Summary for non-specialists
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The Economic Adjustment Programme for Cyprus

Fourth Review – Spring 2014

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia from 6 May to 17 May 2014 for the fourth review of Cyprus' economic adjustment programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The objectives of Cyprus' programme are to restore financial sector stability, strengthen public finance sustainability, and adopt structural reforms so as to support sustainable and balanced long-run growth.

Cyprus' programme remains on track. Fiscal targets for the first quarter of 2014 were met with a considerable margin, reflecting better than projected revenue performance and prudent budget execution. Progress has been made with the recapitalisation and consolidation of the cooperative credit sector, and banks are advancing with their restructuring plans. This has allowed for further liberalisation of domestic payment restrictions, in line with the government's roadmap. The authorities have also taken steps toward implementing their ambitious structural reform agenda.

While the recession is bottoming out, the outlook remains challenging. The contraction of output for 2014 has been revised down to 4.2% from 4.8%, given the better than expected outturn for 2013 and other recent indicators pointing to gains in confidence. While the increase in unemployment has slowed significantly, it has reached unprecedented level, and large non-performing loans are constraining the ability of banks to supply credit to the economy. As a result, the recovery is now expected to be more subdued than previously forecast, with growth projected at 0.4% in 2015 and only gradually improving thereafter, as domestic demand is weighed down by the need to reduce very high levels of indebtedness.

Reform in the financial sector has progressed, but the high level of non-performing loans remains an issue. Deposit outflows have eased somewhat and the liberalisation of domestic payment restrictions is progressing, in line with the government's roadmap. Supervision and regulation are being strengthened and will improve risk management in the banks, although some policies were delayed or partially completed. Considerable efforts are being put into improving arrears management. A new insolvency framework is in preparation, which should provide the right incentives for borrowers and lenders to find constructive solutions for dealing with non-performing loans. Also, a task force was established to study the title deeds issues. The authorities have further advanced in the implementation of the Customer Due Diligence framework and they continue strengthening the anti-money laundering supervisory function for financial institutions as well as other obliged entities under the anti-money laundering regime.

Fiscal performance has remained strong. Budgetary developments are on track vis-à-vis the targets in the Memorandum of Understanding. The 2014 government primary deficit is estimated at 1.7% of GDP, broadly unchanged compared to the third review. Building on the strong fiscal performance to date, the authorities will need to continue to implement their budget prudently. As agreed at the onset of the programme, an additional adjustment will be necessary in the outer years to attain the long run objective of a sustained 4% of GDP primary surplus, which is needed to place public debt on a sustainable downward path.

Structural reforms have progressed, although some delays have been observed. In the areas of public financial management, the secondary legislation for staffing the fiscal council has been adopted. Reforms of revenue administration are also advancing, although further efforts are needed to strengthen collection powers to resolutely address tax evasion and non-compliance. The head of the Privatisation Unit has now been appointed. The authorities have also advanced in their preparations to launch the reform of the welfare system. Progress is also being observed in a wide range of the goods and services market reforms, e.g. regulated professions, public administration review, tourism and energy.

The 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 to be taken by mid-July. Its approval would pave the way for the disbursement of EUR 600m by the ESM, and about EUR 86m by the IMF.