and fiscal sustainability. To face the challenges ahead, we are proposing a strong and ambitious reform program, backed by substantial financing from international organizations, aimed at stabilizing our financial system, achieving fiscal sustainability, and supporting the recovery of economic activity to preserve the welfare of the population and social cohesion.

We have already taken major steps to address these challenges. In the financial sector, these include: divestment of the Greek operations of the domestic banks; the prompt intervention and resolution of Cyprus Popular Bank and transfer of part of it to the Bank of Cyprus; recapitalization of the transferred part with the participation of shareholders, bank debt holders, and partial conversion of uninsured deposits into equity, while fully protecting insured depositors; recapitalization of Bank of Cyprus with the participation of shareholders, bank debt holders, and partial conversion of uninsured deposits into equity, while fully protecting insured depositors; and imposition of temporary restrictions on financial flows to preserve financial stability. On the fiscal side, key recent measures include: the inclusion in the 2013 budget of substantial consolidation measures for the period 2013-15; reform of the public sector COLA wage indexation mechanism; and implementation of reforms of the pension system to improve its long-term sustainability.

But more needs to be done. Under the proposed program, we intend to implement a comprehensive strategy to restore the viability of the financial system and strengthen the banking supervision and regulatory framework. We are also committed to an ambitious fiscal consolidation path that protects the most vulnerable. We will target a primary balance of 4 percent of GDP by 2018, required to ensure that that the public debt-to-GDP ratio is placed on a sustained downward trajectory toward a level of 105 percent of GDP by 2020. Finally, we are proposing substantial structural reforms to improve the efficiency of the public sector, including through the timely privatization of viable state-owned enterprises.

We are turning to our international partners for support as we implement these far-reaching objectives. Our estimate is that the external financing need would be up to €10 billion until the first quarter of 2016. We therefore request that the Fund support our policy program through an arrangement under the Extended Fund Facility which can be drawn over a period of 36 months in the amount of SDR 891 million (about €1 billion and 563 percent of quota). This arrangement, along with support of about €9 billion from the European Stability Mechanism, will help ensure financial stability as we restore market confidence and return to durable growth.

The attached Memorandum of Economic and Financial Policies (MEFP), which has been approved by the Council of Ministers on April 3, outlines the economic and financial policies that the Cypriot government and the Central Bank of Cyprus will implement during the next three years to restructure Cyprus' financial system and ensure fiscal sustainability. The government is fully committed to the policies stipulated in this document and its attachments. We are confident that by the end of the program we will achieve robust growth - eventually supported by the development of prospective gas resources - and lasting stability that will enable us to maintain social cohesion and create entrepreneurial opportunities for our people.

The implementation of our program will be monitored by the Fund through quarterly reviews, quantitative performance criteria and indicative targets, as well as structural benchmarks as described in the attached MEFP and the Technical Memorandum of Understanding (TMU). There will be 11 quarterly reviews under the arrangement. The quarterly reviews will assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

While we are confident that the policies set forth in the MEFP are adequate to achieve the objectives under the program, we stand ready to take any corrective actions that may be needed for this purpose. In accordance with the Fund's policies, we will consult with the Fund on the adoption of such actions in advance of revisions to the policies contained in this letter and the MEFP.

Sincerely,

/s/	/s/
Minister of Finance	Governor of the Central Bank of Cyprus

II. Cyprus: Memorandum Of Economic And Financial Policies

A. Objectives, Strategy, and Outlook

1. **Cyprus is going through an unprecedented banking crisis.** The crisis came to a head following a buildup of large vulnerabilities in recent years. In part, these were related to significant bank exposure to Greece, which resulted in sizeable losses following the Greek debt restructuring (an amount in excess of €4 billion of losses was suffered by the Cypriot banks as a result of the Greek Government Bond restructuring). But the unwinding of a domestic housing boom and the economic downturn in Cyprus also contributed to the deterioration of the banks' loan portfolio. As a result, the two largest banks, comprising about 80 percent of our domestic banking sector and 400 percent of GDP in assets, were confronted with solvency problems. Loss of confidence in the system required prompt resolution of one bank, restructuring of the other bank, and imposition of temporary restrictions to financial flows, which constitute a severe strain on economic activity.

2. **Our weak public finances cannot fully support the large needs of the banking sector without significantly affecting public debt sustainability**. Over the last few years, expenditures have grown faster than revenues, leading to rising fiscal deficits and public debt. Last year, we took significant fiscal consolidation measures to correct these imbalances. However, given massive needs of the financial sector, burden sharing with bank creditors, including uninsured depositors, was also required to ensure that public debt does not become unsustainable. In this way, we have ensured that the Cypriot taxpayer does not need to bear the full burden of bank recapitalization costs. Still, given the difficult economic outlook and significant financing needs, in the absence of policy action, our public finances and sustainability would remain vulnerable.

3. **The country faces two key challenges**. The first challenge is to repair the banking sector, whose business model will need to adapt, so as to restore financial intermediation and support the economic recovery. The second challenge is to attain a sizeable primary fiscal surplus required to place public debt on a firmly downward path. These efforts need to be complemented with structural reforms aimed at raising the efficiency of Cyprus' public sector.

4. **To address these challenges, the government is undertaking a policy adjustment program based on two main pillars**:

- **The first pillar focuses on restructuring the financial sector**. We have already taken steps to deal with insolvency problems in the two largest banks: the Greek branches of the domestic banks have been sold; Bank of Cyprus (BOC) has been recapitalized through partial conversion of uninsured deposits into equity; and Cyprus Popular Bank (CPB) has been resolved and its insured deposits, central bank liabilities (ELA) and certain assets were folded into to BOC. Our efforts will continue to be focused on completing the bank recapitalization process, gradually restoring normal financial flows, and facilitating private sector debt restructuring. Moreover, the credit cooperative institution (CCI) sector will be recapitalized and restructured. To prevent the build-up of risks in the future, we will reform supervision and regulation and enhance transparency.

- **The second pillar entails a comprehensive fiscal consolidation plan underpinned by structural reforms.** This will build on the fiscal consolidation measures introduced last year, while taking into account short-run cyclical conditions and the need to protect vulnerable groups. In the short run, we will implement additional measures focused on increasing our corporate income tax and tax on interest. Other measures needed to attain our primary fiscal targets will be defined in future budgets. Structural fiscal reforms will focus on revenue administration, public financial management, and privatization. We are also planning to supplement the recent reform of the pension system with additional measures as needed to ensure its long-run sustainability.

5. **Our program will help to build the foundation for sustainable growth over the long run.** Nevertheless, in the short run, the outlook remains challenging and subject to high uncertainty:

- **Real GDP** is projected to contract by 12½ percent cumulatively in 2013-14. Short-run economic activity will be negatively affected by the restructuring of the banking sector and temporary restrictions on transactions, which have been required to safeguard financial stability. This, compounded by the impact of fiscal consolidation already underway, will result in a sharp fall in domestic demand. Little reprieve can be expected from exports amid uncertain external conditions and a shrinking financial service sector. Having had addressed our banking sector problems upfront, we expect growth to rebound in 2015 and attain close to 2 percent over the long run. Upside potential from exploitation of our recently discovered gas resources could further boost growth prospects.

- **Inflation** is projected to fall in the short-run as a result of the downturn. The recent reform of the COLA wage-indexation mechanism will help to ensure that public wages are aligned with developments in economic activity. Over the medium run, this will lead to an adjustment in overall wages and prices that can improve competitiveness and support the economic recovery.

- **The current account** deficit is expected to contract to less than 1 percent of GDP in 2013 from 5 percent of GDP in 2012, in tandem with the improvement of the trade balance. A modest adjustment is expected to continue in the medium term, with the current account stabilizing roughly in balance. External debt, in particular related to external liabilities of financial institutions, is expected to decline as part of the broader deleveraging of the financial sector.

1. **The policies contained in our program will put public debt on a sustainable path**. Given that Cyprus has lost access to the international capital markets, financing needs for the coming years will be largely covered by official loans. The banking sector restructuring strategy has been designed to minimize costs to the government. Nevertheless, support to our credit cooperative sector, together with fiscal deficit needs, are expected to lead to an increase in public debt, which is expected to reach around 120 percent of GDP by end-2016. Debt will continue to decline steadily thereafter, reaching about 105 percent of GDP by 2020, as a result of the rebound in the economy and sustained fiscal efforts to maintain a primary fiscal surplus. Achieving debt sustainability will require full and timely implementation of the program, which is essential to providing a sound foundation for long-run growth.

B. Financial Sector Policies

7. **We are committed to restoring the health of our financial sector and reducing contingent risks from the banks to the sovereign**. Our oversized banking sector has experienced large losses and liquidity pressures. We are addressing these through a strategy based on five pillars: (i) resolving one insolvent bank and restructuring another at least cost to the Cypriot taxpayer, and restructuring and recapitalizing remaining financial institutions; (ii) normalizing financial flows; (iii) deleveraging core and non-core operations of deposit-taking institutions to reduce the size of the domestic banking sector to the EU average by end-2018; (iv) upgrading the supervisory and regulatory framework; and (v) enhancing preparedness to deal with troubled borrowers. We will also strengthen our AML framework.

Resolving, recapitalizing, and restructuring weak institutions

8. **We have identified capital needs in the banking sector.** In late 2012, in close consultation with program partners, PIMCO was commissioned to undertake an independent due diligence of Cypriot financial institutions accounting for about ¾ of the banking system assets. In February 2013, the final report identified an overall capital shortfall of close to €9 billion for the system, required to reach a core tier I ratio of 6 percent under a stress scenario. It also showed that the two largest banks were confronted with solvency problems, with negative capital of close to €6 billion and overall capital needs of about €8 billion. A sample of 17 cooperatives and the third largest bank were found to be undercapitalized by about €1 billion.

9. **In a first step, we have decisively addressed institutions facing solvency problems without recourse to public resources.** We have taken the following actions:

- **Effective intervention and restructuring of the two largest Cypriot banks**. To address insolvency problems in these banks, on March 25, 2013 the CBC intervened CPB and BoC. The Greek branches of the two banks were sold to Piraeus Bank. CPB was split according to a "good bank—bad bank" strategy. Insured deposits were fully protected by separating them, together with central bank liabilities (ELA) and with sufficient assets to attain a Core Tier I capital ratio of 9 percent under PIMCO's stress scenario by end-program, and were immediately folded into BoC. Shareholders and other bank creditors, including uninsured depositors and remaining assets were kept in CPB, which is to be liquidated over time. The resolution of CPB was done under the auspices of our new bank resolution law, passed on March 22, which provides for burden sharing, thus minimizing fiscal costs.

- **Completion of BoC's recapitalization**. On March 29, 2013 the resolution authority initiated the recapitalization of the bank with the participation of equity and bond holdings and subsequent conversion of 37.5 percent of uninsured deposits into shares with preferred voting and dividend rights. This was required to attain a CT1 capital ratio of 9 percent under PIMCO's stress scenario by end-program. This resulted in an immediate increase in the CT1 ratio to well above 9 percent. Part of the remaining uninsured deposits was temporarily frozen until the completion of an independent valuation (see below). As with CPB, this process minimized fiscal costs.

10. **In a second step, we will continue working toward finalizing the resolution process and ensuring the viability of the intervened banks.** Our work in this area aims to:

- **Complete an independent valuation of BoC and CPB assets by end-June 2013 (structural benchmark) as mandated in the resolution law**. This is needed to ensure that capitalization targets can be met based on a more detailed and updated valuation of assets. To this end, no later than end-April 2013, we will agree with the EC/ECB/IMF staff on the terms of reference of this valuation exercise.

- **Finalize the recapitalization of BoC.** Following the independent valuation described above, if required, an additional conversion of uninsured deposits into shares with preferred voting and dividend rights will be undertaken to ensure that the CTI target of 9 percent under stress by end-program can be met. Should the bank be found to be overcapitalized relative to the target, a share-reversal process will be undertaken to refund depositors by the amount of over-capitalization.

- **Ensure that BoC can operate with maximum safeguards to preserve stability and continued viability during a transition period**. In this regard, we plan to appoint a Board of Directors to manage the bank, in accordance with the resolution law. This team will take over the responsibilities of the special administrator once the resolution process is completed and until a new general assembly is convened. The CBC will require the board to prepare a restructuring plan defining the bank's business objectives by end-September-2013 (**structural benchmark**). To ensure that these issues do not affect its normal business activities, by end-June 2013 we will have ready institutional arrangements to insulate BoC from reputational and governance risks.

11. **In a third step, we will ensure adequate recapitalization of other commercial banks.** The CBC will increase minimum CT1capital requirement to 9 percent by end-2013. We have communicated the identified capital needs to remaining banks covered in the PIMCO due diligence. We will instruct them to take the necessary steps to ensure they meet regulatory

requirements under PIMCO's stress scenario by end-September. If needed, public funds from the program will be used to recapitalize these institutions.

12. **We are also taking steps to recapitalize and restructure the CCI sector.** The government is committed to preserving a viable credit cooperative sector, as it provides valuable services while maximizing stakeholders' value. To this end:

- Sufficient program resources will be provided at the time of the first review in a dedicated account at the central bank to support the recapitalization and restructuring of the CCI sector. This will help to boost confidence in the sector. The amounts will be injected in the sector following the identification of capital needs and in accordance with the strategy below.

- We will instruct the CCIs covered by the PIMCO due diligence to meet capital requirements by end-July. If they are unable to raise capital, they will be recapitalized and/or restructured in the context of the overall strategy.

- For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability by end-June 2013 (**structural benchmark**). This will be done in accordance with terms of reference prepared in consultation with EC/ECB/IMF by end-April.

- By end-July 2013, the CBC will develop a strategy to recapitalize and restructure the sector with public money as needed **(structural benchmark)**.

Normalizing financial flows and ensuring adequate liquidity

13. **To safeguard financial stability, it was necessary to impose temporary administrative measures.** Following the intervention of the two banks and recapitalization of BoC, which required a bank holiday of six days, on March 28, 2013 the banks were opened with temporary capital controls and deposit withdrawal restrictions. Cash withdrawals, electronic payments and transfers abroad have been temporarily restricted to prevent deposit outflows and protect the liquidity position of the banks. The implementation of these measures has been appropriately differentiated across transactions to minimize disruptions in the payments system and ensure the execution of essential transactions.

14. **We aim to gradually lift deposit restrictions and capital controls**. We are committed to removing restrictive measures, including those that are inconsistent with our obligations under Article VIII of the IMF's Articles of Agreement, as soon as conditions allow. To this end, we will monitor liquidity conditions and the impact of restrictions in the banks on a daily basis and will review and relax current restrictions as needed in consultation with the EC/ECB/IMF. In the meantime, we request approval from the Fund of any measures that require such approval under Article VIII.

15. **We will ensure adequate liquidity in the banking system**. The CBC, in close cooperation with the ECB, stands ready to take appropriate measures to maintain sufficient liquidity in the banking system in accordance with Eurosystem rules and procedures. To this effect, the CBC and the ECB will require banks to submit funding plans and closely monitor their progress on returning to a sustainable funding model. Restrictions will be lifted as soon as funding conditions normalize. We commit not to impose any new restrictions or intensify any existing restrictions on the making of payments and transfers for current international transactions, nor to introduce any new multiple currency practices.

Deleveraging of the banking sector

16. **We are taking resolute steps to reduce the size of our banking sector.** Our aim is to downsize our domestic banking sector to the EU average by end-2018 from more than 500 percent of GDP at end-2012. This will better serve the needs of our economy and ensure that contingent liabilities from the banks to the sovereign are further reduced. To this end:

- On March 25, 2013 we sponsored the agreement through which Cyprus Popular Bank (CPB), Bank of Cyprus (BoC), and Hellenic Bank (HB) transferred the assets and liabilities of their branches in Greece to the Greek bank Piraeus. This helped to reduce the size of our banks by about 130 percent of GDP, limiting contingent liabilities on the state and transferring responsibility to cover €9 billion of insured Greek deposits from Cyprus to Greece.

- In the context of the resolution of CPB and restructuring of BoC, fair value their asset portfolios as part of the independent valuation exercise mandated by the resolution law. The recognition of fair value losses on the asset portfolio will help to further reduce the size of our domestic banking sector to about 350 percent of GDP.

- We will encourage banks to further deleverage non-core assets and will downsize the CCI sector. This will help to meet the target of reducing the system to the euro-area average by end-2018.

Enhancing the supervisory and regulatory framework

17. **We remain committed to strengthening the supervisory and regulatory framework of the banking system.** This is paramount to prevent buildup of new vulnerabilities in the system and limit potential future contingent liabilities onto the state. To this end, we will:

- **Ensure conservative implementation of accounting standards on loan provisioning.** By end-May, the CBC will amend its regulations to classify as nonperforming (NPL) all loans past due by more than 90 days. To enhance transparency, the reclassified historical NPL series will be promptly published. Provisioning for NPLs will be done following international accounting standards and conservative provisioning practices. In this regard, by end-September 2013, we will complete, with the support of an international accounting firm, a technical comparison of the accounting practices followed by the Cypriot banks against those followed by other international financial institutions in other relevant jurisdictions.

- **Assess and strengthen oversight of bank credit-risk management practices.** New prudential regulations covering underwriting standards, proper loan-collection practices, and appropriate collateral valuation practices, will enter into force by end-March 2014. Additionally, legislation will be passed by end-September 2013 to strengthen governance by prohibiting commercial banks from lending to their independent board members including their related parties and removing any board members in arrears on existing debts to their banks.

- **Set up a central credit register.** This register aims to monitor credit risk concentration and enhance the monitoring of large business groups (including those related to bank owners), and become an important tool of off-site and on-site banking supervision. The legal framework for the credit register will be set up by end-September 2013 (**structural benchmark**) and the register will be operational by end-September 2014.

- **Introduce early corrective measures.** To provide stronger safeguards against forbearance and enhance supervisory independence, by end-March 2014 we will pass a law establishing a framework for mandatory supervisory action based on capitalization levels. This framework will require prompt supervisory remedial action at a bank or CCI upon deterioration of its capitalization (such as suspension of dividend payments, etc.).

18. **Supervision and Regulation of CCIs will also be revamped.** To prevent excessive risk taking and protect consumers, we will undertake a reform of supervisory practices for the credit cooperative sector. The reform will include the following elements:

- **Transferring supervisory responsibility to the CBC**. By end-June 2013 we will submit legislation establishing the CBC as the supervisor of CCIs with the view to completing the operational, supervisory, and regulatory transfer of powers by end-July 2013. By end-March 2014, regulatory and supervisory frameworks for CCIs will be harmonized with those of commercial banks to ensure a level playing field and reduce potential mispricing of risks.

- **Enhancing transparency of financial information.** To enhance transparency, by end-September 2013 the largest CCIs (threshold to be determined by the CBC in consultation with the EC, ECB and IMF), will be required to have an annual audit performed by a recognized and independent auditing firm, starting with the 2013 annual accounts.

- **Revising lending practices.** We plan to submit legislation by end-September 2013 to strengthen the governance of CCIs to *inter alia* limiting the CCIs from lending to natural persons that are non-members, independent board members including their related parties, and removing any board members in arrears on existing debts to the cooperative credit institution.

Enhancing preparedness to deal with troubled borrowers

19. **We will take measures to provide for private sector debt restructuring.** We plan to establish a framework for targeted private sector debt restructuring following the implementation of the resolution and recapitalization of weak banks. This will help to revive financial activity, facilitate new lending, and diminish credit constraints. We are working on three fronts:

- **Temporary moratorium.** Before end-April, 2013 the CBC will issue a directive to recommend banks to provide borrowers a grace period of 60 days without penalties to pay interest only on loans coming due. This measure aims to prevent disruptive effects in related payments throughout the whole economy.

- **Tax incentives to facilitate debt restructuring.** By end-May, 2013 we will amend legislation if needed to eliminate any tax deterrents to credit institutions and customers that may currently be in place with respect to loan restructurings. This will include elimination of any tax deterrents with respect to any losses of income associated with voluntary early loan repayments or discounts given for such repayments to problematic but viable borrowers.

- **A well-targeted approach to debt restructuring of viable debtors.** By end-June 2013 we will identify measures as needed to address legal, administrative, or other impediments affecting the restructuring of viable borrowers while preserving credit discipline. Our approach will be based on market-based voluntary workouts underpinned by measures to strengthen the legal framework to support debt restructuring. In this regard, in addition to the central credit registry, a framework for seizure and sale of loan collateral will be implemented by end-2014, macroeconomic conditions permitting. Moreover amendments to ensure the reduction of built-in costs (fees, requisites) for credit institutions and clients during restructuring will be introduced. Finally, we will establish by end-June 2013 a mediation service to intermediate between banks and their clients to achieve fair debt restructuring.

Strengthening the AML framework

20. **We remain fully committed to strengthening our anti-money laundering (AML) framework in line with the FATF standards**. While Cyprus' AML regime has received an overall positive evaluation in the 2011 MONEYVAL report, we have agreed to an independent audit of the implementation of the AML framework in credit institutions. We remain committed to strengthening our AML legal and implementation framework. To this end:

- We will further build on recent revisions to our legal framework, as appropriate to:(i) ensure the exchange by the financial intelligence unit of financial intelligence on money laundering, associated predicate offenses and terrorist financing with foreign counterparts without the need to secure a court order; (ii) ensure that all trustees of trusts under Cyprus law are regulated or otherwise registered; (iii) ensure that adequate and accurate information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities; and (iv) ensure that the use of "nominee directors" (i.e., professionals who provide director services) or nominee shareholders does not create any obstacle to the timely access to adequate, accurate and current information on the beneficial ownership and control of companies. We will finalize these by end-September 2013 (**structural benchmark**).

- To implement the revised legal framework related to the transparency of Cypriot corporations and trusts, we will: (i) conduct a third party assessment of the functioning of the Registrar of Companies and appropriately resource the department of the Registrar; and (ii) strengthen the AML/CFT supervision of lawyers, accountants and trust and company service providers by providing adequate staffing of supervisors, applying a risk-based approach to supervision, and revising the methodology used for supervision and inspection by end-December 2013.

- The supervision department of the CBC will revise its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision by end-December 2013.

- Finally, should the independent audit reveal that there is a need, we stand ready to take corrective actions in the implementation of the preventive measures by financial institutions. These will be agreed by end-June 2013.

C. Fiscal Policy

21. **To place debt on a sustained downward path, the government is committed to achieving a primary fiscal surplus of 4 percent of GDP by 2018.** We will pursue a balanced fiscal consolidation that boosts credibility in our public finances and lowers debt in the long run, while taking into account cyclical considerations. For 2013, we will target a primary balance of -2.4 percent of GDP, after taking into account a significant consolidation already underway, as well as some one-off revenues. Our target may be revised down to incorporate compensation for pension funds in CPB with program funds to ensure equal treatment with such funds in BoC following the conversion of deposits into equity. With the economy continuing to contract and no additional one-off revenues, we will aim for a primary balance of -4.3 percent of GDP in 2014. Thereafter, we will plan to reach a primary deficit of -2.1 percent of GDP in 2015, and surpluses of 1.2, 3, and 4 percent of GDP in 2016, 2017, and 2018 and beyond, respectively.

22. **In a first step toward fiscal consolidation, last December we legislated a comprehensive package of measures for 2013-15.** Under our revised macroeconomic framework, these are estimated to yield about 5 percent of GDP. On the expenditure side, we

implemented permanent wage cuts applying to the broad public sector, abolished and/or reduced a number overlapping benefits, increased the mandatory retirement age in the public pension scheme, and implemented an early retirement penalty, while preserving acquired rights. On the revenue side, we increased excise taxes and VAT rates, extended the existing extraordinary contributions on wages scheduled to expire in 2014, and further increased the contribution rate to the general pension system by both employees and employers.

23. **Achieving our planned fiscal path will require additional consolidation measures amounting to about 7 percent of GDP during 2013-2018**. To this end, we will implement an additional 2.2 percent of GDP in measures in 2013. To secure our long-term primary fiscal target of 4 percent of GDP, we commit to identifying an additional 4.7 percent of GDP of measures to be implemented during 2015-2018. Given our still relatively high budget spending, we will ensure that our consolidation efforts deliver at least 60 percent of total specified yields for 2013-18 in expenditure rationalization.

24. **At the onset of the program, we will implement measures amounting to 2.2 percent of GDP through the adoption of legislation and Council of Minister decisions, as needed (prior action).** On the revenue side, these measures will include: (i) increasing the corporate income tax rate from 10 to 12.5 percent; (ii) raising the bank levy rate from 0.11 to 0.15 percent; (iii) raising the withholding tax rate on interest received to 30 percent; and (iv) reforming the property tax; and (v) other. These measures are expected to yield 2 percent of GDP. On the expenditure side, we will rationalize housing benefits, which will save 0.2 percent of GDP.

25. **During upcoming reviews, we commit to identifying an additional 4.7 percent of GDP in measures to attain a primary balance target of 4 percent of GDP by 2018**. These will be included in the annual budgets for 2015-18 and the corresponding medium term frameworks. Fiscal structural reforms in the areas of expenditure rationalization and revenue administration will help us to achieve these needed budget savings. In the event of revenue shortfalls or higher social spending needs, the government stands ready to take additional measures to preserve the program's medium-term fiscal balance and debt objectives, including by reducing discretionary spending. Conversely, if there is an over-performance, to the extent that it is deemed permanent, it will reduce the need for additional measures in the outer years. Finally, one-off windfall revenues will not be used to increase spending.

A. Structural Fiscal Reforms

26. **We are committed to implementing structural reforms to support our fiscal consolidation efforts and ensure the sustainability of our pension system**. Last year, we implemented a comprehensive reform of the COLA wage indexation mechanism to limit the growth of the public sector wage bill. We also implemented parametric pension reforms to improve the system's financial viability and make it more equitable. Building on these efforts, we will: (i) review the system of social insurance and social welfare schemes to contain spending

while protecting the vulnerable and preserve long-run viability; (ii) improve public financial management by strengthening our budget framework, and enhancing the management of fiscal risks and future revenues from natural resources; (iii) reform our revenue administration to fight tax evasion and improve revenue collection; and (iv) rationalize the public sector by discontinuing non-core activities and privatizing public assets.

Social Insurance and Social Welfare System

27. **We will continue our reforms of the general insurance pension scheme (GSIS) and the public sector occupational pension scheme (GEPS) to enhance their intra- and inter-generational fairness and to ensure their financial viability**. Taking into account the recent reforms, by end-July 2013 we will conduct an actuarial analysis to determine options to ensure the long-run viability of GSIS until 2060 without the need for government transfers beyond credited contributions. In this context, we will separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) GSIS pension scheme. Reforms resulting from the actuarial analysis will be adopted by end-December 2013 and enter into force by end-March 2014. The reform will encompass an adequate combination of benefit reduction, statutory retirement age increases, and/or contribution rate increases, taking into account the latter's impact on labor costs. The recent GEPS pension reforms will also be extended to the broader public sector.

28. **We will also reform the social welfare system to minimize overlaps in benefits and improve targeting**. Spending on social programs has increased rapidly in recent years to levels well above the EU average, in part due to overlapping benefits and suboptimal targeting. Building on earlier reforms, by end-June 2013, we will prepare an action plan based on a review that will cover all social programs (i.e., social assistance, housing benefits, family benefits, education allowances, and any other transfer schemes) provided by all public entities. The plan, which will include proposals to consolidate welfare programs, improve targeting, and streamline administration, will aim to attain the budget savings required to reach our program fiscal targets, while ensuring that the poor and vulnerable groups are adequately protected. We will implement this reform by end-2013 (**structural benchmark**).

Public Financial Management

29. **We are committed to improving our budget processes.** We have legislated a medium-term budget framework (MTBF) in line with EU directives, including a rolling three-year budget framework with a view of enhancing fiscal discipline. In consultation with the EC/ECB/IMF, through regulations in the form of an expanded budget circular, we will ensure that the MTBF will be fully effective starting with the 2014 budget. In the context of a broad review of our PFM system to be completed by end-June 2013 we will develop a new comprehensive *Law on Fiscal Responsibility and Budget Systems* including supplementary secondary legislation to address any remaining inconsistencies between the MTBF law and existing legislation, which will be submitted to parliament by end-December 2013 (**structural benchmark**). The new law will provide an enabling framework for a medium-term PFM reform program.

30. **We will establish a framework for the management of natural resources in line with best practices**. To ensure transparency and accountability, the framework's legal basis and governance structure will be based on internationally recognized best practices. In this context, we plan to establish a resource fund with clear rules governing inflows and outflows as part of our budgetary framework, taking into account the need to develop the hydrocarbons industry, the need to bring public debt on a steady downward path, and the need to invest for future generations. We will submit both a draft legal framework and a strategy to the EC/ECB/IMF by end-September 2013.

31. **Management of and reporting on fiscal risks from public-private partnerships (PPPs) will be strengthened.** We will put in place a legal and institutional framework for assessing and entering into PPPs or concession agreements, as well as for monitoring their execution by end-2013 through: (i) establishing an effective "gateway process" that verifies the fiscal affordability of projects; (ii) adapting fiscal management laws to formalize the role of the Ministry of Finance in reviewing and approving PPPs at critical points in the gateway process; and (iii) developing financial reporting and accounting rules that ensure timely and transparent communication of PPP related obligations. We will not enter into any new PPPs or concessions (except for any project having reached commercial close by end October 2012) at any government level until the new framework is in place.

Revenue Administration

32. **We will modernize our revenue administration to increase its efficiency, improve taxpayer compliance, and boost revenue collection.** Enforcing the timely collection of tax revenues and controlling tax evasion remain a challenge, as the current arrangements do not provide for modern and harmonized systems and procedures, good sharing of information between tax agencies, alignment of filing and payment arrangements, and adequate enforcement tools and approaches. The tax administrations need to find ways to benefit from economies of scale and optimized operations. Correcting this means that not only will tax administration be more effective and efficient, but taxpayer compliance costs can be reduced. We will reform the revenue administration in line with the recommendations provided by recent technical assistance on inland revenue and VAT. To this end, we will present by end-June 2013, a comprehensive reform agenda to improve the efficiency and effectiveness of revenue collections, taxpayer services, and compliance, in line with best international practices.

Rationalization of Broader Public Sector and Privatization

33. **To ensure debt sustainability and improve the efficiency of the public sector, we will streamline extra-budgetary entities and consider divesting state-owned enterprises (SOEs).** While many extra-budgetary entities do not perform essential public services, they are costly to the budget, receiving almost 2 percent of GDP in transfers. To reduce costs, we will take the following steps:

- **Based on their functionality, extra-budgetary entities will be assessed with a view to determine the need to reclassify, restructure, or divest them.** All extra-budgetary entities will be assessed on their relevance for the public sector and their operational performance. On this basis, entities will be classified according to functionality. Entities that perform necessary public functions will be considered to be integrated into the budget, the rest will be either restructured or divested by the end of the program period.
- **We will develop a privatization plan for SOEs and other state assets**. As a first step, by end-June 2013 we will create an inventory including assets with the highest commercial value and at least one third of SOEs, while the full inventory will be completed by end-December 2013. A privatization plan will be developed by end-September 2013 with the aim of achieving proceeds of at least €1.4 billion by end-2018. To support the privatization process, we will implement a legal and institutional framework by end-December 2013.
- **Other SOEs will be closely monitored or closed if needed.** To improve the monitoring of SOEs and semi-government entities, starting with the 2014 budget, we will include a "Statement of SOEs and semi-government entities" as an Appendix I to the annual budget law and annual financial reports. Non-viable SOEs will be either restructured or closed.

B. Program Financing

34. **Cyprus will face sizable financing needs during the program period.** To reduce these needs and their impact on public debt, we will undertake several measures during the program period:

- Rolling over and extending the maturity of at least €1 billion of domestic debt held by residents. In order to implement this, we will undertake a voluntary sovereign bond exchange covering bonds maturing in 2013-15. The maturing bonds will be exchanged for new longer dated sovereign bonds with maturities between 5 and 10 years. This offer would be par for par and with no change in annual interest cost. The recapitalization bond of €1.9 billion injected in CPB in June 2012 will also be rolled over (both rollovers are an end-June 2013 **structural benchmark**).

- Realizing privatization receipts of at least €500 million for financing purposes.

- Intensifying efforts to obtain financing assurances from the Russian authorities to reschedule the Russian bond falling due in 2016 and extend its maturity to be paid in 5 equal installments starting in 2018 and lower the interest rate to 2 ½ percent.

- Using the allocation of future central bank profits of EUR €0.4, in line with the CBC duties under the Treaties and the Statute (subject to the same safeguards, balance sheet adjustments by the central bank decided by the Board of Directors of the CBC and in accordance with the Treaty will also contribute approximately €1.4 billion in terms of debt reduction).

35. **Remaining balance of payments financing needs of about €10 billion will need to be covered through official financing**. Cyprus faces sizable balance of payments financing needs that are medium term in nature, in particular (a) pressures on the capital account, (b) the need to refinance external debt and (c) a small current account deficit. Beyond our request to the Fund for a three-year EFF (in an amount of SDR891 million, equivalent to about €1 billion, or 563 percent of quota), we have secured additional financial resources from our European partners to fill remaining needs. Euro area partners have committed a total of €9 billion over the period covering May 2013–March 2016. To ensure that this financing helps to maintain debt on a sustainable debt trajectory delivering a debt-to-GDP ratio of about 100 percent by 2020 and declining thereafter, they have committed to new lending at an average maturity of 10-15 years and at favorable interest rate (2.5-3 percent), using the ESM as a financing vehicle. We are confident that resolute implementation of our economic program will help our economy recover and bolster market sentiment. If fiscal consolidation proceeds faster than expected, or if market conditions improve significantly during the program period, we would refrain from drawing on the IMF support on an as needed basis.

C. Program Monitoring

36. **Progress in the implementation of policies under our program will be monitored through quarterly (and continuous) quantitative performance criteria (PCs) and indicative targets, and structural benchmarks.** These are detailed in Tables 1 and 2. The attached Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria, indicative targets, and structural benchmarks under the program. Quantitative targets up to September 2013 are PCs. The remaining targets for end-2013 and 2014 are indicative. Quarterly targets for the remainder of 2013 will be converted into PCs at the time of the first review. A Memorandum of Understanding (MoU) on specific policy conditionality agreed with the EC, on behalf of the European Stability Mechanism, specifies additional structural policies, and sets a precise timeframe for their implementation.

37. **As is standard in all Fund arrangements, a safeguards assessment of the CBC will be completed by the first review.** In this regard, the CBC will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review. As a related matter, and given that financing from the IMF, in the context of addressing Cyprus' balance of payment needs, will be used to provide direct budget support, a framework agreement will be established between the government and the CBC on their respective responsibilities for servicing financial obligations to the IMF. As part of these arrangements, Fund disbursements will be deposited into the government's account at the CBC.

Table 1. Cyprus: Quantitative Conditionality, 2013 1/
(millions of Euros)

	Performance criteria		Indicative targets	
	Jun-13	Sep-13	Dec-13	Mar-14
Floor on the general government primary balance 2/	-222	-248	-395	-54
Ceiling on the general government primary expenditure 2/	3230	4911	7069	1576
Ceiling on the stock of general government debt	17153	17464	17917	18076
Ceiling on the accumulation of new general government guarantees 2/ 3/	145.3	145.3	145.3	0
Ceiling on the accumulation of external arrears 4/	0	0	0	0
Ceiling on the accumulation of domestic arrears 2/	0	0	0	0
Ceiling on the accumulation of new VAT refund arrears by the general government 5/	10	10	10	10

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ The figures for 2013 reflect guarantees already approved by the government on loans not yet drawn.
4/ Continuous performance criterion.
5/ Cumulative since March 2013.

Table 2. Cyprus: Structural Conditionality	
Measures	**Timing**
Prior action	
Adopt legislation and Council of Minister decisions, as needed, implementing measures consistent with the program targets. Measures include: increasing the CIT rate from 10 to 12.5 percent, raising the bank levy rate from 0.11 to 0.15 percent, raising the tax rate on interest from 15 to 30 percent, and reforming the property tax (for a total consolidation of 2 percent of GDP with immediate effect); and rationalizing the housing benefits (savings of 0.2 percent of GDP).	Before Board meeting
Structural benchmarks	
A. Strengthen financial stability	
There will be no measures to intensify restrictions on the making of payments and transfers for current international transactions or to introduce multiple currency practices	Continuous performance criterion
Complete the due diligence valuation of CPB and BoC assets as described in the resolution law in accordance with the terms of reference agreed with the EC/ECB/IMF	End-June 2013
For individual CCIs not covered by the PIMCO due-diligence exercise, the CBC jointly with the CCI supervisor will complete an assessment of capital needs and viability in accordance with terms of reference prepared in consultation with EC/ECB/IMF	End-June 2013
Develop a strategy to recapitalize and restructure the CCI sector with public money as needed	End-July 2013
Revise the anti-money laundering legal framework (TMU ¶15)	End-September 2013
CBC to require the BoC board to prepare a restructuring plan defining the bank's business objectives	End-September 2013
Adopt the legal framework for a central credit register (TMU ¶16)	End-September 2013
B. Strengthen fiscal institutions, reduce fiscal risks and protect vulnerable groups	
Roll over and extend the maturity of at least €1 billion of domestic debt held by residents through a voluntary debt exchange covering maturities falling due in 2013-15 and roll over the € 1.9 billion recapitalization bond of CPB.	End-June 2013
Submit to Parliament a law on fiscal responsibility and budget systems (TMU ¶17)	End-December 2013
Adopt measures to improve the targeting of social assistance, consolidate welfare programs, and streamline administration costs.	End-December 2013

Table 3. Cyprus: Actions Taken Prior to the Signature of the MEFP

A. Strengthen financial stability	B. Strengthen fiscal institutions and reduce fiscal risks
Anti-money laundering. Amended legislation with a view to providing the widest possible range of cooperation to foreign counterparts (December 2012) **Identification of capital needs**. Hired a consultant to assess the capital needs of the financial institutions accounting for about 75 percent of total financial system assets (February 2013) **Bank Resolution**. Adopted legislation putting in place a modern bank resolution framework (March 2013) **Deleveraging of non-core assets**. Sponsored the agreement through which CPC, BoC, and HB transferred the assets and liabilities of their branches in Greece to the Greek bank Piraeus (March 2013) **Bank intervention and resolution**. Intervened CPB, split it according to a "good bank-bad bank" strategy, sold the "good bank" to BoC while safeguarding insured deposits (March 2013) **Recapitalization**. Recapitalized BoC through the full dilution of equity and bond holdings and conversion of 37.5 percent of uninsured deposits into preferred shares (March 2013).	**COLA reform**. Implemented a reform of the COLA wage indexation mechanism in the public sector by extending its freeze to the end of the program and limiting its application to 50 percent of the price index thereafter. **Pension reform.** Introduced reforms to the General Social Insurance Scheme, including freezing pensions under the Social Security Fund until end-2016 and raising employee and employer contributions in 2014. Also introduced reforms to the government pension scheme and froze public sector pensions. **Medium-term budget framework.** Legislated a framework in line with EU directives, including a rolling three-year budget framework. **2013 budget**. Implemented a budget with significant fiscal consolidation measures for 2013-15, including: • Reduced outlays for social transfers through the abolition of a number of redundant and overlapping schemes. • Introduced a graduated reduction of the remuneration of the public and broader public sector employees (6.5-12.5%) and legislated a 3% flat reduction for 2014. • Extended the freeze of general wage increases in the public and broader public sector and temporary contribution in the public, broader public and private sectors on gross earnings and pensions until end-2016. • Took steps with a view to reducing the number of public sector employees by at least 4,500 over the period of 2012-16. • Reduced transfers to SOEs and semi-public institutions. • Increased excise duties on tobacco products, alcoholic beverages, and oil products with effect in 2013; and legislated an additional increase for energy products in 2014. • Increased the standard VAT rate from 17 to 18% in 2013 and to 19% in 2014, and the reduced rate from 8 to 9% starting in 2014. • Increased fees for public services by at least 17%. • Abolished all exceptions for paying the annual company levy of EUR 350.

III. Cyprus: Technical Memorandum Of Understanding

April 29, 2013

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to quantitative targets (performance criteria and indicative targets), specified in the tables annexed to the Memorandum of Economic and Financial Policies (MEFP). It also describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets. We will consult with the Fund, European Commission and ECB on a timely basis before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the European Commission, ECB and the Fund with the necessary information for program monitoring.

2. For program purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at "program exchange rates" as defined below, with the exception of the items affecting government fiscal balances, which will be measured at current exchange rates. The program exchange rates are those that prevailed on April 15. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.308099 dollar, €1 = 129.0309 Japanese yen, €1.15222= 1 SDR.

3. For reporting purposes, the Ministry of Finance (MOF) and the Central Bank of Cyprus (CBC) will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the Fund.

A. Quantitative Performance Criteria and Indicative Targets

Floor on the General Government Primary Cash Balance (performance criterion)

4. For the purposes of the program, the general government includes the institutions listed under this category according to ESA 95 for Excessive Deficit Procedure (EDP) reporting purposes. In particular, the general government includes:

- *The central government*. Includes the Constitutional Powers, the Constitutional Services, the Independent services, the Independent offices, the Ministries and the departments, services, and other bodies they supervise, 21 special purpose funds, and 14 semi government organizations.
- *The local governments*. Comprise 39 municipalities, 356 village authorities, and all agencies and institutions attached thereto which are classified as local governments according to ESA 95.

- *The social security funds*. These include the medical treatment scheme, the regular employees' provident fund, the social insurance fund, the holiday fund, the redundancy fund, and the protection of the rights of employees' fund.
- *Any newly created institution defined as general government under ESA 95*. This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are re-classified from outside general government into general government during that year.

5. The performance criteria are set on the general government cash primary balance (GGPCB), defined as the general government cash balance (GGCB) minus general government interest receipts plus general government interest payments. In turn, GGCB is defined as total revenue (tax revenue, social security contributions, grants and other revenue) minus total expenditure. The payment of called guarantees will be recorded as cash expenditures. Privatization receipts, as defined below, and the proceeds from the sale of land and buildings, will be excluded from revenue. The floor on the GGPCB in each year will be measured cumulatively from the start of that calendar year.

- Privatization receipts are those receipts associated with the disposal to private owners by a government unit of the controlling equity of a public corporation or quasi-corporation.

6. The floor on the GGPCB will be adjusted downwards by:

- The payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- The payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank.

Ceiling on the General Government Primary Expenditure (performance criterion)

7. General government primary expenditure (GGPE) includes compensation of employees, goods and services, subsidies, social benefits, other recurrent expenditure, and capital expenditure.

8. The ceiling on the GGPE will be adjusted upwards by:

- The payments related to bank support, when carried out under the program's banking sector support and restructuring strategy. Transactions that may be excluded from the balance include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- The payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank

Ceiling on the stock of General Government Debt (performance criterion)

9. The general government debt constitutes total outstanding gross liabilities as defined by ESA95. This includes the debt of all institutions included in the general government as defined above and other ESA 95 adjustments. Debt will be measured at nominal value. The program exchange rate will apply to all non-euro denominated debt.

10. The ceiling on the general government debt will be adjusted:

- Upward (downward) by the amount of any upward (downward) revision to the stock of end-March 2013 general government debt.
- Upward, by debt arising from payments for bank restructuring carried out under the program's banking sector support and restructuring strategy. These payments may include loans to financial institutions and investments in equity of financial institutions (requited recapitalization); unrequited recapitalization and purchases of troubled assets. However, any financial operation by central government to support banks, including the issuance of guarantees or provision of liquidity, will be immediately reported to IMF, European Commission and ECB staff.
- Upward by the payments to compensate pension funds for the losses related to the resolution of Cyprus Popular Bank

Ceiling on the Accumulation of new General Government Guarantees (performance criterion)

11. The ceiling on new general government sector guarantees shall include domestic and external guarantees granted during the test period, as well as guarantees for which the maturity is being extended beyond the initial contractual provisions. The ceiling shall exclude guarantees granted under a risk sharing instrument of the EU structural funds (see COM (2011) 655 final) that do not create contingent liabilities for the Cypriot State. Government entities outside of the general government (e.g. state owned enterprises) but within the non financial public sector are not permitted to grant guarantees. The stock of guarantees at end March 2013 was €3.1 billion.

For reporting purposes, the stock of guarantees within the year will be derived on the basis of material fluctuations.

Ceiling on the Accumulation of External Arrears (continuous performance criterion)

12. External payment arrears are defined as payments on debt to non-residents contracted or guaranteed by the general government, which have not been made within seven days after falling due. The stock of external payment arrears as of end-March 2013 was €0.

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

13. Domestic expenditure arrears are defined as unpaid invoices that have past the due date by 90 days. In case no due date is specified on the supplier contract, an unpaid commitment is considered to be in arrears 90 days after the initiation of the invoice. The stock of domestic expenditure arrears as of end March 2013 was €0 million.

Ceiling on the Accumulation of new VAT Refund Arrears by the General Government (performance criterion)

14. VAT refund arrears consist of unpaid VAT refunds that have past the due date for payment established in the tax legislation and/or the corresponding regulations. The stock of VAT refund arrears as of end March 2013 was €140 million.

B. Monitoring of Structural Benchmarks

15. **Revision of the anti-money laundering legal framework (end-September 2013).**

Specification. The adopted legal framework will provide for the following:

- Ensure that the financial intelligence unit can exchange adequate information with foreign counterparts on money laundering, associated predicate offenses and terrorist financing, in the context of its analytical function, without having to secure a court order;
- Ensure that all trustees of trusts created under and governed by Cyprus law are regulated or otherwise registered. Registers will be kept by the relevant supervisory authorities in order to enable them to carry out their duties and will contain adequate, accurate and current information on the name of a trust and the name and address of its trustee(s);
- Ensure that adequate, accurate and up-to-date information on the beneficial ownership of legal entities registered in Cyprus can be obtained in a timely manner by competent authorities;
- Ensure that the use of "nominee" directors (i.e. professionals who provide director services) or "nominee" shareholders does not create any obstacle to the authorities' timely

access to adequate, accurate and up-to-date information on the beneficial ownership, and control of companies by having a mechanism in place consistent with the FATF standards. To this end, the authorities will require that all nominee directors and nominee shareholders be authorized or otherwise regulated (i.e. as lawyers, accountants or TCSPs) and maintain information on the identity of their nominator, which is to be made available to the competent authorities upon request. A record of director's or shareholder's nominee status will be accessible through the registers under the TCSP Law, which list all regulated persons (i.e. lawyers, accountant and TCSPs).

16. **Adopt the legal framework for a central credit register (end-September 2013)**

Specification. The adopted legal framework shall include provisions to:

- Establish a framework that allows credit institutions to keep in a centralized manner critical information on household and corporate borrowers (including their consolidated debt exposure, past due and performing loans, collateral, etc.), while sensitive and/or confidential information shall be safeguarded;

17. **Submit to Parliament a law on fiscal responsibility and budget systems (end-December 2013).**

Specification. The adopted legal framework will contain the following elements:

- It will provide a comprehensive coverage of the general government sector and the government's financial relationships with state enterprises and other public entities that are outside the boundary of the general government sector.
- It will incorporate provisions (i) on fiscal transparency and accountability requiring the government to articulate a comprehensive, legally based and independently monitored fiscal strategy consistent with EU requirements and (ii) for the development over time of a disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down approach to budget preparation that is closely linked to the process of fiscal policy-making, and providing more flexibility to ministries and semi-governmental organizations.

C. Reporting requirements

18. Performance under the program will be monitored using data supplied to the IMF by the Ministry of Finance, Cystat, and the Central Bank of Cyprus. The authorities will transmit to the IMF staff any data revisions in a timely manner. Table 1 describes the supporting data needed for monitoring of the quantitative targets, the required frequency of the data, the institution/department responsible for providing the data, and the timing for provision of the data.

Table 1. Cyprus: Reporting Requirements

Information required	Data Frequency	Institution/Department responsible for providing information	Maximum time lag for submission after the end of the reporting period
Detailed execution of revenues, expenditure and financing provided in EDP reporting format	Monthly	MOF. Budget Department/Cystat Government Financial Statistics.	25 days after the end of the month, except end-December data which will be provided 30 days after the end of the month
Debt Issuance, Amortization, and interest cost details by type of debt instrument, maturity, currency, type of debt holder (resident, non-resident).	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Details on any financial balance sheet transactions	Monthly	MOF. Treasury Department	25 days after the end of the month except December data which will be provided 30 days after the end of the year
Central Government Debt stock by type of debt instrument, maturity, currency, type of debt holder. Interest bill for each type of debt instrument on a monthly basis for the current year and the next year, and annual for each year thereafter until 2020	Monthly	MOF. Public Debt Management Unit.	25 days after the end of the month
Budgetary Central Government deposits in the Consolidated Fund and in the Banking System.	Monthly	MOF. Public Debt Management Unit.	5 days after the end of the month
Stock of expenditure arrears of the Budgetary Central Government and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure	Monthly	MOF. Treasury Department	15 days after the end of the month
Stock of VAT refund arrears and their corresponding quarterly flows	Quarterly	MOF. Customs and Excise Department, VAT service	15 days after the end of the quarter
Stock of government guarantees and their quarterly flows by institution.	Quarterly	MOF. Treasury Department.	25 days after the end of the quarter.

Stock of external arrears	Monthly	MOF. Treasury Department.	15 days after the end of the month
Assets and liabilities of the central bank	Weekly	Central Bank of Cyprus	1 working day after the end of the week
Assets and liabilities of the domestic operations of the banking system – aggregate monetary balance sheet of credit institutions by institutional category	Monthly	Central Bank of Cyprus	30 days after the end of the month
Assets and liabilities of the banking system (consolidated group balance sheets, including foreign operations) by institutional category	Quarterly	Central Bank of Cyprus	45 days after the end of the reporting period
Individual operational balance sheet of the domestic operations of the largest banks and coops with detailed information on deposits (by maturity, currency, and type of depositor), central bank funding, interbank funding, debt securities, loans provided to the public and the private sector, details on liquid assets (cash and securities), liquidity position (i.e. the pool of assets eligible for ELA but not already encumbered), other assets and liabilities 1/	Monthly	Central Bank of Cyprus	30 days after the end of the month
Deposits by institution, currency, and residency and end-of-day liquidity buffers	Daily	Central Bank of Cyprus	Next working day
Financial soundness indicators—core set, deposits, NPLs, profitability, asset quality, balance sheet and capital adequacy ratios	Quarterly	Central Bank of Cyprus	90 days after the end of the month 2/

1/ Reporting requirements for cooperative banks will be revisited after the CBC becomes their supervisor.

2/ The scope and frequency of reporting of financial soundness indicators will be revised at the time of the first review.

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