Summary for non-specialists
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The Economic Adjustment Programme for Cyprus Second Review – Autumn 2013

Staff teams from the European Commission (EC), European Central Bank (ECB) and the International Monetary Fund (IMF) visited Nicosia on 29 October – 7 November 2013 for the second quarterly review of Cyprus' economic adjustment programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The programme's objectives are to restore financial sector stability, strengthen public finance sustainability and implement structural reforms so as to support sustainable and balanced long-run growth.

Cyprus' programme is on track. All fiscal targets have been met with considerable margins, reflecting the ambitious fiscal consolidation underway, prudent budget execution, and a less severe deterioration of economic activity than originally projected. Structural reforms are also advancing. Furthermore, since the last review, the on-going recapitalisation and restructuring of the financial sector has significantly progressed. This has allowed further relaxation of payment restrictions since July, in line with the government's milestone-based roadmap. New foreign direct investment in the banking sector has been a positive sign. The authorities' strong programme implementation so far is welcome. Nevertheless, given prevailing significant risks ahead, continued full and timely policy implementation remains essential for the success of the programme.

The economic situation remains difficult, although so far the recession has been less pronounced than expected. Based on recent indicators, output in 2013 is projected to contract less than originally envisaged. The households and some sectors such as tourism and professional services have proven relatively resilient, and confidence has improved somewhat since April 2013. Looking forward, output in 2014 is expected to contract more than initially foreseen, and to recover gradually starting in 2015. The uncertainty surrounding the outlook remains substantial.

The authorities have made important strides with the recapitalisation and restructuring of the financial sector. Hellenic Bank has been successfully recapitalised with private funds, including foreign investment, and without state support. The restructuring of Bank of Cyprus (BoC) and cooperative credit sector is advancing. New Boards of Directors for BoC and the Cooperative Central Bank have been appointed and funds for the recapitalisation of the cooperative credit sector have been secured, without involving depositors. Deposit outflows abated, pointing to some return of depositors' confidence, but further improvement of bank's balance sheets is needed to resume credit to the private sector and support economic recovery. Diligent implementation of banks' restructuring plans will be critical, including tackling the still rising level of non-performing loans and making efforts to protect troubled borrowers, while discouraging strategic defaults. The published milestone-based roadmap remains the guiding principle for gradual relaxation of payment restrictions while safeguarding financial stability. Finally, the authorities need to further strengthen the supervisory and regulatory frameworks and implement the anti-money laundering action plan as a priority.

Fiscal performance has remained strong. The authorities have maintained a primary surplus of about 0.7% of GDP through end-September, meeting the programme targets comfortably and placing end-of year targets well within reach. Given the outturns to date, both the 2013 and 2014 fiscal deficits are expected to be up to 1% of GDP lower than anticipated during the last review.

Structural reforms are advancing, although delays and partial compliance were observed in a number of cases. A governance structure has been put in place to carry out an ambitious revenue administration reform aimed at improving efficiency of collections. Progress has also been made on the reform of the social welfare system, aimed at introducing a guaranteed minimum income scheme providing financial assistance to those in need. These efforts need to be complemented by a credible and detailed privatisation agenda, backed up by strong political will.

This review is expected to be concluded with all necessary decisions by the Eurogroup, the ESM Board of Directors and the Executive Board of the IMF taken in December. Its approval would pave the way for the disbursement of EUR 100m by the ESM, and about EUR 86m by the IMF.