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Statement by the European Commission, ECB and IMF on the Third Review Mission to Cyprus

Staff teams from the European Commission (EC), European Central Bank (ECB), and the International Monetary Fund (IMF) visited Nicosia during January 29-February 11, 2014 for the third review of Cyprus's economic programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The objectives of Cyprus's programme are to restore financial sector stability, strengthen public finance sustainability, and adopt structural reforms so as to support long-run growth, while protecting the welfare of the population. Discussions with the authorities during this visit focused on policies to restore confidence in the financial system and implementation of the structural reform agenda.

Cyprus's programme remains on track, with the macro-fiscal outturn better than expected. Fiscal targets for 2013 have been met with considerable margin, due to both continued prudent budget execution and a less severe recession than anticipated. Output in 2013 is estimated to have contracted by about 6 percent in real terms, which, while significant, is almost two percentage points better than forecasted at the time of the last review. Private consumption contracted, although by less than expected, while tourism and professional services have proven resilient. The financial sector is also showing signs of stabilisation. The economy is adjusting flexibly as prices and wages are declining, helping to cushion the full impact of the recession on jobs. Still, unemployment remains very high.

The outlook remains challenging. Output is projected to contract by 4.8 percent in 2014, with domestic demand weighed down by the need for an adjustment of private and public sector debt from currently high levels. A return to positive but modest growth of around 1 percent is expected in 2015, led by non-financial services. Nonetheless, risks to the outlook are substantial.

In the financial sector, the first challenge is dealing with the high level of non-performing loans. With the two largest banks now recapitalised and the cooperative credit sector expected to be recapitalised shortly, the authorities need to ensure that banks and coops effectively implement their restructuring plans. This requires putting in place adequate arrears management frameworks and carefully monitoring progress toward reducing loans in arrears. For coops, it is also important to complete planned mergers and strengthen governance. To facilitate the clean-up of banks' balance sheets and the reduction of private sector indebtedness—both of which are needed to restore credit and sustainable growth—an appropriate debt-restructuring framework is necessary. In this regard, the authorities need to reform the insolvency legislation to offer balanced incentives that can prevent strategic defaults while providing solutions for voluntary debt restructuring for viable borrowers.

A second challenge is the need to normalise payment flows in the economy while safeguarding financial stability. With key milestones in the authorities' roadmap now completed, the second phase of gradual relaxations of restrictions is expected to start shortly. Finally, efforts also need to continue to strengthen implementation of banking sector regulation and supervision as well as of the anti-money laundering framework.

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 four percent of GDP primary surplus, which is needed to place public debt on a sustainable downward path.

The implementation of structural reforms needs to be accelerated. A key priority is the reform of the social welfare system. This will consolidate existing welfare benefits and introduce a guaranteed minimum income scheme, so as to provide adequate social protection of vulnerable households during the current downturn. To improve the efficiency of revenue administration the authorities need to take steps to advance the merger of the two main tax collection agencies. Moreover, efforts need to be intensified to protect revenue collections in the short term, including by fighting tax evasion. Public financial management should be strengthened by adopting without delay and implementing the fiscal responsibility and budget systems law. Finally, privatisation of state-owned enterprises is essential to increase economic efficiency, attract investment, and as a means to reduce public debt. In this regard, the adoption of the framework law for privatisation is a key step to kick-start the process.

While the programme remains on track, Cyprus still faces significant risks. Continued full and timely policy implementation remains essential for the success of the programme.

Conclusion of this review is subject to the approval process of both the EU and the IMF and is expected to be considered by the Eurogroup, the ESM Board of Directors, and the Executive Board of the IMF by early April. Its approval would pave the way for the disbursement of €150 million by the ESM, and about €86 million by the IMF.