Summary for non-specialists
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The Economic Adjustment Programme for Cyprus

Third Review – Winter 2014

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia from 29 January to 11 February 2014 for the third 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 2013 have been met with considerable margin, due to both continued prudent budget execution and a less severe recession than anticipated. Signs of stabilisation are emerging in the banking sector, although significant challenges remain. Despite some delays, structural reforms are also advancing. Given the prevailing substantial risks, continued full and timely policy implementation remains essential for the success of the programme.

The macroeconomic outlook remains challenging. While the recession has been less pronounced than expected in 2013, GDP is forecast to decline by broadly the same magnitude as expected in the last review (-4.8%) in 2014, despite continued improvements in business sentiment and consumer confidence indicators. The need for an adjustment of private and public sector debt from the current high levels will continue to act as a drag on growth. The economy is projected to return to modest growth next year. Nonetheless, risks to the outlook remain on the downside.

There has been further progress toward the restructuring of the financial sector, and dealing with the high level of non-performing loans is now a priority. The restructuring plan of Bank of Cyprus was approved by the Central Bank of Cyprus in November 2013. The consolidation process of the cooperative credit institutions has continued and their restructuring plan was approved by the European Commission in February 2014, which enabled the recapitalisation with programme money. Deposit outflows have slowed and banks' liquidity buffers have strengthened. Reforms to supervision and regulation have also progressed satisfactorily. With key milestones in the authorities' roadmap now completed, the second phase of gradual relaxations of restrictions has started. Despite this progress, challenges remain, notably relating to the need to clean up banks' balance sheets and reduce private sector indebtedness. Both are needed in order to restore credit and sustainable growth and require the establishment of an appropriate debt restructuring framework. Work also needs to continue on strengthening the implementation of banking sector regulation and supervision as well as of the anti-money laundering framework.

Fiscal performance has remained strong. The 2013 government deficit is estimated at around 2 percentage points lower than targeted, while the 2014 fiscal deficit is projected to be about 1

percentage point lower than anticipated earlier. 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 percent of GDP primary surplus, which is needed to place public debt on a sustainable downward path.

The implementation of structural reforms has also advanced, although some reforms need to be accelerated. Progress was notably observed in revenue administration reform, which aims to improve the efficiency of collection; in public financial management, with the adoption of the fiscal responsibility and budget systems law; in immovable property tax reform, with the objective of improving the fairness of the tax burden; and in improving labour market activation policies. However, a key priority is the adoption of a social welfare reform, which will introduce a guaranteed minimum income scheme, so as to provide adequate social protection for vulnerable households during the current downturn. Following the adoption of the privatisation law on 4 March, the privatisation plan must now be implemented without delay.

The review has now concluded, with all necessary decisions by the Eurogroup, the ESM Board of Directors, and the Executive Board of the IMF having been taken by early April. Its approval paves the way for the disbursement of EUR 150m by the ESM, and about EUR 86m by the IMF.