

The Economic Adjustment Programme for Cyprus

Fifth Review – Summer 2014

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia from 15 July to 25 July 2014 for the fifth 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.

A staff-level agreement was reached on policies that could serve as a basis for the completion of the fifth review. The authorities have continued to meet the fiscal targets with significant margin in the first half of the year, as a result of prudent budget execution. In the financial sector, banks are advancing with their restructuring plans and capital raising, while supervisory monitoring of their actions and operational capacity to address non-performing loans has been enhanced. The authorities have also taken steps toward implementing their ambitious structural reform agenda.

While the recession is bottoming out, the outlook remains challenging. Output is expected to contract by 4.2% in 2014 unchanged compared with the fourth review, with growth in the tourism and professional services sectors cushioning weak activity in other sectors. Unemployment remains very high, although signs of a stabilisation are emerging. Prices have fallen in the first six months, although the pace of decline has slowed. Growth in 2015 is projected at 0.4%, with the recovery constrained by the high level of private sector debt and high level of non-performing loans. Risks remain significant, related to constraints to the supply of credit, as well as to the on-going crisis in Ukraine.

Reforms in the financial sector have progressed, but the high level of non-performing loans remains a cause for concern. Deposit outflows have eased, but developments differ across banks. Domestic payment restrictions have been lifted, in line with the government's roadmap. Bank of Cyprus and the cooperative sector have also continued to implement their restructuring plans, although serious challenges remain ahead particularly for the coop sector, where the framework for arrears management and governance should be strengthened further. To deal effectively with the non-performing loan problem, the necessary legal instruments need to be put in place. Cyprus has taken an important first step with the adoption by the council of Ministers on 30 July of a comprehensive outline of a modernised insolvency framework. As a next step, the House of Representatives adopted a reformed Foreclosure Law on 6 September. On-going efforts by banks to proactively raise capital in the private markets will be conducive to a smooth transition to the Single Supervisory Mechanism following the completion of the pan-European Comprehensive Assessment. The Cypriot authorities have continued to implement the Anti-Money Laundering (AML)

action plan, focussing in particular on measures to strengthen effective supervision of financial institutions, lawyers, accountants and administrative service providers.

The authorities have continued to pursue a cautious fiscal policy, leading to a primary balance for the first half of the year exceeding the forecast by about $\frac{3}{4}$ pp of GDP. The 2014 government primary deficit is now estimated at 1.3% of GDP, 0.4% better compared to the fourth review. The authorities will need to continue implementing their budget prudently in light of lingering risks. 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 were observed, notably in the areas of healthcare and state-owned enterprises' corporate governance, progress has been observed in a wide range of reforms. The welfare reform legislation was adopted and first payments are expected in autumn. The revenue administration has been strengthened with the adoption of the law formally establishing the new tax department and legal amendments enhancing compliance and strengthening collection enforcement powers. The privatisation unit has also started its work.

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 end-December. Its approval would pave the way for a cash disbursement of EUR 350m by the ESM, and about EUR 83m by the IMF following the consent of the Executive Board of the IMF.